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Economics Group

Special Commentary

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Money Flowing Out of China Despite Stable GDP Growth

Executive Summary

Real GDP in China grew 6.8 percent on a year-ago basis in Q4-2016, the sixth consecutive quarter in which growth has been between 6.6 and 7.0 percent. Despite generally stable GDP growth over this period, money is clearly flowing out of China, as demonstrated by the $1 trillion decline in the government's FX reserves since mid-2014. Not only have capital inflows softened, but Chinese companies and individuals are taking an increasing amount of money out of the country. In our view, the Chinese government will keep the depreciation of its currency "orderly", at least for the foreseeable future, by a mixture of sales of its FX reserves and more stringent enforcement of capital controls.

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Chinese Economy Has Achieved a "Soft Landing"

Data released today showed that real GDP in China rose 6.8 percent on a year-over-year basis, a slight pickup from the previous quarter (Figure 1). This marks the sixth consecutive quarter in which the year-over-year growth rate has been between 6.6 and 7.0 percent, an indication that economic growth in China has stabilized after its marked slowdown between 2010 and 2014.

A breakdown of the real GDP data into its underlying demand-side components is not readily available. However, the preliminary disaggregation of the GDP data into broad industry categories showed that growth in the "secondary" industries, which include the construction and industrial sectors, appears to have held steady around 6 percent, while growth in the "tertiary" industries, essentially the service sector, appears to have strengthened somewhat.

Figure 1

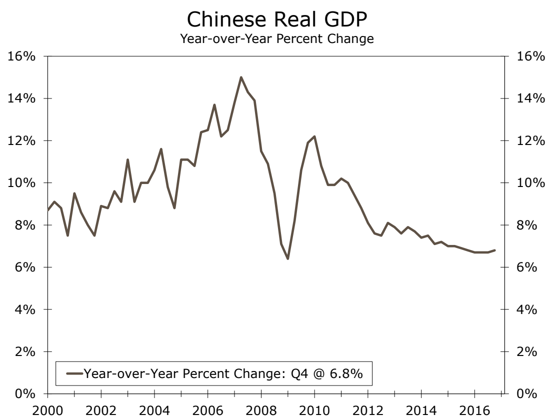
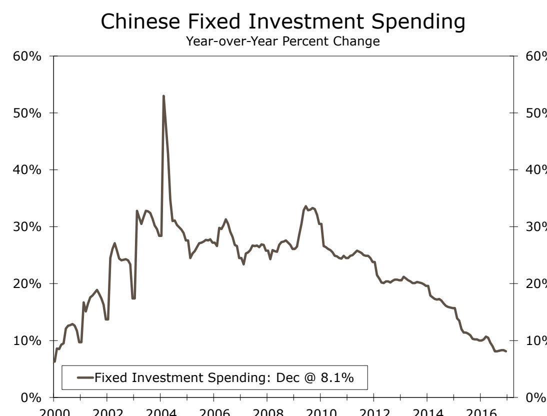


Figure 2



Source: Bloomberg LP and Wells Fargo Securities

In that regard, the growth rate in nominal retail spending has picked up recently, but it remains well below growth rates of the past several years. Despite the strong headline GDP figure, the sharp slowdown in investment spending that has occurred this decade is the primary cause for the

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deceleration in the Chinese economy (Figure 2). Housing starts continue to decelerate, further evidence of a pullback in investment spending in the residential market. Although we do not foresee the Chinese economy crashing anytime soon, we anticipate a gradual slowdown with GDP growth slowing to 6.3 percent in 2017 before edging down further to 5.8 percent in 2018.

Net capital outflows have increased sharply over the past three years.

Net Capital Outflows > Current Account Surpluses

The dynamics in the Chinese economy that are captured by the GDP data, which show that economic growth has been more or less stable in recent quarters, are arguably not all that interesting. Perhaps of more interest has been the dynamics in the country's external accounts. Although China continues to incur sizeable current account surpluses, the deficit in its financial account, which measures capital flows in and out of the country, has widened markedly since early 2014 (Figure 3). In other words, net capital outflows have increased sharply over the past three years.

Authorities have spent about $1 trillion supporting the value of the Chinese yuan vis-à-vis other currencies since mid-2014.

Because net capital outflows have consistently exceeded the value of China's current account surpluses beginning in 2015, the country has been running down its foreign exchange (FX) reserves. Although China still has a staggering amount of FX reserves, the value of those reserves has receded from nearly $4 trillion in mid-2014 to about $3 trillion today (Figure 4). That is, authorities have spent about $1 trillion supporting the value of the Chinese yuan vis-à-vis other currencies since mid-2014, a topic to which we will return later. Because net capital outflows have exceeded the value of the country's current account surplus in recent years, the value of the Chinese yuan would be significantly weaker than it is today if the Chinese government allowed the currency to float freely in FX markets.

