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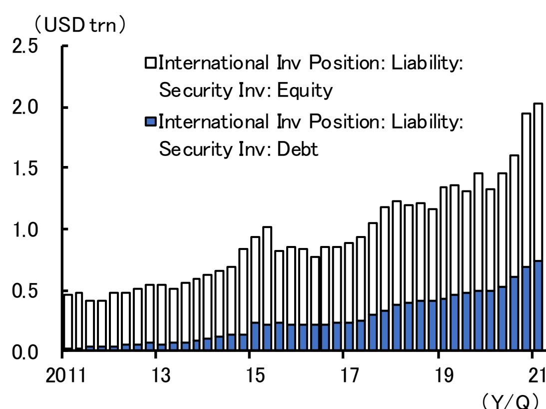
Topics Growing headwinds to the inflow into China's securities markets

China has advanced capital deregulation and succeeded in increasing inward portfolio investment. However, the intensifying confrontation between the U.S. and China, along with the normalization of U.S. monetary policy, has brought the Chinese authorities into a crucial stage with regard to accepting more inward portfolio investment.

■ Investors from Singapore, U.S. and EU are aggressively investing in Chinese securities

Despite rising tensions with China, particularly among developed countries, global investment in securities in mainland China has increased significantly. The balance of China's inward portfolio investment rose 39.7% to USD 2 trillion in the January-March 2021 from the October-December 2019 before the outbreak of COVID-19. According to the IMF's Coordinated Portfolio Investment Survey (the latest figures are as of June 2020), the amount of investment in Chinese securities by Singapore, the U.S. and the EU has been increasing significantly in recent years. Inward portfolio investment by Japan has also been increasing slightly, particularly in bonds. These developments are supported by 1) the easing of capital movement regulations by the Chinese authorities, 2) the active incorporation of Chinese securities in the asset management of overseas investors, and 3) the inflow of surplus funds faced with difficult fund management conditions due to excessive liquidity.

<Inward Portfolio Investment in China Mainland>

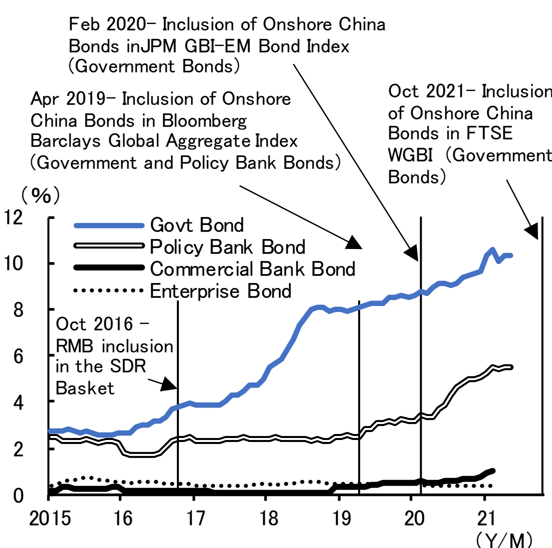


Source: JRI, based on SAFE

■ Improved access to the mainland Chinese market has encouraged foreign investors to invest in China

In China, capital movement regulations are being eased, and access to the mainland Chinese markets from abroad has been improving, albeit with limitations. In particular, Bond Connect, a mechanism for trading mainland Chinese securities via Hong Kong, was introduced in the bond market in July 2017, following Stock Connect for the stock market introduced in April 2011. Although the China Interbank Bond Market (CIBM) direct scheme was introduced for foreign investors in 2015, the Bond Connect made it easier for foreign investors to access the mainland Chinese market. In addition, the investment limits for qualified foreign institutional investors (QFIIs) and renminbi qualified foreign institutional investors (RQFIIs), who are eligible to trade mainland Chinese securities, were removed in 2020. Although administrative procedures, such as for reporting capital movement to authorities, remain cumbersome, investors' convenience has greatly improved.

