China Economic Outlook

3Q 2020

BBVA Research, Asia

July 2020
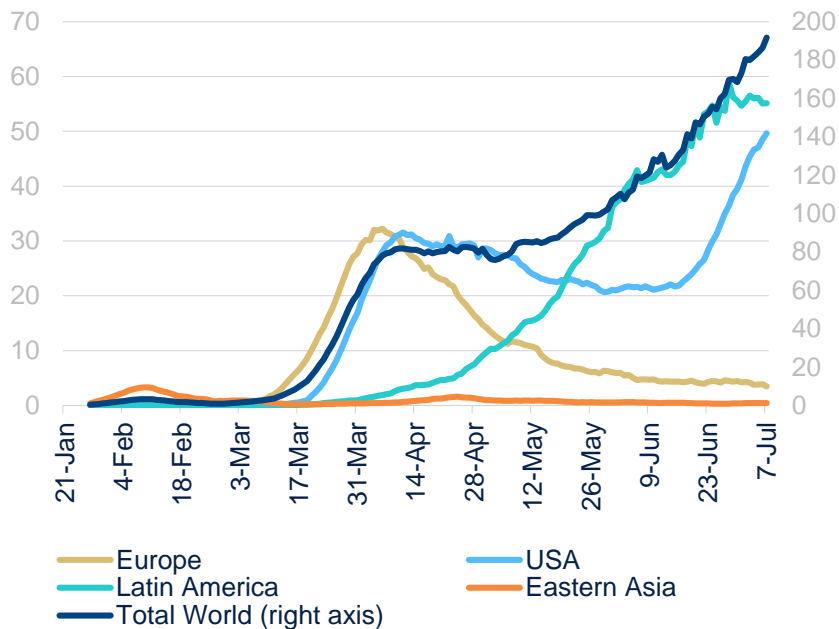
Creating Opportunities

01

Global Outlook
3Q20

The pandemic continues to advance, particularly in America and South Asia, despite the decline of infections in Europe and East Asia

DAILY CASES OF COVID-19
(THOUSANDS OF PEOPLE, 7-DAY MOVING AVERAGE)

Legend: Europe, USA, Latin America, Eastern Asia, Total World (right axis)

- The Chinese pattern (shock and short confinement ending the pandemic), which was thought to be the model for other regions, is not being repeated in other countries.

- Europe has cut the number of cases very significantly, but as they have not been yet fully eliminated, the complete normalization of the economy seems more difficult.

- Other regions (USA, Latam and India, among others) are still lagging behind in terms of controlling the virus.

Source: BBVA Research using data from John Hopkins University

Three different approaches to face the epidemic

DAILY CASES OF COVID-19
(THOUSANDS OF PEOPLE, 7-DAY MOVING AVERAGE)

Coexistence Europe — Disregard
Coexistence Latam — Eradication
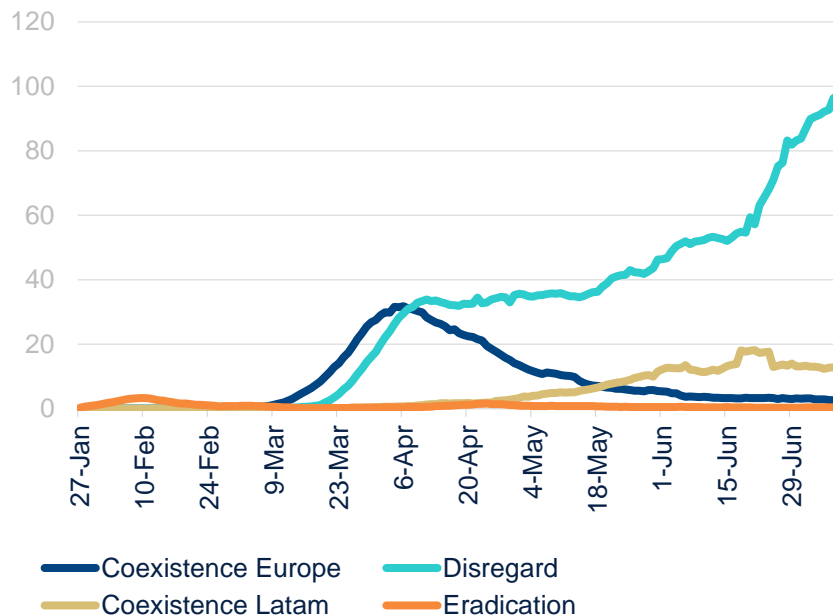
Three policy approaches:

- **Eradication:** countries (mostly in East Asia) that have acted early and decisively to tackle the virus.

- **Coexistence:** contagions are kept at levels which are manageable by the health system; used successfully in Europe and with less success so far in most Latin American countries.

- **Relative passivity** of central governments resigned to the situation: position adopted by countries such as Brazil, Mexico, the USA and Sweden.

Source: BBVA Research using data from John Hopkins University

We continue expecting an "incomplete V" recovery, which however will be slower and heterogeneous across regions; uncertainty remains high

FORECAST ASSUMPTIONS

COVID-19

We assume a widely available treatment within a year, with new waves, but no strict confinement before that.

Economic Policy

Additional stimulus measures are likely, at least in developed economies; the margin is low in emerging economies.
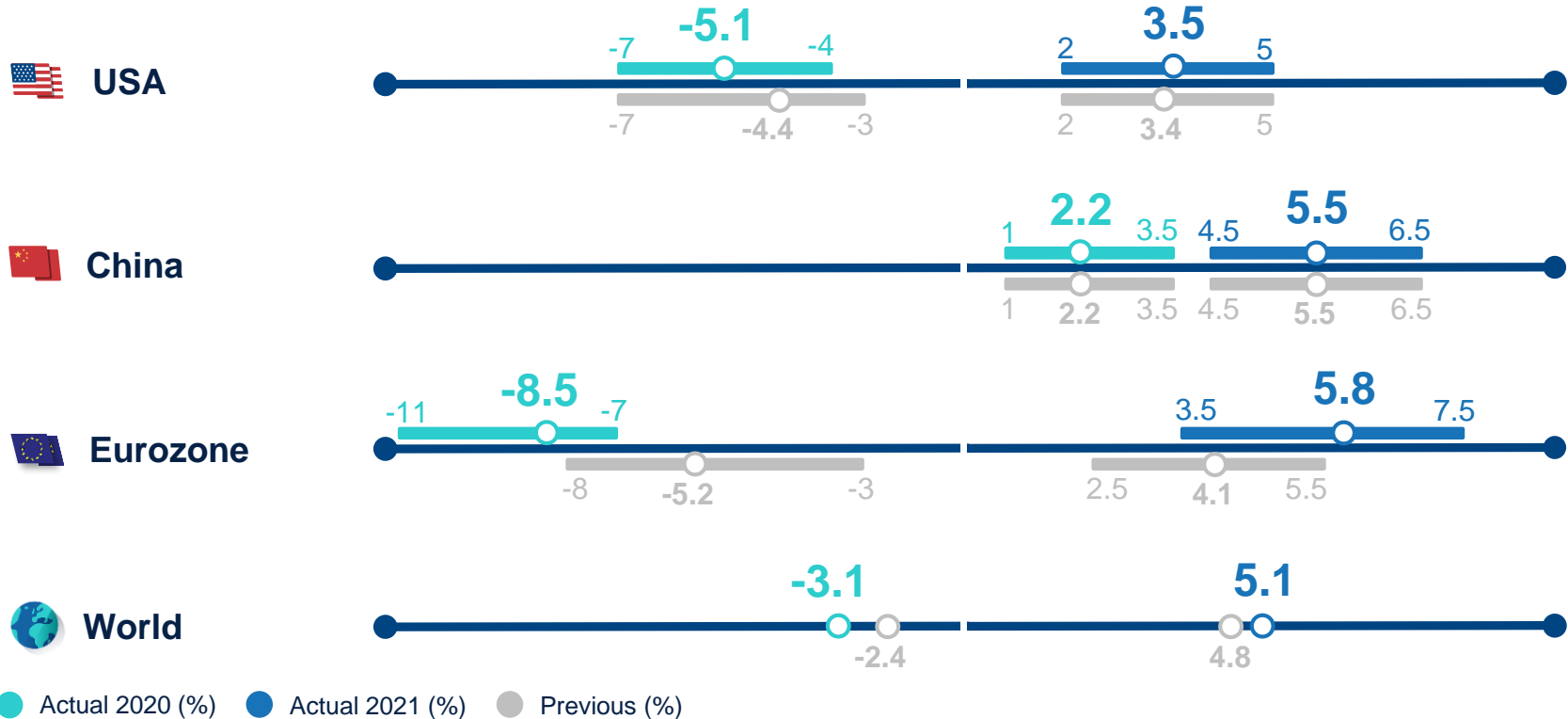
Financial Markets

No significant spikes in financial tensions, but volatility will remain high.

Economic Activity

Heterogeneous and partial recovery until treatment is available. The recovery will be slower in emerging economies.

