Current Issues

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China's financial integration into the world economy

Scrutinising China's international investment position

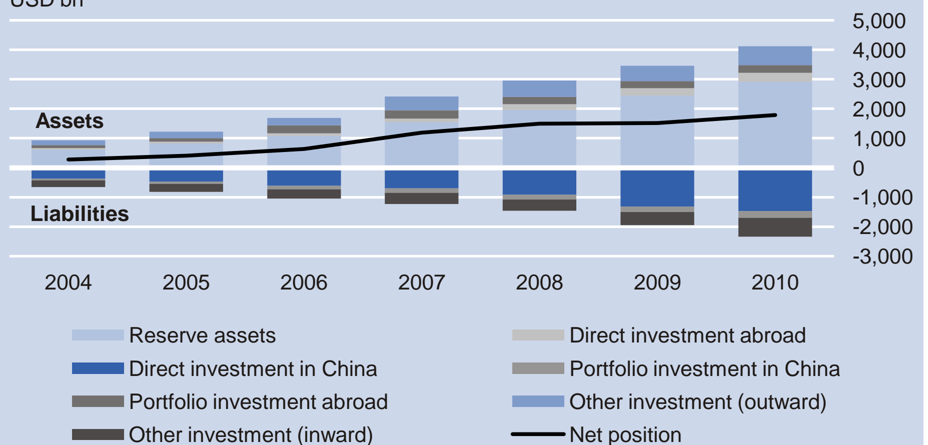
China's financial integration into the world economy progressed rapidly during 2004-2010, mostly through accumulation of reserve assets and direct investment. This reflects China's twin surpluses in its current and financial account.

Portfolio investment is still underdeveloped. This is the case both for Chinese investment abroad and for foreign investment in China. Portfolio investment is held back by the authorities' concerns over complications in monetary management and a potentially destabilising impact on the domestic economy. In contrast, direct investments (both ways) were liberalised years ago.

Success in rebalancing the economy and bringing inflation under control will be the key determinant of a more liberal portfolio investment regime. Gradual liberalisation of the capital account is the most likely outcome, judging from historical reform processes. And although no commitments have been made so far, steps in that direction may be rolled out over the next five years.

We look at possible scenarios for China and the world economy until 2015. In all of them, China will continue to accumulate FX reserves, so that reserve assets will remain the largest component of China's overall foreign assets, but the pace of accumulation is likely to slow down. China faces increasingly limited options (or, equivalently, higher marginal costs) for adding more foreign exchange reserves to its large existing stock.

China's IIP over time: Rapid accumulation of net assets
USD bn



Sources: SAFE, DB Research

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1. Introduction

With China's economic clout growing, attention has been increasingly focused on the direct investment activities of Chinese companies overseas. We think it is useful to take a step back and examine China's international investment position (IIP), which is essentially a balance sheet of cumulative financial flows, as this is an important holistic indicator of the extent of its financial integration into the world. Alongside trade linkages, stocks of foreign assets and liabilities act as another conduit for transmission of domestic shocks from one country to another, via currency movements and other wealth effects. Second, understanding the different IIP categories and their changes overtime enables us to place in context China's historical policy decisions regarding financial relations with the rest of the world, and to try to anticipate how these will play out in the next few years.

2. Rapid accumulation of net assets over time

Chinese assets and liabilities have been steadily increasing from 2004 to 2010, congruent with its economic ascendency and trade integration with the rest of the world. In 2010, reserve assets accounted for the largest part of total assets at 69%, whereas inward direct investments (DI) accounted for the largest part of total liabilities at 63.2%. Foreign exchange reserves (FXR) under the management of the State Administration of Foreign Exchange (SAFE), has always been the major component of reserve assets (RA), at 98% or more.[1]

Overall, China's net foreign asset (NFA) position grew more than six-fold from USD 276.4 bn in 2004 to USD 1,790.7 bn in 2010, which translates into a 36.5% compounded annual growth rate (CAGR). This is primarily driven by the growth of reserve assets, which rose at 29.5% CAGR over the same period. China ranked amongst the world's major creditors in 2009 (chart 1). In contrast, the US is a debtor country with a negative external asset position of USD 2,471 bn 2010.[2]

China: second largest creditor

% of world GDP (2009)

Country	Net foreign assets
Japan	4.99
China	2.61
Germany	2.23
Switzerland	1.28
Hong Kong	1.24

Sources: National authorities, IMF, DB Research 1

International Investment Position (IIP): IMF definitions by functional category

Reserves assets (RA) are those external assets (in the form of gold, foreign exchange or special drawing rights at the IMF) that are readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for intervention in exchange markets to affect the currency exchange rate, and other related purposes (such as maintaining confidence in the currency and the economy, and serving as a basis for foreign borrowing). Potential assets are excluded. Notions of control and availability for use by monetary authorities are essential to this definition.

