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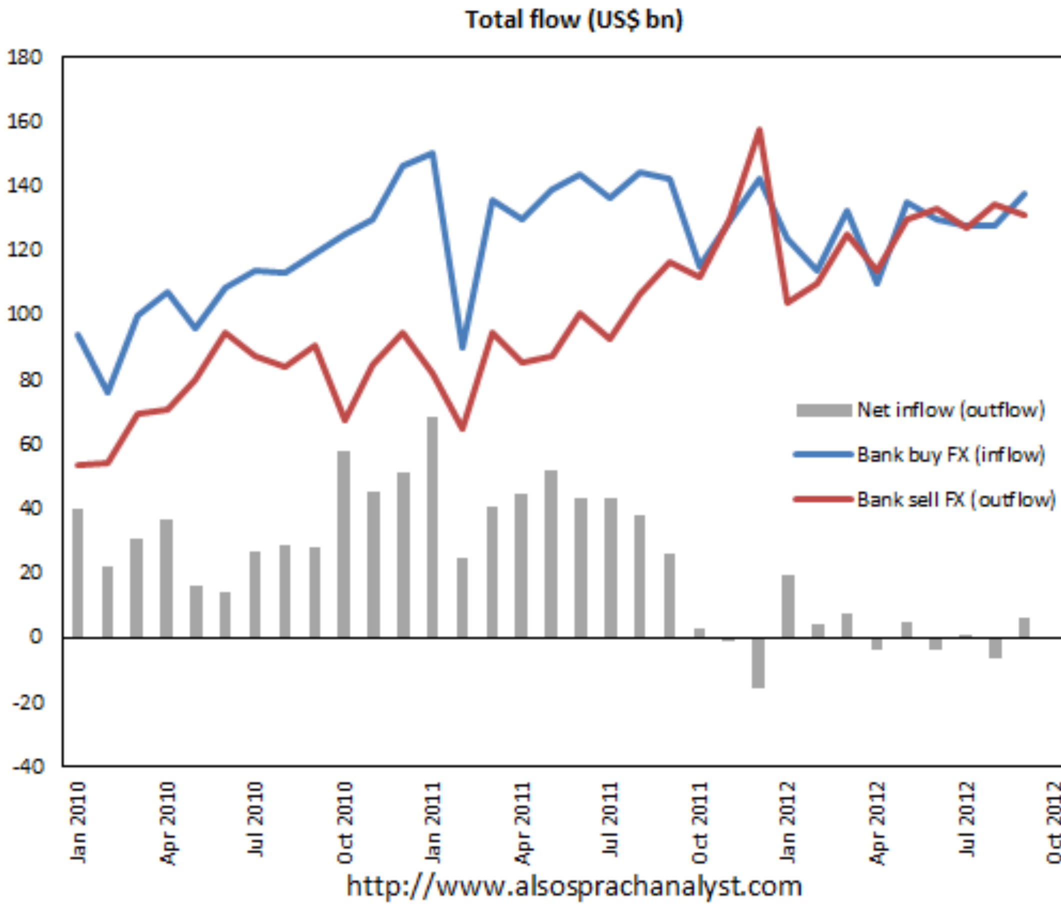
Changing pattern of China’s money flows

30 October, 2012, 14:13. Posted by Zarathustra

Over the past year, we have looked at this issue of changing money flows in and out of Chia from various angles. We looked at that from PBOC statistics of banks' position of forex purchases, changes in foreign reserve, size of PBOC's balance sheet, etc. We have also examined anecdotes on behaviours of exporters as well as theories on why rich people in China are trying to move money out of the country.

