

## China Economics

# Will Capital Outflows Intensify in 2024?

### Capital Outflows May Continue in Coming Quarters

Net capital flows turned negative in 3Q 2023 for the first time in three and a half years. Unlike the last episode of net outflows in 1Q 2020, which was a blip induced by pandemic-era seizures in global trade, the drivers behind this quarter's softness are more likely to be sustained in the coming quarters. This puts downward pressure on the balance of payments (BOP) in 2024.

China recorded net outflows of \$38.1b in 3Q, including \$100.7b of net outflows from the capital account (Fig 1). The latter was the most significant leakage—besides the 1Q 2020 episode—since the BOP stresses of 2015/16, which saw cumulative net outflows of \$707.3b from the capital account in six quarters. While there is minimal risk of BOP strains of such scale re-emerging, China may continue to see moderate net outflows next year. We expect the People's Bank of China (PBOC) to respond with a combination of depreciation against its trade-weighted currency basket, judicious intervention and more scrutiny over financial flows.

### Three Forces Weighing on Flows in 2024

Three emerging drivers will weigh on different parts of the current and capital accounts going into 2024. **First**, Chinese travel demand has contributed significantly to the services trade deficit pre-Covid. As outbound tourism normalizes, its drag on the current account will re-emerge, weighing on what is presently a modest surplus. **Second**, foreign direct investment (FDI) inflows have turned negative. They face structural headwinds and may struggle to offset outward direct investment (ODI) outflows in the near term. **Third**, portfolio investments have become more important components of the capital account, as cross-border capital market linkages grew. Their recovery will depend on global and domestic investor sentiment, which is less assured.

### Current Account More Stable vs. Volatile Capital Account

In the past five years, since the authorities took concerted steps to stem illicit outflows, the capital account has had a reduced impact on the BOP. From 2Q 2019 to 2Q 2023, the current account balance had outweighed the capital account balance as the deciding factor as to whether the country saw net capital inflows. In the last quarter, even though the current account posted a healthy surplus of \$62.6b, the capital account deficit of \$100.7b led to overall net outflows. Notably, two-thirds of the capital account deficit was due to a net outflow of direct investment (Fig 3).

### Steady Goods Surplus, Widening Services Deficit

The goods trade surplus has been largely steady, averaging 3.3% of GDP over the last five years (Fig 2). Thus far this year, it has stayed at around 3.5% of GDP, reflecting the gradual bottoming out of merchandise imports and exports. In 2024, the goods trade surplus is likely to remain at a similar share of GDP, as we expect regional goods exports to recover, and for domestic inventory restocking to spur imports.

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In contrast, the services trade balance had been dictated by a deficit in tourism services, which ballooned before the pandemic struck. Tourism accounted for 90% of the country's services trade deficit pre-pandemic, as far more Chinese travel abroad than foreigners visited China.

### **Driver #1: Rising Outbound Tourism Widening Services Deficit**

During the pandemic, the tourism services deficit had plunged 83% from its peak to \$14b at its trough. As a result, the services deficit tapered from around 2% of GDP pre-Covid to 0.3% of GDP in end-2021.

Since borders reopened, the resumption of travel has led to the tourism services deficit widening to reach 1.5% of GDP in 3Q 2023. Outbound tourism payments are 72% of their pre-pandemic peak and have been partly held back by a lack of flight capacity. Their normalization will widen the services trade deficit in 2024. In addition to services trade, the primary income balance should continue to pose a drag on the current account balance in 2024, as repatriated income by foreign entities outstrips those by domestic entities.

### **Driver #2: FDI in Retreat**

In 3Q 2023, FDI flows into China turned negative for the first time—implying that foreign firms were starting to pull back from expanding capacity on the mainland (Fig 4). The unprecedented retraction, although modest at \$11.8b, aligns with foreign companies' professed desire to deploy resources to more countries in the region, as well as back to their home countries, amidst geopolitical tensions and de-risking efforts.

