

China's Global Integration and Capital Flows

Will Turmoil Give Way to Progress?

Jakob Wilhelmus, Perry Wong, Keith Savard, and Cindy Li

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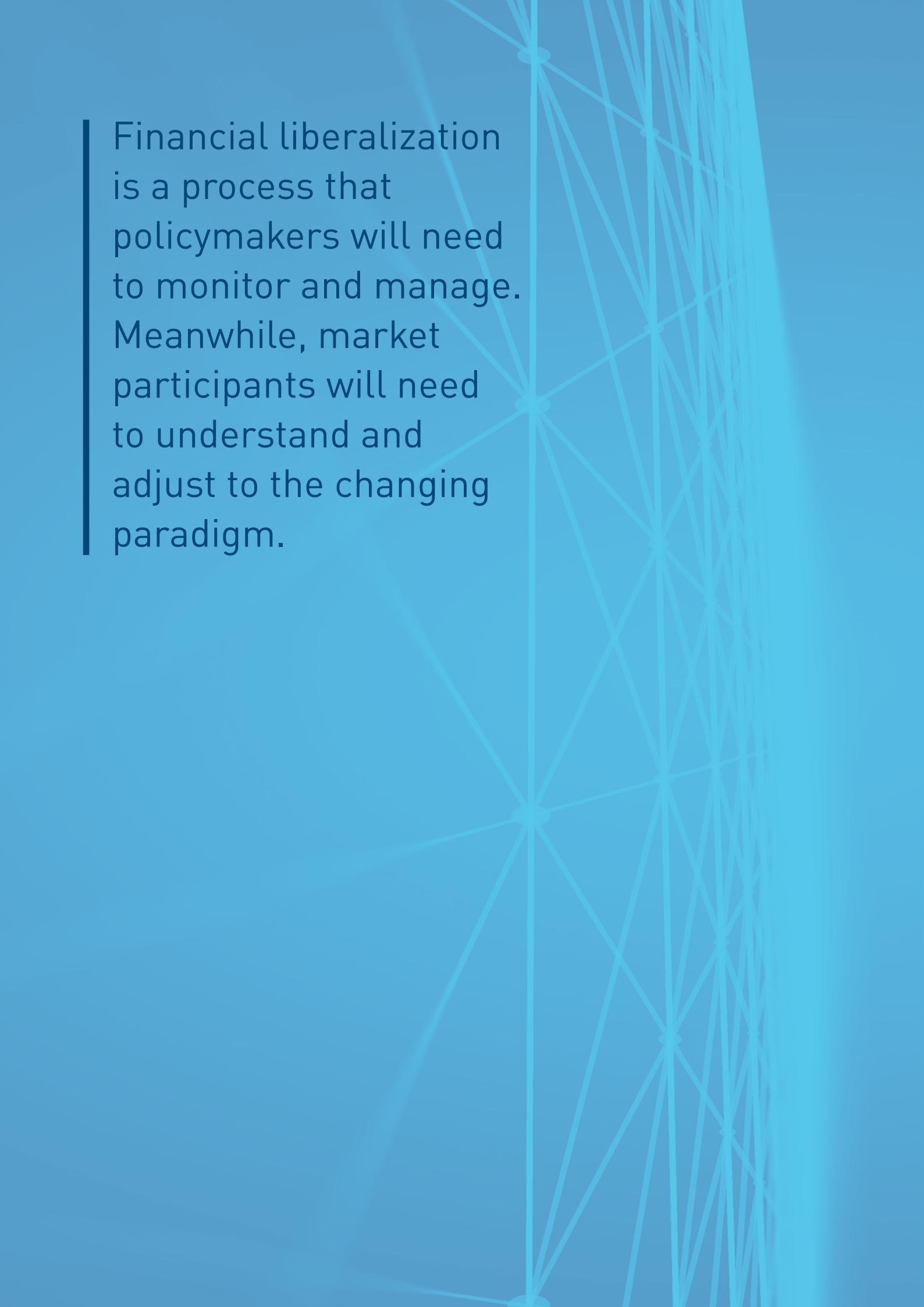
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Financial liberalization is a process that policymakers will need to monitor and manage. Meanwhile, market participants will need to understand and adjust to the changing paradigm.

Overview

China has become an engine of the world economy in recent decades, contributing 20 percent to global GDP growth in 2015. China's success has coincided with its integration into the global trade and financial systems. For most of the past two decades, China has run surpluses on both its current and financial accounts, resulting in a significant accumulation of foreign exchange reserves. However, this situation has changed in recent years as net private-sector capital flows have turned negative.

In 2015, China suffered net capital outflows of \$486 billion, roughly \$329 billion of it in the second half of the year.¹ The pace of outflows slowed considerably in the second quarter of 2016 to an estimated \$65 billion,² down from \$123 billion in the preceding quarter. Still, the pressure persists in the near term as the global economic environment remains volatile, China's growth trends down, and market participants expect the Chinese currency, the renminbi, to further depreciate. Over the longer run, the evolution of China's capital flows will likely be shaped by the pace of reforms at home and the progress of financial integration with the rest of the world.

In the past, China's cross-border capital movements have been dominated by direct investment and bank-related flows.³ Portfolio investment, including equity and debt securities, remains a small portion of total flows due to capital controls. Going forward, however, as China gradually opens its capital markets, cross-border portfolio investment has the potential to grow substantially. Further openness will introduce more complexity into the magnitude, direction, and patterns of cross-border capital flows. This is an issue that policymakers will need to monitor and manage. Meanwhile, market participants will need to understand and adjust to the changing paradigm.

This report is the first in a series whose goal is to summarize and present the most pertinent information on Chinese capital flows to investors and policymakers. We start with a discussion of the recovery from the global financial crisis and progress to outline the forces of primary interest to this analysis: capital markets and exchange rates.

1. "Net capital outflows" refers to the net balance of China's financial account in the balance of payments statistics.

2. Institute of International Finance, "Capital Flows to Emerging Markets."

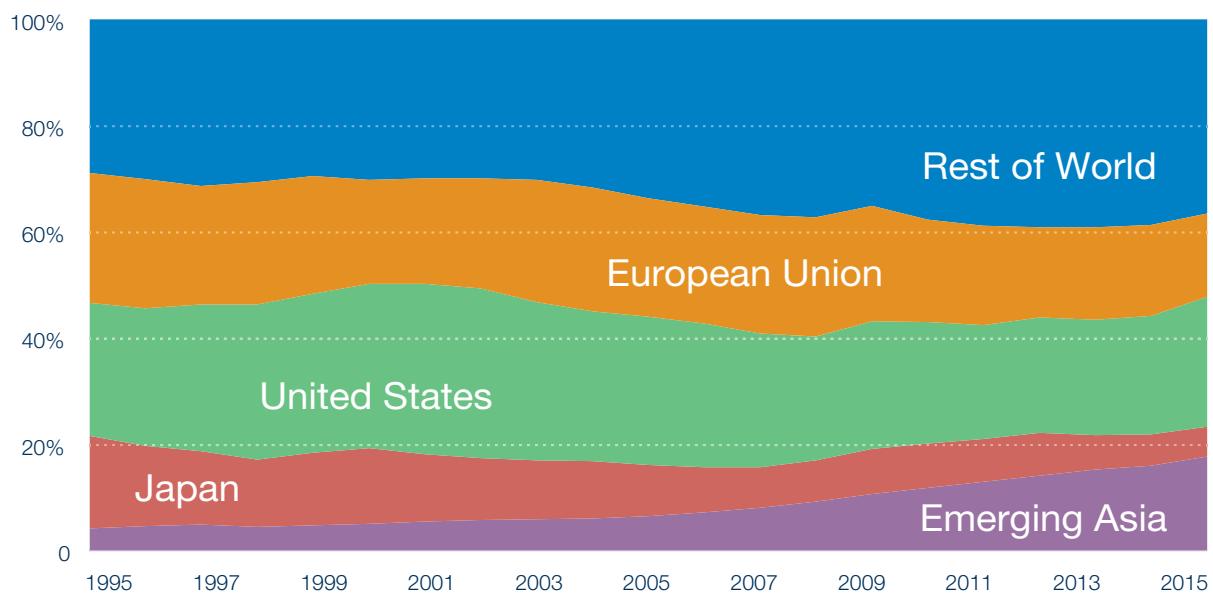
3. Classified as "other investment" in China's balance of payments statistics, which includes bank loans to Chinese residents, trade credit, and currency and deposits.

