



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.

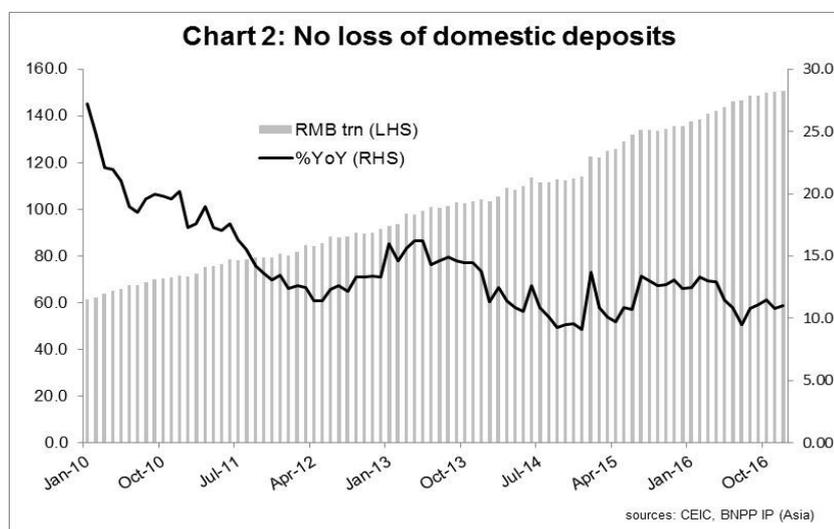
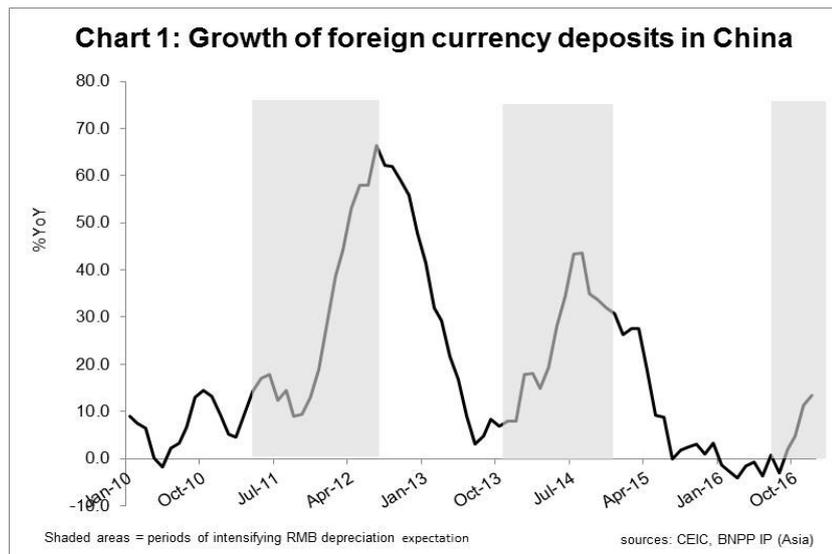
However, the estimated USD512.6 billion outflow in 2016 was 39% smaller than the USD 843.3 billion outflow in 2015. While outflow pressure is evident in the sharp growth in China's FX deposits recently, the growth this time has been much slower than in the past two rounds when market sentiment turned 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.



