Chinese capital account liberalisation: process, structure and consequences

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Financial Integration in the Asia-Pacific

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ABOUT THE PROJECT

The Asia-Pacific region is among the most financially restrictive and fragmented in the world, and this fragmentation has significant implications for consumers and businesses. This project aims to bring forward evidence to enable a dialogue around the future of financial integration. It will provide Australian and Asian industry practitioners, policymakers and other stakeholders with the data and research necessary to enhance long-term strategic planning and decision-making.

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EXECUTIVE SUMMARY

What happens in China matters to the world economy. China is the largest merchandise trader, second largest economy and third largest net creditor nation globally. It also has the largest banking system, second largest stock market and third largest bond market on earth.

For decades China has absorbed private capital from the rest of the world while serving as a big official lender in the world but this is now changing. The gradual liberalisation of capital flows has led to a major shift in offshore investment from China. Reinforced by a switch from entities parking funds in renminbi (RMB) to take advantage of ongoing appreciations of the currency, to moving money out of RMB as depreciation seems more likely, this has led to Chinese official reserves falling from mid-2014 onward.

We expect ongoing liberalisation of the capital account. The process will be gradual and punctuated as has been the norm with the government’s managing of liberalisations in other areas. As a one party state, China cannot afford to make major economic mistakes. The current tightening of regulations, processes and oversight of offshore investment should be seen as a pause, not more.

The Chinese offshore investment position is currently dominated by official holdings of reserves. Private outflows have been small, and dominated by inflows even though those too have been controlled and restricted in many sectors.

As the opening progresses, outflows are likely to dominate inflows. The best available estimates suggest this is likely to be of the order of a net 10 per cent of GDP, with outflows of over 25 per cent and inflows of around 15 per cent.

The implications for Australia are relatively clear.

We can expect a lot more foreign direct investment (FDI) from China into Australia, a lot more portfolio investment, and probably a lot more private investment including into property. This may cause political issues but is part of the normal diversification of portfolios we see as countries open their capital accounts.

We can also expect China to open its markets to increased foreign investment so that the opportunities to invest into China will also be substantial. This is likely to progressively shift away from FDI towards portfolio holdings (because FDI has been relatively less closed in the past).
The risks of a contagion from an economic or financial disruption in China increase to the extent that our economies become more closely integrated. However, given the deep engagement of our resources and trade sectors with China, the major challenges to Australia from any shock are likely to dominate through the trade channel rather than the financial channel.

That said, opening the capital account will inevitably make macroeconomic management in China more difficult. Fuller internationalisation of the RMB will put strains on the local financial institutions and financial markets. Currency markets will need to deepen significantly and hedging markets expand so that people can trade into and out of RMB positions at speed and at scale. Few countries have managed the transition without some sort of financial shock.

Australia has a huge stake in a successful and relatively smooth financial integration of China into the global market. To add to the risk to this historical transition, the country currently faces the challenges of rising leverage and slowing economic growth as it attempts to transition from a development model based around public investment and export-led growth.

1. CHINA’S INTERNATIONAL PAYMENTS POSITION

An economy’s financial integration into the world involves external payment flows associated with both goods and investment, hence the International Monetary Fund (IMF) balance of payments framework is a sensible starting point. Within this framework, the current account for goods and services trade, the capital account for private capital flows and official reserve account for reserve flows in principle ought to balance out or add up to zero for each reporting period. According to the IMF classification, private capital flows are typically classified into three broader categories: direct investment, portfolio investment, and other (bank-related) investment (as well as financial derivatives). These different investment flows can behave quite differently.

The international investment position framework corresponds to the balance of payments framework and summarises the stock positions of a nation’s international assets and liabilities. We look at both flows and stocks of China’s external financial transactions. As capital flows can respond to both cyclical and structural forces, we also consider some of the cyclical and structural factors influencing China’s cross-border capital flows.

The broad swings in China’s international payments are clear from Figure 1 below. For most of the period since 2000 China has experienced a current account surplus and a net private capital inflow matched by a very large build up in official reserves. Gradually the position has
Come closer to an equilibrium and private capital outflows have now far exceeded current account surpluses, resulting in a rundown of official reserves.

**Figure 1: China’s current account, capital account and reserve flow (% of GDP)**

The dominant role played by incoming direct investment is clear from Figure 2 below, which reports on gross outflows and inflows of various types of cross-border investment flows. It is clear that inward portfolio investment has been relatively small. By contrast, outflows (as reported in detail later) have typically been smaller relative to gross domestic product (GDP), more volatile and more balanced across sectors. The fall in net inward foreign direct investment (FDI) is also obvious.

*Sources: State Administration of Foreign Exchange 2016, CEIC 2016 and authors' estimation.*
Figure 2: Private capital flows into and out of China (% of GDP)

Source: Schipke 2016.

The significant swing from inflows and towards outflows is partly driven by the process of liberalisation of restrictions on capital movements. Schipke (2016) for example reports that comparing the quantum of restrictions on financial flows out of 185 countries, against their level of GDP per capita, shows China to be a clear outlier. That is, China has a more extensive network of controls than countries with similar levels of GDP per capita. This suggests that liberalisation is likely to lead to significant outflows. As reported below most studies reflect this expectation.

China’s balance sheet (assets plus liabilities net of reserves) is relatively small, below that of economies like Indonesia and only about half that of Korea. However, and despite the recent changes, China’s net international investment position does not look unusual. Its assets less
liabilities (excluding reserves) of about +20 per cent of GDP compares with the UK with -14 per cent and Germany with +63 per cent. Broadly we would normally expect countries with older populations and low growth prospects to hold assets offshore, and those with high growth prospects to be net borrowers. China’s high savings rate and unusual demographics suggest that a significant offshore flow would be a sensible strategy for it and its citizens to follow, of course assuming that the return offshore can match onshore opportunities. A more fundamental switch, often mostly through non-official investors, away from holding low yielding bonds of other governments (including the United States (US)) into higher yielding investments in the same markets would also make sense. The overall effect would be to increase the size of the balance sheet significantly while increasing the net position by a smaller amount.

1.1 China in 2020: The evolution of the financial system

With this starting point, we can form some conjectures about the way China’s international balance sheet and cross-border capital flows might evolve in the medium term. The outlooks for these international financial stock and flow variables will in turn form a base for discussing the implications for Australia’s financial services industry in particular and economy generally.

China currently hosts a fairly large stock of foreign inward direct investment already but owns relatively small corporate controlling rights overseas. Also, China’s gross asset and liability positions for portfolio investment are both quite tiny. We know the Chinese private sector has a big net debtor position and may wish to achieve a more balanced position by diversifying its growing wealth overseas, especially as income rises. Slower growth, lower return to capital, low inflation and low domestic interest rates, together with a high saving rate, mean a bias towards increased private capital outflows as the capital account is slowly opened.

We know that the country’s foreign exchange reserves remain large and it is likely to continue running a reasonable current account surplus in the coming years, given that the saving rate tends to be sticky and the investment rate may fall considerably. Continued current account surpluses, adjustments in official reserves and a more flexible currency should together help accommodate growing Chinese net private capital outflows.

We also know Chinese policymakers still want to further liberalise the capital account, albeit incrementally and selectively, pending market conditions. We believe that China’s capital account, while becoming more open, would most likely remain managed to some extent and increasingly through macroprudential measures.

