MILLENNIUM GLOBAL RESEARCH NOTE

China Evolving from Capital Exporter to Capital Importer

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China evolving from capital exporter to capital importer: what are the implications for its policy priorities and for foreign investors?

China's integration to world trade has proceeded much more rapidly than its integration to world capital flows. With global trade no longer growing faster than world GDP over recent years and protectionist measures on the rise, the relative trend is likely to go into reverse over the coming decade in our view. We argue below that Chinese investment outflows to the rest of the world may not accelerate after their sharp increase over the past decade. In contrast, it is likely in our view that **the share of China's assets in global portfolios will rise much more sharply over the next few years.** China will thereby benefit from access to a bigger pool of capital inflows while foreign investors will see diversification benefits from adding RMB debt to their portfolios. While the volatility of these foreign inflows could raise financial instability risks in China, foreign investors in local assets will need to assess the associated CNY risk. With a less solid balance-of-payment position and high private sector debt leverage, China will need a **more flexible currency regime** to absorb external shocks and avoid domestic financial stress. Meanwhile **foreign investors in Chinese debt markets will need to manage the FX risk**.

1. China's deteriorating current account balance: a long term trend

Ironically at a time when US protectionist attacks are intensifying, China's large current account surpluses have become a relic from the past. China's current account surplus has eroded from a high of 10% of GDP in 2007 to 0.4% over the year to September 2018 (see chart 1). The economy even recorded a current account deficit in the first half of 2018. Specific factors that may prove temporary have exacerbated the deterioration in 2018: for instance, rising oil prices that widened the oil deficit. But we see the deterioration in the current account balance as a trend over the medium term. From a savings/investment balance perspective, the ageing of the population and the creation of a social safety net are set to lower the exceptionally high savings of households (25% of income) at the root of external imbalances, i.e. excessive current account surpluses. Looking at the components of the current account deficit, a similar conclusion can be reached. The service deficit is on a widening trend over the past decade, which in part reflects stronger tourism spending abroad. Although tourism abroad can be curtailed by government restrictions in the near term (e.g. restrictions of tour operators), these can hardly be sustained as the evolution of society inexorably leads to more demand for travelling and studying abroad. Finally, the income deficit has worsened sharply, partly reflecting higher dividend payments on the high stock of FDI. Income payments on debt owed to foreign investors and FDI in China have multiplied by 5 since 2006.

2. China's portfolio investment abroad expected to start to catch up with outward direct investment

With excess domestic savings over the past few decades and an ambition to increase its global influence, it is no surprise that Chinese investment abroad has grown considerably. China's stock of foreign direct investment abroad is in the top 5, which has transformed a number of EM economies. FDI from China now represents about 2.8% of Latin America's GDP, 6.5% of Asia's and 4.8% of Africa and the Middle East's. China as a lender to emerging markets has overtaken the US. What is different in the case of China compared to large external creditors in emerging or developed markets is the concentration of its overseas investments in direct investment and bank lending. That pattern of outflows sets China apart from other emerging or developed markets (see chart 2). A few factors explain why China stands out. First, it is not so much the expansion of external trade that has fed into growing direct investment overseas but China's strategy to secure access to natural resources and raise its global influence. Second, it is no coincidence that Chinese lending abroad (see chart 3) has accompanied large direct investment projects in infrastructure, explaining why Chinese bank claims have grown in tandem with outward investment flows. Third, Chinese approach to liberalisation of its capital account has predominantly favoured direct investment as opposed to other financial flows.

Both domestic and international factors are now likely to favour some catch up of portfolio outflows with direct outward flows over the coming years in our view.

First, since 2016 when the RMB joined the SDR and the process of opening up the capital account was set in motion, we believe there has been scope for large Chinese investment abroad in financial markets. In view of still limited domestic investment opportunities, the demand for international assets by Chinese residents is set to be strong. The experience of more advanced economies with an open capital account shows how considerable those portfolio outflows can be. Total portfolio outflows by residents amount to as much as 6% of GDP per year (latest: 2017) in Japan, above 5% in the Euro area and over 3% of GDP in Korea (see chart 3). If China were to follow similar trends to Japan or the Euro area its portfolio investment flows abroad could rise to reach about USD 700 to 850 bn per year, although historical experience suggests that such a process of diversification abroad will take time. A trend increase in Chinese portfolio investment abroad could over time transform global financial markets in the same way that large FDI outflows from China have shaped the development of a number of EM economies over recent years.

