BBVA Research

China Economic Outlook

2Q22

Creating Opportunities

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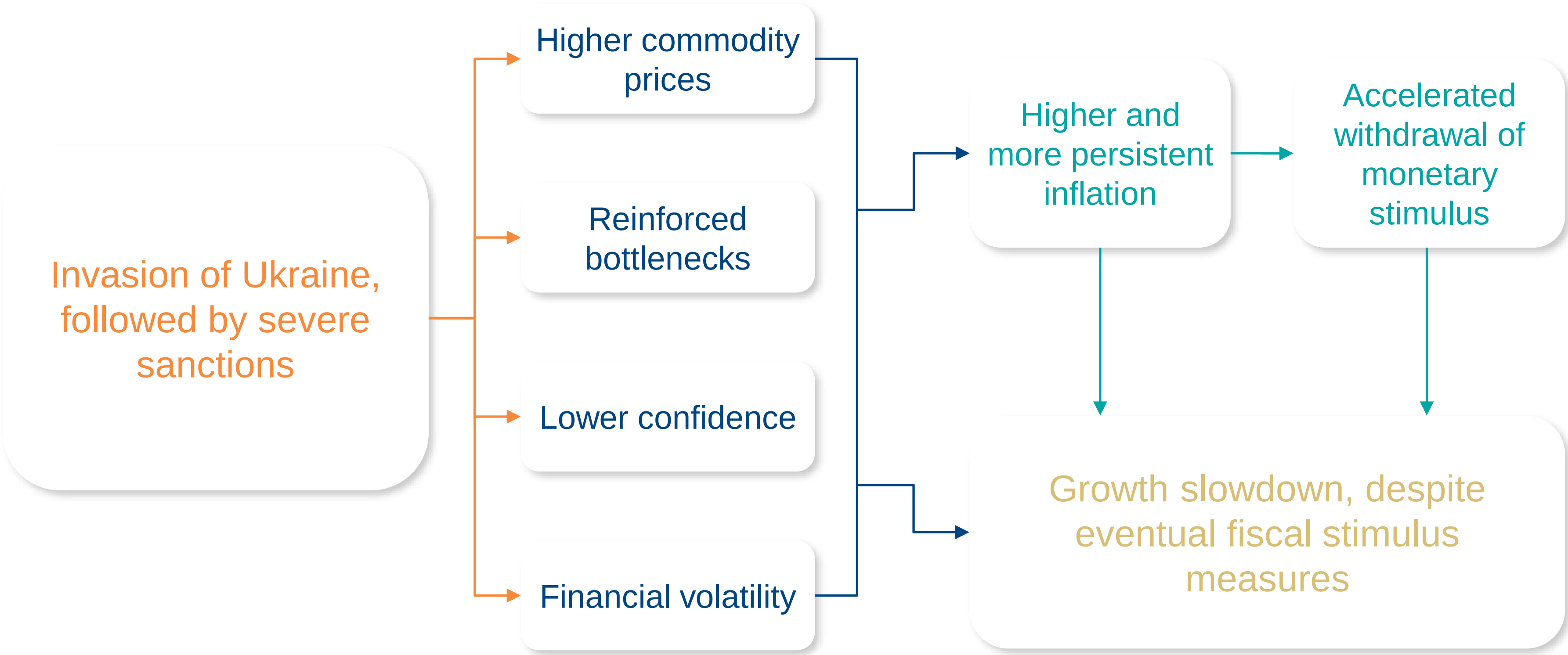
01

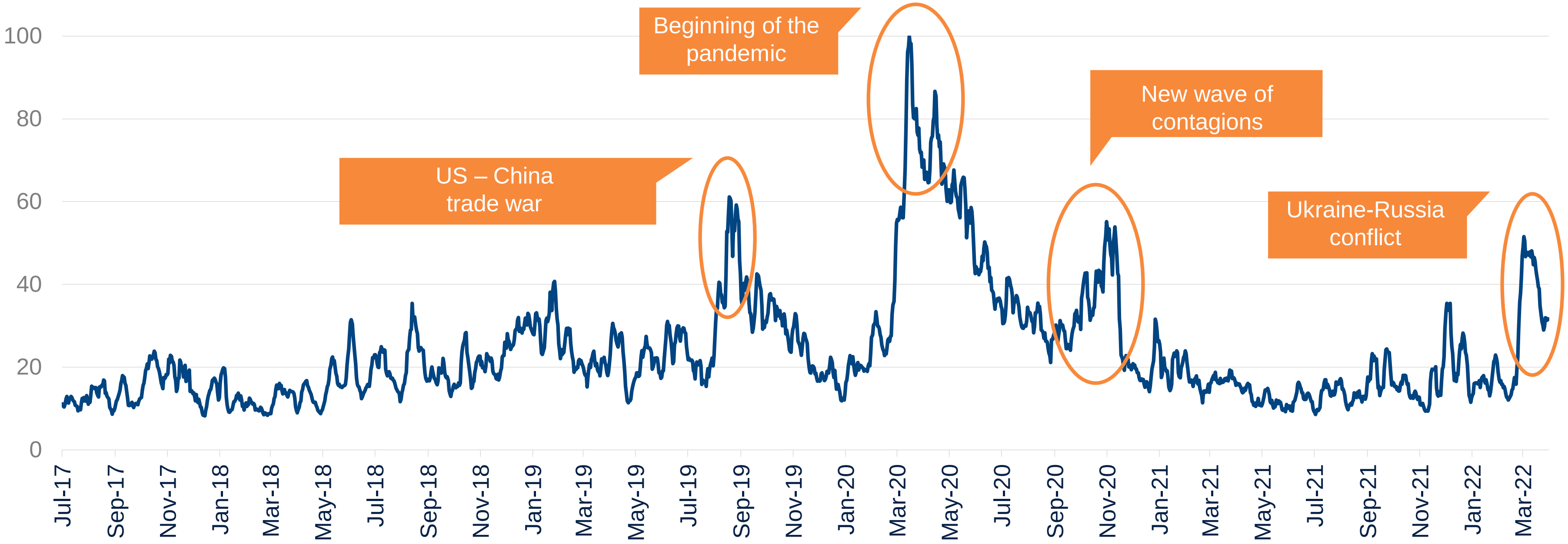
Global economy: from reflation to stagflation

The Ukraine-Russia conflict reinforces both inflationary pressures and the moderation trend in activity growth, mainly in Europe



Economic uncertainty, at unusually high levels, once again

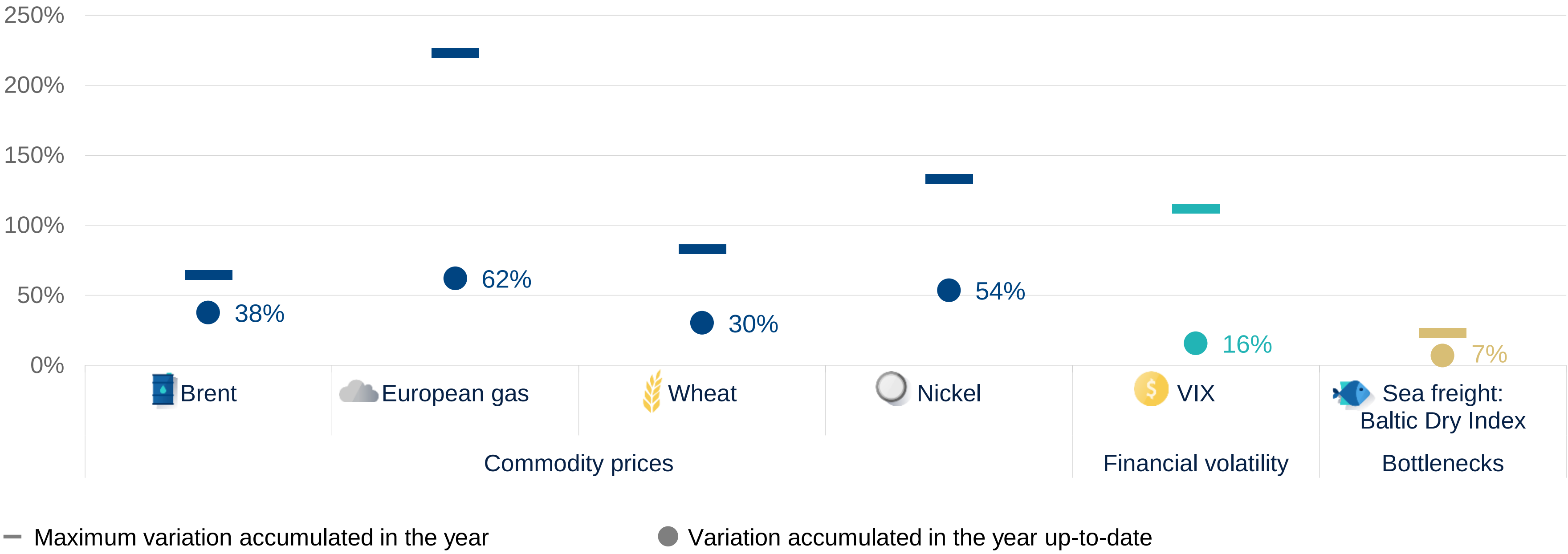
BBVA RESEARCH INDEX DE ECONOMIC POLICY UNCERTAINTY
(INDEX FROM 0 TO 100)



Source: BBVA Research based on data by GDELT.

Sharp rise in commodity prices, financial volatility and signs of further deterioration of supply bottlenecks

SELECTED INDICATORS OF COMMODITY PRICES, FINANCIAL MARKETS AND SUPPLY BOTTLENECKS
(PERCENTAGE CHANGE ACCUMULATED IN THE YEAR UP TO MARCH 31ST, 2022)

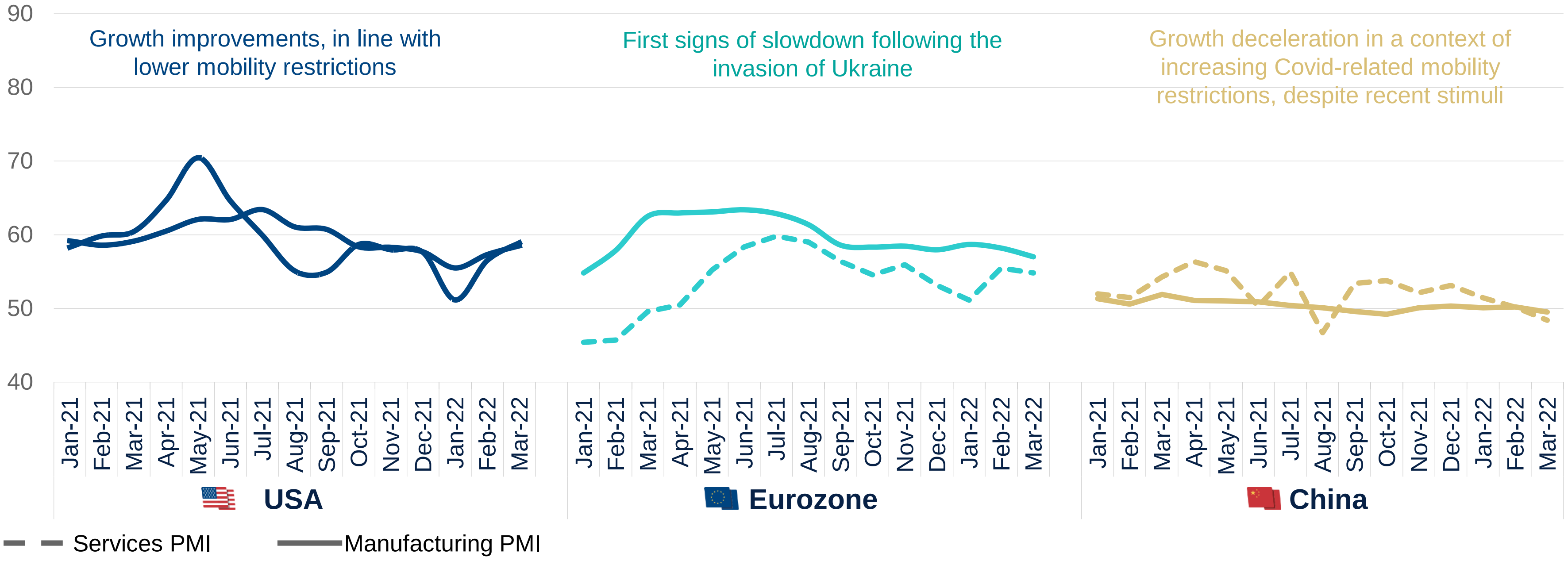


Source: BBVA Research based on data by Haver.

