BBVA Research

China Economic Outlook

3Q22

Creating Opportunities

BBVA Research

01

Global economy: from reflation to stagflation

Main messages

Inflationary pressures

Inflation remains at unusually high levels. The pressures on prices have recently been reinforced by the impact of the war in Ukraine on commodity prices and the maintenance of supply bottlenecks, in a context of relative strength in demand (despite the recent slowdown). The risk of significant second-round effects and de-anchoring of expectations is moderate, given central bank reaction, but it is increasing.

Central bank reaction

Central banks have accelerated the process of raising interest rates. Their recent tone suggests that they will not hesitate to do what is necessary to control inflation in the medium and long term. The Fed will soon raise rates to restrictive levels, while in the Eurozone, in a context of less robust demand and risk of financial fragmentation, rates will converge to neutral rates.

Economic prospects

The global economy will slow down significantly, with negative growth for more than a quarter in the US and the Eurozone, that will contribute to slow down inflation, which, however, will remain well above central bank targets in the short term. In the Eurozone, GDP contractions are expected in the coming quarters, fundamentally due to the disruptions created by the war, including energy shortages. The sharp monetary tightening makes a (mild) recession in the US likely. The environment is very uncertain due to the co-occurrence of multiple shocks.

Risks

A more persistent inflation could trigger even more severe increases in interest rates, and thus a deeper and more widespread recession. Other risks are a financial fragmentation within the Eurozone, crises in the debt and emerging markets, the persistence of the pandemic (mainly in China), stagflation, social protests, etc.

In a complex and uncertain environment, central banks have been forced to accelerate rate hikes in order to tackle inflation

RECENT DEVELOPMENTS IN THE WORLD ECONOMY

COMMODITIES
Energy and food prices under heavy pressure due to war in Ukraine

SUPPLY DISRUPTIONS
Persistent bottlenecks due to war and covid mobility restrictions in China

DEMAND RESILIENCE
Robust employment and accumulated savings; weakness caused by covid in China

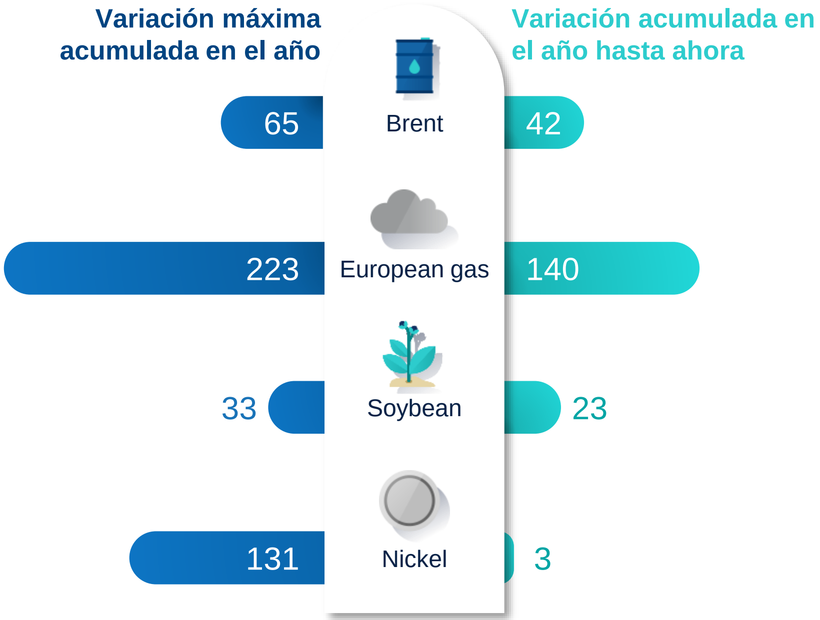
HIGH, PERSISTENT AND GENERALIZED INFLATION
Prices also pressured by incipient second-round effects and structural factors (such as de-globalization), with a risk of de-anchoring expectations.

MORE AGGRESSIVE CENTRAL BANKS AND FINANCIAL VOLATILITY
Stronger and earlier monetary tightening, particularly in the U.S., to reduce demand, which has kept financial volatility high.

Commodity prices have risen more than expected after the war, despite recent global slowdown concerns

COMMODITY PRICES

(ACCUMULATED PERCENTAGE VARIATION IN THE YEAR UP TO JULY 11, 2022)

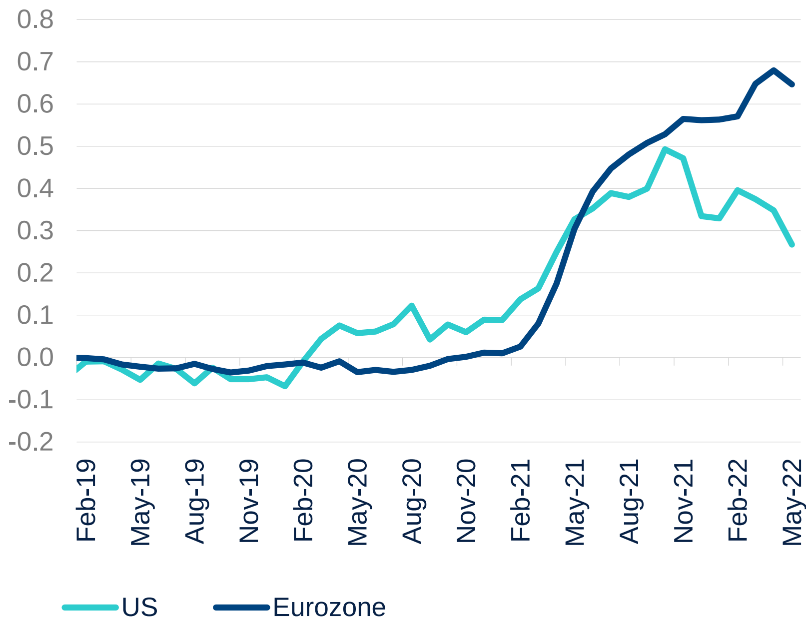


Source: BBVA Research based on data from Haver.

- War and sanctions have pressured commodity prices:
  - oil: affected by sanctions against Russia
  - gas: pressured by fears of supply restrictions b Russia
  - food: impacted by fertilizer prices and disruptions in Ukraine
  - metals: less direct exposure to the war, but pressured by energy transition
- The risk of a sharp global slowdown has recently triggered falls in commodity prices (but not in the gas price in Europe).

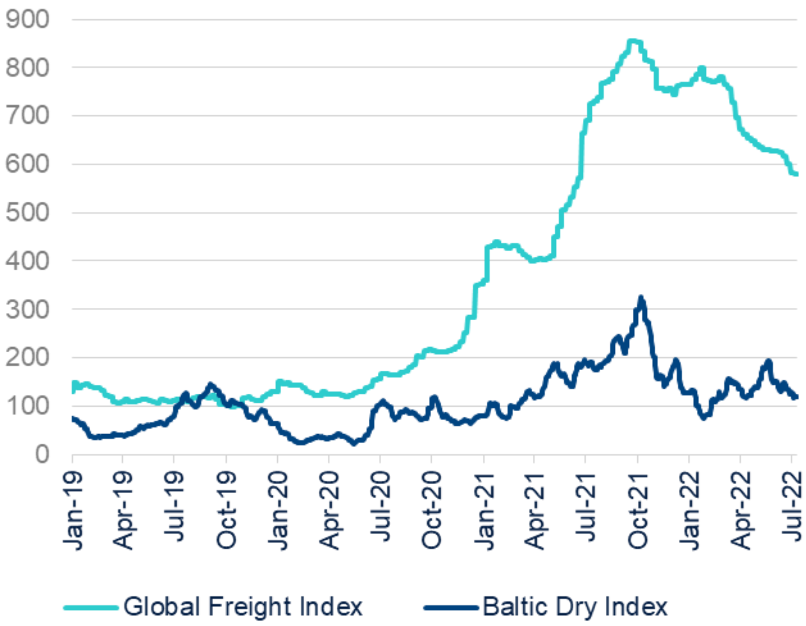
Bottlenecks remain at very high levels, but there are signs of improvement, mainly in the US

BBVA RESEARCH BOTTLENECK INDEX
(INDEX: AVERAGE SINCE 2003 = 0)



Source: BBVA Research.

