New Features and Risks of China's Cross-Border Capital Flows and Policy Recommendations

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Abstract. With mainland China as its primary focus, this article analyzes the patterns of cross-border capital movements. Examining the characteristics and potential hazards of these flows, the study conducts an in-depth analysis of cross-border capital and provides an exhaustive review of pertinent literature. China's international direct investment outflows increased significantly, while capital inflows decreased, and the scope of foreign direct investments expanded, according to the findings. In addition, the research illuminates forthcoming obstacles, specifically the consequences of the COVID-19 pandemic on the equilibrium of the global economy and the volatility of exchange rates. In order to strengthen China's economic stability, the article concludes with policy recommendations that emphasize the significance of flexible policy mechanisms and the strategic allocation of foreign exchange reserves.

Keywords: Cross-border Capital, Capital Flow, Capital Controls, Belt and Road Initiative, Covid-19.

1. Introduction

In the current global financial arena, the flow of cross-border capital is a crucial factor that affects economic development, international trade, and global investments. The focus of this research is mainland China, as it delves into the intricacies of capital flows across borders. As a starting point, this paper shall provide a concise overview of the relevant literature and explicate the notion of cross-border capital. Following this, this article proceeds to an in-depth examination of the evolving economic environment in China with respect to these movements, emphasizing significant transformations and emerging attributes. In addition, this research identifies and assess the possible drawbacks associated with these fluxes, with a particular focus on the volatility of exchange rates and the global economic consequences of the COVID-19 pandemic. In conclusion, we offer policy recommendations designed to strengthen the reliability and sustainability of China's cross-border capital flows within a context that is interconnected on a global scale.

2. Definition and Literature Review

2.1. Definition of Cross-border Capital

Capital flows comprise an extensive array of capital-related transactions and movements, such as the transmission of funds across diverse asset classes and geographic regions. In addition to financial capital, these transfers involve physical and human capital. An example of this phenomenon is cross-border capital, which generally denotes financial and investment capital that flows across national boundaries. The focus of this paper is the frontier, or mainland China; cross-border capital pertains to the exchange, purchase, and transfer of financial resources across this demarcation. When considering capital inflows and outflows, their extensive range of manifestations is generally categorized into four groups. Debt investment, direct investment, and portfolio investment are additional forms of loans and deposits [1]. Cross-border capital, as a comprehensive term, encompasses all forms of international capital flows that occur within financial markets. Although it has the potential to foster global investment, trade, and economic growth, it also poses a multitude of risks and challenges. For example, instability in capital flows and fluctuations in the financial markets. In order to ensure financial stability and national economic security, the Chinese government routinely employs measures to monitor and control capital flows.

2.2. Literature Review

2.2.1. Domestic Related Studies

According to Jiandong Ju and Xinding Yu (2018), China is experiencing a notable and intricate economic transformation [2]. Once a recipient of international capital, China has evolved into a key global investor. Its stature in the global market has amplified, transitioning from a primary manufacturing epicenter to a dominant player on the world stage. Additionally, China has asserted itself in the global economic ladder, overtaking Japan as the leading entity within the Asian economic structure. As observed by Fang J et al. (2021), the bidirectional flow of Chinese capital within the domestic market significantly bolsters its position in the global trade and investment systems [3]. The "One Belt, One Road" (OBOR) initiative, sponsored by the Chinese government, aims to ensure sustainable economic growth and enhance collaboration with other nations. Further, Tong H and Wei S J (2021) have noted that a country can employ strategies such as increasing its foreign exchange reserves to effectively counter sudden reversals in international capital flows or potential currency attacks [4].