Activity moderates in Europe and exhibits resilience in the US, following the invasion of Ukraine, while it slows in China amid increasing Covid restrictions

PMI INDICATORS

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

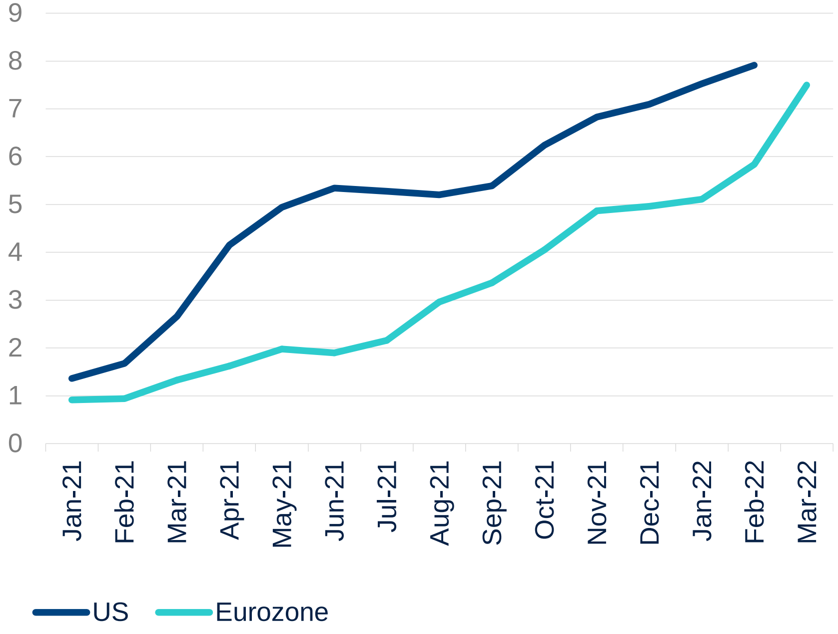


Source: BBVA Research based on data by Haver.

Given the increase in inflationary pressures, expectations of monetary tightening ahead have been reinforced

INFLATION: CPI

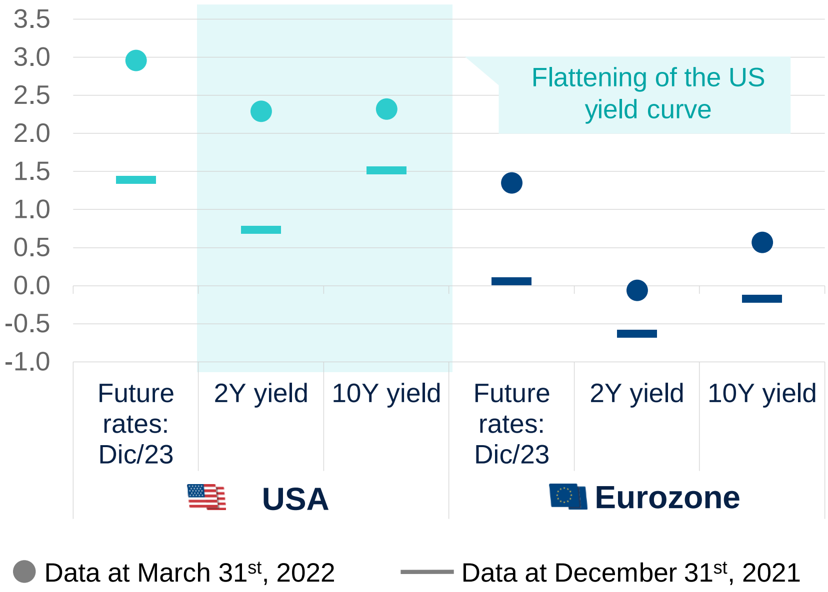
(Y/Y %)



Source: BBVA Research based on local statistics.

POLICY RATES: MARKET EXPECTATIONS; SOVEREIGN BOND YIELDS *

(%)



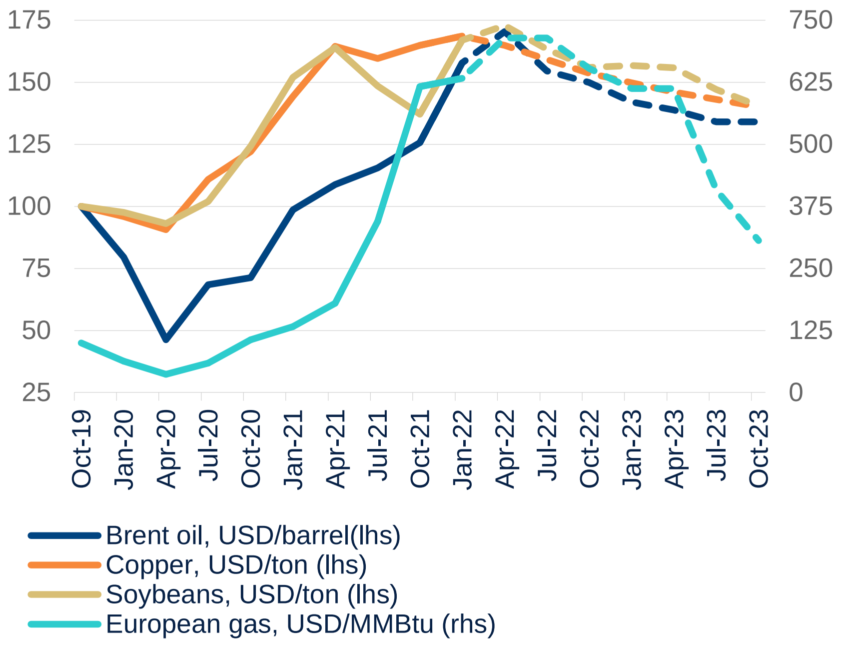
*: Market expectations for policy rates in Dec/23 implicit in future contracts. Eurozone yields: German bond yields. .

Source: BBVA Research based on data by Bloomberg.

The war represents a significant supply shock, with negative economic effects mainly through higher commodity prices

COMMODITY PRICES: FORECASTS

(4Q19 AVERAGE= 100, QUARTERLY AVERAGE)



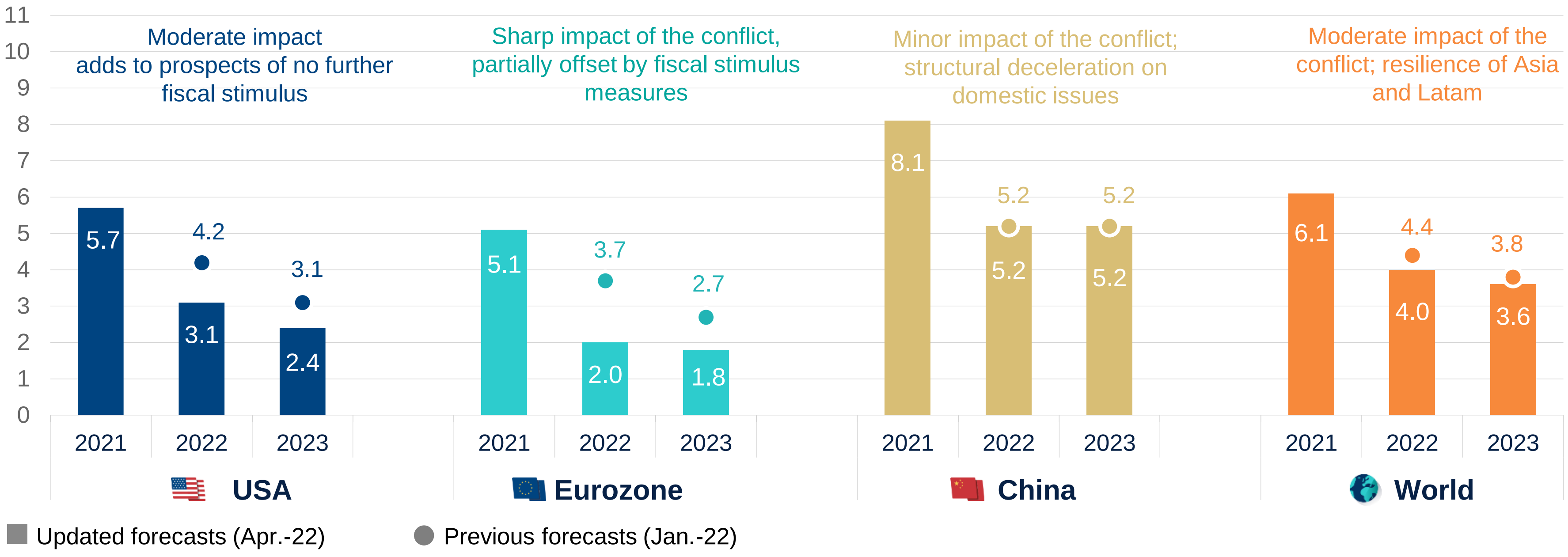
Source: BBVA Research.

- Base economic scenario in an environment of high uncertainty: moderation in growth and higher inflation, mainly in Europe; a scenario of global stagflation is avoided.
- Main assumptions behind the base scenario:
  - the sanctions are potentially permanent and have a higher economic cost in 2022
  - significant further escalation of sanctions (including an imposed reduction of gas/oil flows between RUS and EUR) is avoided
  - commodity prices: strong price increase, especially in the short term
  - confidence: high volatility in 1H22
  - bottlenecks: higher and more persistent
  - financial systems: no significant disruptions.

Growth forecasts are revised significantly to the downside in Europe, despite the expected (but uncertain) fiscal measures, and moderately in other regions

GDP: ANNUAL GROWTH IN REAL TERMS

(%)

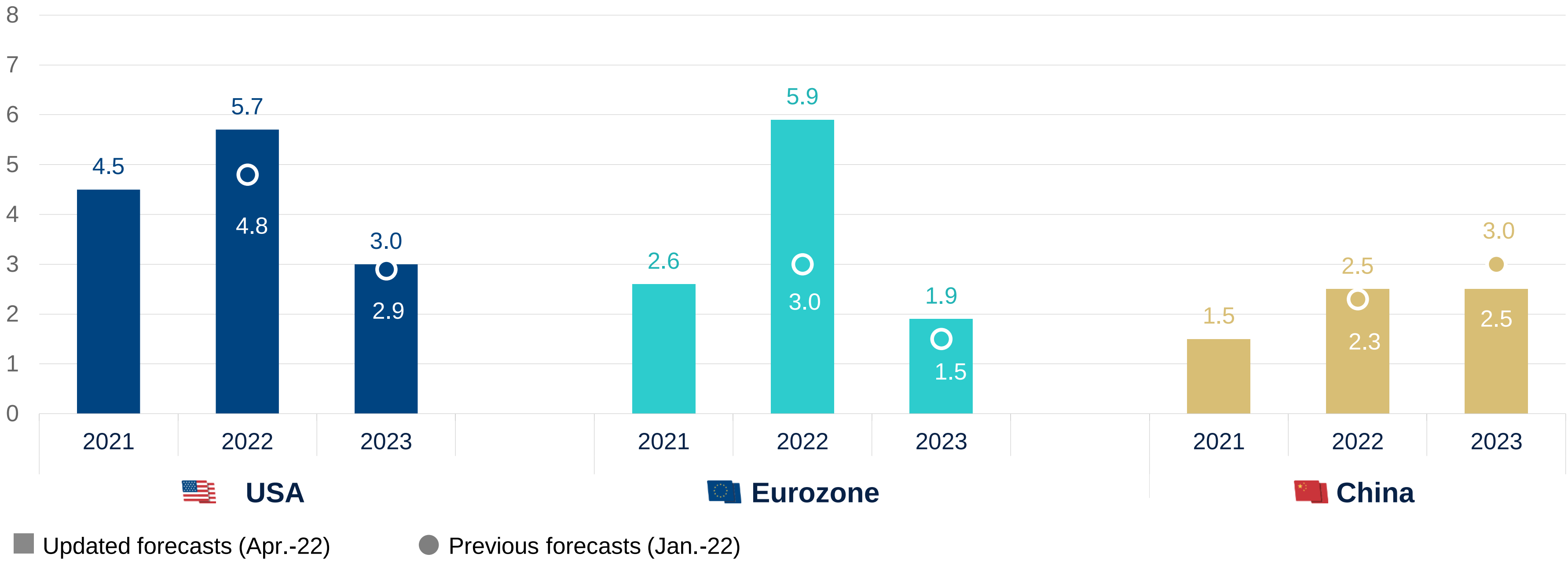


Source: BBVA Research.

Commodity prices and additional bottlenecks will add to previous pressures and keep inflation very high, at least this year

INFLATION: CPI

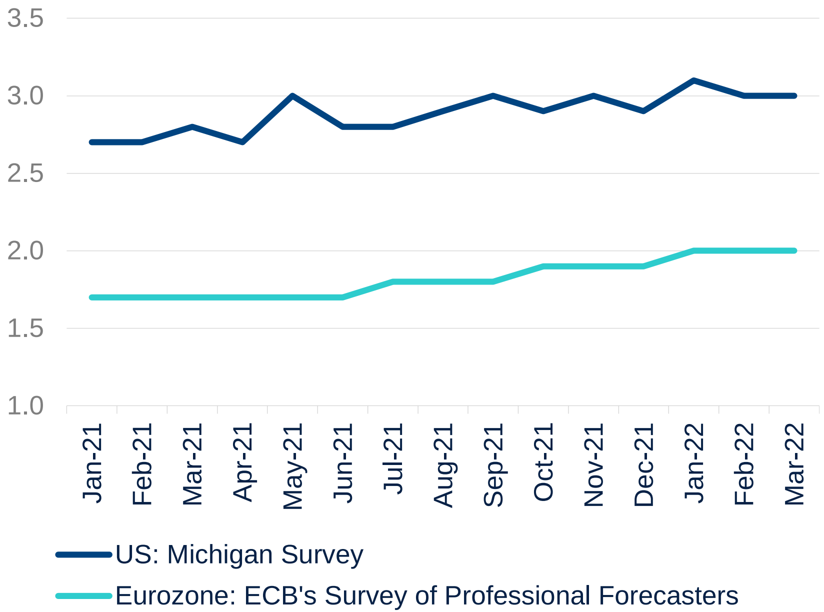
(Y/Y %, PERIOD AVERAGE)



Source: BBVA Research.

