Confluence
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The Mystery of Chinese Capital Flight

Capital flight is defined as the rapid withdrawal of assets out of a country for political, economic or geopolitical reasons. Since late last year, there have been steady reports indicating that capital flight has been occurring in China. China restricts its capital account; inflows of foreign capital are carefully regulated and private outflows face significant restrictions. Chinese citizens can legally transfer only $50k per year out of the country. Despite these restrictions, Chinese citizens are apparently risking arrest (and potentially worse punishments) to move assets overseas.

Early in my career, I worked as a country risk analyst for a St. Louis bank. My job was to write reports that described the general economic, social and political environment of countries where the bank conducted business. In that role, one of the key warning signs was capital flight. In general, the wealthy in most countries tend to be politically well-connected. If large amounts of money suddenly begin to leave, it tends to be an early signal that the country is in serious trouble. Oftentimes, it was initially unclear what the problem was when capital flight was first noticed; however, within a few months, the reason was usually discovered. It was often due to confiscatory changes in taxes, fears of revolution, concerns about social stability, etc. Capital flight is usually a reliable omen that a country is in trouble. Thus, news of capital flight out of China raises concerns that serious problems exist.

In this report, we will discuss the evidence of capital flight, including both economic data and anecdotal reports. From there, we will examine possible reasons why capital flight is occurring. The impact of capital flight will be studied. We will conclude with potential market effects and a reflection on why the steady weakening of U.S. power may be exacerbating the situation.

The Evidence

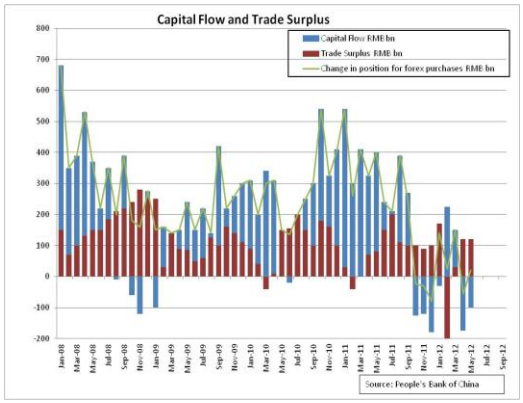
International balance of payments is similar to basic balance sheet analysis. The current account measures the trade account along with private and official remittances. An example of a private remittance is when an immigrant sends money back home.

The capital account is where investment flows are counted. There are essentially two types—portfolio and direct investment. The former represents the cross border buying and selling of debt and equity securities. The latter is either the purchase of existing plants and equipment by a foreigner, or a "green field" investment. When a foreigner buys a Treasury bond, it's deemed a portfolio investment. When a foreign company buys a U.S. company, it is considered a direct investment.

In theory, the sum of these two flows, the current and capital accounts, should equal zero. A current account deficit nation usually runs a capital surplus, as exporting nations usually lend to the deficit nation to pay for the imports. In practice, the two don't always cancel out. When they don't, the residual affects foreign reserves.

If the sum of the current account and capital account is greater than zero, foreign reserves rise (and vice versa). Since the change in foreign reserves can be measured, if the number fails to match the inverse of the sum of the current and capital accounts, there is another residual called the errors and omissions account. Sometimes the errors and omissions account captures capital flight, although it may also simply show mistakes and issues of transactions timing.

This chart shows the recent flows of China's current and capital accounts.



Until last autumn, with the exception of three months in 2008, China's capital and current account flows were positive. This meant that reserves were rising, shown by the green line. Since October, however, capital flows have been mostly negative and have tended to overwhelm the current account inflows. Overall, the reversal in capital flows suggests that either foreign flows have retreated or outflows have increased.

As we mentioned above, China restricts its capital account. There are laws against Chinese citizens moving large amounts of money out of the economy. However, these rules tend to be easily circumvented. Once a country has an open current account, over-and-under invoicing can allow individuals and companies to move excess funds in and out of the country. Although China restricts its capital account, Hong Kong does not and, given the porous border, once funds move into Hong Kong, they can move anywhere. In addition, China is notoriously corrupt. Bribing officials to turn a blind eye to money flows appears to be a regular occurrence. Thus, capital flight can occur in China despite laws against it.

