恒生銀行
HANG SENG BANK

China Economic Monthly

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Balance of Payments and the Currency Risk

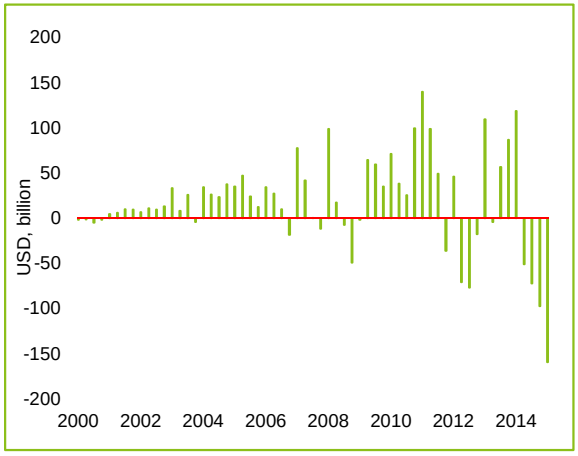
- Over recent quarters, mainland China has seen capital outflows and a worsening balance of payments.
- This may lead to a tightening of monetary conditions in the economy as the renminbi (RMB) is linked to a basket of currencies.
- Monetary easing by the People's Bank of China (PBOC) can help offset this tightening but may put the RMB under pressure.
- With increased borrowing in foreign currencies, Mainland companies are facing the risk that their liabilities may surge if the RMB falls.

Research
June 2015

Capital flowing out

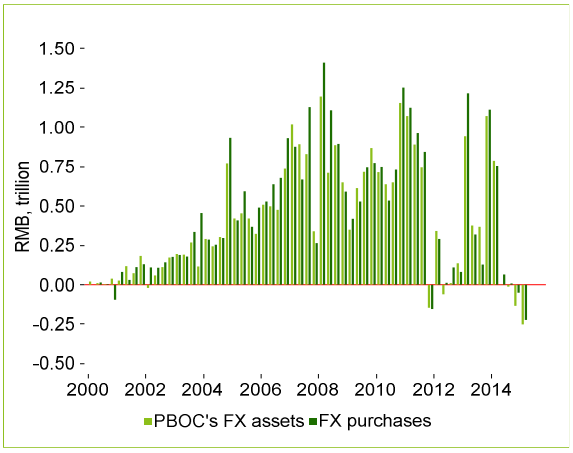
In a reversal of long-term trends, mainland China has been experiencing capital outflows over the past year. On May 13, the State Administration of Foreign Exchange (SAFE) published the latest balance-of-payments data, which showed that capital outflows, defined as deficit on the capital and financial account plus the errors and omissions, reached USD159.2 billion in the first quarter, the biggest quarterly outflow recorded in recent years (Exhibit 1). In fact, money has been flowing out of the country since the second quarter of 2014, due in large part to the economic slowdown and monetary easing by the People's Bank of China (PBOC).

Exhibit 1: Capital Flows



Source: Macrobond, Hang Seng Bank

Exhibit 2: Changes in FX Assets & FX Purchases



Source: Macrobond, Hang Seng Bank

As we stated in our March report, the change in the PBOC's foreign exchange assets (FX assets) or in foreign exchange purchases by Mainland banks (FX purchases) can also be considered a measure of cross-border capital flows as the renminbi (RMB) is linked to a basket of currencies.[1] An analysis of these two FX-related variables also shows that there have been capital outflows in recent quarters (Exhibit 2).

[1] Hang Seng Bank, *China Economic Monthly*, March 2015.

Worsening balance of payments

In the first quarter of this year, there was a USD78.9 billion surplus on the current account of the balance of payments and a USD159.2 billion deficit on the capital and financial account (including the errors and omissions). These figures resulted in a USD80.3 billion balance of payments deficit for the three-month period - the largest such deficit on record (Exhibit 3).