At the same time, outward direct investment (ODI) by Chinese companies abroad has continued apace, as they have an impetus to explore global markets amidst sluggish domestic demand. While mainland capital's overseas forays subtracted \$54b from the capital account in 3Q, FDI ceased to have an opposite effect to offset. In 2024, we expect FDI flows to stay mildly positive at best, and possibly be negative in some quarters, as the fundamental drivers for MNCs' "China+1" diversification thrust are set to remain.

### **Driver #3: Portfolio Investments Become More Volatile**

According to available data up to 2Q 2023, portfolio investment saw net outflows for six consecutive quarters. Foreign investors were significant net sellers of Chinese bonds until Q1 2023, and Chinese investors increased their holdings of foreign debt securities, as spreads between developed market and domestic rates grew (Fig 5). Foreign investors' incremental appetite for Chinese equities was volatile in recent years, and fell to \$6.6b in 2Q 2023 (Fig 6).

Before 2019, the capital account had been influenced more by direct than portfolio flows. Since 2019, however, alongside Chinese securities' inclusion into global bond and equity indices, and as mainland investors gain greater access to offshore assets via China's Connect schemes, portfolio investments' role in the capital account balance had become more significant. Due to the sentiment-sensitive nature of these flows, they are less sticky and assured than direct investments.

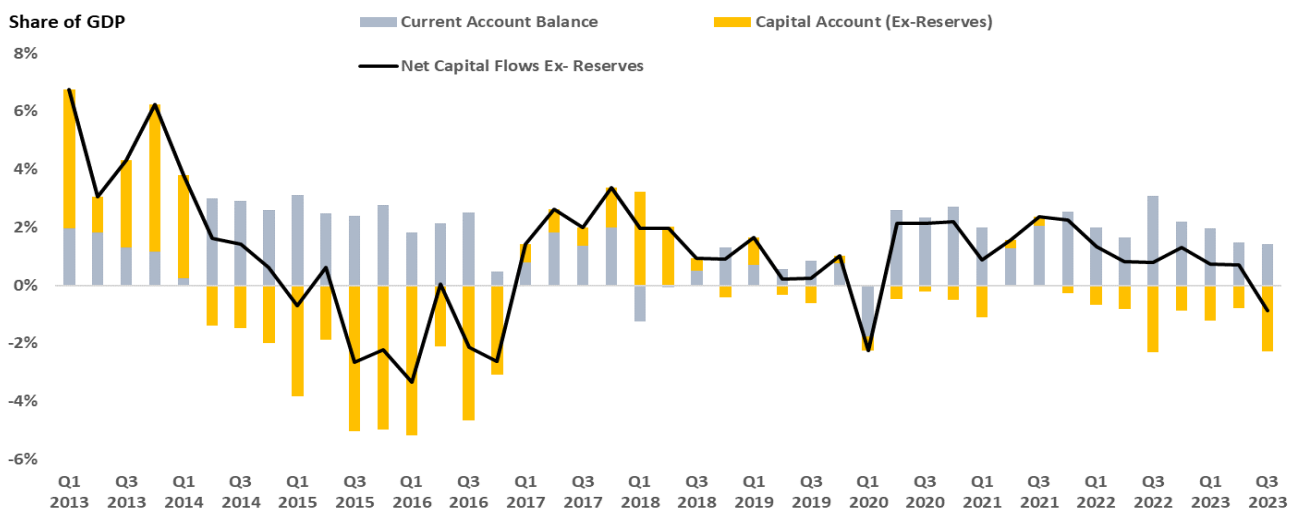
Going into 2024, we expect portfolio investments to remain volatile and render the capital account less predictable than before. However, the return of animal spirits in the onshore capital markets can possibly usher in net portfolio inflows.

## Implications for RMB in 2024: Depreciate, Defend the RMB, or Tighten Controls?

The forces that contributed to net capital outflows in 3Q may continue to hold sway over the BOP next year, at least in some quarters. Hence, we expect the PBOC employ a combination of depreciation, intervention and regulatory scrutiny, to manage capital flows and the RMB exchange rate. The central bank has expended \$38b of foreign reserves intervening in the FX markets in 3Q to support the RMB exchange rate amidst USD appreciation. Consequently, the RMB strengthened against its trade-weighted basket of currencies, even though it weakened slightly against the dollar (Fig 7).

