Capital Market Liberalization – What Can China Learn from Japan in Opening Up Its Financial Markets?


Author Ziyue Li

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Introduction

In July 2019, when trade tensions between China and the United States were as hot as the summer sun, China's State Council established 11 new rules to further open up its financial sector (http://www.gov.cn/xinwen/2019-07/20/content_5412220.htm). Many believe the move could open doors for the wolves of Wall Street, who have long been eyeing the Chinese market. Sceptics worry about a possible lost decade as the move could be seen as a compromise to strike a deal with the US. Japan's lost decades was the period following the burst of the stock and real-estate bubble in the 1990s, which practically halted the growth momentum of Japan's economy. As pressure on the Chinese currency mounted, there was fear of another potential "Plaza Accord", which was believed by many to be a major factor in Japan's lost decades.

As the time of this writing (April 2020), the new rules have come into full effect. This article seeks to explain the latest policies for liberalizing China's financial sector, in particular regarding capital markets, and with my limited experience I will argue why I believe a "Plaza Accord 2.0" is a myth, at least given the current policies. Yet the fact that there are worries and fears, especially learning from Japan's lost decades, sparks my interest in comparing the two countries' histories of financial sector liberalization and deregulation. What lessons could China learn from Japan? What is next for domestic and foreign financial institutions as the sector opens up? As a student aspiring to work in this field, I am interested in taking a close look at these questions.

Latest Policies in a Nutshell

The financial sector covers banking, capital markets, asset and wealth management, insurance and other subdivisions. To limit the scope of discussion, this article will focus on capital market development, namely equity and bond markets, and their supporting institutions and infrastructures. There are reasons to zoom in on this topic: capital markets have witnessed the most drastic changes in the past decades in China. Moreover, "capital market" itself seems fundamentally paradoxical in a socialist state.

By definition and function, capital markets connect private entities that need money to those who have spare money to invest. It channels spare resources in society freely based on market forces, and hence "capital market" has a capitalist nature. However, ever since Deng Xiaoping outlined "Socialism with Chinese Characteristics" in the 1980s, elements of market economics have been legitimized for wealth creation and economic growth. Though the first stock market after independence was established in Shanghai in 1990, it had unique features such as Initial Public Offerings being approved by the central government, highly controlled foreign capital inflows and domestic outflows, and minimal participation of foreign institutions. Hence, when we look at current policies, we have to see them in a comparative light: as a whole, capital markets are not and possibly never will be fully open by Western standards, but compared to their initial construct they have achieved a huge step. Let us look at some of the latest policies on capital market liberalization.

Out of the 11 policies, four specifically touched upon capital markets:

1) The timing of lifting restrictions on foreign shares of securities, fund management and futures companies will be advanced from 2021 to 2020.

2) Foreign-funded institutions are allowed to obtain Type A lead underwriting licenses in the inter-bank bond market.

3) Investment of foreign institutional investors in the inter-bank bond market will be further facilitated.

4) Foreign-funded institutions are allowed to conduct credit ratings on all types of bonds in the inter-bank bond market and the exchange bond market.

What do these measures entail? There are three parts to it – the business scope of foreign financial institutions as service providers, their participation in the capital markets as investors, and supporting infrastructure to make domestic capital markets more robust. First of all, foreign financial institutions are allowed to take control of their Chinese joint ventures or directly enter the market. Right after the date the policy became effective on April 1, 2020, Morgan Stanley and Goldman Sachs both went on to apply for majority control of their local securities joint ventures, Morgan Stanley Huaxin Securities and Goldman Sachs Gao Hua Securities (https://www.ft.com/content/22e8f770-ba64-4c8f-a9f5-a47885d0b7dd). They are able to access more products and service provisions in the local markets and better report their Chinese earnings. Since Chinese financial services have long been heavily driven by licenses, granting lead underwriting licenses in the inter-bank bond market allows more underwriting business for foreign companies. Secondly, foreign players are encouraged to participate more in the inter-bank bond market, bringing in capital and liquidity. The approval of foreign rating agencies like S&P, Moody's and Fitch in rating bonds is a crucial milestone to enhance investor confidence and to show China's commitment to improve its bond market.

China's Rationale

Before we associate rapid financial liberalization and deregulation with the alarming financial crisis we saw in Japan and Southeast Asia in the 20th century, it is worth elongating the timeline and analyzing rationales.

