CHINA ECONOMIC UPDATE SEPTEMBER 2017

Tightening the purse strings – China's foreign investment is slowing in a more closely regulated environment

NAB Group Economics

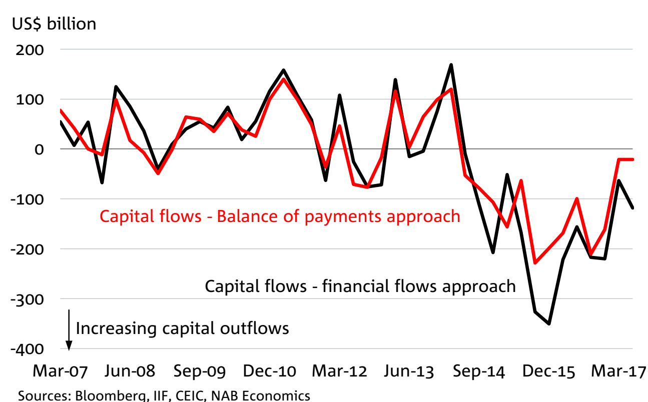
After years of encouraging its firms to 'go out' and invest abroad, China's government has recently been tightening the regulation around foreign investment. This policy shift reflects competing pressures – with potential gains from building its stock of foreign assets and political capital via the Belt and Road Initiative weighed against risks to financial market liquidity and currency stability from uncontrolled capital outflows – but is a backwards step from a reform perspective.

CHINA'S CAPITAL OUTFLOWS PRESSURING FINANCIAL STABILITY AND CURRENCY

Between 2000 and the start of 2014, international capital generally flowed into China – with inflows increasing markedly from around 2006 onwards. In part this reflected international investors searching for yield in the post-GFC period – with returns from investing in China's shadow banking sector far outpacing the poor returns available in advanced economy financial markets.

CHINESE CAPITAL OUTFLOWS

Pulling back from 2015 peaks



From 2014 onwards the trend reversed and capital has generally flowed out of China. China's outward foreign investment has grown, but tighter regulation around shadow banking and fears around the stability of the country's economy have also contributed to capital flight. These fears were particularly elevated across 2015 and early 2016 – when the People's Bank of China cut the Required Reserve Ratio five times to boost financial market liquidity while supporting the currency by selling foreign exchange reserves. Subsequent tightening of capital controls has stemmed much of the tide – albeit relatively modest outflows have continued in the first half of this year.

CHINA'S GROWING FOREIGN ASSETS ARE NOT ALWAYS STRONG PERFORMERS

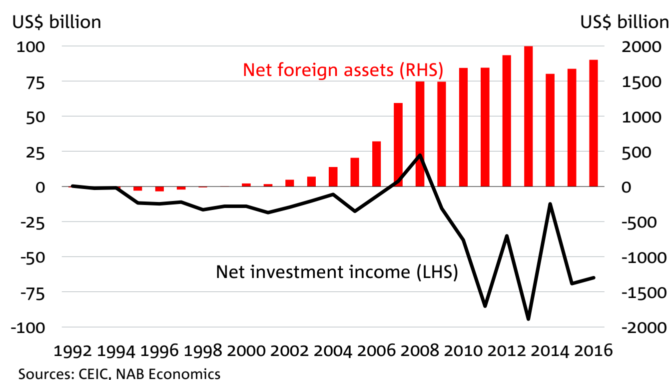
From the start of China's period of opening up, Beijing has encouraged firms to invest overseas – particularly the State Owned Enterprises. A number of factors have driven this policy, including securing access to critical resources, expanding overseas markets for Chinese products and gaining technological and management experience to further the country's economic development.

China's stock of foreign assets rose sharply from the turn of the century until 2013 – increasing on a net basis from around US$33 billion to almost US$2.0 trillion – as rapid industrialisation and surging exports boosted the country's wealth. That said, recent trends have been weaker, with the total value of foreign assets declining from this peak – back to around US$1.8 trillion in 2016 (following a sharp plunge in 2014). This was due to decline in foreign exchange reserves over this period.

Date **September 2017** | Author **Gerard Burg** – Senior Economist – Asia
© National Australia Bank Limited ABN 12 004 044 937 AFSL and Australian Credit Licence 230686

FOREIGN INVESTMENT & INCOME FLOWS

China's assets don't generate income

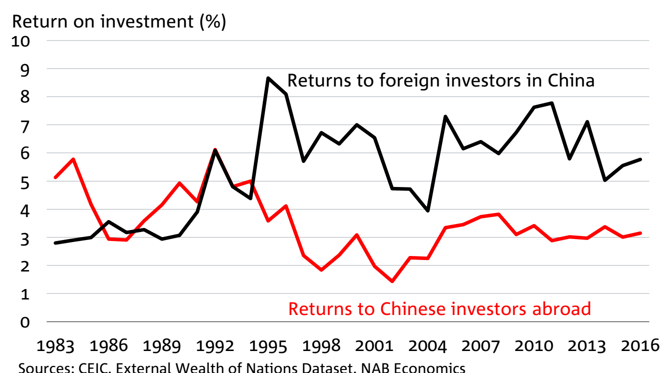


Sources: CEIC, NAB Economics

Despite the sizeable net asset position, the income flows associated with China's international investment position have generally been negative – meaning that foreign investors have earned a greater return on their investment in China than Chinese investors earned abroad. In part this reflects the composition of China's foreign assets – with the majority being foreign exchange reserves. While the People's Bank of China does not provide details on the composition of these reserves, it is generally thought that the majority of them are invested in US government bonds – where returns have trended sharply lower since the turn of the century.