The second-round effects of high inflation are of particular concern in the US, and also, although to a lesser extent, in Europe

5-YEAR INFLATION EXPECTATIONS, BASED ON ANALYSTS SURVEYS(%)



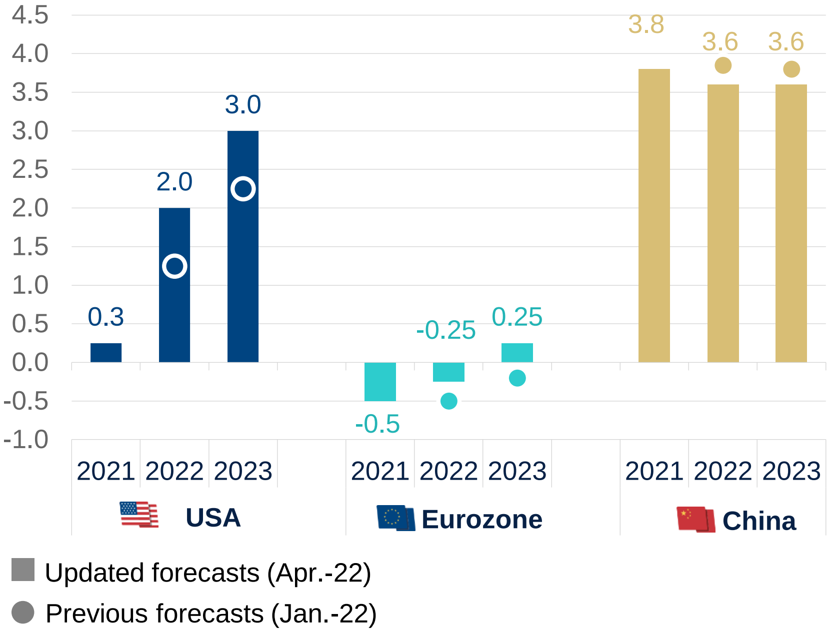
Source: BBVA Research based on data by Haver.

- Persistence of current shocks: high uncertainty, but the pandemic, the war, the energy transition... could have more lasting impacts on inflation.
- Labor markets: dynamism in the US (not so much in the Eurozone) favors second-round effects, but tightness could be temporary.
- Economic policy: central bank credibility is key, but the current environment increases the risk of mismanagements.
- Inflation expectations: above the 2% target in the US and rising, but still anchored, in the Eurozone.

Interest rate hikes by the Fed (more aggressive) and by the ECB (despite the dilemma) from 2022; new fiscal stimulus in the Eurozone, but not in the US

MONETARY POLICY INTEREST RATES*

(%)



* In the case of the ECB, deposit facility rates.
Source: BBVA Research.

Controlling inflation is the main objective

- Fed: more aggressive rate hikes and a reduction in the balance sheet from Jun/22 given high inflation and the labor market strength.
- Fiscal policy: the approval of further fiscal stimulus packages is no longer expected.

Monetary normalization, fiscal support

- ECB: accelerated reduction of the asset purchase program (APP) until its end in 3Q22; gradual rate hikes starting in 4Q22.
- Fiscal policy: additional stimuli at national and European level, in defense, energy, refugees...

Focus on avoiding a sharp slowdown

- PBoC: one/two more rates cuts, credit expansion
- Fiscal policy: local government bond issuance, tax cuts...

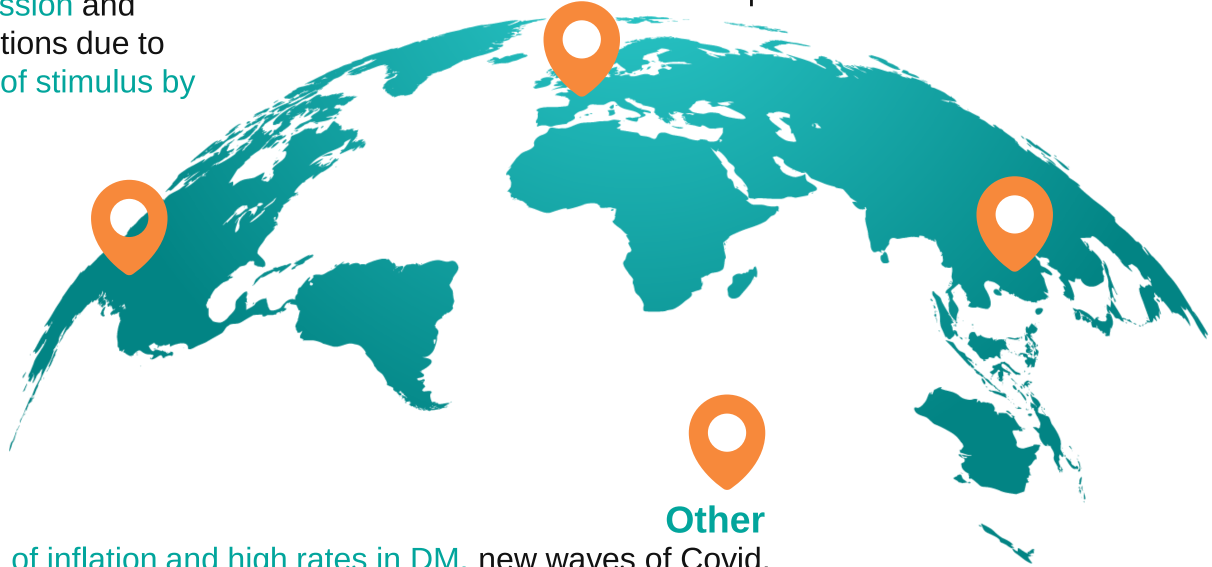
Risks are significant and tilted to the downside, not only because of the conflict in Europe, but also because of the Fed's exit and the deceleration in China

Europe

Stagflation and other extreme economic/geopolitical scenarios due to a worsening of the Ukraine-Russia conflict and further escalation of sanctions limiting the flow of commodity products between Russia and Europe.

USA

Economic recession and financial disruptions due to the withdrawal of stimulus by the Fed



China

A hard-landing of growth and financial stress due to increased restrictions due to Covid or other factors.

Other

Impact on EM of inflation and high rates in DM, new waves of Covid, social tensions, new geopolitical conflicts...

Possible long-term effects of the conflict

Higher military spending and higher taxes

Deglobalization

Higher cost of security (cybernetics, energetic...)

Geopolitics emerge as a salient global risk

New geopolitics map

More incentives to accelerate energy transition

Further EU integration

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02

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

Main messages

Prioritizing growth in 2022

Due to China's "first-in, first-out" of the pandemic and "zero tolerance" strategy, the main character of Chinese economy is its unsynchronized business cycle, inflation cycle thus unsynchronized policy cycle with the rest of the world. Unlike other economies, China's domestic uncertainties particularly the Covid-19 situation dominate external uncertainties as the main risks for growth. 2021 has been a year of regulatory storms, while 2022 is a year of soft-landing. "Two Sessions" which is the top priority in China's political agenda announced the 5.5% GDP growth target for 2022 and expansionary policy stance to prioritize growth; it also outlined the blueprint of China's new growth model in the medium-to-long term.

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, particularly retail sales and investment, continues to lag behind the supply side. "Zero tolerance" strategy on Covid-19 significantly dragged on consumption recovery. Housing sector, due to its previous crackdown, remains lackluster although the authorities adopted regulatory forbearance this year.

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 as well, due to the authorities' efforts to increase the supply of reserved commodity and China's production normalization which solved the global supply-chain bottleneck problem domestically.

Main messages

China's independent monetary 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 comparatively closed capital account provide the room for policy easing.

Main downside risks

Domestic uncertainties dominate external shocks: (i) recent Omicron virus flare-ups in China particularly in Shanghai led to lockdowns in infected cities, posing challenges on consumption recovery and pressure on local government fiscal balance; whether and when to give up "zero tolerance" strategy is uncertain; (ii) to what extent the easing monetary policy could transmit to the real economy and the fiscal expansion could stimulate infrastructure investment; (iii) to what extent the authorities would release real estate sector restrictions to rebuild market confidence to stimulate real estate activities; (iv) to what extent the authorities would adopt regulatory forbearance to avoid regulatory storms as of 2021.

The de-globalization in the aftermath of Russia-Ukraine war will also change China's position as manufacturing center of the world, together with FED tightening measures, triggering massive capital outflows and the global market's sell-off of Chinese stocks in onshore and offshore markets.

Chinese economy: domestic uncertainties dominate external uncertainties

Positive factors

1. Given the low inflation environment and closed capital account, China has a large policy room for the monetary easing;
2. China's central government balance sheet is robust, providing room for fiscal expansion;
3. The authorities eases some of the previous crackdown measures on housing market, trying to rebuild market sentiments.
4. Continuing strong exports momentum supports growth.
5. China' new growth model to foster high-end manufacturing and green economy provide opportunities, offsetting real estate slowdown.
6. The authorities' continuation of financial liberalization and opening-up policy dispels market's worries of previous regulatory storms and common prosperity reforms.

Chinese economy: domestic uncertainties dominate external uncertainties

Risk factors

External uncertainties:

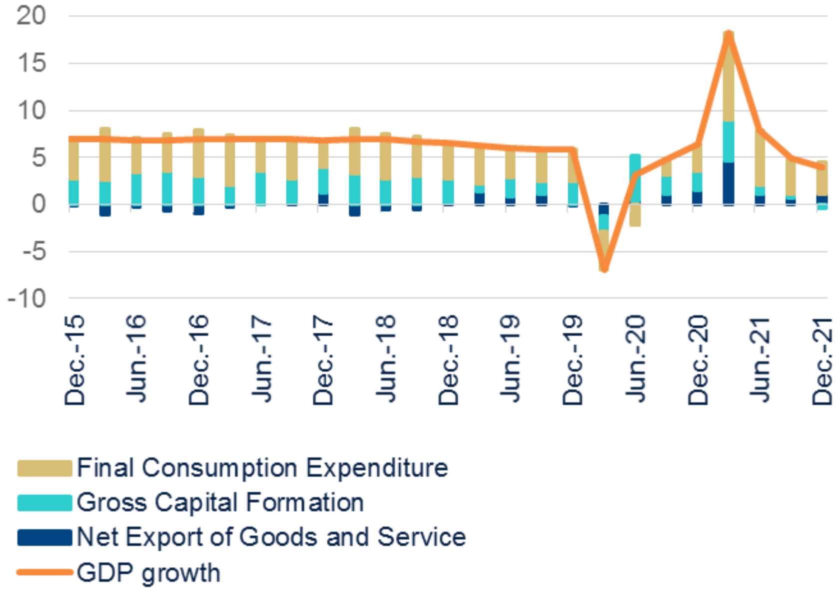
1. Ukraine-Russia war will complicate China's status in international relations and the de-globalization after the war will deteriorate China's position as global manufacturing center, triggering capital outflows and stock sell-off recently.
2. Considering capital outflows and RMB exchange rate stability, FED's interest hike constrain the room for China's interest rate cut, which also leads to capital outflows.

Domestic uncertainties:

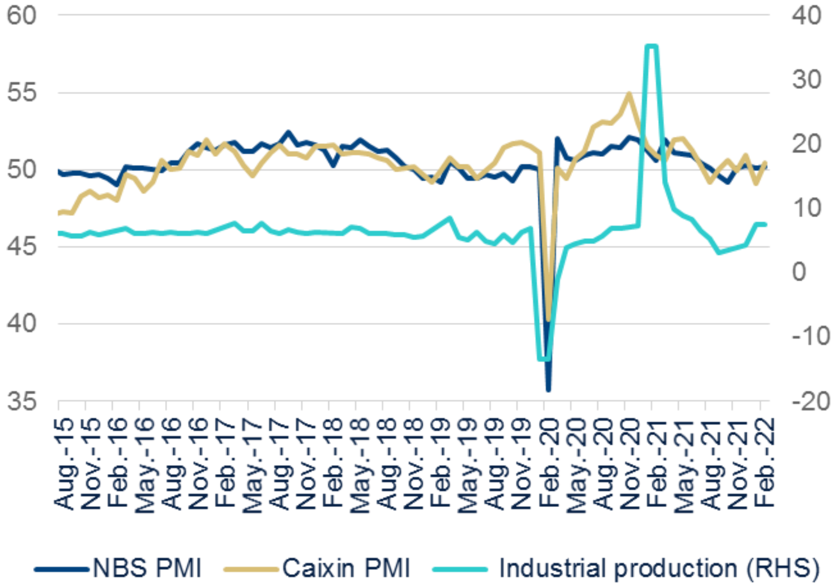
1. Covid-19 situation in Shanghai and the whole city lockdown is the primary risk to the economy;
2. It is difficult to alter people's expectations on real estate sector downturn, which dragged housing market activities and related upstream and downstream sectors.
3. China's "zero tolerance" of the pandemic added large cost of fiscal balance of local gov and dragged consumption recovery.
4. In the short term, the direction of regulatory storms and "common prosperity" will not change, weighing on sentiments.
5. It is challenging for the authorities to strike balance between the carbon neutrality target and short-term growth.