Exhibit 3: Balance of Payments for 2015 Q1

	USD billion	USD billion
Current account balance		78.9
- Trade in goods	117.7	
- Trade in services	-41.1	
- Others	2.3	
Capital & financial account balance (including errors & omissions)		-159.2
- Capital account	0.2	
- Financial account	-159.4	
Overall		-80.3

Source: Macrobond, SAFE, Hang Seng Bank

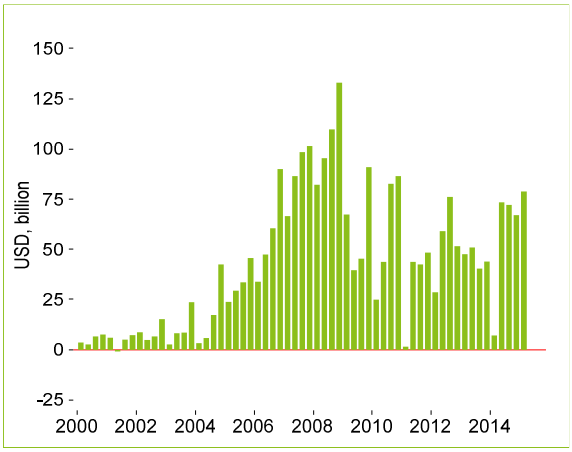
On the face of it, this balance of payments deficit is a worrying sign for the Mainland because, taking into consideration current account and capital and financial account transactions, it reflects net money outflows from its economy. But to many observers, the current account balance is more important than the overall balance of payments in analysing a country's finances, especially with regard to longer term prospects and trends, since movements in the capital and financial account balance, which reflect cross-border capital flows that are subject to current economic and financial market conditions, can be large and volatile.

The current account shows the value of all goods and services a country imports or exports. A surplus in the current account means that the value of the goods and services a country sells abroad exceeds the value of the goods and services it buys. In principle, it can use this surplus money to invest abroad and acquire foreign assets, becoming a net lender in the global capital markets.

In contrast, a current account deficit means that the value of the goods and services a country sells abroad is less than the value of the goods and services it buys. In such a scenario, a country must borrow from abroad (i.e. accumulate debt) to finance its spending on imports of goods and services. It is generally considered impossible or improper to run a persistent current account deficit.

The Mainland has run a current account surplus for at least a decade. It reached a peak of USD133 billion in the fourth quarter of 2008 before falling to its most recently recorded level of USD78.9 billion (Exhibit 4). In terms of gross domestic product (GDP), the current account surplus remained slightly above 2.1% in 2014, down from a high of 9.6% in 2007 (Exhibit 5).

Exhibit 4: Current Account Balance



Source: Macrobond, Hang Seng Bank

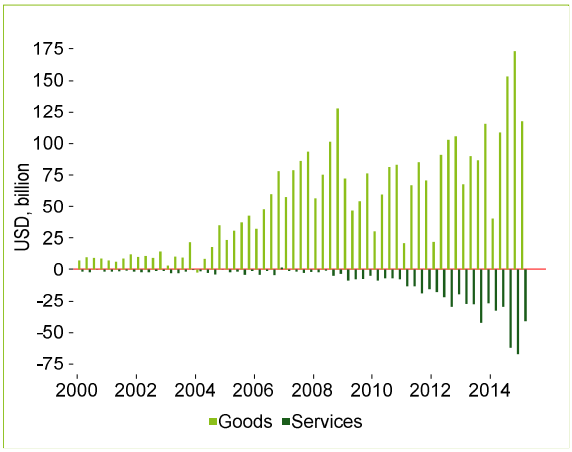
Exhibit 5: Current Account Balance (% of GDP)

Source: Macrobond, Hang Seng Bank

The Mainland's current account has been in surplus mainly because of the contribution from trade of goods (Exhibit 6). The balance of trade in services under the current account has been in deficit for many years. In fact, since 2011, the services deficit has accelerated with the rise in spending overseas by Mainland tourists (Exhibit 7).

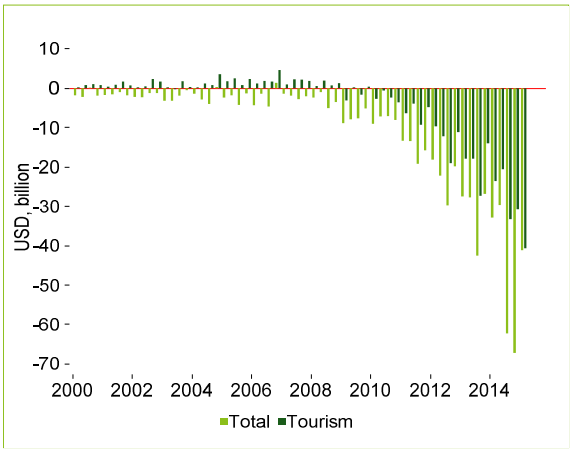
In the near term, the goods surplus is likely to continue to exceed the services deficit. However, if we assume that the goods surplus will be stable in years ahead, the growing services deficit may cause difficulties in the long run because it risks turning the Mainland's current account balance from positive to negative.