Large-scale investment must continue to enable the country to achieve its GDP goals, yet after years of rapid credit expansion amid declining return on investment, signs of stress have surfaced in China's financial system.

Crisis and Recovery

Nearly a decade after the 2008-09 financial crisis, the global economy has yet to settle into a “new normal.” From continual political quandaries in the European Union, highlighted by the recent British referendum to leave the bloc altogether, to the U.S. economy’s struggle to deliver a consistent recovery, the advanced nations are grappling with new constraints. Emerging Asia, in contrast, has delivered stable and solid growth during this period. Thanks to government spending and investment, emerging Asia exhibited remarkable resilience and was nearly unscathed by the crisis. The region’s share of world gross domestic product has been increasing, as illustrated in Figure 1. The uneven performance between advanced and emerging economies—especially Asia—has sent sizable net inflows of capital into emerging markets after the crisis.

FIGURE 1 | Regional Contributions to World GDP

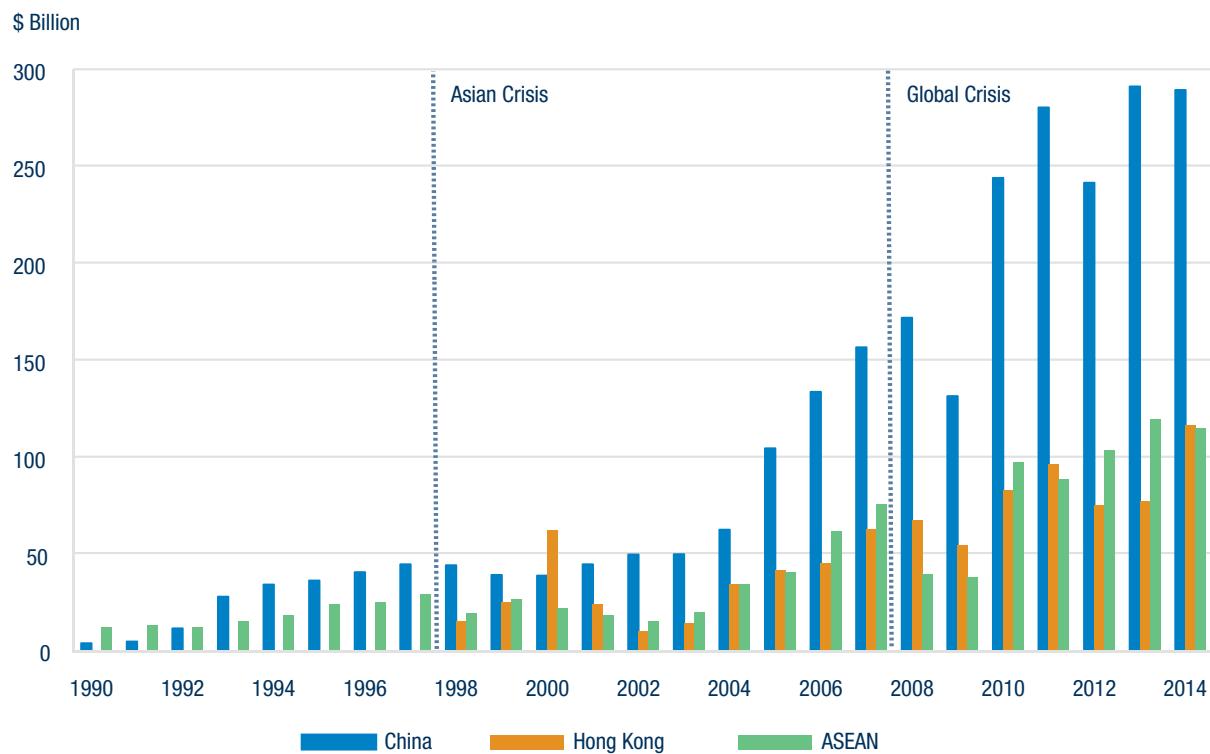


Sources: World Bank, Thomson Reuters.

Historically, investors from the developed world have generally preferred direct investment to portfolio investment when they enter Asian markets, which allows them to reap higher returns without being exposed to the risks posed by immature financial systems in these countries. This approach, as well as Asian countries’ restrictions on capital flows, helps explain the swift growth of foreign direct investment (FDI) in Asia in contrast to the subdued growth of portfolio investments, including equity and debt securities. Since 2000, the flow of FDI into the Asian region has exploded. As Figure 2 shows, annual FDI in China increased by about \$250 billion between 2000 and 2014—approaching \$300 billion in 2014. The ASEAN nations and Hong Kong have also seen inflows expand, although at a less rapid pace. Each reached roughly \$120 billion in 2014.

In reaction to the decline in trade and to counteract the global turmoil of the financial crisis, the Chinese government launched a number of investment programs after 2008, nullifying the risk of an economic downward spiral. As seen in Figure 3, the 2009 decline in trade was almost compensated for by investment, mainly through credit expansion.

FIGURE 2 FDI Growth: China, Hong Kong, and ASEAN Nations*



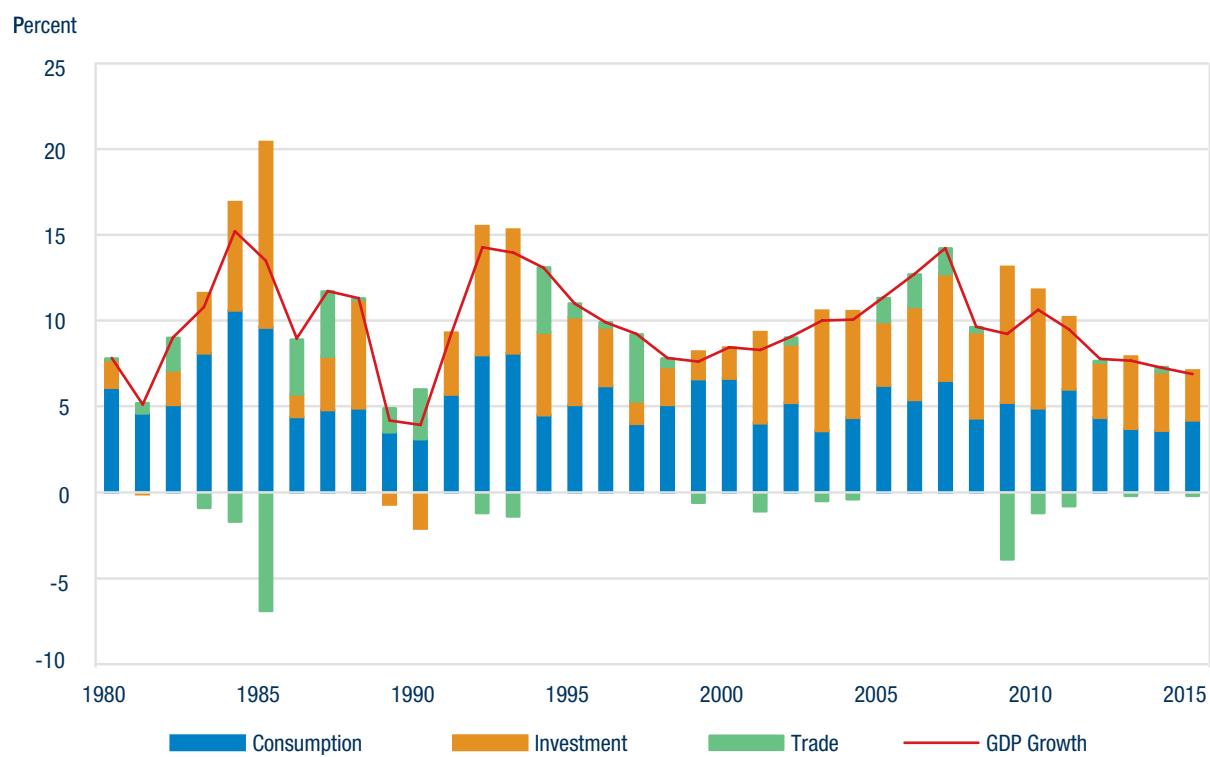
*The Association of Southeast Asian Nations: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam

Source: Thomson Reuters.

