China’s Capital Flight Syndrome*

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China, now one of the world’s two largest nations measured by gross domestic product (GDP), is displa- ying a strange malady. A sudden and large outflow of capital from the country is resulting in a sharp fall in its reserves. Going by International Monetary Fund (IMF) statistics, between the quarter ending June 2014 and the one ending June 2016, China’s foreign exchange reserves fell by $752 billion, from $4.1 trillion to $3.3 trillion. According to recent reports, reserves had fallen further to $3.1 trillion by the end of October 2016.

This collapse in reserves due to an outflow of capital is surprising in a country that for decades was considered the favoured destination for global capital flows, especially foreign direct investment (FDI). The outflow has been large eno- ugh to exert downward pressure on the currency, resulting in a depreciation of the Chinese renminbi (RMB) from RMB 6.11 to RMB 6.95 to the dollar (or of close to 14%) between August 2015 and - January 2017.

August 2015 was when China decided to loosen controls over the value of the RMB with respect to foreign currencies. Till then the People’s Bank of China (PBoC) set and administered the reference rate of the RMB relative to the dollar and other currencies. Starting August 2015, the PBoC decided to align the RMB to market trends. It chose to set the reference rate, around which the currency’s value can fluctuate within a 4% (plus or minus 2%) band, taking into account the previous day’s trading and market developments. Since the supply of foreign exchange is determined by export earnings and the exogenously determined inflow of foreign exchange, the market develo- p- ments and the market influenced exch- ange rate would be influenced by the demand for foreign exchange. Con- trolling demand requires the tightening or - loosening of restri- ctions on the use of foreign exchange. China has since the turn of the century been liberalising access to foreign - exch- ange to firms and individuals, partly to meet entry conditions set for its membership of the World Trade Orga- nization (WTO) and partly because of its own policies of financial liberalisation.

Financial Liberalisation

After China’s entry into the WTO, foreign investment into China and China’s exports rose, resulting in an increase in foreign exchange reserves and upward pressure on the RMB. This encouraged further liberalisation that would allow outflow of a part of the surplus foreign exchange. The thresholds for Chinese enterprises that could retain foreign exchange earned were relaxed and the proportion that could be retained by them enhanced. Overseas investment rules for Chinese enterprises were simplified. The access of individuals to foreign exchange for travel and other current account purposes was simplified. Individuals were allowed to transfer up to $50,000 abroad in a year for a variety of purposes. This liberalisation trend gathered further momentum when China decided to internationalise the RMB and seek reserve currency status through inclusion in the basket of currencies defining the IMF’s Special Drawing Rights.

In the new situation, managing the currency increasingly required adjusting the available supply of foreign exch- ange relative to the liberalisation-indu- ced in- crease in the demand for it. The only way the supply of foreign currency could be controlled was through the sale or pur- chase of foreign currency, which in- volved shrinking or expanding the volume of foreign reserves accumulated in the past. Increasingly, therefore, the operations of the central bank and the State Administration of Foreign Exch- ange (SAFE) in the market for foreign ex- change became crucial when influencing the level and trend in the exchange rate of the RMB. This, it appe- ared for long, was not a problem for China, whose foreign exchange reserves had burgeoned over the years to exceed $4 trillion by mid-2014. Any surplus of foreign exchange that could lead to RMB appreciation could be absorbed into that reserve by state purchases. Any shortage of foreign exchange in the market, which threatened excessive currency depreciation, could be countered thr- ough the sale of a part of the large accumulated reserves.

In any case, the problem in China was seen as one of excessive appreciation, rather than depreciation, of the RMB, given its export success and the large capital inflows it attracted. In fact, it was its huge reserves that partly encouraged China to loosen capital controls and measures regulating the official exc- h- ange rate. However, what followed after August 2015 came as a surprise to many. A country that was till then under pressure to allow its currency to appreciate because of its trade surpluses witnessed a continuous depreciation of its currency once controls were actually relaxed. While the initial fall in the exchange rate of the RMB may have been acceptable since the growth of exports was slowing, subsequent declines have occu- rred des- pite the effort of the central bank to shore up the currency by deple- ting its reserves to meet the demand for foreign currency in the market. Despite sustained intervention to stabilise the RMB and reverse its decline, the fall has persisted. On the other hand, as noted earlier, reserves have been considerablydepleted.

Not the Current Account

The point to note is that the weakness of the currency is not due to developments in the current account. China has con- sistently recorded current account sur- plu- ses, and the average quarterly surplus over the period between the quarter ending June 2014 and the one - ending September 2016 was in excess of $75 billion. If yet, there was a fall in reserves it was largely because of the demand for - foreign - exch- ange for repatriation of capital abroad.

