

MIZUHO CHINA MONTHLY

China's Economy	1
China has started to prioritize stability	
Industrial and Regional Policies	10
The expansionary trend in China's outbound FDI under the Belt and Road strategy and the outlook for the future	
Part 1: An Overview	
News from the China Advisory Department	24
Comparison Between the Current Situation and the Time of the Chinese Financial Crisis from the Viewpoint of Capital Outflow	

October 2018 Edition

Mizuho Bank, Ltd.
Mizuho Bank (China), Ltd.

China Business Promotion Department
Advisory Department

- Executive Summary -

China's Economy	China has started to prioritize stability
<p>It is getting harder to ignore that the Chinese economy will face downward pressure from measures to control financial risk and US/China trade frictions. Uncertainty is particularly high when it comes to the latter, with concerns about the future economic stability within China. After recognizing this situation, the Chinese government announced measures that placed more emphasis on stability when it comes to economic policy management. From here on, it will probably make effort to maintain the economic stability through more supportive fiscal and monetary policy, such as the expansion of tax cuts, accelerated government spending, and the provision of sufficient liquidity. The emphasis on stability may lead to a delay in deleveraging and financial system reform as well as overheating in the real estate market. All this might inadvertently serve to preserve several unhealthy aspects of the Chinese economy, with the risk of Chinese economic destabilization dragging on into the long-term, so caution will be required.</p>	
Industrial and Regional Policies	The expansionary trend in China's outbound FDI under the Belt and Road strategy and the outlook for the future Part 1: An Overview
<p>Ranked the world's second largest foreign direct investment (FDI) recipient after the United States, China, which has accepted large amounts of foreign investment, has also seen rapid increases in outbound FDI and in 2015 it reached the number-two position in global rankings. Whilst it slipped to third place in 2017, it leaped from sixth to second place in the investment balance league table, with outbound FDI topping inbound FDI for the third year running (all figures are based on Chinese government statistics). This report offers an overview of the expansionary trend in China's outbound FDI against the progress on its Belt and Road strategy and escalating trade friction with the United States, examines the investment trends of Chinese companies in major regions of the world, considers background factors and the orientation of corporate investment strategies and, having elucidated the outcomes and issues involved, explores adjustments to and future directions for Chinese outbound FDI strategies in its transition to sustainable economic growth.</p>	
News from the China Advisory Department	Comparison Between the Current Situation and the Time of the Chinese Financial Crisis from the Viewpoint of Capital Outflow
<p>Since the beginning of 2018, the SSE Composite Index fell significantly, while the Chinese yuan depreciated in the foreign exchange market due to the trade frictions between the U.S. and China, as well as due to concerns over economic downturn. Thereafter, the People's Bank of China re-introduced a series of measures to control the depreciation of the Chinese yuan, which reminds us of the depreciation of Chinese stocks and the Chinese yuan observed in August 2015, as part of what is known as the "China Shock." At around the same timing, capital outflow from the Chinese domestic market became a serious problem. This article examines the recent depreciation of Chinese stock prices and the Chinese yuan from the viewpoint of capital outflow.</p>	

China has started to prioritize stability

The risk of Chinese economic destabilization could drag on into the long-term if reforms are pushed back

**Yusuke Miura: Senior researcher
China Unit, Research
Department-Asia
Mizuho Research Institute Ltd.**

1. Domestic troubles and external threats pose risks that could destabilize the Chinese economy

At +6.7% y-o-y, China's real GDP growth in April–June 2018 was only down slightly on the previous quarter (+6.8% y-o-y), with the economy still seemingly growing at a stable pace. However, there are actually some deep-rooted economic uncertainties and it is getting harder to ignore the downside risks these present. There are two main factors behind these risks: measures to control financial risk within China (domestic troubles) and trade frictions with the US (external threats).

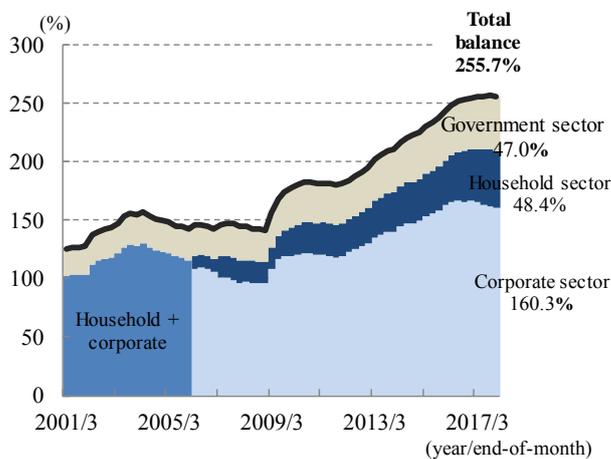
(1) Domestic troubles: Measures to control financial risk are already starting to exert downward pressure on the real economy

We turn first to measures to control financial risk within China. These measures can be divided into two main categories: (1) the regulation of the shadow banking sector (which has become a channel for procuring funds through non-bank sources) and (2) deleveraging. As for (1), the authorities slowly started to guide short-term interest rates higher from August 2016. These efforts were stepped up in 2017, with the China Banking Regulatory Commission (as it was known at the time) conducting intensive inspections of commercial banks, for example, while the People's Bank of China (PBOC) strengthened its control and oversight via the Macro Prudential Assessment (MPA) framework. The Central Economic Working Conference then placed controlling financial risk at the top of its list of key policy issues to be tackled in the three years until 2020. As a result, the authorities have continued to pursue system development and other initiatives entering 2018. A particularly influential document is the *Guiding Opinions on Regulating the Asset Management Business of Financial Institutions* (promulgated in April this year), which covers a wide range of financial business activities that form the basis of the shadow banking sector, including the wealth management products (WMP) offered by commercial banks and the asset management operations of non-banking financial institutions (NBFIs).

As for (2), deleveraging was adopted as a key economic policy in 2016 in tandem with efforts to eliminate overcapacity, for example, with moves in this direction picking up in earnest thereafter. In October 2016, the government also released its basic plan for deleveraging in the corporate sector (*Opinions on Vigorously, Steadily and Properly Reducing Corporate Leverage Ratios*). China subsequently succeeded in putting a halt to rising leverage ratios across the entire non-financial sector (Fig. 1), so in 2018 the government announced it would now focus on the deleveraging of state-owned enterprises (SOEs) and local governments, based on its 'structural deleveraging' plan. Local governments were given permission to issue local-government bonds in 2015, but they also built up substantial 'hidden debt' through PPPs or the private-sector supply of public services, for instance. As a result, the authorities launched regulation initiatives and moves to grasp the actual situation, etc. from mid-2017 onwards.

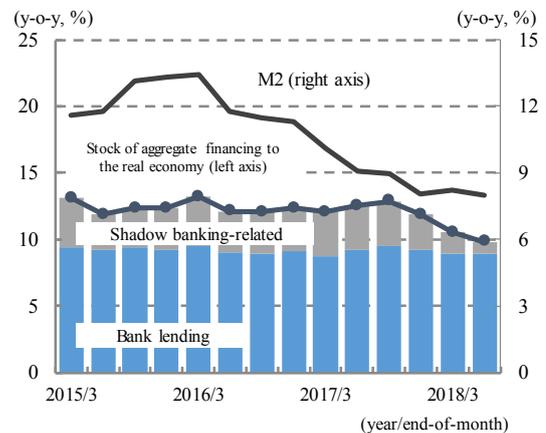
These ongoing, ever-tougher measures to control financial risk are gradually starting to exert downward pressure on the real economy. For example, lending rates have slowly risen and funding from the shadow banking sector is tapering off (Fig. 2). Private companies and small and micro enterprises face higher bank borrowing rates and they also rely more on the shadow banking sector compared to SOEs, so these shifts have made it harder for them to raise funds, with some private enterprises even defaulting. Furthermore, the moves have also made it harder for local government finance platforms to raise funds via the shadow banking sector. An investigation of nationwide PPPs revealed many projects with problems, with the Ministry of Finance excluding a number of PPPs from a project list it compiles. As a result, infrastructure investment (which had previously helped to bolster the economy) dipped into negative territories on a real y-o-y basis over April–June 2018.

Fig. 1. The non-financial sector debt balance to GDP



Note: The most recent figure = as of the end of December 2017
 Compiled by Mizuho Research Institute from BIS materials

Fig. 2. The stock of aggregate financing to the real economy and M2

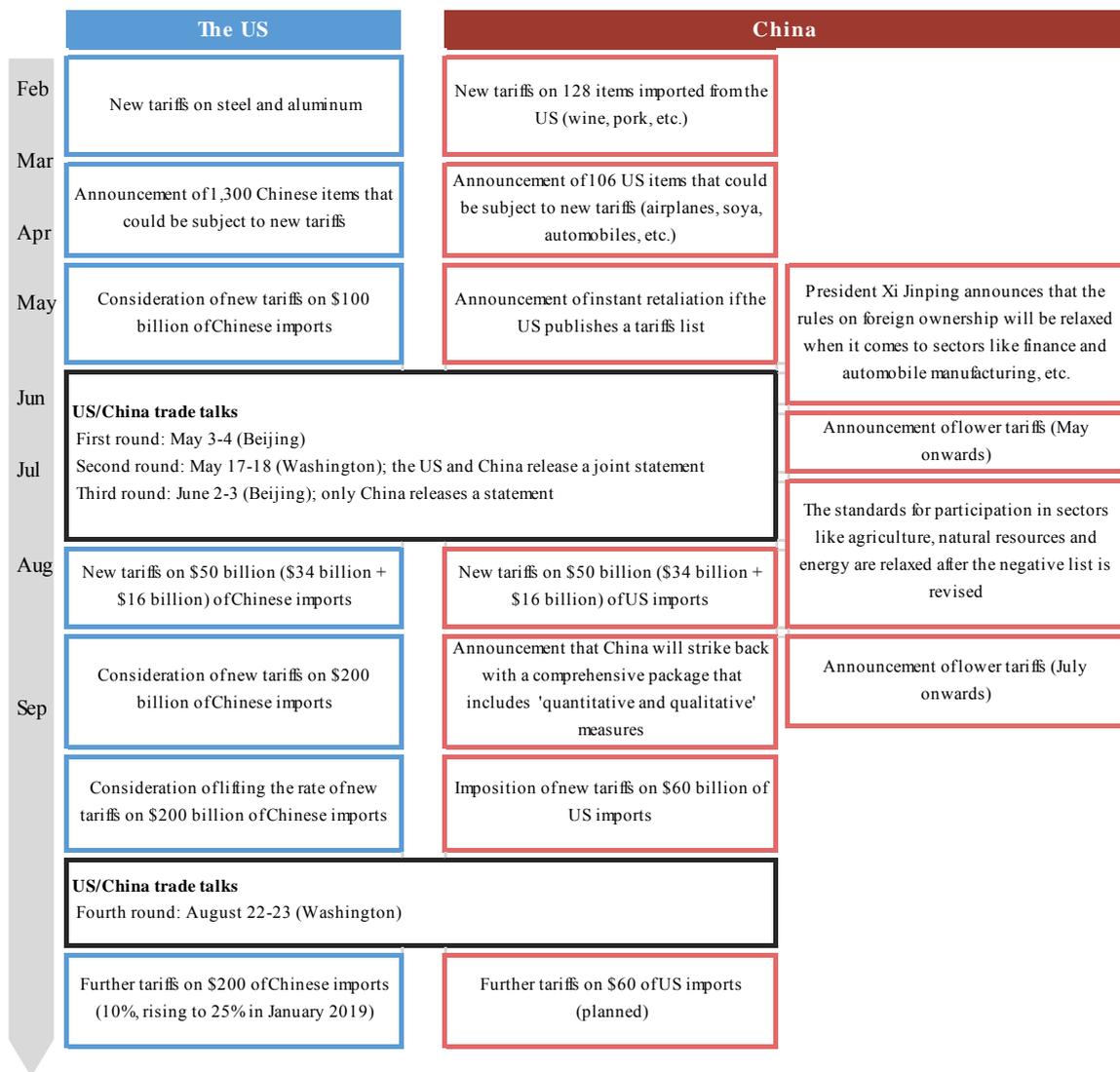


Note: The most recent figure = as of the end of June 2018; ‘shadow banking-related’ refers to the sum total of entrusted loans, trust loans, banker’s acceptances and corporate bonds (it does not include equity finance).
 Source: Compiled by Mizuho Research Institute based on materials from the PBOC and CEIC Data

(2) External threats: Trade frictions with the US are becoming a major concern as a potential risk factor from here on

Next, we turn to trade frictions with the US. From the launch of the Trump administration in October 2016 to 2017, China and the US held a series of heads-of-state meetings and cabinet-level talks. During this period, no major volatile factors emerged on the economic management front. In February 2018, though, risk flared up when the US announced it was placing new tariffs on steel and aluminum imports from its major trading partner countries and regions, including China (Fig. 3).

