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CHINA'S PATH TO OPEN MARKETS

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Dianna Raedle is CEO/Founder/Managing Director of Deer Isle Group and is responsible for all activities, including investment management. Dianna has over 20 years of experience in both public and private markets across the capital structure, specializing in emerging markets and special situations.

In 2012, Dianna identified an attractive investment opportunity in the Chinese onshore fixed income market and has partnered with one of China's largest asset managers to provide institutional investment management service to US/International investors who want to access the market. A China-focused fixed income strategy fund ("Deer Isle-Bosera RMB Income Fund") also has been launched to provide such access.

Since founding Deer Isle, Dianna has raised approximately $5 billion in assets and has advised numerous companies and funds with regard to their strategy, structure and capital raising.

Prior to founding Deer Isle Group, Dianna co-founded Millennium Americas where she was a member of the Investment Committee and was on the investment team. Millennium Americas was an advisor to Millennium Global Investments Ltd., an ~$12 billion London based investment management company for the Millennium Global Special Situations Americas Fund (MGSS). Prior to Millennium Americas, Dianna had extensive experience creating highly structured transactions at ABN AMRO, and SBC Warburg Inc, where she was a Director and at Credit Suisse First Boston (London and Switzerland), where she was a Vice President.

Dianna is on the Board of Directors for the Harvard Business School Club of New York and is Board Emeritus for the Harvard Business School Club of New York Community Partners program. In addition, she is a mentor and teaches a work shop for the Princeton University Keller Center for Technology and Entrepreneurship. She is also a 2011 winner of the International Women's Entrepreneurial Challenge, sponsored by the Manhattan Chamber of Commerce.

Dianna has an MBA from Harvard Business School and a BA from Princeton University. She has Series 7, 24, 63, 65, 79 and 99 Registrations.

Introduction

China's path to opening its capital accounts and markets has been well broadcast since 2012. The approach to opening its markets is consistent with China's general approach to change, which is to state the goal, make a long term plan, and try to balance competing interests/agendas as the plan is implemented.

This paper analyzes the path that China has taken in letting market mechanisms influence or set it's Capital Accounts, Currency Markets, Equity Markets, and Fixed Income Markets, and Interest Rates. The reforms are being implemented while balancing China's goal of continuing to build its rising middle class.

The plan to create a fully developed market mechanism for China's financial accounts has been in place since 2012 and has been restated in the annual official announcements with concrete annual actions being implemented since that time (which are outlined in the paper).

China's implementation has been slow (at least according to Western standards) and steady despite several well publicized falters.

Given the distance that China has traveled in less than 5 years and the extent to which its economic growth depends upon maximizing share of global GDP, it is hard to imagine that China will turn the clock back on its achievements. China clearly understands the waters it is trying to navigate and has repeatedly stated that plans to open its accounts are integral to being able to continue to sustain long term growth.

Quotes from China's Economic Outlook at the Beginning of the 2016 Year by Authoritative Person:

"The Five Tasks of supply-side structural reforms is a systemic project and each one is very arduous. As the Five Tasks are complementary with the each other, they need to be thoroughly planned. During execution, various stages should have different focuses ("rice should be eaten mouth by mouth and works should be done step by step"). Since the beginning of this year, a number of policies have been carried out. For instance, we have reduced enterprise costs and put more effort into improving shortcomings. Next step, we will proceed with reducing excess production capacity and closing "zombie" enterprises. This is a challenging issue that involves people and money, which means employment and debt.

- Our goal is to further reduce administrative intervention and let the market play a decisive role. However, "It's better for the doer to undo what he has done". Reducing government intervention requires the government to reform itself.
- The government should not intervene in areas where the market has already played a positive role and requires no administrative intervention."

- from the full article published on the website of People's Daily, government official media, 5/9/2016[1]

1. Source: People's Daily, http://paper.people.com.cn/rmrb/html/2016-05/09/nw.D110000renmrb_20160509_6-01.htm (in Chinese).

Developed and EM Countries Implement Capital Controls: Free Market Includes Controls

Even though, the Western perspective is that open capital accounts means no or very limited financial controls, the IMF, after the 2008 global financial crisis has stated that full liberalization of capital accounts is not appropriate in all countries at all times (Figure 1).

In addition, the IMF's tracking of capital accounts demonstrates that most countries have capital controls on major capital account categories. For example, according to the IMF, the US has controls on 8 categories while China has controls on 10 (Figure 2).

China does have more to accomplish in this area but its progress is clearly recognized.

Figure 1: IMF Quotes on Capital Account Control

IMF: "…Countries with extensive and long-standing measures to limit capital flows are likely to benefit from further liberalization in an orderly manner. There is, however, **no presumption that full liberalization is an appropriate goal for all countries at all times**…For countries that have to manage the macroeconomic and financial stability risks associated with inflow surges or disruptive outflows, **a key role needs to be played by macroeconomic policies, including monetary, fiscal, and exchange rate management**…"[1]

Figure 2: Features of Exchange Arrangements and Regulatory Frameworks for Current and Capital Transactions for Selective IMF Members

Capital Account Control on (total 11 categories)	Total number of countries with control features		China (10/11)	Germany (9/11)	US (8/11)	UK (7/11)	France (6/11)	Canada (4/11)	Japan (2/11)
	2010[2]	2014[3]	2014	2014	2014	2014	2014	2014	2014
1. Capital Market Securities	144	151 (↑)	•	•	•	•	•	•	•
2. Money Market Securities	124	127 (↑)	•	•	•	•	•		
3. Collective investment securities	121	127 (↑)	•	•	•	•	•		
4. Derivatives and other instruments	94	101 (↑)	•	•	•				
5. Commercial credits	86	85 (↓)							
6. Financial credits	120	115 (↓)	•	•					
7. Guarantees, sureties, and financial backup facilities	80	78 (↓)	•		•				
8. Direct investment	148	151 (↑)	•	•	•	•	•	•	•
9. Liquidation of direct investment	47	42 (↓)	•						
10. Real estate transactions	146	144 (↓)	•	•	•	•			
11. Personal capital transactions	97	94 (↓)	•						
Provisions specific to: Commercial banks and other credit institutions	166	170 (↑)	•	•		•	•	•	
Provisions specific to: Institutional investors	138	143 (↑)	•	•	•	•	•	•	

