Economic Watch

China | 2021 outlook of external balance: will China's BoP normalization come soon?

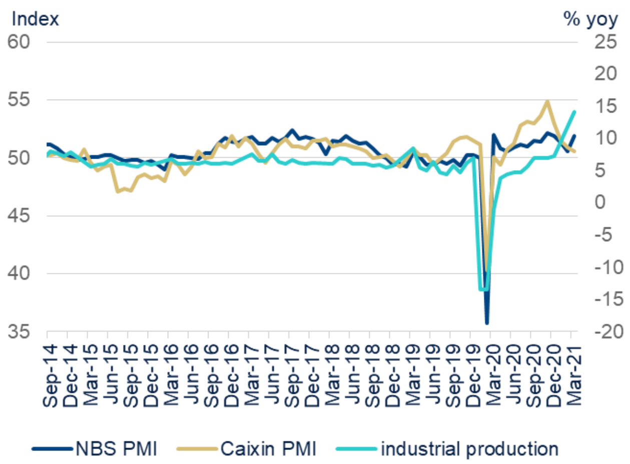
Jinyue Dong / Le Xia

May 17, 2021

China's "first-in-first-out" pattern of the COVID-19 pandemic led to many abnormalities on its Balance of Payments (BoP)

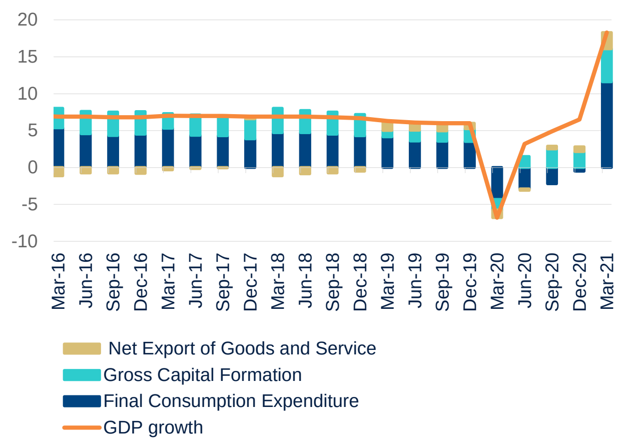
Amid the unprecedented economic blow and dim outlook of global economy caused by the Covid-19 pandemic, Chinese economy seems to be firing on all cylinders after fully controlling the pandemic since May 2020. It has achieved a complete V-shape recovery in Q4 2020, becoming the only positive growth country in 2020 among the main economies in the world. (Figure 1 and 2)

Figure 1. **A QUICK BOUNCE OF ECONOMIC ACTIVITIES PARTICULARLY IN SUPPLY SIDE**



Source: CEIC and BBVA Research

Figure 2. **WE FORECAST CHINESE GDP THIS YEAR WILL REACH 7.5% DUE TO LOW BASE EFFECT OF 2020**

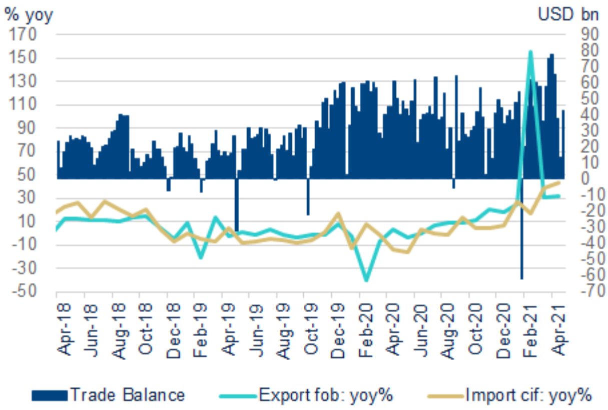


Source: BBVA Research and CEIC

Due to the "first-in-first-out" pattern of the Covid-19 pandemic in China, a number of extraordinary phenomenon took place in the country's Balance of Payments and external sector in 2020. Chief among these abnormalities include: (i) extraordinarily strong momentum in exports after China fully controlled the Covid-19; (Figure 3) (ii) high current account surplus due to a strong trade balance and a significant shrink of service trade deficit due to limited outbound tourism; (Figure 4) (iii) staggeringly high FDI inflows, which surpassed the US to be No.1 in the world in 2020, (Figure 5) and (iv) accelerating foreign investment inflows from USD 147.4 billion in 2019 to USD 254.7 billion (a 72.8% increase), due to the historical high interest rate differentials with advanced economies. (Figure 6)