2.2.2. Foreign Related Studies

Buckley, P.J. et al. (2018) highlight that the expansive and rapidly growing domestic market in China empowers state-owned enterprises to generate liquid funds for overseas investments [5]. There have been numerous inquiries into the feasibility and potency of capital controls concerning China's cross-border capital. Pasricha et al. (2018) contend that with the surge in capital account openness, there's an enhancement in exchange rate stability, albeit at the expense of reduced monetary policy autonomy [6]. Conversely, Juthathip Jongwanich (2019) posits that capital inflows might be hindered by curbs on direct and equity investments [1]. Similarly, constraints on debt securities inflows can deter the entrance of correlated assets. A marked decline in capital outflows can only be realized through alternative investment avenues, underscoring both the efficacy and limitations of capital controls. Adding to this discourse, Petry J (2021) emphasizes that despite its prolonged isolation, China's financial market has integrated with global counterparts. Initiatives like the internationalization of the Renminbi and the "One Belt, One Road" strategy underscore China's pivotal role in global finance [7]. Lastly, Morrison and Wayne M (2023) reiterate that post the 1979 liberalization of its foreign trade and investment policies and the adoption of market reforms, China has consistently been among the fastest-growing global economies [8].

3. FLOW The New Features of Cross-border Capital Flow

3.1. Reduction in Net Capital Inflow

International capital flows have undergone substantial changes at a global level since the occurrence of the 2008 financial crisis. Despite a decline in the proportion of cross-border bank credit and the magnitude of global cross-border capital flows, this trend does not exhibit ubiquitous applicability across all countries and regions. China, as an emerging economy and rising developing nation, has received significant net capital inflows, including direct investment (FDI) from developed and other developing countries, over the past few decades. A proportion of cross-border capital is comprised of FDI. China has implemented a range of policy initiatives, including the relaxation of foreign entry restrictions, the enhancement of the business environment, and the promotion of investments in sectors pertaining to advanced technology. Consequently, foreign corporations have been enticed to allocate resources towards China's financial, technological, and manufacturing sectors, thereby strengthening their presence in the country. Moreover, significant investments of capital have been directed towards relevant development and infrastructure projects due to the Belt and Road Initiative of China. As a result of increased investment in countries along the route, capital has poured across international borders and into China. In contrast to its historical trend of maintaining a surplus, the Total Net Current Account of Mainland China has experienced a substantial decline in recent

years, from $20.2 billion in 2016 to $4.9 billion in 2018. Despite experiencing a marginal resurgence to $14.7 billion in 2019, figure 1 is projected to deteriorate further, reaching $8.2 billion by the conclusion of the year, which can be seen in Figure 1. This indicates that although mainland China continues to draw substantial inflows of foreign capital, the magnitude of these inflows is decreasing. Variables such as worldwide economic circumstances, shifts in China's domestic policies, and additional components could potentially influence this pattern.