But heavy investment to combat declining external demand has consequences. Indeed, growth spurred by government-supported credit can only be a short-term remedy. The Chinese authorities' stimulus came at the price of soaring debt and rising concern about banks' burden of nonperforming loans. China is now faced with a dilemma: Large-scale investment must continue to enable the country to achieve its GDP goals, yet after years of rapid credit expansion amid declining return on investment, signs of stress have surfaced in China's financial system.

FIGURE 3

China's GDP Growth Composition



Note: The legend refers to final consumption, net capital formation, and net exports respectively.

Source: Thomson Reuters.

Debt-to-equity swaps, asset sales, and securitization limit the pressure of nonperforming loans, but they do not address the real issue.

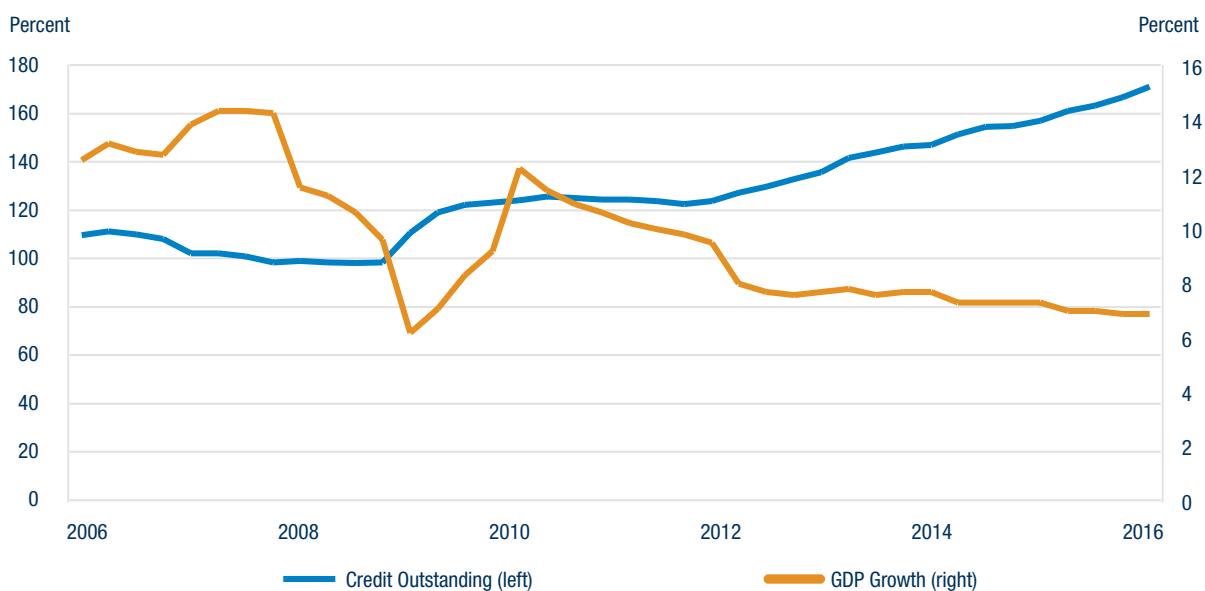
Distressed Markets

Credit-Driven Growth Pressures Banks' Balance Sheets

The first negative effects of growth driven by public investment have become clear as the debt levels of Chinese non-financial corporations, most of them controlled by the state, reached 170 percent of GDP in December 2015 (see Figure 4). Many state-owned enterprises have borrowed heavily from state-owned banks, which leaves the government precariously vulnerable to private-sector troubles.

This has led to initiatives to address the problem and lighten the burden on banks. In the past few years, Chinese banks have aggressively written off bad loans on their balance sheets. Most recently, the government has focused on three main avenues to limit the pressure of nonperforming loans: debt-to-equity swaps, sales to asset management companies, and securitization. While these tools will help to clean up banks' balance sheets, they do not address the real issue—imprudent credit expansion and poor corporate performance—and complicate linkages within the financial system. Debt-to-equity swaps will likely take haircuts during the process and expose banks to distressed companies as shareholders. Selling, pooling, and securitizing the underlying loans shifts risk from banks to asset management companies or investors in securitized products but cannot eliminate or reduce the overall risks embedded in the financial system. If not properly designed and implemented, these approaches could lead to so-called moral hazard, in which market participants insufficiently account for their risk exposure.

FIGURE 4 Non-Financial Corporate Credit Outstanding as a Share of GDP and GDP Growth



Sources: Thomson Reuters, National Bureau of Statistics of China.

The Capital Markets: Market-Oriented?

China's equity markets have become the second-largest in the world, with a total capitalization of \$8.1 trillion as of 2015. That is substantially beyond the scale of third-place Japan's \$4.8 trillion but far behind the United States, with \$25 trillion. Public policy initially identified the stock market as a mechanism to channel the country's immense household savings to support domestic enterprises and push for China's recognition as a market economy. But after the dramatic turmoil that erupted in 2015, China's stock market is struggling to maintain its credibility as market-driven, while policymakers anxiously attempt to rein in extraordinary volatility triggered in large part by ill-designed policies.

FIGURE 5 Shanghai Stock Exchange Index (Monthly Close)



Source: National Bureau of Statistics of China.

The most recent policy intervention occurred after the turmoil in June 2015, when the Shanghai index had fallen nearly 30 percent from its peak in a matter of two weeks (Figure 5). This was met with a number of seemingly uncoordinated government actions such as ordering state-owned enterprises to halt share selling, freezing stock sales by large shareholders, and introducing a “circuit-breaker,” which would automatically halt trading if the market dropped by a certain threshold. While the total impact of the stock market turmoil on the real economy was mild, consistent with households’ limited exposure to the market,⁴ these events have indeed put a dent in investor confidence in the authorities’ ability to maintain financial stability. For the time being, many offshore investors are suspicious that resorting to on/off policy measures will be China’s immediate default position when problems arise in the economy and financial markets.

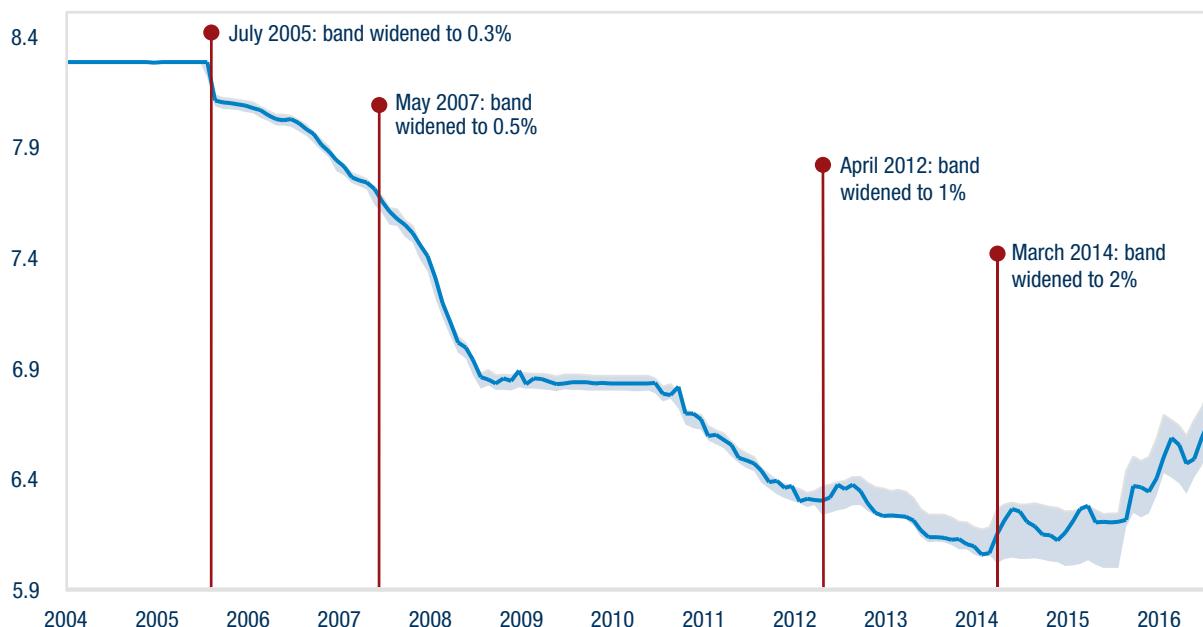
4. According to the China Household Finance Survey (accessed through Global Times) in China, fewer than 10 percent of households participate in the stock market. In the U.S., 55 percent invest.