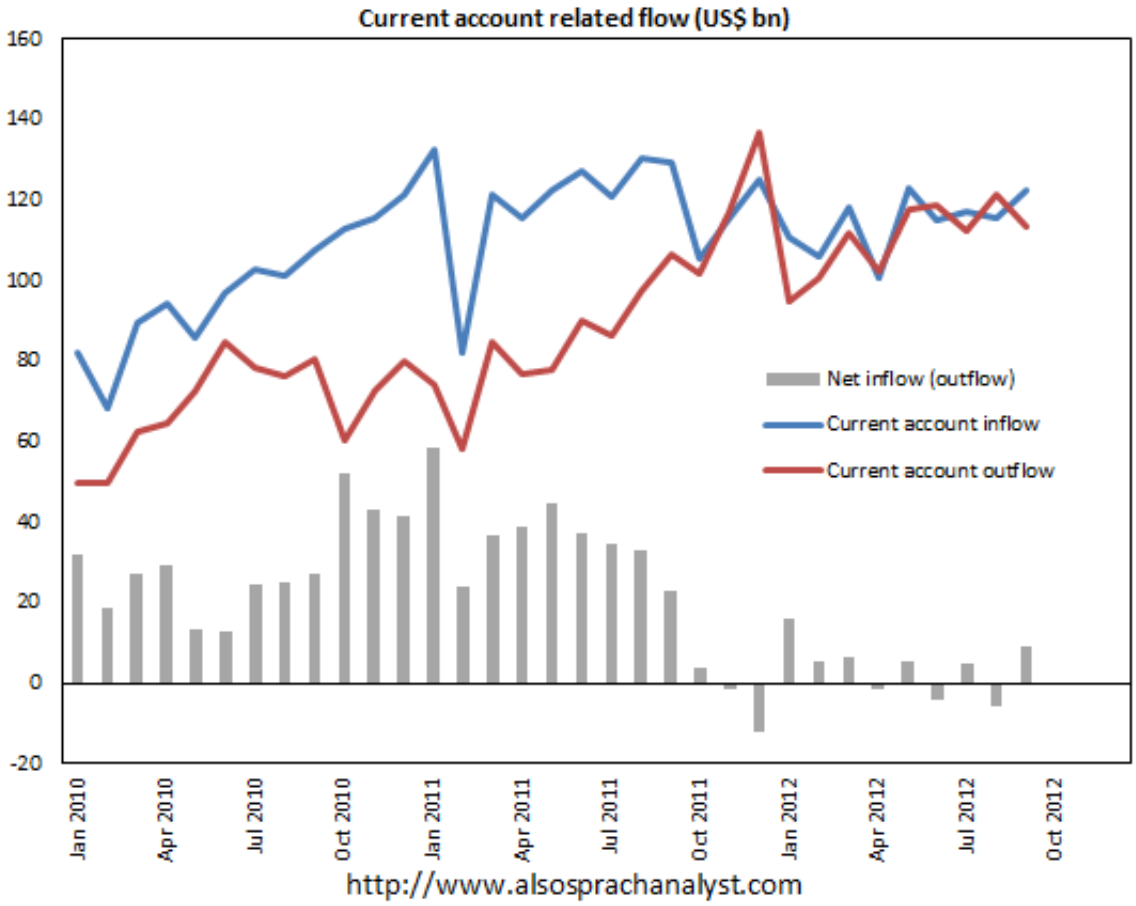
We have another dataset which could shed some more light on this issue. The Sate Administration of Foreign Exchange publishes data regarding Chinese banks buying and selling of foreign currencies. While it once again says nothing about the destination of in- and out-flow, it contains a little bit more detail on the type of transactions.

The blue line here shows banks buying foreign currencies from customers (a gauge of gross inflow), while the red line shows banks selling foreign currencies to customers (a gauge of gross outflow). The grey bar shows the differences between banks buying and selling of foreign currencies. The amount banks buy is an indication of money coming into China, while the amount banks sell is an indication of money leaving the country. Of course, as we have stressed other occasions, **these derivations tell us nothing about the sources and destinations of funds flows**. We cannot tell, for instance, whether the money has really left the country physically.



Source: SAFE

The statistics provide quite a bit more details compared with simply inferring from changes in forex positions as shown in PBOC statistics. For instance, current account and capital account related forex transactions have separate entries (here we use the terms "inflow" and "outflow" in a very loose sense of the words).