Second, the rise of protectionist measures against China, primarily from the US, has extended from targeting trade to Chinese direct investment abroad. The CFIUS is an important case in point, with its use by the US Trump administration much more widespread and frequent than under the previous administration. We believe that US/China tensions are not circumscribed to external imbalances but rather encompass a conflict that goes beyond trade and reflect the heightened rivalry between two world economic powers. The US administration’s desire to “contain” China has led to its attempt to derail the Made in China 2025 strategy, including through restrictions on China’s investment in the US especially in technology. Even a de-escalation of the US-China trade war is unlikely to relieve this source of secular tensions in our view. Moreover, Europe is also sympathetic to the idea of controlling Chinese investment in key sectors. All in all this points to the pace of Chinese direct investment abroad to be more restrained over the coming years in our view.

3. China's growing local market attraction for foreign investors

While the mix of outflows from China is likely to change as discussed above, we expect an overall rise in foreign capital inflows to China over the coming years.

First, the further opening up of the capital account is likely to proceed in an asymmetric fashion, with controls maintained on outflows but inflows being liberalised. As major central banks' policy normalisation raises financial market volatility, the Chinese authorities will be anxious to preserve their strong FX reserves buffer and strengthen selective capital controls on outflows as has been the case earlier this year (e.g. stronger implementation of limits on household transfers abroad and restrictions on outward direct investment). This policy priority will be tested in our view as economic fundamentals currently point to downward pressures on CNY, in view of external trade headwinds, slower domestic growth, easing monetary and credit policies and a still expensive CNY valuation on a trade-weighted basis on our metrics. At the current juncture we expect China to focus on avoiding potentially destabilising capital outflows which would heighten residents' expectations of CNY depreciation: the memory of the large FX reserves losses in 2015-16 is still fresh. Capital outflows will therefore continue to be managed over the near term. However, over the medium term, additional currency volatility will need to be tolerated by the Chinese authorities as they focus on their policy priorities of maintaining monetary policy autonomy and stable FX reserves.

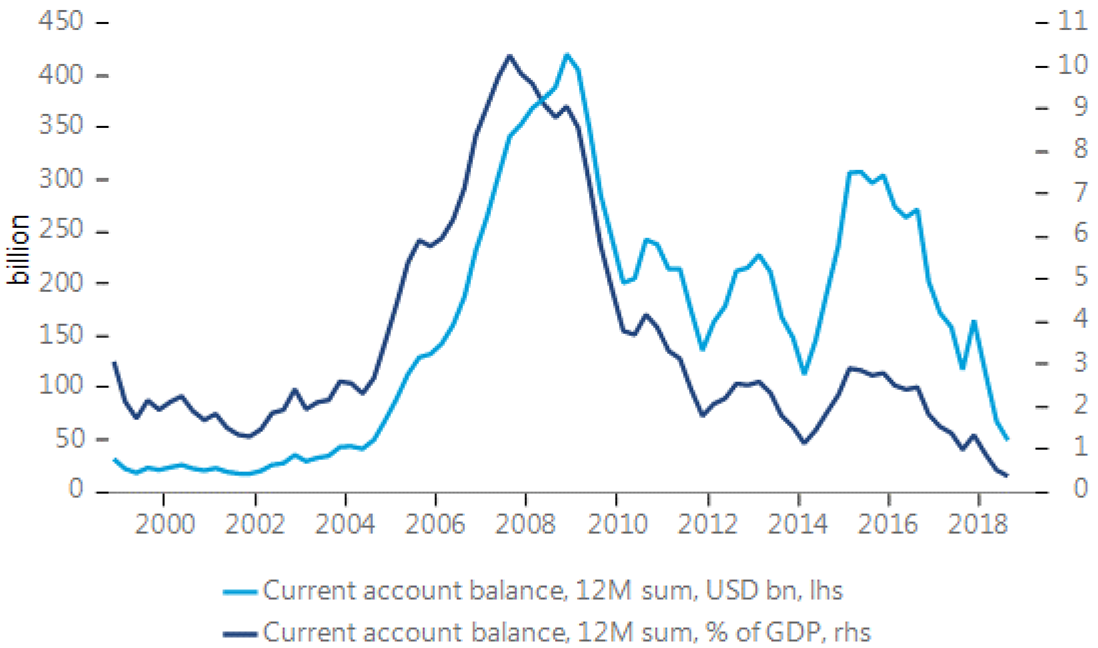
Second, the attraction of the fast growing local bond market will increase for foreign investors. China's government debt has already risen from 21% in 1998 to 48% of GDP in 2018 according to IMF estimates. The corporate sector debt deleveraging and banking sector restructuring will inevitably add to this government debt burden, as will the extension of social safety nets over the coming decade. China will need to tap foreign savings to help finance the restructuring of its economy in our view. The decision has already been made, as the bond market has been liberalised over the past couple of years.