Figure 3

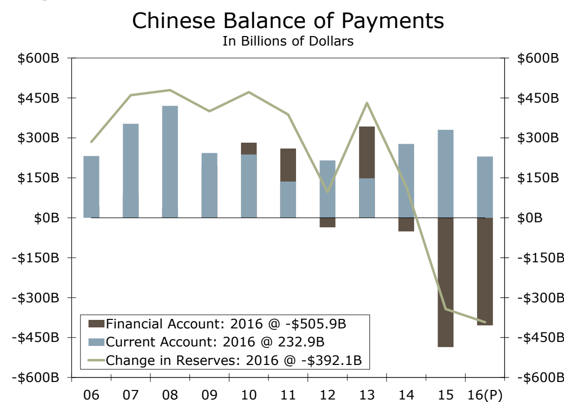
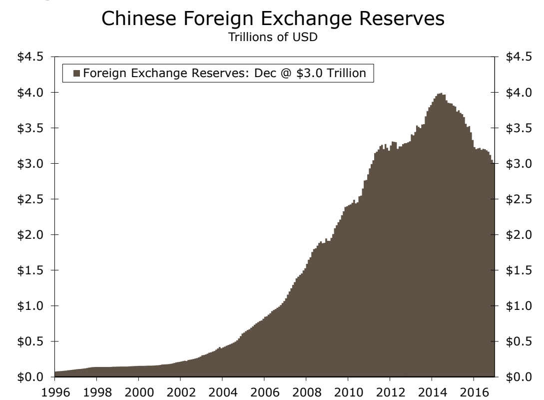


Figure 4



Source: CEIC, Bloomberg LP and Wells Fargo Securities

Why Is Capital Flowing Out of China?

To recap, the primary reason why China's FX reserves have declined by roughly $1 trillion since mid-2014 is because net capital outflows, which are the difference between gross inflows and gross outflows, have picked up over that period. An increase in net capital outflows can be caused by fewer gross inflows and/or more gross outflows. Drilling down further into China's financial account shows that both phenomena have been at work in causing the deficit in the country's financial account to balloon in recent years. That is, gross inflows have weakened while gross outflows have picked up (Figure 5).

Gross inflows collapsed from a record $563 billion in 2013 before turning negative in 2015. Available quarterly data through Q3-2016 suggest that gross inflows rebounded last year, but they appear to have remained well below the pace of earlier years. For starters, foreign direct investment (FDI) in China has downshifted over the past few years. Perhaps the rapid buildup in the foreign presence in China is more or less complete or perhaps the rise in Chinese wages over

the past decade has reduced the attractiveness of using China as an export entrepôt.[1] In any event, the value of FDI inflows into China fell by roughly 50 percent between 2013 and 2016.

A pullback in foreign investment in China has weighed on capital inflows.

Foreign banks have been much more circumspect in making loans to Chinese entities, perhaps due to the high levels of indebtedness in the Chinese business sector, which has also weighed on capital inflows. Data from the Bank for International Settlements show that foreign bank exposure to China has receded from more than $800 billion in early 2014 to about $650 billion in Q2-2016 (latest available data). In addition, foreign deposits in Chinese banks have declined from about $500 billion in 2014 to less than $350 billion today.

On the other side of the ledger, gross outflows totaled about $200 billion in 2013 before rising to roughly $400 billion per annum in both 2014 and 2015. Data through Q3-2016 indicate that gross outflows were on pace to total about $600 billion last year. Disaggregating the data on gross outflows shows that direct investment by Chinese companies in foreign economies shot up from about $70 billion in 2013 to more than $200 billion (projected) last year. In addition, portfolio investment in foreign countries by Chinese investors soared from a paltry $5 billion in 2013 to an estimated $90 billion in 2016 as the country's qualified domestic institutional investor (QDII) program was liberalized. It is a policy goal of the Chinese government to financially integrate the Chinese economy with the rest of the world, and the marked increase in capital outflows from China over the past few years shows that the policy appears to be working.

The policy goal to financially integrate the Chinese economy with the rest of the world appears to be working.