Growth forecasts are revised downwards for 2020 and upwards for 2021, with a larger accumulated loss of product in the biennium

USA
- -5.1 (-7 to -4)
- 3.5 (2 to 5)
- Previous: -4.4 (-7 to -3)
- Previous: 3.4 (2 to 5)

China
- 2.2 (1 to 3.5)
- 5.5 (4.5 to 6.5)
- Previous: 2.2 (1 to 3.5)
- Previous: 5.5 (4.5 to 6.5)

Eurozone
- -8.5 (-11 to -7)
- 5.8 (3.5 to 7.5)
- Previous: -5.2 (-8 to -3)
- Previous: 4.1 (2.5 to 5.5)

World
- -3.1
- 5.1
- Previous: -2.4
- Previous: 4.8

Legend:
- ● Actual 2020 (%)
- ● Actual 2021 (%)
- ● Previous (%)

GDP Growth: forecasts.
Source: BBVA Research

Uncertainty will remain high; many factors, in particular the availability of a vaccine, can generate alternative scenarios

Epidemiological uncertainty

- Pandemic control
- "Opening" process
- New waves of infections
- Vaccine or treatment

Financial uncertainty

- Financial tensions
- Flows into emerging markets
- Public and private debt

Economic uncertainty

- Stimulus effectiveness
- Signficant disruptions in sectors and value chains
- Potential GDP
- Evolution of inflation

Geopolitical uncertainty

- Protectionism
- Multiple focuses of regional tensions
- Social unrest
- *Brexit*

The pandemic has reinforced some pre-crisis structural trends and poses new long-term challenges

PREVIOUS TRENDS AND CHALLENGES	→	NEW TRENDS AND CHALLENGES

Climate Change	Populism and institutions	Debt sustainability (public & private)	Management of global catastrophes
Digitalization and teleworking	Deglobalization and global governance	Role of the public sector in the economy	Behavior, social rule and preferences
Productivity and investment	Inflation and monetary policy	Competition and industrial policy	Privacy and business models

Main messages

- China is undergoing a V-shape recovery. With the COVID-19 pandemic controlled in early April in China, growth picked up significantly in Q2 to 3.2% y/y from -6.8% y/y in Q1, thanks to the authorities' unveiled monetary and fiscal stimulus measures.

- The recovery is not genuine, which is still unbalanced. The supply side spearheaded the recovery while the demand side lagged behind.

- External sector remains the main drag on growth this year as COVID-19 is spreading around the world, the sustainability of the medical equipment exports which have supported export growth in the past months remains questionable.

- Chinese financial market has been booming recently as China is leading global recovery.

Growth picked up significantly in Q2 from plummeting in Q1

## GROWTH PICKED UP SIGNIFICANTLY IN Q2 TO 3.2% Y/Y FROM -6.8% Y/Y IN Q1

- Net Export of Goods and Service
- Gross Capital Formation
- Final Consumption Expenditure
- GDP growth y/y

Source: CEIC and BBVA Research
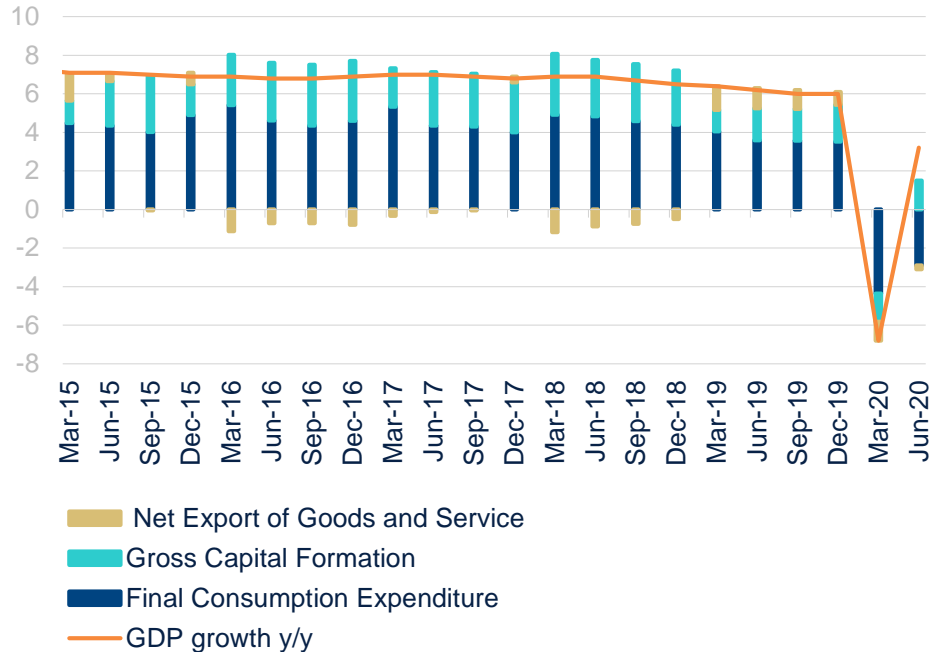
PMIS AND INDUSTRIAL PRODUCTION CONTINUED THE RECOVERY PATH IN Q2

NBS PMI   Caixin PMI   industrial production
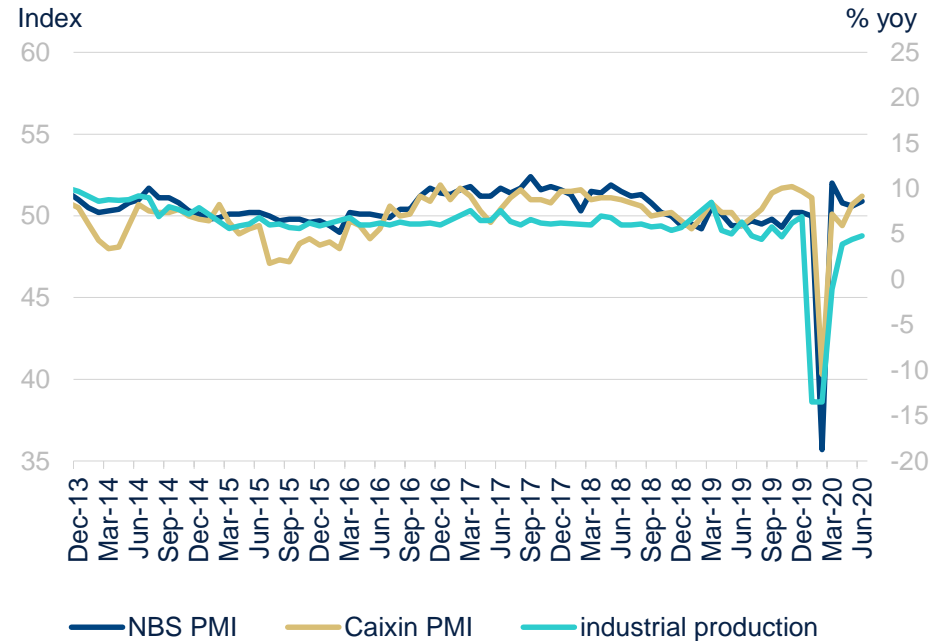
However, the recovery is unbalanced as the demand side recovery lags behind production side (1): Retail sales

RETAIL SALES PICKED UP TO -1.8% Y/Y IN JUNE, STILL UNDER MARKET EXPECTATIONS AND IN NEGATIVE REGION

Y/Y %

Nominal Retail Sales   Real Retail Sales
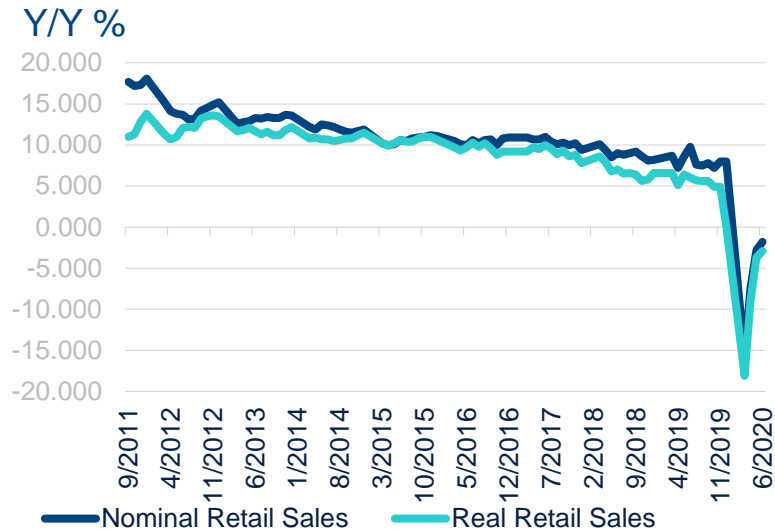
AUTO SALES RECOVERY SUPPORTED RETAIL SALES, WHICH TURNED TO POSITIVE AS PANDEMIC EASED

% y/y

Source: CEIC and BBVA Research
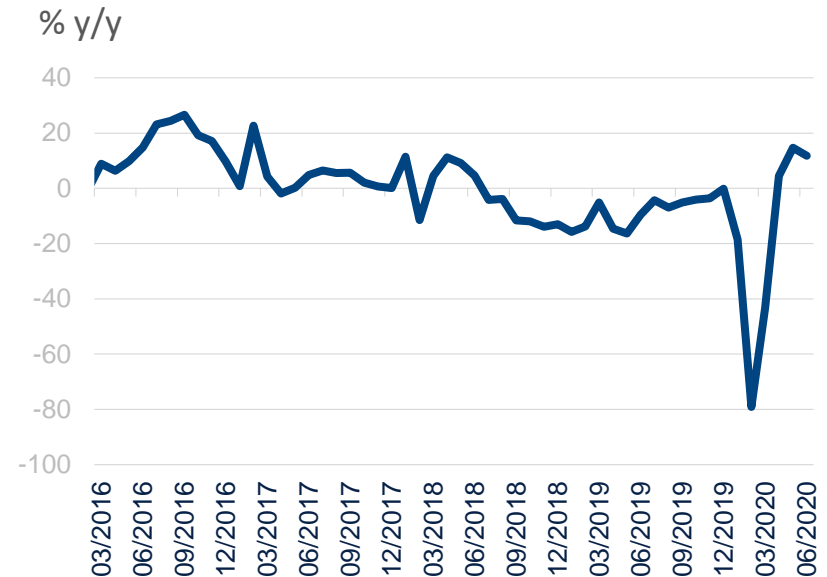
Demand side lagged behind (2): Investment activities were also under expectation

