Economic Watch

China | A reversion of Balance of Payments situation: from pandemic to post-pandemic era

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A significant reversion of China's Balance of Payments (BoP) situation in 2023 from Covid-19 pandemic era

During the 2020-2022 Covid-19 pandemic time, amid the unprecedented economic blow and dim outlook of global economy, Chinese economy was firing on all cylinders after fully controlling the pandemic since May 2020. The unsynchronized business cycle with the other economies in the world during the pandemic time has led to a strong Balance of Payments, featuring in extraordinarily strong exports, current account balance, portfolio inflows and FDI inflows, together with a significant shrink of service trade deficit.

However, as Chinese authorities lifted Covid-19 lockdown and opened its economy at the beginning of 2023, the Balance of Payments situation has reversed significantly in the past year in 2023 compared with the Covid-19 pandemic time. The reversion situation not only displayed in current account such as negative growth of exports, but also in capital account, namely the dipping portfolio inflows and FDI etc.

Specifically, chief among these BoP reversions include:

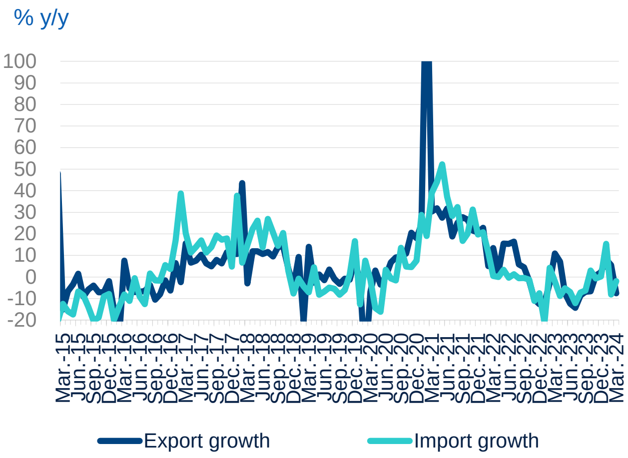
(i) Exports sharply decelerated in 2023 from the Covid-19 pandemic period, leading to a shrinking trade balance; (Figure 1)

(ii) Current account surplus also declined dramatically due to a combination of a shrinking trade balance and a significant increase of service trade deficit as outbound tourism bounced back from almost zero in Covid-19 period; (Figure 2)

(iii) FDI inflows into China also reversed its pattern from historical peak in 2020 to negative growth in 2023, due to the large reversion of China-US policy rate as the FED hiked the rate to historical high while the PBoC conservatively cut the rate to stimulate growth. (Figure 3 and 4) (See our recent Economic Watch: China | Should we worry about falling FDI?)

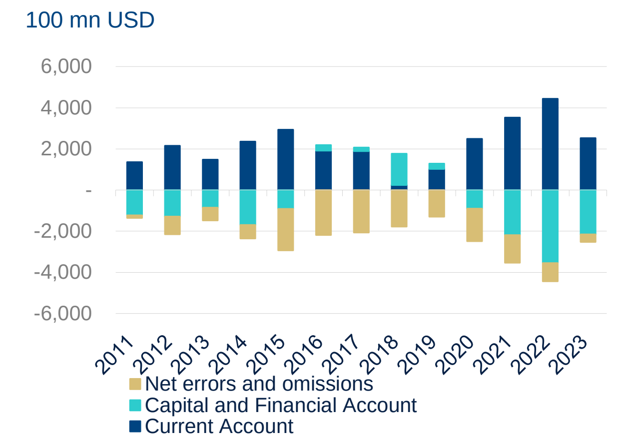
(iv) Portfolio inflows also became negative in 2023, due to the dim outlook of Chinese economy, housing market crash, lackluster performance of China's stock and bond market as well as RMB exchange rate depreciation.