Fig. 3 Major events related to US/China trade frictions (from February 2018)



Source: Compiled by Mizuho Research Institute from various materials

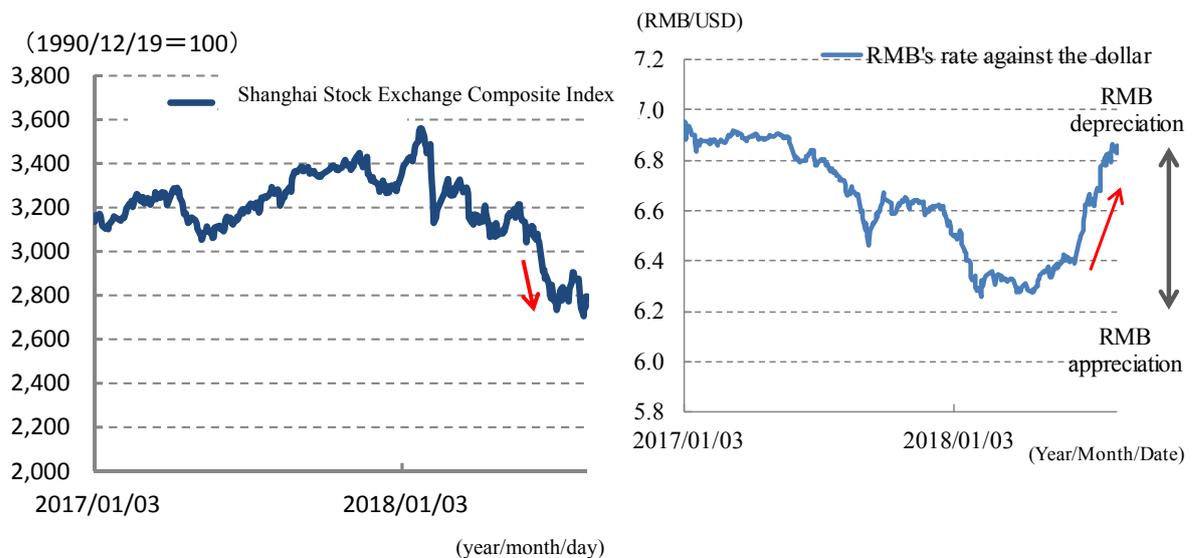
The US ratcheted up the pressure on China in March when it began looking into the imposition of new tariffs on Chinese imports worth around \$50 billion. China reacted to this tougher stance by announcing measures to open up and increase imports while indicating a desire to resolve the issue through talks. However, it also warned that it was ‘not afraid of a trade war’ and it published a list of US imports that would be subject to retaliatory tariffs.

While pursuing this carrot-and-stick approach, China held three rounds of talks with the US from May to the start of June, with hopes for a resolution rising. In the end, though, the talks failed to produce any concrete results. As a result, the US imposed new tariffs on Chinese goods at the start of July, with China then introducing its own retaliatory measures. This tit-for-tat battle continued thereafter, with the US announcing it would place new tariffs on \$200 billion of Chinese imports, for example. High-level trade talks then took place at the end of August, but there are still no signs of the frictions calming down, with the US ultimately deciding to impose the tariffs, for instance.

Concerns about these ongoing tensions are destabilizing the financial markets. Fears about the future flared up following the US decision on June 15 to place new tariffs on \$50 billion of Chinese imports. As a result, by the close of day on June 19, Shanghai Composite index were down -3.8% on the previous day, with the RMB also sliding against the dollar (Fig. 4). PBOC head Yi Gang and others have since called for a rational response, citing China's strong fundamentals, for example. With the authorities also intervening in the currency markets, stock prices have been shored up and the RMB's ongoing slide has been halted. Market participants remain uneasy, though, with stocks and the RMB still facing downward pressure.

The real economy is also expected to gradually face more downward pressure from here on due to falling exports or rising prices, for instance. The US and China have already slapped new tariffs on imports worth \$50 billion. If things stop here, the impact on exports will be limited. However, if further tariffs are imposed on \$200 billion of imports, exports will probably face more downward pressure, with capital investment also hit as sentiments worsen. As such, trade frictions with the US are becoming a major concern as a potential risk factor from here on.

Fig. 4 The Shanghai Stock Exchange Composite Index and the RMB's rate against the dollar



Note: The most recent figure = August 10, 2018

Source: Compiled by Mizuho Research Institute based on materials from CEIC Data

2. The focus of Chinese economic policy management is gradually toward maintaining stability

Amid growing concerns about increased economic instability, China held two key meetings in July, namely the State Council executive meeting on July 23 and the Central Politburo meeting on July 31. The Chinese authorities used these meetings to stress the need to 'keep the economy operating within rational bounds' with a focus on maintaining stability. The Central Politburo meeting also adopted 'keeping the economy on a stable and healthy development track' as its main priority while announcing efforts to 'keep employment, the financial sector, foreign trade, foreign and domestic investments, and expectations stable.'

The authorities seem particularly worried about the impact of the US/China trade frictions. It seems they

regard measures to control financial risk as a matter of domestic policy, so even if these measures lead to slower economic growth, this impact can be controlled by adjusting these measures, for instance. With US/China trade frictions, though, China has to respond to actions taken by the US. This makes this factor the subject of considerable uncertainty and thus harder to control. With this situation not improving, it seems the Chinese authorities have grown more concerned about the future. In fact, the Central Politburo meeting also talked about changes in the external environment. It indicated that although the economy was moving stably, ‘there have been some shifts and the economy faces some new problems and new challenges, with the external environment also undergoing some clear changes.’

Fiscal and monetary policy will play a key role in maintaining stability. The policy measures raised at these meetings are outlined below alongside a projection for the future.

(1) Fiscal policy: In addition to tax cuts and an acceleration of existing projects, the authorities might expand the usage of off-budget financing

When it comes to fiscal policy, China has placed an ‘active fiscal policy’ as its basic policy for this year. The State Council executive meeting called for this to be pursued in a ‘more proactive’ manner, while the Politburo meeting also said that fiscal policy should “play a greater role in expanding domestic demand and structural adjustment.” All this suggests that the deficit-to-GDP ratio might be expanded beyond the 2.6% target announced at the start of the year. Speaking about the goal of pursuing a ‘more active fiscal policy’ during a press conference on July 26, China’s vice-minister of finance said the authorities could tweak policy to meet new circumstances while further increasing the assignment of policy measures.

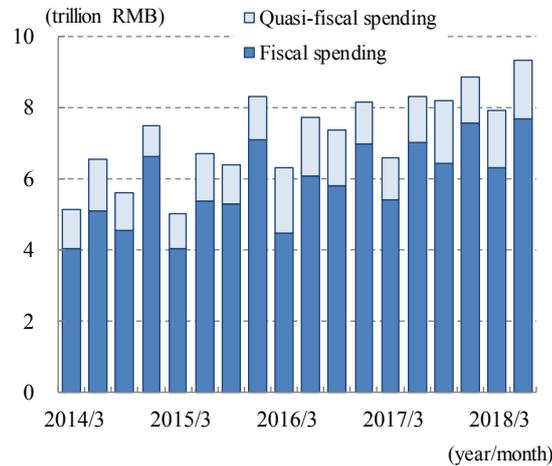
Specific policy measures are likely to include further tax cuts (a priority area for this year’s fiscal policy) and an acceleration and expansion of government spending. The National People’s Congress pledged to cut corporate taxes and fees by RMB 1.1 trillion (RMB 800 billion in tax cuts and RMB 300 billion in reduced fees) when it released its budget proposal this March. The authorities have now moved to the stage of implementing several policies in succession, but the aforementioned State Council executive meeting also pledged to cut taxes by an additional RMB 65 billion through an expansion of the R&D tax credit scheme.

With regards to government spending, meanwhile, the authorities are mainly expected to accelerate planned or ongoing infrastructure construction projects, with a focus on ‘expanding domestic demand.’ Specific measures announced by the State Council executive meeting include issuing special bonds for local governments (planned RMB 1.35 trillion a year) and accelerating the usage of procured funds, for example, as well as providing the necessary funds to local government finance platforms for ongoing construction projects.

In addition to issuing government bonds and local government bonds to cover budget deficits, the Chinese government has other ways of raising funds for fiscal policies. These include: various corporate special bonds approved by the National Development and Reform Commission (NDRC) for the purposes of promoting the development of certain industries, etc.; railroad construction bonds (railway bonds) issued

by the China Railway Corporation; the aforementioned corporate bonds issued by local government finance platforms (municipal corporate bonds); and bonds issued by policy financial institutions. Though the state is not the main body behind these issuances, these bonds are effectively a ‘quasi-fiscal’ form of funding (Fig. 5). From here on, the authorities may expand infrastructure spending by increasing this kind of off-budget financing¹.

Fig. 5 Fiscal spending and quasi-fiscal spending



Note: Fiscal spending = the sum total of budget expenditures and government-managed funds expenditures. Quasi-fiscal spending = the sum total of new issuances of policy finance bonds, municipal corporate bonds, railway bonds, and corporate special bonds approved by the NDRC.

Source: Compiled by Mizuho Research Institute based on materials from the Chinese Ministry of Finance, CEIC Data and Wind.

(2) Monetary policy: Policy has been revised from ‘prudent and neutral’ to just ‘prudent,’ with the scope of accommodation also widened

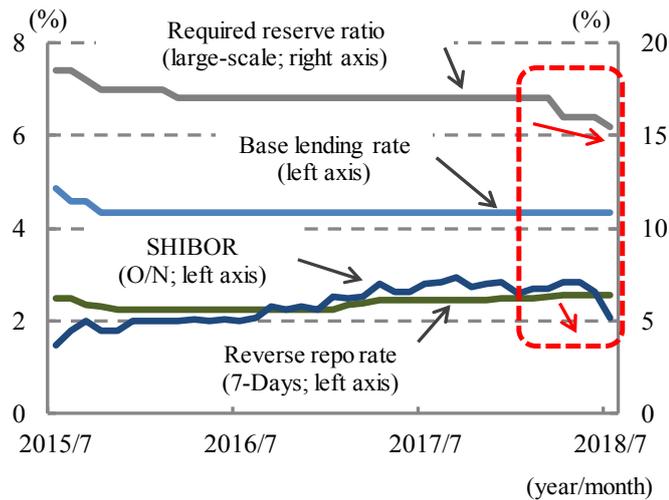
At the beginning of the year, China announced it would ‘maintain a prudent and neutral monetary policy while easing and tightening policy in an appropriate manner.’ The ‘neutral’ aspect was adopted in 2017, but this was revised at the State Council executive meeting and the Central Politburo meeting, with the former pledging to ‘maintain a sound a monetary policy while easing and tightening policy in an appropriate manner’ and the latter pledging to ‘stick firmly to a prudent monetary policy.’ When it came to liquidity provision, meanwhile, the authorities shifted from a policy of ‘firm management’ to one of ‘firm monitoring,’ while the level of liquidity (provided to financial institutions) was revised from ‘reasonable and stable’ to ‘reasonable and ample.’