• means the specified practice is a feature of a country's foreign exchange system

1. Source: IMF, The Liberalization and Management of Capital Flows: An Institutional View. Link: http://www.imf.org/external/np/pp/eng/2012/111412.pdf.
2. Source: IMF, 2010 Annual Report on Exchange Arrangements and Exchange Restrictions. Link: https://books.google.com/books?id=krjuo2UrxekC&pg=PA69&source=gbs_selected_pages&cad=3#v=onepage&q&f=false.
3. Source: IMF, 2014 Annual Report on Exchange Arrangements and Exchange Restrictions. Link: https://www.imf.org/external/pubs/nft/2014/areaers/ar2014.pdf.

China's Perspective: Continued Capital Account Opening Is Essential to Achieve Strategic Policy Goals

China's long term goals, beginning in 1996 (as was laid out in the 9th 5 year plan, Figure 3) are to have an open capital account and to have fully functioning market driven debt/equity capital markets.

China's long term statements about its goals have not deviated much from this path (Figure 3 & 4).

China has achieved many milestones in its quest to open its markets and it continues to be focused on these goals while being realistic about its economic outlook.

Major benefits of opening capital account (which includes currency, debt, and equity markets), according to China, include:

- Provide financial support to the real economy to promote favorable economic growth and full employment
- Achieve external economic balance – stable and long term trade balance to help internal economic balance (favorable growth, full employment and price stability)
- Enhance the influence of China over global economic/financial issues
- Minimize the risk of China's FX Reserves under the current Global Monetary System where US dollar, Euro, and Japanese Yen domain
  - China has $ 3.2 trillion foreign exchange reserves subject to foreign exchange risk[3]

Figure 3: China's 9th 5-year Plan about National Economic and Social Development

"Actively develop the stock and bond markets... Improve the interest rate and currency rate regime…Gradually achieve the capital account full convertibility…"[1]

Figure 4: China's Economic Outlook at the Beginning of 2016 by Authoritative Person

"…In general, China's economic performance will not be **U-shaped** and definitely not **V-shaped**. It will be **L-shaped** for more than one or two years…For now and near future, **supply-side structural reform must be strengthened and on target**, while demand-side reform would aim to create favorable conditions to solve the principal contradiction. Investment should be appropriate rather than excessive. **We should not confuse the priority**…"[2]

Figure 5: Milestones of China's 4 Financial Market Reform Themes

Capital and Financial Account Opening
- 85% of the 40 subcategories under Capital Account have been Partially or Mainly Convertible (See Appendix 1)
- 10 out of the 11 categories under Capital Account have control features, compared to 8 of United States

Developed Multi-layer Capital Market
- China now owns the 2nd largest equity market globally in 2015
- China now owns the 3rd largest bond market globally in 2015
- International access has been improved for both markets significantly

Currency Regime Reform
- RMB was recognized as "freely usable" by IMF and included as one of the SDR currencies in 2015
- RMB is now allowed to float freely against other currencies (PBoC will intervene when the currency is volatile)

Interest Rate Reform
- Bank lending rate floor and deposit rate ceiling were fully removed in 2015 to allow better credit pricing/capital allocation
- Defaults of corporate bonds are allowed for private enterprises and SOEs

1. Source: People.com.cn, the official media website, 3/18/2001. Link: http://www.people.com.cn/GB/shizheng/16/20010318/419582.html.
2. Source: People's Daily, the official media, 5/9/2016. Link: http://paper.people.com.cn/rmrb/html/2016-05/09/nw.D110000renmrb_20160509_6-01.htm.
3. Source: State Administration of Foreign Exchange, 06/30/2016. Link: http://www.safe.gov.cn/.

PBoC, In 2012, Listed Execution Priorities For an Open Capital Account

In 2012, China laid out it's long term goal for opening its capital accounts and for creating financial reforms that allow markets to set financial pricing. China's macro approach is to risk weight its actions to try to achieve the most return with the least systematic financial risk. The devil is in the implementation details as is recognized by the Chinese government (Figure 6).

From an outsider's perspective, the details sometimes can be contradictory as different goals are balanced. However, overall, the trend is clearly on the side of economic liberalization (Figure 7 & 8).

Figure 6: Quotes from China's Economic Outlook at the Beginning of 2016 by Authoritative Person

