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The story behind China's capital controls

By Angelo Katsoras

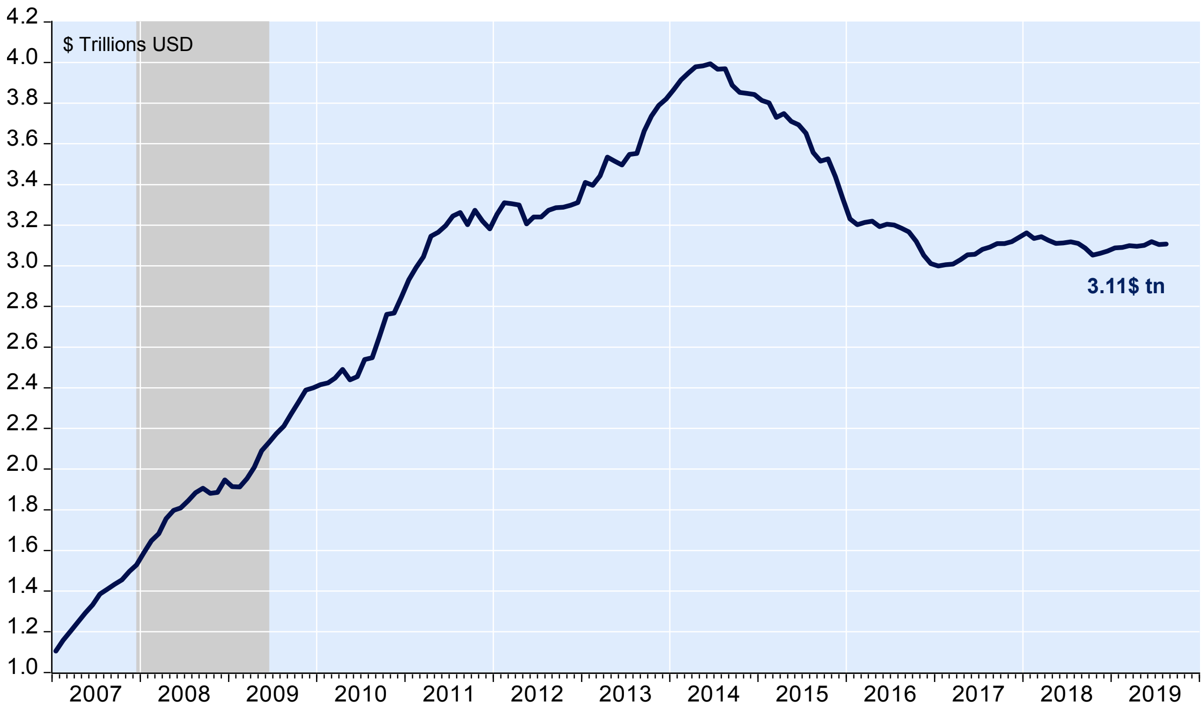
Introduction

China considers its foreign exchange reserves to be a vital shield against potential economic headwinds. This is why, when reserves fell to just under $3 trillion from a peak of $4 trillion during the 2015-2016 period, alarm bells went off throughout the government. Soon after, it began implementing successively tighter controls on money leaving the country.

This report discusses the implementation and the ongoing impact of these controls on China and the global economy.

China: Perspective on foreign reserves

Total foreign currency reserves (As of August 2019)



NBF Economics and Strategy (data via Refinitiv)

Restrictions on outbound capital investments

One of the first restrictions that China implemented in 2017 was on offshore investments in the real estate, sports and entertainment sectors by private-sector Chinese firms. The government feared a repeat of the mistakes many Japanese firms made in the 1980s. Back then, as Japan rose to economic prominence, many of its companies splurged on U.S. real estate and other trophy assets that ultimately resulted in major losses. Examples include Sony's ill-fated 1989 purchase of Columbia Pictures for $3.4 billion, most of which was written off a few years later, and Mitsubishi Estate's 1989 $1.4-billion deal to acquire 80% of Rockefeller Center. Five years later, the company was forced to sell the New York complex at a $600-million loss to stave off bankruptcy. China also feared that some privately owned corporations were deliberately overpaying for international assets as a way to move funds abroad.

Not only did China severely restrict the ability of Chinese companies to continue making these types of purchases, it also forced companies such as HNA Group, Wanda Group and Anbang Insurance Group to sell off some of their existing assets. It is estimated that Chinese companies have plans to unload some $40 billion in overseas assets this year, up from $32 billion for all of 2018.[1]

[1] "Chinese groups turn seller to shed $40bn in global assets," Financial Times, September 15, 2019

Tighter capital controls also imposed on individuals

In the past, existing rules stipulating that Chinese citizens could convert no more than the equivalent of US$50,000 annually in foreign currency and that these funds could not be used to purchase real estate abroad were usually not rigorously enforced. Everything began to change in 2017.

