Introduction: Proactively and Steadily Advancing China's Financial Opening[1]

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China has consistently pursued the opening of its financial sector over the past four decades. In the 1980s, the Chinese Government tried to improve economic relations with foreign countries by reforming the exchange rate regime, establishing special economic zones to pilot the market economy system and implementing an opening policy. In the 1990s, the government actively employed a 'market-for-technology' strategy to attract foreign direct investment. It also adopted a managed floating exchange rate regime after aligning official and market exchange rates in 1994. When entering the World Trade Organization (WTO) in 2001, the Chinese Government promised to open the domestic financial sector and provide foreign-owned financial institutions with pre-establishment national treatment. After the global financial crisis, the government took the initiative to accelerate RMB internationalisation, established the Asian Infrastructure Investment Bank and launched the Belt and Road Initiative.

1 This article is the overview of the 2017 China Finance 40 Forum Jingshan Report. Authors of the report include Huang Yiping, Zhang Yuyan, Zhu Min, Zhang Bin, Xu Zhong, Guan Tao and Zhu Jun. All the experts participated in their personal capacity. Huang Yiping authored the overview, which combines the main analysis and conclusions from seven sub-reports. Not all of the views expressed in the overview are identical to those held by the authors of the sub-reports. Guan Tao, Zhang Bin, Xu Zhong and Zhu Jun provided valuable comments on the overview. Huang Yiping takes full responsibility for any errors or oversights found in this overview.

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China's financial opening over the last 40 years has several notable characteristics. First, progress has been slow, with several reversals; second, the government has shown great determination, but implementation has been difficult; third, policy coordination has been insufficient. These characteristics are related to China's gradual approach to reform. Our overall assessment of China's financial opening up policy is that much has been achieved, but many problems remain. The exchange rate regime reform has moved consistently in the direction of allowing two-way fluctuations of the currency value and letting market forces decide the exchange rate. However, to this day, the exchange rate still lacks flexibility. Liberalisation of the capital account and internationalisation of the RMB have also made substantial progress, but some reversals have occurred over the past two years. Granting market access to foreign-owned financial institutions remains 'long on talk but short on action'—little progress has been achieved, and to some degree retrogression is apparent. Opening of the financial market is severely restricted by the differences between domestic and international market rules and systems, as well as China's 'channelised' mode of opening. China has just started to engage in foreign investment and financing cooperation. China's financial institutions are far behind the enterprises in going global, and their capabilities for providing cross-border financial services are rather limited.

Despite all these problems, financial opening has not affected China's economic growth and financial stability as yet, although many emerging economies have experienced financial crises after instituting opening policies. Should China further open up the financial sector? Currently, China's financial openness lags behind that of other emerging economies; it is also below the degree of openness in the real economy. In addition, there are at least three reasons for China to further open up its financial sector. First, financial opening is essential to sustainable economic growth. Economic growth requires economic innovation, and economic innovation is dependent on financial innovation, which can be boosted by financial opening. Second, financial opening is an important way to prevent and control systemic risks. Expanding financial openness can not only instigate advanced managerial concepts, skills and rules, but also strengthen market discipline and reduce financial risks. Third, financial opening is an important way for China to participate in international economic governance. China must align itself with the international financial system to uphold economic globalisation and promote internationalisation of the RMB and the Belt and Road Initiative.

The Chinese and global economies have undergone many changes in the past 40 years. It is necessary for the Chinese Government to consider ideas and strategies that align with today's economic realities when formulating financial opening policies. First, as a major economy, China should consider fully the spill-over effect of opening policies on other economies and the international market. Second, while actively liberalising the capital account, authorities should consider establishing a moderate and temporary cross-border capital flow management mechanism to ensure financial stability and monetary policy independence. Third, the exchange rate can influence the real economy through both trade and financial channels, with the latter becoming increasingly important. Fourth, reform and opening complement and reinforce each other. China should promote progress on both fronts.

To proactively and prudently open up China's financial sector, we propose the following policy recommendations.

First, the Financial Stability and Development Committee under the State Council should coordinate financial reform and opening policies. 'Promoting reform through opening' is vital, but 'facilitating opening with reform' is also indispensable. Coordination of financial and non-financial reforms is essential. For example, reform of state-owned enterprises (SOEs) is an important condition for interest rate marketisation and capital account liberalisation. Additionally, coordinating domestic and foreign financial policies is required. For example, the opening of financial institutions to the outside world depends on whether foreign-owned financial institutions can truly enjoy pre-establishment national treatment in China. Finally, the coordination of various financial opening policies, especially the 'troika' of financial sector opening, exchange rate regime reform and financial deregulation must occur.

Second, the exchange rate should be more flexible and market forces should play a bigger role in determining the exchange rate. Since the end of 2016, RMB depreciation expectations have subdued, and the real economy has remained relatively stable, providing an important opportunity for the long-expected reform of increasing exchange rate flexibility. If China allows the exchange rate to be determined by market forces in due time, it will provide an important foundation for China to expand financial opening and improve financial regulation. It will also send a very positive signal to the international community, giving China more status in international financial affairs.