Direct investment (DI) is a category of long-term, cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy. Two ways of having control or influence are identified:

(a) Immediate DI relationships arise when a direct investor owns equity that entitles it to 10% or more of the voting power an enterprise. Control exists if the direct investor owns more than 50% of voting power in the enterprise, while a significant degree of influence exists for 10-50% ownership of voting power.

(b) Indirect direct investment relationships arise through the ownership of voting power in one DI enterprise that owns voting power in another enterprise(s), that is, an entity is able to exercise indirect control or influence through a chain of DI relationships.

Portfolio investments (PI) are defined as cross-border transactions and positions in liquid (i.e. easily bought and sold) securities involving debt or equity, other than those included in DI or RA. These securities do not convey control or ownership, e.g. holdings of equity shares with less than 10% of voting rights.

Other Investments (OI) is a residual category which captures all flows that do not fall under the previous categories, such as foreign bank deposits, currency holdings, cross-border loans or trade credits.

Source: Sixth Edition of the IMF's Balance of Payments & IIP Manual (Chapter 13), updated January 2010 .

[1] In 2010, the other 2% of RA comprised monetary gold (USD 48.1 bn), Special Drawing Rights (USD 12.3 bn) and reserve position in the IMF (USD 6.4 bn).

[2] Preliminary figure from US BEA Survey of Current Business (July 2011).

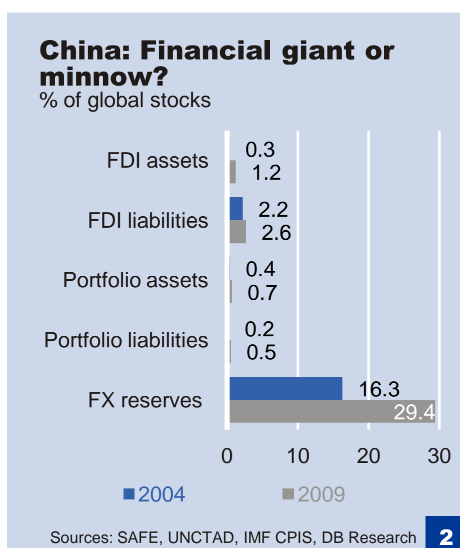
Going by functional category (see box above), we observe in China that:

— **Reserve assets (RA)** have represented the lion's share of total assets, fluctuating around 65-70%. This proportion is on par with India (72%), and significantly higher than South Korea (42%) or Hong Kong (9%).

— **Portfolio investment (PI)** – from 2004 to 2010, the stock of outward PI exceeded that of inward PI. In 2010, outward PI stood at USD 257 bn (or 6.2% of assets) while inward PI was USD 222 bn (or 9.5% of liabilities). However, the stock of inward PI grew very rapidly, almost quadrupling during 2004-10.

— **Direct investment (DI)** – contrary to PI, the stock of outward DI is much lower than the stock of inward DI. At end-2010, outward DI was USD 311 bn (or 7.5% of assets), only about one-fifth of inward DI at USD 1,476 bn (or 63.2% of liabilities). Comparing the different forms of outward investment we observe that direct investment started at a very low level compared with portfolio investment in 2004 but has since caught up and actually exceeded the stock of PI assets (USD 311 bn vs USD 57 bn, respectively, in 2010). The increased policy push to Chinese companies for "Going Global" in recent years has undoubtedly played an important role here.

— **Other investment (OI)** comprises trade credits, loans, currency & deposits and other assets. In 2010 OI was the second largest category of assets (15.6%, after reserve assets) as well as liabilities (27.3%, after DI liabilities).



Asymmetry in China's IIP

% of China's GDP (2010)

Net portfolio equity	-2.4
Net FDI	-19.8
FX reserves (equity)	9.7
Net equity	**-12.6**
Net private debt	3.0
FX reserves (debt)	38.7
Net debt	**41.8**

Sources: SAFE, DB Research 3

In a global context, only FX reserves are significant

To place the size of Chinese asset and liabilities in a global context, we consider the respective IIP stock levels relative to the world total. Only the stock of FX reserves (29.4%) form a significant proportion of the world's total (see chart 2). At roughly 2.6% of the global total, the stock of direct investment into China trails behind and all other asset classes are negligible at around 1% of the global total, including China's direct investment overseas. Nevertheless, there are signs that SAFE has started to diversify its enormous pool of FXR into asset classes other than low-yielding government debt. For instance, SAFE's holdings of FTSE 100 companies are estimated to be worth around USD 18.6 bn (or 0.7% of FXR), sprinkled across two-thirds of the index.[3] Also, Yi Gang, Deputy Governor of the People's Bank of China (PBoC) and Administrator of SAFE, said in a 2010 interview that "we have always insisted upon the diversification of our foreign exchange reserves, on the two levels of currencies and assets."[4]

China is long debt, short equity

China's IIP has an asymmetric financial profile which can be characterised as "long debt, short equity" (see table 3).[5] While this phenomenon is not unusual among developing countries with capital flow restrictions for residents, the return differential between equity and debt carries a cost. Specifically in China's case, its sizeable holdings of foreign government debt means that it pays more on its equity liabilities than what it earns on its debt assets. In addition, China is vulnerable to credit risks such as the downgrade of

[3] The Economist (June 2011).
[4] Transcript of interview (July 2010), Hu Shuli and Yi Gang, SAFE website.
[5] See Lane and Schmukler (2006).

developed markets' sovereign debt ratings. Should it choose to liquidate its FXR at some point in the future the paper losses would be converted into real losses.