Figure 1. **CHINA'S EXPORTS DIPPED SIGNIFICANTLY IN 2023 FROM THE PANDEMIC TIME**



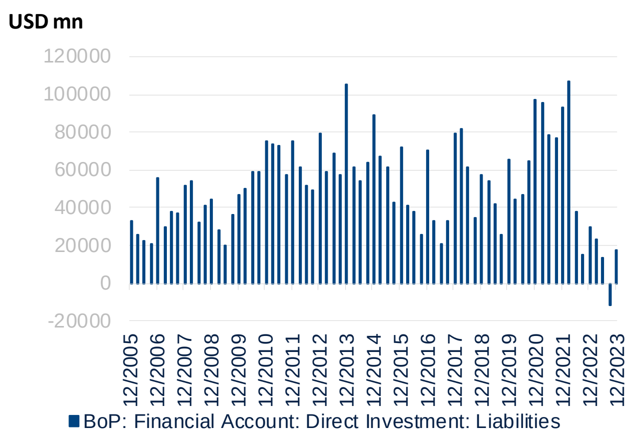
Source: CEIC and BBVA Research

Figure 2. **A LOWER TRADE BALANCE WITH LARGER SERVICE TRADE DEFICIT LEADS TO A SHRINKING CURRENT ACCOUNT SURPLUS IN 2023**



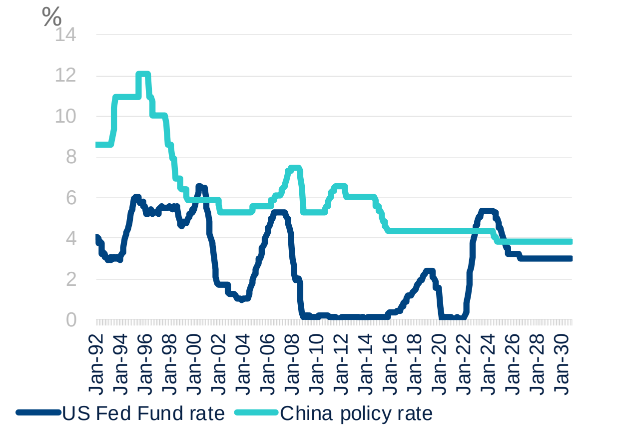
Source: BBVA Research and CEIC

Figure 3. **CHINA'S FDI INFLOWS DROPPED TO HISTORICAL LOW IN 2023…**



Source: CEIC and BBVA Research

Figure 4. …**DUE TO THE REVERSION OF CHINA-US POLICY RATE**



Source: BBVA Research and CEIC

Under this circumstance, it is important to understand what was going on in the past year's BoP reversion and to predict this year's BoP items in 2024. This report is an update of our previous annual BoP Outlook: Economic Watch: China | 2021 outlook of external balance: will China's BoP normalization come soon? Given that the post-pandemic situation changed dramatically compared with the situation in the Covid-19 pandemic period, we have to re-set the key assumptions for predicting China's Balance of Payments outlook for 2024.

A deeper dive of BoP components: understanding China's Balance of Payments (BOP) reversion in 2023 and predictions for 2024

We examine and summarize how the different components of the BoP changed in 2023 qualitatively and quantitatively in the aftermath of Covid-19 pandemic time. We then predict the 2024 BoP, based on our understanding of the evolvement of China's current and capital account components in the post-pandemic era.

Our main analysis and predictions are summarized below:

- **Current Account - Goods Trade:** During the pandemic time, China's "first-in-first-out" of the pandemic pointed to a surge in exports since June 2020 till end-2022, as the supply-side substitution effect persisted when most countries were still stumbling with the pandemic. During 2021 to 2023, China's exports growth increased by 5.2% y/y, 28% y/y and 4.1% y/y respectively. However, the strong exports momentum faded and reversed after Chinese authorities lifted the zero-Covid policy at end-2022 amid global economic normalization from the pandemic. In 2023, exports growth significantly dropped to -5% y/y together with global economic slowdown thus weak external demand from other economies.

  Regarding 2024, we estimate that the total exports will expand by 3% growth, due to the low base effect in 2023. Meanwhile, imports growth is anticipated to modestely expand at 2.8% in 2024 amid domestic growth recovery (in line with Bloomberg consensus). As a consequence, trade balance is estimated to increase to USD 616.9 billion in 2024 from USD 593.9 billion in 2023.