**THE AGGREGATE FAI IMPROVED TO -3.1% Y/Y IN Q2, BUT STILL SLOWER THAN THE SUPPLY SIDE RECOVERY**

% ytd
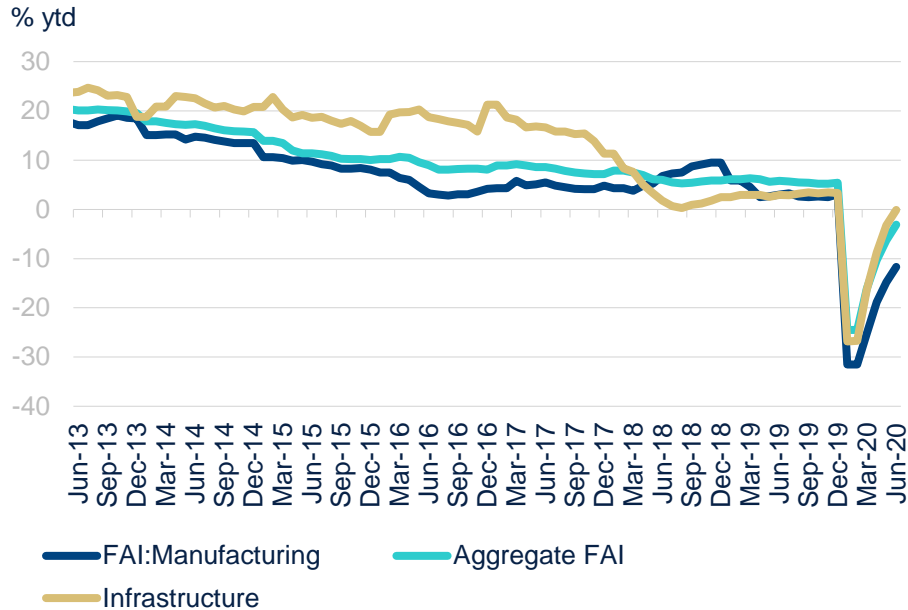
**…WITH SYNCHRONIZNED PERFORMANCE OF BOTH PUBLIC AND PRIVATE SECTORS, AMONG WHICH PUBLIC FAI LEADS THE RECOVERY**

% ytd y/y

- FAI:Manufacturing
- Aggregate FAI
- Infrastructure

- Private FAI
- Aggregate FAI
- Public FAI
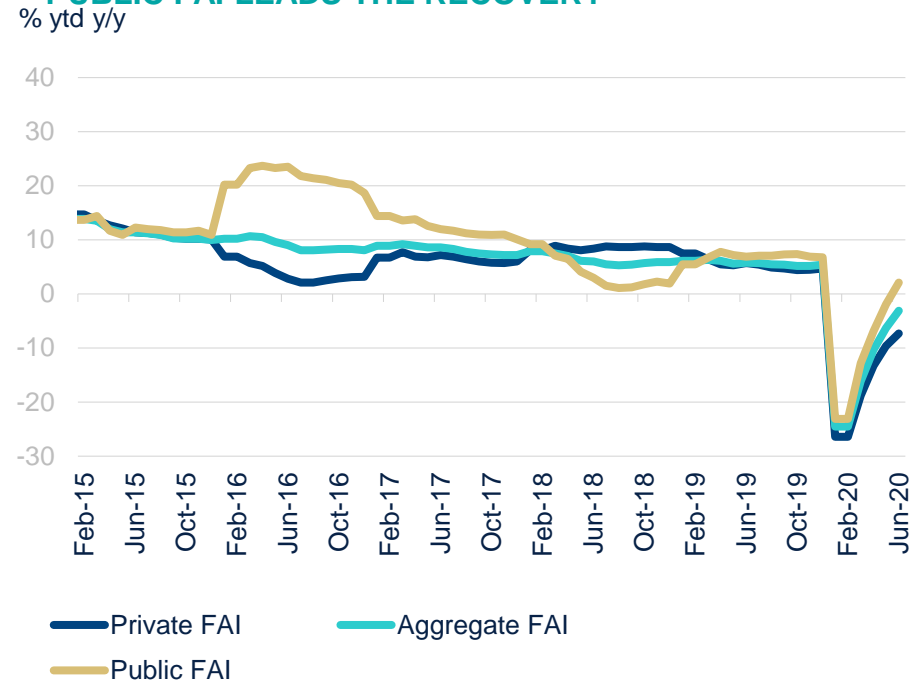
The external sector remains the main drag on growth this year

"RECESSIONARY SURPLUS" CONTINUED IN Q2, WHICH IS EXPECTED TO REMAIN IN THE REST OF THIS YEAR


% yoy   USD bn

Legend: trade balance — export growth — import growth
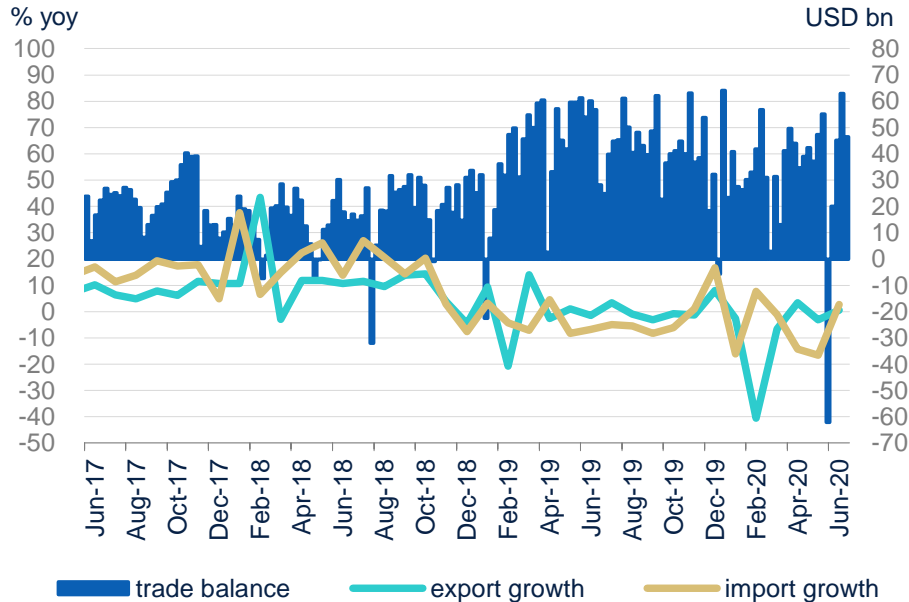
WHETHER THE MEDICAL EXPORTS COULD CONTINUE TO SUPPORT EXPORT GROWTH STILL UNCERTAIN AS GVC DECOUPLING CONTINUES

% y/y

Legend: Medical products exports — Total exports

Source: CEIC and BBVA Research
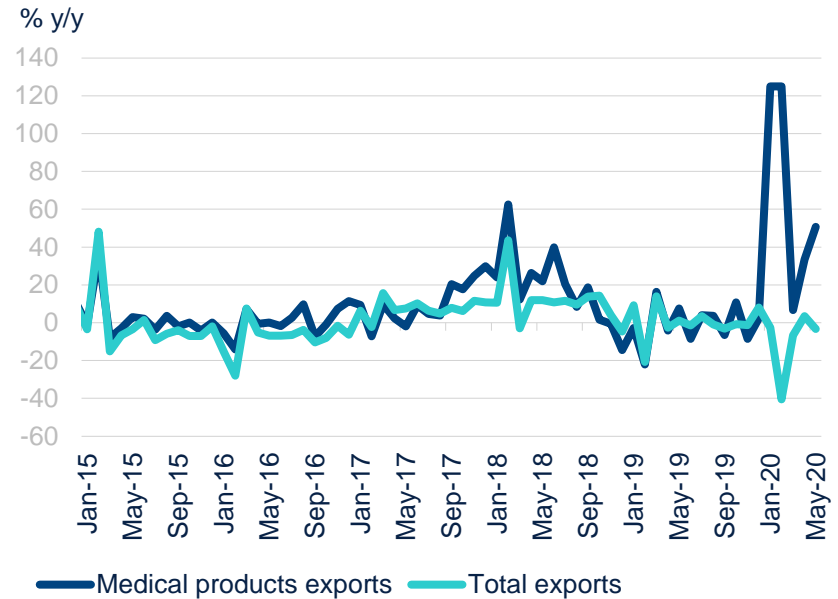
The authorities have no intention to stimulate growth by housing market, the principle of "houses are for living in, not for speculation" will be held

HOUSING PRICES REMAINED STABLE IN BIG CITIES IN Q2, NO SIGNIFICANT EASING MEASURES OBSERVED…

% yoy
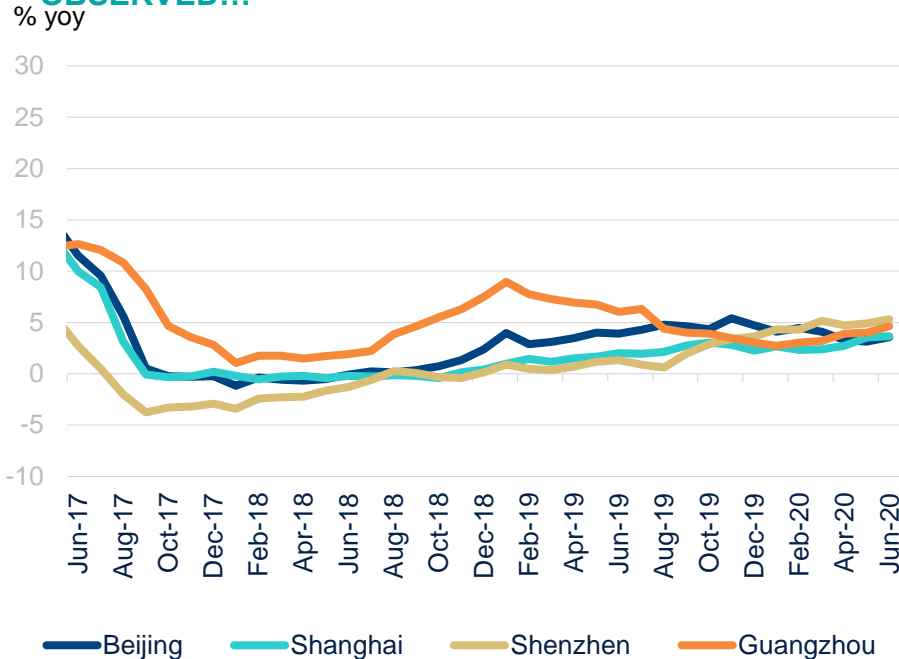
…WHILE THERE ARE INCREASING NUMBER OF CITIES THAT REPORTED HOUSING PRICE INCREASING IN Q2 AS LOCKDOWN ENDED (M/M GROWTH)

