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China's rising stature in global finance

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The country's financial markets are deepening, foreign investment keeps pouring in, and capital is flowing outward. What would it take for China to assume a new role as world financier?

China, as the world's largest saver, has a major role to play in the global financial rebalancing toward emerging markets. Today, these countries represent 38 percent of worldwide GDP but account for just 7 percent of global foreign investment in equities and only 13 percent of global foreign lending.[1] Their role seems poised to grow in the shifting postcrisis financial landscape, since the advanced economies face sluggish growth and sobering demographic trends. As a lead player in that shift, China could become a true global financier and, with some reform, establish the renminbi as a major international currency.

Yet a long-closed economy—even one with more than $3 trillion in foreign reserves—can't swing open its doors overnight. China's domestic financial markets will have to deepen and develop further, and returns earned by the government, corporations, and households must rise if the country is to attract and deploy capital more effectively. At the same time, the barriers that prevent individuals and companies from investing more freely outside the borders of China, and foreigners from investing within them, will have to diminish gradually, and the country must build the trust of global investors. Continued reform in China, coupled with its vast domestic savings and outsized role in world trade, could make the country one of the world's most influential suppliers of capital in the years ahead.

Growth and growing pains in China's markets

As China's financial markets have become more robust and deeper, the value of its domestic financial assets—including equities, bonds, and loans—has reached $17.4 trillion, trailing only the United States and Japan (Exhibit 1). That's a more than tenfold increase in a span of two decades, and it doesn't include Hong Kong's role in channeling funds to and from China.

In contrast to most advanced economies, where lending has been stagnant amid widespread deleveraging, bank loans in China have grown by $5.8 trillion since 2007, reaching 132 percent of GDP—higher than the advanced-economy average of 123 percent. About 85 percent of that Chinese lending has been to corporations; households account for the rest. This rapid growth has raised the specter of a credit bubble and a future rise in nonperforming loans, though regulators have attempted to slow the pace in overheated areas such as real estate.

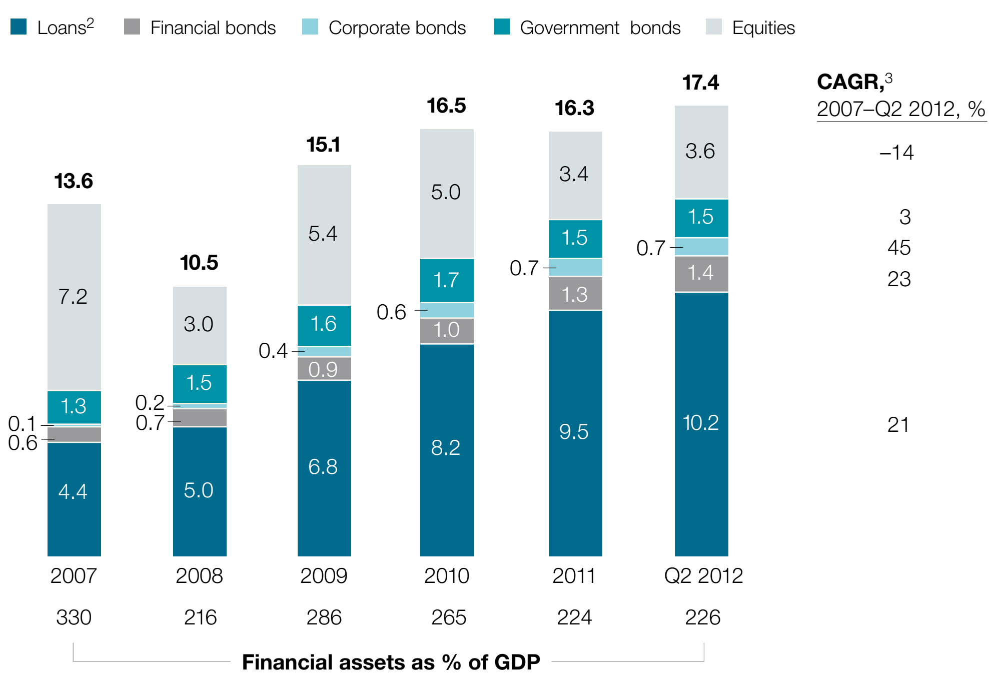
China's corporate-bond market is also developing. Bonds outstanding from nonfinancial companies have grown by 45 percent annually over the past five years, bonds from financial institutions by 23 percent.[2] There is ample room for further growth, since China's levels of bond-market borrowing are significantly below those of advanced economies. Indeed, bond financing could provide an alternative source of capital for the country's expanding corporate sector, enabling banks to increase their lending to households and to small and midsize enterprises.

