

Global Capital Flows from China

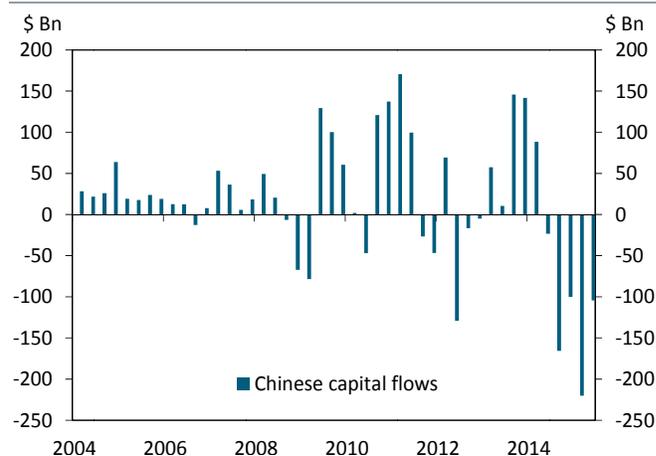
By Jun Nie and Nicholas Sly

China has experienced large capital outflows recently, reflecting its lower growth prospects. A portion of these capital flows has been directed toward real investment activities in the United States, consistent with the relative strength of the U.S. economic outlook.

Growth expectations in China have softened in 2015 as the Chinese economy transitions to a “new normal” that relies more heavily on domestic consumption and less on traditional channels such as exports, real estate investment, and government investment. Questions linger about exactly how much Chinese growth will decelerate in the near and medium term. Recent estimates from the World Bank forecast growth of approximately 7 percent in 2015, with small slowdowns expected through 2017. Recent financial turmoil in China has further increased the market’s concern about the Chinese growth outlook. In short, expected growth over the next several years is substantially slower than the double-digit growth achieved in recent years.

The conventional wisdom on how China influences the global economy is through trade linkages. A slowdown in China’s growth has sizable effects on the economies from which it imports, such as core European countries and many emerging economies, which then spill over to other countries that export to these regions. In contrast, the Chinese financial sector has been historically isolated from the rest of the world due to tight capital controls, limiting the impact of Chinese capital flows on the global economy. However, in recent years, the Chinese government has started to relax capital controls. Eased restrictions on capital flows, combined with lower growth expectations and a declining return to capital in China, have generated large capital outflows (Chart 1). In 2014-15, China experienced five consecutive quarters of capital outflows for the first time since 2000, and the annual volume of outflows is at a record level. If growth expectations continue to soften, this trend may continue in the near future.

Chart 1: Chinese capital flows



Note: Capital flows are approximated by the change in quarterly average foreign-exchange reserves minus the current account balance. A negative value refers to capital outflow.

Sources: International Monetary Fund, State Administration of Foreign Exchange, and Haver Analytics.

A significant portion of the recent surge in capital outflows from China is attributable to a rising amount of loans leaving China (Chart 2). The exit of loans is due to both an increase in Chinese loans to the rest of the world and an increase in foreign loans withdrawn from China. Since mid-2014, total loans leaving China account for about 40 percent of the total volume of capital outflows. While striking in magnitude, aggregate statistics on the Chinese financial account do not provide information about the destinations of the loans made, nor the origins of loans withdrawn.

Another significant source of Chinese capital outflows is the continued increase in foreign direct investment (FDI) (Chart 2). Similar to the exit of loans, we cannot observe the destination of Chinese FDI directly from financial account data. However, observed cross-border merger and acquisition activity offers a useful alternative to the financial account, which can be used to infer the direction of inbound and outbound FDI flows. Rather than providing only an aggregate picture, merger and acquisition activity provides information about investment activities within specific industries, and tracks the origin and destination of merging firms. The overwhelming majority of foreign direct investment occurs through cross-border merger and acquisition activity, ensuring that observed activity captures salient features of global investment patterns.

Chart 2: Investment and loan flows from China

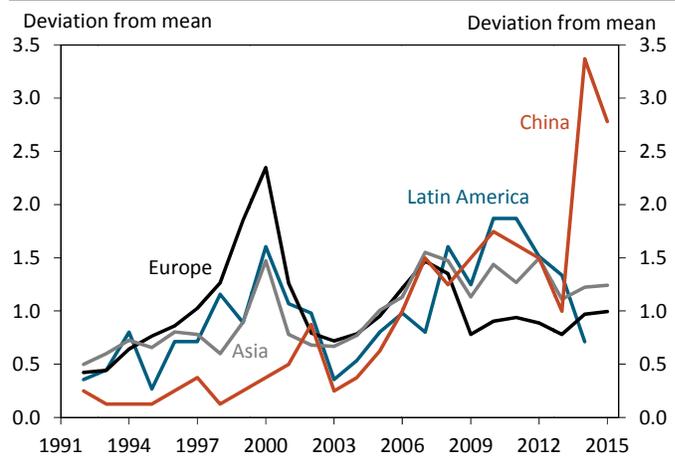


Source: China's State Administration of Foreign Exchange (SAFE).

Chart 3 illustrates cross-border merger and acquisition activity into the United States across all industries, excluding activity by financial holding companies. The lines in the chart correspond to real foreign direct investment from different geographical regions. The number of cross-border acquisitions of U.S. establishments from each region is plotted relative to its overall mean (=1). In the last half of 2014 and the first half of 2015, U.S. inbound acquisition activity from China spiked to more than three times its historical average. In other words, a portion of the capital flowing out of China recently has been absorbed by real investment within U.S. industries.

How do capital outflows from China affect the countries that absorb them, in particular the United States? The extent to which the United States absorbs Chinese capital flows partially reflects the strength of the U.S. economy. Going forward, if the slowdown in China is larger than currently expected and the resulting capital outflow continues to be absorbed by U.S. industries and financial markets, then investors will need to compete more aggressively for viable domestic opportunities. As a result, more projects could be funded than would have been absent such capital flows, leading to greater U.S. investment activity. Though, greater competition for the most attractive opportunities will also likely lead investors to accept a lower return. Combined, these effects suggest that higher capital

Chart 3: U.S. inbound mergers and acquisitions activity



Note: Transactions involving financial holding companies are excluded. Source: Thomson Reuters.

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inflows into the U.S. may be beneficial for supporting investment activity in the near term, but also may pose a risk if markets underprice risks associated with less attractive investment opportunities.

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