Third, China should establish a management framework for cross-border capital flows at both the macro and micro levels, while steadily accelerating RMB internationalisation. At the micro level, it is important to promote capital account convertibility and facilitate trade and investment. The focus of regulation should shift from ex-post regulation to ex-ante and concurrent regulation. At the macro level, a two-dimensional management framework—one on capital control and one on macroprudential management—should be established. Regulatory tools such as the macroprudential monitoring mechanism and stress test should be improved, and capital control measures such as the Tobin tax should be maintained as counter-cyclical instruments. However, capital controls should only be temporary measures to buy time for further reform.

Fourth, China should fully implement the pre-establishment national treatment towards foreign financial institutions and relax the cap on shares owned by foreign investors. When foreign-owned financial institutions enter China, they become resident business entities and are subject to the supervision of Chinese regulators. Their influence on financial stability is completely different from that of short-term capital flows. The Chinese authorities should treat local and foreign institutions equally in terms of ownership percentage, forms of incorporation, shareholder qualifications, business scope and the number of licences allowed, to provide a level playing ground for foreign investors.

Fifth, China should respect international rules and practices to achieve a higher level of financial opening. Opening the domestic market is essential to enhancing China's international competitiveness and achieving RMB internationalisation. A substantial gap exists between the openness stipulated by policies and those that are achieved. This is mainly due to misalignments between domestic and international rules and regulations. China should open up the credit rating market and foreign issuers should be given more flexibility in choosing auditing and accounting standards. Taxation issues faced by foreign investors in the Chinese bond market should be clarified as soon as possible. In addition, the financial infrastructure should be based on Chinese conditions, but should adapt to international practices.

Sixth, the opportunities presented by the Belt and Road Initiative and domestic industry upgrading and restructuring should be seized. This could help construct a framework for outbound investment and financing. In addition to development finance and policy, China should also create a comprehensive commercial financial services system. Regulators could guide Chinese financial institutions to plan their overseas presence rationally and encourage financial institutions to expand the scope and depth of their cross-border financial business. Overseas investment and financing services can be improved by using the correspondent banks, syndicated loans, assistance provided by host countries and multilateral development banks, capital markets in developed economies and international financial centres.

Finally, a macroprudential regulatory framework that matches an open financial system should be established. This will prevent and mitigate risks that could occur in the opening process. An open financial system can enhance efficiency, but may also increase risk. The regulatory framework should be expanded based on rules regarding cross-border financing risks in the People's Bank of China's (PBC) macroprudential assessment (MPA) system. Consideration should be given to the roadmap, timetable and coordination of financial opening policies. The authorities should adjust policies to adapt to different stages of development, reduce the volatility of capital flows, maintain external debt at a reasonable level and optimise its structure.

Overview

Four decades of financial opening

When the Third Plenary Session of the 11th Communist Party of China Central Committee decided to shift the government's focus to economic development in late 1978, China had only one formal financial institution—the PBC. The PBC performed the functions of both the central bank and commercial banks. The distribution of funds was based on central government planning, while the role of commercial financial institutions was almost negligible. However, the government established three specialised commercial banks in 1978: the Bank of China, China Construction Bank and Agricultural Bank of China.

For nearly four decades since 1978, the reform and opening up policy has brought tremendous changes to China's financial sector. China's financial reforms have not followed a simple linear process; they have been successful in increasing the quantity of financial services provided, but the quality has not improved much (Huang, Wang, Wang & Lin, 2013). The types and quantity of financial institutions have increased significantly, and the scale of financial assets has also expanded dramatically. All types of financial institutions can now be found in China. China now ranks first in the world in terms of commercial bank assets, second in terms of stock market capitalisation and third in terms of private sector bond market capitalisation, although most derivatives markets are still at an early stage of development, except for commodities futures. Judged only by these quantitative indicators, China's financial system is already a leader in the world (Zhu, Zhang et al., 2017).

In contrast, market mechanisms for the pricing and allocation of funds are faced with many constraints (Huang & Wang, 2017). The government intervenes in many areas. Some examples that challenge market discipline include the rules for benchmark deposit and lending rates, intervention in the foreign exchange market, guidance on fund allocation in the credit and capital markets, control over cross-border capital flows, government holdings in large financial institutions, soft budget constraints of SOEs and guaranteed payment on financial products. Economists at the International Monetary Fund (IMF) used 2005 data to create a financial repression index measuring the degree of government intervention in the financial system; China ranked fourth out of 91 countries (Abiad, Detragiache & Tressel, 2010).

Since the beginning of China's economic reform, financial opening has become increasingly important in policy considerations. China's financial opening can be divided into four stages.

The period from 1978–1991 was an exploratory stage for financial opening, and the most important move during this period was the launch of 'special economic zones' and adjustment to the exchange rate system. The focus of economic reform at this stage was first on rural regions. It gradually shifted to urban areas after 1984. In 1979, Japan Export-Import Bank became the first foreign bank to set up an office in Beijing. In 1982, CITIC Bank issued the first foreign bond since 1978 in Japan's financial market, with help from Nomura Securities. In 1979, Deng Xiaoping called forth establishment of 'special economic zones'. The first one was set up in Shenzhen in 1980. These special economic zones rolled out favourable policies like tariff exemption, aiming to create a beneficial environment to attract foreign investment. Meanwhile, the authorities tried to increase the proportion of market allocation of foreign exchanges by adopting a dual exchange rate system, where both an official exchange rate and a market rate existed. To support export growth, the government gradually devalued the RMB exchange rate against the USD from 1.498 in 1980 to 5.323 in 1991.

