BBVA Research

China Economic Outlook

2Q21

Creating Opportunities

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01

The bumpy global normalization path

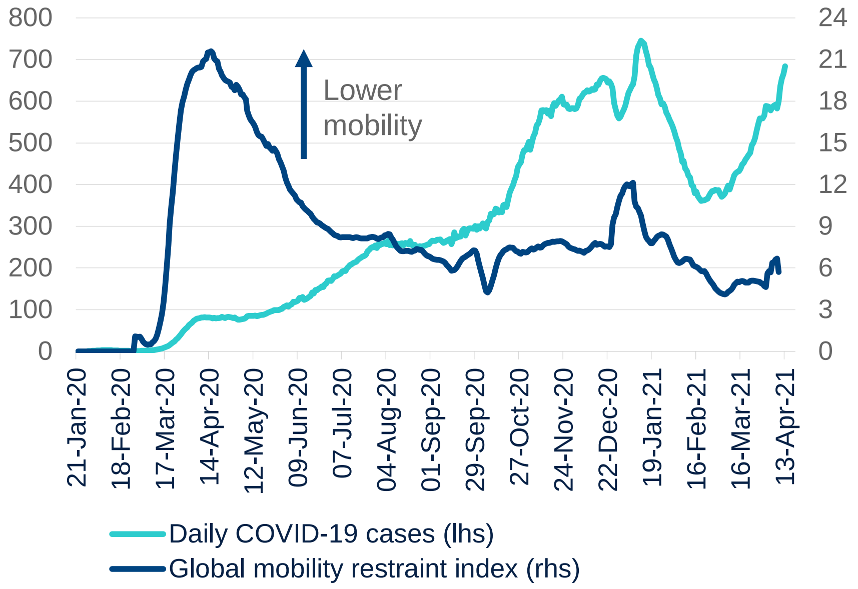
Creating Opportunities

The global economy continues to recover despite the still complex epidemiological context

2020	Start of 2021
Beginning and expansion of the pandemic, lockdowns, and vaccines developments	Start of vaccination, at different paces
Massive fiscal and monetary stimuli	Reinforced stimuli (fiscal packages in the US)
Sharp rise in financial volatility, followed by a gradual normalization	Increase of long term yields in the US and dollar appreciation
Incomplete and heterogeneous GDP rebound after the initial crash	Recovery at different paces, depending on vaccination and stimuli

COVID-19 infections have increased again, following a sharp decrease at the start of the year, but mobility remains relatively high

WORLD DAILY COVID-19 CASES AND GLOBAL MOBILITY RESTRAINT INDEX (*)
(CASES: THOUSANDS OF PEOPLE , 7-DAY MOVING AVERAGE)

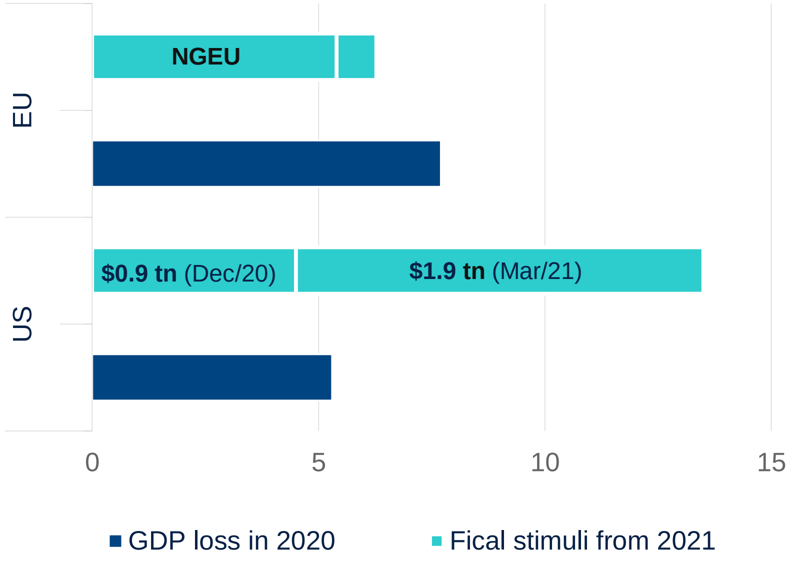


- Recent augment in infections in the US and, mainly, in Europe and Latin America, which have been forced to consider new restrictions.
- Virus mutations facilitate its spread.
- Less severe restrictions have limited the effect of contagions on mobility and on economic activity.

(*) The mobility restraint index reflects changes with respect to the period of reference (January 3 to February 6 2020). Higher values represent lower mobility.
BBVA Research based on data from John Hopkins University and Google.

The new fiscal impulse in the US reinforces the view that economic policy is fully committed with the recovery, although it creates risks

GDP LOSS IN 2020 AND FISCAL STIMULUS(*)
(PP, % OF GDP)

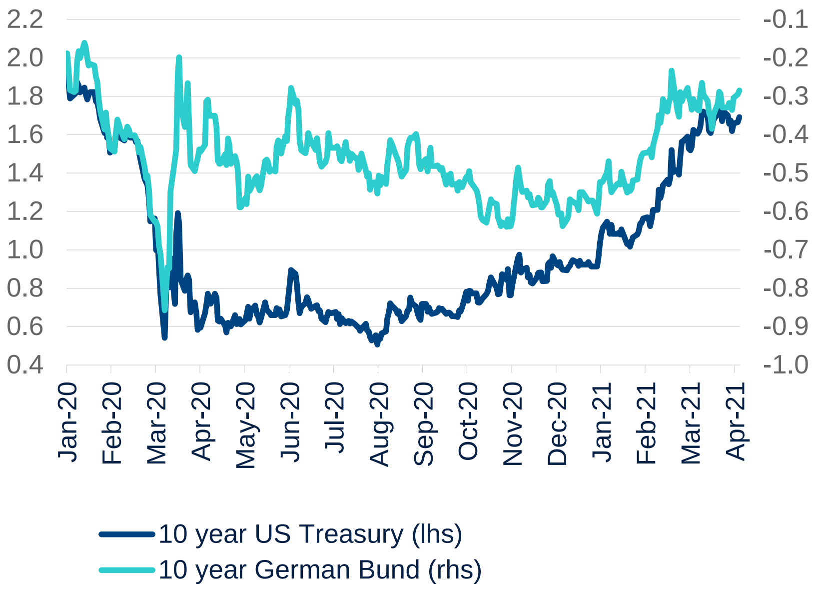


- Fiscal policy in the US: approved measures supporting consumption (13% of GDP) and measures supporting investment currently being discussed (up to 15% of GDP over the next 10-15 years).
- The Fed is not worried about inflation and has suggested it will keep interest rates at zero level through at least 2023.
- In Europe the focus is on making NGEU funds available from mid year on.
- The ECB is intensifying asset purchases in this quarter with the aim of preserving the monetary policy accommodative stance.

(*) GDP loss in 2020: difference between forecasted GDP before the crisis and the actual data. Fiscal stimuli to be implemented from 2021. US: USD 900 billions approved in Dec 2020 and USD 1.900 billion approved in Mar 2021. EU: NGEU and measures announced by the main countries in the region.
Source: BBVA Research.

Fast vaccination and the fiscal impulse in the US have triggered a rise in long term yields and a dollar appreciation

10-YEAR BOND YIELDS
(%)

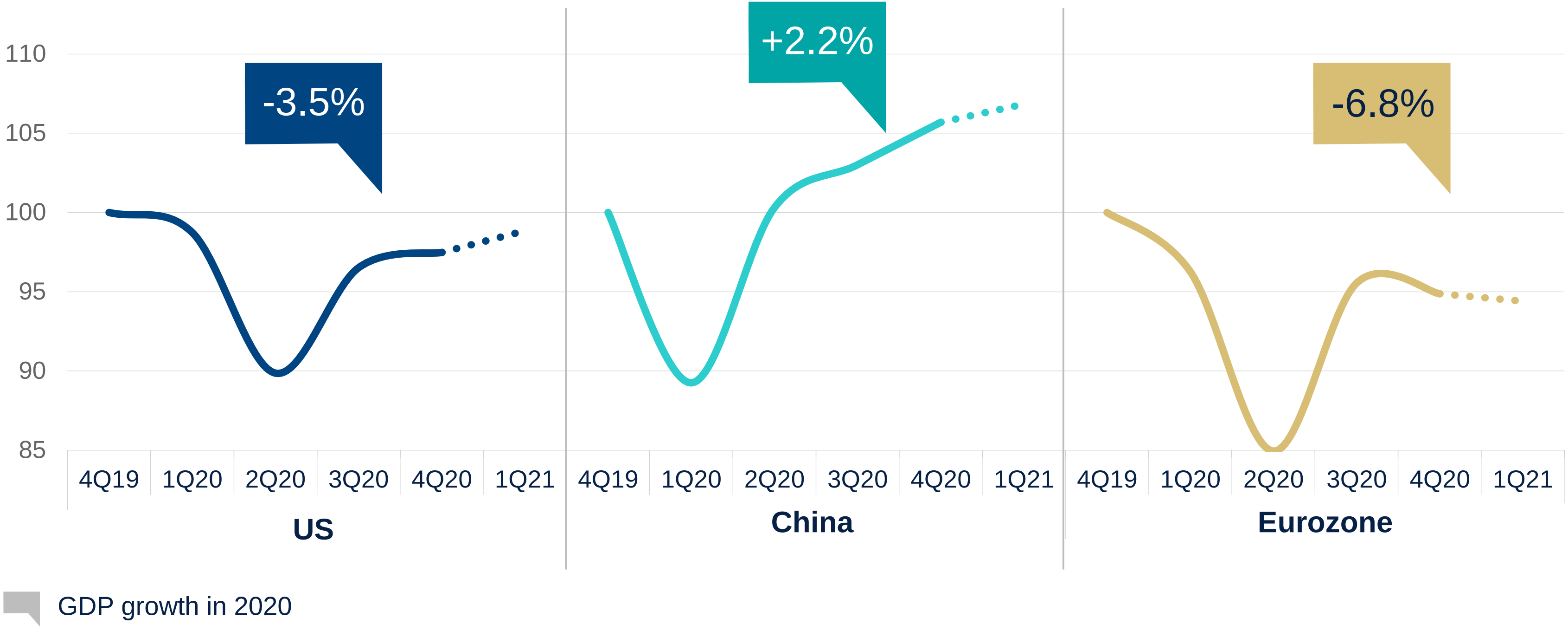


Source: BBVA Research based on date from Bloomberg.

