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Focal Point

China's capital flows back to more stability

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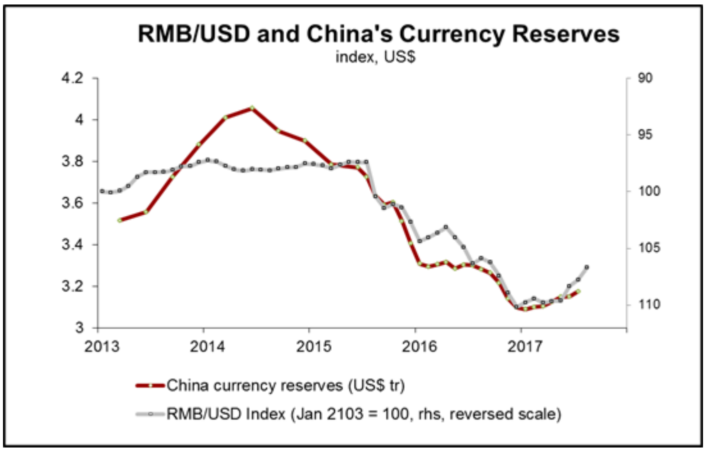
- After China's foreign currency outflows have repeatedly caused major market turmoil in the past, they have stabilized since the turn of the year as indicated by the slight increase in currency reserves of the People's Bank of China.
- We see the main reason for this development to be the successful stabilization of China's growth, which dispelled fears of a further RMB depreciation. In addition, administrative tools and the recent dollar weakness also played a role.
- However, hidden capital outflows masked by trade relations might modify the picture. They are best quantified by the Errors & Omissions component in the Balance of Payments, which is only available on a quarterly basis.
- In order to obtain a higher frequency analysis, we develop a monthly net capital outflow indicator from the current account side. Our calculations suggest already small net capital inflows, supporting the stabilization view.
- Looking ahead, we expect net capital flows to stay more balanced as we foresee China's growth to slow only mildly and the Yuan to depreciate only limitedly versus the US-dollar, thereby not generating a marked rise in speculative outflows.

After China's foreign currency (FX) outflows have repeatedly caused major market turmoil in the past, they have stabilized since the turn of the year. One of the most important indicators in this regard – the currency reserves of the People's Bank of China (PBoC) – showed a slight increase in July for the sixth month in a row, summing up to a total of US$ 85.7 bn since February 2017. Adjusted for estimated valuation effects, the increase amounts still to US$ 60.6 bn. In addition, broader FX flow measures, which also incorporate FX holdings of the banking as well as of the private non-banking sector, point in the same direction. As the state influence on the banking sector in China is rather tight, markets had feared for some time that in order to smooth official data, interventions had been de facto transferred to the banking sector. However, according to an HSBC indicator, outflows of commercial banks also dropped of late, compared to recent quarters.

On top, "hidden" FX outflows have also been a topic on markets. As China has a relatively closed capital account, goods trade flows have been used to circumvent the restrictions. One possible technique could be to simply over-invoice import bills. The most comprehensive measure of trade and capital flows is the Balance of Payments (BoP) statistics. Inconsistencies between the Current Account (CA) and the Capital/Financial account (FA, the difference between the two is small) – which might signal those hidden flows – are recorded as Errors and Omissions (E/O). In fact, China temporarily witnessed substantial increases of the E/O component, which consequently needs to be added to capital outflows to show an upper bound of the "true" outflows. As the BoP statistics is quarterly, we subsequently develop a monthly indicator to provide a more frequent insight into the current development, after first delving into the likely reasons of recent capital flows.

