Guest post: uncovering the conduits for China’s capital flight

Guest writer Mar 06 11:00 1 comment

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Chinese investors have discovered a new way to spirit money out of the country behind the backs of the country’s regulators.

In recent years, savvy investors have used false invoicing as a way to disguise their capital flight. A Chinese company pays $1m to a foreign company for a machine tool that is actually worth $500,000; the rest is invested in property or stocks in London or Sydney or New York.

In the fourth quarter of 2014, the China Banking Regulatory Commission (CBRC) became wise to the scheme and began requiring banks to provide more documentation when they allocated foreign exchange to such overseas transactions. As a result, this form of evading capital controls has become more difficult to pull off.

Instead, clever bankers have discovered a new way to move the money offshore for their clients: service payments. Instead of overpaying for an item, they simply pay for a service that never occurred.

Why is this capital flight occurring? With China’s property bubble coming to an end, athe ability to generate quick profits through the Shadow Banks is no longer available to the country’s wealthier citizens. Many also are faced with President Xi Jinping’s continuing crackdown against corruption.

Meanwhile, the declining GDP numbers – with Premier Li Keqiang this week pointing to 7 per cent as the new normal – has made the one way bet on the renminbi less attractive. This explains why investors are looking for a safe haven for the money overseas.

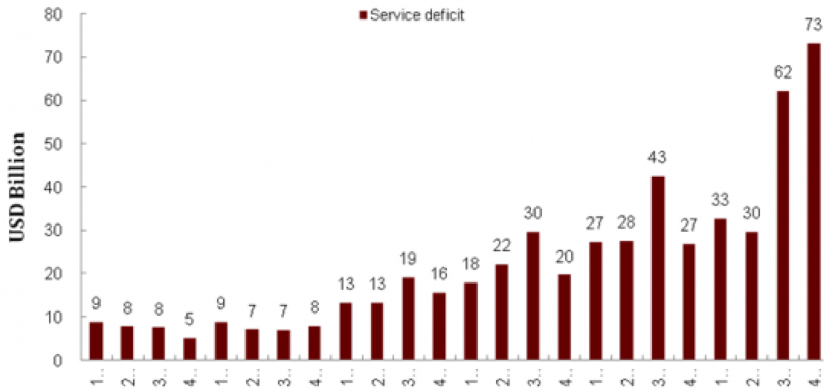
The data for service sector payments tells the story of the new capital flight channels.

The service deficit is widening in terms of both quarterly and accumulated values. In 2014, the service deficit was US$198bn, 59.1 per cent higher than in 2013. For the fourth quarter of 2014, the service deficit was 170 per cent higher than in the same period in 2013.

Similarly, the capital outflow through services is increasing. On average, the quarterly service outflow more than doubled from US$40bn in 2009 to US$96bn in 2014.

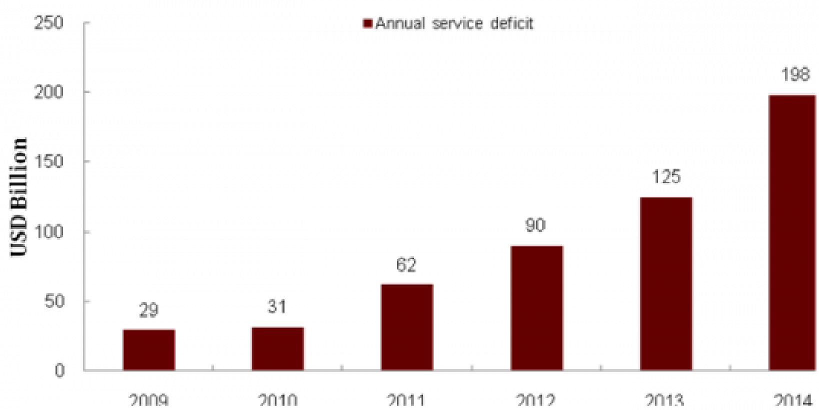
Fake companies

Quarterly service deficit



Source: SAFE, OCR

Accumulative service deficit (Yearly)



Source: Orient Capital Research

We interviewed bankers in China who were quite candid about how they evade capital controls. Currently, the State Administration for Foreign Exchange (SAFE) has the fewest document requirements for consulting and service fees."It's simple for our clients to get the proof of materials as long as they know an overseas company that is willing to write a receipt. In fact, a VAT invoice issued by a restaurant in China could have more legal power than the receipt provided by an overseas company," one foreign commercial banker in Shanghai told us.

There are a couple of methods that have become popular over the past few months.

1) Study Abroad Schemes
More than half of the study-abroad agencies in China have a second identity as underground money shops. The client calls half-an-hour earlier to specify the amount of money and specific currency to transfer. "We will tell him the floating exchange rate (black market). If he is ok with the exchange rate, he needs to transfer the money into our domestic banking account in 30 minutes. We promise our clients they will receive the money in their overseas accounts about in an hour," said one moneylender.

2) Interbank Borrowing
There is also private interbank borrowing. Often the moneylender will offer them faster and cheaper transfer services by matching their requests with domestic clients who want to transfer their money abroad, usually for amounts exceeding 100 million Renminbi.

3) Overseas Branches of Domestic Companies
Since the Chinese government began encouraging domestic companies to expand overseas, millions of subsidiaries have been set up offshore, which are now being used to transfer funds."As long as the consolidated financial reports don't look terrible, no one cares about who actually contributes the profits, especially for the heads of the state firms," said a senior executive with a large state owned company.

4) False Joint Ventures
Many domestic companies have established joint-venture companies with their own overseas subsidiaries, even though this is technically illegal. The JV partner keeps the profits for overseas investing.

How Big is the Problem and What Does it Mean for China's Economy?
The SAFE, CBRC and other regulators in Beijing appear to be unaware of how large these transfers are.Bankers involved estimate that as much as 40% of the larger service transactions do not involve actual services. This suggests close to $200 billion of all service payments are in reality permanent exports of capital. That number could double in 2015.

Clearly, if $300bn to $400bn of China's money supply leaves the country in 2015, that would have significant global macroeconomic effects. These would include the value of the renminbi, the amount of domestic money supply and the ability of China to stimulate the economy.

As political scientist Victor Shih of the University of California at San Diego noted in a report several years ago; "As companies pay overseas counterparties and as HNWIs (High Net Worth Individuals) withdraw money from banks to sneak out through the underground banking system, banks will quickly become unable to make new loans since 60 per cent of banks' loan balance is trapped in medium to long term loans with maturity above 1 year."

There is also a huge impact on the value of global assets where the money is being invested, such as overseas property and stocks.

In addition, there is the unknown impact on the value of the assets held by China as foreign exchange. The country declares official foreign exchange reserves of $3.9 trillion, although it does not provide a precise breakdown. The known reserves include bonds in the U.S. and other western countries.

However, there are likely to be substantial holdings outside of government bonds, including gold, equities (declared to be more than $100bn), European Stability instruments, non U.S. dollar deposits, and other assets. SAFE also owns foreign shares of China's own banks and insurance companies. Capital flight could force China to sell some of these assets.

Estimating which instruments and the amount of sales is difficult without more precise data. But it is reasonable to assume that SAFE's ability to control the exit of capital is less than widely assumed.

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