Exhibit 6: Current Account Balance (by category)



Source: Macrobond, Hang Seng Bank

Exhibit 7: Balance of Trade in Services



Source: Macrobond, Hang Seng Bank

Tightening monetary conditions

Continued capital outflows have the potential to tighten monetary conditions on the Mainland. As mentioned in our March report, when there are outflows and, in response, the PBOC sells its FX assets to maintain exchange rate stability, both the foreign exchange on the asset side of the PBOC's balance sheet and the deposits held by commercial banks at the PBOC (recorded as reserve money) on the liability side will be reduced (Exhibit 8). If the required reserve ratio (RRR), which specifies how much of a commercial bank's deposits must be set aside as a reserve at the PBOC, remains unchanged, commercial banks may have to cut their lending to the private sector in order to add funds to their reserve at the PBOC to meet the RRR.

One way to mitigate the adverse impact of capital outflows on domestic monetary conditions is for the PBOC to slash the RRR. Indeed, the central bank has taken such action twice since early February, bringing the RRR down from 20% to the current 18.5%, the lowest level since January 2011 (Exhibit 9).

Exhibit 8: Capital Outflows (for illustrative purposes, RMB6 = USD1)

PBOC

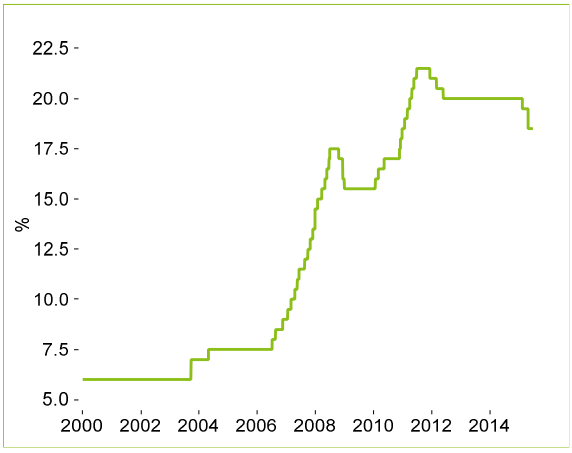
2	Foreign exchange	- RMB 6	Commercial bank's deposits (part of reserve money)	- RMB 6	2
		↓		↓	
3	*(foreign exchange assets denominated in USD)*	- USD 1	*(converted into USD)*	- USD 1	3

Commercial bank

1	Cash	- RMB 6	Customer deposits	- RMB 6	1
		↓		↓	
4	*(converted into USD)*	- USD 1	*(converted into USD)*	- USD 1	4

Source: Hang Seng Bank

Exhibit 9: Required Reserve Ratio (for large banks)



Source: Macrobond, Hang Seng Bank

Another way to offset this tightening is for the PBOC to ease monetary policy by printing money and lending it to banks, an action which will lead to the expansion of the PBOC's balance sheet. As we pointed out in previous reports, the PBOC has actually been taking such action.[2] Moreover, it has been pumping even more money into the financial markets than has been flowing out.

[2] Hang Seng Bank, *China Economic Monthly*, March & May 2015.

Between the second quarter of 2014 and the first quarter of this year, newly printed money, in terms of the increase in reserve money on the liability side of the PBOC's balance sheet, totaled RMB1,585 billion, whereas net money outflows, in terms of the decrease in FX assets on the asset side of the PBOC's balance sheet, were just RMB397 billion (Exhibit 10).[3]

Exhibit 10: PBOC Balance Sheet (2015 Mar vs 2014 Jun)

