

# Analysis of Influencing Factors on China's International Speculative Capital Inflows

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**Abstract** – Since the second half of the year 2011, the scale of “hot money” inflows into China shows a downward trend. According to this phenomenon, this paper estimated the scale and trend of “hot money” in a new method, analyzed the main driving factors of International hot money inflow and outflow, and then interpreted the reason why International capital Inflows into China was reduced or even out flowed, which includes Inner driver analysis and External driver analysis .The final section analysis the Influence of this phenomenon on Chinese Macro-economy .

**Keywords**–hot money; International speculative capital; driving factors; RMB appreciation expectation

## 1. Introduction

It has been reported that at the background of the transformation of RMB appreciation expectation , the slowing down of China's economic development, and the European debt crisis since the second half of the year 2011, the tendency that a large scale of foreign capital flowing into China since 2005 has been transformed. The continuous "double favorable balance" between the current account and the capital-financial account presented a downward trend, service trade and “other trade balance” in FDI trade deficit , reducing the size of international speculative capital inflows into China. Such a situation is rarely seen in the past 10 years.

## 2. The definition and estimation of hot money

### 2.1 The definition of International speculative capital

There is not a unified definition for “hot money”. Four characteristics of it were generally accepted as: (1) high-yield and high-risky; (2) high informatization and sensitivity; (3) high liquidity and short-term; (4) high virtual and speculation (word bank 2000).

Due to China's rigorous capital supervision, the inflows of International hot money have to takes twists and turns, which would reduce its liquidity seriously. In addition, the “hot money” flowing into China would not be withdrawn in a short term in order to gain the profit on anticipated exchange rate shifts and asset price booms. These two factors determine that, in China, high-flow characteristics of the international hot money are not

obvious. While considering the other three characteristics, it will be more appropriate to call it “International speculative capital”.

## 2.2 The estimation of International speculative capital

For there is no legitimate channels for International speculative capital to flow in, there is no well-defined method for estimating the amount of International speculative capital flowing into China during a period of time.

Two problems need to be solved to estimate inflows of international capital flows : Firstly, the channel of fund inflow ; Secondly, the related statistic data .

International speculative capital flows into China through four channels: current trade, balance by over

trade surplus; FDI entry, through “bet poor”, This part of the amount can be estimated by foreign external debt ;Personal investment entities donation transfer activities, measured by the current account of transfer; As well as illegal channels of investment inflows, estimated by errors and omissions in the BoP. The desired assessment data was obtained from the statistics of the State Administration of Foreign Exchange.

Taken together, the amount of International speculative capital inflow can be calculated as follows: International speculative capital inflow = over trade surplus + the balance of foreign external debt +Net current transfers + Errors and omissions.

Estimated by this method, the amount of “hot money” inflowing into China in the past trend is shown in the following figure, (data from the State Administration of Foreign Exchange).

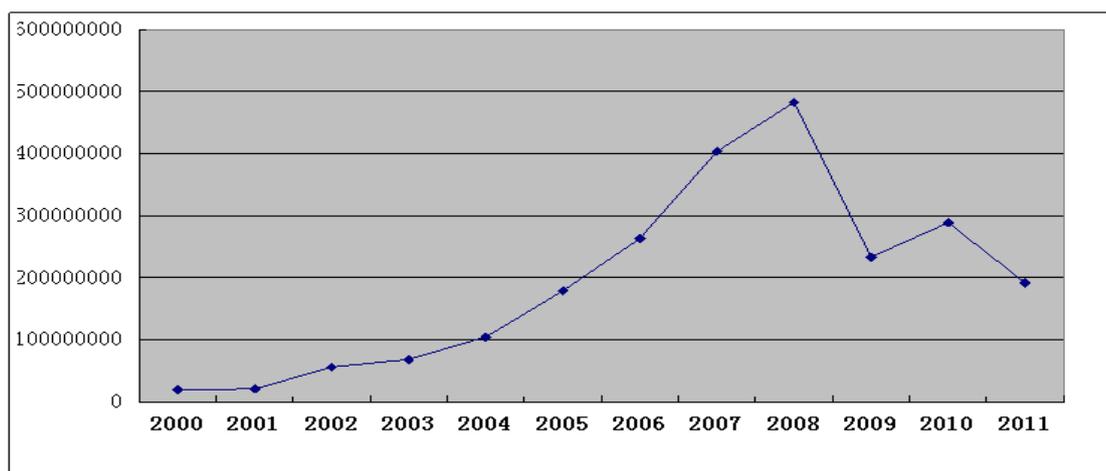


Fig.1.China's international speculative capital inflows charts (2001—2011)

As shown in **Fig.1**, China's international speculative capital from 2001 to 2007 inflows show an increasing trend. In contrast, from 2009 until now, the amount shows general trend of downward, with two-dimensional Dynamics.

Section 3 discusses from a theoretical point of view of the influencing factors on International hot money which flows into China, then use the theory to explain the recent China's international speculative capital outflows in section 4.The final section analysis The Influence of this phenomenon on Chinese Macro-economy .

