CHINA

FURTHER TURMOIL

The sudden and ill-prepared abandonment of the zero-Covid policy at the start of December 2022 has plunged China into further turbulence. The large epidemic wave has hindered production in the manufacturing sector and again delayed the recovery in private consumption and activity in the services sector. However, assuming that the pandemic starts to ease off in February 2023, domestic demand should finally rebound, helped by additional monetary and fiscal support measures. On the other hand, exports are likely to remain affected by the weakness in global demand. While the current account surplus should narrow in 2023, how capital flows will develop is more uncertain.

AN ABRUPT CHANGE IN COVID-19 POLICY

The recovery in economic activity following the lockdown period in spring 2022 has been fragile and uneven, and was interrupted in the last quarter of the year. Exports of goods and industrial growth, the main drivers of Chinese growth since 2020, have slowed down considerably in recent months. Exports (in value terms) contracted by -6.6% year-on-year (y/y) in Q4 2022, after an increase of +10.1% in Q3; and growth in industrial production (in real terms) slowed to +2.8% y/y in Q4 2022, after having picked up to +4.8% in Q3.

The manufacturing sector (and the electronics sector in particular) firstly adjusted its production in response to the rapid deterioration in export performance. In addition, the effect of tax incentives to buy cars abated, which led to a slowdown in car production. Finally, factories experienced significant disruption due to the Covid-19 pandemic. Until the beginning of December, this disruption resulted from the mobility restrictions imposed in various regions as part of the zero-Covid policy. Since December 7th, the very sudden and ill-prepared abandonment of this strict policy has plunged the country into further turbulence.

Most health restrictions were abruptly lifted, and these changes have caused a spike in the number of Covid-19 cases – not least because of the overly low levels of vaccination rates in the population and in older people in particular. The authorities have stopped the publication of data, but the various surveys and the overwhelmed hospitals have revealed the extent of the pandemic wave. The negative consequences for activity have been significant, with effects on production as a result of absenteeism in the workforce and effects on demand linked to the number of people falling ill and the fears of the Chinese given the risk of infection.

Activity in the services sector and consumer spending are therefore expected to need further time to recover. They remained depressed throughout 2022 in the face of strong headwinds, which may not ease rapidly over the very short term: constraints linked to the pandemic, a serious crisis in the property sector, deteriorating conditions in the labour market (the urban unemployment rate rose again in Q4 2022, reaching 5.6%), a slowdown in disposable income growth, and a significant confidence crisis among enterprises and households. The consumer confidence index, published by the National Bureau of Statistics, collapsed from 120 at the beginning of 2022 to 87 in the spring, reaching record lows, and has not recovered since then. In Q4 2022, services production fell by -0.9% y/y and retail sales volumes by -4% (vs. around +1% in Q3 2022).

MODERATE PICK-UP IN ECONOMIC GROWTH IN 2023

After a turbulent period, which could last until after the Chinese New Year in late January, activity driven by domestic demand should rebound and the easing of the pandemic is likely to be accompanied by a catch-up effect (this scenario assumes that vaccine coverage is expanded rapidly and that the consequences of the pandemic on the medical system are not out of control, forcing certain regions to reintroduce restrictions). In particular, households could use some of the extra savings accumulated during the pandemic. It is estimated that the household savings rate rose from 35% of disposable income in 2019 to 38% in 2020, before falling back to around 36% in 2021, and it is likely to have increased slightly again in 2022.

To encourage recovery, the authorities are considering a further strengthening of fiscal and monetary support policies. Their statements made at the end of the Central Economic Work Conference in mid-December announced measures to support private consumption and new measures in the property sector.

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth, %	2.2	8.4	3.0	5.1	5.3
Inflation, CPI, year average, %	2.5	0.9	2.0	2.7	2.5
Official budget balance / GDP, %	-3.7	-3.1	-2.8	-3.2	-3.2
Official general government debt / GDP, %	45.9	46.9	50.7	53.2	54.5
Current account balance / GDP, %	1.7	1.8	2.4	2.0	1.5
External debt / GDP, %	16.3	15.4	15.6	15.5	15.1
Forex reserves, USD bn	3 217	3 250	3 128	3 050	3 040
Forex reserves, in months of imports	16.2	12.6	11.8	11.1	10.1

TABLE 1 e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CHINA: WEAK FOURTH QUARTER OF 2022

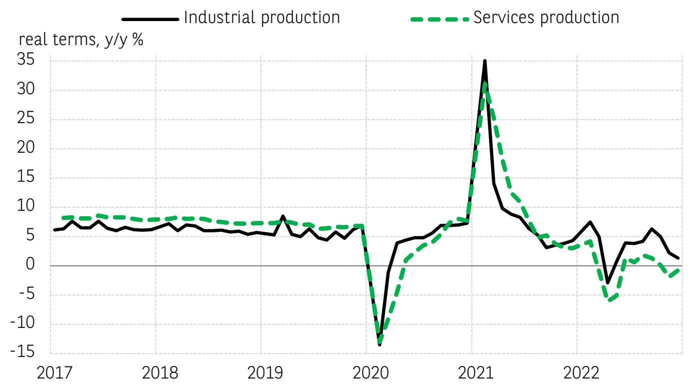

CHART 1 SOURCE: NBS, BNP PARIBAS

The objective of the authorities is to provide more short-term financing to the healthiest developers in order to mitigate credit risks in the financial sector and help them complete unfinished construction projects, as well as to boost household demand for housing (property sales volumes fell by another 32% y/y in December). With these support measures, and assuming that the health situation improves, the property sector should, at best, stabilise over the course of 2023.

