ECONOMIC ANALYSIS

China | Revising outbound FDI downwards

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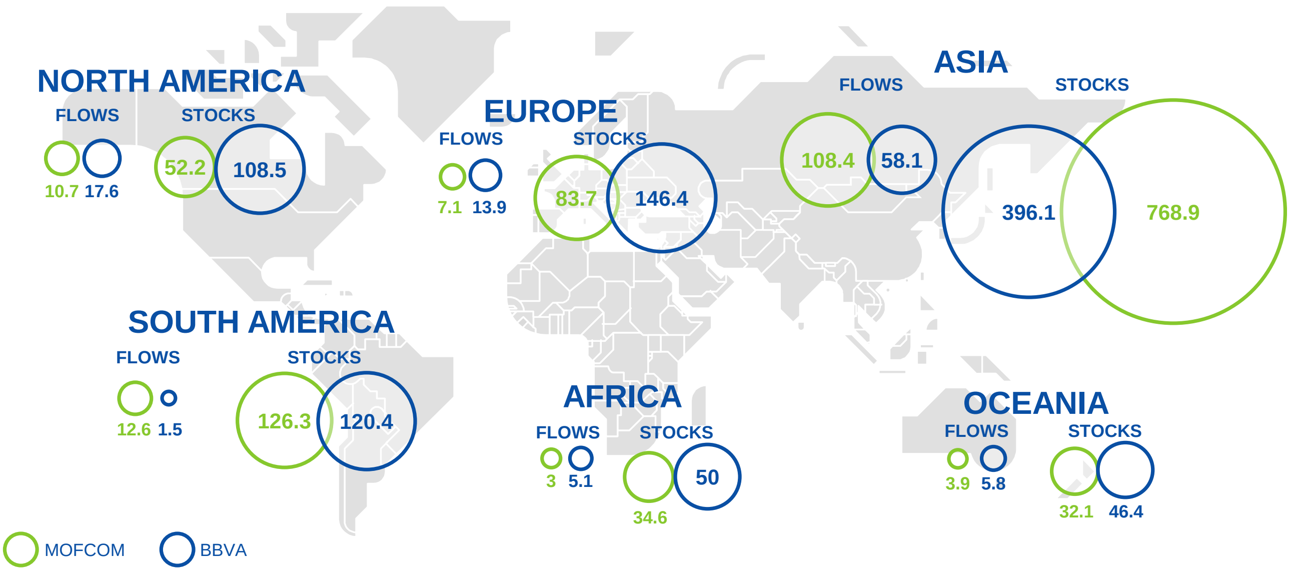
China's share of global ODI stocks may be larger than previously thought if we factor in Hong Kong's role as an offshore center. That said, our estimates show that MOFCOM figures overstate ODI flows, raising questions regarding the country's status as a net creditor. Geographically speaking, ODI flows have been going to developed markets in North America and Europe, although Asia continues to account for most of China's investments overseas. Growth of ODI could slow in case that main drivers, including access to technology, RMB depreciation and geopolitical considerations, stumble into difficulties.

Chinese investments overseas are soaring but questions remain

While China remains one of the world's most important recipients of foreign direct investment (FDI), these volumes have been overshadowed by rapidly increasing outbound foreign direct investment (ODI) flows. According to the Ministry of Commerce (MOFCOM), in 2015 financial and non-financial ODI reached $146 billion, exceeding inbound FDI, which reached $126 billion, for the first time in China's modern history. What's more, the trend is set to continue into 2016, with ODI (excluding financial ODI) reaching $134 billion YTD in September, compared to just $95 billion in inflows.

However, as we have highlighted in our previous report, Chinese ODI figures present some limitations. MOFCOM requires companies to register the first (not the final) destination of their cross-border transactions and do not take into account reverse flows. This makes it hard to determine the final size and distribution of Chinese ODI, as figures are significantly distorted by the presence of intermediaries such as Hong Kong and tax havens in the Caribbean. We have recalculated MOFCOM figures to account for some of these inaccuracies. Specifically, we exclude round tripped funds to benefit from preferential conditions and redistribute flows to offshore intermediaries according to weights (Figure 1).

Figure 1
Chinese ODI in 2015 after accounting for round tripping and offshoring



Source: CEIC, MOFCOM and BBVA Research

MOFCOM figures amplify flows. Where do these go?

Figures published by MOFCOM don't answer this question accurately as data limitations result in a bloated representation of Asia (74% of the total) followed by Latin America (9%). This reflects the role played by intermediaries such as Hong Kong, Cayman Islands and BVI, which together accounted for 70% of total flows and stocks in 2015. Our estimates paint a different picture.

First of all, we find that that outbound FDI only accounted for $102 billion in 2015, implying that China may have not become a net creditor in 2015. This claim is hard to quantify given that much of the flows to Hong Kong end up round-tripped back into mainland China. In terms of geographical distribution, Asia continues to account for the lion-share of total ODI flows (57%). North America and Europe emerge in 2nd and 3rd spots (17% and 14% respectively), overtaking Latin America, which appears much smaller (2%).

