FOR PROFESSIONAL INVESTORS – 7 December 2023

Chi Time

Is foreign direct investment leaving China, for good?

Know thy self, know thy enemy. A thousand battles, a thousand victories.

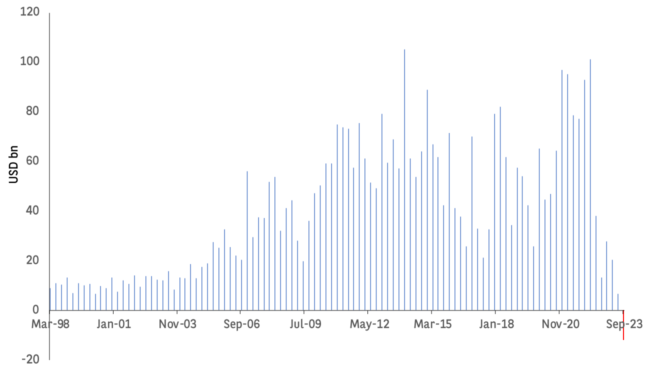
Sun Tzu

Balance of payments (BoP) data for 3Q 2023 shows that China suffered an outflow of foreign direct investment (FDI) for the first time since the records began (Exhibit 1). This has revived the market's worry about China decoupling and raised the concern about its long-term growth, as FDI contributes to growth by adding to investment potentials and creating links with other countries. Some observers also argue that the outflow was a sign of foreign firms de-risking or friend-shoring their businesses; in other words, leaving China for good.

The billion-dollar question is whether this data marks the start of foreign investors deserting China or a short-term phenomenon that will reverse as the international dynamics change.

Exhibit 1

FDI leaves China for the first time ever*



* Balance of payments data

sources: CEIC, BNP Paribas Asset Management 30 Nov 2023

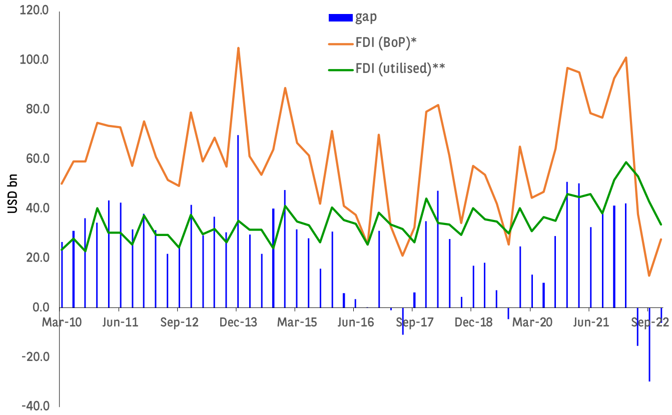
Decoupling?

The difference between China's BoP data (reported by SAFE) and utilised FDI data (reported by the Ministry of Commerce) gives a clue as to whether foreign firms are deserting China. The BoP data includes foreign firms' undistributed profits and unremitted profits while the utilised FDI data does not. Hence, the value of the former is usually larger than the latter.

This data gap has been narrowing since 2016 (Exhibit 2) due to a fall in the BoP data on the back of relatively stable FDI utilisation. This phenomenon suggests that foreign firms were repatriating profits, as reflected by the fall in the BoP data, rather than withdrawing investment from (or reinvesting their earnings in) China.[1]

Exhibit 2

Foreign firms repatriating profits rather than reinvesting in, or leaving, China



* SAFE data, incl. undistributed and unremitted profits
** Ministry of Commerce data

sources: CEIC, BNP Paribas Asset Management 30 Nov 2023

Thus, there is no conviction for China decoupling until 2022, when both the BoP and utilised FDI data fell sharply, pushing the gap into negative territory. This seems to underscore the concern about foreign investors leaving China (even though the utilised FDI data for 2023 are not yet available at the time of writing).

Outflows permanent or temporary?

Nevertheless, two factors argue that the drop in FDI inflows to China in 3Q 2023 could be temporary.

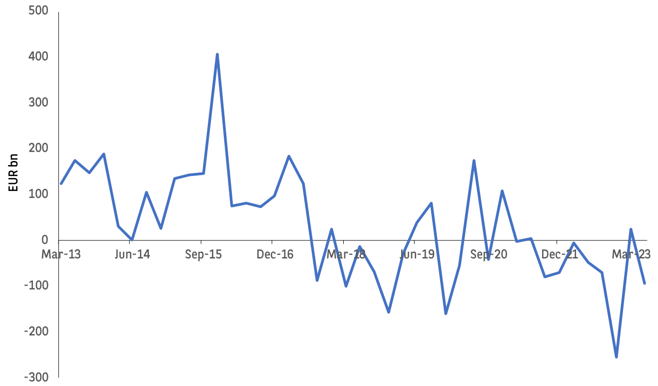
Firstly, the excess return on FDI – the rate of return on FDI minus the risk-free rate – has fallen significantly since the US Federal Reserve's sharp policy tightening that raised the risk-free rate to an average 5.25% in the first three quarters of 2023 from just over 2.0% in 2022 and 0% in 2021. This has reduced the businesses' risk appetite and FDI incentive.

