Chi Time

HOW BAD ARE CHINA'S CAPITAL OUTFLOWS?

Thinking is the hardest work there is, which is probably the reason why so few engage in it.

Henry Ford

Capital outflows from China have been rampant; but perhaps they are not as bad as market perceptions have it. There are signs that they may be slowing down.

Headline data shows that China's FX reserves dropped by USD319.8 billion YoY in 2016 on the back of an estimated current account surplus of USD192.8 billion. This suggests that capital outflows amounted to USD512.6 bn, or more than 16% of FX reserves. Conventional wisdom has it that capital outflows have continued to soar, putting an undue pressure on renminbi depreciation and prompting the PBoC to tighten up on capital controls.

However, the estimated USD512.6 billion outflow in 2016 was 39% smaller than the USD 843.3 billion outflow in 2015. While outflow pressure is evident in the sharp growth in China's FX deposits recently, the growth this time has been much slower than in the past two rounds when market sentiment turned against the renminbi (Chart 1). There has also been no loss of domestic renminbi deposits (Chart 2), suggesting no evidence of capital flight.

Statistically, capital outflows have been distorted by a valuation effect on China's FX reserves. Since China reports its FX reserves in USD terms, a soaring dollar against other currencies would have trimmed the value of the reserve portfolio by eroding the dollar value of other currency assets even when there was no change in the asset positions. By our estimates, the valuation effect reduced China's FX reserves by USD57.1 billion, or 11% of the estimated capital outflows. Adjusting for this, capital outflows were USD455.5 billion in 2016.

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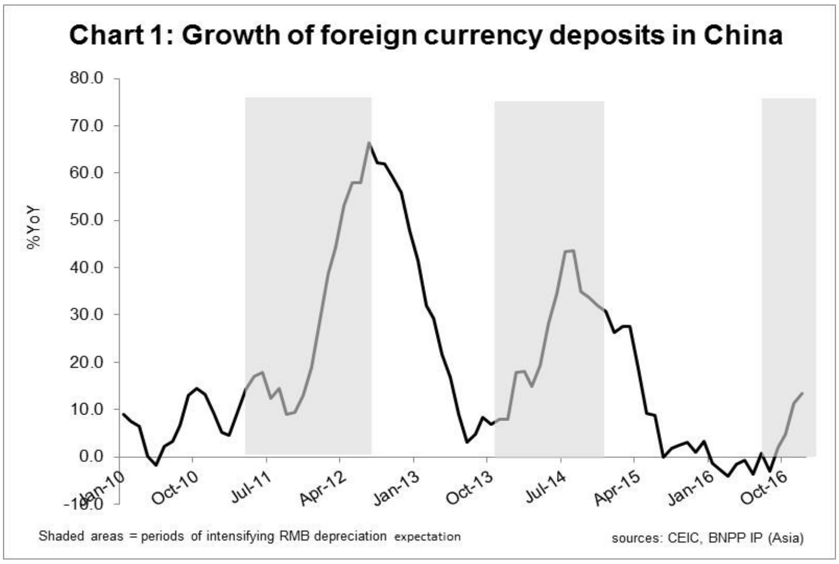