FX outflows stabilized in line with RMB/USD

After a long period of accumulation, currency reserves of the PBoC peaked in mid-2014 at around US$ 4 tr. Subsequently, the Chinese central bank deployed about US$ 1 tr by the end of 2016 in order to defend its managed currency peg. As the graph shows, the movement was very much in line with the RMB/USD exchange rate, which started to depreciate in early 2014 until December 2016, but appreciated against the US dollar since then by more than 5%. Currency outflows were very much motivated by benefitting from a continued dollar appreciation, temporarily generating further appreciation expectations in a vicious



circle. This bet reflected to a large extent the downswing of the Chinese economy, starting with slowing international trade already in spring 2014, accelerating by the several stock market crashes from July in 2015 onwards and the reform of the currency fixing method in August, while monetary policy easing reduced the interest spread to the US. Tensions cumulated even further with markets worrying about China starting a "currency war" to overcome its business cycle problems in early 2016, resulting in widespread fears of a hard landing. Empirically, the relationship between the negative mood towards China and capital outflows can be supported by the correlation between the change of currency reserves and the Caixin manufacturing PMI. While they typically correlate only very little, the time series moved very much in line from mid-2014 onwards. Conversely, the recovery of international trade, rebounding PMIs and recent relatively strong growth of 6.9% yoy in the first two quarters of 2017 amid a strong impulse from fiscal policy have contributed to dispel those fears.

However, while we consider the macroeconomic background the most important factor, China has also used administrative/policy tools to reduce capital outflows. Among them were random checks for fake trades, restrictions to use credit cards for special purposes, less approvals for outbound direct investment by SoEs (with a marked impact on China's outbound foreign direct investment) as well as a suspension of portfolio quotas. At the same time, China also tried to promote inflows (e.g. launch of the Shenzhen-HK stock/ the bond connect and – looking ahead – the MSCI's recent decision to include A shares in its index).

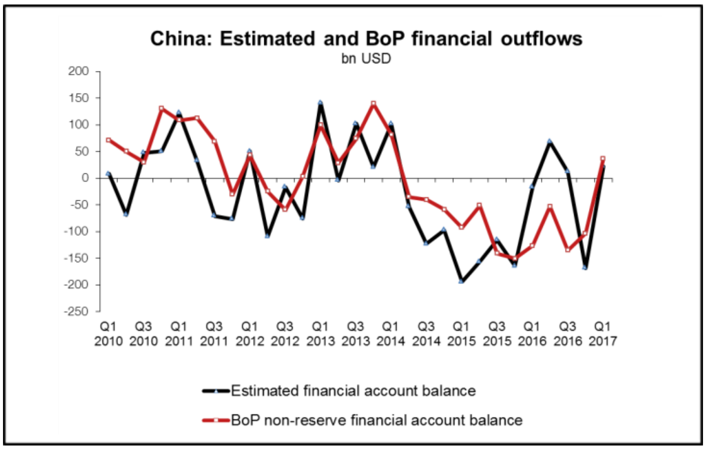
Moreover, the recent more general US-dollar weakness combined with the PBoC's RMB/USD fixing mechanism was also of help. Basically, the PBoC forms its daily central exchange rate parity ("fix") by relying on the previous day closing rate and overnight changes in a currency basket. There is a policy focus on a relatively stable RMB vs a trade-weighted currency basket (while the PBoC also wants to maintain a two-way RMB volatility) which could help markets to build appreciation expectations in the current environment. On top, in May 2017 the PBoC introduced a "counter-cyclical adjustment factor", which gives the central bank again more say on the FX development. Nevertheless, while smoothing the fixing may signal some stability to markets, it cannot correct more fundamental FX supply and demand imbalances in our view.

China's double surplus

This fundamental FX balance had been violated for a long time. In the absence of PBoC currency interventions, China's traditional export strength (resulting in a CA surplus) would have theoretically been matched by a capital account deficit. However, prior to 2014 markets were used for a long time to a twin CA and FA surplus (see graph), absorbed by the PBoC accumulating currency reserves. However, especially over the past two years, the picture changed fundamentally. The previous FA surplus turned into a large deficit and the strong rise in E/O suggest that the trade channel was additionally used to transfer capital abroad. The resulting FX demand could only be matched by the PBoC deploying large amounts of currency reserves on top of a still positive CA. Thus, the long period of a twin surplus ended abruptly. On top, the marked rise in E/O strongly argues for setting up a monthly estimate of capital outflows from the CA side, adding the change in the (valuation adjusted) reserves assets plus E/O.