BNP PARIBAS
INVESTMENT PARTNERS

The asset manager
for a changing
world

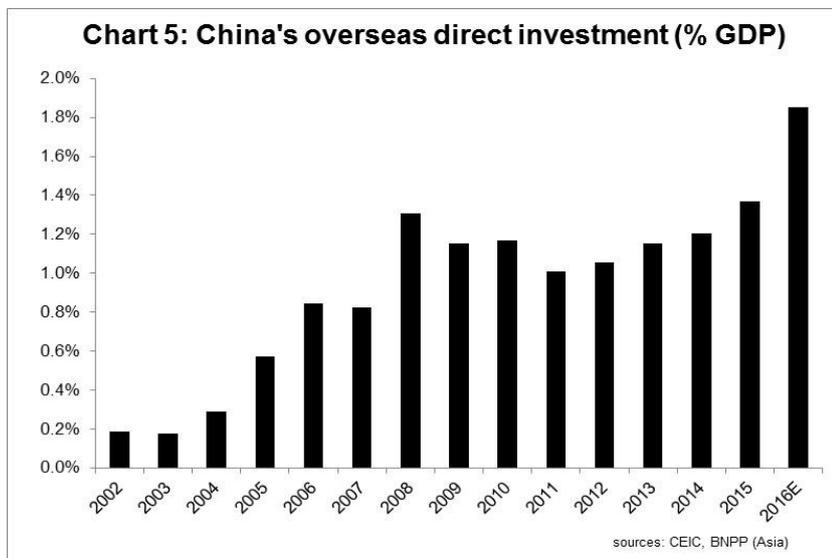
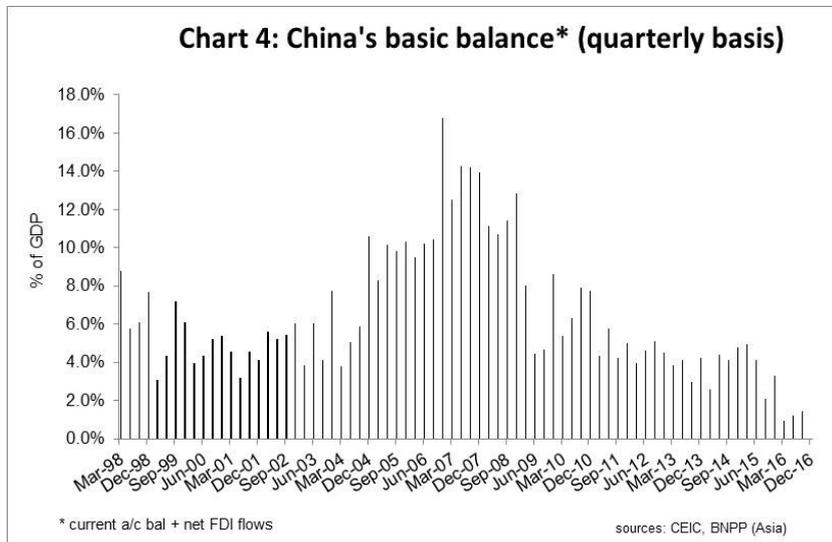
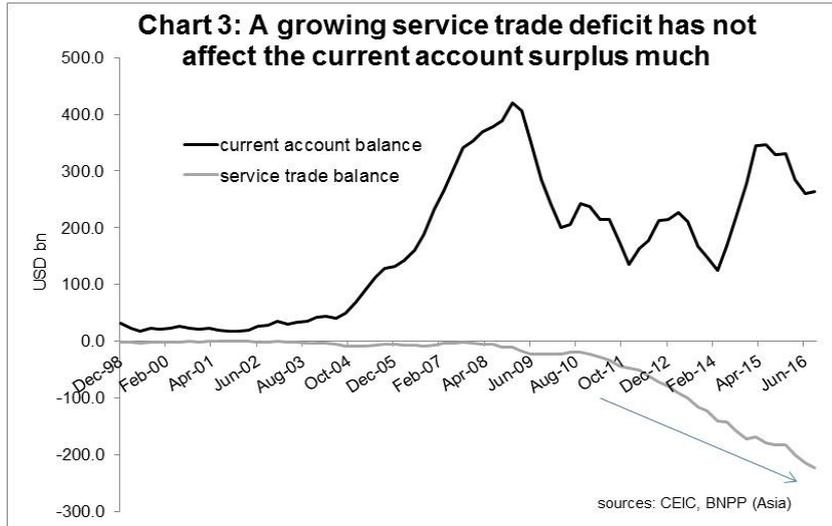