The period 1992–2000 was the foundation stage for financial opening, and the most important move during this period was the implementation of a managed floating exchange rate system and the effort to attract foreign direct investment. Deng Xiaoping's visit to South China in early 1992 opened a new era for economic reform. In October 1992, the 14th National Congress of the Communist Party of China made it clear that the objective of China's economic reform was to establish a socialist market economy. In 1993, the government introduced the 'market-for-technology' policy to attract foreign investment. In the following 22 years, China attracted more foreign investment than any other developing country. In early 1994, the central bank cancelled the dual exchange rate system and unified the official exchange rate with the market rate to establish a single managed floating exchange rate system based on market demand and supply. Current account convertibility was achieved in December 1996. When the Asian financial crisis broke out in 1997, the government tried to maintain the stability of the RMB and adopted a temporary exchange rate policy that pegged the RMB to the USD. In the meantime, the government accelerated reform of state-owned commercial banks.

The period 2001–2008 was an expansion stage for financial opening. The most important move at this stage was to open the domestic market to foreign-owned financial institutions. China's official accession to the WTO at the end of 2001 prompted the government to increase its efforts at economic reform. The government promised to open RMB business to foreign banks completely within five years, and similar commitments were made to foreign securities and insurance companies. To open up channels for investment in domestic and foreign capital markets, Chinese regulators set up the Qualified Foreign Institutional Investor (QFII) scheme in 2003 and the Qualified Domestic Institutional Investor (QDII) scheme in 2006. In 2004, the government began to encourage Chinese enterprises to 'go global'. Soon, China became one of the world's largest home countries of direct investment. In July 2005, the central bank dropped the RMB's peg to the USD. At the end of 2003, the central bank issued a notice on providing clearing arrangements for personal RMB business in Hong Kong, and then expanded such arrangements to Macau in 2004. By then, the cross-border circulation and use of the RMB entered a new stage. In October 2005, the International Finance Corporation and the Asian Development Bank issued the first RMB-denominated bonds (commonly known as 'Panda bonds') in China; in June 2007, the first RMB bond was issued in Hong Kong (commonly known as 'Dim Sum Bonds'). At this point, although the internationalisation of the RMB was not yet a national strategy, China had been quietly testing the waters.

The period 2009–2017 saw steady advancement of financial opening, and the most important move was accelerating RMB internationalisation and introducing the Belt and Road Initiative. Since early 2009, the central bank has actively expanded the offshore RMB market and supported RMB settlement for cross-border trade and investment. In July 2015, the central bank opened the interbank bond market to foreign central banks, international financial institutions and sovereign wealth funds; schemes such as the Shanghai–Hong Kong Stock Connect, Shenzhen–Hong Kong Stock Connect and Bond Connect were established to bridge the domestic and foreign capital markets. On 1 October 2016, the RMB was officially included in the IMF's special drawing right (SDR) basket. However, reform of the RMB central parity formation mechanism on 11 August 2015 led to prevalent depreciation expectations. President Xi Jinping proposed the Belt and Road Initiative in 2013, and the first multilateral development institution initiated by China—the Asian Infrastructure Investment Bank—was established in Beijing in December 2015.

Great achievements but many problems

From the perspectives of economic growth and financial stability, China's financial reform and opening up in the past four decades have undoubtedly been successful. Notably, China's gross domestic product grew at an average annual rate of nearly 10 per cent in the first three decades. Additionally, China is the only country of the major emerging market economies that has not experienced a serious financial crisis. However, if a thorough analysis is conducted on China's financial opening policies, many problems can be identified, despite the evident progress. Understanding regarding the appropriate degree of openness in areas like financial institutions is also lacking. Regarding exchange rate policies, although a certain consensus has been reached on the objective of a more flexible exchange rate, it has been difficult to put such policies into practice.

In some areas, such as foreign investment and financing cooperation, the opening process is still at a very preliminary stage. The following presents a brief assessment of the financial opening policies in a few major areas.

First, the problem with the exchange rate policy is that the authorities have tried to let market forces play a bigger role in determining the exchange rate level, but the flexibility of the exchange rate is still inadequate (B. Zhang, 2017). The RMB exchange rate policies (including the exchange rate regime) have undergone many changes, from consistent devaluation in the early days to gradual appreciation, from pegging the RMB to the USD to pegging it to a basket of currencies, and from the once fixed regime to a managed floating system. A lasting theme can be found in the process over the past four decades, which is the desire to increase the flexibility of the exchange rate and gradually move towards a market-determined exchange rate system. In fact, China's exchange rate policies have achieved much. The exchange rate is moving towards equilibrium level without wild fluctuations. The exchange rate has also effectively supported export growth, helping China maintain a healthy balance of payments and accumulate massive foreign exchange reserves.