RETURNS ON INVESTMENT

Returns to Chinese investors lag foreigners

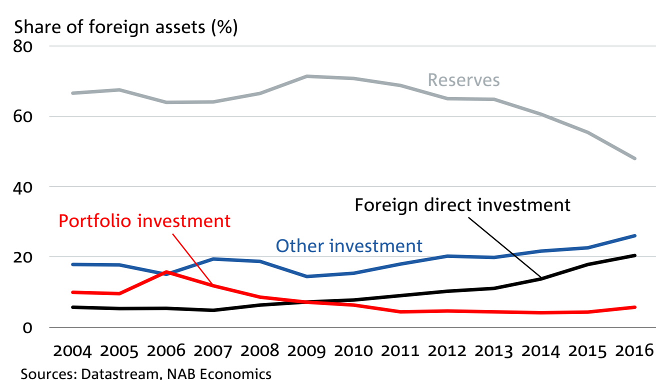


Sources: CEIC, External Wealth of Nations Dataset, NAB Economics

That said, weak returns on reserve assets were not the sole driver of the poor return on investment – as the share of reserves in China's international investment position has steadily declined since 2009. This suggests that the returns on China's direct and short term investments have generally underperformed – suggesting that some of this investment has been poorly directed – contributing to recent policy restrictions. This view is also supported by a sharp slowdown in capital gains (including retained earnings) for direct investment in recent years – estimated at just 0.4% in 2016 (compared with an average of around 11% between 2007 and 2014).

CHINA'S FOREIGN ASSETS

Reserves the largest share but declining



Sources: Datastream, NAB Economics

Poor returns on foreign investment pose some risk for China's financial sector. Chinese State Owned banks have been the main source of funding for highly leveraged State Owned Enterprises investing abroad – meaning that the failure of a foreign investment could increase domestic risks – a major concern given China's already high debt levels.

Foreign investment outflows have been comparatively weak in 2017 – reflecting the impact of tightening regulation in recent times. In the first eight months of the year, outbound direct investment declined by 42% yoy.

TIGHTENING REGULATION OF FOREIGN INVESTMENT

From 2016 onwards, Chinese authorities have tightened regulation on foreign investment – helping to slow the pressure from capital outflows. This has included lowering the thresholds for oversight and approval of investment proposals and restricting investment from outside a firm's core business.

In addition, high profile private sector firms such as Dalian Wanda and Anbang Insurance have come under closer scrutiny by regulators – having been particularly active in mergers and acquisitions activity in recent years. The China Banking Regulatory Commission has ordered banks to tighten credit lines to these firms, among others.

In August 2017, China's State Council issued a new guideline on foreign investment, significantly curtailing the capacity of Chinese firms to invest in certain sectors. In particular, the policy prohibits foreign investment in real estate, hotels, entertainment, sports clubs, 'outdated' industries and all investment in countries without diplomatic relations with China.

This is likely to further slow China's foreign investment and restrict capital outflows in the next few years.

CONCLUSION

Capital outflows have slowed considerably in recent quarters – from peaks in late 2015 – reducing some of the risks around China's economy. The continued tightening in regulation around China's foreign investment will reduce some risks in the country's financial sector, but it represents something of a backwards step within the broad reform agenda to modernise and open up China's economy.

CONTACT THE AUTHOR

Gerard Burg
Senior Economist – Asia
Gerard.Burg@nab.com.au
+613 8634 2788
+61 477 723 768

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Riki Polygenis
Head of Australian Economics
+(61 3) 8697 9534

James Glenn
Senior Economist – Australia
+(61 4)55 052 519

Phin Ziebell
Economist – Australia
+61 (0) 475 940 662

Amy Li
Economist – Australia
+(61 3) 8634 1563

Behavioural & Industry Economics

Dean Pearson
Head of Behavioural & Industry Economics
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 3837

Steven Wu
Economist – Behavioural & Industry Economics
+(613) 9208 2929

International Economics

Tom Taylor
Head of Economics, International
+(61 3) 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics
Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

David de Garis
Senior Economist
+61 3 8641 3045

Tapas Strickland
Economist
+61 2 9237 1980

FX Strategy
Ray Attrill
Head of FX Strategy
+61 2 9237 1848

Rodrigo Catril
Currency Strategist
+61 2 9293 7109

Interest Rate Strategy
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Alex Stanley
Senior Interest Rate Strategist
+61 2 9237 8154

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Andrew Jones
Credit Analyst
+61 3 8641 0978

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Jason Wong
Currency Strategist
+64 4 924 7652

UK/Europe

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Asia

Christy Tan
Head of Markets Strategy/Research, Asia
+852 2822 5350

Julian Wee
Senior Markets Strategist, Asia
+65 6632 8055

Important Notice

This document has been prepared by National Australia Bank Limited ABN 12 004 044 937 AFSL 230686 ("NAB"). Any advice contained in this document has been prepared without taking into account your objectives, financial situation or needs. Before acting on any advice in this document, NAB recommends that you consider whether the advice is appropriate for your circumstances.
NAB recommends that you obtain and consider the relevant Product Disclosure Statement or other disclosure document, before making any decision about a product including whether to acquire or to continue to hold it.

Please click here to view our disclaimer and terms of use.