There have been attempts in the literature to estimate the possible scale of China’s cross-border capital flows and international assets and liabilities, upon fuller capital account
opening. These include those by the Hong Kong Monetary Authority (He et al, 2012), the IMF (Bayoumi and Ohnsorge, 2013), the Bank of England (Hooley, 2013), and the Reserve Bank of Australia (Hatzvi et al, 2015). Some of these efforts cover portfolio investment only, while others consider both direct and portfolio investment. Most of these estimates point to increases in gross positions, assets and liabilities alike, and project private foreign assets to increase more than private foreign liabilities. Thus China is expected to experience net private capital outflows in the coming years.

Two observations about these projection exercises are of special interest. First, none of these efforts even attempts to cover the most important and volatile component of private capital flows — ‘other’ (bank-related) investment, understandably for good reasons. Second, three or four years later, most of these projections by now have already become widely off-the-mark, underlining the challenge for projecting capital flows over the medium term and cautioning against over-interpretations about these simple projections (Ma and McCauley, 2014).

A representative group of economies may serve as a benchmark to anchor expectations about the likely scale and composition of China’s international balance sheet by 2020. The purpose is to come up with some reasonable ballpark estimates for China’s asset and liability positions to 2020 on the basis of the benchmark and the estimates of the existing literature. Then, we proceed to use these baseline estimates to derive the average annual gross capital flows for the period of 2016-2020 and for the three categories of investment. Over the period under consideration, we assume a steady and strong pace of capital account opening, no change in the exchange rate for the RMB, a current account surplus of 3 per cent of GDP, and an average nominal GDP growth rate of 7 per cent per annum. We will not consider reserve assets in our projection.
### Table 1: Outlook for China's external assets and liabilities

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<tbody>
<tr>
<td>FDI asset</td>
<td>2.8</td>
<td>5.3</td>
<td>10.4</td>
<td>20.0</td>
<td>1,129.3</td>
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<td>FDI liability</td>
<td>20.8</td>
<td>26.0</td>
<td>26.2</td>
<td>22.0</td>
<td>2,842.3</td>
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<td>Net FDI position</td>
<td>(17.9)</td>
<td>(20.7)</td>
<td>(15.8)</td>
<td>(2.0)</td>
<td>(1,713.0)</td>
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<tr>
<td>Portfolio asset</td>
<td>5.1</td>
<td>4.3</td>
<td>2.4</td>
<td>12.0</td>
<td>261.3</td>
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<tr>
<td>Portfolio liability</td>
<td>3.4</td>
<td>3.7</td>
<td>7.5</td>
<td>18.0</td>
<td>810.5</td>
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<tr>
<td>Net portfolio position</td>
<td>1.8</td>
<td>0.6</td>
<td>(5.1)</td>
<td>(6.0)</td>
<td>(549.2)</td>
</tr>
<tr>
<td>Other asset</td>
<td>9.5</td>
<td>10.4</td>
<td>13.1</td>
<td>12.0</td>
<td>1,422.2</td>
</tr>
<tr>
<td>Other liability</td>
<td>11.8</td>
<td>10.6</td>
<td>8.9</td>
<td>9.0</td>
<td>969.6</td>
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<tr>
<td>Net other position</td>
<td>(2.3)</td>
<td>(0.1)</td>
<td>4.2</td>
<td>3.0</td>
<td>452.5</td>
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<tr>
<td>Asset (ex reserve)</td>
<td>17.5</td>
<td>19.9</td>
<td>25.9</td>
<td>44.0</td>
<td>2,812.8</td>
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<tr>
<td>Liability</td>
<td>35.9</td>
<td>40.2</td>
<td>42.5</td>
<td>49.0</td>
<td>4,622.5</td>
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<tr>
<td>Asset + liability</td>
<td>53.5</td>
<td>60.2</td>
<td>68.4</td>
<td>93.0</td>
<td>7,435.2</td>
</tr>
<tr>
<td>Private net position</td>
<td>(18.4)</td>
<td>(20.3)</td>
<td>(16.6)</td>
<td>(5.0)</td>
<td>(1,809.7)</td>
</tr>
</tbody>
</table>

**Source:** Authors’ calculations. We assume 7% compound annual growth rate (CAGR) for nominal GDP over 2016 to 2020.

**Note:** ‘F’ indicates forecast, ‘( )’ indicate negative amount.
Table 2: Outlook for China’s private capital flows

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Chinese outward direct investment</td>
<td>(1.25)</td>
<td>(2.94)</td>
<td>(128.0)</td>
<td>(383.5)</td>
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<tr>
<td>Foreign inward direct investment</td>
<td>2.63</td>
<td>0.78</td>
<td>269.6</td>
<td>101.9</td>
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<tr>
<td>Net direct investment</td>
<td>1.38</td>
<td>(2.16)</td>
<td>141.7</td>
<td>(281.7)</td>
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<tr>
<td>Chinese outward portfolio investment</td>
<td>(0.29)</td>
<td>(2.40)</td>
<td>(29.8)</td>
<td>(313.4)</td>
</tr>
<tr>
<td>Foreign inward portfolio investment</td>
<td>0.52</td>
<td>2.96</td>
<td>52.7</td>
<td>386.3</td>
</tr>
<tr>
<td>Net portfolio investment</td>
<td>0.22</td>
<td>0.56</td>
<td>23.0</td>
<td>73.0</td>
</tr>
<tr>
<td>Chinese outward other investment</td>
<td>(1.95)</td>
<td>(0.62)</td>
<td>(199.5)</td>
<td>(81.2)</td>
</tr>
<tr>
<td>Foreign inward other investment</td>
<td>(0.28)</td>
<td>0.62</td>
<td>(29.1)</td>
<td>80.3</td>
</tr>
<tr>
<td>Net other investment</td>
<td>(2.23)</td>
<td>(0.01)</td>
<td>(228.6)</td>
<td>(0.9)</td>
</tr>
<tr>
<td>Chinese private outward investment</td>
<td>(3.49)</td>
<td>(5.96)</td>
<td>(357.2)</td>
<td>(778.1)</td>
</tr>
<tr>
<td>Foreign inward private investment</td>
<td>2.87</td>
<td>4.36</td>
<td>293.3</td>
<td>568.5</td>
</tr>
<tr>
<td>Outward + inward flows</td>
<td>6.36</td>
<td>10.32</td>
<td>650.5</td>
<td>1,346.6</td>
</tr>
<tr>
<td>Net private capital flow</td>
<td>(0.62)</td>
<td>(1.61)</td>
<td>(63.9)</td>
<td>(209.6)</td>
</tr>
</tbody>
</table>

Source: Schipke 2016.

Tables 1 and 2 incorporate and illustrate our base case for China’s international balance sheet and capital flows, for the non-official sector only. Most of our estimates fall within the ranges of the estimates by the mainstream efforts discussed above. We expect the size of China’s international balance sheet to double in dollar terms and increase by one third as a share of GDP. International assets would rise faster than liabilities, with the net private liability position shrinking by half in dollar terms or by two thirds as a share of GDP. In other words, over the next five years, the Chinese private sector is expected to acquire more international assets than take on more liabilities, therefore resulting in net private capital outflows. We expect China’s annual net private capital outflow to triple on average over the next five years from the
average of the past three years. Meanwhile, China’s net private capital outflows as a share of GDP are expected to more than double.