Current account related flow (US$ bn)
160
140
120
100
80
60
40
20
0
-20
Net inflow (outflow)
Current account inflow
Current account outflow
Jan 2010
Apr 2010
Jul 2010
Oct 2010
Jan 2011
Apr 2011
Jul 2011
Oct 2011
Jan 2012
Apr 2012
Jul 2012
Oct 2012
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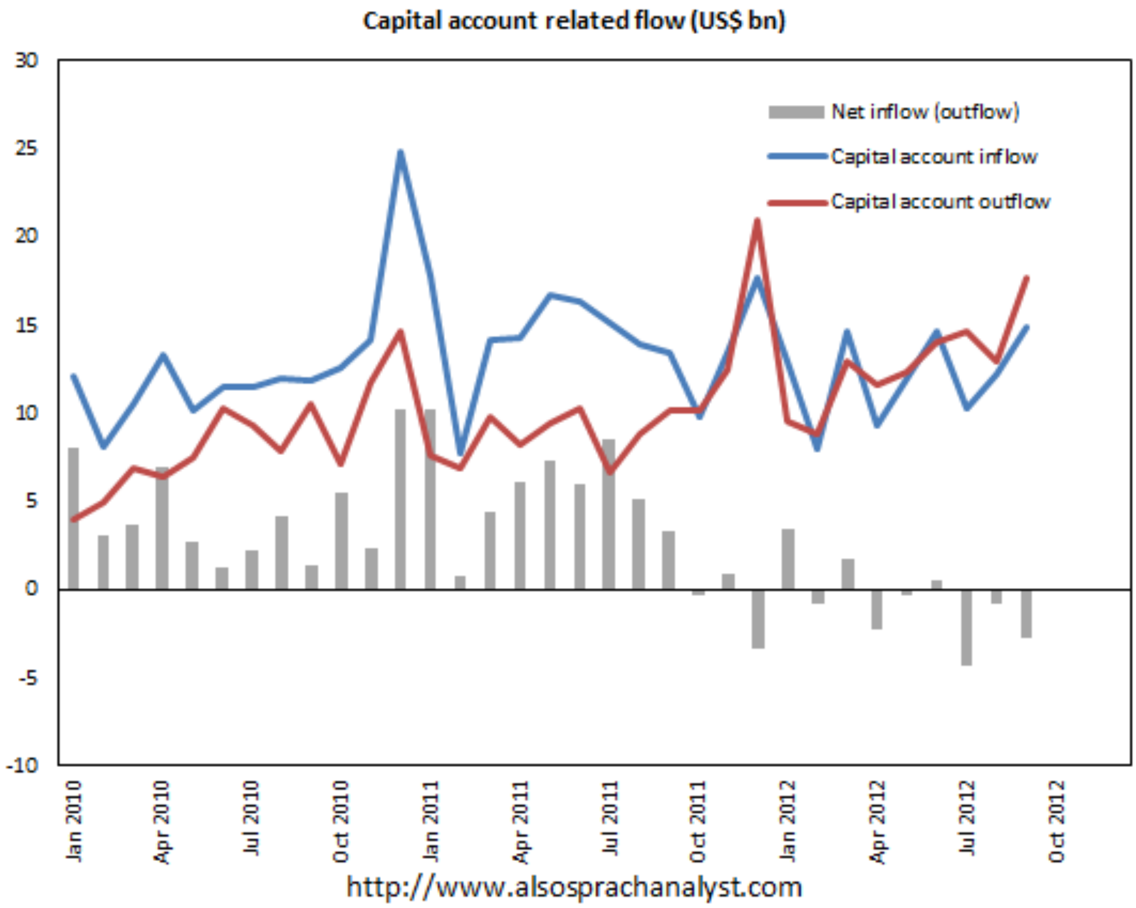
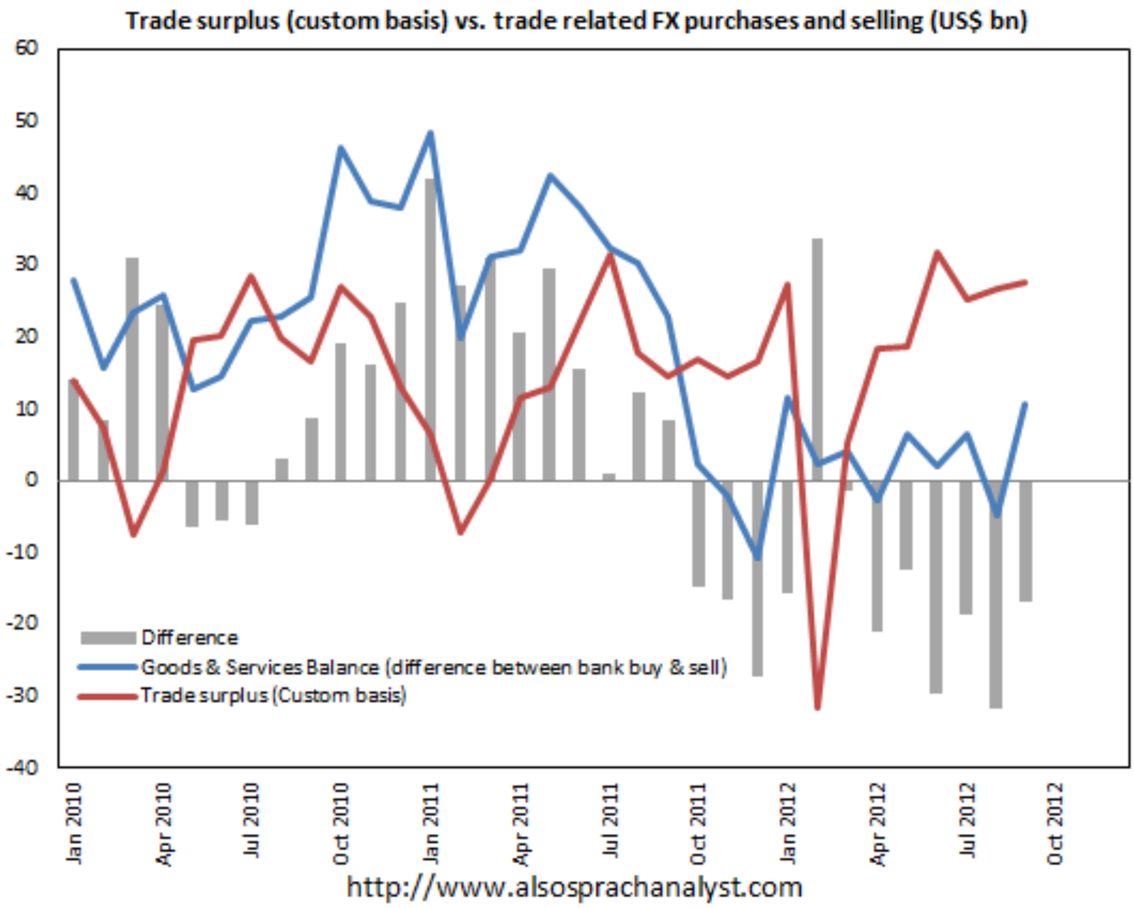

