HD **Capital flight is China's house of cards**

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Another weekend and another couple of days filled with anecdotes about Chinese buyers snapping up residential homes in Sydney, Melbourne and Brisbane. What are Chinese private citizens up to? Why are they so eager to buy non-liquid foreign assets - such as residential real estate - in countries like Australia?

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Much of this is driven by push factors arising out of China, rather than pull factors emanating from Australia. To be sure, Australia is seen as a stable, comfortable, environmentally clean and rule-of-law country that is inherently attractive to many Chinese compared to the dynamic but politically and economically uncertain environment that is China. It is why more than half of China's millionaires, according to a recent Huron Report survey of 980 people worth over $US1.6 million ($1.8 million), are looking to leave China for a Western country. The United States is listed as the most preferred destination. (Note to readers: many in the West think it will be a China-dominated century, but that's not how its richest citizens seem to behave.)

Meanwhile, this is all very promising for existing Australian homeowners, although not so good for those wanting to get into the housing market. But the consequences for the domestic Chinese financial system could be serious in the longer term.

First, who owns the wealth in China? The common assumption is that there is a large and cashed-up middle class in the country, and these middle classes are sufficiently wealthy to transfer some of their capital abroad.

Calling the majority of these cashed-up Chinese buyers the 'middle-class' is not really accurate. Using various surveys and methodologies, the general consensus is that the wealthiest 1 per cent of urban households in China (about 2.1 million households or 5.2 million people) have a combined net worth of about $US4.5 trillion. When one traces their liquid assets such as cash, bank savings and stock and bond holdings, the top 1 per cent of urban households own around 30-50 per cent of all such liquid assets in the country.

Incidentally, this group of the richest 1 per cent of urban households is also estimated to own around 30 per cent of all real estate assets in the country. In 2010, all financial and real estate assets were valued at about $US10.5 trillion. This means that the richest 1 per cent of households (2.1 million out of about 530 million households) own 40-50 per cent of the $US10.5 trillion worth of real estate and financial assets in the country.

Second, who's doing all the buying? While the current or trading account is open, the capital account is largely closed, meaning that there are significant restrictions on the flow of capital in and out of China. Exorbitant taxes are also generally imposed on the purchase of assets in foreign currency, if such purchases are officially permitted and done by the book.

In response, Chinese citizens have become quite clever and skilled at 'illegally' transferring large amounts of money out of the country. This is done through schemes such as 'over-invoicing' of legitimate or false trading activity (i.e. effectively using a complicit trading company outside mainland China to exploit looser current account restrictions in order to take money out of the country), or else using financial services firms to set up complicated schemes to bypass capital account controls. For example, a 2012 report by Global Financial Integrity suggested that about $US3.79 trillion left China illegally through 'over-invoicing' of trade settlements alone.

This is important because it is overwhelmingly the uber-rich - covering the top 1 per cent of households - that have the nous, means and connections to exploit these techniques for capital flight. Capital flight involving millions of dollars each transaction is beyond the 'average' millionaire in China. In other words, much of the money entering the Australian and other **residential property** markets is doing so because of intricately constructed schemes for the ultra-rich that have been going on for around a decade.

Third, why are they taking money out? It could be that many want to emigrate. But while the majority of average millionaires want to leave the country in order to hold on to what they have and seek a better and more comfortable life in a Western country, the ultra-rich are more inclined to want to stay in **China** for a number of reasons.

One is that being intimately connected to the **Chinese** Communist Party, as almost all the ultra-rich are, they have no chance of accumulating similar wealth outside **China**'s CCP-dominated political-economy. As one indication of the importance of CCP connections for extreme wealth generation, the net worth of the 70 richest delegates at **China**'s National People's Congress in 2011 was worth an astounding $US90 billion. More broadly, 90 per cent of the 1000 richest people tracked by the Hurun Report are either officials or members of the CCP.

So if they do not want to emigrate, why are they buying such large assets as Australian **residential property** for themselves or their children, many of whom are students in Australian universities?

One is that over-paying for an Australian **residential** home will hardly register on the personal balance sheets of the **Chinese** ultra-rich. Another is that real deposit interest rates remain close to zero or negative in **China**, as the government remains stuck in a pattern of encouraging investment over consumption (despite what the official press is saying). Why not speculate on a home in Sydney's Chatswood or Melbourne's St Kilda when the few million dollars would be losing value in the domestic banking system? Besides, local **Chinese** citizens realise that the fundamentals of the **Chinese residential** housing market are even more precarious than so-called bubble housing markets in countries such as Australia. In Australia, there is at least a housing shortage in major urban **residential** areas. In **China**, there is a huge housing surplus following the construction boom from 2009 onwards.

What might all this mean for the **Chinese** economy? The actual and potential scale of capital flight by the ultra-rich is truly scary for **Chinese** authorities and is one major reason why there will be no broad-based relaxation of capital controls. As calculations by Northwestern University professor Victor Shih indicate, a 20 percent reallocation of net wealth by the top 1 per cent of households would cause a substantial but controllable drain on the domestic financial system. But if the ultra-rich decided to reallocate 30 per cent or more of their net worth outside the country - and surveys indicate that this is a realistic possibility - then this would amount to flight of at least $US1 trillion leaving the country. In such a scenario, the People's Bank of **China** will be faced with a choice of having to flood the domestic financial system with liquidity (and confronting the risks that such policies carry), or else suffer an illiquid financial system.

Meanwhile, current Australian home-owners obviously have an interest in what the ultra-rich in **China** decide to do in the future. But what they do is more about what the ultra-rich think is happening in **China**, and less about the attractiveness of owning **property** in Australia.

IN irreal : Residential Real Estate | i85 : Real Estate Transactions | icre : Real Estate/Construction | ireest : Real Estate

RE china : China | austr : Australia | queensl : Queensland | sydney : Sydney | apacz : Asia Pacific | asiaz : Asia | ausnz : Australia/Oceania | bric : BRIC Countries | chinaz : Greater China | devgcoz : Emerging Market Countries | dvpcoz : Developing Economies | easiaz : Eastern Asia | nswals : New South Wales

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