Beijing — Shanghai — Shenzhen — Guangzhou

Increase   Unchange   Decrease

Source: CEIC and BBVA Research
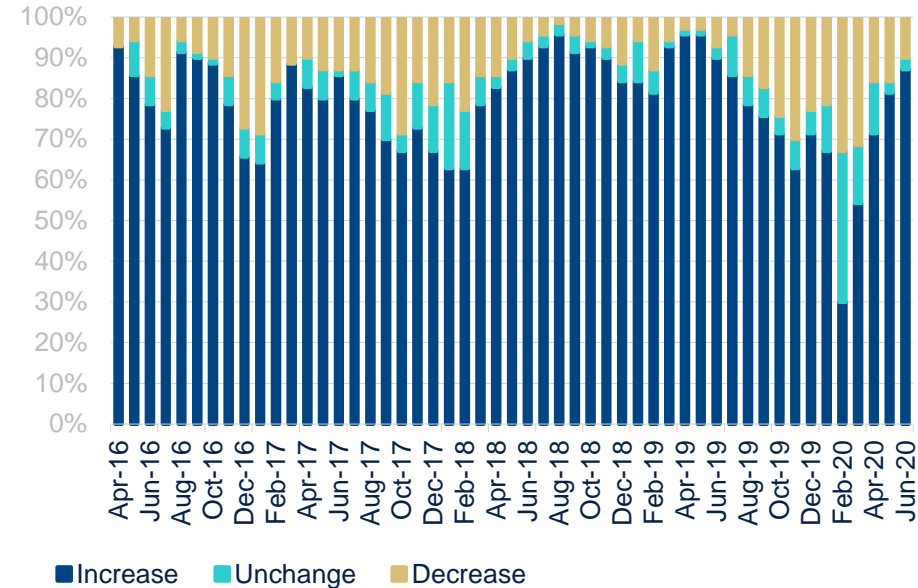
Housing-related activities are undergoing the recovery path together with the economic growth

THE GROWTH RATE OF RESIDENTIAL BUILDING SOLD AND LAND PURCHASED STARTED TO RECOVER
% ytd, y/y

## ...SO DID THE REAL ESTATE INVESTMENT AND FLOOR SPACE STARTED&COMPLETED
% ytd,y/y

Building Sold: Residential   Land Area Purchased

Real Estate Investment: ytd
Floor Space Started: Residential
Floor Space Completed: Residential

Source: CEIC and BBVA Research

High CPI caused by ASF eased in Q2, now more worries on deflation pressure

THE FOOD PRICES SLOWED SIGNIFICANTLY DUE TO COVID-19 OUTBREAK AND THE EASED ASF
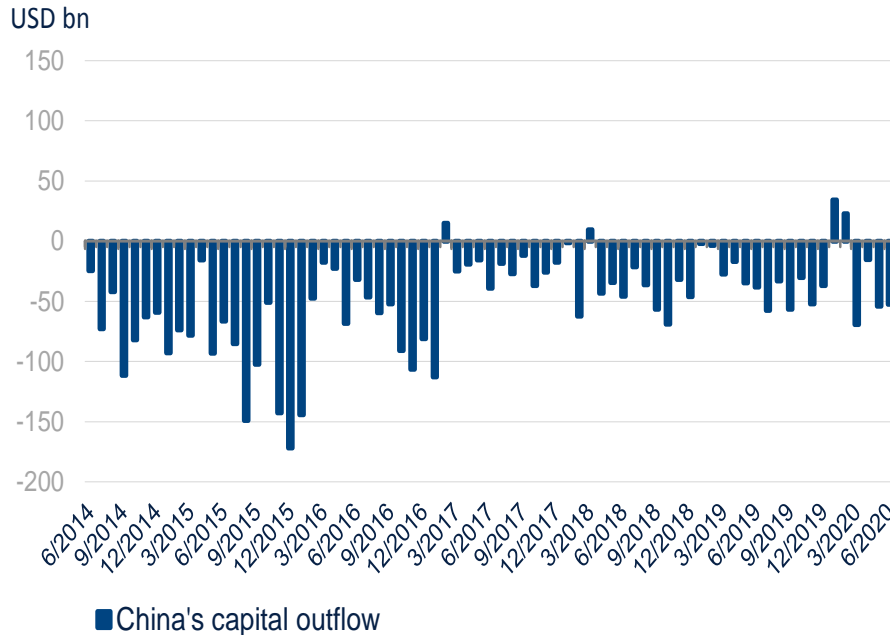
% yoy

— CPI:food   — CPI:non-food   — CPI
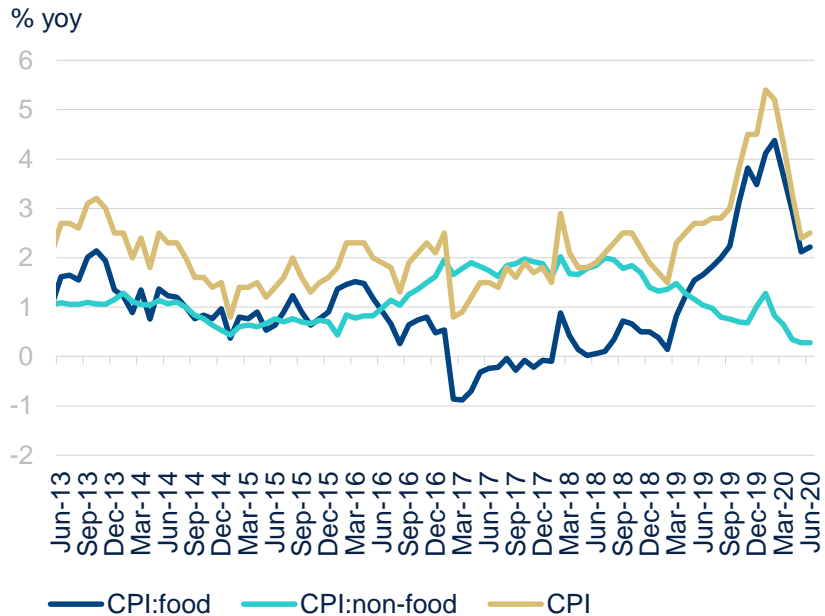
PPI REMAINS IN THE NEGATIVE TERRITORY IN PAST MONTHS AMID SLUGGISH ECONOMY

% yoy

— PPI   — CPI

Source: CEIC and BBVA Research
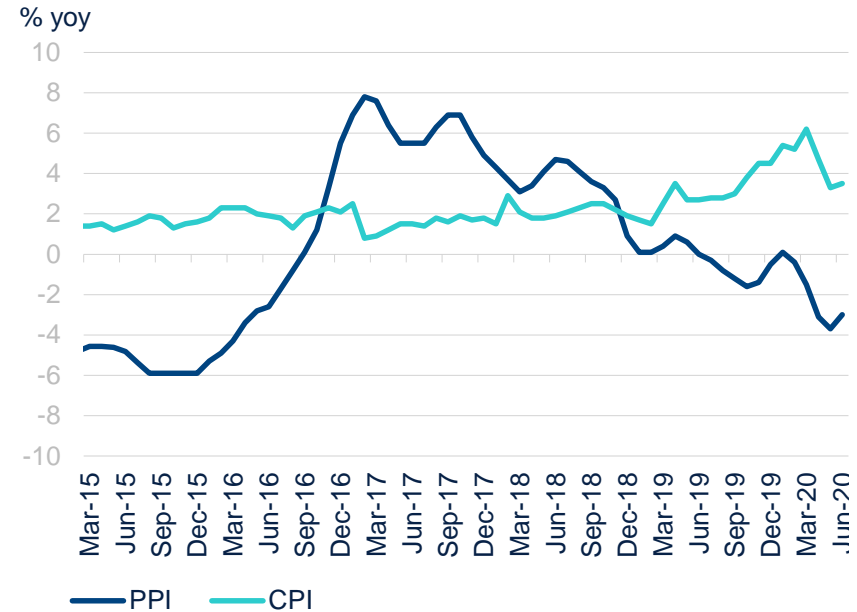
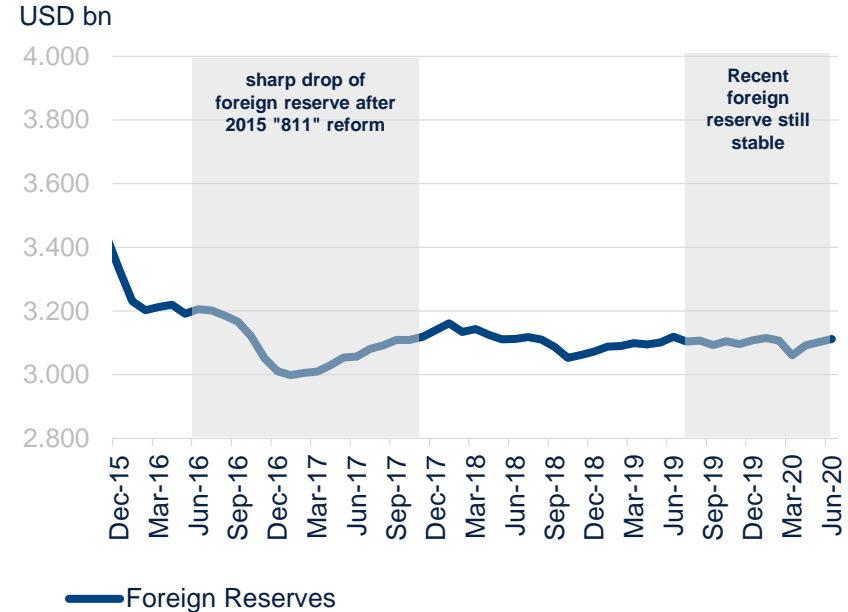# The impact of COVID-19 on China's Balance of Payments is limited

