CHINA'S PRUDENT EXCHANGE RATE POLICY IS EXPECTED TO CONTINUE

EXCHANGE RATE

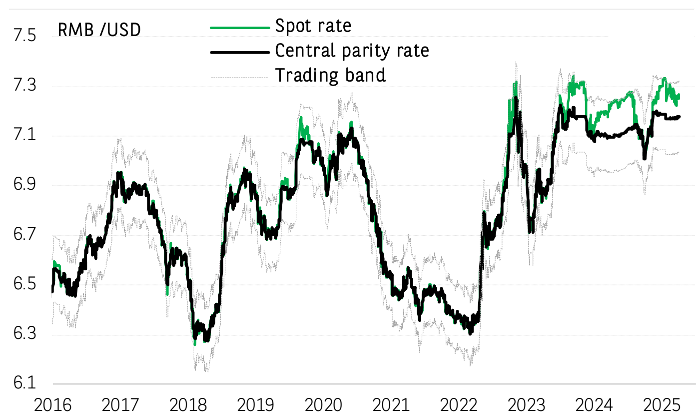

CHART 1 SOURCE: CHINA FOREIGN EXCHANGE TRADING CENTER, BNP PARIBAS

BALANCE OF PAYMENTS

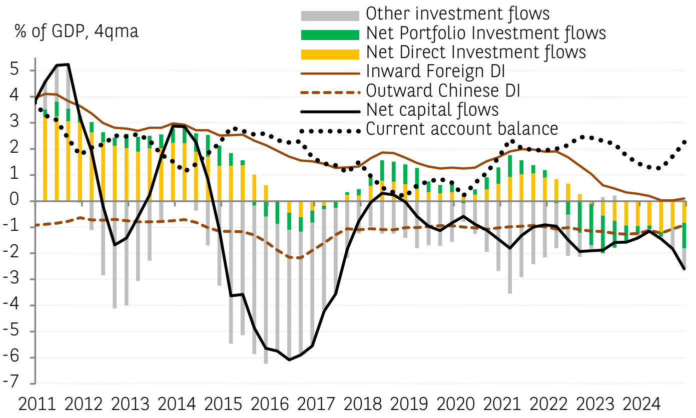

CHART 2 SOURCE: SAFE, BNP PARIBAS

How will Beijing react to the imminent US protectionist measures? Will the central bank allow the yuan to depreciate in order to offset the effect of tariff hikes on the price competitiveness of Chinese exports?

Since the start of President Trump's second term, and despite the hikes in US tariffs, the People's Bank of China (PBOC) has kept the central parity rate of the yuan against the USD almost stable (*Chart 1*). Downward pressure on the yuan eased over this period. But as the Liberation Day promised by Trump approaches, this pressure has increased once again, with the markets testing the PBOC's tolerance for a weaker yuan. However, it is likely that the Chinese authorities will continue to use the exchange rate weapon with great caution.

Preference for stability. On the one hand, the yuan is already at a historically weak level. On the other, the stability of the exchange rate is part of the central bank's mandates. The PBOC also needs to ensure the stability of the financial system and the stability of external accounts. Yet China is vulnerable to capital outflows, which a sudden devaluation of the yuan might aggravate. Moreover, Beijing might also fear the repercussions of a weakening yuan on the exchange rates of neighbouring countries, while strengthening trade and financial links in Asia is one element of the strategy for its response to US protectionism.

Vulnerability to capital outflows. Total net capital outflows in China's balance of payments have become structurally negative (*Chart 2*). In 2024, the deficit even hit its highest level for eight years (-USD 486 bn, or -2.6% of GDP). This deterioration came hand in hand with the increase in the current account surplus (to USD 424 bn, or +2.3% of GDP), and forex reserves remained stable (USD 3,450 bn). But growing net capital outflows also reflect the fact that China's economy and financial markets have become less attractive.

Net flows of direct investment (DI) have been negative since 2022, due to the collapse in foreign DI inflows (from USD 344 bn in 2021 to USD 19 bn in 2024), as the COVID pandemic, regulatory risks and geopolitical and trade tensions have prompted foreign and Chinese groups to secure their supply and production chains. Meanwhile, net resident DI outflows were very slightly up over the period 2022-2024, as China strengthened its investments to allies, strategic countries and 'connector' countries. The net balance of other capital flows (portfolio investments, debt, other) is also negative; it deteriorated in 2024, notably due to the US-China interest rate differentials and worsening prospects for Chinese economic growth.

It was to reverse these dynamics and probably add a little leeway to its exchange rate policy that the government recently stepped up measures to encourage residents to invest on local financial markets and adopted a more favourable tone vis-à-vis foreign investors.

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