CONTAINER FREIGHT RATES: GLOBAL AND BALTIC
(INDEX: 2012 = 100)

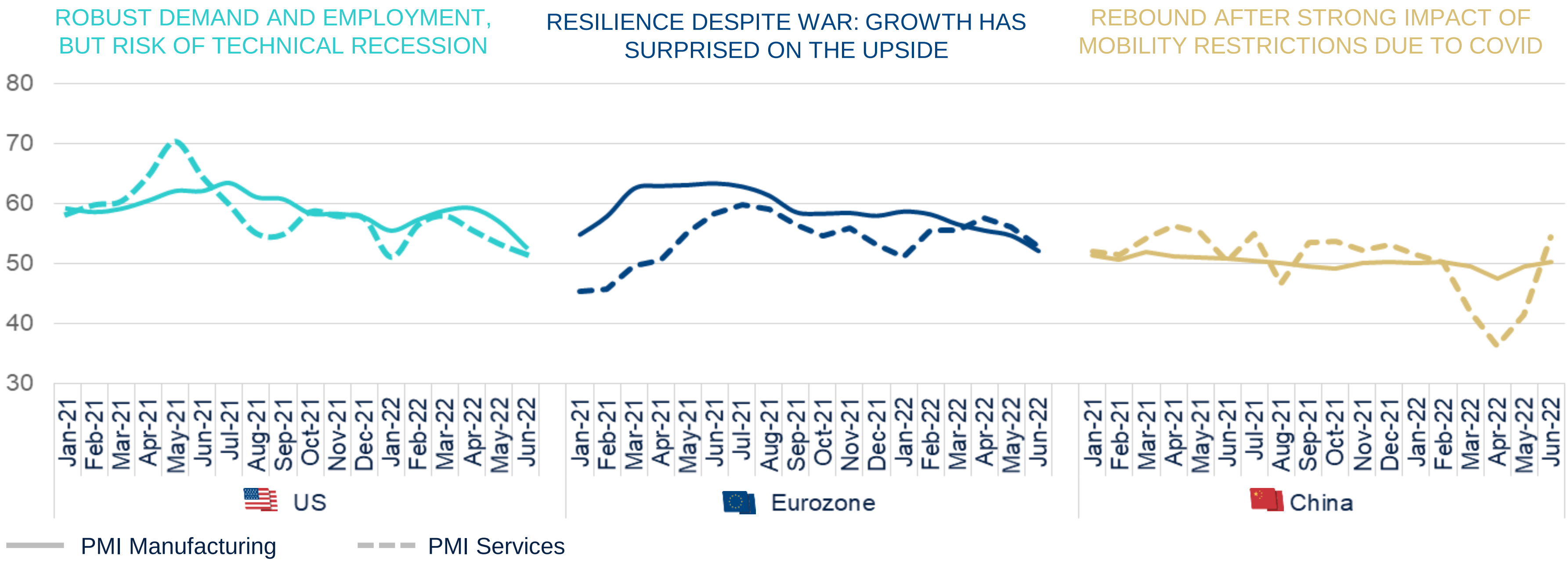


Source: BBVA Research based on data from Haver.

Growth is easing, but demand remains resilient given the high level of accumulated savings and the dynamism of both consumption and services

PMI INDICATORS

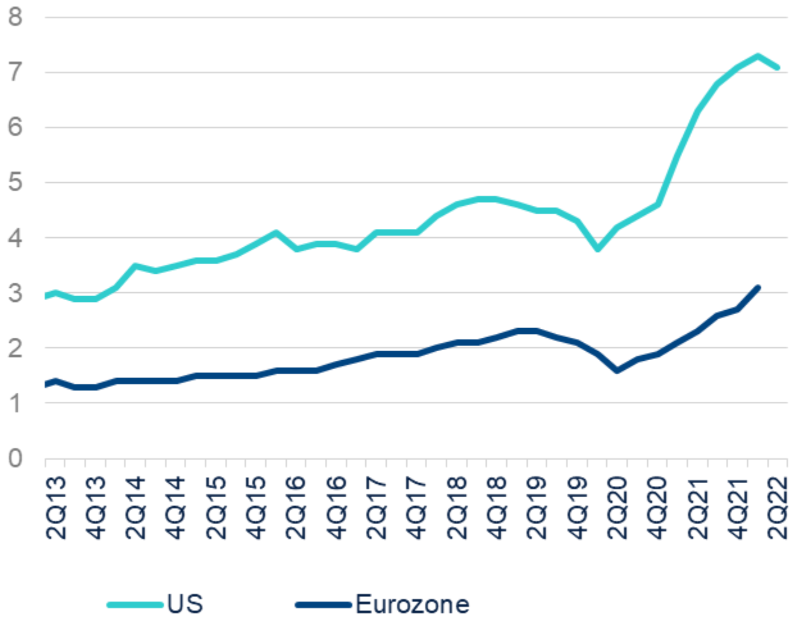
(MORE THAN 50: EXPANSION; LESS THAN 50: CONTRACTION)



Source: BBVA Research based on data from Haver.

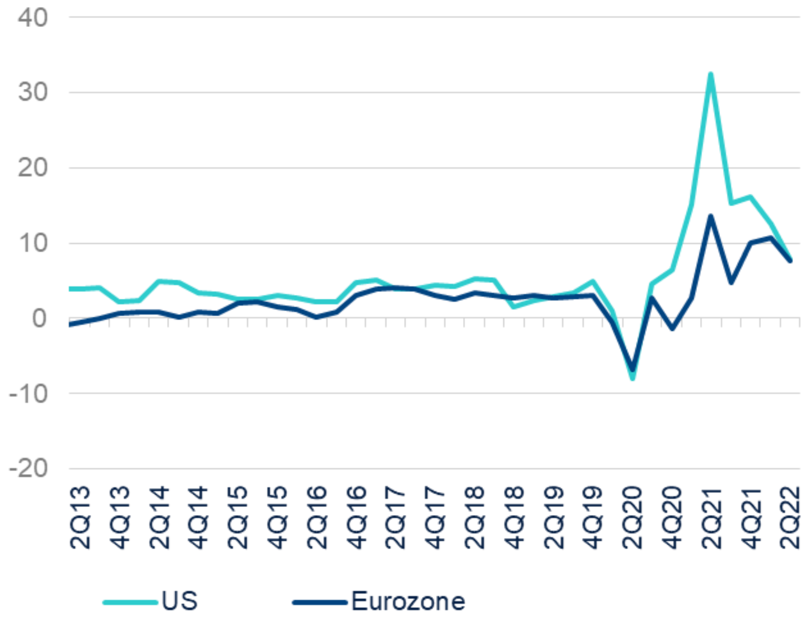
Dynamic labor markets support private consumption, but reinforce concerns about inflationary dynamics

LABOR MARKET: VACANCY RATE
(%, QUARTERLY AVERAGES)



* Vacancies as a proportion of the sum of total employment and the number of vacancies.
Source: BBVA Research based on data from Haver.

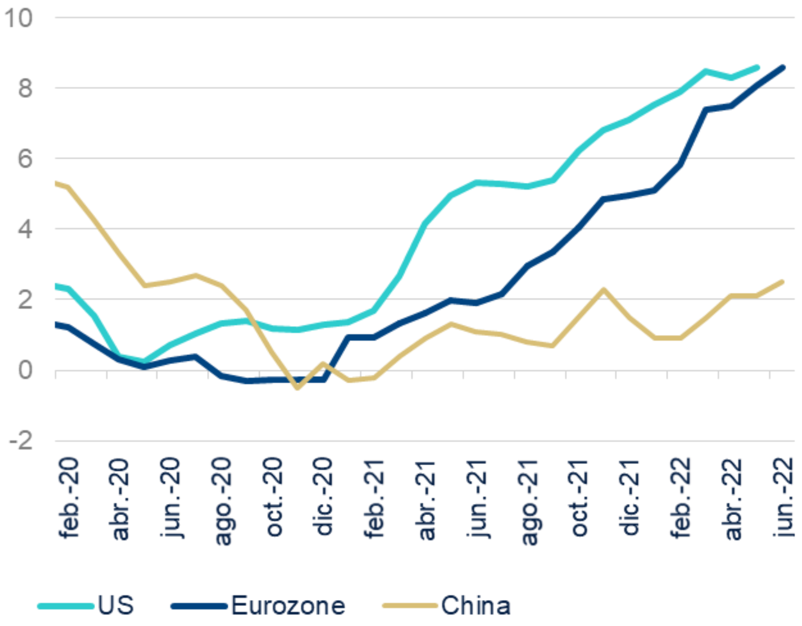
PRIVATE CONSUMPTION: RETAIL SALES
(% Y/Y, QUARTERLY AVERAGES)



Source: BBVA Research based on data from Haver.

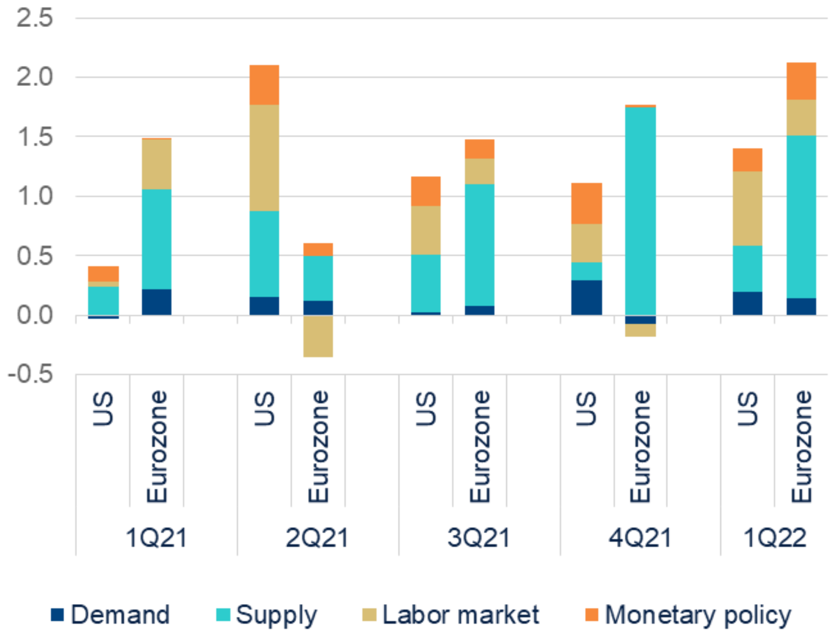
High, persistent and widespread inflationary pressures, largely due to supply-side and labor market-related factors

INFLATION: CPI
(Y/Y %)



Source: BBVA Research based on local statistics.