1) Experimental & Gradualist Approach

Policies outlined and implemented in 2019-2020 are not a sudden push, even though they seem a rapid step possibly due to trade war pressure.

Starting with the equity market, one of the first notable attempts to welcome foreign investors was the launch of the Qualified Foreign Institutional Investor (QFII) program in 2002, as a promise to the World Trade Organization (WTO) to open up capital markets. Through this channel, licensed foreign institutions are allowed to invest in onshore stock exchanges, as well as the bond markets. Initially, the qualification was much more stringent and had a tight quota of only $40 billion. Such quota was increased to $80 billion in 2012 and recently was scrapped completely. The restriction on licensing has been gradually relaxed as well, but a certain lock-up period is still implemented to prevent speculation and excessive volatility.

Another more innovative channel is Stock Connect, a mutual market access mechanism initially implemented between Shanghai and Hong Kong Stock Exchange (HKEx) in 2014. China's tight capital control does not allow foreign investors to open onshore accounts. Linking HKEx with China's onshore stock markets, foreign investors, whether institutional or retail, are able to gain access to onshore stocks in a single step. Moreover, there is no mandatory lock-up period unlike the QFII scheme.

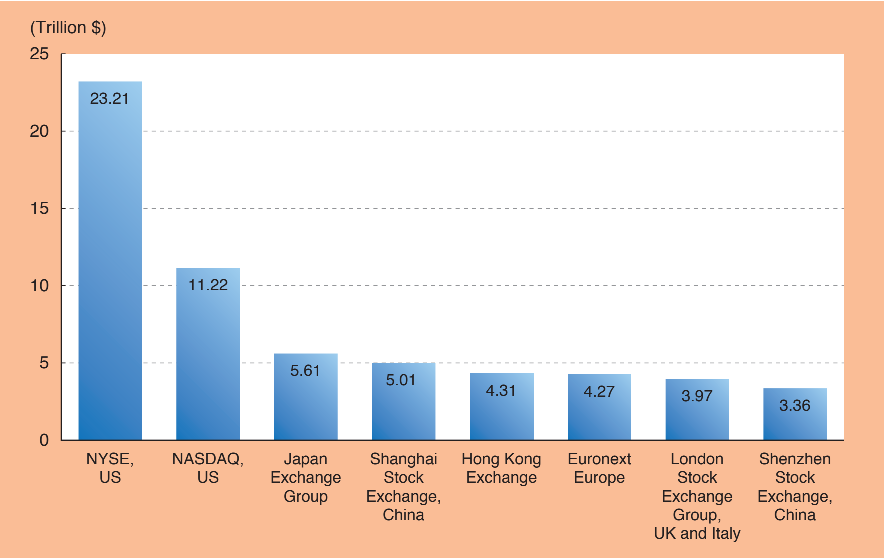
A parallel development emerged in the bond market. Foreign investors were initially allowed to invest in domestic bond markets with QFII and Renminbi Qualified Foreign Institutional Investors schemes, and later on were provided with more options such as the China Interbank Bond Market and Bond Connect, which have no specific quota or lock-up period restrictions. The innovation of Panda Bonds allowed foreign issuers to tap into domestic investors, which gradually opened up to a larger pool of international investors utilizing Bond Connect.

If we consider the capital markets as a pool, crucial factors to enable it to mature include enlarging the pool volume, increasing the amount of flows, and making the flows consistent. For this reason, allowing more companies to be listed and gradually opening up to foreign investors serve the first two purposes well. In recent years, as China A-shares have been added to Morgan Stanley Capital International's emerging market index, and China's domestic bond markets into the Bloomberg Global Aggregate index, the third purpose of consistent flows is slowly being achieved *(Chart 1)*.

2) "Liberalization Forces Internal Reforms"

China has a track record of *"kai fang dao bi gai ge"* – which literally means "liberalization forces internal reforms." Joining the WTO and the subsequent economic boom testify to the strategy. By

CHART 1
Market capitalization by stock exchanges
(as of May 2019)



Note: By 2019, Chinese stock exchanges, including Shanghai and Shenzhen Stock Exchanges, and Hong Kong Exchanges, are among the largest stock exchanges in the world by market capitalization.
Source: Compiled by the author based on Statista

the same logic, faster liberalization could transform the domestic market into a more robust one.