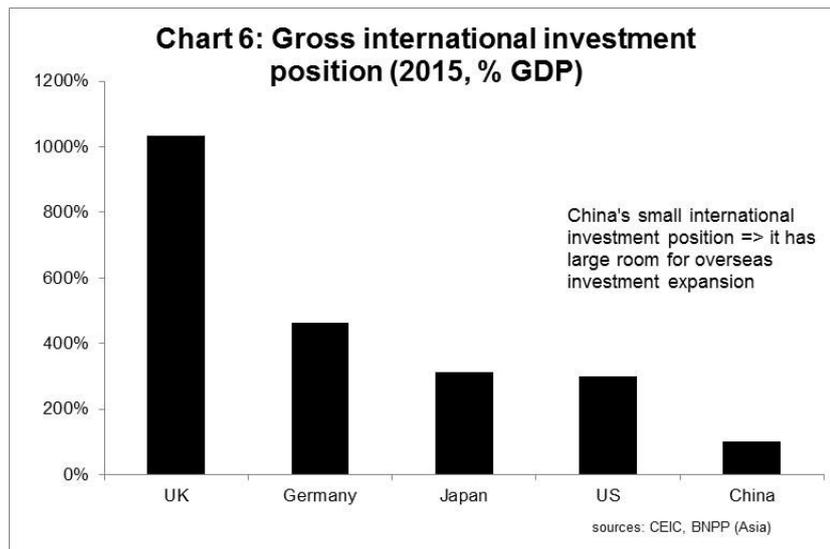
Capital outflows drivers

On the trade side, China's widening service trade deficit¹ 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).

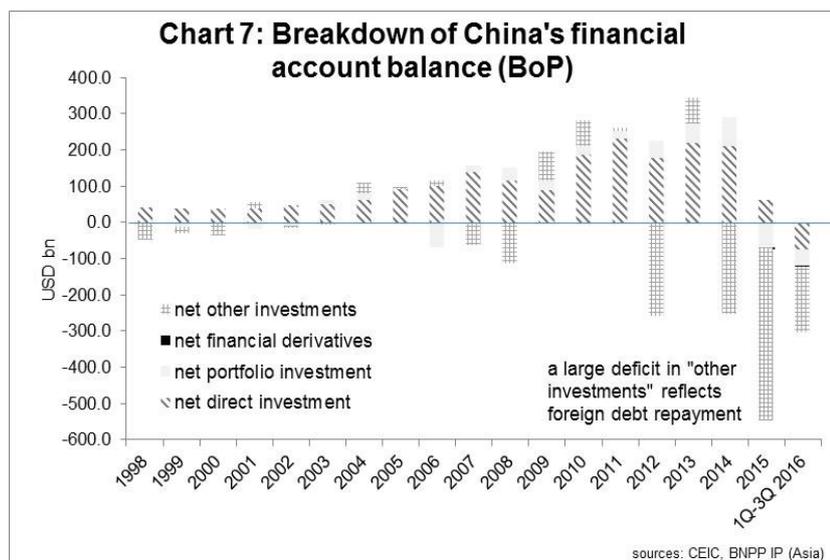
¹ Outbound tourism has accounted for 90% of the service trade deficit so far.





Another major outflow item is Chinese companies' repayment of USD debt². China's financial account³, 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.



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

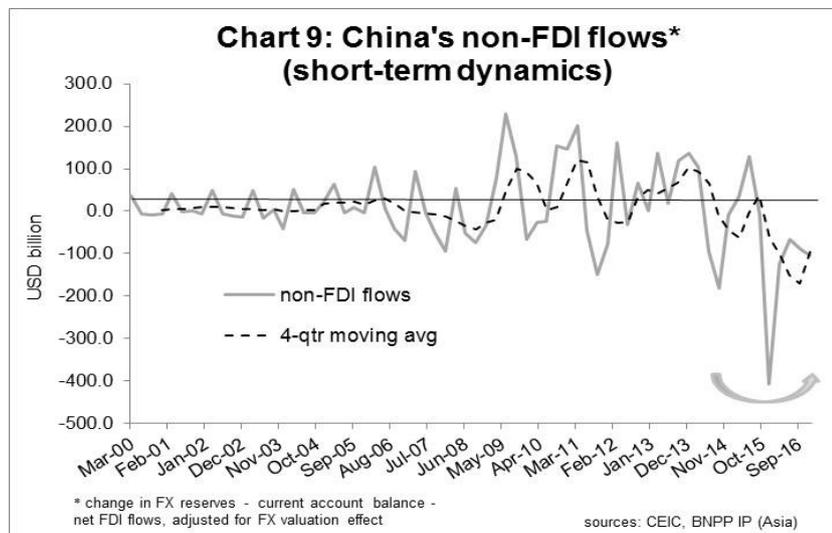
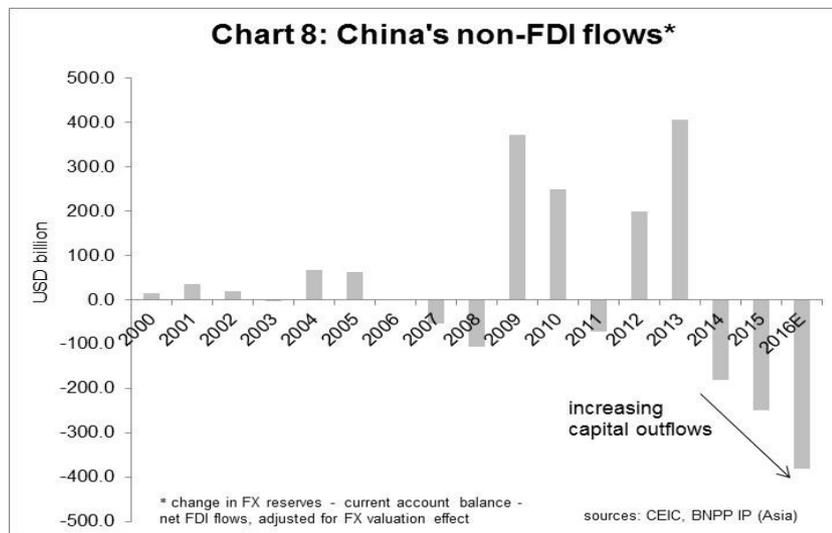
³ The financial account includes non-reserve items (including foreign direct investment, portfolio investment, financial derivatives and other investments) and reserve assets (including SDR, gold, reserves at the IMF, foreign exchange etc.)