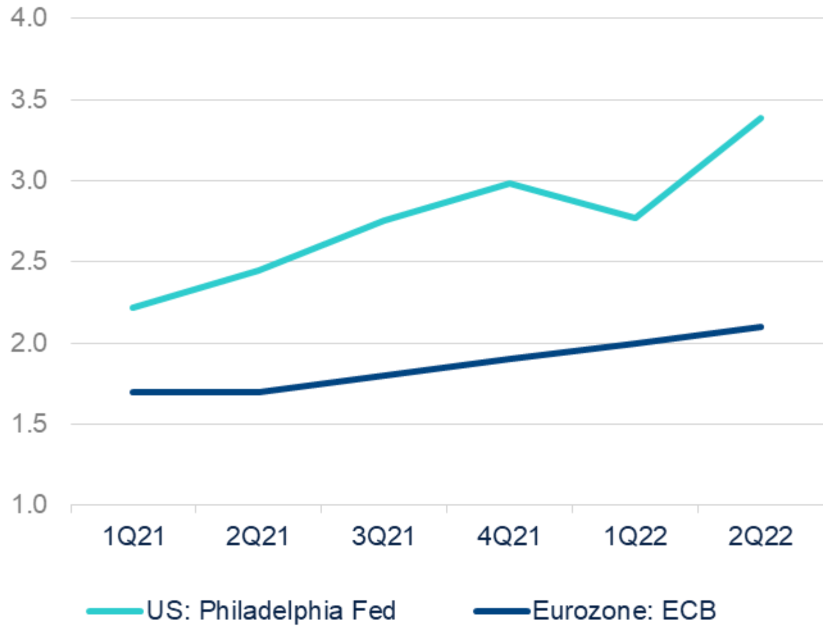
SHOCKS TO CORE INFLATION
(PP)



Source: BBVA Research estimates using a SVAR model.

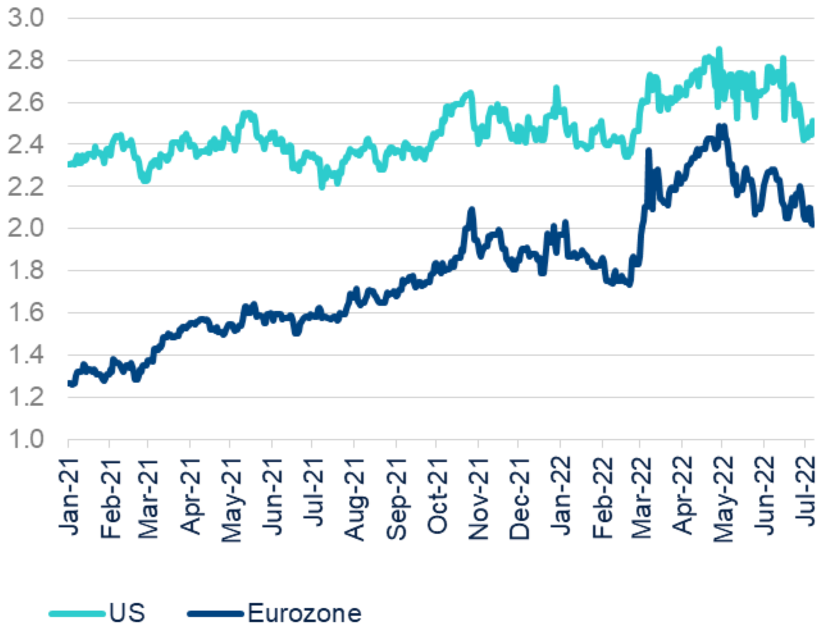
Inflation expectations have risen significantly

5-YEAR INFLATION EXPECTATIONS: ANALYSTS SURVEYS (%)



Source: BBVA Research based on data from the Fed and the ECB.

LONG-TERM INFLATION EXPECTATIONS: MARKETS* (%)



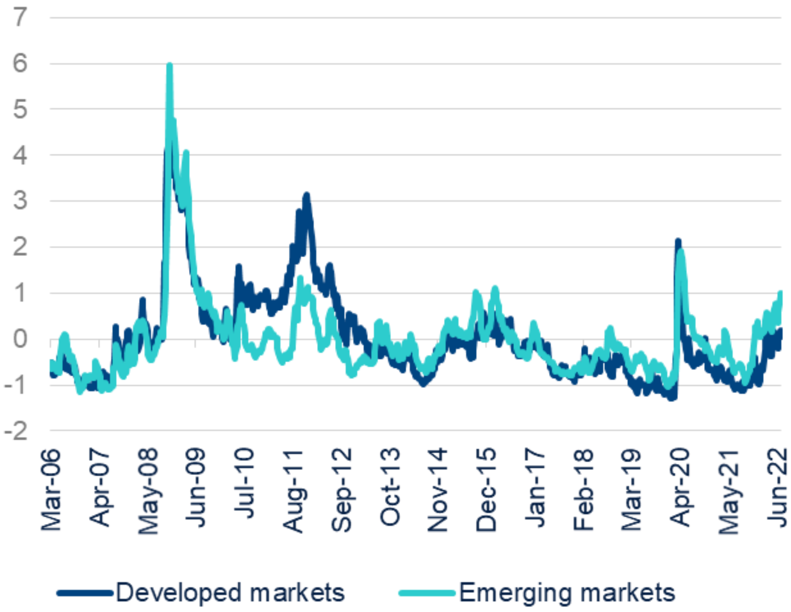
* Based on 5Y5Y forward swaps

Source: BBVA Research based on Haver data.

Central banks hawkish tone in response to rising inflation, in a context of activity slowdown, has increased financial volatility

BBVA RESEARCH FINANCIALTENSIONS INDEX

(INDEX: AVERAGE SINCE 2005 = 0)



Source: BBVA Research.

- The Fed has raised rates to 1.75% (+150bp since March) and has indicated further significant adjustments in the coming months.
- The ECB has indicated that its rate hike cycle will begin this month and that it will address the risk of fragmentation with flexible PEPP reinvestment and a new instrument.
- Sovereign bond yields have risen sharply since March, although they have recently moderated due to cyclical risk.
- Stock markets have fallen, risk premia have moved higher and the dollar has appreciated.

The interest rate hikes needed to anchor inflation expectations will have a negative impact on activity and cause recessionary episodes

BBVA RESEARCH CENTRAL SCENARIO

MONETARY TIGHTENING
Impact through demand (consumption/investment), financial burdens/wealth, credit...

COMMODITIES
Price pressure will be compounded by gas shortages in the Eurozone (at least in the coming winter).

SUPPLY DISRUPTIONS
In the absence of new negative shocks, supply bottlenecks reduce gradually

GROWTH SLOWDOWN
Mild recessions in the Eurozone, due to gas shortages, and in the U.S., due to interest rate hikes

INFLATION MODERATES SLOWLY
It remains well above inflation target in 2022-23

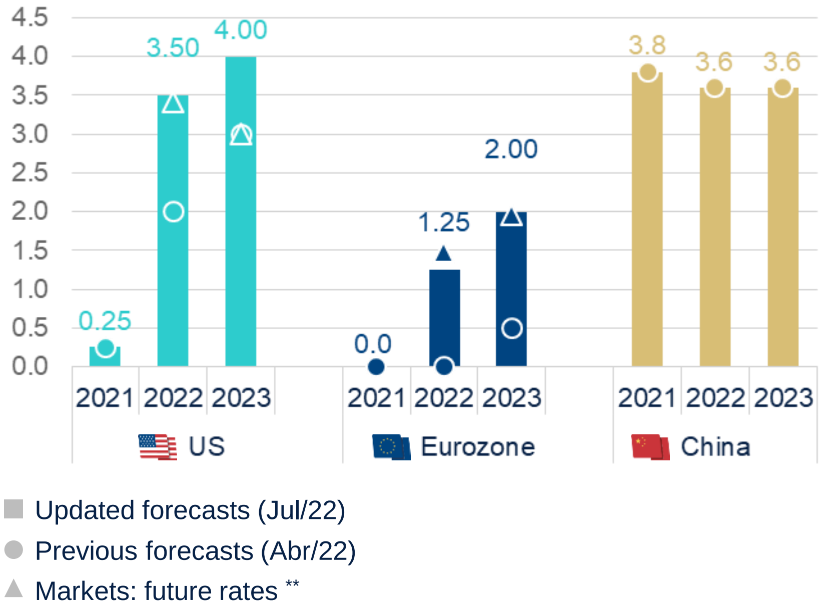
FINANCIAL VOLATILITY
Stronger dollar, higher risk premia, capital outflows from EM

RISKS: BIAS TOWARDS LOWER GROWTH WITH THE POSSIBILITY OF A CRISIS
A more persistent inflation could trigger more negative macroeconomic scenarios

Interest rates will rise more and sooner than expected; they are expected to reach restrictive levels in the US and be close to neutral in the Eurozone

MONETARY POLICY INTEREST RATES*

(%, END OF PERIOD)



- The Fed is expected to raise rates to 4.0%, above equilibrium levels (between 2% and 3%), while continuing to sell assets to reduce its balance sheet.
- The ECB is already starting its rate hike cycle, which will be less aggressive than the Fed's due to lower demand pressures and the risk of financial fragmentation.
- Unlike the US, fiscal policy in the Eurozone will focus on growth, through NGEU funds and the suspension of fiscal rules until 2023.
- In China, policies will continue to exhibit a moderately expansionary tone.

