How China is Managing Capital Flows – and why*

Jayati Ghosh

The global financial media are always on the lookout for signs of an impending financial crisis in China – and the dark prognostications about the future made by several external observers relate to both internal and external financial flows. But there are reasons to believe that both concerns may be overplayed, and that what is occurring especially with respect to cross-border flows is a much more complex process reflecting a medium-term plan of the Chinese state, in accordance with its much more assertive role in the global scene.

There has been much discussion on rising internal debt levels, with analysts of China's economy frequently noting that the rapid increases in debt especially of corporations and provincial governments and municipalities, are giving rise to an unsustainable situation, especially since the totality of such debt has nearly doubled over the past decade and now amounts to an estimated 280 per cent of GDP. While this would certainly be true for most other developing countries, in China it is necessary to remember that much of the internal debt is held by large public sector banks, whose viability is not under question, and which can always be refinanced by the Chinese state if and when required.

So while there are some signs of excessive indebtedness creating financial fragility, it is also true that these are quite different in both scale and intensity from the concerns that would arise in a less regulated and less publicly owned financial system, such as exists in most developing countries. Until a few years ago, many analysts believed that this was also true of the external financial account, since China's capital controls were believed to be sufficient to prevent any significant outflows of capital from the country.

But from around the middle of 2014, there was a substantial outflow of funds in China's capital account, to the point that financial media quickly picked up the theme of "capital flight" from China. The significant decline in foreign exchange reserves from a peak of around $4 trillion in late 2014 to $3 trillion in late 2016 was seen to substantiate this claim. External analysts also provided various reasons to explain this sudden and rapid capital flight from what is otherwise a strong economy, since it is hard to expect anything like exchange rate risk. In any case, the standard determinants of capital flight from a developing country are all completely inapplicable in China's case, since the country runs a current account surplus and has much stronger GDP growth than almost all others, and in addition hold the largest stocks of international reserves in the world. So the explanations have related more to quasi-political risks, including the transfer of funds abroad by both companies and high net worth individuals worried about the anti-corruption drive and other domestic policies that could affect their locally held assets.

But it now appears that this judgement about capital flight from China may have been too hasty, and even misleading. Recent research by two Brazilian economists (Paulo Van Noije and Bruno De Conti, "China: Capital flight or RenMinBi internationalization?", paper presented at the Forum on Macroeconomic and Macroeconomic Policies 21st Annual Conference, Berlin Germany, 9-11 November

2017) provides an insightful analysis of the nature of the capital flows in and out of China over the past three years. They find that, far from representing a potentially destabilising flight of capital from the country, the reduction in China's foreign exchange reserves may be part of the government's broader policy of shifting China's net external asset-liability position and encouraging a partial internationalisation of the RenMinBi.

The authors note that the Chinese authorities could well be trying to diversify the holding of international reserve assets, given the low returns on US government securities (in which form much of the reserves are held) and the structural deficit of investment income which needs to be corrected. Indeed, average nominal returns on reserve assets over the past five years have been as low as 0 per cent, while that on foreign direct investment was 5 per cent. While China's net foreign asset holding ($6.4 trillion at the end of 2016) has much larger than its net foreign liabilities ($4.7 trillion), returns have been so much lower on assets that there was an investment income deficit of $60 billion in 2016. This is probably why a 2015 Report of China's State Administration of Foreign Exchange (SAFE) noted that in future, a major policy goal would be that of "promoting the innovative use of foreign exchange reserve assets, and improving foreign exchange reserve management".

One change was consequently that in the net foreign direct investment position of China. Until 2014, annual inflows of FDI were at least $100 billion higher than FDI outflows, but then this gap reduced and by 2016, FDI outflows exceeded inflows. Meanwhile, other investment outflows (particularly external loans and trade credit) continued to increase while the equivalent inflows decreased. In other words, not only was there an increase in such foreign assets but also a simultaneous decrease in foreign liabilities. This is what has been seen as indicative of capital flight – but Van Noije and De Conti point out that it could equally reflect a different official strategy of diversifying investment to areas with higher returns (both economic and political) as well as more international financial integration.

This is suggested by the fact that a growing part of the increase in Chinese loans, financings and even overseas deposits are being made in RMB. One big global shift occurred when the RMB was included in the basket of currencies that make up the SDR of the International Monetary Fund. But there are also proactive efforts by China to make the RMB a more widely used currency among its trading and investment partners.

According to the People's Bank of China, the RMB is increasingly being used to settle China's international trade. In 2016, China's international trade settled in RMB amounted to RMB 3.8 trillion in receipts and RMB 6.1 trillion in payments, creating a notable deficit of RMB 2.3 trillion, "which is conducive to expanding the offshore capital market and the offshore RMB business". Even more significantly, outward FDI settled in RMB was RMB 1.1 trillion in 2016 (nearly US$ 150 billion) while inward FDI in RMB was as high as RMB 1.4 trillion. Meanwhile, loans (which have been significant in many developing countries) are also increasingly provided in RMB, with the net balance of such overseas loans coming to RMB 437 billion in 2016.

In fact, over the past two years, outflows on the capital account have been mainly in RMB, to the point that the RMB has become the main currency flowing out of China!

This has effectively provided more externally held RMB liquidity to encourage the process of internationalisation of the currency. In some ways the shift of capital in RMB could even be seen to have been officially tolerated precisely for that reason. But obviously, insofar as capital controls of different kinds are introduced or returned to (as occurred after the 2 per cent devaluation of the currency in 2015), that also essentially affects the flows of RMB rather than other currencies like the US dollar.

This is the cleft stick of policy choice that the Chinese authorities have to deal with now. The ability to impose capital controls at will to regulate the foreign exchange market is clearly important for financial stability and several other domestic purposes. But insofar as that affects the further use of RMB offshore, it clearly inhibits the process of RMB internationalisation. Thus far, it appears that the government has managed to control those capital flows in foreign currency that will affect the exchange rate, while allowing more transactions denominated in RMB. But increasing internationalisation will necessarily reduce the ability to control the exchange rate as well as other types of current and capital flows.

So why would the Chinese state want to internationalise the RMB in any case? The most obvious answer is to reap the advantages of seignorage, which accrue to the holder of an international reserve currency, and which the US economy has greatly benefited from over many decades. This is where the medium-term ambitions and plans of the Chinese state matter a great deal. It is evident that China is seeking a much larger and more influential role for itself in the global economy, and one of the ways in which it seeks to expand its influence and power is through greater use of its currency by others, in both trade and financial flows.

But it is a moot question whether the gains to be had from this in a global economy in which the basic rules of the game are till set by the advanced capitalist economies will be enough to counterbalance the costs of increased fragility and potential volatility, and particularly the inevitable loss of some domestic policy space in what is still very much a developing country.

This is a long game – and like so much else in China, it is clear that the Chinese authorities are fully aware of this. But long games involve dealing with many imponderables, including both the “known unknowns” and the “unknown unknowns” famously described by former US Secretary of State Donald Rumsfeld. The external financial liberalisation that will necessarily be required of a country that wants to have a fully international reserve currency is like riding a tiger – even when it is a wild ride, it’s not so easy to get off.

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