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EMERGING MARKETS DEBT

China's Drift Toward 'Closing-Off' Policies Faces Major Test This Fall

By: Kyle Lee, CFA | August 4, 2022

Boston - China's zero-COVID policy of rolling lockdowns of major cities, accompanied by border closings, has generated a steady stream of headlines for the past couple of years as has the government's crackdown on tech companies, including industry giants Alibaba and Tencent.

Are such moves part of a larger policy of government control of the private sector and an inward-looking "closing off" of Chinese markets to outsiders? From a broad perspective, our opinion is yes. But the financial market serves as a major counterexample, and the trend is not certain to be permanent — with President Xi Jinping up for reappointment for a third term this fall, much will depend on the new high-level political alignment.

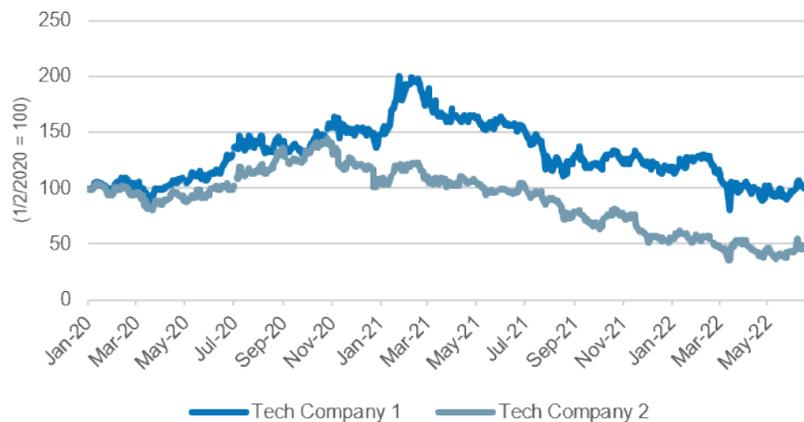
An inward-looking China marks a sea change from a "reform and opening up" policy that goes back several decades, in which the country's broad economic liberalization helped it attain historic growth rates and modernization.

Political backdrop has changed

But today's global political backdrop is different. Worsening relations with the U.S. and rising geopolitical tensions have prompted China to examine its reliance on the rest of the world — what the country considers "strategic interdependency." This has resulted in a greater push for diversification and self-sufficiency for key goods including technology, food and energy, in what might be viewed as "preemptive closing."

Some areas, like education tech, have been effectively eliminated from the private sector. Overall, what the government views as "consumer technology" is being closed off to foreign investment and deemphasized internally — a major development, because that is where much investment capital had been flowing. The chart below shows the negative impact this has had on Chinese tech stocks.

Chinese tech stocks have suffered with the government's crackdown



Sources: JHU CSSE Covid019 Data, Our World in Data, EMED, Bloomberg. As of 6/30/22. This is provided for illustrative purposes only and is not meant to depict the performance of a specific Eaton Vance investment. Past performance is no guarantee of future results.

The end of the road for the successful business model of "opening up" and "strategic interdependency" has taken its toll on the Chinese economy and eroded productivity. To maintain growth, the government allowed leverage to increase substantially. But GDP growth has slowed anyway, and major problems like Evergrande in the real estate sector illustrate the high degree of leverage in the system.

"Inward-looking" also becomes harder to sustain, given China's aging demographic. The working-age population is contracting, which puts pressure on various parts of the financial and economic systems, including social security.

Foreign bond ownership is growing

From these examples, it would be easy to conclude that a substantially closed China is now the new normal. But the country's large reforms to its financial markets are important counterexamples, especially the bond market. Foreign ownership of government bonds has gone from negligible to a little under 11% of the total in a short period.¹

In general, China has improved onshore access for foreign investors, and its assets are being added to multiple indexes. The International

Monetary Fund (IMF) added the Chinese renminbi (RMB) to the Special Drawing Rights (SDR) basket in 2016. All in all, these are impressive steps in opening up its financial markets.

Finally, the Chinese Communist Party's (CCP) 20th congress this October will provide important clues as to whether the "inward-looking" trend will gain steam. Xi is politically strong and widely expected to get a third term. He will likely be able to get the appointees he wants to help carry out his "closing-off" policies, but there is a lot of uncertainty around that. Conceivably, Xi could be forced to concede politically to people who advocate different types of policies. There could be yet another change in direction at the margin toward opening up if the CCP appoints economic technocrats in important positions.

Bottom line: Xi has definitely pushed China toward "closing-off" policies but has simultaneously opened its markets to foreign investors. The CCP's moves this fall will tell us much about how the future of open versus closed will unfold.

¹ AsiaBondsOnline. As of 6/30/2022.

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