<Foreign Investors's Share of Mainland Chinese Bond Market>



Source: JRI, based on CCDC, Reuters

Circumstances on the part of foreign investors also contributed to an increase of investment in mainland China. For the FX reserves of central banks, the total value of assets denominated in RMB swelled to about USD 300 billion in the January-March 2021, accounting for 2.5% of the total, most of which is believed to be invested in Chinese government bonds. The influx was prompted by the inclusion

of the RMB in the Special Drawing Rights (SDRs) in October 2016, triggered by the IMF's appreciation of China's progress in financial market liberalization. In addition, since 2019, Chinese government bonds and policy-based bank bonds have been included in the key bond indices, which serve as investment benchmarks. In recent years, there has been an increase in the number of passive investments in pension funds around the world that are linked to these indices, and this has prompted an influx of investment funds into the Chinese securities market. Originally, China's bond market was of sufficient market size and received high credit ratings, and this appears to have been boosted as a result of improved market access. As a matter of fact, as of the end of 2020, the amount of Chinese bonds issued and outstanding totaled USD 18.6 trillion, exceeding that of Japan (USD 14.7 trillion); and China's S&P sovereign bond rating is A+, on par with that of Japan. Looking at equity indices, even after China A shares, which are traded in mainland China, were included in the MSCI Emerging Markets Index for the first time in June 2018, China A shares were also included in the FTSE indices (started in June 2019) and S&P Dow Jones Indices (started in September 2019), one following another, accelerating the inflow of funds to the mainland Chinese stock market.

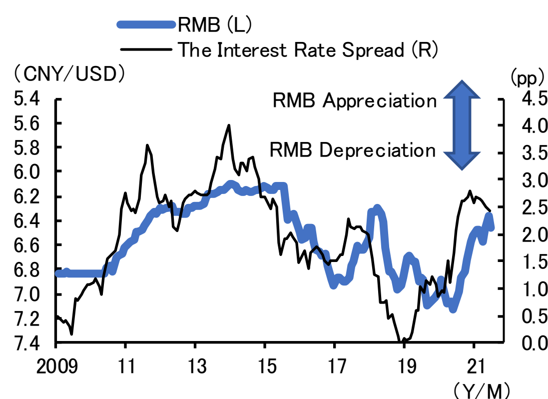
Surplus foreign funds also have a large impact. Interest rates have been falling across the board as a result of large-scale monetary easing, particularly in developed countries, making China's government bond yields (around 3% for 10-year government bonds) relatively attractive. In Japan, it has been reported that major insurance companies are increasing their investment in Chinese bonds due to difficult fund management conditions caused by low interest rates.

■ Faced with a strong backlash, the Chinese authority's guidance toward fully opening up the Chinese securities market will be questioned

Despite the foregoing, 1) the intensification of the confrontation between the U.S. and China and (2) the normalization of U.S. monetary policy could pose adverse challenges for the Chinese securities market in accepting inward portfolio investment in the future.

The U.S. is tightening regulations on investment in Chinese companies that are believed to have ties with the Chinese People's Liberation Army (PLA). Equity index providers excluded the suspected Chinese companies from their indices in December 2020. The size of the target companies is still small (0.28% of total weight in the MSCI Emerging Markets Index), but the impact could become larger in the future. In addition, heightened interest in human rights issues could accelerate regulations on Chinese investment and selection of Chinese companies for investment.

<RMB and the Spread of Interest Rates between US and China>



Source: JRI, based on CEIC

Moreover, monetary policy is gradually normalizing in the U.S. Amid this situation, the rise in U.S. interest rates will likely prompt the unwinding of funds that had flown into mainland China, putting downward pressure on the RMB. Concerns may also be raised regarding capital outflows, as in 2015 when RMB devaluation shocked global markets. The Chinese authorities are also wary of such capital outflows, so they are willing to accept inward foreign investment in China, but are somewhat reluctant to promote China's outward foreign investment. In fact, the investment limits for qualified domestic institutional investors (QDIIs) have remained, while southward investment through Bond Connect (bond trading in Hong Kong by mainland Chinese investors) is only expected to begin this year. If capital movement regulations are tightened (e.g. through the introduction of restrictions on transactions in market access), overseas investors are likely to suffer disadvantages. As the amount of foreign investment in Chinese securities is more than double that during the time of the RMB devaluation, stricter regulations will likely damage the credibility of the Chinese securities market.

Expanding the flow of investment funds with overseas investors is important not only for the future growth of the Chinese economy but also for promoting internationalization of the RMB. These headwinds will pose a major challenge for Chinese authorities to create an open capital market that is attractive to foreign investors.

(Minoru Nogimori)

Topics *The introduction of a minimum corporate tax rate and its impact on Asia*

At present, the impact of introducing a global minimum corporate tax rate for Asia is seen as limited, but if there is further momentum towards strengthening taxation, the Southeast Asian economy, which has been driven via the attraction of foreign companies, may stagnate.