However, China's exchange rate policy seems to have fallen into a dilemma of 'hate to fix but fear to float' since 2005. A managed floating exchange rate regime that lacks flexibility is rarely adopted by large economies. While the Chinese authorities have long claimed that market factors should play a bigger role in determining the value of the currency, they took measures to stabilise the exchange rate quickly whenever fluctuations were apparent. Over the past decade, the central bank either tried to reverse the expectations of unilateral RMB appreciation or eradicate unilateral depreciation expectations, except for some rare periods. The lack of flexibility not only affects monetary policy independence and macroeconomic stability, but also impedes economic restructuring, RMB internationalisation and the 'going global' efforts of Chinese enterprises.

Second, despite considerable progress in capital account liberalisation and RMB internationalisation, the past two years have seen some reversals (Guan, Zhang, Xie, Gao & Ma, 2017). The Third Plenary Session of the 16th Communist Party of China Central Committee proposed a policy objective of 'gradually achieving capital account convertibility'. Since then, capital account liberalisation started to accelerate and expanded from direct investment to external debt and credit, securities investments and other cross-border capital and financial transactions. The regulation of the capital account also shifted from 'lax on inflows and strict on outflows' to 'balanced management on bidirectional flows'. The number of items more than partially convertible on the capital account increased from 34 in 2012 to 37 by the end of 2016, and the share in total transactions by these items increased from 85 per cent to 92.5 per cent, while only three items were left unconvertible. A traditional puzzle with capital account liberalisation is how to balance the benefits and risks, including how to open up the account and to what degree.

Policies on RMB internationalisation were introduced in 2003. In late 2003, the central bank began to provide clearing arrangements for Hong Kong banks with individual RMB business. In 2009, cross-border RMB use for current account transactions was expanded to the whole country, while cross-border RMB use for capital account transactions was also greatly liberalised. Meanwhile, RMB offshore centres, represented by Hong Kong, developed rapidly. On 1 October 2016, the IMF officially announced the inclusion of RMB in the SDR basket. According to the IMF's data on the currency composition of official foreign exchange reserves, the RMB accounted for 1.1 per cent of the total reserves by the end of 2016. However, since mid-2015, part of the RMB internationalisation effort was reversed to encourage stability in the foreign exchange market. SWIFT data shows that the RMB's ranking in international payment fell from fifth in 2015 to sixth by the end of 2016, and its share declined from 2.31 per cent to 1.67 per cent.

Third, the opening of the financial services sector—especially to foreign-owned financial institutions—is basically 'long on talk and short on action' (Zhu, Guo, Ai, Bai & Zhao, 2017). After China joined the WTO in 2001, the country gradually relaxed restrictions on the form of incorporation, location and business scope, allowing for foreign-owned financial institutions. By the end of 2016, the assets of foreign banks accounted for 1.3 per cent of the total assets of banking institutions in China; joint-venture securities companies accounted for 10 per cent of securities companies, and their assets accounted for 4.5 per cent of the total; foreign-owned property insurance companies and joint-venture life insurance companies accounted for 30.4 per cent of the total. Meanwhile, Chinese financial institutions were 'going global' proactively, with networks covering the Asia-Pacific, North America and Europe. They also collaborated with an increasing number of banks globally in providing financial services, using various approaches.

However, China's openness with regard to foreign-owned financial institutions lags significantly behind the international average. Regarding the banking sector, the share of foreign bank assets in China is much lower than the average level of OECD countries (above 10 per cent), and is lower than the level of 2 per cent when China joined the WTO. The share of foreign assets in the insurance sector also fell to 5.6 per cent in 2016 after reaching a peak of 8.9 per cent in 2005. The decline of foreign shares is an indication of China's poor business environment and multiple policy barriers faced by foreign institutions. China is one of the few countries that impose restrictions on foreign ownership in the banking, securities and insurance sectors. Restrictions on business scope and licensing rules also constrain the development of foreign-owned financial institutions in China. For example, foreign securities firms can only enter China as joint ventures, and can only conduct very limited types of business, such as underwriting and the brokerage of foreign shares and bonds. Foreign-owned financial institutions are not really given pre-establishment national treatment.

Fourth, the opening of China's financial market is restrained by regulatory and institutional differences at home and abroad, and by China's 'channelised' mode of opening (Xu, Zhang, Cao, Tang & Wan, 2017). The bond market opened up by allowing foreign institutions to issue RMB bonds or invest in the interbank market; the stock market opened up by introducing a series of schemes such as QFII, QDII, the Shanghai–Hong Kong Stock Connect and the Shenzhen–Hong Kong Stock Connect to encourage two-way investment; the interbank foreign exchange market opened up by introducing 66 foreign institutions. However, the openness of these markets is generally limited. For example, total foreign shareholdings through schemes like QFII, RMB Qualified Foreign Institutional Investor, the Shanghai–Hong Kong Stock Connect and the Shenzhen–Hong Kong Stock Connect account for no more than 5 per cent of the stock market, much lower than 30 per cent in South Korea. Foreign holdings in China's bond market account for less than 2 per cent, while 10 per cent of Japan's treasury bonds are held by foreign entities. In China, transactions by foreign investors account for less than 1 per cent of the total trading volume in the interbank foreign exchange market.

