CHINA Insights

OCBC Bank

Concerns about China's capital outflows may be exaggerated

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Highlights:

- **We think market may overestimate China's capital outflow situation for 2015 due to misinterpretation of FX reserve data.**
- **The valuation effect accounted for 33% loss of China's FX reserve in 2015. The actual net Balance of Payment outflow was US$342.3 billion.**
- **The decline of FX reserve is partially the result of rising overseas direct investment, which more than doubled in 2015 to US$167 billion.**
- **The popular methodology of estimating China's capital flow via the sum of absolute change of FX reserve, current account surplus and FDI is flawed due to rising usage of RMB in cross border trade.**
- **January FX reserve data will be the key focus. The valuation effect may not in China's favour due to the volatile market.**
- **China has increased flexibility for RMB index. RMB Index broke below 100 for the first time since the birth of index despite higher RMB fixing against the US dollar.**

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How big was China's capital outflow in 2015? The most quoted figure by media is US$1 trillion. This is derived from the popular methodology via sum of three parameters including the absolute change of FX reserve, current account surplus and foreign direct investment (FDI). For 2015, China recorded US$293.2 billion current account surplus and US$244.2 billion FDI while China's FX reserves fell by US$512.7 billion. As such, market tends to reach the estimation of US$1 trillion outflow via simply adding those three numbers together. **We think this methodology may significantly overstate the situation due to a misunderstanding of China's FX reserve data for three reasons.**

First, the change of FX reserves is usually due to two reasons including the underlying balance of payment flows and valuation effects. Given the massive size of China's FX reserve, the valuation effect has become more apparent in absolute term amid rising volatility in global financial markets. Although China's reserve allocation strategy remains a black box for us, the valuation effect can be estimated based on the difference between the change of FX reserve and the change of reserve assets under the Balance of Payment. In 2015, China's FX reserve fell by US$512.7 billion; however the reserve assets under the Balance of Payment only fell by US$342.3 billion. This suggests that the loss of FX reserve arising from negative mark to market effect was around US$170 billion, which was confirmed by the SAFE press statement on 4 Feb.

Chart 1: Valuation effect on China's FX reserve

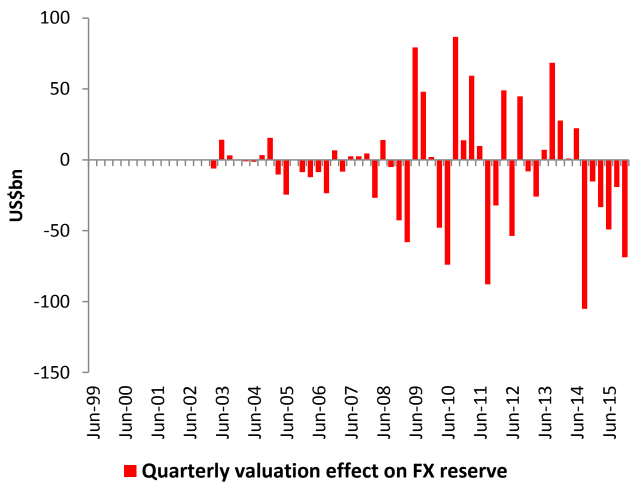
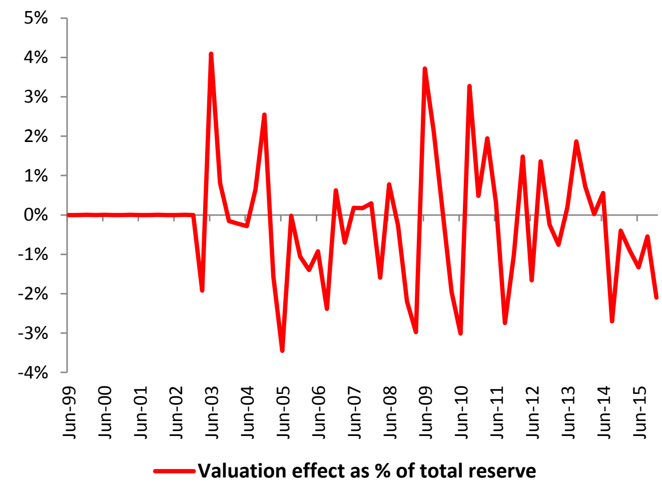


Chart 2: Valuation effect as % of total reserve is stable despite increasing absolute valuation effect



Source: SAFE, OCBC

Second, after excluding US$170 billion valuation effect, the estimated capital outflow in 2015 was narrowed down to about US$850 billion, which also include China's overseas direct investment (ODI). China's ODI jumped by 108% in 2015 to US$167.1 billion driven by initiative such as one belt one road. As such, the real outflows based on the sum of the change of FX reserve, current account surplus and FDI went down to less than US$700 billion.

