Research on Correlation Analysis of Capital Outflow and Financial Crisis

Mingying Geng[a], Ying Mao[b]

Industrial Economics Research Center of Wuhan Textile University, Wuhan, 430200, China

e-mail: [a]813535187@qq.com, [b] 78922665@ qq.com

Keywords: Capital Outflow; Financial Risks; Correlation

Abstract: Since the second half of 2014, China's foreign exchange reserve has been falling and capital outflow has been increasingly prominent. The Central Economic Work Conference held in December 2016 made it clear that "the prevention and control of financial risks should be put in a more important position". Based on the typical examples of financial crisis caused by the soar of capital outflow in some countries, this paper analyzes in detail the potential factors that may cause the financial crisis in China due to the soar of capital outflow, and provides reference for exploring the effective control of China's capital outflow and ensuring that systemic financial risks do not occur.

1. Introduction

Over the past two years, the soar of capital outflow in China has been a topic of concern at home and abroad. According to the statistics released by the authorities, China's foreign exchange reserve has fallen from more than $4 trillion in 2014 to less than $3 trillion in January 2017, a drop of nearly 30 percent. Only in 2016, the capital outflow through illegal channels like underground banks was as high as more than 900 billion yuan, which are likely to be converted into dollars and withdrawn from China. The decrease of foreign exchange reserve and the illegal outflow of RMB have shown the increasing trend of capital outflow in China in recent years.

Although since 2017 China's macroeconomic performance has shown a steady trend towards positive growth, economic development has always been two-sided. A strengthening economy does not mean that the financial crisis risk point has been eliminated. Therefore, President Xi Jinping stressed again at the meeting of the Political Bureau of the Communist Party of China (CPC) Central Committee on April 25 this year: "The prevention and control of financial risks should be put in a more important position. And we should be determined to deal with a number of risk points, focus on the prevention and control of asset bubbles, improve regulatory capacity and ensure that systemic financial risks do not occur." In general, China's economy is still in a hard time of transformation. The better the economy develops, the more alert we should be to avoid the occurrence of the financial crisis.

2. Typical examples of the international financial crisis caused by capital outflow since the 1980s

2.1. Latin American financial crisis since the 1980s

In the 1960s and 1970s, Latin American countries adopted a development model of "foreign-led" economy, introducing a large amount of capital into western developed countries with the U.S. at their core and large multinational corporations. This led to the economic development of Latin America. After the 1980s, Latin American economies were manipulated by the United States and European countries, which were reflected in the strong dependence on foreign investment, the widening gap between the rich and the poor and political instability. Coupled with the battle for islands between Argentina and the United Kingdom, a large number of European and American enterprises withdrew investment from there. Within almost six months, 90% of foreign capital fled Argentina and Latin America, thus leading Argentina to be the first to suffer the worst financial

  DOI: 10.25236/cstss.2019.078

crisis in its history. Banks and corporates went bankrupt, the Argentina Peso continued to depreciate and domestic inflation reached 3,079.5 percent in 1989.

2.2. The Asian financial storm of the 1990s

In the 1980s, the rise of the Newly Industrial Economics drove the economic development of Southeast Asian countries. The emerging countries in Asia with its high returns attracted a large number of Western capital inflows, the influx of which caused Asian capital markets to accumulate mass asset bubbles. In 1997, Thailand has seen a sharp devaluation of the Thai Baht, a great deal of dollar capital flight, and the stock market crash. Therefore, it became the starting point of the Asian financial crisis. Then, the stock markets of several emerging markets in Asia were also attacked, with large amounts of capital fleeing these countries, leading to a sharp fall in the Indonesian Rupiah, the Philippine Peso, the Malaysian Ringgit, and the Korean Won and so on. Capital bubbles of countries burst. Consequently the Asian financial crisis was fully burst in 1998.

2.3. The Greek financial crisis in 2010

After the global financial crisis in 2008, EU countries were hit hardest by their close financial ties with the US, among which Greece was one of the hardest hit countries. As a peripheral country in the Eurozone, Greece's export-led industries have been hit hard because of its weak economic base. Not only did it result in the rapid withdrawal of foreign capital, but also the relocation of large numbers of domestic enterprises as well as the transfer of large amounts of Greek bank deposits. As a result, the Greek banking sector fell into a capital outflow crisis. In April 2010, the U.S. Standard and Poor downgraded Greece's sovereign debt credit rating to junk status, making its financial crisis trigger Greece's sovereign debt crisis.