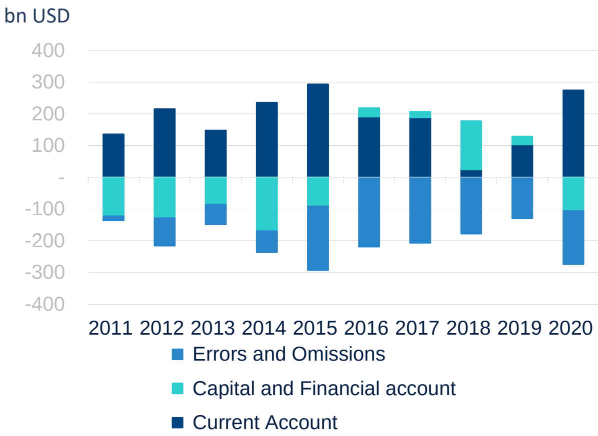
When and how all of these BoP abnormalities could be normalized hinge on the course of global economic recovery and the tapering steps of monetary policy normalization by advanced economies' central banks. However, we do not anticipate a complete global economic and policy normalization this year. That means, China could still take the advantage in its external sector in the short term. Looking ahead, what we really concern is to what extent this kind of BoP normalization could drag on China's growth in the future.

Figure 3. **CHINA'S EXPORTS MAINTAINED A STRONG MOMENTUM SINCE JUNE 2020 …**



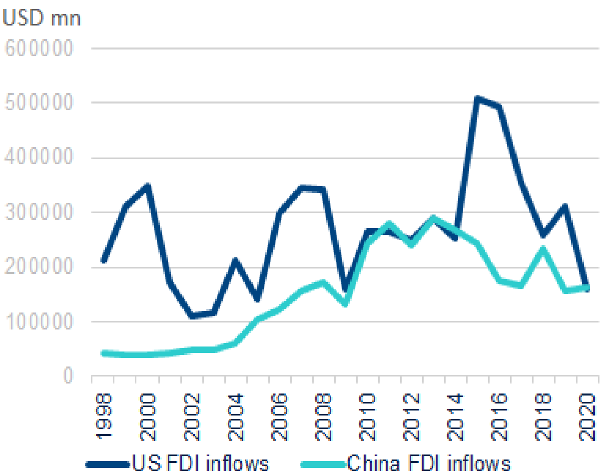
Source: CEIC and BBVA Research

Figure 4 **A STRONG TRADE BALANCE WITH A SHRINKING SERVICE TRADE DEFICIT, LEADING TO A LARGE CURRENT ACCOUNT SURPLUS IN 2020**



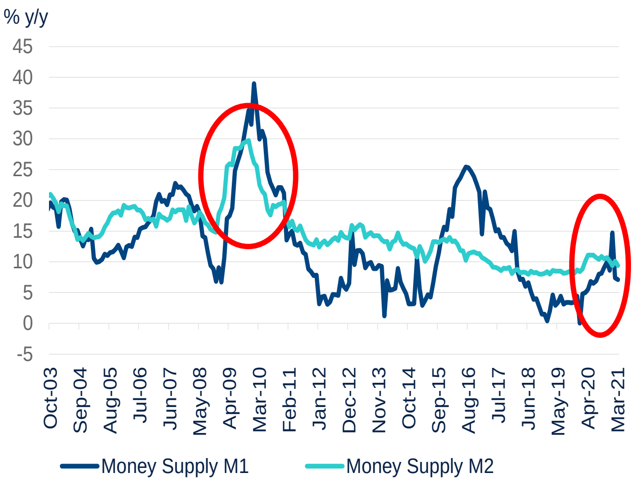
Source: BBVA Research and CEIC

Figure 5. **CHINA'S FDI INFLOWS SURPASSED THE US TO BE NO.1 IN THE WORLD IN 2020**



Source: CEIC and BBVA Research

Figure 6. **DUE TO CHINA'S MEASURED MONETAYR POLICY, CHINA HAD HISTORICAL HIGH INTEREST RATE DIFFERENTIALS WITH THE US**



Source: BBVA Research and CEIC

Under this circumstance, it is important to understand what was going on in the past year's BoP abnormalities and to predict this year's BoP items while investigating the sustainability of them. This report is an update of our last year's China Economic Watch: The impact of COVID-19 on China's Balance of Payments and foreign reserves: An update. Given that the situation changed dramatically compared with last February when the pandemic just started in China, we have to re-set the key assumptions for predicting China's Balance of Payments outlook for 2021.