Third, the estimation of around US$700 billion after adjusting for valuation effects and overseas direct investment may still overestimate the number as the methodology is based on one assumption that China's current account surplus will automatically go to reserve. This assumption is flawed given there are increasing usage of RMB in China's international trade as well as rising retained earnings in the offshore market by Chinese traders. In 2015, CNY6.39 trillion of China's trade was denominated in RMB, accounting for about 25.7% of China's total trade. The trade surplus in RMB has no impact on China's FX reserve.

Overall speaking, based on the three factors above, we think market's concerns on China's capital outflow risks may be exaggerated due to a misinterpretation of China's reserve data. In our latest report <RMB policy risks: a look from external debt and reserve adequacy ratio perspective> dated 3 Feb, we argued that the de-leveraging process has started for Chinese corporates and the risk is still manageable given China's relative large FX reserve. We still hold that view, especially after stripping out the valuation effects from the change in FX reserves.

January FX reserve data will be the key focus

China's January FX reserve data, which will be due on 7 Feb, will be the key focus of the market. Given the volatile market conditions in January, valuation effects may not be in China's favour despite rally in US Treasuries. As such, we think there is the risk that China's FX reserves may fall by more than US$100 billion in January.

More flexible RMB index

Last but not least, in our latest report, we mentioned that China may allow a wider trading range for RMB Index. For the past two trading days, China allowed RMB index to break below 100 taking advantage of broad dollar weakness. RMB Index has weakened by 1.4% in the past two days to 99.22 from 100.63 on Wednesday despite stronger RMB fixing against the dollar. To conclude, the fact that China has increased the flexibility for RMB's basket value such as RMB index, may pose downward pressure for RMB should dollar regain its strength in the global market. Nevertheless, as we mentioned above, we think market is overly pessimistic about China's capital outflows and China's fundamentals. As such, we think RMB may be stuck in the current range of 6.50-6.70 for the near future.

Chart 3: China's total trade denominated in RMB

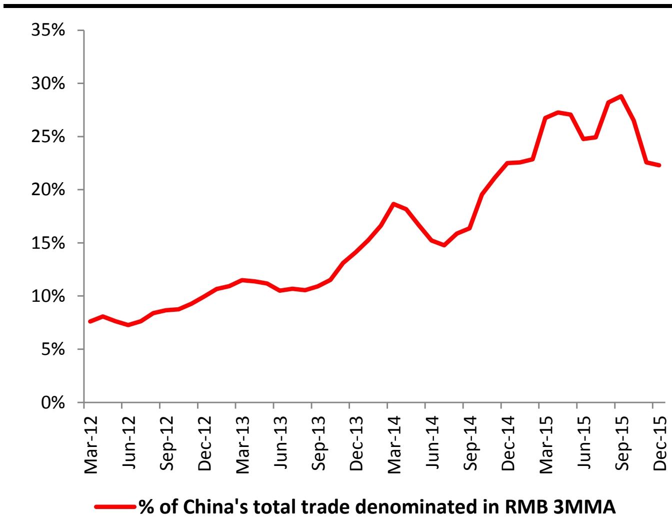
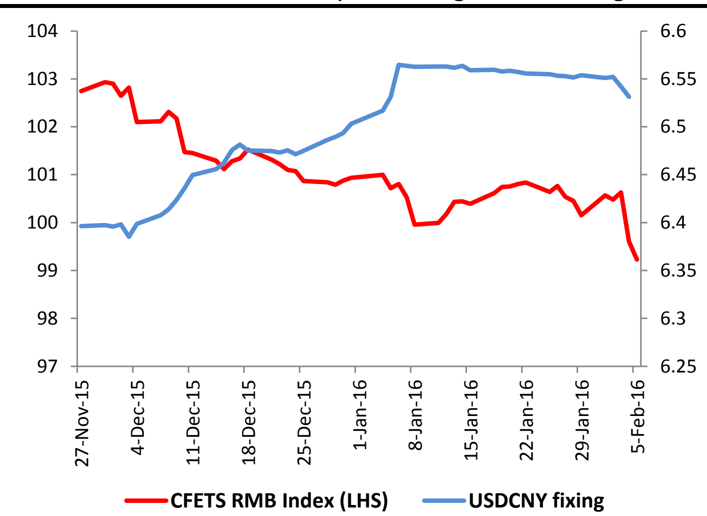


Chart 4: RMB Index fell despite stronger RMB fixing



Source: PBoC, CEIC, Bloomberg, OCBC

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