- Fiscal measures in the US have reinforced growth and inflation prospects.
- Markets have brought forward their forecasts for the withdrawal of monetary stimuli.
- Long term debt yields have significantly increased in the US, and at a lower degree in Europe.
- Equity markets have exhibited volatility episodes.
- The dollar has appreciated and emerging markets assets have suffered losses amid diminished capital inflows.

Growth is accelerating in the US, moderating in China and remains negative in Europe at the start of 2021, following a better-than-expected end of 2020

GDP LEVEL IN REAL TERMS(*)
(4Q19=100)



(*) Observed data up to 4Q20. BBVA Research forecasts for 1Q21
Source: BBVA Research based on local statistics.

Reinforced recovery prospects on stimuli and vaccines rollout; inflation and financial stress to remain contained, despite risks

Rest of 2021	2022
Mass vaccination with high heterogeneity across countries	“New normal”
Reinforced fiscal stimulus and unchanged rates in G3	Reinforced fiscal stimulus, unchanged rates in G3 and start of Fed tapering
Limited risk aversion, only a gradual rise of long term rates and a slightly dollar depreciation	Limited risk aversion, only a gradual rise of long term rates and a slightly dollar depreciation
Global recovery, led by the US and China	Global recovery, including in Europe and emerging markets

Assumptions and main features of BBVA Research’s global scenario.

Global growth will be higher than previously forecast and it will be led by the US and China

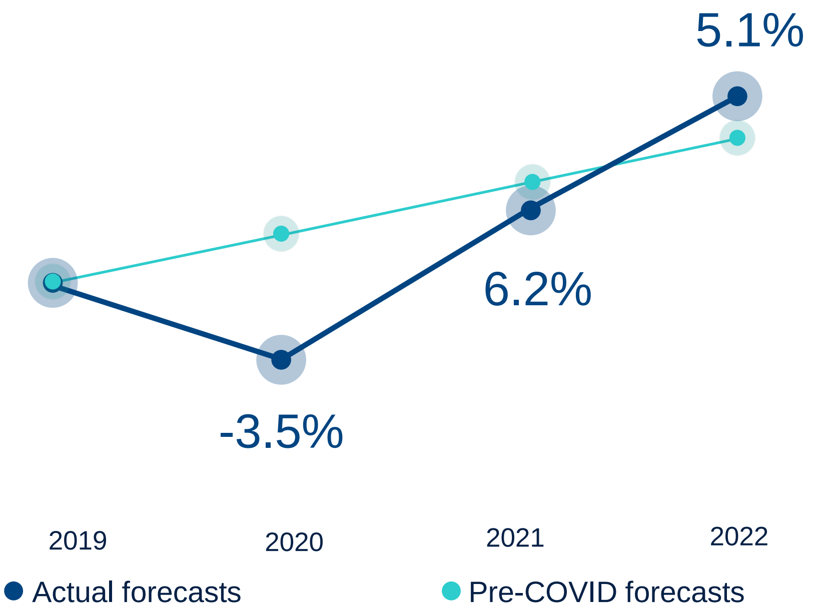
	US	Eurozone	China	World
2020	-3.5	-6.8	2.2	-3.3
2021	6.2 (upwardly revised)	4.5 (upwardly revised)	7.5 (unchanged)	5.9 (upwardly revised)
2022	5.1 (upwardly revised)	4.9 (upwardly revised)	5.5 (unchanged)	4.8 (upwardly revised)

- Upwardly revised forecast
- Unchanged forecast
- Downwardly revised forecast

Source: BBVA Research.

US: growth will pick up sharply, but the Fed will take some time before starting to withdraw the monetary stimulus

US: REAL GDP
(LINES REPRESENT GDP LEVEL AND FIGURES REPRESENT ACTUAL GDP GROWTH FORECASTS)

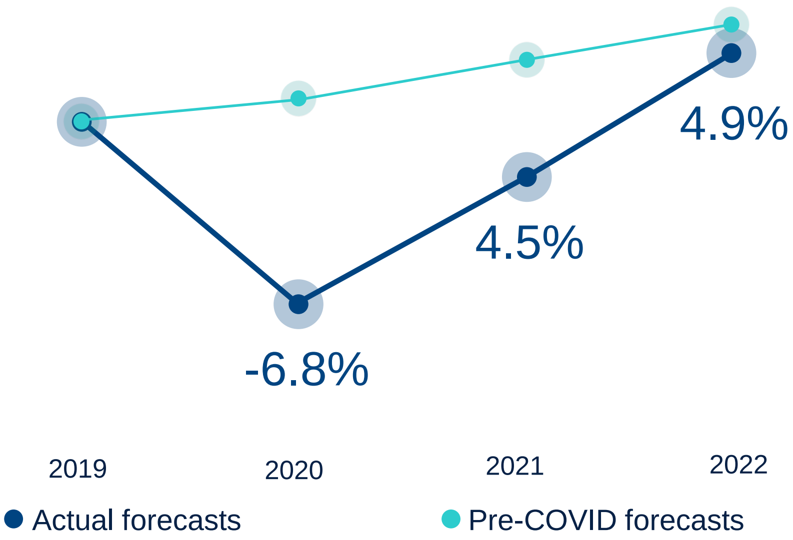


Source: BBVA Research.

- Revised growth (2021: +2.6 pp; 2022: + 2.7 pp) on stimulus, reopening and fast vaccination.
- Approved fiscal measures will have a particularly strong effect on consumption.
- A new, investment-focused fiscal package is likely to be approved in 2021.
- Inflation will rebound, but will remain under control, averaging 2.5% in 2021.
- The labor market recovery will be gradual and the Fed will only start hiking rates in 2023

Eurozone: growth will accelerate from the middle of the year onwards due to vaccination, the NGEU and the effects of higher growth in the US

EUROZONE: REAL GDP
(LINES REPRESENT GDP LEVEL AND FIGURES REPRESENT ACTUAL GDP GROWTH FORECASTS



Source: BBVA Research.

- The pandemic continues to affect the economy: GDP has fallen moderately in 4Q20 and probably also in 1Q21
- Higher growth forecasts (2021: + 0.4pp; 2022: + 0.5pp) mostly due to greater US dynamism
- The ECB will focus on maintaining accommodative monetary conditions, while reviewing its strategy
- NGEU: small short-term impact, but long-term effect could be high
- In a context of higher oil prices, inflation will average 1.5% this year

Risks will remain significant, mostly on the downside, but a positive scenario with an even faster recovery cannot be dismissed

EPIDEMIOLOGICAL RISKS

- Virus mutations
- Slow vaccination
- New waves of infections

ECONOMIC-FINANCIAL RISKS

- Inflation
- Savings evolution
- Financial stress
- Flows into EMs
- Corporate bankruptcies
- Public debt sustainability

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02

Moderated growth momentum with a more balanced structure

Main messages

The pace of economic recovery is still solid in that the Q1 GDP registered a record-high year-on-year growth rate of 18.3% due to the low base of last year. On sequential terms, the growth moderated to 0.6% q/q (versus 1.4% q/q of market consensus) from the reading of 3.2% q/q in Q4 2020, broadly in line with our projected trajectory of a full-year growth at 7.5%.

The supply and demand gap further narrowed, making the recovery more healthy and sustainable. Despite the authorities' travel restrictions during Lunar New Year holidays, the retail sales regained its momentum quickly in March. Inflation risk is at bay, thanks to anchored food prices.

The authorites are phasing out their policy stimulus. More policy attention has shfited to winding down the legacy debt caused by the anti-pandemic relief measures and tackling other financial vulnerabilites. The authorites are walking a fine line to defuse the risks in a smooth manner.

US-China tensions remain after President Biden took office. The bilateral confrontations seemingly spill over to more fronts and involve more countries. It could take a few years for the two sides to reach a new equilibrium.

2021 Chinese economy: positive and risk factors

Positive factors

Vaccination will add impetus for global economic recovery.

From policy perspective, normalization but “no sharp turnaround” is the main stance for 2021, dispelling the worries of an early exit of accommodative measures.

Strong exports momentum provides the authorities more room for policy maneuver.

Certain external arrangements such as RCEP and EU-China CAI are expected to help China to improve its relation with other countries.

Risk factors

Financial vulnerabilities deteriorate in the aftermath of the pandemic : SOE default risk, debt overhang, housing market bubble and shadow banking etc.

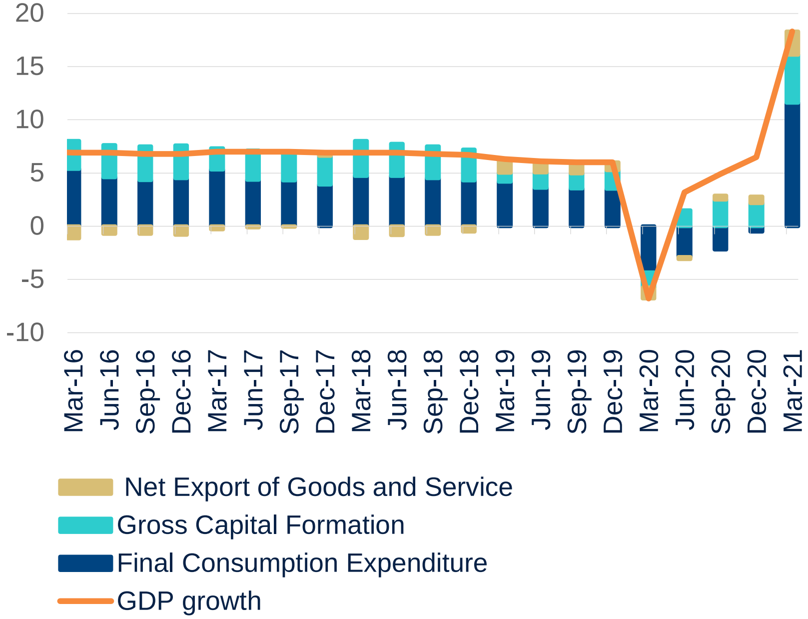
Tightening regulations of monopolistic e-commerce giants and internet firms, as well as “passive deleveraging” strategy might weigh on growth.

