The Telegraph

Capital exodus from China reaches $800bn as crisis deepens

China is reverting to credit stimulus after attempts to engineer a stock market boom failed horribly. The day of reckoning is delayed again

The Chinese central bank is being forced to run down the country's foreign reserves to defend the yuan Photo: Alamy

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China is engineering yet another mini-boom. Credit is picking up again. The Communist Party has helpfully outlawed falling equity prices.

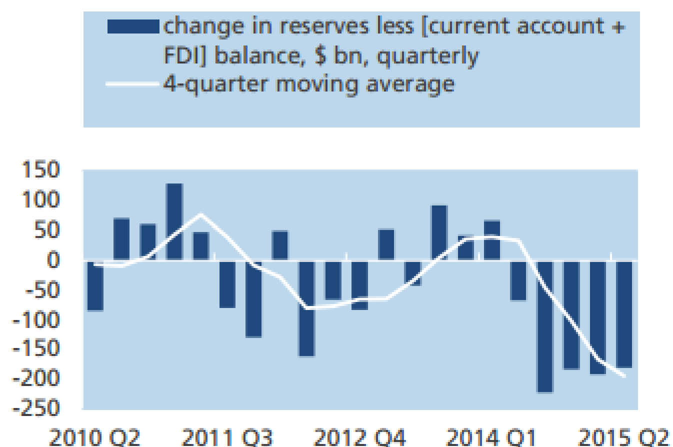
Economic growth will almost certainly accelerate over the next few months, giving global commodity markets a brief reprieve.

Yet the underlying picture in China is going from bad to worse. Robin Brooks at Goldman Sachs estimates that capital outflows topped $224bn in the second quarter, a level "beyond anything seen historically".

The Chinese central bank (PBOC) is being forced to run down the country's foreign reserves to defend the yuan. This intervention is becoming chronic. The volume is rising. Mr Brooks calculates that the authorities sold $48bn of bonds between March and June.

Charles Dumas at Lombard Street Research says capital outflows - when will we start calling it capital flight? - have reached $800bn over the past year. These are frighteningly large sums of money.

Net private capital outflows at $800bn a.r.



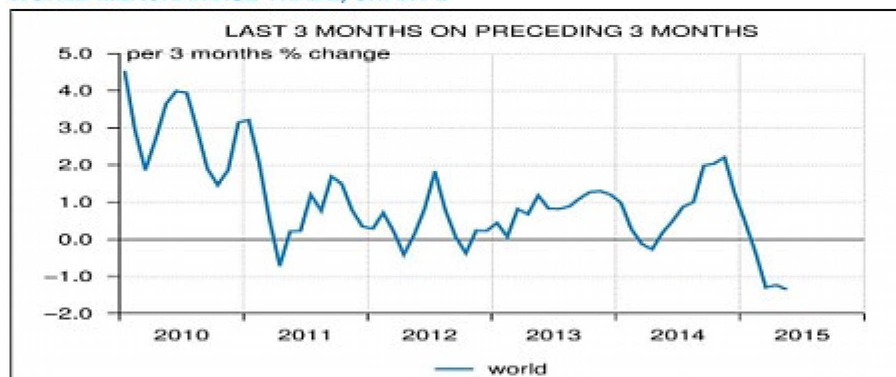
Source: CEIC, Macrobond, LSR

China's bond sales automatically entail monetary tightening. What we are seeing is the mirror image of the boom years, when the PBOC was accumulating $4 trillion of reserves in order to hold down the yuan, adding extra stimulus to an economy that was already overheating.

The squeeze earlier this year came at the worst moment, just as the country was struggling to emerge from recession. I use the term recession advisedly. Looking back, we may conclude that the world economy came within a whisker of stalling in the first half of 2015.

The Dutch CPB's **world trade index** shows that shipping volumes contracted by 1.2pc in May, and have been negative in four of the past five months. This is extremely rare. It would usually imply a global recession under the World Bank's definition.

