EconoFact Chats: How Much of Your Investments Are in China?
Matteo Maggiori, Stanford University
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Michael Klein

I'm Michael Klein, executive editor of EconoFact, a nonpartisan, web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein

How much of your portfolio is in Chinese stocks and bonds, and why does that matter? China is the world's second biggest economy. Its growth over the past three decades has been exceptional. Investing in a rapidly growing economy is typically a smart move, both for the lender and for the borrower. But is that the case with China? The Chinese government restricted capital inflows because of stability concerns. Money that flowed in could also quickly retreat. There are also concerns that issuing stocks to those outside China would cede control to foreign investors. For international investors, there are concerns about the Chinese government taking moves that would limit access to their investments or reduce their returns. So what is the stance of foreign investment in China? The answer provided by the Global Capital Allocation Project, a research lab based at Stanford University and Columbia University, may surprise you. My guest today, Professor Matteo Maggiori, is one of the directors of the Global Allocation Project. He's a professor at Stanford University and a recipient of the Fischer Black Prize, which is awarded to an outstanding financial economist under the age of 40. Matteo, welcome to Econofact Chats.

Matteo Maggiori

Thank you for having me on the show, Michael.

Michael Klein

Matteo, it's great to have you on. As you know, the famous economist John Maynard Keynes wrote about the extent of international investment before the First World War, saying how easy it was for an English gentleman to, in his words, ‘adventure his wealth in the natural resources and new enterprises of any quarter of the world and share without exertion or even trouble in their prospective fruits and advantages.’ What was the rationale for this statement by Keynes, for the English to invest abroad before the First World War?

Matteo Maggiori

England back then was the key country in the international monetary system, so it was the world banker. The big safe asset at the time were bills like short-term securities denominated in pounds and traded in London, think of them a little bit like US treasuries today for the current system. The British financial system took those funds and recycled part of them abroad in risk investments. That's what Keynes was talking about. Of course, on top of that, there were traditional motives of diversification, capital searching for high risk return trade-offs all around the world. This was a period of free capital mobility. What do I mean by that? It was a period where you could invest anywhere. There were very few restrictions from moving capital across countries.

Michael Klein

So, when Keynes wrote this in the early 1920s, about 100 years ago, it was actually elegiac, he was looking back at a period where there was, as you say, free capital mobility, but then that fell apart after the First World War. What's the situation today? Is it more like what Keynes wrote about the First World War, or more like the period after that when free capital mobility fell apart?

Matteo Maggiori

So there are actually some parallels with today where, again, we're experiencing a period post-1973, where more and more countries have removed barriers from trading capital internationally. So US residents can invest in many countries around the world, and they do. And also the U.S. is now at the core of the international monetary system. So it has taken on the role that England played before the 1920s being the world banker. The rest of the world buys safe assets in the U.S.. Today, they are short-term treasuries, for example, denominated in dollars. And the U.S. financial system recycled some of those funds abroad in risk investments of various types. Of course, there are some differences. One major one is that England runs a current account surplus. The U.S. runs a deficit. But being a world banker is about borrowing safe and lending risky. So it's about the gross activity. This, of course, has an impact on the net because on average, you make money out of doing this, but it's not mechanically required to run a deficit. And this is going to be something we're going to touch base when we talk about China. China also has a big account surplus, but it would like to play a bigger role as a provider of safe assets to the rest of the world. And there are ways to think about that that we can explore.

Michael Klein

So as you and I teach in our basic classes, Matteo, when you run a current account surplus, you're necessarily on net, as you say, lending to the rest of the world. And when you run a current account deficit, you're necessarily running on net, borrowing from the rest of the world. But as you mentioned, it's not just the net amount, but the gross amounts as well that matter. Correct?

Matteo Maggiori

Absolutely. So the gross amounts are much larger than the net amounts. And they're not necessarily in the same assets. So the reason why economists think of the U.S. as a world banker is because the assets and liabilities are very different. It looks like a bank. It has very safe assets, like short-term assets on the liability side, but it has long-term potentially liquid assets on the asset side. And you wouldn't want to net the two. There are interesting things that happen to the net because the bank on average makes money. But there's a lot of risk involved in taking on this activity. And gross capital flows have been an important topic to understand what's happening to the financial system over the last 20, 30 years.

Michael Klein

And that's something that was pioneered by Philip Lane and Gian Maria Milesi-Ferretti in some pathbreaking work they had that uncovered that data, right?

Matteo Maggiori

Absolutely. I mean, they did fantastic work documenting all of these gross capital flows and what was happening for many, many countries in the data.