3. China's accumulation of foreign exchange reserves – a matter of choice or necessity?

The obvious questions that come to mind when looking at China's IIP and the spectacular growth of its FXR, are to what extent this has surpassed an 'optimal' level, and whether the trend will continue on a medium- to long-term horizon. Table 4 shows that not only have China's FXR risen steadily as a proportion of GDP, but also that they almost doubled as a percentage of the world's total reserves from 2004 to 2010. Asian peers' FXR stock as a share of GDP in 2010 mostly lagged China's 48%, with the exception of two city-states, Hong Kong (115%) and Singapore (100%).[6] China's pace of FXR accumulation peaked in 2007, at 43.3% yoy.

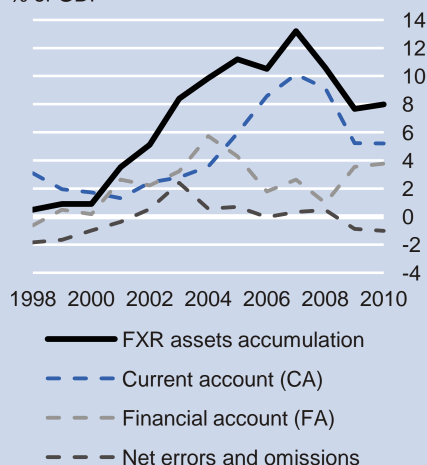
Evolution of China's foreign exchange reserves (FXR)

	2004	2005	2006	2007	2008	2009	2010
Reserve assets, USD bn	618.6	825.7	1,080.8	1,547.3	1,966.2	2,451.3	2,914.2
- of which FXR, USD bn	609.9	818.9	1,066.3	1,528.2	1,946.0	2,399.2	2,847.3
Growth of FXR, % yoy	-	34.3	30.2	43.3	27.3	23.3	18.7
FXR as % of GDP	31.6	36.3	39.3	43.7	43.1	48.1	48.4
FXR as % of world FXR	16.3	19	20.3	22.8	26.5	29.4	30.8

Sources: SAFE, IMF COFER, DB Research 4

China's FXR accumulation fits with persistent twin surpluses

% of GDP



Sources: CEIC, DB Research 5

To better understand the dynamics of FXR accumulation, we review the balance of payments (BoP) identity. This captures the annual change in trade and capital flows for an open economy, which then impact the IIP functional category stocks:

Current Account Balance + Financial Account Balance[7] *+ Capital Account Balance*[8] *+ Net Errors and Omissions = Change in Foreign Exchange Reserves*

In China, the accumulation of FXR has been associated with both current account (CA) and financial account (FA) surpluses (chart 5). Although the CA surplus as a share of GDP has halved since its 2007 peak, in part due to the global financial crisis, this was offset by a rise in the FA surplus, i.e. from 2.6% to 3.8% of GDP.

China's FXR are clearly higher than what is needed by a number of measures (see table 7).[9] China's central bank governor, Zhou Xiaochuan, also confirmed this recently, publicly stating that

6 Japan (19%), Korea (28.5%), India (17.4%)

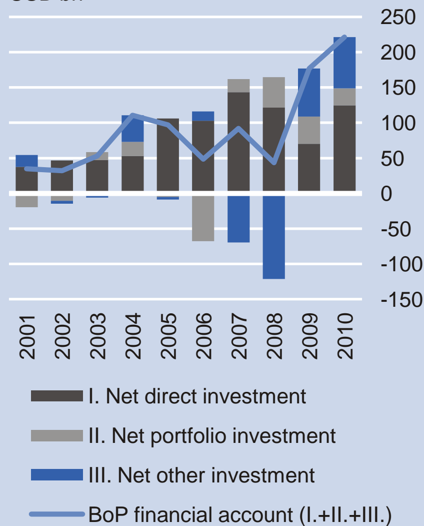
7 FA records change in ownership of financial assets transactions (inflows - outflows) between a country & the rest of the world.

8 The capital account shows (a) capital transfers and (b) the acquisition and disposal of non-produced, non-financial assets between residents and non-residents. For China this amount is negligible relative to the other components of BoP flows.

9 Cheung (2010) proposed to categorise reserve assets into 3 purposes: a) covering repatriation of capital inflows (Transitory Capital Reserves), b) sterilisation of government bonds in the medium term (Sterilisation Reserves) and c) the remainder as being available for longer-term investment (Surplus Reserves). According to this method, he estimated China's surplus reserves to be USD 614.9 bn or about one-quarter of China's total foreign reserves (of USD 2,399 bn) in 2009.