Export sustainability is uncertain. The risk of supply chain relocation looms large if the global economy recovers from the pandemic.

The tensions between China and the USA are intensifying as the Biden administration pursues a long-term ideological confrontation and technology competition against China.

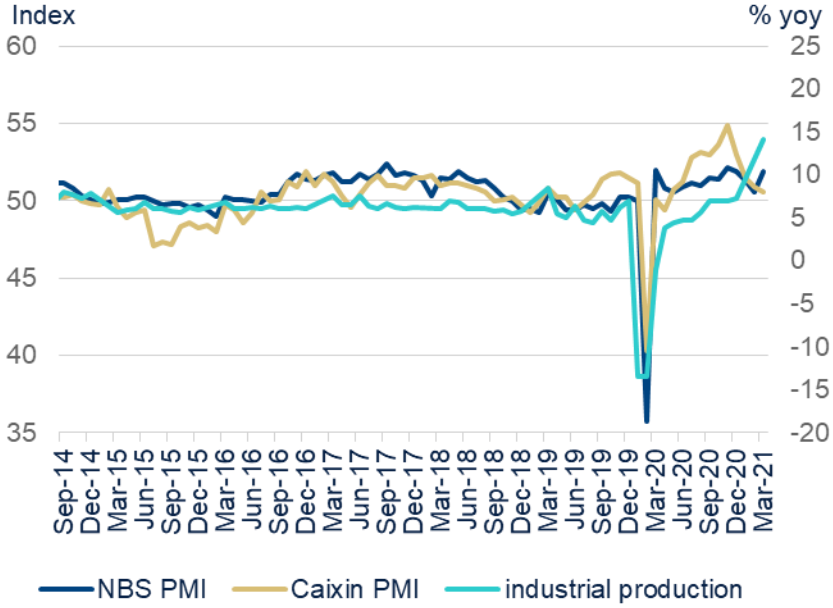
Economic growth: Moderated growth momentum with balanced structure

GROWTH PICKED UP SIGNIFICANTLY IN Q1 2021 FROM 6.5% Y/Y IN Q4 2020 to 19% Y/Y, BUT MOSTLY DUE TO THE LOW BASE EFFECT



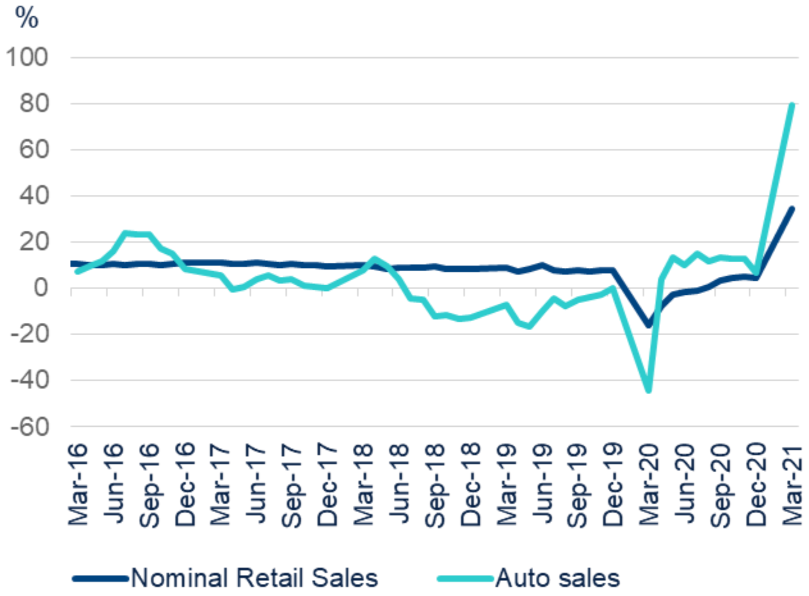
Source: CEIC and BBVA Research.

PMIS BOUNCED BACK IN MARCH, WHILE INDUSTRIAL PRODUCTION PICKED UP SIGNIFICANTLY FROM LAST YEAR'S TROUGH

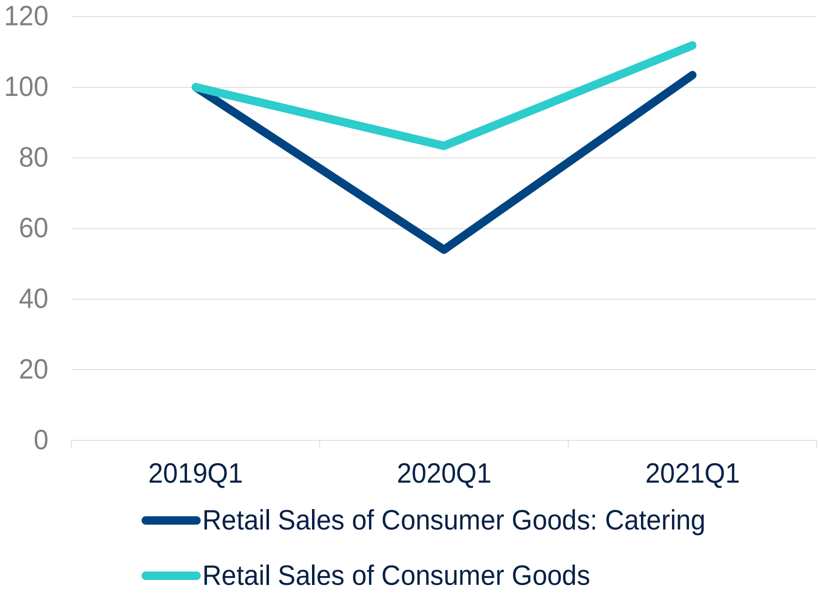


Gradual close of supply-demand gap becomes the new growth engine in 2021

RETAIL SALES GROWTH ACCELERATED TO 34.2% IN MARCH FROM 33.8% PREVIOUSLY, WITH AN INCREASING M/M GROWTH AT 1.75%, SUPPORTED BY AUTO SALES



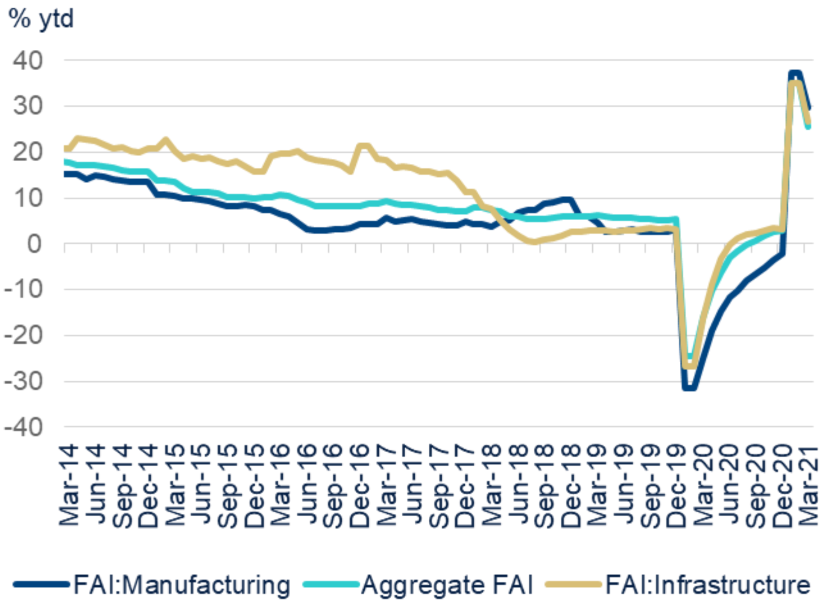
CATERING SECTOR CAUGHT UP TO 2019Q1 LEVEL



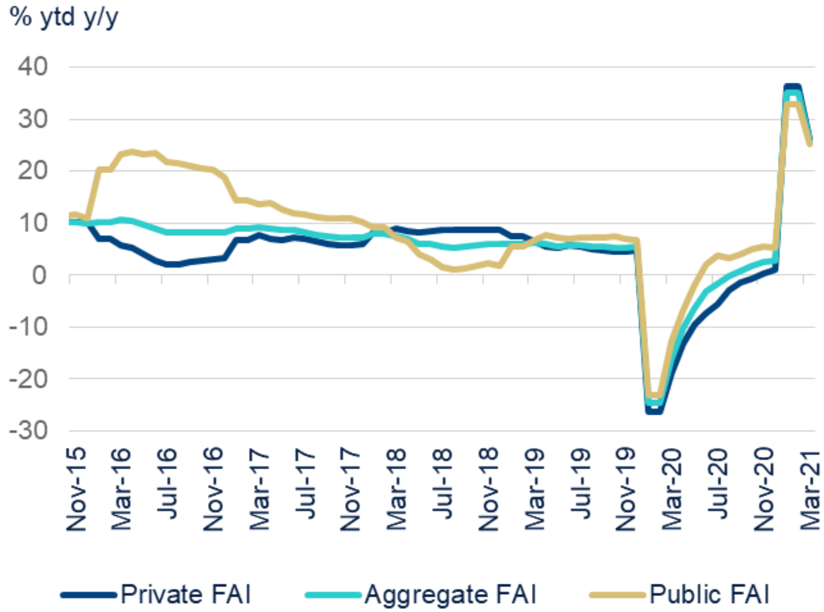
Source: CEIC and BBVA Research.

