Economic Watch

The impact of COVID-19 outbreak on China's External Balance

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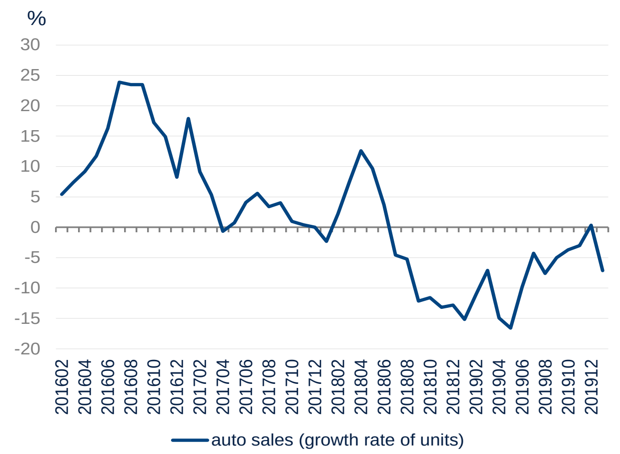
The outbreak of COVID-19 takes its toll on China's economy…

The outbreak of COVID-19, due to its fast spread and high death toll, has already been labelled by World Health Organization (WHO) as a Public Health Emergency of International Concern (PHEIC). By February 21st 2020, the infectious disease has led to around 75,000 infected cases and 2,000 deaths in China and spread to more than 25 countries around the world. To contain the spread of the disease, China's authorities locked down several big cities in Hubei province, including its capital Wuhan with a population of more than 11 million. Even outside Hubei province, the authorities have taken great pains to ensure that people avoid unnecessary contact with each other to reduce the infection chance.

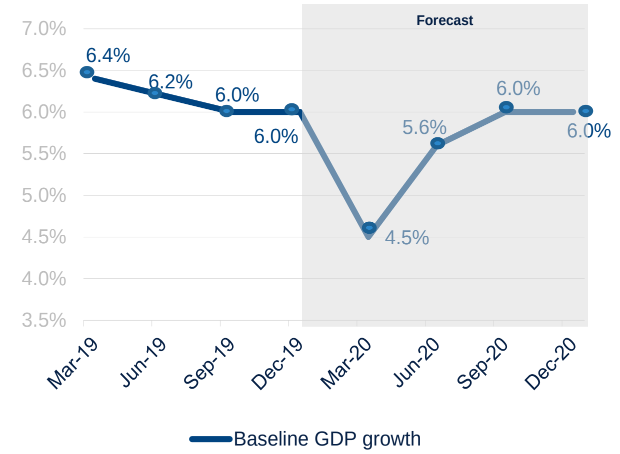
The measures implemented to contain COVID-19 infection, together with the panic caused by the virus, have substantially dampened the economic activities nationwide. Certain high frequency data pointed to a steep slowdown in a number of sectors such as travel, tourism, restaurant, entertainment and even auto sales. (Figure 1) Meanwhile, employees started to come to work since mid-February from the prolonged Chinese New Year (CNY) holidays. The impact of COVID-19 on the manufacturing sector is set to fade away. More importantly, the authorities pledged to meet their unannounced growth target for 2020 even with the disruption of COVID-19. Such a commitment implies more pro-growth measures down the road.

Figure 1. **AUTO SALES GROWTH DIPPED TO -7.12% Y/Y IN JANUARY 2020**



Source: CEIC and BBVA Research

Figure 2. **WE REVISED OUR BBVA FORECAST FOR CHINESE GDP IN 2020 FROM 5.8% TO 5.5%**



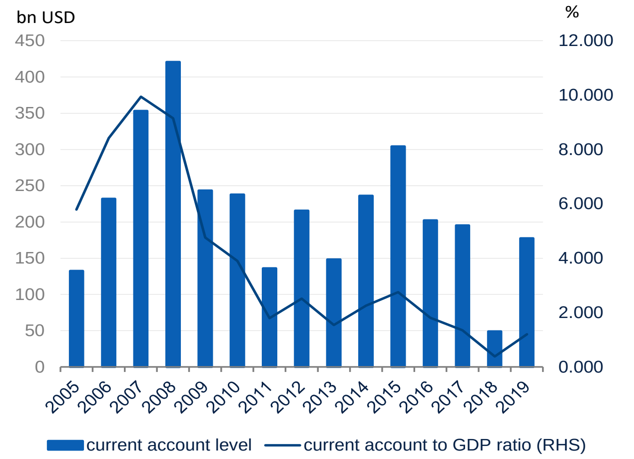
Source: BBVA Research and CEIC

On balance, the development of COVID-19 is still consistent with our baseline growth projection made at the outset of the COVID-19 outbreak. We envisage that the adverse shock of COVID-19 to China's economy is a short-term one. The economy, with the government's existing and to-be-implemented pro-growth initiatives, will bounce back rapidly after the virus infection is fully contained, most likely in April-May. Under our baseline scenario, 2020 growth rate will slow to 5.5% from 6.2% in 2019. (Figure 2)

