Despite strict capital controls, China is being flooded by the biggest wave of speculative capital ever to hit an emerging economy

A popular game this summer among watchers of the Chinese economy is to guess the size of speculative capital or “hot money” flowing into the country. One clue is that although China’s trade surplus has started to shrink this year, its foreign-exchange reserves are growing at an ever faster pace. The bulk of its net foreign-currency receipts now comes from capital inflows, not the current-account surplus.

According to leaked official figures, China’s foreign-exchange reserves jumped by $115 billion during April and May, to $1.8 trillion. In the five months to May, reported reserves swelled by $269 billion, 20% more than in the same period of last year. But even this understates the true rate at which the People’s Bank of China (PBOC) has been piling up foreign exchange.

Logan Wright, a Beijing-based analyst at Stone & McCarthy, an economic-research firm, has done some statistical detective work to make sense of the figures. The first problem is that reported reserves exclude the transfer of foreign exchange from the PBOC to the China Investment Corporation, the country’s sovereign-wealth fund. The reserve figures have also been reduced in book-keeping terms this year by the PBOC “asking” banks to use dollars to pay for the extra reserves that they are now required to hold at the central bank. Adding these two items to reported reserves, Mr Wright reckons that total foreign-exchange assets rose by an astonishing $393 billion in the first five months of 2008 (see chart), more than double the increase in the same period last year.

China’s trade surplus and foreign direct investment (FDI) explain only 30% of this. Deducting investment income and the increase in the value of non-dollar reserves as the dollar has fallen still leaves an unexplained residual of $214 billion, equivalent to over $500 billion at an annual rate. Some economists use this as a proxy for hot-money inflows. But some of it may reflect non-speculative transactions, such as foreign borrowing by Chinese firms. Mr Wright therefore estimates that China received up to $170 billion in hot money in the first five months of 2008. This far exceeds anything previously experienced by any emerging economy.

Michael Pettis, an economist at Peking University’s Guanghua School of Management, reckons that speculative inflows during that period were perhaps well over $200 billion, because hot money also comes
into China through companies overstating FDI and over-invoicing exports. Foreign firms are bringing in more capital than they need for investment: the net inflow of FDI is 60% higher than a year ago, yet the actual use of this money for fixed investment has fallen by 6%. Some of it has been diverted elsewhere.

It is one thing to deduce how much money is coming in. It is another to work out where it is going and how it gets past China’s strict capital controls. The stockmarket, which continues to plunge (see article), is no home for hot money. Some has gone into property. The lion’s share is in bog-standard bank deposits. An interest rate of just over 4% on yuan deposits compared with 2% on dollars, combined with an expected appreciation in the yuan, offers a seemingly risk-free profit for those who can get money into China.

It comes in via various circuitous routes. Big Western investment funds which care about liquidity would find it hard to move money into China, although rumours abound of hedge funds that are investing money through Chinese partners. Trade and investment offers a big loophole for Chinese and foreign firms. Resident individuals can use the $50,000 annual limit for bringing money into China from abroad—many also use their friends’ and relatives’ quotas. Another big loophole lets Hong Kong residents transfer 80,000 yuan ($11,600) a day into mainland bank deposits.

The government is trying to crack down, but that risks shifting the activity towards underground money exchangers. And if the government were to increase its monitoring of FDI and trade flows, the extra bureaucracy could harm the real economy. China needs to reduce the incentive for destabilising capital inflows, rather than block the channels.

Massive hot-money inflows present two dangers to China’s economy. One is that capital could suddenly flow out, as it did from other East Asian countries during the financial crisis a decade ago and Vietnam this year. China’s economy is protected by its current-account surplus and vast reserves, but its banking system would be hurt by an abrupt withdrawal.

A more immediate concern is that capital inflows will fuel inflation. The more foreign capital that flows in, the more dollars the central bank must buy to hold down the yuan, which, in effect, means printing money. It then mops up this excess liquidity by issuing bills (as “sterilisation”) or by lifting banks’ reserve requirements. But all this complicates monetary policy. China’s interest rates are below the inflation rate, but the PBOC fears that higher rates would attract yet more hot money and so end up adding to inflationary pressures. The central bank has instead tried to curb inflation by allowing the yuan to rise at a faster pace against the dollar—by an annual rate of 18% in the first quarter of this year. But this encouraged investors to bet on future appreciation, exacerbating capital inflows. Since April the pace of appreciation has been much reduced, in a vain effort to discourage speculators.

Mass sterilisation

Some economists argue that the problems caused by hot money have been exaggerated. After all, the PBOC has so far succeeded in sterilising most of the increase in reserves. Inflation, at an annual rate of 7.7% in May, has also started to decline, and the impact of last week’s rise in fuel prices is likely to be offset over the next couple of months by falling food-price inflation.

The snag is that money-supply growth would explode without sterilisation, which is now close to its limit. It is becoming very costly for the central bank to mop up liquidity by selling bills, so it is now relying more heavily on raising banks’ reserve requirements (the PBOC pays banks only 1.9% on their reserves, against over 4% on bills). Since January 2007 the minimum reserve ratio has been raised 16 times, from 9% to 17.5%. But it cannot climb much higher without hurting banks’ profits. To curb future inflation, China therefore needs to stem the flood of capital.

One solution would be a large one-off appreciation of the yuan so that investors no longer see it as a one-way bet. This, in turn, would give the PBOC room to raise interest rates. The snag is that the yuan would probably have to be wrenched perhaps 20% higher to alter investors’ expectations, and this is unacceptable to Chinese leaders, especially when global demand has slowed and some exporters are already being squeezed.

This implies that monetary policy will remain too loose. The longer that the torrent of hot money continues and interest rates remain too low, the bigger the risk that underlying inflation will creep up.