

China: capital flight or renminbi internationalization?

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Abstract: Motivations that may be understood only through the lenses of Political Economy induce many analysts to the prognostic of an imminent economic crisis in China. In this framework, several authors claimed the occurrence of an important capital flight in China in 2014-16. This paper aims therefore to answer: did China really undergo a Capital flight? Its methodology includes an analysis of the Chinese external stocks and flows in 2014-16; and an analysis that goes beyond macroeconomics, looking also to the currency hierarchy and the international usage of the renminbi (RMB). We conclude: i) the fall in the foreign reserves in China in 2015-16 was partially due to a strategy of the Chinese government to diversify its international assets (due to economic and political reasons); ii) there has occurred a capital flight in China in 2015-16, but these outflows were mostly in RMB. Due to that core difference, the effects over the domestic economy are much lower. Further, it may contribute to the internationalization of the RMB, strategic quest of the Chinese government that will have important economic and geopolitical implications.

Keywords: China, international reserves, currency hierarchy, capital flight.

Resumo: Motivações que só podem ser compreendidas pelas lentes da Economia Política induzem muitos analistas ao recorrente prognóstico de que uma crise econômica na China é iminente. Nesse ínterim, diversos autores alegaram que estaria ocorrendo uma importante fuga de capitais na China no período 2014-16. Para contribuir com esse debate, o objetivo deste artigo é responder à pergunta: a China realmente passou por uma fuga de capitais no período em tela? A metodologia da pesquisa inclui uma ampla análise dos estoques e fluxos externos chineses entre 2014 e 2016; e uma análise que transcende a macroeconomia e procura avaliar a hierarquia monetária e o crescente uso internacional do renminbi (RMB). Concluímos que: i) a queda das reservas internacionais na China em 2015-16 deveu-se, em parte, à estratégia do governo chinês de – por motivos econômicos e geopolíticos – diversificar seus ativos externos; ii) ocorreu uma fuga de capitais na China em 2015-16, mas essas saídas de recursos foram principalmente em RMB. Dada essa diferença crucial em relação ao que usualmente ocorre nos momentos de fuga de capital, os efeitos sobre a economia doméstica são muito menores. Além disso, esse processo pode contribuir para a internacionalização do RMB, objetivo almejado pelo governo chinês e que terá implicações econômicas e geopolíticas importantes sobre o globo.

Palavras-chave: China, reservas internacionais, hierarquia monetária, fuga de capitais.

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1) Introduction

Chinese economic performance in the last 40 years is completely astonishing. During this period, the average Gross Domestic Product (GDP) growth was almost 10% per year. China is already the second largest economy in the world – the first one if we consider the Purchasing Power Parity (PPP) – and the most important nation in the world for international trade.

Yet, this impressive trajectory created some imbalances in the Chinese economy. As a matter of fact, while the annual income per capita in the Eastern part of China surpassed 28 thousand yuan in 2016, western China accounted for only 16 thousand yuan (NBOC, 2016). However, even regional inequality has been on the rise and China has currently one of the highest GINI coefficients of the world (Zhang, 2016).

From the macroeconomic point of view, it is important to notice that consumption still has a low contribution on economic growth. In the last decades, the high economic dynamism has been determined mostly by exports and investments. However, the global financial crisis that broke out in 2008 accelerated the will of the Chinese government to reinforce a process of endogeneization of economic growth. In order to avoid the effects of the global crisis, some anti-cyclical policies have been implemented in 2009-10, resulting in very high rates of investment. These programs have been successful in curbing the deceleration of economic growth, but they may create some profound problems related to overinvestment and the deterioration of capital returns. In other words, after such a long period of economic growth, the probability of an investment to be either redundant or not profitable is now higher (Krober, 2016).

Other authors point out to the over indebtedness of the Chinese economy, and its possible negative consequences to the financial system. China's non-financial corporation credit-to-GDP ratio grew from 135% in the pre-crisis to 200% in 2012 (Mackenzie, 2013). Also keeping in mind the low return of projects, some authors have questioned the soundness of the Chinese financial system (e.g. Chen and Kang, 2018). Nonetheless, this is not a consensus, since other experts highlight the fact that most of this debt is denominated in local currency and the capacity of Chinese government to recapitalize its public banks (e.g. Lardy, 2016).

After all, in spite of the impressive performance of the Chinese economy highlighted above, some analysts suggest the country is facing the risk of a huge crisis. The two most common “potential crises” indicated by such literature are: i) a demand crisis related to the overcapacity of the industrial sector; ii) a financial crisis. Concerning the first possibility, it is true that China has currently high idle capacity in many sectors, specially amplified by the abovementioned anti-cyclical policies held in 2009-10⁴. Nevertheless, one should not forget the ability of the Chinese government to foster demand. Regarding the second possibility, it is also important to notice that a public bank system tends to be much more resilient than a private one.

Beyond these prognostics stating that China will face a huge crisis in the near future, there has also been many authors and market practitioners claiming that in the last few years Chinese economy is already facing a potentially important problem: capital flight (e.g. Gunter, 2017; Bloomberg, 2016, *The Economist*, 2015, Kärnfelt, 2017). Even Chinese authorities tried to calm market sentiments, when the deputy director of the State Administration of Foreign Exchange, Wang Xiaoyu, emphasized

⁴ See for instance European Chamber (2016).

in a press conference that the capital outflows that occurred in 2015 were not caused by “panic” and could not be considered a capital flight (Chen, 2015).

There has been indeed a massive decline in their international reserves in the last three years, but it is still curious to talk about a capital flight in a country that has international reserves of more than US\$ 3 trillion. Why is this capital running away?

Because of the exchange rate risk? Of course, it is rather a consensus that Chinese renminbi (henceforth RMB) is artificially undervalued, so if the exchange rate has any long term trend it is probably going in the direction of an appreciation, increasing the gains of its holders; it is true that in the recent period there had been some devaluation, but the volatility of the exchange rate in China is still very low, so for speculative gains it would be more reasonable to operate in other currencies/markets.

Because of Political risk? This hardly looks like an answer for even if it happens in a really gradual pace, China keeps the movement of opening-up its economy. Thus, in order to understand this supposed capital flight, more research is required.