The relatively low degree of openness in China's financial market can be largely attributed to regulatory and institutional differences between the domestic and international markets. This difference has caused much inconvenience to foreign issuers and investors and has dampened their enthusiasm to participate in the Chinese market. China's stock market opened up in a 'channelised' approach and the foreign exchange market is a managed market based on demand. Such practices have suppressed the degree of openness. The bond market is even more problematic, as foreign institutions struggle with different accounting and auditing requirements. China's bond market differs from the international market in that it requires filing for market access and adopts approaches such as single-tiered custody and centralised trading. Moreover, China's rating agencies generally lack credibility, and the variety of bond-related foreign exchange and derivative products is quite limited.

Finally, China has just started to establish a framework for overseas investment and financing cooperation. China's financial institutions clearly lag behind the enterprises in their 'going global' efforts, and their capabilities to provide cross-border financial services remain quite limited (Zhu, 2017). While China remains a large recipient of capital inflows, it has gradually become an equally powerful exporter of direct investment. The focus of overseas investment and financing cooperation has gradually expanded from Asian economies to advanced economies in Europe and North America, and the sectoral distribution has also shifted from the mining industry to business services, financial services and manufacturing. Investments made by non-SOEs rose from 19 per cent of total investment in 2006 to 49.6 per cent in 2015. However, Chinese enterprises investing overseas face substantial financing difficulties, as their investment projects are often long term, large scale and involve high risks. Moreover, many host countries are short of funds themselves. Chinese enterprises lack sufficient credit in foreign countries, and the overseas presence of Chinese financial institutions is mainly concentrated in developed economies, rather than in the developing and emerging economies where Chinese companies are investing heavily.

Many problems have surfaced as Chinese financial institutions have 'gone global' to conduct investment and financing cooperation. Some financial institutions have 'rushed forward' to seize new projects, resulting in distorted market competition. Some companies are ignorant of the host country's environmental and social norms, but invest in the country despite possible significant risks. It is also quite common that responsibilities, rights and interests are not properly aligned among stakeholders, especially in relation to public and concessional funding, as an ongoing tracking and accountability mechanism is missing.

The overseas distribution of domestic financial institutions does not match that of Chinese enterprises, and the overseas branches of Chinese financial institutions lack the strength and capability to provide sufficient service to companies investing overseas. Although the size of cross-border merger and acquisitions activities initiated by Chinese investors has increased rapidly, Chinese companies have a relatively high ratio of debt financing. The median ratio of debt to EBITDA for Chinese cross-border merger and acquisition deals is 5.4, while the global median is 3.

Government policies aiming to open up the financial sector over the past four decades have several prominent features. First, they are slow with reversals. China has been trying to open up its capital account for more than 20 years since the RMB became convertible under the current account in 1996. For more than a decade, the authorities repeatedly proposed a more flexible exchange rate, but the tolerance for exchange rate fluctuations remained low. The Chinese Government made a strong commitment to financial opening when China entered the WTO, but has been slow in fulfilling its promises.

Second, the government has shown great determination, but implementation has been difficult. When China joined the WTO, people in the domestic financial sector were largely pessimistic about the impact of foreign competition. However, it seems that foreign shares in the domestic banking and insurance sectors have declined rather than increased. In more recent years, the PBC has opened up the interbank bond market vigorously to international organisations, sovereign funds and commercial financial institutions. However, the actual degree of openness is still surprisingly low, due to gaps between domestic and international rules, systems and infrastructures.

Third, policy coordination is insufficient. China's financial reforms are ahead of its economic reforms, and RMB internationalisation is ahead of the financial reform. This lack of coordination has often reduced the effectiveness of opening policies for the financial sector. Financial policies and institutions are intrinsically related. They should be coordinated in the process of reform, or they will hinder each other and possibly trigger new risks. In the last two years, the authorities have suppressed the implementation of some existing policies for capital account liberalisation and RMB internationalisation in order to stabilise the foreign exchange market.

The aforementioned characteristics of financial opening policies can be attributed to many factors, including sectoral interests and policy ideas. The slow progress or even retrogression of financial opening may be explained by concerns over the perceived harm to the vested interests of domestic financial institutions. It is also obvious that policies discriminate against foreign-owned financial institutions in terms of shareholdings and business scope. Many people worry that financial opening may be detrimental to China's financial security and stability. Some of these worries are unnecessary, but some make sense. For example, massive short-term capital flows can easily trigger financial risks or even financial crises. If China is to further open up, it needs to put in place an efficient mechanism to prevent and respond to these potential risks.

Policy ideas and strategies should evolve with the times

Should China continue opening up the financial sector and, if so, how should the country achieve this? Once no doubts existed, but now this is a pressing question. Although China's financial openness is still relatively low, its economic and financial performance is highly regarded globally. If China's policies are working, why should they be changed? Conversely, China has taken developed countries in Europe and North America as a model for its financial reforms, but these economies have experienced serious financial crises in the past, and the progress of economic globalisation has slowed down or even reversed. Moreover, some developing countries, such as Indonesia and Mexico, have experienced financial crises after opening up their financial sectors. All these indicate that China needs to balance efficiency and stability when formulating financial opening policies.

However, China should continue to open its financial sector for at least three reasons.

