Economic Watch

The impact of COVID-19 on China's Balance of Payments and Foreign Reserves: An update

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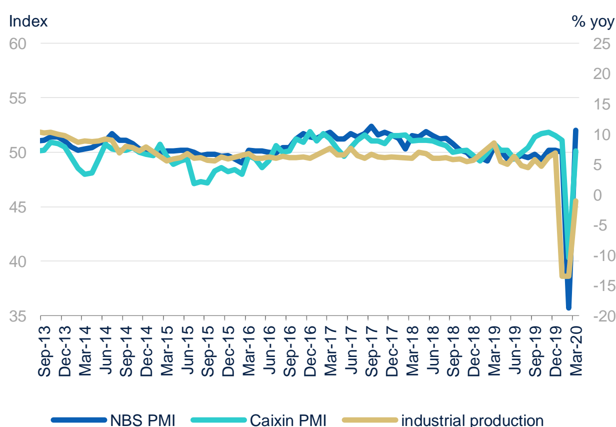
The outbreak of COVID-19 pushing the world into a deep recession

The catastrophic spread of COVID-19, along with ever-rising high death toll around the world, is set to cause a global economic recession. Many virus-containing measures adopted by countries, including forceful quarantines, regional lockdown, social distancing etc., slowed the COVID-19 contagion but hampered economic activities. The pandemic also led to widespread panic among global financial markets, posing a material threat to the existing global financial order. Many observers reckon that the COVID-19 pandemic is likely to impose enormous loss on the global economy comparable to the 2008-2009 Global Financial Crisis (GFC).

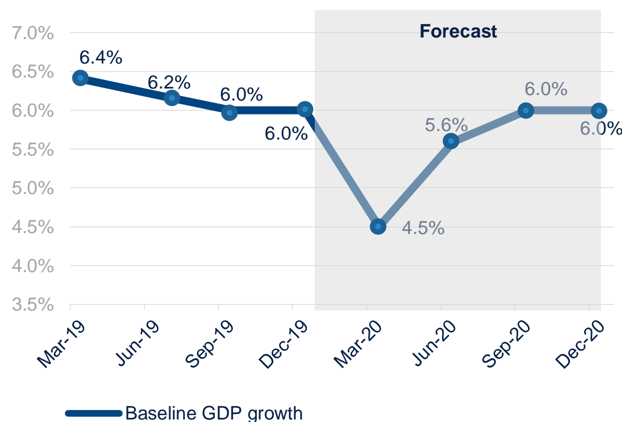
Amid the dim outlook of global economy, investors anticipate the Chinese economy to bring about a silver lining in that it is among the first group of regions which has brought the COVID-19 under control. The recently announced China's March activity indicators suggest that the Chinese economy has somewhat got back on its feet after a deep fall in the first quarter. Although the domestic consumption and investment may bounce back quickly, the plunging external demand, together with a turbulent global financial market, will weigh on China's growth in the medium to long term. (Figure 1 and 2) Those external headwinds will be largely reflected in China's Balance of Payments (BoP) and foreign reserves.

Figure 1. **A QUICK BOUNCE OF ECONOMIC ACTIVITIES IN MARCH AS WORK RESUMED ORDERLY**



Source: CEIC and BBVA Research

Figure 2. **WE FORECAST CHINESE GDP THIS YEAR WILL HAVE A V SHAPE, REACHING 2.2% IN 2020**



Source: BBVA Research and CEIC

This report is an update of our China Economic Watch: The impact of COVID-19 outbreak on China's external balance, in which we assumed that the shock of the COVID-19 was a severe but local one. Since the COVID-19 has become a global pandemic now, we have to re-set the key assumptions and revise our conclusions.

The COVID-19 impact on China's Balance of Payments (BOP) is mixed and limited

We examine how the COVID-19 outbreak affects different components of the BOP qualitatively and quantitatively. Our main predictions are summarized below:

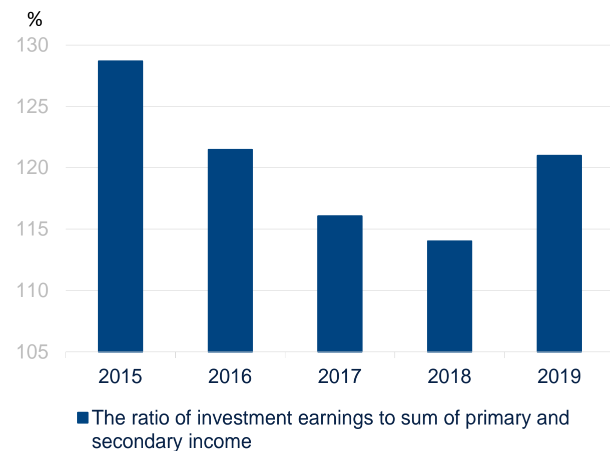
- **Current Account - Goods Trade:** The negative impact of the COVID-19 on China's goods trade likely amounts to the same degree as that of the 2008-2009 Global Financial Crisis (GFC). We estimate that the total exports will plunge by -16% this year, almost at the same pace of the fall during the 2008-2009 GFC. Meanwhile, imports growth will slide albeit with a slower pace. A number of deployed measures aiming to boost domestic consumption and investment will benefit imports as well. Moreover, China is obliged to fulfill the massive purchase of US products included in the phase-one trade deal signed this January. Altogether, we predict imports will dip by -12% this year. As a consequence, the falling exports and imports of this year will decrease trade balance to USD 310 billion from USD 425 billion in 2019.
- **Current Account - Services Trade:** Over the past several years, China's gaping deficit of services trade was mainly driven by the boom of Chinese overseas travel. In 2019, the deficit of overseas travel accounted for 84% of total service sector deficit. (Figure 3) After the outbreak of COVID-19, many countries unveiled the lockdown and border control policies, which are unlikely to be relaxed soon. China's international airline business was reported to drop by around 60-70% in February. Such a trend is set to continue through most time of the year. We therefore forecast that China's inbound and outbound travel will shrink by -60% this year. Meanwhile, we assume that changes of other service-trade items will move in tandem with that of goods trade. As such, the deficit of China's service trade will be narrowed to USD -117 billion in 2020, from USD -261 billion in 2019.
- **Current Account - Primary and Secondary Income:** Investment income flow is the dominant item under Primary and Secondary Income. (Figure 4) In theory, the COVID-19 outbreak could affect it in both ways. Subdued economic activities will reduce the investment incomes of foreign entities in China and China's entities' interest income earned abroad. If investment income flows from and back to China decrease by the same degree, the COVID-19 tends to lower the net outflow of investment income. We therefore forecast the deficit of primary and secondary income will shrink to USD -7 billion (the smallest deficit over the past five years) from USD -23 billion in 2019.

Based on the above assumptions, the COVID-19 will have mixed effects on flows under China's current account. The shock will shrink the goods trade surplus while narrow the deficit in service trade, primary and secondary income. In sum, we expect current account surplus will expand to USD 186 billion this year, around 1.5-1.6% of GDP, from USD 141 billion in 2019.

Figure 3. **THE CONTRIBUTION OF TOURISM TO SERVICE TRADE DEFICIT HAS BEEN INCREASING**

Source: CEIC and BBVA Research

Figure 4. **INVESTMENT INCOME FLOW'S CONTRIBUTION TO PRIMARY AND SECONDARY INCOME OF BOP**



Source: CEIC and BBVA Research

- **Financial and Capital Account – Direct Investment:** The pandemic's impact on both inward and outward FDI tends to be negative. The limit of cross-border business travel is likely to hold up the progress of foreign investment projects, limiting foreign FDI to China. On the other hand, Chinese outward FDI will correspondingly decline due to the COVID-19 outbreak in China's target countries. The United Nations Conference on Trade and Development (Unctad) recently estimate that FDI flows could drop as much as 30% to 40% this year. We therefore assume a 35% decline of both inward and outward FDI for China this year, surpassing -23% and -24% respectively in 2008-2009 GFC. Based on the assumptions, surplus under FDI item will decline to USD 37.8 billion.
- **Financial and Capital Account – Portfolio Investment (including errors and omissions):** China has a large amount of errors and omission on the Balance of Payments (BoP). For instance, in 2019, the term of errors and omissions reached USD -198 billion, much larger than net inflow of USD 56.7 billion under capital and financial account. It is widely believed that most of errors and omissions are hidden under "net portfolio outflows". That is why we include errors and omissions into the portfolio investment item. Amid COVID-19, the global financial markets especially stock and bond have been plunging drastically in the past couple of months. However, due to effective containment of the COVID-19 in China, the country's risk assets have performed relatively well compared with other assets in advanced economies. In particular, after the major central banks unveiled ultra-loosening monetary policy in response to the pandemic shock, China's interest rate differential with those of advanced economies became more attractive to international capital. All in all, portfolio inflows might increase in China in 2H after a temporary decline in Q1.