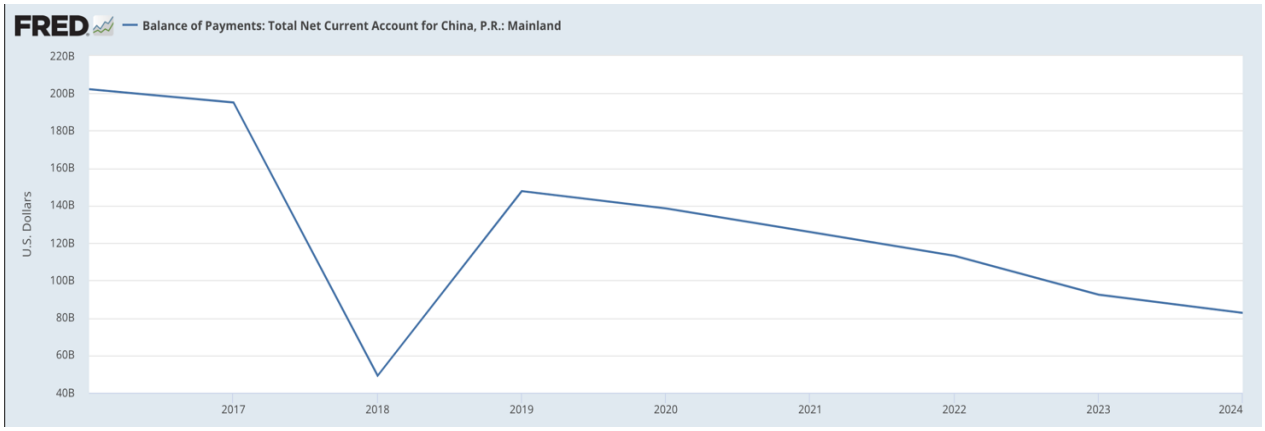


Figure 1. Balance of Payments: Total Net Current Account for China, Mainland

In general, the Chinese mainland has attracted significant cross-border capital inflows, solidifying its position as a key destination for international capital. Subsequently, two primary factors account for the decrease in these inflows. To begin with, there has been a decline in the allocation of capital inflows from foreign or expatriate investors to Chinese assets. At the opposite end of the spectrum, net capital outflows have increased due to domestic capital or domestic investors investing in foreign assets.

Analysis of current account, capital, and financial account data can provide insight into the recent upsurge in China's net capital outflow (i.e., capital outflow from China). Trade, services, income, and remittances are included in the current account. China is projected to sustain a growing current account surplus from 2016 to 2022, according to the available current account data. This indicates that China is presently undergoing a period of robust strength in its foreign trade industry, as evidenced by the increasing surplus of exports over imports. The relative scarcity of industrial production resources in China [6] accounts for the country's surplus of completed products exported to developed nations and imports of raw materials from resource-rich nations. China imports these materials preponderantly as a result.

The possibility exists that the surplus growth is attributable to China's export sector's sustained expansion, as opposed to domestic demand for foreign goods and services being relatively lethargic. Reserve assets, direct investment, portfolio investment, and additional investments are all represented in the capital and financial account. Between the years 2008 and 2022, China experienced significant alterations in its current account. 2008 marked the highest point of the current account surplus at $420.6 billion. The following year, it decreased significantly to $237.8 billion, followed by $243.3 billion in 2009. Subsequently, a conservative recovery of the current account ensued, which has maintained a steady ascent, especially since 2014. Stable conditions are reached for the current account surplus by 2022, amounting to $401.9 billion (SAFE).

Additionally, modifications have been made to the capital and financial account, which complements the current account. China received a significant influx of foreign investment in 2008, which resulted in a capital and financial account deficit of -$439.4 billion, which constituted a loss. The subsequent period witnessed a decline in the deficit, which remained negative despite falling to -$201.9 billion in 2009 and -$184.9 billion in 2010. From 2011 to 2016, there was a steady reduction in the capital and financial account deficit, which ultimately resulted in a surplus of $27.2 billion. As a consequence, China initiated the process of transitioning from being a destination to a source of net foreign direct investment and capital inflows. Nonetheless, the capital and financial account deficit

has expanded since 2017 and is projected to reach -$311.3 billion by 2022, indicating a surge in capital outflows from China which can be seen in Figure 2. It also indicates Chinese domestic firms and citizens expended a more substantial volume of capital abroad compared to the influx of foreign investment into China.