Regarding direct investment, we anticipate that as a share of GDP, China’s gross direct investment assets may double to 20 per cent by 2020 from 2015, while its gross direct investment liability may decline modestly to 22 per cent in 2020 from 26.2 per cent in 2015. Thus, China will experience a swing from net direct investment inflows on average over the past three years to net direct investment outflow over the next five years on average.

Both China’s portfolio asset and liability positions may expand significantly in the coming years. Its gross portfolio asset position may rise fivefold to 12 per cent of GDP by 2020, while the gross liability position could double to 18 per cent of GDP. In dollar terms, we expect Chinese outward portfolio investment flows to increase tenfold on average over the next five years relative to the past three years, while inward portfolio investment flows may rise sevenfold. However, China is still expected to experience a net portfolio inflow, simply because of its initially larger net portfolio liability position.

Finally, as a share of GDP, China’s other (bank-related) assets and liabilities may not change on average much over the next five years, for three reasons. First, market volatility since mid-2014 might have exaggerated movements in gross bank-related investment flows and their associated asset and liability positions over the past three years. These banking flows should normalise over the next few years. Second, while China’s low inflation and low interest rate environment may not help induce much greater banking inflows upon further capital account liberalisation, a rising portion of debt securities with negative yields in some advanced economies may not help attract outward flows either. Third, other (bank-related) investment flows tend to be more cyclical and volatile over time, so it is difficult to ascertain the timing of their cycles.

1.2 China in 2020: Outlook for different types of private capital flows

As previously noted, private capital flows can typically be classified into three broader categories: direct investment, portfolio investment, and other (bank-related) investment¹. Within Chinese private capital flows, we have witnessed pronounced changes in their composition in recent years. A central feature has been a noted underweighting of the portfolio investment category (Hatzvi, Meredith and Nixon, 2015).

¹ There is a fourth category, financial derivatives. This paper will not cover this type of investment, as it can be safely assumed that financial derivative flows will be quite trivial in the coming years.
Going forward, the pace of capital account liberalisation may vary from time to time across these categories, and some of the broader forces discussed above would influence these capital flows to varying extents. Therefore, these different private capital flows will likely wane and wax over time. For instance, in 2015 a smaller net capital inflow under the direct investment category, an outright net outflow of portfolio investment, and a much bigger net other (bank-related) capital outflow all contributed to and drove a sizable combined net private capital outflow.

1.2.1 Direct investment

Under the direct investment category, FDI into China used to be favoured and encouraged, while controls on overseas direct investment by Chinese firms remained strict until the late 2000s. As discussed, this asymmetry owes much to the overriding priority to build up foreign exchange reserves to safeguard the highly political dollar peg during the Asian financial crisis. On average, foreign inward direct investment has been three or four multiples of Chinese outward direct investment in the past five years. Moreover, as a share of GDP, Chinese outward direct investment is only about half of the average of our benchmark group of economies, while foreign inward direct investment is 50 per cent higher. Thus, China's balance of direct investment has enjoyed a steady and sizable net inflow over the years.

**Figure 3: Inward and outward direct investment flows (US$bn)**

![Graph showing inward and outward direct investment flows (US$bn) from 2000 to 2014.](image)

*Sources: State Administration of Foreign Exchange 2016, CEIC 2016 and authors’ estimation.*

However, FDI into China may have peaked in recent years and could slow further going forward, in part because of a slower Chinese economy, an existing exceptionally high stock of foreign corporate ownership accumulated over the past decades, and fewer incentives offered
by the more financially constrained Chinese local governments. These factors all tend to weigh on returns to FDI. On the other hand, an enhanced supply of skilled labour, a less corrupt business environment and the expanding domestic market should continue attracting a reasonable scale of FDI into China over the medium term.

Meanwhile, we expect Chinese overseas direct investment to continue the recent uptrend in the years ahead, in the form of both greenfield and merger and acquisitions (M&A) projects, under the Chinese government’s policy to enhance risk-adjusted returns on international assets and as part of Chinese corporate strategy to cultivate new overseas markets, upgrade technology, diversify risk, and source new supply to meet the potential demand from a rising Chinese middle class. The annual gross outward direct investment by Chinese corporations increased more than threefold over the past five years. The latest news reports show that non-financial outbound direct investment by Chinese residents jumped some 70 per cent year-on-year during the first four months of 2016.

As a result of the combined peaking of foreign inward direct investment and expanding Chinese outward direct investment, net direct investment inflows have trended lower, shrinking by two thirds over the past two years. Thus it would not be a surprise that within a decade or so, China’s direct investment balance may become negative or register net capital outflows. The pace of such a change will also depend in part on how the rest of the world responds to Chinese overseas investment into various sectors of their local economies. This factor, together with underlying trade complementarity and institutional arrangements such as bilateral free trade agreements and local policy predictability, may influence the profile for overseas destinations of Chinese outward direct investment.

These patterns for two-way direct investment also mirror China’s international balance sheet. Years of large inflows have built up a quite high level of direct investment liability stock compared to our benchmark average. On the other hand, Chinese corporate ownership of foreign assets, while rising in recent years, remains quite low to date and only a quarter of our benchmark average. As a share of GDP, China’s direct investment assets doubled in the 2010s from 5 per cent to 10 per cent but remain tiny relative to many other comparable economies. In sum, over the next five years, we are likely to observe rising Chinese outward direct investment and peaking foreign inward direct investment.

1.2.2 Portfolio investment

To date, the sizes of China’s two-way portfolio investment flows have been fairly tiny relative to both total cross-border capital flows and GDP, by international comparison. As a result, both China’s gross portfolio asset and liability positions have also been trivial. This is true relative
to other types of investment and relative to international peers. Hence, upon fresh capital account liberalisation, the upside potential for such cross-border securities investment should also be significant and indeed the most promising among the various components of private capital flows. In the foreseeable future, nevertheless, Chinese cross-border securities investment flows are most likely to remain somewhat managed.

In 2015, a combination of rapidly rising Chinese outward portfolio investment and a sharp slowdown in foreign portfolio investment into China resulted in a near-record annual net capital outflow of US$66bn, in the face of the still stringent official regulations that pertain to this investment category.

**Figure 4: Inward and outward portfolio investment (US$bn)**

As discussed, portfolio flows into and out of China mostly go through managed schemes. Some of these schemes deal with one-way flows only, others with two-way flows. The schemes managing two-way portfolio flows include the Hong Kong-Shanghai and Hong Kong-Shenzhen Stock Connect schemes, as well as the mutual recognition arrangement for registered funds between Hong Kong and mainland China. The two Stock Connect schemes are subject to restrictions on both aggregate balance and daily flow quota as well as the list of eligible stocks.

On the other hand, the Qualified Foreign Institutional Investor (QFII and RQFII) schemes deal with portfolio inflows only, while the Qualified Domestic Institutional Investor (QDII) scheme deals with outflows only. Most schemes have restrictions on quota, qualification, registration, repatriation, lockup, and exchange conversion. In 2016, one of the most promising
development is the improved access for a broad range of foreign institutional real-money investors into the Chinese onshore interbank bond market with minimum registration requirements and without repatriation restrictions and lockup requirements.

Domestic financial market development and regulatory integrity could also be a factor influencing foreign portfolio investment into China. In addition to restrictive access to onshore securities markets, the functioning of onshore financial markets remains a challenge to potential foreign investors, in light of stock market volatility and the dominance of state corporate debt issuers. As a consequence, foreign ownership of Chinese stocks and bonds onshore remains minimal to date. The shares of foreign ownership in the domestic bond and stock markets are currently around 2 per cent – less than one-third to one-fifth of the levels often seen in the advanced economies and other major emerging markets. By contrast, some two-thirds of Australian government bonds outstanding are held by foreign investors.