Unlike many major equity markets, China's stock market has not rebounded since the financial crisis and global recession. Total market capitalization has fallen by 50 percent since 2007, plunging from $7.2 trillion in 2007 to $3.6 trillion in the second quarter of 2012. Investors sent valuations soaring at the market's peak, but fears of a slowdown and a more realistic view of company valuations dampened their enthusiasm,

Exhibit 1

A surge in lending has boosted China's financial assets by $3.8 trillion since 2007, but growth has not kept pace with that of GDP.

China's financial assets outstanding, $ trillion[1]



[1]Constant 2011 exchange rates; figures may not sum to 100%, because of rounding.
[2]Sum of securitized and nonsecuritized loans.
[3]Compound annual growth rate.

Source: McKinsey Global Institute analysis underscoring the fact that China's equity markets, like those of other emerging economies, remain subject to sharp swings.

Cross-border investment surges

China has defied global trends in cross-border capital flows, which collapsed in 2008 and remain 60 percent below their precrisis peak. For China, by contrast, foreign direct investment (FDI), cross-border loans and deposits, and foreign portfolio investments in equities and bonds are up 44 percent over 2007 levels (Exhibit 2). Total foreign investment into China reached $477 billion at the end of 2011, exceeding the 2007 peak of $331 billion.[3] Foreign companies, eager to establish a presence in China, account for roughly two-thirds of the inflows.

Capital from foreign institutional and individual investors could provide another leg to growth as long-standing restrictions on foreign portfolio investment continue to ease. The number of qualified foreign institutional investors (QFII) approved by Chinese regulators has grown from 33 in 2005 to 207 in 2012 and will undoubtedly rise further. Regulators also are giving registered foreign funds more latitude to invest their holdings of offshore renminbi in China's domestic capital markets. Both moves have further opened the door to foreign participation in those markets.

Famously, the People's Bank of China, the nation's central bank, has accumulated the world's largest stock of foreign-currency reserves: $3.3 trillion at the end of 2012. While much of this money is invested in low-risk sovereign debt—for instance, US treasuries, which account for at least $1.2 trillion of China's reserves—the growth in such investments has slowed considerably. Instead, China is both loosening restrictions on other types of financial outflows and moving to diversify its foreign holdings. That was the impetus behind the 2007 creation of the China Investment Corporation (CIC), one of the world's largest sovereign-wealth funds, with assets of $482 billion. CIC's holdings include shares in many of the world's blue-chip companies; mining, energy, and infrastructure projects; global real estate; and even a stake in London's Heathrow Airport.