Capital account related flow (US$ bn)
30
25
20
15
10
5
0
-5
-10
Net inflow (outflow)
Capital account inflow
Capital account outflow
Jan 2010
Apr 2010
Jul 2010
Oct 2010
Jan 2011
Apr 2011
Jul 2011
Oct 2011
Jan 2012
Apr 2012
Jul 2012
Oct 2012
http://www.alsosprachanalyst.com

Source: SAFE

There are a few observations here. First of all, the first chart for the total spot transactions shows that while the amount of foreign currencies being bought by banks have been, for most of the time in the previous 2 years, far larger than the amount being sold, the gap has been more or less completely closed since October 2011. Since then, the net buying/selling of foreign currencies has been hovering around zero. More or less the same pattern can be observed in both current account and capital account related foreign currencies purchases and selling.

Also, even though the [position of forex purchases as per PBOC is showing improvement for September](), the statistics for banks' FX transaction here shows that there is not any improvement in capital account related FX buying and selling.

Another interesting observation is that exporters have seemingly changed their behaviour in buying and selling foreign currencies, which is consistent with what we have previously heard and read. In the chart below, we show the trade surplus on the custom basis, and compared that with the goods and services balance of banks' foreign currencies transactions. It should be noted that while trade surplus is larger this year than last year, the numbers as derived from the banks' foreign currencies transactions have turned negative on the very same month: October 2011. It appears that trading companies might have sold more foreign currencies than they actually received in the past, but now might have been selling much less foreign currencies than they received.



Source: SAFE, China Custom

The picture we infer from various data sources are surprisingly consistent in this regard, which is not often in Chinese data (which are often time inconsistent). On a net basis, money has stopped entering the country since October 2011 (current account and capital account included). We will not be certain at this point, but we suspect that October 2011 marked **an important structural break in terms of Chinese**

funds flow pattern, from massive current account surplus and consistent capital account inflow to nothing or (occasionally) downright deficit.