As mentioned above, from the latter half of 2016, the Chinese government inclined policy in a slightly tighter direction (by guiding short-term interest rates to high levels, for example) in order to prevent financial risk, before then adopting a ‘prudent and neutral monetary policy’ from 2017. Since entering 2018, though, China’s monetary policy management has been marked by a series of accommodative measures. This trend was also confirmed by a shift in monetary policy. In particular, while maintaining base lending

¹ At the start of August, media reports stated that the amount spent on railway construction could be upgraded from the initial annual plan of RMB 732 billion to RMB 800 billion. However, it is unclear whether this will be covered from the government’s budget or by the issuance of railway bonds.

rates and reverse repo rates at a certain level, the authorities lowered required reserve ratio three times in January, April and July (Fig. 6). In June, meanwhile, the PBOC announced it would expand the range for acceptable collateral for the Medium-term Lending Facility (MLF) to include corporate bonds rated AA+ or AA (it was previously just bonds rated AAA), for instance. This was done to encourage financial institutions to lend to these firms. Furthermore, in July the Shanghai interbank interest rate (SHIBOR) was lowered, while the PBOC provided substantial funds via the MLF on July 23 (the same day the State Council executive meeting opened).

Fig. 6 The required reserve ratio and key interest rates



Note: The required reserve ratio applies to all financial institutions. The cut in January 2018 was only aimed at certain institutions, so it is not reflected in this graph.

Source: Compiled by Mizuho Research Institute based on materials from the PBOC and CEIC Data

From here on, the authorities will probably continue to manage monetary policy in the same way in order to maintain the stability of the real economy and the financial system. Specifically, they are expected to provide liquidity to the real economy by cutting the required reserve ratio again and utilizing the MLF, for example, while continuing to control credit with a greater focus on financial institution liquidity. As for other monetary policy means, it seems likely base lending rates will be kept fixed for now owing to the substantial signaling effect on the markets.

Though policy is expected to remain focused on controlling financial risk, the authorities are unlikely to adopt any measures drastic enough to threaten stability. The Central Politburo meeting stated that “China must better combine the task of forestalling and defusing financial risks with serving the real economy...while firmly grasping the intensity and tempo of policy.” This suggests the authorities will consider the negative impact on the economy when planning and designing policies and adjusting the pace of reforms.

3. The risk of Chinese economic destabilization could drag on into the long-term if reforms are pushed back, so caution will be needed

Based on the above, it seems the Chinese authorities will manage economic policy with a focus on maintaining stability as they try to prevent the economy from being destabilized (by US/China trade

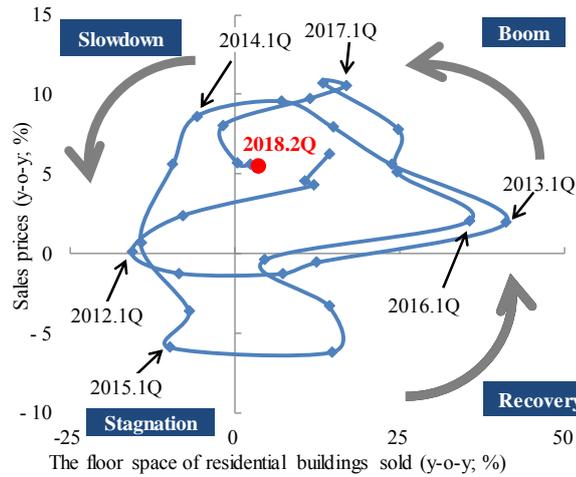
frictions in particular). The State Council executive meeting said China would 'not resort to a deluge of strong stimulus policies,' thus signaling that the government would refrain from taking any excessive measures to boost the economy. However, the policy of prioritizing stability will require monitoring to see if it produces any side effects.

For example, one worrisome factor from here on will be whether the government slips behind when it comes to its ongoing deleveraging efforts. As mentioned above, the non-financial sector debt balance to GDP (a representative indicator of leveraging conditions) has stopped rising. However, this is mainly because GDP grew at a fast clip in 2017 on healthy external demand rather than because the debt balance has shrunk. If the outstanding debt of SOEs and local governments expands more than necessary as the government steers monetary policy in an accommodative direction to support the economy through infrastructure spending, there are concerns this could slow the pace of deleveraging.

There are also concerns about the impact of financial system reforms on the RMB's exchange rate or capital transaction reforms, for example. After the launch of the Xi administration's first term, China moved to make the RMB's exchange rate more market-driven, but the RMB's rate against the dollar plummeted after the method of calculating the central parity rate mechanism was revised on August 11, 2015 to make it more market-oriented. After that, China introduced a number of measures that ran counter to the goal of 'marketization.' These included introducing a foreign exchange risk reserve requirement, introducing a counter-cyclical factor to control one-sided foreign-exchange movements, and strengthening capital outflow restrictions. The RMB subsequently faced less downward pressure and it appreciated, so the authorities moved to phase out or relax these measures. However, the RMB has begun sliding again, so the PBOC reintroduced the foreign exchange risk reserve requirement on August 10 and the counter-cyclical factor on August 24 (a day when the exchange rate approached seven RMB to the dollar). All this suggests concerns are becoming a reality.

In addition, the impact on the housing market, which has been moving bullishly again from the end of 2017, mainly due to brisk housing sales in regional cities will also require monitoring (Fig. 7). One reason for the recent sales recovery was the payment of compensation in relation to the redevelopment of urban barrack zones, but the government has already begun to adjust this policy. The Central Politburo meeting also pledged to 'resolutely rein in rising house prices' based on a policy of 'strengthening the resolve to tackle the problems of the real estate market.' As such, it seems house buying restrictions and so on will also be extended to regional cities from here on. However, if the government cannot adequately control how funds are used after boosting the supply of funds through adjustments to monetary policy, this might prompt a flood of money into the housing market and this could lead to overheating.

Fig. 7 The floor space of residential buildings sold and prices



Note: The movements of newly-constructed commercial house prices. House prices = the average of 70 cities; the floor space of residential buildings = the nationwide figure.

Source: Compiled by Mizuho Research Institute based on materials from China's National Bureau of Statistics and CEIC Data

During the Xi administration's second term, the government has been prepared to tolerate an economic slowdown as it prioritizes structural reform. However, it seems that the US/China trade frictions have thrown a spanner in the works. If the reform program stagnates, this might inadvertently serve to preserve several unhealthy aspects of the Chinese economy, with concerns about the increase of future risks. As such, maintaining a balance between reform and stability remains a pressing issue. As mentioned above, the US/China trade frictions are unlike anything the government faced during the Xi administration's first term in the sense that they are difficult for China to control and thus pose a huge destabilizing threat. For this reason alone, the Xi administration might push back reforms for now as it prioritizes economic stability, with the risk of Chinese economic destabilization dragging on into the long-term, so this issue will also require monitoring.

Outbound FDI under the Belt and Road Strategy and the Outlook for the Future Part 1: An Overview

Yongyu Shao, Ph.D. and Economist
China Business Promotion
Department
Mizuho Bank, Ltd.

A New Phase in China's Outbound FDI

For many years now, China has ranked as the world's second largest foreign direct investment (FDI) recipient after the United States (top of the developing countries), but its outbound FDI has also increased rapidly in recent years. According to Chinese government statistics, the momentum in outbound FDI growth is approaching that of direct investment from overseas (inbound FDI), reaching US\$102.9 billion in 2014, or 86 percent of the latter. Outbound FDI topped inbound FDI in 2015, hitting a record high of US\$196.15 billion in 2016 (an increase of 34.7% over the previous year and more than 9 times higher than the figure for 2006, a decade earlier) and demonstrating an upward trend that is far stronger than that in inbound FDI (though outbound FDI declined by 19.3% in 2017 to US\$ 158.29 billion. **Figure 1**).

Figure 1: Trends in China's FDI/ flows (inbound/outbound)

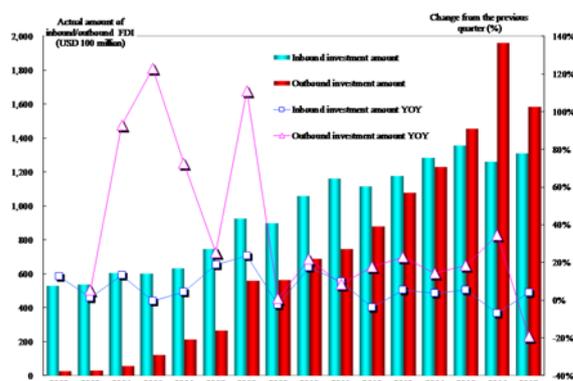
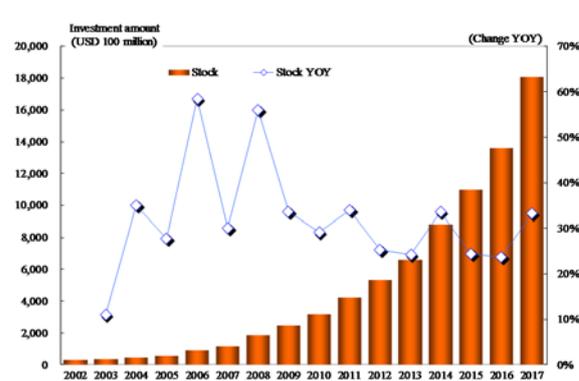


Figure 2: Trends in China's outbound FDI on a stock basis



Source: Compiled from respective yearly editions of **Statistical Bulletin of China's Outward Foreign Direct Investment**, published by the Ministry of Commerce (MOFCOM), National Bureau of Statistics (NBS) and State Administration of Foreign Exchange (SAFE).

Source: As for Figure 1.

According to the United Nations Conference on Trade and Development (UNCTAD) **World Investment Report 2018** (Chinese version), which was released on September 7 in Xiamen, China was the second largest recipient of inbound FDI in 2017 after the United States, with inflows reaching US\$ 136 billion, and whilst outbound FDI decreased to US\$ 125 billion, China has ranked third globally since 2013 and it retained its position at the top of the ranks of developing and transition economies. Specifically, the latest government statistics on accumulated outbound FDI as of the end of 2017 show China moving up to second place in world rankings (**Figure 2**)².