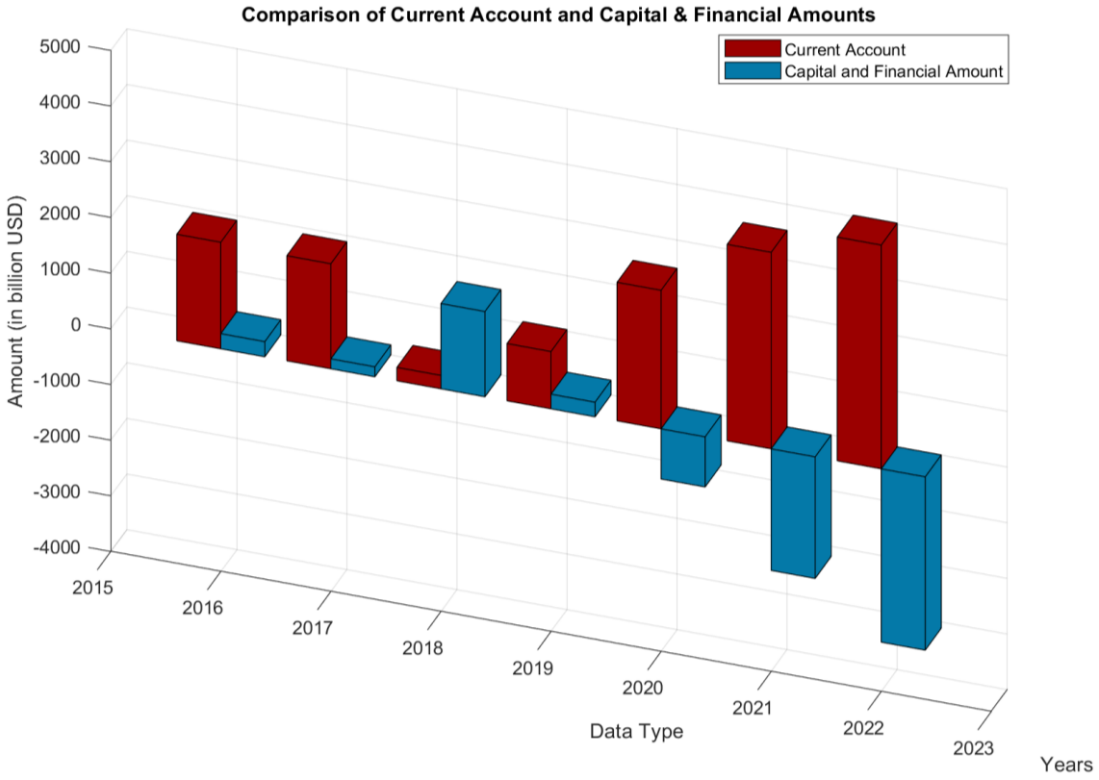


Figure 2. Comparison of Current Account and Capital & Financial Amounts

In an effort to encourage greater domestic capital inflows into global markets, the Chinese government has been easing capital outflow restrictions. Possible policy adjustments may involve easing restrictions on foreign exchange transactions and enhancing the availability of foreign currency, both of which have effectively supported the capital investment endeavors of Chinese enterprises and citizens living abroad.

3.2. Sharp Increase in China's Gloabal Direct Investment Ourflows

There is clear and indisputable evidence regarding the trajectory of China's outflows of global direct investment. A vivid and sustained upward trend over the past decade which can be seen in Figure 3 (UNCTAD). Foreign direct investment (FDI) outflows from China increased significantly from 2013 to 2022, according to the available data. China's increasing engagement in international investment is highlighted by this substantial and continuous growth, which facilitates economic interconnections with numerous regions and economies worldwide by channeling a growing volume of capital beyond its borders.

This outflow of FDI appears to be experiencing a momentum increase rather than a decrease. The rise in foreign direct investment (FDI) outflows from 2013 to 2014 is clearly significant. The period from 2019 to 2021, nevertheless, is even more remarkable. China's dedication to outbound investment appears to have intensified significantly, as evidenced by the substantial increases in these figures. As one examines the data, a number of significant milestones that mark China's international investment trajectory become apparent. A pivotal juncture in the nation's expansion of international investment occurred in 2016 when China's FDI outstock surpassed the significant milestone of one trillion US dollars. Predictions for 2022 approach an astounding three trillion US dollars, which is an astonishing rate of increase for such figures.

