BBVA Research

China Economic Outlook

1Q22

Creating Opportunities

BBVA Research

01

Global economy: reflation, policy restructure and economic recovery

Global environment: growth moderation, with high inflation and earlier withdrawal of monetary stimuli

More persistent pandemic

Longer lasting bottlenecks

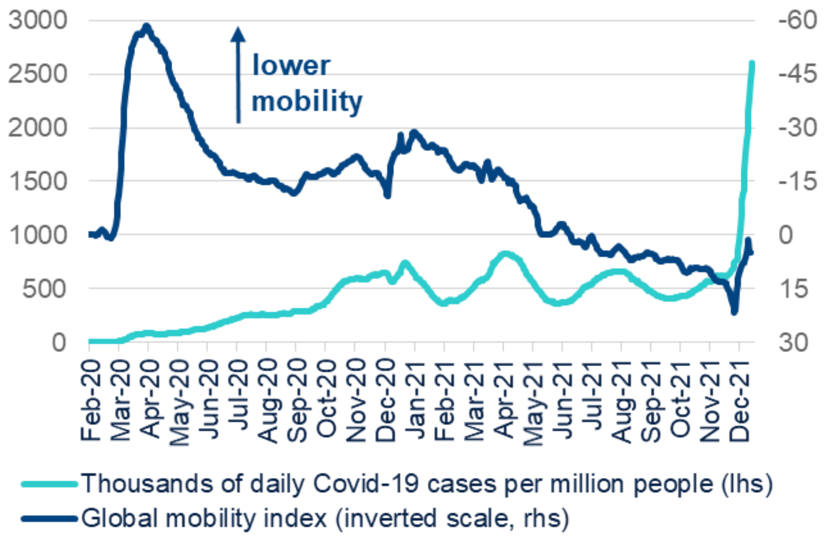
High inflation

Earlier withdrawal of stimuli

Slowdown in economic growth and higher financial volatility

The new variants of the coronavirus have increased infections, but with a limited negative effect due to vaccination

WORLD: DAILY CODIV-19 CASES AND MOBILITY RESTRAINT INDEX*
(7-DAY MOVING AVERAGE)

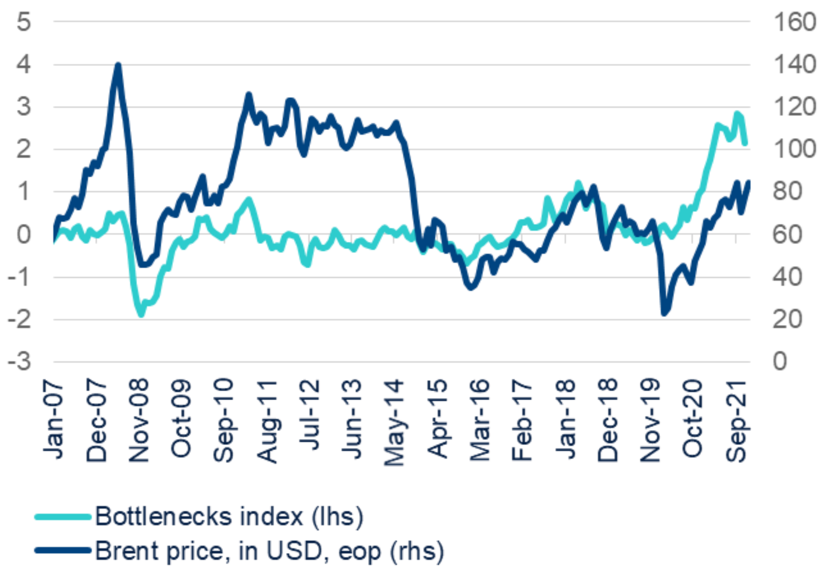


* The mobility index reflects changes with respect to the period of reference (January 3 to February 6 2020) based on retail and recreation mobility.
Source: BBVA Research based on data by John Hopkins University, Google and Our World in Data.

- New, highly contagious strains: coronavirus mutations in the context of incomplete vaccination.
- Strong increase in infections in Europe and more recently in the US and Latam.
- Limited impact on mobility, hospitalizations and mortality: widespread immunization in many countries.
- Increasing supply of vaccines and better treatments should allow greater control of the pandemic.
- Risk: new variants that evade vaccines.

Significant problems in global supply chains remain in place, but they could have peaked

SUPPLY BOTTLENECK INDEX (US) AND BRENT PRICE
(INDEX: 1998-2021 AVERAGE=0; BRENT PRICES:: IN USD)



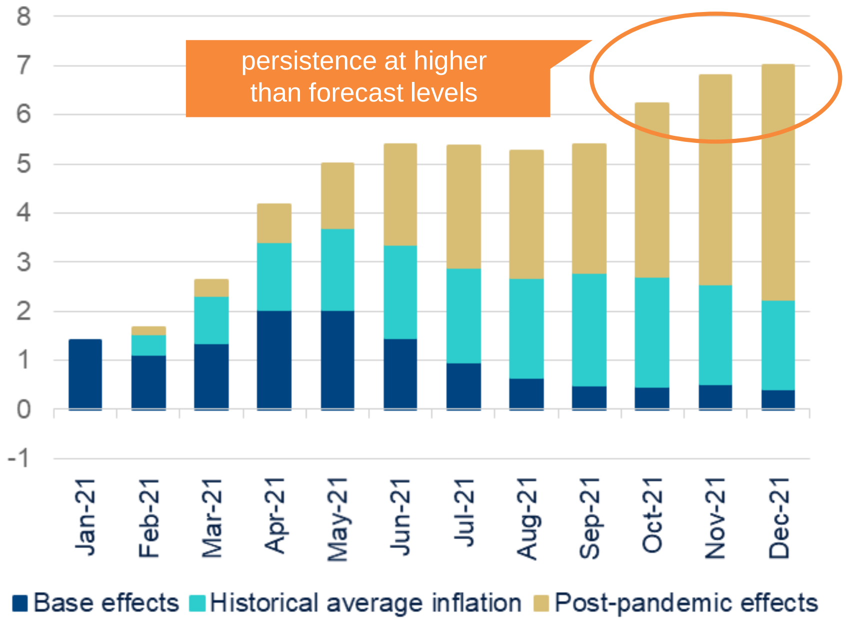
Source: BBVA Research based on data by Bloomberg.

- Production bottlenecks reflect an imbalance between a relatively robust demand and a relatively inelastic supply of goods.
- The problems are largely related to the pandemic, which means that they could be reinforced by the omicron strain.
- Energy transition policies, protectionism and geopolitical problems add complexity and put pressure on energy prices, which remain high despite the moderation in gas prices.
- Anyway, there are recent signs of moderation in bottlenecks, at least in manufacturing.

Inflation remains high, largely on pandemic-related issues (confinements, reopening, consumption composition, spending of accumulated savings...)

US : INFLATION

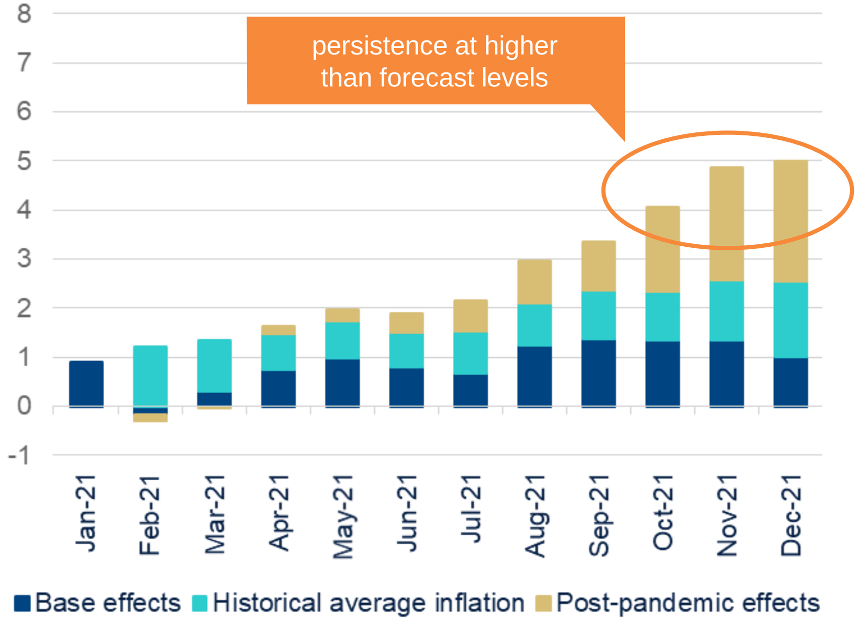
(CPI; Y/Y %)



Source: BBVA Research.

EUROZONE: INFLATION

(CPI; Y/Y %)

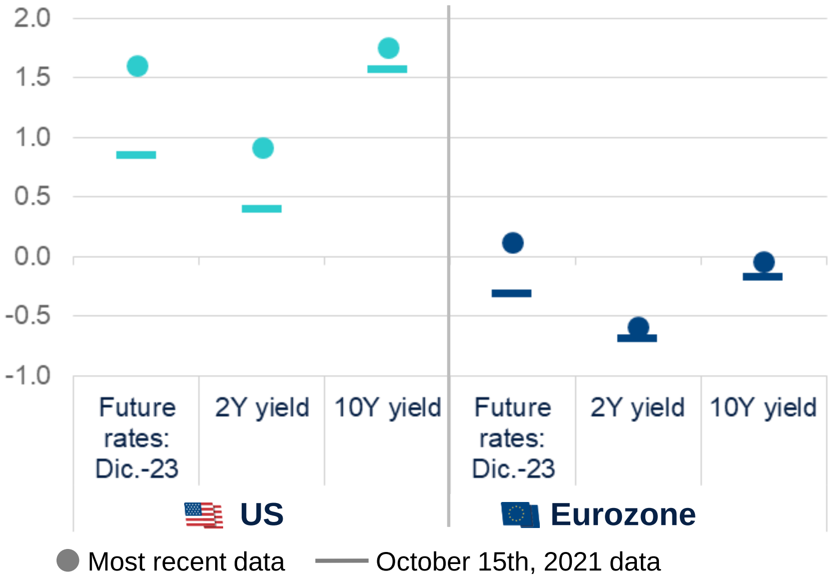


Source: BBVA Research.