² According to an official report: **The 2017 Statistical Bulletin of China's Outward Foreign Direct Investment**, which was released by the Ministry of Commerce at a press conference on September 28, China's accumulated outbound FDI reached over US\$ 1,809.04 trillion at the end of 2017, accounting for 5.9 percent of the world's total, with China investing in 189 countries and regions worldwide. China's accumulated outbound FDI increased by US\$ 451.65 billion over the previous year moving it from fourth to second place in the global

This growth in China's outbound FDI is closely linked aggressive support measures and regulatory easing by the government (**Table 1** and **Table 2**) that can be broadly traced across the following five stages. The first stage (1979-1995) broadly spans the early years of China's **Reform and Opening Up** policy to the final year of its Eighth Five-Year Plan. At the time, introducing foreign capital was a major policy objective, the international expansion efforts of Chinese corporations were subject to rigorous government scrutiny and were small in scale due to lack of experience and insufficient foreign currency funds. The second stage (1996-1999) essentially spans the years of China's Ninth Five-Year Plan. During this phase and partly as the result of the Asian currency crisis, the government encouraged international expansion through the processing trade as a means of acquiring foreign currency and large state-owned enterprises were primarily responsible for the growth in outbound FDI. The third stage (2000-2005) corresponds to the Tenth Five-Year Plan period, a period of stable high growth in the Chinese economy. Then president, Jiang Zemin, launched the **Go Out** (also referred to as the **Going Global**) strategy to promote international expansion and to supplement the **Bring In** strategy (which was designed to attract foreign investment), which resulted in further growth in outbound FDI as the government eased approval procedures and introduced measures to support overseas business expansion by its enterprises.

Table 1: The development of major government measures to promote and administer outbound FDI

No.	Date promulgated	Issuing organ	Title of Measures
1	Jan. 2009	MOFCOM	Foreign Investment Administration Measures
2	May 2009	MOFCOM	Measures for the Administration of Investment in Taiwan by Mainland Enterprises
3	Oct. 2010	MOFCOM	Several Opinions on Encouraging and Supporting Foreign Company Buyouts by Service Outsourcing Enterprises
4	Feb. 2012	MOFCOM	Guidelines on Managing the Safety of the Employees of Overseas Chinese Enterprises Overseas
5	May 2012	MOFCOM, etc.	Several Opinions on Establishing a Chinese Corporate Culture Overseas
6	Jul. 2012	NDRC	12 th Five-Year Plan for Foreign Capital Utilization and Overseas Investment
7	Oct. 2012	CIRC	Detailed Regulations on the Implementation of the Interim Measures on the Administration of Overseas Investment of Insurance Capital
8	Oct. 2012	MOFCOM	Notice on Outward Investment Cooperation Management by Chinese Enterprises and Organizations
9	Nov. 2012	SAFE	Notice on the Simplification of Foreign Exchange Administration Rules on Direct Investment
10	Dec. 2012	MOFCOM	Country and Region-specific Guidelines on Outward Investment Cooperation
11	Feb. 2013	MOFCOM and MEE	Environmental Protection Guidelines for Outward Investment Cooperation
12	Mar. 2013	MOFCOM	Provisions on Competitive Acts in the Field of Outward Investment Cooperation
13	Apr. 2013	MOFCOM	Notice on Strengthening the Delivery of Go Out Information

rankings (People's Daily, September 29, 2018).

No.	Date promulgated	Issuing organ	Title of Measures
14	Sep. 2013	MOFCOM	Trial Measures on the Keeping of Bad Credit Records in the Fields of Outward Investment Cooperation and Foreign Trade
15	Nov. 2013	MOFCOM	Notice on the Classification and Administration of Outward Investment Cooperation Overseas Personnel
16	De. 2013	MOFCOM and CDB	Notice on Issues Relating to Supporting the Construction and Development of Overseas Economy and Trade Zones
17	Sep. 2014	MOFCOM and CDB	Foreign Investment Administration Measures (revision of the 2009 edition)
18	Feb. 2015	SAFE	Notice on the Further Simplification and Improvement of Rules on Foreign Exchange Administration Policy relating to Outward Direct Investment
19	Mar. 2015	NDRC, MFA and MOFCOM	Vision and Actions on Jointly Building the Silk Road Economic Belt and 21 st Century Maritime Silk Road (One Belt, One Road)
20	May 2015	State Council	Opinions on Promoting International Cooperation in Production Capacity and Equipment Manufacture
21	Dec. 2015	MOFCOM	(Trial) Administrative Measures for Overseas Technical Assistance Projects
22	Dec. 2016	State Council	Notice on the Issuance of Government-approved Investment Project Records
23	Aug. 2017	NDRC, MOFCOM, and PBOC, etc.	Notice on the Guiding Opinions on Further Guiding and Regulating the Direction of Overseas Investments
24	Dec. 2017	NDRC, MOFCOM, PBOC, etc.	Regulations on Overseas Investment by Private Enterprises
25	Dec. 2017	NDRC	Administrative Measures on Enterprise Outward Investment
26	Jan. 2018	MOFCOM, PBOC, SASAC, etc.	Notice on Provisional Measures on Reporting for Outbound Investments subject to Record Filing/Approval
27	Apr. 2018	NDRC, MOF, etc.	Guiding Opinions on Guiding the Healthy Development of Foreign Investment Funds
28	Jul. 2018	State Council SASAC	(Trial) Implementing Measures on the Responsibility for Investment Management arising from Breaches of Discipline by Central Enterprises

Source: Compiled from various Chinese government websites.

Note: The table lists related measures that have been issued since 2009, but is not all inclusive.

Table 2: Moves by China to further ease the regulations governing outbound FDI

Year	Method of regulation	Examination and approval authority
Prior to 2004	Review and approval	Investments exceeding US\$ 1 million must be examined and approved by the NDRC.
Jul. 2004	Confirmation and approval	Non-resource development projects exceeding US\$ 10 million and resource development projects exceeding US\$ 30 million must be approved by the NDRC or the State Council.
Feb. 2011	Confirmation and approval	Non-resource development projects exceeding US\$ 100 million and resource development projects exceeding US\$ 300 million must be approved by the NDRC or the State Council.
Apr. 2014	Registration + confirmation and approval	Investments and sensitive investments exceeding US\$ 1 billion and resource development projects exceeding US\$ 400 million must be approved by the NDRC or the State Council, but all other projects need only be registered.
Dec. 2014	Registration + confirmation and approval	Sensitive investments require NDRC approval, but all other projects need only be registered.

Source: Compiled from the NDRC Report on China's Outbound Investment (November 2017), People's Publishing House

Stage four (2006-2010) corresponds to the period of the Eleventh Five-Year Plan. This was

also the period of the financial crisis that swept through global financial markets following the bankruptcy of Lehman Brothers in 2008, but China's abundant foreign exchange reserves and the asset impairment sustained by European and American companies meant that China's outbound FDI peaked, led by M&A activity. Stage five (2011-2015) corresponds to the period of the Twelfth Five-Year Plan. With their accumulated international business experience, stronger technological capabilities and financial muscle, and the added pressure of excess capital, the number of Chinese companies in the Fortune Global 500 increased and further progress was made on the road to multinationalization.

China's outbound FDI entered a new phase in 2016, when investment hit a record high (of US\$ 196.15 billion, up 34.7% year-on-year). 2016 marked the start of China's Thirteenth Five-Year Plan, gathering momentum for the Fourth Industrial Revolution and Made in China 2025, China's grand strategy for upgrading its manufacturing industry. With the realization of China's latest vision for international economic cooperation – the Belt and Road strategy, a growing need for industrial relocation brought on by China's structural transformation, and trade friction with America – the global powerhouse in foreign investment, major change was also afoot in the economic environment both at home and overseas.

2. Major factors underpinning and the characteristics of expanding China's outbound FDI

Whilst it is difficult to define outbound FDI, the IMF's Balance of Payments Manual (which deals with balance of payment statistics) defines the direct investment relationship as one in which the parent company owns at least 10 percent of the ordinary shares or voting power of a direct investment enterprise (DIENT)³, and this interpretation is broadly adhered to in Chinese government statistics. In recent years, the drive towards international expansion by Chinese companies has increasingly been discussed in terms of their multinationalization, but these moves are underpinned by complex factors making it difficult to debate the matter without making exceptions. Again, as a country that is both in transition and developing, China's massive outbound FDI and progress on the multinationalization of its companies within an extremely short period of time have attracted strong interest, but there is no genuinely persuasive argument to explain the situation or the key drivers behind it⁴. However, few would object to the argument that factors such as the rapid increase in China's foreign exchange reserves and its surplus of domestic capital equipment, factors that have come with the surpluses in both its current account balance and its capital account balance that are the product of processing trade-led export expansion in former years, have boosted the drive towards international expansion by Chinese companies. The rapid increase in China's foreign exchange reserves is particularly conspicuous and there can be little doubt

³ A textbook on international economics defines international direct investment as the transfer of capital across international borders that is being supplied for the purpose of acquiring a certain percentage of an enterprise's stock so that the investor may participate in the business decisions of the DIENT (Wakasugi Ryuhei, "Kokusaikeizaigau" (International Economics) (in Japanese), Iwanami Shoten, 1996, etc.).

⁴ Marukawa Tomoo, Kajitani Kai, "Keizaiohkokuka no kishimi to inpacuto" (The discord and impact of becoming an economic superpower) (in Japanese), University of Tokyo Press, February 2015

that the quest for ways in which to hedge the risks and utilize these massive reserves following the global financial crisis was an urgent necessity for China.

The data shown in **Table 3** is based on a survey conducted by the NDRC and gives the economic motives underlying outbound FDI by Chinese companies for both state-owned and private enterprises. It shows that whilst China's state-owned enterprises are predominantly looking to acquire market share and technologies, the motives of its private enterprises are more scattered, spanning market share acquisition, technology acquisition and the acquisition of strategic assets, which argues that private enterprises have a greater need and motivation to expand into the international arena.

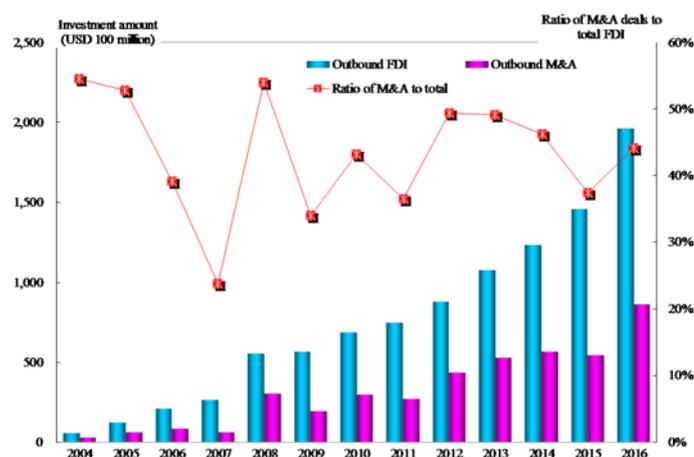
Table 3: Motives for outbound FDI by China's manufacturers

Category	Scale of investment	Private enterprises	State-owned enterprises	Total
Acquisition of market share	Investment projects (No.)	10	11	21
	Ratio (%)	21.7	39.3	28.38
	Amount of investment (100 million USD)	3.09	5.72	8.815
	Ratio (%)	8.3	27.35	15.18
Acquisition of natural resources	Investment projects (No.)	3	1	4
	Ratio (%)	6.5	3.6	5.41
	Amount of investment (100 million USD)	2.938	1.776	4.714
	Ratio (%)	7.9	8.49	8.12
Acquisition of technologies	Investment projects (No.)	14	13	27
	Ratio (%)	30.4	46.4	36.49
	Amount of investment (100 million USD)	6.217	10.425	16.642
	Ratio (%)	16.7	49.85	28.65
Acquisition of strategic assets	Investment projects (No.)	9	2	11
	Ratio (%)	19.6	7.14	14.86
	Amount of investment (100 million USD)	22.722	2.743	25.465
	Ratio (%)	61.1	13.12	43.85
Improvements in productivity	Investment projects (No.)	10	1	11
	Ratio (%)	21.7	3.5	14.86
	Amount of investment (100 million USD)	2.193	0.25	2.443
	Ratio (%)	5.9	1.2	4.21

Source: Excerpted from Bijun Wang and Huiyao Wang "*Chugoku seizokigyō taigaichokusetsutōshi: moshiki, doki, chōsen*" (Foreign Direct Investment by Chinese Manufacturers: Types, Motivations and Challenges). The raw data is drawn from relevant survey data published by the NDRC.