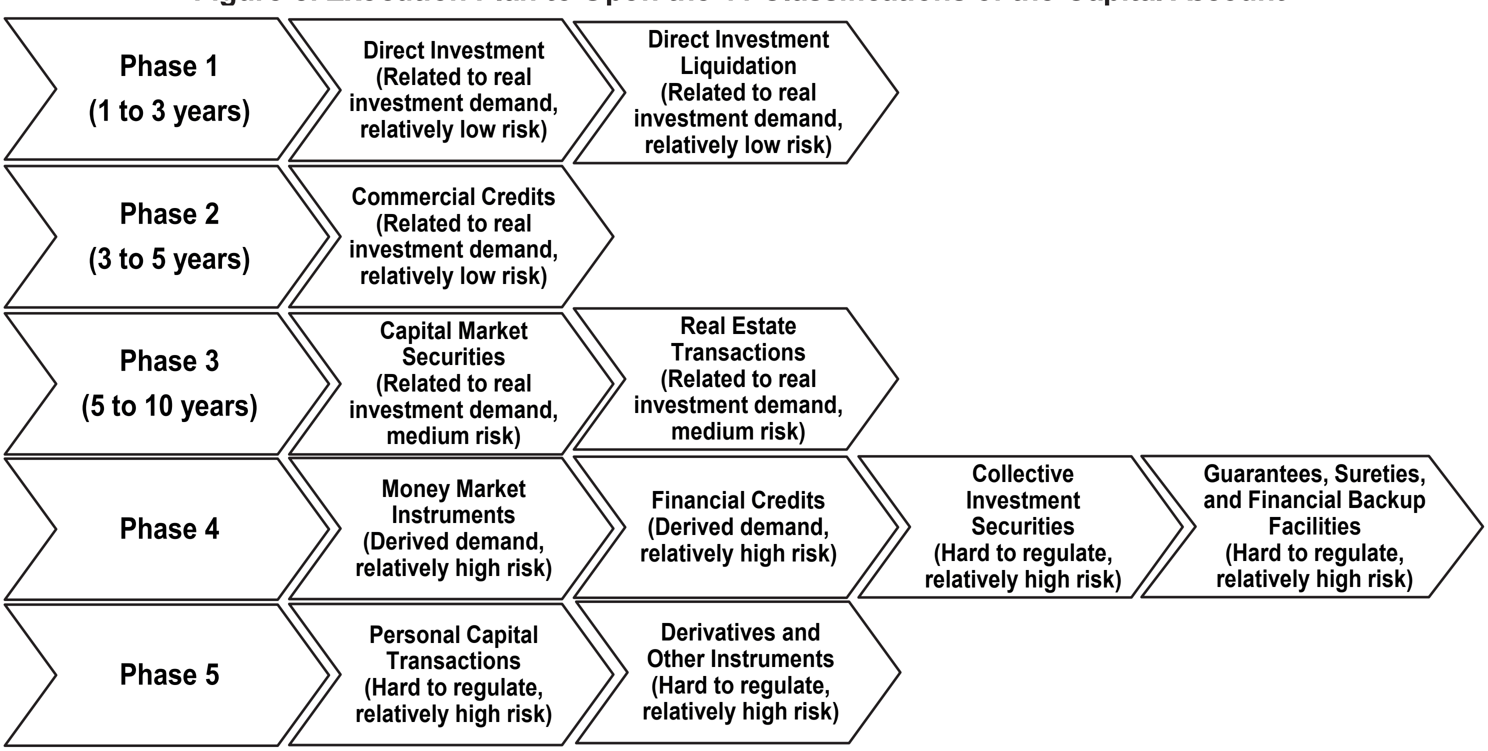
"…Second, make sure the central government's decided policies are fully executed. The central government has emphasized several times that 10% of the job is deployment and 90% is implementation. Appropriately expanding the aggregate demand and promoting the supply side structural reform have been the consensus of various parties. Through working to move forward in the decided direction can we solve the problems that constrain economic development and make the situation better and better…"[1]

Figure 7: China's Priority Guideline for Opening Capital Account[2]

China's priorities for opening the capital account are:

- Start from the accounts that provide highest expected returns, lastly those with highest risks
- Start from the accounts that have real demand, lastly those with speculative demand
- Start with marginal change, lastly with the existing base

Figure 8: Execution Plan to Open the 11 Classifications of the Capital Account[2]



1. Source: People's Daily, the official media, 5/9/2016. Link: http://paper.people.com.cn/rmrb/html/2016-05/09/nw.D110000renmrb_20160509_6-01.htm.
2. Source: The Current Situation and Outlook of RMB Capital Account Opening (in Chinese), Shusong Ba and Zilong Zheng, 7/6/2016. Link: http://money.163.com/16/0404/21/BJRB15TU00253B0H.html.

Capital Account Reform: Annual Announcements/Actions

China's open capital account is being implemented with multiple initiatives and, at this point, 85% of the 40 capital account items are considered to be partially or mainly convertible (Appendix 1). Considering China is the world's second largest economy, its reforms seem to demonstrate significant progress integral to China's growth (Figure 9 & 10).

Figure 9: Quotes on Capital Account Opening in Annual Announcements and Following Execution

2012		2013		2014		2015		2016	
Official Quotes[1]	**Execution**	**Official Quotes[1]**	**Execution**	**Official Quotes[1]**	**Execution**	**Official Quotes[1]**	**Execution**	**Official Quotes[1]**	**Execution**
• **Achieve the full opening of capital account** and **freely convertible RMB**, and increase the usage of RMB in cross border trade and investment	• Launched **RQFII regime** after the launch of QFII in 2006 to allow foreign investors invest in domestic market[2]. • PBOC allowed **more lending quotas** for multinational corporations (MNCs) to support RMB globalization[3].	• **Achieve the full opening of capital account** and **free convertibility of RMB**, and increase the usage of RMB in cross border trade and investment	• **Shanghai Free Trade Zone** was set up as a trial program to help implement a more active opening-up strategy[4]	• Increase the usage of RMB in cross border trade and investment	• China's **foreign direct investment (FDI) rose** to a record $119.56 billion, while **outbound direct investment (ODI) surged** to a new high of $102.9 billion [5].	• **Achieve the full opening of capital account** and **free RMB convertibility**, and increase the usage of RMB in cross border trade and investment • Accelerate setting up RMB global payment and settlement system • Initiate the trial of QDII2, start SZ-HK Stock Connect and develop a multi-layer capital market	• Promoted the Shanghai Free Trade Zone experience and set up **Guangdong, Tianjin and Xiamen Free Trade Zones**[6]. • **The RMB global cross border inter-bank payment system** was set up[7]. • **Mutual Recognition of Funds** program was launched to allow international fund managers to distribute funds in Mainland[8].	• Promote a fully-opened personal capital accounts items • Gradually increase and ultimately remove the quota limitation for outbound and inbound investments	• **85% out of the 40 capital account items have been partially or mainly convertible[9]** • QFIIs and RQFIIs have grown dramatically[10] •China to open commodities futures to foreign investors[11]

Source: Official quotes are from the annual addresses (which are the government's annual working plans) delivered by the Premier to the Chinese Congress. Please see detailed footnotes in Appendix 2.

Figure 10: Quotes and Execution for Capital Account Opening at Different Government Levels

2012: "…**Gradually open the capital account to promote the RMB convertibility** …and to increase the usage of RMB in cross-border transactions."