**Figure 5: Foreign ownership of local currency government bonds (2015, % of total)**

![Bar chart showing foreign ownership of local currency government bonds (2015, % of total)](image)

*Sources: Asian Bonds Online 2016, CEIC 2016 and authors’ estimation.*

Putting it differently, China has been grossly underrepresented and underweighted in most global investor portfolios for both equity and fixed-income securities. Despite the fact that China has the world’s second largest stock market and third largest bond market, for a variety of reasons, China is yet to be formally represented by the leading benchmark equity and bond market indices, such as the MSCI and FTSE for the equity market and the Merrill Lynch Domestic Master, Citi World Government Bond Index, and JPMorgan Government Bond Index for government bonds (Overholt, Ma and Law, 2016). For instance, while the FTSE has devised two transitional indexes to include the A-share stock market in a staged process, the
MSCI is still delaying a decision on the expected partial inclusion of the A-share market over market concerns about a number of outstanding issues.\(^2\)

A combination of partial inclusions of both Chinese government bonds and A-shares into leading global leading stock and bond indexes could easily see a tripling of foreign ownership (to 8 per cent) of the Chinese stock and bond market capitalisation in a matter of five years, driven by substantially larger flows of securities investment by non-residents into China. Nevertheless, given the large size of the Chinese securities market in the global context, the inclusion of Chinese onshore securities assets in the major international fund indexes may have visible impact on other financial markets, even in a phased manner, as global investors rebalance their portfolios. For instance, the A-share market capitalisation is estimated to be as high as 8-10 per cent of the global equity market capitalisation (varying depending on the timing and volatility of the markets).

With potentially stronger foreign inward portfolio investment flows, Chinese policymakers may be more willing than otherwise to carry out additional deregulations on outward portfolio investment by Chinese residents, offsetting some of the possible rebalancing effects on other financial markets and easing the pressure on the renminbi. There may be other competing factors influencing the inward and outward portfolio flows. For instance, Chinese onshore markets generally have lower yields than their emerging market peers. On the other hand, a sizable segment of the bond markets in many advanced economies has lately witnessed negative yields, which should be a positive factor for foreign portfolio flows into China. We project an increase in net portfolio inflows into China over the coming five years. In any case, the expanded but more balanced two-way portfolio flows may potentially be mutually reinforcing.

1.2.3 Other (bank-related) investment

Under the bank-related and other investment category, cross-border capital flows appear to be large and volatile relative to other types of capital flows (Figure 6). This has mostly reflected the joint impacts of a large trade sector, increased discretion on the part of corporates disposing and retaining their foreign currency earnings, the advancement of RMB internationalisation, and the strong influence of cyclical factors. Instruments under this category include loans, deposits, trade credit and others. Some of these instruments may not

\(^2\) These issues include a slow application process for the QFII quota, the failure of daily capital repatriation so far, the 20 per cent assets under management (AUM) monthly repatriation limit, uncertainty about the new rules over trading suspension, and anti-competitive clauses (i.e. the pre-approval requirements) for any offshore financial products linked to an index containing A-shares.
involve banks at all, while other bank-related transactions simply reflect the decisions and transactions of bank clients.

These flows tend to be sensitive to changing global monetary conditions as well as to evolving market expectations of the exchange rate. In response to both currency expectations and interest rate differentials, Chinese firms can generate potentially large capital flows through shifts in their trade payments and receipts (so-called “leads and lags” of overseas payments). An advance payment of import bills, for instance, could result in a capital outflow recorded as a fall on the liability side under trade credit. Given that China’s exports and imports are equivalent to some 35 per cent of GDP, a 3-month shift of these trade payments may give rise to a potential cross-border capital flow exceeding 8% of GDP (35% x 3/12). RMB internationalisation would only make such leads and lags all the more convenient.

**Figure 6: Inward and outward other (bank-related) investment flows (US$bn)**

While the low-yield environment globally and a steadily appreciating renminbi have encouraged Chinese corporations to borrow dollars and hold renminbi assets (carry trade) in the wake of the global financial crisis, the latest divergence of monetary policy cycles between the US and China and the change in currency expectations around mid-2014 prompted Chinese firms to hold more dollar deposits and extinguish their dollar debts faster. These together resulted in a large net capital outflow under the category of other (bank-related) investment.

As a consequence, the net capital outflow under the other (bank-related) investment category reached US$480bn in 2015, equivalent to China’s entire net private capital outflow that year.

**Sources:** State Administration of Foreign Exchange (2016), CEIC (2016) and authors’ estimation.
Of this US$480bn, we estimate that roughly one-third could be attributable to Chinese overseas investment to acquire dollar assets, one-third to the rush by Chinese borrowers to actively retire their dollar debts, and one-third to the pulling out by foreign investors.

The Bank of International Settlements’ (BIS) data also confirm this pattern. The claims of BIS reporting banks on China surged sharply during the phases of intense quantitative easing while their liabilities to China dipped, resulting in a fivefold rise in net dollar borrowing by Chinese banks and non-banks during 2010-2014. Since mid-2014 however, net Chinese dollar borrowing from international banks fell by three quarters, because of a combination of reduced dollar borrowing and increased dollar deposits by Chinese banks and non-banks. Going forward, the volatility of the two-way gross and net investment flows under this category could remain high.

**Figure 7: BIS reporting banks’ claims on and liabilities to China (US$bn)**


**2. CHINA’S EVOLVING CAPITAL ACCOUNT MANAGEMENT REGIME**

For decades, two-way cross-border capital flows have been extensively regulated by the Chinese government, in terms of foreign exchange controls and administrative allocation, external borrowing and overseas investment by Chinese residents, and access to domestic financial markets by non-residents. In 1996, China officially committed to current account convertibility in the wake of unifying its multiple exchange rates and soon envisioned an ambitious plan to achieve capital account convertibility within a decade. However, the 1997/98 Asian financial crisis apparently changed the mind of the top Chinese policymakers, who responded to the crisis by significantly strengthening capital controls as part of their defence
of the tightened dollar peg amid a sharp competitive devaluation of many neighbouring Asian currencies.

Even today, the basic framework and regulatory rules of the Chinese capital control regime are similar to those shaped in the late 1990s. In fact, China’s persistent twin balance of payments surpluses on both the current account and capital account in the 2000s were to an important extent because of this much strengthened capital control regime. In short, the policy response to the Asian financial crisis essentially defined both the principal features of China’s capital control regime and in turn the main characters of China’s balance of payments flows for the subsequent two decades.

Soon after, the top priority of the Chinese government shifted to the urgent task of disposing non-performing loans and recapitalising commercial banks (Ma, 2006). A widening of the current account surplus put appreciation pressure on the renminbi in the mid-2000s and permitted a tentative restart of the capital account liberalisation campaign. Despite all the control measures, China’s capital account has been leaky and become more porous over time, given a big and expanding current account and growing wealth inequality. But make no mistake, China’s capital control still binds and has been more binding than that of India throughout the 1990s and 2010s (Ma and McCauley, 2013 and 2014). One price indicator is the persistent and sizable gap between the onshore forwards and offshore non-deliverable forwards of the RMB, which has been larger than that that of the Indian rupee. Another quantity indicator is the tiny portfolio flows over the years.