The Exchange Rate: Renminbi in Reverse Gear

China is still an economy in transition, and the opening of a previously closed market can be an erratic and unpredictable process. The nation's exchange-rate policies have provoked relentless concern and controversy, even more so than the sometimes alarming movements of its stock market. Starting in 2005, the People's Bank of China (PBoC) removed the fixed peg of the renminbi and slowly moved in the direction of a broader managed float. This was achieved by allowing the exchange rate to move within a daily range around the RMB reference rate set by the PBoC. The exchange rate was re-pegged to the U.S. dollar after the global financial crisis for approximately two years, before the PBoC allowed more flexibility.

It does not come as a surprise that a trade-driven country such as China would be reluctant to leave the exchange rate entirely to global supply-and-demand dynamics. However, on Aug. 11, 2015, the PBoC caught the market by surprise by devaluing the renminbi by 2 percent. At the same time, the PBoC announced that it would let the daily fixing of renminbi exchange rates align better with the previous closing price, an important step in relaxing controls. The attempts to widen the interval in which the daily exchange rate can adjust (see Figure 6) and move toward a general market-based rate have been welcomed by the International Monetary Fund (IMF). However, the lack of official communication confused investors and caused volatility as many market participants interpreted these actions as steps toward competitive devaluation. Meanwhile, the renminbi has ended its appreciation trend and recently settled into reverse gear, adding to capital outflow pressure.

FIGURE 6 Chinese Renminbi to the U.S. Dollar



Note: The gray area depicts the official trading band of the renminbi.

Source: Thomson Reuters, authors' calculation.

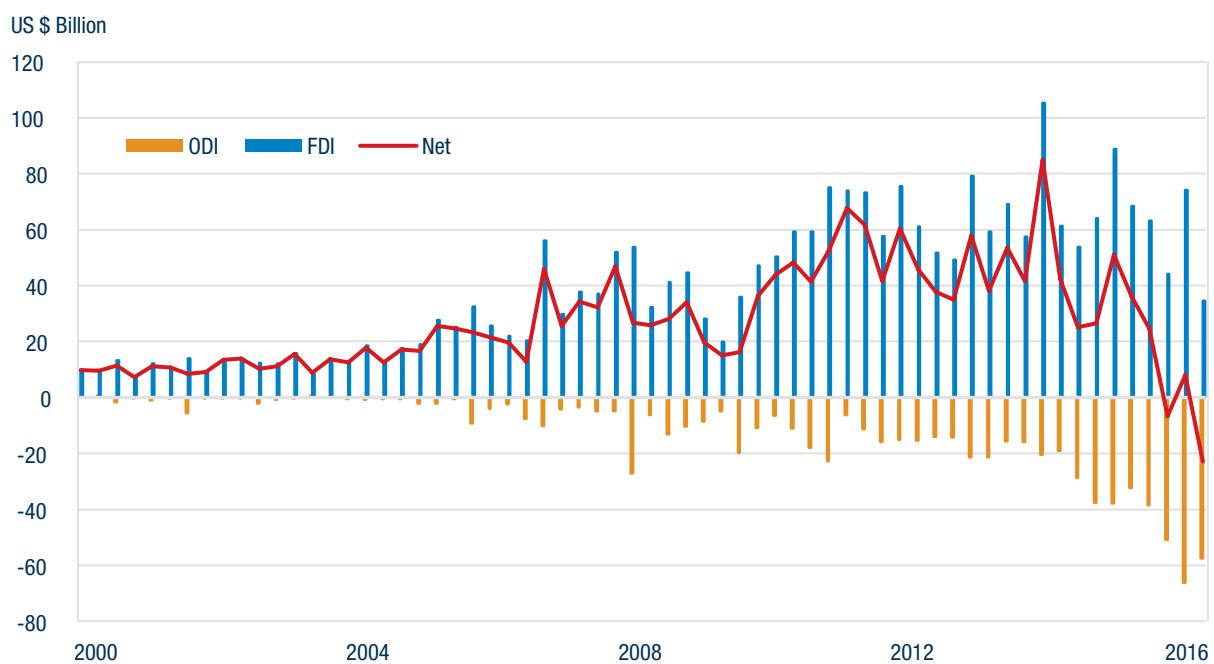
This changing view of the currency's intrinsic value prompted offshore investors to reduce their renminbi assets and motivated Chinese corporations to repay debt denominated in foreign currencies.

A Closer Look at Capital Outflows

Currency devaluation, however, isn't the only concern that threatens China's goal of financial integration with the rest of the world. All three sources of net capital inflows—direct investment, portfolio investment, and banking—softened in 2015. While FDI inflows slowed, outward investment flows registered solid growth and China became a net exporter of direct investment in early 2016 (Figure 7). Portfolio investment flows were negative, although this component's contribution to total 2015 capital outflows was not significant due to its relatively small share of China's balance of payments.

FIGURE 7

China Has Become a Net Direct Investor (FDI, ODI: Foreign and Outward Direct Investment)



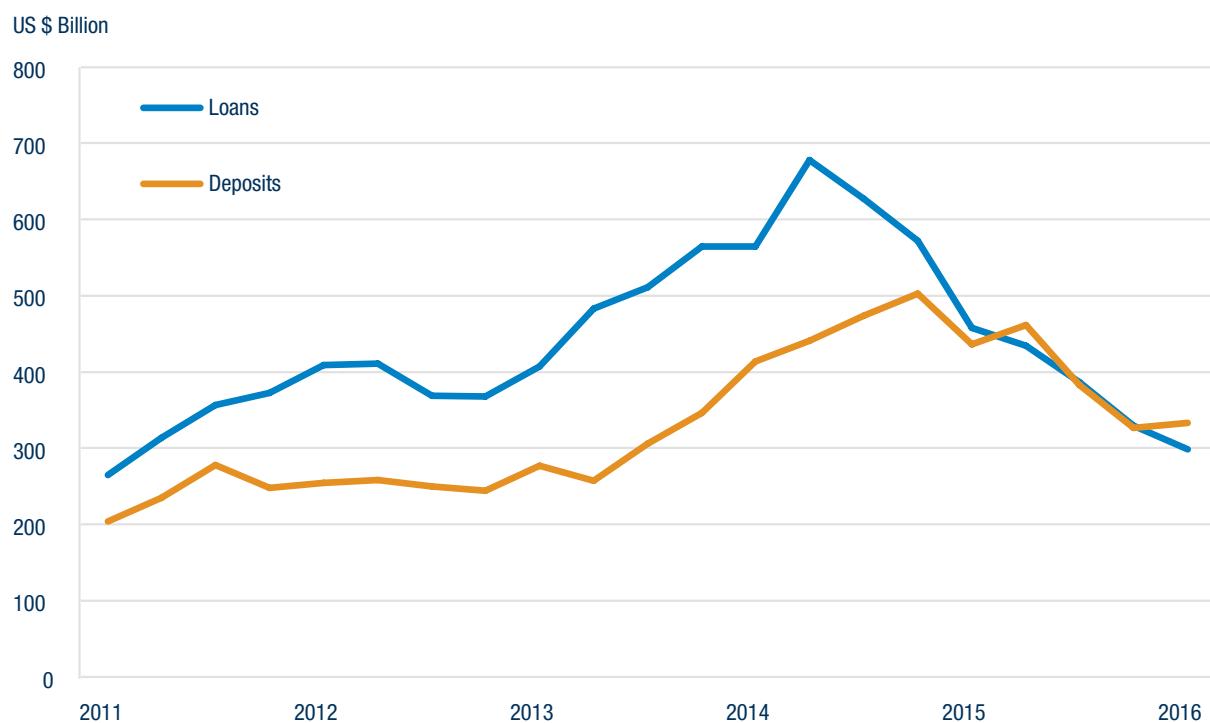
Source: Thomson Reuters.