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 benchmarks⁴.

Chi Lo
Senior Economist BNPP IP

15 February 2017

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>

DISCLAIMER

This material has been prepared by BNP Paribas Investment Partners Asia Limited* and is issued by BNP Paribas Investment Partners Singapore Limited ("BNPP IPS")** and BNP Paribas Investment Partners Asia Limited, members of BNP Paribas Investment Partners (BNPP IP)***. The content has not been reviewed by the Monetary Authority of Singapore ("MAS") or the Hong Kong Securities and Futures Commission.

This material is produced for information purposes only and does not constitute: an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever; or any investment advice.

Opinions included in this material constitute the judgment of BNP Paribas Investment Partners Asia Limited or its relevant affiliate(s) at the time specified and may be subject to change without notice. BNP Paribas Investment Partners Singapore Limited and BNP Paribas Investment Partners Asia Limited are not obliged to update or alter the information or opinions contained within this material. Such opinions are not to be relied upon as authoritative or taken in substitution for the exercise of judgment by any recipient and are not intended to provide the sole basis of evaluation of any strategy or instrument discussed herein. The contents of this material are based upon sources of information believed to be reliable, but no warranty or declaration, either explicit or implicit, is given as to their accuracy or completeness. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the Financial Instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for a client or prospective client's investment portfolio.

Investments involve risks. Investments in emerging markets involve above-average risk. Given the economic and market risks, there can be no assurance that the Financial Instrument(s) will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the Financial Instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to the Financial Instrument(s) may have a significant effect on the results portrayed in this material. Past performance is not a guide to future performance and the value of the investments in Financial Instrument(s) may go down as well as up. Investors may not get back the amount they originally invested.

Any reference to past performance of any market or instrument should not be taken as an indication of future performance. Neither BNP Paribas Investment Partners Singapore Limited, BNP Paribas Investment Partners Asia Limited nor any BNP Paribas Group company accepts any liability whatsoever for any loss arising, whether direct or indirect, from the use of any part of such information. A BNP Paribas Group company may, to the extent permitted by law, have acted upon or used the information contained herein, or where relevant the research or analysis on which it was based, before its publication. This material is for the use of the intended recipients only and may not be delivered or transmitted to any other person without the prior written consent of BNP Paribas Investment Partners Singapore Limited and BNP Paribas Investment Partners Asia Limited. Furthermore, any translation, adaptation or total or partial reproduction of this document, by any process whatsoever, in any country whatsoever, is prohibited unless BNP Paribas Investment Partners Singapore Limited and BNP Paribas Investment Partners Asia Limited has given its prior written consent.

* BNP Paribas Investment Partners Asia Limited, 30/F Three Exchange Square, 8 Connaught Place, Central, Hong Kong.

** BNP Paribas Investment Partners Singapore Limited, 10 Collyer Quay, #15-01 Ocean Financial Centre, Singapore 049315.

*** "BNP Paribas Investment Partners" is the global brand name of the BNP Paribas group's asset management services. The individual asset management entities within BNP Paribas Investment Partners if specified herein, are specified for information only and do not necessarily carry on business in your jurisdiction. For further information, please contact your locally licensed Investment Partner.