WORLD MERCHANDISE TRADE, CHART 2

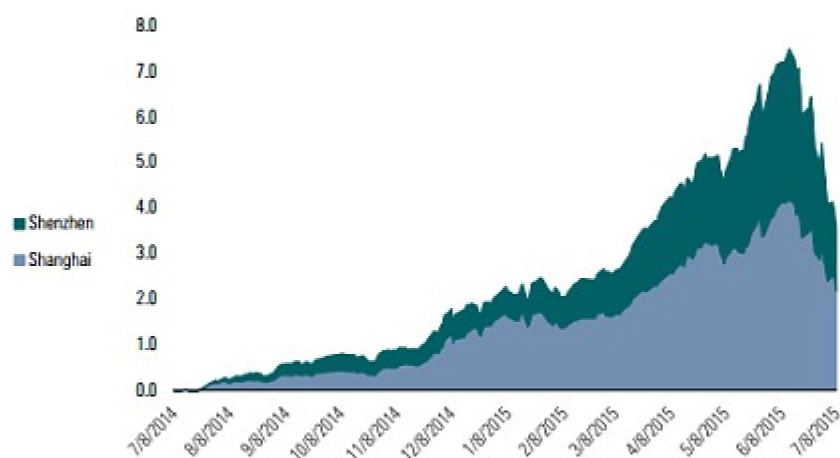


The epicentre of this crunch has clearly been in China, with cascade effects through Russia, Brazil and the commodity nexus.

Chinese industry ground to a halt earlier this year. Electricity use fell. Rail freight dropped at near double-digit rates. What had begun as a deliberate policy by Beijing to rein in excess credit escaped control, escalating into a vicious balance-sheet purge.

The Chinese authorities have tried to counter the slowdown by talking up an irresponsible stock market boom in the state-controlled media. This has been a fiasco of the first order.

The equity surge had no discernable effect on GDP growth, and probably diverted spending away from the real economy. The $4 trillion crash that followed has exposed the true reflexes of President Xi Jinping.



Half the shares traded in Shanghai and Shenzhen were suspended. New floats were halted. Some 300 corporate bosses were strong-armed into buying back their own shares. Police state tactics were used hunt down short sellers.

We know from a **vivid account** in Caixin magazine that China's top brokers were shut in a room and ordered to hand over money for an orchestrated buying blitz. A target of 4,500 was set for the Shanghai Composite by Communist Party officials.

Caixin says the China Securities Finance Corporation - a branch of the regulator - now owns an estimated $200bn of Chinese stocks and has authority to buy a further $500bn if necessary to prop up the market.

This use of "brute force" - in the **words** of Peking University professor Michael Pettis - has done the trick. Equities have recovered. How could they not do so, since selling was illegal, and not to buy was also illegal?

Yet it is hard to see what remains of Xi Jinping's pledge at the Communist Party's Third Plenum in 2013 to let market forces play the "decisive role" in the economy. There was always a contradiction in this pledge. Mr Xi was touting free enterprise, even as he tightened control on the internet, academia and political dissent.

His failure to see through his reform strategy is fatal for China's economy. The World Bank and China's Development Research Centre - the brain-trust of premier Li Keqiang - published a long report three years ago calling for a market revolution before the Chinese economy hits a brick wall.

It warned that the country's 30-year growth model is obsolete. The low-hanging fruit of state-driven industrialisation has been picked.

Either China breaks its dependence on export-led growth and imported know-how or it will drift into the "middle income trap" awaiting all catch-up countries that fail to reform in time, and to make this fundamental break it must relinquish political control over the economy and let a hundred flowers bloom.

"The role of the private sector is critical because innovation at the technology frontier is quite different in nature from catching up. It is not something that can be achieved through government planning," it said.