Inflation has forced the Fed to bring forward its plans to withdraw stimulus and has caused a moderate adjustment in financial markets

POLICY RATES: MARKET EXPECTATIONS; SOVEREIGN BOND YIELDS *

(%)



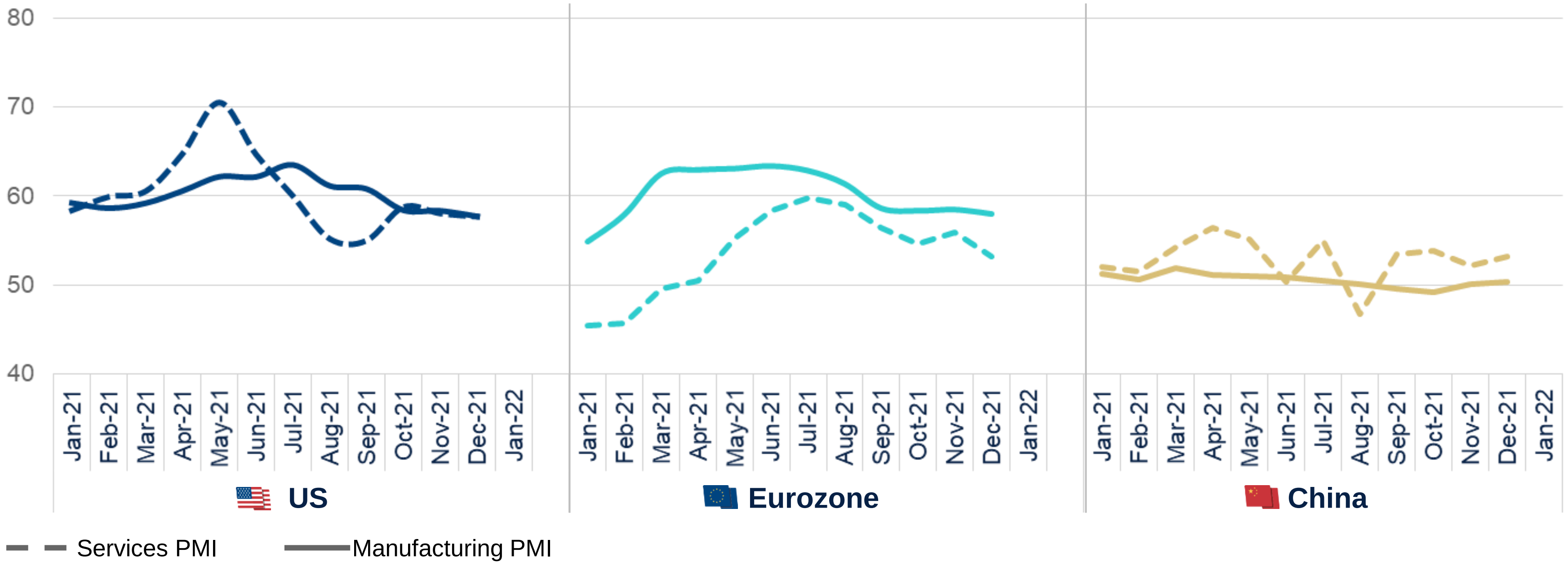
*: Market expectations for policy rates in Dec/23 implicit in future contracts. Eurozone yields: German bond yields. .
Source: BBVA Research based on data by Bloomberg.

- The Fed has started a more aggressive tapering and suggested that it will raise policy rates earlier and faster than expected.
- In the Eurozone, markets now discount earlier interest rate hikes, but the change in expectation has not been as sharp as in the US.
- The US 2-year yield has increased significantly, in contrast with the smaller increase of the 10-year yield; in Europe yields remain low.
- The Fed's shift towards a more rapid withdrawal of stimulus has caused a moderate rebound in volatility and in the US dollar.

Activity continues to expand in the main regions, but is slowing down more than expected

PMI

(HIGHER THAN 50: EXPANSION; LOWER THAN 50: CONTRACTION)



Source: BBVA Research based on data by Haver

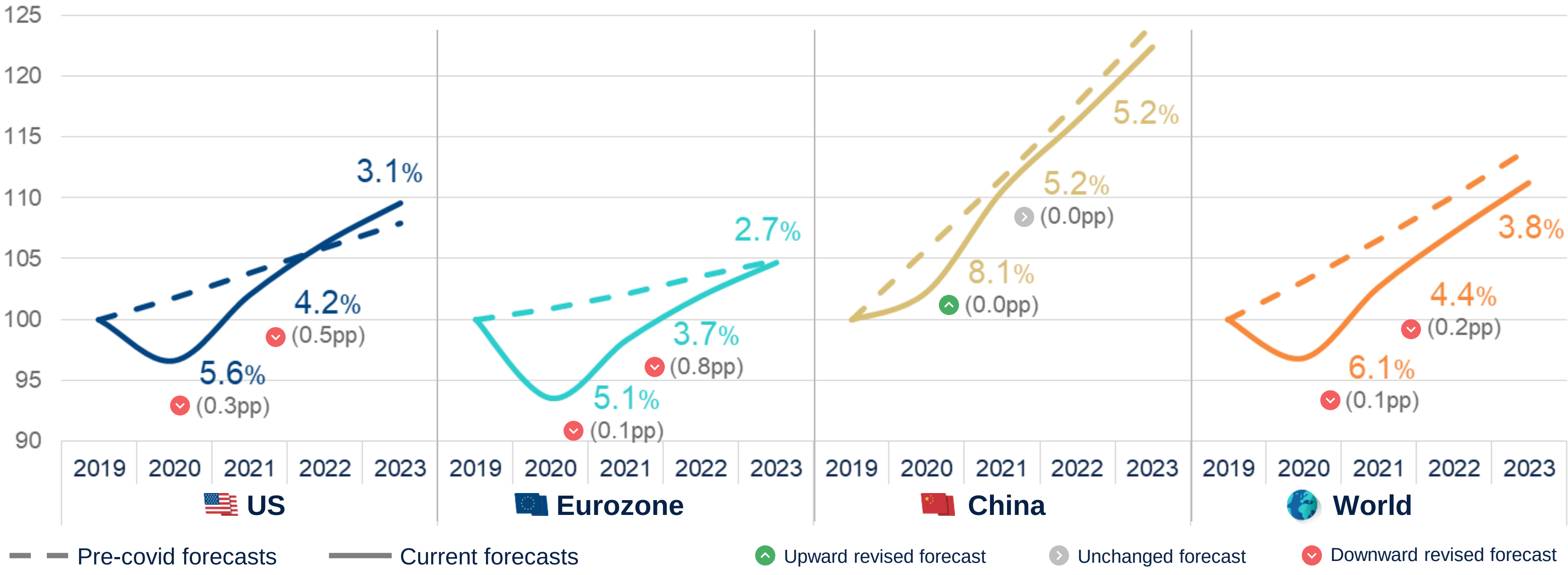
The process of economic normalization will continue, albeit gradually and with eventual turbulences, in a context of increasing risks

BASELINE SCENARIO		RISKS ON SEVERAL FRONTS
New waves of infections, with decreasing effects on health systems and the economy (on vaccination and better treatments)	Pandemic	New strains elude vaccines and significantly reduce mobility
Remain in place in the first half of 2022 and then normalize on the moderation of demand and the reaction of supply	Bottlenecks	More significant and persistent due to the pandemic, energy transition, protectionism, etc.
High -mainly in the short term and in the US- but gradually decreasing and under control	Inflation	Relevant second-round effects with de-anchoring of expectations and wage pressures
Early withdrawal of economic stimuli to control inflation; limited volatility in financial markets	Economic policy	More aggressive withdrawal of stimuli creates turmoil, particularly in debt and emerging markets
Gradual moderation of growth, which remains relatively robust	Global context	In the limit, recession; not only on the aforementioned risks but also on China's sharper deceleration and social and geopolitical tensions

Global growth is estimated to be relatively robust in the next two years, although it will be weaker than previously anticipated

REAL GDP

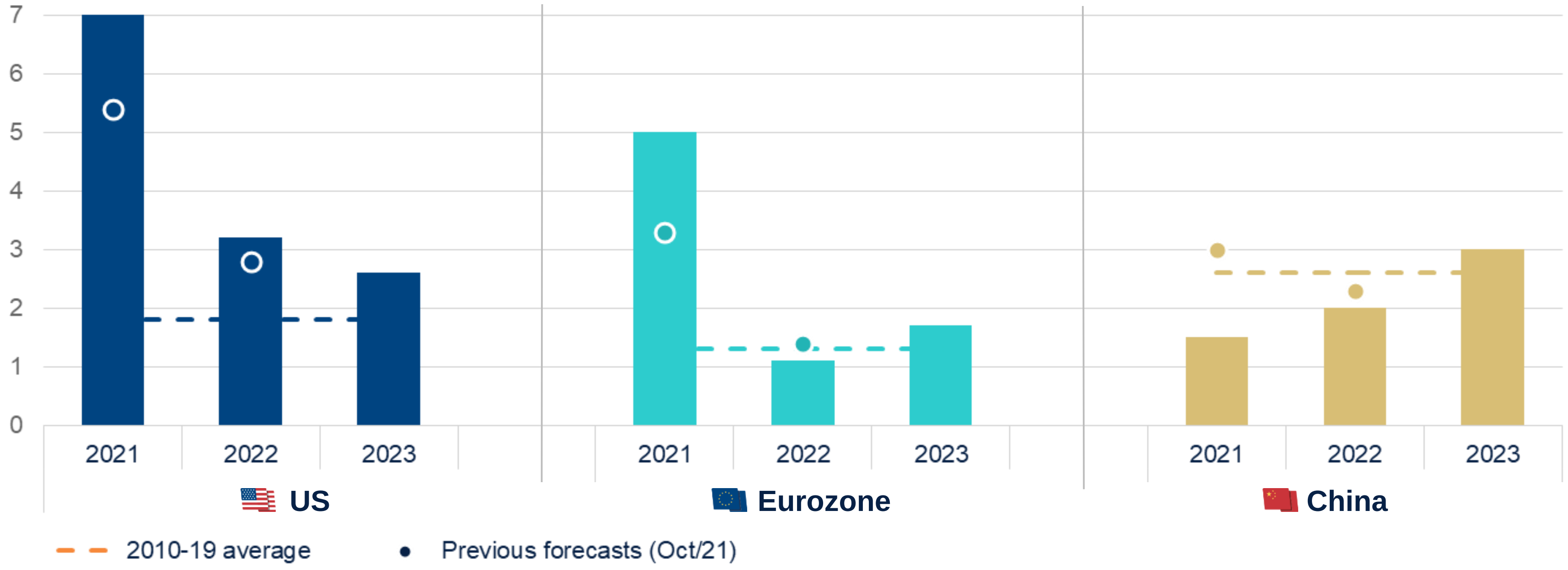
(LINES: GDP LEVEL 2019=100, FIGURES: FORECASTS AND CHANGES WITH RESPECT TO THE PREVIOUS ONES)



Source: BBVA Research.

Inflation will remain high, mainly in the short term and in the US; risks are to the upside, it is key to avoid significant second-round effects

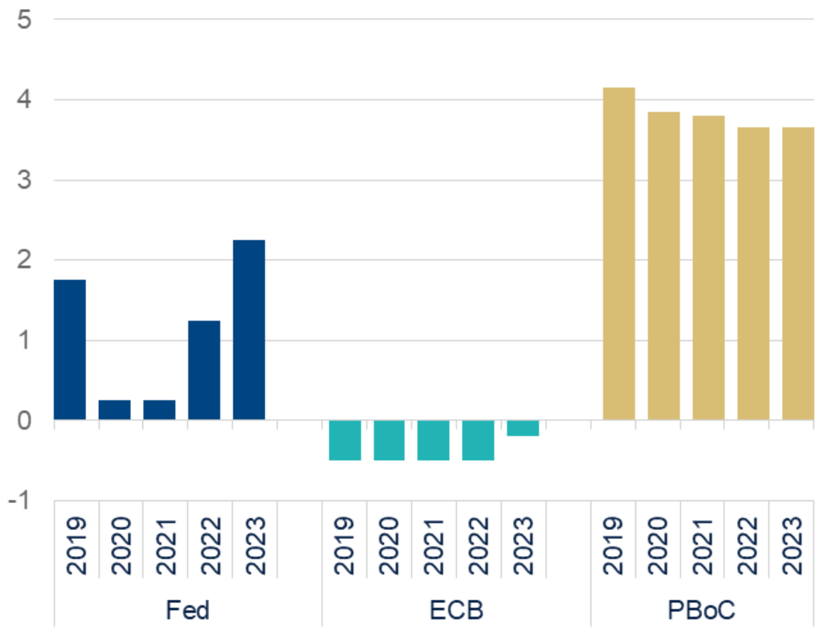
INFLATION: CPI
(Y/Y %, END OF PERIOD)



Source: BBVA Research.