In 2021, manufacturing FAI is poised to surpass real estate and infrastructure FAI to spearhead the FAI growth

MANUFACTORY INVESTMENT LED THE FAI GROWTH IN MARCH



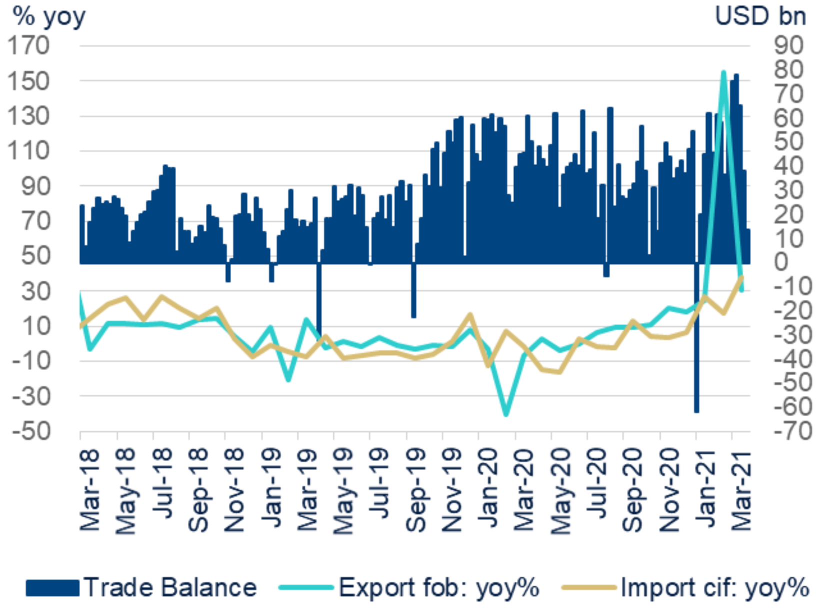
DUE TO FISCAL NORMALIZATION, INFRASTRUCTURE WILL SLOWDOWN; WHILE TIGHTENING FINANCIAL REGULATION SUPRESSES HOUSING INVESTMENT



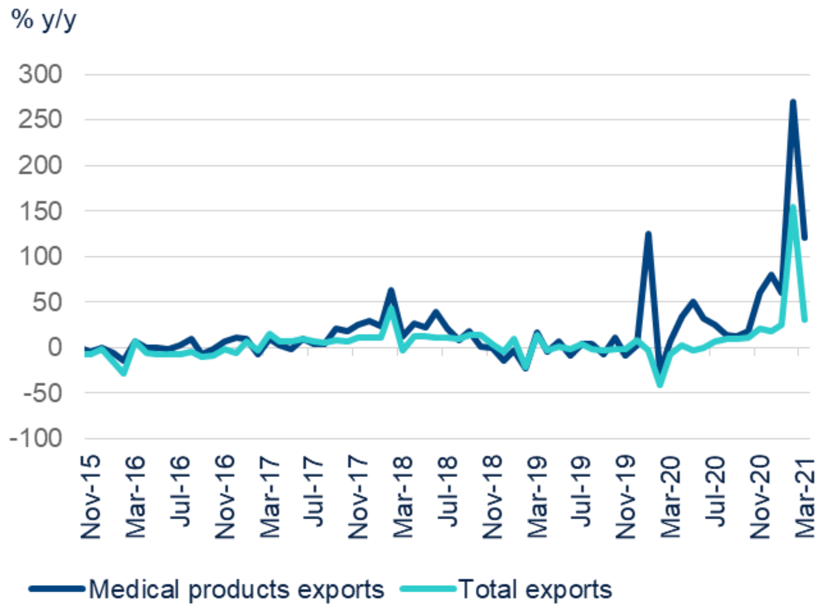
Source: CEIC and BBVA Research.

Global commodity price surge led to a significant shrink on trade balance, while global pandemic raging still support China's exports

MARCH TRADE BALANCE SHRANK TO A HISTORICAL LOW DUE TO A SIGNIFICANT INCREASE OF IMPORTS AMID COMMODITY PRICE SURGE



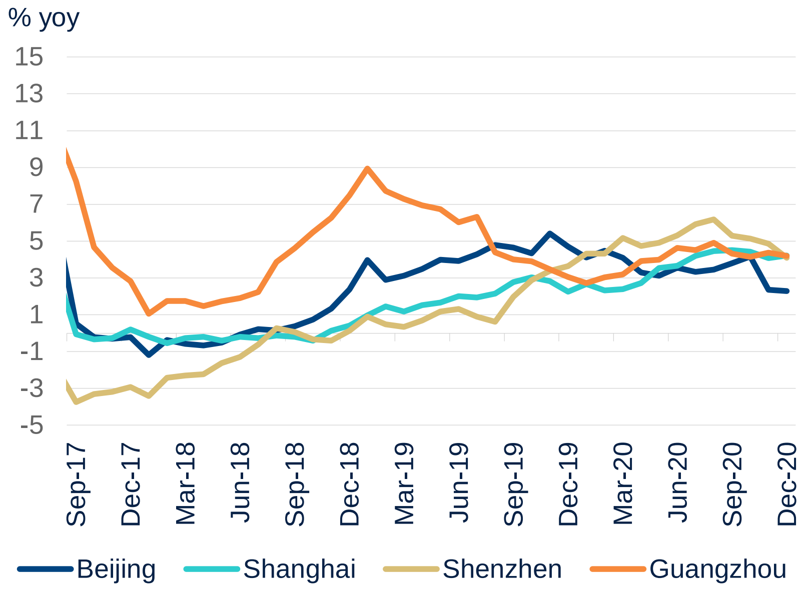
GLOBAL ECONOMIC RECOVERY AND RMB APPRECIATION TREND MIGHT NORMALIZE CHINA' STRONG EXPORTS GROWTH IN THE FUTURE



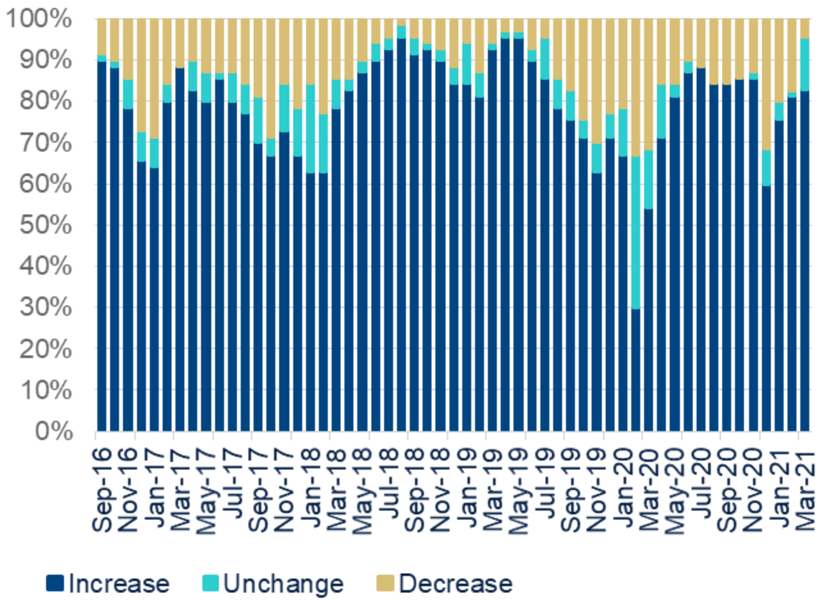
Source: CEIC and BBVA Research.

More regulatory measures on the overheating housing market, especially in tier-1 cities

THE RECENT FINANCIAL REGULATION MEASURES CURBED HOUSING PRICE SOARING



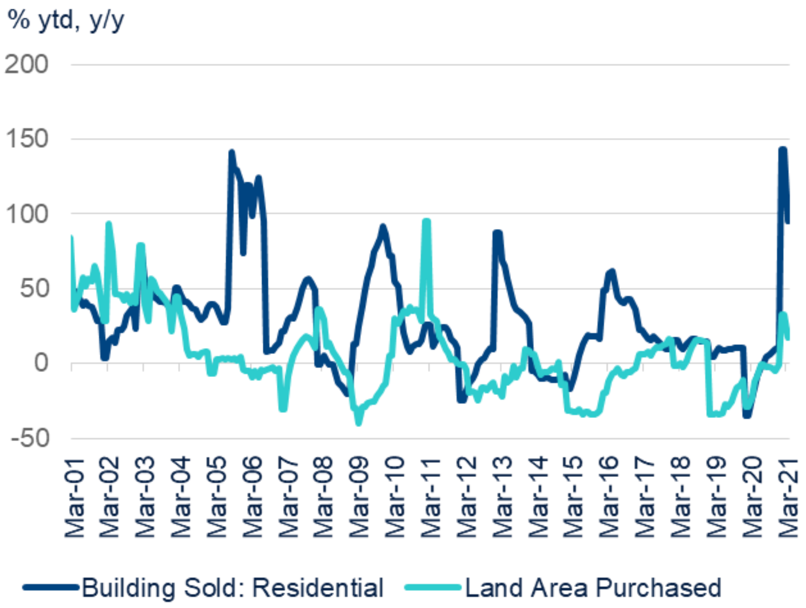
THERE ARE INCREASING NUMBER OF CITIES THAT REPORTED HOUSING PRICE PICKUP, RAISING THE AUTHORITIES' CONCERN (M/M GROWTH)



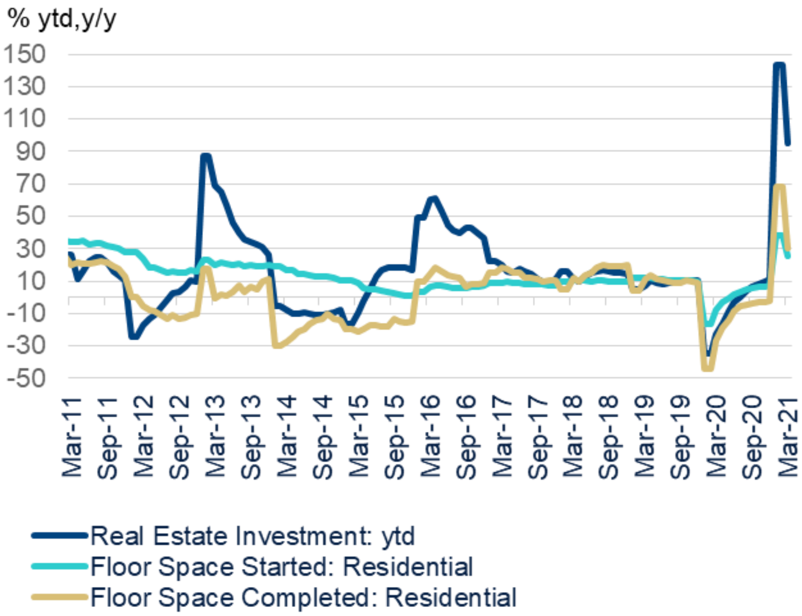
Source: CEIC and BBVA Research.

