YUAN UNDER PRESSURE

The depreciation of the yuan since the beginning of the year and portfolio investment outflows have been largely due to diverging trends in Chinese and US interest rates. They also reflect a loss of investor confidence and the deterioration in China's economic growth outlook. Meanwhile, China's external financial position is still very strong.

The yuan has lost 11% of its value against the US dollar since the beginning of the year, which is almost the same extent as in 2015-2016. This weakening is firstly linked to the general strengthening of the dollar, which has accompanied US monetary tightening since March. In fact, the depreciation of the yuan in nominal effective terms has been much more moderate: the CFETS index (calculated by the China Foreign Exchange Trade System based on a basket of 24 currencies) fell by only 5% over the first eleven months of 2022. However, the weakening of the yuan has also resulted from internal factors and the dynamics of the Chinese balance of payments.

While US interest rates have increased rapidly in 2022, the Chinese authorities have relaxed (moderately) their monetary policy in order to stimulate domestic demand, in the absence of strong inflationary pressures. The spreads between US and Chinese interest rates have therefore reversed and widened, 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 balance of payments data, net portfolio investment outflows reached a record USD 159 bn in H1 2022 (-1.8% of GDP). They resulted from an increase in net portfolio outflows from residents (whose net portfolio flows are structurally negative) and from significant sales of Chinese securities (mainly bonds) by non-residents (whose net portfolio flows were negative in H1 2022 for the first time since H2 2015, and represented -0.9% of GDP). It is estimated that total net portfolio investment outflows continued (but moderated) over the rest of 2022.

Chinese enterprises that are most reliant on foreign financing (especially property developers) are experiencing difficulties in these circumstances, but the impact on China's overall capacity to cover its external financing needs is very limited. Firstly, because the other components of the balance of payments have performed better. In the financial account, net direct investment (DI) flows decreased but remained positive over the first three quarters of 2022; and net outflows related to debt and other investments reduced (in part thanks to the decline in Chinese credit abroad). The risk of a massive capital flight is in fact contained by the existence of controls, which have been reinforced since 2015 and are notably aimed at limiting resident capital outflows. Meanwhile, the current account surplus has continued to increase, reaching USD 310 bn over the first three quarters of 2022 (+2.4% of GDP).

Secondly, China remains little dependent on external financing despite the gradual opening up to foreign investors. Its basic balance (current balance + net DI flow) is positive, its external debt is low (15% of GDP) and foreign investors' participation in its financial markets remains modest (they accounted for 3% of total outstanding local bonds at the end of 2021 – but 11% of government bonds – and less than 5% of equity market capitalisation). Finally, China has a very solid external liquidity position. Its foreign exchange reserves (USD 3,052 billion at the end of October) largely cover total external debt and protect against episodes of capital outflows. Foreign exchange reserves have declined only slightly since the beginning of the year, partly because 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 combat currency pressure via prudential measures (such as the cut in the reserve requirement ratio on foreign currency deposits). In addition, the authorities could also be satisfied with a weaker yuan in an attempt to support the export sector.

In the short term, however, the weakening in global demand will continue to slow China's export growth. The current account surplus is expected to fall, exerting new downward pressures on the yuan. Future dynamics in capital flows – and thus in the exchange rate – are more uncertain. The interest rate spreads between the United States and China should narrow when the US Federal Reserve interrupts its monetary tightening cycle (which is expected in Q1 2023) and assuming China's economic growth prospects improve. However, foreign investors are likely to 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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GROWTH & INFLATION

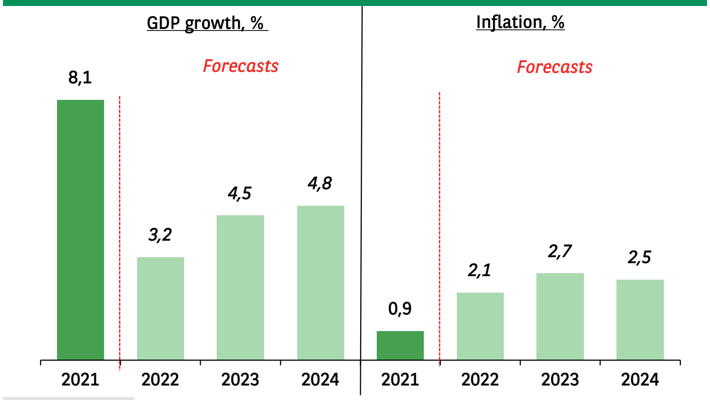

CHART 1 SOURCE: REFINITIV, BNP PARIBAS

CHINA: DIVERGING INTEREST RATES

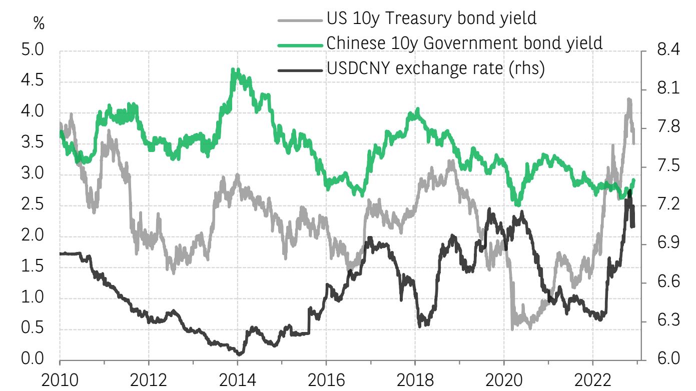

CHART 2 SOURCE: REFINITIV, BNP PARIBAS