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CHINA

Should we fear capital flight?

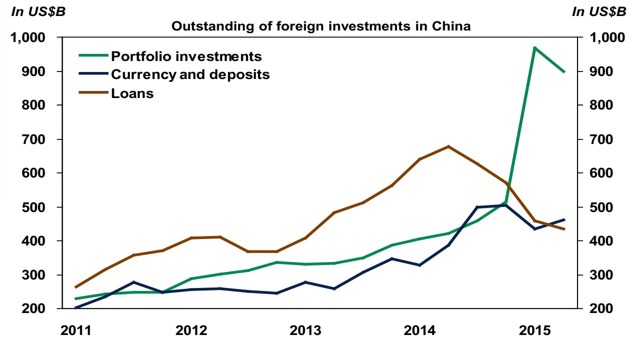
Capital flight could seriously damage an economy if it triggers a sharp rise in interest rates or sudden reigning-in of credit. The crisis in emerging countries in 1997 and 1998 was greatly amplified by capital flight. At the time, China was spared mainly due to restrictions on capital movement the country applied.

Still today, China applies fairly strict control over its capital flows, but a gradual liberalization process is underway. Reforms have to date permitted a wider range of foreign investors to access the Chinese market and facilitated the acquisition of more liquid assets. The other side of the coin is that China is becoming increasingly sensitive to the whims of international investors when times are turbulent.

According to official Chinese data, total foreign portfolio investment was close to US$900B at mid-year, up nearly 300% since the start of 2011. Other investment categories can also be taken into consideration in analyzing capital flight risk. We can include currency and deposits held by non-residents (around US$500B), as well as loans granted by financial institutions outside of China (a little over US$400B). However, all these amounts likely exaggerate the real risk. First, the Chinese stock market correction over the summer should have already deflated the value of portfolio investments. Next, the loans granted by foreign institutions cannot all be terminated quickly. Only short-term loans really represent a capital flight threat. As such, we estimate the amounts at play to be lower than US$1,500B, or slightly more than 10% of China's GDP.

That may still seem like a lot, but it should be looked at with China's specific context in mind. The country generates a savings surplus and possesses the largest foreign exchange reserves in the world. At over US$3,500B, these reserves would be more than sufficient to offset a flight of foreign capital .

Capital inflows have generally increased in the more liquid investment categories in the last four years



Sources: State Administration of Foreign Exchange and Desjardins, Economic Studies

All that remains is the question of capital held by the Chinese, as they could also be tempted to invest their wealth outside the country. On that front, the capital controls applied by the authorities are still very strict, severely limiting the flight potential. For example, Chinese portfolio investments abroad totalled US$276B at mid-year, up only 22% since the start of 2011. In recent years, reforms to liberalize capital outflow have especially targeted direct foreign investment, a much less volatile type of investment that is much easier to control if necessary.

Implications: Capital flight risks appear limited for Chinese economic growth due to the country's significant capacity to free up financial resources by selling its foreign exchange reserves. That said, China dumping around US$1,500B of securities over a short period could increase international financial market volatility. The U.S. bond market, where China's foreign currency reserves have largely been invested, could be particularly hard hit.

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