■ There are moves to introduce a global minimum corporate tax rate

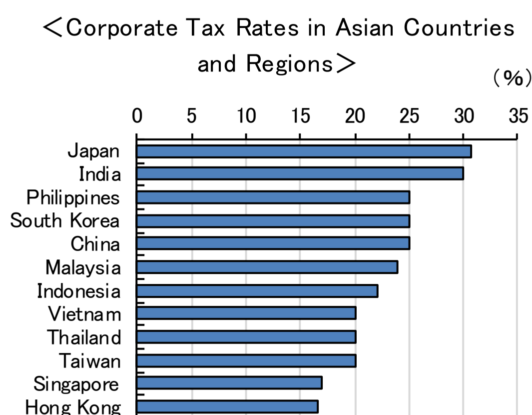
At the Group of 7 (G7) meeting in June and the Organisation for Economic Co-operation and Development (OECD) and Group of 20 (G20) meetings in July, a broad framework agreement was reached on new international taxation rules aimed at introducing a minimum corporate tax rate of 15% or more. By introducing a minimum corporate tax rate, the government of the country where a company's head office is located will be able to levy the difference from the global minimum tax rate, even if the tax burden of a foreign subsidiary falls below the global minimum tax rate. This means that companies will no longer benefit from the transfer of profits overseas, and incentives to move operations to countries with low tax rates will decrease. Along with the introduction of a digital tax (a tax that can be imposed on multinational companies with sales and profits above a certain level, even in countries where they do not have business bases), the OECD has been involved in consultations and negotiations on the global minimum tax rate, with the aim of reaching a final agreement in October 2021 and implementing the new tax in 2023.

One reason behind the progress in discussions on international taxation rules this year is that the United States has changed its policy and is now leading the discussions. Under the Trump administration, the United States withdrew from the talks due to its opposition to increasing taxes on U.S. IT companies, but the Biden administration, which advocates for international cooperation, resumed these negotiations. The Biden administration also requires financial resources for large-scale economic stimulus packages. On the other hand, looking at the situation in countries other than the United States, as a result of increased fiscal spending in response to the COVID-19 pandemic, the agreement was backed by the general desire to halt competition to reduce corporate taxes in order to secure tax revenues.

■ The impact on Asian countries and regions is currently limited

Although corporate tax rates in all major Asian countries and regions exceed 15%, some industries and specific regions, particularly in Southeast Asia, have adopted corporate tax incentives in order to attract foreign capital, and in some cases, the effective tax rate falls below 15%.

It is yet to be decided how corporate tax incentives will be treated when the minimum tax rate is introduced, and discussions will likely be held in the future along with talks on the level of the minimum tax rate. On the other hand, the OECD statement proposed a formulaic substance carve-out exclusion that would reduce the tax base to which the minimum tax applies in consideration of businesses that have local bases and employ people. The carve-out will exclude an amount of income that is at least 5% of the carrying value of tangible assets and payroll. Given that the minimum tax rate will likely be 15% in order to obtain the support of low-tax countries and emerging countries in the final agreement, adverse effects on the Asian economy are considered to be limited at present.



Source: Prepared by The Japan Research Institute, Limited based on the JETRO website (Taxation)
Note: India's corporate tax rate is based on company type and amount of taxable income. The tax rate for companies whose total annual revenues or turnover exceeds 4.0 billion rupees is 30% for domestic corporations and 40% for foreign corporations.

However, some in Asia are wary of introducing a minimum tax rate. In Thailand, Prime Minister Prayut has ordered his ministers to investigate the impact of such a move on investment activities. In Singapore, the effective tax rate for most of the 1,800

multinational companies subject to the new global rule is under 15%, and Minister of Finance Wong has expressed his view that it will be difficult to attract foreign capital going forward. In Hong Kong, Financial Secretary Paul Chan Mo-po has mentioned the possibility that the minimum corporate tax rate will affect some tax incentives. In addition, there were reports that China was negotiating behind closed doors to exempt the special economic zones from the scope of application.