- **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, which accounts for more than 60% of service trade deficit. For instance, in 2019, the deficit of overseas travel accounted for 84% of total service sector deficit. (Figure 5) However, after the outbreak of COVID-19 in 2020, China and many other countries unveiled the lockdown and border control policies, thus China's inbound tourism slumped by 61% in 2020 while outbound tourism dipped by 49%. Such a trend persisted during most time of the pandemic.

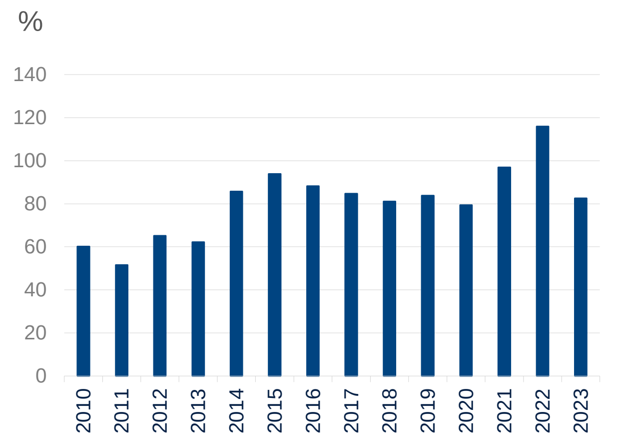
  By contrast, the Covid-19 restriction lift-off and the normalization of people movement since the beginning of 2023 makes the international travel boom again, although the progress has been gradual. Meanwhile, we assume that changes of the other service-trade items will move in tandem with that of goods trade. As such, the deficit of China's service sector is estimated to expand to USD -261 billion in 2024 (similar level as of 2019 pre-pandemic time) from USD -206.8 billion in 2023.

- **Current Account - Primary and Secondary Income:** In the past years, investment income flow is the dominant item under Primary and Secondary Income, compared with other items under this category. (Figure 6) 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. On the other hand, as China achieved a stunning economic recovery during Covid-19, the investment incomes of foreign entities in China increased to USD 331.5 billion from USD 300.8 billion in 2019. Thus, considering other items under this category altogether, primary and secondary income deficit significantly shrank to USD -95.7 billion in 2020.

- By sharp contrast, in the post-pandemic time, this trend also reversed in 2023. For instance, China's entities' interest income earned abroad shrank to USD 212.8 billion in 2023 from USD 245.7 billion in 2022, while foreign entities's investment incoms in China also significantly shrank to USD 371.8 billion from USD 371.8 billion compared with pandemic time. Following this new trend, we therefore forecast the deficit of primary and secondary income combined will maintain at the 2023 level of USD -133.1 billion in 2024, representing the reversed trend of the investment income flows in the aftermath of Covid-19 pandemic.

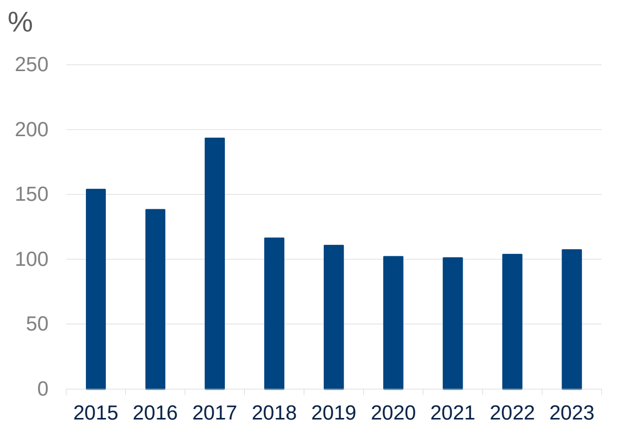
In sum, we predict that the current account surplus will further shrink to USD 222.8 billion in 2024, around 1.2% of GDP, from USD 253 billion in 2023 (1.4% of GDP).

Figure 5. **THE CONTRIBUTION OF OVERSEAS TOURISM HAS BEEN DOMINANT IN SERVICE TRADE CATEGORY IN BOP**



Source: CEIC and BBVA Research

Figure 6. **INVESTMENT INCOME FLOW'S CONTRIBUTES LARGEST TO PRIMARY AND SECONDARY INCOME OF BOP**



Source: CEIC and BBVA Research

- **Financial and Capital Account – Direct Investment (FDI):** The Covid-19 pandemic's impact on inward and outward FDI was different in 2020. The re-invigoration of Chinese economy in the 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).