Importantly, bank loans and deposits were a major contributor to overall outflows in 2015. Since the high of almost \$700 billion in loans to Chinese residents in the second quarter of 2014, the position has dwindled to \$300 billion in the first quarter of this year, largely due to Chinese corporations retiring their loans issued overseas. The massive outflows of 2015 were driven in large part by an unwinding of the carry trade,⁵ reflecting a pullback in the lending cycle that had been building up since early 2013 as investors unanimously predicted that the renminbi would further appreciate. Following this argument, those outflows are most likely to eventually wane rather than further accelerate in the future. As shown in Figure 8, the outflows have been driven by the liabilities side, which is slowly returning to its normal pattern as of early 2016. Moreover, domestic investors account for the majority of net capital outflows, as shown in Figure 9.

5. In a carry trade, investors take advantage of divergent interest rates by borrowing at low rates to invest in assets that are expected to provide higher returns.

FIGURE 8

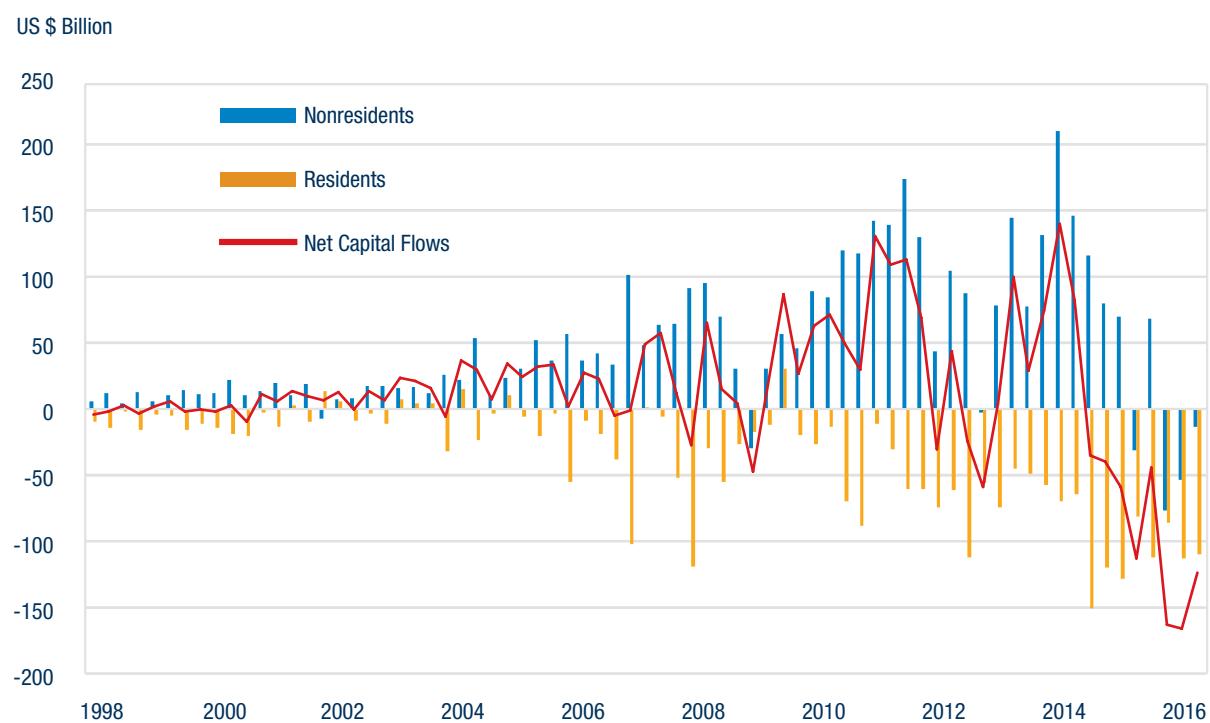
Foreign Loans to Chinese Residents and Deposits by Nonresidents



Source: Thomson Reuters.

FIGURE 9

Breakdown of Chinese Net Capital Flows, Residents and Nonresidents



Source: Thomson Reuters.

The substantial capital outflows in recent quarters were ultimately caused by weakening economic fundamentals. China's long-term growth prospects have trended down since the global financial crisis, reflecting demographic aging, diminishing returns on capital, and declining total factor productivity. Its leadership has committed to rebalancing the economy, which also entails structural changes that will be beneficial to sustainable growth in the long term but are likely to take a toll on near-term economic performance.

Meanwhile, China's trade surplus has shrunk to around 2 to 3 percent of GDP in recent years, due to a long period of renminbi appreciation, higher labor costs at home, and weak demand for Chinese exports from advanced economies. Consequently, the accumulation of foreign exchange reserves has slowed. These factors led investors to expect that renminbi appreciation would slow or even reverse. This changing view of the currency's intrinsic value prompted offshore investors to reduce their renminbi assets and motivated Chinese corporations to repay debt denominated in foreign currencies.

Liberalization and Modernization

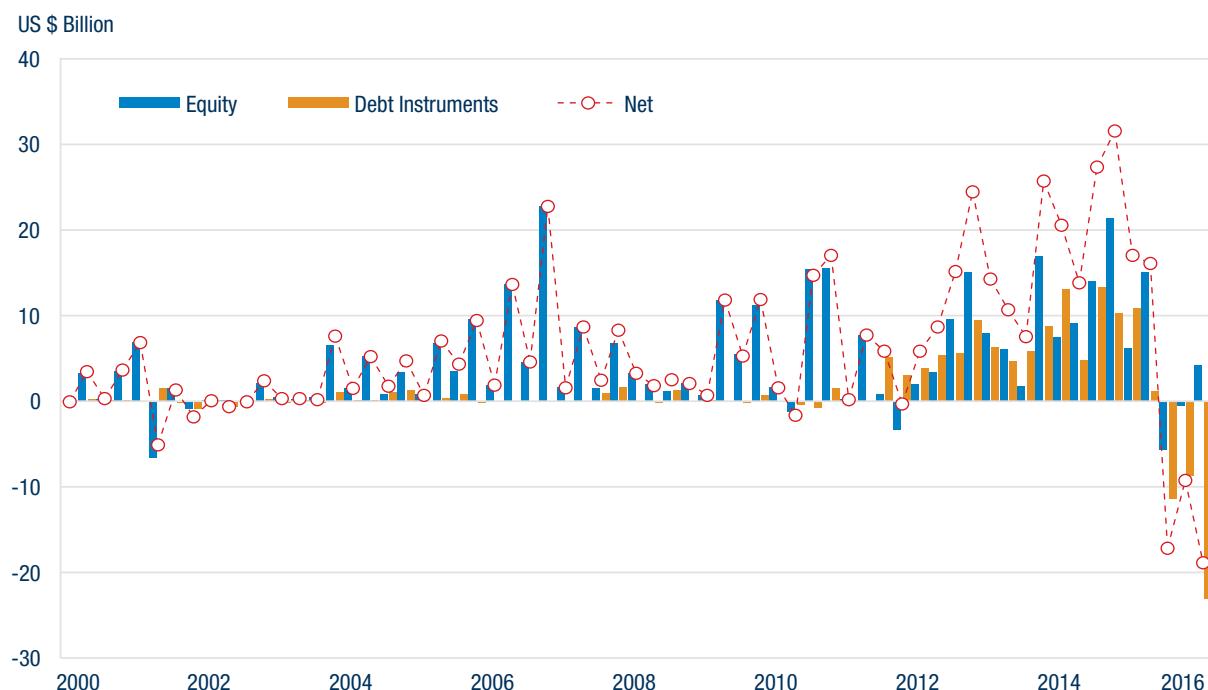
Along with economic fundamentals, China's ongoing financial reforms will spur considerable change in the magnitude, pattern, and direction of cross-border capital flows. It is helpful to review the progress Chinese authorities have made in modernizing and liberalizing the financial markets. A number of important steps were taken in 2015, including the PBoC's decision to allow renminbi exchange rates to align more closely with the previous day's closing price (referenced in "The Exchange Rate," above); the elimination of restrictions on bank deposit rates; the opening of the onshore interbank foreign exchange market to international central banks and sovereign wealth funds; and the adoption of the IMF's Special Data Dissemination Standards.

