CROSSING THE RIVER BY FEELING THE STONES

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Forecasting the impacts of ongoing Chinese capital account liberalisation is an art rather than science. However, we may still raise the most important questions and might as well get some answers using the international research results. For example, how much capital may flow from China abroad and vice versa in the coming years? Through which channels may the investments flow? According to the market and expert expectations the two-way portfolio investments may increase dynamically in the future, and outward portfolio investments may gradually replace some of the foreign exchange reserves within the international assets of China. In addition, China may not only be the recipient of the direct investment inflows, but more and more outward FDI may originate from China. However, the outcomes and the speed of the process greatly depends on whether the Chinese policy-makers remain committed to the reforms. Naturally, the circumspection similar to that when one crosses the river is also justified on the part of China's counterparty countries, including Hungary, when assessing and grabbing the opportunities.

This analysis is the fourth part of a series of articles. The first part of the series described the milestones of the internationalisation of renminbi, the second part dealt with exchange rate policy of the Chinese central bank, as well as the details of the foreign exchange swap agreement concluded with the MNB and other central banks while the third part reviewed the central bank's responsibilities related to the internationalisation of renminbi. The closing article of the series will be published in May, and it will discuss the key features of the international renminbi centres and renminbi initiatives.

1. THE DIRECT INVESTMENT OUTFLOWS MAY ACCELERATE IN THE NEXT YEARS

Deng Xiaoping, who launched the economic reforms, compared the reforms to *crossing the river, during which one should progress slowly and gradually, always feeling the stones beneath the feet*.

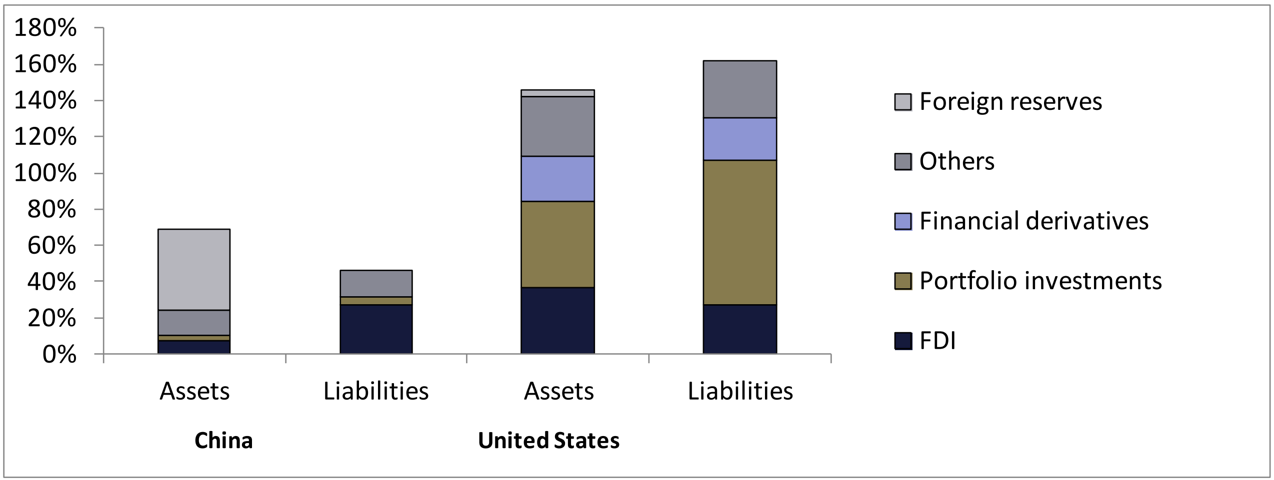
China is progressing with the international economic policy reforms slowly but steadily. The liberalisation generally followed the former practice of other emerging countries; the first step was the elimination of restrictions on current account transactions before China gained WTO membership in 2001, followed by the gradual liberalisation of the capital account in recent years.

"crossing the river
by feeling the stones"
Deng Xiaoping[1]

China may remain to be one of the most important savers in the global financial market, while the structure of the country's international investment position may undergo a considerable transformation. In the past decades the investments of developing China were dominated by the foreign exchange reserves, while on the liabilities side the inward foreign direct investments were the determinant factor (Chart **1**).

