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Will China-U.S. tensions reverse the trend of ever-greater financial ties?

By Angelo Katsoras

Despite rising tensions between China and the United States in the past several years over such matters as trade, intellectual property protection, human rights, and the origins of COVID-19, until recently they had not prevented the two countries' financial markets from becoming ever-more interconnected. Chinese firms continued to list on American exchanges, and Wall Street not too long ago gained further access to China's burgeoning financial markets.

However, recent measures taken by the United States and China have not only paused this trend, they have also potentially set in motion a partial unwinding of these ties.

Overview of China-U.S. financial market ties

A growing number of Chinese firms have listed on U.S. financial markets over the past few decades. Today, about 400 are trading on U.S. exchanges, about twice as many as in 2016.[1]

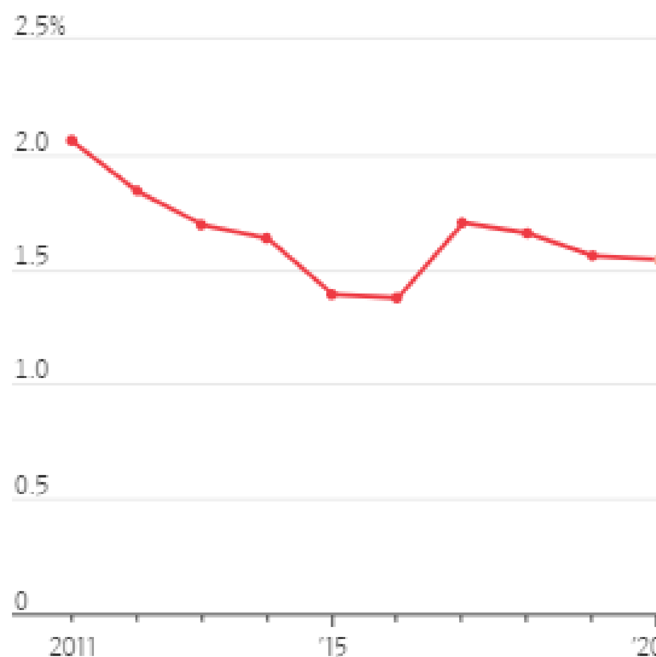
In addition to profiting from this wave of IPOs in U.S. markets, several Wall Street firms have recently been granted increased access to China's financial markets. For example, Goldman Sachs and Morgan Stanley have become majority owners of their Chinese securities firms and BlackRock is the first foreign company to win approval to start a wholly owned mutual-fund business.

What China gets in return is expert help building up its financial markets that would, among other things, allow it to better withstand a partial unwinding of financial ties with the US and the hopes of increased political influence in Washington. A case in point was the visit that Vice Premier Liu He, Beijing's chief trade negotiator, made to the U.S. capital for negotiations with the Trump administration in February 2018. During his stay, Liu also participated in a conference with top business leaders mostly from Wall Street. On the subject of trade-related tensions, he reportedly told attendees: "We need your help."[2]

Skeptics doubt whether Beijing will ever let Wall Street gain more than a foothold

While Wall Street is celebrating its greater access, it is important to note that by delaying the opening of its financial markets for decades, China has enabled its national champions to dominate most activities. For instance, Visa and MasterCard were effectively barred from China for decades until the dominance of domestic payment providers was complete. Western firms will have a very hard time overcoming this home field advantage, which entails continued government support.

[1] "China seems intent on decoupling its companies from Western markets," The Economist, July 10, 2021
[2] "China Has One Powerful Friend Left in the U.S.: Wall Street," Wall Street Journal, December 2, 2020



Source: "China Has One Powerful Friend Left in the U.S.: Wall Street," WSJ, December 2, 2020

Wall Street must also contend with the growing political mood against China in Washington. This is summarized by the following quote taken from Jake Sullivan, U.S. national security adviser, in a piece he wrote for Foreign Policy Magazine last year: "Why, for example, should it be a U.S. negotiating priority to open China's financial system for Goldman Sachs?[3]

Growing U.S. financial restrictions on Chinese companies

The strong bipartisan view that China is a strategic competitor is translating into ever-tighter financial restrictions on its firms. The speed with which these measures are passed stands in stark contrast to the gridlock experienced by most other pieces of legislation not involving China. How China is being targeted is discussed in the next section.