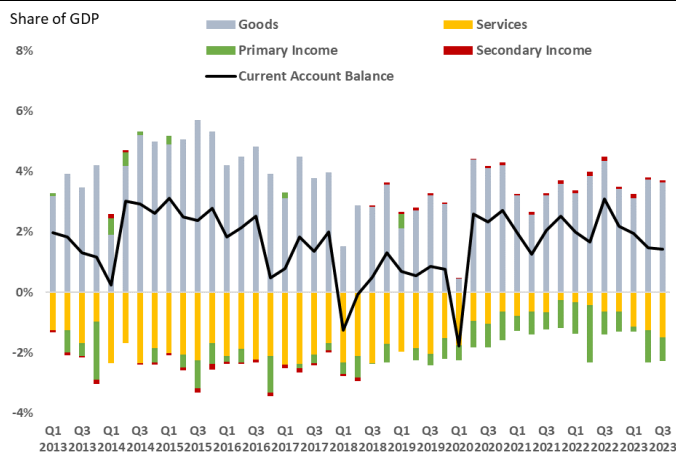
Going into 2024, the PBOC is likely to allow the yuan to depreciate vis-à-vis the basket, but still strengthen against the dollar. Concomitantly, it may then intervene more judiciously, to cushion excessive volatility in the yuan exchange rate. With net capital flows likely to be less predictable next year, the PBOC has recently communicated its pivot towards a more cautious stance toward capital account convertibility (see [Financial Work Conference: RMB - Safety Over Openness](#), 1 November 2023) This may translate into more scrutiny into short-term financial flows, while long-term investments will be favored.

**Fig 1: China Posted Net Capital Outflows for the First Time in Three and a Half Years, Amounting to \$38.1b (-0.9% of GDP)**



