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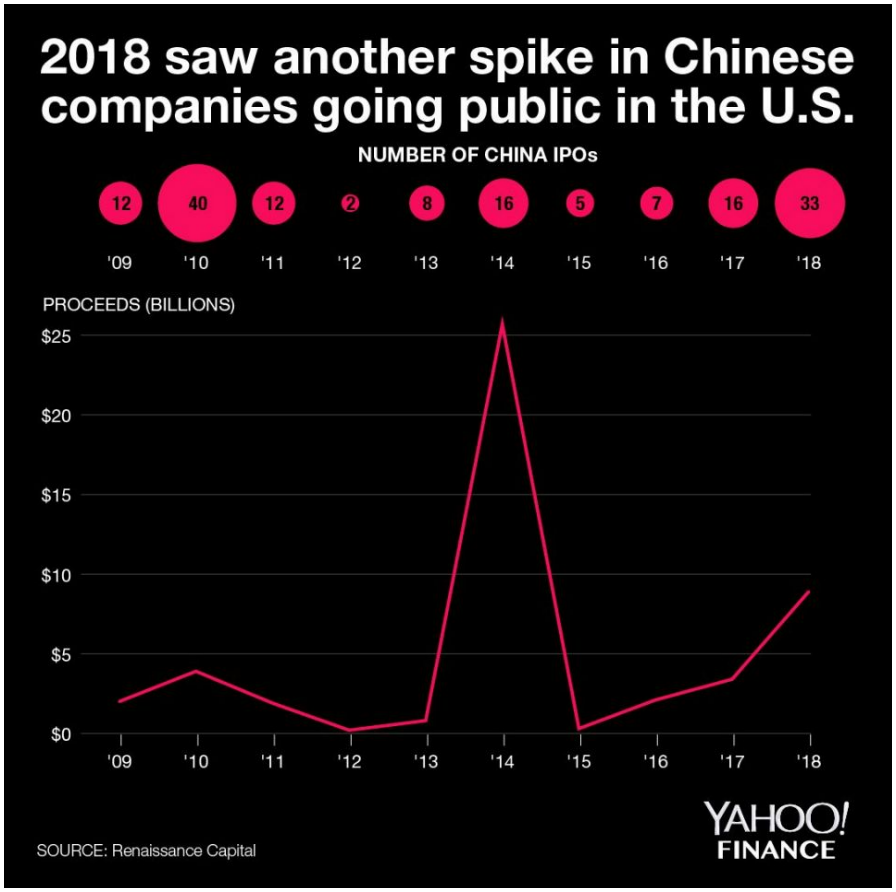
Expect more financial decoupling between China and the United States

By Angelo Katsoras

Introduction

In yet another sign that tensions between China and the United States will persist even if they manage to sign a limited trade deal, financial markets have emerged as the latest battleground in their ongoing political rivalry. The latest tension point centres on the United States potentially imposing limits on Chinese companies accessing U.S. financial markets and funding.

Complicating matters further are the deep interconnections between the two superpowers. For example, the market value of the few hundred Chinese companies listed in the United States is $1.3 trillion if we include the depositary receipts of firms whose primary listings are either China or Hong Kong.[1] Chinese companies also accounted for 17% of the total IPOs in the United States last year.[2]



Source: "New bipartisan bills threaten Chinese IPOs and Chinese companies listed in the U.S.," Yahoo Finance, June 8, 2019

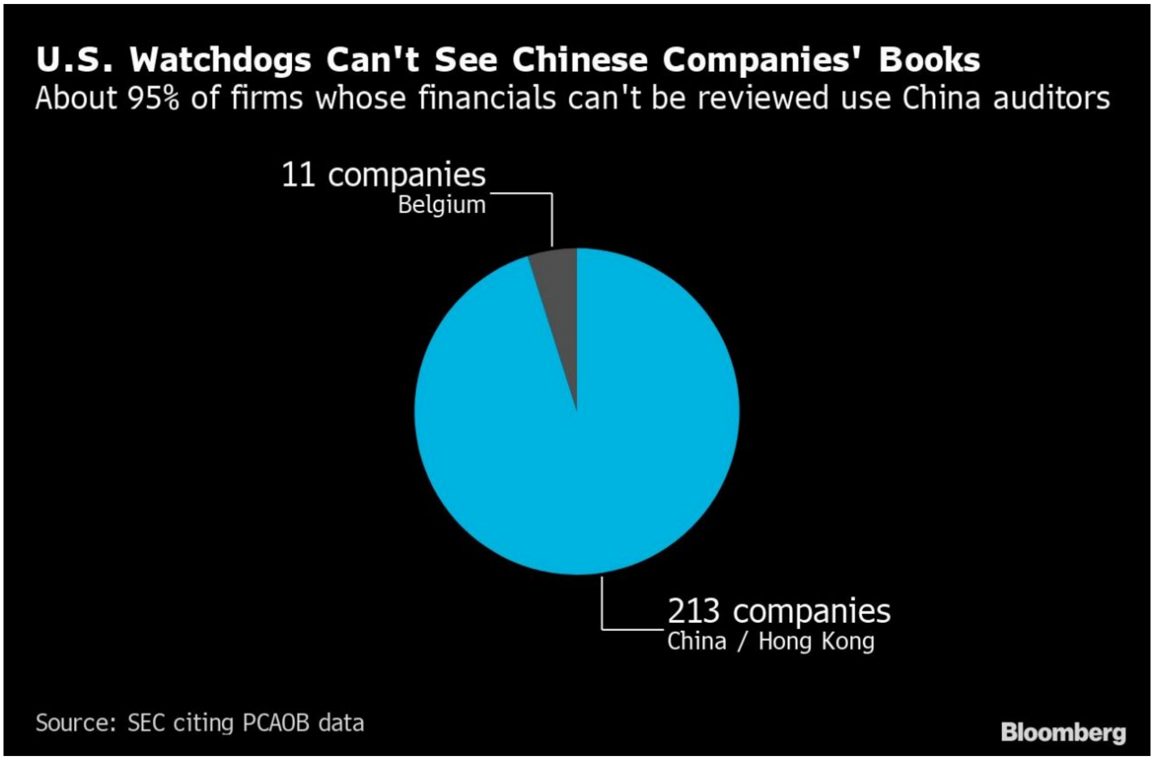
China and the United States clash over audits

