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China's FX Spike Is a One-Off but Short-Term Inflows Remain a Risk

We have been trying to unravel the fund-flows in China's balance of payments (BOP) to explain the massive increase, reported earlier this week, in first-quarter foreign-exchange (FX) reserves. We have concluded that the surge is a one-off phenomenon. It throws into relief, however, the enormity of the challenge China faces in managing its external inflows.

Total FX reserves at end-March were US$1.2 trillion, a staggering US$136 billion higher than the previous quarter. The increase was double that recorded in the December quarter and almost three times that seen in third-quarter 2006. The big shock, however, was not the size of the increase so much as its composition: Short-term inflows—after netting-out known contributions from the trade surplus and foreign direct investment (FDI)—have resurged dramatically.

Have Speculative Inflows Resumed?

China publishes its BOP statistics semi-annually (the latest available numbers go up to mid-2006), forcing economists to estimate fund flows from available information such as monthly statistics on customs trade and the reported value of gross FDI inflows. By adjusting the customs trade statistics into BOP-based numbers and estimating *net* FDI flows based on gross inflow data, we find that trade surplus explains about US$57 billion of first-quarter FX reserves accumulation while net FDI inflows account for another US$21 billion. The balance—some US$58 billion—would normally be defined as 'short-term' capital inflows or, loosely, 'hot money' or speculative inflows (**Display 1 and 2**). The flow of speculative funds into China is hardly a new phenomenon. The first-quarter figures, however, contrast starkly in this respect to the second half of 2006, when short-term inflows literally disappeared—in fact, they turned into a massive US$75 billion outflow. The question is: Have speculative inflows resumed as dramatically as the first-quarter data implies? If so, why?

Forex Swaps and IPOs

The People's Bank of China (PBOC), in an attempt forestall speculation about a new surge of hot money, took the unusual step of offering an explanation. Speaking at a conference, deputy governor Wu Xialing said the main reason for the high inflows had been the unwinding of FX swap agreements entered into by the PBOC, which had resulted in hard currency coming back on to the central bank's books. Another had been a decision to allow Chinese banks and enterprises which had listed on overseas stock exchanges during the last two years to repatriate some of the offshore proceeds from their initial public offerings (IPOs). The four Chinese state banks alone raised about US$42 billion over the past two years.

Wu's explanation raises more questions, however. Why did the central bank bring so much foreign exchange onshore in such a short time, given that the whole point of the swaps had been to take foreign exchange out of the country? And why was IPO money suddenly allowed home when excess liquidity in China's interbank market is a persistent problem?

Two Plausible Explanations

We think the dynamics behind the swap transactions point to a possible explanation. The mechanics were as follows. With domestic state commercial banks as counterparties, the PBOC last year entered into a series of undisclosed FX swap agreements with contract periods believed to range from one to three years and a total value of between US$50 billion and US$60 billion. The central bank sold US dollars to large local banks in exchange for Chinese renminbi, with an agreement to buy back

the US dollars in the future at a higher RMB/US$ price. The deals took foreign exchange out of the PBOC's books. Through the 2% to 3% annualized RMB/US$ appreciation rate set into the contracts, the deals also provided a benchmark in the onshore renminbi non-deliverable forward market. Interestingly, the spot rate at the time the forward contract expired almost matched the forward rate set a year ago.

When the swap positions were unwound, US dollars flowed back from the commercial banks to the PBOC, and the central bank's reserves suddenly ballooned. The other side of the trades, of course, resulted in more renminbi liquidity in local banks' balance sheets. The deals may partly explain the short-term outflows in the second-half of 2006 as well as the resumption of inflows in the first-quarter of 2007.

This still does not explain why, at a time of abundant domestic liquidity, the PBOC chose not to roll over the contracts and thereby continue to park the US dollars offshore. We can think of two plausible explanations, both for the unwinding of the swaps and the repatriation of some of the IPO proceeds (the latter represents 'fresh' capital inflows, which also exacerbates the liquidity overhang problem).

First, as suggested by Wu, Chinese banks and enterprises increasingly want to take advantage of the renminbi's appreciation. The narrowing yield gap between renminbi and US-dollar assets illustrates why. The yield on China's 10-year government bond has risen from a low of 2.9% last October to 3.5% and is set to reach 4% soon if monetary tightening continues. Yields on US Treasury bonds, by contrast, have dropped off from the peak in mid-2006 (the 10-year yield has come down from 5.2% in June 2006 to the current 4.6%). Given this narrowing yield differential and a rising expectation that the pace of renminbi appreciation will accelerate, converting US dollars into renminbi makes sense. If the motivation is as straightforward as Wu suggests, it throws light on how profit-maximization is becoming an increasingly important objective for Chinese state commercial banks. It also suggests that the PBOC's control of local banks may not be as strong-arm as believed. This bodes well for the reform of China's banking system.

Second, the unwinding of the swaps—as noted earlier—resulted in more renminbi liquidity in the onshore banking system. This might be a preparation for the supply of foundation capital to China's new State Foreign Exchange Investment Corporation (SFXIC). The SFXIC, which is expected to be launched with US$250 billion–US$300 billion of assets under management, will issue renminbi bonds to the market in exchange for foreign exchange from the State Administration of Foreign Exchange (see *Asian Weekly Economic Insights, China's New Investment Fund Unlikely to Rattle Markets for Now, March 30, 2007*). If this theory is correct, the extra liquidity will eventually be absorbed with no additional monetary sterilization required of the PBOC.

Hot Money Plays a Part

The liquidity generated by the unwinding of the swaps and the repatriation of IPO funds amounted to around US$100 billion. Short-term inflows in the first quarter were, as noted, US$58 billion. The government, in other words, seems to have allowed more than half of the swaps and IPO proceeds to return onshore in just three months. Why so much in so short a time?

