CHINA Insights

OCBC Bank

Outflow in an orderly fashion

Tuesday, June 07, 2016

Highlights:

- **The decline of FX reserve in May is due to both valuation effect and capital outflows.**
- **The trend of capital outflows has yet to be reversed since the second half of 2015.**
- **On the positive note, the outflow is in a more orderly manner thanks to a more transparent RMB fixing mechanism and power window guidance.**
- **The opening of onshore bond market may provide a buffer to capital outflows.**

As widely expected, China's FX reserve fell by US$27.96 billion in May to US$3.191 trillion from US$3.219 trillion, below US$3.2 trillion for the first time since December 2011, after two months' stabilization in March and April. The valuation effect, which is the main supporting factor to stabilize China's FX reserve in March and April, is likely to be one of the key drivers behind the decline of FX reserve given the strong dollar and generally weaker equity market in May.

Clearly, the decline of FX reserves is also partially attributable to capital outflows in addition to valuation effect. The trend of capital outflow has yet been reversed since the second half of 2015. Capital outflows continued in both formal channel such as overseas direct investment and informal channel such as fake trade and cross border insurance purchase. For example, China's overseas direct investment surged by 71.8% in the first four months of this year to US$60.08 billion. Meanwhile, China's import from Hong Kong surged by a record pace of 203.5% in April despite exports to Mainland China reported by Hong Kong fell by 4.8% in the same month. The prominent mismatch between the two data pointed towards capital outflow from China.

Having said that, we think the outflow is in a more orderly fashion. Judging by the stable daily USDCNY trading volume in the onshore market, it seems market is much calmer in May compared with beginning of the year despite RMB's more than 1.6% depreciation against the dollar in May.

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Chart 1: China's imports from Hong Kong surged

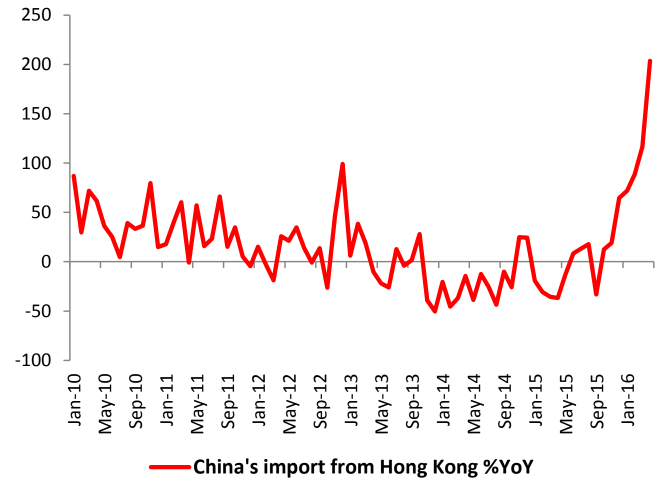
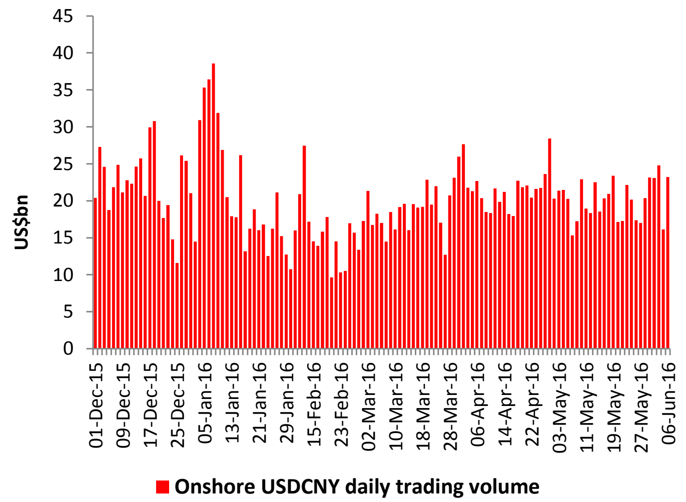


Chart 2: Daily USDCNY trading volume remained stable



Source: Bloomberg, OCBC

We think the orderly capital outflows are attributable to two reasons including a more transparent USDCNY fixing mechanism and powerful window guidance on capital outflows.

Transparency matters

We have been arguing for the past few weeks in our report that China has been closely following the fixing mechanism. The fact that we are able to forecast the daily USDCNY fixing more accurately following the guidance from central bank's report as a non-market maker shows that China is moving towards a more transparent market driven fixing mechanism. This helps contain RMB volatility, which in turn stabilize market sentiment.

Kick the can down the road

The powerful window guidance also helps smooth out capital outflows after corporates are advised to remit large amount of money out of country in instalment rather than in one big lump sum. This bought the time for market to recover from the panic sale of RMB in early 2016 by kicking the can down the road.

The opening of bond market may provide buffer to capital outflows

It is not all bad news. At least, the detailed rules released by PBoC on investment in China's onshore interbank bond market is likely to attract more capital inflows from medium to long term investors, which is unlikely to be disrupted by short term RMB volatility. Given the extreme low participation of foreign investors in China's bond market, which is less than 2%, we do expect more inflows from offshore bond investors. This will help provide buffer to capital outflows.

To conclude, we think the decline of FX reserve in May is due to both valuation effect and capital outflows. The trend of capital outflows has yet been reversed since the second half of 2015. On the positive note, the outflow is in a more orderly manner thanks to more transparent RMB fixing mechanism and power window guidance. We expect this orderly outflow to persist in the coming months.

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