

China's yuan under pressure amid 'unprecedented' capital outflows following Russian invasion of Ukraine

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- **China's yuan under pressure amid 'unprecedented' capital outflows following Russian invasion of Ukraine**
- **Investors have pulled money out of China on a huge scale even as flows to other emerging markets held up, the Institute of International Finance says**

[Photo: Analysts expect fund outflows in yuan-denominated assets to remain volatile in coming weeks, raising concerns about how authorities will manage the yuan.]

Global investors have withdrawn money out of China on an "unprecedented" scale since Russia invaded Ukraine in late February, according to a report by the Institute of International Finance (IIF), with the yuan likely to face more pressure in coming months.

High-frequency data detected large portfolio outflows from Chinese stocks and bonds, even as flows to other emerging markets held up, the IIF wrote in a report on Thursday.

"Outflows from China on the scale and intensity we are seeing are unprecedented, especially since we are not seeing similar outflows from the rest of emerging markets," said the IIF report.

"The timing of outflows - which built after Russia's invasion of Ukraine - suggests foreign investors may be looking at China in a new light, though it is premature to draw any definitive conclusions in this regard."

[Video: China aims for modest 5.5% GDP growth in 2022, citing economic pressures 01:25]

According to China Central Depository & Clearing, a depository for government bonds, overseas investors' holdings of Chinese onshore bonds fell by 67 billion yuan (US\$10.5 billion) in February.

"It's likely that the outflows [out of bonds] would be even larger in March," said Macquarie Capital on Tuesday.

In the first 21 days of March, China also saw a net outflows of 59 billion yuan through the northbound Stock Connect programme with Hong Kong, although the total amount was smaller than the 70 billion yuan of fund outflows recorded in March 2020, the Macquarie report noted.

Analysts expect fund outflows in yuan-denominated assets to remain volatile in the coming weeks,

raising concerns about how the People's Bank of China will manage the yuan amid predictions that another rate increase by the US Federal Reserve to tackle inflation could exacerbate outflows from emerging markets and weaken currencies.

If the authorities are not able to get creative about creating liquidity, China is headed for its equivalent of a recession

Freya Beamish

The war has renewed fears in Taiwan of increasing risks of military aggression from the Chinese mainland, which views the island as a breakaway province to be reunited, by force if necessary. The sentiment, in addition to the expectations of the US Federal Reserve rate decision, has weighed on the island's stock market.

Foreign investors have sold NT\$450.2 billion (US\$15.7 billion) worth of stocks in the four weeks since the start of the war on February 20, almost equal to the total equity sales by foreign investors in 2021, according to SCMP calculation based on data from the Taiwan Stock Exchange.

The global market has been volatile since the start of the war, partly also due to the 25-basis-point increase in its short-term benchmark rate by the US Federal Reserve earlier this month.

US Federal Reserve policymakers on Wednesday also signalled they are ready to take more aggressive action to bring down unacceptably high inflation, including a possible half-percentage-point interest rate increase at the next policy meeting in May.

[Graph: Yuan - US dollar exchange rate. Price trends over time for how the Chinese currency trades against the US dollar]

Freya Beamish, head of global macro at London-based research firm TS Lombard, said that China's "stubborn" management of the yuan would test political limits of low growth.

"Prolonged weak growth would in any case lead to yuan depreciation ... eventually," she said on Thursday.

"If the authorities are not able to get creative about creating liquidity, China is headed for its equivalent of a recession."

The country's foreign exchange reserves, the world's largest, fell to US\$3.214 trillion at the end of February from US\$3.222 trillion, despite a strong yuan exchange rate with the dollar.

[Video: Ordinary Russians feel economic pain of Western sanctions on Moscow over Ukraine invasion. 02:52]

Credit demand was much weaker than expected in February as new bank lending in China fell to 1.23 trillion yuan (US\$193.2 billion), down sharply from a record 3.98 trillion yuan in January, raising pressure on the central bank to ease policy further to support the slowing economy. Beijing

has set a growth target of “around 5.5 per cent” for 2022.

China’s economy in the first quarter is expected to reflect damage from its worst coronavirus outbreaks in more than two years, as new infections have climbed over the past few weeks.

“As it is already the end of the first quarter, the risk of quarter [gross domestic product] growth falling short of 4 per cent has been on the rise. If that is the case, the entire year’s growth target, at 5.5 per cent, would be facing tremendous uncertainties as well,” said Commerzbank on Friday.

Already, US moves to tackle inflation have resulted in hesitation by China’s central bank over how much loosening – including rate cuts – it needs to bolster the economy, while it also tries to avoid adding pressure on the yuan.

China’s yuan appreciated slightly to 6.3585 per US dollar on Friday, rebounding from a 10-day low seen on the day before.

The currency is among the few in the region on track to end the week stronger than where it started.

Swiss bank UBS said in a note last week that it expected China to allow “limited” depreciation in the yuan.

“The limited yuan depreciation in all cases is in part due to UBS global view that the US dollar will weaken from current levels, but also because we believe the Chinese government would not want to see significant currency depreciation and is likely to tighten controls on capital outflows if necessary to slowdown the depreciation,” UBS said.

The pressure for capital outflows does increase this year, due to the Fed hike cycle and the war
Larry Hu

China’s foreign-exchange regulator the State Administration of Foreign Exchange said last week it would track cross-border capital flows more closely while trying to help companies defend against forex risks.

“In any case, the pressure for capital outflows does increase this year, due to the Fed hike cycle and the war. As a result, we expect the yuan to weaken modestly to 6.5-6.6 against the US dollar toward the year-end,” said Larry Hu, chief China economist at Macquarie Capital.

“That said, the elevated trade surplus and the large dollar pool built by Chinese banks and corporates over the past couple of years could help cushion the shocks from the external side.

“As a result, the pressure from capital outflows would not constrain the policy easing this year.”

Amanda Lee in Beijing and **Wendy Wu** in Beijing

P.S.

- South China Morning Post. Published: 5:00am, 26 Mar, 2022:
<https://www.scmp.com/economy/china-economy/article/3171889/chinas-yuan-under-pressure-amid-unprecedented-capital>

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