China tends to allow foreign direct investment but impedes portfolio flows. Chinese officials prefer companies to build plants in China not only for jobs but to acquire intellectual property. Western companies constantly complain that their intellectual property is at risk in China. Portfolio flows, on the other hand, are less stable and don't offer the same benefits. As the previous chart indicated, for most of the past four years, both current and capital account flows have been positive. Thus, the recent reversal in flows raises questions about why this has occurred.

In the fourth quarter of last year, newspaper reports began describing elements of capital flight. Articles noted a surge in EB-5 applications to the U.S. These applications allow foreigners to achieve residency status if they (1) invest $1.0 mm into the U.S. economy and create a minimum of 10 jobs in two years, or (2) invest $500k into depressed rural or urban areas. In other words, it's a program designed to allow foreigners to effectively buy residency status. In 2006, only 63 Chinese citizens applied for this status; in 2011, this number rose to 2,408 (these applications are for family units so the number of actual individuals is hard to measure). In addition, unusual locales such as St. Kitts and Bulgaria have reported a surge in Chinese applications. Canada has tended to be a popular destination but has temporarily

halted applications because the process has been overwhelmed by demand.

In addition, New York, Los Angeles, San Francisco and even Florida are reporting a surge in Chinese nationals buying real estate. In fact, over the last 12 months, through March, the National Association of Realtors reports that Chinese buyers are the second largest contingent of foreign buyers of residential real estate. In contrast, Canada is the largest foreign buyer but also shares the world's largest undefended border with the U.S. Chinese buyers represent 11% of all foreign buyers, up from 5% in 2007. Reports indicate that Chinese buyers tend to buy high-end properties and usually pay cash. Demand is rising so quickly that realtor groups in these cities say they are hiring Mandarin-speaking agents to service these buyers.

Other Signals

Not all Chinese citizens are wealthy enough to navigate the loopholes to move money out of the country and make potential arrangements to leave. Those who remain have few investment choices. Equity markets appear unstable and real deposit rates are persistently negative. After 2008, real estate was seen as a safe venue for savings. However, that market is widely seen as being in a bubble.

In response, demand for gold has soared. In May, imports rose three times compared to the prior year. Last year, Chinese investors purchased 490 tons of gold, twice as much as in 2010. In addition, legal foreign currency deposits have increased significantly with nonfinancial firms, boosting deposits 72% from last year to $256.6 bn.

The accumulation of gold and flight from the Chinese yuan (CNY) to other currencies suggests worries about currency and financial stability. Gold is a traditional safety asset and an increase in gold investing often signals investor worries.

In March, Western money managers reported that Chinese financial authorities unexpectedly eased capital controls on portfolio investment. In a series of phone calls, officials offered to increase investing quotas but demanded near immediate acceptance. Managers reported that they had less than two hours to respond. It appears that China, who previously had severely restricted foreign buying of its financial assets, suddenly was trying to quickly bring in investments. Based on the analysis below, it would appear that this move was designed to offset a dollar shortage.

Why is this happening?

The evidence of capital flight, along with the accumulation of gold and foreign currency deposits, and the sudden interest in attracting foreign portfolio flows suggests growing worries. A key question is, "What exactly is raising these fears?" The *Hurun Report*, a monthly magazine published in China, recently surveyed Chinese citizens with a net worth of $1.6 mm and higher. Of this group, 54% were considering leaving China and, of this group, 14% have already actively taken steps to exit. A number of reasons were offered for leaving.

Fear of the new government: In November, the next leadership generation will take control of the Chinese Communist Party (CCP). Seven new members of the nine-member Politburo Standing Committee will be appointed, with Xi Jinping expected to be the next leader. Little is known about Xi; in fact, it appears that the CCP is purposely keeping news flow about Xi very low. The purge of Bo Xilai (see WGR, April 2, 2012,

The Purge of Bo) may be raising worries that the new government may crack down on corruption, and so the uncertainty may be encouraging wealthy Chinese to look for an exit.