Figure 3 shows that the ratio of outbound FDI in the form of mergers and acquisitions (M&A) hovers at more than 40 percent annually. This is perhaps the most distinguishing feature of China's outbound FDI, with buyouts understood to be a strategy for quickly acquiring a controlling stake, management resources, and/or a product market.

Figure 3: China’s high ratio of outbound FDI in the form of M&As



Source: Compiled from data published by MOFCOM, etc. Percentages are estimates.

Table 4 lists the top ten buyouts of European and American companies by Chinese firms in 2016, the year in which outbound FDI in the form of M&A investment reached its highest level on record. Aside from the sheer size of the acquisition prices, the range of industries covered by the target companies suggests that these Chinese buyers were looking to acquire technologies relating to robotics and machinery and equipment manufacturing. What is also noteworthy is that leading private enterprises, as well as state-owned firms, were amongst the biggest spenders. According to the survey (the data used in Table 4), the acquisition of technologies and R&D capabilities are the leading motives for China’s outbound M&A investment, followed by brand and reputation, with efforts to shore up domestic operations and ensure component supply ranking third and fourth, respectively.

Table 4: A list of China’s top 10 global M&A deals in 2016

I: China’s Top 10 Acquisitions in Europe					
No	Buyer	Company acquired	Acquisition price (billions)	Industry	Country
1	ChemChina	Syngenta	USD 43.0	Agribusiness	Switzerland
2	Tencent	Supercell	USD 7.4	Gaming	Finland
3	Midea Group	Kuka	EUR 3.145	Robotics	Germany
4	Daily Tech, etc.	Global Switch	EUR 2.8	Telecom	U.K.
5	JAC Capital	NXP Standard	USD 2.75	Semiconductor	The Netherlands
6	Hainan Airlines	Avolon	EUR 2.3	Aircraft leasing	Ireland
7	CTRP	Skyscanner	EUR 1.7	Tourism	U.K.
8	Hainan Airlines	Cate Group	USD 1.4	Flight catering	Switzerland
9	Beijing Enterprises	EEW Energy	EUR 1.44	Clean energy	Germany
10	Shandong Ruyi Group	SMCP Group	EUR 1.3	Fashion	France
II: China’s Top 10 Acquisitions in North America					
No	Buyer	Company acquired	Acquisition price (billions)	Industry	Country
1	Bohai Capital Holding	CIT	USD 10	Aviation	U.S.
2	Hainan Airlines	Hilton Group	USD 6.5	Hotels	U.S.
3	Tianjin Investment	Tianhai Ingram Micro	USD 6.0	IT	U.S.

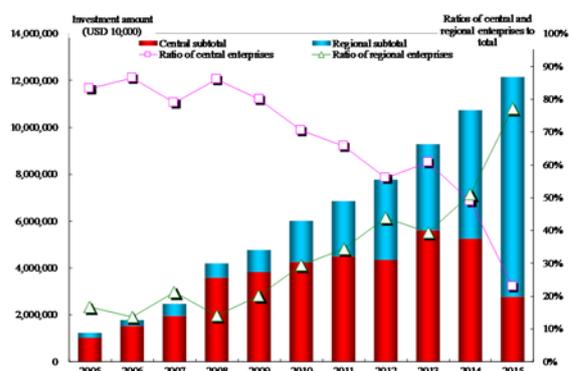
4	Chinese consortium (including Shanghai Giant Network Technology and Alibaba Group Holdings)	Caesars	USD 4.4	Gaming	U.S.
5	Apex	Lexmark	USD 3.9	Manufacturing	U.S.
6	Wanda Group	Legendary Pictures	USD 3.5	Media, entertainment	U.S.
7	Zoomlion Heavy Industry Science and Technology	Terex Corporation	USD 3.0	Machinery and equipment	U.S.
8	China Zhongwang	Aleris Corp.	USD 2.3	Manufacturing (aluminum)	U.S.
9	Weichai Power	Dematic	USD 2.1	Machinery and equipment	U.S.
10	China Life Insurance Company	Starwood Hotels	USD 2.0	Hotels	U.S.

Source: Compiled from <http://www.chinagoabroad.com/zh/article/22555> (in Chinese), etc.

Up until 2013, central enterprises (state-owned) accounted for the majority of China’s outbound FDI, but the scale of investment by regional enterprises began increasing in 2014, and the distribution has now reversed (**Figure 4**).

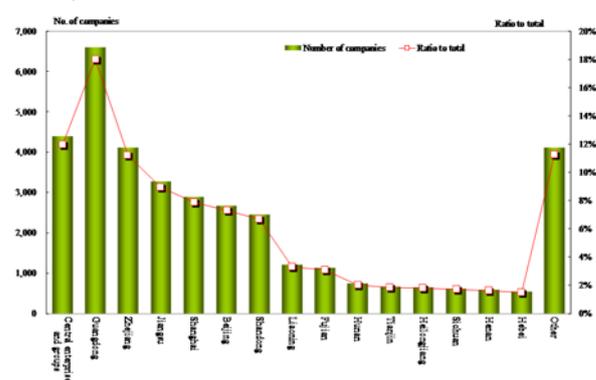
Figure 5 gives a breakdown of the number of companies established outside China by central and regional enterprises (cumulative totals as of the end of 2016). Rather than central enterprises and/or groups, it is Guangdong-based enterprises that are responsible for the largest number of overseas subsidiaries (6,592 or around 18% of the total), this province boasting both a highly developed economy and greater market sophistication, followed by the economically advanced regions of Zhejiang, Jiangsu, Shanghai, Beijing, and Shandong.

Figure 4: The changing presence of central and regional enterprises in China’s outbound FDI



Source: As for Figure 2 and Figure 3

Figure 5: Numbers and ratio-to-total of overseas subsidiaries established by central and regional enterprises (as of the end of 2016)



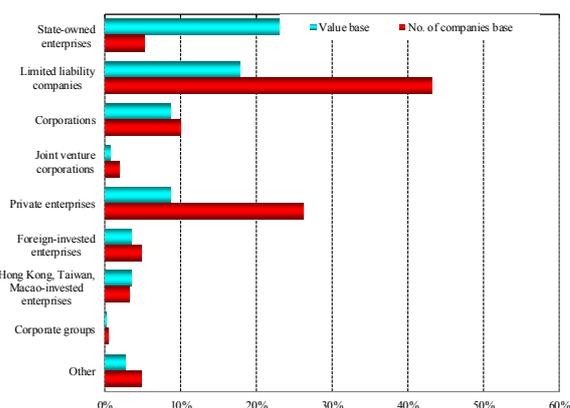
Source: As for Figure 2 and Figure 3

The breakdown of amounts and numbers of investment by type of enterprise given in **Figure 6** is also characteristic. State-owned, limited liability and private enterprises are the top three in terms of investment amounts, but it is limited liability and private enterprises that have established the largest numbers of overseas subsidiaries. The share of subsidiary numbers is considerably larger than the share of investment amounts, suggesting that state-

owned enterprises with their ample capital resources invest more capital per project and are able to establish relatively large companies as a result.

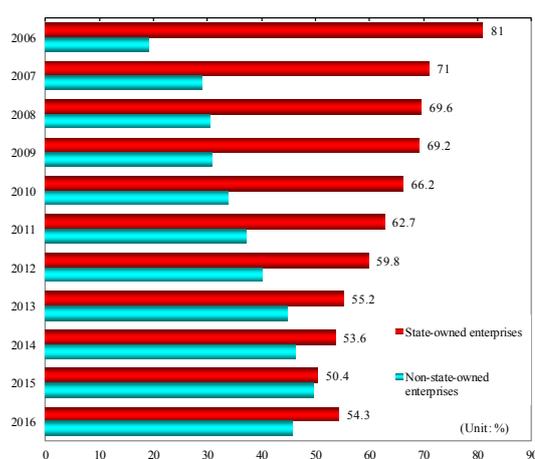
These figures are cumulative, but the data for respective years points to a major shift in the ratio of state-owned and private enterprises (non-state-owned) in China’s outbound FDI. In 2015, the ratio between the two was roughly fifty-fifty, but state-owned enterprises again seized the majority in 2016 (accounting for 54.3%) and in terms of the scale of investment, they continue to have the edge over private enterprises (Figure 7).

Figure 6: China’s outbound FDI by type of enterprise in terms of numbers of overseas companies established and amounts invested



Source: As for Figure 2 and Figure 3

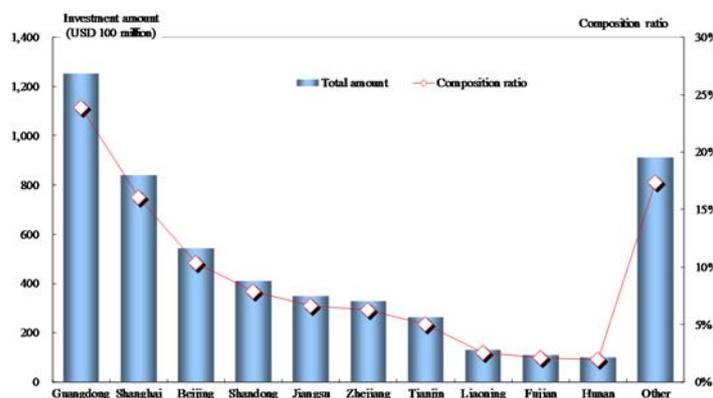
Figure 7: The ratio of state-owned enterprise investment to total outbound FDI



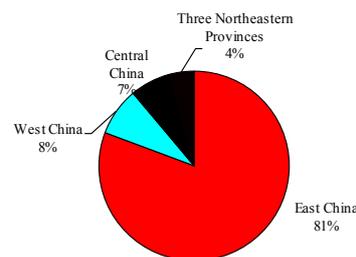
Source: As for Figure 6

Figure 8 gives the cumulative amounts of outbound FDI for each of China’s administrative regions. Commensurate with the data on company numbers given in Figure 5, the scale of investment and ratio to the total is largest in Guangdong, with Zhejiang and Jiangsu, the two provinces that ranked second and third in terms of overseas enterprise numbers, being pushed down by the two direct-controlled municipalities of Shanghai and Beijing and Shandong Province in terms of monetary amounts. The inference being, in other words, that enterprises in these regions invest more capital per outbound FDI project and that much of this investment is being made by state-owned enterprises, and it is state-owned enterprises that are investing on a larger scale, something that is also clear from the regional breakdown. Looked at in terms of large regional blocks, the Eastern coastal area accounts for 81 percent of total outbound FDI, with central and western China accounting for 8 percent and 7 percent, respectively, and the northeast for a mere 4 percent of the total (Figure 8, pie chart). Looking ahead, the strengthening of policy in regions associated with the Belt and Road strategy and improvements in the climate for investment suggest that outbound FDI flows from regions other than eastern China will expand.

Figure 8: Outbound FDI total by region (as of the end of 2016)



Outbound FDI ratios for the four major regions of China (as of the end of 2016)



Source: As for Figure 6

3. A breakdown of China's outbound FDI by industry and region

Figures 9 and 10 offer an overview of the main industries towards which China's outbound FDI is directed. Again, there is a considerable gap between the cumulative total (where the leasing and business services sector is far and away the lead investor) and the cumulative number of overseas companies established. In terms of the latter, the manufacturing industry has established the largest number of overseas enterprises (more than 7,600 or 31.2% of the total), followed by the wholesale and retail industry (approximately 7,000 companies, 28.7%), with leasing and business services coming in third (2,100 companies, 8.7%). Next in line is information services (1,276 companies, 5.2%), followed by agriculture, forestry, animal husbandry and fisheries (985 companies; 4%), construction (800 companies, 3.3%), and science and technology services (670 companies, 2.8%).