This paper claims that analyses which only take into account the variation of international reserves may be deceptive. There are at least two very important (and related) movements that are underneath and have to be considered as well: i) a change in the composition of Chinese external stocks; ii) the efforts for the internationalization of the Chinese renminbi (RMB). Although this may not tell the whole story, it does help to elucidate concerns over the so-called capital flights in China

This paper aims therefore to answer the question: did China really undergo a Capital flight between 2014 and 2016? In order to answer this question we have to go beyond the mere analysis of the reserves. For this reason, the methodology of this paper includes a broader analysis of the Chinese external stocks and flows between December/2014-December/2016, combined with an analysis of the international usage of the Chinese RMB. Our research resources consist in databases and reports from the People’s Bank of China and the State Administration of Foreign Exchange – some of them exclusively published in Mandarin.

Besides this Introduction, the paper has four more sections. The second one presents some brief discussions regarding capital flights; the third one makes an analysis of the Chinese external flows and stocks in the period 2014-2016; the fourth one discusses the International Monetary System (IMS) hierarchy and the usage of the RMB; concluding the paper, we present some final remarks.

2. Capital flights: some brief discussions

First of all, it is important to discuss the definition of capital flight, since the diverse uses of this concept may cause misunderstandings. In some contexts, capital flight is related to the illicit operations to take resources away from a country. It happens when travellers do not declare the money they are transporting from a country, but also through fraudulent financial operations

Kar & Freitas (2012) points that this sort of capital flight may provoke economic problems to the remitter country. For instance, they may result in a lack of international currency, which engenders an unnecessary growth in a country's foreign debt or even undermines the tax base. In this sense “illicit inflows do not provide a benefit that offsets the initial loss of capital through outflows, as they cannot be taxed

or used to boost productive capacity [...] more likely to drive the underground economy than be invested in the official economy” (Kar & LeBlanc, 2013, p. 3).

Nevertheless, this is not the kind of capital flight that is important for this paper⁵. The capital flight we are dealing with here is not at all a crime, since it constitutes a capital exit through the institutional and legal channels. In this sense, when an individual household or enterprise takes money out of the country, it does not constitute a problem. It becomes one when this withdrawal movement is done by many households and enterprises at the same time, that is, when it constitutes a collective action and therefore a sudden and massive volume of outflows⁶. It may be measured by the difference between the international inflows and outflows, that is, the net capital outflows.

Dornbusch (1990) suggests that a capital flight occurs when economic agents fear having losses related to an investment made in a certain country, as a consequence of political risk, financial repression, expected changes in the exchange rate or for tax considerations. In a similar manner, Gunter (2008) considers capital flight an outflow of resources from a country driven by an adversative alteration in the country's political, economic, or social situation. Both authors state therefore that the responsibility for the capital flights is related to the country that suffers it (any kind of “bad policy”).

However, this point of view is not at all a consensus. With a different view, many authors say that the determination of the capital flows are more related to the international liquidity cycles than to domestic reasons (Ocampo, 2001; Flassbeck, 2002; Rey, 2015). It is true that sometimes the massive outflows may be related to domestic problems – either economic or political –, but empirical analyses show that in many circumstances the reversal of the capitals movements from inflow to outflow in peripheral countries may be rather related to changes in the monetary policy in the central countries (e.g. in the United States).

Whatever its cause, Epstein (2005) asserts that a capital flight is related to the transfer of assets out of a country to escape ownership claims, as well as losses in returns or even in part of the principal. And the important point is that capital flights can have significant economic and social costs – mainly in peripheral countries –, since they may create a lack of US dollars and/or exchange rate crises. According to Epstein (*op. cit.*), these costs may include sacrificed investments in infrastructure, in human capital, in social services and on new plants and equipments. The author states that rather than curbing capital flight, financial liberalization tends to exacerbate it. Given the severe social costs and dislocations inflicted by capital flight upon the developing world, he suggests the adoption of capital controls.

When it comes to China, the subject of capital flight is not new. Sicular (1998) wanted to investigate why China was at the same time facing expressive sums of inward foreign capital investment and outward capital flight, and one of his main explanations was the different treatment experienced by foreign and domestic investors. Kar & Freitas (2012) points that there has been an increasing income inequality after the liberalization of the Chinese economy in the late 1970s and the richest people are moving the wealth abroad.

Gunter (2017) estimates that the capital flight from China since 1984 was US\$ 3.2 trillion – i.e., nearly US\$ 105 billion a year – and the pace has accelerated since 2005, reaching US\$ 425 billion in 2014. According to the author, the favoured routes

⁵ We are not saying that this kind of capital flight does not exist in China, but only that this is not the issue we are investigating here.

⁶ Normally due to a “herd behaviour” *à la* Keynes.

of these flights have changed during the analysed period. From 1984 to 1999, the financial transactions were very important. In 1999 some capital controls have been imposed, as a result capital flight through trade mis-invoicing - non-declaration of part of the value of exports - were predominant during the following decade. From 2012 onwards, the capital flight route was increasingly done by private foreign banks borrowing from Chinese organizations and individuals. The author claims therefore that capital controls appear to have influence only in the preferred route of capital flight, leaving other possible routes open. According to him, the motivations for capital flights changed over time, varying from a search for lower investment transaction costs in China to the migration of the upper class and, finally, to the surpassing of the anti-corruption campaign.

The concept of capital flight adopted in this paper is not merely an outflow of financial resources as in Gunter (2017), Sicular (1998) and Kar & Freitas (2012). The capital flight being investigated here is a massive and sudden withdrawal of financial resources through legal channels.

In general, the abovementioned authors identified two types of capital flights occurring in China. The first one is a long-term tendency of illegal transactions to withdraw money from the country (as in Gunter, 2017; and Prasad, 2017). Despite the importance of this kind of operations, in this article we are concern with the second type, that is the supposed massive pull out of capital between 2014 and 2016. According to some analysis, the sharp decrease of Chinese foreign reserves (around US\$ 1 trillion) is a thermometer of a critical capital flight problem⁷. Despite of the severe reduction of foreign reserves, China still has more than US\$ 3 trillion.