<Tax Incentives in Asian Countries and Regions>

Country	Item	Targets	Examples of Tax Incentives
Vietnam	Investment in the designated areas	Companies investing in socially and economically disadvantaged areas, special economic zones, and high-tech zones	- Application of a preferential tax rate of 10% for 15 years in principle, or tax exemption for four years and tax reduction for nine years in principle
Thailand	Additional incentives to improve competitiveness	Businesses related to the development of target technologies (Biotechnology, nanotechnology, advanced materials technology, etc.)	- Full exemption of corporate income tax for up to 13 years
Malaysia	Pioneer status	Manufacturing industries related to designated businesses (computers, medical devices, biotechnology, etc.)	- Corporate tax exemption for 70% of legal income for five years; full tax exemption for cutting-edge materials manufacturers, etc.
Philippines	PEZA registration	PEZA-registered export-oriented manufacturers	- Exemption of corporate income tax for up to seven years; payment of corporate tax will be limited to the amount equivalent to 5% of gross profit for 10 years thereafter
Indonesia	Pioneer industries	Companies investing in pioneer industries (automotive components, smartphone components, computer components, ship components, etc.)	- Up to 100% corporate income tax reduction for up to 20 years
China	Investment in Special Economic Zones (Shenzhen, Zhuhai, etc.)	High-tech companies (electronic information technology, biological and new drug technology, aerospace technology, etc.)	- Exemption of corporate income tax for the first two years; application of a 50% corporate income tax reduction from the third to the fifth year
Hong Kong	Corporate treasury center	Financial headquarters of multinational corporations	- Application of a preferential tax rate of 8.25%
Singapore	Tax incentives for regional headquarters	Companies with global headquarters and regional headquarters functions	- Application of a reduced tax rate of 10% for up to five years

Source: Prepared by The Japan Research Institute, Limited based on the JETRO website (Tax Incentives for Foreign Companies)

■ **It is necessary to pay close attention to developments stemming from future discussions**

The United States will not allow exceptions to the minimum tax rate and maintains the position that discussions to raise the minimum tax rate from 15% should be continued. As the United States has taken the lead in the discussions, talks to review the conditions in order to strengthen taxation in the future cannot be ruled out.

Because companies do not focus only on tax costs, they may continue to invest if the market's attractiveness is evaluated, even if the tax burden increases due to reduced tax benefits. However, if taxation is further strengthened, the Southeast Asian economy, which has been driven by attracting foreign companies, may stagnate. According to a JETRO survey, 40.7% of enterprises cited the "substantial tax benefits including the low corporate tax rate and favorable tax treatment for regional headquarters" as the reason for setting up their regional headquarters in Singapore. According to a survey by the Japan Bank for International Cooperation (JBIC), "the growth potential and size of the local market," "cheap labor," and other factors were cited as the top reasons for enterprises to consider a particular country in Southeast Asia as a promising destination when expanding into the region. On the other hand, approximately 10% of enterprises cited "preferential taxation on investments" as a reason for expanding businesses in the Philippines and Malaysia.

＜Reasons Why Japanese Manufacturers Consider These Countries as Promising Destinations for Business Expansion＞

Reasons	Indonesia	Philippines	Malaysia	Thailand	Vietnam	China
Future growth potential of the local market	69.6%	54.3%	41.2%	42.3%	59.5%	58.1%
Current size of the local market	34.8%	22.9%	26.5%	38.7%	20.6%	66.5%
Cheap labor	30.4%	45.7%	11.8%	20.7%	42.7%	9.0%
As a third-country export base	20.7%	11.4%	8.8%	24.3%	15.3%	9.0%
Brilliant talent	8.7%	17.1%	5.9%	18.0%	25.2%	13.8%
Industrial clusters	6.5%	8.6%	14.7%	23.4%	4.6%	22.8%
Development of local infrastructure	3.3%	5.7%	17.6%	18.0%	3.8%	12.6%
Preferential tax treatment on investments	1.1%	11.4%	8.8%	7.2%	6.9%	2.4%
Number of companies considering each country as promising	92	35	34	111	131	167

Source: Prepared by The Japan Research Institute, Limited based on the "Survey Report on Overseas Business Expansion of Japanese Manufacturers" by the Japan Bank for International Cooperation (JBIC)
Note: The percentage shown in the table indicates the percentage of enterprises that selected the reason among those that responded that the country was promising (multiple answers were available). Eight of the 18 items were selected as reasons.

Of the 139 countries and regions that participated in the OECD meeting, seven countries, including Ireland and Hungary, did not join the agreement as of July 12. However, the G20 and other parties have been lobbying for a broad agreement that includes low-tax rate countries, and the possibility of realizing stricter taxation is increasing. It is necessary for Japanese companies to bear in mind the possibility that they will not be able to receive the tax breaks they have received up to now, and to fully consider other advantages when expanding overseas.

(Mitsuhiro Matsumoto)