Before, converting yuan to foreign currency could be done quite easily. Now, Chinese banks demand official documentation specifying the reasons for the exchange and require people to sign a pledge that their foreign currency quotas will not be used to purchase property offshore.[2] In late 2018, the amount of U.S. dollars that could be withdrawn without scrutiny was lowered from $5,000 to $3,000.[3] Anyone needing more than the equivalent of $50,000 in foreign currency must apply for a permit from China's State Administration of Foreign Exchange.[4] China also increased efforts to prevent friends and family members from sidestepping regulations by pooling their $50,000-a-year quotas in order to get large sums of money out of the country.

Further, penalties have been stiffened. Anyone found guilty of illegal foreign-currency transactions worth more than 5 million yuan ($1.04 million) could be jailed for five years. Should such transactions exceed 25 million yuan ($5.19 million), the prison term could be more than five years.[5]

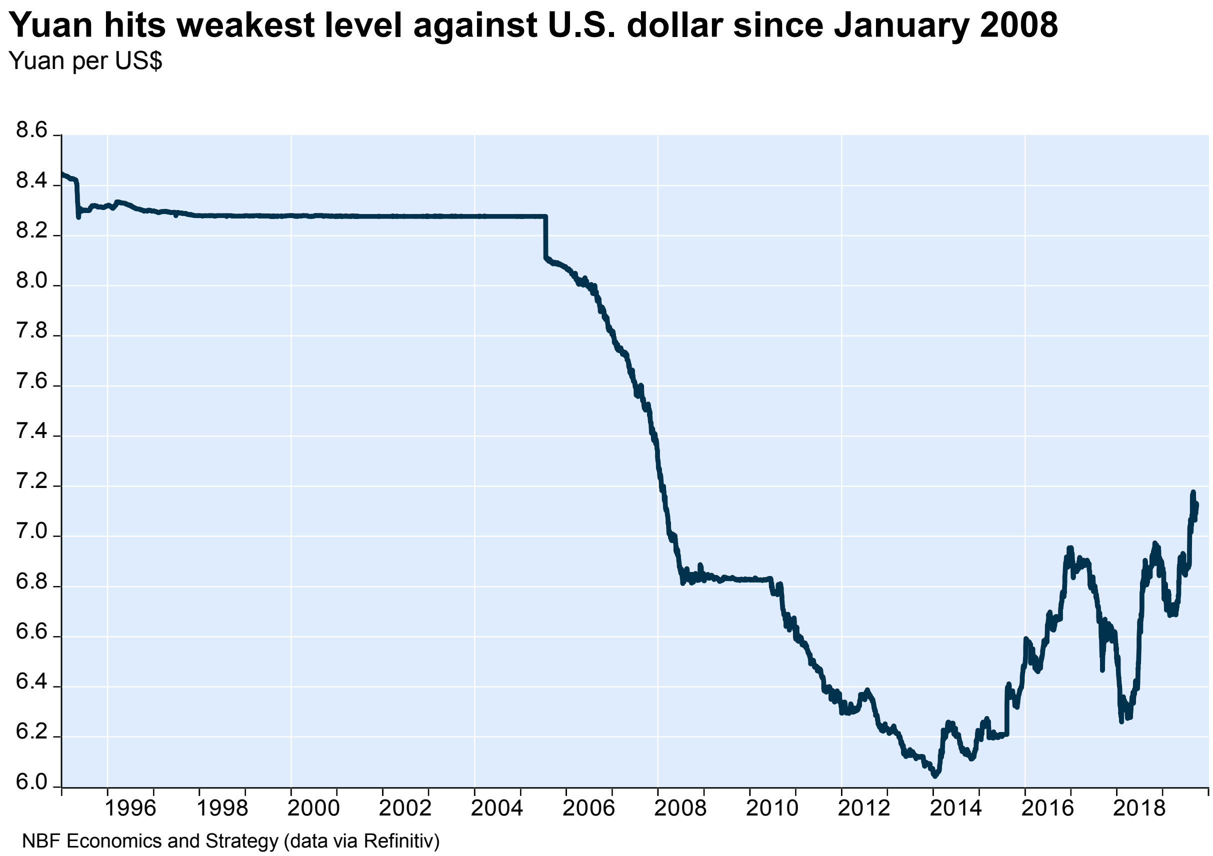
The growing risk of USD-denominated corporate debt

Some analysts feel the biggest source of capital outflows in the future will not be Chinese citizens but Chinese companies making payments on USD-denominated debt. According to Bloomberg, the stockpile of Chinese USD-denominated debt has more than doubled to $729.8 billion since the end of 2015.[6] This prompted the government recently to begin restricting the ability of property developers to issue offshore bonds for anything other than refinancing maturing USD-denominated debt.[7]