* In the case of the Eurozone, interest rates on refinancing operations.

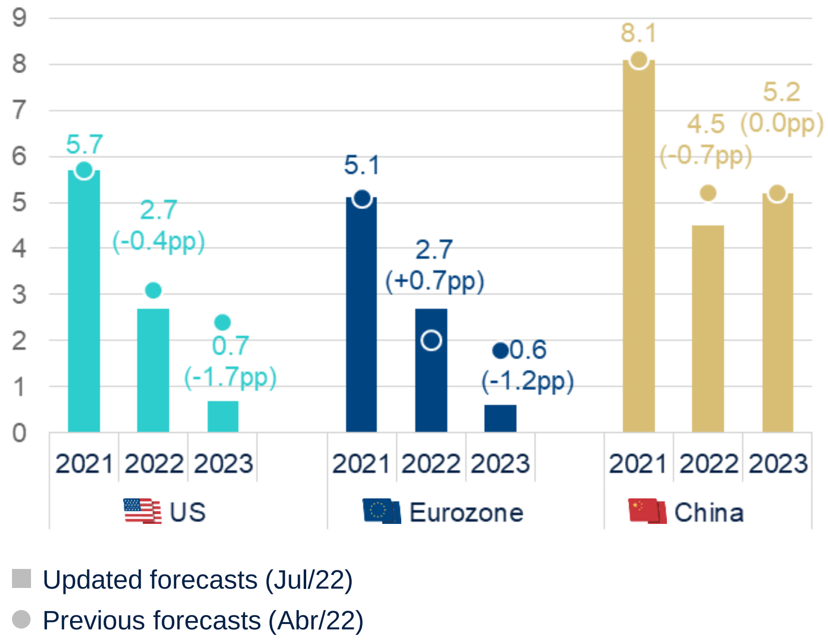
** Data as of July 11.

Source: BBVA Research based on Bloomberg data.

Global slowdown: after growing 6.2% in 2021, world GDP will grow 3.4% in 2022 and 2.5% in 2023 (respectively, 0.6pp and 1.1pp less than expected)

GDP: ANNUAL GROWTH IN REAL TERMS

(%)

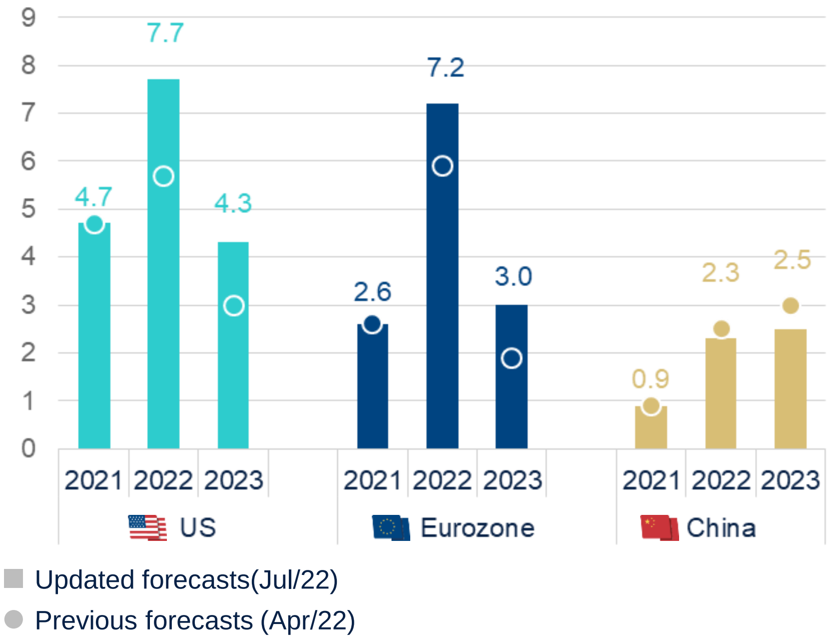


* Forecast change in parentheses.
Source: BBVA Research.

- Rising rates will likely push the US into a recession in 2023, which is expected to be mild given robust employment and sound household and financial system balance sheets.
- In the Eurozone, the impact of the war will be stronger in the coming quarters due to the expected gas restrictions, pushing GDP growth to slightly negative rates.
- In China, growth will recover from the impact of recent lockdowns, but the "zero-covid" policy remains as a potential problem.

Inflation to remain well above central bank targets, mainly in the short term

INFLATION:CPI
(Y/Y %, PERIOD AVERAGE)



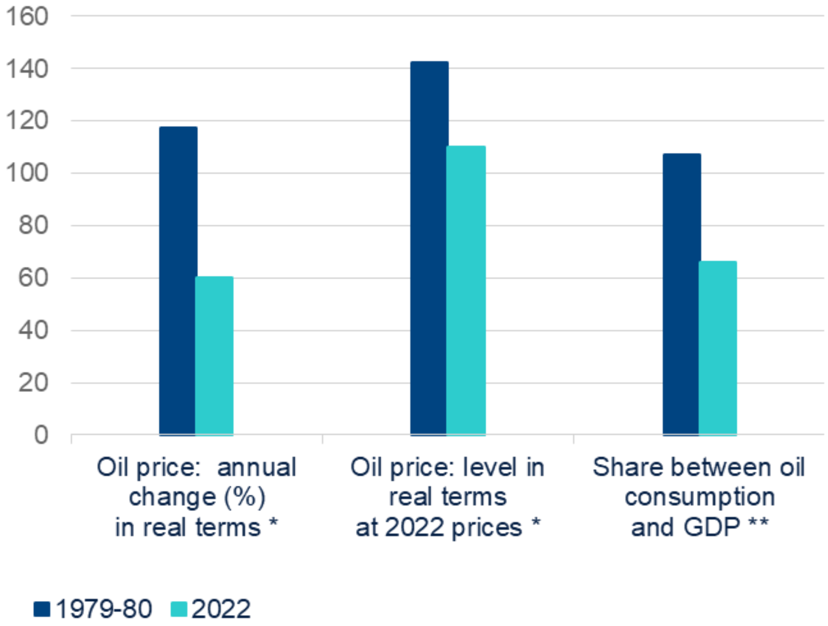
Source: BBVA Research.

- Upward revision of inflation forecasts, mainly due to higher commodity prices.
- Inflation will eventually decline as current shocks lose strength and central banks continue to act
- Slowing demand will reduce the scope for significant wage increases, making a wage-price spiral unlikely.

The likelihood of a prolonged period of higher inflation has increased, but a return to the inflationary spiral of the 1970s remains far away

OIL: PRICE AND INTENSITY OF USE

(PRICE VARIATION AND INTENSITY: %; PRICE LEVEL: USD/BARREL)



* Maximum observed in each period.

** For the world economy.

Source: BBVA Research based on data from the Fed and Haver.

A less vulnerable economic structure:

- less oil-intensive production
- more open economies and lower levels of unionization make a wage-price spiral less likely

A more credible monetary policy:

- independent
- with explicit inflation targets
- with exclusive prerogative to fight inflation
- with effective action and monitoring tools

Risks: further inflationary persistence could trigger more aggressive interest rate hikes and a sharp macroeconomic deterioration

MAIN SHORT-TERM RISKS TO THE WORLD ECONOMY

- Persistent inflation
- More severe recession
- Financial fragmentation in the EZ
- Tension in debt and emerging markets
- Stagflation
- Deterioration of the war in Ukraine or other geopolitical conflicts
- Hard-landing in China
- Covid
- Social tensions and populism

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02

"Impossible Trinity" of China's 2022 policy targets

Main messages

“Imposible Trinity” in 2022

Chinese authorities face an “Impossible Trinity” or “Trilemma” in 2022 policy setting among three policy targets: “Zero Covid”, financial stability and 5.5% growth target. Given that the authorities still stick to “Zero Covid”, there are only two possible policy mix: (i) if the authorities want “Zero Covid” and 5.5% growth target, they have to conduct aggressive easing monetary measures unsynchronized with the US FED, leading to capital flight and sharp RMB depreciation etc.; or (ii) if they want “Zero Covid” and financial stability, they have to accept a lower growth. The authorities are trying (i) or even want a modest combination of all the three targets, but the ultimate scenario might be (ii).

Economic recovery from Shanghai lockdown

The economic recovery path will be similar to that of Wuhan lockdown in 2020, that means, production and investment will lead the recovery while consumption will significantly lag behind. GDP figures have confirmed the slowdown from 4.8% y/y in Q1 to 0.4% y/y in Q2 and we lowered our 2022 prediction from 5.2% to 4.5% while highlighting the downside risk (IMF: 4.4%, Bloomberg consensus: 4.1%).

Reverting to “old” growth engine

The authorities have to revert to “old” growth engine-infrastructure, real estate and exports-to stimulate growth, amid “zero Covid” lockdown and other restrictive pandemic measures in 2022.

Main messages

Low inflation environment bears some change

China's low inflation environment bears some changes, together with the US FED aggressive tightening, shrinking the room for the easing monetary policy. As pork price shrinks its negative growth amid the faded effect of African Swine Flu cycle, CPI ticked up recently and is anticipated to increase further.

Factors determining economic recovery pace

The pace of economic recovery from lockdown depends on: (i) whether further large-scale lockdown will be imposed again in large cities; (ii) how large is the policy room, as the recent trending-up inflation and RMB sharp depreciation shrink the room for easing measures; (iii) how effective of the easing measures, i.e. the monetary transmission mechanism; and (iv) how to rebuild market confidence, i.e. real estate market.