CAPITAL FLOWS REMAIN MANAGEABLE DUE TO THE AUTHORITIES' CAPITAL CONTROL MEASURES

USD bn

■ China's capital outflow

FOREIGN RESERVES STABLE AT THE CURRENT STAGE AND IS EXPECTED TO INCREASE THROUGH THE REST OF YEAR

USD bn

sharp drop of foreign reserve after 2015 "811" reform

Recent foreign reserve still stable

—— Foreign Reserves
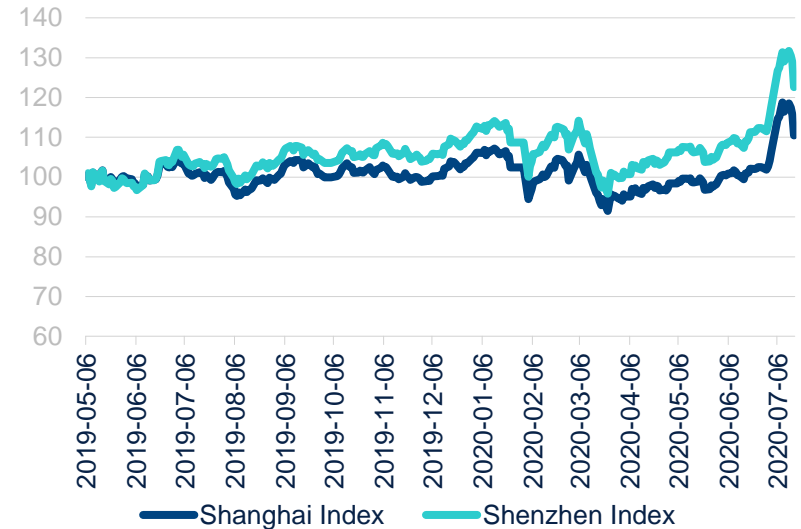
Source: CEIC and BBVA Research

China's financial market boom as China is leading global recovery

YUAN APPRECIATED BY 2.3% FROM THE REGIONAL LOW IN THE PAST MONTHS AMID THE ECONOMIC RECOVERY AS PANDEMIC EASED
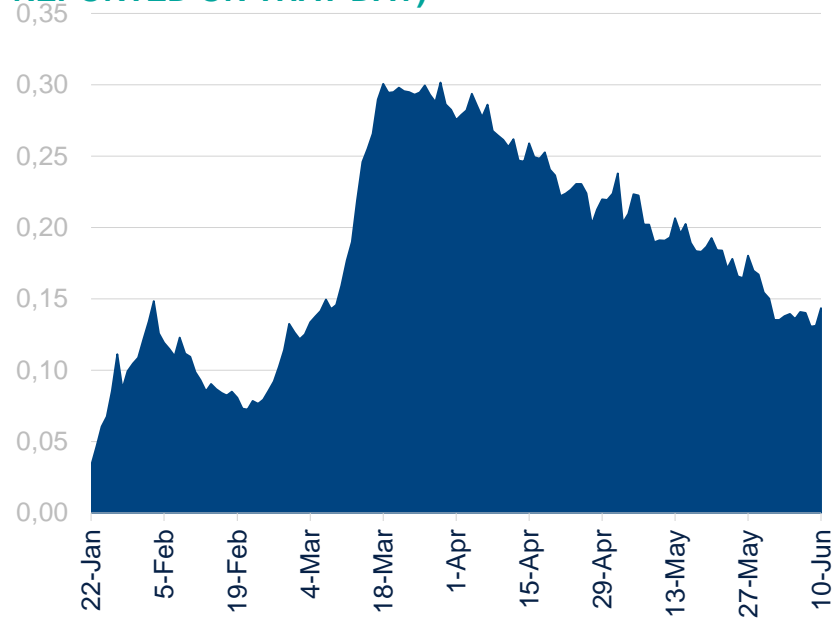

CFETS Currency Basket(LHS)   USD/CNY(RHS)
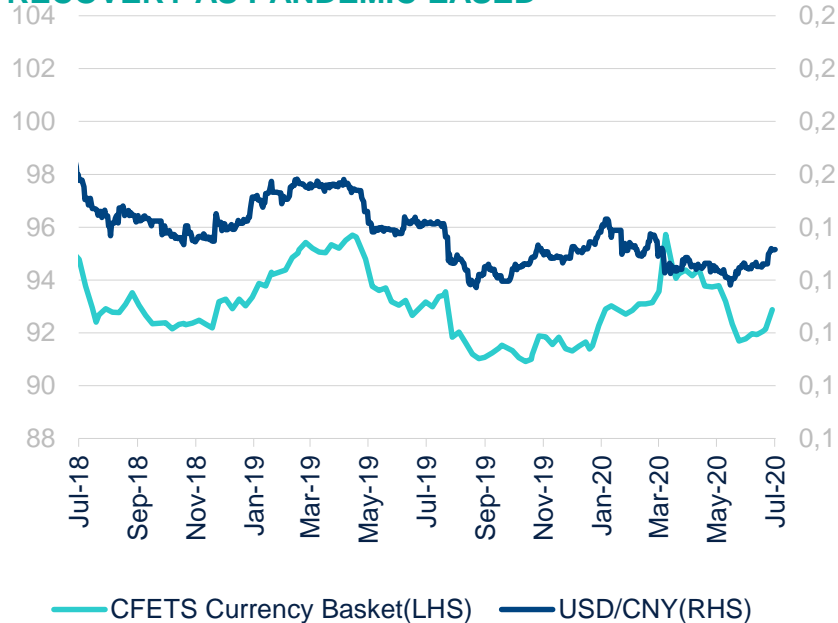
CHINESE STOCK PICKED UP SIGNIFICANTLY RECENTLY (NOMALIZED: FIRST PERIOD=100)

Shanghai Index   Shenzhen Index

Source: CEIC and BBVA Research

Evolution path of the media coverage and sentiment on COVID-19: Big data analysis

MEDIA COVERAGE OF THE COVID-19 DECLINED SIGNIFICANTLY (AS A RATIO OF THE TOTAL EVENTS REPORTED ON THAT DAY)

BBVA MEDIA STRESS INDEX ON COVID-19: FROM CHINA FOCUS TO GLOBAL PANDEMIC FOCUS
(AS MEASURED BY SENTIMENT IN THE MEDIA WEIGHTED BY COVERAGE)

Source: CEIC and BBVA Research
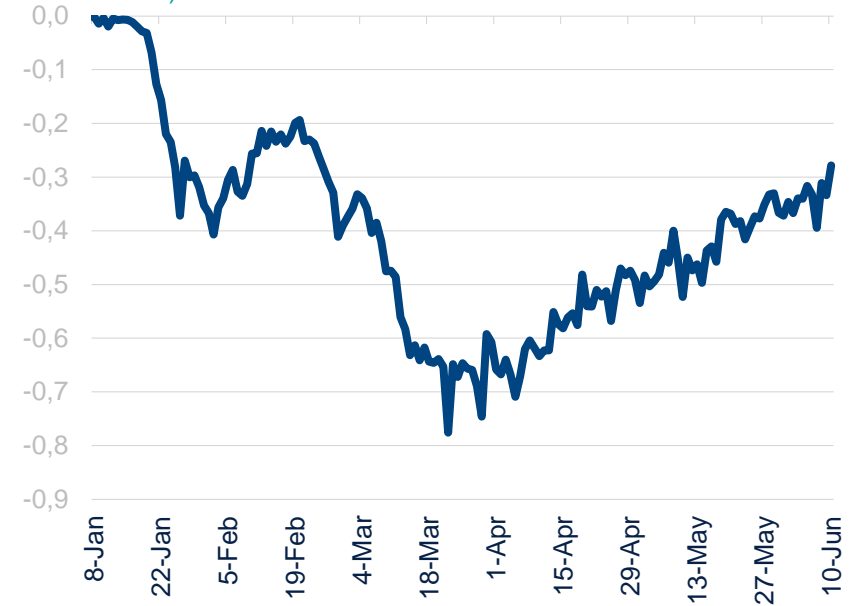
03

The way to finance fiscal stimulus package and the conservative monetary easing ahead

Main messages

▰ The recently concluded National People's Congress announced the monetary and fiscal easing measures to support growth. The fiscal stimulus package is equivalent to around 5% of total GDP, coupled with monetary loosening measures including RRR and LPR cuts and targeted monetary measures on SMEs etc., is set to inject additional steam to growth.

▰ The better-than-expected Q2 GDP outturns tend to make the 2H stimulus measures more conservative, leaving the room for future stimulus amid global uncertainties.

▰ The current policy mix is to make the fiscal easing play a leading role while monetary policy coordinates.

▰ The authorities planned to finance the fiscal stimulus package by traditional government bond issuance, while the current debate of "fiscal deficit monetarization" amid shrinking fiscal room is still relevant as the fiscal stimulus measures are not the "one-off" act.