The Fed will react to inflation with a quick tapering and interest rate hikes; the ECB will be more patient and the PBoC will remain focused on growth

POLICY INTEREST RATES*
(%, END OF PERIOD)



*: In the case of the ECB, deposit facility rates. Forecasts for 2022 and 2023.
Source: BBVA Research

US

- The Fed is focused on controlling inflation.
- We expect i) the tapering to end no later than in Feb/22, ii) four 25bp rate hikes in 2022 and four in 2023, iii) a balance sheet reduction from this year on.

Europe

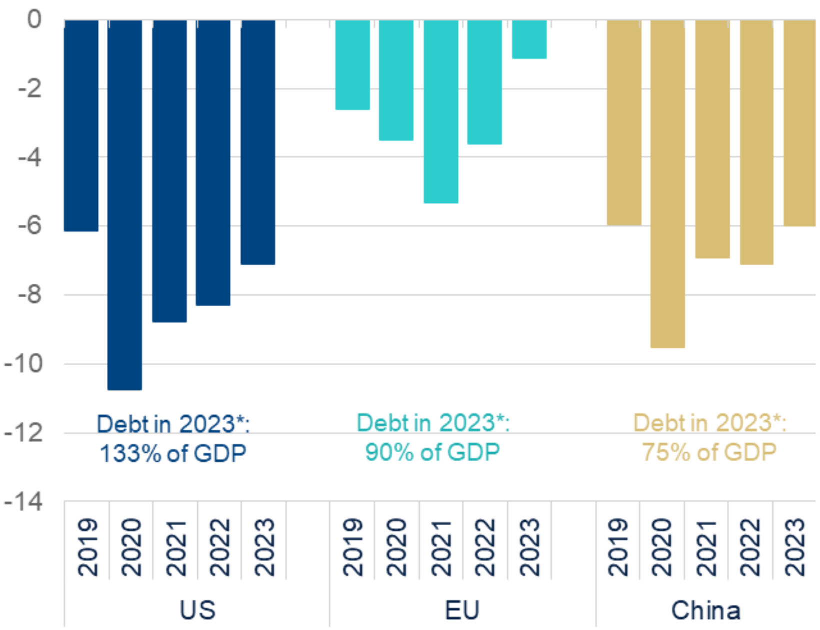
- End of the PEPP on Mar/22, and bond purchases via APP will be reduced until mid-2023.
- Interest rates will remain unchanged until the second half of 2023; ECB to exhibit an increasingly hawkish tone.

China

- Monetary stimulus is resumed: further cuts in interest rates and bank reserve requirements, among other measures, in 2022 to avoid a sudden slowdown in the economy.

Fiscal policy will still be expansionary in the coming years, but the stimuli will not be as notable as in 2020-2021

STRUCTURAL FISCAL RESULT
(% OF POTENTIAL GDP)



*: General government gross debt estimated by the IMF.
Source: BBVA Research based on data by the IMF and the European Commission.

US

- New stimuli, more focused on supporting supply (with less impact on inflation).
- After the approval of the infrastructure plan (less significant than expected), the social investment plan is now being debated.

Europe

- Increasing use of NGEU resources will support growth in 2022-23.
- Increasing debate on fiscal rules from 2023 on.

China

- Additional stimulus measures to counteract the impact of regulatory activism, real estate market adjustments, “zero tolerance” on COVID and energy transition policies.

02

China's unsynchronized business cycle, inflation cycle and policy cycle

Main messages

Growth slowdown continues

Growth has continued its downward trend in Q4 2021. GDP slowed to 4% y/y in Q4 from 4.9% in Q3, concluding 2021 GDP growth at 8.1%. The growth is expected to further dip to 5.2% in 2022. A number of growth headwinds weigh on the economic outlook, including the "zero tolerance" strategy which dragged on consumption recovery, real estate sector crackdown, exports normalization and continuing regulatory storms.

The economic structure is unbalanced

Economic structure remains unbalanced as the economy depends too much on exports while domestic consumption and investment keep lackluster; in addition, the demand side continues to lag behind the supply side. To regain all the lost ground to the pre-pandemic growth, quite a bit of perseverance is still needed.

Low inflation environment

By contrast with high inflation in US and the EU, China's CPI is still at low level as dipping pork prices in the African Swine Flu cycle dominates the CPI and offsets pass-through effect from high PPI. PPI started to moderate recently, due to the authorities' expansion of the reserved commodity supply and China's production normalization which solved the global supply-chain bottleneck problem domestically.

Main messages

China's independent easing policy

By sharp contrast with the FED speed-up tightening measures of QE Tapering, interest rate hike and central bank balance reduction, China's monetary and fiscal policy will be more expansionary in 2022 to deal with growth slowdown. Low inflation environment and closed capital account provide the room for policy easing.

Main downside risks ahead

(i) The authorities' crackdown on real estate sector weighs on growth given real estate contributes 25% of GDP; (ii) The regulatory storms and "common prosperity" initiatives will continue, deteriorating market sentiments particularly for private sectors; (iii) China's "zero tolerance" strategy towards the pandemic gives large pressure on fiscal balance and delays consumption recovery. (iv) Exports, which used to be the main growth engine in 2021, is set to decelerate in 2022. (v) The lingering China-US tensions, particularly in the technology competition and ideological conflicts, lead to more uncertainties on global and regional outlook.

Chinese economy: positive and risk factors

Positive factors

A large policy room for the monetary and fiscal policy to stimulate growth amid contained inflation environment and closed capital account.

The authorities' new growth model to foster high-end manufacturing and green economy provide more investment opportunities, offsetting real estate slowdown.

Continuing strong exports momentum supports growth before its truly normalization.

The authorities' continuation of financial liberalization and opening-up policy to dispel the market's worries.

Risk factors

Real estate sector slowdown dragged growth significantly, given its large share of economy considering indirect and direct linkages.

China's "zero tolerance" of the Covid-19 pandemic added large extra cost of fiscal balance and dragged consumption recovery.

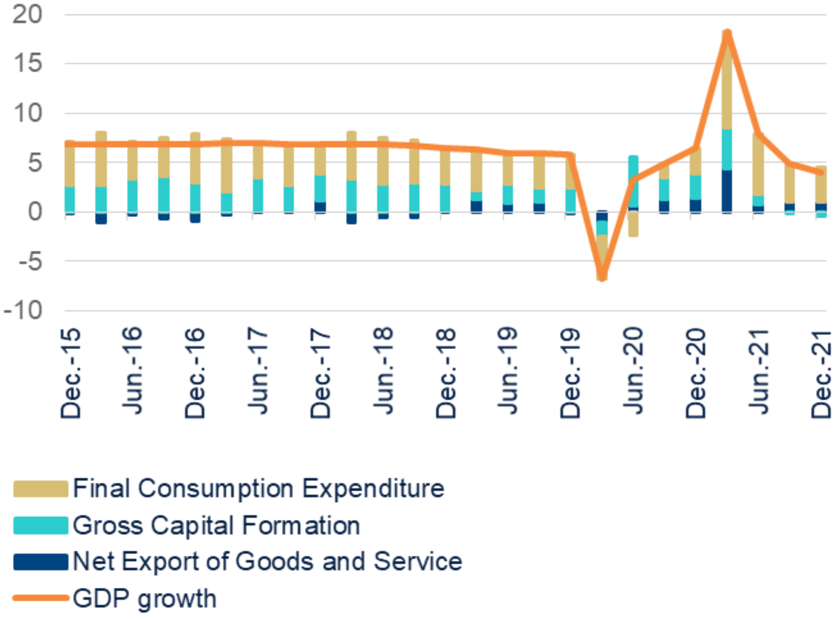
Exports which used to be the main growth engine in 2021 may lost its momentum in 2022.

Regulatory storms to promote "common prosperity" will continue which weigh on market sentiments.

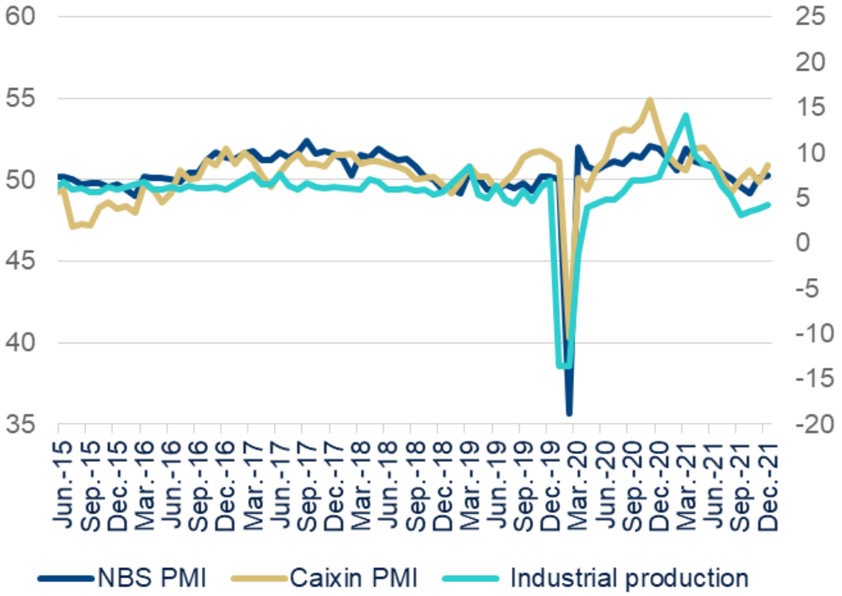
Tensions with the US also lead to uncertainties to regional outlook.