- State Administration of Foreign Exchange (SAFE)

2013: "Key reform measures include…speeding up RMB capital account convertibility by **promoting the two-way opening up of capital markets**, and the easing of restrictions on cross-border capital and financial transactions."

- Xinhuanet, the official press agency of the PRC

2014: "China has proposed **cutting by more than half the number of sectors restricted or off limits to foreign investors**."

- The State Council of the People's Republic of China

2015: "China will realize the yuan's **full convertibility under the capital account** and expand its global reach."

- Premier of Republic People of China, Li Keqiang

2016: "China will further **ease foreign investors' access**…Sectors of finance, education, culture and logistics **will be opened wider to foreign capital**, and restrictions on high-end manufacturing will be relaxed."

- China Daily, the official English newsletter for the State Council Information Office

Approved Financial Market Access Has Been Continuously Increasing

Originally China only gave limited access to its financial markets under a QFII quota (which also had very limited liquidity). QFII quotas currently account for only about 1% of the onshore equity market and $80 billion has been granted to 273 foreign institutional investors (Figure 11).

The quota system then expanded to include RQFII quota which were originally issued, in 2011, to local Chinese asset managers to allow them to manage fixed income assets on behalf of international investors. Specific RQFII quotas currently account for only about 1% of the onshore bond market. Currently $77 billion RQFII quota has been granted for 168 funds (equity, bond and ETFs) managed by asset managers regionally (Figure 11). The RQFII quota restriction was further relaxed on Sep 6 2016 - prior approval will no longer be required (instead, a routine filing process with SAFE) if the quota being applied for is within a certain percentage of the RQFII's AUM (Basic Quota); only the quota amount exceeding the Basic Quota needs SAFE approval.

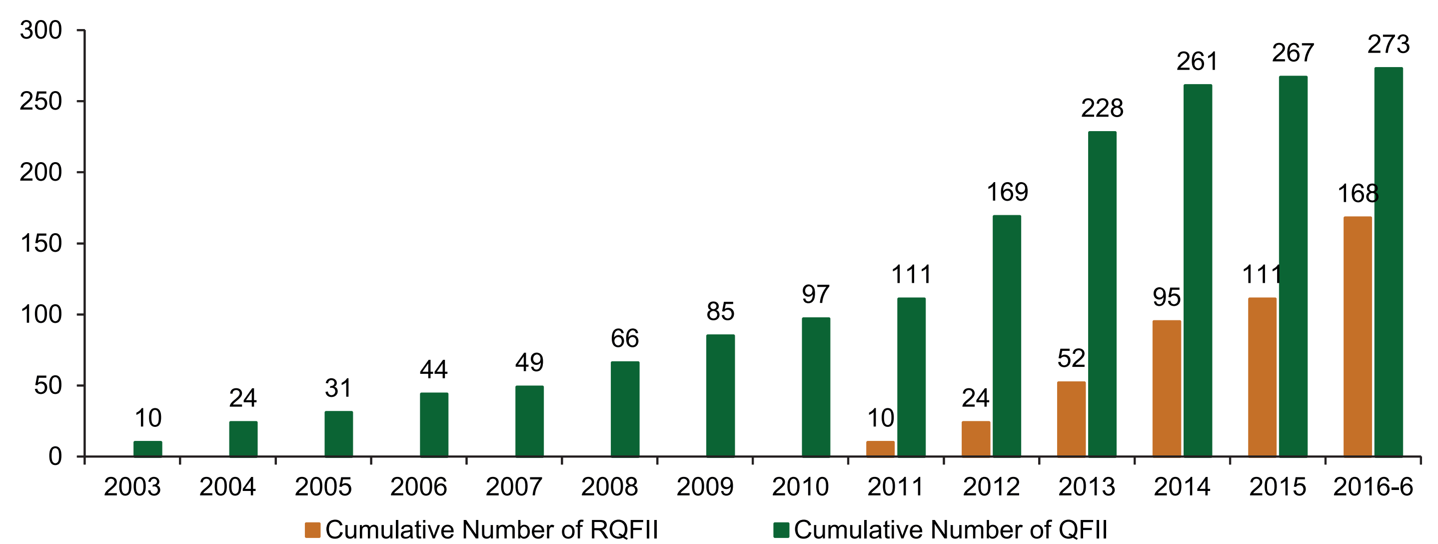
In addition to specific RQFII quota's there is $45 billion RQFII Quota for Shanghai – Hong Kong Stock Connect. And, with the successful experience of launching the Shanghai - Hong Kong Stock Connect, China is likely to not impose quota limit for the upcoming Shenzhen – Hong Kong Stock Connect (although daily limit applies). Furthermore, there is no quota limit for institutional investors' access to China's onshore interbank bond market.

Eligible regions for RQFII have also been expanded beyond Hong Kong to include Singapore, UK, France, Korea, German, Australia, Swiss, Canada and Luxembourg.

Finally, RMB internationalization progress is being accelerated by setting up more offshore RMB clearing centers including Hong Kong, Singapore, Bangkok, Kuala Lumpur, Seoul London, Frankfurt, Luxembourg, Paris, Doha, Toronto, and Sydney.

2012 RQFII Launched and Expanded Continuously Since Then → **2013** Shanghai Free Trade Zone Opened and Expanded → **2014** Shanghai Hong Kong Stock Connect Launched → **2016** China Interbank Bond Market Opened to Foreign Institutional Investors → **2016** Shenzhen Hong Kong Stock Connect Approved

Figure 11: Number of QFII and RQFII[1]



Currency Reform: Annual Official Announcements/Actions

China's currency reforms have been some of the most widely watched of its financial market reforms. China seems to have fallen into lock step with the rest of the world in terms of managing its currency through the open market. China's addition to the SDR basket gives its currency reforms global recognition (Figure 12 & 13).

