HOW SERIOUS ARE CHINA'S RECENT CAPITAL OUTFLOWS?

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Executive Summary

1. Capital outflows have accelerated since mid-2014. Approximately US$1 trillion (after adjusting for valuation changes and taking into account current account surplus) was estimated to have left China from mid-2014 to end of last year.

2. Using balance of payments data, an analysis of the underlying factors that drove China's recent capital outflows reveals that the repayment of foreign debt and the demand for foreign assets were the main drivers behind such outflows.

3. Driven by changing market expectations of the renminbi (RMB) and the unwinding of the RMB carry trade, corporates repaying their foreign debt is a positive development. In a way, such corporate balance sheet adjustment is a normal and desirable outcome for policymakers aiming to shift the forex exchange (FX) asset holdings to the non-government sector ("藏汇于民").

4. The accumulation of foreign assets by resident firms and households is a serious cause for concern even as Chinese investors diversify overseas. This is because RMB depreciation expectations particularly since the reform of the exchange rate regime on 11 August 2015 have been an important factor driving such outflows and accelerating the decline in FX reserves.

5. The accelerated erosion of China's FX reserves could result in tighter domestic liquidity, hence undermining the effectiveness of the monetary policy. Despite increased outflow pressures, liquidity conditions remain largely stable in the money market.

6. China's FX reserves are sufficient and liquid but the buffer created by the reserves could diminish if RMB depreciation sentiment worsens and the exodus of capital continues.

7. To stabilise capital flows and currency expectations, the People's Bank of China will need to improve communication with the market to anchor expectations and establish credibility of the new exchange rate regime.

8. Macro-prudential measures are important policy measures in the short term to exercise some degree of control on capital outflows. In the medium to long term, an improvement in the economic fundamentals and the effective management of vulnerabilities in the Chinese economy (i.e. overcapacity and debt problems) are crucial.