Fear of the poor: China has become increasingly unequal. The last published Gini coefficient for the U.S. (by the World Bank) from 2007 was .469, which is consistent with the U.S. reading in 2010. Unlike the U.S., it is widely believed that the Chinese reading has become much worse. The Gini coefficient is a measure of income inequality—a reading of 1 means perfect inequality (one person has all the income) and 0 is perfect equality (all have exactly the same amount). In January, the Chinese government, for the 11th consecutive year, has refused to publish the country's Gini coefficient although it acknowledged it was calculated. The fact that the ratio wasn't published has raised concerns that it has worsened. There has been a steady rise in unrest in China. For the most part, the government has tried to keep growth around 8%, which has kept employment rising. However, if growth cannot be sustained, the poor may react negatively to the wealthy. Many of the poor in China believe those who become wealthy do so through political and family connections and bend the rules for their own gain. If growth cannot be sustained, the poor may demand a larger share of income at the expense of the wealthy.

Fear of corruption and regulation: Every culture has different perceptions of laws (see WGR, Sept. 26, 2011, Reflections on the Eurozone Crisis). The Chinese perception seems to be that laws don't necessarily apply to the rich and powerful. Comments from Chinese businessmen suggest that no operation in China can avoid breaking some regulation. Most of the time, these regulations can either be ignored or the violation is not registered if a bribe is paid. However, if a political leader decides that he wants to close or confiscate a business, it is fairly easy to find some law that was broken by that company's owners or managers. Bo Xilai engaged in a massive crackdown in Chongqing; many businesses were accused of corruption and their owners were jailed. Security officers under Bo have been accused of framing victims, using torture to extract confessions and using extortion to raise funds. It is possible that successful Chinese entrepreneurs fear that their businesses will be seized in the change in power and so they are preparing to exit by moving funds abroad. There have been reports that government officials are doing the same thing. The Chinese have a name for officials who are trying to flee, calling them *luo guan*, or "naked official." According to media reports, the CCP is trying to prevent Chinese officials from leaving. The People's Bank of China, in a leaked report, suggested that $126 bn was skimmed from public funds by officials from the mid-1990s into 2008. It is quite possible that the outflows we are seeing are these officials trying to secure their ill-gotten gains.

Fear about the economy's future: China's economy has been a major global success story. Rapid growth and millions being lifted out of poverty is truly an amazing feat. However, there are worries that the good times may be coming to an end. The "Chinese miracle" rested on an importer of last resort—the United States. As long as American consumers (and to a lesser extent, European consumers, too) would buy China's exports, the Chinese economy could continue to expand. The 2008 financial crisis indicated that export markets may not be reliable in the future. In response, policymakers encouraged banks to

aggressively lend, which has led to a real estate bubble. China has not shifted to an economic model based on consumption despite widespread acknowledgement that it is necessary. A big part of the reason for this lack of change is that the large state-owned enterprises (SOE) benefit from the current system of growth coming from either investment or exports. China's export and investment-driven model of development required the suppression of consumption and the repression of household finances. Savings were accumulated by households and deposited at banks with interest rates below inflation. This allowed for easy investment growth for the SOEs as rates were low enough to justify nearly any investment *as long as growth came from somewhere*. Shifting to a consumer-driven growth model will mean deposit rates will exceed inflation and cause a slowdown in investment growth and exports. Unfortunately, the leadership of the CCP dominates these firms and, since their wealth tends to come from the SOEs, they have little incentive to change. However, without change, the Chinese economy will struggle to grow (unless, of course, the West suddenly recovers, which looks unlikely).