Figure 12: Quotes on Currency Reform in Annual Announcements and Following Execution

2012		2013		2014		2015		2016	
Official Quotes[1]	**Execution**	**Official Quotes[1]**	**Execution**	**Official Quotes[1]**	**Execution**	**Official Quotes[1]**	**Execution**	**Official Quotes[1]**	**Execution**
• **Improve the RMB Exchange Rate formation mechanism** - widen the fluctuation range of RMB while maintaining its stability at equilibrium level	• The Yuan is allowed to trade **1% on both side of the midpoint** set by PBoC each day, signaling PBoC's willingness to widen the Yuan's flexibility[12] • CNY appreciated by 1.02% YOY against USD[13]	N/A	• CNY allowed to appreciate by 2.83% YOY against USD[13]	• Maintain RMB's stability at equilibrium level while widening the fluctuation range	• PBoC **expanded the Yuan's trading band from 1% to 2%**, making market-driven interest rate more posibble[14] • CNY depreciated by 2.49% YOY against USD[13]	• Maintain RMB's stability at equilibrium level while widening the fluctuation range	• China's State Council announced **widening the trading band against USD from 2% to 3%**[15] • **RMB included in the SDR basket16** • CNY depreciated by 4.64% YOY against USD[13]	• Improve the RMB Exchange Rate formation mechanism- widen the fluctuation range of RMB while maintaining its stability at equilibrium level	• Since March, China has been **letting RMB currency rates follow other EM currencies to fall against the dollar**[17] • China to continue "market-oriented exchange rate reform that allows for two-way flexibility"[18]

Source: Official quotes are from the annual addresses (which are the government's annual working plans) delivered by the Premier to the Chinese Congress. Please see detailed footnotes in Appendix 2.

Figure 13: Quotes and Execution of Currency Convertibility at Different Government Levels

2012: "…the country is considering "appropriately" widening the yuan's trading band to better reflect an **exchange rate regime decided by market supply and demand**…" - Xinhuanet, the official PRC media

2013: "…to **increase exchange rate flexibility in both directions**…and to keep exchange rate **stable around a reasonable point**…" - Director of the State Administration of Foreign Exchange/Deputy Governor of PBoC

2014: "PBoC Vice Governor Xiaolian Hu stated that **market-driven RMB exchange rate was speeding up**."
- People's Daily, the newsletter from the Chinese Communist Party

2015: "PBoC announced to reform the central parity rate against USD as a way to **promote interest rate marketization** and basic formation in terms of central parity rate."
- China Daily, the official English newsletter for the State Council Information Office

2015: "**RMB currency rate** should not only refer to USD but more importantly, should refer to **a basket of currencies (CFETS basket)**, which can better reflect the overall competitiveness of a country's goods and services and function as an adjustor for exports and imports, cross-boarder investments and balance of payment." - PBoC website announcement

2016: "China would **continue to promote an exchange rate mechanism** which meets higher standards of market economy in the next stage." - Xiaochuan Zhou, China's central bank governor

Equity Market Reform: Annual Official Announcements/Actions

While China has taken many steps to create access to its equity markets, it is still working though the rules and regulations that will help it be an efficient means for capital allocation. This market seems to be most complex for the Chinese to set a regulatory framework most likely because the State Owned Enterprises(”SOE”) focus on employment as well as productivity. The government is slowly changing this focus as the equity markets open.

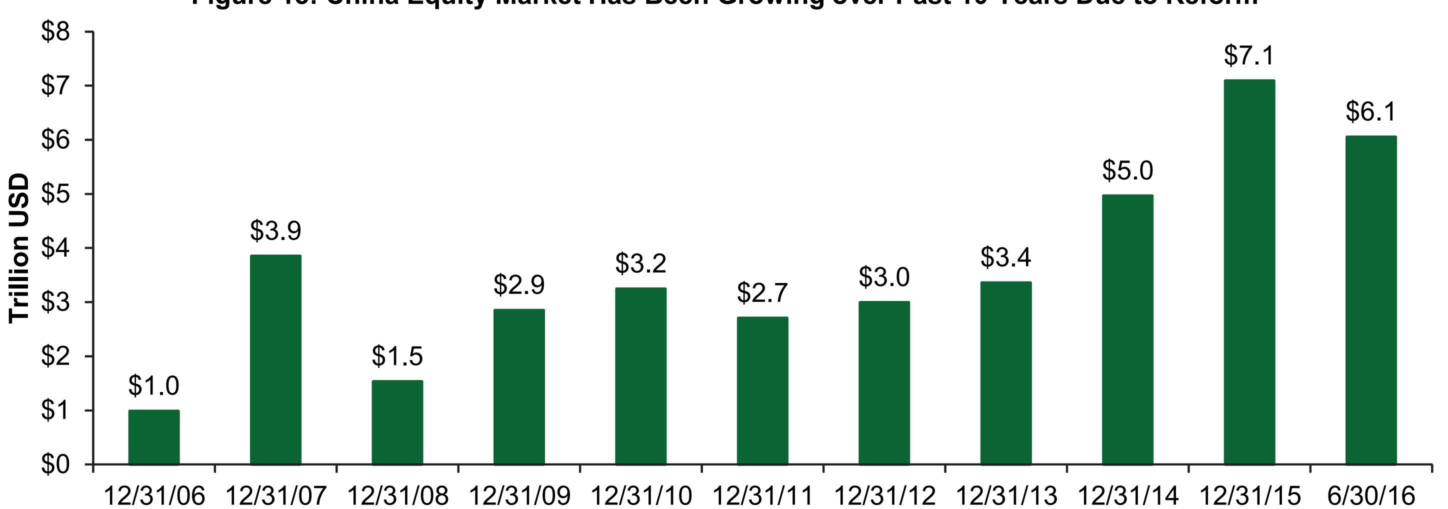
China’s equity markets have been growing over the past 10 years due to reform (Figure 15). As of May 2015, there were 1,012 listed state-owned enterprises. Their shares accounted for 68.14% of the total equity of companies listed in Shenzhen and Shanghai Stock Exchanges, which means that private enterprises listings are over 30%[1].