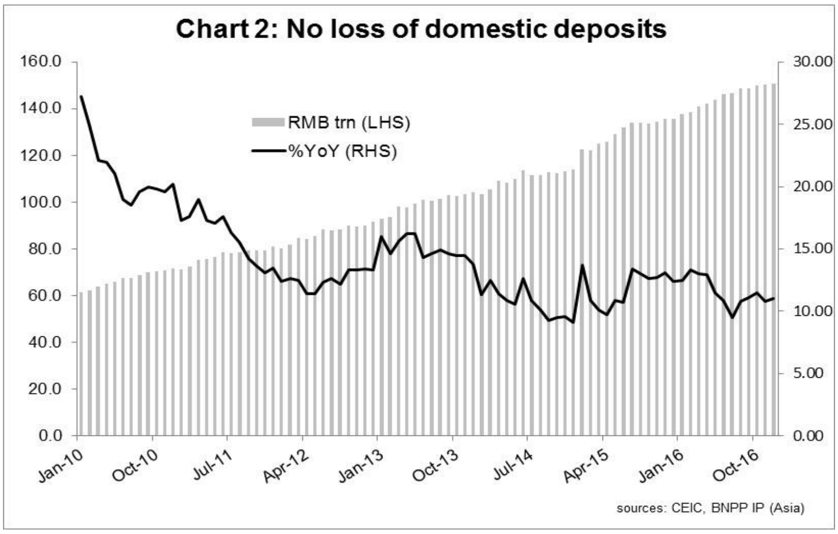

Capital outflows drivers

On the trade side, China's widening service trade deficit[1] is a source of capital outflows. This is less of a concern at this stage as it is not large enough to overwhelm China's current account surplus (Chart 3), which is a source of capital inflows. China still enjoys a basic surplus (Chart 4), although it has declined recently due to capital outflows.

Overseas direct investment (ODI) has become a new source of outflows since Beijing pushes for renminbi internationalisation and a "going out" investment strategy in recent years. Annual ODI has risen exponentially (Chart 5), albeit from a very low base, and is also responsible for the decline in China's basic surplus by eroding net FDI inflows. The rising trend of ODI will likely continue in the longer-term since China's international investment position remains small relative to other major countries (Chart 6).

[1] Outbound tourism has accounted for 90% of the service trade deficit so far.

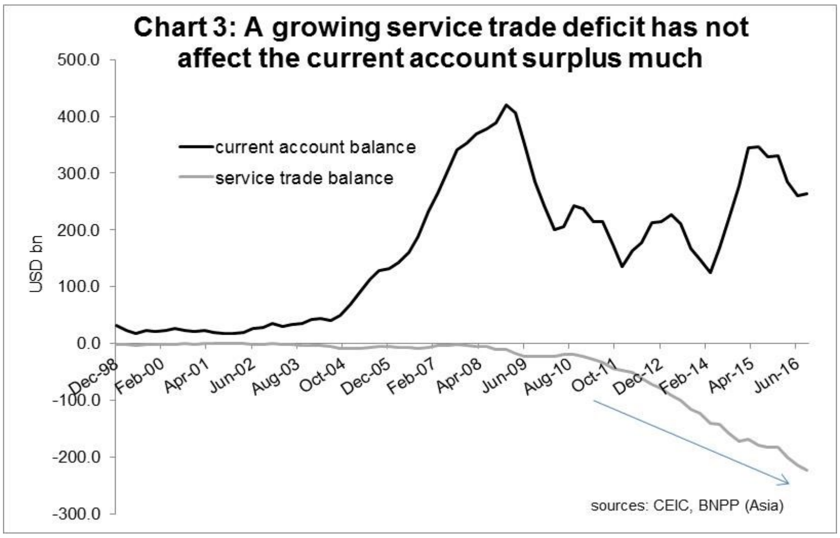
Chart 3: A growing service trade deficit has not affect the current account surplus much
current account balance
service trade balance
USD bn
500.0
400.0
300.0
200.0
100.0
0.0
-100.0
-200.0
-300.0
Dec-98
Feb-00
Apr-01
Jun-02
Aug-03
Oct-04
Dec-05
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Apr-08
Jun-09
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Oct-11
Dec-12
Feb-14
Apr-15
Jun-16
sources: CEIC, BNPP (Asia)