Growth slowdown with an unbalanced structure tilting towards strong exports and production, while domestic demand lackluster

2021 Q4 GROWTH SLOWED TO 4% FROM 4.9% IN Q3, CONCLUDING 2021 GDP AT 8.1%; THE AVERAGE OF 2021 AND 2020 ONLY 5.2%, LOWER THAN 5.9% IN 2019



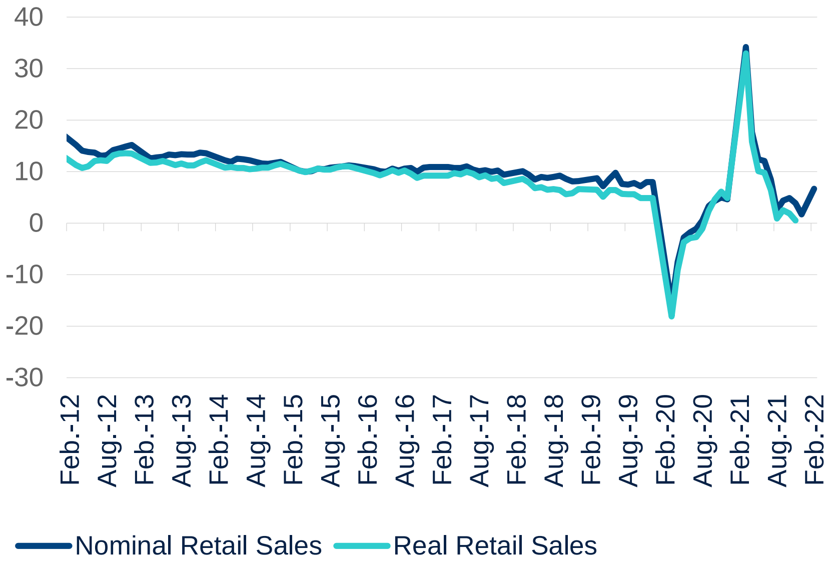
FROM SUPPLY SIDE, PMIS AND IP REBOUNDED IN FEBRUARY, AS THE AUTHORITIES' EASING MEASURES BEAR SOME EARLY FRUITS (INDEX, % YOY)



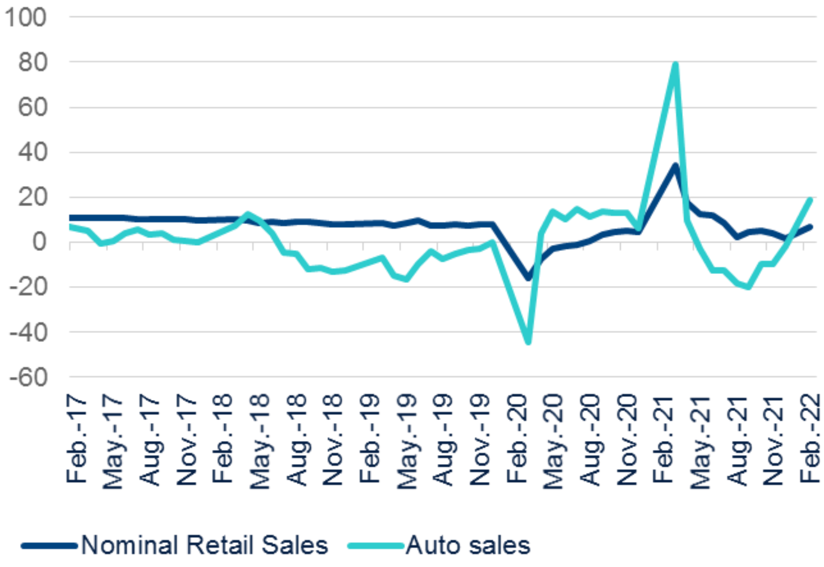
Source: CEIC and BBVA Research.

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

JAN-FEB RETAIL SALES GROWTH SIGNIFICANTLY PICKED UP TO 6.7% FROM 1.7% PREVIOUSLY, BUT RECENT OMICRON OUTBREAK WILL HALT THIS IMPROVEMENT (%)



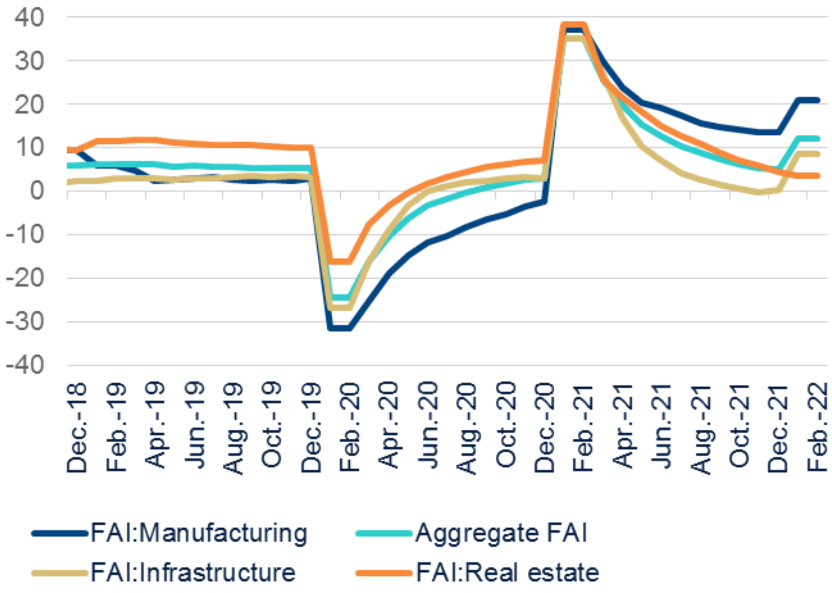
RETAIL SALES IS SUPPORTED BY THE AUTO SALES AND SERVICE SECTOR, BUT RECENT VIRUS OUTBREAK WILL ALTER THIS TREND (%)



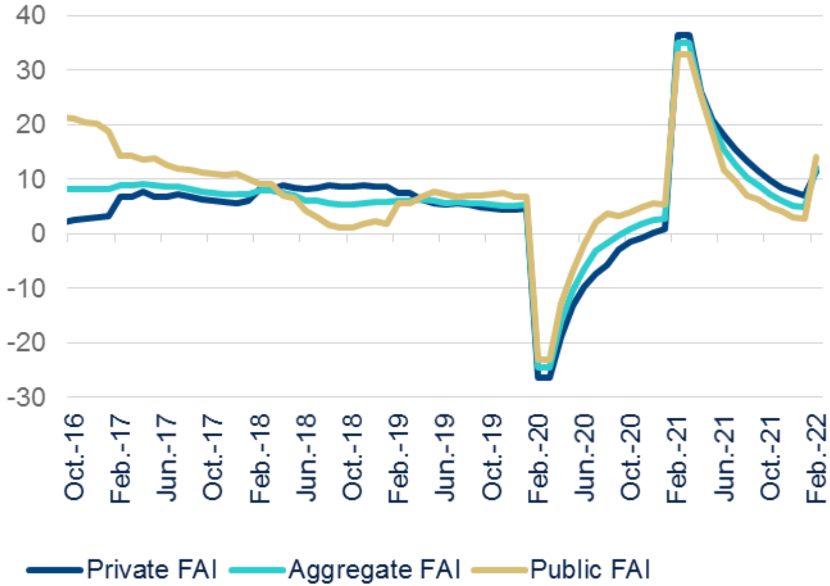
Source: CEIC and BBVA Research.

Infrastructure investment has room to accelerate due to fiscal stimulus while real estate investment remains lackluster

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



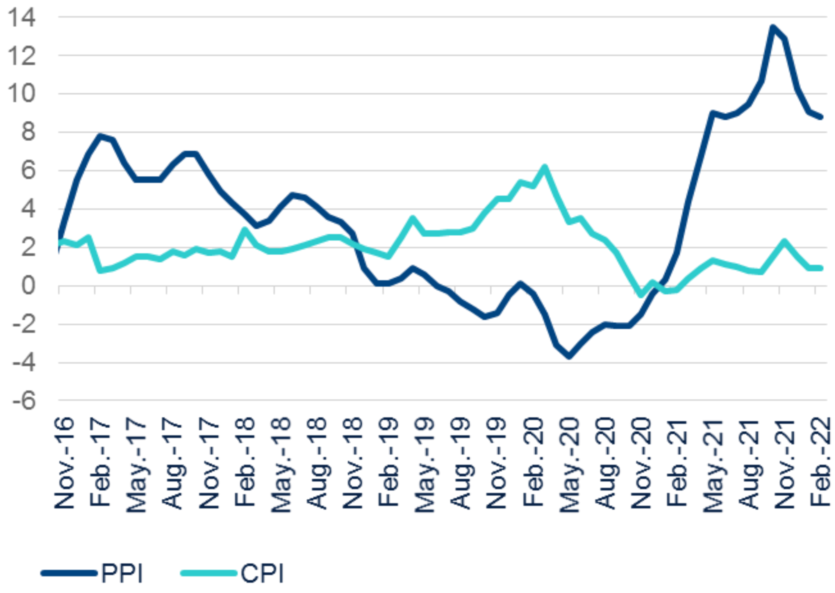
PUBLIC FAI REBOUNDED SIGNIFICANTLY AS THE AUTHORITIES SPEED UP LOCAL GOVERNMENT BOND ISSUANCE TO STIMULATE GROWTH (% YTD, Y/Y)



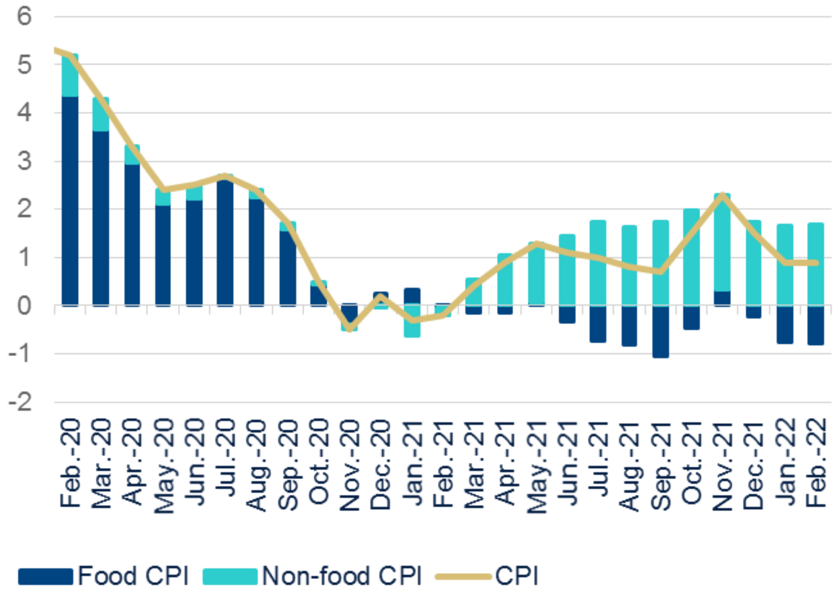
Source: CEIC and BBVA Research.