On the current account side, we can see that now exporters might be converting less of their receipts in foreign currencies into Chinese Yuan than they used to. Some are probably hoarding US dollar instead. On the capital account side, net inflow has simply stopped, and overall we see more of a net outflow (although we cannot draw any conclusion as for the destination of such outflow). On the balance, we are left with a more or less unchanged position for forex position on banks' balance sheets, a more or less unchanged size of official reserve, and these facts corroborate with these data from SAFE, foreign currencies transactions into and out from Chinese Yuan have been hovering around zero for a year. And if one still has doubts on Chinese data, US Treasury's data confirm that the accumulation of US Treasury by China has stopped, confirming Chinese data as far as the general trend is concerned.

What outflow actually does to liquidity

Recently there have been various estimates about just how much money has got out of the country, ranging from US$225 to US$300 billion according to WSJ. Our rough estimation is consistent with the lower end of this range

But having a precise estimate of the outflow is, to us, not the key issue. The most important issue, in our view, which remains to be the least understood even to this date, is the impact of a halt of persistent inflow and the occurrence of outflow.

The first and very common, yet totally nonsensical response to anyone's suggestion of the threat of capital outflow is that China has a huge foreign reserve. This post from Heritage, for instance, emphatically repeats such view, which is **nonsense**:

> The final fact to consider is that even the maximum $300 billion is small potatoes. China's official foreign exchange reserves were $3.3 trillion at the end of September. China's broad money supply is over 90 trillion yuan (over $14 trillion). In terms of Chinese participation in money markets, $300 billion is not that much. What's going on is neither surprising nor obviously important.

Foreign inflows and the subsequent intervention in exchange rate (to keep Chinese Yuan low for the most part of the last 10 years, but probably no longer) is at the heart of the mechanism of foreign reserve assets accumulation, and foreign reserve accumulation is what Chinese central bank used to rely on in monetary base expansion, a mechanism which is not unlike quantitative easing. With excess liquidity being caused by reserve accumulation, it is inflationary. As a result, PBOC had to sterilise the inflow in forms of central bank bills and raising reserve requirement ratio.

Such situation has stopped for a year since October 2011 (a point which we believe might prove to be a structural break), and the desire to keep the currency stable in the past 12 months means that despite pressure from the outflow, PBOC cannot really perhaps monetary base expansion in a way they used to. As a result of the lack of foreign reserve accumulation:

1. The size of PBOC's balance sheet has remained unchanged for the previous 12 months or so;

2. The size of PBOC's balance sheet has been **decreasing** relative to the size of the Chinese economy for the previous 12 months; and

3. Extrapolating the old trend-line of balance sheet expansion, PBOC's balance sheet should be RMB3 trillion or so larger than it actually is right now.

To further complicate the matter for this year, as PBOC fears the return of inflation as well as (or perhaps more importantly) the housing boom, PBOC has been reluctant to reduce reserve requirement ratio, but instead relied on temporary measures to boost liquidity. Although the massive reserve repo injections over the past many months are equivalent to 2 or 3 RRR cuts, the signals of monetary easing from a reduction in RRR is arguably stronger. So the Chinese banking system has been left with recurring liquidity crunch, especially in the past few months.

Another even more nonsensical yet official line is that the fact that now the central bank has stopped accumulating foreign currencies means that it is now Chinese households and companies accumulating foreign currencies, not so much that those money has been physically moved to other countries, and they reasoned that this is a good thing. Again, this is just utter nonsense. The impact on liquidity tightening in Chinese Yuan is no different whether the money has actually been moved physically out of the country, and the negative consequence has been seen, as explained above. To suggest that this is a good thing is at the height of absurdity.

What "firepower" does US$3+ trillion FX reserve actually buy?

It is true that US$300 billion (or whatever numbers which are being suggested) is a small compared with US$3+ trillion of reserve, but many continue to refuse to recognise that there have been damages being done by that, and continue to insist that because of large FX reserve, there is nothing to be worried about outflow.

There are theories proposed on how the richest people in China could have enough money to be moved out of the country, and how this alone can deplete half of China's foreign reserve, if not more. But most dismiss such threat by saying that it is overstated, and that China has large FX reserve.