A hallmark of China’s capital account liberalisation strategy is its cautiousness and gradualism. Its pace may pick up here and there, but there is no “big bang”, at least not until now. Capital account opening typically advances with small and incremental steps on many fronts, including the latest twist of applying a new macroprudential assessment framework to regulate cross-border flows. Moreover, China’s capital control regime generally follows a policy of stricter controls on capital outflows, portfolio flows and short-term flows and has two important features.

First, capital controls tend to be tighter for cross-border flows thought to be more volatile than for more stable flows. Chinese capital controls on FDI into China have been the least stringent and those on portfolio outflows the most restrictive. As direct investment is considered less volatile and undertaken mostly by institutional and corporate investors, the management of such inflows and outflows tends to be lighter, and these flows are sometime even encouraged.
Portfolio flows have been considered more volatile and tend to be more heavily regulated, mostly through various designated investment schemes with managed quota, qualification, application, repatriation restrictions and lockup requirements. The most well-known would be the QFII scheme for foreign investment into the onshore securities market and the QDII scheme for Chinese investment in overseas securities markets. There are other variations of such schemes, such as RQFII and QDII2. Also, a Hong Kong-Shanghai Stock Connect scheme was introduced in 2015 to permit two-way investment in stocks listed in Hong Kong and Shanghai by onshore and offshore retail and institutional investors. A similar Hong Kong-Shenzhen Stock Connect scheme was established in 2016.

Second, the regulatory regime over time has shifted from one biased against outflows towards one managing two-way cross-border capital flows in a more balanced fashion. Related to the latter is the tendency for policymakers to systemically “lean against the wind” in the sense that control measures over outflows are strengthened to resist depreciation pressures on the exchange rate and vice versa (Ma and McCauley, 2013 and 2014). This could be seen during the Asian financial crisis and the latest change of the official fixing of the daily spot rate in 2015 and 2016 when the control on outflows was strengthened to resist depreciation pressure on the renminbi. Alternatively, during the mid-2000s as well as 2009-2013, a weak dollar and large external surplus all put appreciation pressure on the renminbi, resulting in easing of controls on outflows while controls on inflows tightened.

Thus a first-order question asks how far and how soon China will move towards full capital account convertibility. In early 2015, People’s Bank of China (PBC) Governor Zhou publicly called for a “basically open capital account” by the end of 2015, arguing that China had already achieved full or partial convertibility in 35 out of 40 items under the IMF’s classification of capital account transactions. To confuse the debate further, soon the term of “managed capital account convertibility” was coined (Chow, 2015). However, the latest Chinese five-year plan for 2016-2020 does not impose a firm deadline of making the yuan convertible under the capital account.

Realistically, we believe that China may choose not to rush achieving the average degree of capital account convertibility seen in the G10 economies by 2020, in part because it may take time to establish deeper hedging markets and to manage the risky domestic deleveraging process. Investors care much less about the vague notion of capital account convertibility than the true extent of actual capital mobility. If Hong Kong serves as a real-world benchmark for perfect (100 per cent) capital mobility, our sense is that China’s capital mobility currently is somewhere around 50 per cent and in a best scenario may approach 80 per cent by 2020 (Overholt, Ma and Law, 2016). Indeed, during the currency turmoil in 2015 and 2016, the
Chinese authorities quietly tightened capital controls by scrutinising documentation and slowing down or delaying granting of approvals related to outflows. Thus, China's capital account may still be more open in five years' time but unlikely to be near “full convertibility”. One implication is that the compliance cost of investing into China could remain high for quite some years to come.

3. RENMINBI INTERNATIONALISATION, ASIAN INFRASTRUCTURE INVESTMENT BANK AND 'ONE BELT ONE ROAD'

A major milestone in China's capital account management was its campaign in 2009 to promote greater external use of the RMB (or RMB internationalisation) in the wake of the global financial crisis. Before Beijing first allowed Hong Kong (HK) residents to convert their HK dollars into RMB, subject to a daily limit of 20,000 RMB, in 2004, the offshore use of the Chinese currency was strictly banned. But then nothing happened again until 2009 when suddenly Chinese policymakers rushed to actively promote RMB internationalisation (PBC, 2015; Walsh and Weir, 2015; and Overholt, Ma and Law, 2016).

This campaign started first with pilot cross-border trade and two-way direct investment transactions settled in renminbi, expanding bilateral local currency swap agreements between the PBC and a growing number of central banks, and increased issuance of renminbi-denominated bonds offshore, and then proceeded with the appointment of renminbi-clearing banks and other policy measures.

In a matter of five years or so, the PBC signed bilateral local currency swap agreements with 33 central banks, with a total notional amount of RMB 3.3 trillion; the share of Chinese exports and imports settled in RMB rose from nil before 2009 to 5 per cent in 2012 and exceeded 20 per cent by early 2014 (Figure 8). The share of renminbi deposits in Hong Kong’s total bank deposits surged from below 2 per cent in 2010 to a local peak of 13 per cent (Figure 9). However, there has been a visible setback in RMB internationalisation momentum in the wake of the market turbulence around mid-2014, as measured by these two indicators.
There are questions about the motives to rush the programme and its potential effects on China’s capital flows and broader economy. Is Beijing’s rush to internationalise the Chinese currency a bit precocious at this time, in light of a still tightly regulated capital account, a heavily managed exchange rate, and underdeveloped local financial markets? In our view, the three mostly likely motives include a desire to mitigate China’s own huge long-dollar and short-RMB position; a strategy to use international commitments to speed up politically difficult domestic financial liberalisation in the manner of the 2001 World Trade Organization (WTO) accession; and a need to be part of the global monetary system with an aim to trim its dependence on the US dollar by, for example, broadening the basket of the IMF’s Special Drawing Right (SDR) (Cheung, Ma and McCauley; and Overholt, Ma and Law, 2016).
One big trophy for the RMB internationalisation campaign and its associated liberalisation measures so far is the IMF’s decision to include the RMB into the SDR basket, taking effect in 2016. While mostly symbolic as far as short-term financial market impact is concerned, the RMB’s inclusion into the SDR club provides much needed momentum for China’s domestic and external financial liberalisation. It also represents a historical milestone in the global monetary system, as the renminbi has become the first emerging market currency in the SDR basket. One would expect China to take advantage of this new-found momentum to promote and expand the use of both the SDR and RMB globally in the coming years.

The increased offshore use of the RMB has effectively punched more holes in China’s still heavily managed capital account, with closer interactions between the onshore and offshore RMB markets. For instance, the RQFII scheme, which channels RMB already offshore back to the onshore stock and bond markets, helps widen access to the still partially closed onshore stock and bond markets. More importantly, growing RMB deposits offshore reflect a net outflow of RMB from mainland China, or an increase in the claims on China by non-resident holders of these offshore RMB deposits. Thus in balance of payments terms, net RMB outflows from China represent net capital inflows into China. In other words, the RMB internalisation campaign and the ultra-loose monetary policies of major central banks in advanced economies might have inadvertently reinforced each other to expand capital inflows into China, potentially inflating the RMB during the 2010s, before the currency market expectations finally turned in mid-2014.

Associated with RMB internationalisation have been China’s recent foreign policy initiatives, including the Asian Infrastructure Investment Bank (AIIB) and the “One Belt One Road” strategy. The AIIB is a China-led international financial institution created with the aim of providing finance to infrastructure projects. It complements as well as competes with other established multilateral development banks, thus helping broaden and diversify the existing global financial system. The AIIB can also be viewed as a part of the institutional building needed to underpin a globalising RMB as well as an additional source of long-term financing to foster cooperative development internationally (Overholt, Ma and Law, 2016).