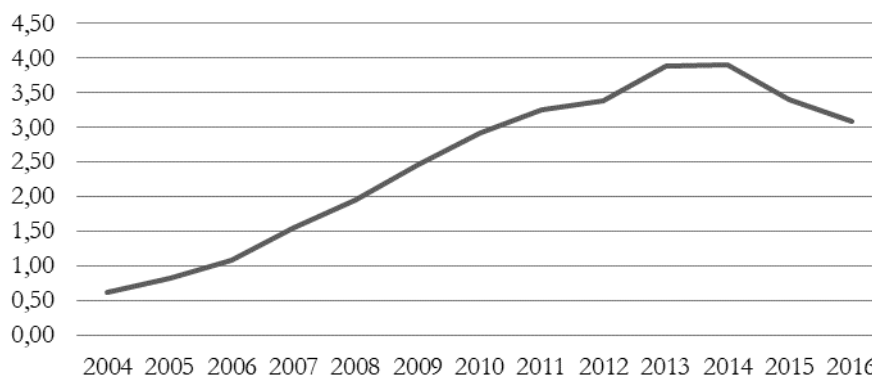
After this brief presentation of how different authors discuss the issue of capital flights, the next section presents an analysis of the international reserves and the other external flows and stocks in China in the recent period.

3. Chinese external flows and stocks (2014-2016)

Numerous articles – either academic ones or in the media – have pointed to the occurrence of a supposed capital flight in China in the recent period (Bloomberg, 2016; The Economist, 2015; Kärnfelt, 2017). According to them, the decrease in foreign reserves was not entirely the result of capital flight (they also account for devaluation of assets), yet, some analysts affirm that at least half of the aforementioned contraction was provoked by capital flight. The large decline in China's international reserves deserves attention because it constitutes a reversal in the strong upward trend that was going on since the 1990s. Figure 1 reveals that after ten years of increasing, Chinese international reserves reached the impressive amount of almost US\$ 4 trillion in 2014. This apex was followed by a quick decline and, two years later, this amount had been reduced by almost US\$ 1 trillion.

⁷ It is fair to mention that, the authors do not account the US\$ 1 trillion decreased as all capital flight. They mention that part of the reserve reduction also accounts for losses due to exchange rate variation.

Figure 1: China: International Reserve Assets
US\$ trillions (End of the year)



Source: State Administrator of Foreign Exchange. Authors' elaboration.

Although Chinese reserves still stand as the world's biggest (around 30% of world's total international reserves) and the current level is still very high (around US\$ 3 trillion), the recent and significant reduction in its size requires more analyses to understand its nature and whether this phenomenon constituted a capital flight or not.

Firstly, it is important to grasp how Chinese reserves are allocated and managed. According to the Peoples' Bank of China (PBOC), by December 2016 foreign reserves accounted for US\$ 3 trillion, among which 97% were securities held by central banks or government agencies. Although China does not report the detailed composition of its foreign reserves, it is estimated that more than two-thirds of the amount are dollar-denominated assets (Wildau, 2014). The State Administration of Foreign Reserves (SAFE), under the administration of the PBOC, is responsible for managing these reserves.

As Feng (2007) points, the Chinese authorities used to give priority to a liquid position then to asset profitability. Nonetheless, there was never a consensus on how to best manage Chinese foreign reserves. Many scholars and Chinese authorities called attention to the risks and costs of having such large and dollar dependent foreign reserves. In fact, China pays a very high premium for choosing a liquid position. Firstly, the accumulation of reserves may result in enormous increases of the means of payment in Chinese economy. In order to accommodate it, the PBOC needs to sterilise this excess liquidity. By 2010, the PBOC had sold 20 trillion yuan in bonds in exchange for its foreign reserves (Feng, 2011).

Huang & Tang (2017) show that China's foreign reserves had a smaller return than Direct Investments all over the period of 2005-15. According to their data, nominal returns on reserves were normally near to 0% whilst the direct investment incomes reached at least 5.0% per year in most years. Unquestionably, this constitutes a good reason for the diversification on China's external assets and the decrease in the amount of reserves. Finally, Xin Wang (2007) already highlighted the danger of capital losses in case the RMB appreciated against core currencies. It is not by chance that there is a lasting pressure over the PBOC and the SAFE to push them to a more efficient way of operating foreign reserves (Feng, 2011).

According to SAFE (2015), in 2014 external liabilities income payments totalled US\$ 242.9 billion and external assets income receipts totalled US\$ 183.1

billion; the net investment income of the BOP recorded therefore a deficit of US\$ 59.9 billion. These happened despite the fact that China has a net positive international investment position – i.e. external assets are larger than external liabilities. These results occurred because the assets yield rates are persistently lower than the liabilities yield rates (SAFE, 2015, p 53). If China wants to have better results in the investment income it would be necessary to increase the diversification in its assets to ensure higher yields.

More recently, the incentives for changing the management of foreign reserves became clearer. In the magazine *Qiushi*, which is the Communist Party main Theoretical journal, the Vice President of the People's Bank of China and Director of the State Administration of Foreign Exchange, Gongsheng Pan, emphasized that the foreign reserves should serve the country's opening-up strategy such as the Belt and Road and Going Global initiatives (Pan, 2017). Further, the Director also affirmed that China's reserves should serve investments in the real economy, and help economic growth. This calls the attention to one more reason to China change the composition of its foreign assets: the realization of some specific investment project. Myers, Gallagher and Yuan (2016) analyse the investments of the Belt and Road initiative, which intends to enable an extensive infrastructure development throughout Eurasia; for this purpose, the authors show that in 2015 China used its foreign exchange reserves in a domestic sovereign wealth fund and a policy bank. This can explain part of the decrease in Chinese reserve assets.

To advance in the analysis, it is important to have in mind that the foreign exchange market in China is kept under a tight control by monetary authorities. According to the State Administration of Foreign Exchange (SAFE, 2015), China's balance of payments (BOP) was projected to maintain a two-way fluctuation (surpluses and deficits) in the capital and financial account and a surplus in the current account. SAFE is therefore making some adaptations to what they name "the new normal" of BOP. In this sense, they declare they would actively promote foreign exchange market development and trade and investment facilitation, construct an external debt and capital flow management system in the context of macro prudential management, promote key reforms for capital account convertibility, and improve foreign reserve management with the aim of guarding the economy against shocks from cross-border capital flows.