… while its impact on Balance of Payments (BOP) is mixed and limited

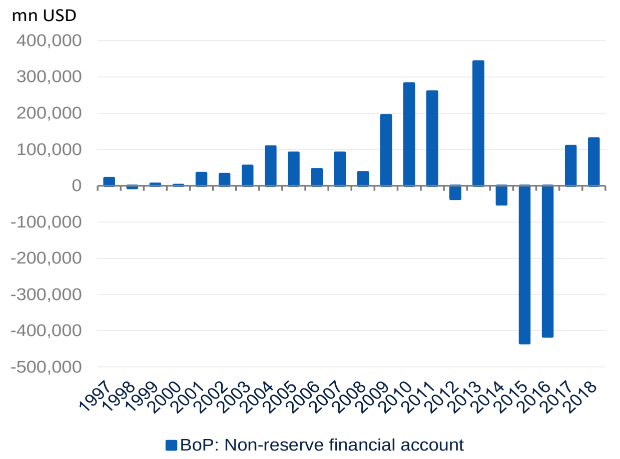
A couple of profound changes have happened to China's Balance of Payments (BOP) since 2015. First, the current account surplus, measured as its percentage of GDP, persistently declined to around 1% in 2018-2019 from around 3% in 2015. Second, the balance of financial and capital account (including the item of error and omission which is believed to a chunk of disguised capital outflows) oscillated between surplus and deficit. (Figure 3 and 4)

Figure 3. **CURRENT ACCOUNT TO GDP RATIO HAS SHRANK SIGNIFICANTLY AFTER ITS PEAK IN 2007**



Source: CEIC and BBVA Research

Figure 4. **CAPITAL ACCOUNT HAS OSCILLATED BETWEEN SURPLUS AND DEFICIT**



Source: CEIC and BBVA Research

In analyzing the knock-on effects of the COVID-19 outbreak on China's BOP, we differentiate the short-term effects from long-term ones. In our baseline scenario, we predict that the virus will become under control by the end of May. Accordingly, the short term in our analysis refers to the period of March-May. Meanwhile, the long term refers to the full year of 2020.

We examine how the COVID-19 outbreak affects different components of the BOP. Our preliminary and qualitative analysis show that the epidemic tends to expand the surplus (defined as positive) under the current account (defined as positive) while deepen the deficit under the financial and capital account.

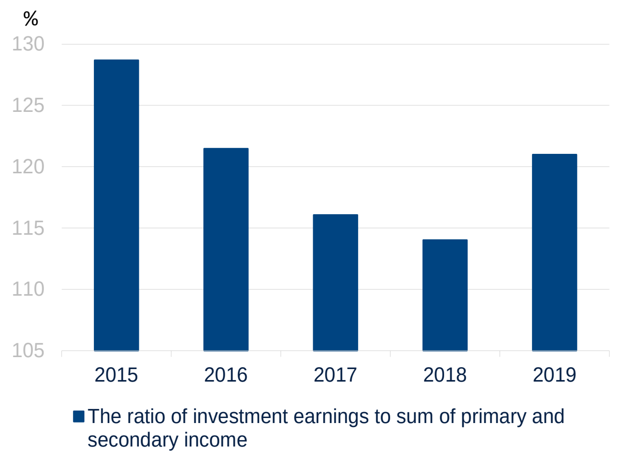
- **Current Account - Goods Trade:** China's goods exports to have a quicker rebound than imports over the short term. Now the authorities have started to push enterprises back to operation after the growth of infected cases slowed in the past week. In our baseline scenario, more than 80% of manufacturing enterprises will resume production outside Hubei Province. Accordingly, China's goods exports can come back to the normal level soon. In contrast, consumption activities such as shopping and entertainment are still suppressed by the threat of virus contagion, which is to hold back the recovery of demand for imported goods. As such, the disparate recovery rates of production and consumption will make goods exports outperform the imports in the short run. The performance of goods imports will catch up in the second half of the year as the economy gains traction. The impact of COVID-19 outbreak on the balance of goods trade is expected to be neutral for 2020 as a whole.

- **Current Account - Services Trade:** Over the past few years, China's gaping deficit of services trade was mainly driven by the boom of Chinese overseas travel. (Figure 5) After the outbreak of COVID-19, Chinese demand for international travel drops substantially because people prefer to stay home over the concern of the virus infection. Several countries and regions banned the international travel from China in a bid to contain the virus transmission, such as the US, Singapore, Taiwan, Korea etc. Moreover, the recovery of tourism and business travel is likely to be slower than goods exports. We therefore believe the epidemic tends to narrow the deficit of travel in both short and long run.
- **Current Account - Primary and Secondary Income:** Investment income flow is the dominant item under Primary and Secondary Income. (Figure 6) In theory, the COVID-19 outbreak could affect it in both ways. Subdued economic activities will reduce the investment return of foreign entities in China, making them unable to remit more profits to their home countries. Meanwhile, if the COVID-19 outbreak makes those foreign investors panic and decide to reduce their exposure to China, they might accelerate to move their previously retained profits out of China to minimize risk exposure. In our baseline scenario, we consider the epidemic as a temporary event. Therefore, we believe that it will reduce the net outflow of investment income in both short and long run.