The One Belt One Road blueprint is essentially an ambitious strategic, geopolitical and economic initiative to create an economic land belt that includes countries along the original Silk Road through Central Asia, West Asia, the Middle East and Europe, as well as a maritime ‘road’ that links China’s port facilities with the African coast, pushing up through the Suez Canal into the Mediterranean. But its geographic scope can be flexibly interpreted. Both the AIIB and “One Belt One Road” initiatives may help expand China’s outward direct and bank-related investment, while facilitating the absorption of China’s huge infrastructure-related
manufacturing capacity. These initiatives may also involve a broad range of services such as tourism, education and financial and legal services.

Yet meanwhile, many challenges and risks can also arise, just like any other overseas investment plan. Thus the momentum of these Chinese initiatives is mostly likely to be gradual going forward, because of a slowing Chinese economy, the rising distress in the Chinese financial system itself, and the global economy entering a new phase of uncharted waters. These projects could become less ambitious than initially envisioned, in part because of the latest currency market turbulence and the major turning point in China’s balance of payments since mid-2014.

4. BROADER ECONOMIC AND FINANCIAL FORCES

Alongside the latest campaign to expand the international use of the RMB and the AIIB and One Belt One Road initiatives, there were two other important forces shaping China’s cross-border capital flows leading up to the 2014 turning point in China's balance of payments. These were the emerging headwinds facing the Chinese economy, and the substantial appreciation of the RMB for almost a decade. We discuss these two factors first in this section, before later discussing the details of China’s balance of payments, including the latest change to the pattern of persistent twin surpluses.

Some of the powerful structural tailwinds supporting double-digit Chinese economic growth over the past two decades have now gradually faded and might even reverse into headwinds, lowering the nation’s potential or long-run growth. These long-term factors include diminishing returns to scale, a widening income gap, a narrowing scope for technological catch-up through imitation, less favourable demographic dynamics, signs of saturation in the housing market after breakneck expansion for more than a decade, and a less supportive global market environment. The combined consequence is likely slower but still decent economic growth, low inflation or even deflation, a trend decline in return to capital, and low interest rates. Our projection assumes an average annual real GDP growth rate of 6 per cent and inflation of 1 per cent for the period of 2016-2020.

Against this broad backdrop, we think that upon fuller capital account opening, in addition to the expected increase in gross two-way capital flows, China is likely to experience net private capital outflows for the following three considerations.

- First, return differentials between China and other emerging markets may narrow. Hence there will be greater incentive for Chinese residents to diversify wealth and seek higher
returns overseas, as China’s international asset allocation should gradually converge to global norms in the coming decade from the current underweight level (Hooley, 2013).

- Second, as discussed earlier, China has a history of tighter controls on private capital outflows than inflows. Thus, any balanced liberalisation measure would tend to trigger larger outflows than inflows, other things being equal (Ma and McCauley, 2013 and 2014).
- Finally, as argued by Ma and Wang (2010), China’s exceptionally high domestic saving rate (Figure 10) implies a trend current-account surplus for many years to come and less external financing need from foreign savings. This should help facilitate more private capital outflows and mitigate, to some extent, the possible impact of net Chinese private capital outflows on the RMB.

**Figure 10: China’s saving, investment and current account (% of GDP)**

![](image)

*Sources: People’s Bank of China 2015, CEIC 2016 and authors’ estimates.*

Therefore, we are more likely to witness net private capital outflows upon fresh capital-account opening. This contrasts with the experiences of many other emerging markets where a combination of high inflation, high local interest rates and low domestic saving rates pointed to increased net private capital *inflows* upon liberalisation, domestic asset price booms, currency appreciation, and even wider current account deficits. This in turn may bias Chinese policymakers to move more cautiously, and to initially liberalise faster the control measures on capital inflows. It may also highlight the need to have a more market-based exchange rate in place first, before more substantial capital opening.

Moreover, the RMB had appreciated substantially for almost a decade, starting from 2005 when China first loosened its dollar peg (Figure 11). It appreciated by more than 50% in real effective terms and by more than one-third against the US dollar, albeit probably from an
undervalued level initially. The initially large current account surpluses, large capital inflows in the wake of the WTO accession, the RMB internationalisation campaign, the practice of a heavily managed and thus very stable exchange rate, and the attractive carry in the context of highly accommodative global monetary policy all had supported such a sustained currency appreciation — until mid-2014.

**Figure 11: Real and nominal effective exchange rates of the renminbi (2010=100)**


Of course, today one can debate the fair valuation of the renminbi and its likely future path. There are several points to consider:

- First, China’s current account surplus shrank from a peak of 10 per cent of GDP to some 3 per cent in just a few short years. Such a modest current account surplus now may have little to do with the exchange rate and much more to do with the country’s high saving rate (Ma and Wang, 2010).
- Second, China’s unit labour cost surged in the late 2000s and early 2010s, rising much faster than most of its trading partners (Ma, McCauley and Lam, 2013). Measured in unit labour cost, the real effective exchange rate of the RMB could have appreciation by more than 60 per cent over the past decade. Most of China’s recent gain in the world export market share likely comes from its efficient supply chains and infrastructure rather than its conventional cost competitiveness.
- Third, China’s foreign exchange reserves, which indicate the possible scale of central bank interventions in the currency market, stopped rising in 2014 and have since gone downhill, having fallen by some 20 per cent since. Even the IMF in 2015 agreed that the RMB should no longer be considered undervalued (IMF, 2015).
accumulation until mid-2014 might in part relate to the large carry trade inflows that had grossed up China’s external balance sheet.

- Finally, the issue of RMB valuation becomes even more interesting and controversial in light of the apparently increased fragility in the Chinese financial system. China’s debt to GDP ratio surged from 150 per cent of GDP on the eve of the global financial crisis to exceed 250 per cent by 2015, a level only seen in some advanced economies (Figure 12). Over the past few years, there have been growing non-performing loans in the banking system, and more credit events in the debt securities market.

**Figure 12: Total debt-to-GDP ratio: Australia and China (%)**

![Graph showing total debt-to-GDP ratio for Australia and China]


In sum, with diminished foreign exchange market interventions by the PBC, increased two-way volatility of the RMB appears to be the market consensus forecast.

**5. THE BIG TURNING POINT IN MID-2014**

Mid-2014 marked a major turning point in both China’s capital flow pattern and its exchange rate path. For more than a decade before mid-2014, China ran persistent twin surpluses in its balance of payments — both its current account and private capital flow (non-reserve financial flow) balances recorded sizable surpluses, which were to be offset or recycled only through the sizable official ‘outflows’ or accumulation of large foreign exchange reserve assets. As a result, China’s foreign exchange reserves rose more than twenty-fold, to a peak of nearly US$4tn by mid-2014.

But this pattern changed decisively afterwards. While China continued to run a modest current account surplus of 2-3 per cent of GDP, an outsized net private capital outflow resulted in a sharp drop in foreign exchange reserves by the end of 2016. Also, the RMB started coming under pressure and indeed weakened by more than 10 per cent relative to the US dollar.
By the time of an announced change in the official daily fixing in August 2015, market sentiment toward the RMB had swung sharply, triggering a surge in dollar buying by the Chinese private sector.