As to the industries involved in the M&A deals that account for more than 40 percent of outbound FDI, the manufacturing industry tops the rankings (at 22.2%), followed by information services (19.5%), transport and logistics (10.2%), electricity, gas and water production and supply (8.2%), finance (7.2%), leasing and business services (7%), and real estate (6.8%).

One reason why so much Chinese outbound FDI goes into the manufacturing industry is thought to be that it provides quick access to both management resources (including technologies, credibility, i.e. brand power, management techniques, etc.) and production resources. Again, over and above green field investments (i.e. the construction of production facilities, offices, etc.) and strategic partnerships, investment in the form of M&As, which represent an efficient means of acquiring control over foreign companies, is now the leading form of Chinese outbound FDI and a major characteristic thereof. M&A in the wholesale and retail industries, meanwhile, is used to tap into foreign markets.

Figure 9: Industry distribution of Chinese outbound FDI in terms of total numbers of overseas companies established (as of the end of 2016)

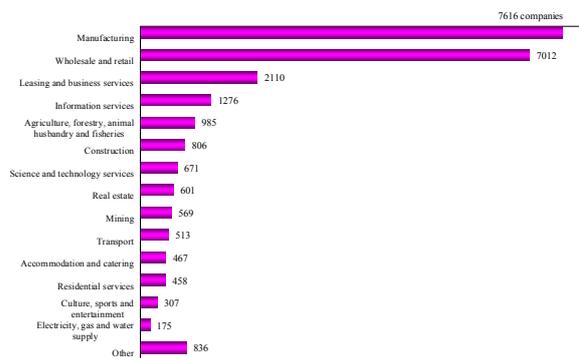
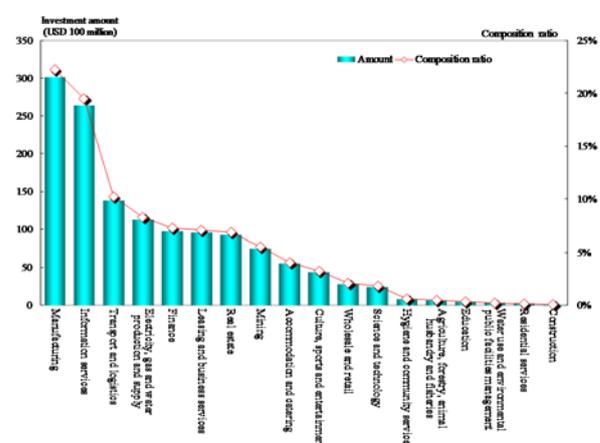


Figure 10: Industry distribution of China's outbound M&A investment (amounts and ratio to total)



Source: Compiled from the MOFCOM, NBS, SAFE 2016 Statistical Bulletin of China's Outward Foreign Direct Investment

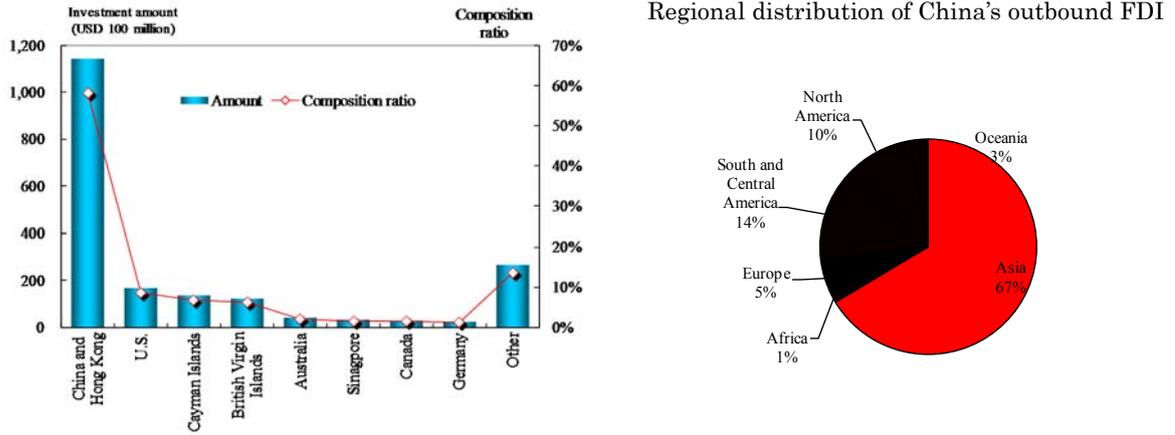
Source: Compiled from the MOFCOM Report on Developments in China's Foreign Investment Cooperation 2017. Ratios are estimates.

A look at outbound FDI target regions in terms of flows reveals Hong Kong Special Administrative Region to have been the largest recipient of Chinese outbound FDI in 2016, accounting for 58.2 percent of the total or US\$ 114.2 billion, followed by the United States (approximately US\$ 17 billion or around 8.7%), and the tax havens of the Cayman Islands and the British Virgin Islands (6.9% and 6.3%, respectively) (Figure 11).

In regional terms, Asia remains the largest recipient, accounting for approximately 70 percent of Chinese outbound FDI (a little less than 70% on a stock basis; see pie chart in Figure 11), followed by Latin America (14%) and North America (10%), Europe (5%), Oceania (3%), and Africa (1%). Asia's popularity is primarily due to the importance of Hong Kong Special Administrative Region (which remains the primary destination for Chinese outbound FDI), whilst Latin America is home to numerous countries with abundant mineral resources and to several tax havens.

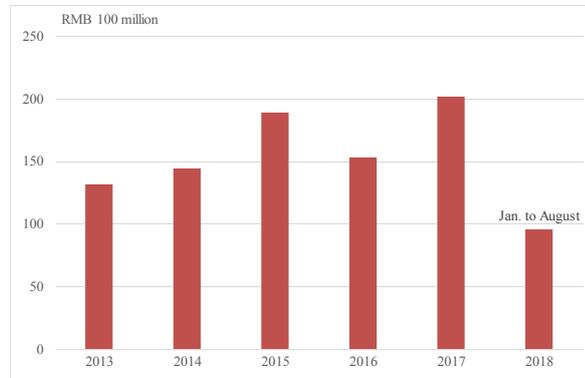
Figure 12 shows trends in investment in Belt and Road (OBOR) regions from 2013 – the year in which the strategy was unveiled, through August of the current year. Investment in OBOR regions in 2017 topped the record highs recorded in 2015 (US\$ 18.93 billion) and has already reached US\$ 9.58 billion in the first eight months of 2018. China is directing more than US\$ 16 billion in investment at OBOR regions annually, which is already a considerable amount. Asia is the primary destination (in terms of both stock and flows; Figure 13), but emphasis is also being given to OBOR projects in Africa and there is expected to be a massive increase in direct investment in the countries of Africa over the coming years.

Figure 11: China's outbound FDI in 2016 by country and region



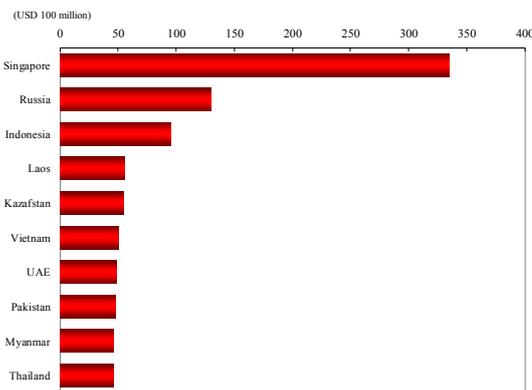
Source: As for Figure 6

Figure 12: Trends in China's FDI in OBOR countries and regions

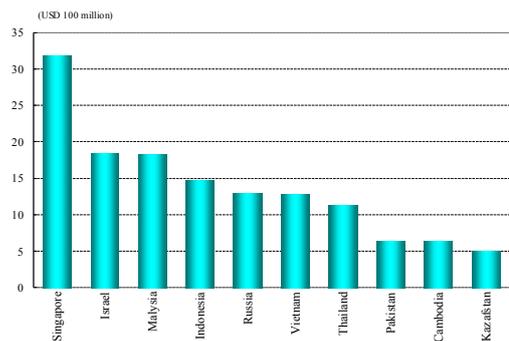


Source: Compiled from the MOFCOM Report on Developments in China's Foreign Investment Cooperation for Fiscal 2017 and other statistics.

Figure 13: Cumulative Chinese FDI in the top 10 OBOR countries



China's FDI in the Top 10 OBOR Countries in 2016



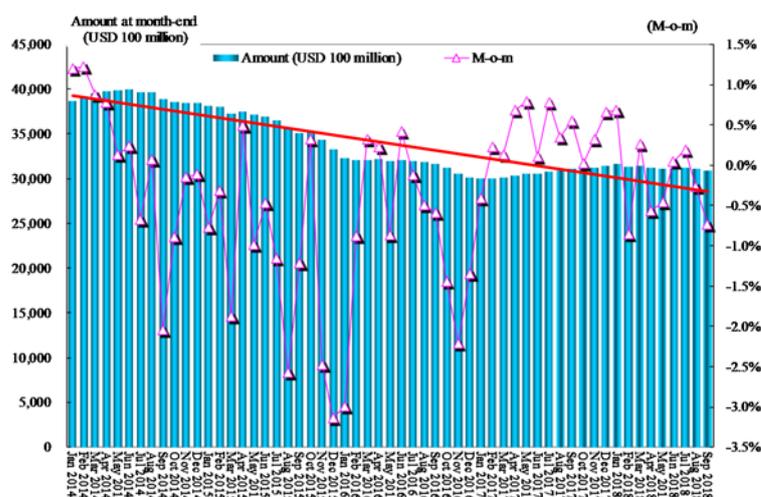
Source: Compiled from the MOFCOM Report on Developments in China's Foreign Investment Cooperation for Fiscal 2017

4. Changes in the domestic and international situation and their impact on outbound FDI in terms of outcomes and future challenges

The above provides what amounts to a rather broad overview of China’s outbound FDI, but demonstrates that the nation has ramped up its overseas investment in an extremely short period of time (2017 outflows were approximately 47 times greater than those recorded in 2002, whilst outbound FDI stock was approximately 50 times higher). The fruits of this investment are, in principal, subject to changes in domestic and world affairs, to the policy guidance provided by China’s government and to rational management decisions on the part of Chinese businesses. As mentioned above, 2016 – the year in which the Thirteenth Five-Year Plan was launched – marked a major turning point for China’s outbound FDI, and both the government and businesses are being forced to confront the challenges thrown up by changes at home and abroad.

According to Zhang Ming, a leading international finance researcher, five changes have begun to appear in China’s outbound FDI in recent years: (1) China’s decreasing foreign exchange reserves (Figure 14) is putting constraints on the funds available for overseas investment, thus changing the structure of investment and loan; (2) the screening and approval requirements for inbound FDI in developing countries in general and the United States in particular are becoming more rigorous; (3) Chinese investors are becoming more conscious of and attaching more significance to returns on investment and the quality of their investments; (4) the Chinese government has recognized that capital flight in the guise of FDI is an issue and have tightened restrictions; and (5) the acquisition of technologies and changes in China’s industrial structure have become key drivers of outbound FDI⁵.