Source: "Renminbi retreat to revive capital outflows pressure," Financial Times, August 14, 2019

[2] "China clamps down on capital flight risk as yuan weakens," Nikkei Asian Review, August 30, 2019
[3] "Chinese banks quietly lower daily limit on foreign-currency cash withdrawals," South China Morning Post, May 3, 2019
[4] "Fears of China capital flight hang over newly sliding yuan," Strait Times, August 6, 2019
[5] "Operators of 'Underground Banks' Which Move Cash Out of China to Face Jail," Australian Financial Review, February 15, 2019
[6] "Fears of China Capital Flight Hang Over a Newly Sliding Yuan," Bloomberg, August 5, 2019
[7] "Chinese Property Developers Face Off Against the Communist Party," Wall Street Journal, July 31, 2019

The weaker the yuan is against the dollar, the more Chinese currency it takes to service these debts. Despite trade tensions with the United States, this will likely prevent the government from substantially devaluing the yuan further in the near future.



Finally, Chinese authorities have begun closely monitoring the amount of yuan that financial institutions wire offshore and the volume of foreign currency that they sell.[8] In this regard, it has been reported that China's exchange regulator recently blacklisted over 40 entities suspected of illegal foreign exchange trading.[9]

Shrinking current account surplus poses capital flight risk too

As recently as 2007, China had a current account surplus equivalent to 10% of GDP. This meant that much more money was flowing into the country via trade and investment than was leaving. However, this surplus shrank to only 0.4% of GDP last year. The factors driving this reversal include an ageing population, outbound tourism (150 million trips abroad last year), an increase in imports and the ongoing transition from investment-based growth to consumption-led growth.[10]

Along with pressure from other countries, the current account deficit may ultimately help push China to provide a more level playing field for foreign firms. There have been a few early signs of this potential shift in policy. These include Tesla being allowed to build the first completely foreign-owned car plant in China, and German chemical giant BASF receiving permission to build and fully own a new plant in China as well.

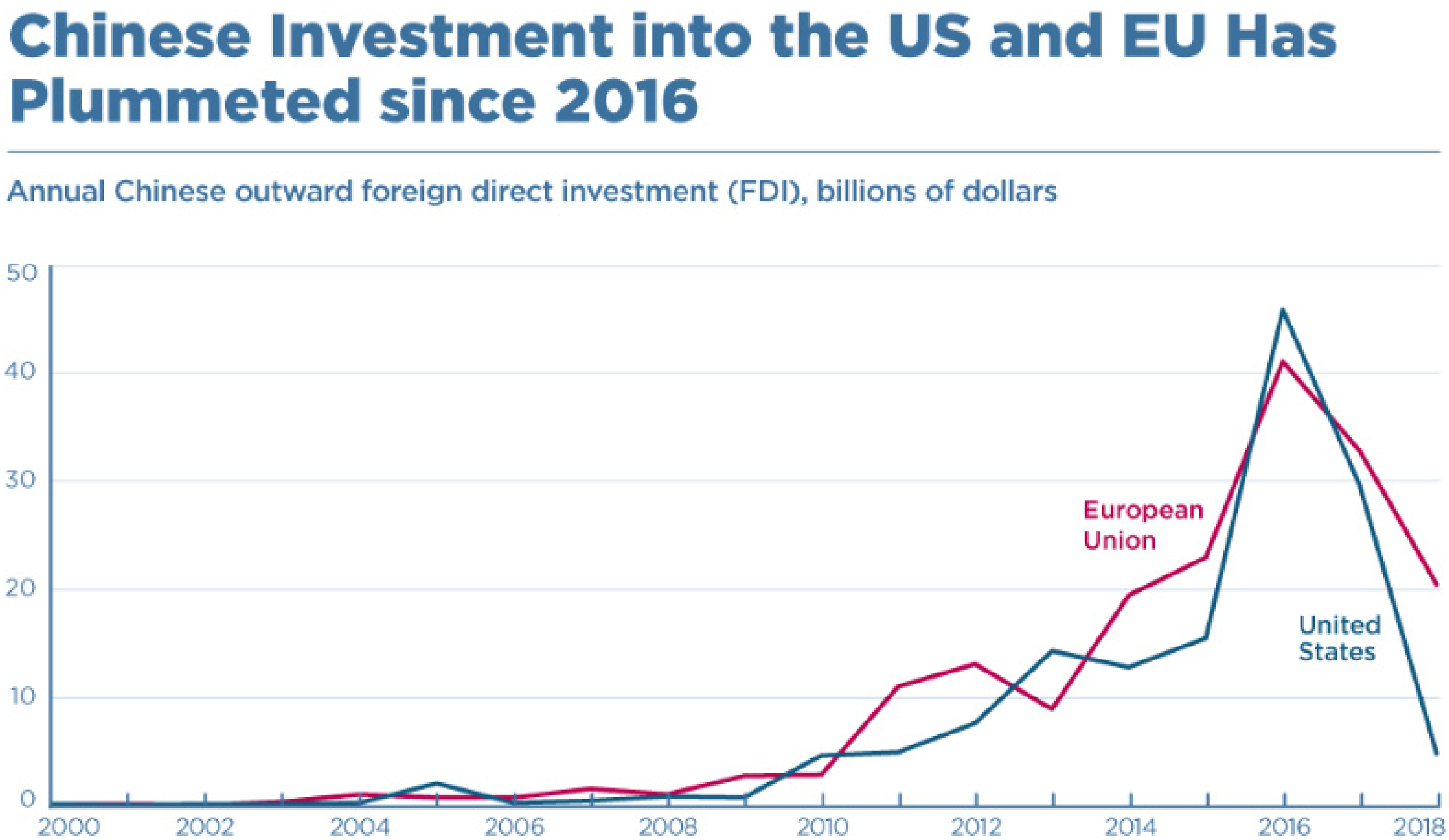
[8] "China clamps down on capital flight risk as yuan weakens," Nikkei Asian Review, August 30, 2019
[9] "China FX regulator steps up scrutiny of cross-border flows, blacklists some firms-sources," Reuters, September 17, 2019
[10] "China's current-account surplus has vanished," The Economist, March 14, 2019

