Macro Musing

UPDATE ON CHINA’S FOREIGN RESERVES AND FX POLICY OPTIONS

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Liquidity infusion by the authorities is lagging the FX intervention.

China’s monthly foreign reserve numbers were watched with bated breath by the markets, and these dropped by $95 billion in August to take the People’s Bank of China’s (PBOC) headline reserve level to $3.557 trillion. This is the largest monthly fall in China’s reserves, and we would like to highlight a few important points:

– The actual FX intervention by the PBOC was even higher than $95 billion. Street estimates of valuation gains (and investment returns) range around $20-30 billion, amid Euro and Yen appreciation in the past month, which implies the scale of the FX intervention/sale was around $115 to $125 billion, or roughly $7 billion per day – quite significant when daily FX turnover been ranging around $30-40 billion.

– Liquidity infusion by the authorities is lagging the FX intervention. In August the authorities infused around RMB 640 billion (or a net amount of around $100 billion), through reverse repos and the PBOC’s medium-term facilities, but, the scale of the FX intervention remained larger. As a result, onshore liquidity remains somewhat tight and the 7-day repo rate flat-lined at around 2.4% but this is off the lows, when the 7-D repo rate had dropped to 2.0%. The 50 basis point RRR (reserve requirement ratio) cut went into effect earlier this month, so this did not contribute to liquidity in August.

– The trade surplus remained robust at $60 billion, and which mainly reflects slackening domestic demand with imports declining by 14% year-over-year, worse than the 8.6% decline expected the Bloomberg market consensus; meanwhile, exports did less worse –shrinking by 6% against a market expectation of a 9% fall.

– Based on FX reserve and trade surplus trends, and assuming a (fairly stable) $30 billion monthly deficit in services and income payments, the imputed scale of capital outflows (including hedging demand) has risen to around $150 billion per month, up from around $80-100 billion per month observed since late 2014.

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– Looking ahead, we reckon the PBOC now faces three choices:

  1) Maintain status-quo and retain a highly interventionist stance (and continue to run down FX reserves at a fairly rapid pace); or

  2) Greater tolerance of the market to set a weaker CNY fixing and spot rate (potentially bad for near-term onshore sentiment); or

  3) Step back from capital account liberalization (potentially bad for special drawing rights (SDR) bid.)

– Over the next 1-2 months, we suspect the authorities will opt for the first (interventionist) option (60% subjective probability) and hope for the real sector data to improve before shifting to a less interventionist stance.

– However, the risk of a sudden weakening of the CNY fixing cannot be ruled out (30% probability). But we suspect they will want the locals to digest the reforms in a bit more piece-meal fashion (after the stock market rout in July-August, and the delays in fiscal spending in the first half of this year.)

– A back-tracking on capital account reforms also cannot be entirely ruled out, though we would still assign this a low (10%) probability. A two-steps forward, one-step back approach was signaled by the imposition of a 20% reserve requirement on the notional amounts of long-USD forward positions put on by the banks on behalf of clients. Essentially this shifts FX hedging to the offshore (CNH) market and lowers the prospect of eliminating the differential between onshore-and-offshore FX rates, which is a key requirement for the "free usability" criteria for SDR inclusion.

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