Growth slowdown with an unbalanced structure; supply side recovers faster than demand side, external demand faster than domestic demand

GROWTH SLOWED TO 4% Y/Y IN Q4 FROM 4.9% Y/Y IN Q3, ALTHOUGH ITS Q/Q GROWTH PICKED UP FROM 0.2% TO 1.6%, CONCLUDING 2021 GDP AT 8.1%



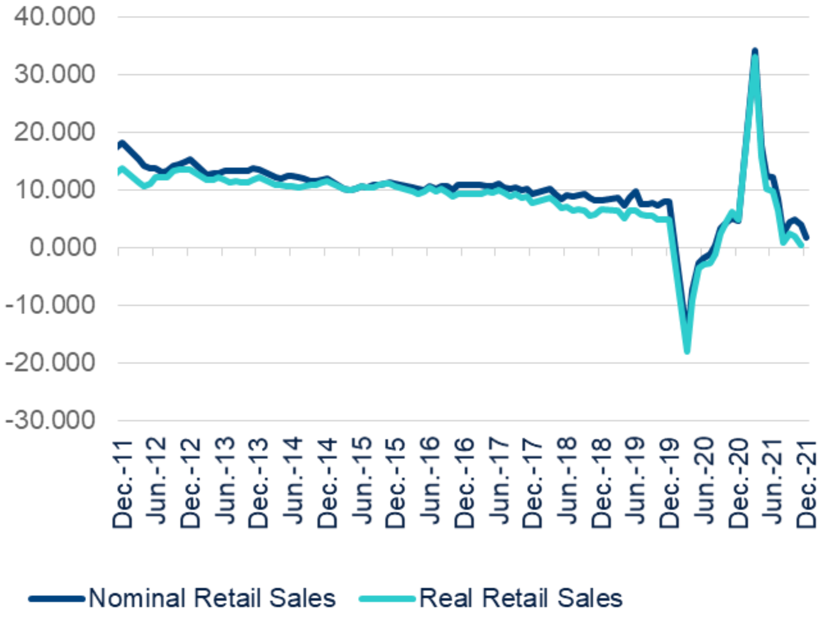
SUPPLY SIDE: INSUDTRIAL PRODUCTION AND PMIS ACCELERATED FROM THE PREVIOUS READINGS, THANKS TO THE RECENT STIMULUS (INDEX, %YOY)



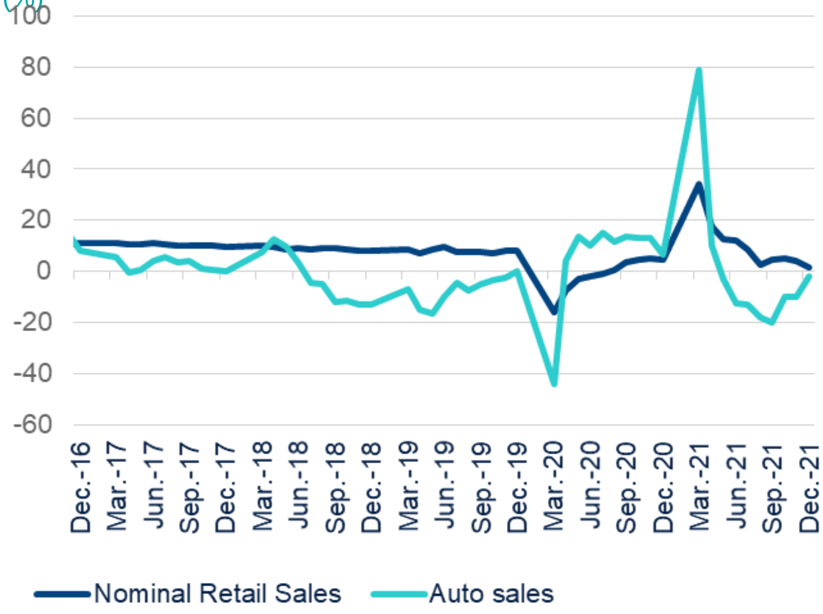
Source: CEIC and BBVA Research.

Lackluster retail sales have been dragged by China's "zero tolerance" strategy on virus

DECEMBER RETAIL SALES GROWTH SIGNIFICANTLY DIPPED TO 1.7% FROM 3.9% IN THE PREVIOUS MONTH (%)



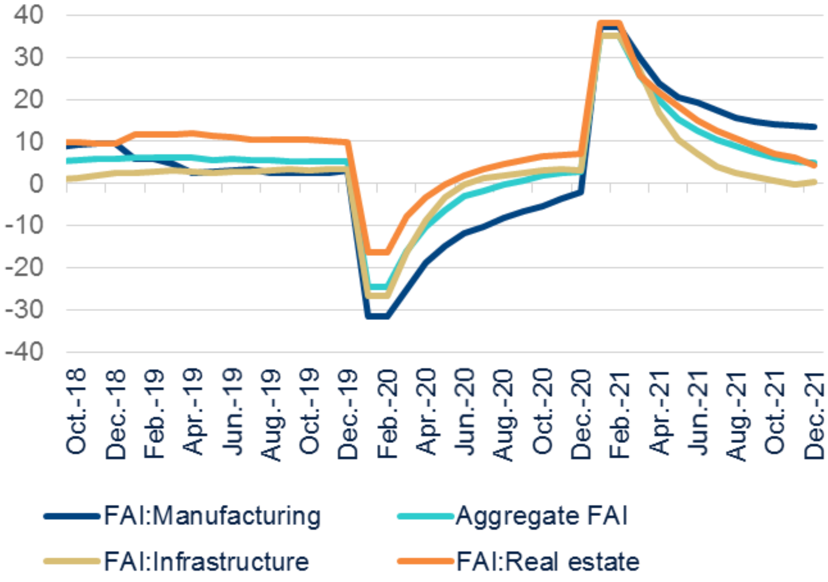
RETAIL SALES IS DRAGGED BY THE AUTO SALES AND SERVICE SECTOR, WITH A LOWER INCOME EXPECTATIONS AMID "ZERO TOLERANCE" STRATEGY (%)



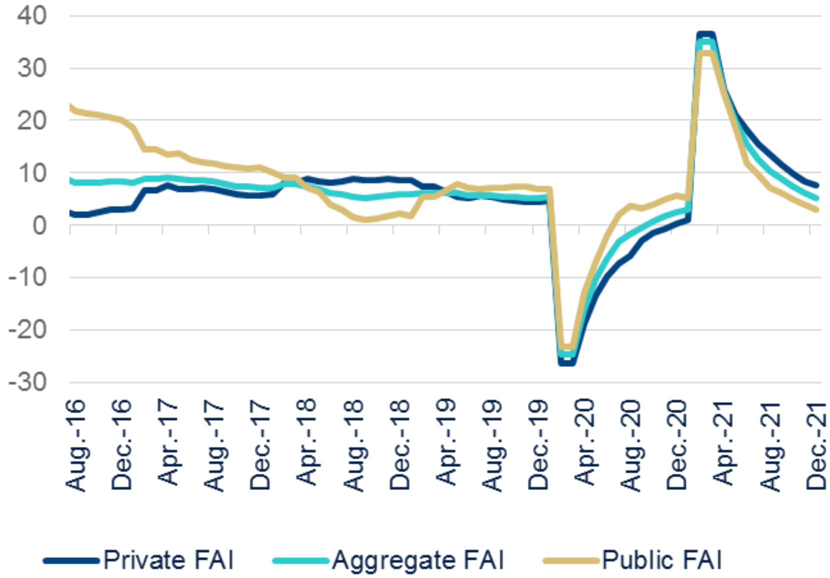
Source: CEIC and BBVA Research.

Weakening real estate and infrastructure investment weigh on growth; the room for FAI growth is still limited in 2022 due to housing sector crackdown

MANUFACTORY INVESTMENT SURPASSING INFRASTRUCTURE AND REAL ESTATE TO LEAD THE FAI GROWTH (% YTD)



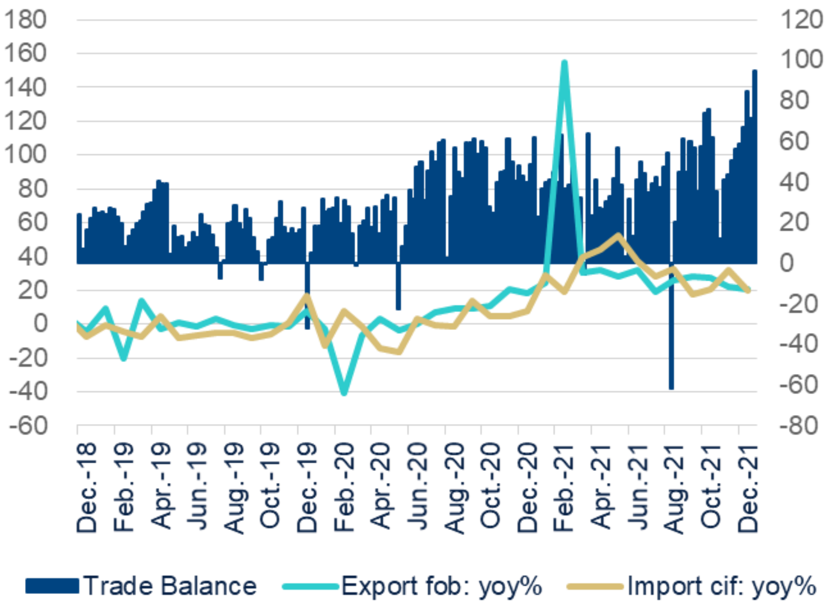
WE ANTICIPATE PUBLIC FAI WILL PICK UP AS THE AUTHORITIES SPEED UP LOCAL GOVERNMENT BOND ISSUANCE TO STIMULATE GROWTH (% YTD, Y/Y)



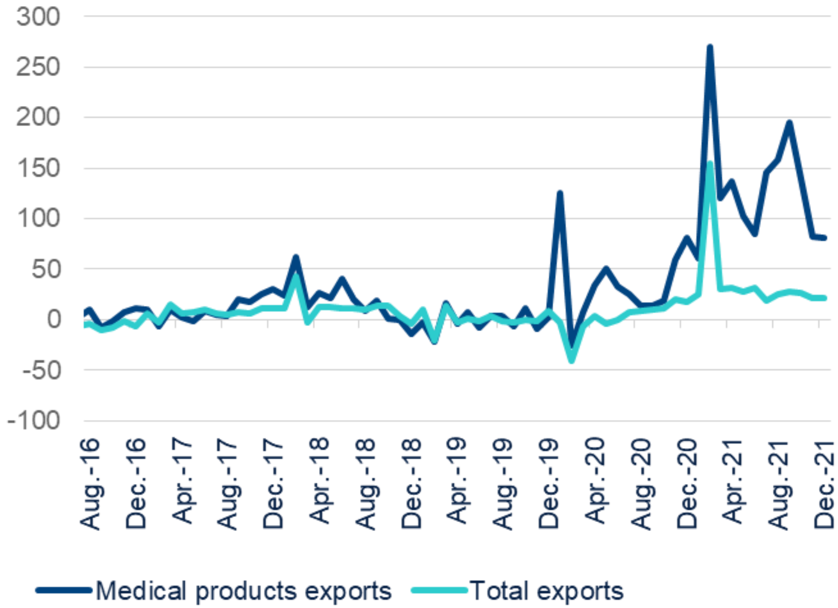
Source: CEIC and BBVA Research.