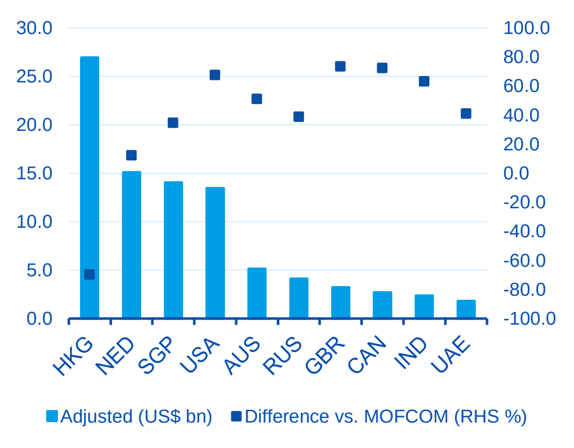
This result reflects the interest that Chinese companies have shown in developed markets in North America and Europe. In particular, the upwards revision was greatest in European countries such as Germany, France, the UK and Italy. The US and Canada also strengthened their spots as top recipients (Figure 2). With regards to Latin America, correcting for inaccuracies in the data naturally resulted in a smaller volume of flows to the region. However, flows on a country basis were higher according to our estimates.

China's share of global ODI stocks may be larger than previously thought

China's share of global GDP increased fourfold between 2000 and 2015, from 3.5% to 15.2%, while its share of global ODI stocks increased almost tenfold during the same period, from 0.4% to 4.0%. This projected China from 22nd to 10th place in global investor rankings according to UNCTAD figures. But despite this vertiginous increase, China's ODI stocks in the world remain underrepresented relative to the size of its economy, which should, at least in theory, support the case for even faster growth going forward (Figure 3).

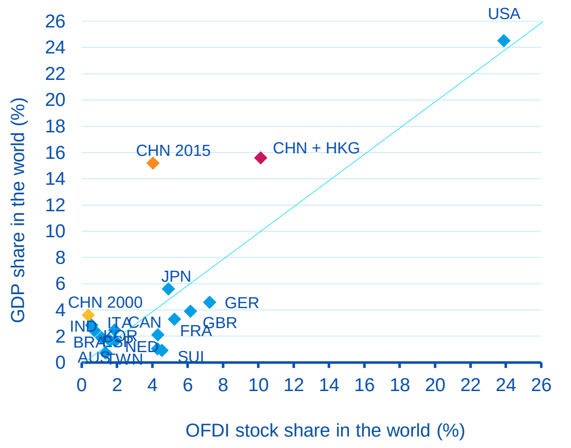
Not so fast. It is important to highlight that while the UNCTAD database reflects much lower figures than MOFCOM, this narrative changes dramatically if you factor in Hong Kong. The region's share of global GDP is quite small (0.4%), but its share of global ODI stocks is unusually large (6%). We think it's unlikely that this investment is endogenous to the region given Hong Kong's role as an intermediary of flows between China and the world. Together, China and Hong Kong ranked 2nd in 2015, up from 3rd place in 2000, hinting that China has been one of the most important investors in the world for quite some time (second only to the US).

Figure 2
Chinese ODI flows: Top destinations 2015



Source: CEIC, MOFCOM and BBVA Research

Figure 3
Officially, ODI remains underrepresented vs. GDP



Source: UNCTAD, IMF and BBVA Research

Drivers to ODI growth spell trouble ahead

If the share of China's global ODI stocks is not underrepresented vis-à-vis its share of global GDP, what other factors could be behind this year's surge in Mainland outbound flows? We have identified three drivers:

1) **Access to technology:** We could now be entering a phase whereby the need to access technology to facilitate a shift up global value chains becomes more important than securing natural resources. This would explain why many of China's top investment destinations are developed economies.
2) **Depreciation expectations:** Another factor to take into consideration is expectations of future RMB depreciation. China has expended vast amounts of sovereign resources to support the RMB, fuelling fears of future depreciation. This may have prompted domestic actors to relocate capital resources overseas in order to hedge against a weaker RMB.
3) **Geopolitical implications:** Asia is recipient to most of China's ODI. This is no surprise given China's efforts to boost its economic and political clout in the region. MOFCOM defines this region very broadly, encompassing both the Middle East and Central Asia, both of which should continue to benefit from further inflows on governmental support for initiatives such as Belt & Road (B&R) and the Asian Infrastructure Investment Bank (AIIB).

In sum, while we believe that Chinese ODI flows will continue to increase, headwinds abound in case a number of risk scenarios materialize in the future. For example, regulators in developed markets may tighten their scrutiny over Chinese deals. The latest wave of support for populist/isolationist policies does not bode well in this regard. Furthermore, large capital outflows could trigger Chinese authorities to revise their ODI policy, making it harder for Chinese corporates to shift funds overseas. Last but not least, it may take a few more years before Chinese initiatives such as B&R and AIIB come to fruition.

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