China Business

China to clamp down on outbound M&A in war on capital flight

Rules to tighten deal approval process take shape as renminbi and forex reserves fall

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NOVEMBER 29, 2016 by: **Gabriel Wildau** in Shanghai, **Don Weinland** in Hong Kong and **Tom Mitchell** in Beijing

China is readying new restrictions on outbound foreign investment in an effort to curb capital outflows that are putting downward pressure on the renminbi (http://next.ft.com/content/94f39188-ac6e-11e6-9cb3-bb8207902122) and draining foreign exchange reserves (http://next.ft.com/content/6359c170-6e52-11e5-8171-ba1968cf791a), according to people who have seen a draft of the rules.

The State Council is most concerned about outbound mergers and acquisitions worth more than $10bn, said two people familiar with the government's deliberations. They added that Chinese officials would scrutinise purchases of more than $1bn if they were outside the investor's core business. Meanwhile, state-owned enterprises will not be allowed to invest more than $1bn on a single overseas real estate transaction.

News of the stricter measures worried many company executives, investment bankers and M&A lawyers on Tuesday as they tried to assess the impact on their pending transactions. Censors also rushed to delete apparent copies of the draft regulations that circulated online, further clouding the picture.

Chinese regulators often relax and tighten rules informally, allowing them to react flexibly to changing market conditions.

"Under its World Trade Organisation commitments, China (https://www.ft.com/china) is supposed to have a more transparent legal framework," said one frustrated Chinese lawyer, adding that the situation was "harmful".

Capital flows

Beijing crackdown

"The reversal of measures to liberalise capital outflows reflects China's zig-zag approach to reforms," said Eswar Prasad, a China finance expert at Cornell

[Beijing battles to close capital flight loopholes (http://next.ft.com/content/1249fb38-b613-11e6-ba85-95d1533d9a62)](http://next.ft.com/content/1249fb38-b613-11e6-ba85-95d1533d9a62)
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University. "This step signals the government's conventional preference for stability and control rather than economic liberalisation and resulting volatility."

In a terse, three-line statement issued on Tuesday evening, the State Administration of Foreign Exchange (Safe) said only that it would crack down on "fake" transactions while continuing to clear genuine ones. Safe declined to comment on reports that it would begin vetting cross-border money transfers worth $5m or more, compared with a previous threshold of $50m.

Others sought to play down the potential impact.

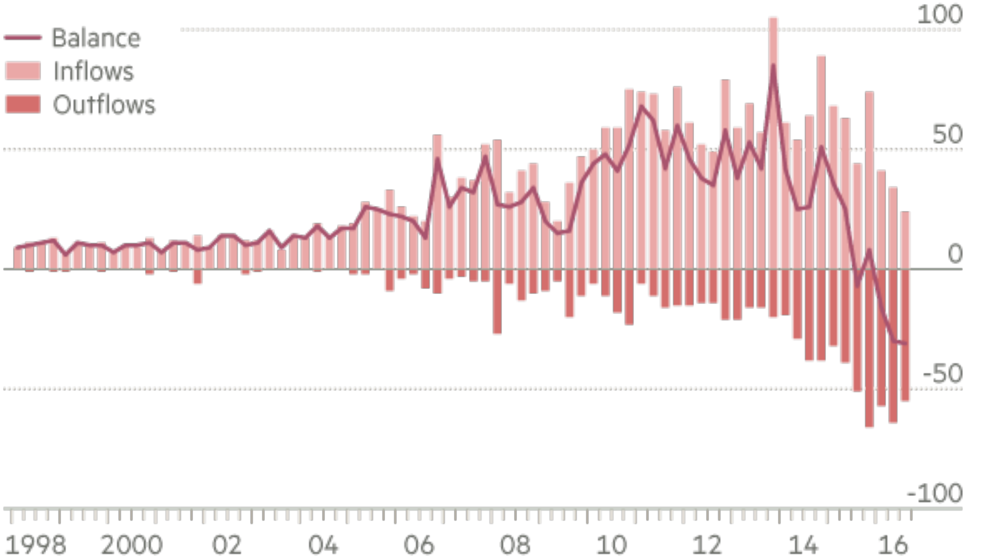
"This doesn't mean the Chinese government is cracking down on legitimate M&A activity," said one Beijing-based investment banker. "They are just exercising more control, which is necessary. The volume of outbound M&A is mind-boggling in terms of how fast it's growing."