Still according to Gongsheng Pan, China has a strategy of foreign exchange holders' diversification. According to him, the changes in the Chinese foreign assets was actually a process of "allocating foreign exchange to people" (*cang hui yu ming*), in order to fulfill the residents demand for outside investments or their need for paying foreign debts (Pan, 2017).

In this sense, it is clear that SAFE was worried about improving the foreign reserve management. It is possible to find more evidence in the reports of this institution. We can see this evidence in three passages of its reports. In the first one:

Meanwhile, as the world's largest consumption market and with the implementation of the reforms and the opening-up of the domestic financial markets, China will continue to invite foreign capital flows, especially long-term foreign capital inflows. Finally, **with adequate foreign exchange reserves**, China is sufficiently strong to withstand external shocks. (SAFE, 2015, p. 71/72; our emphasis).

Even if it is not very explicit the meaning of **adequate foreign exchange reserves**, in our article we assume that Chinese institutions have deliberately chosen to diversify the country's external assets⁸ (as the aforementioned strategy of *canghui yumin* reveals) and also to reduce the level of international reserves. Regarding the reduction of the reserves, in 2011 the President of the Peoples Bank of China Zhou Xiaochuan affirmed that the Chinese international reserves were in fact too much (Feng, 2011)

The Chinese authorities highlight the opening-up process of the domestic financial markets, arguing that this would allow the country to continue attracting long-term capital inflows, but the aim is to maintain an **adequate** level of reserves, even without explaining what this means exactly. In the second passage, these aims are more evident:

(...) Third, transforming administration, accelerating the construction of macro-prudential-related external debts and capital flow management, and **improving policy reserves** and response plans (...); and fifth, adhering to the target of serving the overall situation, **promoting the innovative use of foreign exchange reserve assets**, and **improving foreign exchange reserve management** (SAFE, 2015, p. 75/76; our emphasis).

In the next year's report, SAFE was more explicit, by stating that it is concerned about:

Optimizing diversified use of foreign exchange reserves to serve national strategies. The SAFE enhanced coordination and adhered to market-oriented operations through equity, bonds and funds. In discharging its responsibilities as an investor, the SAFE focused on supporting the "Belt and Road" Initiative and international industrial capacity cooperation to serve enterprises going global and promote economic prosperity and social development in China.(SAFE, 2016, p. 71; our emphasis).

In order to contribute to this diversification process, there has been also a transfer of funds to the Chinese Sovereign Funds and to some bilateral or multilateral funds (Teixeira, 2018). According to the Sovereign Funds Wealth Institute, the four most important Chinese Sovereign Funds accumulate since 2016 more than US\$ 2 trillions. The biggest one is the China Investment Corporation (CIC), administrated by the Ministry of Finance, whose total assets have increased from US\$ 652.7 billions in 2013 to US\$ 813.5 billions in 2016⁹. Aglietta (2013) states that:

⁸ "Changing external assets reflected the strategy of encouraging foreign exchange held by the private sector" (SAFE, 2015, p. 49). By the end of 2014, outstanding international reserve assets totaled USD 3899.3 billion, which was still the largest component of the external assets and accounted for 61 percent of the total external assets, 4 percentage points lower than the ratio in 2013 and a historical low since 2004. The private sector accelerated its going-out investment. It preferred traditional investment due to its preference for low risks. Outward direct investments and other investments, such as loans and deposits, amounted to USD 2246.9 billion, accounting for 35 percent of total external assets, which represented a historical high. Outward portfolio investment assets totaled USD 262.5 billion, accounting for 4 percent of total external assets, 0.2 percentage point lower than the ratio in 2013" (SAFE, 2015, p. P49/50).

⁹ CIC was created in 2007 with US\$ 200 billions and the following mission: "CIC is committed in diversifying China's foreign exchanges and seeking maximum returns for its shareholder within acceptable risk tolerance" (CIC, 2013). From its creation to 2016, CIC's portfolio annual average return was 4.76% (CIC, 2016), much higher than that of the international reserves administrated by SAFE.

China Investment Corporation (CIC) get their resources from excess FX reserves. The stabilization function of the currency is done by the SAFE (foreign exchange department of The Peoples Bank of China). CIC has the mission to invest mainly abroad and to take risk in order to get higher return than a stabilization fund.

In sum, to understand this change in strategy, it is important to highlight the reasons why the Chinese authorities want to seek diversification of their external assets: i) the realization of some specific investment projects (such as going global and Belt and Road initiative); ii) the increase in the profitability of the country's foreign asset, given the low profitability of international reserves; iii) the net investment income recorded a structural deficit – this is intrinsically related to item ii. Beyond these reasons discussed above, in this article we argue that we need to take into consideration one more reason: iv) the attempt to internationalize the renminbi, an aspect that will be elaborated in the next section.

At this point, it is probably already clear that in this research the focus should not be on the mere analysis of these reserves. The methodology of the paper includes a broader analysis of the Chinese external stocks and flows, comparing their evolution between December/2014 and December/2016.

Some results are shown in Table 1. First of all, the external stocks in China's International Investment Position indicate that the country's international reserves have been reduced in US\$ 801 billion from December 2014 to December 2016. However, other Chinese external assets had a different trend: Outward Direct Investments (ODI) increased US\$ 435 billion, Portfolio Investments increased US\$ 103 billion and Other Investments abroad increased US\$ 287 billion. It means that this fall in reserves was more than offset, since these other external assets increased US\$ 824 billion in the same period. This allows us to think of the occurrence of a mere change in the composition of Chinese foreign assets¹⁰. As a matter of fact, the total external assets are quite similar in the beginning and in the end of the time series (around US\$ 6.4 trillion).