Michael Klein

So going back to the comparison with the pre-World War I period when there was high level of capital mobility, when it was very easy to borrow and lend abroad, today is also an era when it's relatively easy to invest abroad because of technology that transmit buy and sell orders instantaneously, and the interconnectedness of the world, which gives us the ability to learn about conditions almost anywhere, and also the fact that many countries have dismantled rules and regulations that inhibited international investment. So the conditions in the world look pretty much like our stark economic models that include very few frictions that prevent people from investing anywhere and assume that people have lots of information. But does the actual outcome of the world, Matteo, mimic what's found in the models?

Matteo Maggiori

Well, when you look at the data – and this is what I've been doing in my own research work – you find a number of differences with at least the very traditional models. So let me mention some of the most famous ones which were established well before I started doing research. Probably the most famous is what is called home-bias. It's the idea that countries over-invest in securities issued by their own domestic firms.

Michael Klein

And then the counter thing, what theory would predict is that people should invest sort of the same all over the world, not tilted towards their own home domestic markets, right?

Matteo Maggiori

You can take a very simple benchmark, which is what economists call CAPM. It's a fancy name for the following idea: that you should buy everything in proportion to what exists around the world. So if China is a big chunk of all assets out there, you should have big investments in China and the U.S. and so on. What you find in the data is that countries tend to over-invest compared to that model in their own domestic assets. Another very prominent one is what is called the Lucas paradox. And it's named after the economist Robert Lucas. It's the idea that capital, you would think that capital will flow towards countries that have high growth prospects and low stocks of capital because that's where the returns are high. And emerging markets might be the typical country that we have in mind that has those characteristics. But in the data, capital doesn't flow nearly as much as we would have predicted towards those countries. Another effect that is closer to my own work, so together with Brent Neiman and Jesse Schreger, we documented what we call home currency bias. It's the idea that countries tend to over-invest in bonds issued in their own currency, even when they invest abroad. So to make it concrete, Americans, even when they invest abroad, tend to buy a lot of bonds in dollars, even when they're buying bonds issued by European entities, for example. Again, the more national prediction would have been that since most bonds issued by European entities are in euros, the Americans will buy those. But actually, they turn out to over-invest in dollar bonds.

Michael Klein

And that's because dollar bonds are being issued outside of the United States, so there is that opportunity, correct?

Matteo Maggiori

Absolutely. So for many major currencies, what you will find is that particularly large firms will tend to issue in multiple currencies, so some American firms will issue in euros, and Europeans will tend to buy those. Some British firms might issue in Canadian dollars, and the Canadian investors will tend to be big in those bonds. So there's a lot of sorting according to currency in all of these world investments.

Michael Klein

So it doesn't look like our models. We've been talking about investor decisions. What about the countries that are receiving funds? Are there clear advantages? Like when British investors, you know, what Keynes was writing about, they funded the constructions of railroads, canals, and industry in countries like Canada, Australia, Argentina, and even the United States in the late 19th century. Are there disadvantages to countries receiving capital from abroad as well?

Matteo Maggiori

Well, there are some very obvious advantages, which you mentioned. Foreign capital can be used to fund productive assets domestically, so production. It can also be used as a substitute for domestic capital. So you might want to have your domestic residents free out some of their investments substituted for foreign capital, and invest abroad so that they can get some diversification. But unfortunately, there are a number of ugly properties of foreign capital to put it that way. What are those ugly properties? Well, the major one is what economists call sudden stops. It’s the idea that foreigners tend to get scared and move their capital out all of a sudden. And unfortunately, receiving a stream of capital inflows over time slowly, and then a big lumpy reversal of these flows tends to be very deleterious to the economy. It can cause a financial crisis. It's a little bit about the speed of adjustment – the fact that it goes out altogether that makes it very difficult for the domestic banking system and the economy to adjust to this sort of sudden movement of capital out of the country. So a lot of policy making, particularly in emerging markets over the last 10, 15 years, has been finding ways to deal with the sudden withdrawals of capital.

Michael Klein

I think when the economist Rudi Dornbucsh introduced the term sudden stop, he was talking about when you're in a car accident, it's not the speed that hurts you, it's the sudden stop.

Matteo Maggiori

Absolutely.

Michael Klein

So what's a particular example of a sudden stop, Matteo, that we can think about where we actually saw these sort of destructive properties of a quick outflow of capital?

Matteo Maggiori

Well, emerging markets like Brazil had a number of those, for example, where capital comes in and then the foreigners might get scared either about political risk, or some particular choices of the government in either monetary policy or a loan default risk and they pull out. Sometimes, it's not about the destination country. It's about where the source of capital comes from. The typical example is what in the financial process called the taper tantrum, is when the US first announced that they were going to stop or reduce potentially quantitative easing, financial institutions in the US got scared and they started repatriating their capital very suddenly from the investments they had made abroad, and that caused some ripple effects around the world.