2.4. Russia's financial crisis in 2014

After the global financial crisis in 2008, with the rising global oil prices, Russia's economic development has improved considerably. But after the Ukraine crisis broke out in late November 2013, The United States has joined the European Union in imposing tough economic sanctions on Russia, which has hit the country's economy hard. Especially after June 2014, the Russian economy was exacerbated by a cliff-like drop in international oil prices. According to statistics from the Central Bank of Russia, Russia's net capital outflow in the year 2014 was $151.5 billion, doubling the outflow in 2013.This led to a further fall in the value of the Russian Ruble, plunged foreign exchange reserve to their lowest level since 2009, and made inflation reach a seven-year high of 15%. GDP fell 3.7% year-on-year. Import and export trade fell by 30%. Despite the economic recovery in 2016, Russia has not yet been fully out of the shadow of the financial crisis.

3. Potential factors that may trigger financial crisis in China's capital outflow

3.1. China's balance of payments shifted from a "double surplus" of trade and capital to a "net outflow of capital"

Currently, China's balance of payments has changed from the original trade, capital "double surplus" to "net outflow of capital". According to data from China's State Administration of Foreign Exchange, China's capital and financial projects have run a deficit for three consecutive years since 2014, and in fact both domestic and foreign investors have a desire to move their funds abroad. On the other hand, the desire of domestic enterprises to invest abroad has expanded, with foreign direct investment of $145.67 billion in 2015 and more than $170 billion in 2016, making them become the contributors for net capital outflow for consecutive three years. With the continued growth of China's foreign direct investment and the promotion of the global allocation of assets of Chinese enterprises and residents under the background of the Belt and Road, we cannot ignore the transformation of capital flows under the current downward trend of the macro-economy, which may become the driving factors for exacerbating China's capital outflow.

3.2. China's RMB faces the pressure of sharp depreciation and future expectations

At present, although the RMB exchange rate remains stable overall, it still faces great depreciation pressure, and the frequency of fluctuations in exchange rate is still high. Under the current managed exchange rate system, if RMB continues to depreciate, leading to an increase in capital outflows, the People's Bank of China (PBOC) will continue to use its foreign exchange reserve to prevent currencydevaluation. If the reduction of foreign exchange reserve accelerates, it will certainly exacerbate RMB depreciation expectation, resulting in the withdrawal of a large number of foreign investors. The impact of the sharp devaluation of RMB will lead market participants to have a consistent depreciationexpectation of RMB exchange rate, and quickly translate intomarket-consistent action. A large number of RMB is expected to be undersold, the RMB exchange rate will slump, capital outflow will intensify. This is very likely to cause a vicious circle of exchange rate depreciation and capital outflow, and become a sensitive risk point for the domestic financial crisis.

3.3. The continuous growth of non-performing loan balance of commercial banks in China

At present, China's domestic commercial banking system may be a significant risk point for the financial crisis, because not only the banks' capital flow has a clear phenomenon of "de-reality", but more importantly, the operating profit of the banking system has fallen sharply. The scale of non-performing loans and non-performing loan ratios showed a trend of "double rising". (see Figure 1). At the same time, with the acceleration of the country to cut overcapacity and de-leverage, the number of "zombie enterprises" will increase, and the banks' bad debts will also have greater expansion; especially thecapital bubble of the real estate industry with the most concentrated bank loans will be enlarged, and if there is any disturbance,the tide of non-performing loans of commercial banks may be a high probability event in the future. Therefore, if the non-performing loan balance of commercial banks in China is not effectively controlled, it may become an important potential factor to aggravate China's capital outflow.

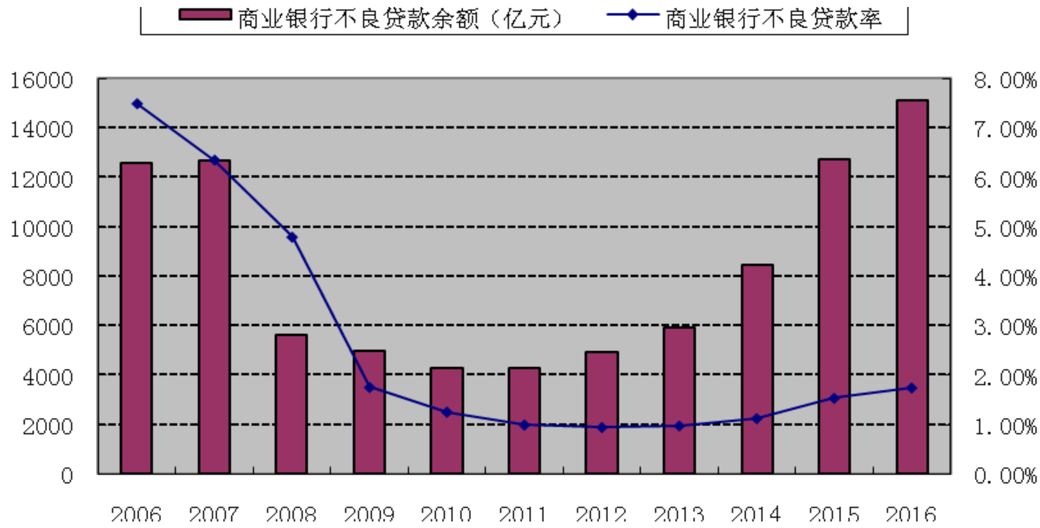

Figure 1 Non-performing loan balance and non-performing loan ratio of China's commercial banks from 2006 to 2016

Data source: China Banking Regulatory Commission "Commercial Bank's Main Regulatory Indicators Table" and "Non-performing Loans Table"

Note: In 2008, China packaged non-performing assets and divested them into four major asset management companies, resulting in a sharp decline in the balance of non-performing loans of commercial banks.