…housing sales and investment moderated together with the authorities' clampdown of overheating housing market

THE GROWTH RATE OF RESIDENTIAL BUILDING SOLD AND LAND PURCHASE MODERATED IN MARCH



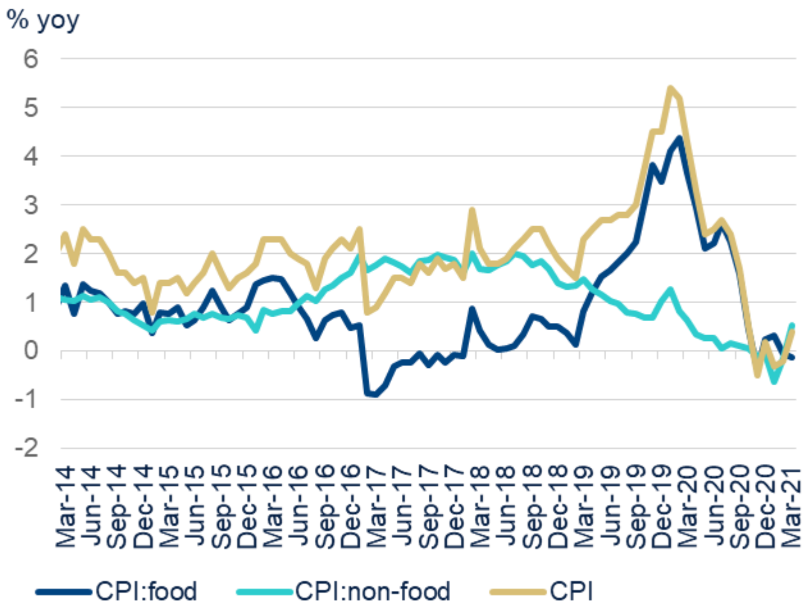
...SO DID THE REAL ESTATE INVESTMENT AND THE STARTED/COMPLETED FLOOR SPACE



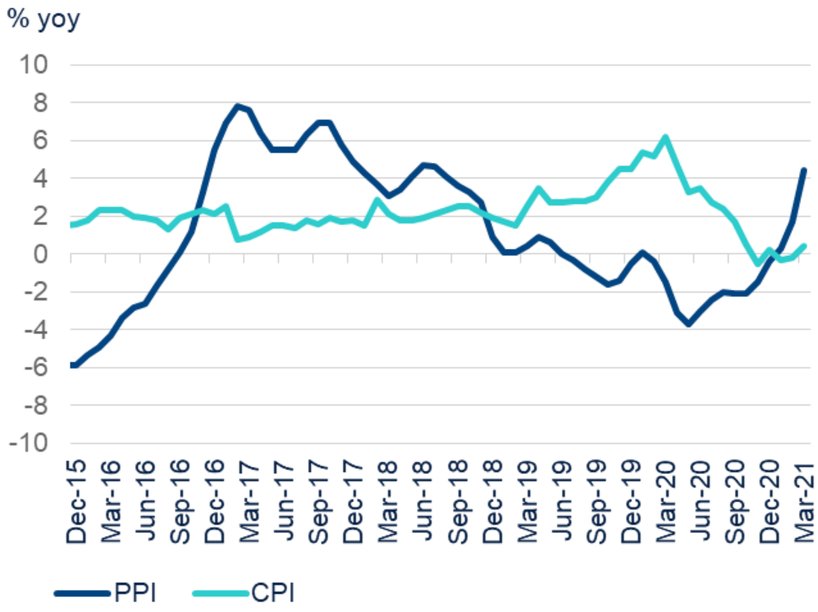
Source: CEIC and BBVA Research.

PPI inflation ticks up to historical high while CPI remains moderated

CPI SWINGS AROUND 0, DUE TO THE EASE OF AFRICA SWINE FLU AND HIGH BASE EFFECT OF PORK PRICE



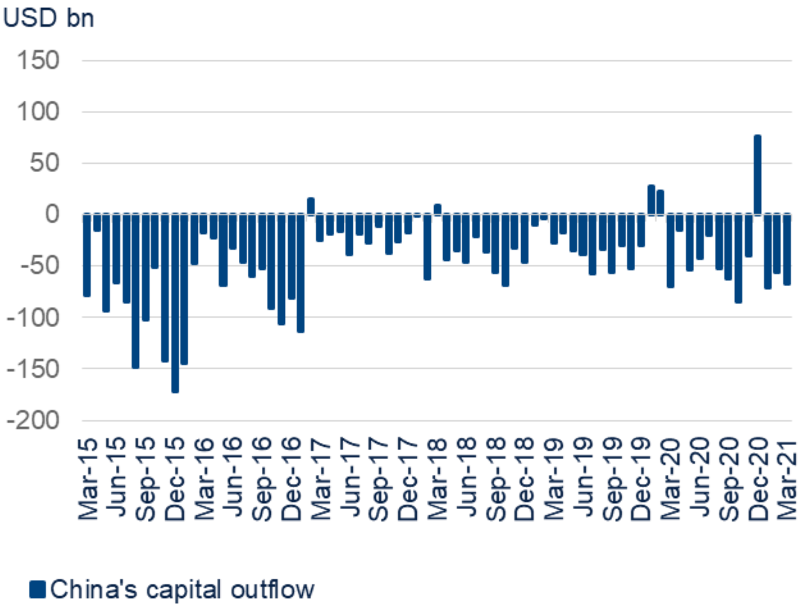
PPI RAMPS UP SIGNIFICANTLY IN MARCH, SUPPORTED BY GLOBAL COMMODITY PRICE SURGE; A DIVERGENCE OF CPI AND PPI IS SET TO CONTINUE



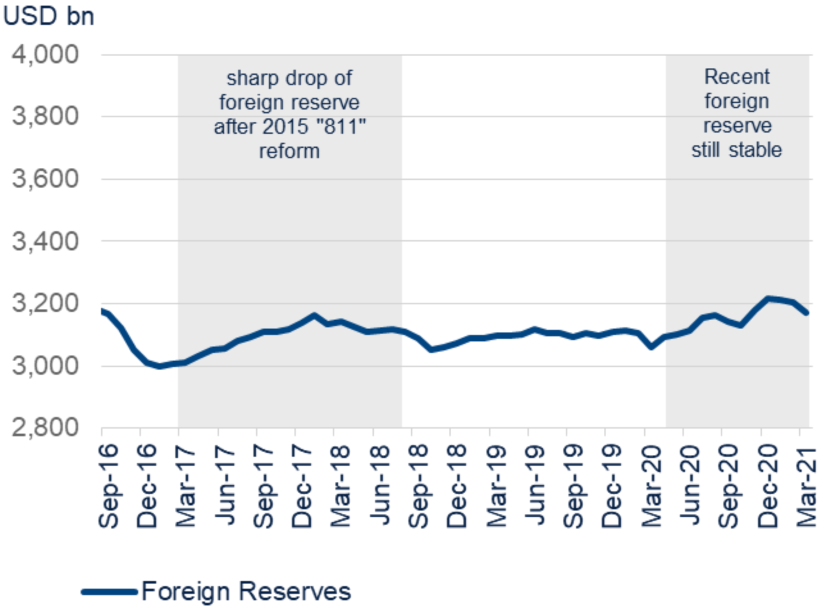
Source: CEIC and BBVA Research.

Should China hike interest rate to avoid capital outflow?