Exports, the main growth engine in 2021, will unavoidably decelerate in 2022

DECEMBER EXPORTS STARTED TO MODERATE; WHILE IMPORTS DECLINED BOTH FOR VOLUME AND VALUE (% YOY, USD BN)



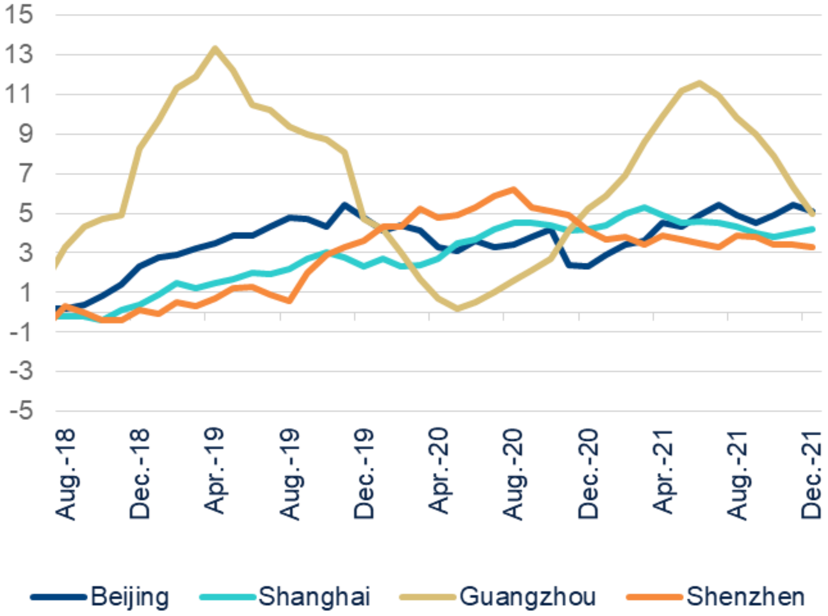
CHINA'S STRONG EXPORTS MOMENTUM MIGHT NORMALIZE IN 2022 AMID GLOBAL RECOVERY (% Y/Y)



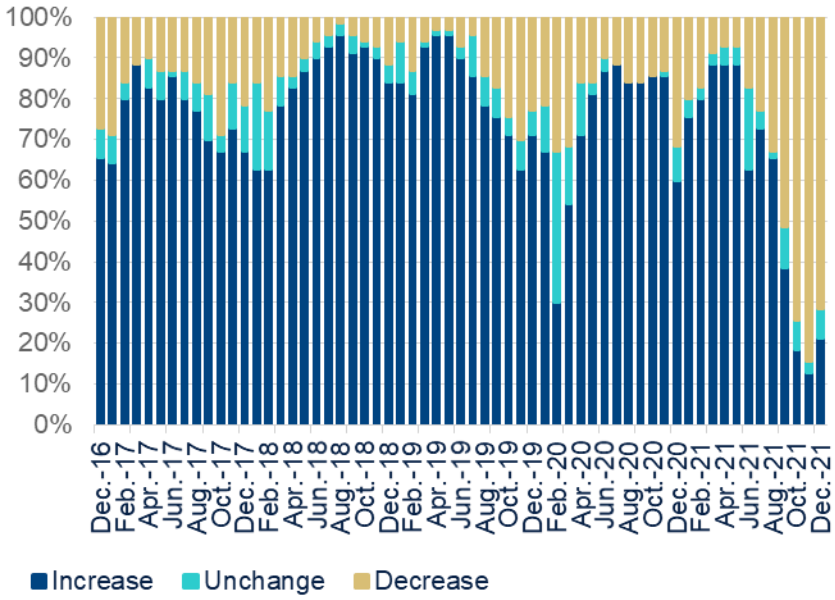
Source: CEIC and BBVA Research.

Real estate market calls for a soft landing(1): housing prices are sliding due to the regulatory storms on real estate sector

REGULATORY MEASURES PARTICULARLY “THREE RED LINES” CURBED HOUSING PRICE IN TIER-1 CITIES (YOY %)



THERE ARE INCREASING NUMBER OF CITIES THAT REPORTED HOUSING PRICE DECREASING (M/M GROWTH)

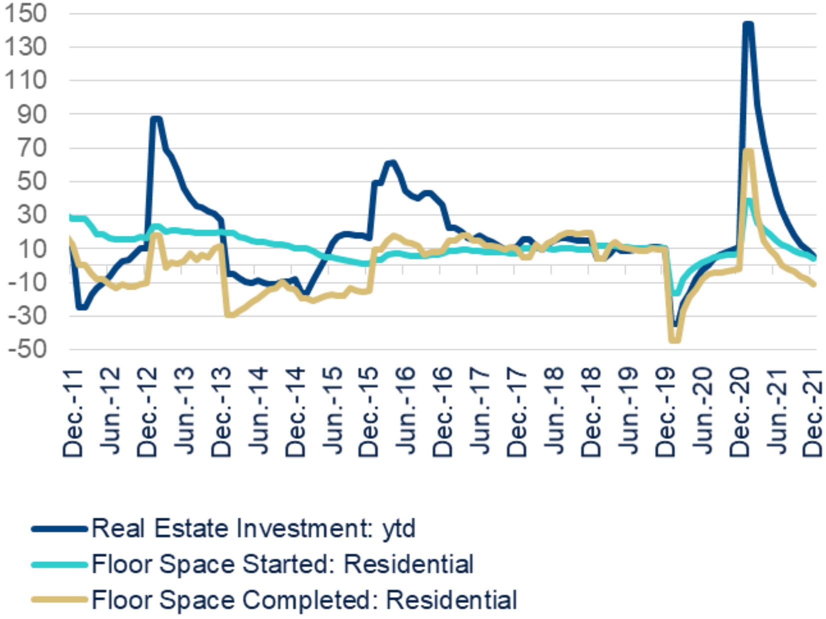


Source: CEIC and BBVA Research.

Real estate market calls for a soft landing(2): other real estate activity indicators also decelerated significantly

LAND PURCHASED REVENUE GROWTH FOR LOCAL GOVERNMENT DIPPED SIGNFICANTLY TO NEGATIVE

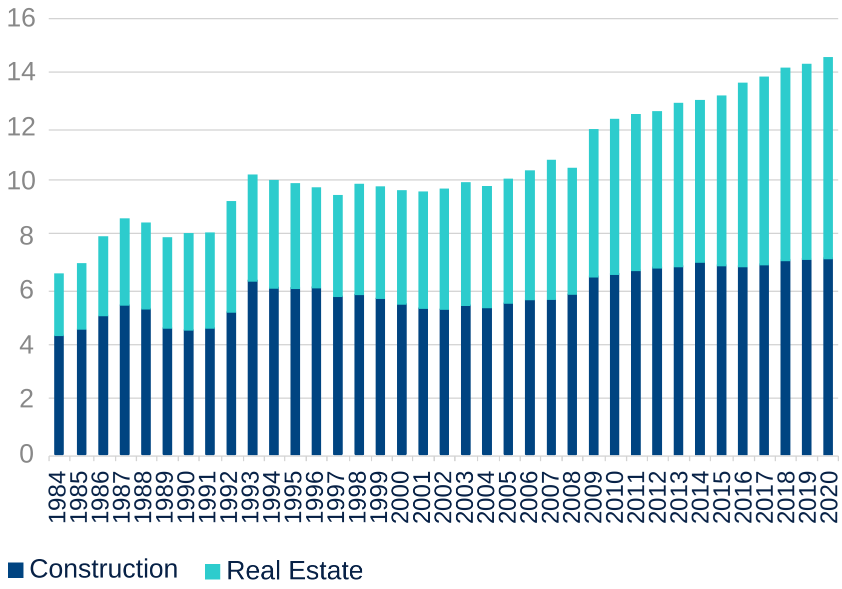
FLOOR SPANCE STARTED AND COMPLETED ALSO DECELERATED TOGETHER WITH REAL ESTATE INVESTMENT SLOWDOWN



Source: CEIC and BBVA Research.

Real estate market calls for a soft landing(3): How important is housing sector to Chinese economy?

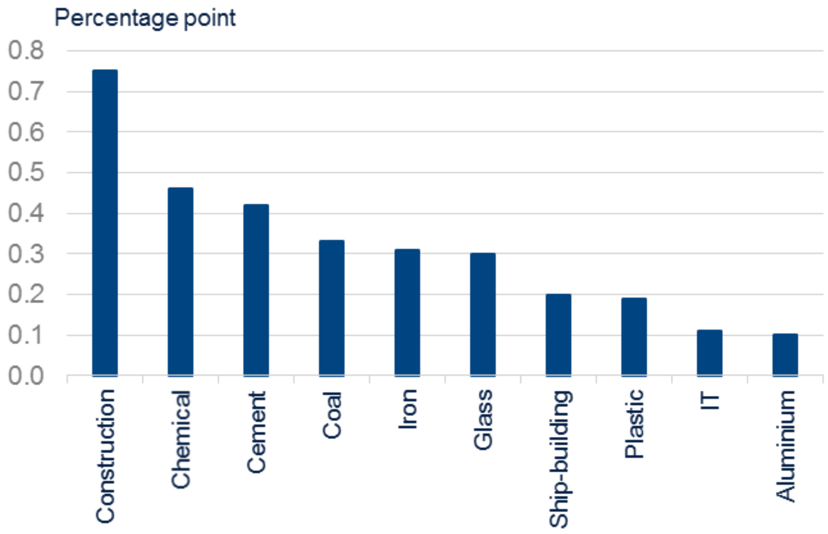
THE DIRECT CONTRIBUTION OF CONSTRUCTION AND REAL ESTATE ACCOUNTS FOR 14.5% OF TOTAL GDP



Source: CEIC and BBVA Research.

THE INDIRECT CONTRIBUTION WHICH TAKES ACCOUNT OF UPSTREAM AND DOWNSTREAM SECTORS ACCOUNT FOR 25% OF GDP

(SPILLOVER EFFECT OF HOUSING SECTOR: THE IMPACT OF 1 S.D SHOCK OF HOUSING PRICE ON OTHER RELATED SECTORS)



Source： Hong Kong Monetary Authority and HKIMR working paper.

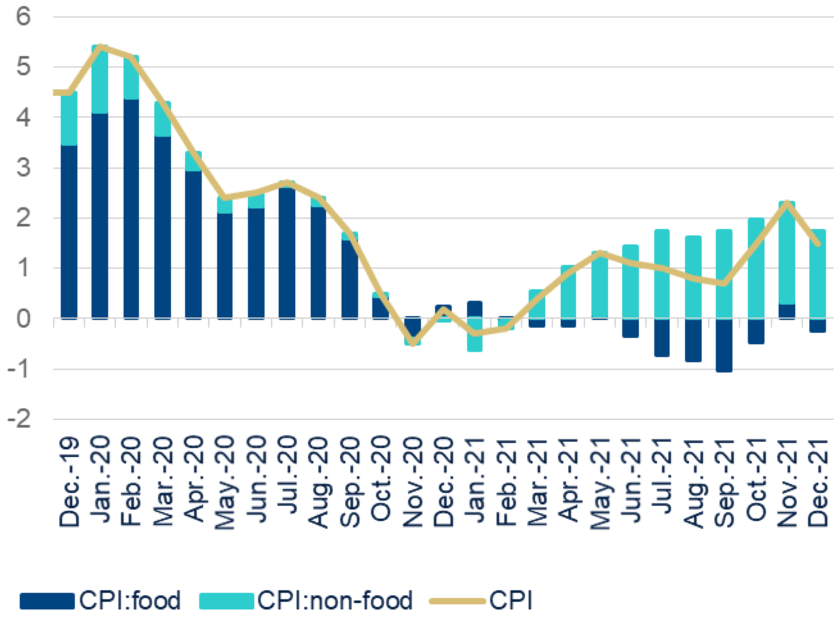
Real estate market calls for a soft landing(4): A stress test on the impact of the two scenarios of housing price fall on four economic sectors

	Scenarios	
Sectors	**Housing price decreases by 10%**	**Housing price decreases by 30%**
Government	Local government revenue decreases by RMB 0.84 trillion, indicating it has RMB 0.84 trillion credit gap to maintain the current fiscal expenditure.	Local government revenue decreases by RMB 2.52 trillion, indicating it has RMB 2.52 trillion credit gap to maintain the current fiscal expenditure.
Banking sector	Banks' NPL increased from 1.92% at end-2020 to 2.07% after one year and increased to 3.36% after three years.	Banks' NPL increased from 1.92% at end-2020 to 2.39% after one year and increased to 6.16% after three years.
Enterprises	Stock market value will evaporate RMB 98.14 bn; book value of enterprises' real estate investment will decrease RMB 39.1 bn.	Stock market value will evaporate RMB 294.4 bn; book value of enterprises' real estate investment will decrease RMB 117.3 bn.
Household	Household wealth per capita decreases by RMB 18 thousand; Aggregate household wealth decreases by RMB 25.2 trn.	Household wealth per capita decreases by RMB 54 thousand. Aggregate household wealth decreases by RMB 75.6 trn.