FDI takes the lion's share of the financial acct. surplus

USD bn

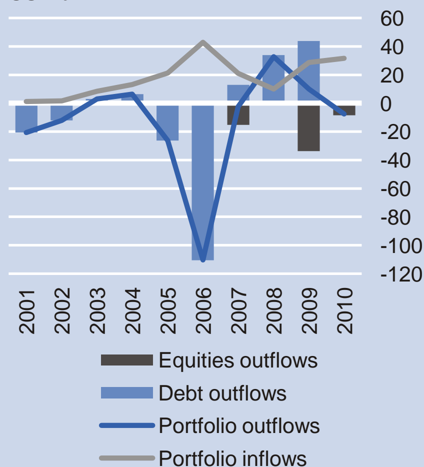


Note:
Other investment refers to trade credits, loans, currency & deposits and other investment

Sources: SAFE BoP annual statements, DB Research 6

Evolution of portfolio flows

USD bn



Notes: Positive number (by category) indicates inflows, and vice versa

Sources: SAFE, BoP annual statements, DB Research 8

"foreign-exchange reserves have exceeded the reasonable levels that we actually need."[10]

Gauging China's reserve adequacy in 2010

Measures of reserve adequacy	Critical value	China
FXR / short-term external debt	≥1	11.9
FXR-to-M2 ratio	0.05 – 0.20	0.26
Import cover	3 – 4 mths	22.7

Sources: EIU, Park (2007), DB Research 7

The evolution of China's FX reserves in the medium term will depend on

— how much progress is made with rebalancing the economy and reducing excessive net savings. This requires domestic reforms to increase household disposable income, and to strengthen the pension systems and banking sector in order to boost domestic consumption on a sustainable basis.

— trade-offs in FXR accumulation as perceived by politicians and policymakers. A global slowdown may lead the government to stack the odds against more rapid FX appreciation (and thus lower FXR accumulation)[11], while a further rise in domestic inflation may work in the other direction.

4. Portfolio investments: more evolutionary, less revolutionary

China's approach to managing capital flows is best described as gradual and "learning-by-doing", in a bid to enhance the efficiency of financial intermediation and promote economic development, while minimising risks to economic stability. This seems to be a justified approach, given that international experiences show that managed exchange rate regimes with a liberalised capital account are more prone to crises (Prasad et. al, 2005 and Chen et. al 2009), while the IMF has recently acknowledged the destabilising effects of volatile capital flows.[12] Accordingly, the Chinese government has favoured long-term direct investments over short-term portfolio investments, as the latter are more reversible and subject to speculative fervor. China has consistently been a net recipient of direct investment (see chart 6), even as the 'Going Global' policy to promote overseas direct investment gained pace in the late 2000s. On the contrary, net portfolio flows fluctuated visibly from year to year, reversing in 2002, 2005 and once again in 2007. PI outflows have been sensitive to the monetary authorities' priorities and how they have reacted to global economic developments. For example, during the 2008 global financial crisis, SAFE perceived capital flight to pose enough of a threat to suspend the approval of the Qualified Domestic Institutional Investors (QDII) scheme for overseas PI[13], only to resume it in October 2009.

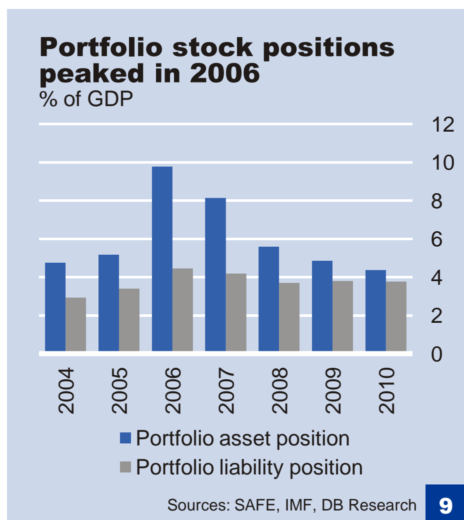
Portfolio investment inflows started from a very low basis of USD 1.2 bn in 2001 and peaked at USD 42.9 bn in 2006 (chart 8). Thereafter, the financial crisis played a role in dampening inflows,

[10] Bloomberg, April 19, 2011. See http://www.bloomberg.com/news/2011-04-18/china-must-cut-foreign-exchange-reserves-pboc-s-zhou-says-1-.html?cmpid=

[11] See Dyck et al. (2011) for a discussion of global implications of slower Chinese growth.

[12] See Ostry et al (2010). IMF incorporated capital controls in a stylised package of policy recommendations for coping with surges in capital inflows, reversing an earlier position against their use.