Figure 14: Monthly trends in China’s foreign exchange reserves (January 2014 – September 2018)

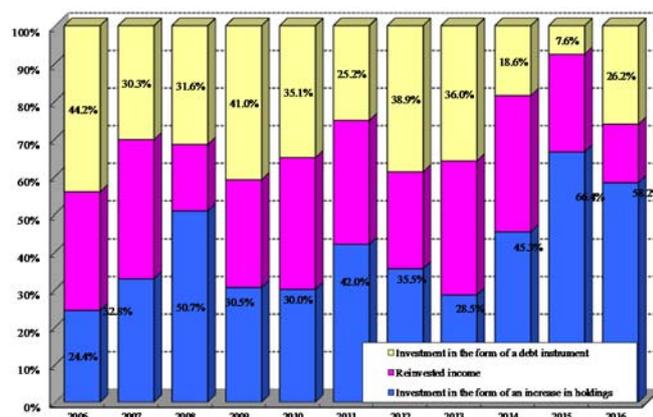


Source: Compiled from statistics published by the People’s Bank of China PBOC.

⁵ Zhang Ming, leading economist at Ping An Securities and researcher at the Institute of World Economics and Politics, Chinese Academy of Sciences,中国对外直接投资的五个新变化—兼评《关于引导对外投融资基金健康发展的意见》 (Five New Changes in China’s Foreign Direct Investment – Comment [Opinions on Guiding the Healthy Development of Foreign Investment and Financing Funds]).

The Chinese government began tightening its restrictions on outbound FDI at the end of 2016 in an attempt to stem the outflow of foreign capital and stabilize domestic financial markets. Specifically, the NDRC, MOF and MOFCOM issued the **Guiding Opinions on Further Guiding and Regulating the Direction of Overseas Investments** (Item 25 in Table 1) in April that year, which is the key document governing policy on China’s outbound FDI. According to Chinese government statistics, China’s outbound FDI takes three forms: (1) an increase in holdings (share capital), (2) reinvestment of net profits, and (3) debt instruments (other capital, including intercompany loans)⁶ (**Figure 15**), though (1) is the leading form accounting for around 60 percent of total outbound FDI in 2015 and 2016 (or an annual average of 37%), with (2) and (3) accounting for an annual average of 26.8 percent and 27.9 percent, respectively. The ratio of (2) fell sharply in 2016, whilst (3) rose by 7.6 percent to 26.2 percent. Changes in the investment climate a greater potential for foreign investment in the form of debt instruments and the other forms that are being pushed by the government (including public-private partnerships, etc.) in coming years, though this is also expected to bring major challenges, too. The drop in Chinese investment in the United States that has resulted from trade friction between the two nations is also expected to trigger increased support for and growth in investment in OBOR regions.

Figure 15: Ratios of Chinese FDI on a value basis by type of investment



Source: Compiled from the MOFCOM, NBS and SAFE **2016 Statistical Bulletin of China’s Outward Foreign Direct Investment**.

The biggest challenges China faces in the coming years is the impossible trinity (or trilemma, a concept in international finance which states that is impossible to have all three of the following simultaneously: a stable foreign exchange rate, an independent monetary policy and free capital movement) that will come with an escalation or lengthening of China-U.S.

⁶ According to System of Outbound FDI Statistics (issued by MOFCOM, NBSC and SAFE in December 2016), the “increase in holdings” is obtained by multiplying the increase in holdings of a foreign country by the holdings of the Chinese investor, and includes the principal paid by the investor in the current fiscal year and its return on investment in the form of share earnings. “Reinvestment of net profits” is the difference between retained earnings (undivided profit) at year-end and the beginning of the year as calculated for the Chinese investor’s holdings on the balance sheet of the foreign company in the reporting year, and, where such results in a negative value is reckoned as negative flow. “Debt instruments” refer to debt transactions between the Chinese investor and a foreign subsidiary, branch or affiliated company, and include related loans and securities, etc., where intercompany loans between the Chinese investor and a foreign affiliate are also counted.

trade frictions⁷, though it will also have to address issues such as progress towards sounder local management, localization and corporate social responsibility as investment expands. The next installment of this report will examine investment trends in major regions of the world and highlight the status China's overseas expansion into key industries, including automobiles, telecommunications, iron and steel, and production equipment, will clarify the successes and challenges of corporate China's forays into the international arena, and look at where they are headed.

[Continued in Part 2: China's Outbound FDI by Region]

⁷ Readers are referred to the latest publication from Kajitani Kai, a specialist on the Chinese economy: *Chugoku Keizai Kogi* ("A Lecture on the Chinese Economy"; Chuokoron-Shinsha, September 2018), for a detailed analysis of this issue.

Comparison Between the Current Situation and the Time of the Chinese Financial Crisis from the Viewpoint of Capital Outflow

Kei Yano
Treasury Diepartment
Mizuho Bank (China) Ltd.
Kei.yano@mizuho-cb.com

1. Introduction

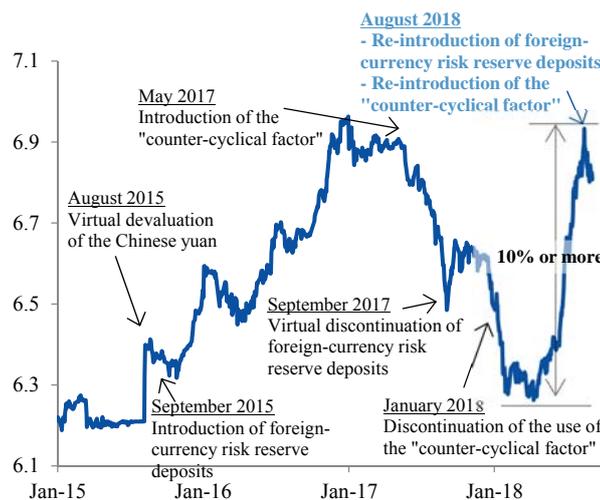
Since the beginning of 2018, downward pressure on the Chinese yuan has been strengthening due to the trade frictions between the U.S. and China, as well as due to concerns over economic downturn. On June 15, 2018, the U.S. introduced a customs duty against China as a means of sanction, after which the SSE Composite Index fell below 3,000, leading the Chinese yuan to depreciate sharply. The depreciation range of the Chinese yuan against the U.S. dollar reached 10% or more at the highest point (Fig. 1).

In August, the People’s Bank of China (PBOC) announced its decision to resume foreign-currency risk reserve deposits on futures transactions by companies selling the Chinese yuan. Furthermore, the “counter-cyclical factor” was re-introduced for the calculation of the PBOC’s central parity rate. Thus, various measures were taken to control the depreciation of the Chinese yuan.

The sharp depreciation of the Chinese yuan and the subsequent measures to control the depreciation of the Chinese yuan remind us of the sharp depreciation of Chinese stock prices and the depreciation of the Chinese yuan caused by the change in the calculation method of the PBOC’s central parity rate in August 2015.

The problem at that point was capital outflow from China. Thus, this article will examine the depreciation of the Chinese stock prices and the Chinese yuan from the viewpoint of capital outflow. Please note that this article is in large part written from the personal viewpoint of the author.

Figure 1: U.S. dollar/Chinese yuan exchange rate and measures to control the depreciation of the Chinese yuan



Source: Bloomberg

2. Comparison of the current situation with the depreciation of Chinese stock prices and the Chinese yuan at the time of the Chinese financial crisis and the subsequent capital outflow

In 2015, concerns over the downturn of the Chinese economy and the sharp depreciation of the Chinese stock prices led to confusion in the global market, comprising part of what is also known as the “China Shock.” The confusion of the market was particularly serious for the following two reasons: (1) stock prices depreciated within an extremely short period and (2) concerns over capital outflow grew due to the substantial decline in foreign-currency reserves.

In 2012, the government under President Xi Jinping was established, after which expectations grew for economic revitalization through the efficient use of the stock market. In 2014, the “Shanghai-Hong Kong Stock Connect” initiative was introduced, leading foreign capital into the Chinese stock market. Thanks to these measures, Chinese stock prices appreciated significantly before said “China Shock.” However, thereafter, stock prices were led to depreciate sharply, as a reaction to economic downturn in China, along with the depreciation of the crude oil price and the rewinding of funds supplied for monetary easing in the U.S., in addition to the interest rate hikes in the U.S. (Fig. 2). With the unstable situation in the Chinese stock market, market concerns spread throughout the market over the outflow of foreign capital that was previously invested in China.

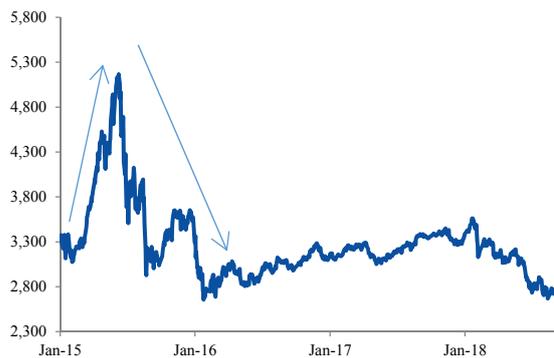
When funds are moved from China to abroad, the Chinese yuan generally depreciates, as a result of growing demand to convert the Chinese yuan into foreign currencies. Therefore, the PBOC took a measure to control the depreciation of the Chinese yuan by selling foreign currencies and buying the Chinese yuan. As a result, the foreign-currency reserves that had accumulated to reach USD 4 trillion at the beginning of 2014 declined sharply (Fig. 3). In response to the fact that foreign-currency reserves started to decline, concerns over capital outflow grew further throughout the market, accelerating the depreciation of stock prices and the Chinese yuan. In order to stop this phenomenon, the Chinese monetary authorities did not have any choice but to strengthen regulations.

Then, what about the current situation regarding the depreciation of Chinese stock prices and the Chinese yuan? Since 2017, Chinese stock prices were not appreciating significantly due to measures to control the bubble economy as taken by the Chinese monetary authorities and due to the deleveraging policy to solve the problem of excess debt. The current situation therefore seems a little different from that of the times of the “China Shock.”

This time, stock prices depreciated because cases of company default increased in 2018 at a faster rate than in 2016, with the worst record seen due to the promotion of deleveraging by the monetary authorities, fueling concerns over economic downturn in China, all while concerns were also growing rapidly over the trade frictions between the U.S. and China.

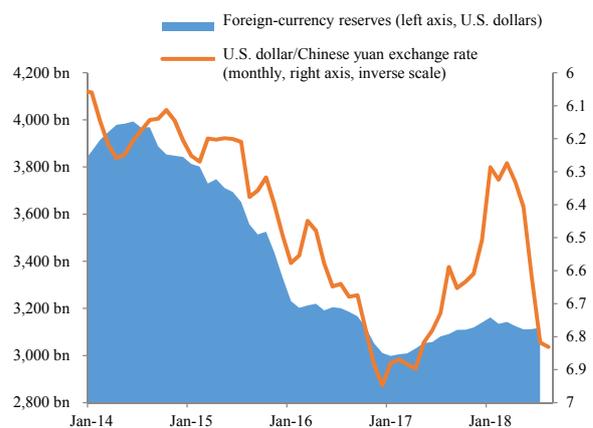
Therefore, the Chinese monetary authorities were able to mitigate the situation with a series of fiscal and monetary measures to slow down the depreciation of stock prices, thus keeping the market from falling into the level of confusion seen during the times of the “China Shock.” On the other hand, the Chinese yuan has been depreciating at a rate faster than the times of the “China Shock,” temporarily recording a fall of 10%—as was discussed above. The next section will examine whether capital outflow is observed at the time of the depreciation of the Chinese yuan.