PBOC

(RMB billion)	2014-06	2015-03	Change	*(RMB billion)*	2014-06	2015-03	Change
Foreign exchange	27,213	26,816	-397	Reserve money	27,990	29,575	1,585
Other foreign assets	804	791	-13	Non-reserve money deposits	152	173	21
Claims on Government	1,531	1,531	0	Bond issuance	713	652	-61
Claims on banks & non-bank Fis	2,337	3,933	1,596	Foreign liabilities	148	141	-7
Claims on non-financial sector	2	4	2	Deposits of Government	3,328	2,983	-345
Others	1,083	1,148	65	Other liabilities	617	677	60
				Capital	22	22	0
Total	32,970	34,223	1,253	Total	32,970	34,223	1,253

Source: PBOC, Hang Seng Bank

To some observers, the PBOC's easing efforts are of little use, because money just flows out of the country when the PBOC pumps money in. However, as detailed above, our analysis suggests that the PBOC's money injection has so far been bigger than the size of the outflows. It should also be noted that the outflows have occurred in part because the Mainland's economic growth has been slowing. It is therefore possible that fund flows will reverse when growth stabilises.

In our view, capital outflows themselves are not the primary reason for the PBOC to cut the RRR and expand its balance sheet. Rather, it is the possibility that the outflows may tighten monetary conditions, which may lead to higher interest rates and lower investment, that has caused the PBOC to take such actions.[4]

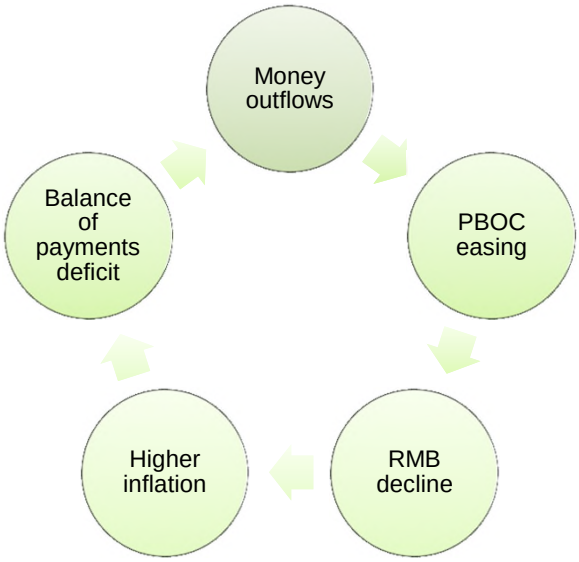
[3] In terms of balance of payments deficit, net money outflows during the period were USD110.5 billion, or RMB685 billion, at an exchange rate of RMB6.20 per US dollar.

[4] Some observers are of the view that policymakers should not be distracted from capital movements. During the Asian financial crisis in the late 1990s, some central banks tightened, rather than loosened, monetary policy in response to capital outflows. Such moves were ultimately believed to have ultimately resulted in weaker economic growth and even more capital outflows.

Growing currency risk

Some observers are also worried that the Mainland economy may be caught in a vicious cycle as the PBOC's monetary easing may lead to RMB depreciation, higher inflation and hence higher export prices of goods and services, a worsening balance of payments and more money outflows (Exhibit 11). Such a concern is legitimate. As we pointed out previously, the PBOC is now printing money without a corresponding increase in its FX assets, that is, without this new money being fully backed up by US dollar reserves.[5] Intuitively, this should imply a fall in the value of the RMB. In addition, from an economic perspective, with greater capital mobility across borders the PBOC's easing measures should also result in a depreciation of the RMB.[6]

Exhibit 11: Fears of Vicious Cycle



Source: Hang Seng Bank

That said, it is fair to say that central bank easing is not necessarily followed by exchange rate depreciation. Many observers expected the US Federal Reserve's launch of quantitative easing measures after the 2007-08 financial crisis to lead to a free fall in the value of the US dollar. This did not happen. Instead, the US dollar just stayed low for a period of time and has in fact recently reached a multi-year high (Exhibit 12).

[5] Hang Seng Bank, *China Economic Monthly*, March & May 2015.
[6] It is impossible to have an independent monetary policy and free capital mobility across borders without allowing greater flexibility in the exchange rate.