The above analysis is summarized in the below table. (Table 1)

Table 1. **HOW THE COVID-19 OUTBREAK AFFECTS DIFFERENT COMPONENTS' BALANCE OF THE BOP**

Components of BOP	Impact through 2020
Goods Trade	Negative
Services Trade	Positive
Primary and Secondary Income	Positive
Direct Investment	Negative
Portfolio Investment	Positive

Projecting foreign reserves change in 2020

Based on our above analysis of the BOP shock exerted by the COVID-19, we are able to do a quantitative exercise of forecasting the change of foreign reserves in 2020. To estimate the change of foreign reserves, we adopt the foreign reserve decomposition model used in one of our previous report (see our China Economic Watch: It's not time to relieve yet: updating projections of China's foreign reserves):

Foreign reserves change= foreign reserves' currency valuation effect +current account balance +net FDI +net RMB cross-border flow + domestic FX holding change + portfolio flow

In the Table 2 below, we summarize our assumptions of every item of the foreign reserve decomposition formula above in details. All the assumptions are based on the qualitative analysis in Section 2. The quantitative results of the forecasting for each item are displayed in Table 3. The model yields a projected increase of USD 112.1 billion in foreign reserves by the end of 2020, implying that foreign reserves at end-2020 reach USD 3,220 billion.

Table 2. **KEY ASSUMPTIONS OF THE COMPONENTS OF FOREIGN RESERVE IN 2020 BASED ON THE ANALYSIS IN SECTION 2**

	Assumptions
(1) Foreign reserve's currency valuation effect (negative)	We assume that USD index (DXY) will reach 102 due to the so-called "Dollar Shortage" in the crisis time. Thus, other currencies (GBP, JPY and EUR) which count 30% of the foreign reserve currencies, will depreciate accordingly relative to USD. Altogether, foreign reserve will decrease by USD 58.7 billion by currency valuation effect.
(2) Current account balance (positive)	We first decompose current account into goods trade, service trade, primary and secondary income (combined). (i) Exports growth is predicted to be -16% while imports growth -12%; (ii) Both the debit and credit side under international travel item will decline by -60% this year. We assume that changes of all other items under service trade item will be at the same proportion as that of goods trade. Under these assumptions, China's service trade balance will shrink to USD -117 billion from USD -261 billion in 2019.; (iii) We forecast the deficit of primary and secondary income will shrink to USD -7 billion from USD -23 billion in 2019, the historical high. Altogether, the 2020 current account balance will be USD 186 billion.
(3) Net FDI (negative)	We predict a 35% declining of both inward and outward FDI this year, surpassing -23% and -24% respectively in 2008-2009 GFC. Thus, surplus under FDI item will decline to USD 37.8 billion.
(4) Domestic FX holding change (neutral)	FX deposit change by household and enterprises: we assume 2020 household and enterprises will change their FX deposit as the historical average for the past three years, which is USD 16.8 billion. Bank's FX positions change: similar as FX deposit change by household and enterprises, we assume banks' FX positions will change as the historical average for the past three years, which is USD -29.5 billion.
(5) Net RMB cross-border flow (neutral)	Similar to item (4), given that COVID-19's impact on RMB cross-border flow is neutral, we predict the 2020 net RMB cross-border flow as historical average for the past three years which is USD -7.75 billion.
(6) Portfolio Flow (positive)	Given that COVID-19's impact on portfolio flow is positive due to better performance of China's financial markets, we predict the 2020 portfolio flow to be historical high of the past three years, which is USD -23.4 billion.

Source: BBVA Research

Table 3. **FORECASTING THE COMPONENTS OF CURRENT ACCOUNT IN 2020**

(Unit: USD bn)	2017	2018	2019	2020 (f)
1.Current account Balance	**195**	**49**	**141**	186
1.1 Goods trade	419	351	425	310
Goods exports	2,263	2,487	2,399	2,041
Goods imports	1,844	2,136	1,974	1,731
1.2 Service trade	-259	-292	-261	-117
1.3 Primary and Secondary income	-22	-54	-23	-7
2.Valuation effect	**-0.18**	**100.1**	**-62.2**	**-58.7**
3.FX deposit position change for household an enterprise	**-28.1**	**73.0**	**5.4**	**16.8**
4.FX deposit position change for banks	**-26.0**	**-76.0**	**13.5**	**-29.5**
5.Net RMB cross-border flow	**42.9**	**-22.7**	**-43.5**	**-7.8**
6.Net FDI flow	**27.7**	**107.0**	**58.1**	**37.8**
7.Portfolio flow	**-308.1**	**-311.2**	**-23.4**	**-23.4**

Conclusions

Based on our analysis in previous sections, we draw the conclusion that China's external sector is resilient to the COVID-19 shock. It is because that the COVID-19, after becoming a pandemic, will have two-way effects on most of BOP components. However, the authorities should be aware of the fragility of this equilibrium based on weak global environment and domestic economic woes. That being said, the authorities should warily manage the capital account to guard against capital flight. Meanwhile, the authorities need to take the chance to press ahead with financial reforms of domestic financial sectors. In addition to strengthening banking sector, the authorities could make domestic equity and bond markets more accommodative to international investors. After all, foreign holdings of Chinese bond and stock market are only around 4% of total market value, implying a lot of room for capital inflows.

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