The opening up of the capital account will eventually end financial repression that has been characterised by artificially low yields and the misallocation of capital to SOEs in China. We see China's bond yields on the rise, catching up with other emerging markets over the medium term. Yield attraction combined with diversification benefits and the ability of hedging currency risk should boost interest from active investors abroad. Looking at passive flows, MSCI inclusion, which will see the weight of China gradually rise in the index, is estimated to trigger up to USD 1.5 trillion of inflows. Similarly, the addition of China to global bond indices possibly from 2019 onwards could result in USD 1 trillion of inflows over the next few years. Bond inflows to China have so far tripled in 2018 vs. 2017 (see chart 4) and there is probably scope for a fast pace of foreign inflows to be sustained over the coming years. The Chinese local bond market amounts to USD 11 trillion which makes it the third biggest in the world but less than 7% of it is held by foreigners. In view of the trend deterioration of the current account balance and need for more RMB flexibility, investment in local Chinese bond markets will require active FX management in our view.

Conclusion:

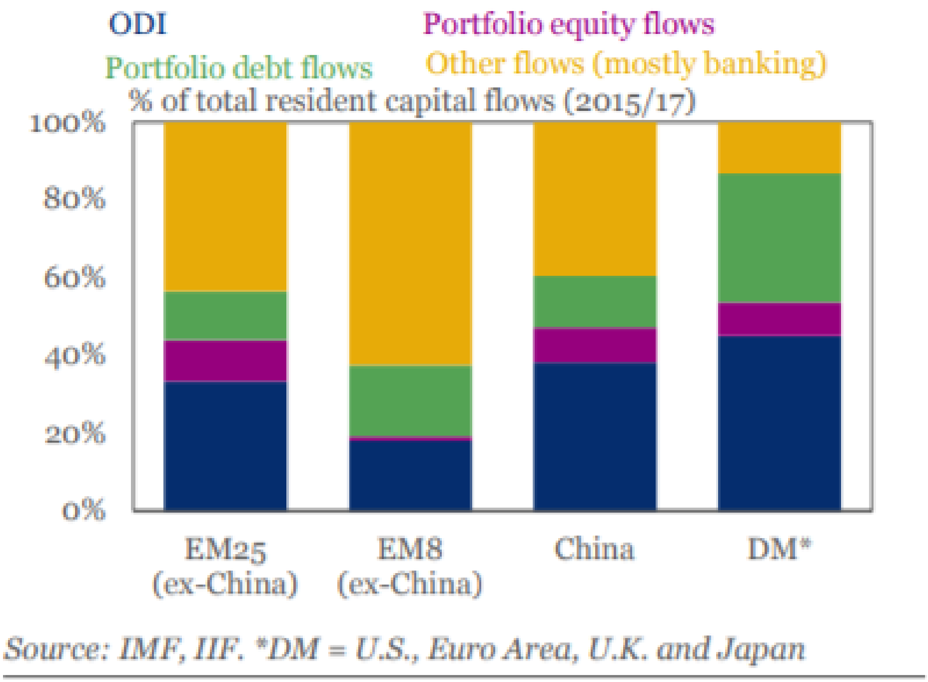
From being one of the biggest capital providers to emerging markets China may well start to crowd out investment to EM over the next decade. Already this year China represents a disproportionate share of no-resident capital flows to EM (about half, see chart 6). In turn, the fortunes of commodity currencies or other Asian currencies may become less correlated with CNY outlook. Meanwhile, the importance of China's business and financial cycle for global financial markets is bound to grow further.