Thus, despite its trade prowess, China seems to be suffering from the same malaise that affects many developing countries that have liberalised their exchange rate systems and loosened capital controls. In most of the so-called emerging markets, capital outflow consists largely of the outflow of portfolio investment from debt and equity markets. This partly corroborated the view that FDI flows, being more stable, are preferable to portfolio flows, and that, therefore, capital controls, if any, should focus on the latter. Outflow of portfolio capital is visible in China as well, especially in the period since the quarter ending March 2015. After positive inflows in every quarter starting with that ending June 2011 to the one ending December 2014, portfolio inflows turned negative and the outflow rose from $8.1 billion in the quarter ending March 2015 to $40.9 - billion in the one ending March 2016. After that, partly in response perhaps to government intervention, to which we return later, inflows turned positive.

There are, however, specificities in the Chinese case that are revealing, especially two striking features of the financial account in China's balance of payments. The first is evidence of large outflows under the "other investments" head since the quarter ending March 2014, and, second is evidence of a rise in net FDI outflows since the quarter ending March 2016.

Other investment outflows that tur- ned positive in the quarter ending June 2014 have since fluctuated violently, varying from $13.1 billion to $90 billion in different quarters, with the figure ex- cee- ding $50 billion in four out of the nine quarters ending June 2016. Other investment in the financial account of the balance of payments (as per IMF's Balance of Payments Manual 6) consists of "other equity, currency and deposits, loans, insurance, pension schemes and other standar- dised guar- antee schemes, trade credits and ad- - vances, and other accounts receivable/payable." These are sundry flows other than conventional portfolio and direct investment flows, most of which are short term in nature. A sudden increase in such outflows can be convincingly treated as reflective of an effort by entities and individuals choosing to hold or exercise purchasing power outside the country and, therefore, as evidence of capital flight.

Not surprisingly, the evidence of a sudden exit of capital from China is being considered as a problem created not just by the exit of foreign investors, but resident wealth holders as well. This is what makes a second, yet emerging, trend in the financial account of China's balance of payments of some interest. This is that quarterly FDI inflows that fluctuated - bet- ween $25 billion and $85 billion between the quarter ending March 2011 and the quarter ending June 2015, have turned negative, with average net outflows of $11.3 billion between the quarters ending September 2015 and June 2016, with the figure in the last of those quarters being an outflow of $30 billion. The main reason for this net outflow is a spate of investments abroad by Chinese firms, especially in acquisitions of firms abroad, which is being interpreted as an effort by these companies to acquire dollar denominated assets rather than invest domestically. According to the Financial Times, overseas investments by Chinese companies touched $146 billion over the first 10 months of 2016, exceeding the previous year's record of $121 billion for non-financial outbound investments.

Finally, the period since mid-2014 has seen a significant increase in the (negative) errors and omissions (E&O) figure in China's balance of payments account. Over the eight quarters ending June 2016, the aggregate E&O figure amo- unted to a negative $383 billion, as compared with minus $107 billion over the eight quarters ending June 2014. A negative E&O figure points to inflated credits or understated debits in the current and capital accounts or understated net asset acquisition or overstated increase in - capital liabilities—all suggestive of an unreported outflow of foreign exchange or capital flight.

Liberalisation Predicament

In sum, China is paying the price for the capital account liberalisation measures that it began to adopt with its entry into the WTO. But these elements of liberalisation have been underway for around a decade and a half now, whereas the outflow of capital from the country has become pronounced only recently. What accounts for the sudden desire of resident firms and individuals to move their wealth out of the country? One factor is, of course, the slowing of growth in China and the uncertainty for firms and individuals about the returns from investment at home, which encourages acquisition of assets abroad. The other is, of course, the fact that the only country which offers hope of revival in the near future and whose markets are strengthening and interest rates rising is the United States, making dollar denominated assets attractive for residents and investments in China (especially financial investments) unattractive for foreigners. And the third is that, liberalisation of the exchange rate mechanism requires the PBoC to run down reserves to shore up the RMB, while falling reserves feed fears of a fall in the relative value of the RMB to the US dollar.

The fallout is that the RMB is depreciating despite the surplus on the current account of China's balance of payments. Capital flight and currency depreciation are forcing the government to impose a range of restrictions on foreign exchange outflows. Starting November 2016, restrictions have been placed on repatriation on funds abroad, leading to objections from representatives of foreign firms. Restrictions are also being imposed on outbound foreign investment. A country that was seen as having used exchange rate controls to keep its currency undervalued, is now combating depreciation of its currency.

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