A low CPI environment remains, while PPI also decelerated

PPI STARTED TO DECELERATE AS THE GOVERNMENT INCREASED THE RESERVED COMMODITY SUPPLY



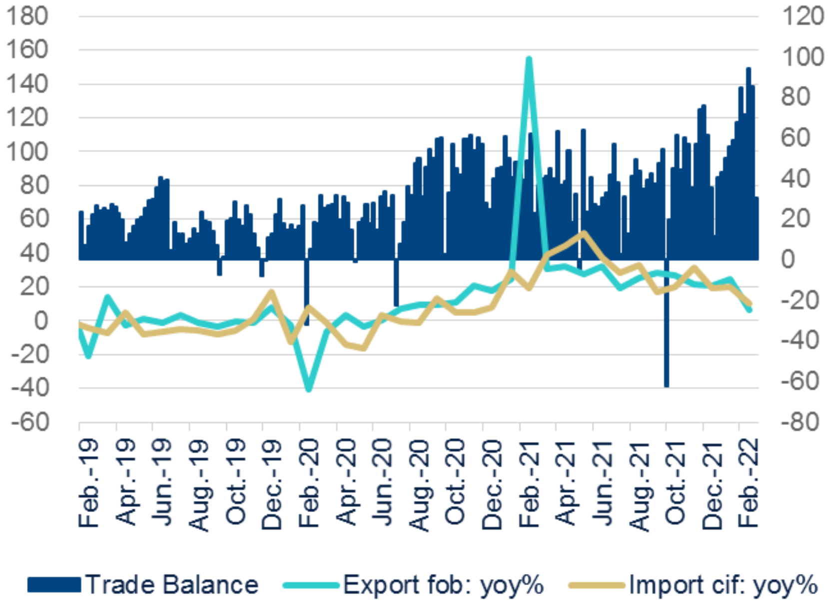
LOW CPI IS STILL DOMINATED BY AFRICAN SWINE FLU CYCLE, WITH PORK PRICE DIPPING BY -40%, AND TRANSMISSION FROM PPI IS INSIGNIFICANT (%)



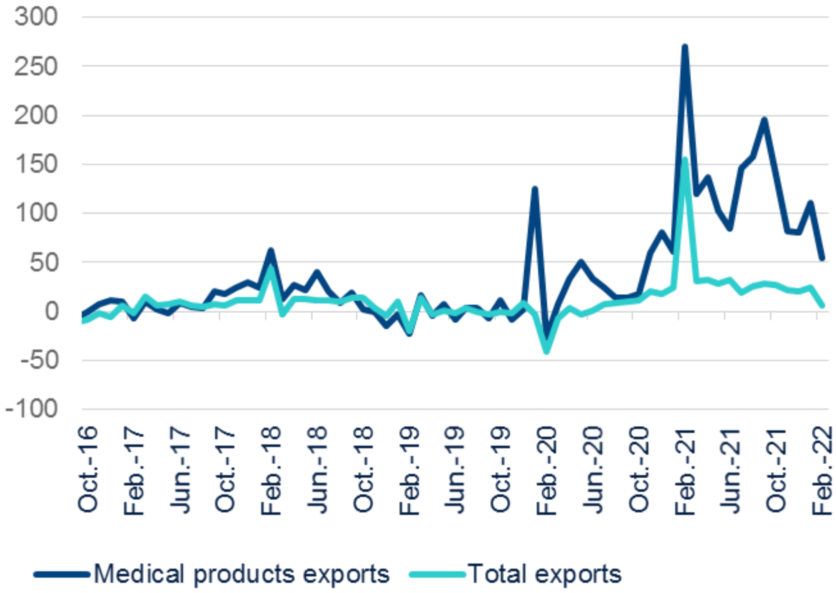
Source: CEIC and BBVA Research.

Supply-side substitution effect supports China's exports as other countries suffer from supply-chain distortions, but its sustainability is questionable

EXPORT GROWTH REACHED 30% IN 2021, HIGHEST IN PAST DECADES, BUT STARTED TO DECELERATED IN JAN-FEB



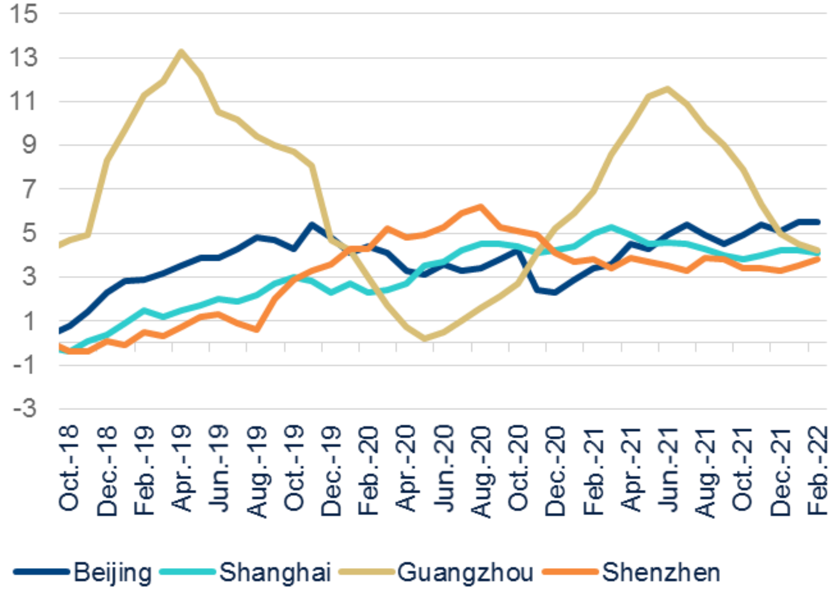
GROWTH OF MEDICAL AND VIRUS-RELATED PRODUCTS HAS BEEN DECELERATING AS THE TIME GOES



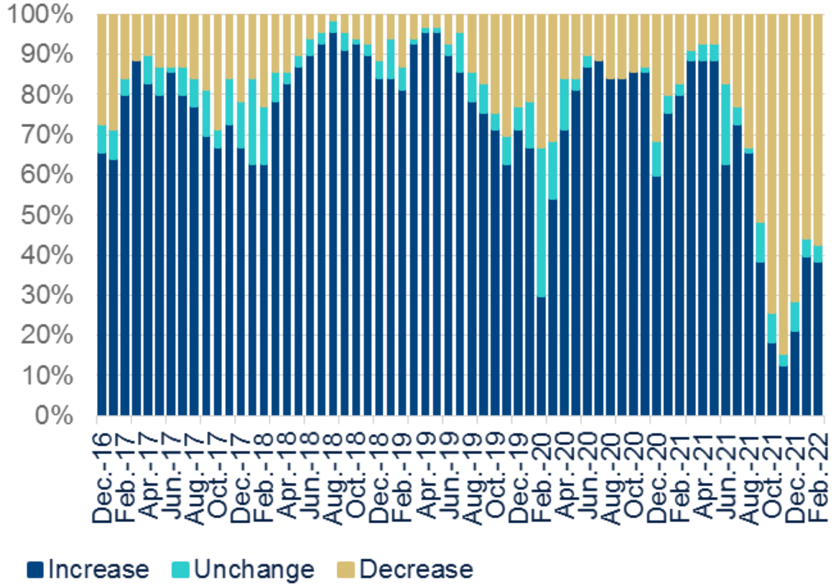
Source: CEIC and BBVA Research.

Housing prices sliding, as people’s expectations of real estate downturn is difficult to be altered

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



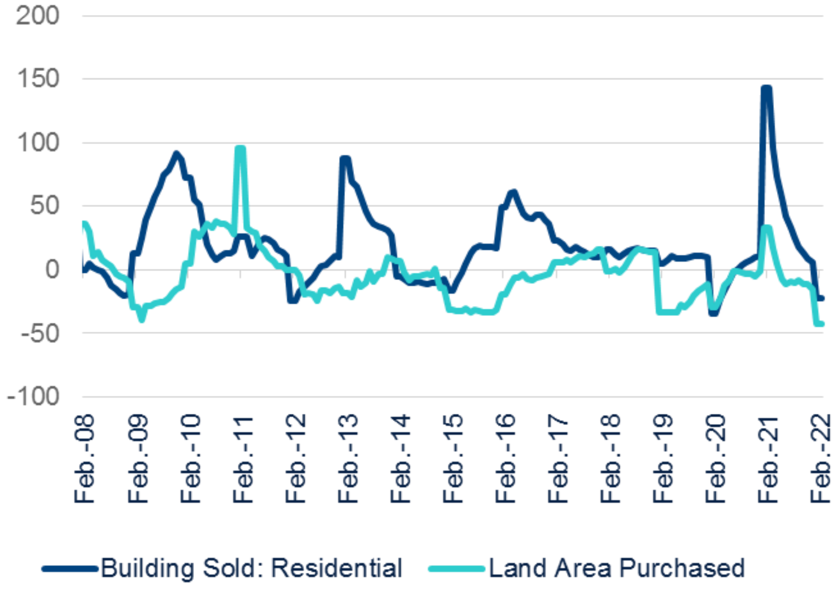
THERE ARE INCREASING NUMBER OF CITIES THAT REPORTED HOUSING PRICE DECREASING IN 70-CITY SURVEY (M/M GROWTH)



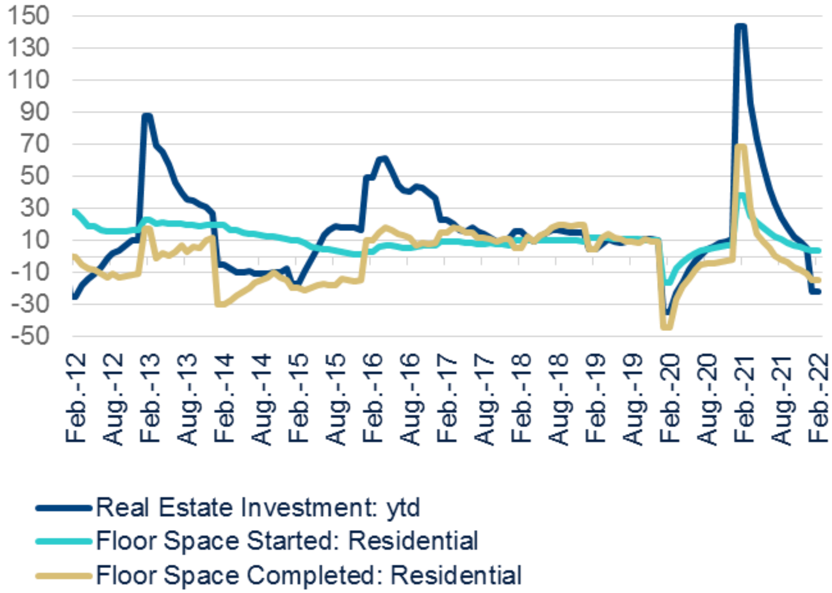
Source: CEIC and BBVA Research.

Other real estate activity indicators also decelerated significantly, due to the authorities' previous crackdown on housing market

LAND PURCHASED GROWTH FROM LOCAL GOVERNMENT DIPPED SIGNFICANTLY TO NEGATIVE



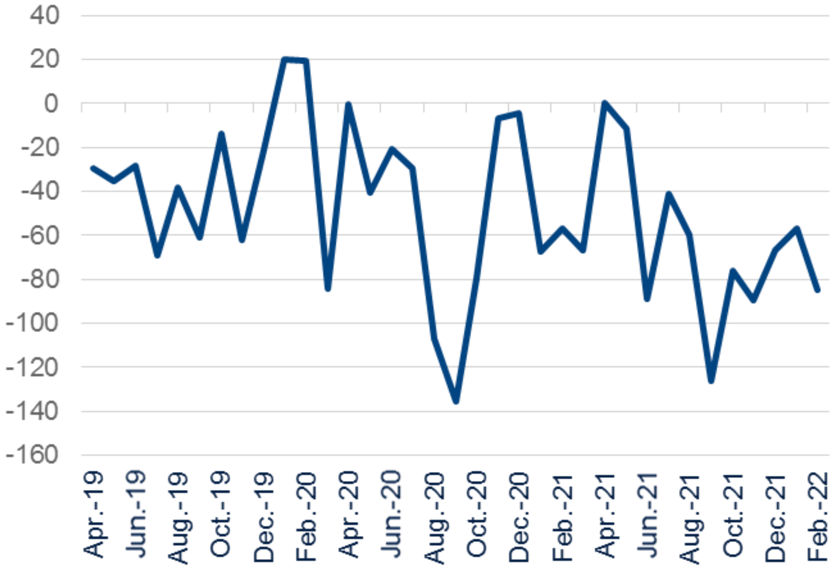
FLOOR SPACE STARTED AND COMPLETED ALSO DIPPED TO NEGATIVE, TOGETHER WITH REAL ESTATE INVESTMENT SLOWDOWN



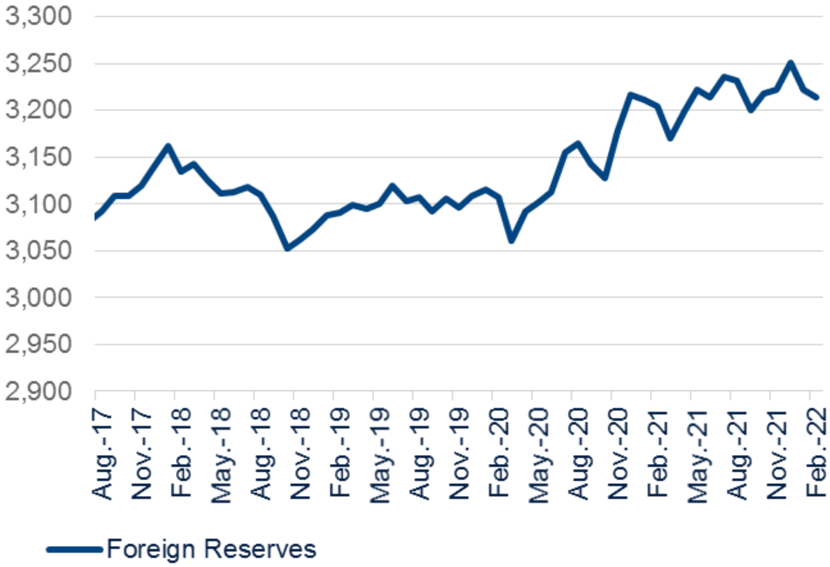
Source: CEIC and BBVA Research.