When outlining the future prospects related to the opening of the Chinese capital account several analyses compare the international investment position of the United States, the economy that has probably the most developed capital market, to that of China. The GDP-proportionate value of the foreign assets and liabilities of the United States are considerably higher and their composition is also more diversified. One of the most important differences is that the weight of the portfolio investments and the weight of derivatives is higher both in the case of the assets and liabilities (Chart 1).

Chart 1: International investor position in China and in the United States (GDP-proportionate value, 2013)



Source: IMF IFS

In parallel with the liberalisation of the capital account, in the future the value of outward direct investments and the portfolio investments from China to abroad and vice versa may considerably increase. At present there is only limited possibility for investments flowing into China within narrow quotas (QFI, RQFII, central bank bond programme, etc.). He et al (2012) estimated that the FDI outflow may increase from the present 5 per cent to 27 per cent of the world GDP over 10 years based on the expected GDP growth, the liberalisation of the capital account, the institutional factors and international patterns. Hooley, 2013 also arrived at similar results. The historic experiences of other countries also confirm that the capital flows may soar following the lifting of the restrictions.

[1] Deng Xiaoping , *Chinese reformer and head of state between 1978 and 1992, who pioneered the opening of the socialist market economy .*

In the light of the former financial liberalisation measures of China, the deregulation of the capital account may take 5-10 years, and could serve both Chinese and global interests. Advanced economies support the Chinese liberalisation already now, for example **by purchasing renminbi foreign exchange reserves**, and in the long run this process **may also lead to the official reserve currency status of renminbi subject to the continuation of the Chinese liberalisation (deregulation of the exchange rate regime, interest rates and capital account)**. So far only a few of the central banks holding renminbi instruments (BoE – Bank of England, RBA – Reserve Bank of Australia) have published details of their renminbi investments, and further central banks have communicated their intentions (BoK – Bank of Korea, BoN - Bank of Nigeria, BdF - Banque de France, etc.).

In addition, the efforts made to support the renminbi (RMB) financial markets (**for example the RMB government bond issuance**) may help China to appear in the global financial markets. The **institutional and governance reforms of the IMF and WB** are also such measures on the part of the advanced countries, **that have been long urged by the Asian partners**, and these may encourage the continuation of the Chinese reform measures in the future. **The shrinking of the Chinese foreign exchange reserves may be facilitated by the convergence of the country, the diminishing of its openness, the increasing global weight of the country, as well as the increasing flexibility of the exchange rate regime**.

Eichengreen(2014), however, warn that the liberalisation of the Chinese capital account is subject to a number of conditions, and that the liberalisation process is not necessarily a one-way road. Amongst others, it is important condition that the Chinese economic reforms continue (transformation of the state-owned companies, improvement of the asset allocation and investment quality, the broadening of the middle class's investment spectrum beyond deposits and real estate to other assets, the development of the institutional system, transparency, etc.). Furthermore, it was experienced in several countries that after commencing liberalisation of the international economic policy, the partial easing of the regulations strengthened the activity of the shadow banking system. In addition, the opening of external economy may also open new channels of contagion; therefore the development of the financial stability institutional system is an extremely important task in China (e.g. the deposit insurance system, the supervisory framework, credit rating, cross-border supervisory cooperation, etc.). **It is a question though whether under the increasing risks or upon the occurrence of certain unfavourable future events China would go on with the reforms, or rather decelerate or even reverse them, since all this may have a fundamental influence on the future prospects of the capital account.**

2. COMPONENTS OF THE CHINESE CAPITAL FLOWS

2.1. China may remain one of the most important global savers

Both the gross and net savings of China are exceptional by international standards as well, and according to the expectations China may continue to roll a current account surplus. Between 2010 and 2014 the gross savings in China accounted for 51 per cent of the GDP. Within the gross savings the share of the households and – rather unusually – the share of corporations were approximately the same; however, the latter is mainly attributable to the state subsidies.

