Capital In and Out of China

THE RATE AT which foreign capital has been flowing into China over the last decade has received much attention. China is now the second largest recipient of foreign direct investment in the world, after the United States. What few observers appreciate is that despite these announced capital inflows, China is a net capital-exporting country. Most interesting is that much of the net outflows are unreported in any normal way. This oddity on China's international accounting books looks like much more than just a statistical discrepancy.

No one who applies the arithmetic of balance of payments accounting would be surprised that China is a net capital-exporting country. That is not an oddity. With respect to financial flows, what is true of individuals is true of nations, except that capital inflows and outflows involve movements in foreign currency. As an individual, if I spend more than I earn, I must make up the difference by borrowing—which is a capital inflow to me. Likewise, if a country imports more than it exports—buying more than it sells—it is a matter of pure arithmetic that the difference between the imports and exports is made up by foreign capital inflows. Conversely, if I make more than I spend, I must by definition be saving. Something similar happens with nations but is expressed a little differently. If a country exports more than it imports, receiving more in foreign currency than it spends on foreign products, the difference must typically be made up by capital outflows—outflows of foreign currency.

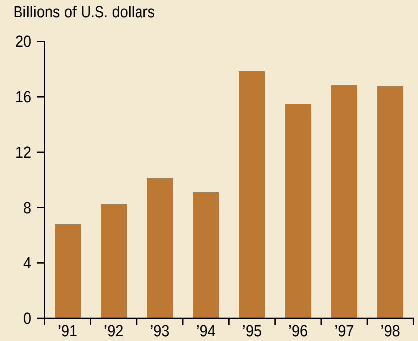
Since China's trade surplus is well known, the likely direction of China's capital flows should be obvious. China's accounting and reporting of this impact, however, is so irregular that it raises many questions. China's current account—which records exports and imports of goods and services—and its financial and capital accounts—which are supposed to specify legitimate capital inflows and outflows—are positive on net. A look at Table 1 shows that in most years between 1991 and 1998 the positive foreign currency inflows under the current account were accompanied by positive foreign currency inflows under the financial and capital accounts. This is not how things are supposed to work.

In tracking down capital flow oddities, however, we have to exhaust all the normal accounting entries first. There is one more common accounting avenue that could be used when a current account surplus is not offset by a financial and capital accounts deficit. That outlet is reserves and related items, a sort of savings account at the central bank booked in foreign currency. When a country runs a current account surplus, it can legitimately accumulate foreign currency reserves, which it books under reserves and related items. Countries with fixed exchange rates routinely do this to accumulate the foreign reserves they need to maintain confidence and to defend their currency against speculative attacks if necessary. As seen in Table 1, that is what happened most years during 1991–98. A negative entry means foreign currency is leaving the rest of the Chinese economy and becoming foreign currency reserves at the central bank.

Now that we have examined relations between the current account, the financial and capital accounts, and the reserves and related items, it is obvious from Table 1 that everything is still not accounted for and in balance. This brings us to what is surprising and peculiar about China's capital flows. This final avenue is the net errors and omissions

(Continued on page 12)

Chart 1
Net Capital Outflows under Net Errors and Omissions



SOURCE: *Balance of Payments Statistics Yearbook*, 1999, International Monetary Fund.

Table 1
China's Balance of Payments, 1991–98
(Millions of U.S. dollars)

	1991	1992	1993	1994	1995	1996	1997	1998
Current account	13,272	6,401	–11,609	6,908	1,618	7,243	29,718	29,325
Financial and capital accounts	8,032	–250	23,474	32,645	38,674	39,966	22,957	–6,323
Reserves and related items	–14,537	2,060	–1,769	–30,453	–22,469	–31,705	–35,857	–6,248
Net errors and omissions	–6,767	–8,211	–10,096	–9,100	–17,823	–15,504	–16,818	–16,754

SOURCE: *Balance of Payments Statistics Yearbook*, 1999, International Monetary Fund.

Beyond the Border

(Continued from page 10)

entry, which is supposed to account for measurement errors, generally small discrepancies, but definitely does not for China. If the net errors and omissions entry were just a measurement error, the size of the entry, whether positive or negative, would not be far from zero. Similarly, if this entry were really just a discrepancy, we would expect over time that the positive and negative values would cancel each other out. In that case, the accumulated annual balances under this item would not show a persistent pattern. This, in fact, is not only how the net errors and omissions entries of most industrial countries behave over time but is how these entries typically behave for Asian developing or newly industrialized countries.

China is the exception. From 1991 through 1998, the most recent year for which data are available, China's net errors and omissions showed a net capital outflow every year (see Chart 1). A positive value one year did not offset a negative value the next, as in other countries. The cumulative net outflow over this period was $101.1 billion, nearly two-fifths of total foreign direct investment in China.

What makes China's net errors and omissions particularly interesting is that they are not measured directly. The amounts are simply what is left over after the difference between exports and imports is accounted for by other, known, capital flows. China imposes strict foreign exchange and capital controls. What causes these flows to be concealed so much more than in other countries? Political and economic uncertainty? Mistrust of the domestic financial system? Taxes and tariffs? In any case, the magnitude and persistence of this entry at least give us an idea that something large is going unmentioned year in, year out.

—Dong Fu

Dong Fu is assistant economist at the Federal Reserve Bank of Dallas.

Federal Reserve Bank of Dallas
p.o. box 655906
Dallas, Texas 75265-5906

ADDRESS SERVICE REQUESTED

BULK RATE
U.S. POSTAGE
PAID
DALLAS, TEXAS
PERMIT NO. 151