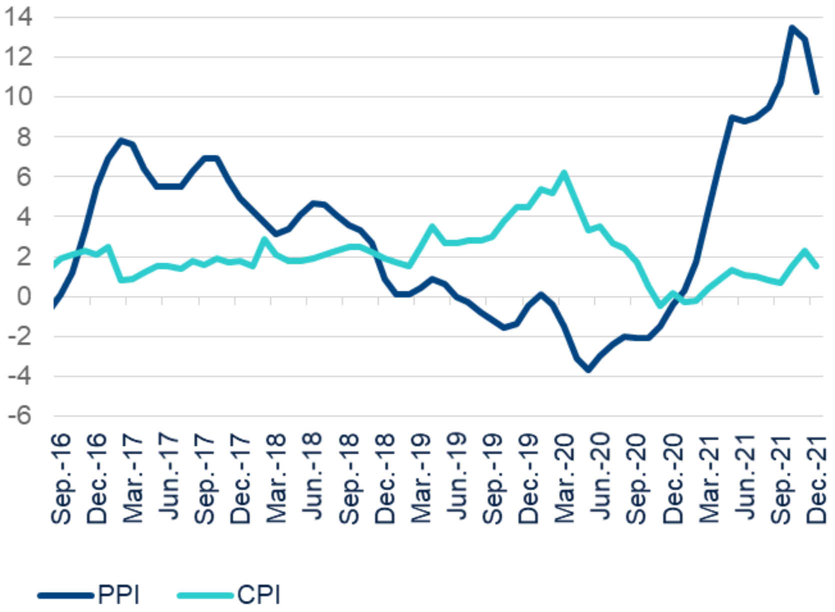
We do not believe the ongoing housing market correction led by tightening regulatory measures could trigger an economic hard-landing but its tumbling needs to be aware of and addressed. Given the powerful market intervention ability of Chinese authorities on land supply, housing transactions and credit market; more importantly, the awareness of the economic slowdown with plenty of policy room to stimulate growth, particularly the ongoing marginal easing measures on housing sector, the nationwide housing market collapse is impossible.

Low inflation environment remains amid a moderated CPI and PPI

CPI MODERATED IN DECEMBER, WHICH IS STILL DOMINATED BY DECELERATING PORK PRICE IN THE AFRICA SWINE FLU CYCLE (% YOY)



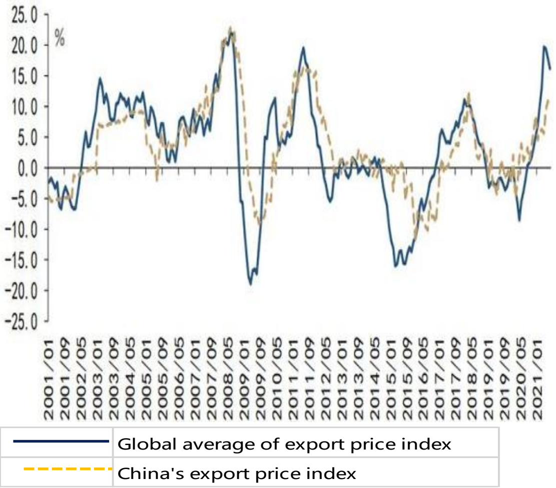
PPI STARTED TO MODERATE, DUE TO A CONTAINED GLOBAL COMMODITY PRICE AND THE AUTHORITIES' EXPANSION OF THE RESERVED SUPPLY (% YOY)



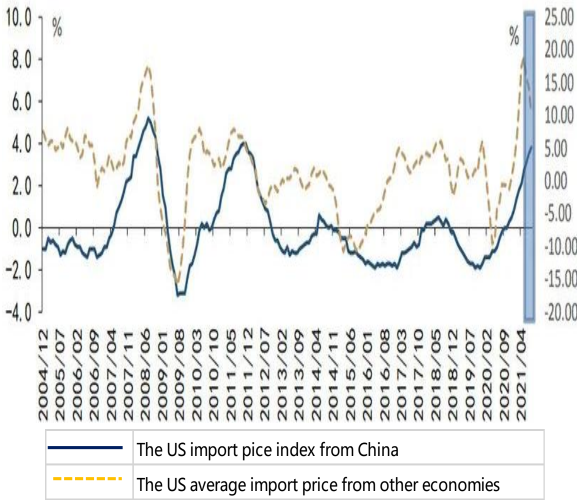
Source: CEIC and BBVA Research.

Is China exporting inflation? (1): in the short term, the answer is not.

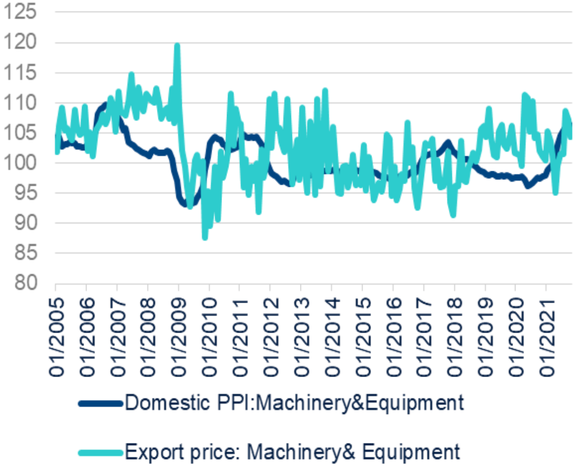
CHINA'S EXPORT PRICE INDEX IS LOWER THAN THE GLOBAL AVERAGE PRICE INDEX



THE US IMPORT PRICE FROM CHINA IS LOWER THAN THAT FROM OTHER INDUSTRIAL COUNTRIES



BY SECTOR: CHINA'S EXPORT PRICE HAS NOT CONSTANTLY HIGHER THAN THE DOMESTIC PRICE

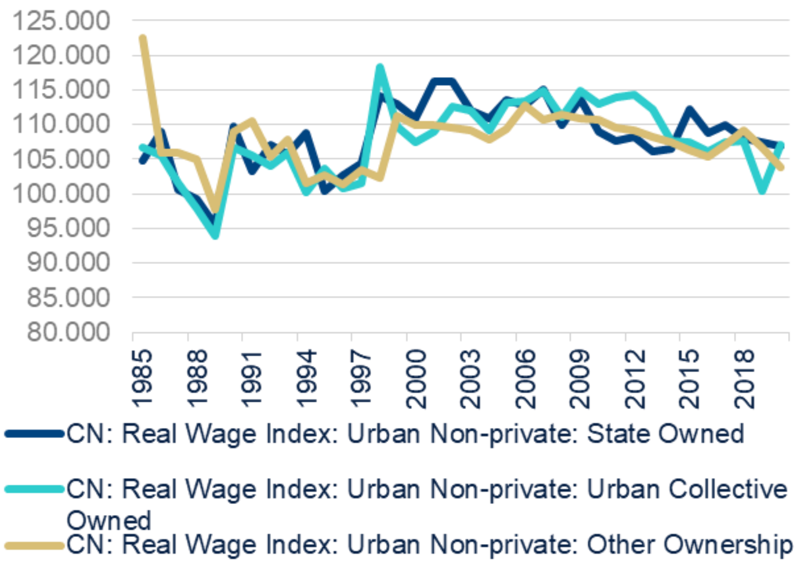


Source: Macro report "China's exports price and US inflation" by Industrial Securities.

Source: CEIC and BBVA Research.

Is China exporting inflation? (2): in the long term, it remains ambiguous.

THE REAL WAGE INDEX DOES NOT HAVE UPWARD TRENDING

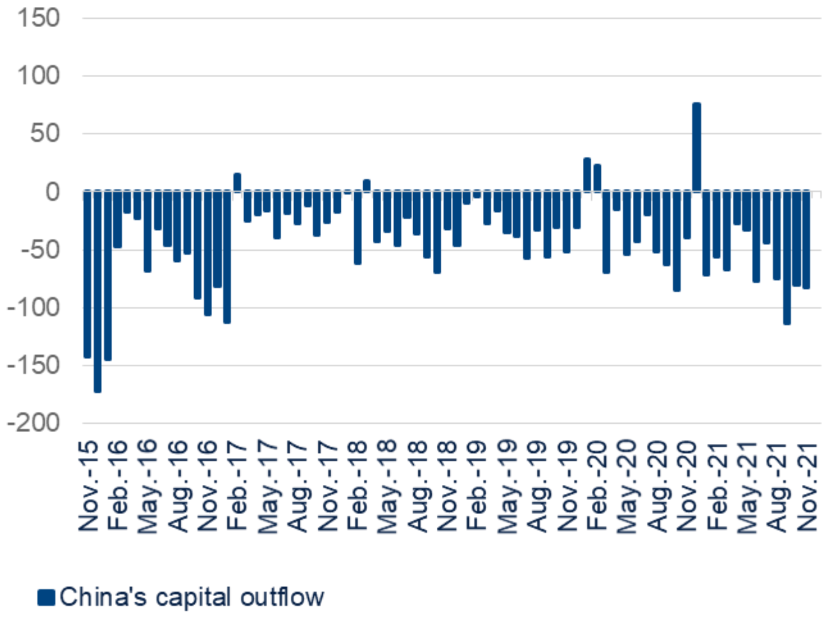


Source: CEIC and BBVA Research.