[13] See Appendix for a description of the QDII scheme.



before they started recovering in 2009-10. Regarding portfolio outflows, there was a sharp reversal in 2004 to 2007, driven by debt investments.[14] The start of equity outflows from 2006 onwards coincides with the QDII scheme which began that year, and then ceased temporarily in mid-2008. There is general consensus that growing pressure from external imbalances and fast-growing FX reserves prompted the Chinese government to formally launch the QDII scheme, and the bullish turnaround of Chinese equity markets in 2006 made this proposal a reality.

Portfolio investment stocks are representative of cumulative flows and incorporate market value fluctuations. Chart 9 shows that PI assets expressed as a share of GDP peaked at close to 10% in 2006 and then fell gradually towards 4%. In comparison, portfolio liabilities (reflective of inward PI by foreign investors) held relatively steady at 4% since 2006. As a result, the net portfolio asset position almost balanced out in 2010. At the global level (chart 10), China's outward portfolio stock still looks insignificant compared to developed economies such as Japan, UK and the US. This suggests huge potential for mainland private capital to diversify into international capital markets, should the Chinese government take explicit steps to speed up capital account liberalisation. This would not be surprising as, for example, a new generation of wealthy entrepreneurs have benefited from China's economic expansion and will seek new ways to optimise their portfolio allocation. A recent study by Bain & Company, in collaboration with China Merchants Bank, projected the number of Chinese high net worth individuals (HNWIs – individuals with more than RMB 10 m in individual investable assets) to rise to 585,000 in 2011, nearly twice as many as in 2008. Also, a sizeable shift in Chinese HNWI asset allocation may be underway – 81% of survey respondents plan to diversify further in the future.

Table 11 aims to provide an overview of the geographical diversification of China's outward portfolio stock, but our effort is somewhat constrained by data availability as China does not yet participate in the IMF Coordinated Portfolio Investment Survey (CPIS). Based on latest figures reported by investee countries as shown below, we found that portfolio investments in the US and Japan alone already constituted more than half of China's outward portfolio stock in 2009.

What will likely be the direction of change for China's portfolio flows over the medium term? Although the Chinese government still values exchange rate stability, this will most likely give way to its ambition to internationalise the RMB and make Shanghai an international financial centre by 2020.[15] There have already been explicit statements made by senior government officials to increase the yuan's flexibility, even though commitment to a specific timeline was lacking.[16] Relaxed controls on the financial account will follow, of which portfolio flows are an important component. With Hong

[14] By technical definition, outflows ought to be negative but this was not the case during 2003-04 and 2007-09, possibly because coupon payments and/or repayment on prior debt stock surpassed new investment in debt securities in these years. Secondly, as QDII started in 2006, part of the portfolio debt outflows in 2006 and earlier years may be associated with overseas investment activity of public sector entities, e.g. social insurance funds or state-owned enterprises.

[15] The latter goal was announced by the State Council in early 2009.

[16] At the Boao Forum for Asia in April 2011, PBoC governor Zhou Xiaochuan said that China will make the yuan's exchange rate more flexible, but in a "step-by-step" manner. Yi Gang, deputy PBoC governor, also said that "our ultimate goal is to make the RMB a convertible currency," in his 2010 interview (ibid).

Kong as a test-bed for RMB market-making, we do not think that China is in a hurry to relax portfolio flows into and out of the mainland with its under-developed financial markets.[17] Most probably, portfolio outflows will outpace inflows as a means to ameliorate imported and structural inflationary pressures (at least for officially approved flows), and diversification of PI outflows across emerging and developed markets will likely broaden.

Geographic distribution of China's outward portfolio investment

	2004	2005	2006	2007	2008	2009
China's stock of outward PI, USD bn	92	116.7	265.2	284.6	252.5	242.8
I. Japan, USD bn	13.04	15.99	24.68	41.84	52.21	37.2[p]
- as % of total stock	14	14	9	15	21	15
II. United States, USD bn	19	39.11	62.82	57.51	126.29	94.04
- as % of total stock	21	34	24	20	50	39
III. Rest of world, USD bn	59.96	61.6	177.7	185.25	74	111.56
- as % of total stock	65	53	67	65	29	46

Notes: (1) Part I - IMF CPIS is a voluntary survey and very few participating countries (17 out of 75) report their PI liabilities by country of non-resident holder e.g. Japan; (2) Amounts less than USD 0.5 m are recorded as nil anyway; (3) p – preliminary; (4) Part II - this refers to Chinese holdings of equity and corporate debt in the US, as sourced from US Treasury data.

Sources: IMF CPIS, US Treasury, SAFE, DB Research 11

5. Direct investment abroad poised to expand

At 3% of the global stock, FDI into China already forms a significant part in a global comparison, making China number 9 in the world. However, due to late liberalisation, China's DI assets held overseas are still small, accounting for only 1.5% of the worldwide total stock as of 2010. With respect to flows, outward investment from China grew much faster than inflows into China from 2005 to 2010, but inflows made up 8.5% of the world's while outflows made up only 4.5% in 2010. We believe Chinese DI flows will rise in both directions in the foreseeable future, on the wings of government support.