Figure 5

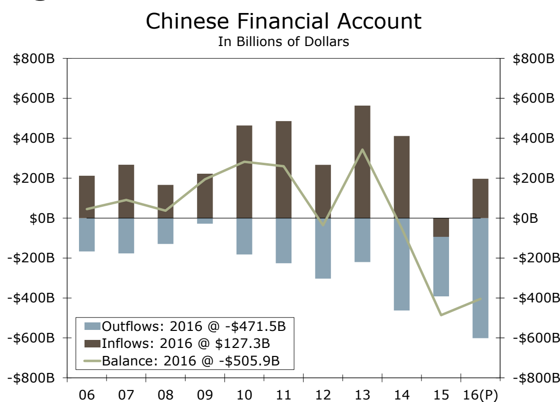
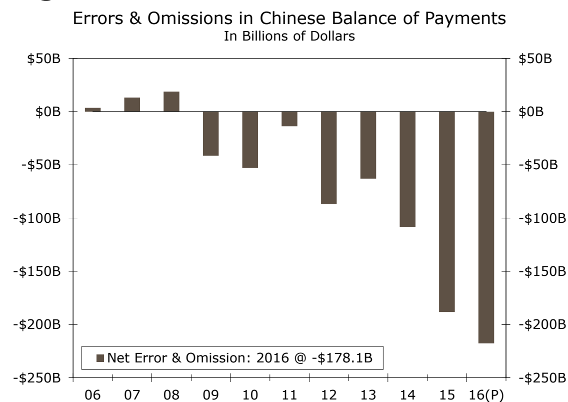


Figure 6



Source: CEIC and Wells Fargo Securities

According to the principles of balance-of-payments accounting, the balance in a country's current account should be exactly offset by the balance in its financial account. Because it is essentially impossible to precisely measure all the transactions an economy has with the rest of the world, however, a country's measured current account is rarely offset exactly by its financial account. In order to force balance in a country's balance of payments, which is required by the principles of accounting, economists use a third balance that is euphemistically called "errors and omissions."

Although there could be numerous reasons for "errors and omissions" in a country's balance of payments, unrecorded capital flows are widely considered to be an important culprit. The sizeable negative "errors and omissions" in China's external accounts in recent years suggests that there may be more gross outflows than captured in the official financial account (Figure 6). Chinese residents and foreigners who have investments in China may be discreetly taking money out of the country.

[1] The average wage in the private manufacturing sector in China shot up from about $2400/year in 2008 to more than $6000/year in 2015.

Government Efforts to Slow Rate of Yuan Descent

Against the greenback, the yuan has fallen roughly 12 percent since its January 2014 peak.

When individuals or businesses take money out of China they will look to ultimately sell Chinese yuan for foreign currencies, either domestically or in offshore financial centers such as Hong Kong, Singapore or London. Selling yuan puts downward pressure on the Chinese currency vis-à-vis other currencies. If the Chinese yuan was a freely floating currency, then it could have depreciated significantly and in a disorderly fashion as net capital outflows accelerated over the past few years. However, the Chinese government prioritizes stability, and it has sold foreign currencies and purchased yuan in the FX market (i.e., it has run down its FX reserves) to slow, but not entirely stop, the rate of the yuan's decent. In trade-weighted terms, the Chinese yuan has depreciated about 10 percent since peaking in mid-2015 (Figure 7). Against the greenback, the yuan has fallen roughly 12 percent since its January 2014 peak.

Figure 7

Source: HIS Global Insight and Wells Fargo Securities

The Chinese government has tightened controls recently in an attempt to restrain capital outflows.

As noted above, the Chinese government has spent about $1 trillion since mid-2014 to slow the rate of descent of the yuan. Although there is still $3 trillion left in the FX coffers, the government has apparently come to the conclusion that it cannot intervene in the FX market indefinitely. Consequently, it has tightened controls recently in an attempt to restrain capital outflows, at least at the margin. For example, transfers to foreign economies in excess of $5 million, which include payments such as dividends, internal company loans, and early repayments of loans, are now subject to government scrutiny. New restrictions have also been placed on individuals' currency transactions. Other restrictions could clearly be implemented if capital continues to flow out of the country.

Conclusion

Despite stable GDP growth over the past few years, money is flowing out of China. Some of the outflow has been encouraged by government policy such as the liberalization of the QDII program. But concern about the underlying state of the economy, expectations about further depreciation of the yuan, and rising rates of return in many foreign economies, are probably contributing to the capital exodus as well.

China has been acting to offset some of the downward pressure on its currency for nearly three years, and it still has ample FX reserves. It could also tighten capital controls even further should the downward pressure on its currency continue. The Chinese government prizes stability and we think it will continue to sell down FX reserves and tighten capital controls to essentially control the rate of descent of its currency. We do not lose sleep at night worrying about a sharp, and potentially disorderly, plunge in the value of the Chinese yuan, at least not in the foreseeable future. That said, we will be keeping a close eye on the actions of the Chinese government for any significant changes it may make in its exchange rate policy.

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