The difficulties in the export sector are expected to persist over the short term because of weaker global demand. The slowdown in exports, coupled with a recovery in imports, should limit the recovery in real GDP growth expected in 2023. In addition, the trade and current account surpluses, which increased in 2022, are expected to narrow. The dynamics of capital flows are much more uncertain in the short term, which complicates forecasts about the yuan's exchange rate.

YUAN UNDER PRESSURE

The yuan depreciated rapidly in 2022 after more than 18 months of appreciation. It lost 11% of its value against the US dollar over the first eleven months of the year, and then regained 3% in December. The weakening of the yuan was firstly linked to the general strengthening of the dollar which has accompanied US monetary tightening since March. The depreciation of the yuan in nominal effective terms has in fact been much more moderate: the CFETS index (calculated by the China Foreign Exchange Trade System based on a basket of 24 currencies) fell by 5% over the first eleven months of 2022 before strengthening slightly in December. However, the weakening of the yuan was also the result of internal factors and dynamics in the balance of payments.

The current account surplus continued to increase in 2022, reaching USD 310 bn over the first three quarters (or +2.4% of GDP, compared with +1.8% in 2021), but the other components of the balance of payments deteriorated. Therefore, the sum of the balances of the financial account, the capital account and errors and omissions reached -1.9% of GDP over the first three quarters of 2022, compared to -0.7% in 2021. While US interest rates rose rapidly in 2022, China instead relaxed its monetary policy (moderately) in order to stimulate domestic demand, in the absence of strong inflationary pressures. The spreads between US and Chinese interest rates therefore reversed and widened sharply, which has significantly changed international financing conditions and capital flow determinants.

Against this backdrop, China has recorded large capital outflows, in particular due to interest rate arbitrage transactions. According to the balance-of-payments data, net portfolio investment outflows reached a record USD 261 bn over the first three quarters of 2022 (-2% of GDP). They resulted from an increase in net portfolio outflows from residents (whose net portfolio flows are structurally negative) and from significant net sales of Chinese securities (mainly bonds) by non-residents (whose net portfolio flows were negative over the first three quarters of 2022 for the first time since 2015, representing -0.8% of GDP). In addition, net direct investment (DI) flows remained positive but recorded a significant reduction. On the other hand, net outflows related to debt and other investments declined (in part thanks to the decrease in Chinese credit abroad). The risk of a massive capital flight is in fact contained by the existence of controls, which have been strengthened since 2015 and are notably aimed at limiting resident outflows.

Chinese enterprises that are most fragile and most dependent on foreign credit (especially property developers) have experienced difficulties because of the deterioration in international financing conditions. But the impact on China's overall capacity to cover its external financing needs is very limited. Indeed, despite the gradual opening up to foreign investors, China continues to have a low level of dependence on external financing. Its basic balance (current account balance and net DI flow) is structurally positive, its external debt is low (15% of GDP) and the participation of foreign investors in its financial markets continues to be modest despite its increase until 2021 (they accounted for 3% of the total stock of local bonds at the end of 2021 – but 11% of government bond stocks – and less than 5% of market capitalisation).

CHINA: DIVERGING INTEREST RATES

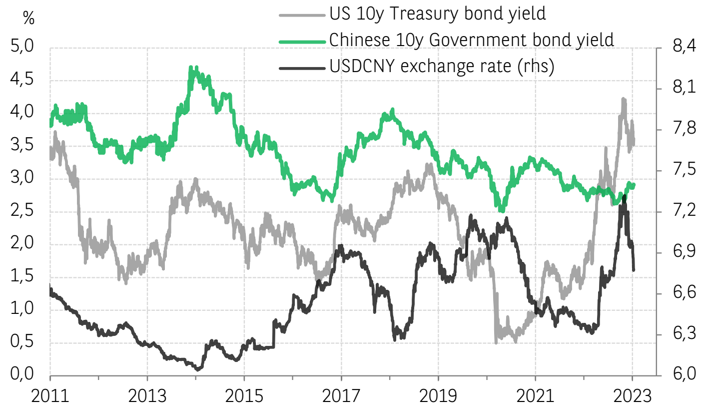

CHART 2 SOURCE: REFINITIV, BNP PARIBAS

Furthermore, China has a very strong external liquidity position. Its foreign exchange reserves (USD 3128 bn at the end of December 2022) are sufficient to cover the external debt and to provide protection against episodes of capital outflows. Forex reserves have fallen only slightly in recent months, particularly as the central bank's direct interventions in the foreign exchange market to contain the depreciation of the yuan have been small. The central bank has preferred to use other instruments, with the aim for example of controlling certain forex flows of financial institutions, as well as prudential measures (the reserve requirement ratio on foreign-currency deposits was reduced to 6% compared to 9% at the end of 2021, and the foreign exchange risk reserve ratio for forward trading was increased to 20% at the end of September).

In the short term, dynamics in capital flows, and therefore in the exchange rate, are uncertain. The interest rate differential between the US and China is expected to decrease when the US Federal Reserve stops its monetary tightening cycle (which is expected by the end of Q1 2023) and China's economic growth outlook should improve. However, investors may remain cautious, as their confidence has been weakened in the past two years by China's zero-Covid policy, the crisis in the real estate sector, the rise in regulatory risk and geopolitical tensions.

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