According to commerce ministry data, Chinese companies' [overseas purchases (http://next.ft.com/content/0989dae0-3c0f-3501-bd4e-0b4422a72348)](http://next.ft.com/content/0989dae0-3c0f-3501-bd4e-0b4422a72348) have surged past last year's record of $121bn for non-financial outbound investments, reaching $146bn over the first 10 months of 2016.

Chinese investment into Europe in the first three quarters of this year is almost three times European investment into China, according to Rhodium Group, the economic research house. Another recent study by Rhodium found that Chinese companies' acquisitions in the US last year for the first time exceeded those by US groups in China.

China foreign direct investment

Quarterly, US$bn



Sources: State Administration of Foreign Exchange; CEIC

Due largely to capital outflows, the renminbi has fallen 5.8 per cent this year, on track for its worst year on record. China has sold dollars from its foreign exchange reserves to try to curb downward pressure on the currency, with reserves hitting $3.12tn at the end of October, the lowest level since March 2011 (http://next.ft.com/content/4361ad64-a4f3-11e6-8898-79a99e2a4de6).

"This is a big move," said Wang Jun, an economist at China's Center for International Economic Exchange. "The government has stepped up capital controls to prevent further depreciation of the renminbi.

“The trend of US dollar appreciation and renminbi depreciation is obvious,” Mr Wang added. “They are worried about capital flight.”

Analysts and bankers said Beijing was also concerned about the quality of Chinese overseas investments. The government fears some transactions are being rushed through without proper due diligence to cash in on the dollar’s continuing appreciation against the renminbi.

“This is not only about foreign exchange reserve concerns,” said Xiang Songzuo, chief economist at Agricultural Bank of China. “Some of our SOE’s overseas acquisitions have led to huge losses in the past.”

If issued formally, the State Council document would make explicit a policy shift already under way informally. Bankers and executives say forex purchase approvals from Safe were once routine but have taken as long as two or even three months, ever since panic gripped China’s equity and currency markets (http://next.ft.com/content/4cde4cc4-b847-11e5-b151-8e15c9a029fb) in January.

“These are stricter applications of Safe rules,” said Zhao Xijun, a finance expert at Renmin University in Beijing. “Before, the rules were there but no one paid attention.”

In a joint statement (http://www.sdpc.gov.cn/xwzx/xwfb/201611/t20161128_827847.html) by four agencies including Safe and the central bank on Monday, the government said it would “combine increased convenience of outbound foreign investment with prevention of foreign investment risks".

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China is on course to record its first net foreign direct investment deficit this year, according to balance of payments data. Inbound FDI exceeded outbound flows every quarter from 1998 until the middle of last year but China has reported FDI deficits for four of the past five quarters, including a record $31bn in the third quarter of 2016.

Despite the increase in FDI outflows, such investments remain only a small slice of China's broader capital outflow. Excluding FDI, China suffered a capital and financial account deficit of $176bn in the third quarter — much higher than the $31bn of FDI outflows. These so-called "hot money" outflows include investment in stocks and bonds, as well as trade credit and other bank loans.

Jonas Short at NSBO, a Beijing-based policy research firm, said the new curbs were a reaction to the recent declines in the renminbi, but raised doubts about their effectiveness.

"The move happened now largely as a result of the high outflows in September," he said. "But it can be a bit of a whack-a-mole game. As soon as you try to stem outflows in one channel, they will find another and the overall anxiety of investors trying to get their money out will increase."

Additional reporting by Lucy Hornby, Yuan Yang and Wan Li

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