It is true, of course, that US$3+ trillion of FX reserve give China a lot of firepower. But most continue to misunderstand exactly what this firepower can be used for. It is not uncommon to hear people saying that China can surely stimulate the economy because it has large FX reserve, or bad loans in Chinese banks does not matter because it has large FX reserve, or outflow does not matter because it has large FX reserve.

As explained above, this is simply part of the base money creation process. It does not mean anything about the nation's wealth, the ability to stimulate the economy, or the ability to bail out failed banks. **The size of FX reserve only means that the central bank has this much of money to spare in the event of massive capital outflow before it has to inevitably give up defending the currency value**. It is also very important for one to realise that **the ability to defend currency come at the expense of domestic monetary condition. Namely, if PBOC needs to defend a falling Chinese Yuan, at some point PBOC must be forced to tighten monetary condition**, either by selling off FX reserve assets (thus contracts monetary base) and/or raise interest rates in hope to attract inflows.

We have not been to this extreme yet (and far from it, for sure). However, negative impact from the lack of inflow have been seen, as we have repeatedly explained over the past year, and has detailed above. The fact that PBOC is not expanding its balance sheet along the old trend-line and that the size of balance sheet is shrinking relative to the economy has, in our view, already made monetary condition too tight for the best part of the past 12 months.

Is inflow really coming back?

But there are two things which have probably improved the situation a bit over the last two months.

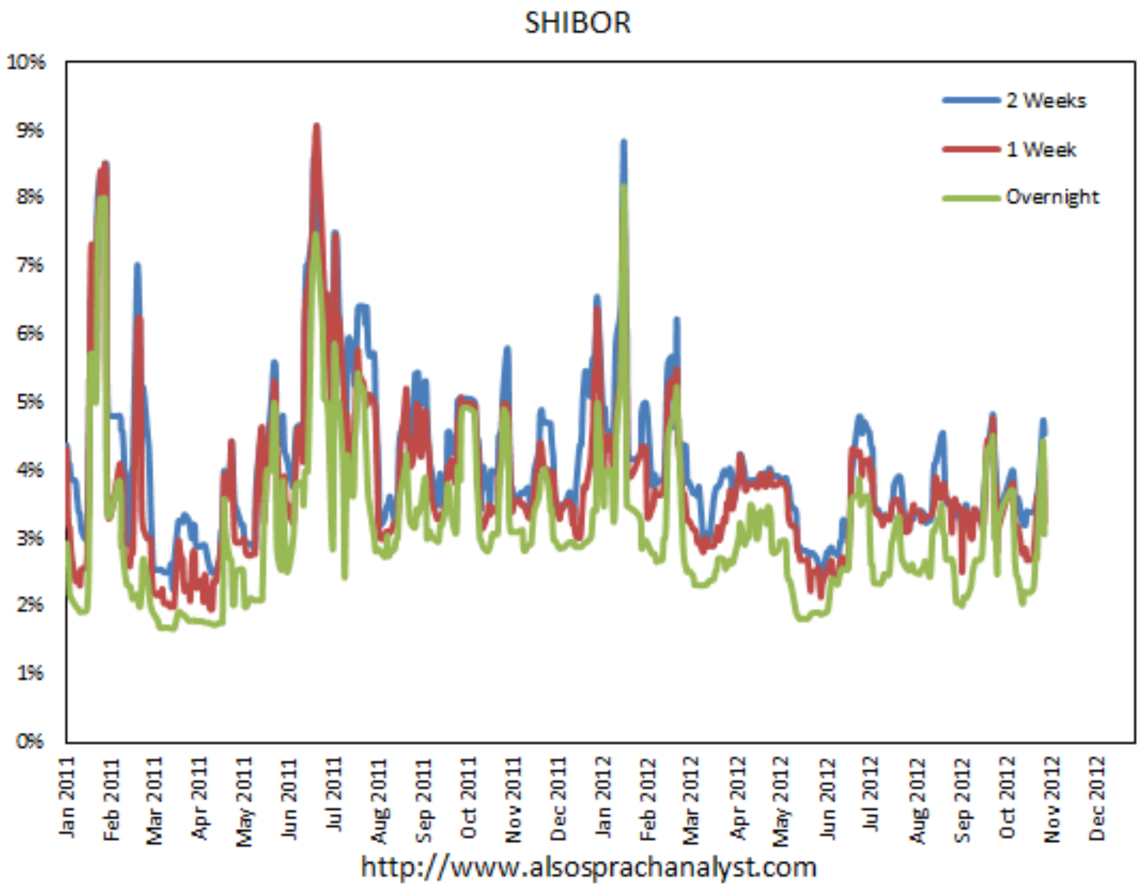
We have repeatedly stressed over the past month and a half, if ECB and Fed monetary easing (OMT and QE-Infinity) are able to reverse funds flow back into China (by improving risk-appetite of foreign investors), then it will alleviate the problem of tight liquidity by eventually forcing PBOC's balance sheet to expand again, and this will last so long as funds flow remain favourable.