China's FDI – Outflows grow faster than inflows

	2005	2006	2007	2008	2009	2010
FDI outflows, USD bn	12.3	21.2	22.5	52.2	56.5	68.0
- % of world FDI outflows	1.4	1.5	1.0	2.7	4.8	5.1
- % of EM FDI outflows	10.1	9.4	7.6	16.9	20.9	20.8
FDI inflows, USD bn	72.4	72.7	83.5	108.3	95.0	105.7

Note: EM - emerging markets.

Sources: UNCTAD WIR 2011, DB Research 12

In a paper earlier this year, our colleagues at DB analysed the key target regions, countries and sectors of Chinese outward direct investment, based on completed M&A deals.[18] They also highlighted that ODI absolute figures provided by the Chinese Ministry of Commerce (MOFCOM) include outflows to a few countries which accounted for around 80% of China's total ODI in 2009.[19] In table 13

[17] For a critical discussion on the state of China's banking sector and its potential, see DB Research paper by Dyck et al (2009).
[18] Rabe et al. (2011).
[19] These are Hong Kong (63% of China's total OFDI stock in 2009), Cayman Islands and British Virgin Islands (12%) and Luxembourg (4%). Round-tripping, i.e. the re-routing of foreign investment back into the source country, is likely to be the main explanation for this.

we compare both sets of figures with a new dataset from the Heritage Foundation.[20]

Direct comparison of Chinese ODI across sectors is less meaningful, due to differences in sector classifications which cannot be reconciled across the three datasets. It suffices to say that energy[21], metals and financial services were the top 3 sectors (by value of investment) for Chinese OFDI from 2005-10, according to Heritage Foundation data. This is generally consistent with our colleagues' conclusion that mining, computer & electronics, oil & gas and financial services (in decreasing order) were the most frequently targeted overseas industries over the past 10 years.

Where did Chinese ODI go from 2005 to 2010?

	Heritage Foundation		MOFCOM		DB (Rabe et al.)	
	USD bn	%	USD bn	%	# of deals	%
Asia	74.8	22.6	31.0	43.2	974	55.3
Africa	68.3	20.6	13.0	18.1	64	3.6
North America	40.7	12.3	8.0	11.1	302	17.1
Western Europe	33.4	10.1	6.1	8.5	219	12.4
Eastern Europe	11.4	3.4	4.9	6.8	31	1.8
South America	55.1	16.6	3.2	4.5	81	4.6
Middle East	32.7	9.9	3.2	4.4	17	1.0
Far East	14.6	4.4	2.4	3.4	73	4.1
Total	331.0	100	71.9	100	1761	100

Notes:

(1) Heritage data is based on cumulative flows (2005-10) and excludes transactions valued at less than USD 100 m;

(2) MOFCOM data is based on ODI stock as of end-2010, excluding potential tax havens (HK, Luxembourg, Cayman and British Virgin Islands)

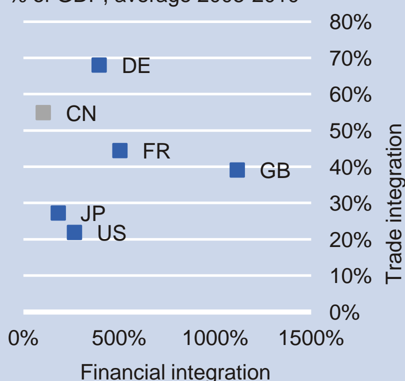
(3) DB data is from Dealogic and based on cumulative completed M&A deals by China and Hong Kong acquirers, 2005-09.

(4) For details on country classification into the above 8 regions, please refer to Rabe et al. (2011) p. 98

Sources: MOFCOM, Heritage Foundation, GMR 13

China's financial integration with upside potential

% of GDP, average 2005-2010



Financial integration: Assets+liabilities
Trade integration: Exports+imports
Sources: IMF, DB Research 14

6. Looking ahead to 2015

The gross size of China's international balance sheet, in terms of both assets and liabilities, is set to grow exponentially in the coming years as financial integration catches up with trade integration (chart 14). But at what pace will this occur relative to the past, and how will the composition of its net asset position change? These are the two key questions we seek to explore in this section.

Although a quick review of the existing literature[22] reveals that China's IIP evolution is affected by a complex mesh of factors, we believe that a) the strength of the global recovery and b) the orientation of China's domestic growth will greatly influence the size and composition of the country's net foreign assets, overshadowing long-run structural factors such as changes in demography and political reform. Taking into account a combination of outcomes for the two driving factors, we derive the following four scenarios:

