From Capital Flight to Speculative Onslaught:

The Tidal Shift in China’s Balance of Payments

Calla WIEMER & ZHANG Jikang

Executive Summary

1. China has accumulated official reserve assets at a phenomenal pace in recent years, amassing US$471 billion as of June 2004 (US$516 billion with the inclusion of assets transferred from official reserves to state commercial banks for recapitalization). This puts China second only to Japan in reserve asset holdings.

2. Recent accumulations have been driven by a sharp escalation in capital inflows motivated largely by expectations that the renminbi (RMB) will be revalued in response to external pressure.

3. A crude gauge of speculative or "hot money" flows is the accumulation of reserve assets minus the sum of (i) the trade surplus on goods and services and (ii) inward foreign direct investment. The figure was negative through 2002, but turned sharply positive in 2003 as the accumulation of reserve assets soared while the trade surplus and inward foreign direct investment (FDI) remained roughly constant.

4. Capital is moved into China for the most part by those with a local business presence rather than by detached speculators. Often, it is a matter of moving funds in sooner rather than later in anticipation of possible future business outlays. The vast pool of flight capital may be particularly sensitive to anticipated exchange rate movements.

5. An important channel of hot money inflows is short term borrowing. Foreign invested enterprises (FIEs) have shifted to borrowing in dollars to be converted to RMB then back again when the loan is repaid. If a revaluation takes place, the hard currency loan then becomes cheaper to repay in RMB

terms.

6. Other channels of speculative capital inflow lie hidden. One telling measure of the tidal shift in the direction of flows is the residual category “net errors and omissions” on the balance of payments which after long registering negative has leapt into positive territory.

7. Speculative inflows are responsive to the broad increase in porosity of the foreign exchange system that has come about over time. Notwithstanding the maintained formality of non-convertibility on the capital account, it has become easier to get money out and consequently more attractive to bring money in. For FIEs in particular, the general environment with respect to currency transactions and investment activities has become increasingly lax.

From Capital Flight To Speculative Onslaught:

The Tidal Shift in China's Balance of Payments

Calla WIEMER & ZHANG Jikang[1]

Foreign Capital Flows on China's Balance of Payments

1.1 China has accumulated official reserve assets at a phenomenal pace in recent years, amassing a sum of US$471 billion as of June 2004 – second only to that of Japan. Recent accumulations have been driven by a sharp escalation in capital inflows motivated largely by expectations of a revaluation of the renminbi (RMB). These speculative inflows stand in sharp contrast to the capital flight that marked the preceding decade.

1.2 To some extent, the speculative aspect of the inflows is a matter of hedging – moving funds in sooner rather than later in anticipation of possible future outlays. Such inflows are likely to be readily reversible, however, if plans do not materialize. A substantial part of the inflows may well be returning flight capital that having found its way out once could do so again.

1.3 The speculative nature of the inflows is suggested by the locus of sudden shifts in the balance of payments accounts. Values for the trade surplus and foreign direct investment remained roughly constant in 2003 relative to the previous year. The real action occurred in the short term loan components of the accounts. Also indicative of speculation, the sign on the residual element "net errors and omissions" has turned positive after long registering negative.

