BNY MELLON
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MACRO MORNING BRIEFING

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The Ongoing Evolution Of China's FX Inflows

Financial account improvement crucial to liquidity and renminbi

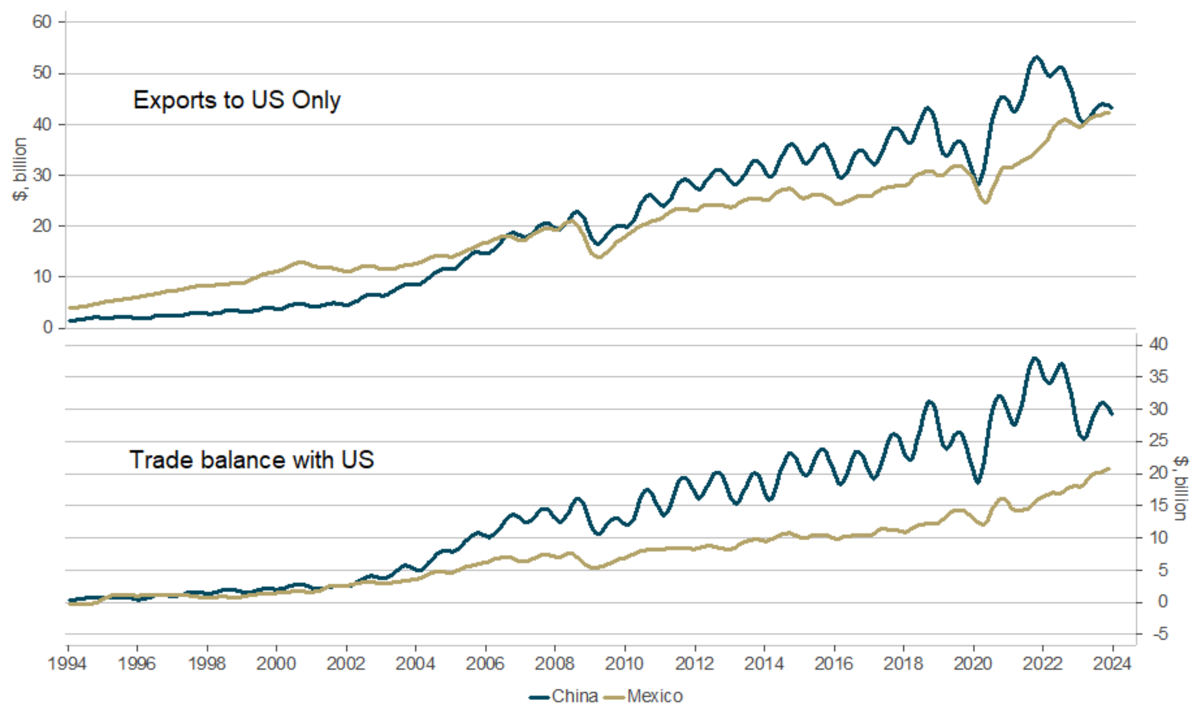
- Shifts in trade patterns could mean more-limited support on current account
- Reversing FDI trends likely a priority
- Lower US yields would materially benefit the financial account

Trade pressures an opportunity for China to re-balance

During his European travels in January, China's Premier Li Qiang was singularly focused on attracting foreign investment into China. This may have surprised his hosts, who were anticipating difficult conversations around the surge China's electric vehicle exports to boost China's balance of payments. Clearly, increasing exports of high value-added manufactured goods is a crucial part of China's "high-quality growth" initiatives. The lack of emphasis on domestic demand implies that trade surpluses will continue and support the renminbi. However, long-term trends in global trade are moving away from the prior globalisation consensus. Given China's current balance-of-payments setup, absorbing FX remains important for financial conditions. Beijing has likely acknowledged that the trade balance will not be able assert dominance in China's balance of payments as in the past.

Trade with the Eurozone and European Union was never a major contributor to China's balance of payments, especially compared to trade with the US. China's trade with Europe is also at risk of facing renewed barriers, or just a general decline in demand for EVs. Even before the likely headline risk to Sino-US trade heading into the US electoral season, fundamental restructuring is now taking balance in the US's trade flows. As Exhibit 1 shows, exports from Mexico to the US (smoothed over 12 months) have all but converged with China's, and it would be no surprise if there is a permanent change in leadership. Measured by the trade balance, China continues to enjoy a healthy and growing surplus. Considering the path of exports, however, the growing balance is wholly attributable to a lack of domestic demand, which should not be considered a favourable development, either. Either way, the uncertainty around China's trade relationships renders it fully logical that Premier Li would be far more assertive on the investment flow, in various shapes and forms.