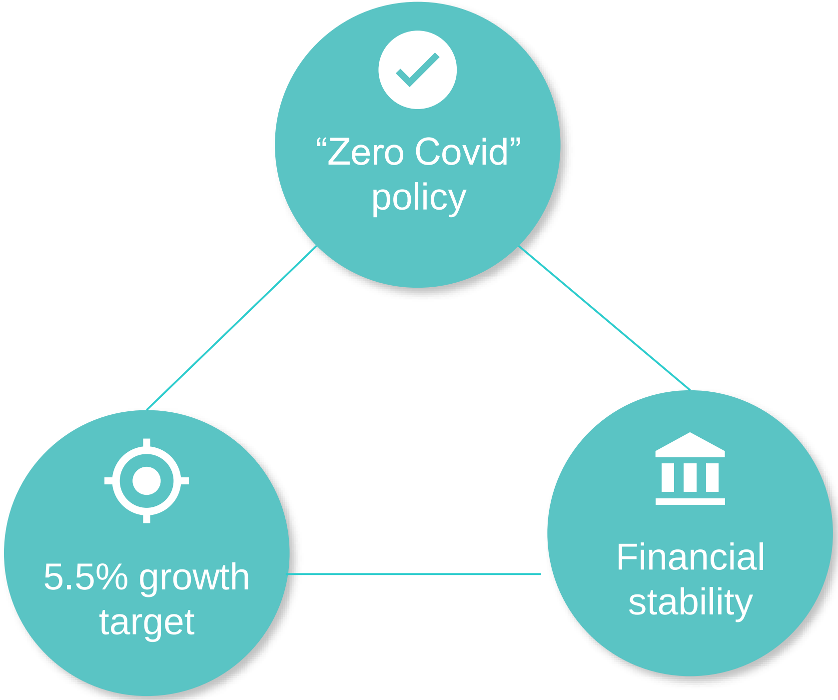
“Impossible Trinity” of China’s policy setting in 2022

Given that “zero Covid” will maintain, only two policy mix:

- if Chinese authorities want “Zero Covid” and 5.5% growth target, they have to conduct aggressive easing monetary measures, unsynchronized with the US FED, leading to capital flight and sharp RMB depreciation;

- if they want “Zero Covid” and financial stability, there will be some synchronized monetary policy with the US and less aggressive easing measures, then they have to accept a lower growth rate.

The authorities are trying to experiment (i), even a modest combination of the three targets, although the ultimate real-world scenario might be (ii).



Chinese economy: domestic uncertainties dominate external uncertainties

Positive factors

1. Given the comparatively low inflation environment and closed capital account, China has a policy room for the monetary easing;
2. China's central government balance sheet is robust, together with the residual fiscal budget of 2021 to be transferred to this year, providing room for fiscal expansionary measures to support infrastructure investment;
3. The authorities have reverted to "old growth engine" to stimulate growth amid "zero Covid" policy and lockdown measures, namely, real estate, infrastructure and exports: they have largely eased previous crackdown measures on housing market, trying to rebuild market sentiments.
4. Continuing strong exports in recent months support growth. The willingness of the US to reduce or cancel tariffs imposed by Trump will help sustain exports 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 reform.

Chinese economy: domestic uncertainties dominate external uncertainties

Risk factors

Domestic uncertainties:

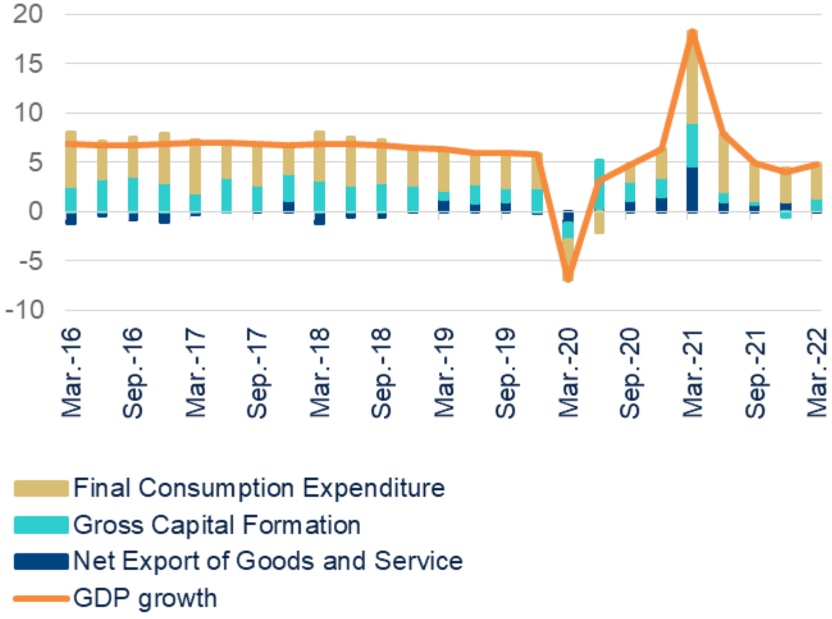
1. The prime growth headwind is China's "zero Covid" policy which have added large cost of fiscal balance of local government and dragged consumption recovery significantly.
2. It is difficult to alter people's expectations on housing price downturn, which led housing market activities dipped to historical low and spilled over to the related upstream and downstream sectors.
3. The monetary transmission mechanism is not smooth, as banks are reluctant to lend and enterprises and households are reluctant to borrow amid growth slowdown.

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.
2. Considering capital outflows and RMB exchange rate stability, FED's interest hike constrain the room for China's interest rate cut.

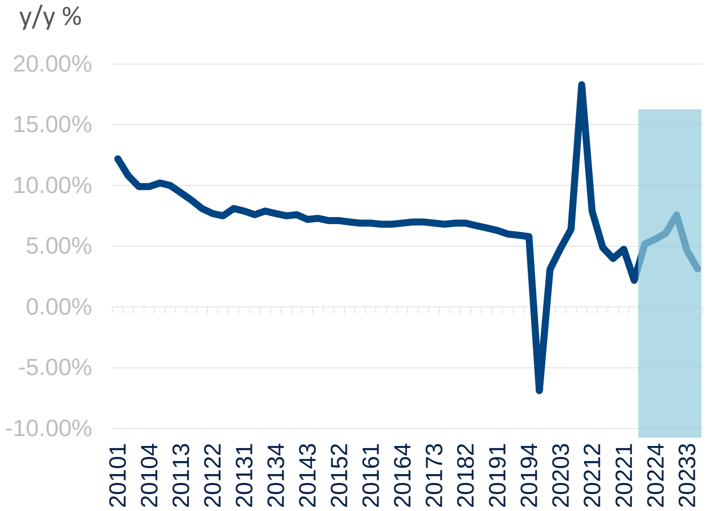
The growth recovery path from Shanghai lockdown is similar to that of Wuhan lockdown in 2020

THE GROWTH DIPPED FROM 4.8% IN Q1 2022 TO 0.4% IN Q2, AND IS ANTICIPATED TO RECOVERY FASTLY IN Q3 AND Q4



Source: CEIC & BBVA Research.

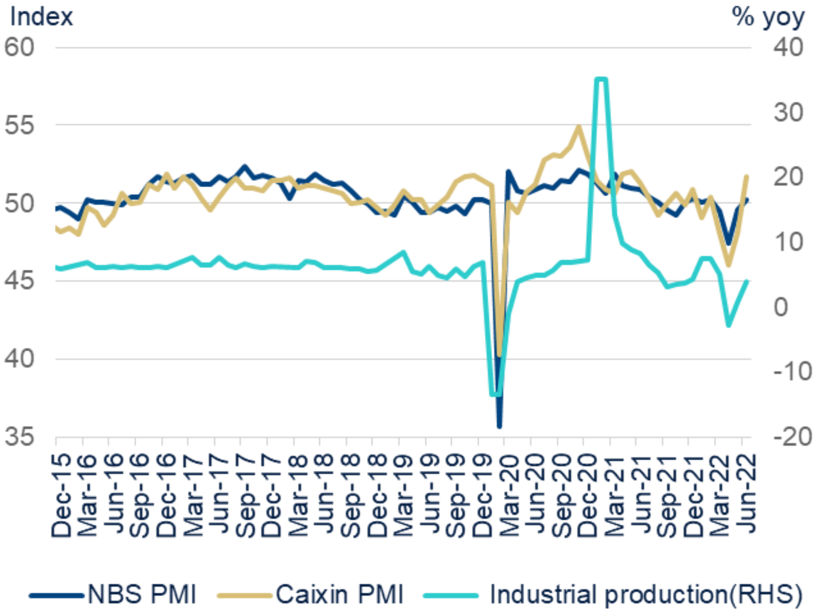
GROWTH IS ANTICIPATED TO BOUNCE BACK TO ABOVE 5% IN Q3 AND Q4, SIMILAR RECOVERY PATH AS OF THE AFTERMATH OF WUHAN LOCKDOWN IN 2020



Forecast	2022Q1	2022Q2	2022Q3(F)	2022Q4(F)
Y/Y%	4.8	0.4	5.5	6.9
Q/Q%	0.65	-2.8	6	3.2