China's stock market has exhibited price swings, with likely reasons being thin trading, the investor mindset and investor composition. For a stock market to be healthy, there needs to be an appropriate mix of three strategies – value investing, relative investing and speculation. The Chinese stock market is driven by the latter group of investors, who focus more on speculating on a market consensus and for short-term gain. Worse still, these investors are more often retail investors, with the remaining being a few wealthy insiders who are able to influence the market with their strong positions. There is a lack of long-term institutional investors who can inject large and constant volumes of capital. For this reason, welcoming foreign investors is a necessary step to change the environment.

As for the primary markets and financial service industry, welcoming foreign institutions is a step to increase the competitive market landscape in China. As mentioned, the Chinese financial service industry has been reliant on licenses in carrying out different lines of business. Foreign financial institutions that have reputable pricing ability, merger and acquisition experience and other services were only allowed limited business in China. This might breed a sense of complacency for domestic peers, and opening up services will hopefully create a more dynamic market and benefit more corporate clients.

3) Aligned with Macro Directions

Apart from rejuvenating the capital market itself, broad macroeconomic conditions also suggest a need to open up. Firstly, more investing and financing channels are needed for people and firms. As the Chinese population grows more affluent with a high savings rate (36.1% household savings rate in 2016), people struggle to find means to preserve and grow their wealth, with housing so far being the main investment opportunity – which rings a bubble alarm (https://tradingeconomics.com/china/personal-savings). Developing capital markets could help stabilize the housing market by providing people with a sustainable, long-term investment channel. Similarly, financing in China has historically been dominated by indirect financing, where larger commercial banks shouldered the main lending responsibilities. One obvious drawback is the lack of financing channels and the high level of information required to obtain loans, which for a period bred shadow banking and P2P lending that twisted the market dynamics.

Secondly, China is undergoing economic transition and carrying out a large-scale deleveraging campaign (at least before Covid-19 hit the country). Since the post-2008 4 trillion yuan ($586 million) stimulus package, China has experienced a surge in debt and prompted a policy response to deleverage, especially by cracking down on risky shadow banking and unlicensed lending practices. This, however, collides with the transition from a fast-growing economy to a modestly-growing economy, where ample financing means are still required to stimulate growth. Therefore, instead of merely shutting down informal funding channels, formal and more sophisticated channels such as stock, bond and derivatives markets should be developed to meet the growth needs of the economy. Especially for the bond market, a slowing economy with a well-managed inflation rate could benefit it due to likely lower interest rates. In fact, foreign investors have shown their appetite when rushing to find safety nets for their investments amid Covid-19, as they injected $10.7 billion into Chinese bond markets in February 2020 alone using the aforementioned liberalization policies (https://www.ft.com/content/41044876-6ab4-11ea-a3c9-1fe6fedcca75).

Japan's 1980s Financial Liberalization

People look at history when confused by current events, and Japan's history leading up to its lost decades alarms many. The valid reasons for such a comparison include a similar economic relationship with the US and a set of similar capital market liberalization policies. This section is a brief reminder.

1) Japan-US in the 1980s

Japan and the US have enjoyed an amicable relationship since World War II, with Japan's economy not only recovering but also flourishing after its war-torn state. Much of it could not have happened without US economic assistance. However, the late 1970s was tough for the US, when the sharp increase in oil prices coupled with soaring inflation and unemployment rates created stagflation. When its domestic policy of increasing interest rates could not suffice (instead further depreciating the dollar and widening the current account deficit), the US turned to Japan, its biggest trading partner, for "help" – which was not framed in a direct call for assistance, but reflected in a series of liberalization policies with the establishment of the Yen/Dollar Committee. Specifics are detailed below.

2) Japan's Liberalization Policies

Academics in Japan tend to view 1984 as a crucial point in its financial market development. ("Japan's Experience of Financial Deregulation Since 1984 in an International Perspective" by Kazuhito Osugi, *BIS Economic Papers No. 26*, January 1990). Before 1984, Japan had taken a gradualist approach to liberalization, with key events such as OECD membership in 1964, liberalization of direct and securities investment in the early 1970s and issuance of euro-yen bonds by non-residents in 1977. These events happened across two decades at a measured pace.

However, measures post-1984 were seen as sudden if not rushed. Bilateral dialogue between Japan and the US outlined three goals – Japanese capital market liberalization and deregulation, internationalization of the yen, and strengthening of the yen.