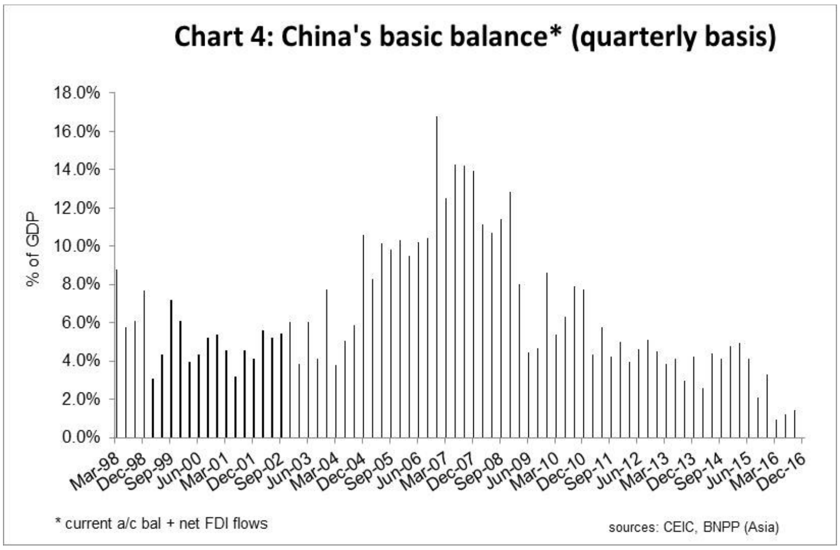


Chart 4: China's basic balance* (quarterly basis)
% of GDP
18.0%
16.0%
14.0%
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
* current a/c bal + net FDI flows
sources: CEIC, BNPP (Asia)

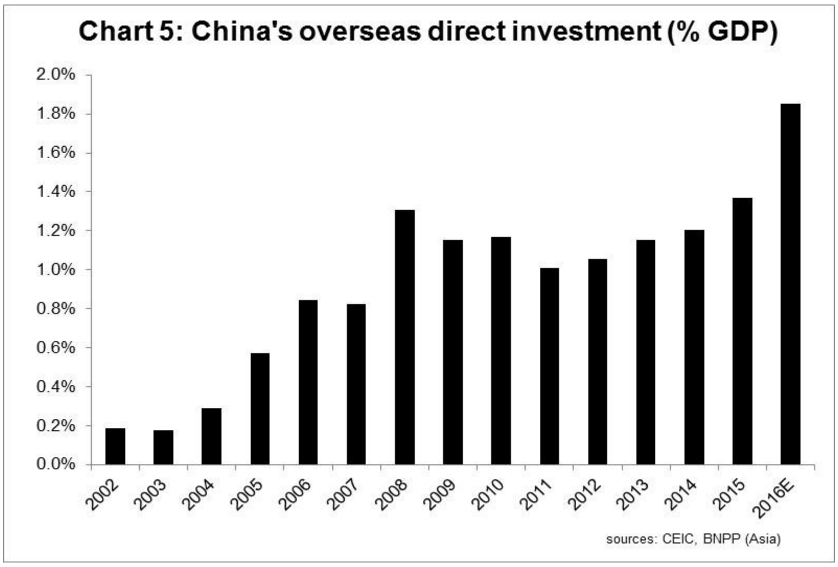
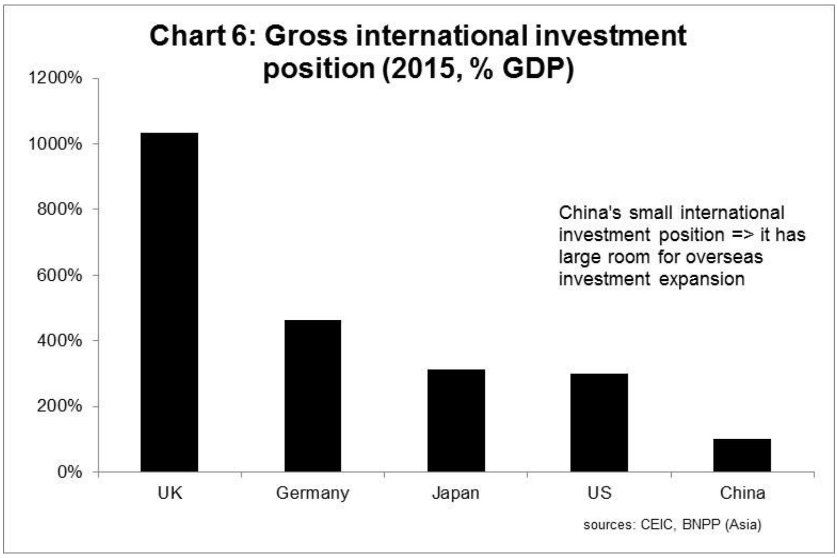
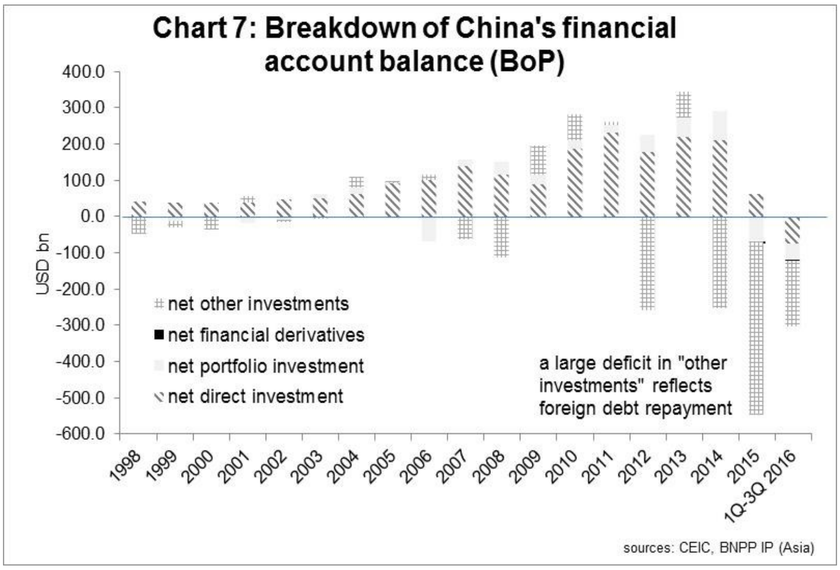


