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China Free to Tighten Policy as Hot Money Inflows Stay Cool

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Fears that rising interest rates would trigger speculative currency inflows into China and constrain Beijing’s efforts to tighten monetary policy further appear unfounded, judging by the latest foreign exchange reserves data.

The release of China’s foreign exchange reserves data for fourth quarter 2009 has provided new information on which to base our estimates of speculative inflows. The latest data suggest to us that the influx of hot money is even smaller than we previously thought, and net inflows may have dropped off markedly towards the end of last year.

This supports our argument (“China’s Decisive Rate Rise Keeps It Ahead of the Curve,” *Asian Perspectives*, January 15, 2010) against the widespread view that fear of hot money inflows would constrain Beijing’s ability to increase policy rates in the current tightening cycle.

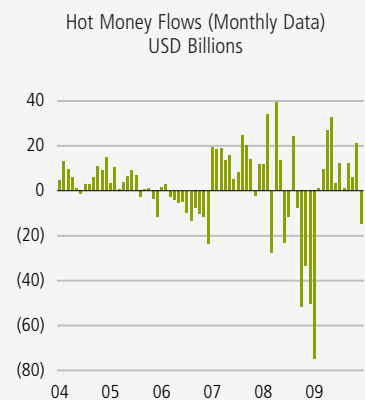
Speculative Inflows Actually Ease

The absence of published monthly balance of payments data in China makes anything more than a crude estimate difficult, but a proxy can be derived. We do this by netting out the trade balance, net foreign direct investment flows and currency valuation changes in total reserves from the monthly change in foreign exchange reserves.

Displays 1 and 2 show our latest estimate based on data up to December 2009. First, in quarterly terms, we estimate that speculative inflows have dropped to about US\$13 billion in fourth quarter 2009, from US\$25 billion and US\$63 billion, respectively, in the third and second quarters. This is nowhere near the scale of inflows which grossly exacerbated China’s monetary overhang problem during 2007–2008.

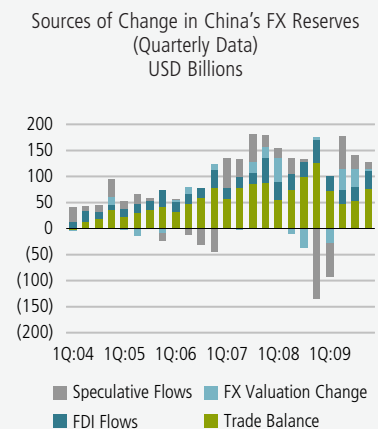
Second, the monthly trends show a surprising net outflow of speculative funds of around US\$14.5 billion in December. The outflow dragged China’s reserves accumulation that month to a mere US\$10 billion, from the monthly increases of US\$61 billion, US\$56 billion, and US\$62 billion, respectively, in November, October and September. Moreover, since China’s reserves are marked-to-market in US dollar terms and some of the reserves assets are invested in non-US-dollar markets such as the euro and Japanese yen, we estimate that the depreciation of the euro and yen against the US dollar last month may have resulted in a valuation loss, or outflow, of another US\$15 billion.

Display 1
Speculative Inflows Appear Limited...



Source: CEIC Data and AllianceBernstein estimates

Display 2
...and Contribute Little to Reserves Accumulation



Source: CEIC Data and AllianceBernstein estimates

No Constraint on Policy

A useful check on whether foreign inflows—foreign exchange reserves accumulation—are causing a major blowout in liquidity is to look at the central bank's balance sheet. If external inflows are increasing, and if domestic sterilization operations are not keeping pace, the balance sheet will show a surge in the growth of reserve money. An increase in reserve money, or high-power money, would tend to boost broad money growth if there are no counteracting measures to slow financial intermediation in the banking system.

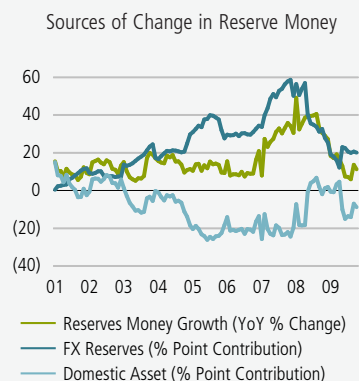
Display 3 shows not only that China's reserve money growth remains relatively benign but also that the disruption from external liquidity is considerably less serious than it was in 2007–2008. Also, a gradual tightening of domestic operations should prevent reserve money growth from getting out of control.

Central Bank Can Manage Inflows

In light of this analysis, there is nothing in our view to suggest that Beijing's ability to tighten monetary policy is in any way constrained by current concerns about hot money inflows.

As we argued last week, there is also little historical evidence to suggest a strong correlation between movements in interest-rate differential and speculative currency inflows into China. While a favorable interest-rate gap may make the Chinese currency marginally more appealing to speculators, the real driver of hot money inflows historically has been the pursuit of significant returns from an expected currency revaluation. Market expectations of a renminbi appreciation are, in our view, nowhere near as intense at present. Moreover, the likely size of current inflows remains well within the capacity of the People's Bank of China to manage, and should not cause too large a disruption to China's liquidity position. ■

Display 3
Not Too Alarming



Source: CEIC Data and AllianceBernstein estimates

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