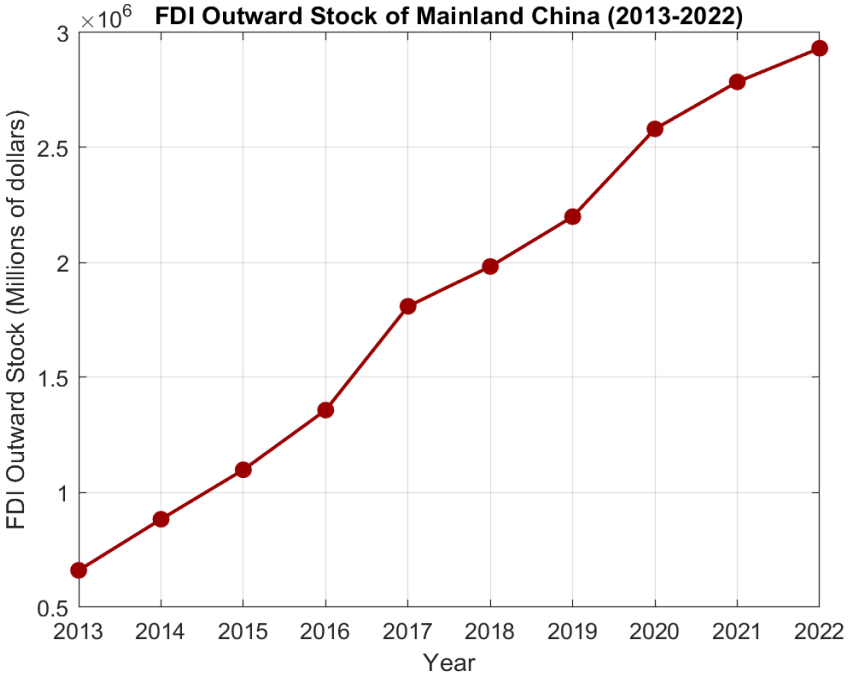


Figure 3. FDI Outward Stock of Mainland China

China's outbound direct investment has increased substantially as a result of the Belt and Road Initiative (BRI), which the Chinese government ardently supports and which strongly encourages Chinese businesses to collaborate with affiliated nations. China invested $15.6 billion in non-financial FDI in countries affiliated with the Belt and Road Initiative (BRI) in 2018, an increase of 8.9 percent from the previous year, according to a report from the Ministry of Foreign Trade (MOFCOM) of China [5].By implementing this coordinated approach, Chinese enterprises have increased their involvement in international infrastructure initiatives, trade, and economic cooperation, in addition to exerting an impact on patterns of foreign direct investment worldwide.

Furthermore, in terms of enhancing the innovation capabilities and market position of Chinese entities [5], the steadfast support of the Chinese government for its businesses to acquire and integrate foreign managerial and technological expertise has been instrumental. China's international investment landscape has been significantly broadened and strengthened as a result of this strategic incentive, which has stimulated a discernible increase in investments in innovative and technology-oriented enterprises abroad.

China's active involvement in international trade agreements, notably the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the Regional Comprehensive Economic Partnership (RCEP), has substantially bolstered its global direct investment activities. These pacts facilitate trade liberalization and streamline investments, offering member nations broader market access and a more stable investment ambiance [9]. Such provisions ease investors' entry into the markets of participating countries, further diversifying investment avenues.

3.3. Diversification of Foreign Direct Investments

The significant surge in foreign direct investment (FDI) outflows from China serves as evidence of the government's deliberate effort to expand the scope of its external investment endeavors [5]. In contrast to the past, when the majority of China's foreign direct investment (FDI) was directed towards developed economies, a noticeable shift has occurred, as investments now encompass 71 emerging markets, Belt and Road Initiative (BRI) nations, and other regions. By implementing this strategic expansion, Chinese enterprises not only mitigate investment risk but also increase their presence in international markets. The primary objective is readily apparent: cultivating economic unity and establishing strong connections with diverse partners spanning continents such as Africa, Asia, and Europe [5].

