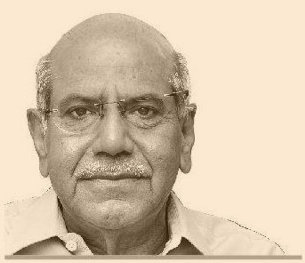
ILLUSTRATION: BINAY SINHA

China's quest for a new financial order

The step by step opening up of its markets offers unprecedented opportunities for global banking and financial firms

China is committed to full internationalisation of its national currency, the Renminbi (RMB), but is unwilling to embrace the liberalisation of its financial markets with consequent prospects of exchange rate volatility and potential capital flight. Its efforts so far have been to promote the use of the RMB in trade settlement, in investment products and as reserve currency to enhance its international profile. The Belt and Road Initiative (BRI) also enables China to expand the use of the RMB in project related finance in partner countries. A major initiative was taken in March 2018 when the Shanghai International Energy Exchange was set up to promote a petro-yuan market to rival the petro-dollar market. Since China is the world's largest importer of oil, it is encouraging the settlement of oil contracts in its own currency. The Shanghai Exchange deals in oil futures rivalling those in New York and London and could potentially set price benchmarks in the Asian region. The Shanghai Exchange dealt with 6 per cent of the spot market in just one year of trading. Fifteen per cent of the futures are held by foreign entities. The petro-yuan market has also been given a boost by imposition of US sanctions on Russia and Iran, providing an alternative to dollar-designated contracts. As the functioning of the Exchange matures, it is likely to rival the West Texas International and Brent as benchmark for oil prices globally.



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Another significant development during 2018 was foreign access granted to China's bond market, which is currently worth $12.7 trillion, and likely to double in the next four years. It is the third largest bond market in the world after the US and Europe. In 2017, China set up the Bond Connect which allows qualified and designated foreign financial entities such as banks, sovereign wealth funds and central banks, to invest in Chinese bonds through authorised entities in Hong Kong. However, the current foreign holding of Chinese bonds is a mere 2 per cent of the total but rising rapidly. In November 2018, the Chinese government announced that foreign investments in the bond market would be exempt from corporate income tax and value added tax for the next three years. The quota for foreign investors using the Bond Connect has been raised to $300 billion in the current year. It may be noted that Chinese domestic investors do not have the permission to invest in foreign bonds and this detracts from the creation of a truly international and open bond market.

An important gain for China last year was the inclusion of select Chinese A-shares traded on the Shanghai stock market in the MSCI Emerging Market Index. These shares have a current weight of 0.7 per cent in the index, but MSCI has announced that it will quadruple the number of Chinese shares to be included in its index by November this year, increasing their weight to 3.3 per cent. The Standard and Poor(S&P) Index and the Financial Times Security Exchange(FTSE) Index have also followed suit in including Chinese shares in their Emerging Market benchmarks.

With the liberalisation of the Chinese bond market, China has been pressing these indices to include Chinese government bonds in determining their benchmarks. Just recently, Bloomberg Barclays Global Aggregate, which is the most prominent in this field, has announced that it will, over a 20-month period, include 363 Chinese securities in its benchmark index, with a weight of 6 per cent. Other Indices such as J P Morgan Government Bond Index and Citi World Government Bond Index are likely to follow suit. The inclusion of Chinese stocks and bonds in these international indices would automatically direct funds to Chinese financial markets since many international sovereign wealth funds and pension funds allocate money passively tracking such indices. It is estimated that there may be, in the first year itself, a $ 80-billion inflow into Chinese stock market, while purchases of Chinese bonds may be at $250-$300 billion. It may be noted that this could result in deflection of such financial flows from countries like India.

In the context of Chinese efforts to promote the use of RMB internationally, one must also consider the success of Union Pay which has become the world's largest credit card issuing company. It was established in 2002 and having issued 7 billion cards, commands 56 per cent of the global market. It has been used mainly by the rapidly growing outbound Chinese tourists but currently there are 100 million card holders outside China. The card can be used in as many as 150 countries and a deliberate policy has been adopted to promote its use in BRI partner countries.

Chinese banks are encouraged to establish a strong overseas presence. They currently hold $2 trillion in overseas assets. The Bank of China is ranked sixth among the top 10 international banks. China set up 12 financial Free Trade Zones to experiment with a number of financial sector reforms and liberalisation, with Shanghai occupying the pride of place. However, these initiatives have yielded disappointing results. The focus has shifted in these zones to a broader economic reform agenda not limited to the financial sector. For example, Chengdu in the inland Sichuan province, is being developed as a logistics base to cater to the Eurasian corridor which is part of the BRI.

Taken together these various developments add up to a substantial agenda of financial reform through a step by step integration with the global financial system. China is leveraging its weight as the second largest economy in the world and the attraction of its vast and expanding market, to obtain access and deeper working arrangements with established international players. This is in sharp contrast to the headwinds the country is encountering on the trade and technology fronts. The gains it is making in the global financial markets may suffer a setback if its economy heads into a serious slowdown or even a crisis triggered by the ongoing US-China trade war. However, it is unlikely that the overall trend will see a reversal. For the major international banking and financial firms, the opening up of the Chinese securities and bond markets offers unprecedented profit opportunities. China may well achieve its aim to become a global financial hub. The global financial system is being reshaped in ways that are only dimly understood.

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