Table 1: China's International Investment Position (quarterly), 2014-16
US\$ Billion (End of period)

Item	dec/14	mar/15	jun/15	set/15	dec/15	mar/16	jun/16	set/16	dec/16
International Investment Position	1603	1469	1397	1538	1673	1715	1818	1874	1801
Assets	6438	6290	6351	6197	6156	6196	6283	6464	6467
Direct investment	883	904	919	965	1096	1161	1221	1280	1317
Portfolio investment	263	249	276	257	261	297	307	341	365
Other investment	1394	1334	1381	1378	1389	1427	1446	1575	1681
Reserve assets	3899	3785	3771	3590	3406	3305	3303	3264	3098
Liabilities	4836	4821	4954	4659	4483	4481	4465	4589	4666
Direct investment	2599	2676	2742	2770	2696	2752	2775	2806	2866
Portfolio investment	796	888	969	788	817	790	734	795	809
Other investment	1440	1242	1232	1090	964	930	944	983	985

Source: State Administrator of Foreign Exchange. Authors' elaboration.

Note: Financial Derivatives were excluded, because the values were not significant.

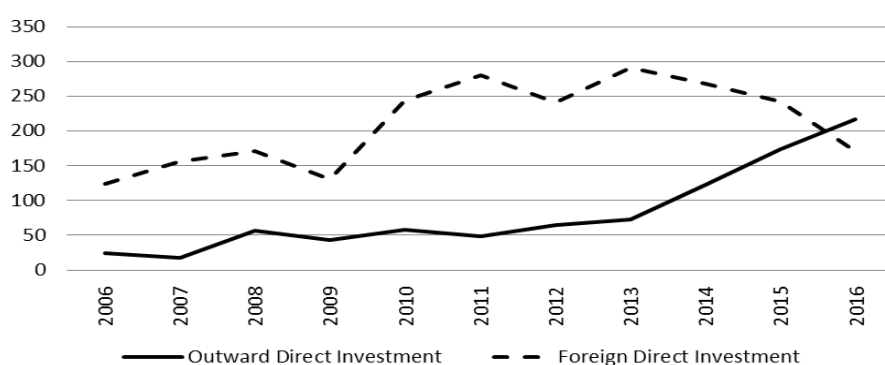
¹⁰ One may obviously not say that this change in the composition of the external assets is totally due to a strategy of the Chinese government – since they reflect also private decisions motivated by a quest for yield –, but we may at least state that it has not been contradictory to these governmental strategies.

This partial analysis that initially looks only to the external assets allows us to say therefore that the statement of Prasad (2014, p. 257) is still valid:

Although gross capital outflows from China have increased significantly, they are consistent with the government's steps to liberalize outflows. Nongovernment outflows are likely to increase further as Chinese corporations look for investment opportunities abroad and as financial market development allows households to take advantage of avenues to diversify their savings into foreign investments. There is little reason (so far) to panic about China's rising capital outflows – they may be a sign of a maturing economy rather than a troubled one.

Turning the focus to the external liabilities in Table 1, Foreign Direct Investment (FDI) rose US\$ 267 billion in the period, which suggests that China made more Outward Direct Investment than it received as Foreign Direct Investment¹¹. Figure 2 displays the external flows, showing that after a long period with a preponderance of FDI, in 2016 for the first time it was surpassed by the ODI. Since it is aligned with the new policy of the Chinese government regarding ODIs, it will possibly constitute a new trend, contributing to the transformation in China's International Investment Position.

Figure 2 China's Balance of Payments, Direct Investments, 2006-16
US\$ billions



Source: State Administrator of Foreign Exchange. Authors' elaboration.

Therefore, either through flows or through the variation of the external stocks, it is clear that the net balance of direct investments in 2015 and 2016 is not relevant as a reason for the supposed capital flight in the Chinese economy.

Still looking to the external liabilities in Table 1, the stock of Other Investments decreased US\$ 455 billion. According to the State Administration of Foreign Exchange, many Chinese entities opted for accelerating the repayment of external loans in order to avoid foreign exchange risks, resulting in the payment of US\$ 167 billion (SAFE, 2016). At the same time, the country increased its external assets in Other Investments. To understand this movement, it is useful to analyse China's Balance of Payments. Table 2 shows that the net result of Other Investments had expressive negative values in the period 2014-16 (one could include 2012 in this list) due to the net assets increase in 2014 and 2016, as well as the liabilities decrease in 2015.

¹¹ With the only caveat that changes in external assets and liabilities are caused not only by flows but also by price variations.

Table 2: China's Balance of Payments, Other Investment and Reserves, 2007-16
US\$ billion

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Other investment	-64	-113	80	72	9	-260	72	-279	-434	-304
Assets	-155	-98	18	-116	-184	-232	-142	-329	-82	-334
Other equity	0	0	0	0	0	0	0	0	0	0
Currency and deposits	-6	-24	2	-58	-116	-105	-7	-186	-55	-43
Loans	-21	-19	3	-21	-45	-65	-32	-74	-47	-115
Insurance, pension, and standardized guarantee schemes	0	0	0	0	0	0	0	0	-3	0
Trade credit and advances	-24	6	-34	-62	-71	-62	-60	-69	-46	-101
Other accounts receivable	-104	-61	48	24	48	0	-42	-1	69	-74
Liabilities	90	-15	62	189	192	-28	214	50	-352	30
Other equity	0	0	0	0	0	0	0	0	0	0
Currency and deposits	41	3	12	60	48	-59	76	81	-123	10
Loans	17	4	7	79	105	-17	93	-34	-167	-20
Insurance, pension, and standardized guarantee schemes	0	0	0	0	0	0	0	0	2	-1
Trade credit and advances	29	-19	32	50	38	42	45	-2	-62	16
Other accounts payable	3	-2	1	0	1	5	0	5	-2	24
Special drawing rights	0	0	11	0	0	0	0	0	0	0
Reserve assets	-461	-480	-400	-472	-388	-97	-431	-118	343	444

Source: State Administrator of Foreign Exchange. Authors' elaboration.

Notes: a positive value for assets represents a net decrease while a negative value represents a net increase. A positive value for liabilities represents a net increase while a negative value represents a net decrease.