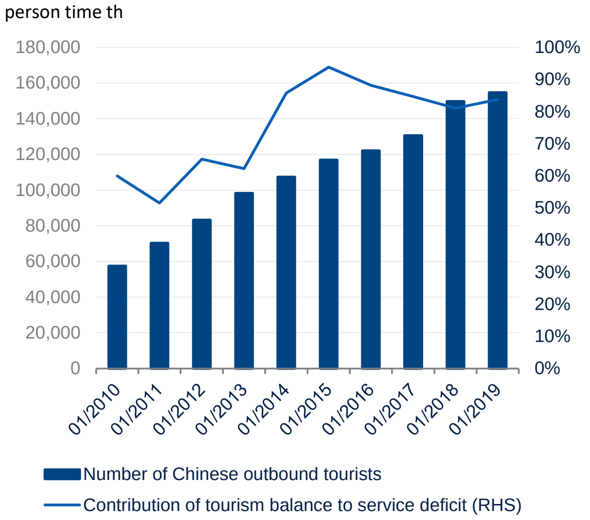
China's Balance of Payments (BOP) abnormalities in 2020 and how they will evolve in 2021

We examine and summarize how the different components of the BoP changed in 2020 qualitatively and quantitatively due to the Covid-19 pandemic outbreak. We then predict the 2021 BoP, based on China's "first-in-first-out" pattern of the pandemic and the unsynchronized economic recovery with other regions. Our main analysis and predictions are summarized below:

- **Current Account - Goods Trade:** China's "first-in-first-out" of the pandemic pointed to a continuing surge in exports since June 2020, as the supply-side substitution effect persists when most countries were still stumbling with the pandemic. After an unprecedented dip of exports to -40.6% in February, China's exports stunningly bounced back to 9% y/y in Q3 and 17% y/y in Q4 after the pandemic got fully controlled. For 2020 as a whole, exports growth increased by 3.6% while imports marginally dipped by -1.1% on average. Due to the low base effect of 2020, we estimate that the total exports will continue its momentum by a 10% growth in 2021, considering the global economy is still far from normalization. Meanwhile, imports growth is anticipated to snap back to 11% in 2021 amid domestic growth recovery. As a consequence, trade balance is estimated to increase to USD 546.7 billion in 2021 from USD 515 billion in 2020.
- **Current Account - Services Trade:** Over the past several years, China's gaping deficit of service trade was mainly driven by the boom of Chinese overseas travel. For instance, in 2019, the deficit of overseas travel accounted for 84% of total service sector deficit. (Figure 7) However, after the outbreak of COVID-19 in early 2020, many countries unveiled the lockdown and border control policies, which are unlikely to be relaxed in the short term before the vaccine coverage reaches a certain level. Thus, China's inbound tourism slumped by 61% in 2020 while outbound tourism dipped by 49%. Such a trend is set to continue through most time of this year. However, the progress in vaccine coverage in most advanced economies and the possible "travel bubbles" in the foreseeable future might support the international travel in the 2H of this year. According to the estimation of China Airline, China's inbound and outbound travel will recover to 47% of the pre-Covid level of 2019. As such, the deficit of China's international travel item is estimated to be narrowed to USD -102.8 billion in 2021 from USD -116.3 billion in 2020. Meanwhile, we assume that changes of the other service-trade items will move in tandem with that of goods trade. Thus, the deficit of service trade will narrow to USD -133.7 billion in 2021 from USD -145.3 billion of 2020.
- **Current Account - Primary and Secondary Income:** Investment income flow is the dominant item under Primary and Secondary Income. (Figure 8) In 2020, the COVID-19 outbreak led to subdued global economic activities which reduced China's entities' interest income earned abroad from USD 257.5 billion in 2019 to USD 224.4 billion in 2020. However, as China achieved a stunning economic recovery, the investment incomes of foreign entities in China actually increased to USD 331.5 billion from USD 300.8 billion in 2019. Thus, primary and secondary income deficit significantly shrank to USD -95.7 billion in 2020. Following this trend, we therefore forecast the deficit of primary and secondary income combined will shrink to USD -95.7 billion (the largest deficit reading over the past five years, equal to that of 2020) in 2021.

