Cross-Border Capital Flows and Risk Management\(^1\)

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Abstract: Cross-border capital flows and risk management is a frequently discussed topic and a focus of the monetary authorities’ work at present and for the foreseeable future. The task can be approached from three perspectives: better balance of payments, more robust risk management, and greater coordination of international economic and financial policies.

I. China’s international balance of payments becomes more balanced under the new development pattern.

Amid a constantly changing environment, 2021 saw the continuing global spread of COVID-19, uneven economic recoveries, and shifts to monetary easing among major economies. By coordinating pandemic control and economic development, China has managed to sustain an economic recovery, laying the groundwork for a better international balance of payments. Overall, China’s current account surplus remained within a reasonable range in the first three quarters; cross-border investment grew at a relatively high rate, and the size of forex reserves remained stable at around US$3.2 trillion.

In terms of the current account, the surplus was kept in a reasonable and balanced range.

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In the first three quarters of 2021, according to preliminary data, the current account surplus was $202.8 billion, or 1.6% of the GDP for the same period; for 2020, it was 1.9%.

A current account balance of below 4% of GDP is regarded as a key indicator of a balanced international balance of payments. Since accession to the WTO, China has experienced rapid growth in international trade, with a surplus peaking at nearly 10% of its GDP in 2007.

However, in recent years, China's economic transformation has produced a more reasonable surplus, accounting for less than 2% of GDP after 2016.

**In terms of the capital account, cross-border capital flows continued to be dynamic but inflows and outflows were more balanced.**

**Inflows surged.** In 1H21, foreign investment in China amounted to $442.8 billion, up 1.7 times yoy. The growth of inbound investment reflects the attractiveness of China's economic development momentum, complete industrial system, and massive domestic demand to foreign investors.

**Outflows grew steadily.** In 1H21, China's outbound investment totalled $414 billion, up 1.1 times yoy. The increase reflects domestic entities’ demand for diversified asset allocation, which balanced the inflows and China's balance of payments.

**Financial openness has invigorated cross-border flows.**

In recent years, China's financial market has opened up to attract international financial institutions, with the establishment of the first foreign-owned securities company, the first wholly foreign-owned life insurance company, futures company, and public offering fund. After Citi, Bloomberg, and JP Morgan included Chinese bonds in their major indices, FTSE Russell began including Chinese government bonds in its bond index in stages from October 29.
China’s State Administration of Foreign Exchange (SAFE) has been promoting forex reform and opening up by supporting the official launch of the Southbound Bond Connect, regularly granting qualified domestic institutional investor (QDII) quotas, carrying out multi-currency cash pooling pilot for multinationals, and pushing ahead reform of cross-border investment by private equity funds.

**China's "twin surpluses" have largely been balanced.** Efforts during the 13th Five-Year Plan period allowed the Chinese economy to achieve comprehensive and groundbreaking development, as well as wider opening of the real and financial sectors.

China's current account surplus is expected to remain within a reasonable range, and cross-border capital flows to stay balanced. Despite the pandemic-caused surge in current account surplus, the long-term trend towards balance will remain intact.

II. With the two-way opening of financial markets, risk management becomes more robust: "opening-up" and "control" are promoted in tandem.

**Abundant forex, more flexible RMB exchange rate, and greater market depth give China the confidence to promote further opening-up.**

Following the 1994 reform of the forex regime, China's forex reserves experienced a period of rapid growth, withstood cyclical shocks of cross-border capital flows after the 2008 crisis, and stabilized at around $3 trillion in recent years.

At the same time, the RMB exchange rate has become more flexible and resilient, shifting away from unilateral movements as the market matures.

Chinese forex management centers on serving the real economy, making continuous but steady progress in opening-up based on China’s own reality, and establishing a new forex management system suited to an open and high-quality economy. The SAFE has been implementing financial opening policies, facilitating trade and investment, and opening up the capital account.
The financial opening will have to be market-based, law-based, and internationalized and conducive to the further internationalization of RMB. As determined by the international monetary system and financial landscape, major developed countries provide liquid and safe international assets, while emerging markets and developing economies (EMDEs) provide assets with high yields. As China transitions from a major financial player to a financial power, it will need to not only sustain the yield of RMB assets, but also improve their liquidity and safety through market-based, law-based, and internationalization reforms.

Continuously improved forex management capacity and increasingly sophisticated management framework pillared on macro-prudential policies and micro-supervision provide a solid foundation for risk control.

Forex regulators will strike a balance between facilitation and risk prevention, strengthen governance system and capacity building, improve the two-pillared management framework, ensure stability of the forex market and national economic and financial security, so as to help achieve the high-quality development goals laid out in the 14th Five-Year Plan.

First, improve the macro-prudential management framework and enrich management tools to prevent systemic risks arising from large-scale cross-border capital flows.

Second, improve the micro-regulatory approach, strengthen off-site capacity, and carry out "targeted crackdowns" on illegal financial activities to achieve the dual objectives of serving the real economy and preventing risks.

Third, encourage market players to be "risk-neutral" when making forex trades, and strive to enhance the compliance of forex-related entities to prevent cross-border financing risks.
Fourth, embrace technology to enhance forex management. Adopt a technology-driven supervision model by applying new technologies such as big data, visualization, and AI. Promote dynamic risk monitoring, identification, and assessment by developing a multi-level, multi-dimensional, and full-process monitoring and assessment system for cross-border capital flows.

III. Adopt a global perspective, understand the drivers of cross-border capital flows and pay attention to the international coordination of economic and financial policies.

Understanding cross-border capital flows against the backdrop of a deeply intertwined global economy and highly connected financial markets necessitates a global perspective.

The United States is the primary source of global cross-border capital flows, with EMDEs frequently being the passive recipients. In other words, US monetary policy and dollar movements have important externalities on EMDEs, often exposing them to the risk of large cross-border capital inflows and outflows.

The QE conducted by the US Federal Reserve after the 2008 financial crisis led to the injection of massive capital into EMDEs, feeding asset bubbles in these markets; the withdrawal of QE afterwards triggered capital outflows and added to the risk of bubble burst in EMDEs.

At present, the Fed is shifting away from the unlimited QE implemented in 2020 in response to the pandemic shock, which will again put EMDEs to the test. However, given China's strengthened resilience as a result of reform and opening-up, as well as its wider and deeper financial markets, this type of macro policy shifts in major developed economies are expected to have only a limited and controllable impact on China.

Management of cross-border capital flows anchored on opening-up should aim to build a fairer global governance system:
First, we should broaden our global perspective, improve our participation in international financial governance, and strengthen China's cross-border financial legal system.

Second, engage in bilateral and multilateral international cooperation to establish a cooperative governance mechanism that is both aligned with international rules and consistent with China's development reality, protect the country's sovereign financial interests, and jointly prevent cross-border financial risks.

Third, as a responsible major power, China should participate in the reform of the international financial governance framework, advocate for and promote international economic and financial policy coordination, and set up a regular high-level consultation mechanism. China should be mindful of policy spillovers from major developed countries and work to create a fairer and more equitable international environment for EMDEs.

In its new journey towards fully building a modern socialist country, China should promote a more balanced balance of payments, more orderly cross-border capital flows, and more powerful risk prevention and control in its forex management. The forex administration will continue to pursue high-quality development, high-level capital account opening, cross-border trade and investment facilitation, cross-border capital flow risk prevention and control, with the purpose of creating a new global financial landscape with more coordinated international policies and a fairer market environment.