The fastest pace of capital outflows stem from the spillover effect of Russia-Ukraine war, China-US tech war and FED tightening measures

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



FOREIGN RESERVES TRENDED DOWN RECENTLY AMID TRADE BALANCE SHRINKING AND CAPITAL OUTFLOWS (USD BN)



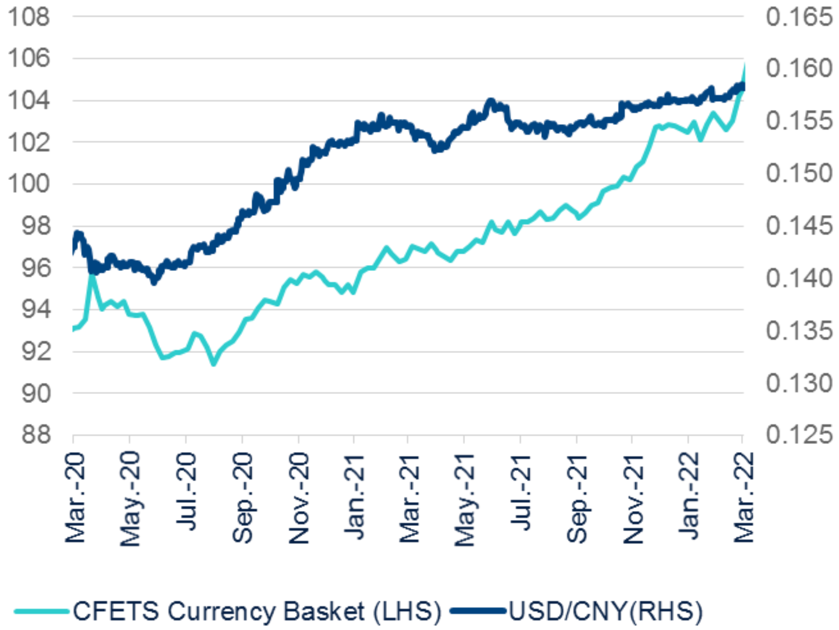
Source: CEIC and BBVA Research.

What’s behind the massive capital outflows from China?

- Foreign investors' concern of China's position in Russia's invasion, the Covid-19 flare-ups in Mainland China, and the US-China regulatory altercation about Chinese listed firms in the US, all contributed to the recent stock market selloff and capital flight.
- Fortunately, some positive signals have emerged to alleviate markets’ worries. China's neutral position in the Russia-Ukraine war has been clarified and accepted by more countries, including the US and EU. China's authorities have also softened their previous stance and are willing to make more concessions to the US so that they can enhance their supervision on Chinese listed firms in the US. Regarding the Covid-19 flare-ups, China's authorities are able to bring the situation under control.
- This round of capital flows is through the channel of portfolio investment. For these portfolio investment in China, the authorities have been cautiously maintaining certain quota and restrictions to make sure that these foreign investors’ portfolio adjustment won’t affect the country’s financial stability and BOP position.
- We don’t believe that foreign capital will come back to Chinese capital market soon. As the main theme of major central banks’ monetary policy is tightening, the global financial markets might experience more rounds of corrections. It is reasonable for fund managers to start their portfolio rebalancing with China’s exposure.
- In the long run, the de-globalization trend in the aftermath of Russia-Ukraine war will significantly change China’s position as manufacturing center in the world amid supply chain relocation. The Russia-Ukraine crisis might aggravate people’s worries about China’s outlook amid escalating geopolitical conflicts. But the crisis also exemplifies how painful to decouple a relatively smaller economy like Russia from the global supply chain. In essence, foreign capital’s view of China depends on the country’s authorities’ policy reactions. China’s authorities still show their strong willingness to embrace foreign capital and maintain its position in the global supply chain.

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

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



Source: CEIC and BBVA Research.

- We anticipate the current strong RMB to USD exchange rate will be changed in 2H 2022 amid FED QE Tapering, interest rate hike and central bank balance sheet reduction, as well as the ongoing massive capital outflows from China.
- We expect RMB to USD exchange rate will depreciate to 6.6 at end-2022.
- Our forecast of RMB is based on: (i) the shrinking of China-US growth divergence, (ii) the shrinking of interest rate divergence with the US, (iii) China's exports (current account) deceleration in 2022 and (iv) accelerating capital outflows from China in the aftermath of Russia-Ukraine war.
- The relation of RMB exchange rate and USD DXY seems to become loosening recently as both RMB and USD DXY went stronger.

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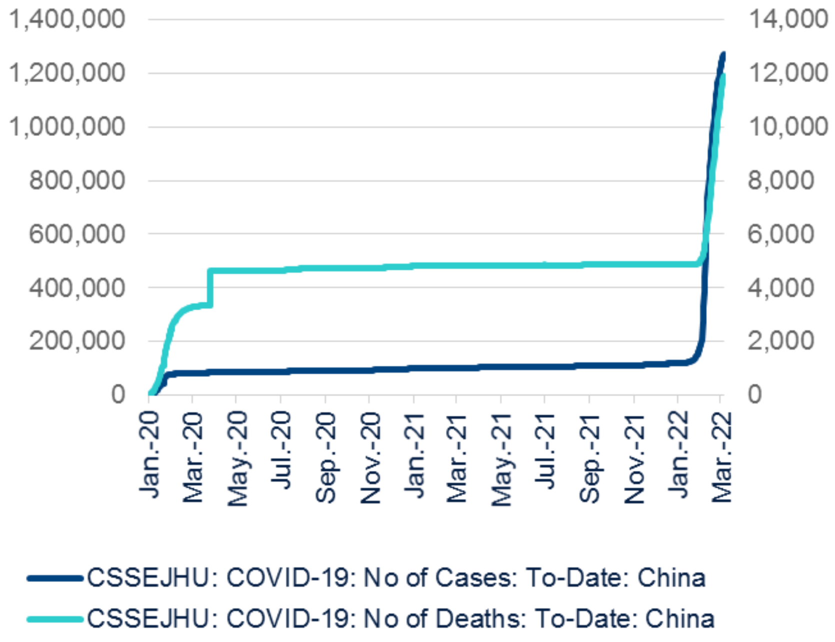
03

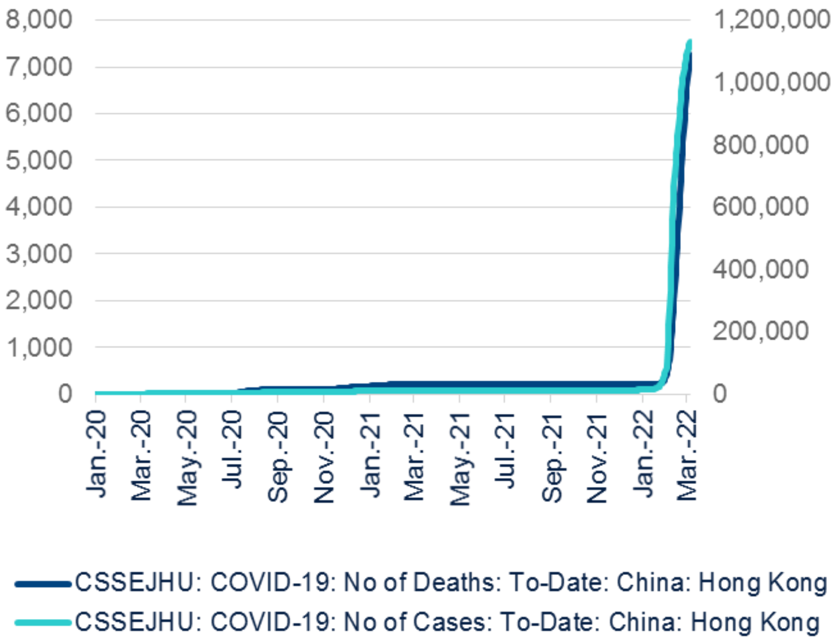
The impact of Shanghai's lockdown due to Covid-19 flare-up

The Omicron flare-ups in mainland China and the lockdown measures significantly dragged consumption recovery

ACCUMULATED INFECTED CASES AND DEATH TOLL IN CHINA (INCLUDING HK) (No. OF PERSON)

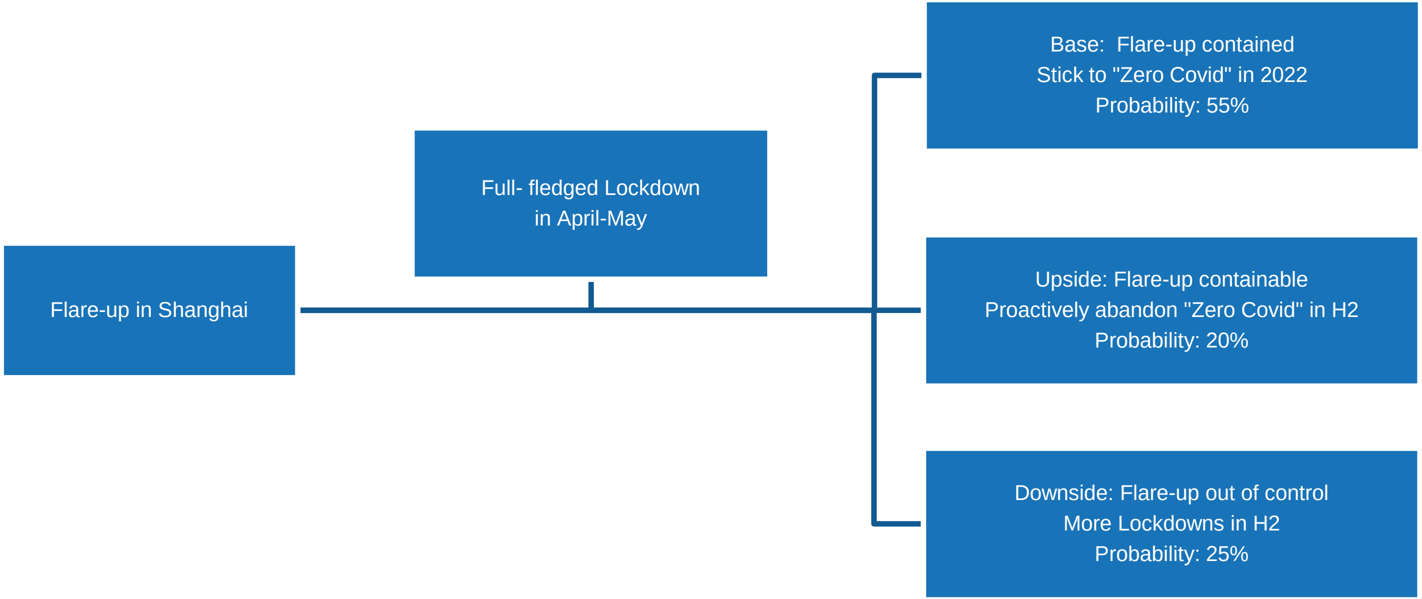


ACCUMULATED INFECTED CASES AND DEATH TOLL IN HK SAR (No. OF PERSON)



Source: CEIC and BBVA Research.

Scenario of Shanghai’s lockdown



The impact of Shanghai's lockdown on global supply chain (1)

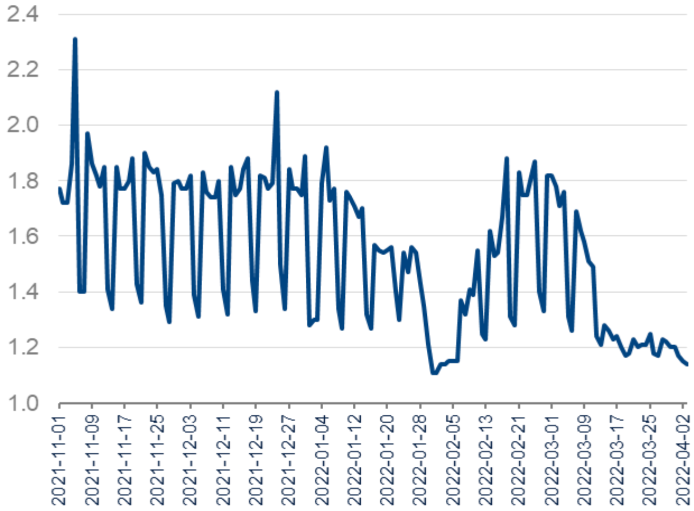
MARKET SHARE OF SHANGHAI PRODUCED EXPORTS AND SHIPMENTS

PROCESSING TRADE AND GENERAL TRADE (UNIT: RMB 100 MN)

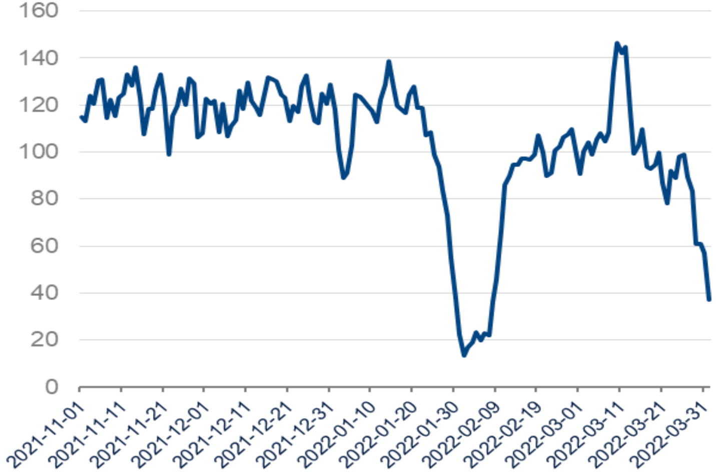
Source: WIND and BBVA Research.