## 3. Theoretical analysis of the influencing factors on Chinese International speculative capital inflows

The purpose of the international capital flows is mainly attributed to the pursuit of higher returns and disperses risks, while their specific driving factors are reticular and also varied from time to time in different places. Calvo and Reinhart (1996) divided them into inner drivers and external promoting factors. Khan Reinhart (1995) asserts that the Asian country's capital inflows are mainly droved by inner drivers, in contrary, external drivers are more important for Latin American

countries. Based on the statistic data from 2001 to 2011, the paper analyses the influence on two sides, inner drivers and external promoting factors.

### 3.1 Inner driver analysis

The internal factors affecting the hot money inflows primarily consist of domestic asset prices, domestic economic growth situation, as well as the policy and market environment.

Domestic asset prices expectation. As “Hot money” flows from one country to another aim to gain short-term profit. The natures of hot money determining its investment field are mainly high-yield and high-risky,

financial market and real estate market are suitable selections.

When the amount of hot money inflows ( $F_t$ ) increases, the domestic monetary supply ( $M_2$ ) will rise, leading to the increase of Domestic asset prices( $q_t$ ). It would to some extent weaken the expectation of asset price increasing, which conversely, could reduce the capital inflows of the next period. However, if the expectation of asset price increasing keeps in a high level, capital inflows would still show a growing trend.

Based on the above analysis, we found that the relationship between  $F_t$  and  $q_t$  is that they linked tightly with each other and presented a helix rising theory of relationship.

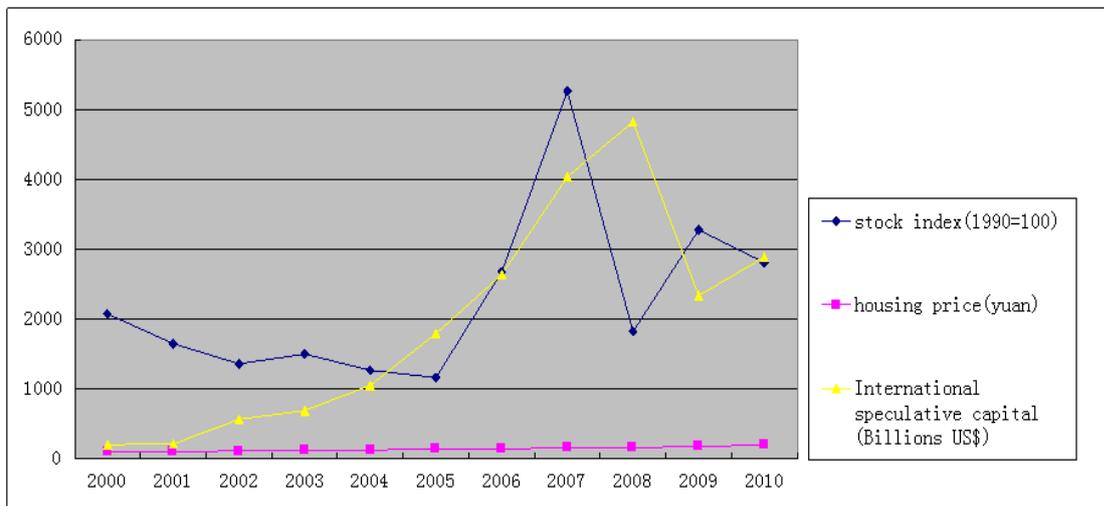


Fig.2 International speculative capital movements, stock price and Housing price (2000-2010)

The three economic variables included in Fig.2, which are retrieved from the National Bureau of Statistics Database, are defined as follows: The Stock price is refers to the composite index of Shanghai Stock Exchange. The International speculative capital-we calculate is amounted by the measure which was proposed in Section 2. Housing price is measured by the national average selling price of commodity building per square meter. As the Fig.2 shows, China's real estate prices have been in a steady upward trend, price fluctuations, and no significant relationship with the international speculative capital inflows. However, the stock price and International speculative capital presented a significant helix rising relationship, meanwhile, capital inflows change lagged behind the change of stock price, which confirmed the above

theoretical analysis.

The growth of the country's economic impact on hot money inflows. Through exchange rate movements and changes in asset prices, the growth of the country's economic situation mainly exerts conducting effect on the hot money inflows. When the economic uptrend, bring along the expectation of asset price increasing and currency appreciation.

Next the paper will stay the impact of policy and market environment on the inflow of hot money. Inner driver of hot money inflows also includes good monetary and fiscal policy, the process of market-oriented reforms (such as the liberalization of trade and capital markets), and a low-inflation environment. These factors would help enhance the confidence of international investors and attract international capital inflows at the mean time.

Renu Kohli (2001) found significant positive correlation between international commercial capital inflows and their national credit rating.

### 3.2 External drivers' analysis

Local currency Exchange rate appreciation. Expectation is the most important external factors of hot money inflows. The Exchange Formulation Mechanism of one country or region has important influence on the international capital inflow, especially on the speculative capital inflows. On the one hand, the expected appreciation triggered capital inflows, on the other hand, capital inflows in turn led to a rise in the exchange rate. MeloDabos, V. HugoJuan, and Ramon found from Mexico that in the long run, the real exchange rate and capital inflow (capital inflows: GDP ratio) has significant statistical correlation.