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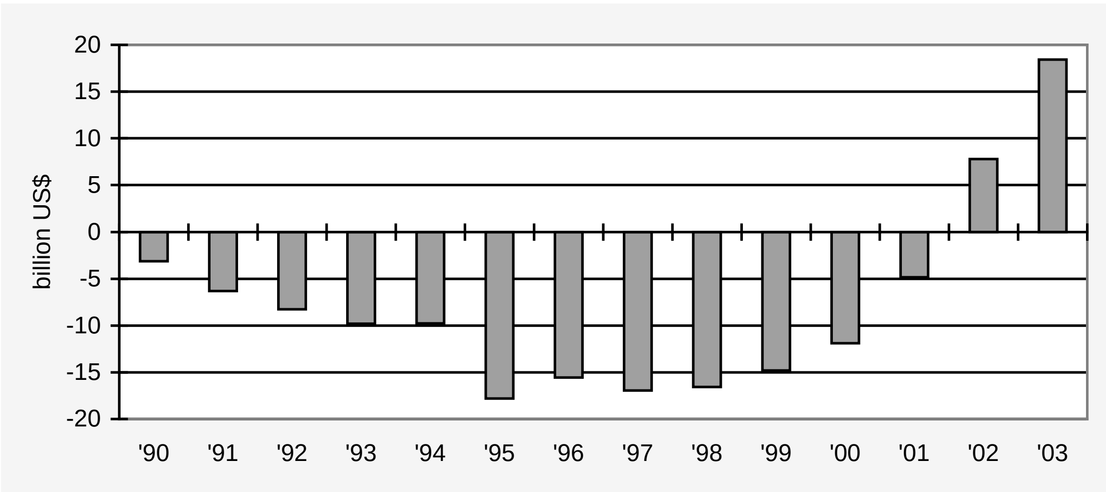
1.4 "Net errors and omissions" is a balancing element in the accounts. In principle, balances on the three substantive components of the balance of payments – the current account, the capital and financial account (or simply the "capital account"), and the accumulation of reserve assets – should be offsetting. To the extent that surpluses on the current and capital accounts are not matched by an accumulation in reserve assets, a negative value for "net errors and omissions" results.

1.5 Through the latter half of the 1990s, the magnitude of "net errors and omissions" was sustained at negative US$15 billion or more per year in absolute terms (see Figure 1). The year 2002 then witnessed a shift to positive ground, and 2003 a further jump to US$18.4 billion.

Figure 1: "Net Errors & Omissions" in China's Balance of Payments, 1990-2003



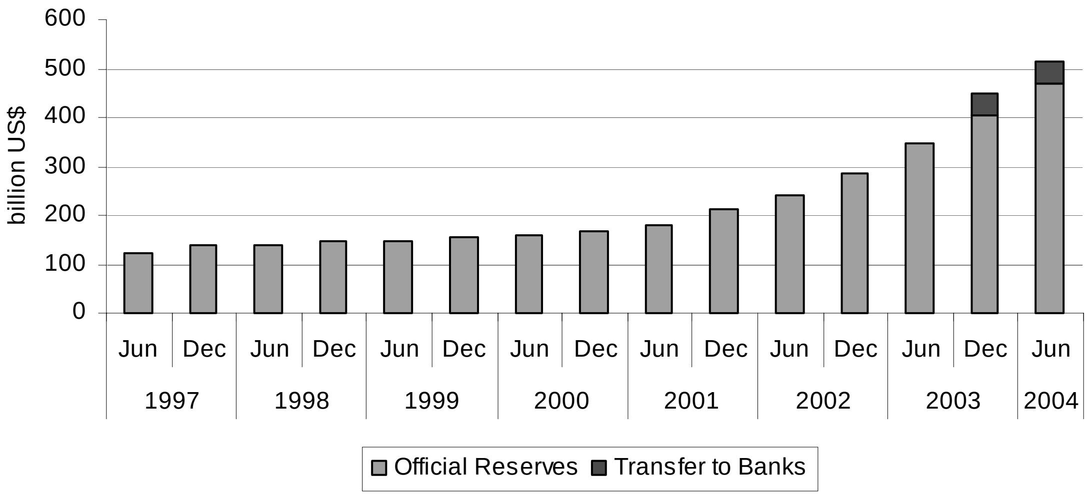
Source: State Administration of Foreign Exchange[2]

1.6 Though symbolically telling, the increase in inflows captured by "net errors and omissions" in 2003 is the tip of the iceberg quantitatively. In two and a half years, from December 2001 to June 2004, China's official reserve assets

2 http://www.safe.gov.cn/0430/tjsj.jsp?c_t=1, viewed 25 July 2004.

soared by US$258 billion (see Figure 2). This does not include US$45 billion transferred from official reserves held by the People's Bank of China to two state owned banks (the Bank of China and the Construction Bank) to support recapitalization in preparation for overseas listing. Inclusion of this sum raises the growth in reserves for the year 2003 to US$162 billion, and boosts China's reserve asset position as of June 2004 to US$516 billion.

Figure 2: Official Reserve Assets, 1997-2004



Source: same as Figure 1.

1.7 Speculative capital inflows are not transparent on China's balance of payments. Officially, China allows full currency conversion under the current account but imposes restrictions on conversion under the capital account. Speculative or "hot money" inflows thus assume a variety of different guises in the circumvention of restraints.