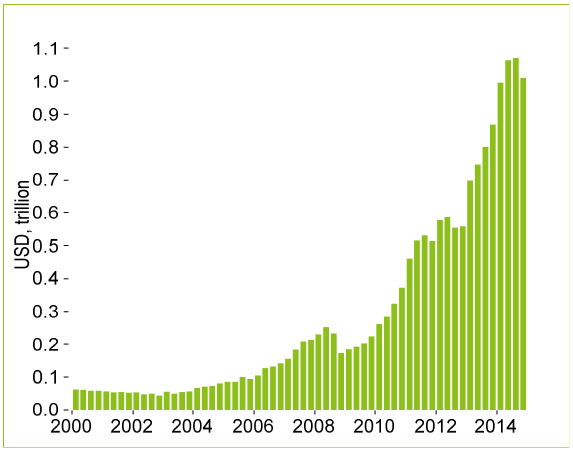
Forecasting exchange rate movements involves more than simply analysing supply and demand. Factors such as expectations regarding economic growth and interest rates, investor sentiment, and movements in other currencies also matter. For example, it is possible that the prospect of an interest rate hike by the Fed, rather than the PBOC's easing, will be what leads to a fall in the RMB against the US dollar.

In this regard, we see a growing currency risk in the Mainland economy. In recent years, Mainland businesses have increased their foreign currency borrowing as major central banks, including the Fed, the European Central Bank and the Bank of England have cut interest rates to exceptionally low levels. According to the Bank for International Settlements, foreign banks' outstanding loans to Mainland households, firms and banks rose from USD372 billion in 2010 to over USD1 trillion in 2014 (Exhibit 13). If the RMB falls either because of the PBOC's easing or because of other factors such as rising hopes for the Fed to raise rates in the US, then the foreign currency liabilities of Mainland businesses may rise sharply against their RMB-denominated assets. This, in turn, raises a question of solvency for these businesses, with potentially negative consequences for the entire economy.

Exhibit 12: Federal Reserve's US Dollar Index

Source: Macrobond, Hang Seng Bank

Exhibit 13: Foreign Banks' Lending to the Mainland



Source: Macrobond, Hang Seng Bank

China Economic Monitor Statistics

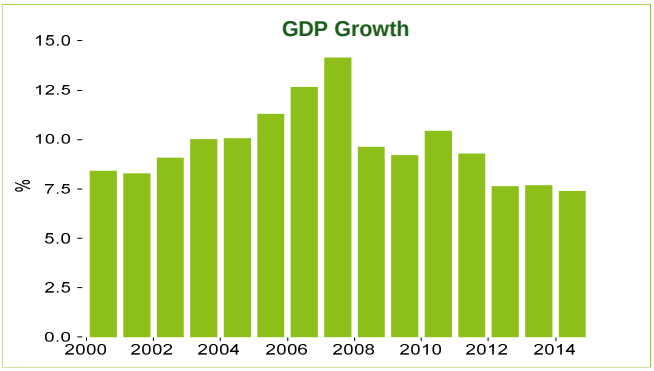
June 2015

	GDP		Industrial output	Fixed asset investment	Retail sales	Foreign trade			Consumer prices		
						Exports	Imports	Trade balance		Food	Non-food
	Nominal RMB bn	Real yoy (%)	Real yoy (%)	Nominal ytd (%)	Nominal yoy (%)	yoy (%)	yoy (%)	USD bn	yoy (%)	yoy (%)	yoy (%)
2010	40,151	10.4	15.7	24.5	18.4	31.3	38.7	183.1	3.3	7.2	1.4
2011	47,310	9.3	13.9	23.8	17.1	20.3	24.9	155.1	5.4	11.8	2.7
2012	51,947	7.7	10.0	20.6	14.3	7.9	4.3	231.1	2.6	4.9	1.6
2013	58,802	7.7	9.7	19.6	13.1	7.9	7.3	259.7	2.6	4.7	1.6
2014	63,646	7.4	8.3	15.7	12.0	6.1	0.4	382.5	2.0	3.1	1.5
2015F	**NA**	**7.0**	**8.0**	**14.0**	**12.0**	**8.0**	**4.0**	**496.0**	**2.0**	**3.0**	**1.5**
Q3 2013	13,875	7.8	10.1	20.2	13.3	4.0	8.4	61.5	2.8	5.3	1.6
Q4	18,208	7.7	10.0	19.6	13.5	7.4	7.2	90.5	2.9	5.5	1.6
Q1 2014	12,821	7.4	8.7	17.6	12.0	-3.4	1.6	16.7	2.3	3.5	1.7
Q2	14,083	7.5	8.9	17.3	12.3	5.0	1.6	86.0	2.2	3.4	1.7
Q3	15,086	7.3	8.0	16.1	11.9	13.0	1.2	128.0	2.0	3.0	1.5
Q4	21,656	7.3	7.6	15.7	11.7	8.5	-1.6	149.5	1.5	2.6	1.0
Q1 2015	14,067	7.0	6.4	13.5	10.6	4.7	-17.6	123.7	1.2	1.9	0.8
Jan 2015	NA	NA	6.8	13.9	10.7	-3.3	-19.9	60.0	0.8	1.1	0.6
Feb	NA	NA	6.8	13.9	10.7	48.3	-20.5	60.6	1.4	2.4	0.9
Mar	NA	NA	5.6	13.5	10.2	-15.0	-12.7	3.1	1.4	2.3	0.9
Apr	NA	NA	5.9	12.0	10.0	-6.4	-16.2	34.1	1.5	2.7	0.9
May	NA	NA	6.1	11.4	10.1	-2.5	-17.6	59.5	1.2	1.6	1.0
YTD	14,067	7.0	6.2	11.4	10.4	0.7	-17.3	217.3	1.3	2.0	0.9