When the flows of Other Investments are disaggregated (Table 2), we may notice that in the liabilities side, after a considerable inflow of funds in the form of "Loans" and "Currency and Deposits" during the period 2007/13 (mainly in 2010, 2011 and 2013), in 2015 there was an expressive outflow – which meant the reduction of external liabilities in this item. The outflow of US\$ 123 billions in this year in "Currency and Deposits" may indeed be considered as a sign of a possible capital flight. Nevertheless, this needs also to be nuanced. Out of the total amount, US\$ 47,7 billions referred to deposits, meaning the volume of the reduction of deposits held by non-residents in China (SAFE, 2017)¹². The rest (US\$ 75,3 billions) corresponds to currency and, according to IMF guidelines, variations in the liabilities in this item regards operations in banknotes and coins in local currency (IMF, 2013)¹³. Hence, the decrease in the liabilities in this item means that RMB is being transferred from non-residents to residents – non-residents are hence buying US dollars to "escape from the RMB" or they are simply buying goods and assets in China.

On the assets side, there is an outflow of funds mainly from 2010 onwards in the form of "Loans", "Currency and Deposits" and "Trade credit and advances" (mainly on the years 2012, 2014 and 2016), which meant the increase of the external asset in this item.

In short, we may notice that the country is not only liquidating loans, denominated in foreign currency, and financing against its economy (decreasing the liabilities), but it is also doing the same operations externally, but as a lender (increasing its assets). This may indicate a new financial integration strategy of the Chinese economy.

Some important characteristics of this new financial integration strategy are clearly shown below:

¹² Data provided by the Chinese version of the China's Balance of Payments Report.

¹³ Whilst variations in the assets mean operations in banknotes and coins in a foreign currency.

The major ways to distribute foreign exchange are to encourage holding of foreign exchange by the people and repayment of the debt. Against the background that RMB exchange rate was moving in the direction of an equilibrium and remarkably fluctuating both upward and downward, domestic enterprises and individuals adjusted and optimized their balance sheets. In 2014, newly increased foreign exchange deposits amounted to USD 108.4 billion, and newly increased foreign exchange loans amounted to USD 20.4 billion. The difference between foreign exchange deposits and loans was utilized by banks in foreign markets, which became the major source of remarkably **increased external lending and deposits under other investment assets. Foreign assets holdings were diversified among market participants instead of only by the government**, whereas they were controlled by domestic entities. Meanwhile, other investment liabilities recorded net inflows of USD 50.2 billion, a drop in the growth rate by 77 percent year on year, reflecting that **domestic enterprises had accelerated their repayment of the USD debt** (SAFE, 2015, p. 21-21; our emphasis).

In this sense, according to SAFE (2015, p. 42) China's BOP status is importantly influenced by the Other Investments account, that had a large effect on gross flows; for example, in 2014 the other investment outflows accounted for 88% of the capital and financial account outflows; and their inflows accounted for 77% of the capital and financial account inflows. These are quite expressive values, but which are often not perceived when one observes only the net value of the capital and financial account. Moreover, it is important to notice, according to SAFE (2015), that due to both domestic and international uncertainties, China's Other Investments have frequently alternated between surpluses and deficits.

Nevertheless, as Table 2 shows, between 2014 and 2016 the country issued expressive values of outflows within the Other Investments account. In a 2015 document the SAFE considered that the rising outward flows in that moment was a reflection of the "changing expectations of domestic entities regarding the exchange rate, interest rate, and market environment, driving them to increase their allocation of assets in the international market" (SAFE, 2015, p. 43). Another alleged reason was that "domestic banks reduced their external trade finance liabilities, such as letters of credit and payments by overseas banks to avoid risks" (op. cit., p. 44). That trend probably persisted until 2016.

Finally, there is one more detail that it is worth mentioning. Table 2 shows that during the 2007/16 period approximately US\$ 598 billion exited China in the item "Currency and deposits", which means the constitution of a huge Chinese foreign asset in this item. However, there is a point that is quite important for the comprehension of this dynamics that is not being taken into account by the literature: the currency of these external flows and stocks. SAFE (2016) shows for instance that the China's banking sector had in 2016 US\$ 670.5 billions as external **Deposits and loans**; out of that, US\$ 99.6 billions were in Chinese renminbi. That is, a non-negligible part of the Chinese external flows and stocks are in their own currency and these shares are increasing. The process of internationalization of the Chinese currency is therefore important for our researches and this analysis is done in the next section.

4. The International Monetary System hierarchy and the usage of the Chinese RMB

The International Monetary System (IMS) has always been asymmetric. As a matter of fact, most of the national currencies of the world are not able to fulfil classical functions of currency for international economic transactions – that is, they **do not operate as money beyond the national borders** of the countries where they were issued. On the other hand, there are some few national currencies that are used for international economic operations¹⁴. The most used currency is the US dollar; the second one is the euro; after them, we may still find a considerable usage of the pound sterling, the Japanese yen, the Swiss franc and to a lesser extent the Canadian dollar and the Australian dollar. Not by chance, only currencies issued by central countries (Cohen, 1998; De Conti & Prates, 2016).

The Chinese economy is already the second biggest in the world, but the international usage of its currency is far below its importance. The reasons explaining this divergence are beyond the scope of this paper, but we may state at least two important ones: i) the IMS has an inertia, because the usage of currencies is also based in some conventions and networks that are not easily modified; ii) the strict control of the financial account and the foreign exchange markets in China, related to a previous policy that for many years did not stimulate the international usage of the Chinese RMB.

Nevertheless, even if it is still not high, the international usage of the Chinese currency is clearly rising. Table 3 reveals that the share of the operations in the world forex markets that have the RMB in one of the sides of the operation is only 4%¹⁵, but since 2007 it is roughly doubling every three years.

For its own international operations, China already succeeds in using its currency in a much higher proportion. According to the PBOC (2016), 28.7% of total payments involving China Mainland and overseas parties were settled in RMB in 2015. For international trade, 18.6% of China's exports and imports were settled in its own currency in 2016 (IMI-RUC, 2017).

It is therefore clear that in spite of its still low position in the IMS hierarchy, the Chinese RMB is unquestionably increasing its role in international economic operations. This may seem as a consequence of the raising importance of China for the global economy, but that is not the whole story. According to De Conti & Prates (2016), besides the economic and geopolitical power, one of the important determinants of the international usage of currencies is the **political will**, that is, the effort of the National State to stimulate – or even enforce – the usage of its currency. History shows that England and the United States have frequently created strategies to foster or even impose the international usage of their currencies. And the novelty is that after a long period in which the Chinese government was not acting in this behalf, in the recent period it has explicitly declared its intention and implemented strategies for the internationalization of the Chinese RMB – notably after the outbreak of the world financial crisis, in 2008.

