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CHINA'S MONEY TRAIL

In Reversal, Cash Leaks Out of China

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China's $50,000-a-year limit on moving capital hasn't prevented about $225 billion from leaving China, equivalent to about 3% of the nation's economic output last year. The WSJ's Alex Frangos explains China's money trail.

China, once a catch basin for the world's money, is now watching cash stream out.

Wealthy Chinese citizens are buying beachfront condos in Cyprus, paying big U.S. tuition bills for their children and stocking up on luxury goods in Singapore, frequently moving cash secretly through a flourishing network of money-transfer agents. Chinese companies, for their part, are making big-ticket foreign acquisitions, buying up natural resources and letting foreign profits accumulate overseas.

China hasn't reported on capital inflows and outflows since last year, but it is possible to gauge more recent flows using trade data, foreign-exchange reserves numbers released Saturday and other economic statistics. A Wall Street Journal analysis of that data

Associated Press

A visitor to the China Property Investment Show in Beijing on Sept. 21 tours booths of foreign developers.

suggests that in the 12 months through September, about $225 billion flowed out of China, equivalent to about 3% of the nation's economic output last year.

"We all noticed what we suspected, which is that there was significant capital flight," says Michael Pettis, a finance professor at Peking University who witnessed capital flight up close in his previous career trading Latin American distressed debt. "It's not a good sign when local businessmen begin to think it's better to take money offshore, especially when the world economy is in such bad shape."

China officially maintains a closed capital account, meaning it restricts the ability of individuals and businesses to move money across its borders. Chinese individuals aren't allowed to move more than $50,000 per year out of the country. Chinese companies can exchange yuan for foreign currencies only for approved business purposes, such as paying for imports or approved foreign investments.

In reality, the closed system has become more porous and the rules are routinely ignored. "The wealthy in China have always had an open capital account," says Eswar Prasad, a Cornell University economist and former International Monetary Fund official.

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Zheng Nan recently spent €300,000 ($390,000) on a beachfront condo in Cyprus. At 50 years old, he says he is retired from selling telecommunications gear in China for foreign manufacturers. "My plan is to spend winter there because of the pollution in Beijing," he says. "And we will be back for summer."

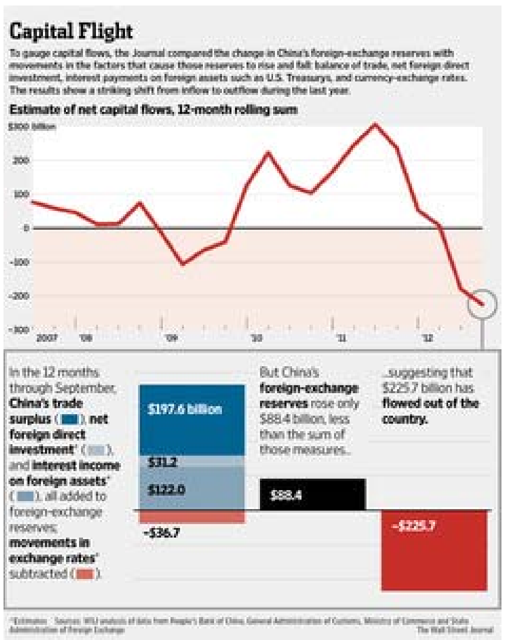
China's $50,000-a-year limit on moving capital out presented a problem for him. He says he got around the restriction by recruiting friends to move chunks of his money under their own names. Real-estate agents in China say that is a common practice that is largely tolerated by authorities.

For years, China's economy benefited from large flows of cash into the country from exports and from foreign investors. Incoming dollars were exchanged for yuan at China's central bank, putting more yuan into the economy. That made it easier for banks to lend and companies to grow, but it also stoked inflation and contributed to real-estate and stock-market bubbles.

When money leaves, that system swings into reverse, and there is less money available to fund growth. The outflow of money began to pick up in mid-2011, when concern about slowing economic growth, stalled yuan appreciation and falling stock and real-estate prices made holding cash in China less appealing. Money has left China before, most recently during the financial crisis, when outflows peaked at about $110 billion in the 12 months ended March 2009, the Journal's calculations indicate.

The outflow helps explain why China's banks have been slow to increase lending this year. Accelerated outflows might force China's central bank to push the yuan to appreciate more strongly against foreign currencies, to encourage Chinese investors to keep their money in the country.

The State Administration of Foreign Exchange, part of China's central bank, said in a statement that China experienced "a certain degree of capital outflows" in the first half of this year. It attributed the outflows largely to more investment overseas by Chinese companies and individuals. It said it wasn't concerned that the outflows could destabilize the economy.



In 1998, during the Asian financial crisis, Indonesia saw the equivalent of 23% of its annual economic output leave the country—far higher than the 3% estimated to have exited China over the recent 12-month period. China's economy is protected from such catastrophic outflows by its restrictions on capital movement and by its substantial foreign-currency reserves, currently $3.29 trillion.

The Journal's $225 billion estimate for the year ended in September captures both legal capital outflow and some of the illicit flow. Several economists also have attempted to calculate outflow. Charles Dumas, an economist at Lombard Street Research, estimated net outflows of $300 billion over the same period.

To gauge the size of the outflow, the Journal compared the change in the country's foreign-exchange reserves with changes in the main components that cause reserves to rise and fall: the trade surplus, foreign direct investment, interest on foreign assets and movements in exchange rates.

The two sides of the equation should match. If foreign-exchange reserves increase more than the sum of the components, it suggests extra cash is flowing into China. If reserves increase less, or even fall, it means money is somehow getting out. China's foreign currency reserves saw their first quarterly drop since 1998 in the last quarter of 2011, and fell again in the second quarter of 2012, a sign that the outflows had increased to the point that they offset inflows from trade, foreign direct investment and interest paid on existing reserves.