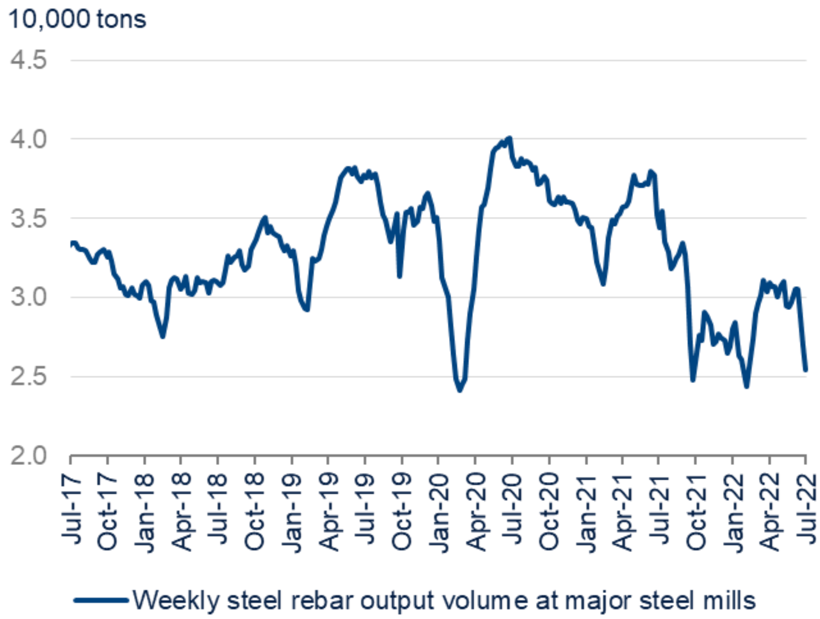
The structure of the recovery path: production rebounded first and production and investment surpass consumption recovery

PMIS AND INDUSTRIAL PRODUCTION REBOUNDED FROM A SIGNIFICANT SLUMP IN APRIL, AS LOCKDOWN LIFTED AND PRODUCTION RESUMED



HIGH FREQUENCY INDICATORS ALSO SHOW THE SUPPLY SIDE GRADUALLY RECOVERED

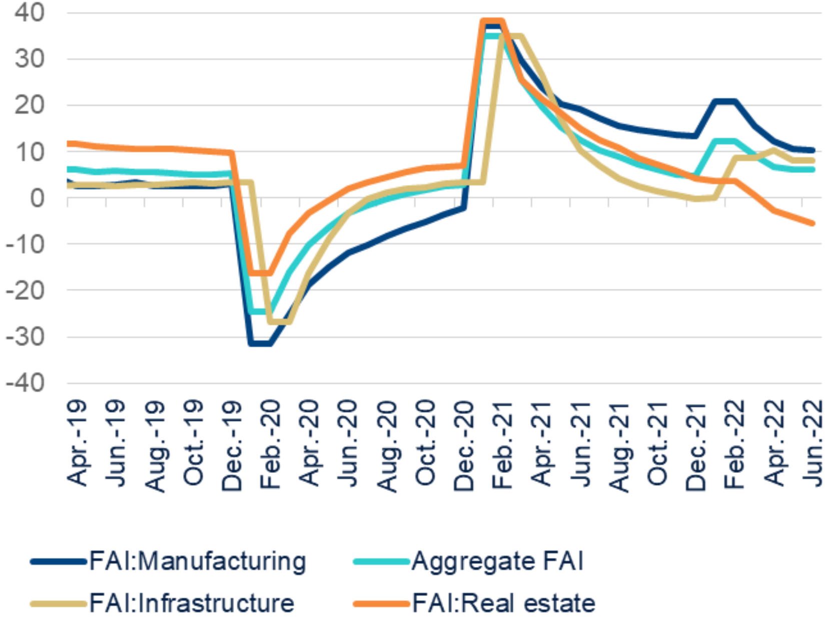
(SEE MORE HIGH FREQUENCY FIGURES IN APPENDIX)



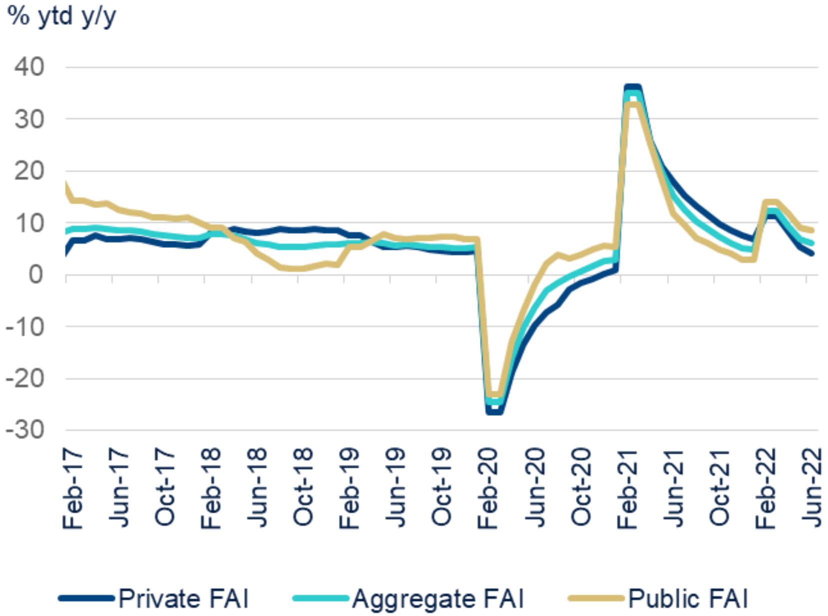
Source: CEIC & BBVA Research.

Infrastructure investment ticked up due to fiscal stimulus; manufacturing FAI fares well, but real estate investment remains lackluster

INFRASTRUCTURE FAI PICKED UP AMID EXPANSIONARY LOCAL GOVERNMENT BOND ISSUANCE, BUT REAL ESTATE FAI GROWTH REMAINED NEGATIVE



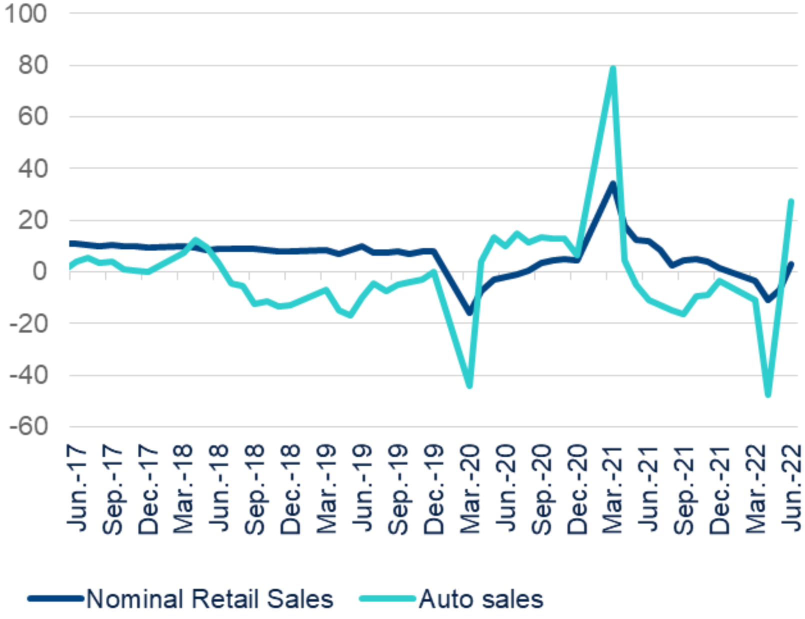
PUBLIC FAI LED THE INVESTMENT RECOVERY DUE TO THE FISCAL STIMULUS



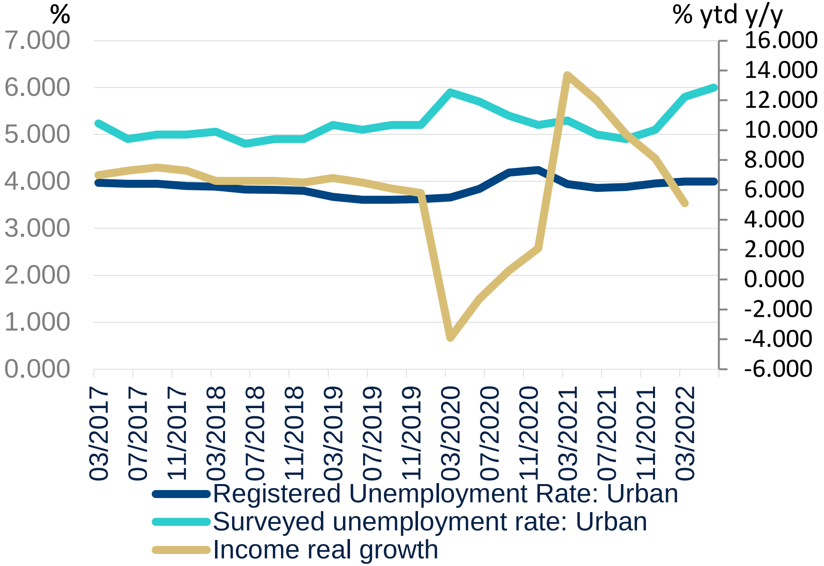
Source: CEIC & BBVA Research.

Retail sales bounced back strongly in June, but "Zero Covid" restrictions, increasing unemployment and worsening income expectations weigh on it

RETAIL SALES BOUNCED BACK SIGNIFICANTLY IN JUNE, EVEN HIGHER THAN THE PRE-LOCKDOWN GROWTH



BUT THE INCREASING UNEMPLOYMENT RATE AND LOWER INCOME EXPECTATION AMID "ZERO COVID" STILL WEIGH ON CONSUMPTION OUTLOOK



Source: CEIC & BBVA Research.