1.8 One measure commonly used as a crude gauge of hot money flows is the accumulation of reserve assets minus the sum of (i) the trade surplus on goods and services and (ii) inward foreign direct investment (see Table 1).[3] This

[3] This is indeed a crude gauge but nevertheless serves to highlight abrupt changes over time that

figure was negative through 2002 but turned sharply positive in 2003 as accumulation of reserve assets soared while the trade surplus and inward FDI remained roughly constant.

Table 1: Gauge of Hot Money Inflows, 2001-2003

billion US$

	Change in Reserves	– Trade Surplus	– FDI	= Hot Money
2001	47.3	28.1	46.8	-27.6
2002	75.5	37.4	52.7	-14.6
2003	162.0*	36.1	53.5	72.4

*Includes US$45 billion bank bailout.

Source: same as Figure 1.

Why the Money Flows

2.1 Why has a longstanding outflow of capital been transformed so suddenly into an inflow? The transformation hinges foremost on expectations about the value of the renminbi which has long been tied to the US dollar. China has come under vociferous pressure from foreign governments, particularly the United States, to revalue its currency. A higher value for the RMB would reduce China's export competitiveness and raise its demand for imports. In the run-up to the US presidential election, alleged RMB undervaluation has become a political scapegoat for American outsourcing and the "jobless recovery". The international pressure has motivated expectations of an RMB revaluation and thus prompted movement of speculative funds into China.

2.2 The sense of underlying need to revalue the RMB has been amplified by the depreciation of the US dollar relative to the euro and the yen. In tandem with

are suggestive. Speculative capital flows can, of course, be hidden within the trade account and FDI, while other components of the balance of payments may legitimately fluctuate unrelated to speculative capital movements.

the dollar, since April 2002, the RMB has lost 38% of its value with respect to the euro and 20% with respect to the yen. To maintain a semblance of parity with respect to these currencies as the dollar falls, the RMB dollar-peg would need to be adjusted.

2.3 Apart from the speculative motive, burgeoning demand for RMB is also being driven by the pursuit of real return on assets. With China's GDP growth reaching 9.1% in 2003 and climbing to 9.7% year on year for the first half of 2004,[4] real investment opportunities are certainly to be had. Growth in the external sector has been even more blistering with exports up around 35% and imports 40% in 2003, and that pace continuing through the first half of 2004.[5] Although realized FDI barely increased in 2003 due to SARS, contracted FDI soared by nearly 40% suggesting a torrid pace of new project development.[6] Further, investors holding financial deposits in China have been motivated to convert to RMB by favorable interest rate differentials.[7] Interest rates on US dollar deposits at the Bank of China are only 0.375% per annum on three-month deposits and 0.6875% on 24-month deposits as opposed to rates on RMB deposits of 1.71% for three months and 2.25% for four months[8] (where real differentials would, however, depend on expected rates of inflation).

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4 National Bureau of Statistics as cited in press reports.

5 Customs Administration, http://www.customs.gov.cn/tongjishujv/a/Page3.htm, viewed 30 July 2004.

6 Ministry of Commerce, http://english.mofcom.gov.cn/article/200403/20040300197230_1.xml, viewed 30 July 2004.

7 http://news.xyfund.com/032004/11/83704.html, viewed 30 July 2004.

8 Bank of China, http://www.bank-of-china.com/english/index.html, viewed 30 July 2004.

Whose Money

3.1 Due to high transactions costs associated with actual currency conversion, particularly given restrictions on capital account convertibility, the capital inflow would have to be supported largely by those with real potential uses for RMB. Investors desiring to pursue purely speculative plays on exchange rate movements may place their bets in the non-deliverable forward (NDF) markets of Hong Kong and Singapore. Contracts in these markets are settled in dollars for the difference between the forward contract value and the realized value of the currency without possession of RMB assets ever being taken.

3.2 Thus those with some real use for RMB would logically pose the main motive force behind the capital inflows. Anticipation of a currency revaluation would prod investors to convert sooner rather than later in preparation for planned or entertained future RMB outlays. In this sense, the timing of the recent rush of financial capital into China may serve a hedging function against intended future business investment. In so far as business plans may not actually be realized however, investors would wish to have an avenue for reversing their RMB positions.