The scope of the government's vision extends beyond advocating for investments in natural resources. It has consistently supported investments in service, manufacturing, technology, and infrastructure projects. The process of diversification serves to enhance China's competitive position on the international platform while also strengthening its economic resilience. Consider the diversification strategies implemented by prominent corporations such as Dalian Wanda Group [6]. The diversified holdings of the individual have incorporated Sundance International, a yachting company based in the United Kingdom, Atletico Madrid, a football club from Spain, and the esteemed AMC Theaters, a cinema chain from the United States. The wide range of investments underscores the overarching trend of Chinese corporations expanding their operations internationally, encompassing various sectors and regions.

Moreover, China's active participation in negotiating multilateral and bilateral trade agreements intends to reduce investment barriers in potential host nations. Through its endorsement of these treaties, China grants its enterprises greater access to a vast array of countries and territories. Illustrative instances include the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the Regional Comprehensive Economic Partnership (RCEP). These agreements serve to not only support Chinese companies in their efforts to expand their global footprint but also to bolster the appeal of foreign direct investments.

Fundamentally, China's strategic initiative to broaden the range of foreign direct investment (FDI) it withdraws is evident through its expansion into various sectors and regions, supported by the government's flexible policies and dedication to international trade agreements. By adopting this comprehensive strategy, China not only strengthens its economic resilience but also contributes to the enhancement of the international investment landscape through heightened interconnectivity and cooperation.

4. Emerging Risks to China’s Cross-border Capital Flows

4.1. Exchange Rate Risk

Stability of exchange rates is frequently regarded as a critical determinant of transaction flows in international trade. Variations in exchange rates have a direct and substantial effect on the pricing structure of imports and exports, thus influencing global trade significantly. In contrast, exchange rate fluctuations have significantly and equally affected both international trade and FDI [10]. A depreciating currency is likely to increase import costs and decrease a nation's export competitiveness, whereas a currency appreciating generally yields the opposite outcome. Price fluctuations of this nature commonly give rise to uncertainty, which in turn impacts the transaction choices of global consumers and sellers and may even impede trade operations.

Similarly, with regard to Foreign Direct Investment (FDI), exchange rate stability is of critical importance. When engaging in cross-border investment, investors initially evaluate the economic stability of the target country, with exchange rate volatility emerging as a major risk factor. A currency depreciation may result in a reduction in the investment cost for foreign investors; however, it may also lead to a decline in future returns as a consequence of fluctuations in exchange rates. On the contrary, in the event that a nation's currency appreciates, despite the augmented investment cost, returns could remain relatively significant provided the nation continues to demonstrate strong economic performance.

An example of this is the negative correlation observed between exchange rate fluctuations and foreign direct investment (FDI) in countries associated with the "Belt and Road" Initiative. Mitigating exchange rate fluctuations could potentially facilitate the expansion of foreign trade and the influx of foreign direct investment into China [3].

4.2. Covid-19 Triggers Global Economic Decline

The COVID-19 pandemic has had a significant impact on the worldwide economy, leading to a recession and increased levels of uncertainty. Significant instability may befall the international

financial markets due to the outbreak, economic stagnation, and unpredictability surrounding government intervention. According to projections by the International Monetary Fund (IMF), global economic development is expected to decelerate from an estimated 3.5% in 2022 to 3.0% between 2023 and 2024 [3]. The recessionary economic trajectory mentioned earlier could potentially have a significant impact on the investment and international financing decisions made by Chinese corporations.

In addition to reducing the demand for Chinese exports, a contraction of the global economy will also encourage more prudent capital allocation on the international market. This could potentially lead to a reduction in the inflow of foreign direct investment (FDI) across national boundaries, especially in sectors high in risk. Effectiveness of measures implemented to prevent and control the COVID-19 outbreak has a direct bearing on the confidence of international investors. Consequently, their propensity to consider international investments becomes more judicious. Moreover, stagnation of production activities and disruptions in global supply chains have the potential to affect FDI inflows, thereby affecting multinational corporations and their supply chain partners in China [3].

