Economic Analysis

China | Narrowing trade surplus cannot fully explain November's unexpected slump in foreign reserves

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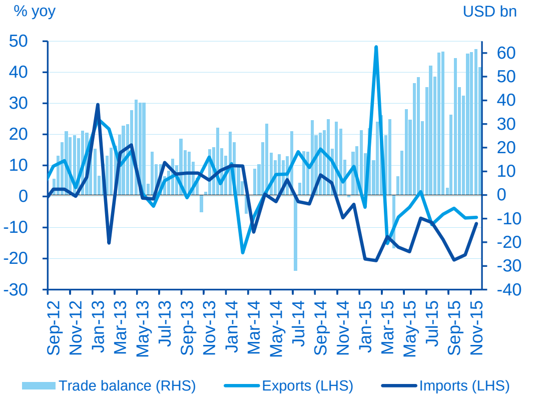
Today, the authorities announced a series of trade indicators for November, which suggest that the woes in China's external sector persist. Most importantly, the narrowing trade surplus in November doesn't concur with the unexpected but significant slump in foreign reserves during the same period. As reported by the central bank yesterday, China's foreign reserves experienced a monthly decline of USD 87 billion in November, slightly below the record decline in August (USD 94 billion), just after China announced the devaluation of its currency causing large-scale capital outflows. More data is needed in order to piece together the whole picture. We suspect that the sharp decline in foreign reserves was caused by a confluence of factors, ranging from a valuation effect, to beefed-up market interventions by Chinese authorities in the run-up to the RMB inclusion into the Special Drawing Rights (SDR).

All in all, there is no need to worry about the adequacy of China's foreign reserves in terms of defending the exchange rate and stemming capital outflows. What's happening is still in line with the "benign scenario" outlined in our expectations (see our Thematic Report about China's Foreign Reserve). Meanwhile, it is almost certain that the RMB will continue its deprecating trend into next year. We maintain our projections at around 6.45 CNY/USD by the end of 2015 and 6.8 CNY/USD by the end of 2016.

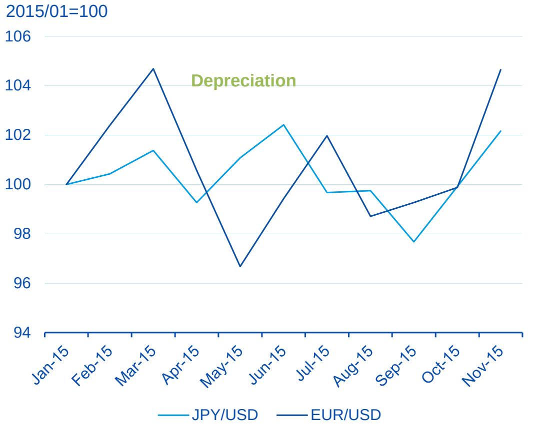
- **Mixed readings of exports and imports data.** In particular, the RMB value of exports fell by -3.7% y/y in November, in line with October's outcome of -3.6% y/y, but below market expectations (consensus: -2.9% y/y). Weaker-than-expected exports can be attributed mainly to external uncertainties, stemming from a dampening in European demand due to the Paris terrorist attacks. In the meantime, the declining pace of imports narrowed in November, coming in at -5.6% y/y from -16.0% y/y in the previous month (consensus: -11.3% y/y). This could suggest that domestic demand has somewhat recovered from the mid-year market turmoil, although the sustainability of this recovery still warrants close monitoring.
- **The trade surplus has narrowed, but it cannot fully explain the fall in foreign reserves.** The trade surplus narrowed to RMB 343 billion (USD 54 billion) in November, down from RMB 392 billion (USD 62 billion) in October. However, the magnitude of the narrowing trade surplus in November is relatively small (USD 8 billion), making it difficult to reconcile this with the significant fall foreign reserves during the same period (USD 87 billion).
- **A few other factors could also lurk behind the November fall in foreign reserves.** First, valuation effects could have played a significant role. In November, the Euro registered a monthly fall of -4.4%, which could have translated into a USD 34 billion fall in the value of China's foreign reserves. It is estimated that roughly 22% of China's foreign reserves are denominated in Euro. Second, China's authorities may have beefed-up their interventions in onshore and offshore markets to defend the RMB exchange rate in the run-up to the IMF's decision to include the currency into the SDR (official approval was announced on November 30th). These interventions require tapping into China's foreign reserves. Last but not least, we suspect that the sharp decline in foreign reserves is also related to the authorities' previous interventions in the forward and swap markets. Forward and swap contracts come due soon, so the central bank may have had to use foreign reserves in order to expedite settlements.

Figure 1
Trade surplus doesn't square with the November fall in foreign reserves



Source: CEIC and BBVA Research

Figure 2
Sharp depreciation of the Euro could translate into valuation effect in foreign reverses



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