First, further opening of the financial sector is an important condition for achieving sustainable economic growth. Currently, the openness of China's financial industry is not only far below the openness of the real economy, but is also significantly below the openness of the majority of emerging economies. While repressive financial policies, including capital account control, contributed to economic growth in the 1980s and

1990s, the impact of such policies has been negative since the turn of the century (Huang & Wang, 2011). China's future economic growth needs innovation to obtain new momentum, and economic innovation needs support from financial innovation. As China's WTO entry experience shows, the more developed, competitive and internationalised sectors are usually those that are opened up more thoroughly to the outside world and are more actively involved in global resource allocation. Financial progress also relies on further opening, even though problems in the financial sector are more complicated than in other sectors. At present, Chinese financial institutions are far behind Chinese enterprises in their 'going global' efforts.

Second, financial opening is also an important means to prevent and control systemic financial risks. The recent increase of systemic financial risks can be attributed to many factors. The continued economic slowdown has caused the deterioration of corporate balance sheets, and government bailouts for financial products and enterprises have worsened the moral hazard problem. Government bailouts seem to stabilise the financial market in the short term but may instigate further financial crises. Further opening the financial sector can not only introduce advanced management concepts, technologies and rules; raise economic efficiency; and strengthen competition and market discipline (thus lowering financial risks), but can also facilitate the diversification of risks. Clearly, financial opening measures should not be implemented all at once, but need a carefully designed roadmap and a prudential regulatory framework.

Finally, financial opening is also crucial for China to participate actively in international economic governance. Since 2008, some 'black swan' events have occurred in the international political and economic arena. However, peace and development remain the major theme of our time, and China is expected to see an extended period of strategic opportunities for reform and development (Y. Zhang, 2017). Over the past four decades, China has been a major beneficiary of economic globalisation, and it is in the country's interest to maintain an open global economic order. China today can hardly assume the role of a rule maker for international economic affairs, but it can be active as a key participant. The new initiatives recently launched by the Chinese Government—including the Belt and Road Initiative, Asian Infrastructure Investment Bank and RMB internationalisation—should be progressed on the premise of closer integration with the international economic and financial system.

The Chinese and global economies have undergone many changes compared with the early days of reform and opening up almost 40 years ago. It is necessary for the Chinese Government to consider ideas and strategies that are adapted to today's new economic realities when formulating financial opening policies.

First, as a major economy, China should take full account of the spill-over effect of its financial opening policies on other economies and the international market. A few years ago, it was quite common for experts to regard RMB exchange rate policies as China's internal affairs that did not involve other countries. This argument was incorrect then and is even more so in today's context. The exchange rate is the relative price between currencies, and an undervalued or overvalued yuan will affect other countries. More importantly, China has evolved from a small economy to the world's second largest. The international economic environment has changed from an exogenous variable to an endogenous variable of the Chinese economy, and its economic policy has become an important part of the international system. Studies have found that China's monetary policy can have a significant impact on the Asian economy through the real economy and financial channels (Cho, Huang & Kim, 2017). This was not so 40 or even 20 years ago.

Second, on the premise of further liberalising cross-border capital flows, moderate and temporary management of cross-border capital flows can maintain financial stability and enhance monetary policy independence. After the establishment of the Bretton Woods system in 1944, the IMF supported capital account control. When the US removed the gold standard in 1971, the IMF supported the free flow of cross-border capital. After 2009, the IMF's stance on the free flow of capital shifted again towards allowing governments to take appropriate management policies for financial stability (IMF, 2011). Recent studies have found that many developing countries only have the dilemma between free flow of capital and independent monetary policy. Therefore, appropriate management of cross-border capital flows could also enhance monetary policy independence (Rey, 2013). However, the IMF believes that China's capital flow management is stricter than that of most developed economies. The future direction would be for China to gradually lift capital controls, shifting from quantitative control and a quota system to price control, from residence-based administrative control to currency-based regulatory measures, and from ex-ante approval to ex-post reporting and supervision.

Third, exchange rates used to affect the real economy through trade channels, but now the financial channel is becoming increasingly important. Undervalued currencies usually increase exports and reduce imports, thereby improving trade balance and supporting economic growth. Recent studies have determined that exchange rates can affect the economy through financial channels in addition to trade channels (Hofmann, Shim & Shin, 2016). Since mid-2015, the depreciation of the RMB forced many Chinese enterprises to accelerate repayments of their foreign debt; this is equivalent to capital outflows and is detrimental to economic growth. In the past, China's economic activities with foreign countries mainly involved trade. Now, with a more open financial sector, an undervalued currency may not stimulate economic growth. Neither can an overvalued currency be assumed to support economic growth. Instead, China should aim for exchange rates that align with its economic fundamentals, while maintaining adequate flexibility.