Chart 1: A downward trend in the current account surplus on a 4Q trend



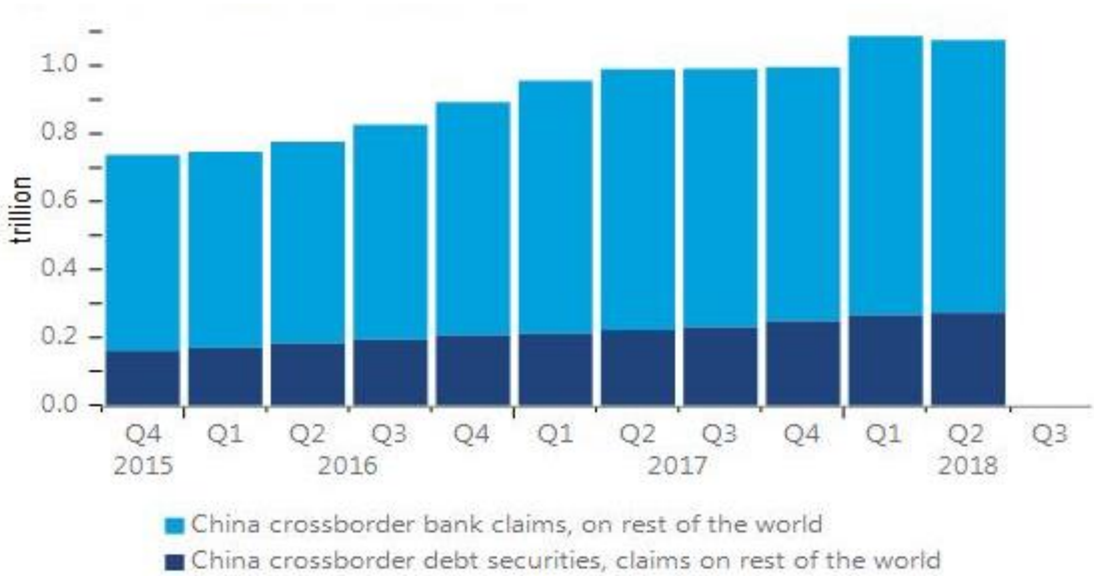
Source: Macrobond. Data as of July 2018

Chart 2: China's pattern of overseas flows stands out compared to other large EM or DM



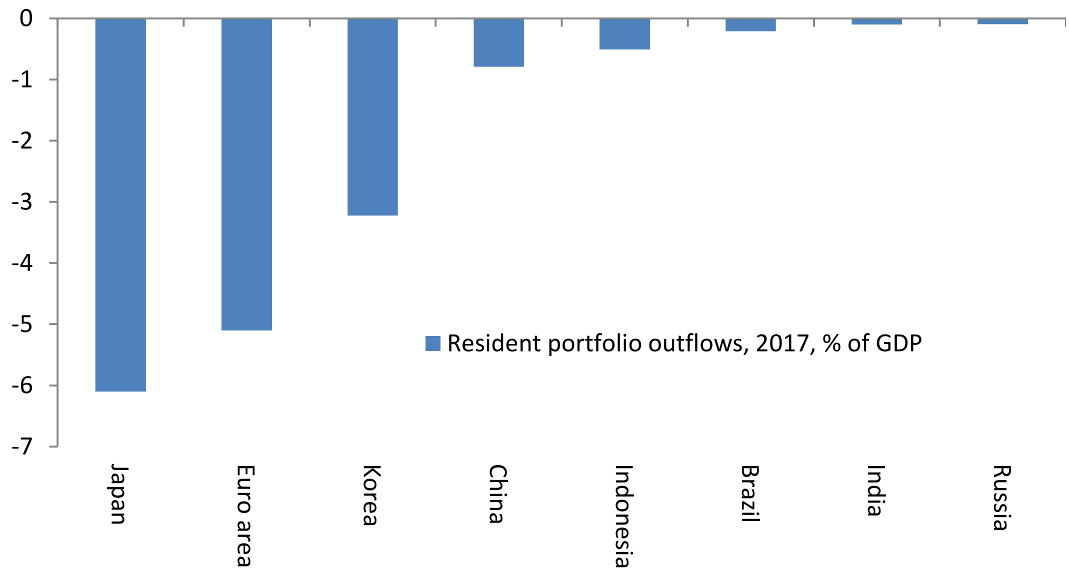
Data as of December 2017.