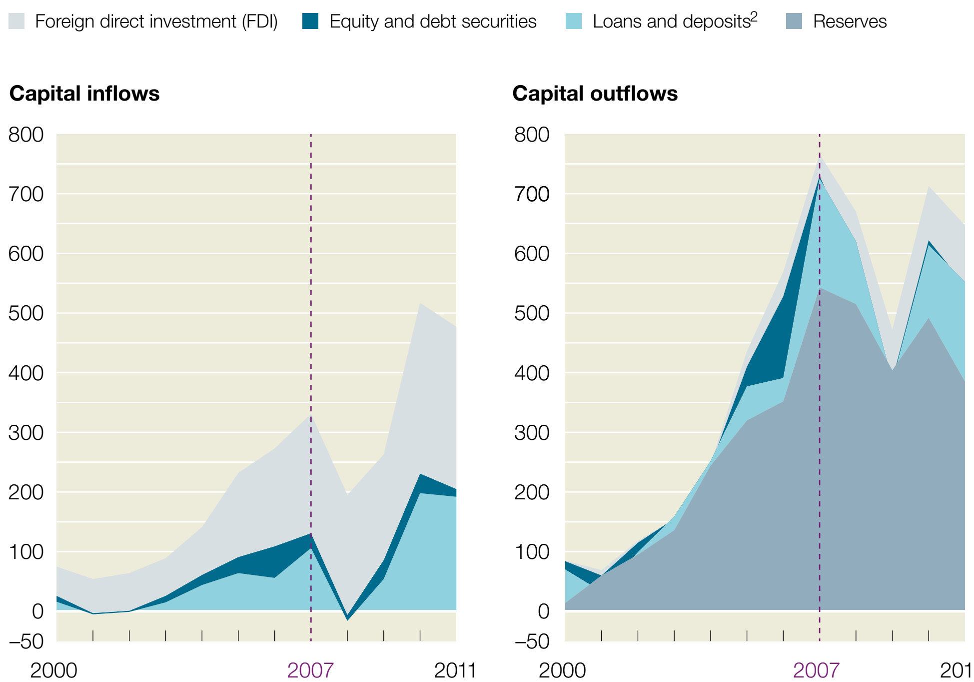
Chinese companies are also stepping up their role in global finance. Foreign direct investment by both state-owned and private-sector Chinese companies grew from just $1 billion in 2000 to $101 billion in 2011. At the end of 2011, Chinese companies accounted for $364 billion of global foreign direct investment, with most of it tied to commodities. About half of these investments went to other emerging markets—a share higher than that for companies in advanced economies.

Much of China's rapidly increasing global lending is tied to foreign investment deals involving Chinese companies (for instance, financing a mine in Peru, with construction to be undertaken by a Chinese company). Outstanding foreign loans and deposits totaled $838 billion at the end of 2011. To put this sum in perspective, consider

Exhibit 2

China's capital flows have been approaching new heights.

China's capital inflows and outflows, $ billion[1]



[1]Constant 2011 exchange rates.
[2]In 2008, inflows of loans and deposits totaled –$16 billion, while in 2009 outflows of loans and deposits totaled –$19 billion.

Source: McKinsey Global Institute analysis

the fact that the total level of loans outstanding from the world's five major multilateral development banks is about $500 billion. Since 2009, Chinese loans to Latin America have exceeded those of both the Inter-American Development Bank and the World Bank (Exhibit 3).

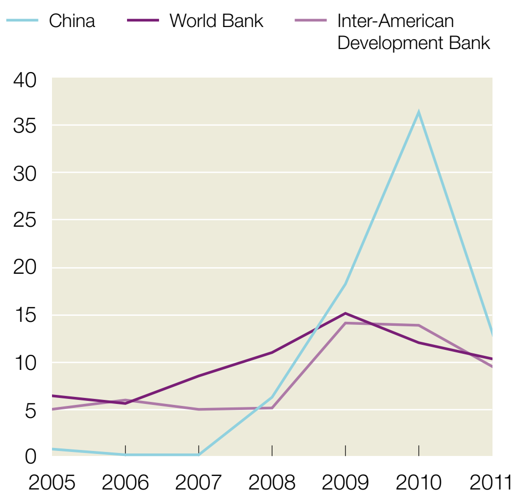
Africa is another priority. At the 2012 Forum on China–Africa Cooperation, China pledged an additional $20 billion in new lending to that continent over the next three years. In March 2013, President Xi Jinping traveled to Africa for his first overseas trip as head of state, reaffirming this lending pledge and signing an agreement to build a multibillion-dollar port and industrial zone in Tanzania.