	Deposits (domestic currency)		Loans (domestic currency)			Lending rate	Money supply (M2)	Forex reserves	Foreign direct investment	CNY per USD (period end)	Total social financing
	RMB bn	yoy (%)	RMB bn	yoy (%)	New loans RMB bn	1-year %	yoy (%)	USD bn	ytd (%)		RMB bn
2010	71,823	20.2	47,920	19.9	7,950	5.8	19.7	2,847	17.4	6.5897	14,019
2011	80,940	13.5	54,790	15.8	7,470	6.6	13.6	3,181	9.7	6.2940	12,829
2012	91,740	13.3	62,990	15.0	8,200	6.0	13.8	3,312	-3.7	6.2303	15,760
2013	104,380	13.8	71,900	14.1	8,890	6.0	13.6	3,820	5.3	6.0543	17,290
2014	113,860	9.1	81,680	13.6	9,780	5.6	12.2	3,840	1.7	6.2055	16,460
2015F	**122,969**	**8.0**	**91,680**	**12.2**	**10,000**	**5.2**	**12.0**	**3,800**	**2.0**	**6.30**	**17,000**
Q3 2013	103,090	14.6	70,280	14.3	2,198	6.0	14.2	3,663	6.2	6.1209	3,808
Q4	104,380	13.8	71,900	14.1	1,613	6.0	13.6	3,820	5.3	6.0543	3,322
Q1 2014	109,100	11.4	74,910	13.9	3,010	6.0	12.1	3,948	5.5	6.2171	5,600
Q2	113,610	12.6	77,630	14.0	2,726	6.0	14.7	3,993	2.2	6.2031	4,920
Q3	112,660	9.3	79,580	13.2	1,945	6.0	12.9	3,888	-1.4	6.1394	2,280
Q4	113,860	9.1	81,680	13.6	2,098	5.6	12.2	3,843	1.7	6.2055	3,503
Q1 2015	124,887	14.5	85,907	14.7	3,671	5.4	11.6	3,730	10.6	6.1997	4,602
Jan 2015	122,406	18.3	83,699	14.3	1,471	5.6	10.8	3,813	29.4	6.2506	2,047
Feb	122,325	16.0	84,722	14.7	1,020	5.6	12.5	3,802	16.4	6.2694	1,357
Mar	124,887	14.5	85,907	14.7	1,180	5.4	11.6	3,730	10.6	6.1997	1,239
Apr	125,758	16.0	86,615	14.4	708	5.4	10.1	NA	10.5	6.2032	1,050
May	128,990	17.5	87,520	14.3	901	5.1	10.8	NA	NA	6.1976	1,220
YTD	128,990	17.5	87,520	14.3	5,280	5.1	10.8	3,730	10.5	6.1976	6,913

NA: not available; (A)= actual; (F)= HASE forecast; yoy= year-on-year; ytd= year-to-date

Source: State Statistical Bureau, China Statistical Yearbook, Macrobond, CEIC, Bloomberg, Hang Seng Bank