Conclusion

Substantial capital flight combined with the risk of private companies suffering heavy losses on overseas investments prompted Chinese authorities, beginning in 2017, to implement strict capital controls in order to reduce and redirect outbound investments.

Another factor that has reduced outbound investment is that China's continued push to have its firms invest abroad in strategic sectors such as IT, robotics and agriculture is being met with more and more resistance from countries not wanting to lose control of strategic assets. The fact that foreign companies are for the most part prevented from purchasing similar Chinese assets has only bolstered this resistance.

Not surprisingly, all of these factors have caused overseas acquisitions by Chinese companies to plummet to $24.5 billion in the first half of 2019. According to Dealogic, this is down 42% from the same period a year earlier and represents less than 20% of the most recent peak reached in the first half of 2016. The decline includes a significant drop in real estate purchases. Chinese investors acquired a total of $15.7 billion worth of overseas real estate in 2018, down 63% from 2017.[11] The decline in Chinese foreign direct investment has been particularly significant in the United States and Europe.



Source: Peterson Institute for Economics, September 2019

The Peterson Institute for Economics has estimated that, overall, Chinese outward investment flows declined from a high of $216 billion in 2016 to only $96 billion in 2018.[12]

Greater government control over capital outflows and over the economy in general has also meant greater involvement by large state-owned enterprises in certain key sectors. Despite their receding role in the economy as a whole over the past few decades, they continue to dominate crucial sectors such as banking, energy, telecommunications, manufacturing, and defence. While China has 109 corporations listed in the Fortune Global 500, only 15% of these are privately owned.[13] Given the increased government scrutiny of private sector corporations, institutional investors looking for joint-venture partners in China might find it less risky from a political perspective to partner with state-owned enterprises.

[11] "Beijing's capital controls are weighing on Chinese investors looking to buy property abroad," CNBC, February 26, 2019
[12] "Chinese Investments in the US and EU Are Declining—for Similar Reasons," Peterson Institute for Economics, September 2019
[13] "Explained, the role of China's state-owned companies," World Economic Forum, May 2019

Key factors to watch:

1. Will tighter capital controls on individuals make it more difficult for them to invest in foreign residential real estate, or will they just exploit new loopholes to get their money out of the country? The answer to this question could impact the residential real estate markets of major cities in certain Western countries, including Canada.
2. While China has largely succeeded in avoiding a repeat of the massive capital flight that resulted in a trillion dollars leaving the country a few years back, the risk of high outflows recurring persists. This could come about through people findings new ways to game the system, Chinese firms paying off USD debt, and/or the current account balance turning negative in the near future. Indeed, despite stiff capital controls, "errors and omissions", the term used to refer to unexplained discrepancies between reported capital outflows and actual positions, increased to $85 billion in the second quarter of the year from about $21 billion in the first quarter.[14] This could be an indication that Chinese residents are still finding ways to get money out of the country, albeit on a much smaller scale than in the 2015-2016 period.

[14] "China FX regulator steps up scrutiny of cross-border flows, blacklists some firms-sources," Reuters, September 17, 2019

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

Paul-André Pinsonnault
Senior Fixed Income Economist
paulandre.pinsonnault@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
MD & Head of Public Sector Strategy
warren.lovely@nbc.ca

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