The impact of Shanghai's lockdown on global supply chain (2)

CONGESTION DELAY INDEX: SHANGHAI



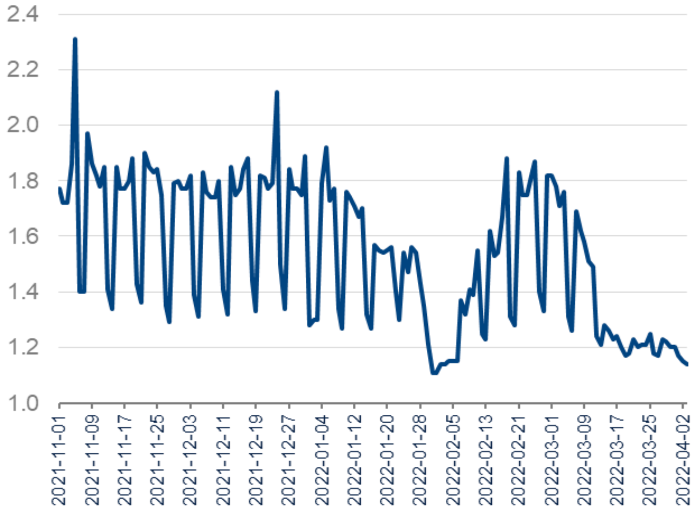
VEHICLE FREIGHT FLOW INDEX: SHANGHAI



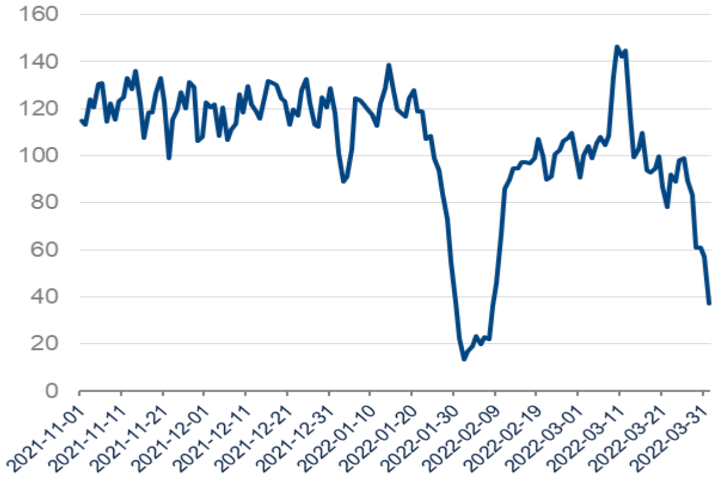
Source: WIND and BBVA Research.

The impact of Shanghai's lockdown on global supply chain (3)

CONTAINER PRICE INDEX BETWEEN SHANGHAI AND CHINA



NUMBER OF VESSELS WAITING OUTSIDE SHANGHAI PORT



Source: WIND and BBVA Research.

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04

China's independent expansionary monetary and fiscal policy

Main messages

Easing monetary policy ahead

"Two Sessions" which are the top priority in China's political agenda promulgated the stimulus package for 2022: easing monetary and fiscal measures which are unsynchronized with main central banks' tightening measures. For the monetary policy, following recent two RRR cuts and LPR cuts, 1-2 more LPR and RRR cuts anticipated, together with targeted credit expansion tools to support SMEs and green economy financing.

Expansionary fiscal policy

The new fiscal stimulus package promulgated by "Two Sessions" include: (i) Fiscal budget: -2.8% of GDP (less than -3.2% in 2021); however, considering the fiscal transfer of RMB 1.27 trn from 2021, total deficit is -3.8%, more expansionary than 2021.(ii) Local government bond issuance: RMB 3.65 trillion; (iii) Fee deduction and tax cut/refund: RMB 2.5 trillion, compared with RMB 1 trillion in 2021.

China's new growth model in the long term

The new growth model includes three "pillars": common prosperity, technology self-sufficiency and green economy. It will provide opportunities for high-end manufacturing, technology sector and green economy, transforming Chinese economy from housing and infrastructure driven to technology and green economy driven.

“Two Sessions”: What are the authorities’ economic targets and policy stance of 2022?

Targets of economic indicators in 2022

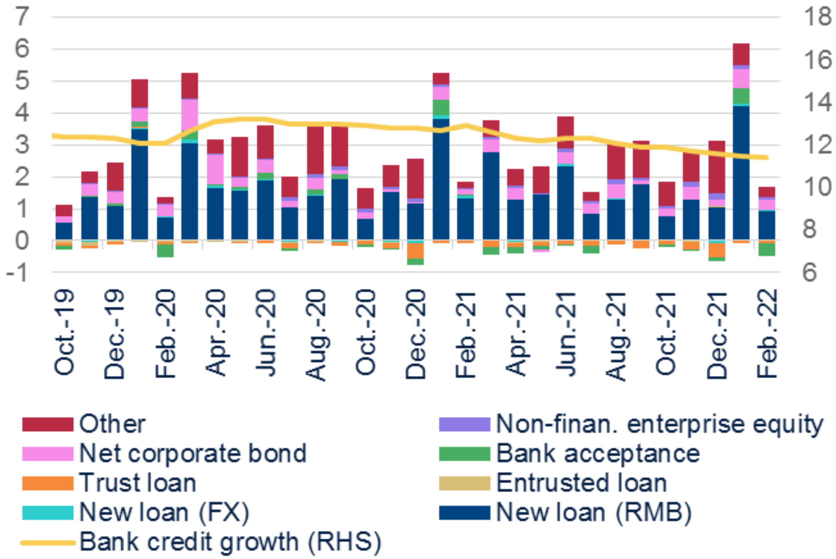
1. GDP growth target: 5.5%; (compared with 5.2% average actual growth for 2020 and 2021).
2. Employment: new increasing urban employment: 11 million; surveyed unemployment rate: less than 5.5%;
3. CPI: less than 3%;
4. Household income growth: in line with GDP growth;

Monetary and fiscal policy stance in 2022

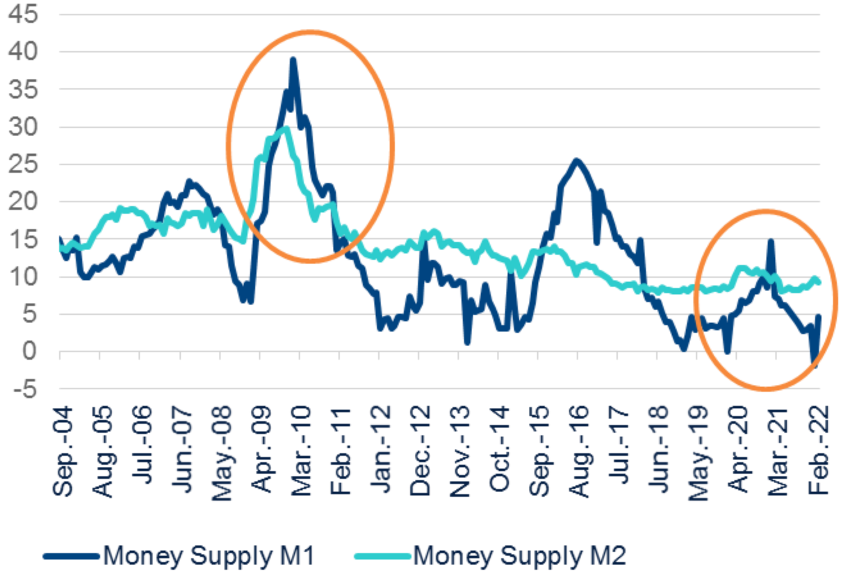
1. M2 and total social financing growth: in line with nominal GDP growth, which is around 8.5%;
2. Fiscal budget: -2.8% of GDP (less than -3% in 2021); however, considering the fiscal transfer of RMB 1.27 trn from 2021, total deficit is -3.8%, more expansionary than 2021.
3. Local government bond issuance: RMB 3.65 trillion, the same scale as of 2021, but RMB 1.46 trillion of local government bond quota has already been pre-allocated to end-2021 to stimulate infrastructure investment;
4. Fee deduction and tax cut/refund: RMB 2.5 trillion, compared with RMB 1 trillion in 2021.

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

CREDIT ACCELERATED, BUT ITS STRUCTURE MORE WORRIESOME AS MOST LENDING ARE SHORT-TERM BANK NOTES WHILE LONG-TERM LENDING LIMITED (RMB TRN, %YOY)



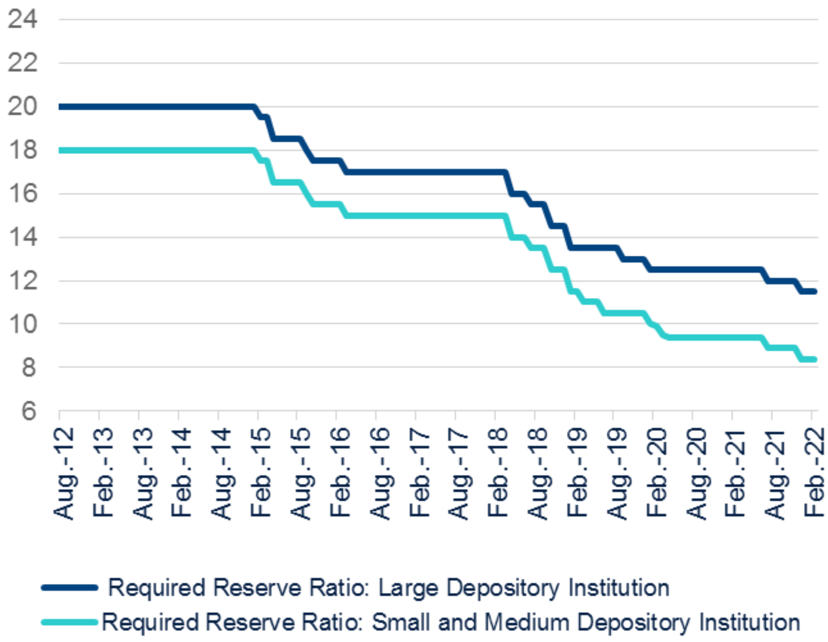
M2 GROWTH ALSO PICKED UP ACCORDINGLY, REFLECTING THE RECENT EASING MONETARY STANCE (Y/Y)



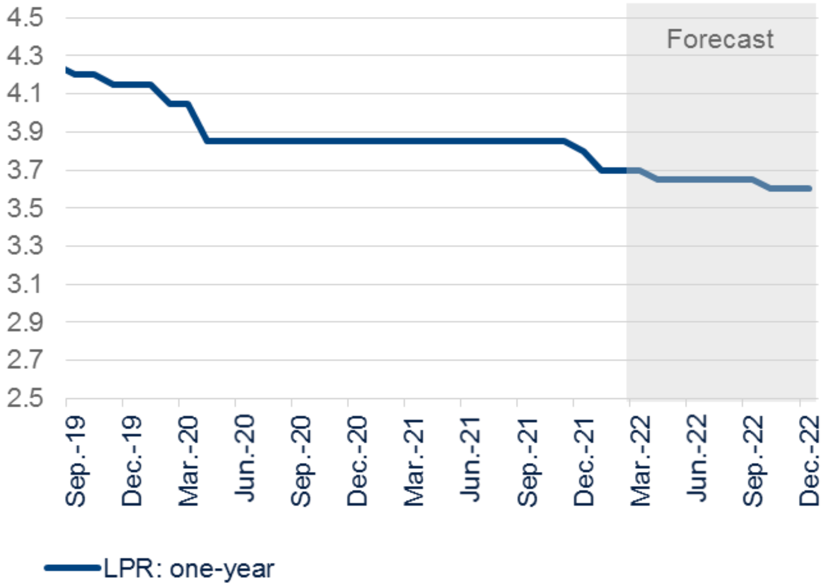
Source: CEIC and BBVA Research.