Chart 5: China's overseas direct investment (% GDP)
2.0%
1.8%
1.6%
1.4%
1.2%
1.0%
0.8%
0.6%
0.4%
0.2%
0.0%
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016E
sources: CEIC, BNPP (Asia)



Another major outflow item is Chinese companies' repayment of USD debt[2]. China's financial account[3], excluding reserve assets, in the balance of payments showed a deficit of USD303.2 billion in the first three quarters of 2016 (the latest data available). This was due to a portfolio investment and financial derivatives deficit of USD46.8 billion, a net FDI deficit of USD75.7 billion (the first deficit ever) and most importantly an USD180.7 billion deficit in "other investments" (Chart 7).

"Other investments" are dominated by loans (including trade credits) and deposits (including receivables). This deficit also reflects repayment of foreign debt. When Chinese companies borrow overseas (including via trade credits), they incur a foreign liability. But that represents capital inflows and appears as a positive entry in the financial account. Similarly, when foreign investors make deposits in China, these are capital inflows but represent a foreign liability for China.



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2 See "*Chi Time: How Much has China Repaid its Foreign Debt?"* 9 March 2016.

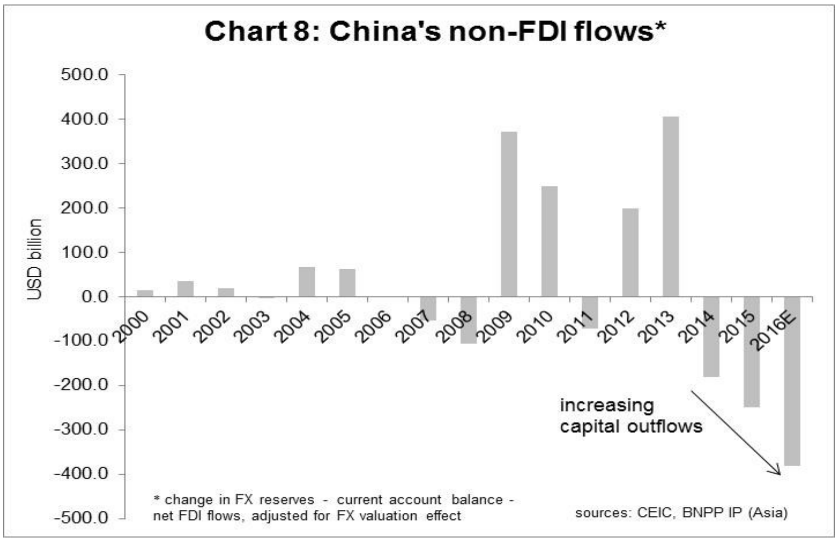
3 The financial account includes non-reserve items (including foreign direct investment, portfolio investment, financial derivatives and other investments) and reserve assets (including SDR, gold, reserves at the IMF, foreign exchange etc.)

