

China foreign reserves to avoid hot money inflows in 2018

China's foreign exchange reserves rose more than we expected due to a weaker dollar and a possible slowdown in outward investments during the end of the year



Foreign reserves accumulation in 2017, finally

A weaker dollar and more importantly capital outflow controls have helped Chinese foreign exchange reserves reach \$3139.9bn, up 4.3% from a year ago.

The weak dollar has inflated the value effect of the assets. Specifically, the dollar index fell nearly 10%, and the euro rose more than 14%. Tightening of capital controls has stemmed capital outflows in the second half of 2017, which was an essential factor that helped the accumulation of reserves.

\$3.14trn

China foreign reserves 2017

Up from \$2998.2bn in January 2017

Don't expect capital controls to relax, at least not in 1H18

We expect Chinese foreign reserves to continue to increase in 2018 due to dollar weakness, and a stronger yuan would attract capital inflows.

However, the Chinese central bank would be very reluctant to relax outflow controls. Liquidity was tightened by the PBoC to facilitate financial reforms. If there were additional capital outflows, then liquidity in the domestic market would drain to offshore markets, and this would add pressure to liquidity strain. Unless the PBoC sees a stable net capital inflows into China, we don't expect capital controls to relax, at least not in 1H18.

Risk of hot money inflows is rising

In 2018, we might see hot money inflows, which is a risk that hasn't been considered for several years. Due to liquidity tightening onshore, interest rate spread against the dollar together with yuan appreciation would attract capital inflows. Money could flow into quasi-government assets and through direct investments in technology-related sectors.

However, in our opinion, the central bank would be cautious of attracting too much hot money into China as these could become outflows in the future when yuan reverse trend (though not in 2018). This also explains why we forecast a [mild yuan appreciation of 3% in 2018](#). In short, we expect foreign exchange reserves to rise around 5% in 2018.

[Read why we expect the yuan to appreciate by 3% in 2018](#)