One factor contributing to the reduced reserves is that Chinese exporters are keeping more of the money they make abroad in dollars, rather than converting it to yuan, economists say.

Because the $225 billion figure is derived from broad economic statistics, it is impossible to say how much of the outflow is legitimate personal and corporate transactions and how much was moved illegally or was the product of illegal activities.

A sprawling industry has developed to help Chinese get money out. Services range from the money-transfer agents to private jets that ferry money by customs officials unmolested, according to lawyers and brokers who help Chinese investors find investments abroad. Sometimes bank transfers by companies hide personal money being moved out, these people say. Another method is to piggyback personal cash atop legitimate export and import transactions, at times by using fake invoices, they say. People even carry bags of cash across the border.

Charlie Zhang, an agent in Shenzhen who matches wealthy mainlanders with real-estate investments abroad, says getting money out isn't a problem.

"We suggest them to other people, some special channel, that can exchange money outside the banks, outside supervision," Mr. Zhang says. "It's not hard for people to solve this problem."

Cyprus has become a popular investment destination for wealthy Chinese. The island nation in the Eastern Mediterranean gives permanent European Union residency to anyone who spends €300,000 on a property.

"People in China are rich," says Arthur Cheung, a Hong Kong-based immigration consultant who matches Chinese buyers with foreign property sellers, including from Cyprus. "They just buy a passport or permanent residency like a Louis Vuitton bag."

Paschali Developers in Cyprus has sold more than 90 condos to Chinese buyers in recent months. Company spokesman Paschalis Paschali says buyers want to get residency. He declined to discuss how the company's Chinese customers get their money out.

Evis Hadjipetrou, business-development manager for Pafilia Property Developers in Cyprus, says the company has sold 30 condos with Mediterranean views in the past four months to buyers from mainland China. He says he was assured by his Chinese partners who helped line up buyers—among them an agency that is a subsidiary of the Ministry of Commerce, he says—not to worry about the restrictions on moving money. A ministry spokesman declined to comment.

Hong Kong, although part of China, has a separate financial system and currency—and no restrictions on outbound capital. Consequently, there are restrictions on mainland Chinese moving money to Hong Kong.

One legal way that some elite Chinese have gotten money offshore is by taking their companies public in Hong Kong, then selling shares. Since 2005, 350 mainland companies have raised more than US$150 billion in Hong Kong, according to data provider Dealogic. Company owners can accomplish the same thing by listing in New York or Singapore.

Many other Chinese have resorted to money-transfer agents operating outside the official banking system. The agents provide loans and transfers that Chinese use to evade the limit on overseas transfers. Working as a money-transfer agent is illegal in China, but it is perfectly legal and lightly regulated in Hong Kong.

Chinese regulators intensified a crackdown on agents last year when China started to experience capital outflows, said Zhao Qingming, an economist at state-owned China Construction Bank .

In Chongqing, home to purged Communist Party official Bo Xilai, authorities closed a money-transfer organization they said moved $10 billion for clients. They said it was run by Chen Huizhuan, a 36-year-old former electronics saleswoman, with the help of her extended family. In July, she was sentenced to six years in jail. A lawyer for Ms. Chen, contacted through intermediaries, declined to comment.

People with direct knowledge of the case say there was a large transfer by Qi Gang, a construction project manager from eastern Zhejiang province who they say was a client of Ms. Chen. In January 2011, Mr. Qi lost the equivalent of $1.3 million in two days of gambling with borrowed money at a Macau casino, these people allege. Macau, like Hong Kong, is part of China but has its own financial system, and mainlanders face the same restrictions on moving money there. Mr. Qi had the money to pay off his debt, these people say. The problem was getting it out of China.

Mr. Qi's company, which wasn't identified by authorities, transferred the cash into an account set up by Ms. Chen in Chongqing, claiming it was paying for building materials, say the people knowledgeable about the case. Then Ms. Chen had the equivalent amount in Hong Kong dollars deposited into a separate account belonging to the entity that had lent Mr. Qi the gambling money, they say.

"No funds actually cross the border, so this method is difficult to detect and impossible to measure," says Stephen Green, head of China research at Standard Chartered Bank, who has studied Chinese money flows but has no direct knowledge of the case.

Mr. Qi couldn't be reached for comment. It is unclear whether he has been charged with any wrongdoing.

A recent decision by Hong Kong's highest court highlighted the territory's role as a facilitator for mainland money to escape. Yan Suiling, a wealthy Amway saleswoman, insurance agent and restaurateur in the southern Chinese city of Guangzhou, moved $2 million via a money-transfer agent from the mainland to Hong Kong between 2007 and 2009, according to case records and lawyers involved with the case. She used the money to invest in Hong Kong's stock market.

Ms. Yan got into trouble when a check deposited in her Hong Kong account in one of the transactions included proceeds that Hong Kong authorities traced to a $1 million mortgage fraud by someone else. Despite having no involvement in the mortgage fraud, she was convicted in a Hong Kong court of money laundering and served 18 months in prison.

On appeal, her lawyers argued that she thought the money was part of a money transfer and couldn't be expected to know it had come from the mortgage fraud. While such transfers are against the rules on the mainland, they are permitted in free-market-oriented Hong Kong. Her lawyers declined to comment, and Ms. Yan didn't respond to a request for comment.

Hong Kong's Court of Final Appeal agreed and cleared her record. The court said it was "not surprising" that she would "find it necessary" to use a money-transfer agent since she had to evade the mainland's currency regulations in order to invest in Hong Kong's stock market.

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