Fear of environmental degradation: Part of China's growth miracle has come at the expense of the environment. Air pollution is legendary; in fact, last month, Chinese officials protested the fact that U.S. Consulates in China regularly tweet air quality readings from the roofs of their buildings. Chinese government readings regularly report air quality as "good" even when U.S. readings suggest poor quality. There have been numerous food scares in China, including melamine in baby formula. Wealthy Chinese indicate that environmental issues are encouraging them to leave the country—after all, what good is it to be rich if you are dead!

Fear about the future of the CNY: American policymakers have made it a crusade to force China to appreciate the CNY. It has generally been an article of faith that the Chinese currency is undervalued and thus it's a profitable idea to hold the CNY. However, the recent weakness in the economy and worries about the country's economic future has also raised concerns about the future exchange rate. If the CNY were to suddenly depreciate, it could be very costly, especially for wealthy citizens looking to emigrate to the U.S. or elsewhere.

What may be exacerbating this latter concern is a recent analysis from Standard Chartered that indicates Chinese companies may have built a large short position on the U.S. dollar. Companies, expecting the dollar to continue to weaken, paid for imports by borrowing dollars. In addition, it appears that some companies used letters of credit to essentially swap their debt into dollars and out of CNY to take advantage of lower dollar interest rates. It is now believed that the often reported "mountains" of raw commodities (copper, coal, steel, etc.) were accumulated as collateral for dollar borrowing.

Various media reports indicate that Chinese firms are hoarding dollars. Usually, firms sell their greenbacks to China's central bank, the People's Bank of China (PBOC), for CNY. This swap boosts domestic liquidity. However, it now appears that firms are keeping dollars, either on fears of CNY depreciation or to cover their dollar shorts. If these shorts are covered quickly, the CNY could weaken significantly.

Finally, it is also important to note that China has been through a tumultuous century. Over the past 100 years, it has seen the emperor overthrown, been invaded by

Japan, suffered through a civil war and became communist under Mao Zedong. Mao proved to be a mercurial leader; he caused thousands to die during the famine caused by the "Great Leap Forward" and nearly destroyed the social structure of China during the "Cultural Revolution." After Mao, Deng Xiaoping essentially ended socialism and supported a market economy, suggesting that "to become rich is glorious." Such ideas under Mao could lead to arrest and worse. Given such major changes in a relatively short time frame, it's no wonder that the average wealthy Chinese citizen is a bit wary that it could all go away quickly, especially when new, relatively unknown leaders are about to take control.

What could be the impact of capital flight?

The long-term problem of capital flight is the potential loss of investment capital and the associated "brain drain" as people follow their money out of the country. However, the focus of this report is the short-term effects. The primary worry is the drain on reserves. Given that China sits on $3.2 trillion of foreign reserves, this fear seems overdone. After all, how could all that money leave quickly?

Victor Shih, a professor of political science at Harvard, authored an interesting study last year where he measured how the high concentration of wealth in China may actually lead to a massive drain on foreign reserves. Shih estimates that the top 1% of Chinese wealthy families control anywhere from $2.0 to $5.0 trillion of wealth. If they were to move 30% to 40% of their wealth out of the country, Shih estimates that reserves could decline by at least $1.0 trillion, or about a third of the total. Japan, in contrast, has $1.3 trillion of reserves, but since income and wealth are more equitably distributed, the risk of a massive reserve drain is far less.

If the Chinese elite decide to move funds out of China, a relatively small part of the population could precipitate a serious financial crisis. If the PBOC didn't react, the markets would push the CNY sharply lower. In addition, liquidating the reserves would likely lead to selling of U.S. Treasuries. There has always been a deep concern in the U.S. that China may "dump" Treasuries; in fact, there have been worries that China would use such sales as a financial weapon. How ironic it would be if the sales occurred not to punish the U.S. but due to the lack of confidence in the Chinese economy and government.