Chart 3: Bank claims of China on the rest of the world have increased sharply over the past decade to reach 1 076 USD bn by Q2 2018 according to BIS data



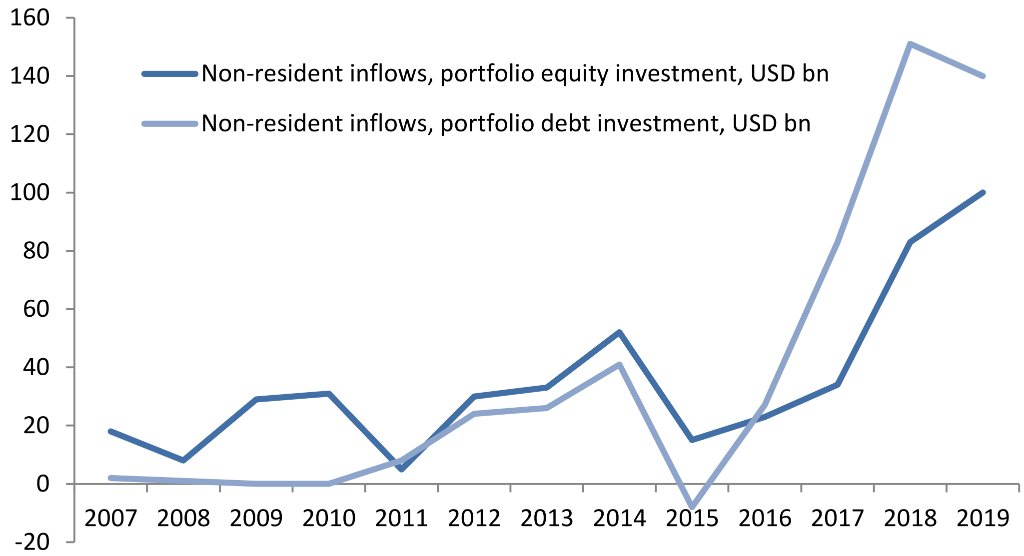
Sources: Macrobond. Data as of April 2018.

Chart 4: China's resident portfolio outflows have room to grow



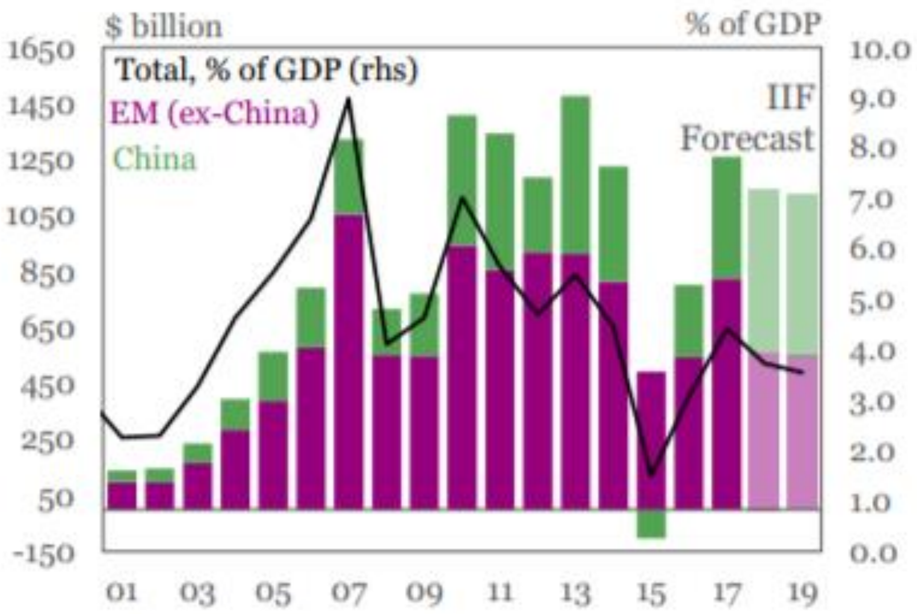
Sources: IIF, Macrobond. Data as of October 2018.

Chart 5: Rising foreign portfolio flows to China



Source: IIF. Data as of October 2018

Chart 6: China represents a growing share of non-resident capital flows to EM



Source: IIF. Data as of October 2018

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