China's Trade Surpluses and the Cost of Sterilization

China's trade surplus may set a new record this year. Those surpluses represent large net capital inflows of foreign currency that the PBoC either must sterilize or convert into RMB which would translate into explosive growth in domestic money supply that already is growing too rapidly. Moreover, sterilization itself has become an expensive and, in my opinion, unsustainable strategy for the PBoC. The only other options are to liberalize capital flows, to allow the RMB to appreciate more (and ultimately to float the RMB), to develop local debt markets with market-based interest rates to absorb more of China's surplus savings and to allow the PBoC to diversify the currency composition of international reserves. In short, the implication of the rising cost of sterilization is that it is too late for China to backtrack on financial liberalization and recent announcements attest to China's intent to shift into a higher gear on reforms.

Specifically, China today outlined the next steps toward liberalization of market interest rates. The first step will be to create an interbank market for certificates of deposit (CDs), with rates set off SHIBOR, either fixed up to a year or floating for tenures longer than that. There will be a secondary market in the CDs that will be available to banks and to fund managers who operate in the interbank market, but will not be available to retail investors. However, the plan eventually could allow for the creation of money market funds that would invest in CDs on behalf of retail clients. Rates will be set by the market, with demand coming in particular from smaller banks that have deposit shortfalls and hence are likely to want to attract savers with higher yields than those now available on bank deposits.

Opening up the CD market to corporations for liquidity management is a logical next phase, which would introduce market pricing to wholesale deposits that now are governed by the regulated deposit rates. There also will be a pilot program in the Shanghai free-trade zone to allow qualified financial institutions to issue CDs.

China's trade surplus in itself has become the driver of more rapid implementation of financial liberalization. The PBoC must sterilize a large portion of the capital inflows generated by trade surpluses that otherwise would create far too many RMB deposits and ultimately to excessive domestic credit creation. Over the past 10 years of large surpluses, the PBoC has sterilized about 75% to 80% of its net capital inflows and, notwithstanding this huge intervention, domestic money supply consistently has increased 15% to 20% per year, well in excess of nominal GDP growth. After a decade of intervention, this sterilization has created US$3.1 trillion in deposit reserves held by the PBoC on behalf of state-owned banks plus about $700 billion in bonds issued by the PBoC to further withdraw bank liquidity. The PBoC must pay interest to the banks on these assets, which now carry a rate of around 3.7%. This subsidy to banks now

amounts to 1% of GDP (see table below) and in my opinion has reached a tipping point whereby the PBoC needs to speed up financial liberalization both of the exchange rate and interest rates because the cost of the subsidy rises inexorably in tandem with the trade surplus. China was able to take its time in opening the capital account during the early years of large trade surpluses because bank's deposit reserves and the cost of sterilization were small. Now that the cost is escalating rapidly, however, China has little choice except to allow two-way capital flows and greater RMB flexibility.

I expect the RMB band will widen to 4-5% (2% to 2-1/2% either side of central parity) in 2014. After some initial volatility, the RMB is likely to settle again at the strong side of the band. I also expect China to allow increasing foreign investment into the domestic debt market in order to develop a sovereign RMB yield curve and increasingly market-based deposit rates, as is evident by these initial steps in today's commentary. And one of the unspoken roles of the Shanghai Free Trade Zone is to serve as a relief valve for capital outflows so that greater RMB flexibility is not dominated at the onset by capital flight by the excess savings at home. The new CD market will offer an alternative to low-yielding bank deposits and to increasingly sketchy private wealth products whose underlying assets often are local real estate deals dependent on capital gains.

Has the PBoC reached a tipping point?

People's Bank of China (in trillions of US$)

	Assets		Liabilities
Total of which:	$5.0	Total	$5.0
Intl. reserves	$4.1	Deposit reserves	$3.0
Non-gold reserves	$3.66	PBoC bonds	$0.7
		Currency	$1.0

Federal Reserve (in trillions of US$)

	Assets		Liabilities
Total of which:	$3.8	Total	$3.8
UST	$2.1	Reserve balances	$2.4
Mortgages	$1.5	FRB notes	$1.5

Cost of PBoC sterilization = interest on deposit reserves and PBoC bonds LESS return on intl. reserves
= 3.6% ($3.0 + $0.7tr) - 1.5% ($3.66tr) = **$78 billion (1% of GDP)**

The cost of sterilization and waste in lending are beginning to outweigh the benefits of stabilizing the RMB.

Sources: People's Bank of China, Federal Reserve, Fenwick Advisers estimates.

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From "Are We Sowing the Seeds of the Next Bubble?", presentation to Australian investors November 2013, Fenwick Advisers.

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