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CHINA: SHIFTING BALANCE OF PAYMENT

CONSISTENT CURRENT ACCOUNT SURPLUS IS BEHIND US

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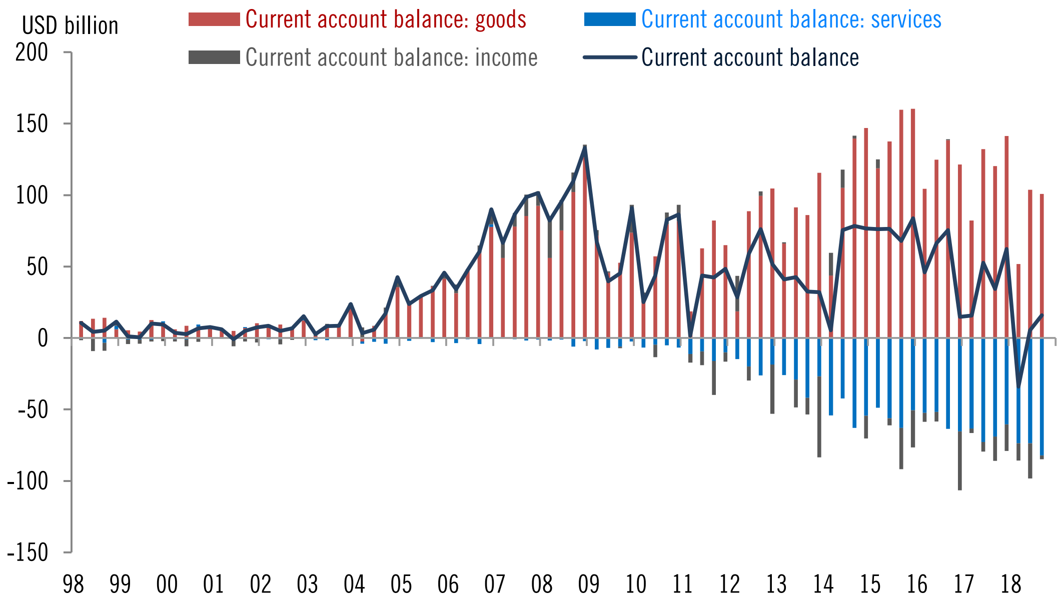
SUMMARY

- In the first three quarters of the year, China ran a current account deficit of USD12.8 billion. It looks likely that China will see its first full-year current account deficit in over two decades in 2018.
- China's current account balance is undergoing a structural shift, so that China's reliance on foreign capital inflow will increase going forward.
- Over the long term, it looks likely that the Chinese government will have to allow the renminbi to depreciate more against the currencies of its major trading partners, although for the moment it remains subject to the central bank's intervention.

Since 2014-15, China's balance of payment has gone through some substantial changes. China's current account surplus started to diminish in this period and the capital and financial account went into significant deficit. As a result, China's foreign reserves decreased by nearly USD1 trillion within 30 months. Although the massive deficit in the capital and financial account has been closed, the changes in the current account are structural. Looking forward, China may start to run a small current account deficit, making the country more reliant on foreign capital inflows.

CHART 1: CHINESE CURRENT ACCOUNT BALANCE BY COMPONENT



Source: PWM - AA&MR, SAFE

Diminishing current account surplus

China reported a current account surplus of USD16 billion in Q3, up from a surplus of USD5.3 billion in Q2 and a deficit of USD34.1 billion in Q1. As a result, in the first three quarters of the year as a whole, China ran a current account deficit of USD12.8 billion

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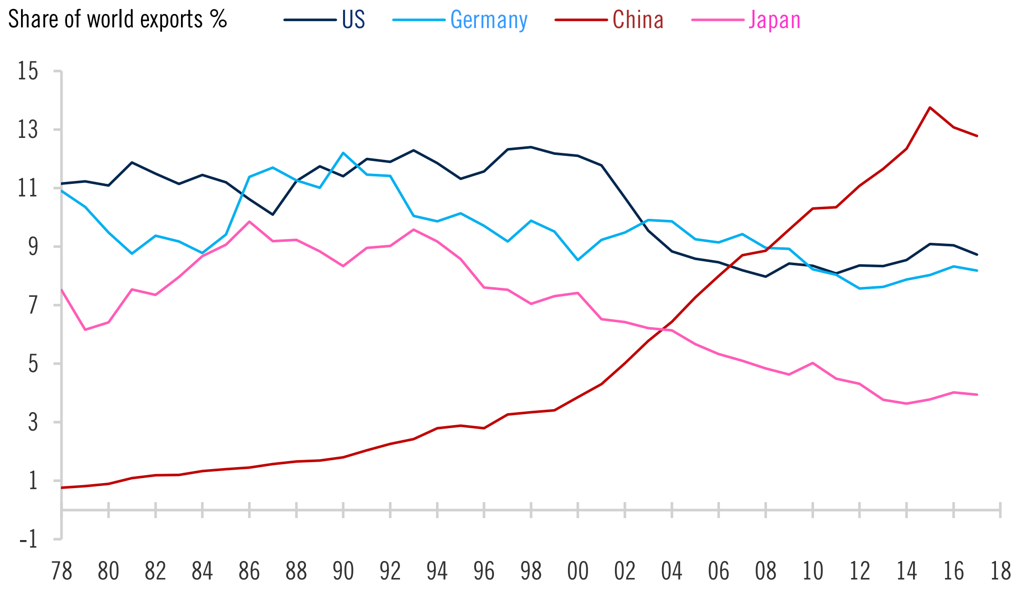
(*Chart 1*). Unless there is a surge in the trade surplus in Q4, it looks likely that China will see its first full-year current account deficit in 20 years in 2018.