Arguably, such risk aversion has led to FDI outflows from China. This problem is not unique to China. Europe has also suffered (Exhibit 3). However, with the US interest rate cycle peaking and eventually turning down, FDI incentive should resume and reverse the outflows from China.

[1] The exception year was 2021 when the pandemic stopped international capital flows including MNCs' profit repatriation, thus boosting the data gap.

Exhibit 3

FDI flows to Europe also drop*



* Balance of payments data

sources: CEIC, BNP Paribas Asset Management 30 Nov 2023

Secondly, negative sentiment on China due to its disappointing post-Covid economic recovery and geopolitical tensions with the US has also hurt FDI flows to China. But this may also be changing.

China's economy has reached a 'pain point' prompting Beijing to ease policy more aggressively to stabilise the property market and economic growth momentum. There is evidence that China's policy shift is happening. If Beijing can sustain its assertive easing to repair confidence, there is a fair chance for a sustained rebound in Chinese growth and stocks in 2024. That should help turnaround the negative sentiment and reverse the FDI outflow.

There are also signs that Sino-US relations are stabilising, with the two countries increasing dialogues since May this year and that led to the Xi-Biden meeting at the APEC summit in November. Stabilisation of Sino-US relations will go a long way to reduce the risk premium of cross-border investments, allowing companies to focus on economic fundamentals.

Meanwhile, the worry about FDI outflow hurting China's economic growth has been exaggerated. China does not depend on FDI to finance its development. This is because FDI only accounts for about 3.0% of China's total investment.

Rather, FDI is important for China because it is a channel through which technological and business management knowhow are transferred to Chinese firms. Furthermore, FDI brings in international market discipline, which helps to enhance the competitiveness of domestic enterprises and improve governance.

New sources of FDI

While the US's strategic competition foreign policy is reducing US FDI (and portfolio investment) to China, especially in sectors that the US deems strategic to its national interest, the Middle East (especially the Gulf Cooperation Council, or GCC, countries) is ready to step up its investments in China amid improving diplomatic and economic relations.

The six GCC nations – Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain, and Oman – have sovereign wealth funds totalling an estimated USD4 trillion, but less than 2.0% of this is invested in Asia, including China. This situation is set to change.

Market players estimate that this investment capital would grow to US$10 trillion by 2030, with USD1 to 2 trillion allocated to China. This could potentially offset the decline in US FDI in China. Furthermore, some FDI could flow to China by stealth when players skirt the US government's restrictions on directly investing in China by repackaging their investments in financial hubs such as the UAE and sending the money to China (and Asia).

There are signs of increasing engagement between the GCC and China which coincide with the acceleration of China's renminbi internationalisation momentum since March 2023, when Saudi Arabia announced that its state-owned oil and gas company Aramco would build oil refineries with China for RMB 83.7 billion, and that it would join the China-led regional security and trade club, the Shanghai Cooperation Organisation. The latter is an important sign of Saudi Arabia's improving diplomatic relationship with China which should help advance their talks on trading oil in renminbi.

In May 2023, the UAE signed three agreements with Chinese nuclear energy organisations, giving China an entry point into the GCC region. Then in August 2023, the BRICS bloc (comprising Brazil, Russia, India, China and South Africa) expanded its membership by adding six countries, including Saudi Arabia and UAE. In 3Q 2023 alone, Saudi Arabia, UAE and Qatar signed investment and partnership agreements with China worth at least USD5 billion, covering sectors in energy, R&D, industrial/green projects, and finance.

The list of events and agreements will grow as Sino-Middle East cooperation increases.

Too early to quit

While the latest FDI outflow data gives China critics the firepower to argue for a decline of China's prowess, they are ignoring this development of new FDI flowing into China from the Middle East (and other countries, especially Asia) at their peril. This changing investment dynamics argue that FDI flows to China are undergoing a transitional phase with outflows (led by the US) in the short-term being replaced by inflows (from the Middle East) over the medium-term.

When the global financial dynamics change from the negative to positive with a falling risk-free rate, improving Chinese economic growth and stabilising Sino-US geopolitical relations, FDI inflow to China will resume.

Time will tell; want to bet?

Chi Lo BNP Paribas Asset Management

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