China: Capital Controls Aren't So Scary After All

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There was a time not so long ago when the passing mention of the two words 'capital controls' would automatically strike fear into the hearts of international investors. Times, however, have changed since the onset of the Great Recession and the European sovereign debt crisis, which contributed to the rise in anti-globalization sentiment. One need only observe what is happening in China where there has been a rising number of high-profile media reports indicating that new capital controls have been introduced in recent weeks. But Beijing is unlikely to face any stinging criticism for its recent moves given the heavy depreciation pressure the renminbi has been facing since mid-2015. Additionally, its measures are targeted at containing the pace at which Chinese residents and corporations transfer money out of the country, not locking in foreign capital[1].

Although it is admittedly difficult to ascertain whether the recent spate of announcements are indeed new capital controls or are, in fact, old measures that are being enforced or monitored more strictly, the decision to tighten capital controls, in our view, is not inappropriate. On the contrary, it is probably the best option given the two other choices – namely, (1) let the renminbi depreciate further against the U.S. dollar in order to preserve foreign exchange reserves, or (2) allow foreign exchange reserves to fall to maintain a stable renminbi. The key rationale for tighter capital controls, at least temporarily, does not simply revolve around preventing the renminbi from experiencing a sharp, sustained depreciation or, worse yet, a large one-off devaluation – something that Beijing has repeatedly promised not to pursue. Rather, it has more to do with preserving broader financial stability.

Concerns over China's Housing and Banking Sectors Persist

There are concerns that a housing bubble has developed and that China's exceptionally large banking sector (bank assets exceed 300% of GDP) may not be as healthy as its key financial soundness indicators show. On the former, new housing restrictions were rolled out in more than 20 first- and second-tier cities in late 2016 due to concerns that price increases had become excessive once again. Meanwhile, non-financial corporate debt surged to 168% of GDP in 2016Q2 (vs 96% in 2008) in the wake of Beijing's RMB4.0 trln fiscal stimulus plan. A corresponding easing in monetary policy along with the rise in shadow banking activity provided further fuel to the credit boom, which has led to greater concerns that credit has become less productive. There is a high degree of skepticism that the official non-performing loan (NPL) ratio of 1.8% in 2016Q3 reflects the 'true' state of bank asset quality.

It goes without saying that keeping more money on-shore in China will help guard against a severe tightening in domestic liquidity conditions, which could spark a sharp rise in interest rates and, in turn, precipitate a faster-than-expected slowdown in the economy and/or a bursting of the housing or corporate debt bubbles. What makes the situation more complicated, in our view, is that China has not fully completed its financial reforms process and, more critically, has generally not followed the traditional sequencing of financial reforms.

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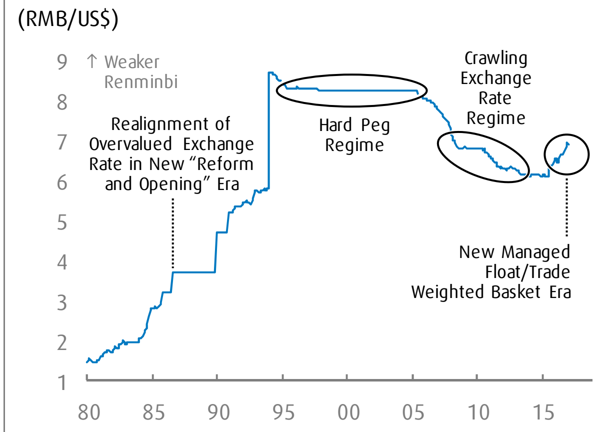
[1] The People's Bank of China, however, introduced a 20% unremunerated reserve requirement on foreign exchange forwards in August 2015, which affected both domestic and foreign banks. ("*China Orders Banks to Hold Reserves for Currency Forwards*." www.bloomberg.com, August 31, 2015.)