Michael Klein

So when this happens in a country, interest rates rise, the currency could fall quite a bit, which makes the people in that country poorer with respect to buying foreign goods, there could be sort of a seizing up of the financial markets, so it leads to a downturn and very severe economic conditions, correct?

Matteo Maggiori

Correct. I mean, one thing that we see for example now is capital, particularly in the bond market flowing out of China. Now, for China's case, it's quite different in the sense that foreigners were a small part of the overall market in China. So the system is able to absorb a moment where the foreigners are taking their money out of their bond market. But you know, foreigners were something like 3 or 4% of the bond market. But had they been 20% or 30%, the same, you know, the same proportional withdrawal of capital would have caused much more havoc to the domestic economy than what we're seeing right now.

Michael Klein

Well, let's turn to the case of China. When the Chinese economy started to open up to the world, it enjoyed sustained high growth rates that were unprecedented and people at the time spoke of red chip stocks, which were seen to be very attractive because of the rapid growth of China. But the Chinese authorities limited investment inflows. Why did they do that, for the reasons that you were talking about in terms of fears of instability?

Matteo Maggiori

So China is a very interesting case because it touches on many of the topics that we discussed. They've been opening up slowly. In my view, trading off financial stability concerns, so the idea that if you let the foreign capital come in too quickly…exposed when there might be a sudden stop. So the foreigners might want to take their capital out. That can be very expensive. So you might want to do it very gradually. And China has been strategic in this, in the sense that they first let in foreign financial players that are understood to be less likely to withdraw the capital quickly. Think of it as official institutions, insurance companies, or maybe the endowment of a university. These are players that are very long term. They're not the typical hedge fund or mutual fund that might face redemption and liquidate very quickly. And then more recently, they've actually opened up more and more to that kind of flighty capital. And right now, for example, you know, we are observing outflows from Chinese markets for all of 2022 continuing in 2023. And that's an interesting situation. You know, we'll see what happens over the course of this year.

Michael Klein

In terms of what you were saying before about China imposing regulations and rules, so it'd be harder to invest, that's at odds with its other goal of becoming a big player in the international monetary system and perhaps having its currency the Renminbi replace the dollar, right?

Matteo Maggiori

Absolutely. So China has a stated goal of wanting to rival the U.S. in the financial sphere, particularly when it comes to being at the center of the system. And, you know, many countries have that goal. Many have had in the past and the dollar has been very difficult to displace. To think about why, in my view, it has to do with the financial stability concerns. So you would like to have a great reputation as a country that can provide safe financial markets for the rest of the world to invest in. But when a crisis comes and the foreigners, for example, want their money out, there's going to be a short run temptation to in some sense prevent that, to avoid these liquidations. And that's a big concern right now with China. If you ask investors, what is one of the big concerns they have is, well, I can bring my money in, but am I sure that I'm going to be able to get it back whenever I want it?

Michael Klein

So that means they don't bring the money in to begin with, right? Because of those concerns?

Matteo Maggiori

Absolutely. They're going to do it slowly. And China is trying to build this reputation. So every time there is a crisis, if you keep behaving, the investors will trust you a little bit more, and they'll bring more capital in into the future. But it takes a very long time to build a reputation like the one in the US, where the rest of the world is reasonably sure that they can get their money back, and there’s not going to be default, there's not going to be imposition of capital controls or anything else in a crisis. That's a stellar reputation, but it's very hard to both achieve it and maintain it.

Michael Klein

Matteo, I know you've done a lot of work on offshore markets. Can you briefly describe what those are and how that relates to China?

Matteo Maggiori

For sure. So the offshore markets are places like the Cayman Islands or the British Virgin Islands. There are essentially jurisdictions where companies, or sometimes governments, but mostly companies, register subsidiaries for the purpose of issuing securities. So for example, the Cayman Islands attracts a tremendous amount of bond and equity investment, but it's clearly a small island with a few billions of GDP. Everybody understands that the capital is not staying there. It's getting to the Caymans and then going somewhere else. And one of the big questions has been, where is that capital going? So a lot of my research work together with Antonio Coppola, Brent Neiman, and Jesse Schreger has been trying to document this systematically at the world level. And it turns out that China plays a major role in this. This is not something that is entirely commonly understood. Why? Because it's changed dramatically over the last 20 years. So if you were looking at the data 10 or 15 years ago, China would have been a minor player in these offshore jurisdictions. But when you look at the data today, China has a dominant role. It accounts for about 60% of equity outstanding in these jurisdictions and about 20% of the bonds. So it's a really major player.

Michael Klein

So this is your work with the Global Capital Allocation Project that I mentioned at the outset. And also at the outset, I asked the question, how much of your wealth is invested in China? And you're finding through this by digging deeply into the data that it's actually a lot more than what people realize, correct?