Figure 2: SSE Composite Index



Source: Bloomberg

Figure 3: Foreign-currency reserves



Source: Bloomberg

3. Did the depreciation of the Chinese yuan observed this time cause capital outflow?

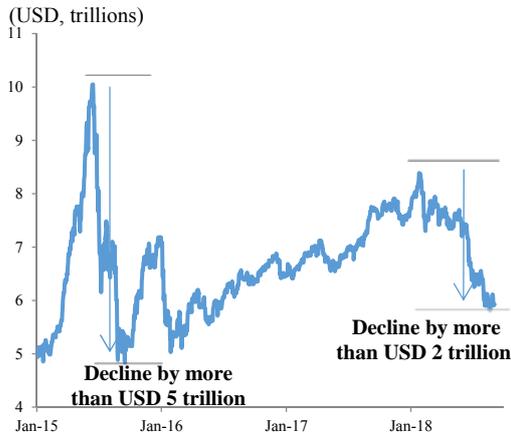
First of all, as a result of the depreciation of stock prices observed this time, market capitalization declined by more than USD 2 trillion in five months. However, at the time of the “China Shock,” market capitalization declined by more than USD 5 trillion, out of which USD 3.2 trillion declined within the first three weeks. These figures suggest that the Chinese stock market lost less capital this time compared to the times of the “China Shock” (Fig. 4).

With regard to foreign-currency reserves, when stock prices depreciated this time, there was no decline in foreign-currency reserves to fuel concerns over capital outflow, unlike the times of the “China Shock.” Furthermore, the Chinese monetary authorities introduced a regulation to control the conversion of the Chinese yuan into foreign currencies, targeting companies and individuals during the times of the “China Shock” (Fig. 5), and part of the regulation is still in effect. As a result, Chinese companies that used to be active in acquiring foreign companies stopped acquiring such companies. Therefore, the amount of direct investment that used to be a negative net figure during the times of the “China Shock” turned into a positive figure thanks to a decline in foreign direct investment and an increase in domestic direct investment (Fig. 6). As a consequence, market participants have not been actively selling the Chinese yuan or buying foreign currencies in the onshore market (Fig. 7).

Furthermore, as a result of deregulation toward the external market, there has been constant capital inflow into the Chinese onshore bond market from abroad despite the depreciation of the Chinese yuan observed in the last several months. The Chinese bond holdings by foreign investors recorded positive growth for 18 consecutive months until August, realizing the longest period of expansion (Fig. 8).

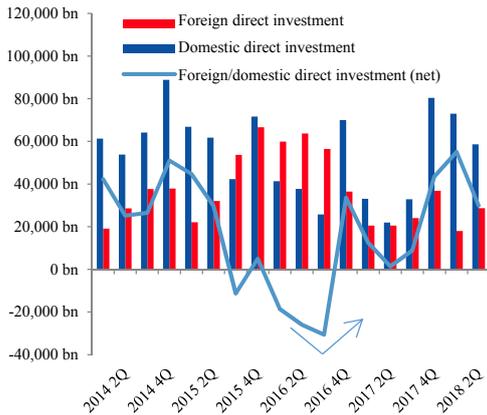
While domestic interest rates are falling in China, interest rates are rising in the U.S., narrowing the interest rate differentials and lowering hedge costs, which is considered to be another reason for the increase in Chinese bond holdings. As was discussed above, there has currently been no significant capital outflow. However, then, is there no risk of capital outflow from this time onward, while stock prices and the Chinese yuan have been depreciating significantly? The next section will discuss the possible risks of capital outflow in the times ahead.

Figure 4: Market capitalization of Chinese stocks (denominated in U.S. dollars)



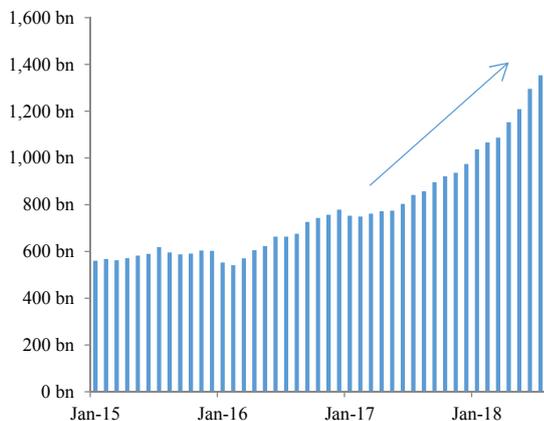
Source: Bloomberg

Figure 6: Foreign/domestic direct investment (denominated in U.S. dollars)



Source: Bloomberg

Figure 8: Holding balance of Chinese bonds by foreign investors (denominated in the Chinese yuan)



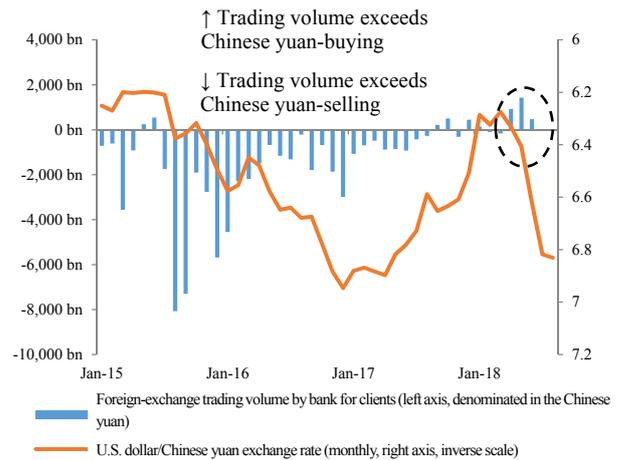
Source: Bloomberg

Figure 5: Major capital regulations taken during the times of the “China Shock”

Target	Content	Purpose
Companies	Approval by the Chinese monetary authorities is required beforehand if the investment exceeds USD 5 million involving foreign exchange.	To control the conversion of Chinese yuan into foreign currencies by Chinese companies
	A Chinese subsidiary of a foreign company can lend up to 30% of its equity capital to its headquarters.	To control the conversion of Chinese yuan into foreign currencies by local subsidiaries of foreign companies
Individuals	Conversion of Chinese yuan into foreign currencies is capped at USD 50,000 annually per person.	To control the conversion of Chinese yuan into foreign currencies inside China
	The use of the “Union Pay” card by those from Mainland China for shopping abroad is regulated.	To control the conversion of Chinese yuan into foreign currencies outside China
	It is in principle prohibited to convert Chinese yuan in order to buy real estate, securities, and insurance products abroad.	

Source: Various media reports etc.

Figure 7: Inter-bank trading volume in the foreign-exchange market



Source: Bloomberg

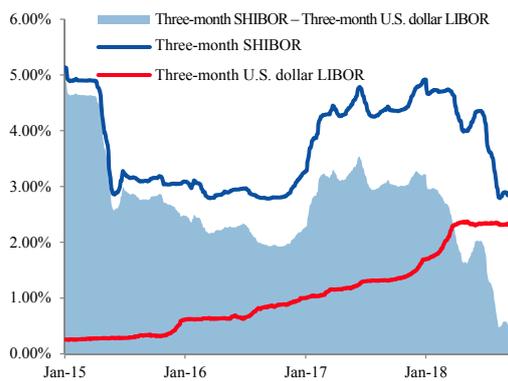
4. Regarding possible capital outflow in the times ahead

The first possible risk regarding capital outflow in the times ahead would be the narrowing of the interest rate differentials between the U.S. and China (Fig. 9). Even though the current situation is currently contributing to capital inflow into the onshore bond market, as a means of cutting hedge costs, if said current situation lasts for a long period, investors would hope to hold assets denominated in U.S. dollars. As a result, market participants are expected to start selling the Chinese yuan to buy the U.S. dollar.

Furthermore, it is also important for Chinese monetary authorities to mitigate the slowdown in Chinese economic growth, which China is currently facing. While the problem of trade frictions between the U.S. and China persists, if the economy slows down more significantly than expected, the Chinese monetary authorities may consider cutting the interest rate to stimulate the economy. If this happens, Chinese interest rates would not rise easily until the fund procurement costs for companies fall to a sufficient level. If the interest rates depreciate in China, it would not be interesting for investors to invest in the Chinese domestic bond market, and the capital inflow into the Chinese bond market may decrease.

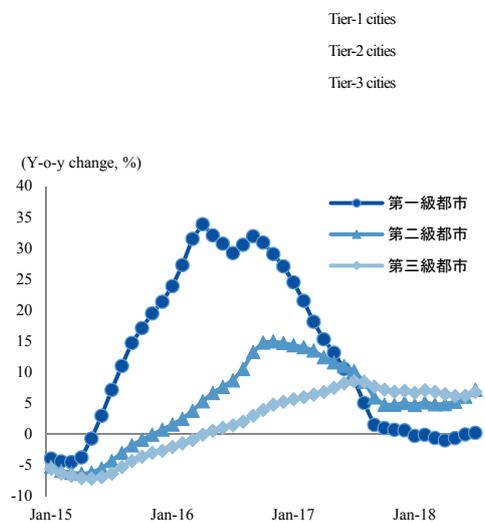
The depreciation of real estate prices is another risk factor for the times ahead. The Chinese government introduced a restrictive measure for housing purchases in 2016 in order to control the appreciation of real estate prices, as the current situation can be described as a housing bubble. The measure had some effect in stabilizing real estate prices for a while. However, real estate prices have recently been rising again in terms of the year-on-year price appreciation rate (Fig. 10). As was once the case in Japan, real estate prices may appreciate to an unrealistic level that eliminates buyer motivation, thus causing price depreciation. If that happens, investors may move their funds from the domestic real estate market to the foreign market in fear of the fall of asset values. As can be seen from above, there are currently various risks involving capital outflow, making it possible for capital outflow to become a serious problem in the market.

Figure 9: Interest rate differentials between the U.S. and China



Source: Bloomberg

Figure 10: Price of newly built houses



Source: Bloomberg

5. Conclusion

This article examined the current depreciation of Chinese stock prices and the Chinese yuan from the point of view of capital outflow. Even though there has been no sign of capital outflow, such is highly probable in the times ahead, and thus it is an important moment for Chinese monetary authorities to take the right moves in order not to repeat the same mistakes made during the times of the “China Shock.”

In addition to the measures to be taken by the Chinese monetary authorities, there will be many important points that could impact the Chinese stock market and the Chinese yuan exchange market in the times ahead, such as the mid-term elections in the U.S. scheduled for fall this year as well as decisions by the Chinese government regarding the trade frictions between the U.S. and China and the economic slowdown in China.

In six years of working in the market, the author has witnessed many situations in which monetary authorities lose control over emerging currencies. We can only hope that the Chinese monetary authorities can accurately control the market this time.

Caution

1. **Legal or accounting advice:** The information included in this material does not contain any advice on legal, accounting, or tax matters. If you require any advice on such matters, you should consult your respective professional advisors.
2. **Confidentiality:** The information included in this material is disclosed to you on the premise of your confidentiality obligation, and should be used for internal purposes only. Disclosure of the contents herein to a third party is prohibited.
3. **Copyright:** Copyright of the information included in this material belongs to the bank, in principle. You are prohibited to make a copy of, make a reproduction of, quote, reprint, translate, loan, or in any way exploit the content of this material in part or in whole, by any means, for any purpose, without our permission.
4. **Indemnity:** The information included in this material is obtained from various sources that the bank believes are reliable. However, the bank shall not guarantee its correctness, trustworthiness, or integrity. The bank shall also not be liable for any damage, whatsoever, arising from this information.
5. This publication is not deemed to constitute advice, solicitation or recommendation to sell financial assets.
6. This document is a translation of the Japanese original, and the original will take precedence in the event of any difference between the two versions.