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Follow the money: The strength of China's outward foreign investment during pandemic raises questions

NAB Group Economics

China's outward foreign direct investment accelerated rapidly between 2000 and 2016 – initially to secure access to natural resources, before diversifying into a range of services and higher value technology sectors. Tighter regulation in subsequent years saw a decline in the flow of outward investment, however official data point to an increase in 2020, despite the negative impacts of the COVID-19 pandemic. These recent data are inconsistent with other international measures of China's investment, raising questions around their accuracy.

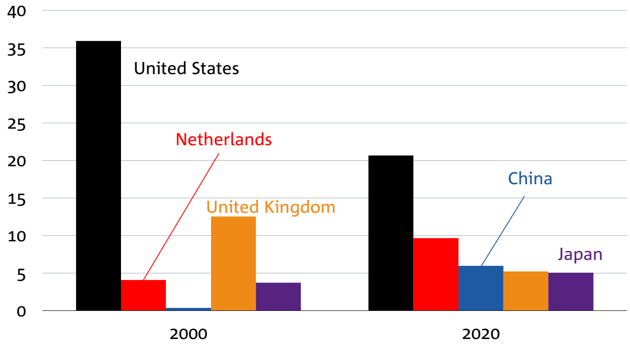
OFFICIAL DATA SHOW THE CHINA'S INVESTMENT HAS HELD UP DURING THE PANDEMIC

During the early part of this century, Chinese firms were encouraged to expand outward foreign investment under the "going out" strategy – that aimed to secure resources and intellectual property and technology necessary to support China's economic development. Official outward investment data showed that this investment peaked in 2016 before starting to decline – as regulation around investment tightened due to concerns of excessive debt among investing firms, inappropriate investment and capital flight, during a period where the currency was coming under considerable pressure.

According to a joint report by the Ministry of Commerce, the National Bureau of Statistics and the State Administration of Foreign Exchange, China's outward foreign direct investment rose by 12.3% in 2020 to total US$153.7 billion. The report noted that China was the world's largest investor for the full year (the first time that this has occurred based on global investment data from UNCTAD) and at the end of 2020, China's total stock of foreign direct investment was the third largest worldwide, behind the United States and the Netherlands.

GLOBAL STOCK OF FOREIGN INVESTMENT

China's share has rapidly increased since the turn of the century



Source: UNCTAD, NAB Economics

Official data suggests that China's investment slowed a little in 2021 – down to US$145.1 billion – data for 2021 was less complete (lacking any details on the destination country) at the time of writing and may be subject to revisions.

UNOFFICIAL DATA PAINT A DIFFERENT PICTURE

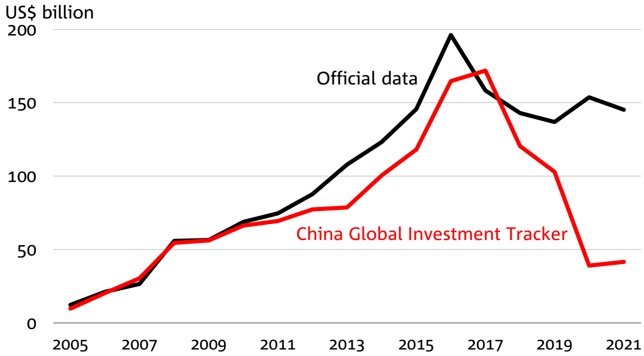
Questions have been raised around the strength of China's outward foreign investment over the past two years, particularly given the disruptions to global economic activity triggered by the COIVD-19 pandemic.

The American Enterprise Institute produces the China Global Investment Tracker (CGIT), which monitors China's investment flows based on public disclosures by companies in host countries, bypassing the uncertainty that often exists in China's data. There was some discrepancy between official data and the CGIT over the period from 2005 and 2019, with the American Enterprise Institute arguing that much of this historical gap reflected smaller scale projects – with the organisation excluding transactions under US$95 million. That said, the broad trends between these measures were similar over this period.

However, the CGIT plunged in 2020 – falling by 62% to just US$39.1 billion, the smallest annual total since 2007, and almost four times smaller than the official measure. There was only a marginal increase in 2021 (given the scale of the decline in 2020) – up by 6.3% to US$41.6 billion.