¹⁴ De Conti (2011) names the currencies that are used internationally as central currencies and those that are not able to fulfil the classical functions of money for international transactions as peripheral currencies.

¹⁵ Whilst the Chinese GDP represents around 15% of the world GDP.

Table 3: Currency distribution on global foreign exchange market turnover
Net-net basis, percentage shares of average daily turnover in April of each year

Currency	2001	2004	2007	2010	2013	2016
US dollar	89,9	88,0	85,6	84,9	87,0	87,6
Euro	37,9	37,4	37,0	39,0	33,4	31,4
Yen	23,5	20,8	17,2	19,0	23,0	21,6
Sterling pound	13,0	16,5	14,9	12,9	11,8	12,8
Australian dollar	4,3	6,0	6,6	7,6	8,6	6,9
Canadian dollar	4,5	4,2	4,3	5,3	4,6	5,1
Swiss franc	6,0	6,0	6,8	6,3	5,2	4,8
Renminbi	0,0	0,1	0,5	0,9	2,2	4,0
Swedish krona	2,5	2,2	2,7	2,2	1,8	2,2
NZ Dollar	0,6	1,1	1,9	1,6	2,0	2,1
Other	17,8	17,7	22,5	20,4	20,4	21,5
Total	200,0	200,0	200,0	200,0	200,0	200,0

Source: Bank of International Settlements (2016)

Note: the sum is 200% because each operation at the forex market involves two currencies.

It is evident that this political will cannot have concrete results if the international community does not see this currency as reliable – reliability is obviously related to the importance of the economy that backs a certain currency. Nevertheless, there are already some important signs showing an increasing reliability of the Chinese RMB. The most important one came from the International Monetary Fund (IMF) that included the RMB in the basket of currencies that compose the Special Drawing Rights (SDR)¹⁶. According to the People’s Bank of China, this is “a milestone in the process of RMB internationalization” (PBOC, 2016, p. 41)¹⁷.

After all, money is power. And having an international currency is obviously part of the Chinese strategy to increase its importance and influence in the world economy. A document by Bloomberg (2017, p. 1) stated that “the yuan’s advance into global markets demonstrates President Xi Jinping’s ambition to challenge the hegemony of the dollar and a global economic order dominated by the US and Europe”. Actually, the possibility of the Chinese RMB to become a real rival to the US dollar as the key-currency of the IMS is still not foreseeable. But still, even if it is not going to be the top currency in the near future, it is undeniable that it is becoming an international currency.

Coming back to the main topic of this paper, it is important to analyse if the supposed capital flight in China relates somehow to this strategy of RMB internationalization.

This hypothesis arises from the doubts about the currency denomination of Chinese economic outflows. Aware of the gradual but unambiguous strategy of the Chinese government to internationalize its currency, it is possible to imagine that a growing part of the increase in Chinese loans, financings and even overseas deposits are being made in RMB and are part of the abovementioned strategy.

¹⁶ “The weight of the RMB in the SDR basket is 10.92%, whereas the weights of the U.S. dollar, the euro, the Japanese yen and the British pound are 41.73%, 30.93%, 8.33% and 8.09% respectively” (PBOC, 2016, p. 43).

¹⁷ Another symbolic event has happened in May 2017, when the European Central Bank has purchased Chinese RMB to compose its international reserves – the amount was really low, but it shows the Chinese RMB being already seem as a potential store of value at the international level.

The People's Bank of China provides quite interesting data regarding this issue. In 2016, the international trade settled in RMB had 3.79 trillion yuan¹⁸ as receipts and 6.06 trillion yuan as payments. That is, the cross-border RMB flows related to trade resulted in a deficit of 2.27 trillion yuan. And this is not by chance, but is rather part of the strategy for the internationalization of the RMB. As stated by IMI-RUC (2017, p. 16), "the expansion of the RMB payment deficit means that the RMB flowed overseas through the trade channel, which is conducive to expanding the offshore capital market and the offshore RMB business". Chinese government knows that one of the functions of a key-currency is providing liquidity to the world: "while consolidating trade settlement, we constantly strengthen the financial transaction function of RMB to provide safe assets and inject liquidity into the international community" (*op. cit.*, p. 7).

For the researches regarding capital flights however, it is important to go deep into the analysis of financial flows. Starting with Direct Investments, Chinese institutions have been also explicit that this account may be used as a channel for the internationalization of the RMB:

Direct investment can expand the use of RMB in many ways and play an efficient leveraging role. It can become an important facilitator of RMB internationalization. In the new situation where the multinational corporations dominate international trade, expanding direct investment can consolidate China's trade position and provide markets and impetuses for domestically funded financial institutions to go global and develop offshore RMB business (IMI-RUC, 2017, p. 5).

When we go into the data, we indeed see that the outstanding growth of the Chinese direct investments abroad is followed by an equally impressive growth in the usage of RMB for these investments. According to the statistics provided by the Ministry of Commerce, Chinese direct investments abroad settled in RMB totalized 1.06 trillion yuan in 2016 – that is, nearly US\$ 150 billion or the impressive share of 81.3% of the total ODI¹⁹. Further, the inward FDI in RMB in 2016 reached 1.4 trillion RMB. The result in this specific account – and considering only the Direct Investments settled in RMB – was a surplus²⁰, but the growing trend of the outward flows allows us to foresee that in the near future this will be another source of liquidity in RMB for the rest of the world.

Besides Direct Investments, Chinese analysts are aware that the credit market is also one of the most important pillars to strengthen the financial transaction function of RMB. According to IMI-RUC (2017, p. 21), the balance of RMB overseas loans for domestic financial institutions reached in 2016 437.3 billion yuan (nearly US\$ 62 billion). It is still a modest, but raising level (a 38.7% growth compared to 2015). The strategy is to push international credit in RMB taking advantage of the importance of Chinese trade:

The dependence of the global economy on China's trade has increased, the problem of currency mismatch in developing countries has made the development of international RMB credit market an inevitable trend, and the appreciation of the US dollar

¹⁸ The unity of account of the Chinese Renminbi is the yuan.