Matteo Maggiori

Yes, because most of it is indirect. So if you go back to a discussion we were having about investors being worried about onshore markets in China, so bringing their money into China, well, one response is Chinese firms are issuing in these offshore markets and investors are buying the securities there. And if you look at American investors or European investors, they're big holders of these securities, both bonds and equities. And in equities it’s largely the tech companies, so think of it as Alibaba, Tencent, Baidu. In bonds, it's not just the tech companies. It's also a lot of state-owned enterprises in China.

Michael Klein

So this use of the Cayman Islands also has an aspect of being a tax haven. What's the problem with a tax haven, Matteo?

Matteo Maggiori

So there are several issues. One of the most prominent is of course taxation. So a typical example of that are American companies that tax invert into Ireland to minimize their corporate taxation. A second problem that is distinct has to do with regulation and the ability to protect the investors in these offshore jurisdictions. That's probably more prominent in the case of the Chinese technology companies. So they're setting up in the Cayman Islands not so much to minimize what they pay in corporate tax, but to bypass a Chinese regulation that, as you mentioned at the very onset, would prevent foreign ownership of strategic assets. And China thinks of all of these technology companies as strategic assets. And that's why they're there, but it creates an issue of, are we sure that when an American investor buys a security in the Cayman Islands, it actually has the typical rights that we associate with a bond holding or with an equity holding? That's an open question and there are reasons to doubt that.

Michael Klein

So the rights would be like the right of corporate control and things like that, but they actually don't have that. You mentioned in your research, shell companies, which are called WFOEs, W-F-O-E's. Can you describe a little bit what those are?

Matteo Maggiori

Absolutely. So this is going to take a minute, but bear with me. The way to think about a group like Alibaba is that you and I as American residents cannot invest directly in the company in China. The Chinese regulations don't allow for that. So what Alibaba is going to do is it's going to set up first a shell company in the Cayman Islands. That one has equity listed in New York that you and I can buy. How is that company related to the operating company in China? Well, there will be a third company in the group called a WFOE, a wholly foreign-owned enterprise. That's a company in China that is licensed to operate in a sector that is not strategic and therefore can be fully owned by foreigners. For example, consulting is a typical sector. And the problem is that what they're going to implement is a structure that without getting into the details from an international accounting standard principles allows the company in the Cayman Islands to tell me and you that when we buy its equity, we're buying a share into the entire group, including the operating company in China. At the same time, because none of these contours are actual equity, the company in China can tell the regulators that he has no foreign equity holders whatsoever. And the problem is how well this structure is going to work. It's an untested hypothesis.

Michael Klein

So it sounds like the Chinese authorities wouldn't be so happy with this either because Alibaba or other countries are using it to get around the restrictions that the Chinese authorities wanted to put in place as well.

Matteo Maggiori

Absolutely. So China has progressively tightened its grip on these technology companies. And these structures have come under pressure from precisely the crackdown on tech. So far, they've not been wiped out. So they've been enforced. But China has put, for example, a lot of restrictions on new companies using these structures to lease abroad. In some sense, the existing ones were somewhat stuck with on both sides because there are now billions of dollars worth of this outstanding and it's not so easy to unwind them.

Michael Klein

And for the investors, we already mentioned you don't have a voice in the company because you don't have any voting rights. Also, I guess the Chinese government could stop recognizing the rights of these investors. Are there also national security concerns about funding China?

Matteo Maggiori

So the one that you mentioned that is most prominent is both having a voice in the company and also in case of bankruptcy, what exactly are your legal records is to get hold of liquidation value from the company? Those are open questions. If you actually looked at the prospectus when this company is leased in New York, if you read their disclosures, one of the things that they're going to disclose is precisely what you said. They're going to say, you should be aware as an investor that the Chinese government might deem our financial structure invalid, at which point you do not have a claim on the actual operating company in China that pretty much is the entire value and you have an empty shell in the Caymans. In terms of the national security concerns, I mean, that's a broader conversation. Both countries, as you know, have had a lot of political pressure that surrounds data, information sharing, access to the books of these companies and, you know, these international offshore structures are part of that. Certainly the U.S. has wanted, for example, access to the accounts of these companies and being able to scrutinize the accounts if they're listed in New York.

Michael Klein

Well, Mateo, we've come a long way from talking about this simple CAPM model with perfect information and a lack of frictions. And your very important empirical work in digging into the data, I guess, was the source of the decision to award you the Fischer Black Prize, which is very, very well deserved. And I appreciate you joining me today to talk about these issues, things that are important, both from individual investors' points of views, but also national points of views as well. So thanks a lot, Mateo.

Matteo Maggiori

Thank you, Michael. Thank you for having me on the show.

Michael Klein

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