We have to point out once again, however, that the support from fund flows can only last as long as they can last, and no one knows exactly how long it can last. If anything, we are already having a sense that funds inflow simply will not last for too long.

The recent strength of Chinese Yuan against the USD is one sign which suggests that flow might become more favourable. The latest available data, however, have yet to confirm the presence of money inflow.

Perhaps more curiously, despite what appears to be the return of funds inflow, it appears that the liquidity situation of the Chinese banking system remains highly unstable. Before the Golden Week holiday, for example, the usual pre-holiday liquidity crunch was unusually severe that required record injection despite tentative sign of improvements in funds flow. And now, with Chinese Yuan getting even stronger, a sign of further improvement in money flows. However, it appears that two weeks of net draining of liquidity from the People's Bank of China has done more damage to the liquidity condition than what the "inflow" has been able to offset.

The chart below shows the Shanghai interbank offered rates in the shorter end of the curve. As you can see, after the post-Golden week plunge, interbank rates are creeping higher again as we approaches the month-end. Short-term rates are returning to the pre-Golden Week holiday peak level even though there looks as if there is inflow. It requires a record injection from the PBOC to make the rates low, yet they remain at relatively elevated levels.



For the moment, no one can be sure exactly why Chinese Yuan strengthens against the USD in the recent weeks. Although we did speculate that it is related to the improvement in risk appetite as well as weakness of the US dollar since the summer, which encourage inflows, the fact that liquidity conditions remain unstable in the Chinese banking system makes us wonder if there is really that much of inflow (if at all), and whether such inflow is actually large enough to make any meaningful difference.

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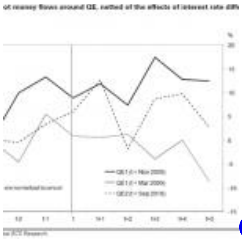
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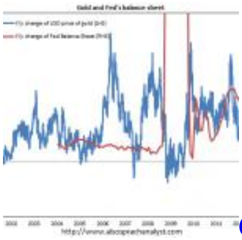
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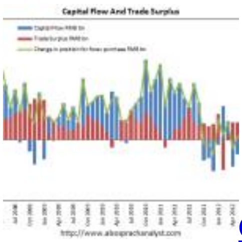
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Zarathustra: Founder and Managing Editor of [Also sprach Analyst]. Once an analyst, now an investor and entrepreneur. Based in Hong Kong, but Londoner at heart.

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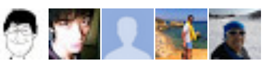

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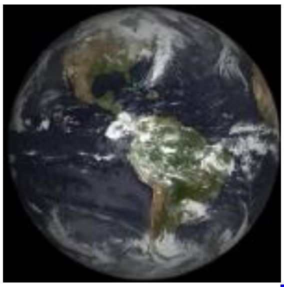[11 key things to watch out for in the global economy]

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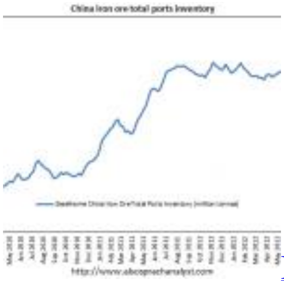[Iron ore and cotton inventories at Chinese ports remain at elevated levels]

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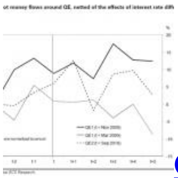
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