Unprecedented capital inflows test Chinese regulators

by Lin Jianyang

BEIJING, July 1 (Xinhua) -- China has taken a series of increasingly aggressive measures in the past several months to blunt the impact of so-called "hot money," amid the explosive growth of its foreign exchange reserves, which have soared beyond what can be explained by trade and investment flows.

The inflows have been so massive as to raise alarms over the country's financial security.

According to the State Administration of Foreign Exchange (SAFE), as of the end of May, forex reserves stood at 1.797 trillion U.S. dollars.

During the first five months of 2008, forex reserves increased by 18.7 percent year-on-year, or 268.7 billion U.S. dollars, SAFE figures showed.

Where is all that money coming from, and where is it going?

HOW MUCH IS "HOT MONEY"?

What caught the attention of analysts was that forex reserves jumped at the same time as the current-account surplus and foreign direct investment (FDI) into the fixed-asset field declined year-on-year.

Set against the increased forex reserves in the first five months of this year, there was the 78.02 billion U.S. dollars represented by the trade surplus, which was down 8.6 percent year-on-year.

Another 42.78 billion U.S. dollars was connected with FDI in the first five months, which soared nearly 55 percent year-on-year. But FDI going into fixed assets (longer-term investment), actually fell 3.5 percent in the same period.

Jiang Zheng, a macro-economist at a Beijing-based securities firm, has closely tracked these figures and analyzed the data.

Deducting the trade surplus and the FDI, there was an unexplained 147.9 billion U.S. dollars in the forex reserve increase figure, which Jiang and numerous other analysts consider to be "hot money", which is usually defined as short-term global speculative funds moving among financial markets in search of the highest short-term return.

The government doesn't release official figures on this category of funds; in fact, it doesn't even use the term "hot money". So analysts can only make estimates.

Jiang said the "hot money" figures deduced by analysts might even be underestimates. "There is a tricky decline among the FDI figures, i.e. the drop of fixed-asset investment," he explained.

"Foreign direct investment in the first five months soared about 55 percent. But strangely, fixed-asset FDI in the first five months fell 3.5 percent from last year's figure," Jiang said.

Jiang said it appeared that some speculative money had managed to move into China in the guise of FDI.

But there are many other channels for "hot money" to flow into China. These include falsified international trade with over-invoiced exports and underground private banks, according to Jiang.

Jiang and other analysts maintained that as much as 600 billion U.S. dollars in "hot money" had surged into the country, most of it after 2005.

Jiang said he was somewhat surprised at the scale of "hot money" inflows in the first five months of this year. The monthly inflow of "hot money" from January-May was estimated at 35 billion U.S. dollars, more than double the 15 billion U.S. dollar figure for the same period last year, Jiang said.

In April alone, deduction showed that a record 50.2 billion U.S. dollars of "hot money" poured into China, he said.

WHY CHINA AND WHERE DO THEY INVEST?

Many will ask why such huge sums of "hot money" have been continuing to flood into China and where it is going.

Li Yang, head of the Financial Research Institution at the Chinese Academy of Social Sciences, said the disparity between Chinese and U.S. interest rates, the appreciation of the Chinese currency (the yuan) since 2005 and the profits from the Chinese capital and real estate markets were the main causes of the unstoppable "hot money" inflows.

Since the start of the global financial crisis, which surfaced last summer with problems in the U.S. subprime mortgage market, the U.S. Federal Reserve has since September cut interest rates seven times to stimulate economic growth. The Fed funds target rate has fallen from 5.25 percent to the current 2 percent.

In contrast, the People's Bank of China (PBOC, the central bank), hiked interest rates six times between March and December 2007 to cool economic growth, with the one-year deposit rate rising from 2.52 percent to the 4.14 percent.

These opposing actions created a disparity that helped to lure global speculative money to into China at an accelerated pace this year.

Next