So far, the returns on many of China's investments at home have been below their cost of capital. There is almost an expectation of low returns—in some cases, negative real returns—on corporate invested capital, on domestic bank deposits, and even on returns the government earns on its foreign

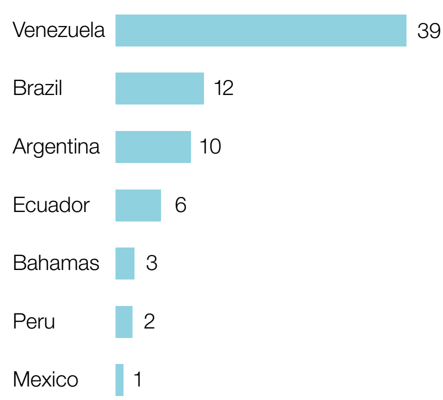
Exhibit 3

China now provides a higher volume of loans to Latin America than the World Bank and the Inter-American Development Bank.

Annual flow of bank loans to Latin America, $ billion



Recipients of Chinese lending in Latin America, cumulative flows, 2005–11, $ billion



Source: World Bank; Inter-American Development Bank; Inter-American Dialogue; Heritage Foundation; McKinsey Global Institute analysis

reserves. The returns that will be earned on many of China's recent foreign direct investments and foreign loans remain to be seen. The pace and process of the migration to market-level returns will be a challenge for policy makers.

The long road to renminbi convertibility

As China's economy and financial clout continue to grow, so will use of the renminbi. China has aspirations to make it an international currency, perhaps eventually rivaling the US dollar and the euro for global foreign reserves. But realizing these ambitions will require substantial progress on several fronts.[4]

One is developing deep and liquid domestic capital markets for renminbi-denominated financial assets. Despite the progress described above, China's financial depth (the total value of its financial assets as a share of GDP) remains less than half that of advanced economies. Developing larger bond markets, as well as derivatives markets to hedge currency and other risks, will be essential.

To take on a greater global role, the renminbi must also become an international medium of exchange. In recent years, China has promoted the use of its currency to settle international trade contracts; for instance, it has created swap lines to supply renminbi to

15 foreign central banks, including those of Australia and Singapore. As a result, the use of the renminbi in China's trade has grown from around just 3 percent several years ago to an estimated 10 percent in 2012. According to a survey by HSBC, Chinese corporations expect one-third of China's trade to be settled in renminbi by 2015.[5]

However, to become a true international currency, the renminbi will have to be fully convertible—meaning that any individual or company must be able to convert it into foreign currencies for any reason and at any bank or foreign-exchange dealer. China's central bank has acknowledged that the time has come to move in this direction and accelerate capital-account liberalization,[6] and it recently outlined both short- and long-term road maps for this process. Short-term moves could include reducing controls on investment directly related to trade and encouraging Chinese enterprises to further increase outward foreign direct investment. For the longer term, the bank has outlined actions such as opening credit channels to flow both into and out of China and moving from quantity- to price-based approaches to monetary policy management. And over time, China will need to build trust in its institutions by developing a set of rules, applying them consistently, and sticking with them.

For now, however, the doors remain only partially open. Achieving the institutional development needed to fully liberalize capital accounts and remove currency controls will take time.

To assume the role of financier to the world, China will have to embrace financial globalization and advance reform more fully, and that won't happen overnight. There is already movement toward greater openness, though, which makes China's recent once-in-a-decade leadership transition a telling moment: if the new economic team picks up the pace of reform, the world financial system could have a very different look in just a decade's time. o

1 This article is based on the McKinsey Global Institute report *Financial globalization: Retreat or reset?*, March 2013, mckinsey.com.

2 Compound annual growth rate.

3 The 2011 data are the latest available from the Chinese government on capital inflows and outflows.

4 A number of papers have been written about the internationalization of the renminbi. See, for instance, Eswar Prasad and Lei (Sandy) Ye, *The renminbi's role in the global monetary system*, Brookings Institution, February 2012.

5 See "RMB maturing as cross-border usage broadens, says HSBC survey," Hongkong and Shanghai Banking Corporation, hsbc.com.tw, October 24, 2012.

6 See the full report, *Accelerating capital-account liberalization* (in Chinese), People's Bank of China, cs.com.cn, February 23, 2012.

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