Tighter audit requirements

Last December, then-President Donald Trump signed into law with unanimous congressional support legislation that calls for foreign companies that refuse to allow their audits to be inspected by American accounting regulators for three consecutive years to be delisted. It also requires all US-listed public companies to disclose their political and military ties.

Chinese companies are the prime targets of this measure because they are the only ones refusing to cooperate.[4] This is due to the fact China considers audit documents to be state secrets. U.S. authorities reportedly rejected an offer from their counterparts in Beijing to have their regulators conduct audit inspections and to make these findings available.[5]

Many analysts feel the United States allowed China to flout its rules for so many years because of the mistaken view that the more China developed economically, the more it would eventually adopt American-style regulations.

[3] "America Needs a New Economic Philosophy. Foreign Policy Experts Can Help," Foreign Policy, February 7, 2020
[4] "Audit Reports Issued by PCAOB-Registered Firms in Jurisdictions where Authorities Deny Access to Conduct Inspections,
" Public Company Accounting Oversight Board, 2021
[5] "China's crackdown on U.S. listings threatens $2tn market," Financial Times, July 7, 2021

America's ever-expanding blacklist

The Biden administration has also maintained and expanded a list originally begun by its predecessor that prohibits Americans from doing business with certain Chinese technology and military-affiliated businesses. In early July, the United States added another 23 companies to the blacklist for alleged connections to the Chinse military or use of forced labour.

Congress is expected to also approve legislation later this year that would prohibit imports of all products from Xinjiang unless the importer can prove their items are free of forced labor. This restriction already applies to cotton and tomato products from this region. Xinjiang accounts for about 85% of China's cotton and 20% of global supply.[6]

China cracks down on IT sector

Efforts by the United States to become less financially intertwined with China have now received a boost from Chinese authorities who have decided to rein in the power of big tech.

One of the most prominent moves to date has been the crackdown on the Chinese ride-hailing company Didi just days after it listed on the New York Stock Exchange. Chinese authorities announced soon after that businesses, including those with data from more than one million users, would require government approval to list shares abroad.

Reasons given for the crackdown include the risk of sensitive data falling into the hands of foreign governments and the anticompetitive practices of China's biggest tech companies.

Showing the private sector who is boss

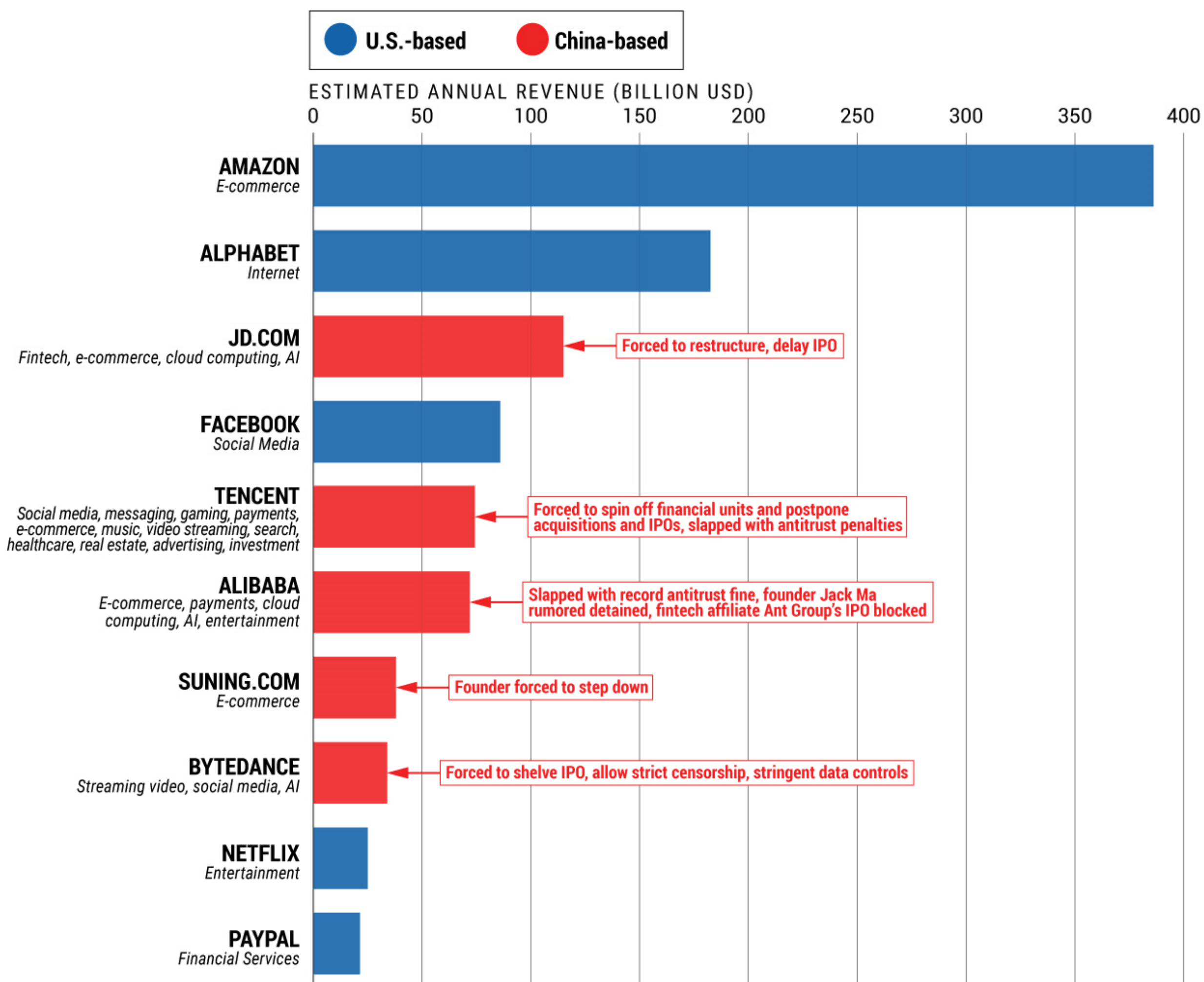
However, given that China already requires companies to store their data domestically and that it does not seem bothered by Huawei's and ZTE's domination of the telecom sector, we feel the main reason for the crackdown is to prevent the emergence of centres of power that could eventually challenge the total control exercised by the Communist Party. IT companies are of particular concern because their payment, gaming, fintech, health care, real estate, and e-commerce platforms give them access to huge databases.

