

## What's behind the fall in China's foreign reserves this month?

China's foreign exchange reserves fell significantly in March 2020, making it the biggest fall since November 2016. The size of the fall was much bigger than our expectations. Is this about outflows? Things should stabilise in April as investors consider China to be a 'first in and first out' case



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### Biggest fall in FX reserves since November 2016

China's foreign exchange reserves fell by \$46.1bn in March 2020 to \$3.061 trillion, amid the coronavirus pandemic, making it the biggest fall since November 2016.

The last time we saw such a fall was during the yuan liberalisation experiment in 2015 - 2016 by the People's Bank of China. This created large volatilities which saw the yuan depreciating by 12% from around 6.20 to around 6.70.

But the fall in reserves was a result of massive capital outflows from China. However, that is not the case this time.

## FX volatility is the main factor

On this occasion, the fall in FX reserves is because investors have been selling global risky assets in exchange for US treasuries, which has resulted in a strong US dollar that has suppressed the value of non-USD assets.

China's foreign reserves are held in EUR, JPY, GBP and other non-USD assets, and these asset prices have fallen in value when calculated in terms of USD - the currency foreign reserves are usually denominated in. DXY fluctuated by more than 12% in March and even the monthly change was a mere increase of 2.8%.

This partly explains the loss of foreign exchange assets but the fall could also be partly attributed to foreign investors selling off Chinese onshore assets.

## Do foreign investors hold fewer Chinese assets?

Official records from [Chinabond.com](http://Chinabond.com) show, foreign investors in China held onshore bonds worth CNY1951.6 bn in February which increased to CNY1957.8 bn in March. So there wasn't a net capital outflow from the Chinese bond market.

Even though there weren't capital outflows from China's onshore bond market, there should be some outflows from the stock market as the A-share index fell by more than 6% in March. Some investors could have redeemed their assets in foreign funds, e.g. MSCI-A shares, which could have possibly induces some outflows.

## Things should stabilise in April

We think a small group of risk-loving investors willing to take more risk look at China as a "first-in-first-out" case from the damages of the coronavirus outbreak. This is why it's possible that there will be some inflows into the Chinese bond market in April as well as the A-share market when other major asset markets are still suffering from the aftermath of the pandemic.

The yuan is likely to play an investor-friendly role as the central bank is trying to keep the currency stable via the daily fixing rate. We expect USD/CNY to reach 7.25 by the end of 2Q20. But having said that, we don't expect massive capital inflows into China given that the number of new cases is still quite high and fatalities are still rising.

It will be a while before risky asset markets resume a prolonged risk-on sentiment.