In May 2016, the PBoC opened the interbank bond market to foreign institutional investors. This progress suggests that despite recent setbacks, China will inevitably become more integrated into the global financial system. The active pursuit of the renminbi's inclusion in the IMF's special drawing rights basket also shows China's commitment to opening up its financial markets. One caveat, however, is that the pace will be gradual and the authorities may even accept temporary retreat to ensure financial stability, as evidenced by the de facto tightening of capital controls after last year's market turmoil.

Such integration will have profound implications for the future of China's cross-border capital flows. As discussed earlier, these flows are still dominated by direct investment, while both portfolio outflows and inflows remain relatively subdued (Figure 10 and Figure 11). Assuming an aggressive pace of financial integration in the next few years, portfolio flows will likely grow larger and more complex, posing challenges to the health of China's financial markets as well as their infrastructure. Chinese households' desire to diversify their savings via foreign currency denominated assets, as well as corporations' interest in taking stakes in foreign companies through portfolio and direct investment, could fuel future capital outflows.

FIGURE 10

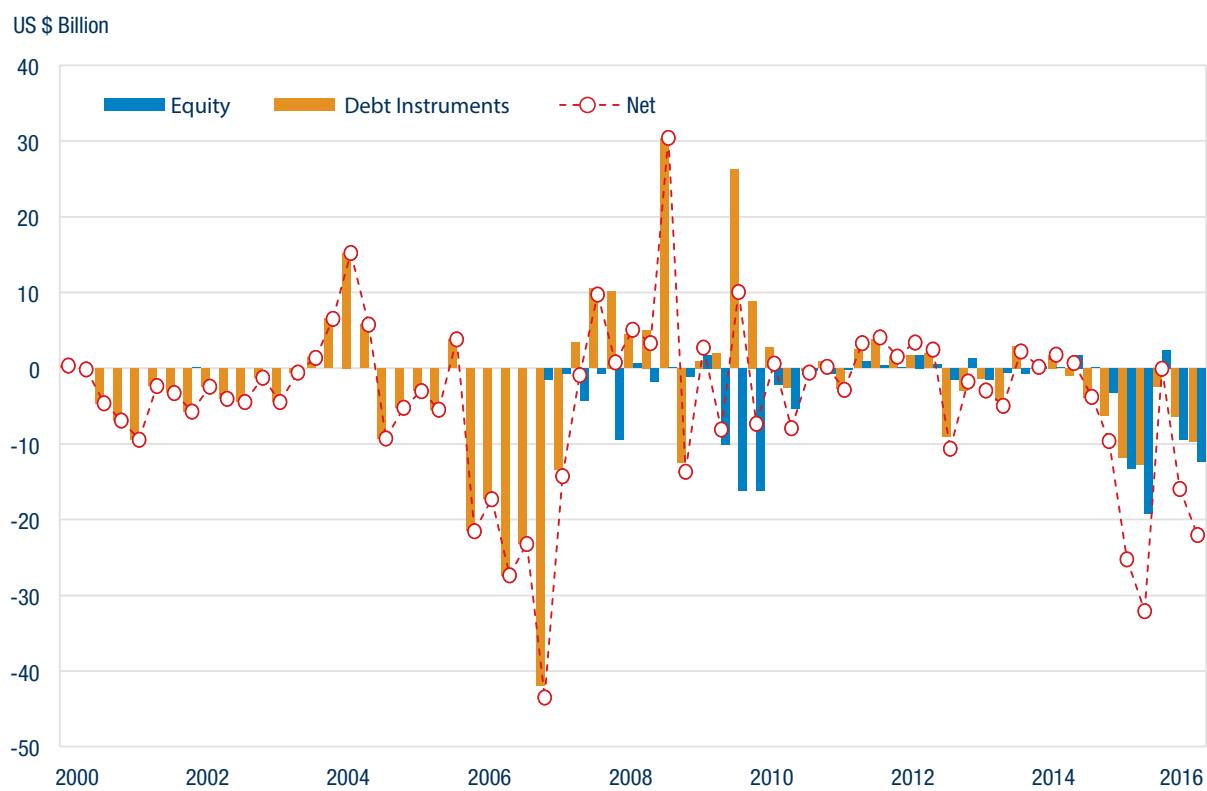
Portfolio Investments: Liabilities



Source: Chinese State Administration of Foreign Exchange.

FIGURE 11

Portfolio Investments: Assets



Source: Chinese State Administration of Foreign Exchange.

But financial integration is not a one-way street. There are also important drivers of portfolio inflows. For example, the internationalization of the renminbi has the potential to stimulate demand for renminbi-denominated assets, as more of them will be held by overseas investors and banks, more trade deals will be settled in the currency, and central banks may hold a larger share of renminbi assets in their foreign reserves. Also, currently China has the world's second-largest equity market and third-largest bond market. Although China is not yet included in MSCI's major benchmark indexes, MSCI released a roadmap to Chinese inclusion this year and, in a classification review paper, acknowledged important steps China has taken. Assuming China will continue to improve its capital market infrastructure and eventually be included in a major MSCI index, investors who track those indexes will expand their allocation of capital to onshore and offshore renminbi assets. Granted, the initial inflows will likely be small, but over the long run the inflows can be substantial if China eventually gains more weighting.

To summarize, China's financial integration with the rest of the world implies that the pattern of capital flows will be more complex and the volume higher. Most of the incremental changes will likely be seen in portfolio flows, but greater openness will influence direct investment and bank flows in general.

International Influences

International influences are also important factors that drive cross-border capital flows. Although not a surprise, the Federal Reserve's decision to raise the U.S. benchmark interest rate by 25 basis points in December—its first move in seven years—still sent shock waves through the global financial system. As market participants expected, the action contributed to volatility and sparked capital outflows from emerging-market countries, including China, to developed countries. In recent months the U.S. central bank has taken a softer stance, due in part to risks stemming from global economic events such as Brexit, which has nudged investors back into emerging market assets in search of high yield.