Exhibit #1: China & Mexico Trade With US



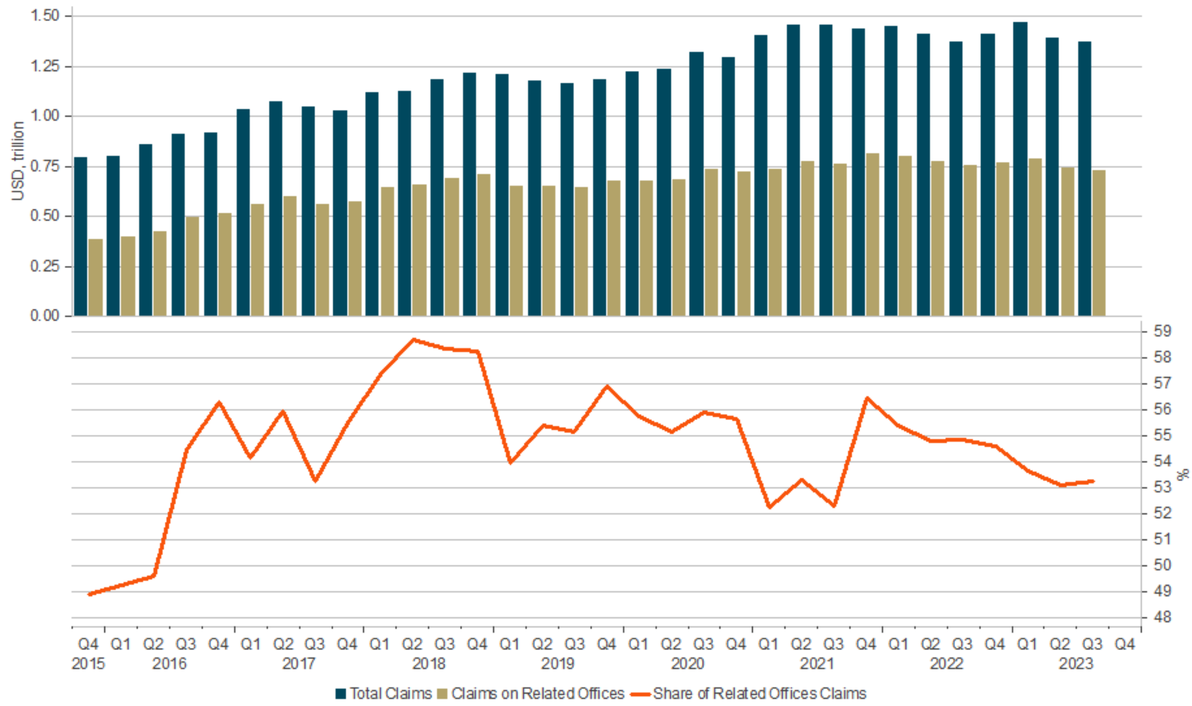
Source: Macrobond, BNY Mellon

We stress that in the near term there is no material balance-of-payments risk to the renminbi. The People's Bank of China itself has stated that Federal Reserve easing will provide some policy space. It is also debatable whether a stronger currency is in China's interests given the level of the yen and the ongoing disinflationary impulse domestically. Recent developments in equity markets may have led to market expectations that higher FX reserve coverage is needed to meet 'contingent liabilities' in the form of ongoing outflows. Meanwhile, some newswires have reported a potential need to source new funding to lead a state-backed purchase programme for domestic equities.

Fears that the funding does not yet exist are overblown. Total reserves are still below the highs in 2021, but China has long since moved away from solely allocating FX inflows to reserves or its sovereign wealth funds. With the world no longer in a low-interest-rate environment and large Chinese banks encouraged to expand operations overseas, there has been participation in conventional market activities such as dollar lending. Exhibit 2 (Bank for International Settlements data) shows total lending to 'related offices', defined as "different offices of the same bank, including head offices, branch offices and subsidiaries". For much of the past decade, over half of the overseas claims of Chinese banks have consistently been directed this way for various purposes, originally anticipated as part of strategic efforts such as renminbi internationalisation, the Belt and Road Initiative and others. The jump in 2021 is likely more related to higher yields on offer through dollar lending, especially as this was during generally closed borders which inhibited other forms of cross-border activity requiring a stronger physical presence.