3.4. The bubble of China's enterprises and local debt appears

According to statistics from the Ministry of Finance, the debt balance of China's central and local governments stood at 27.33 trillion yuan at the end of 2018, and the total amount of foreign debt rose to nearly 10 trillion yuan (equivalent to 1420.7 billion U.S. dollars). Although China's debt scale and debt ratio are lower than the international warning line, due to the substantial downward pressure on China's economic growth, the scale of debt is expanding, especially the local government debt bubble has emerged and become an important risk source to trigger the crisis. As local debt soars, the capital turnover rate will continue to decline, the capital efficiency will also decline, and a large number of bank repayments will be indefinite. The IMF's latest Global Financial Stability Report estimates that the potential loss of corporate loans in China's banking industry could be equivalent to about 7% of GDP, which means that corporate debt problems are closely related to bank assets, while the debt created by large amounts of local engineering and local companies is closely related to the blind expansion of investment by local governments. Once foreign capital is withdrawn from certain places and areas, capital outflows will intensify, and local debt may become the first falling domino that sets off the financial crisis.

3.5. China’s economy transition faces challenges from outside world

Chinese economy transition enters the key stage, but the change of the economy and trade policy will be influenced by other countries’ policy. The Black Swan events from outside world are unpredictable. Since in office, president Trump has practiced protectionism guided by American First, which not only influences the stability of the world economy, but also makes more friction come out between China and America. In the long run, American First actually means maintaining American hegemony in economy and politics and curbing the rising of China’s economy. As a result, American following economy and trade policy will put much pressure on China’s economy, as the manufacturing industry and export is the main part of China’s economy. In addition, the Federal Reserve’s regulation, keeping raising interest rates and tightening monetary, accelerate the backflow of dollar, so as to accelerate American asset’s back. It’s evident that American new protectionism and tightening monetary policy will challenge greatly China’s economy transition. At first, it will make more trade friction between China and America; secondly, it will make the RMB depreciation more possible and even more capital flight.

3.6. The risk comes from uncertainty of geopolitics

Recent years, with the changing of international political, economic and military situation, there is much uncertainty of China’s geopolitics. At first, American military provocation and block. America, taking advantage of South Korea, Japan, Taiwai Ireland, Vietnam, Philippine and other countries, forms a semi-ring encirclement, to curb China’s economy development. Secondly, due to the hostile relation between the United States and North Korea, the situation on the Korean peninsula is further strained. The North-South confrontation, large-scale military exercises and nuclear weapons tests, the danger of war at any time and the deployment of Sade in South Korea, all these factors will threaten China’s territorial security. The China-Japan dispute over the sovereignty of the East China Sea and the Diaoyu Islands has intensified, and the situation in the Taiwan Strait has become complicated and severe. The risk have risen, greatly enhancing the geopolitical uncertainty surrounding China. Once the contradictions intensify and even trigger local military conflicts, China’s involvement in it will inevitably lead to panic among domestic and foreign investors. Not only will large capital outflows be inevitable, but it may even disrupt China’s economic development and deployment, resulting in more serious harm than the financial crisis.

4. Conclusion

Although China's economy in 2017 has shown a trend of “more steady and better growth,” the pressure is considerable. We should not conceal the problems in economic development, and we should not shy away from the possibility of a financial crisis caused by the intensification of capital outflows in a short period of time. The typical examples of the international financial crisis since the 1980s have warned us that large-scale capital outflows or fleeing are the triggers for financial crises. China should use history as a mirror to objectively analyze the intensification of China’s capital outflows, which may trigger financial crises, and potential factors to effectively prevent financial risks.

References

[1] Tingyu Chen. Signs of Greek capital flight are obvious, banking industry may be in a new round of crisis[N]. 2010-04-07, China Securities Journal

[2] Zhiyuan Zhang, Liang Zhang. The reform of the financial supply side on the real economy [N]. 2017-01-26, Financial Times

[3] People's Bank of China. 2015 Annual Report: Further promote the two-way opening of the capital market[N]. 2016-06-22, Economic daily

[4] Luewen Zhang. The Causes and Countermeasures of Corporate Debt Risk in China [N]. China Securities Journal, 2016-07-18