Figure 14: Quotes on Equity Market Reform in Annual Announcements and Following Execution

Year	Official Quotes[1]	Execution
2012	• Deepen reform of the financial system and **improve the modern financial system** • Improve the **stock issuance and delisting system** • Stress the protection of investor interest	• Issued supplements for **“The rule for security issuance and placement”**[19] • Issued “The trial rules for asset managers to manage the assets for accredited accounts”[20] • Issued “The rules for non-listed public companies” to protect investors’ interests[21] • Issued “The rules for mutual fund companies”[22]
2013	• Speed up developing the **multi-tier capital market**	• **SMEs will be waived with approval requirements to raise capital** in the national equities exchange and quotation system[23] • Issued “The new rules for RQFII managers” and **enabled foreign asset managers to apply for RQFII quotas**[24] • Issued “The rules for selling and custodian of mutual funds”[25]
2014	• Speed up developing the **multi-tier capital market** • Promote the **reform of stock issuance system** (from approval system to registration system)	• Issued “**The rules for IPO and issuances in ChiNext Board**”[26] • Issued “The rules for **Hong Kong – Shanghai Stock Connect**”[27] • Issued “The rules for M&A for non-listed public companies”[28] • Issued “The rules for private funds”[29] • Issued “The rules to improve the **stock delisting system**”[30]
2015	• Speed up developing the **multi-tier capital market** • Implement the stock registration system reform • Initiate the Shenzhen – Hong Kong Stock Connect when appropriate •Develop regional stock exchange markets for SMEs and trial equity crowdfunding program	• Issued “The rules for Margin Trading and Short Selling”[31] • Issued “The rules for arbitration”[32] • A State Council document called for expansion of equity crowdfunding in China as a way to offer more financing options[33] • Issued “The rules for hearing”[34] • State Council approved the plan to modify Security Law for **registration IPO system**[35]
2016	• Improve implementation of rule of law for equity market • Promote **market-driven stock and bond markets** and **a multi-tier capital market** • **Increase the share of direct financing** • Initiate the Shenzhen – Hong Kong Stock Connect when appropriate	• Issued “The rules of funds to protect investors”[36] • Issued “The rules for stock-option incentive program of listed companies”[37] • **State Council approved the Shenzhen-Hong Kong Stock Connect**, expected to be launched Nov 2016[38]

Source: Official quotes are from the annual addresses (which are the government’s annual working plans) delivered by the Premier to the Chinese Congress. Please see detailed footnotes in Appendix 2.

Figure 15: China Equity Market Has Been Growing over Past 10 Years Due to Reform[2]



1. Source: World Trade Organization, June 15, 2016. Link: https://www.wto.org/english/tratop_e/tpr_e/s342_e.pdf.
2. Source: Bloomberg as of June 30, 2016.

Equity Markets Volatility/Government Reaction Should Not Change Reforms

Regulators have stated a commitment to continue to develop the equity market even though China's actions during the summer's volatility created doubt for many market participants (Figure 16). It is widely understood that the government learned from its handling of the situation and that it does not intend to repeat its mistakes. China seems willing to learn from its mistakes as it balances competing agenda and seeks efficient markets.

Figure 16: Quotes and Execution of Capital Market Reform at Different Government Levels

During the summer of 2015, the stock market experienced volatility and declined by 37% within the 3-month period (as of the end of Sep, 2015).

- "Recently, the stock prices went through irrational decline. CSRC requested all listed companies to set up plans to stabilize the stock prices, including but not limiting to: **major shareholders and senior management teams to increase holdings**, **shares repurchase**, **employee stock purchase**, and **stock incentive programs**…"

  - The spokesperson of CSRC, Ge Deng at Press Conference, 07/10/2015
- "To **develop the capital market is a key goal of China's reform**, which **will not change** just because of the current fluctuations in the stock market."

  - Interview with WSJ, President of People's Republic of China, Jinpin Xi, 09/22/2015

January 4th 2016, CSRC implemented the circuit breaker regime with an attempt to better maintain the stability of the stock market. The action was proved to be inappropriate for China stock market and was suspended 4 days later.

- "…The newly implemented **circuit breaker** was not able to achieve the expected outcomes of reducing irrational decisions and preventing algorithm trading's magnifying effects when the market experiences volatility, and providing room to react to technical and operational risks… CSRC will **rethink what have been learnt from this event** and **discuss with relevant parties to improve the reform proposal** and continue to improve the stock market operational regimes."

  - The spokesperson of CSRC, Ge Deng at Press Conference, 01/08/2016

The anonymous authoritative person clarified China's economic outlook and government's approach to manage the economy.

- "…We clarified directions of the stock market, foreign exchange market, and property market at the political level. They should **return to their initial function**, respect their respective development patterns, and not be regarded as methods to maintain economic growth.

