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What is behind China's capital outflows?

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China's cross-border capital transactions are being watched closely. The reason is rising capital outflows, which are often seen as capital flight. In the meantime, China has taken measures to put further limitations on what are already restricted capital transactions between it and other countries. Capital flows between China and the rest of the world therefore merit a closer look.

Net capital outflows since mid-2014

The figures initially show a clear picture: China's cross-border capital flows have changed direction since mid-2014. Up to the summer of 2014, funds flowed into China on balance in an aggregate of around USD 900 billion between 2010 and 2014 (Q2). On almost 100% of these were direct investments. Foreign enterprises were pushing towards China and (compulsorily) entered into joint ventures with Chinese partners. That situation reversed in mid-2014. Since then (as at Q3 2016) almost the same sum – nearly USD 900 billion – left China. But these net outflows have a different composition – unlike the net inflows of the preceding years (see figure):

1. Chinese enterprises themselves have increasingly made foreign direct investments (FDIs), including in Germany. As a result, fewer and fewer direct investments have flown into China on balance and in 2016, for the first time, more direct investment flowed from China to other countries than vice versa. This trend is an expression of a maturing economy. The more developed and competitive an economy is, the more its enterprises venture abroad in an attempt to acquire expertise and be successful there with production sites or participations of their own. Of course, this development can also be a sign that domestic investment incentives are declining. But in any case, direct investments usually cannot be seen as capital flight. On a cumulative basis, this has been a minor trend since mid-2014 at any rate because, as mentioned, actual FDI net outflows have been observable only since autumn 2015.

2. Another trend is more significant in quantitative terms. Net outflows since mid-2014 can be explained with what is referred to as other investment. The financial instruments covered by this category (i. a. account movements, bank loans, trade loans) accounted for a net outflow of nearly EUR 900 billion since the summer of 2014. Almost USD 500 billion of this sum can be attributed to the increase of corresponding financial claims abroad (in particular, bank loans granted to foreign borrowers and cross-border transfers). The remaining portion shows that China has reduced foreign receivables and thus repaid external debt.

3. Portfolio investments, on the other hand, which mainly consist in cross-border purchases of marketable securities, play a lesser role between China and the rest of the world because the Chinese side strongly regulates and restricts these capital flows. But here as well, the direction of net flows has reversed from inflows to outflows. As in the case of direct investment, we see this not so much as the result of capital flight but as a (natural) expansion of Chinese investors' possibilities beyond their country's borders.

Currency reserves meet funding needs

As China has closely controlled its currency until recently, the People's Bank of China has been balancing the accounts of China's capital flows to this day – by intervening in currency trading. It used to do this by ultimately absorbing net foreign currency inflows through the banking system and, in this way, accumulating currency reserves. The countermovement set in from summer of 2014: In order to finance the increasing foreign exchange requirements resulting from rising net capital outflows while controlling the exchange rate, on balance the People's Bank of China has sold foreign exchange reserves.

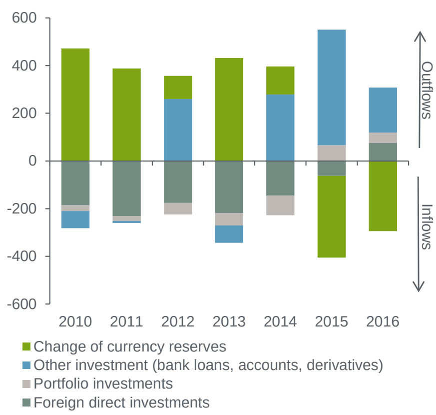
No reason to panic

This decline in foreign exchange reserves has been observed with some concern. However, China's foreign exchange reserves still amount to roughly USD 3 trillion, around three times as much as it has sold since mid-2014. The central bank is therefore still adequately equipped to manage further net capital flows in an orderly fashion.

China's biggest challenge by far is to reduce overcapacity in its industries and real estate market and clean up the banking system, which faces falling margins and rising NPL ratios. ■

Balance on the financial account

USD in billions, figures of 2016 without Q4



Source: CEIC, own calculations