¹⁹ This amount is obviously inflated by the routine of making ODI through the RMB offshore centers; anyway, it shows that these capital flows are leaving China Mainland in RMB and not in US dollars.

²⁰ This surplus in RMB Direct Investments means non-resident investors have already access to RMB offshore, maybe due to the deficit of the trade account in RMB.

provides a window of opportunity. History shows that the main international currency promotes the development of international credit market through the international financial center and trade. (IMI-RUC, 2017, p. 6)

In line with the analysis presented in section 3, it is clear that from the point of view of Chinese assets abroad, nothing allows us to identify a capital flight, but rather movements that are related to the Chinese strategy of exporting capital and internationalizing its currency. Nevertheless, when we move the focus to the liabilities (that is, the assets non-residents hold in China), it is undeniable that some problems took place in 2015 and 2016.

Table 4 reveals that the deposits held by non-residents in China declined from 2.32 trillion yuan in December 2014 to 0.92 trillion yuan two years later. Considering all financial assets held by non-residents, there has been a decline of 34% between its peak (June 2015) and the end of 2016, when it reached 3.03 trillion yuan (around US\$ 430 billion). The total reduction has therefore been equivalent to 1.56 trillion yuan (nearly US\$ 220 billion). According to IMI-RUC, this is due notably to: i) in August 2015 there has been a relaxation in the Chinese exchange rate policy and the RMB started devaluating against the US dollar²¹; ii) uncertainties in the world economy, notably due to speculations around the possibility of an increase in the basic interest rates in the US and later on to the beginning of Donald Trump’s government.

Table 4: Domestic RMB financial assets held by non-residents
RMB billion

	Dec. 2013	Dec. 2014	Dec. 2015	Dec. 2016
Stock	344.8	642.1	598.7	649.2
Bond	399.0	671.6	751.7	852.6
Loan	531.0	819.1	851.6	616.4
Deposit	1604.9	2372.2	1538.1	915.5

Source: People’s Bank of China. Authors’ elaboration.

This perception is compatible with the ones in section 3, that is, there has been a net outflow of capital in China in 2015-16 in the account of Other Investments (notably due to the reduction in Deposits and Loans). But then we arrive to a really crucial perception for current researches: these outflows were mainly in RMB. According to IMI-RUC (2017, p. 13), “RMB has become the main currency that flows out of China’s border”. The same thing was declared by Bloomberg (2016), quoting declarations by the staff of Goldman Sachs: “a rising amount of capital is exiting the country in yuan rather than in dollars”; and the Australia & New Zealand Banking Group in Hong Kong: “We have seen a structural change in China’s capital outflows, with net outbound payments predominantly in yuan this year”.

Connecting therefore the analysis of sections 3 and 4 – i.e. changes in Chinese external stocks and the process of internationalization of the RMB –, we come to a pivotal conclusion: there is effectively a net outflow in China in the Other Investments account in 2015-16, but the peculiar thing is that these outflows are mostly in RMB and it is something totally different from what has frequently happened in many peripheral countries through history – namely, a capital flight in US dollars (or other

²¹ Compared to what happens in peripheral countries, the devaluations were low, but for Chinese standards it was something unusual. In August 11th, 2015, the 2% devaluation was the highest in the last 20 years in China.

central currencies) that begets a lack of this currency (with harmful consequences over their economies, as we have seen in Section 2). Moreover, these outflows in RMB may play a positive role in the process of internationalization of the Chinese currency. Even if the agent who takes these RMB out of China immediately sells them to an offshore financial institution – that will sell this RMB for instance to an importer of Chinese goods – it contributes to the enlargement of the international operations made in RMB.

Finally, this situation engenders an important trade-off for the Chinese government, because it may create new regulations to avoid excessive outflows, but these measures will be counterproductive in the strategy of RMB internationalization. Talking about the changes in the capital account management to restrict capital outflows, IMI-RUC (2017, p. 13) says that “this is of great significance to China's macroeconomic and financial stability, but it is not conducive to the expansion of the international use of RMB in the short term”.

It means hence that China is already facing one of the important dilemmas related to the internationalization of a currency, the one between keeping strict controls over this currency or opening up its financial account in order to foster the international usage of this currency. Several authors foresaw this would eventually happen and this is already the case.

Summing up, even if these capital outflows through the Other Investments account were not planned by the Chinese government, they contribute somehow to the strategy of RMB internationalization. Obviously, if they create a huge volatility in the Chinese economy, this process will be harmful to the reliability of the currency in front of the international community, but this is still not the case.

5. Final remarks

Several articles have suggested the occurrence of a supposed capital flight in China in 2015-16. The large decline in China's international reserves effectively attracts attention because it means a reversal in the strong upward trend since the 1990s. This paper shows however that the analysis of the phenomenon should not be done superficially. First of all, an inspection that looks only to international reserves may be deceptive, requiring researches over the whole set of external stocks and flows. Secondly, it is important to consider not only the flows themselves, but the currency of these flows.

Based on these assumptions, this paper raises two main conclusions. The first conclusion is that the impressive fall in the international reserves that occurred in China in 2015-16 was not only due to a withdraw of international investors' assets from China or indeed to the interventions of the People's Bank of China at the foreign exchange market to avoid an extreme devaluation of the RMB, but also due to a strategy of the Chinese government to diversify its international assets. In reality, Chinese international reserves were reduced in US\$ 801 billion in 2015-16, but other Chinese external assets - Chinese Direct Investment (CDI), Portfolio Investments and Other Investments abroad - more than offset this fall, since they increased US\$ 824 billion in the same period.

However, the analysis of the liability Other Investments reveals a decline of US\$ 455 billion in this period. There we arrive to the second conclusion, that there was indeed a capital flight in China in 2015-16 mostly due to a reduction of non-resident deposits and loans in China. This was probably caused by the devaluation of the RMB and the expectations regarding an increase in the Fed fund's rate.

Nevertheless, these outflows were mostly in RMB and this constitutes a crucial difference in comparison to the capital flight that recurrently takes place in many peripheral countries through history. First of all, because its effects over the domestic economy are much lower, since there is no lack of US dollars and no exchange rate crises. Secondly, because it may paradoxically contribute to the internationalization of the RMB.

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