Fourth, China should combine 'promoting reform through opening' and 'facilitating opening with reform' to promote both financial reform and opening up. One of the most important lessons from China's experience in joining the WTO is to 'promote reform through opening'. For over a decade, China's policymakers have often applied this concept of governance to the financial sector and made much progress. As the links between various elements of the financial sector are very important, policymaking should pay particular attention to the sequencing issue 9 (McKinnon, 1993). For example, the Chinese central bank removed restrictions on the floating range of deposit and lending interest rates at the end of 2015, but the problems with risk pricing and interest rate transmission mechanism have not yet been resolved so interest rate marketisation has barely been accomplished. Another example is the internationalisation of the RMB. After the global financial crisis, the international community became more sceptical about the USD-dominated international monetary system, and expectations for the RMB rose. The Chinese central bank seized the momentum and propelled RMB internationalisation to a new level. However, supporting reforms, such as exchange rate regime reform, lag far behind, which has seriously restricted the progress of RMB internationalisation. The troika of financial sector opening, reform of the exchange rate formation mechanism and reduction of capital controls must be promoted in a coordinated manner.

Promoting reform through opening; facilitating opening with reform

Throughout the process of economic reform and opening, the Chinese Government has actively advanced financial opening, but the degree of openness still lags behind that of China's real economy and the financial sectors in most countries. Historically, this would not have had much of a negative effect on China's economic growth or financial stability. However, now it is constraining further growth. From the perspective of maintaining economic growth, controlling financial risks and participating in international financial governance, China should further open up its financial sector. New policy ideas should be considered in formulating and implementing policies. Here, we propose seven policy recommendations.

First, the Financial Stability and Development Committee under the State Council should coordinate financial opening policy, design the roadmap, and implement the policy proactively and steadily. 'Promoting reform through opening' is very important, but 'facilitating opening up with reform' is also indispensable—a one-sided financial opening policy should be avoided. Of course, this does not mean reform policies cannot be advanced concurrently. However, the success of reform policies in certain areas depends on the completion of reforms in other areas. China has accumulated some experience and has also learned lessons from bringing in foreign banks, opening up the bond market and advancing RMB internationalisation. Now that a high-level committee has been established, it should aim for strengthened coordination. Financial and non-financial reforms should be coordinated. For example, solving the issue of soft budget constraints of SOEs is an important condition for interest rate marketisation and capital account liberalisation. Domestic and foreign financial policies should also be coordinated. For example, the opening of financial institutions to the outside world depends on whether foreign-owned financial institutions can enjoy pre-establishment national treatment and fair competition. Additionally, the promotion of financial opening policies should be coordinated. For example, opening financial institutions and financial markets, reforming the exchange rate formation mechanism and reducing capital controls are highly interconnected. The top priority now is to have a more flexible exchange rate.

Second, exchange rates should be more flexible and market factors should play a bigger role in determining the exchange rate levels. The RMB is still not flexible enough. Once the market shows signs of trouble, the authorities will act to fix it. Government intervention has become a key source of financial instability. However, since the end of 2016, RMB depreciation expectations have almost disappeared, and the real economy has remained relatively stable, providing an important opportunity for the long-expected reform of increasing exchange rate flexibility. Both domestic and international practices show that if China is to let the market decide the exchange rate and achieve a 'clean' float of the yuan, China should do so in favourable conditions when risks are low. China should seize the current opportunity to push forward reform decisively. Missing a good opportunity once again is inadvisable. In the meantime, China should have response plans ready for all sorts of possibilities: prepare for the worst and strive for the best. If China can achieve the leap of exchange rate reform in good time, it will provide an important mechanism for China to expand financial opening and improve financial regulation. It will also send a very positive signal to the international community, giving China a stronger voice in international financial affairs (Y. Zhang, 2017).

Third, China should establish a management framework for cross-border capital flows at both the macro and micro level and steadily accelerate the process of RMB internationalisation. China's 13th Five-Year Plan has promised to 'expand two-way opening of the financial sector, achieve RMB capital account convertibility in an orderly manner, and increase the convertibility and free use of the RMB'. The macro-control function of capital flow management will continue to decline in importance. The micro-supervision function will decouple from the macro-control function. The future reform of capital flow management will be characterised by decentralisation and diversification. The establishment of a dual-pillar framework for cross-border capital flow management is proposed. At the micro level, it is important to promote capital account convertibility and trade and investment facilitation; the focus should shift from ex-ante supervision to concurrent and ex-post supervision, while emphasising authenticity and compliance checks. At the macro level, a two-dimensional management framework—one on capital control and the other on macroprudential supervision—should be established. Upgrading the policy toolkit and improving the macroprudential assessment mechanism and stress tests is urgently required. Capital control measures such as the Tobin tax should be retained as instruments for counter-cyclical control and ex-post regulation. However, cross-border capital controls should only be temporary measures, as they will cause market distortions and increase transaction costs. China should use cross-border capital flow management to buy time for other reforms such as improving monetary policy independence and boosting economic growth. China should take immediate action to manage financial risks and support the orderly adjustment of the balance sheets of the private sector so that they can become better adapted to a more flexible exchange rate. At the same time, measures regarding RMB internationalisation should be steadily promoted. Such measures include providing more RMB liquidity in offshore markets, promoting RMB settlement in international trade and investment, expanding the proportion of RMB in international payments and reserves, and promoting the use of RMB in pricing products in the international market (Guan et al., 2017).