Trade tensions between China and the United States have led to a renewed focus on their long-standing disagreement regarding audits. The main area of contention is China's refusal to allow American regulators to examine the audits of Chinese firms whose shares trade on U.S. financial markets. While the Securities and Exchange Commission (SEC) insists that its rules must apply to all companies trading in the United States, China cites national security concerns for restricting access to its companies' accounting information.

All of this has led U.S. administration officials and politicians on both sides of the aisle to increasingly question why Chinese firms that refuse to provide their audit papers are allowed to be listed in the United States. Many of these critics point out that China would never

[1] "Banning American investments in Chinese firms is mooted. Again," The Economist, October 3, 2019
[2] "New bipartisan bills threaten Chinese IPOs and Chinese companies listed in the U.S.," Yahoo Finance, June 8, 2019

tolerate foreign firms refusing to comply with its local regulations. The following chart shows the vast majority of firms refusing to provide their financial information are based in either China or Hong Kong.[3]



Source: "Trump's China Financial Decoupling Move Has Roots in Enron Saga," Bloomberg, October 11, 2019

Legislation targeting U.S.-listed Chinese firms

Last June, a bipartisan group of senators introduced legislation to address the issue. Under the Equitable Act, companies would have three years to either comply with regulations or withdraw from U.S. financial markets.

Marco Rubio, the Republican senator spearheading this legislation, recently wrote in the Wall Street Journal that: "China has reaped enormous economic rewards while exploiting the freedom and openness of the U.S.-led global order. Now, the U.S. and its allies must send a clear message: If Chinese companies want to be listed on U.S. exchanges, they must comply with American laws and regulations for financial transparency and accountability."[4]

In what is perhaps a sign of things to come, China's top maker of semiconductor chips, Semiconductor Manufacturing International Corporation (SMIC), voluntarily delisted its shares from the New York Stock Exchange last May. This occurred soon after Washington blacklisted one of SMIC's main clients, Huawei Technologies.[5]

Is the Trump administration contemplating restrictions?

In early October, Bloomberg cited a leaked memo indicating that the Trump administration was considering restrictions on U.S. portfolio flows into China. Among other things, the document reportedly gave the go-ahead to analyze the pros and cons of barring the Federal Retirement Thrift Investment Board (FRTIB) from investing in Chinese capital markets. The FRTIB, which manages nearly $600 billion, is the retirement savings vehicle for federal government employees, including lawmakers and members of the military.

This issue came to the fore in 2017 when the FRTIB decided to switch its index asset mix in a manner that would increase its exposure to China and other emerging markets starting in 2020. In mid-October, a bipartisan group of senators sent a letter to the FRTIB urging

[3] "Public Companies that are Audit Clients of PCAOB-Registered Firms from Non-U.S. Jurisdictions where the PCAOB is Denied Access to Conduct Inspections," Public Company Accounting Oversight Board, September 2019
[4] "You Can't Trust a Chinese Audit," Wall Street Journal, June 4, 2019
[5] "Financial decoupling: five things to know about US-China stocks delisting," Nikkei Asia Review, October 2, 2019

it to reverse its decision, which they said would result in government retirement funds being invested in companies "that assist in the Chinese government's military activities, espionage, and human rights abuses."[6]

Adding to the pressure was a recent op-ed article by Secretary of the Navy Richard V. Spencer in which he stated: "Imagine retiring after a long career serving in uniform, only to learn that your savings all those years had helped fund advanced weapons systems for America's adversaries. This tragedy will soon become reality unless a decision by the Federal Retirement Thrift Investment Board is immediately reversed."[7]

So far, the FRTIB has responded by delaying changes to its asset mix. It is widely felt that the Emergency Economic Powers Act of 1977 grants the President the legal authority to unilaterally restrict capital flows to China via an executive order.[8]

Conclusion

Even as the United States and China are trying to put the finishing touches on a trade deal or truce, there is increasing pressure from Democrats and Republicans, as well as the national security establishment, to impose restrictions on Chinese corporate access to U.S. financial markets and funding.

Indeed, deal or no deal, investors and businesses must learn to navigate a world that features two superpowers with radically different economic systems and a growing mutual mistrust. This often means navigating a maze of contradictory rules where complying with U.S. financial regulations can place a company in violation of Chinese law, and vice versa.

In this new landscape, China and the United States will increasingly adopt different approaches to economic policy, standards, technology, human rights and governance. As a result, market access for companies in sectors deemed strategic by both sides will often depend on whether their business plans, products/services and supply chains are compatible with the geopolitical objectives of either country. Based on these criteria, the company with the best products or services will not always be the one to come out ahead. This has long-term implications for productivity and inflation.

[6] "Chinese Investment Pits Wall Street Against Washington," New York Times, October 28, 2019
[7] "Servicemen's Savings Shouldn't Fund Russia and China," Wall Street Journal, October 23, 2019
[8] "The threat to limit capital flows and pending impeachment conflict," Ray Dalio, October 2, 2019

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