3.3 Among the most sensitive in terms of timing their currency shifts vis-a-vis exchange rate fluctuations are likely to be the holders of flight capital. For Chinese who have moved funds offshore but see their investment future lying at home, the time to repatriate would be before a rise in the value of the RMB. The pool of flight capital on which to draw is potentially enormous: estimates of the cumulative outflow approach one trillion US dollars.[9] The dominant channel for capital flight has been the misinvoicing of traded goods,

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9 Frank R. Gunter, "Capital Flight from China: 1984-2001," *China Economic Review*, 15 (2004): 63-85.

both over-invoicing of imports and under-invoicing of exports. Estimates of misinvoicing are derived by comparing Chinese trade data with counterpart data for major trading partners. This technique yields annual discrepancies peaking at nearly US$100 billion in the late 1990s. The implication is that had China's exports and imports been rendered accurately in the balance of payments accounts, substantially larger trade surpluses would have been manifested.

3.4 A tradition of Chinese flight capital round tripping as foreign direct investment is well established. The list of FDI source countries provides a clue as to this.[10] Hong Kong tops the list by a large margin, accounting for 45% of China's inward FDI over the 1994-2001 period. For 2003, the Virgin Islands ranked second with Western Samoa and the Cayman Islands also in the top ten, all obvious stop-offs on the round tripping circuit. Capital leaves China only to return under foreign title for a variety of reasons: first are such regulatory advantages as lower tax rates, preferential access to international financial services, special land use privileges, and so forth; second is the more nebulously defined yet very real superior protection of property rights conferred on foreign capital; third is the value added derived from financial and commercial services received when funds become internationalized; and finally, there is the legitimacy that can be acquired for ill-gotten gains. Estimates are that a quarter to a half of annual FDI inflows is attributable to round-tripping and that cumulatively roughly a quarter of all flight capital has found its way back as FDI.[11]

3.5 Contracted FDI surged in 2003 as did even harder-to-trace forms of capital

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10 Ministry of Commerce, http://www.mofcom.gov.cn/article/200401/20040100171259_1.xml, viewed 2 August 2004.

11 Geng Xiao, "Round-Tripping Foreign Direct Investment in the People's Republic of China: Scale, Causes and Implications," ADB Institute Discussion Paper No. 7, June 2004.

inflow. The extent to which flight capital underlies these inflows can only be guessed. But it stands to reason that money spirited out under the radar once would be particularly responsive to speculative opportunities that may or may not pan out thus leaving capital owners to perhaps again reverse course.

Tracking Inflows on the Balance of Payments

4.1 The balance of payments accounts provide insight as to how the recent capital

Table 2: China's Balance of Payments, 2002-2003

billion US$

	2002 Credits	2002 Balance	2002 Debits	2003 Credits	2003 Balance	2003 Debits
Current Account	**387.53**	**35.42**	**352.11**	**519.58**	**34.07**	**473.71**
Goods	325.65	44.17	281.48	438.27	44.65	393.62
Services	39.74	-6.78	46.53	46.73	-8.57	55.31
Income	8.34	-14.95	23.29	16.09	-7.84	23.93
Current Transfers	13.80	12.98	0.81	18.48	17.63	0.85
Capital & Financial Account	**128.32**	**32.29**	**96.03**	**219.63**	**52.73**	**166.90**
Capital Account	0.00	-0.05	0.05	0.00	-0.05	0.05
Financial Account	128.32	32.34	95.98	219.63	52.77	166.86
Direct Investment	53.07	46.79	6.28	55.51	47.23	8.28
Portfolio Investment	2.29	-10.34	12.63	12.30	11.43	0.88
Other Investment	72.96	-4.11	77.07	151.82	-5.88	157.70
Reserve Assets	**0.00**	**-75.51**	**75.51**	**0.00**	**-117.02**	**117.02**
Net Errors & Omissions	**7.79**	**7.79**	**0.00**	**18.42**	**18.42**	**0.00**

Source: State Administration of Foreign Exchange[13]

Notes on specific components' contribution to the 2003 increase in capital inflows:

Income: Up US$7.11 billion due mainly to increased payments received on foreign investment.