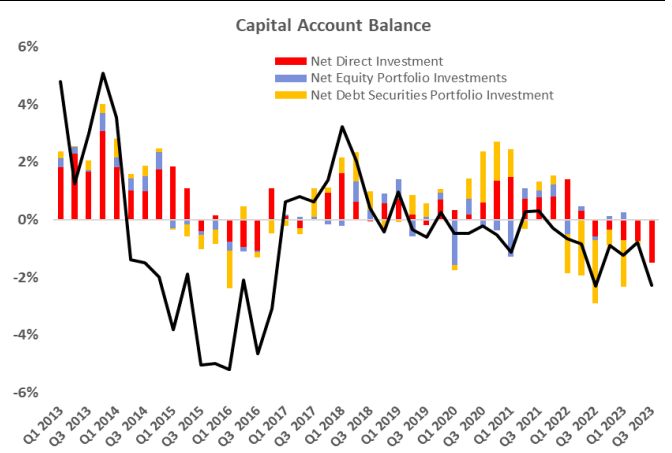
Source: CEIC

**Fig 2: The Services Trade Deficit is Set to Widen Next Year, Partly Offsetting a Steady Goods Trade Surplus**



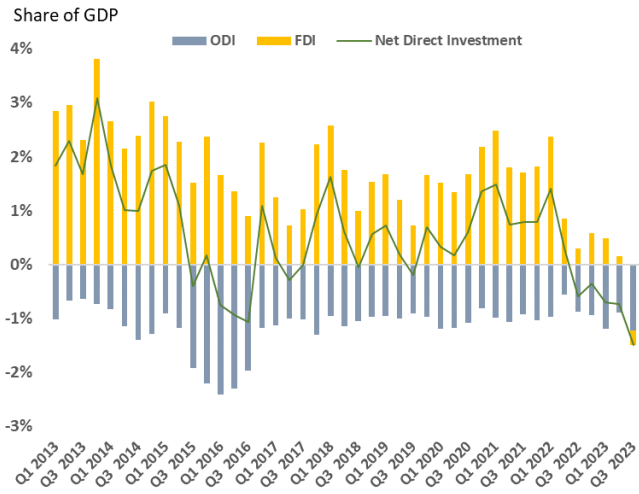
Source: CEIC

**Fig 3: Net Direct Investment Account for Two-Thirds of the Capital Account Deficit in 3Q 2023**



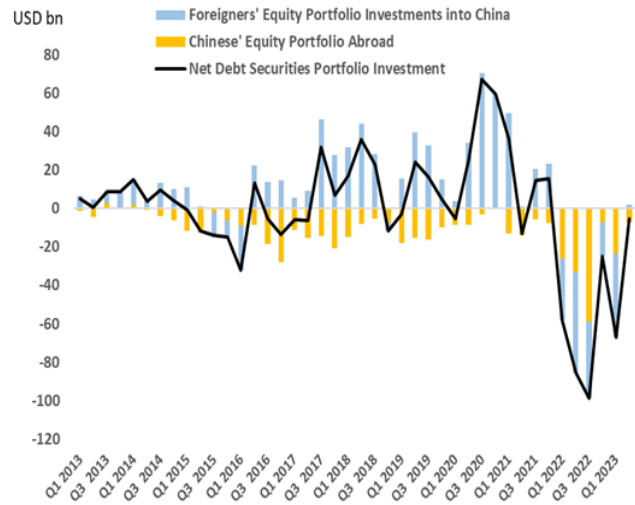
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**Fig 4: FDI Had Been Tailing Off Since 2022, But Turned Negative for the First Time in 3Q**



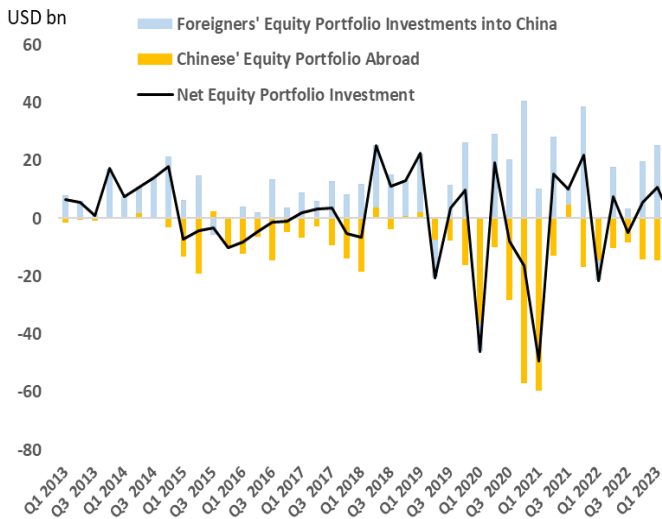
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**Fig 5: Net Investments in Debt Securities Were Negative for Six Quarters**



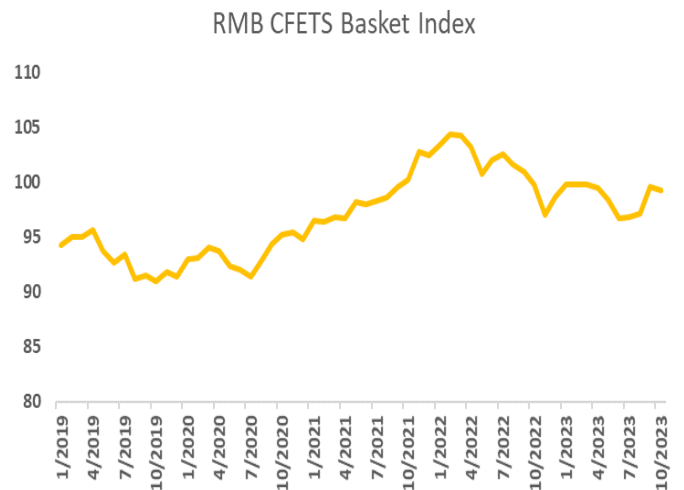
Source: CEIC

**Fig 6: Foreign Investors' Equity Purchases Fell at \$6.6b in 2Q**



Source: CEIC

**Fig 7: In the Past Quarter, the RMB Has Been Appreciating Against its Trade-Weighted Currency Basket**



Source: CEIC

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