Reverting to "Old growth model" (i): infrastructure investment. Could it sufficiently offset consumption and real estate slowdown?

MODERN INFRASTRUCTURE SYSTEM

Under 14th 5-Year Plan

NETWORK INFRASTRUCTURE

TRANSPORTATION
- The backbone of transportation network
- Ports

ENERGY
- Intelligent electricity network
- Low-carbon green energy
- Oil and natural gas pipelines

WATER CONSERVANCY
- Water conservancy network

INDUSTRY INFRASTRUCTURE

INFORMATION
- Cloud computing;
- AI platforms;
- 5G infrastructure

TECHNOLOGY
- Blockchain
- Digital economy

LOGISTICS
- Branch line airports
- Cargo airports
- Civil airports

URBAN INFRASTRUCTURE

CROSS-CITY RAILWAY NETWORK

RAIL TRANSITS

FLOOD AND NATURAL DISASTER PROTECTION; AND REFUSE DISPOSAL

PUBLIC HEALTH EMERGENCY

AI BASED INFRASTRUCTURE

RURAL INFRASTRUCTURE

IRRIGATION WORKS

FARMLAND

TRANSPORTATION NETWORK IN RURAL AREA

SUPPLY CHAIN BETWEEN URBAN AND RURUAL AREA

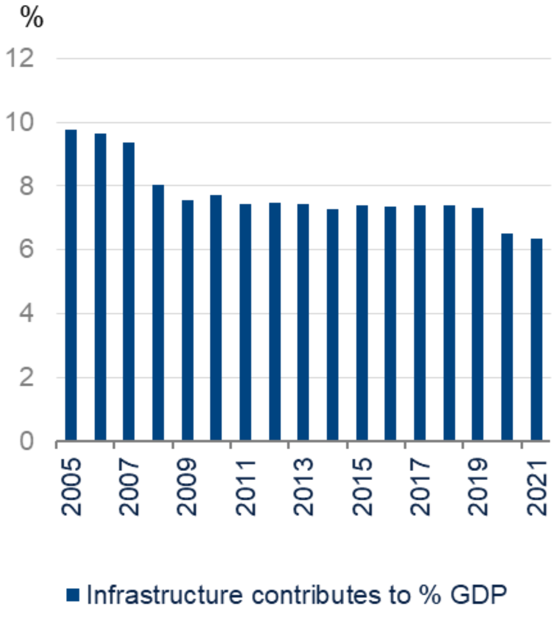
REFUSE DISPOSAL

NATIONAL SECURITY

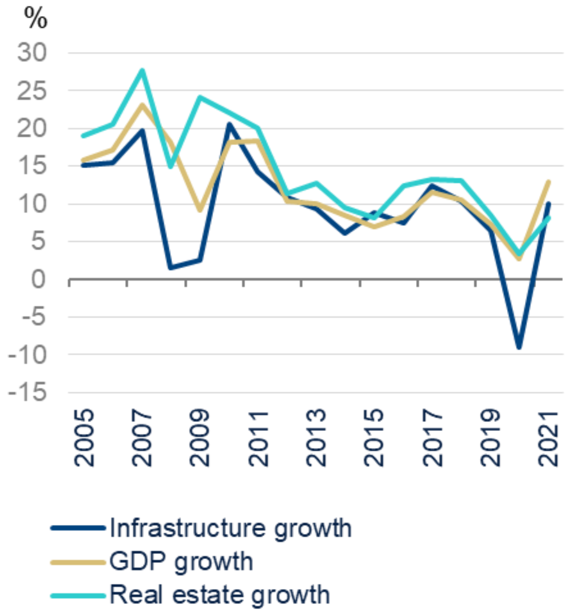
Unlike the other two "old growth engine" i.e. housing and exports, infrastructure is controlled and led by the authorities through local government bond issuance, thus, the most efficient way to stimulate growth during the business cycles in the past decades.

Infrastructure investment has always been an important counter-cyclical measure for China in the past decades

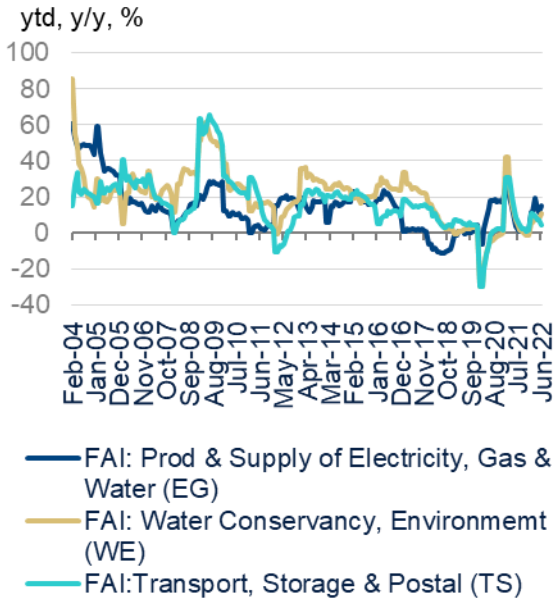
INFRASTRUCTURE CONTRIBUTES TO AROUND 6.5% OF GDP IF ONLY DIRECT EFFECT IS CONSIDERED



CHINA'S BUSINESS CYCLE IS EQUIVALENT TO REAL ESTATE & INFRASRTCUTURE CYCLE



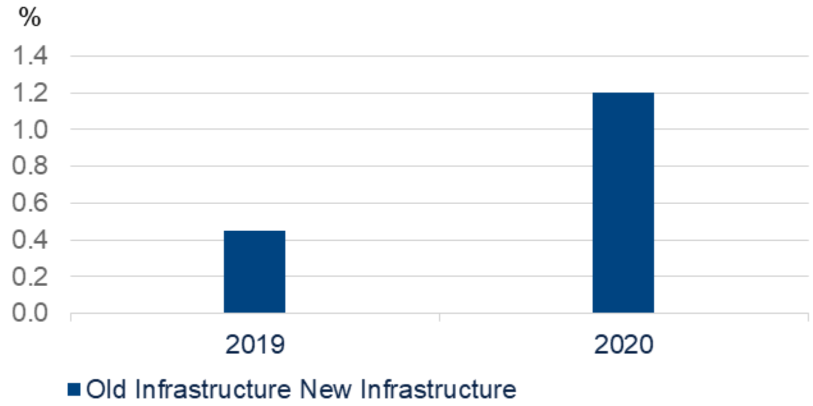
RMB 4 TRILLION STIMULUS ON INFRASTRUCTURE SUCCESSFULLY SECURED A SOFT-LANDING IN 2008-09



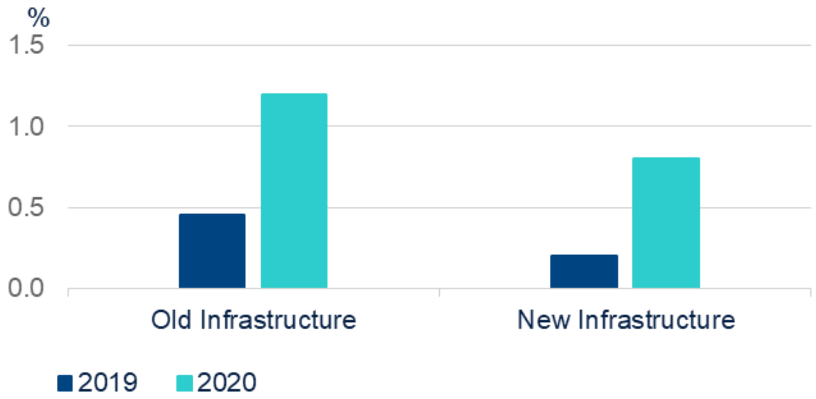
Source: CEIC & BBVA Research.

Synergizing the New and Old Infrastructure investment

THE ESTIMATED MULTIPLIER OF NEW INFRASTRUCTURE INVESTMENT IS TWO TIMES LARGER THAN THAT OF OLD INFRASTRUCTURE



AT THE CURRENT STAGE, OLD INFRASTRUCTURE DRIVES GDP GROWTH TO A LARGER EXTENT THAN THAT OF NEW INFRASTRUCTURE

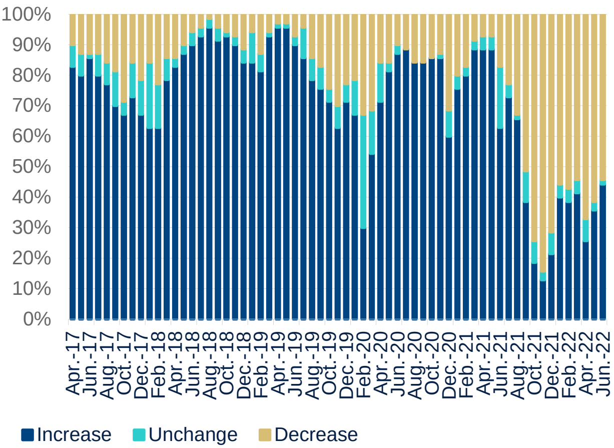


- Old infrastructure includes traditional investment in airplane, high-speed road, train trail and public facilities such as water conservancy projects, etc.
- New infrastructure includes but not confined with “ABCDG”, namely Artificial Intelligence (AI), Blockchain, Cloud computing, Big data center and 5G infrastructure etc. In a more generalized sense, new infrastructure investment also indicates the digital and intelligent transformation of the traditional infrastructure.