ESTIMATED CAPITAL OUTFLOWS HIGHER THAN INFLOWS, IN LINE WITH INFLATION EXPECTATION INCREASING IN ADVANCED ECONOMIES



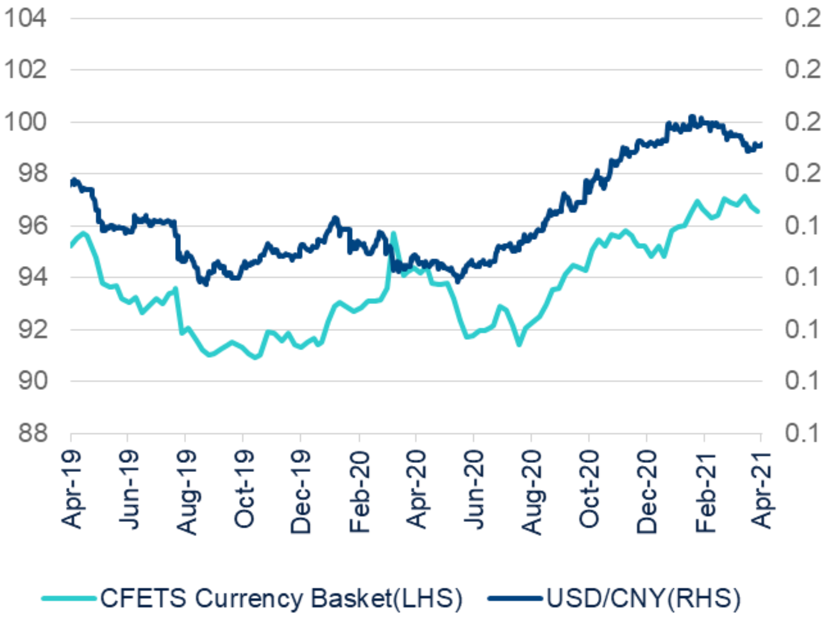
FOREIGN RESERVES DECLINED MARGINALLY IN MARCH BUT GENERALLY REMAIN STABLE IN THE PAST MONTHS



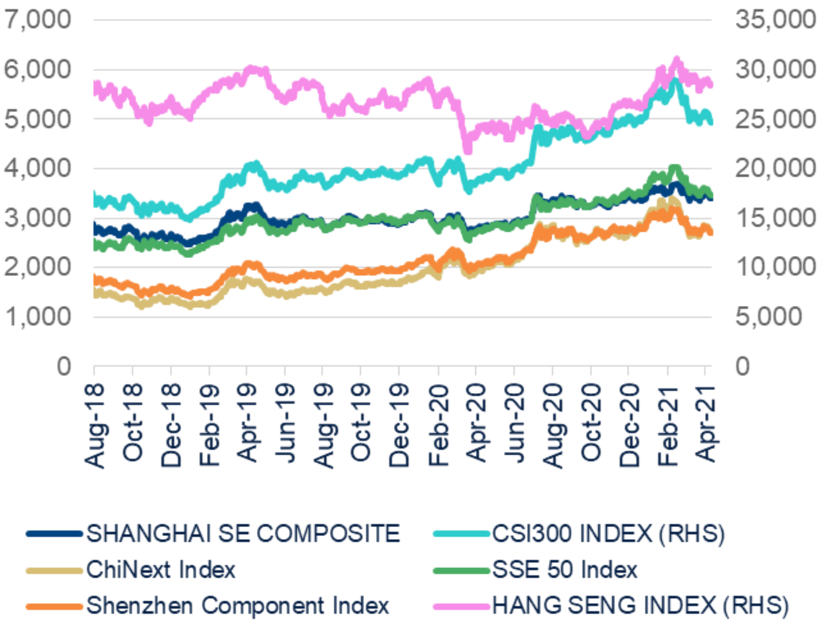
Source: CEIC and BBVA Research.

RMB appreciation turnaround amid a strong USD and the recent adjustment of Chinese stock markets

RMB TO USD EXCHANGE RATE REVERTED THE PREVIOUS APPRECIATION TREND IN LINE WITH A STRONG USD DXY



CHINESE AUTHORITIES HIKED INTERBANK RATE TO ALEART THE SOARING STOCK MARKET BEFORE CHINESE LUNAR NEW YEAR



Source: CEIC and BBVA Research.

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03

Policy normalization with “no sharp turnaround”

Understanding China’s 2021 “Two Sessions”

Main messages

A neutral but still accommodative monetary policy is the main stance in 2021. But there will be "no sharp turnaround" indicated by the 2021 "Two Sessions". At the same time, a tightening financial regulation has been enhanced to curb monopolistic behavior of E-commerce giants and tech firms.

Key challenges of China's monetary policy in the post-pandemic world include several perspectives: (i) Monetary policy normalization steps and the market communication to avoid "taper Tantrum"; (ii) To smooth monetary policy transmission mechanism; (iii) To deal with the role of monetary policy in financial stability and the relationship with fiscal policy; (iv) Should China's central bank include asset prices into monetary policy's price target?

Fiscal policy normalization is also the main stance in 2021. The "Two Sessions" announced a reduction of local government bond issuance and no more special government bond issuance. Fiscal consolidation of approximately 3.2% of GDP fiscal deficit relative to 2020's 3.6%.

2021 "Two Sessions": An easy-to-achieve growth target but more sustainable growth

GDP growth target for 2021 at "above 6%", indicating the authorities' consideration of global economic uncertainties and the potential turbulence led by QE Tapering, and to leave more space for policy normalization.

The 14th Five-Year Plan is formally launched and details will be reviewed in the "two sessions".

Fiscal policy: normalization is the main theme.
(i) Fiscal consolidation of approximately 3.2% of GDP fiscal deficit relative to 2020's 3.6%. (ii) No additional issuance of special treasury bonds. (iii) Reduction of special-purpose bonds issuance from RMB 3.75 trillion to RMB 3.65 trillion.

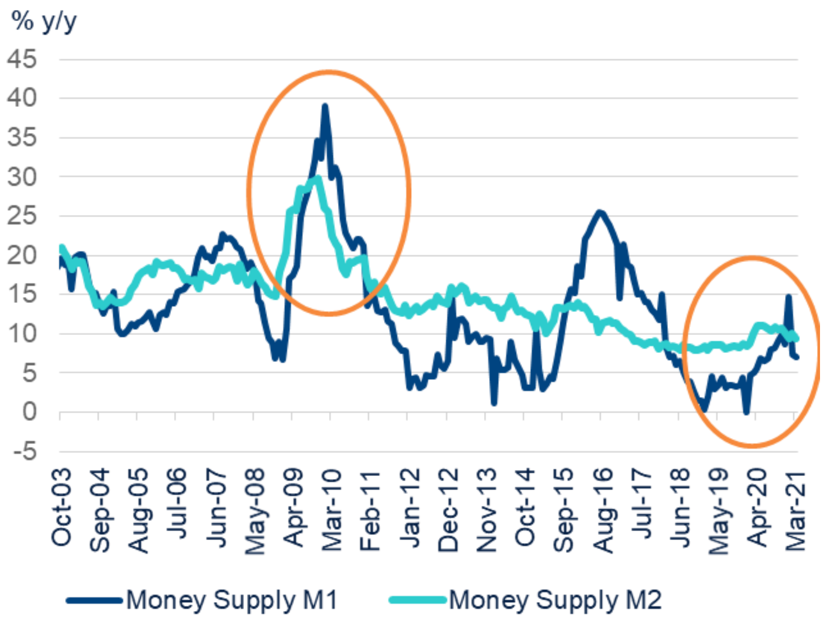
Neutral but still accommodative monetary policy to foster economic recovery. M2 and total social financing annual growth are set to be in line with the nominal GDP growth rate which we estimate will be around 10%.

Boost technology innovation and upgrade self-sufficient supply-chain.

Environment protection and carbon neutrality target. Energy consumption and carbon emission per unit of GDP should be reduced to 13.5% and 18% y/y.

China's monetary policy gradually normalizes after the containment of the virus in April 2020; A neutral but still accommodative monetary stance in 2021

M2 GROWTH STABILIZED FROM 10.3% IN 2020 TO AN EXPECTED GROWTH OF 9% IN 2021



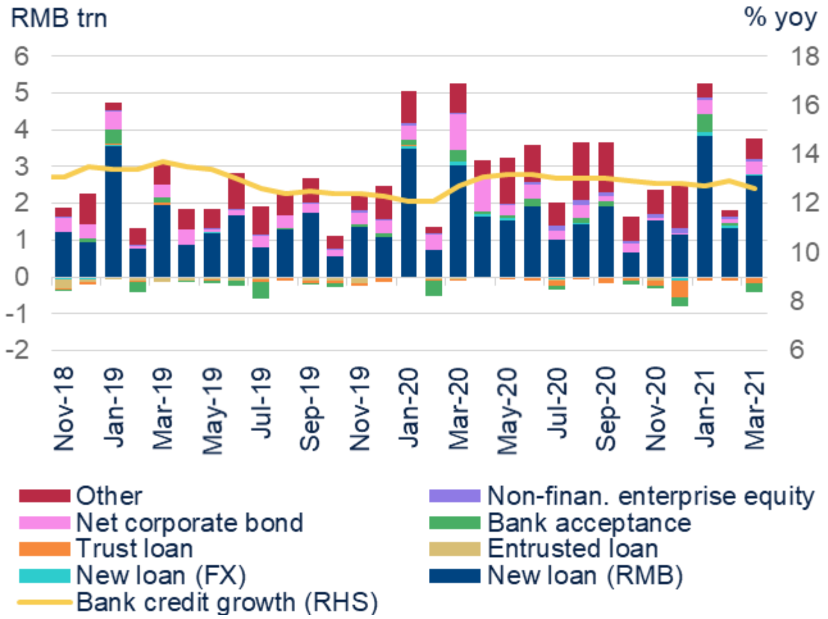
Source: CEIC and BBVA Research.

