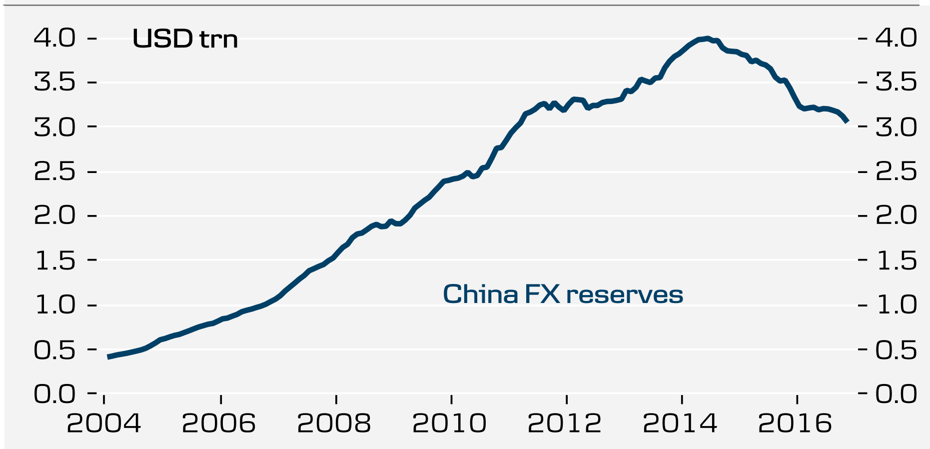
07 December 2016

Flash Comment

China: decline in FX reserves shows rising vulnerability

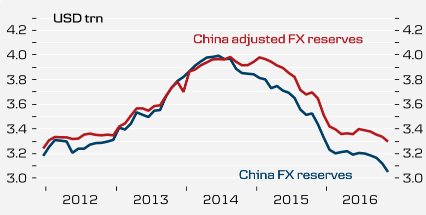
- **Chinese FX reserves for November fell more than expected** to USD3051.6bn – a decline of around USD69.1 bn. Reserves have not been lower since February 2011.
- It was the **biggest drop since January this year,** when outflows were very high. However, a big chunk of the decline was due to valuation effects, as most currencies weakened against the USD in November, lowering the value of non-USD reserves (USD index increased 3.3% in November). We estimate adjusted reserves fell USD40bn, which is still the biggest drop since January, pointing to increased intervention from the PBoC recently into the depreciation of CNY versus the USD.
- **Chinese reserves have fallen a total of 25% from the peak in 2014,** shaving off USD1trn out of the USD4trn reserves it had in 2014. Hence, even though reserves are still high, they can fall quite rapidly. A few years down the road – or possibly before – FX reserves may have eroded enough for China to be unable to defend a rapid depreciation.
- **This is probably the reason why China is now tightening capital controls**. Recently, limits have been put on outbound direct investments and on imports of gold. However, **this in itself can end up proving to be destabilising** if it reinforces outflows from the viewpoint of 'getting money out while you still can'. For example, a Chinese citizen is entitled to exchange USD50,000 from CNY every year. If people fear this could be banned at some point, it might encourage some to do it while it is still possible.
- **Although it has been calm around China since the start of the year, we continue to see a high risk that financial turmoil could return in 2017,** when growth is expected to slow down again. We continue to **recommend short CNH as a hedge against a potential crisis and hedging of CNY receivables**.

Chinese FX reserves down USD1trn from the peak in 2014



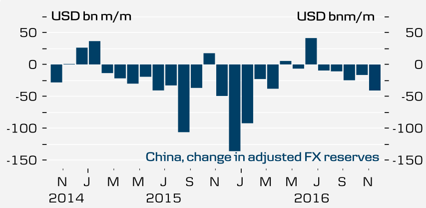
Source: Macrobond Financial

Decline in FX reserves picking up again



Source: Macrobond Financial

Decline in adjusted reserves rising



Source: Macrobond Financial

Recent China research:

FX Strategy: Rise in USD/CNY reflects stronger USD – more to come, 16 November 2016

The Big Picture (pp 13-15: Chinese recovery to lose steam in 2017), 30 November 2016

Flash Comment – China: What does Trump mean for China?, 9 November 2016

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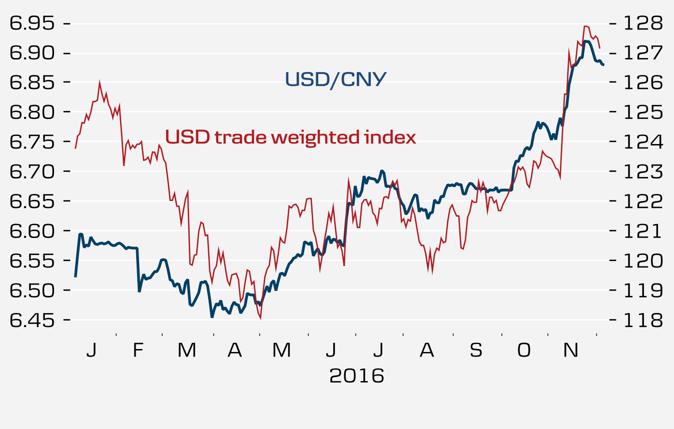
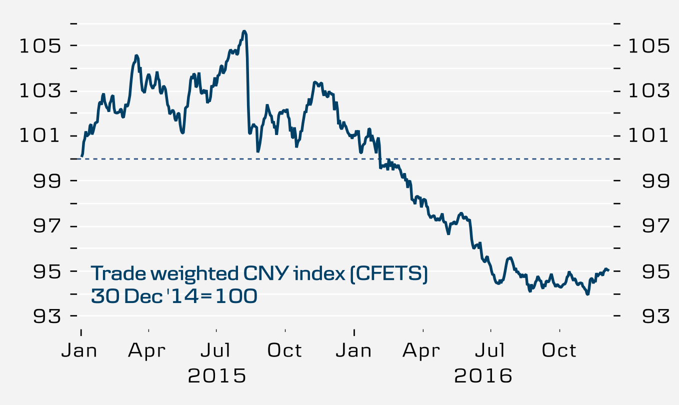
FX charts

USD/CNY moving higher as USD has strengthened



Source: Macrobond Financial

Trade-weighted CNY broadly stable since June



Source: Macrobond Financial, Danske Bank Markets

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