[6] "U.S. retailers told to target forced labor in China after cotton import crackdown," Reuters, January 15, 2021

The government's position was neatly summarized in a recent article in the China Daily, a state-owned newspaper: "No internet giant is allowed to become a super database that has more personal data about the Chinese people than the country does."[7] Beijing feels government control over these data platforms is the only way to ensure that IT companies remain politically compliant.

The Chinese government's opinion has also been influenced by the experiences of Russia following the collapse of the Soviet Union and, more recently, developments in the United States. The collapse of the Soviet Union was followed by the rise of Russian oligarchs that for a period of time had more power than the state. Recent moves by Twitter and Facebook to block then President Donald Trump from their platforms also caught Beijing's attention. **China wants to avoid any scenario that would permit its companies to have anywhere near the same level of influence.**

Another major reason for China to discourage IPOs in the United States and push companies to raise capital domestically is, in its opinion, the likelihood that many Chinese companies will eventually be forced to delist from American exchanges. Beijing is thus attempting to minimalize the financial impact of these actions by preparing ahead of the time. It also feels that it is logical for large Chinese companies to list domestically. Indeed, one can imagine how American politicians would react if the likes of Google and Amazon were listed only in China.



Source: "The Trouble With China's Tech Titans," Geopolitical Futures, July 19, 2021

[7] "Why Didi's removal from app win public support," Global Times, July 5, 2021

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Chinese companies relocating to Hong

Many Chinese companies that have been dissuaded from listing in the United States will no doubt look towards Hong Kong. In fact, even before the recent crackdown on the IT sector, many of them had set up secondary listings in Hong Kong as a hedge against the risk of a forced U.S. delisting (see chart below). In 2020, the Hong Kong Stock Exchange generated $51.3 billion in IPOs, trailing only the NASDAQ and the NYSE.[8]