The PBoC halted the following stimulus measures imposed in Covid-19 period (2020 Jan to May) which have already been conservative compared with zero interest rate in advanced economies:

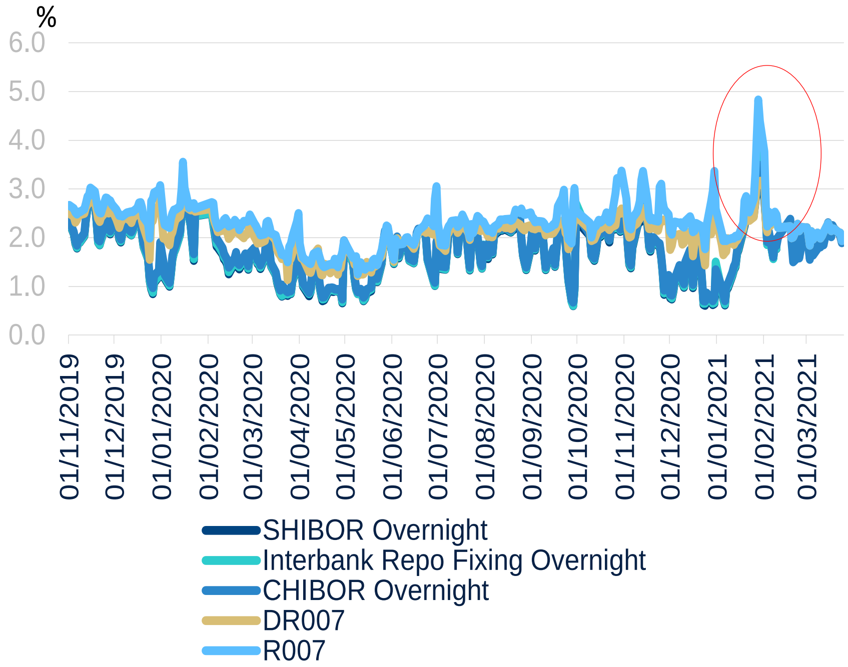
- MLF (médium-lending facilities) rate: declined by 30bps
- DR007 (7-days Reverse Repo rate): declined by 30bps
- SLF rate (standing lending facilities): declined by 30bps
- LPR (loan prime rate): declined by 30bps
- Excess RRR rate: 0.72%→0.35%
- RRR：three cuts (released 1.75 trn RMB)
- Re-lending and re-financing: 1.8 trn RMB
- Extension of SMEs loans: 8.7 billion RMB
- Support for SME financing program: 170 bn RMB

However, the exit of easing monetary measures is a global challenge

THE PBOC INTENDED TO GRADUALLY NORMALIZE M2 AND TOTAL SOCIAL FINANCIAL AFTER THE PANDEMIC GOT CONTROLLED



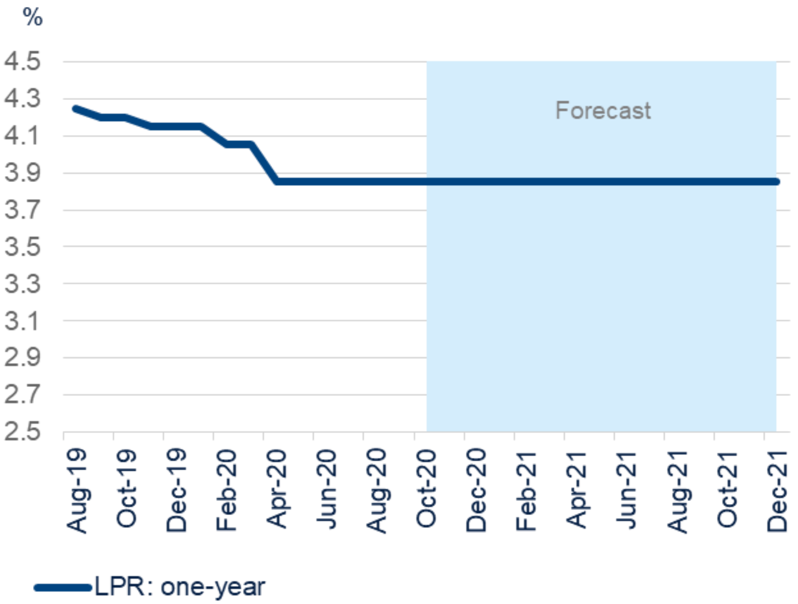
IN CHINA, INTERBANK RATE HIKE IN FEBRUARY 2021 ALSO REFLECTED THIS CONCERN



Source: Xxxxxxxxxx.

Monetary policy normalization should avoid a “sharp turnaround” and should enhance central bank’s communication with the market

A NEUTAL BUT STILL ACCOMODATIVE MONETARY STANCE INDICATES NO ADJUSTMENT OF LPR AND RRR IN 2021

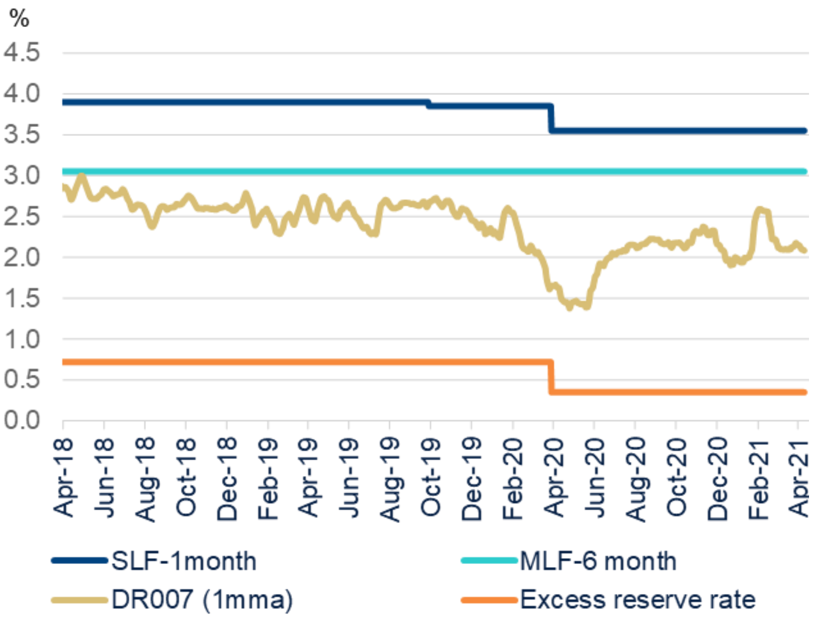


Source: BBVA Research and CEIC.

- Several factors decide this year’s monetary policy normalization should avoid “sharp turnaround”: uncertainties of global economic recovery, unsatisfactory vaccine coverage, China-US relationship, fading exports momentum etc.
- Then, why liquidity crunch in interbank market in February 2021? (i) Central bank wanted to alert a soaring housing and stock market (ii) a temporary failure of PBoC’s OMO liquidity projection model under a complicated market environment: mobility control in Lunar New Year, Southbound Stock Connect movement, RMB appreciation promoted exporters to exchange foreign currencies for RMB, etc.

China's monetary policy has multi-targets and multi-tools

UNDER CORRIDOR SYSTEM FORMED IN 2016-17, THE PBOC ALWAYS DEPENDS ON CREATING NEW POLICY TOOLS TO SOLVE TRANSMSSION PROBLEM

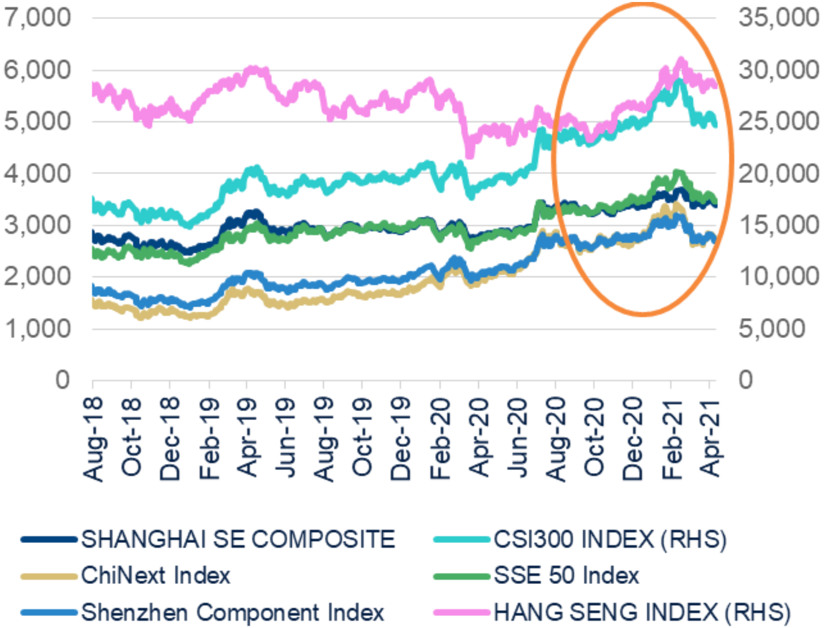


Source: BBVA Research and CEIC.

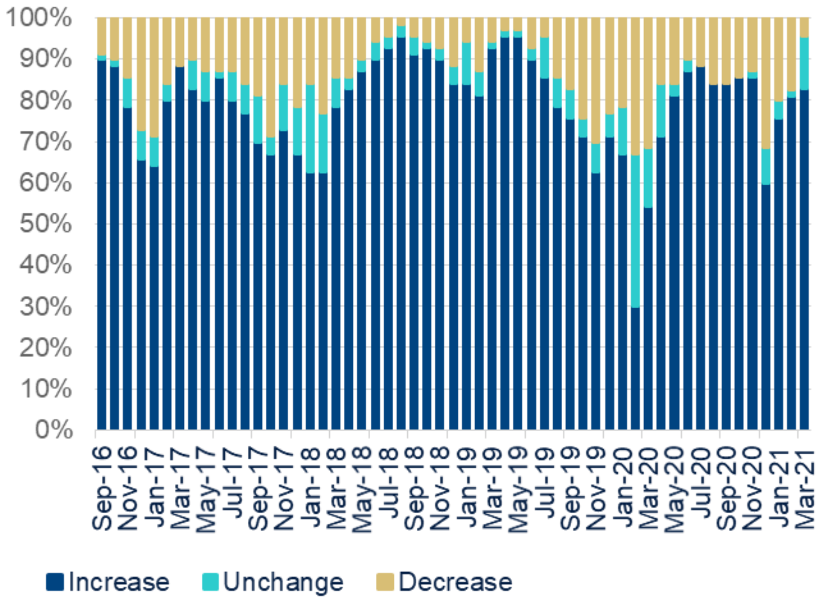
- China has multiple monetary policy targets: stabilizing inflation, promoting economic growth, maintaining employmet, promoting financial stability and maintaining Balance of Payments,
- And multiple monetary policy tools: policy rate-DR007 (7-days Reverse Repo rate), LPR (Loan Prime rate; MLF (médium-lending facilities) rate; SLF rate (standing lending facilities), LPR (loan prime rate); Excess RRR and RRR, Re-lending and re-financing, PSL (pledged supplementary lending), SLO (Short-term Liquidity Operations),
- Compared with the US market which only concerns FED Fund Rate and QE purchasing, China's such a lot of tools complicates the central bank and market communication.