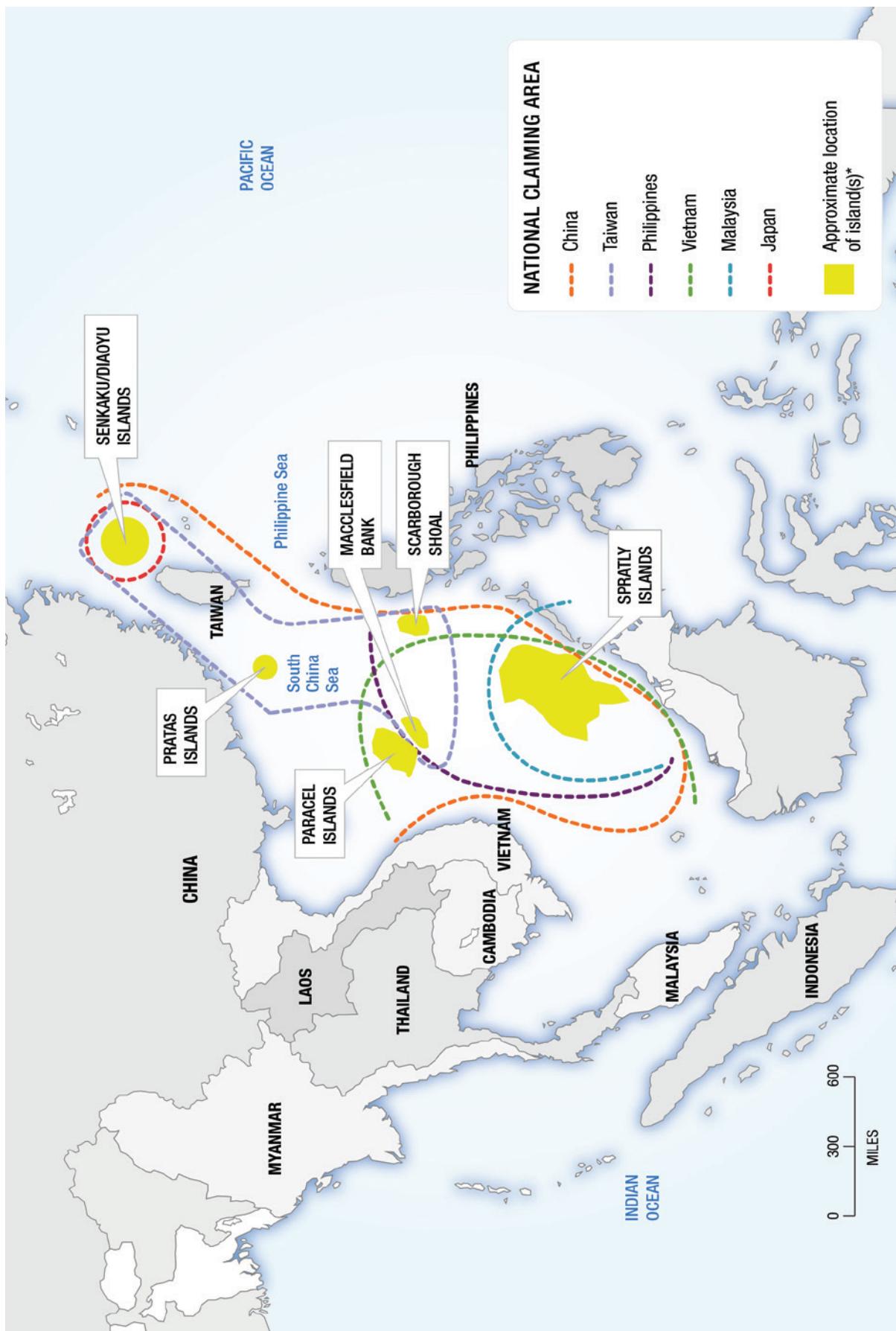
The prospect of higher U.S. interest rates (albeit still low by historical standards) could prolong the dollar appreciation cycle and result in overhanging investor concerns about the ability of emerging market companies to service and roll over their dollar-denominated obligations. A softening or outright reversal in cross-border capital flows could hurt Asian nations grappling with fiscal and/or current account issues. But even for countries with healthy government finances and persistent current account surpluses, there is the concern that a sooner-than-expected U.S. interest rate hike may trigger an abrupt repricing of domestic assets and expose corporate-sector vulnerability.

Another factor that can have significant impact on China's integration agenda is geopolitics. China-led Asian Infrastructure Investment Bank aims to stimulate regional development and enhance the nation's profile. These efforts are more or less offset by Beijing's belligerent approach to the South China Sea. For most of its history, China has been viewed as a semi-isolationist country, with the state constrained by geography, economics, and internal security and political issues. However, the current leadership appears to be reexamining and challenging these inward-looking imperatives, unsettling China's smaller neighbors.

Although all sides appear willing to avoid escalation, a resolution is not expected in the near future, despite a recent United Nations tribunal's ruling against China's maritime activities. However, the evolving geopolitical landscape can potentially restrain China's financial integration efforts and economic ambitions.

FIGURE 12

South China Sea Claims



Charting a Path to Smoother Integration

The Chinese leadership presented its 13th Five-Year Plan at the end of 2015 against the backdrop of a slowing economy and turbulent financial markets. Despite these headwinds, President Xi Jinping laid out the leadership's vision for transitioning China's economy into a "new normal." The plan, the first developed under Xi's leadership, aims to achieve balanced growth with higher living standards and commits to further opening the Chinese economy. The document is guided by five principles:

- » Innovation: Promote high-value-added industries and entrepreneurship
- » Openness: Increase openness in domestic and international markets and transparency of government regulation
- » Green: Promote environmentally sustainable economic growth
- » Coordination: Coordinate development across geographies and industries
- » Inclusion: Build a shared economy with prosperity for all

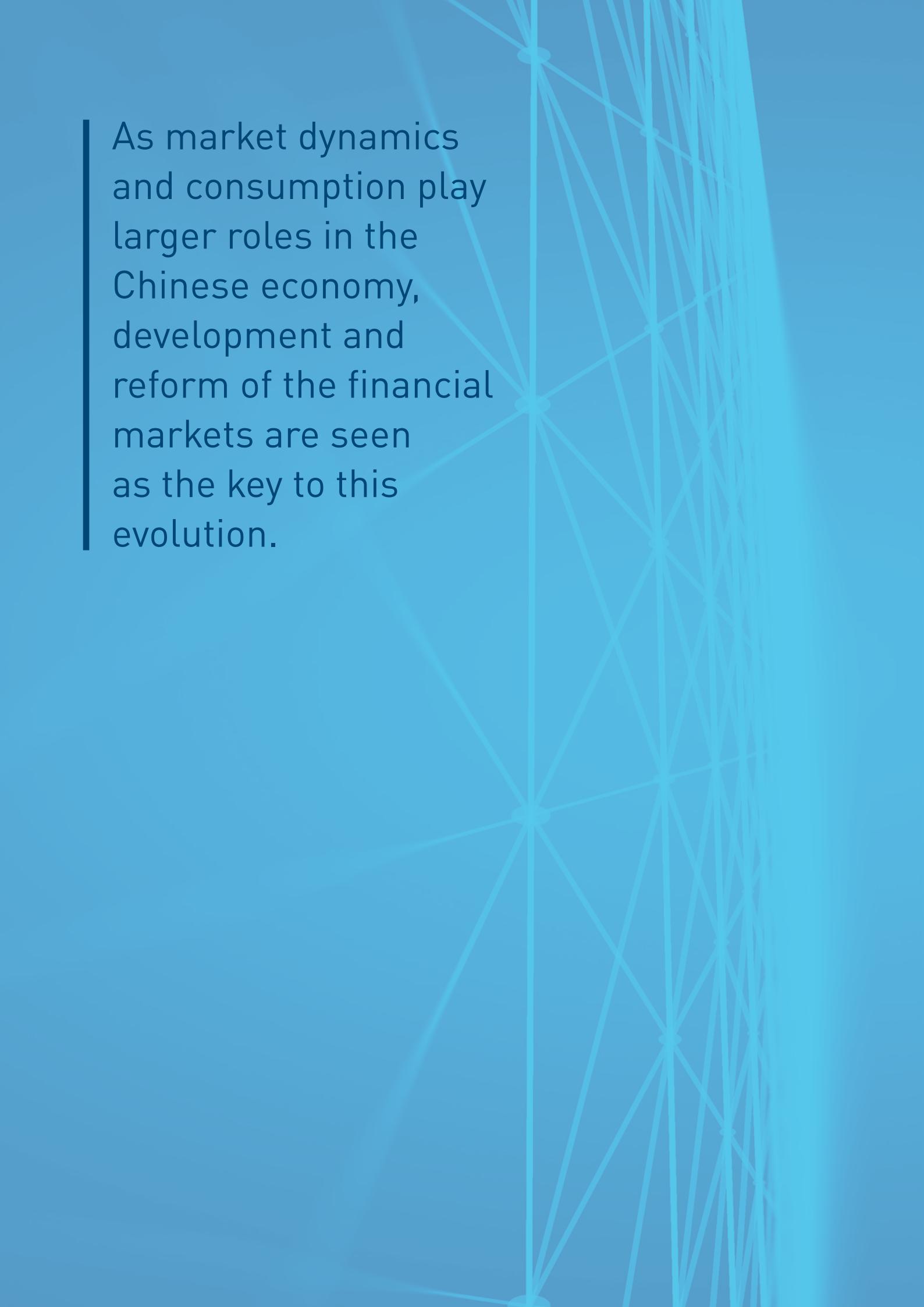
The Five-Year Plan sketches out detailed goals based on these principles. As market dynamics and consumption play larger roles in the Chinese economy, development and reform of the financial markets are seen as the key to this evolution. Among the goals are generating economic growth at a "medium-high" rate of 6.5 percent annually and renminbi convertibility by 2020. This would be accompanied by moving China toward higher-value industry and the Made in China 2025 initiative. The latter envisions widespread advanced manufacturing based on the Internet of Things. Chinese appliance maker Midea's deal to acquire Germany's Kuka, a global leader in industrial robotics, can be seen as a first step in that direction.