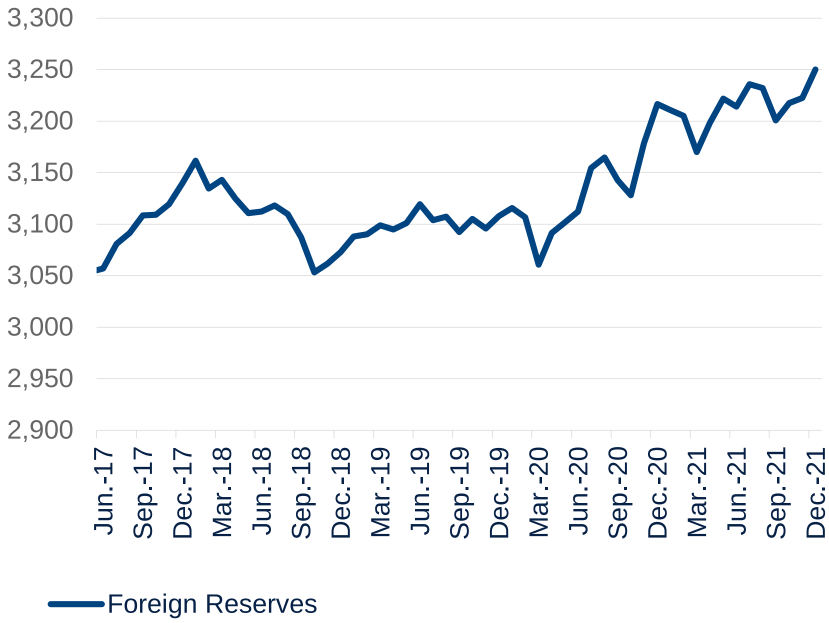
- Carbon Neutrality target will be 2060, again, a long-term issue and it is also a global effort, instead of the effort of China only; difficult to identify how much commodity inflation is from China’s capacity reduction.
- Regarding labor shortage and aging problem, China has a special phenomenon of migrant workers, farmers moving to cities to conduct low-end work, which indicates China still has a lot of buffer to deal with the labor shortage (salary increasing) issue.
- China's exchange rate is still managed by the central bank, based on the historical evidence, the PBoC has not allowed the one-way appreciation to last for long.
- We cannot find evidence on China’s real wage growth up-trending in the past decade.

Capital outflows are under control but will be of concern as the FED speeds up QE tapering, interest rate hike and central bank balance sheet reduction

ACCELERATING CAPITAL OUTFLOWS ARE ANTICIPATED WITH US TIGHTENING THUS CAPITAL IS "SEARCHING-FOR-YIELD"(USD BN)



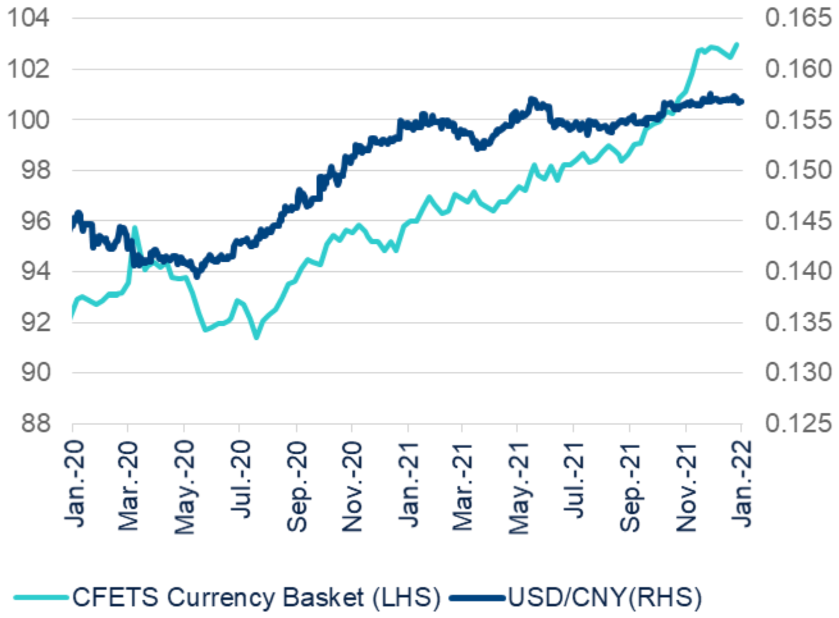
FOREIGN RESERVES TRENDED UP RECENTLY AMID TRADE BALANCE EXPANSION(USD BN)



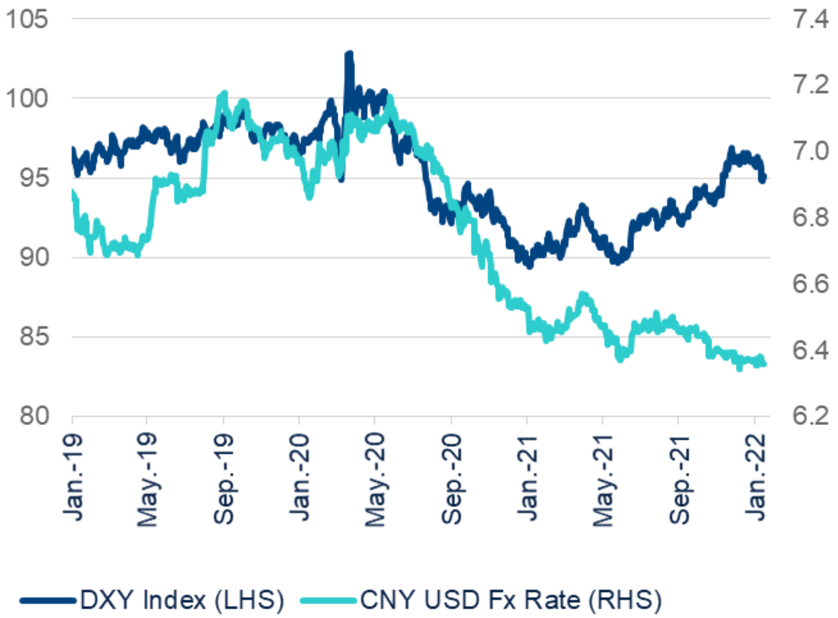
Source: CEIC and BBVA Research.

RMB to USD exchange rate is set to depreciate in 2022 due to the US tightening measures, a stronger USD and China's easing monetary measures

RMB EXCHANGE RATE IS SET TO DEPRECIATE IN 2022 AND TWO-WAY FLUCTUATION IS ANTICIPATED



THE RELATION OF RMB EXCHANGE RATE WITH USD SEEMS TO BECOME LOOSENING RECENTLY AS BOTH CURRENCIES WENT STRONGER



Source: CEIC and BBVA Research.

Research

03

China’s independent easing policy measures

Main messages

Easing monetary policy ahead

Due to the closed capital account and low inflationary environment, the PBoC could manage its independent easing monetary policy, which is unsynchronized with advanced economies. On top of the recent two RRR cuts and two LPR cuts, we anticipate 2-3 RRR cuts and 2-3 interest rate cuts in 2022. Other quantitative tools will be deployed such as SLF, MLF and other more targeted easing measures to support green economy and SMEs.

Expansionary fiscal policy

The authorities will speed up the issuance of local government bond to RMB 3.8-4 trillion in 2022. The total fiscal budget in 2022 is anticipated to be above -3.2%. Thus, infrastructure investment will significantly pick up to support growth. Tax cut and fee deduction are also anticipated.

China's new growth model in the long term

The new growth model includes three "pillars": common prosperity, technology self-sufficiency and green economy. The new growth model will have profound impact on global economy.

2022 policy stimulus in front of “three pressures” of shrinking domestic and global demand, supply shock and weakening market sentiments

based on the December 2021 Central Economic Work Conference

Monetary policy

Expansionary monetary policy stance to stimulate growth.

More RRR and LPR cuts are anticipated.

Targeted easing measures to support SMEs, green economy, high-end manufacturing and tech advancement through re-lending and re-financing.

Injecting liquidity through other monetary policy tools such as SLF, MLF, re-lending and re-discount etc.

Marginally easing measures on housing developers and house purchasers, but will not reverse the principle of “housing is for living not for speculation”.

Fiscal policy

Proactive fiscal policy is the main stance in 2022.

Tax cut and fee deduction.

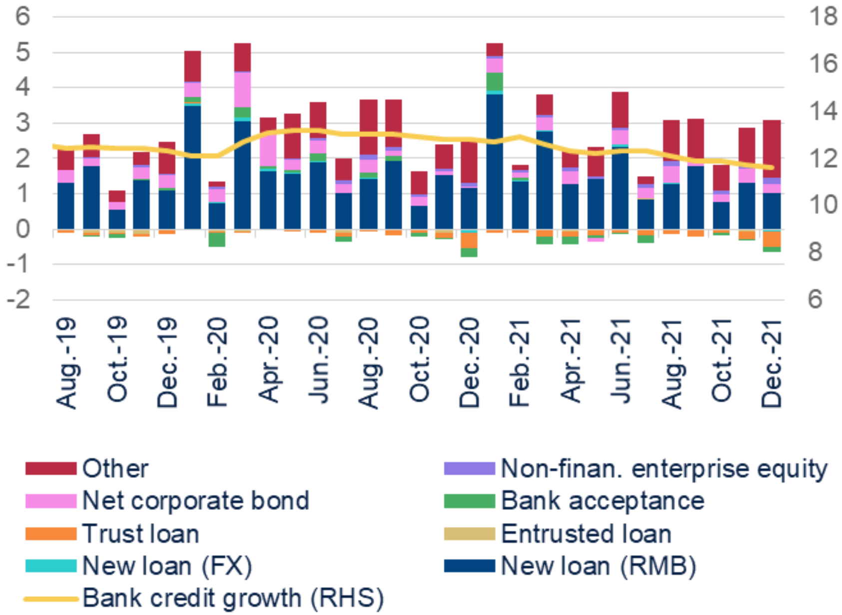
Speed up local government bond issuance to support infrastructure investment. Newly increased local government bond is expected to be RMB 3.8-4 trillion in 2022.

The authorities emphasize efficiency and sustainability of fiscal expenditures.

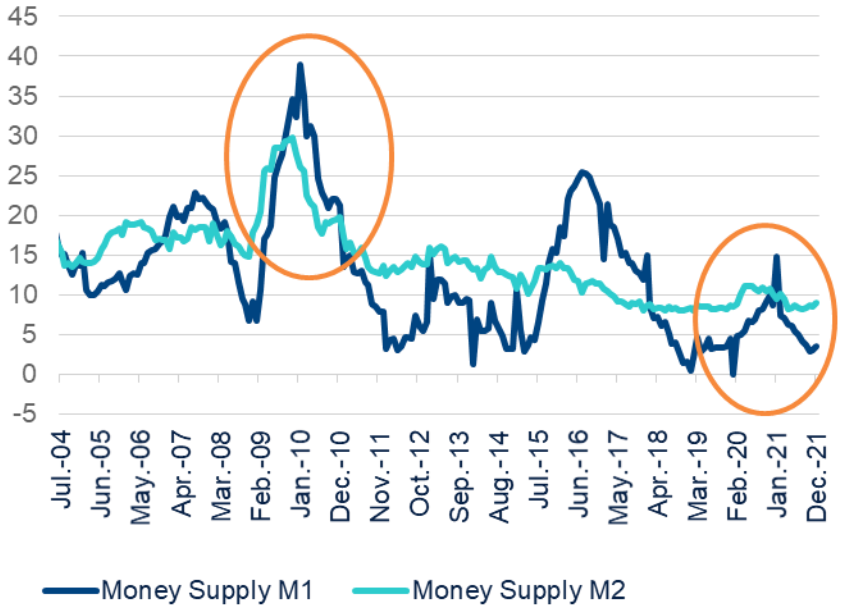
Fiscal deficit is expected to be above 3.2% of GDP in 2022, which will be announced officially in the Two Sessions in March 2022.