To do so, we use monthly statistics from the Customs Office, the State Administration of Foreign Exchange (SAFE) and the PBoC for tracking the CA and the change in currency reserves. The SAFE data on cross border receipts and payments (by banks on behalf of clients) also provides us with an E/O estimator to calculate a monthly indicator for China's net capital exports (see graph below).

Our estimate suggests that China had already small net capital inflows recently, which followed a period of substantial capital outflows before. Lately, a low net current account surplus provided some FX supply. However, dollar demand from the PBoC's increase in currency reserves plus E/O overcompensated this supply, so that net capital inflows must have been able to satisfy the demand position. In order to test the monthly estimator, we aggregated the series into quarters and plotted it against the official BoP non-reserve financial account balance, resulting in a reasonable correlation.



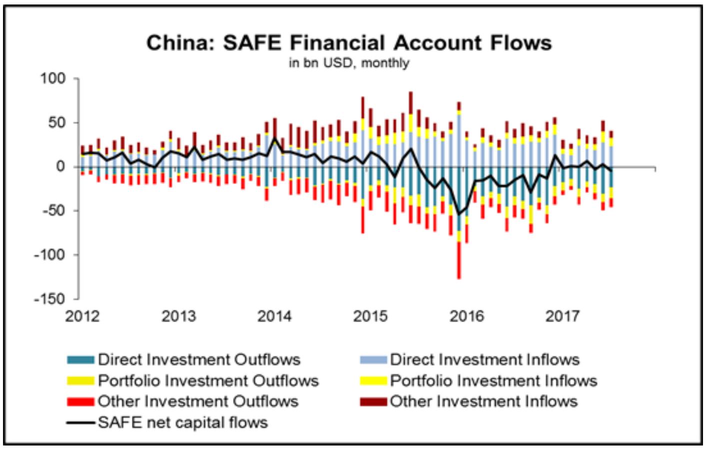
However, most recently China published the first preliminary Q2 BoP, which showed an increasing current account surplus but a zero entry for E/O. A detailed breakdown will only be published in September.

SAFE capital flows support FX stabilization view

SAFE statistics also comprise monthly flows with regard to the capital account, but with less detail than the BoP. The breakdown includes direct investment, securities investment and "other investment", with the latter being mainly the sum of (unpublished) international loans, FX purchases and trade credit. Overall, SAFE flows show the already known pattern of outflows in 2015/16, which diminished recently close to zero (see graph). The stabilization has so far been more the result of a reduction of outflows (not yet a sustained increase in inflows), which reflects less outbound direct investment (due to administrative restrictions) amid a substantial decrease in "other investment" outflows. The latter is typically considered the component most prone to outright speculative currency flows as well as using trade credit to additionally benefit from currency developments. Trade credit, FX purchases and also short-term international loans are likely to have increasingly reflected the recent RMB appreciation against the dollar, with the more positive expectations ultimately rooted in the stabilization of the Chinese economy. In addition, securities investment started to trend slightly up again, after a large drop in summer 2015.

Capital flows to remain more balanced

Looking ahead, we expect China's growth to slow only mildly, especially ahead of the October 2017 leadership reshuffle. Further out, structural issues like the needed shift to a more consumption based economy as well as the high credit to GDP ratio will warrant some softening of growth. Nevertheless, Beijing's fiscal policy is likely to stand ready to smooth possible major disruptions. The PBoC will probably maintain its tighter liquidity management, in order to contribute to the deleveraging of the Chinese economy. Moreover, data show that the PBoC was able to almost completely sterilize the impact on currency outflows on the domestic monetary base. Thus, despite the managed floating system but thanks to the relatively closed capital account, the PBoC has still means to define the monetary base domestically. Finally, we see the RMB/USD to depreciate only very limitedly, going forward, thereby not generating a sudden rise in speculative outflows. Against this rather calm outlook, net capital flows will likely to be more balanced again. The main risk factors are an escalation in the US-China trade dispute and increasing tensions with North Korea. Both could imply abrupt shifts in expectations, safe haven flows and a deterioration of the economic outlook.



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