Figure 5. **THE CONTRIBUTION OF TOURISM TO SERVICE TRADE DEFICIT HAS BEEN INCREASING**

Source: CEIC and BBVA Research

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



Source: CEIC and BBVA Research

- **Financial and Capital Account – Direct Investment:** The effects of COVID-19 outbreak on FDI are two-folded. The limit of cross-border business travel is likely to hold up the progress of investment projects. More importantly, it will take a longer time for foreign investors to regain their confidence in China's economy, which could lead to a slower recovery of inward FDI compared to China's outward FDI (ODI). As a result, the epidemic tends to have negative impact on Direct Investment in both short and long run.

- **Financial and Capital Account – Portfolio Investment:** Although the COVID-19 outbreak has its negative impact on investors' sentiment, it might not hamper foreign investors' participation in China's domestic financial market. Indeed, China's authorities have been actively pushing forward the opening of its domestic equity and bond markets as complementary measures to increase international use of the RMB. The recently high-frequency data of Shanghai- Hong Kong Stock Connect program shows that international investors accelerate to acquire Chinese listed stocks when the COVID-19 outbreak resulted in a deep market correction.

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

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

Components of BOP	Impact during March-May	Impact through 2020
Goods Trade	Positive	Neutral
Services Trade	Positive	Positive
Primary and Secondary Income	Slightly Positive	Slightly positive
Direct Investment	Negative	Negative
Portfolio Investment	Neutral	Neutral

Projecting foreign reserves change in 2020

Here we do a quantitative exercise of forecasting the change of foreign reserves in 2020, based on our above analysis of the BOP shock exerted by the COVID-19 contagion. 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 summarized in Table 3.

Table 2. **KEY ASSUMPTIONS OF THE COMPONENTS OF FOREIGN RESERVE IN 2020 BASED ON THE ANALYSIS IN SECTION 2 AND TABLE 1**

	Assumptions
(1) Foreign reserve's currency valuation effect (neutral)	We assume that USD index (DXY) will be the historical high for the past three years which is 99.6. 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 0.04 billion by currency valuation effect.
(2) Current account balance (positive) (see Table 3 in detail)	We first decompose current account into goods trade, service trade, primary and secondary income (combined). (i) Exports growth is predicted to be 4% while imports growth 3%; (ii) Service trade is predicted as the historical high for past three years; (iii) Primary and Secondary income predicted as historical high in past three years. Altogether, the 2020 current account balance will be USD 208 billion. (see Table 3 in detail).
(3) Net FDI (negative)	We expect 2020 net FDI to be the historical low in the past three years, which will be USD 27.8 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 (neutral)	Similar to item (4), given that COVID-19's impact on portfolio flow is neutral, we predict the 2020 portfolio flow to be historical average of the past three years, which is USD -192.8 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**	**178**	**208**
1.1 Goods trade	419	351	463	489
Goods exports	2,263	2,487	2,430	2,515
Goods imports	1,844	2,136	1,967	2,026
1.2 Service trade	-259	-292	-262	-259
1.3 Primary and Secondary income	-22	-54	-24	-22
2.Valuation effect	**0.00**	**0.11**	**-0.06**	**-0.04**
3.FX deposit position change for household an enterprise	**-28.14**	**72.98**	**5.42**	**16.75**
4.FX deposit position change for banks	**-26.00**	**-76.00**	**13.45**	**-29.52**
5.Net RMB cross-border flow	**42.93**	**-22.69**	**-43.50**	**-7.75**
6.Net FDI flow	**27.79**	**107.02**	**67.41**	**27.80**
7.Portfolio flow	**-308.28**	**-201.18**	**-68.94**	**-192.80**

Altogether, based on the above analysis and forecasts, the foreign reserve change, according to our decomposition formula, will be increasing USD 22.45 billion in 2020. That means, the end-2020 foreign reserve will reach USD 3130.37 billion.

Policy implications

Our results show that the impact of COVID-19 on China, although very large on Q1 and Q2 economic growth, will be limited on China's Balance of Payments, especially the foreign reserve. This is because the COVID-19, although will have a large negative impact on net FDI flow, will on the other hand shrink the service trade deficit significantly (especially the tourism abroad). In addition, although the COVID-19 will influence the exports and imports items, its impact is temporary in Q1 and Q2 and it will eventually bottom out in 2H 2020. Moreover, its impact on portfolio flow is mixed.

However, the authorities still need to carefully manage the capital account considering the market sentiments and capital flight. The previous measures on regulating capital outflow should be continuing to implement, such as the capital control measures etc. On the other hand, according to the ongoing financial liberalization plans, the authorities need to further open up the capital account to attract more capital inflows on stock and bond market.

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