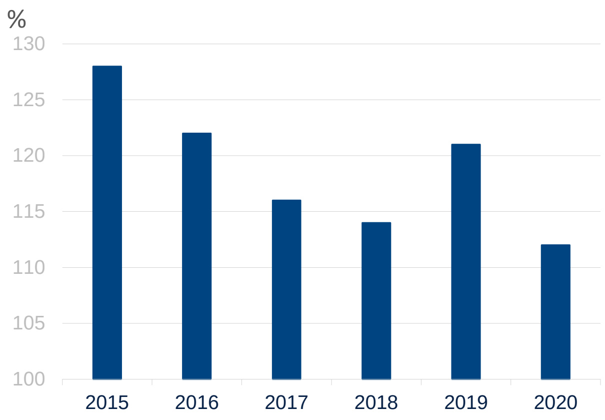
In sum, we predict that the current account surplus will further expand to USD 317.3 billion this year, around 2% of GDP, from USD 274 billion in 2020 (1.86% of GDP).

Figure 7. **THE CONTRIBUTION OF INTERNATIONAL TOURISM HAS BEEN DOMINANT IN SERVICE TRADE**



Source: CEIC and BBVA Research

Figure 8. **INVESTMENT INCOME FLOW'S CONTRIBUTES LARGEST TO PRIMARY AND SECONDARY INCOME OF BOP**



Source: CEIC and BBVA Research

- **Financial and Capital Account – Direct Investment:** The Covid-19 pandemic's impact on inward and outward FDI tends to be quite different in 2020. The re-invigoration of Chinese economy in the post-pandemic time significantly boosted foreign FDI inflows to China to USD 212.5 billion from USD 187.2 billion in 2019, a 13.4% increasing, which made China surpass the US and become the No. 1 FDI recipient country in 2020. On the other hand, Chinese outward FDI declined to USD 109.9 billion from USD 136.9 billion in 2019 due to the lingering COVID-19 pandemic in China's target countries, such as Latam, Europe and other ASEAN (19.7% decline). The global economic normalization progress in 2021 will prompt FDI activities, we therefore assume a 20% increasing of inward FDI in China and 20% increasing of outward FDI this year. Based on the assumptions, surplus under FDI item will increase to USD 123.1 billion in 2021 from USD 102.6 billion in 2020.
- **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 2020, the term of errors and omissions reached USD -168.1 billion, even larger than net inflow of USD -105.8 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. In 2020, the capital flow trend is quite mixing. On the one hand, due to effective containment of the COVID-19 in China, the country's risk assets have performed relatively well compared with assets in advanced economies. Moreover, 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 to be historical high to attract international capital inflows. Thus, security investment inflows reached USD 87.3 billion from USD 57.9 billion previously, a 50.8% increase. By contrast, the outflows under the items of "foreign currency and deposit" and "foreign loan" became much larger than that of 2019 to USD -53 billion and USD -163.6 billion respectively, leading to a large amount of capital outflow. This is most likely due to China's shrinking ODI in 2020. Altogether, the balance of capital and financial account finally reached USD -105.8 billion compared with USD 26.3 billion in 2020. Look ahead, capital outflow is anticipated to be even larger in 2021 when the advanced economies start to normalize its previous easing measures thus shrinking the interest rate differentials with China. The

recent US long-term bond yield indeed illustrates this concern. We predict a 20% expansion of capital outflows in 2021, reaching USD -275.4 billion.

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

Table 1. **HOW THE DIVERGING RECOVERY PATTERN BETWEEN CHINA AND THE OTHER REGIONS AFFECTS THE COMPONENTS OF BOP(BALANCE OF PAYMENTS) in 2021**

Componentes of BOP	Impact through 2021
Goods Trade	Positive, driven by continuous surge of exports
Services Trade	Positive, driven by shrinking deficit of international tourism item
Primary and Secondary Income	Negative, driven by declining investment interest in foreign countries and increasing of that in China
Direct Investment	Positive, by significant increase of FDI inflows into China
Portfolio Investment	Negative, driven by the potential US interest rate hike and monetary policy normalization which lead to capital outflows

Projecting foreign reserves change in 2021

Based on our above analysis of the BOP components in 2021, we are able to do a quantitative exercise of forecasting the change of foreign reserves in 2021. To estimate the change of foreign reserves, we adopt our foreign reserve decomposition model used in one of our previous report (see our China Economic Watch: China | The impact of Covid-19 on China's Balance of Payments and foreign reserves: An update):

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. The assumptions are based on the 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 46 billion in foreign reserves by the end of 2021, implying that foreign reserves at end-2021 reach USD 3285.5 billion, compared with USD 3216.5 at end-2020.