  By sharp contrast, FDI situation was completely reversed in 2023 in the aftermath of Covid-19 pandemic. Due to Chinese authorities' regulation storms on several sectors in 2021, the nearshoring and offshoring which means supply-chain relocation outside of China amid rising geopolitical issues, together with dim outlook of Chinese economy in the post-pandemic time, China's FDI inflows dropped to historica low in 2023. For some months, FDI net inflows even dipped to negative figures, raising global concerns. (see our recent Economic Watch: China | Should we worry about the falling FDI?) At the same time, Chinese authorities and enterprises also slowed their pace of ODI during the post-pandemic time.

  Based on this new trend, deficit under FDI item is anticipated to marginally improve to USD -120 billion in 2024 together with economic stabilization in 2024, from USD -142.6 billion in 2023 which recorded historical low.

- **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.

  During the pandemic time, the capital flow trend was 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 went historical high to attract capital inflows. Thus, security investment inflows reached USD 87.3 billion from

USD 57.9 billion previously, a 50.8% increase in 2020. 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.

By contrast, the portfolio situation in the aftermath of pandemic in 2023 also significantly reversed. For instance, capital outflows reached USD -77.3 billion in 2023 while inflows turned to USD 14.1 billion, making portfolio balance shrank to USD -63.2 billion in 2023. Look forward to 2024, capital outflow is anticipated to be even larger in 2023 due to the persisting China-US policy rate inverse and the US FED's "higher for longer" interest rate. We predict a 20% expansion of capital outflows in 2024, reaching USD -92.76 billion while inflows continued its drop to USD 11.3 billion (20% shrinking), leading to portfolio balance deficit further expand to USD -81.46 billion. Together with errors and omissions we assume to follow 2023, the total portfolio Flow including errors and omissions will be USD -119 billion.

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

Table 1. **A QUALITATIVE SUMMARY OF BALANCE OF PAYMENTS COMPONENTS FORECAST IN 2024**

Componentes of BOP	Qualitative assessment of 2024 outlook
Goods Trade	Negative, driven by global economic slowdown and weak external demand
Services Trade	Negative, driven by expansionary outward international tourism item, thus expanding service trade deficit
Primary and Secondary Income	Ambiguous, driven by declining in both investment interests in foreign countries and in China
Direct Investment	Negative, driven by significant decline of FDI inflows into China due to nearshoring, supply chain moving outside of China amid rising geopolitics
Portfolio Investment	Negative, driven by the persistence of the reversion of China-US policy rate and FED's "higher for longer" rate

Projecting foreign reserves change in 2024

Based on our above analysis of the BOP components in 2024, we are able to do a quantitative exercise of forecasting the change of foreign reserves in 2024. To estimate the change of foreign reserves, we adopt our foreign reserve decomposition model used in one of our previous report (see our Economic Watch: China | 2021 outlook of external balance: will China's BoP normalization come soon?):

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 decrease of USD 99.16 billion in foreign reserves by the end of 2024, implying that foreign reserves at end-2024 will decline to USD 3,140.84 billion, compared with USD 3,240 billion at end-2023.