Current Transfers: Up US$3.65 billion due mainly to increased incoming private transfers.

Portfolio Investment: Up US$21.77 billion due somewhat less than half to increased inflows (of which US$5.5 billion for stock investing) and the remainder to decreased outflows.

Other Investment: Up US$43.23 billion (including the US$45 billion bank bailout transfer) due mainly to increased short term borrowing (up US$28 billion) and increased repayment received on short term lending (up US$21 billion).

Errors and Omissions: Up US$10.63 billion.

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[13] http://www.safe.gov.cn/0430/tjsj.jsp?c_t=6, viewed 2 August 2004.

Underlying Institutions and Behavior

5.1 The escalation in short term loan activity is suggestive of currency speculation. A key behavioral shift underlying this activity pertains to the borrowing practices of foreign invested enterprises (FIEs). Converting dollars into RMB has in the past been relatively easy; it is converting back to hard currency that has presented a problem as authorities have historically been concerned with blocking capital flight, not inflow. Ready access to foreign exchange is, however, available to FIEs needing to repay hard currency loans. Even so, in the past FIEs typically borrowed locally in RMB to finance their domestic expenditures. More recently however, there has been a shift to borrowing locally in dollars or euros to be converted to RMB and then back again when the loan is repaid.[14] If a revaluation takes place, the hard currency loan then becomes cheaper to repay in RMB terms. This is a ready vehicle for currency speculation on the part of FIEs.

5.2 More generally, speculative inflows in all guises are responsive to the broad increase in porosity of the foreign exchange system that has come about over time. Notwithstanding the maintained formality of non-convertibility on the capital account, it has become easier to get money out and consequently more attractive to bring money in.

5.3 On an individual level, not only are Chinese citizens traveling abroad allowed to convert larger sums into hard currency for carrying out, but RMB is being accepted as legal tender in Hong Kong and other tourist destinations around the region where local money changers readily convert it to domestic currencies. Individuals are also allowed to use RMB credit cards in Hong

[14] Keith Bradsher, "China Anxiously Seeks a Soft Economic Landing," *New York Times*, 7 May 2004.

Kong with Hong Kong banks handling currency exchange. Along with the RMB becoming accepted abroad, more and more Chinese are engaging in foreign travel.

5.4 For FIEs, the general environment with respect to currency transactions and investment activities has become increasingly lax. Wholly foreign owned enterprises have supplanted joint ventures as the dominant mode of organization eliminating the watchful eye at partner level. At the supervisory level, as of July 2002 the State Administration of Foreign Exchange relinquished its role in approving FDI currency transactions instead delegating this function to local commercial banks that maintain FIE deposit accounts. Meanwhile, financial service institutions are operating in an increasingly competitive environment with foreign owned institutions entering an ever widening range of activities. In this context, it has become quite easy for FIEs to convert currencies or to borrow in foreign currency and invest in local assets, be it A-shares or bonds, real estate or insurance funds. In effect, the RMB has become near fully convertible under the FIE umbrella.

5.5 There are a variety of ways that FIEs, or Chinese firms for that matter, get money out. A longstanding favorite is the international swap market which ostensibly allows for the exchange of borrowed funds over the term of a loan but which under weak supervision can be manipulated to effect lasting asset exchange. Another way to get money out is to import something, either to be used by the firm itself or sold on the domestic market, and over-invoicing can enhance the volume of funds transferred. Finally, RMB denominated securities are routinely bought and sold for dollars with brokerages providing implicit currency trading services. Some of this activity borders on illegality and some of it crosses the line.

5.6 Often FIEs are pushed into committing larger sums of FDI than they would like due to minimum capitalization requirements, but then once the formalities of registering the capital are met loans can be repaid or funds diverted. After a FDI contract is signed, there is a time frame over which funds must be delivered in increments, but in the interim it is routine to get capitalization levels reduced. The waters are thus muddied as to the purpose for which funds are ostensibly flowing in and the form which investment ultimately takes.

5.7 In so far as the motivation for the surge in capital inflows is to speculate on a currency revaluation, a reversal of the flow might be just as powerful once a revaluation takes place or if the expectation is otherwise somehow dissipated.