The Chinese current account still has a surplus; however, this surplus has substantially shrunken from 10 per cent in 2007 to 2 per cent by 2013. The adjustment of the global imbalances, as well as the significant appreciation of the renminbi exchange rate could have contributed to the shrinkage. It should be also noted that in the past decades the domestic demand was driven by the investments, while in the future the consumption of the households may also increase, which may have an effect on the balance of payments. In 2012 the GDP-proportionate investment ratio was 47 per cent, which was attributable to the investments related to different construction activities (eg road and urban construction). According to the long-term expectations of the OECD, the current account surplus may endure: although the consumption will increase, the investments may gradually decline.

2.2. An increasing number of Chinese social funds may enter the international capital market

The portfolio of the insurance companies may expand due to the development of the Chinese social welfare system and the ageing of the population. The ratio of the urban population is increasing in China, and the income reallocation between the generations within the family is gradually decreasing. Particularly the savings of the high-income classes of the society – or the fast-growing social insurance, pension and other funds representing them – may appear in the international money and capital markets, looking for investment and diversification opportunities. The Chinese capital controls also restricted the investment of the households' savings abroad, and in the future these savings may appear in the international capital market in increasing volumes. According to the estimates the portfolio investment holding may increase from USD 300 billion in 2010 to USD 4-5,000 billion during 10 years, reaching 15-25 per cent of the GDP.

Chinese investment funds may have the largest room for manoeuvre in terms of the investment instruments. In view of the liquidity and risk management considerations they would presumably enter primarily the government securities market.

2.3. Certain central banks and institutional investors already appeared in the Chinese capital market

Chinese public authorities have provided central banks with preferred position when authorising portfolio inflows, hence they may invest in the interbank bond market already since 2010 (see the earlier article of our series).

Upon making the renminbi convertible it may become an international reserve currency and an increasing number of central banks may purchase renminbi assets in the future. A small group of central banks have already started developing their renminbi portfolios, at the same time, the ratio of renminbi investments is only a negligible portion of the entire currency reserve portfolio, even in these central banks, typically 1 to 3 per cent. The United Kingdom, which issued renminbi securities in October 2014 to fund its renminbi reserve portfolio, could serve as an example. The

United Kingdom is the first sovereign state that issued Dim Sum bond[2] in Europe; other non-governmental issuers such as British Petroleum (2011) and HSBC (2012) already appeared with renminbi bonds registered in London.

Financial institutions may also have an opportunity to make portfolio investments in China, capitalising on the possibilities offered by the present quota system (QFI – Qualified Foreign Investor, RQFII – Renminbi Qualified Foreign Investor) (see the first article of the series on the quotas). The RMB assets may have diversification and yield benefits, and the increasing demand may generate favourable price changes. Furthermore, the renminbi may gradually appear in the benchmark indices, which may also increase the demand for RMB assets directly/indirectly, thereby improving the financial profitability prospects of the early bird investors.

Table 1 Chinese capital inflow and outflow opportunities

CHINESE CAPITAL OUTFLOWS	
	INTERNATIONAL EXAMPLES
PORTFOLIO OUTFLOWS Foreign investments of Chinese insurance funds, portfolio diversification Foreing depostis of households and corporates	**UK Government -** RMB bond issuance **Private RMB bond issuance** (BP, BoC Singpore, Unilever, Vokswagen, etc) **Increasing cross-border credit activity (BoC, ICBC, ABC)**
FDI OUTFLOWS trade mark acquisitions, market occupancy, invest in strategic resoruces, growing domestic competition, narrowing profit margins, outsourcing of pollutant industries	**Brand acquisitions** (VOLVO, MG, Hummer) **Acquision of strategic resocurces** (mines in Afrika, Australia, South America, etc. **Increasing market share** (Wanhua-Borsodchem)
CHINESE CAPITAL INFLOWS	
	INTERNATIONAL EXAMPLES
PORTFOLIO INFLOWS* state debt financing, private fund raising	**QFII quotas RQFII quotas**(Hong Kong 270, London 80, Paris 80) Investments of Central Banks' FX reserves (Australia UK, Korea, Nigeria)

*Total capitalization of Chinese capital market is around 50000 bn RMB

[2] Dim sum bonds are renminbi bonds issued outside China.