**Figure 13: China’s foreign exchange (US$bn) and CNY/USD exchange rate**

![Graph showing CNY/USD (reverse order) and Foreign reserves (right axis)](image)

*Sources: State Administration of Foreign Exchange 2016, CEIC 2016 and authors’ estimation.*

In 2015, China experienced a record net private capital outflow of US$670bn (if combined with net ‘errors and omissions’), because of both larger outward investment by Chinese residents and net redemption by non-resident investors. With an annual current account surplus of US$330bn, foreign exchange reserves fell by US$340bn as the Chinese authorities sold dollars to partially accommodate private capital outflows while supporting the currency. Between 2Q2014 and 4Q2015, China experienced net private capital outflows at a pace of nearly US$100bn per quarter, in contrast to an average quarterly net private capital *inflow* of US$65bn over the earlier five years (Figure 14).
This turning point in the paths of China’s balance of payments and currency was most likely triggered by a combination of several related cyclical and structural developments.

- First and foremost, the US Federal Reserve started a new rate-hiking cycle, underpinning the broad-based strength of the US dollar. This trend of a strengthening dollar is unlikely to reverse any time soon, unless the US economy stumbles badly.
- Secondly, the Chinese economy has also slowed both cyclically and structurally, suggesting an extended divergence of monetary policy cycles between the US and China, which may further pressure the RMB. China’s GDP growth rate slowed to towards 6.5 per cent during 2014-2016 from nearly 10 per cent over the previous three decades.
- Thirdly, after almost a decade of sizable appreciation, the RMB may have become fairly valued if not more. This is especially true if one considers the steep rise in China’s unit labour cost, as previously noted (Ma, McCauley and Lam, 2013).
- Fourth, there have been concerns about China’s rising leverage and signs of associated financial fragility, such as the 2015 stock market turmoil and a growing number of credit events in the domestic bond market.
- Finally, partial capital account opening during the RMB internationalisation campaign might have given rise to increased interaction and transmission of shocks between onshore and offshore markets, amplifying volatility. Unfortunately, the onshore hedging market is yet to function well.
This could usher in a new era in China’s capital flows going forward. Much of the net private capital outflow can be attributed to the greater desire of Chinese residents to diversify their growing wealth structurally and to shed their dollar debt cyclically. This in turn reflects both the structural factors of slower potential growth, gradual capital opening, rising income levels, and the need for optimal asset allocation, as well as the short-term factors of a cyclical downturn in the domestic economy and a new US interest rate cycle.

Hence on both structural and cyclical grounds, one may expect a ‘new normal’ for China’s balance of payments in the coming years: net private capital outflows, fluctuations in foreign reserves to smooth excessive market volatility, and a continued current account surplus in the coming years. In 2015, both Chinese outward investment and foreign inward investment experienced net outflows, contributing 80 per cent and 20 per cent, respectively, to the overall net private capital outflow. Accelerated outward investment by Chinese residents has been the principal factor behind the large net private capital outflows, while the reversal of inward investment by foreign investors has also contributed (Figure 15).

**Figure 15: Private capital flows: Chinese outward investment vs. foreign inward investment (US$bn)**

Moreover, one-sided official interventions in the foreign exchange market to buy dollars have mostly vanished. Indeed, the Chinese government since mid-2014 has sold dollars out of official reserves to accommodate private capital outflows to some extent, partly mitigating their impact on the RMB. Already, the share of official foreign exchange reserve assets in China’s
total international assets has started declining meaningfully in recent years, from a peak of more than 70 per cent in 2009 to 55 per cent by 2015 (Figure 16).

**Figure 16: Reserve assets as a share of total external assets and GDP (%)**

![Graph showing reserve assets as a share of total external assets and GDP (2004-2014)](image)

Sources: State Administration of Foreign Exchange 2016, CEIC 2016 and authors’ estimation.

China’s stock positions in international assets and liabilities mirror the past pattern of depressed private capital outflows as well as the latest shifts. Historically, the official sector dominated the asset side of China’s international balance sheet. On the other hand, the non-official sector dominated the liability side of the balance sheet, as China’s external government borrowing has been small. Much of foreigners’ claims on China were concentrated in the corporate and banking sector. Once the reserve assets are removed, the size of China’s international balance sheet shrinks considerably and is comparatively small in an international context (Figure 17).
A heavily regulated capital account naturally depresses two-way cross-border capital flows and thus retards China’s international balance sheet. Excluding the huge official reserve assets and measured in dollar terms, China’s gross foreign assets have risen nine-fold over the past decade, while its gross liabilities have increased by seven times (Figures 18-19). Yet once scaled by China’s growing economy, China’s external balance sheet has expanded only modestly (Figures 20-21). Further capital account liberalisation will likely mean greater gross capital flows and a bigger international balance sheet, to be discussed later. China’s international balance sheet also provides a very clear snapshot of its highly discriminatory capital control regime. In particular, both the tiny asset and liability positions of portfolio investment are indications of the past stringent regulations on portfolio investment.

Figure 17: China’s international balance sheet with and without reserve assets (% of GDP)

Note: A= assets, L= liabilities, R= reserve assets
Sources: State Administration of Foreign Exchange 2016, CEIC 2016 and authors’ estimation.
Figure 18: China’s external assets (non-reserve, US$bn)

Sources: State Administration of Foreign Exchange 2016, CEIC 2016 and authors’ estimation.

Figure 19: China’s external liabilities (US$bn)

Sources: State Administration of Foreign Exchange 2016, CEIC 2016 and authors’ estimation.
Nevertheless, China is also trying hard to implement a more market-based exchange rate before substantially further opening up its capital account. One approach is to bring in more international traders in its onshore RMB market, to broaden and diversify the local RMB trading community. This direct onshore presence may in turn boost the foreign exchange business in the home markets of participating foreign banks. Another approach is greater willingness on the part of the Chinese government to allow the ongoing balance of payments outflows to clear partially through increased currency volatility in addition to adjustments in the foreign exchange reserves. A more important test is the development of a deep and well-functioning
hedging market (Ballantyne et al, 2014). Hence, we caution against the expectation of “full capital account convertibility” by 2020.

Going forward, this new normal of small current account surpluses, increased net private capital outflows and two-way currency volatility may in turn influence both the pace and approach of China’s pledged capital account opening. In particular, we may see the “lean against the wind” liberalisation strategy be deployed from time to time: an accelerated pace of liberalisation on private capital inflows when the RMB comes under depreciation pressure but a speedier capital account opening on private capital outflows when the RMB holds up well. In other words, Chinese policymakers are likely to vary the pace of different market-opening programs in order to help contain and smooth currency market volatility. Policy and regulation could remain fluid for some years to come.

6. OVERSEAS PROFILE OF CHINESE PRIVATE OUTWARD INVESTMENT: APPARENT AND ‘REAL’

The central role of Hong Kong in China’s financial integration with the global system is unrivalled and cannot be overstated. Hong Kong has long been a dominant trade entry point and investment gateway to China, hosting a cluster of Chinese bank affiliates and companies. Hong Kong’s strong legal system, superior market infrastructure, robust regulatory institutions and proven crisis management capabilities are of special value to mainland China. Indeed, the best and largest Chinese companies and banks were often first listed in the Hong Kong stock market before their eventual listings in the onshore A-share market. Hong Kong has played a dominant role in the process of growing an offshore renminbi market (Overholt, Ma and Law, 2016).