  - People's Daily, the government official media, 05/09/2016

Bond Market Reform: Annual Official Announcements/Actions

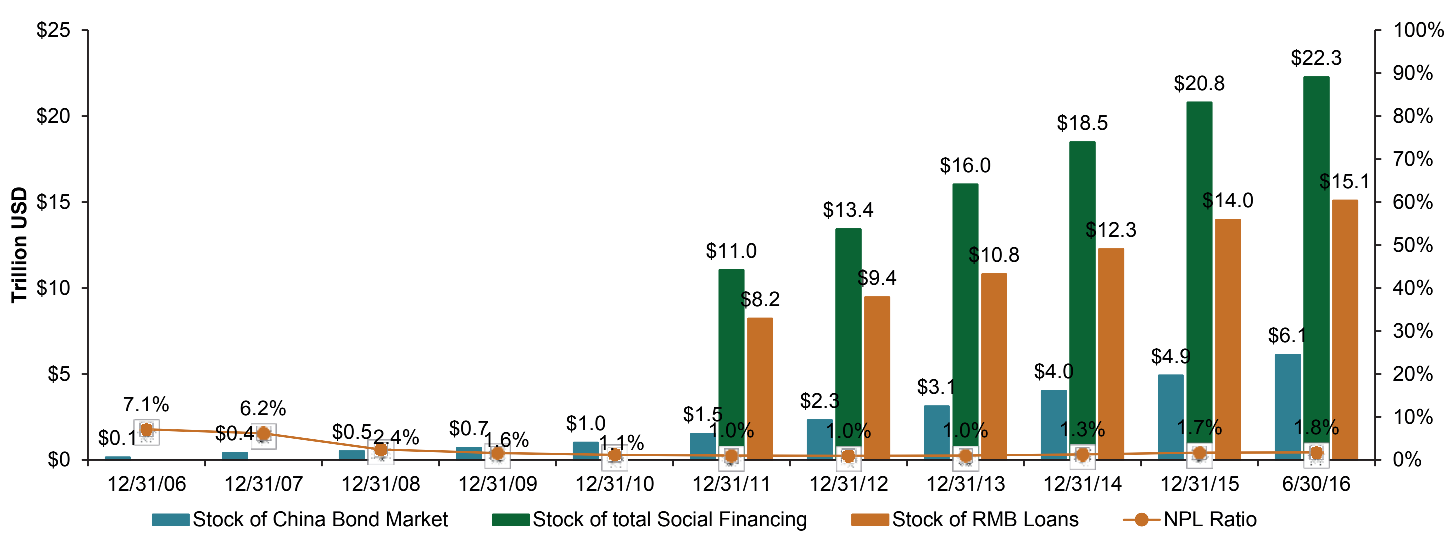
China is undertaking bond market reforms in order to properly price credit. Historically, the market assumed that bonds did not default and there was limited variability in pricing credit risk. As an example of China's gradualism, it let the first company default in 2013. In 2016, thirty-four (34) issuers (out of a $5 Trillion market so a very small percentage) have defaulted including some SOE issuers[1]. Given the SOE defaults, the market has started to re-price (especially SOE issuers). A large majority of defaulted issuances were in industries with excessive product capacity (such as mining, metals and manufacturing) and AA+ or below credit ratings. Rising defaults have not caused bond yields or spreads to rise considerably. The NPL ratio was 1.75% as of end of June 2016 (Figure 18), which the PBoC is investigating, as another sign of the Chinese government's desire to understand credit risk.

Figure 17: Quotes on Bond Market Reform in Annual Announcements and Following Execution

2012		2013		2014		2015		2016	
Official Quotes[1]	**Execution**	**Official Quotes[1]**	**Execution**	**Official Quotes[1]**	**Execution**	**Official Quotes[1]**	**Execution**	**Official Quotes[1]**	**Execution**
• Actively develop the bond market • To reform credit structure…and to **give**…**credit support**…continue to strictly regulate credit for highly-polluting and inefficient industries with over capacity	• **Bond Issuance rose around 60%** by volume in the first half of 2012 compared to a year earlier[39] • China Central Bank cut waiting time for bond issuance approval to just over one month[39]	• Speed up developing the multi-tier capital market; Actively develop the bond market • To utilize multi-strategy currency tools…to **keep currency and credit reasonable growth**, and to moderately **expand social aggregate financing**	• Chinese government **bond futures market was relaunched**, which helps in liberalizing the bond market[40] • Bond market volume increased by 9.05% compared to 2012[41] • First bond default was allowed for better repricing of credit[42]	• Speed up developing the multi-tier capital market; Regulate the development of the bond market • To increase macro-economic monitoring, and to **direct a moderate expansion in currency credit and social aggregate financing**	• China Securities Depository and Clearing Corp (CSDC) issued new rules for bond trading collateral in the interbank market to curb potential risks[43] • Bond market volume increased by 33.9% compared to 2013[44]	• Speed up developing the multi-tier capital market • Expand the corporate bond issuance size • **Develop the financial derivative market** • To keep a moderate expansion in currency credit and social aggregate financing	• **Bond issuance surged** compared to last year, further expanding the bond market[45] • 3.2 trillion RMB local government vehicle bonds were swapped with local government bonds; increase the supervision system for the local government bond issuance[46]	• Promote the market-driven stock and bond markets and multi-tier capital market	• China **opened up the 5.4-trillion inter-bank bond market** for relevant foreign institutional investors and they are no longer required to seek pre-approval from PBoC[47] • **34 issuer defaults** occurred and is expected to help the economy to allocate capital efficiently[48]

Source: Official quotes are from the annual addresses (which are the government's annual working plans) delivered by the Premier to the Chinese Congress. Please see detailed footnotes in Appendix 2.

Figure 18: Annual Growth of China Bond Market, Total Social Financing, RMB Loans and NPL Ratio[2]



1. Source: Chinese Bond Market Defaults Rise in First Half of 2016, Peterson Institute for International Economics. Link: https://piie.com/blogs/china-economic-watch/chinese-bond-market-defaults-rise-first-half-2016.
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Interest Rate Reform: Annual Official Announcements/Actions

A core part of financial market reform is the free setting of interest rates. The PBoC has been moving to allow banks to set their own interest rate policies and to manage interest rates by better open market methods (Figure 19 & 20). Given the importance of interest rates, marketization is important for policy as well as for creating a truly market oriented credit and rate environment.

Figure 19: Quotes on Interest Rate Reform in Annual Announcements and Following Execution

2012

Official Quotes[1]
- Deepen the interest rate reform

Execution
- **PBOC allowed commercial banks to float interest rate on deposits**, introducing competition in banking industry and helping interest rate reform[49]

2013

Official Quotes[1]
- Promote the interest rate and exchange rate reform

Execution
- PBoC **eliminated the banks' lending rate floor and started deposit insurance system**, helping to liberalize interest rates and widen exchange rate trading band[50]

2014

Official Quotes[1]
- Continue the interest rate reform and enhance financial institutions' right to decide interest rate

Execution
- PBoC **expanded the floating interest rate range** to allow more market interest rate reform[51]

2015

Official Quotes[1]
- **Promote market-driven interest rate reform**
- Further build up the interest rate regulation framework

Execution
- **Deposit rate ceiling was removed**[52]
- More defaults both on offshore and onshore market were happening including a central government-controlled company[53]

2016

Official Quote[1]
- Deepen the market-driven interest rate reform

Execution
- PBoC encouraged financial institutions to **improve their interest rate pricing capacity**[54]
- PBoC aimed to increase the efficiency of interest rate operation and to supervise and manage unseasonal interest rate pricing behaviors[54]

Source: Official quotes are from the annual addresses (which are the government's annual working plans) delivered by the Premier to the Chinese Congress. Please see detailed footnotes in Appendix 2.

