Another crack on China's financial stability

Last month, China's foreign exchange reserves just fell blow a psychological threshold of $3 trillion. The event got people talking about yet another spark of a worldwide financial firestorm. For Thailand, things could get even rockier than in 2008 as the epicenter of the earthquake would be much closer to home this time around.

With a prospect of slowing economy, money has been pouring out of China since mid-2014. During this period, the yuan depreciated by over 10% and recently touched an eight-year low mark. This would have been business as usual, had it not been for the staggering pace at which China lost its reserves especially in late 2015. Since then, the speed has slowed down somewhat, but the trend persists.

Generally, foreign exchange reserves are assets that governments hold to pay for foreign debts and manage currencies when needed. Having a sizeable reserve, therefore, projects financial stability and inspires confidence in a domestic currency. Without it, China could be in a destabilized position in battles against financial imbalances like high corporate debts and the overheated property sector; all of which could lead to the much-feared scenario of China's crash-landing.

To slow capital outflows, China has been putting up control measures to ensure stability. Yet, the size of recent China's cross-border flow was as large as 4% of its GDP. This level is basically on par with other countries with an open capital account like Japan and Korea. Under this condition, China will need a large reserve to keep the yuan at its desired level through buying and selling operations. By Bloomberg's calculation, the IMF's methodology suggests a minimum level of reserves at $2.9 trillion that China needs to maintain its peg. This threshold too will be breached within a few months. Soon China would need to ramp up its capital controls, which would have consequences on anyone involved in the flow of money in and out of China.

How worried should Thailand be? In face of tighter capital controls, some segments of the Thai economy stand to lose. The impact depends on the types of control measures and their targets.

China currently subjects all outward direct investment projects valued above US$1 billion, or roughly 35 billion baht to a case-by-case approval. Under a close scrutiny are Chinese companies' deals outside of their core businesses.

The current rule should have limited effect on Chinese FDI in Thailand, given its relatively small project size (averaging at 414 million baht, according to Thailand Board of Investment). Even for one of the larger projects by Sentury, a major tire manufacturer from Shandong Province, recorded at 8 billion baht, is well below the threshold. Nonetheless, a harsher enforcement of existing rules could cause delays in transactions. But, it should not interrupt the long-term trend of Chinese investment in Thailand.

On the other hand, the government has renewed the foreign exchange quota of US$ 50,000 per person per year. Individuals are also required to provide proofs of the purpose for the currency conversion. The restricted amount should be large enough to cover expenses for approved areas such as tourism and education. However, overseas real estate markets that have been benefiting from Chinese investment glut could feel the impact. In Thailand, this concentrates in condos of up to 5 million baht that target Chinese buyers. A survey by Financial Times suggests that this segment accounts for most Chinese real-estate buyers in Thailand. There is also high concentration of real estate purchases in tourist spots like Bangkok, Pattaya, Chiang Mai, and Phuket. On the grand scheme of things, however, this market makes up a small portion of the Thai real estate market and should make no significant macroeconomic impact.

Aside from beefing up its capital controls, China will have to do more to slow down its reserve depletion. Even with seemingly strong barriers, people often find ways to get around the restrictions. One alternative policy tool is to tighten monetary policies by raising interest rates. This will boost returns on domestic assets, effectively keeping more money within its borders. Earlier this month, China's central bank, the People's Bank of China (PBOC), has signaled this tightening stance by raising rates on loans via the government's targeted lending facilities. Yet, the PBOC can only raise interest rates by so much because higher rates will add burden to debt holders, hurting the already-fragile economy.

Another option that is more in line with China's long term goal is to let the market forces prevail and the yuan depreciate more sharply. This could be a risky option, if done in a disruptive manner. A sudden devaluation of the yuan has proven a bitter pill for the financial markets as we have seen in the past few years. In 2015, the PBOC took a surprise decision to devalue the yuan's daily reference rate by nearly 2%. The move prompted a sharp drop in Shanghai's stock market and created rippled effects on Asian currencies, the Thai baht included, and stock markets elsewhere.

Unexpected moves by the PBOC could also derail China's long desire of yuan internationalization. In fact, 2016 saw a small decline in the share of the yuan as international payments, according to the SWIFT international payment network.

A mix of various tools are the most likely choice of the Chinese government to halt capital outflows. However, there is always a risk of the capital situation spiraling out of control. In which case, China would have no choice but take a drastic action in desperation to maintain its economic stability. Against this tail-risk turn of event, the Thai export sectors, especially rubber, primary plastics, and LCDs, would suffer a serious blow as almost a third of Thai exports in these three categories combined go to China.

Things could take a turn for the worse given the current global economic environment. The unpredictable state of US policy towards China adds more complexity to the fragile situation. Even since taking office, Trump has indeed been a "man of action," quickly delivering on his promises; among which is branding China a

currency manipulator. It's difficult to guess what Trump would do to China. Criticism on China for keeping its currency artificially low (though it is untrue) could be damaging enough as the last straw that breaks a camel's back -- in this case, dragon's.

When China sneezes, the whole Asia likely catches a cold. Thailand won't escape the same fate either. For now, we should get ourselves vaccinated through long-term reforms like export restructuring, infrastructure upgrade, and an education system overhaul. Otherwise, once the calamity hits, we could be bed-ridden for a long time.

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