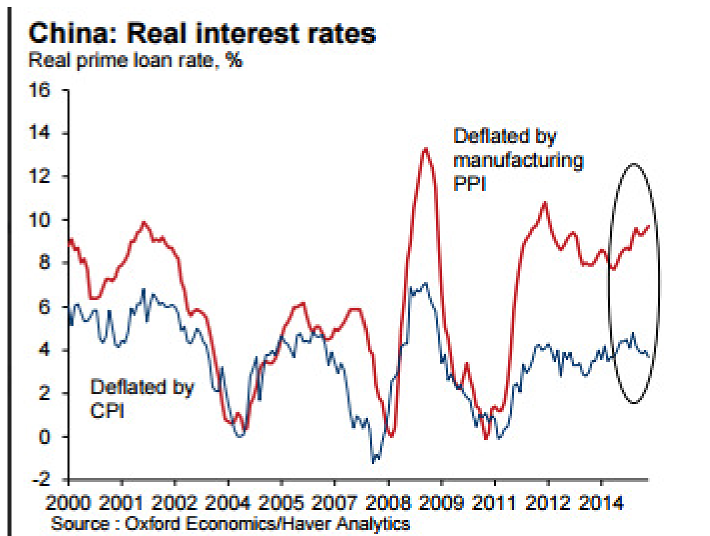
Lombard Street Research says China's true economic growth rate is currently below 4pc, using proxy measures of output. Capital Economics and Oxford Economics have reached a similar verdict with their own tracking systems.

The legacy effect of pervasive excess capacity - the country produced more cement between 2011 and 2013 than the US in the entire 20th century - has been a blanket of deflation. Factory gate prices are falling at a rate of 4.6pc.

Mr Dumas says this has pushed one-year market borrowing costs to 10pc in real terms. "Current monetary conditions are extremely tight," said Mr Dumas.
The Chinese authorities have until now been reluctant to flood the system with fresh stimulus, all too aware that the ratio of private credit to GDP has jumped sixfold to 160pc of GDP since 2007.

This is already far beyond any safe level for a developing economy and has lost its potency, in any case. The extra growth generated by each yuan of new loans has dropped from a ratio of 0.80 in the pre-Lehman era to 0.24pc today. The trade-off has become toxic.

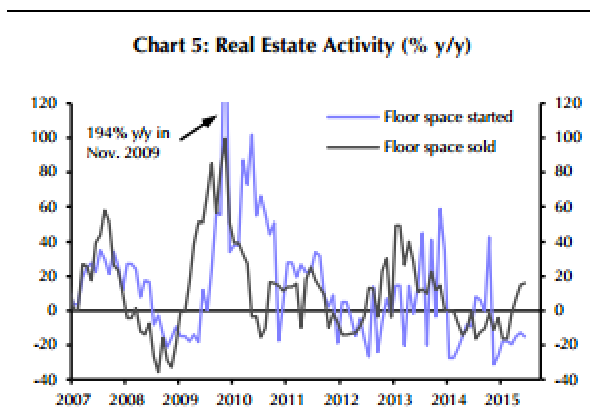
Adam Slater from Oxford Economics says the raft of easing measures since late 2014 have not kept pace with tightening conditions. The real exchange rate has jumped 15pc since mid-2014, chiefly due to China's dollar peg and Japan's yen devaluation.



"If the authorities wanted to quickly and radically ease monetary conditions, exchange rate depreciation would be the obvious way to go," he said.
This relief is blocked - for now - because it would risk other nasty side-effects. Chinese companies have $1.2 trillion of US denominated debt. A yuan devaluation would anger Washington and risk a beggar-thy-neighbour currency war across Asia, with lethal deflationary effects.

Mr Slater says China may instead have to slash interest rates to zero and even resort to "monetary-financed deficit spending" in the end, knowing that this stores up an even greater crisis later.

The early signs are that Mr Xi will now revert to stimulus again - hoping that he can calibrate the dosage, despite the Party's failure to do so on every previous phase of the stop-go cycle - concluding that it is too dangerous to let market forces do their worst after such vast imbalances have accumulated.



The Communist Party still controls the quantity of credit through the state banking system. It is using the power it knows best. New loans jumped to $205bn in June, up from $145bn in May. Local governments - facing new curbs on bank borrowing - issued a further $113bn in bonds. Taken together, they amount to a sugar rush of fresh credit.

Industrial output and electricity use are coming back from the dead. Sales of property floor space are suddenly spiking.

The great scare of early 2015 appears to be over. The hideous denouement has been averted once again. Mr Xi will surely discover that it won't be any easier next time.