China foreign reserves to drop

We expect China's foreign reserves to drop in April. This is for the same reason that drove the rise in previous months-- the US dollar

Dollars surrounded by Chinese yuan

Value effect from dollar move to dominate

The dollar has increased more than 2.5% in April. This would be big enough to reduce the value of non-USD denominated assets in foreign reserves. As we expect the dollar effect to dominate, foreign reserves could fall to $3.128 trillion in April from $3.143 trillion in March.

Inflows from net exports should be bigger than outflows from yuan depreciation

If we take off the valuation effect, and look into the flows of money across the border, we expect a net inflow into China. On trade, we expect net exports of $23 billion in April to add to foreign reserves after a net trade deficit of nearly $5 billion in March. Having said that, we are aware that there is a risk of net outward remittance driven by yuan depreciation in the month. If this effect was significant in April- and we don't think it was- then the fall in foreign exchange reserves would be driven by both the valuation effect and yuan depreciation. Under such circumstances, the central bank would try to avoid yuan depreciation in the coming months.

Inflows to continue due to relaxing FDI in financial sector

We expect inflows will continue to be greater than outflows for the rest of the year, which would help to build up foreign exchange reserves.

There are three reasons:

- First, the government has relaxed restrictions on foreign direct investments in the financial market. These include removing capital restrictions on foreign-owned banks and asset management companies that operate in China and easing ownership restrictions on foreign life insurance, securities and fund companies. The market expects these to be in place around June. At the same time, the central bank has increased outbound financial investment quotas slightly, though they should be small compared to the FDI. The quota for the Qualified Domestic Limited Partnership (QDLP) programme in Shanghai and the quota for the Qualified Domestic Investment Enterprise (QDIE) programme in Shenzhen will be expanded to $5 billion each from $2 billion and $2.5 billion, respectively.
- Second, though trade tensions are escalating, we do not expect China to experience a persistent trade deficit. A smaller trade surplus is more likely.
- Third, we expect yuan appreciation to continue, albeit mildly, at around 2.6% in 2018. This would be enough to prevent continuous capital outflows from China.

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