3. Financial stability is still a big challenge in the aftermath of Covid-19 (1) : Soaring stock and housing markets

CHINA'S STOCK MARKET ROCKETING AFTER COVID-19 CONTAINMENT, UNSYNCHRONIZED WITH ECONOMIC SLOWDOWN



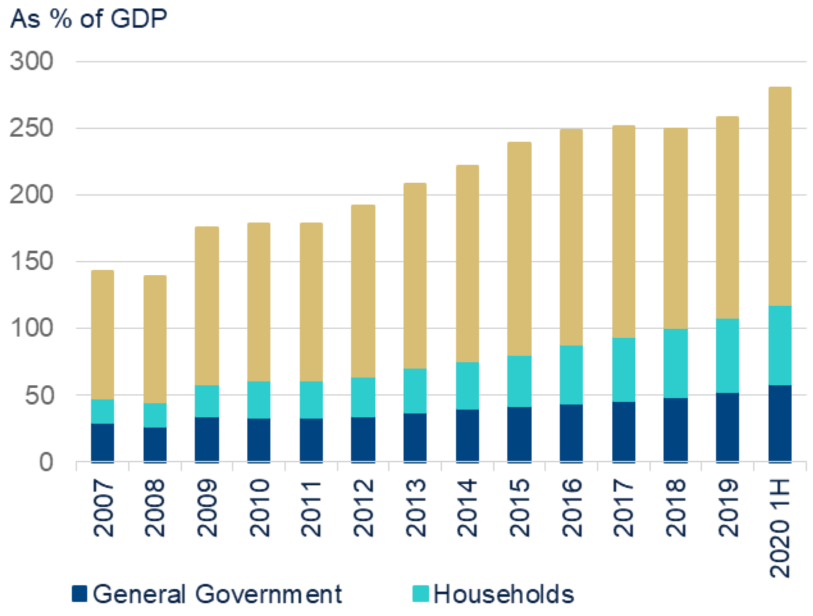
HOUSING MARKET IS ALSO FACING OVER-HEATING IN THE PAST MONTHS



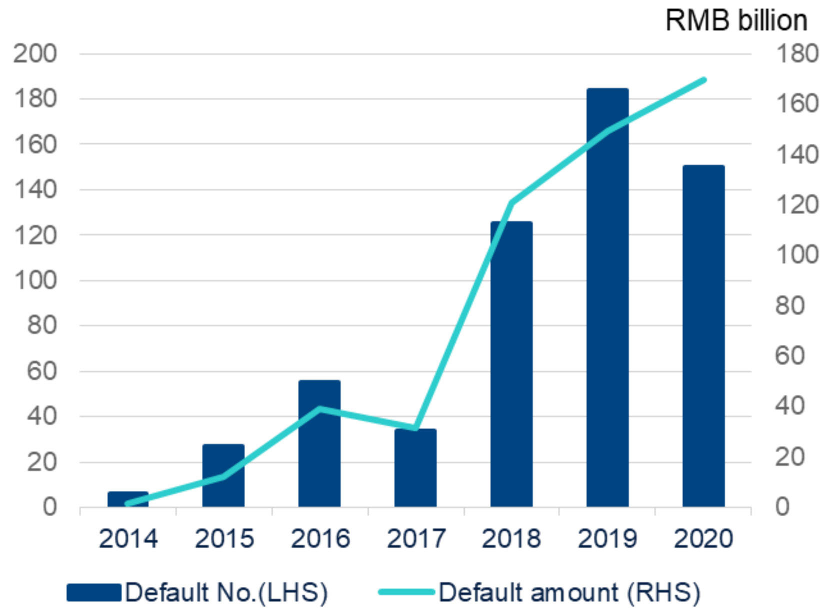
Source: BBVA Research and CEIC.

Financial stability is still a big challenge in the aftermath of Covid-19: (2) Debt overhang problem due to the stimulus measures in 2020 1H

THE MACRO LEVERAGE RATIO HAS BEEN INCREASING IN THE PAST YEAR, INCLUDING GOVERNMENT, HOUSEHOLD AND CORPORATE DEBT



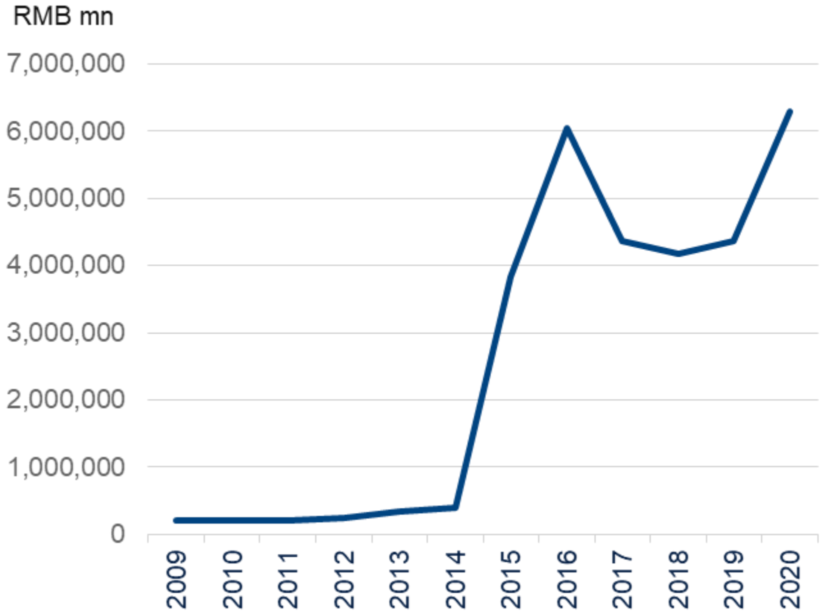
SOE DEFAULT AT END-2020 INCREASED RISKS FOR FINANCIAL STABILITY



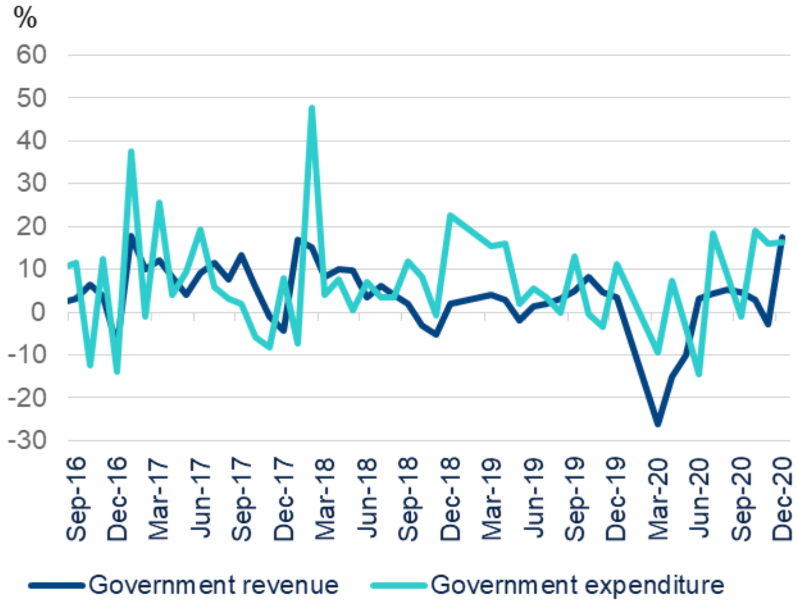
Source: BBVA Research and BIS

No further fiscal stimulus anticipated in 2021 as well

THERE WILL BE NO ADDITIONAL ISSUANCE OF SPECIAL TREASURY BONDS WHILE REDUCING SPECIAL-PURPOSE BOND ISSUANCE FROM RMB 3.75 BN TO 3.65 BN



A SHRINKING GOVERNMENT REVENUE AND INCREASING EXPENDITURE CALL FOR A HALT OF NEW FISCAL STIMULUS



Source: CEIC and BBVA Research.

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Projections

Creating Opportunities

Main messages

Based on low statistical base effect, we forecast 2021 GDP growth to bounce back to 7.5% (Bloomberg consensus: 8%; IMF: 8.4%). The 2021 “Two Sessions” set a conservative and lower-than-expected growth target at 6%, indicating the authorities’ consideration of global economic uncertainties and the potential turbulence led by QE Tapering ahead, as well as to leave more space to curb financial risks and press ahead structural reforms.

China also set a target of creating over 11 million new urban jobs this year, compared to a target of 9 million last year, and a surveyed urban unemployment rate of 5.5%, compared to around 6% last year.

The 2021 inflation target from “two sessions” is set to be around 3%. Inflation is likely to swing around 0 in 1H 2021, due to the significant easing of African Swine Flu and high base effect. PPI will remain its strong momentum, amid shrinking supply-demand gap and rising commodity prices.

No anticipation of interest rate cut and RRR cut in 2021 as of monetary normalization stance.

RMB to USD exchange rate appreciate might experience a soft turnaround together with a strong USD DXY due to the increasing inflation expectation and bond yield in the US. We raise our prediction from 6.4 to 6.5 at year end of 2021.

Economic indicators forecasting

BASELINE SCENARIO

	2019	2020	2021	2022
GDP （%）	6.1	2.3	7.5	5.5
CPI（%）	2.9	2.5	1.7	2.5
Interest rate (LPR, %）	4.1	3.85	3.85	3.85
RMB/USD exchange rate	7.0	6.5	6.5	6.5
Fiscal deficit to GDP (%)	-4.9	-6.5	-4	-3.5

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China Economic Outlook

2Q21

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