The Shanghai-Hong Kong Connect programme commenced in November 2014, which connects the stock exchanges of Shanghai and Hong Kong, providing the investors of Mainland China and Hong Kong with the opportunity to trade with the equities listed in the two markets. At the start of the programme trading is only permitted with the Shanghai equity of class "A". Of the mainland Chinese investors only those having scriptural money of at least 500,000 renminbi may purchase Hong Kong equities. For the moment aggregate quotas were also set for the trading volume for both directions of the turnover.

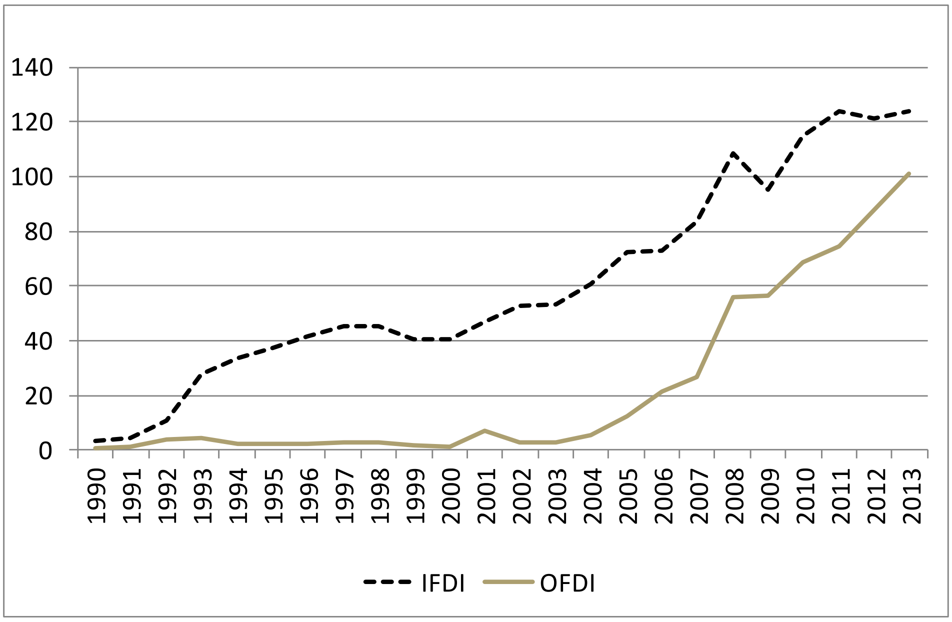
At the same time the article of Mills warns when analysing the reasons for the partial utilisation of the QFI and RQFII quotas that the integrity and transparency of the onshore Chinese markets is limited currently and the acceleration of the capital flow into China may be conditional upon regulatory and institutional changes.

2.4. China may no longer be only the destination of foreign direct investment

FDI inflow has been one of the drivers of Chinese growth since the 1990s. Economic growth in China benefited both from FDI investments and the technology transfer, management and institutional organisation expertise they entailed. At the same time, due to the deceleration of global and Chinese growth and narrowing profit margins, capital inflows have slowed down significantly in recent years.

According to the expectations, following the decades of the Chinese inflows of foreign direct investments, the future may already be dominated by the outward FDI. The most important targets of the Chinese foreign direct investments in the past included: (i) brand purchases (e.g.: Volvo, Hummer, MG), (ii) **export market acquisition, (iii) relocation of polluting industries, (iv) purchase of strategic resources** (mines in Africa, Australia and South America). Outward direct investments may also be encouraged in the future by the economic convergence of China, the new industries being established (e.g. electronics, alternative energy, etc.) and the more open external economy and foreign policy of China.