Scenario A: Strong & stable growth in China

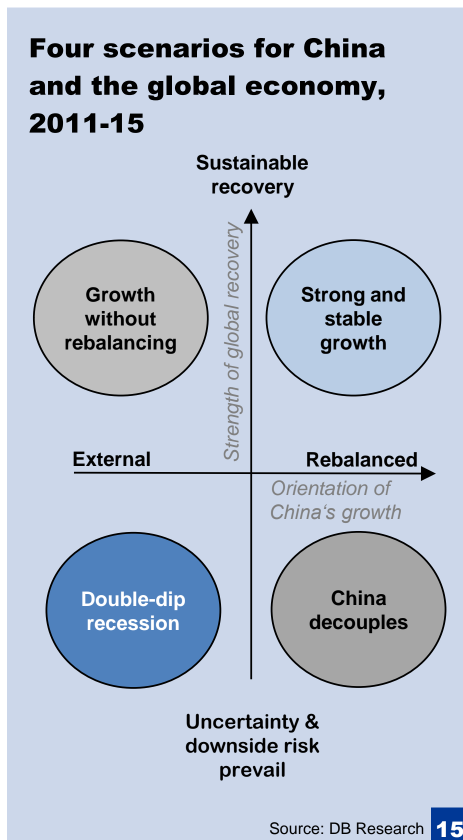
— The world economy gets back on a sustainable growth path and debt-ridden economies recover somewhat. A constructive global political consensus is formed.

[20] See Scissors (2010).
[21] Energy comprises oil, gas and coal as subsectors.
[22] See for example Ma and Zhou (2009), Knight and Wang (2011), Ma and Yi (2010) and Dollar and Kraay (2006).

— In China, ongoing policies to rebalance the economy towards consumption-driven growth make good progress, especially in the arena of strengthening social safety nets and wage increases. The savings-investment gap is reduced, the current account surplus narrows, and the pressure to accumulate FX reserves decreases.

— Chinese authorities proceed with capital account liberalisation in view of the benign external environment and an ambitious goal to advance the international status of RMB. Outward portfolio investment gains pace alongside the "Going Global" initiative.

Four scenarios for China and the global economy, 2011-15



Source: DB Research 15

Scenario B: China decouples

— The already weak global recovery stalls, as concerns deepen regarding the resolution of sovereign debt crises in developed markets. Distrust of politicians undermines investors' and business leaders' confidence, and they cut back on production and investment plans.

— China successfully steers its economy towards consumption-driven growth earlier than expected, by increasing government expenditures and pushing through bold social security reforms. Positive domestic developments form the basis for its de-coupling from the eurozone and US economies. Growth is lower than in recent years, but is sufficient to stave off social unrest.

— As in Scenario A, rebalancing lifts some pressure off accumulating FX reserves in order to stabilise the RMB.

— Outward direct investment takes off but outward portfolio investments does not, due to weak appetite by Chinese institutional investors to invest in volatile international financial markets.

Scenario C: Double-dip recession

— World economy slips into recession (possibly prolonged), with growth prospects in emerging markets also dampened by anaemic consumer confidence everywhere.

— China's rebalancing efforts proceed slowly as the priority once again shifts from controlling inflation to sustaining "reasonable" levels of growth. However, the CA surplus (and accordingly FX growth) declines since Chinese exports to the rest of the world are badly affected.

— Measures for capital account liberalisation stall. Portfolio outflow growth is almost nil as demand is very low.

Scenario D: China grows without rebalancing

— The world's major economies manage to shore up domestic growth but social inequalities rise and domestic agendas dominate over international collaboration.

— China's growth continues to be export-driven as local interest groups make their loud voices heard and efforts to reform social security face delays. Trade retaliation and currency wars become real threats as macroeconomic rebalancing makes slow progress.

— The Chinese government fights overheating by taking a cautious stance on further liberalisation of capital flows.

— Pressure for RMB appreciation stays constant or strengthens. To deter hot money inflows and the associated problem of asset bubbles, capital inflows are temporarily curtailed, while FX reserves continue to pile up at a fast pace.

In order to gauge possible outcomes for 2015 for the different components of China's IIP, we take a look at historical timeframes which share similarities with our scenarios. For simplicity, we take only two opposite scenarios, namely Scenario A ("strong and stable growth") and Scenario C ("double-dip recession"). The proxy for Scenario A is the period 2002-07, while the period 2008-10 resembles Scenario C.

We use these historical averages to derive possible values for the main components of the IIP balance sheet in 2015, with one exception, i.e. that we assume the annual growth of reserve assets to be lower than in past similar episodes in both scenarios (20% expected vs 39% historical in Scenario A; 15% vs 22% in Scenario C). With that in mind, we arrive at the projections presented in table 16.

It is important to note that, in the case of strong and stable growth, reserve assets (RA) will continue to grow significantly in absolute terms, but decrease slightly from 71% to 66% of total assets. This decrease is re-allocated towards portfolio and direct investment categories as capital account liberalisation proceeds favourably. On the other hand, given the situation of a double-dip recession, asset accumulation slows across all categories and results in a much lower net asset position.

