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China's capital flight: Pre- and post-crisis experiences

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ABSTRACT

We study China's illicit capital flow and document a change in its pattern. Specifically, we observe that China's capital flight, especially the one measured by trade misinvoicing, exhibits a weakened response in the post-2007 period to the covered interest disparity, which is a theoretical determinant of capital flight. Further analyses indicate that the post-2007 behavior is influenced by quantitative easing and other factors including exchange rate variability, capital control policy and trade frictions. Our study confirms that China's capital flight pattern and its determinants are affected by the crisis event. Further, both the canonical and additional explanatory variables have different effects on different measures of capital flight. These results highlight the challenges of managing China's capital flight, which requires information on the period and the type of capital flight that the policy authorities would like to target.

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1. Introduction

China is increasingly integrated with the global economy. The pace of integration, however, is uneven across the trade and financial sectors. Since its reform initiatives were launched in 1978, China has gradually evolved from a closed and isolated economy to the world's largest trading nation. While liberalizing trade activity, China is quite conscientious about the stability of its financial sector. Regulations

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and capital control measures are in place to restrict and manage cross-border capital movements. Despite the fact that China is loosening its grip on its financial markets, it maintains explicit controls on capital account transactions to manage its underdeveloped financial sector and protect it from external financial volatility.[1]

China's capital control measures target both inflows and outflows. While excessive capital inflows overheat the domestic economy, massive outflows drain needed resources from development projects and impose pressure on monetary and exchange rate policies. One commonly discussed caveat of China's capital account liberalization policy is the capital outflow and its adverse economic impacts that may occur when China opens up its capital account (Bayoumi and Ohnsorge, 2013). Despite China's infamously tight grip on its capital account, it cannot perfectly regulate money movement across its border.

In the last few decades, China has been adjusting its capital control policy to maintain a stable economic environment for its reform initiatives. Hung (2008) and Prasad and Wei (2007), for instance, describe China's policy measures aimed at curbing illicit capital flows. Although these capital control measures are deemed effective, they do not eliminate all illicit flows. Cheung and Herrala (2014), and Ma and McCauley (2008), for example, show that China's control of cross-border capital movement is porous. While control measures deter money from moving across borders, people find ways to circumvent these barriers. The magnitude of China's capital flight could be quite large. For some years, inward or outward capital flight could be larger than the official foreign direct investment data or the change in external debts (Cheung and Qian, 2010).

Anecdotal evidence indicates that sizable capital flight – both inward and outward – has taken place in China. It is commonly believed that China's outward capital flight is driven by the desire to move money out of a tightly controlled regime. For different reasons, wealthy individuals and corrupted executives/officials choose to shelter their wealth overseas. The anticorruption campaign launched by the Xi Jinping regime reveals and reaffirms the widespread existence of corruption and the magnitude of capital flight related to the embezzlement of public funds. Inward capital flight sometimes is perceived to be hot money that takes advantage of the flourishing real estate sector, shadow banking, and equity market.

Financial crises in the last few decades have always reminded authorities of the detrimental impact of volatile cross-border capital flows on their economies. The 2007/8 Global Financial Crisis is no exception. One new phenomenon of the recent crisis and its aftermath is characterized by an ultra-loose monetary policy, dubbed quantitative easing pursued by the United States to revive its economy. A similar accommodative monetary policy has been subsequently pursued by other economies, including Great Britain, Japan and the European Monetary Union. The developing and emerging economies including China in general are quite concerned about the massive capital inflows triggered by excess global liquidity created by quantitative easing. Typically, these economies have tightened their policies on cross-border capital movements to alleviate destabilizing capital flows. Indeed, China was quite vigilant – it strengthened its management of capital flows in general, and in June 2008 explicitly reinstated its managed exchange rate policy in particular.

In this article, we empirically analyze China's capital flight. The choice of China is motivated by its growing importance on the global stage and the relative size of its capital flight. Kar and Spanjers (2014), for instance, assert that China is the leading source of illicit capital flows among developing countries, and it dominates the flows originating from Asia.[2]

Our exercise considers two approaches to generate a proxy for capital flight. The first, the commonly used World Bank residual approach, uses balance-of-payments statistics and generates the proxy from the difference between the sources and uses of funds (Cuddington, 1986, 1987; World Bank, 1985).

[1] Fernald and Babson (1999) and Yu (2009), for instance, attribute to capital controls China's ability to insulate itself from the massive external financial volatility in the recent global financial crises.

[2] Laws and rules restricting foreign purchases of assets instituted in the 2000s by, for example, Singapore and Australia were perceived to target capital inflows from China. The top five sources of outward capital flight from 2003 to 2012 are China, Russia, Mexico, India, and Malaysia.

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