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

EXCEPT FOR THE TWO RRR CUTS IN 2021, 1-2 MORE RRR CUTS ARE ANTICIPATED IN 2022 (%)



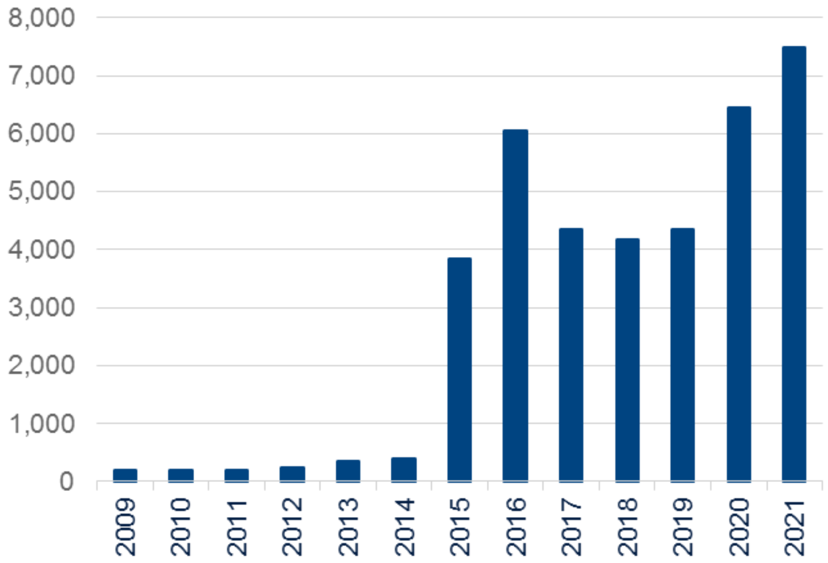
ON TOP OF TWO RECENT LPR CUTS, THERE ARE ALSO 1-2 LPR CUTS ANTICIPATED IN 2022 LEADING LPR TO 3.6% AT END-2022 (%)



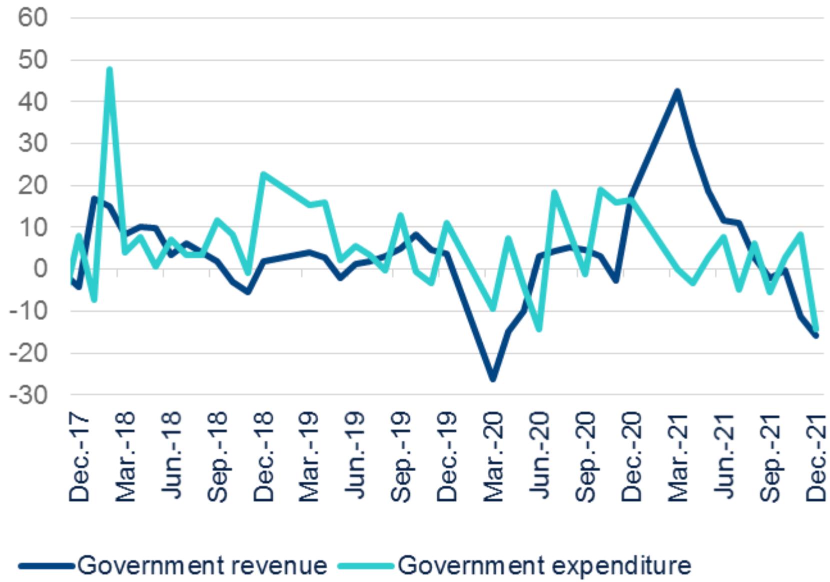
Source: CEIC and BBVA Research.

Fiscal stimulus package includes speed-up of local government bond issuance and tax cut/fee deduction

THE AUTHORITIES HAVE ALREADY PRE-LOADED RMB 1.46 TRN LOCAL GOVERNMENT BOND ISSUANCE QUOTA TO END-2021 TO STIMULATE INFRASTRUCTURE FAI (BN RMB)



DUE TO 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.

BBVA Research

05

The impact of Russia-Ukraine war on Chinese economy is limited

The impact of Russia-Ukraine war on China: qualitative and quantitative analysis (1): baselines

High global commodity prices

- China's imported inflation will rise but on the other hand, China will play a more important role to stabilize global inflation;
- High commodity prices will urge the US FED and ECB to speed up tightening measures (albeit more conservative), which will lead to capital outflow from China and RMB depreciation;
- The possible SETBACK of carbon neutrality target and re-open coal driven power station.

Trade sector

- Limited impact on bilateral trade, as the trade could be settled through RMB and China's CIPS settlement system;
- China will help to absorb Russia's energy exports to increase China's own energy reserve.

The impact of Russia-Ukraine war on China: qualitative and quantitative analysis (1): baselines

Financial markets

- The war will deteriorate sentiments on China's stock market temporally, however, it is just short-term noise. After all, only two wars (1991 Gulf War and 1973 4th Middle East war) in the past 50 years had devastating impact on global stocks as Oil sanction imposed.
- RMB and China bond have been increased in global investors' portfolio due to their quasi-safe-heaven characters, as China has solid fundamentals and unsynchronized business cycle, diversifying the systematic risks.
- Support RMB internationalization.

Political implications are more significant than economic implications

- China and Russia have been traditional ally but with ups and downs. China adopted neutral and "strategical ambiguity" method (against both NATO expansion and Russia's invasion).
- China and Russia signed joint communique and 15 bilateral Agreements on economic cooperation before Beijing Winter Olympic, making China at an embarrassed situation.
- The war in the long-term will make China and Russia closer, but more isolated from the west, which reserves buffer for China-US conflicts and tech war in long run.

What is China's role in Russian-Ukraine war? (2)

China's role for the war?

- China adopted neutral and "strategical ambiguity" method (against both NATO expansion and Russia's military invasion) to maintain its international image. China encourages two sides back to the negotiation table and advocates territorial integrity and peace.
- Both EU and US urged China to play a role as mediator for the truce.
- China will not join western countries to make sanctions on Russia; but will not confront with the west as well.
- China will provide limited and implicit help to Russia in the medium to long term, but not the military aid;
- China and Russia need each other to form the ally to deflect the US pressure in the long term.

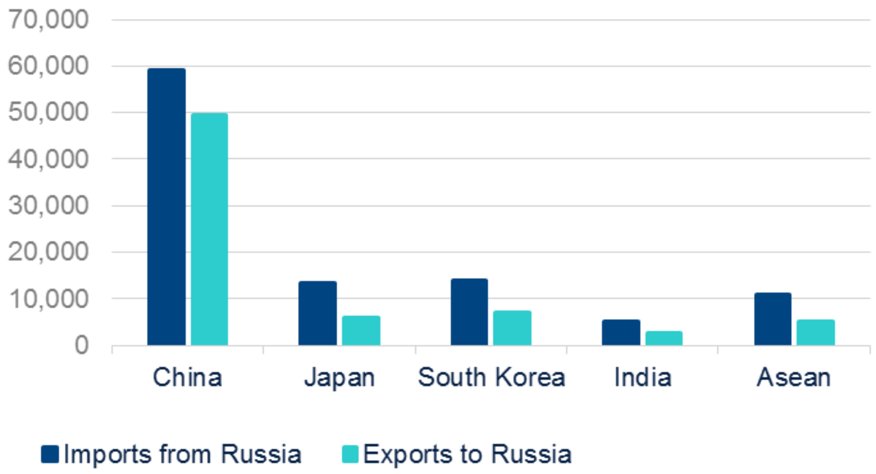
China's economic relations with Russia

1. Trade: will absorb Russia's energy exports of wheat, oil, natural gas etc. The two nations signed 15 agreements on various fronts before Beijing Olympic Games, among which, the new natural gas agreement lasts 30 years with USD 117.5 bn total value.
2. Settlement system: China and Russia will settle the trade by China's CIPS system (independent of USD, more than 167 nations and 3000 banks) to replace SWIFT, with total settlement amount around 5% of the world. Russia has its own SPFS system as well.
3. Payment system: China's Union pay.
4. Digital central bank currency e-CNY for cross-border settlements;
5. Bilateral swap line with the PBoC (scale: 22 USD Bn). Russia's central bank could borrow RMB loans through the existing swap line with PBoC as supplement to their foreign reserves.
6. Help domestic enterprises to establish special vehicles so that the normal economic activities between China and Russia (trade and investment) can proceed.

The impact of Russia-Ukraine war on China: qualitative and quantitative analysis (3): China's exposure to Russia is limited

AMONG THE MAIN ASIAN ECONOMIES, CHINA IS THE NO.1 TRADE PARTNER FOR RUSSIA

(USD MN (AVERAGE OF 2018-2020))



Source: CEIC and BBVA Research.

HOWEVER, TRADE WITH RUSSIA COUNTS ONLY COUNTS 2% OF CHINA'S TOTAL TRADE, AND CHINA'S ENERGY DEPENDENCE ON RUSSIA IS ALSO LIMITED

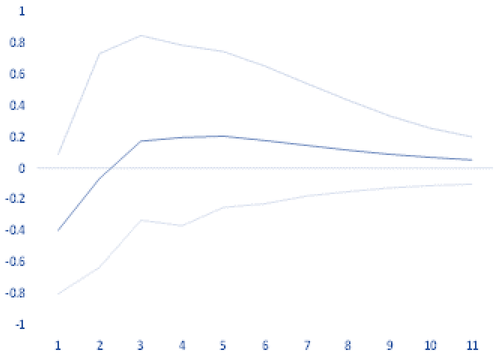
Russia trade as % of total trade	Export	Imports
China	2.00%	2.80%
Japan	1.00%	1.90%
South Korea	1.30%	2.60%
India	0.80%	1.40%
Asean countries	0.40%	0.80%

Russia trade as % of total trade	Crude Oil	LNG and Natural Gas
China	15%	3%
Japan	5%	9%
South Korea	6%	5%

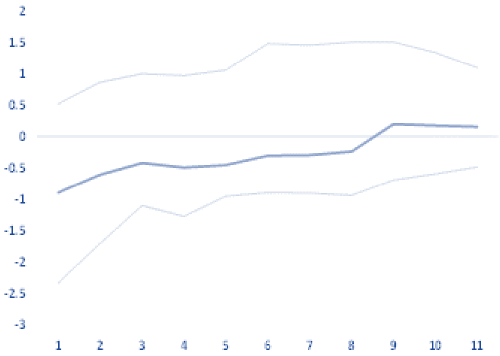
Versus. i.e. German 35% crude oil and 55% natural gas from Russia.

The impact of Russia-Ukraine war on China: qualitative and quantitative analysis (4): Bayesian-SVAR analysis

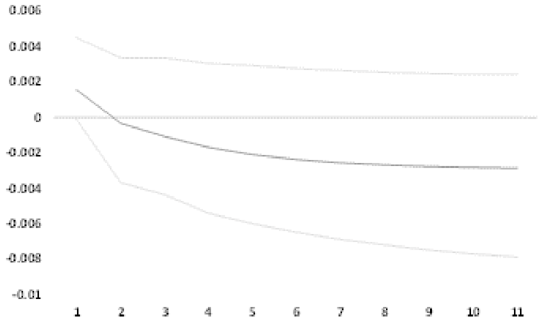
IMPULSE RESPONSE FUNCTION ON CHINA'S INDUSTRIAL PRODUCTION



IMPULSE RESPONSE ON CHINA'S CONSUMER CONFIDENCE INDEX



IMPULSE RESPONSE FUNCTION ON CHINA'S TOTAL TRADE VOLUME



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The impact of Russia-Ukraine war on China: qualitative and quantitative analysis (4): Bayesian-SVAR analysis

- The empirical results based on Bayesian-SVAR methodology and based on a series of literature (see reference) which tried to identify the impact of typical geopolitical conflicts on the global economy since 1985. Although history may or may not repeat, the empirical work will certainly provide a foundation to understand the impact of Ukraine-Russia war on Chinese economy.
- The results show that the geopolitical conflicts had limited impact on China's consumer sentiments (0.002%) and industrial production (-0.4%), but will have more significant impact on China's total trade volume (-1%) but the effect will last less than 9 months. Compared with the impact on the US, the average duration of the impact on China is less than 12 months, only half of the US's 24 months.

Research

05

Projections

Main messages

Growth

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. It is lower than the authorities' 5.5% target but in line with the market predictions.

Inflation

Our forecasts of 2022 CPI and PPI stand at 2.5% and 5.2% respectively. The convergence of them reflects CPI marginally pick up in 2022 due to the fading effect of African Swine Flu Cycle, and higher PPI due to the soaring global commodity and agricultural prices in the aftermath of Russia-Ukraine war.

Interest rate

We anticipate 1-2 LPR cuts in 2022, and 1-2 RRR cuts in 2021.

RMB Exchange rate

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

Forecast: China’s main economic indicators

	Baseline scenario				
	2019	2020	2021	2022	2023
GDP（%）	6.1	2.3	8.1	5.2	5.2
CPI（%）	2.9	2.6	0.9	2.5	2.5
PPI (%)	-0.3	-1.8	8.1	5.2 ↑	2.5
Interest rate (LPR, %）	4.1	3.85	3.8	3.6 ↓	3.6 ↓
RMB/USD exchange rate	7	6.5	6.36	6.6	6.5

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China Economic Outlook

2Q22

Creating Opportunities