The Sequencing of Financial Reforms is in the Spotlight

The literature on the sequencing of financial reforms has tended to prioritize domestic financial reform and exchange rate flexibility ahead of capital account liberalization. Getting this sequence wrong could endanger financial stability (e.g., the premature opening of the capital accounts in some Asian economies is considered to be a key factor contributing to the Asian financial crisis in the late 1990s). In China's case, the optimal sequencing of financial reforms has long been a well-debated subject within policy circles; hence, its uneven pace. More specifically, banking reforms and capital account liberalization have effectively proceeded ahead of the move towards greater exchange rate flexibility (e.g. a market-driven exchange rate).

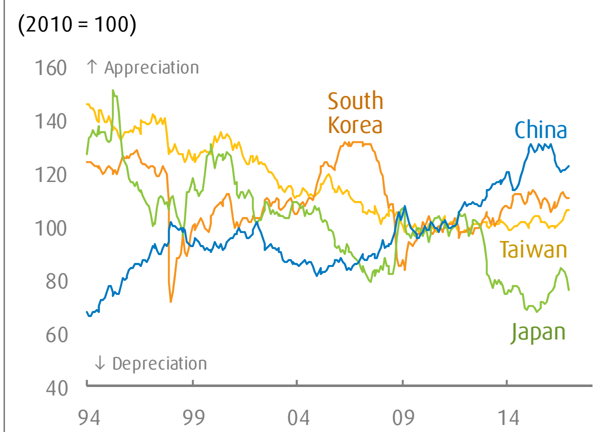
China has made large strides in deregulating the domestic banks, highlighted by completely freeing up banks to set their deposit and lending rates. And, though China does not have a very open capital account, especially when compared to high-income economies, the recent wave of capital outflows suggests it is *de facto* much more porous than *de jure* restrictions would have suggested[2]. And while the authorities have stepped up efforts to increase exchange rate flexibility, the renminbi remains a heavily managed currency.

Chart 1
Recent Exchange Rate Regime Transitions



Sources: BMO Economics, Haver Analytics

Chart 2
Real Effective Exchange Rate



Sources: BMO Economics, Bank of International Settlements

Transitioning to a Market-Driven Exchange Rate Regime is Never Easy

Indeed, it is the renminbi's long history of being so tightly managed that likely explains why moving to a more market-driven exchange rate regime was never going to be easy. The challenge is exacerbated by the fact that China had been operating a crawling exchange rate arrangement from 2005 until early 2014 and prior to that – a hard peg for more than a decade (*Chart 1*). This distorted/magnified expectations that the renminbi could only move one way – appreciate against the U.S. dollar – even though the real effective exchange rate was suggesting it was becoming too strong (*Chart 2*).

Such expectations, however, have clearly reversed course, which was in large part ignited by Beijing's move to a more market-based fixing mechanism[3] on August 11, 2015, characterized at the time as a "one-off adjustment" by the People's Bank of China (PBoC). This 2.0% "mini-devaluation" against the U.S. dollar was all the more surprising given that Chinese policymakers were already struggling with the bursting of the stock market bubble that had taken place in the preceding months.

Capital Outflows Remain Relentless

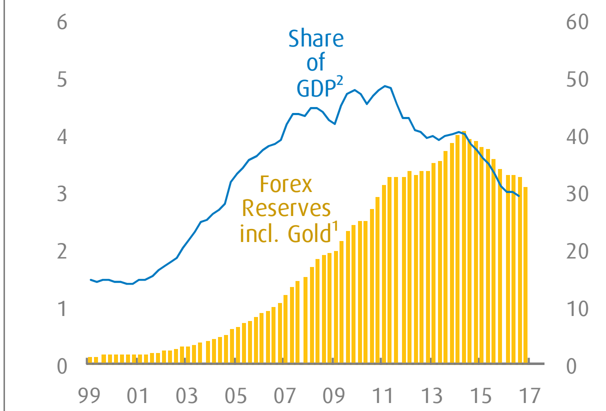
The mini-devaluation or, more precisely, the timing of it, completely altered the expectations of the renminbi's future direction for both financial market participants

[2] IMF, "The People's Republic of China - 2016 Article IV Consultation, IMF Country Report No. 16/270." www.imf.org, August 2016.