Monetary and fiscal stimulus measures announced in "two sessions"

Fiscal policy: (1)
To expand fiscal déficit to GDP ratio from 2.8% to 3.6%.

Fiscal policy: (2)
To issue special government bond of RMB 1 trillion.

Fiscal policy: (3)
To expand local government bond quota to RMB 3.75 trillion from RMB 2.15 trillion in last year.

Fiscal policy: (4)
To increase tax cut and fee reduction scale to RMB 2.5 trillion, RMB 0.5 trillion increasing from the previous year.

Monetary policy: (1)
Interest rate cut: including LPR, MLF, OMO rate etc.

Monetary policy: (2)
RRR cut.

Monetary policy: (3)
Liquidity support, such as to delay the debt payment date for household and enterprises.

Monetary policy: (4)
Newly created targeted monetary policy tools, such as central banks buys commercial banks' SME loans.

However, taken lessons from RMB 4 trillion stimulus in 2008-2009 GFC, the current stimulus package seems conservative and under market expectation

CHINESE NEW RMB LOAN GROWTH IN GFC IS SIGNIFICANTLY HIGHER THAN THAT OF COVID-19(period 1 GFC=2008 Dec, period 1 COVID-19=2019 Dec)
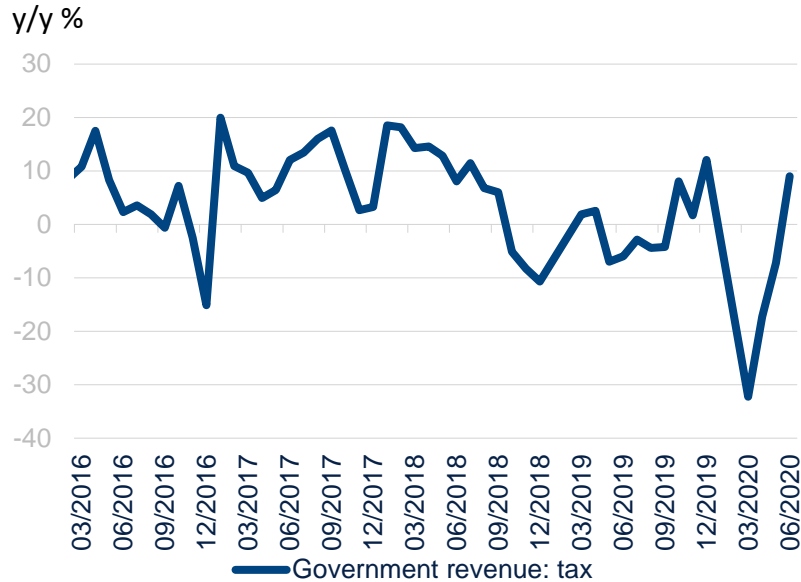
% y/y
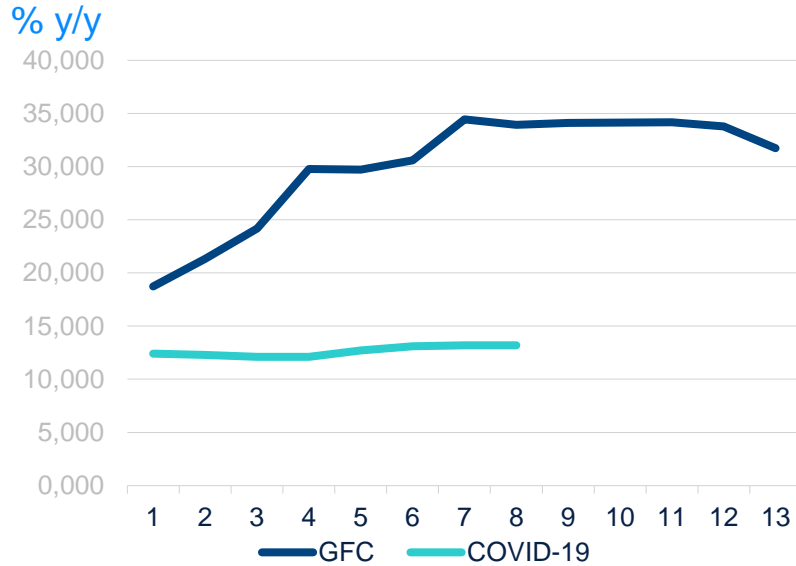
A SHRINKING GOVERNMENT REVENUE AND INCREASING EXPENDITURE INDICATES A LIMITED ROOM OF FISCAL STIMULUS

%

Source: CEIC and BBVA Research
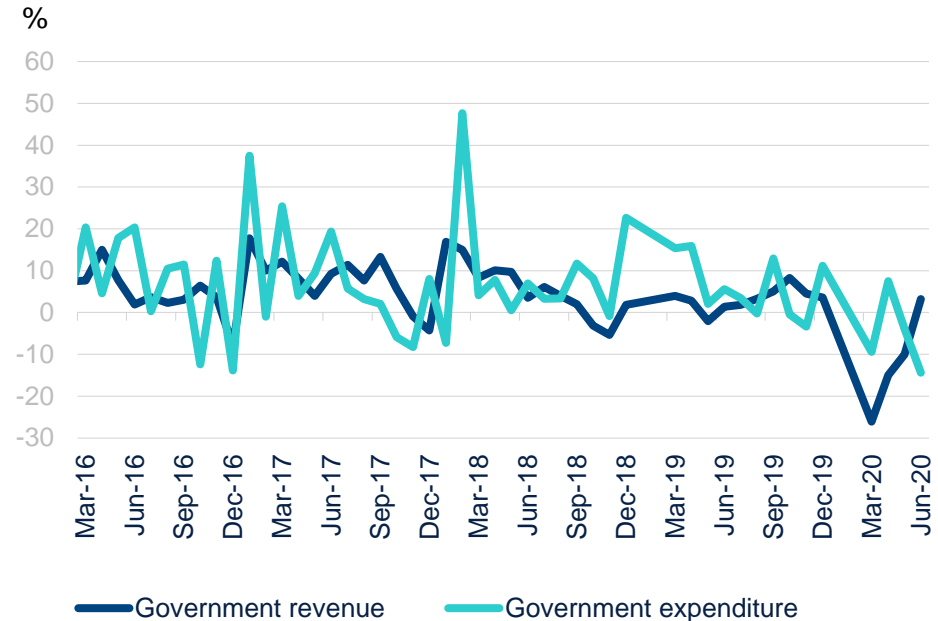
Fiscal stimulus room has shrink amid growth slowdown, raising the debate of "fiscal deficit monetization"

TAX REVENUE OF THE GOVERNMENT SHRANK BY -18.9% Y/Y IN THE FIRST FIVE MONTHS OF THIS YEAR

y/y %

Government revenue: tax

LAND SALES REVENUE WHICH IS CRUTIAL TO LOCAL GOVERNMENT INCOME ALSO DECLINED

% ytd, y/y

land sales revenue

Source: CEIC and BBVA Research
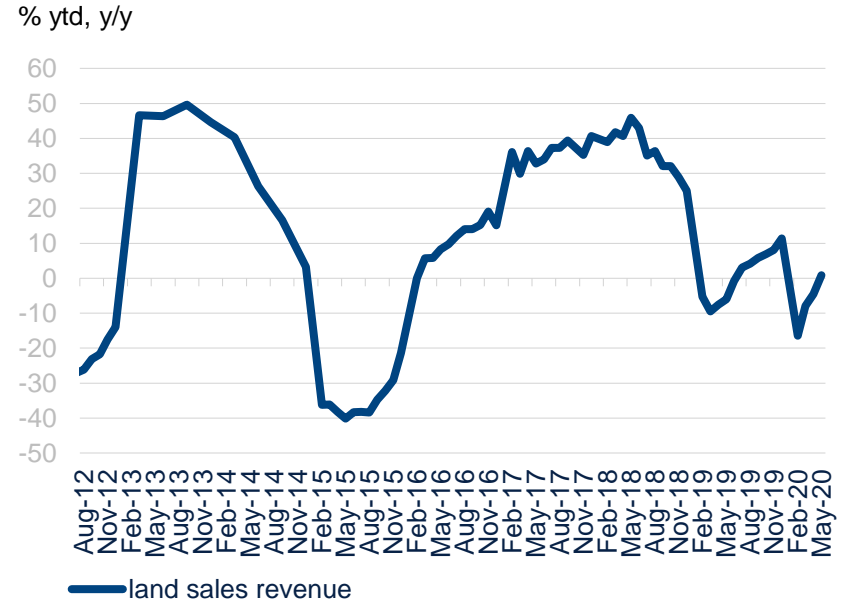
# However, the recent hot debate of "fiscal deficit monetization" is far from a policy choice

01

First, fiscal deficit monetarization destroys the well-established fiscal disciplines in China, which means the bond market has certain constraint on government debt issuance.

02

Second, given that RMB is far from an international reserve currency, fiscal deficit monetarization will have a strong signal effect to ravage the global market confidence of China's fiscal system, leading to capital outflows and financial volatility etc.