CHINA'S OUTWARD FOREIGN INVESTMENT

Wide gap between official and unofficial measures during the pandemic

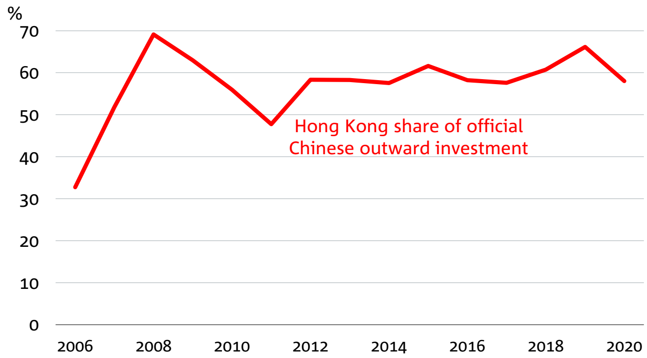


Source: CEIC, American Enterprise Institute, NAB Economics

Issues of transparency in China's official foreign investment data become obvious when they are broken down on a country-by-country basis. In 2020, the largest destination for China's outbound foreign investment was Hong Kong – similar to the issue that exists in trade data, where China Customs lists Hong Kong as the destination of exported goods that are subsequently shipped elsewhere in the world. This is also not a problem that was unique to 2020 data – Hong Kong has accounted for over 57% of China's total official outward investment each year since 2012. Some proportion of these funds would likely be transferred to the Hong Kong-based subsidiaries of Chinese firms and then subsequently invested in other countries – which likely explains much of the historical disparity between country-by-country measures in the CGIT and official data.

LACK OF TRANSPARENCY IN OFFICIAL CHINESE DATA

Hong Kong accounts for majority of outward investment

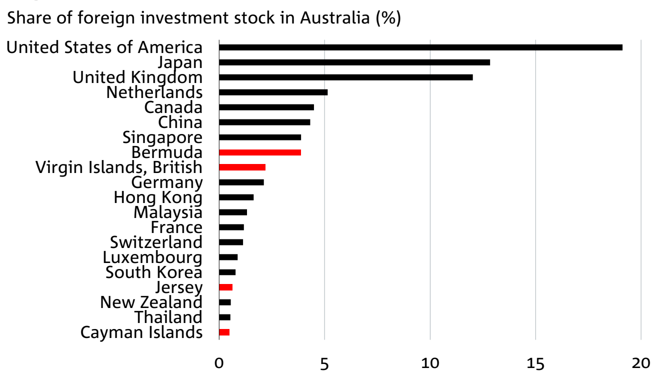


Source: CEIC, NAB Economics

China's official data show that the second and third largest recipients of outward foreign investment in 2020 were the Cayman Islands and British Virgin Islands, which combined accounted for around 10% of the total. Both of these are British Overseas Territories with sizeable offshore financial services industries and minimal tax regimes (often described as tax havens). Much like the flows to Hong Kong, it is likely that some proportion of these funds were then invested in other countries, with financial regulation in these territories allowing the source of the investment funds to be obscured. For example, Australian data show that the British Virgin Islands and Cayman Islands were the sources of the ninth largest and twentieth largest stock of foreign direct investment in 2020 (with Hong Kong ranked eleventh overall). That said, it is worth noting that these stocks are far smaller the three largest countries, namely the United States, Japan and United Kingdom.

FOREIGN INVESTMENT IN AUSTRALIA

Various tax havens – including Cayman Islands and British Virgin Islands – have a significant share of the stock



Source: ABS, NAB Economics

That said, the strength of reported investment flows to Hong Kong, the Cayman Islands and British Virgin Islands may not only reflect efforts to obscure the source of foreign investment funds. In the past, beneficial tax policies in these territories provide incentives to minimise mainland tax liabilities, allowing firms to bring profits (either generated in foreign locations, or domestic profits shifted to these locations using transfer pricing) back onshore by disguising them as inward investment flows. It is possible that the same firms located in these regions could now be used to disguise capital outflow as outward investment – a practice that may have intensified in response to fears of wealth redistribution under China's common prosperity policies.

CONCLUSIONS

The lack of transparency around China's outward foreign investment makes it extremely challenging to verify. The widening gap between official measures and alternatives such as the CGIT in 2020 and 2021 point to significant concerns with the official narrative around outward investment. While it is likely that outward investment exceeded the total estimated by the CGIT – given this measure excludes lower value transactions – considerable flows to tax havens suggests, at best, efforts to disguise the source of investment funds or, at worst, sizeable capital flight disguised as investment.

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