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# Capital outflows reignite debate between China bulls and bears

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With Chinese stock markets suffering big losses, capital flow trends have taken on greater significance

China's foreign exchange reserves have dropped for four straight quarters, leading to a fresh round of warnings about capital outflows.

Interpreting capital flows has long been a favourite parlour game for Chinese economy watchers. An analyst's view on "hot money" outflows is often an indication of his or her broader stance towards the world's largest economy.

For those who believe China's economic slowdown is worsening and risks from spiralling debt and wasteful investment are propelling the country toward a financial crisis, the spectre of capital flight lurks behind each new data

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point. They view capital outflows as a sign of waning confidence in China, and they warn that outflows will drain liquidity from the domestic economy, making it harder for companies and local governments to raise funds.

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For more bullish analysts, moderate capital outflows are a sign that China is liberalising capital controls and abandoning its mercantilist obsession with accumulating foreign reserves. They believe that domestic liquidity concerns are unwarranted, since the People's Bank of China has plenty of new mechanisms to expand the money supply to replace the liquidity once created by foreign capital inflows.

Now, with the Federal Reserve preparing to raise interest rates and the Chinese stock market suffering big losses, capital flow trends have taken on even greater importance. Higher US rates are likely to draw capital out of China and other emerging markets, which could place even greater downward pressure on Chinese share prices.

### China foreign exchange reserves



“The trend of rising outflows reflects policy measures to facilitate outward investments and the lack of stable domestic investment opportunities, with an additional short-run boost in outflows due to stock price volatility and concerns about growth prospects,” said Eswar Prasad, former head of the China division at the IMF, in a nod to both the bullish and bearish views.

After hitting an all-time high of \$3.99tn at the end of June 2014, reserves have fallen by \$299bn. Analysts broadly agree that China has experienced capital outflows on an

unprecedented scale. But they disagree about their size, causes, and the risk to the economy.

Goldman Sachs analysts led by New York-based chief foreign exchange strategist Robin Brooks raised the alarm with their estimate that net capital outflows in the second quarter alone totalled about \$200bn. “Capital outflows have become very sizeable and now eclipse anything seen in the recent past,” Mr Brooks wrote.

JPMorgan has also furrowed its brow at China’s capital flow data. Strategists led by Nikolaos Panigirtzoglou in London estimate capital outflows amounted to \$520bn combined over the past five quarters. “The current capital outflow episode in China is a more sustained and severe episode relative to those seen in the past,” they wrote.

## China capital flows

Quarterly flow of investment funds (\$bn)



Source: JPMorgan

FT

almost all foreign exchange within China as official reserves, while banks, companies, and households held little.

Yet several China-based economists caution that Goldman and JPMorgan use estimates that fail to account for subtler factors. In a report published several days after Mr Panigirtzoglou's, JPMorgan's own chief China economist, Zhu Haibin, obliquely contradicted his colleague's estimate by citing several reasons that made him believe that the estimates were inflated.

One is a shift in China's foreign exchange holdings between the central bank and the private sector. Until recently, the PBoC held

This was due largely to the central bank's intervention in the foreign exchange market. At its peak, the PBoC purchased hundreds of millions of dollars a month in order to restrain renminbi appreciation. Chinese banks and companies, for their part, were happy to fob off their dollars on to the PBoC, since they stood to profit from the slow but steady renminbi appreciation between 2005 and 2013.

That changed last year, when the renminbi suffered its first significant full-year depreciation in more than 20 years. Now many Chinese exporters who receive payments in dollars simply hold them, rather than buying local currency. Though these dollars no longer swell the central bank's coffers, the money remains inside China and so should not be viewed as "outflows", economists say.

Mr Zhu estimates that "corporate balance sheet adjustment" explains \$205bn in apparent capital outflow over the past four quarters.

"The central bank aims to shift the FX asset holding into the non-government sector. In that sense, the corporate balance sheet adjustment is a desirable outcome for policymakers," Mr Zhu wrote.

Economists expect mild capital outflows from China to continue, but most analysts do not see cause for alarm. They note that China's foreign exchange reserves are still by far the world's largest and that a significant chunk of capital outflow is due to intentional policy choices by the Chinese government, rather than panicked investors seeking an exit.

Finally, they note that while China has liberalised capital flows significantly, remaining

controls still severely limit the ability of investors to transfer large sums abroad.

“Concerns about the outflows are exaggerated, especially as regards to outflows in the second quarter, which stabilised rather than worsened,” said Wang Tao, China economist at UBS.

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*Additional reporting by Josh Noble in Hong Kong*

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