Either way, these are cross-border claims which could be repatriated to China in times of need. If Beijing sees a better strategy, given current valuations and return prospects, to keep more funds onshore, we would be on the lookout for a decline in cross-border 'related offices' claims, which would signify that large banks are deleveraging overseas – a process which is always favourable for surplus-based currencies such as the renminbi.

Exhibit #2: Chinese Banks' Overseas Claims

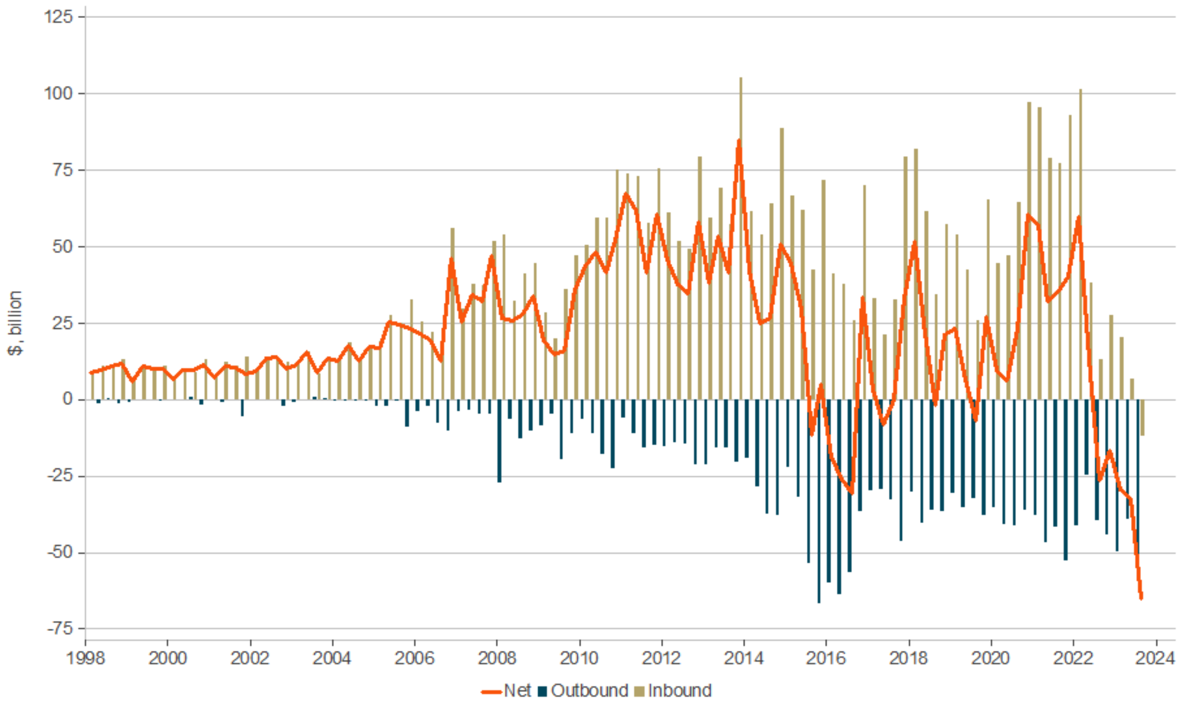


Source: Macrobond, BNY Mellon

Staying with the financial account, one area where China would likely desire to see external liabilities pick up again is in the foreign direct investment item – where the country last year faced outright outflows for the first time on record. Coupled with growing outbound FDI, the pressure on China's financial account is clear (exhibit 3). For the latter, there are mechanisms that could encourage deleveraging or divestment overseas, which is not dissimilar to the cross-border bank-lending form of support for the financial account. Yet, Premier Li's comments suggest that turning around the FDI credit item is a policy priority.

Last year we highlighted that the rise in dollar yields could have generated a drop in reinvested earnings, especially as Chinese yields have fallen materially and are likely to remain well below US equivalents. In his speech at Davos, Premier Li directly addressed this point by reminding the audience that, "In the past five years, the return on foreign direct investment in China stands at around nine percent, which is quite competitive globally." Naturally, a nominal return figure is not enough and various risk adjustments are in play, but in the context of China's financial accounts, it seems sufficiently above a risk-free rate to perhaps allow FDI-relevant counterparties to reassess.