Of course, the Federal Reserve could prevent the "dumping" from boosting rates. The U.S. central bank could simply buy all the bonds China wanted to sell. However, this action is fraught with risk as well. Absorbing these bonds would lead to a massive expansion of the Fed's balance sheet, an inadvertent QE. The political optics would be dangerous—the Federal Reserve would essentially be allowing China to sell its Treasuries at historically favorable prices, a massive support to a foreign nation, instead of allowing the market to "punish" China by forcing them to sell into a falling price market (which would, of course, send Treasury yields sharply higher). In previous QE episodes, the dollar fell sharply and commodity prices rose. A weaker dollar would severely harm Europe and higher commodity prices would weaken the economies of commodity-consuming nations (although it would be a boom for commodity producers).

In addition, the capital flight would almost certainly lead to a sharply weaker CNY. We note that the Chinese currency has been modestly weakening recently. The change has been framed by Chinese officials as broader float; in other words, China is

giving its currency a longer leash and it just happens to be weaker. However, this framing may simply be that—the reality could be that China is facing an outflow problem and is deciding that instead of selling Treasuries to prop up the value of the CNY, it is better off allowing depreciation cloaked as a market-driven event.

Given that this is an election year in the U.S., it is doubtful that the CNY will be allowed to weaken significantly without a political response. It is generally accepted by the American political class that the CNY is purposely (and unfairly) undervalued to support Chinese growth and so a weaker currency will almost certainly prompt calls for direct action, such as tariffs and quotas.

Ramifications

Although it appears a good case can be made that China is suffering capital flight, it is still difficult to determine how serious the problem is or why exactly it's occurring. If funds are moving simply due to concerns about new leadership in China, reassurance by Xi Jinping that the wealthy in China are safe might mitigate capital flight. However, if the problems run deeper (and they probably do), the situation is more serious.

The market ramifications of this issue are complicated and not all negative. During the Asian economic crisis, the U.S. enjoyed inflows from Asia that helped support American financial markets. As noted in the report, it appears that coastal real estate markets are benefiting from Chinese inflows. A major capital flight event in China may actually be positive for many nations that are seen as safe havens and the U.S. would probably be a major beneficiary. Treasuries might initially rally as the flight capital moves into safety assets. It is notable that last week's 10-year T-note auction drew a record 45.4% direct bid. These bids usually come from non-primary dealer financial firms. Official foreign bids are usually delivered by primary dealers or as indirect bidders. However, in March, the Treasury quietly allowed China to become a direct bidder, the only nation on the planet with that capability. It is highly likely China boosted that bid, suggesting a scramble for dollars.

On the other hand, such an event would likely not just be bearish for Chinese equities but emerging market financial assets as well. Commodities would decline, at least initially, as would the equities of commodity-producing nations.

However, the second derivate effect could be more subtle. This would depend on how China and the U.S. deal with the draining of China's foreign reserves. As discussed above, the Federal Reserve could mitigate the interest rate impact of China's Treasury selling and probably would do so. However, there would be considerable political costs for such a bailout. The expansion of the Federal Reserve's balance sheet would likely touch off a flight to hard assets as investors would become increasingly worried about the underlying stability of the dollar specifically and fiat currencies in general. Precious metals prices would likely benefit the most.

Perhaps the most serious signal from a capital flight crisis is that it would be clearly evident that the world has entered a "G-0" phase. Since 1945, the U.S. has generally stepped into global financial crisis situations and become the global importer and financier of last resort. From the Marshall Plan after WWII to the mitigation of the first Arab oil embargo in 1967, the 1995 Mexican Bailout and the "Committee to Save the World" of Alan Greenspan, Larry Summers and Robert Rubin in 1998

responding to the Asian Economic Crisis and the Russian Debt Default, the U.S. has exercised its role as a financial and economic superpower to prevent crises from escalating.

It is highly doubtful the U.S. could respond to a China crisis with equal firepower. Part of the reason is China's size. But the other is that the U.S. economy remains crippled by leverage and simply can't stimulate enough to support China's economy. Such an environment will tend to persistently weaken investor sentiment. Until the U.S. resolves the debt issue, the world is careening toward a leaderless environment.

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Confluence Investment Management LLC

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