Capital Flight: China's Experience

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Summary

The current study examines China's capital flight – an illicit financial channel through which China interacts with the world economy. Capital flight could be seen as a consequence of distortions induced by the political structure and the fiscal, monetary, and exchange rate policies. Indeed, China's capital flight is quite substantial.

We study the empirical determinants of China's capital flight. The World Bank residual method is used to measure the magnitude of capital flight. In addition to the covered interest differential, our empirical exercise includes a rather exhaustive list of macroeconomic variables and a few institutional factors.

One result we do not expect is the limited impact of standard macroeconomic factors. Among a rather exhaustive list of macroeconomic variables, we only identify a few that are significant in China's capital flight regressions. Specifically, quarterly capital flight data are significantly affected by a trade openness variable while monthly capital flight is significantly affected by an international reserve variable. The relevance of the selected institutional factors depends on both data frequency and regression specification. In general, the selected institutional factors do not offer a substantial marginal explanatory power even when they are significant; indeed, they are insignificant in most of the monthly specifications.

Overall, our regression exercise shows that China's capital flight – both at the quarterly or monthly frequency – is quite well explained by its own history and covered interest differentials. The other possible determinants offer relatively small incremental explanatory power. Our estimation results highlight the role of data frequency – different data frequencies could have some significant implications for the empirical capital flight behavior. For the current exercise, we consider the monthly results more intuitive than the quarterly ones.