Financing the fiscal deficit by means of conventional measures such as through the secondary bond market issuance still has room

CHINESE HOUSEHOLD SAVINGS ARE HIGH COMPARED WITH OTHER COUNTRIES DUE TO LONG-LASTING FINANCIAL REPRESSION IN CHINA

%

Ratio of household saving to disposible household income
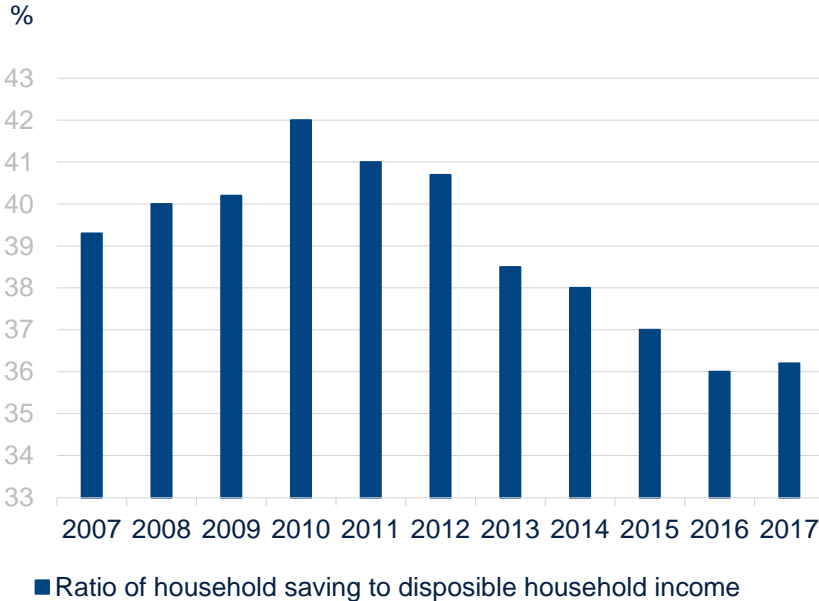
MOST OF CHINESE HOUSEHOLD ASSETS ARE IN THE FORMS OF BANK DEPOSIT AND REAL ESTATE, THUS, GOV BOND DIVERSIFIED THEIR CHOICES

10,50%

11,80%

77,70%

Housing   Financial assets   Others
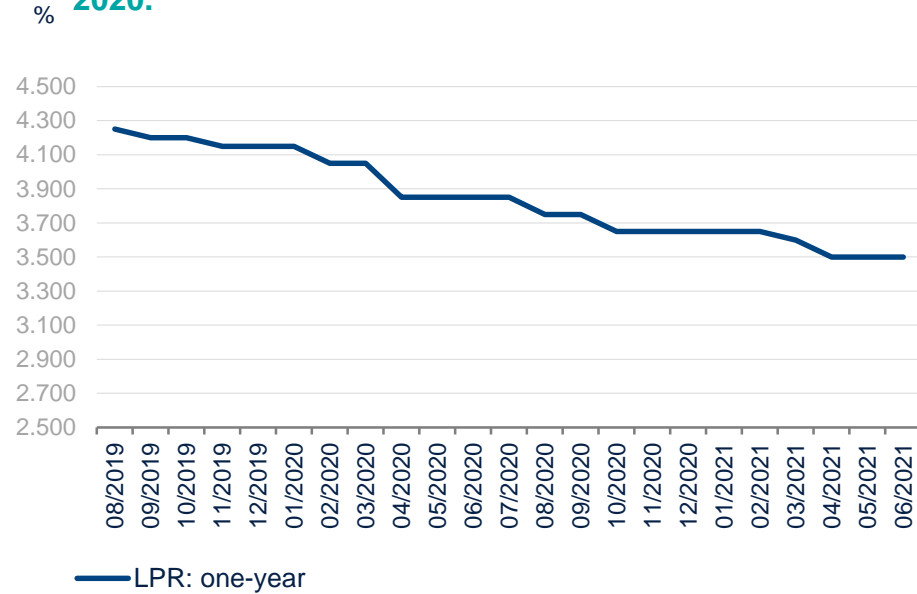
Source: BBVA Research and CEIC
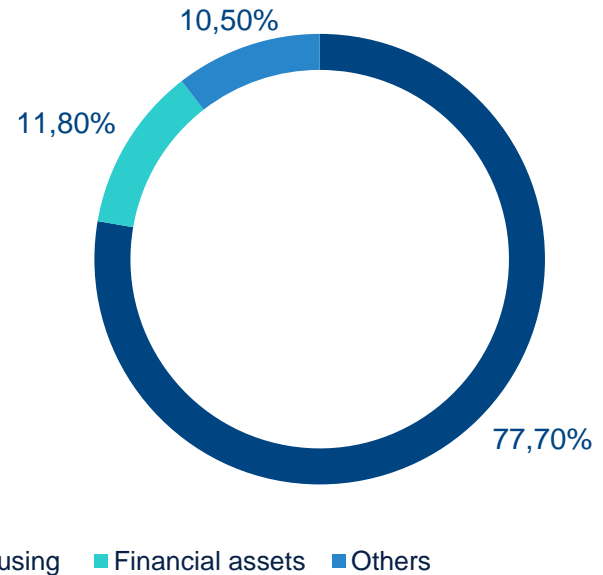
The PBoC took a conservative step on LPR and MLF cut in Q2 amid growth recovery, leaving room for future uncertainties

THE PBOC IMPLEMENTED EASING MONETARY MEASURES BUT BECAME MORE CONSERTIVE IN INTEREST RATE CUT IN Q2
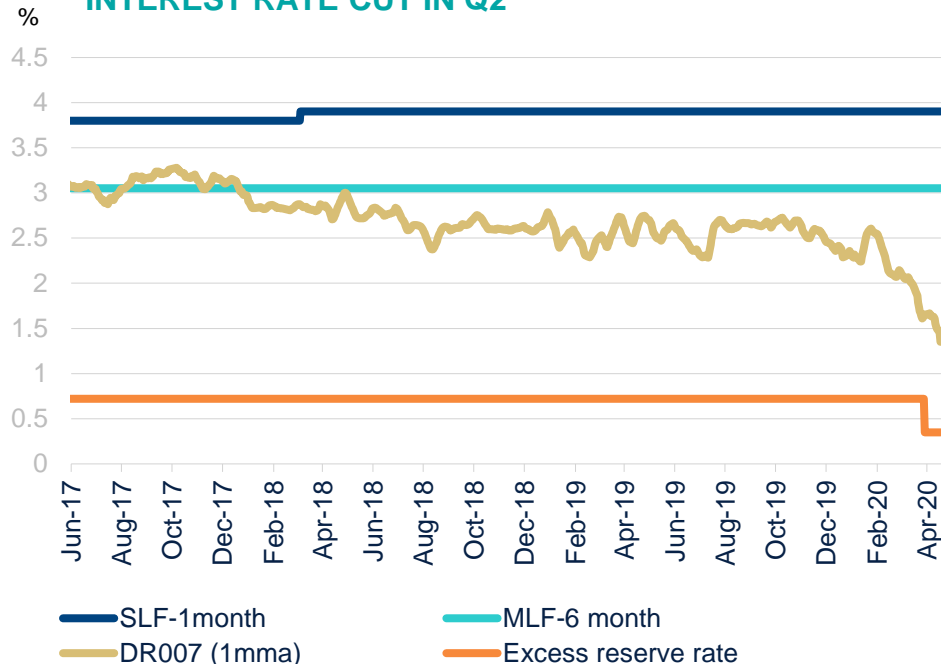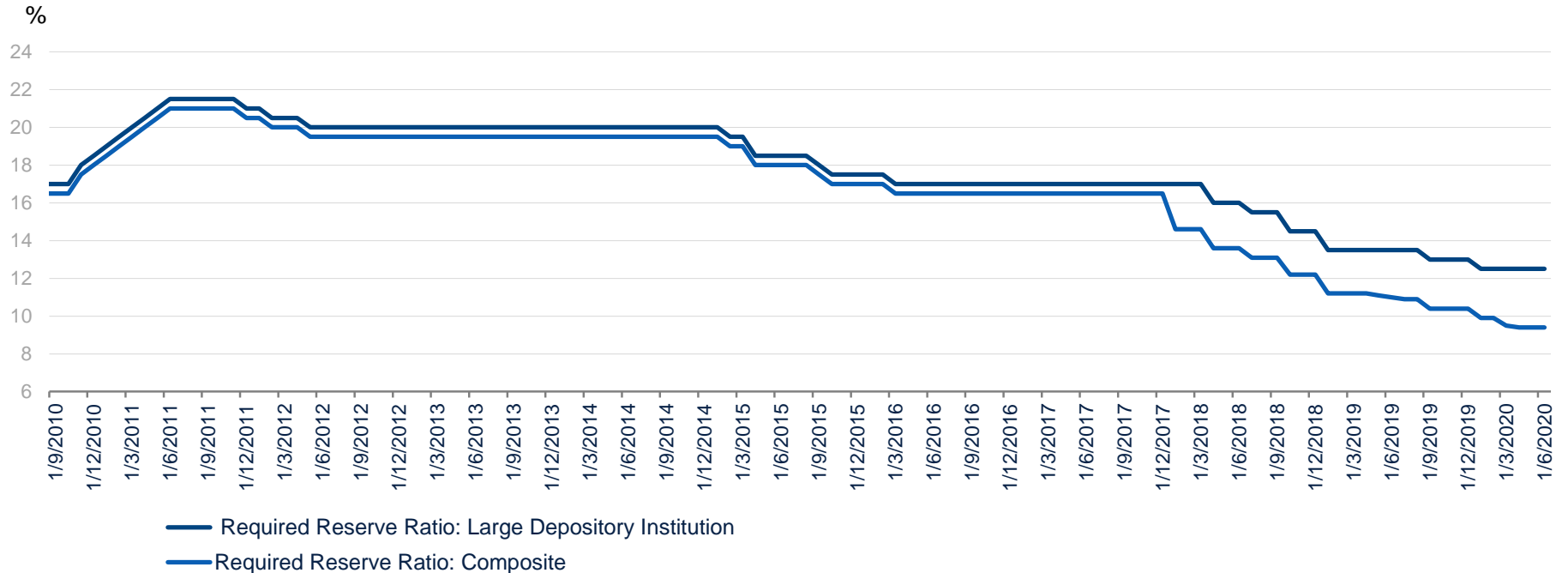
NO LPR OR MLF CUT IN Q2; OUR PREDICTION OF ONE-YEAR LPR: FROM 3.85% NOW TO 3.65% AT END-2020.