For the former two goals, a series of policies were introduced to drastically lower the barriers to capital flows. For the equity markets, the Tokyo Stock Exchange's (TSE) full opening to foreign membership was one of the most notable events. Though permission was theoretically allowed in 1971, the actual membership was minimal due to policy revisions and quotas. In 1985, such limits were scrapped, and six foreign securities companies were immediately listed on the TSE. For the bond markets, international bond issues experienced rapid deregulation as requirements for foreign issuers were eased substantially. The derivatives market was further developed after revision of the Securities and Exchange Act in 1985, as futures began to be traded on the TOPIX and Nikkei 225 index.

The US not only wanted an enlarged market, but also greater business opportunities for their underwriters, which resembles the current Chinese policies. In 1984, the Ministry of Finance gave the right for foreign underwriters to be lead managers in euro-yen bond underwriting, and in 1985 foreign banks were allowed to conduct securities business.

The immediate effects of financial market liberalization were the fluid flows of foreign capital in and out of Japan. Unlike FDI investments that are more long-term and support the real economy, securities investment flows tend to be "hot money" that is driven by short-term capital gains. Risks are more imminent with the easing of capital controls *(Photo)*.

Photo: Japanese book "The Outlook for the Capital Tokyo" (Seiji-Shimbun Sha, c. 1960)

Tokyo Stock Exchange's original building in 1960

3) Plaza Accord & Bursting of the Bubble

However, liberalization and deregulation at best lowered the barrier of hot money entry. What explained the motivation behind such entry and the actual build-up of the stock and real-estate bubbles was more a combination of Japanese consumer sentiment, the effects of the Plaza Accord, and an expansionary monetary policy. For the US, the most important goal was to strengthen the yen and correct its trade imbalance. In the late 1970s, the dollar-yen exchange rate was around 300 yen and after the Plaza Accord the yen strengthened sharply to 130 yen to the dollar in 1987 (https://www.macrotrends.net/2550/dollar-yen-exchange-rate-historical-chart). Such currency appreciation not only created an illusion for the already affluent Japanese consumers to pour investments into stock and real-estate markets, but also attracted foreign capital inflows from those who were equally eager to bet on a bull market. Coupled with expansionary monetary policies, the basic discount rate dropped seven times from 6.25% in 1981 to a historical low of 2.5% in 1987 (https://www.boj.or.jp/en/statistics/boj/other/discount/index.htm/), and the consensus among individuals and businesses alike was to borrow more and invest more. From 1980 to 1989, the Nikkei 225 grew exponentially from 6,000 to 38,000, creating a stock miracle. Japan's Real Residential Property Price Index also increased from 120 to 170 during this decade (https://www.ceicdata.com/en/indicator/japan/real-residential-property-price-index).

Even so, the lost decades cannot be entirely attributed to a strengthening yen, but more to a policy response to the bubble. Instead of slowly deflating the balloon, the Yasushi Mieno monetary policy chose to burst the bubble by drastically levering up the interest rate engine. From 1987 to 1990, a mere span of three years, the basic discount rate was increased five times from 2.5% to 6%, putting a sudden halt to the borrowing momentum. The stock market and real-estate market collapsed accordingly, leaving many out of work yet burdened with life-time mortgages *(Chart 2)*.

Comparison

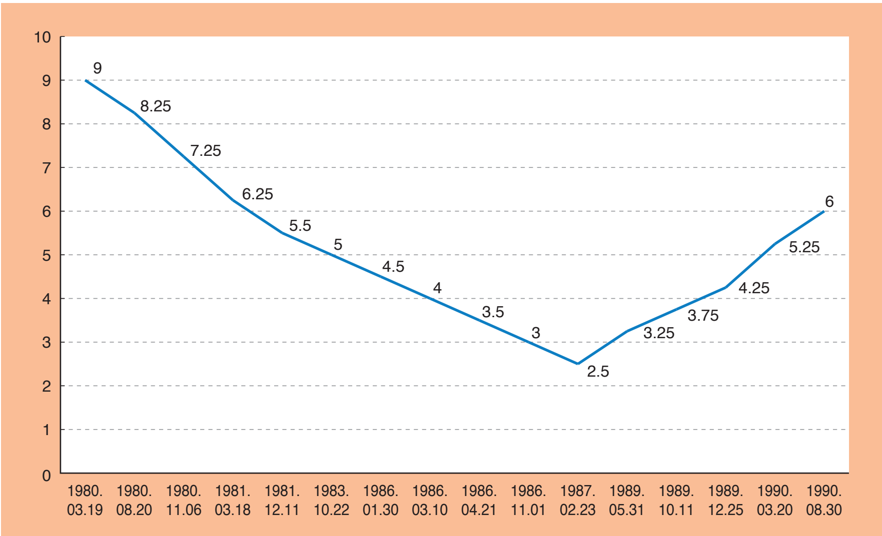
Though similar in many ways, I believe the policies taken by China and Japan are fundamentally different on two levels – rationale and extent.

