

Box B

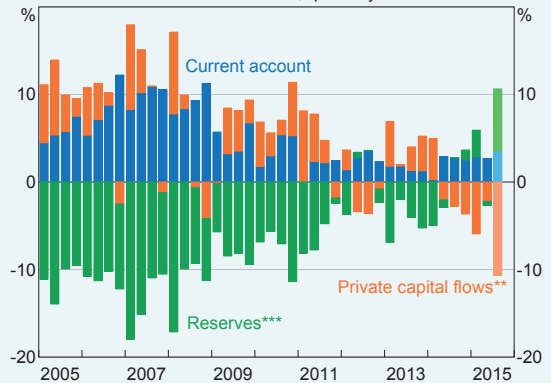
Chinese Capital Outflows

China has been a net recipient of large amounts of foreign private capital over the past two decades (Graph B1). These private capital inflows have accompanied persistent current account surpluses, leading the Chinese authorities to accumulate substantial foreign exchange reserves to mitigate upward pressure on the RMB exchange rate. At its peak in mid 2014, China's reserve portfolio amounted to US\$4 trillion, compared with less than US\$500 billion a decade prior.

These trends in capital flows reversed last year. Between early 2014 and mid 2015, around US\$450 billion of private capital flowed out of China in net terms and the PBC reported selling or letting mature US\$75 billion of its foreign exchange reserves as private capital outflows began to exceed the country's current account surplus. The move towards private capital outflows and reserve sales accelerated sharply in August following the PBC's decision to allow the US dollar-RMB fixing rate to become more market determined. While official data are not yet available, partial data suggest that private capital outflows increased to around US\$300 billion in the September quarter (10 per cent of GDP) and that the PBC sold or let mature a further US\$200 billion of its reserves.

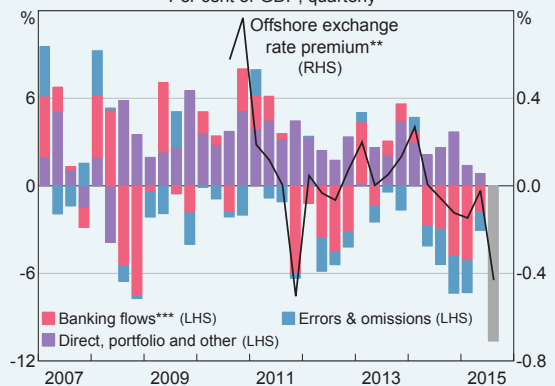
China's capital account is still relatively restricted. This results in the composition of private capital flows typically being different from that in other countries, with the most notable differences being that portfolio flows are small and that banking sector flows tend to drive much of the cyclical variation. This has remained true over the recent period of capital outflow, during which banking flows have accounted for the bulk of net private outflows (Graph B2). However, these banking outflows

Graph B1
China's Balance of Payments
Per cent of GDP, quarterly*



* RBA estimates for September quarter 2015
** Includes net errors & omissions
*** Negative numbers indicate net purchases, which are a capital outflow
Sources: CEIC Data; RBA

Graph B2
China's Net Private Capital Flows
Per cent of GDP, quarterly*



* RBA estimate for net private capital flows for September quarter 2015 (in grey)
** Average premium of offshore USD-renminbi exchange rate over onshore rate
*** Includes currency & deposits, loans and trade credit & advances
Sources: Bloomberg; CEIC Data; RBA

appear to be largely driven by non-financial firms' decisions, rather than the investment decisions of banks themselves. In particular, there appears to

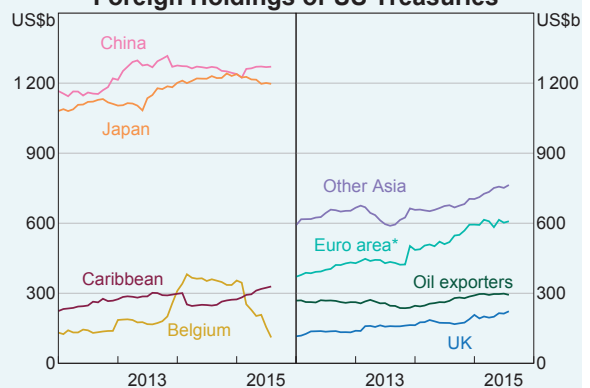
have been a notable increase over the past year in Chinese exporters' desire to keep their US-dollar export receipts in US dollars and a reduction in the willingness of China's foreign suppliers to receive payment in RMB, while the corporate sector as a whole has also been repaying loans denominated in foreign currency.¹ This looks to have been motivated by expectations that the US dollar will appreciate against the RMB, as illustrated by the historically positive correlation between banking sector capital flows and the offshore RMB premium.²

Exporters and importers also appear to account for most of the trends in 'net errors & omissions' (that is, the unaccounted difference between the current account surplus and net capital outflows), which are larger in China than in many other countries and account for most of the remaining recent net capital outflows. This component appears to stem primarily from unallocated net capital flows rather than any misreporting of (or illicit) trade. In particular, when firms choose to prepay for imports it is only recorded as an import at a later date (when invoiced) and so the flow of money associated with that transaction is recorded as a capital outflow (and similarly when they defer receipt of export earnings); moreover, there is evidence that this is not fully captured in the 'trade credit & advances' component. Trends in the net errors & omissions component are also positively correlated with the offshore RMB premium, reflecting the fact that a higher US dollar makes imports more expensive and export receipts more valuable such that an expected US dollar appreciation encourages firms to prepay for imports while deferring US-dollar export receipts.

1 This is explored in more detail in a forthcoming *Bulletin* article.
 2 The offshore RMB premium measures the difference in value between RMB traded in Hong Kong (the 'offshore' market) and RMB traded in mainland China (the 'onshore' market). Positive values arise when the RMB is worth more in Hong Kong than in mainland China. A positive premium typically arises when investors expect the RMB to appreciate, since this is more likely to be reflected in the (more flexible) offshore market rate than in the onshore market. Such differences are possible because capital controls prohibit investors from fully arbitraging differences between the two rates.

The PBC sold large quantities of foreign exchange reserves in response to this private capital outflow in the September quarter. The available evidence suggests that China invests a sizeable share of its reserve portfolio in US bonds. Accordingly, the PBC probably reduced its holdings of US bonds significantly (particularly Treasuries) during the September quarter, in addition to reducing its holdings of other advanced economy sovereign bonds. Indeed, US capital flows data provide some indication of this if a sizeable portion of the decline in Belgian residents' holdings primarily reflects a decline in China's bonds held in Euroclear (which is domiciled in Belgium; Graph B3). Given that private Chinese residents appear to have directed their recent capital outflows towards accumulating bank deposits, trade credits and repaying foreign currency loans, rather than buying sovereign bonds, these PBC sales appear to have shifted the composition of China's overall foreign asset position away from sovereign bonds and are likely to have affected global bond yields.

Graph B3
Foreign Holdings of US Treasuries



* Excluding Belgium
 Source: Thomson Reuters

In aggregate, Chinese entities have around US\$900 billion of foreign currency liabilities (9 per cent of annual GDP, of which two-thirds are in US dollars), mostly owed by non-financial corporations. However, Chinese private and public entities' foreign currency-denominated foreign asset positions are substantially larger (around US\$6.5 trillion in total), so the depreciation of the RMB in August would have on net resulted in valuation gains on China's net foreign asset position. Much of this net long position in foreign currency is due to China's public sector balance sheet, but private entities also hold a net long position in foreign currency that has risen this year as firms have built foreign currency deposits and some of the foreign currency-denominated debt has been repaid. ❖