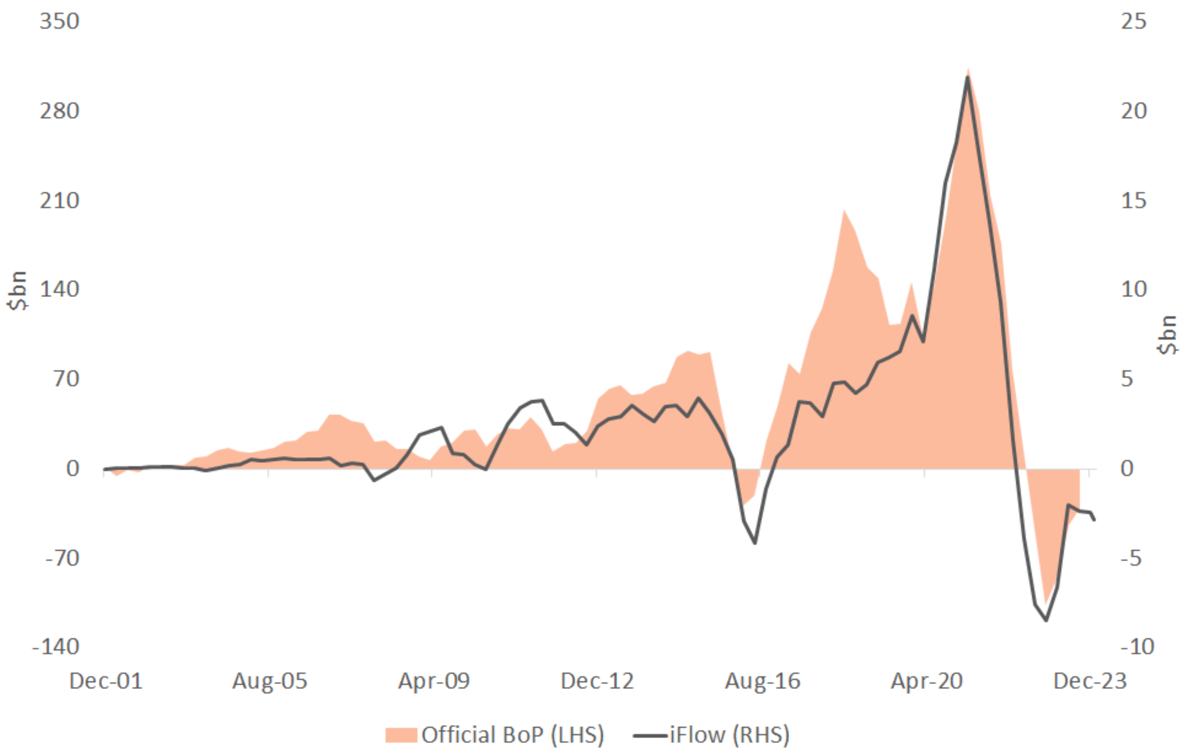
Exhibit #3: China FDI Balance



Source: Macrobond, BNY Mellon

Outside of FDI, a further opening of China's capital markets and attracting external participation is naturally a priority. The recent movements in Chinese equity markets, statements of support and other associated adjustments indicate that it is moving up the policy agenda. Without taking a view on the measures needed to turn things around, both official data and our more up-to-date iFlow proxy figures which track equity and fixed income flows show that external positioning in Chinese assets remains very weak. There has been very little recovery since the gradual liquidation round that commenced in H1 2021.

Exhibit #4: China Portfolio Flows



Source: BNY Mellon* based on rolling 12m sum

The outflows were strong but we note that for much of that round, it was also yield differentials against the US which generated outflows from fixed income – especially Chinese Government Bonds. H1 2021 was the time when the world economy could truly begin to look forward to more sustained reopening and reflation, and yields reacted accordingly. In contrast, corporate bond and equity outflows have idiosyncratic factors at work. Either way, this is a heavy underweight position relative to the size of China's economy, which authorities are trying to unlock, and especially if US yields have now peaked. Successful or otherwise, the days of simply looking at China's trade figures to determine onshore financial conditions and liquidity through the FX channel are long gone.

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