Over the past decade, putting along with the rapid development of China's macro-economics, foreign exchange reserves presented a large increase .China's strong economic growth momentum, made the RMB appreciation expectation to become the consensus of the world, largely attracted foreign speculative capital flows in .

## 4. The Analysis of Current International hot money outflows

### 4.1 Current international hot money outflows

#### 4.1.1 It is not optimistic about the development of the fundamental aspects of the Chinese economy, the stock market and the real estate market downturn.

Since 2011, Chinese government has transformed economic growth mode, restrained inflation, slowed down over quick economic growth momentum, started to carry out prudent monetary ,controlled credit position, raised the deposit reserve rate and policy for several times, and regulated the real estate market prices. Those series of policy, which controlled the CPI and slowed down the speed of economic growth, combined with the impact of the European debt crisis on exports. China's economic fundamentals have shown clear downward trend. These factors to some extent reduced the total

amount of foreign speculative capital inflows.

### 4.1.2 RMB appreciation expectation

The change in the RMB appreciation expectation is also an important factor that caused the decline of international speculative capital inflows. In the late 2011, the RMB/USD Foreign Exchange Rate, which ascending at all times, had appeared an unrestraint stop for four trading days. It was unique in the reform history of RMB exchange rate for more than six years. Those changes were caused by both the impact of the downward trend of China's economic fundamentals and the role of the market.

Firstly, the European debt crisis caused a huge demand on the dollar after the bankruptcy of Lehman Brothers in 2008. Secondly, the pessimistic rise of China's economic growth prospects reduced the demand for RMB assets. Thirdly, international speculative capital deliberately bad-mouthed and made China's economy going "short". In addition, we cannot exclude a large number of domestic enterprises exports, which boost devaluation of the RMB.

The above analysis shows that RMB exchange rate and foreign capital investment inflows going up and down synchronically. It can be considered that the downward of RMB/USD Foreign Exchange Rate had a relationship with the international speculative capital inflows, while the lowering of the exchange rate further reduced speculative capital inflows in turn.

#### 4.1.3 The impact of the international environment

There are two obvious circumstances in the international economy since the second half of 2011: the European debt crisis continues rising and the improvement U.S. economic fundamentals. US dollar emerged strong potential and became the refuge. The data shows that dollar index drew close to 80 points from 74 points in the middle of the year 2011. European debt crisis and the strength of the dollar are both important reasons for the outflow of international speculative capital.

### 4.2 The Temporary International speculative capital outflow is not equal to foreign capital

## mass evacuation

Despite the domestic and international factors mentioned above had caused China's funds outstanding for foreign exchange decrease and capital account deficit, it can not be concluded that the foreign existence of large-scale and long-term centralized evacuation .

On the one hand, theoretically, the current account surplus is greater than the increase of foreign exchange reserves means that China's domestic institutional and individual capital showed a net outflow, net foreign assets increase .However, making a concrete analysis on the data of international expenses and receipts of China, we found capital account deficit was mainly due to that holders of foreign currency assets change from the central bank to the domestic institutions and individuals. It's a process of stockpile foreign exchange reserves in state coffers; there are not yet clear signs of foreign investment evacuation. Meanwhile, other investment liabilities items including trade credits and loans still show a net inflow of funds. China's domestic institutions still show strong financing ability on oversea market.

On the other hand, despite the existence of some uncertain and unstable factors in the external environment, the positive factors for China's economic fundamentals and the balance of international payment are gradually accumulated. First of all, the governments placed the stable economic growth on its higher agenda, a series of pre-tune and fine-tune policies issued since the second high of 2011, would help to boost market confidence and maintain steady economic growth. In addition, given the downturn of the world economy, international commodity prices fall lower to the cost of imports. In the first half of 2013, China is likely to maintain a large-scale goods trade surplus. What's more, some major countries will pay more attention to the growth of economics, and some relevant countries still have resources and determination to prevent the debt crisis from going worse.

## 5. Impact of current international speculative capital outflows on China's economy

Negative impacts of changes in the international speculative capital inflows for China's economic

development are inherent. To some extent ,cash outflow will cause some enterprises bankruptcy since cash flow broke stripe, the international lose confidence on the Chinese economy, the investment bank reduce holding funded line stocks and the stock market downturn.

Comparatively, the positive impacts of hot money gentle outflow are greater.

Firstly, the outflow reduces the RMB appreciation stress, which is desirable to the regulatory agency. The reducing appreciation pressures can not only give Chinese government greater autonomy in the formulation of monetary policy, but also bring benefit to export and promote the development of small and medium enterprises.

Secondly, this situation is in favor of domestic asset prices returning to a reasonable level, and improving the situation of China's overheating economy since 2008. With the continuous improvement of the RMB exchange rate formation mechanism and significantly lessen of the central bank's foreign exchange intervention, China's international balance of payments pattern of current account surplus, capital account deficit will become an ordinary state, and is conducive to promoting the Tibetan sinks in China.

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### Vitae



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