Figure 20: Quotes and Execution of Capital Market Reform at Different Government Levels

2012: "The bank will actively continue to **push forward the interest rate reform** to make the cost of money more market based in line with the goal." - Xinhuanet, the official press agency of the PRC

2013: "We have expanded the scope of the business-to-value added tax pilot reform, and **advanced reforms relating to market-based interest rates**…" - Premier Keqiang Li

2014: "…To promote the cross-border use of RMB, to **steadily advance market-based interest rate reform**, and to deepen foreign exchange administration reform."

- The State Council of The People's Republic of China

2015: "…to **promote market-driven interest rates**…accordingly loosen saving's rate regulation."
- China Daily, the official English newsletter for the State Council Information Office

2016: "…**speed up the process of interest rate marketization**…we need to continue the reform to create a good environment for the interest rate marketization."
- People's Daily, the office newsletter for the Chinese Communist Party

Conclusion

China's path to open capital accounts and markets has been consistently executed since the Chinese government announced in 2012 that there was a long term goal for implementation.

There have been clear milestones that have been achieved while China balances other goals such as maintaining employment and economic growth.

From a western perspective, China's incremental progress is often confusing and not fast enough. In addition, the process has had it's trials and errors.

However, given where China started, the historical context of a centralized government and the complexity of transforming the world's second largest economy from one that is state owned to one that is powered by private enterprise, the progress has been steadily in one-direction.

Chinese leaders have clearly stated that they believe that the key to the next stage of economic growth is to continue building on the changes that have been implemented in order to fully reach China's economic potential which will be necessary to continue to produce economic growth. It is therefore unlikely that the Chinese leadership has the desire and capability to turn the clock back.

Appendix 1: Current Status of the 40 Subcategories under China's Capital and Financial Account

Categories (total 11)		Subcategories (total 40)	Status	Comment
1. Capital Market Securities	**Stocks and other ownership securities**	Nonresidents buy and sell onshore	Partially Convertible	Qualified Investors
		Nonresidents issue onshore	Not Convertible	No Law Allows
		Residents buy and sell offshore	Partially Convertible	Qualified Investors
		Residents issue offshore	Fully Convertible	Fully Convertible
	Bonds and other debt securities	Nonresidents buy and sell onshore	Generally Convertible	Interbank opened to foreign investors
		Nonresidents issue onshore	Partially Convertible	Permits Needed and Restriction
		Residents buy and sell offshore	Partially Convertible	Qualified Investors
		Residents issue offshore	Generally Convertible	Registration
2. Money Market Instruments		Nonresidents buy and sell onshore	Partially Convertible	Qualified Investors
		Nonresidents issue onshore	Not Convertible	No Law Allows
		Residents buy and sell offshore	Partially Convertible	Qualified Investors
		Residents issue offshore	Fully Convertible	Fully Convertible
3. Collective Investment Securities		Nonresidents buy and sell onshore	Partially Convertible	Qualified Investors
		Nonresidents issue onshore	Partially Convertible	Mutual Recognition Program
		Residents buy and sell offshore	Partially Convertible	Qualified Investors
		Residents issue offshore	Partially Convertible	Mutual Recognition Program
4. Derivatives and Other Instruments		Nonresidents buy and sell onshore	Generally Convertible	Stock Index and Commodity Forwards (limited), and Currency Derivatives
		Nonresidents issue onshore	Not Convertible	No Law Allows
		Residents buy and sell offshore	Partially Convertible	Qualified Investors
		Residents issue offshore	Not Convertible	No Law Allows
5. Commercial Credits		Residents offer to Nonresidents	Generally Convertible	Registration and Quota Management
		Nonresidents offer to Residents	Partially Convertible	Subject to Restrict Regulations to Borrow Foreign Debt
6. Financial Credits		Residents offer to Nonresidents	Generally Convertible	Registration and Quota Management
		Nonresidents offer to Residents	Partially Convertible	Subject to Restrict Regulations to Borrow Foreign Debt
7. Guarantees, Sureties, and Financial Backup Facilities		Residents offer to Nonresidents	Generally Convertible	Registration Afterward
		Nonresidents offer to Residents	Generally Convertible	Quota Management
8. Direct Investment		Outward foreign direct Investment	Mainly convertible	Restrictions on industries and sectors
		Inward direct investment	Mainly convertible	Needs to be approved by Ministry of Commerce
9. Liquidation of Direct Investment		Liquidation of direct investment	Fully Convertible	Fully Convertible
10. Real Estate Transactions		Residents overseas purchase	Mainly convertible	Same as direct investment
		Nonresidents overseas purchase	Partly convertible	Commercial presence and owner-occupation rule
		Nonresidents domestic sell	Fully Convertible	Fully Convertible
11. Personal Capital Transfer	**Personal loans**	Residents to nonresidents	Not convertible	No law explicitly allows
		Non-residents to residents	Not convertible	No law explicitly allows
	Gift, donation, bequests/legacy	Residents to nonresidents	Partly convertible	Limit on exchange quota
		Nonresidents to residents	Partly convertible	Limit on exchange quota
	Migrants overseas debt settlement	Migrants overseas debt settlement	–	No clear legal provisions
	Personal asset transfer	Transfer abroad	Partly convertible	Large property transfer requires approval
		Transfer onshore	–	No clear legal provisions
	Income from lottery and prizes transfer	Income from lottery and prizes transfer	–	–

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