An expansionary total social financing and M2 amid easing monetary policy measures

TOTAL SOCIAL FINANCING AND NEW YUAN LOANS ARE SET TO EXPAND TO DEAL WITH GROWTH SLOWDOWN (RMB TRN, %YOY)



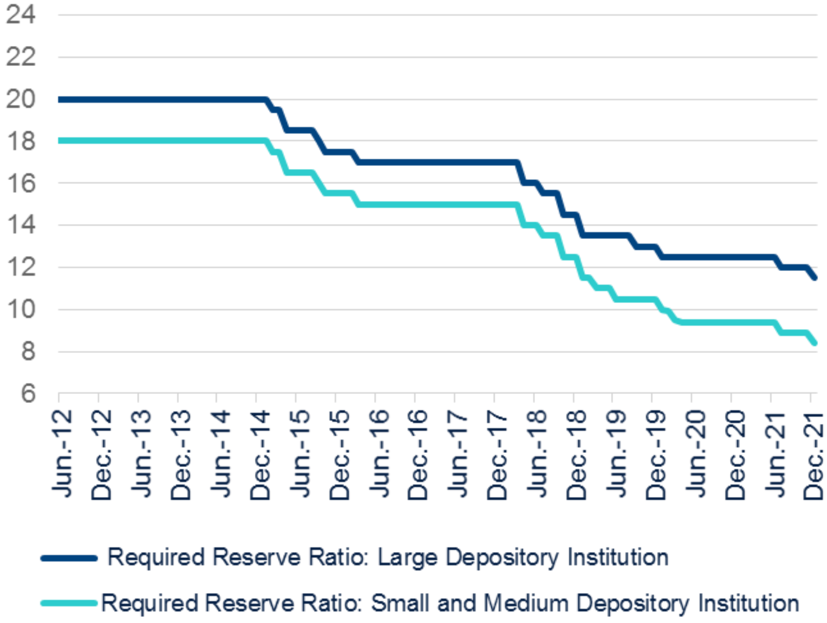
M2 GROWTH ALSO PICKED UP IN DECEMBER, REFLECTING THE RECENT EASING MONETARY STANCE (Y/Y)



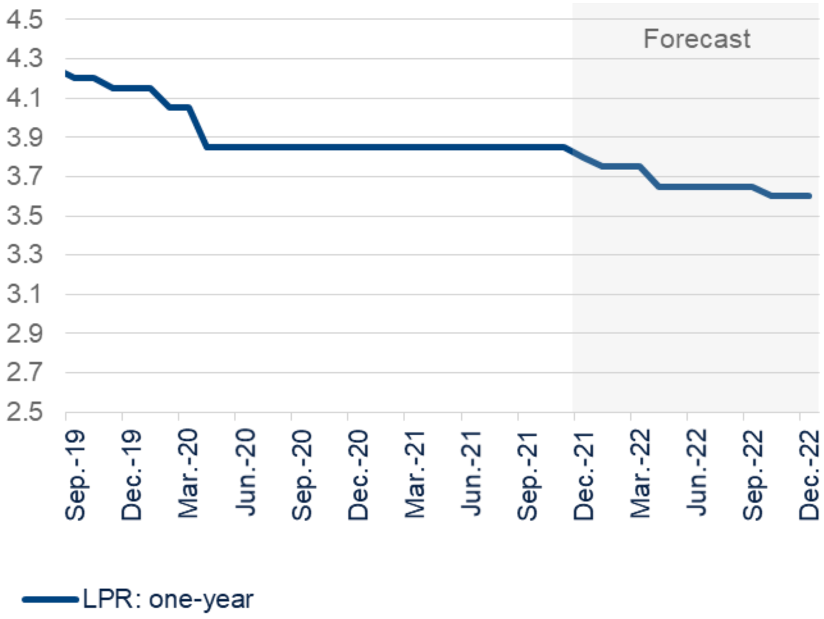
Source: CEIC and BBVA Research.

The PBoC is set to adopt more monetary easing measures to stimulate growth in 2022, diverging from the advanced economies' tightening measures

EXCEPT FOR THE TWO RRR CUTS IN 2021, 2-3 MORE RRR CUTS ARE ANTICIPATED IN 2022 (%)



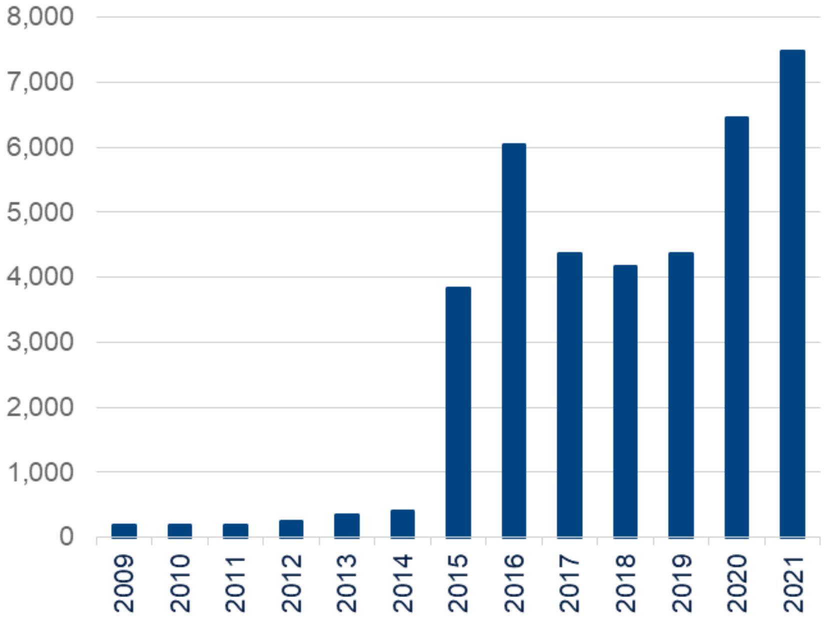
ON TOP OF TWO RECENT LPR CUTS, THERE ARE ALSO 2-3 LPR CUTS ANTICIPATED IN 2022 LEADING LPR TO 3.6% AT END-2022 (%)



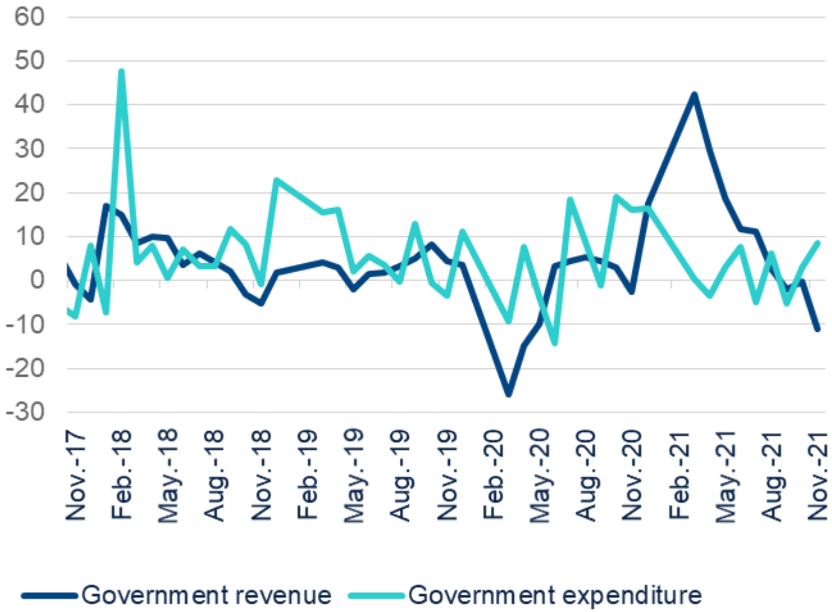
Source: CEIC and BBVA Research.

Fiscal stimulus such as speed-up of local government bond issuance and tax cut/fee deduction is anticipated

ALTHOUGH THE AUTHORITIES SPEEDED UP LOCAL GOVERNMENT BOND ISSUANCE IN Q4 2021, INFRASTRUCTURE INVESTMENT STILL LACKLUSTER



DUE TO THE REAL ESTATE SLOWDOWN AND GOVERNMENT LAND SALES REVENUE DECLINE, THE ROOM FOR FISCAL STIMULUS IS LIMITED (%)



Source: CEIC and BBVA Research.

Long-term strategy: Understanding China's new growth model supported by "three pillars"

Common prosperity

Not "robbing the rich to help the poor", or the nationalization of private enterprises;

Tax reform and other redistribution measures are anticipated;

Aims to tackle tech-induced market monopoly, ever-widening wealth gap, housing affordability, etc.

Self-sufficient technology under "dual circulation" strategy

Not "closed door policy" and self-sustaining everything domestically.

Aims to solve the "bottleneck" technology and be self-sufficient in key tech sectors related to national security and supply chain independency.

Carbon neutrality

The long-term transformation from the coal-centric brown economy to new-energy- centric green economy.

2060 carbon neutrality target urges China to arduously pursue the technology advancement of new energy and clean energy, from taking use of clean energy to generate electricity, to the electricity storage and transformation, to the end-usage of new energy such as new energy vehicles etc.

Long-term strategy: What does China’s new growth model mean for the global economy?

“Common prosperity”

A flurry of regulatory storms in some specific sectors that are against this target will continue, dragged on bond and stock market sentiments in China, leading to portfolio outflows, which has contagion effect to global financial market.

Self-sufficient technology under “dual circulation” strategy

The long-lasting tech war with the US might weigh on China’s technology related exports.

And the tech-related imports, particularly the technology bottleneck products, will be limited by the advanced economies.

Both outbound and inbound FDI in the national security field will be limited, i.e. advanced economies’ refrain of China’s 5G outbound infrastructure investment.

Carbon neutrality

It may decrease China’s processing trade related exports, as enterprises need to relocate polluted manufacturing industries outside China to ASEAN; at the same time, outbound FDI will be accelerated.

Carbon tax imposed by advanced economies may also decline China’s exports.

China’s arduous R&D on new energy tech will significantly lower the cost of clean energy of the world, and foster new growth engine related to green economy.

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04

Projections

Main messages

Growth slowdown will continue

We maintain our 2022 GDP forecast at 5.2% which is set to converge to the potential growth after the large swings of GDP figures in 2020 and 2021. We anticipate the authorities' 2022 growth target to be "around 5%".

Inflation

Our forecasts of 2022 CPI and PPI both stand at 2.8%. The convergence of them reflects CPI marginally pick up in 2022 due to the normalization of African Swine Flu Cycle, and a deceleration PPI due to a slowing global commodity price and eased supply bottleneck.

Interest rate

We anticipate 2-3 LPR cuts in 2022, and 2-3 RRR cuts in 2021.

RMB to USD

Weak RMB to USD exchange rate to 6.6 at end-2022 amid a stronger USD DXY, slower exports and US FED tightening measures.

Economic indicators forecasting

BASELINE SCENARIO

	2019	2020	2021	2022
GDP （%）	6.1	2.3	8	5.2
CPI（%）	2.9	2.5	1.2	2.8
PPI (%)	-0.3	-1.8	8.1	2.8
Interest rate (LPR, %）	4.1	3.85	3.8	3.6
RMB/USD exchange rate	7.0	6.5	6.4	6.6
Fiscal deficit to GDP (%)	-4.9	-6.2	-5.2	-5.8

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Research

China Economic Outlook

1Q22

Creating Opportunities