[3] The move to a more market-based fixing mechanism was also considered to be part of China's drive to have the renminbi join the IMF's Special Drawing Rights (SDR) basket, which eventually succeeded.

and ordinary Chinese citizens. The rapid decline in forex reserves, rather than the 10% plus depreciation of the renminbi to date, perhaps better captures the extent of this change in expectations. Since the mini-devaluation, forex reserves (excluding gold) have fallen by more than US$600 bln to US$3.0 trln as of January 2017[4] (*Chart 3*). Although it is true that part of the decline can be attributed to external debt repayments and the reversal of so-called carry trades by foreign investors, the pace of gross capital outflows remains rapid given the country still generates large trade surpluses.

Chart 3
Forex Reserve Stockpile is Still Ample

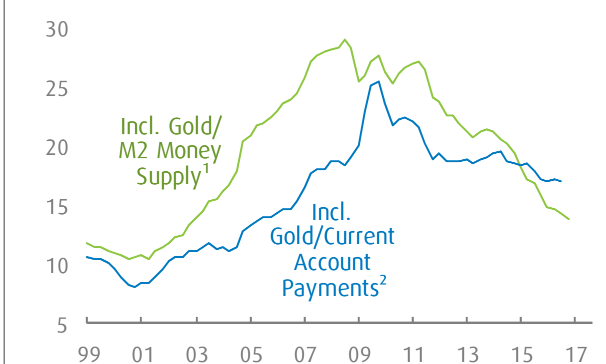


¹ (lhs : US$ trlns) ² (rhs : percent)
Sources: BMO Economics, Haver Analytics

Most traditional measures of reserve adequacy suggest that China's forex reserves, whether measured against imports, short-term debt or broad money supply, are still sufficiently ample to provide a cushion against a wide variety of shocks, but could quickly erode if capital outflows continue at the same pace (*Chart 4*). So while tighter capital controls will not completely stop capital outflows — nor should they given China is a large net saver — they should help slow the pace. We believe that this is critical, as renminbi depreciation pressures are unlikely to relent, especially given on-going concerns over a potential hard landing or China's ability to rebalance the economy (away from investment towards greater consumption). The prospect of a trade war with the U.S. under the new Trump administration could complicate matters further.

Chart 4
Forex Reserve Coverage Ratios Declining

Forex Reserves



¹ (percent) ² (months)
Sources: BMO Economics, Haver Analytics

Key Takeaways

A further tightening of capital controls cannot be ruled out, as it will take time to successfully implement a more market-driven/floating exchange rate that appropriately reflects two-way risks. Once this is achieved, Beijing is likely to carry on with capital account liberalization, which is part of its grander plan to internationalize the renminbi and turn it into a global reserve currency.

From a Canadian perspective, tighter Chinese capital controls may help take some heat off the domestic housing market. Sharply rising housing prices prompted the B.C. government to introduce a 15% property transfer tax for foreign nationals buying real estate in Metro Vancouver in July 2016[5]. Stricter capital controls should reduce speculative/investor demand for housing (as China's citizens are technically barred from purchasing property abroad[6]) but may not necessarily have a large impact on owner-occupied/end-user demand by Mainland Chinese. The latter is still more a function of Canada's immigration policy, where inflows of new permanent residents are unlikely to decline anytime soon.

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[4] Forex reserves had already begun to decline from a peak of US$4.0 trln in mid-2014, which likely reflected increasing concerns over the health of China's economy and the rising desire by both Chinese corporates and individuals to diversify their investments abroad.

[5] Douglas Porter. "*B.C. Housing: Taxing Times*" http://economics.bmocapitalmarkets.com/, BMO Capital Markets Economics, July 29, 2016.

[6] Some of the main channels reportedly used by Mainland Chinese to by-pass prior capital control regulations include: (1) pooling the individual US$50,000 annual foreign currency transfer quota with family and friends, (2) utilizing underground banks to transfer money abroad, (3) utilizing a Hong Kong money changer and (4) carrying cash in a suitcase. ("*China's Money Exodus*." www.bloomberg.com, November 2, 2015.) Other popular measures often cited in the media to transfer money overseas include purchasing insurance products in Hong Kong and using private banks to obtain loans overseas.