China's international investment position: two possible scenarios

	Actual (2010)		Projected (2015)			
			Strong & stable growth		Double-dip recession	
Assets	USD bn	% of assets	USD bn	% of assets	USD bn	% of assets
RA	2,914	70.6	7,251	66.4	5,861	71.5
OI	644	15.6	2,012	18.4	945	11.5
PI	257	6.2	955	8.7	269	3.3
DI	311	7.5	706	6.5	1,126	13.7
Liabilities	USD bn	% of liabilities	USD bn	% of liabilities	USD bn	% of liabilities
DI	1,476	63.2	3,891	63.1	4,876	63.8
OI	637	27.3	1,344	21.8	2,327	30.4
PI	222	9.5	929	15.1	445	5.8
NFA (= A - L)	**1,791**	**-**	**4,760**	**-**	**553**	**-**
A + L	**6,461**	**-**	**17,089**	**-**	**15,850**	**-**

Note that the sum of foreign assets and liabilities (A + L) is an indicator for international financial integration according to Lane & Schmukler (2006).

Sources: SAFE, DB Research **16**

7. Conclusion

We started off by presenting the overall facts about China's international investment position, and then scrutinised the individual before discussing components what might affect their future growth. China today is already the world's second largest net creditor, and in theory, this is an anomaly for a developing country. Its net foreign asset (NFA) position grew more than six-fold from USD 276 bn in 2004 to USD 1,791 bn in 2010. Our analysis shows that China's net asset position would either rise to above USD 4 tr in 2015 under a scenario of strong and stable growth, or decline significantly in a double-dip recession scenario. Reserve assets will surely remain

the largest component of China's foreign assets for many years to come, but China is also faced with increasingly limited options (or equivalently higher marginal costs) for adding more foreign exchange reserves to its large existing stock. The financial integration of China into the rest of the world will really take off only when portfolio investments are liberalised more boldly compared to the "stop-and-go" approach of recent years.

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Appendix

QDII

Cumulatively approved quotas, USD bn

2006	19.6
2007	50
2008	53.3
2009	61.3
2010	68.4
Apr 11	72.6

Source: SAFE 17

Qualified Domestic Institutional Investor (QDII) scheme

The QDII scheme was introduced to give approved domestic institutional investors the opportunity to invest in international, foreign-currency-denominated securities (fixed income, stock, derivatives). It is the primary channel for portfolio outflows in the private sector, where investors include commercial banks, fund management institutions, insurance companies, securities firms as well as trust companies. However, domestic licensees usually do not fully utilise their entitled quota upon approval, either due to their unfamiliarity with the international capital markets or market timing issues.

Timeline at a Glance

Apr 06: QDII scheme opens (limited to fixed income and money market products).

May 07: Scope of QDII widens and banks can offer stock-related products with certain restrictions. In particular, mainland residents are allowed to invest in Hong Kong securities via domestic commercial banks.

Apr 08: Agreement between China Banking Regulatory Commission and US SEC allows Chinese individuals to invest in US stock markets.

Jun 08: QDII approvals suspended due to global financial turmoil, only to resume 16 months later in Oct 09.

Nov 09: SAFE warned that it would reduce quotas of QDII investors who failed to make full use of them.

Jan 10: First floated in Aug 07, a controversial 'through train' proposal allowing mainland citizens to buy shares listed in Hong Kong was formally scrapped.

QFII

Cumulatively approved quotas, USD bn

2003	1.7
2004	3.5
2005	5.7
2006	9.1
2007	10.1
2008	13.4
2009	16.7
2010	19.7

Source: SAFE 18

Qualified Foreign Institutional Investor (QFII) scheme

The QFII scheme allows foreign institutional investors to participate in local stock and bond markets, in order to further open up and attract foreign portfolio investment to the domestic capital market. QFII entities are allowed to invest in A-shares, bonds and other financial instruments approved by the China Securities Regulatory Commission (CSRC), which also sets eligibility rules according to the type of investor, years in operation, assets under management etc. As of April 2011, SAFE had approved investment quotas of USD 20.7 bn to 103 QFIIs.

Timeline at a glance

Nov 02: PBoC and CSRC jointly release an order on Temporary Measures on Administration of Domestic Securities Investment by QFII, effective **Dec 02**.

Jun 03: First batch of QFII approved.

Jul 04: Bill and Melinda Gates foundation becomes the first non-financial institution to gain QFII status.

Sep 06: New QFII rules supersede the original rules. Amendments aimed to attract long-term capital and enhance regulation of investments in PRC, e.g. qualifying criteria for foreign fund management and insurance companies were relaxed, but stayed the same for foreign securities firms & commercial banks.

Dec 07: SAFE raised total investment quota for registered foreign investors from USD 10 bn to USD 30 bn.

Oct 09: SAFE increased the investment quota limit for a single institution from USD 0.8 bn to USD 1 bn; it also reduced the lock-up period from 1 year to 3 months for pension and insurance funds, charity funds and government funds.

Jan 11: CSRC is set to launch the mini QFII pilot programme for Hong Kong this year; the initiative will allow overseas institutional investors to facilitate investments of offshore renminbi deposits back into Chinese capital markets, in contrast to QFII which allows those investors to convert foreign currencies into RMB to invest in China.

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