'Homecoming listings': Chinese firms' Hong Kong IPOs

Company	HKEX IPO proceeds (USD billion)	Year of listing: HKEX	Original IPO (year, exchange)
ALIBABA	12.9	2019	2014: NYSE
NETEASE	3.1	2020	2000: NASDAQ
JD.COM	4.5	2020	2014: NASDAQ
YUM CHINA	2.2	2020	2016: NYSE
HUAZHU GROUP	0.9	2020	2010: NASDAQ
ZAI LAB	0.8	2020	2017: NASDAQ
ZTO EXPRESS	1.5	2020	2016: NYSE
BAOZUN	0.4	2020	2015: NASDAQ
GDS HOLDINGS	1.9	2020	2016: NASDAQ
NEW ORIENTAL EDUCATION AND TECHNOLOGY	1.5	2020	2006: NYSE
AUTOHOME	0.8	2021	2013: NYSE
BAIDU	3.0	2021	2005: NASDAQ
BILIBILI	2.9	2021	2018: NASDAQ
TRIP.COM	1.3	2021	2003: NASDAQ
XPENG	1.8	2021	2020: NYSE

TABLE: YVONNE LAU • SOURCE: REFINITIV FORTUNE

Source: "China's crackdown on U.S. IPOs is a windfall for Hong Kong—so long as it can handle the influx of listings," Fortune, July 18, 2021

Conclusion

Up until recently, many Chinese companies, particularly those in the IT sector, benefited from the best of both worlds. They received foreign funding and later went public on American exchanges while Beijing largely protected them from international competition. Now, China's tech firms and their investors are caught between stricter government controls and escalating geopolitical tensions with the United States.

For example, the Securities and Exchange Commission now requires Chinese companies to disclose more about their connections with the Chinese government, including the risk of interference from Beijing, before allowing them to raise money in the United States.

[8] "China's crackdown on U.S. IPOs is a windfall for Hong Kong—so long as it can handle the influx of listings," Fortune, July 18, 2021

Regulatory pressure coming from both Washington will likely not only dissuade many Chinese companies from launching further IPOs in the United States, but also force certain Chinese companies to delist from American exchanges. Indeed, China's three big telecommunications companies—China Telecom Corp., China Unicom, and China Mobile Ltd.— have already been forced to leave the NYSE on account of their ties to the Chinese military.

All this means that companies and investors will increasingly be forced to navigate a maze of contradictory rules where complying with U.S. regulations could mean violating Chinese law, and vice versa. This includes the increasing difficulty Wall Street firms face in trying to balance their attempts to grow market share in China at the same time Washington is targeting it with more and more sanctions and ramping up efforts to become less reliant on China in the production of green energy infrastructure, electric vehicles, medicines, and other key technologies.

What does this mean for innovation in China's tech sector?

While China has always exercised greater control over businesses than the West has, certain analysts feel that the main reason for the success of many Chinese IT companies is that they were generally given freer rein than companies in other industries to adopt new technologies and business strategies. Going forward, this will no longer be the case. IT companies will increasingly require government approval before making major decisions.

Another factor to consider is that almost all of China's major IT success stories relied on foreign funding to reach their potential. Had the current restrictions on listing abroad been in place two decades ago, many companies would perhaps not have attained the same level of success they enjoy today.

If the crackdown makes it more difficult for China's largest companies to expand, increases their cost of capital, hurts innovation, and makes other countries warier of their motives, this could benefit American tech giants in the competition for global market share.

However, Beijing is betting that the gravitational pull of its economy will eventually convince international investors to put aside concerns over recent events and continue to invest in China's growth story. What will change is that these investors will buy shares in Chinese companies on China's exchanges instead of on American exchanges.

For the time being, foreign investment continues to flow into China. Overseas investors' holdings of Chinese equities and bonds recently reached $806 billion, up from about $570 billion a year ago.[9]

What does the partial unwinding of financial ties mean for the global economy?

The move towards greater financial separation means that Western companies will increasingly be forced to build separate operations for China. This means having separate databases, cloud services, software systems and research centres for China. This also includes financial service companies creating separate platforms to trade Chinese securities. This is in addition to efforts by the United States and other countries to develop their own capacities in the production of semiconductors, health care equipment/medicines and rare earth minerals. **The creation of these dual operations and supply chains will reduce economies of scale and add to operating costs.**

Another development is the increasing media and governmental scrutiny of investments made by Western Institutional investors in China. This will centre on trade practices, concerns over human rights, and questions regarding the environment. Germany, for example, recently passed legislation requiring German firms with over 3,000 employees to verify that their supply chains are free of human-rights abuses starting in 2023.

Finally, China's moves to assert greater control over its major companies represent an attempt to challenge the long-established Western orthodoxy that a country cannot become rich without first becoming democratic and loosening state control over education and business.

[9] "Global investors' exposure to Chinese assets surges to $800bn," Financial Times, July 14, 2021

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