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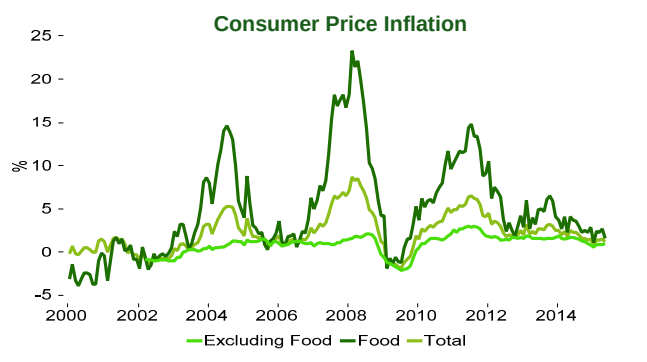

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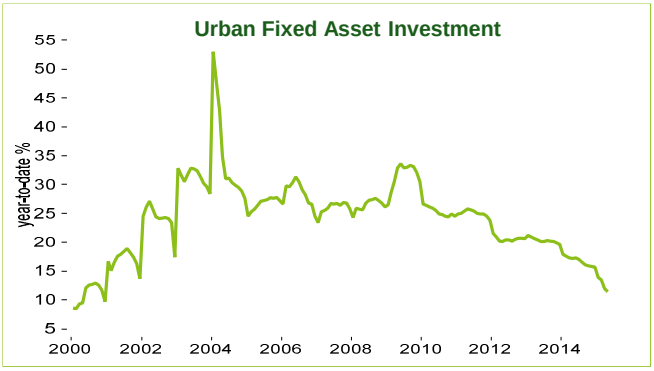

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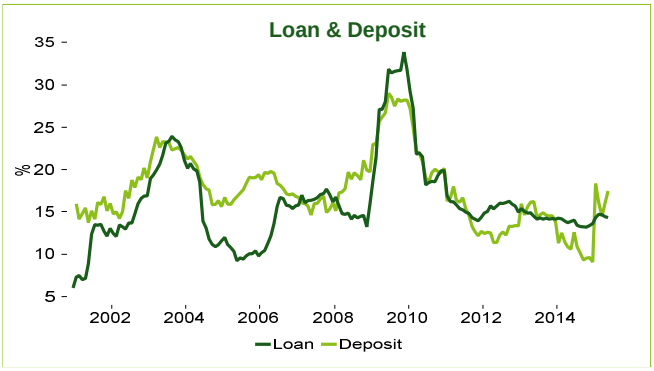

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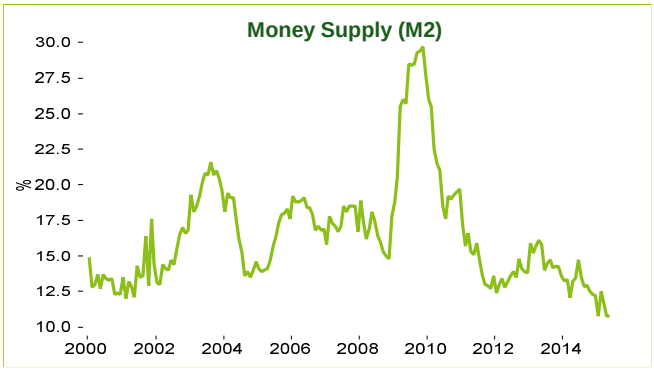

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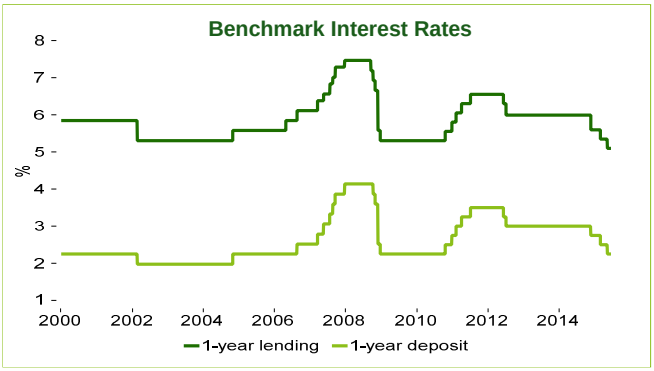

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