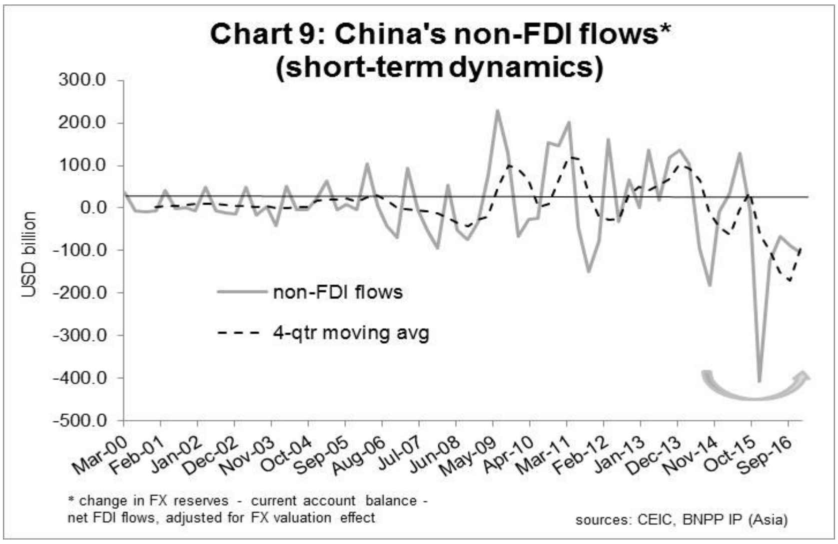
On the other hand, when Chinese companies repay their foreign debt and/or when foreign investors withdraw deposits from China, these transactions represent capital outflows and a reduction in China's foreign liability. They appear as negative entries in the financial account.

So the USD180.7 billion deficit in "other investments" suggests that foreign debt repayment continued to be the biggest driver of capital outflows from the financial account. But this deficit was down from USD330.4 billion in the same period last year (and USD479.2 billion for the whole of 2015), suggesting that Chinese firms might have repaid two-thirds of the USD1 trillion debt that they had incurred. So capital outflows pressure from this major source will abate.

Non-FDI flows

Alternatively, we can assess China's capital outflows is by estimating non-FDI flows, which include portfolio investment/ hot money flows, trade credit flows, foreign lending and borrowing by Chinese companies, interest rate arbitrage flows and illegal capital outflows. We estimate China's non-FDI flows by subtracting the current account balance and net FDI inflows from the change in FX reserves. These outflows have risen in recent years (Chart 8), but short-term outflow momentum seems to have abated (Chart 9).





The bottom lines

Cyclical and short-term outflow pressures seem to be abating. Structural capital outflow pressures, including the service trade deficit, portfolio diversification by Chinese households and ODI, will deepen in the longer-term. They should be viewed as part of China's economic maturing process rather than as financial stress. Meanwhile, the outflow pressure from Chinese firms repaying USD debt is abating and capital controls on curbing excessive outflows are increasing. If sentiment towards China improves due to, say, continued economic and financial stabilisation, capital outflows should abate in the coming year, allowing the current account surplus (which has been quite resilient to withstand the slowdown in global trade) to underpin the renminbi exchange rate.

In the near-term, when capital outflows continue to pressure the renminbi, the PBoC is likely to respond by a combination of tightening capital controls and using overnight rates to squash renminbi speculation (as seen in the CNH market) rather than a large devaluation. But capital controls, even if they are limited to curbing outflows but not inflows, could hurt international confidence in China's asset markets. The MSCI has already warned that China's asymmetric capital controls could affect its decision on including A-shares in the global benchmarks[4].

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[4] "MSCI Head Expresses Concern on China Capital Controls", 25 January 2017, Reuters via CNBC http://www.cnbc.com/2017/01/24/msci-head-expresses-concern-on-china-capital-controls.html

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