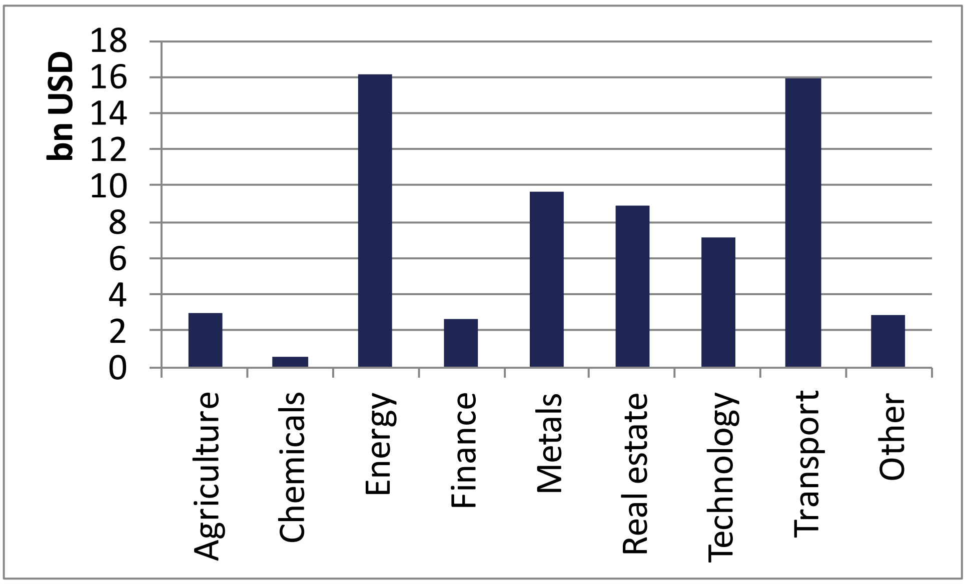
Chart 2: China's FDI stock (USD billions)



Source: [UNCTAD]

The latest direct investment statistics are not yet available; however according to the database of the [Heritage Foundation] that keeps records of the most important Chinese capital investments, after many years of growth the Chinese capital investments considerably fell in 2014. Primarily the South American, African and West Asian investments declined. The investments in transport infrastructure and energetics were key within the Chinese investments.

Chart 3: Distribution of the major Chinese foreign direct investments by sectors (2014)



Source: **[Heritage Foundation]**

In the East European region Hungary has already been an important target country for Chinese FDI. For example, the Wanhua acquired control of Borsodchem in Kazincbarcika, as well as the Huawei investments generated considerable inflows. **According to Szunomár's essays (2014) in parallel with the transformation of the Chinese capital account, the foreign direct investments directed towards the region may rapidly increase.**[3] On the other hand, for the time being the Chinese FDI holdings account for only a fraction of both the investments and the outflows of the total Hungarian FDI.

2.5. Hungary has a favoured role in the CEE region

Hungary has a key position in the region from several aspects, which may facilitate the capitalisation on the growth of the Chinese capital flows.

On the one hand, for the time being the MNB is the only central bank in the region that signed a swap line contract with PBOC (People's Bank of China). The swap line contract may provide a safety valve in the future for the event of market liquidity disorder.

On the other hand Bank of China opened its headquater in Budapest, Hungary and plans to set up a regional business centre.

Furthermore, since the 2000s Hungary has been one of the most important target countries for the Chinese FDIs. On the whole, the direct investments in the East European region accounted for a substantial part of the total Chinese foreign direct investments; however, due to the low level of the Chinese FDI (Chart 1) their ratio in total Hungarian foreign direct investments continues to be small.

In addition, Hungary is one of the most popular target countries in the region for the Chinese immigrants. In the 1980s the visa exemption for China made Hungary an important station for the Chinese migrants whose destination was other EU countries. The social situation of the Chinese population in Hungary is heterogeneous; as opposed to other countries clerks and public corporation managers also settled in Hungary. On 1 January 2013 the number of Chinese residents in Hungary was 12,716, accounting for 9 per cent of the foreign population. Migration on the whole may promote the presence of the Chinese direct investments in the region.

It is expected that the opening of the Chinese capital market will provide opportunities for the agents in the domestic capital market and real economy in an increasing number of areas; nevertheless. However, foresight is also justified when assessing and capitalising on the opportunities. The Heritage Foundation highlights the importance of mutuality when encouraging Chinese investments. For the time being the implementation of the Chinese capital transactions may also be hindered by language and institutional barriers. Therefore, when exploiting the widening Chinese investment and funding opportunities, circumspection is justified ("Crossing the river by feeling the stones") following the strategy of the Chinese partner.

[3] Ágnes Szunomár(2014): Chinese Investments and Financial Engagement in Visegrad Countries, Myth or Reality, Visegrad Fund, MTA KRTK VGI