Table 2. **KEY ASSUMPTIONS OF THE COMPONENTS OF FOREIGN RESERVE IN 2021 BASED ON THE ANALYSIS IN SECTION 2**

	Assumptions
(1) Foreign reserve's currency valuation effect (negative)	We assume that USD index (DXY) will increase to 93 at end-2021 from 89.94 at end-2020, due to the FED's potential monetary policy normalization and the ongoing long-term bond yield hike. Thus, other currencies (GBP, JPY and EUR) which count for 30% of the foreign reserve currencies, will depreciate accordingly relative to USD. Altogether, foreign reserve will decrease by USD 31.78 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 10% while imports growth 11%; (ii) According to the estimation of China Airline, China's inbound and outbound travel will recover to 47% of the pre-Covid level. We assume that changes of all other items under service trade item will be at the same proportion as that of goods trade change. Under these assumptions, the deficit of service trade narrowed to USD -133.7 billion in 2021 from USD -145.3 billion; (iii) we forecast the deficit of primary and secondary income combined will shrink to USD -95.7 billion (the largest deficit reading over the past five years) in 2021. Altogether, we expect current account surplus will further expand to USD 317.3 billion this year.
(3) Net FDI (positive)	The global economic normalization in 2021 will prompt FDI activities; we therefore assume a 20% increasing of inward FDI in China and 20% increasing of outward FDI this year. Based on the assumptions, surplus under FDI item will increase to USD 123.1 billion in 2021 from USD 102.6 billion in 2020.
(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 -32.8 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 -16 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 2021 net RMB cross-border flow as historical average for the past three years which is USD -15.4 billion.
(6) Portfolio Flow (negative)	As the US will potentially hike the interest rate, together with the ongoing US long-term bond yield hike, there will be more capital outflows in 2021 compared with 2020. Thus, we predict portfolio outflow will increase to USD -275.4 billion, a 20% expansion of USD -229.5 billion in 2020.

Source: BBVA Research

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

(Unit: USD bn)	2018	2019	2020	2021(f)
1.Current account Balance	**49**	**141**	**274**	**317.3**
1.1 Goods trade	351	425	515	546.7
Goods exports	2,487	2,399	2,497.2	2746.9
Goods imports	2,136	1,974	1,982.2	2200.2
1.2 Service trade	-292	-261	-145.3	-133.7
1.3 Primary and Secondary income	-63	-28.9	-95.7	-95.7
2.Valuation effect	**100.1**	**-62.2**	**58.5**	**-31.78**
3.FX deposit position change for household and enterprise	**63.5**	**-30.2**	**-131.6**	**-32.8**
4.FX deposit position change for banks	**-76.0**	**13.5**	**14.56**	**-16**
5.Net RMB cross-border flow	**-22.7**	**-43.5**	**20**	**-15.4**
6.Net FDI flow	**107.0**	**58.1**	**102.6**	**123.1**
7.Portfolio flow	**-311.2**	**-23.4**	**-229.5**	**-275.4**

Conclusions

Based on our analysis in previous sections, we draw the conclusion that China's unsynchronized recovery from Covid-19 shock with other regions together with the US potential interest rate hike will have a mix impact on the Balance of Payments (BoP). In particular, the unsynchronized recovery will expand China's current account by increasing the goods trade surplus, narrowing the deficit in service trade and enlarging the primary and secondary income deficit; at the same time, the potential US interest rate hike and shrinking of interest rate differentials in 2021 will significantly increase China's capital and financial account's deficit. Based on our assumption and of BoP involvement in 2021, we also predict China's foreign reserve at end-2021. Our model yields a projected increase of USD 46 billion in foreign reserves by the end of 2021, implying that foreign reserves at end-2021 reach USD 3285.5 billion, compared with USD 3216.5 at end-2020.

Although the results indicate a healthy external balance, the authorities should still be aware of the fragility of this equilibrium based on weak global environment particularly the potential "taper tantrum" and domestic economic woes. That being said, the authorities should warily manage the capital account to guard against capital flight under the QE Tapering going forward. Meanwhile, the authorities need to take the chance to press ahead with financial reforms of domestic financial market. 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.

DISCLAIMER

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Any estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

With regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. Reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process is prohibited, except in cases where it is legally permitted or expressly authorised by BBVA.

ENQUIRIES TO:
BBVA Research: Azul Street. 4. La Vela Building – 4th and 5th floor. 28050 Madrid (Spain).
Tel. +34 91 374 60 00 y +34 91 537 70 00 / Fax (+34) 91 374 30 25
bbvaresearch@bbva.com www.bbvaresearch.com