1) Difference in Rationale

As discussed, China is undergoing a transition where macroeconomic conditions propel the need to open up its capital market. Slowing economic growth, the transition from an export-driven to a consumption-led economy, and lingering debt problems require a more robust capital market to support these changes. While a capital market is indeed a ground for negotiation amid trade tensions with the US, many of the policies were originally scheduled

CHART 2

Japan's Basic Discount Rate from 1980 to 1990



Note: Rates here are Discount Rate of Commercial Bills and Interest Rates on Loans Secured by Government Bonds, Specially Designated Securities and Bills Corresponding to Commercial Bills (abolished on Jan. 4, 2001).

Source: Compiled by the author based on the Basic Discount Rates and Basic Loan Rates, Bank of Japan

for 2021 and only brought forward to 2020.

Regardless of the broader environment, developing top-tier financial centers is always a mid- to long-term goal for the central government, and we could not achieve it without a mature capital market. Current policies also fit under the two pillars of "reform" and "open up", which have shaped China's post-1978 economic history. Gradual opening up is necessary to force domestic participants to reform and auto-correct themselves, whether it be in their investing mindset or business competitiveness.

Japan's liberalization policies came at a time of already highly fluid, mature capital markets and without many macroeconomic concerns. Its rapid liberalization and deregulation to a very large extent was US-driven. Hence, China's policies could be considered as pressure from within, whereas Japan's were more of pressure from outside.

2) Difference in Extent

Another major difference lies in the extent of liberalization, especially regarding the scale, the pace, and the bottom line of domestic policies. In 2019, before this policy round, even though by absolute number China's A-share market was a substantial $8 trillion by market capitalization, foreign ownership was only 2.7% (http://docfinder.bnpparibas-am.com/api/files/E22A3C33-1691-455D-AFD1-7407D1BACBAE). China's capital market was barely open in the first place and hence had room to be opened up. The policies, as discussed were rolled out over a long time span as compared to the sudden push of policies in Japan in the 1980s.

Most importantly, China remains committed to its bottom line of capital control, which in extreme conditions could prevent massive capital flights and impact on the Chinese currency. In fact, one of the most common arguments for not worrying too much about liberalization is that foreign capital that flows in would not flow out as easily as might be wished, as tight restrictions are still in place. At least for the time being, China shows no sign of compromising on its currency or engaging in a policy as extreme as the Plaza Accord. Even so, the Plaza Accord was not the direct cause of the lost decades, considering the later monetary policies.

Conclusion: Measured Optimism

Much of the discussion has the benefit of hindsight – if we were Japanese in the 1980s we most likely would not have foreseen a crisis coming. However, if history is of any value, it teaches us how to act today to the best of our abilities. There are objective observations: China today has valid reasons from within to open up its capital markets, it is doing so at a measured pace, and it is not compromising its bottom line. This at least provides a dose of optimism, but it should be a measured one. Such observations can only be proved to be facts in hindsight, and an overly optimistic outlook in itself influences investor mentality and could make problems worse than they seem. Only measured optimism allows investors and policy makers alike to constantly monitor situations and make rational decisions accordingly.

On the other hand, though foreign players are invited to a lucrative game, they have little control over the rules of the game and are put on the same level playing field as their peers. Ultimately, capital markets work by the golden doctrine of risk and reward. Liberalization brings down competition barriers and creates more rewards, but who reaps them most will depend on the player's ability and risk appetite. JS

Ziyue Li is an undergraduate student in the ESSEC-Keio Double Degree program, and has a strong interest in international business and finance. She has lived and studied in China, Singapore, France and Japan.