Table 2. **KEY ASSUMPTIONS OF THE COMPONENTS OF FOREIGN RESERVE IN 2024 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 105 at end-2024 from 101.4 at end-2023, due to the FED's "higher for longer" rate policy and delayed interest rate cut. Thus, other currencies (GBP, JPY and EUR) which count for 30% of China's foreign reserve currencies (total: USD 3220 billion at beginning of 2024), will depreciate accordingly by 3.5% relative to USD. Altogether, foreign reserve will decrease by USD 33.8 billion by currency valuation effect.
(2) Current account balance (negative)	We first decompose current account into goods trade, service trade, primary and secondary income (combined). (i) Exports growth is predicted to be 3% while imports growth 2.8%; (ii) 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 expanded to USD -261 billion in 2024 from USD -207.8 billion in 2023; (iii) we forecast the deficit of primary and secondary income combined will maintain the same level as of 2023 at USD -133.1 in 2024. Altogether, we expect current account surplus will shrink to USD 222.8 billion this year (1.2% of total GDP).
(3) Net FDI (negative)	We assume a 20% shrink of inward FDI in China and 20% decline of outward FDI this year. Based on the assumptions, deficit under FDI item will marginally increase to USD -120 billion in 2024 from USD -142.6 billion in 2023.
(4) Domestic FX holding change (neutral)	FX deposit change by household and enterprises: we assume 2024 household and enterprises will change their FX deposit as the historical average for the past three years before pandemic time, 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 three years before the pandemic time, which is USD -16 billion.
(5) Net RMB cross-border flow (neutral)	Similar to item (4), we predict the 2024 net RMB cross-border flow as historical average for the past three years which is USD -15.4 billion.
(6) Portfolio Flow combined with errors and omissions term (negative)	As the US FED "higher for longer" and the China-US rate reversion persist, we predict a 20% expansion of capital outflows in 2024, reaching USD 92.76 billion while inflows continued its drop to USD 11.3 billion (20% shrinking), leading to portfolio balance further shrink to -USD 81.46 billion. Together with errors and omissions we assume to follow 2023, the total portfolio Flow including errors and omissions Will be USD -119 billion.

Source: BBVA Research

Table 3. **FORECASTING THE COMPONENTS OF FOREIGN RESERVE FORECASTING MODEL IN 2024**

(Unit: USD bn)	**2021**	**2022**	**2023**	**2024f**
1.Current account Balance	**352.9**	**443.4**	**253**	**222.8**
1.1 Goods trade	562.7	665	593.9	616.9
Goods exports	3215.8	3346.8	3179.2	3274.6
Goods imports	-2653.1	-2681.8	-2585.3	2657.7
1.2 Service trade	-101.2	-87.4	-207.8	-261
1.3 Primary and Secondary income	-108.6	-134.2	-133.1	-133.1
2.Valuation effect	**-34.1**	**-78.77**	**22.93**	**-33.8**
3.FX deposit position change for household and enterprise	**255.8**	**720.9**	**-82.7**	**-32.8**
4.FX deposit position change for banks	**-34.1**	**-28.9**	**-68.9**	**-16**
5.Net RMB cross-border flow	**-15**	**8.7**	**-10.2**	**-15.4**
6.Net FDI flow	**165.3**	**-19.8**	**-142.6**	**-120**
7.Portfolio flow	**-83.1**	**-378.4**	**-101.2**	**-119**

Conclusions

Based on our analysis in the above sections, we draw the conclusion that the favourable factors on China's BoP during the Covid-19 pandemic time have significantly reversed after the pandemic time in the past year in 2023. Several factors in the aftermath of Covid-19 pandemic such as China's economic growth slowdown, supply chain relocation outside of China, weak external demand as well as US-China reversed policy rate continue to have a negative impact on the Balance of Payments (BoP) in 2024, particularly on the items of current account, portforlio flows, net FDI flows etc.

Based on our assumption and of BoP involvement in 2024, we also predict China's foreign reserve at end-2024. The model yields a projected decrease of USD 99.16 billion in foreign reserves by the end of 2024, implying that foreign reserves at end-2024 will decline to USD 3,140.84 billion, compared with USD 3,240 billion at end-2023.That means, the above negative factors on Balance of Payments in 2024 also lead to a slowdown in China's foreign reserve.

Although the results indicate a still healthy external balance, the authorities should still be aware of the fragility of this equilibrium based on weak global environment particularly the interest rate cut process in the US and its spillover effects to China, as well as the domestic economic woes, such as growth slowdown, supply side overcapacity, local government and SOE debt overhang and housing market crash.

That being said, the authorities should warily manage the capital account to guard against capital flight given the historically peak of China-US interest rate reversion 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 should take efforts to stimulate growth in a bid to make domestic equity and bond markets more attractive to international investors. After all, foreign holdings of Chinese bond and stock market are only around 4-5% of total market value, implying a lot of room for capital inflows to achieve a more balanced structure in China's capital account.

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