We suspect, in fact, that some of the US$58 billion consisted of hot money, arising possibly from a re-channelling of speculative funds from the trade account to the capital account. One cause of this, allegedly, is that some Chinese exporters inflate their invoices to convert more US dollars into renminbi, or use transfer pricing to sell at artificially high US-dollar prices to related offshore entities. The allegation has some basis in historical fact: Before 2003 the renminbi had been under prolonged devaluation pressure, and over-invoicing of imports during that period resulted in large volumes of US dollars being parked offshore. Since 2003, as the renminbi has appreciated and expectations of further strengthening have grown, over-invoicing of imports has become less serious while over-invoicing of exports has started to

increase. The Standard Chartered Bank has estimated that over-invoicing had boosted China's total export earnings by about 6% (US$46 billion) in 2005. If over-reporting grew over the past year and had inflated total exports by, say, 10% in 2006, it would have accounted for about US$97 billion. Beijing has recently started to crack down on exporters' over-invoicing, which increases the cost to government of the export VAT rebate (refunds are based on certain percentages of total export values). This suggests that, if the reports of export over-invoicing are correct, some of the inflows might have returned home via the capital account.

Short-Term Inflows Are a Long-Term Challenge

The surge in short-term capital inflows in the first quarter should be a one-off phenomenon, and we expect them to drop back to a steadier monthly level of around US$10 billion–US$15 billion. Arguably, these more sustainable figures pose a greater risk than large one-off numbers. Coupled with a monthly trade surplus of around US$10 billion-US$15 billion, and net FDI inflows of US$5 billion–$US6 billion a month, China's FX reserves could easily expand by an annualized US$300 billion–US$400 billion during the next few years. If this happens, the PBOC's sterilization programme will be working overtime unless there are sizeable outflows or the currency shock is big enough to deflate the trade surplus and kill off speculative inflows. High external inflows might be a problem other countries wish to have. For China, managing them is a serious long-term challenge.

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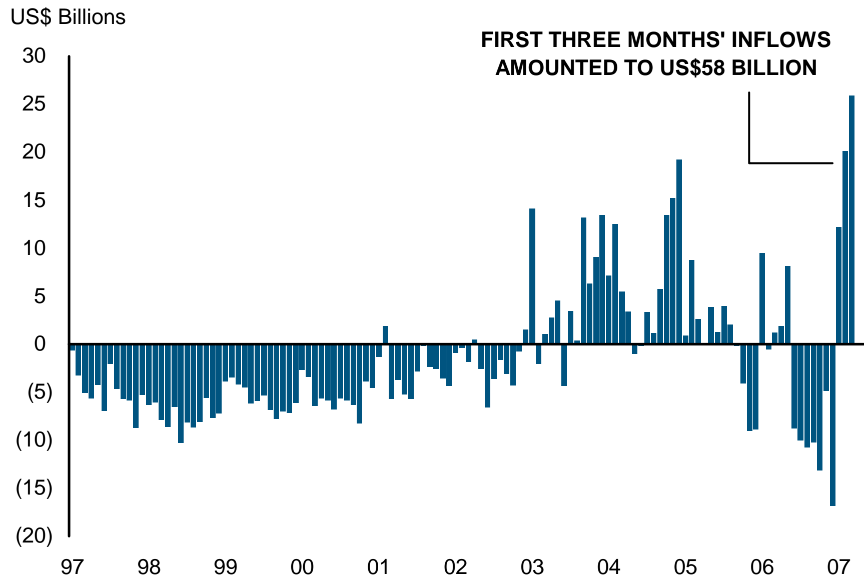
Display 1: Speculative Flows Turned Dramatically in First-Quarter 2007

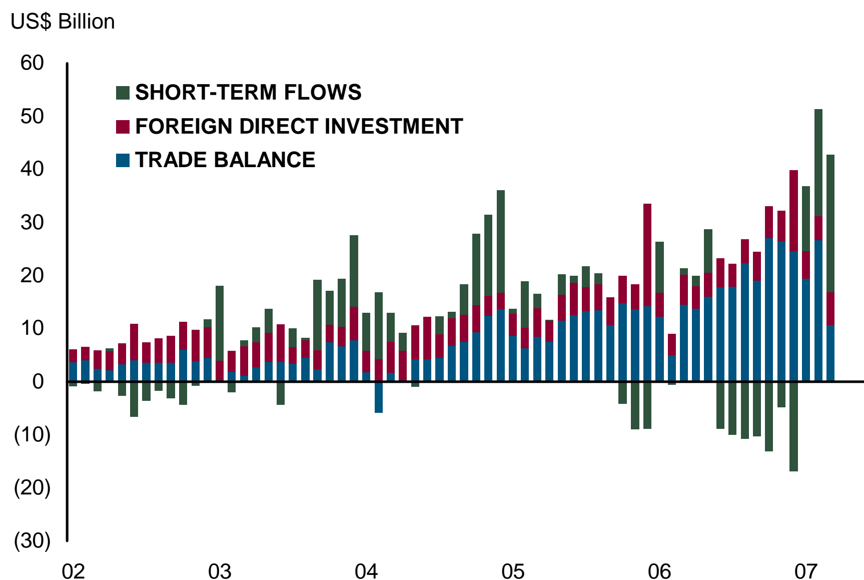
Short-Term Capital Flows



FSource: CEIC Data and AllianceBernstein Fixed Income estimates

Display 2: Short-Term Inflows Accounted For Some 40% of First-Quarter 2007's Forex Surge

Sources of Monthly Foreign Exchange Accumulation



Source: CEIC Data and AllianceBernstein Fixed Income estimates