SLF-1month
MLF-6 month
DR007 (1mma)
Excess reserve rate

LPR: one-year
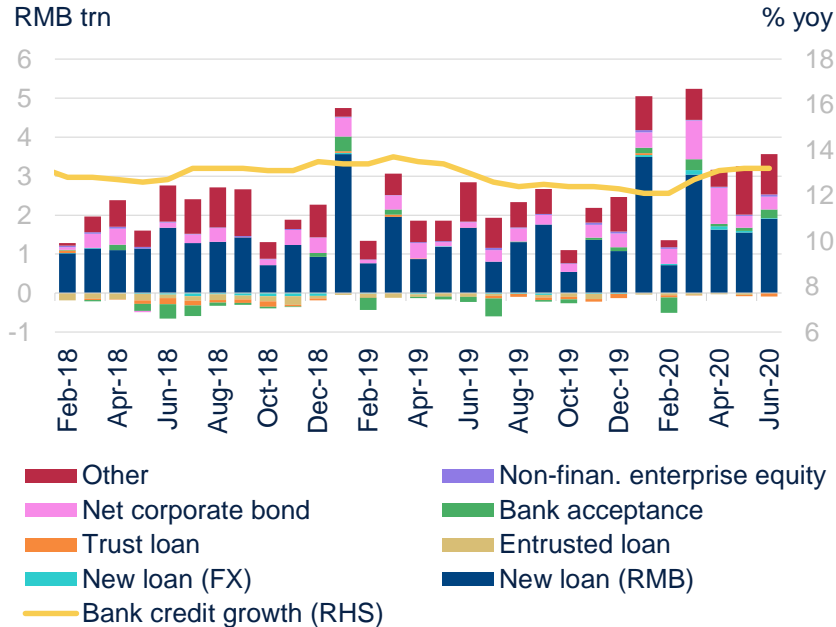
Source: CEIC and BBVA Research

RRR cut seems to have larger policy room and with less costs compared with LPR cut

TWO RRR CUTS IN Q1 AND ONE IN Q2, WE EXPECT ANOTHER TWO CUTS IN THE REST OF 2020

Required Reserve Ratio: Large Depository Institution

Required Reserve Ratio: Composite
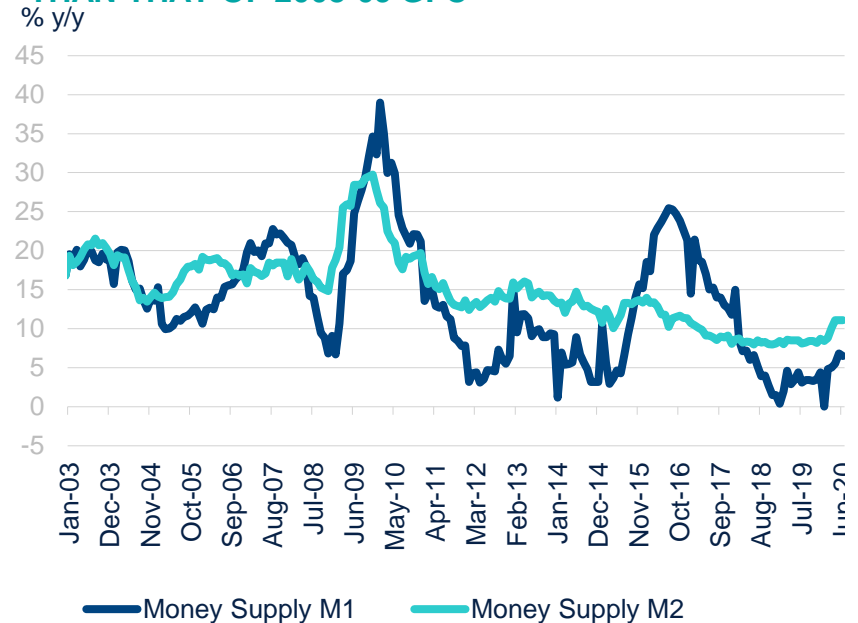
Source: Haver & BBVA Research

M2 and total social financing are picking up in Q2 due to the easing measures

NEW CREDIT SUPPLY INCREASED SIGNIFICANTLY IN FORMS OF NEW RMB LOANS AND OTHER SHADOW BANKING ACTIVITIES

RMB trn   % yoy

Legend:
- Other
- Net corporate bond
- Trust loan
- New loan (FX)
- Bank credit growth (RHS)
- Non-finan. enterprise equity
- Bank acceptance
- Entrusted loan
- New loan (RMB)

Source: CEIC and BBVA Research

M2 GROWTH JUMPED TO 11.1% Y/Y IN Q2 FROM 9.1% ON AVERGA IN Q1；HOWEVER, IT IS FAR LESS THAN THAT OF 2008-09 GFC

% y/y

Money Supply M1   Money Supply M2

Source: Wind & BBVA Research

04

Projections

Main messages

- Looking ahead, growth headwinds remained in the unbalanced domestic recovery and subdued external demand as China's major trade partners are struggling to contain the COVID-19 contagion.

- We forecast GDP growth will pick up to 5% y/y and 6% y/y respectively in Q3 and Q4 (slightly revised down Q4 GDP from 7% to 6%). Thus, the whole year GDP growth prediction will remain at 2.2%, higher than the IMF prediction at 1.1%.

- Inflation is likely to slow down through the rest of the year due to sluggish domestic demand and eased ASF. Now more worries are surrounding deflation pressure.

Forecast of GDP and CPI: baseline scenario

WE FORECAST GDP GROWTH TO BE A V-SHAPE IN 2020

Baseline GDP growth
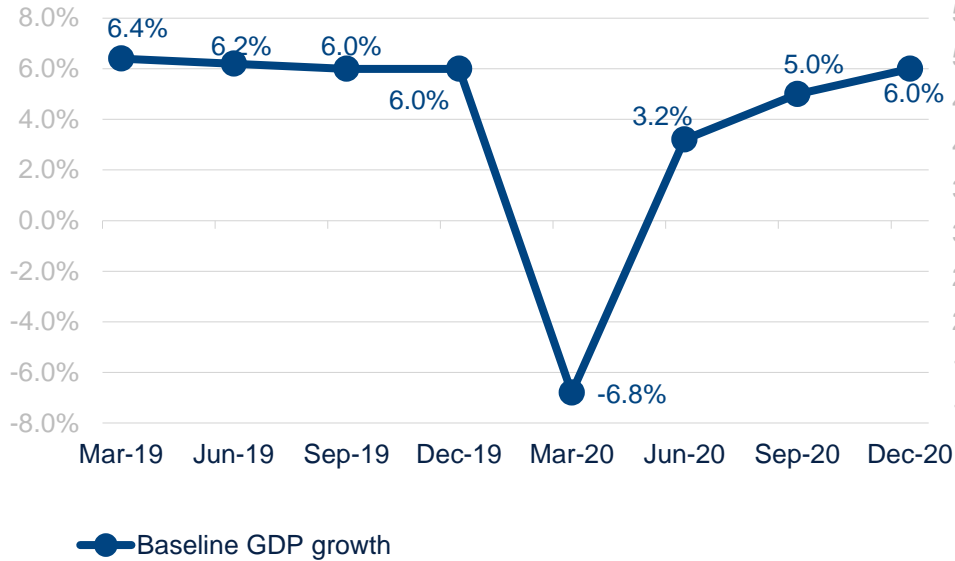
CPI WILL CONTINUE TO SLOW DOWN IN 2H 2020 DUE TO HIGH BASE EFFECT AND EASED ASF

Baseline CPI growth

Source: CEIC and BBVA Research
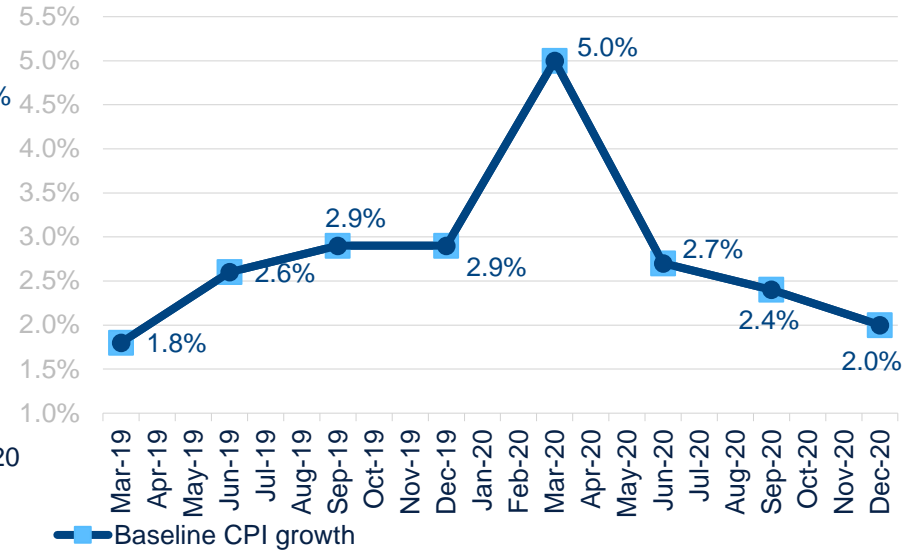
Economic indicators forecasting

BASELINE SCENARIO

	2019	2020 (f)	2021 (f)
GDP （%）	6.1	2.2	5.5
CPI（%）	2.9	3	2.5
Interest rate (LPR, %）	4.15	3.65	3.5
RMB exchange rate	7	7	6.8
Fiscal deficit to GDP (%)	-4.9	-6	-4.5

(f): Forecast
Source: CEIC and BBVA Research

China Economic Outlook

3Q 2020

BBVA Research, Asia

July 2020