Hong Kong typically is the first stop of Chinese companies going overseas for both ‘greenfield’ and M&A investments. Officially, more than half of China’s outward direct investment has gone to Hong Kong on an accumulative basis (Figure 22). In reality, Chinese companies often use Hong Kong (as well as tax havens and other regional financial hubs) as an intermediary to their ultimate investment destinations. For instance, the Chinese official statistics show that Australia has been among the top five destinations for Chinese outward direct investment on an accumulative basis. But if we adjust for the special role of tax havens, Australia could well be among the top two or three Chinese direct investment destinations (KPMG and University of Sydney, 2016). Regardless, Hong Kong has no doubt benefited disproportionally from being a major and first-stop platform for many Chinese companies going abroad and the One Belt One Road initiative. One advantage enjoyed by Australia is its highly complementary factor endowment relative to China.
Much of China’s outward portfolio investment has so far been undertaken by institutional investors under still tight management. These investors mainly encompass banks, insurance companies, sovereign wealth funds, pension funds, and asset managers. The US easily tops the destinations for Chinese outward portfolio investment, representing more than 40 per cent of China’s portfolio asset position as of June 2015. This is not entirely surprising, given the size and depth of the US capital markets. Hong Kong again figures prominently, being the second most important market for Chinese outward portfolio investment and accounting for some 17 per cent.

Interestingly, Australia ranks seventh for Chinese portfolio assets and could easily move into the top five, considering that some of the higher-ranking tax havens have no meaningful securities markets to speak of (Figure 23). China’s huge surplus savings, coupled with Australia’s reliable legal system, large external financing needs, and attractive returns, may further lift Australia’s ranking as a destination for Chinese outward portfolio investment. This is especially so in light of the potential for further capital account opening in the portfolio investment area as well as Australia’s institutional asset management capability.
Hong Kong has long been a major hub for China’s cross-border banking transactions. Hong Kong’s share of the total cross-border claims and liabilities of BIS-reporting banks regarding China has averaged 40 per cent since 2000, and in some years exceeds 50 per cent. Many of these claims on China could relate to Chinese-owned banks located and operating in Hong Kong (Hatzvi, Meredith and Nixon, 2015).

There are a number of concerns with the way in which outward investment is treated in official statistics. The most obvious is that the statistics usually only capture the *immediate* destination...
of investments, and not their final destination. The second is ‘round-tripping’, where money is parked outside China for reinvestment inside China, potentially for speculative purposes but potentially to avoid scrutiny. These issues are important for China given the significance of Hong Kong as an intermediate destination. By some calculations, 70 per cent of China’s outward foreign direct investment goes to Hong Kong, the Cayman Islands or the British Virgin Islands.

Garcia-Herrero, Xia and Casanova (2015) have attempted to disentangle the statistics and while the figures do change over time, the basic picture remains much the same. When intermediate destinations are excluded, the most significant outcome is that Asia becomes much less important as a destination, while Europe and North America receive a greater share of Chinese outbound investment than is apparent from the unadjusted statistics. Table 3 provides a clearer picture of where investments ultimately end up.

**Table 3: Where does it go? Adjusted offshore Chinese investment – stocks and flows (2013)**

<table>
<thead>
<tr>
<th>Region</th>
<th>STOCK (%)</th>
<th>FLOW (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Original</td>
<td>Adjusted</td>
</tr>
<tr>
<td>Asia</td>
<td>68</td>
<td>45</td>
</tr>
<tr>
<td>Latin America</td>
<td>12</td>
<td>9</td>
</tr>
<tr>
<td>Europe</td>
<td>8</td>
<td>19</td>
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<tr>
<td>North America</td>
<td>4</td>
<td>13</td>
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<tr>
<td>Africa</td>
<td>4</td>
<td>8</td>
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<tr>
<td>Oceania</td>
<td>3</td>
<td>7</td>
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<tr>
<td>--- Australia</td>
<td>3</td>
<td>6</td>
</tr>
</tbody>
</table>

Source: Garcia-Herrero, Xia, Casanova 2015.

For the US at least, it is also possible to break down Chinese FDI both by industry and by the nature of the investing party. The most obvious feature is the very rapid run-up in investment into the US in 2016, and the dominance of real estate as a target for investment. More than two-thirds of the inflow was considered to be ‘strategic’ private investment and half of the remainder comprised private financial investments. Overall, about one-sixth was from state-owned entities.
McKissack and Xu (2016) also provide some breakdown of Chinese investment into Australia, albeit on the basis of apparent source. Treasury’s view (based on Australian Bureau of Statistics (ABS) data) is that China accounts for about 4.4 per cent of the stock of foreign investment in Australia. Based on a more extensive dataset, Treasury finds that China accounts for only about 3 per cent of investment in Australia’s major projects. Judging by the analysis presented above, the Treasury figures may understate actual investment by about half.

The 2016 KPMG/University of Sydney (2016) analysis of Chinese investment into Australia found that inward direct investment in 2015 reached some $A15bn, with:

- 45 per cent going into real estate,
- 20 per cent going into renewable energy,
- 17 per cent going into healthcare,
- 9 per cent going into mining, and
- 3 per cent going into each of infrastructure, energy and agribusiness.

### 7. RISKS

The process of opening a country’s capital account has frequently led to economic policy difficulties. The macro management problem changes, and economic actors have to learn to respond to different stimuli. Figure 26 shows the way in which after the float of the Australian dollar, interest rates became far more stable but the exchange rate became much more
volatile. By contrast, China’s interest rates appear to have been mostly liberalised but also have become much more volatile, in part because of its still limited currency flexibility.

**Figure 26: Risks shift from interest rates to exchange rate post-float: Australian experience**

![Graph showing Australian interest rate and dollar volatility](image)

*Source: RBA, 2017*

Such swings in exchange rates can cause significant difficulties to domestic producers, as their costs and/or revenues can swing sharply and hence their competitiveness can change quickly and exogenously. The ability of economies to adapt to such swings varies, as many resource exporters have found in recent years. Firms need to develop alternative strategies for dealing with these swings, some by financial hedging and some by diversification of their production and sales globally.

The issue of when and how to move towards a more open capital account has been widely discussed in the literature. The IMF summarised the important preconditions in the following terms (IMF, 2005):
“Country experiences indicate that four ingredients are generally needed for a successful transition to exchange rate flexibility:

- a deep and liquid foreign exchange market;
- a coherent policy governing central bank intervention in the foreign exchange market (the practice of buying or selling the local currency to influence its price, or exchange rate);
- an appropriate alternative nominal anchor to replace the fixed exchange rate; and
- effective systems for reviewing and managing the exposure of both the public and the private sectors to exchange rate risk.”

China is clearly only partly along the path towards a successful transition, and a major constraint to greater capital account openness is increased financial fragility.

The second broad set of risks associated with the transition are macroeconomic. Woo (2016) provides a clear summary. He considers that China faces multiple risks along the development path. Failures of the basic development model are possible, but more easily addressed in that the problems of middle-income transition have been widely discussed and reasonably well understood. The issues of social harmony, adaptation and accommodation pose a more fundamental challenge. Building the institutions needed to ‘manage’ a modern economy, provide adequate protections and share burdens takes time, and failures become quite obvious. Issues related to corruption, to the sharing of the gains from increased prosperity, to the environment, and to basic issues of governance all pose significant risks in a one-party state.

Since the election of President Trump in the US, foreign relations and global trading risks have clearly climbed in the catalogue of risks facing China and Australia.
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