The plan also reaffirmed the authorities' commitment to the Going Out strategy. China has already ambitiously laid the groundwork for the internationalization of the currency and connecting its financial system to the rest of the world. In recent years, the government has opened offshore RMB clearing centers in Hong Kong, Singapore, and London, with volume exceeding RMB 9.6 trillion in 2015, a 25 percent increase over 2014.⁶ In addition to the rapid establishment of these clearing centers, the development of the Shanghai Free Trade Zone and Shenzhen Qianhai Special Economic Zone also contributes to financial market opening. The plan is to use these special zones as the test case for freer international capital flows. Meanwhile, the government's timetable for full RMB convertibility—linked to the currency's inclusion in the IMF's SDR basket—will facilitate foreign portfolio investment in China.

China's effort to advance financial globalization by "going out" is illustrated by the ambitious One Belt, One Road initiative, intended to promote trade and investment along the historic Silk Road and thereby strengthen ties with the Middle East, Europe, and other parts of Asia. The Chinese government has emphasized the cooperative nature of these programs, involving multilateral teams and public-private partnerships in infrastructure building.

The process of opening Chinese financial markets, while rather jagged at times, has been consistent in recent years—particularly the gradual opening of the bond market to foreign capital. However, openness itself sometimes leads to instability, as it takes time for domestic markets and regulators to learn to deal with volatile capital flows. At the same time, Chinese authorities face constrained policy options since they have committed to maintaining "moderately high" GDP growth over the next five years and will need to balance reform and economic stability. When it comes to financial integration, the preferred path is smooth and gradual.

6. Comments by a Chinese official at the China Development Forum in Beijing, March 2016.



As market dynamics and consumption play larger roles in the Chinese economy, development and reform of the financial markets are seen as the key to this evolution.

Attracting Stable, Long-Term Capital

Large-scale capital inflows are not always blessings. In fact, plenty of historical evidence shows that large and volatile capital flows often create risks for emerging economies, as net inflows tend to be procyclical. While “utilizing foreign capital” has always been one of China’s policy objectives, the actual approach must evolve to suit China’s changing economic landscape and attract stable, long-term capital.

The successful utilization of FDI has supported China’s economic growth and improved efficiency, a fact documented by many studies.⁷ As described earlier, a large portion of China’s capital inflows is currently FDI and, in fact, China’s FDI inflows were ranked second globally in 2013 and first in 2014 (“World Investment Report 2016,” United Nations Conference on Trade and Development). In the past, FDI into China was largely concentrated in manufacturing. However, as the nation undergoes an economic transition and labor costs rise, future FDI growth may be concentrated in services. The 2010 IMF study “Determinants of Foreign Direct Investment: A Sectoral and Institutional Approach” suggested that compared to industrial-sector FDI, service-sector FDI is more responsive to quality infrastructure and governance. China has thus far fostered a relatively open environment for FDI but will need to continue improving the supporting institutional framework to attract more of it.⁸

Of late, the Chinese government has also taken steps to encourage institutional investment inflows while discouraging “speculative” portfolio flows. In April, it opened up its interbank bond and onshore foreign-exchange markets to public investors. Institutional investors are also granted full access to the interbank bond market, but they face restrictions on withdrawing funds from China. Going forward, the government will likely continue to relax controls on cross-border portfolio investments, but cautiously.

With regard to equity investment, in 2014 China launched the Shanghai-Hong Kong Stock Connect Scheme, which allows market access between the two exchanges. In August 2016, the China Securities Regulatory Commission approved the Shenzhen-Hong Kong Stock Connect Scheme after months of preparation and removed the quota limits on the two schemes, which is a clear sign that the government is continuing to open the Chinese capital markets and integrate them with overseas markets. Sound public policy—aimed at developing market infrastructure, improving transparency, enhancing the rule of law, and ensuring confidence—can go a long way in attracting international investors with patient capital.

While these structural changes provide a multitude of benefits to the domestic economy and financial integration, they may introduce instability. Therefore, as China’s financial markets become more interconnected, authorities are focusing on improving institutional arrangements to address potential systemic risk.

At the end of the day, the most powerful magnets for capital inflows are the relative strength of a country’s domestic economy, a stable regulatory environment, and efficient institutions that protect investors’ rights. These economic transitions are underway in China.

Should China succeed in the structural reforms that bring its economy onto a more balanced, sustainable path of growth, the country would continue to be an attractive destination for FDI flows. On financial regulation, it is important not only to implement well thought out, timely, and coordinated policies but to communicate their intent to both domestic and foreign investors. Meaningful progress in structural reforms and continuous improvement of the financial framework would go a long way toward creating a welcoming environment that will help foster stable, long-term capital inflows.

7. For example, see Committee on the Global Financial System, “Capital flows and emerging market economies.”

8. See Adams-Kane, Jonathon, Claude Lopez, and Jakob Wilhelmus, “2016 Global Opportunity Index: Beyond FDI: Lessons From Asia,” Milken Institute.

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Keith Savard is a fellow at the Milken Institute. He has extensive executive management experience, with expertise in evaluating the interrelationship of economic fundamentals and activity in global financial and commodity markets. He also has a background in sovereign risk analysis and applying a disciplined economic approach to investment-portfolio decision-making. Previously, Savard was a senior managing economist at the Milken Institute. Before joining the Institute, he was director of economic research and chief economist at Samba Financial Group (formerly Saudi American Bank) in London. Savard also held positions at Zurich Investments, the Institute of International Finance, the U.S. Department of State, and the Board of Governors of the Federal Reserve System.

Cindy Li is a Milken Institute fellow and country manager at the country analysis unit in the Division of Financial Institution Supervision and Credit (FISC) at the Federal Reserve Bank of San Francisco. In that capacity, she monitors banking, regulatory, and economic developments in Asia, with a special focus on Greater China and the ASEAN region. Her research interests include financial regulation, financial vulnerability, and economic development. Prior to joining the Federal Reserve Bank, Li was a senior economist at the Milken Institute, where she led numerous research projects on global capital market trends, financial regulation, and the Chinese economy. Her research has been published in peer-reviewed journals and presented at major academic and regulatory conferences. She is a co-author of “The Rise and Fall of the U.S. Mortgage and Credit Markets: A Comprehensive Analysis of the Meltdown.” Li holds a bachelor’s degree in international finance from Peking University in China and received a Ph.D. in economics from the University of California, Riverside.



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