Fourth, China should fully put into practice pre-establishment national treatment of foreign financial institutions and liberalise the restrictions on foreign holdings of financial institutions. When a foreign financial institution enters China, it becomes a domestic business entity and is subject to the supervision of Chinese regulators. This is equivalent to foreign institutions conducting direct investments in China. Their impact on financial stability is completely different from that of short-term cross-border capital flows. In this sense, the Chinese authorities should treat local and foreign financial institutions equally in terms of ownership percentages, forms of incorporation, shareholder qualifications, business scope and the number of licences allowed. This would provide a fair competitive environment for foreign investors in the Chinese market. China could relax restrictions on foreign ownership in the banking, securities and insurance sectors and allow the establishment of wholly foreign-owned securities companies and insurance companies. China could cancel the requirement on total assets for foreign bank shareholders, the requirement for minimum years of operation for foreign banks to start RMB business, and the requirement that at least one Chinese shareholder of a joint-venture securities company should be a securities company. China should no longer restrict the development of joint-venture life insurance companies by limiting the number of licences granted and could consider giving new regional operation licences to wholly foreign-owned life insurance companies. At the same time, to encourage Chinese financial institutions to 'go global', China should remove restrictions on the overseas locations of commercial banks. It is suggested that newly established branches be subject to filing procedures only, rather than review and approval procedures. Moreover, applications to incorporate should be allowed to proceed simultaneously in the home country and host country to increase efficiency (Zhu, Guo et al., 2017).

Fifth, China should respect the rules and practices in the international market to achieve a higher level of financial opening. Opening of the financial market is a necessary requirement for China to enhance its international competitiveness and achieve the goal of RMB internationalisation. China should establish an orderly and open credit rating market as well as a uniform registration management system that covers international rating agencies. The specific market management requirements should be clarified and take into account the conditions of international rating agencies. Foreign rating agencies should be allowed to either establish a commercial presence in China or conduct business as foreign corporate entities. Moreover, international rating agencies can be permitted to gradually engage in the domestic bond rating business (beginning with Panda bonds) and foreign issuers should be given more flexibility in auditing and accounting. For private placement bonds issued to institutional investors, it is recommended that a regulatory cooperation agreement between China and the home country of the accounting firm not be a prerequisite. Otherwise, it should be sufficient for the accounting firm hired by the issuer to submit a regulatory confirmation letter to the Ministry of Finance. Accounting firms formed in European Union countries and Hong Kong may be exempt from filing with Chinese regulators. Uniform management measures, including relevant auditing and accounting policies and higher transparency and standardisation requirements, should be released as soon as possible for foreign governments, international developmental agencies and foreign commercial institutions issuing RMB bonds in the interbank market. Finally, tax issues concerning foreign investors in the Chinese bond market should be clarified as soon as possible. At the same time, financial infrastructure construction should take into account both China's conditions and international practices (Xu et al., 2017).

Sixth, China should take the opportunity presented by domestic industry upgrade and restructuring, as well as the Belt and Road Initiative, to construct a comprehensive foreign investment and financing framework. The basic principle is to reduce uncertainties and increase economic returns of overseas investment through reasonable financing arrangements, appropriate risk-sharing mechanisms and proper financial instruments.

China should promote development finance vigorously. Development finance emphasises the commercial viability and financial sustainability of projects rather than maximising profits. It emphasises support for infrastructure investment and other long-term investment projects. China is already a world leader in this field. China should continue improving the export credit mechanism for policy finance. China's export credits lean more towards 'South-South cooperation', rather than 'concessional loans' in the traditional sense. Therefore, China should promote the reform and improvement of international rules on export credit. Finally, China should establish a comprehensive commercial financial service system. Regulators could take the opportunity to guide Chinese financial institutions with planning their overseas presence rationally. They can also encourage financial institutions to expand the breadth and depth of their cross-border financial business, such as experimenting bank-enterprise cost-sharing mechanisms, improving exchange rate risk hedging tools for long-term investment, and relaxing sovereign guarantee requirements for host country project financing. They could also make use of correspondent banking operations, syndicated loans, assistance provided by host countries, multilateral development banks, the capital market in developed economies and international financial centres and employ a variety of investment and financing arrangements, such as equity investments, to improve overseas investment and financing services (Zhu, Guo et al., 2017).

Seventh, a macroprudential regulation framework that matches an open financial system should be improved to effectively prevent and mitigate risks that could occur in the opening process. Financial opening can enhance efficiency; it can also cause more instability to the financial market. Therefore, a key point for financial opening policy is to find a balance between efficiency and stability. Establishing a macroprudential regulation framework is an important way to achieve this balance. The Chinese central bank has proposed an MPA system that monitors seven categories of indicators. One category is cross-border financing risks, indicated by the weighted average of cross-border financing risk exposures. Macroprudential regulation on financial opening can follow this system, but it should include more assessments. For example, financial opening policies should be coordinated to avoid progress on a single front. The opening process should follow a well-designed roadmap and timetable to achieve a balance among opening, development and stability. Opening policies should be adjusted to adapt to different stages of development, and special attention should be paid to the potential risks brought about by opening up, especially the risks of cross-border capital flows. Finally, external debt should be kept at a reasonable size, and its structure should be optimised (Guan et al., 2017).

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This text is taken from *The Jingshan Report: Opening China's Financial Sector*, by China Finance 40 Forum Research Group, published 2020 by ANU Press, The Australian National University, Canberra, Australia.