Hot money poses risks to Chinese stability

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In 2006 China shocked the world by adding $937bn to what was already the largest hoard of foreign currency reserves. In 2007, if correctly counted, China took in more than twice that amount. So far this year it is on track to double yet again.

It is increasingly clear that this level of reserve accumulation is not sustainable. Besides the strains it places on the global balance of payments, the biggest problem it causes is within China itself. The People's Bank of China, China's central bank, has to purchase these soaring reserves by issuing a combination of local currency and central bank bills. The ensuing monetary creation is fuelling rising inflation, systemic overinvestment and an overextended banking system.

But while vast and growing reserves have been an issue for China for several years, in the past few months something new and highly destabilising has been added to the process. The source of reserve accumulation has become much more volatile and perhaps intensely procyclical (exaggerating the swings of the economic cycle).

For many years China's reserve accumulation was largely powered by its high and rising trade surplus and its status as the favourite destination for foreign direct investment. These are relatively stable sources of inflow and are even likely to be neutral or slightly countercyclical. But in recent months, there has been no longer the trade surplus, in combination with FDI, that is powering the increase. The trade surplus is slightly down in 2008 compared with last year, as is the use of foreign-sourced funds for investment, even as the rate of Chinese reserve accumulation has doubled.

During the first halves of 2005 and 2006, the trade surplus, FDI and estimated interest on China's reserves accounted for 80-90 per cent of the country's reserve accumulation. In the first half of 2007, these components accounted for about 70 per cent. This year, however, their share has declined from January to May (after we adjust China's headline growth in reserves to account for a number of transactions that have in effect "outsourced" the job of reserve accumulation to other entities within China). Because there are likely to be speculative inflows buried in the trade and FDI accounts, their true share is probably even lower.

So what is powering China's accelerating reserve accumulation? Probably hot money. As it becomes increasingly clear that China must revalue its currency, more and more people are bringing money in

Consequently a flood of speculative money, amounting possibly to tens of billions of dollars every month, is pouring into China. There is no technical definition of hot money and of course, with much of it entering the country illegally, it is tough to measure, but it is possible to obtain rough proxies for speculative inflows and to track their change over time. In every case the proxy, however it has been derived, shows a startling increase over the past 12 months. The fact that in recent months the authorities have taken increasingly desperate measures to staunch the inflows confirms this interpretation of soaring hot money proxies.

If hot money is indeed increasing as quickly as the various proxies suggest, it indicates that not only is Chinese reserve accumulation going through a large quantitative change as it doubles yet again, it is going through an even more important qualitative change. Hot money is notoriously unstable and even more notoriously procyclical. When the economy is growing, or even overheating, inflows are likely to increase net investment and add even more fuel to the economic engine. But when conditions change and the economy begins to slow or the country faces financial risks, hot money is likely to flee the country, exacerbating the very conditions it is fleeing.

The Asian financial crisis steered Chinese policymakers to create safeguards against capital flight, and China's massive reserves and capital controls are likely to prevent a rapid speculative assault on the renminbi. However, just because China may be less vulnerable to an external financing crisis does not mean that authorities are out of the woods.

The increasing procyclicality of Chinese capital inflows could place the gradualist, consensus-driven Chinese leadership significantly behind the curve when the inflows reverse, when the government should be providing liquidity to the real economy rather than mopping it up. Under these conditions, the risks to the domestic banking system, rather than the currency, are likely to be more significant.

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