5. Policy Recommendations

5.1. Flexible Policy Controls

Administrative agencies may manage the volume and composition of capital transfers via a variety of methods in relation to flexible capital controls [8], including the implementation of prohibition strategies, approval procedures, and explicit quantitative limits. Administrative controls have the potential to vastly affect the scale of cross-border transactions in China. For example, the enforcement of capital controls and oversight through foreign exchange control and exchange rate control functions to protect against the outflow of capital and maintain stability in the economy. Furthermore, it is possible that capital constraints could mitigate a portion of the economic repercussions of the COVID-19 pandemic.

However, capital controls may also result in unfavorable outcomes. For instance, capital controls in capital-receiving nations may stimulate capital flows from nations with minimal or no capital controls [7]. Intense capital control measures have the potential to generate further adverse outcomes, such as impeding economic expansion and curbing market activity. In addition, the impact of capital controls on curbing direct capital movements is limited. Measures restricting capital inflows tend to be more effective than those targeting capital outflows [1]. Governments are therefore typically required to meticulously weigh the benefits and drawbacks of capital control policies in order to ensure that they are appropriately formulated and implemented.

Moreover, variations in capital control instruments and policies may be observed among nations as a result of their unique political systems, economic conditions, and policy objectives. Consequently, the implementation of capital control policies necessitates promptness and accuracy, taking into account the specific circumstances and demands of different countries.

5.2. Foreign-exchange Reserves

The maintenance of relative stability in the RMB exchange rate can be achieved by accumulating foreign exchange reserves; China, which is recognized as one of the largest countries in terms of foreign exchange reserves, implements this approach [7]. The Chinese government has maintained active foreign exchange market intervention via the acquisition and storage of foreign exchange reserves in order to preserve the RMB's relative stability. This initiative facilitates the reduction of substantial exchange rate fluctuations, thus cultivating a more favorable atmosphere for foreign investment.

Moreover, an increase in foreign exchange reserves can serve as an essential safeguard for the country in times of crisis, including sudden disruptions in international capital inflows or currency attacks. One of the main goals of this undertaking is to reduce the economic vulnerability of enterprises and the sector as a whole [4].

Trade imbalance has been a persistent concern for China, as the value of its exports significantly surpasses that of its imports. As a consequence, considerable amounts of foreign exchange reserves have been accumulated. Foreign exchange reserves are employed for various objectives, including debt repayment, international investments, import payments, and the maintenance of exchange rate stability.

In addition, it is noteworthy that foreign exchange reserves can function as a protective measure against external disturbances. China possesses the capacity to protect its financial stability and mitigate external disturbances through the application of its foreign exchange reserves in times of worldwide economic turmoil or financial crisis. This is of the utmost importance in protecting the national economy from external uncertainties. In addition, the maintenance of sufficient foreign exchange reserves is critical in order to safeguard domestic supply chain efficiency, maintain the trust of global investors, and alleviate the repercussions of the COVID-19 pandemic.

6. Conclusion

Cross-border capital flows are critical in the contemporary global economic environment, and China holds a prominent position as a significant participant in the reception and distribution of international funds. This article elucidates the dynamic trends in cross-border capital movements in China, which demonstrate a decline in inflows of capital, a significant surge in outflows of international direct investment, and an increasing variety of foreign investments.

However, this dynamic landscape is not without its challenges. The combination of volatile exchange rates and the worldwide economic repercussions caused by the COVID-19 pandemic introduces significant unpredictability into the capital movements of China. In order to mitigate these uncertainties and enhance the dependability of cross-border capital flows, Chinese policymakers should consider implementing flexible policy frameworks that align with dynamic global events and economic conditions. Moreover, prudent administration of foreign currency reserves can play a crucial role in reinforcing the stability of currency values, thereby strengthening the financial foundation of China.

In summary, the dynamics of China's cross-border capital movements are uncertain, presenting opportunities as well as obstacles. By implementing shrewd policy decisions and strategic maneuvers, China has the potential to strengthen its position in the international financial sphere and fortify its economic stability in the face of turbulent circumstances.

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