Two factors have been driving the structural change in China's current account position, both reflecting the economic transitions that the economy is going through. The first is the decline in China's merchandise trade surplus. Since reaching a peak at nearly 38% in late 2016, exports as a percentage of Chinese GDP have been declining, falling to below 20% in Q3 2018. The trade surplus continued to rise until end 2015, coinciding with the peak of China's share of global exports (*Chart 2*). But the trade surplus started to decline in 2016, partly due to the migration of some labour-intensive manufacturers out of China on rising labour costs since the global financial crisis.

CHART 2: MARKET SHARES OF MAJOR EXPORTERS



Source: PWM - AA&MR, National Bureau of Statistics of China, China Customs

The other major factor behind the declining current account balance is the growing trade deficit in services. The biggest contributor to the services deficit is China's outbound tourism (including overseas consumption) and education abroad (jointly accounting for over 70% of the services trade deficit). Starting from virtually zero prior to the financial crisis, China's deficit in services rose to USD230 billion in the first three quarters of 2018 (*Chart 1*), largely reflecting rising consumption among the Chinese middle class.

Looking ahead, there is little sign that these two trends are going to reverse anytime soon. Given elevated trade tensions with the US, the migration of supply chains out of China may accelerate in the medium to long term. This could lead to further erosion of China's merchandise trade surplus. The growth of outbound tourism, which is part of China's transition towards household consumption, could mean that after maintaining a current account surplus for more than two decades, China may start to see its first full-year deficit as early as this year.

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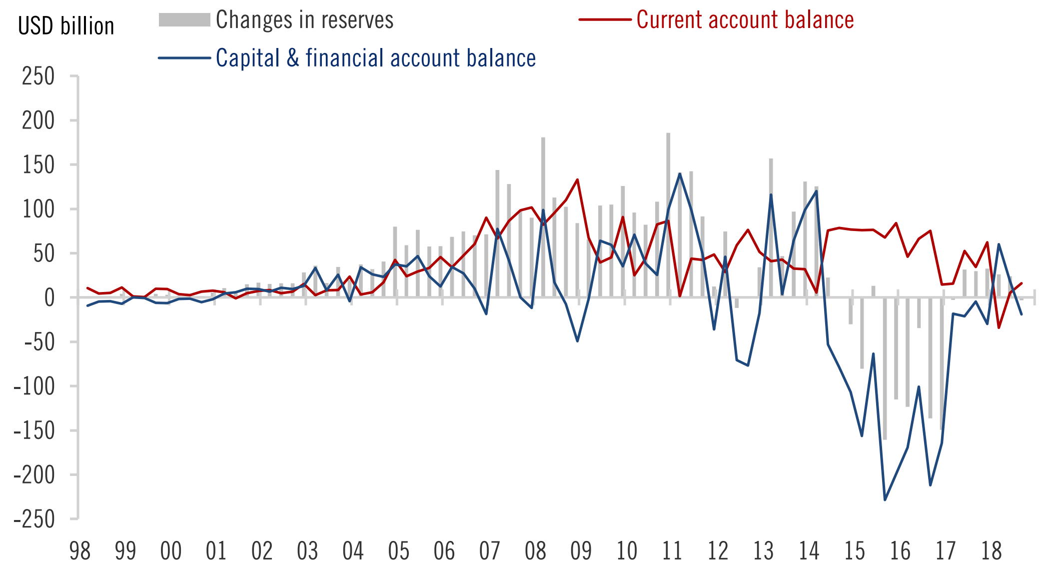
Implications

The structural shift of the Chinese current account from surplus to deficit has several implications.

First, to fund the current account deficit, the capital and financial account need to remain in surplus (or the other way around). Otherwise, foreign reserves could be depleted quickly, as illustrated in Chart 3. This means China's reliance on foreign capital inflows will be increasing going forward.

Foreign direct investment (FDI) to China has been largely stable since 2014. To encourage more FDI inflows, the government has reduced entry barriers in various industries, including retail and wholesale and financial services. In addition, the government has put more restrictions on Chinese companies' outward investment. As a result, several Chinese conglomerates that had engaged in aggressive foreign acquisition strategies have stopped their buying binge and some have even divested interests acquired. To further boost capital inflows, the Chinese authorities could decide to continue to open up China's domestic financial markets.

CHART 3: CHINESE CURRENT ACCOUNT BALANCE, CAPITAL & FINANCIAL ACCOUNT BALANCE AND CHANGE IN FOREIGN RESERVES



Source: PWM - AA&MR, SAFE

The waning of China's current account surplus also means the renminbi is facing structural downward pressure in the medium to long term. Unless measures are taken to enhance productivity, which usually takes a long time, currency depreciation is the most natural (and fastest) way to regain competitiveness. Given the downward trend in China's current account balance, over the long term it looks likely that the Chinese government will have to allow the renminbi to depreciate more against the currencies of its major trading partners, although for now the currency remains supported by central bank interventions.