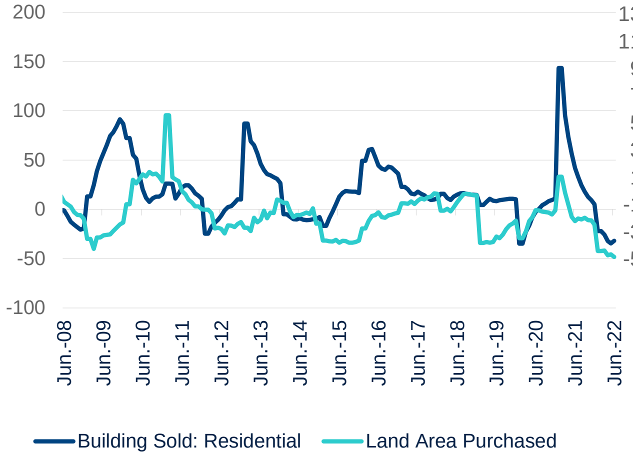
Source: CEIC & BBVA Research.

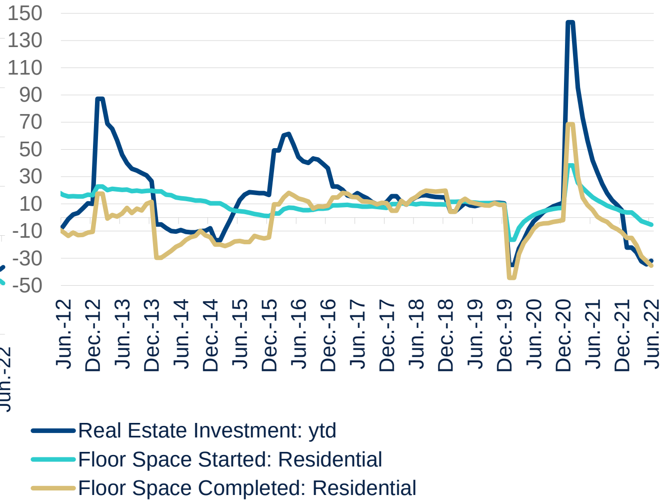
Reverting to "Old growth model" (ii): Real estate: A significant policy turnaround from 2021 crackdown to regulatory forbearance

MORE CITIES REPORTED HOUSING PRICE DECLINE COMPARED WITH 2021



A SERIES OF REAL ESTATE INDICATORS ALSO SHOW A SIGNIFICANTLY DECELERATION OF CHINA'S HOUSING MARKET (%, Y/Y)





Source: CEIC & BBVA Research.

Chinese authorities cracked down the housing market in 2021, taking use of the precious time-window to press ahead "common prosperity". As long as the housing price increase expectation is broken, it is difficult to re-build market sentiments, no matter how much easing measures promulgated amid "policy seesaw" to stimulate housing activities.

Understanding the recent home buyers' refusal to pay mortgage loans due to developers' delayed delivery of the pre-sale properties

Will it lead to systemic financial and economic risk?

1. This phenomenon mirrors the chain effect of private property developers' financial stress caused by the previous policy clampdown in 2021;

2. Many private property developers are faced with liquidity problems, making them unable to complete the projects under construction, which were already sold to home buyers based on China's property market's pre-sale mechanism;

3. Some research institutes estimated that the affected property projects might currently amount to RMB 600 billion, or 10% of pre-sales in 2021.

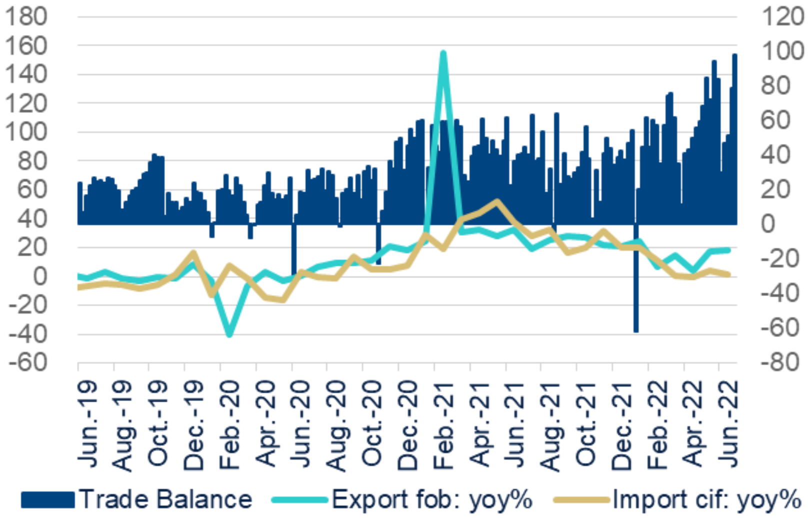
4. As the time going on, the real situation could be worse due to its contagious effects. The current potential home buyers could bluntly avoid all the private developers or just hold up their home buying decision. This will add further financial pressure on the high-quality private developers which are still pressing ahead their projects since their financial condition is also reliant on the funds obtained from presales.

5. Apparently it has constituted a systemic risk to China's economy and financial system. It concerns a lot of home buyers and could evolve into a large-scaled social unrest. China's authorities won't let it go given the political agenda of this year (in autumn the Communist Party will hold its 20th national congress on which President Xi is set to get his third term). We expect the authorities to intervene resolutely and quickly to limit the systemic and social risks.

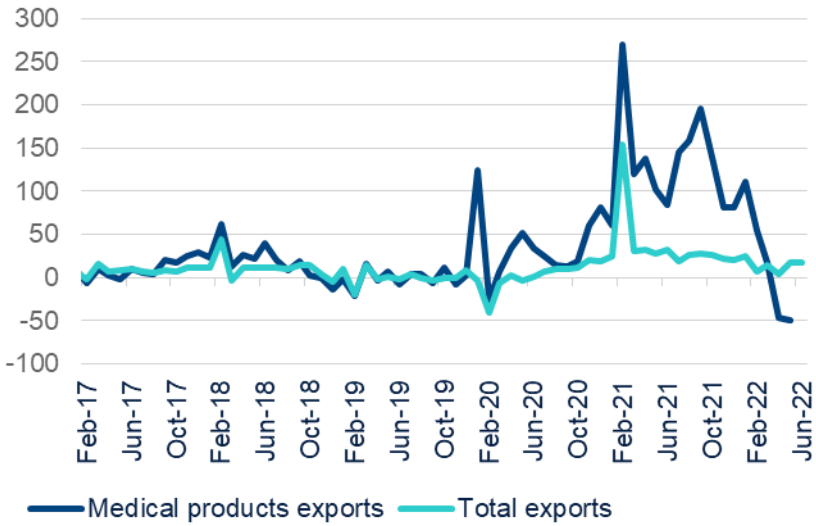
6. In a nutshell, the problem is reduced to a game of who is to pay the bill. The stakeholders include central and local governments, property developers, home buyers and banks. The bill will be shared among them based on their relative bargaining power. Banks will take a large share of losses. The authorities are likely to allow home buyers to stop paying mortgage loans until their acquired apartments are completed. At the same time, the authorities will urge property developers to complete all the pre-sale projects. In this respect, banks might need to provide additional financial support for the cash-strapped developers.

Reverting to "Old growth model" (iii): Exports: when will the export sector "normalization" eventually materializes?

EXPORT GROWTH DIPPED SHARPLY TO 3.9% Y/Y IN APRIL, ALTHOUGH BOUNCED BACK TO 17.9% IN JUNE



MEDICAL EXPORTS HAVE SIGNIFICANTLY SLOWED, THUS CHINA HAS TO REVERT TO PROCESSING TRADE

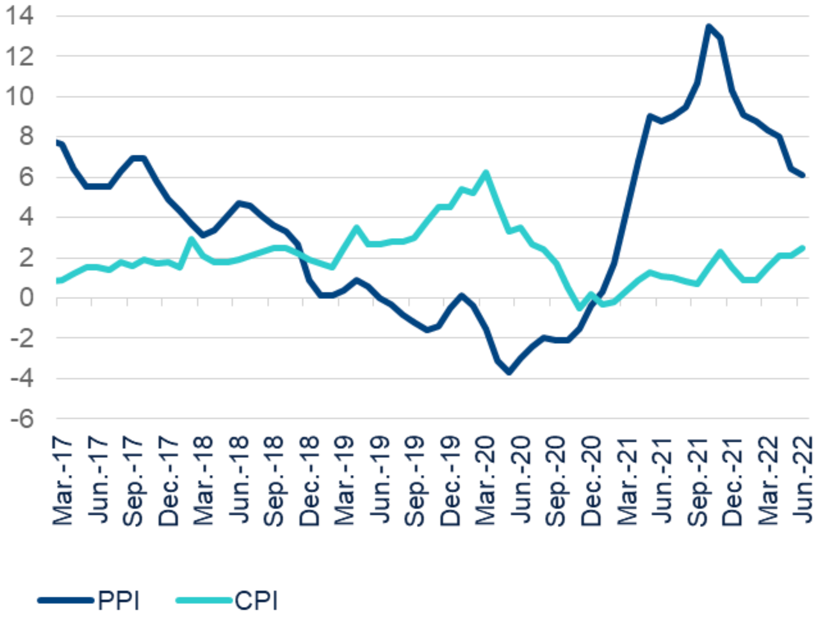


Source: CEIC & BBVA Research.

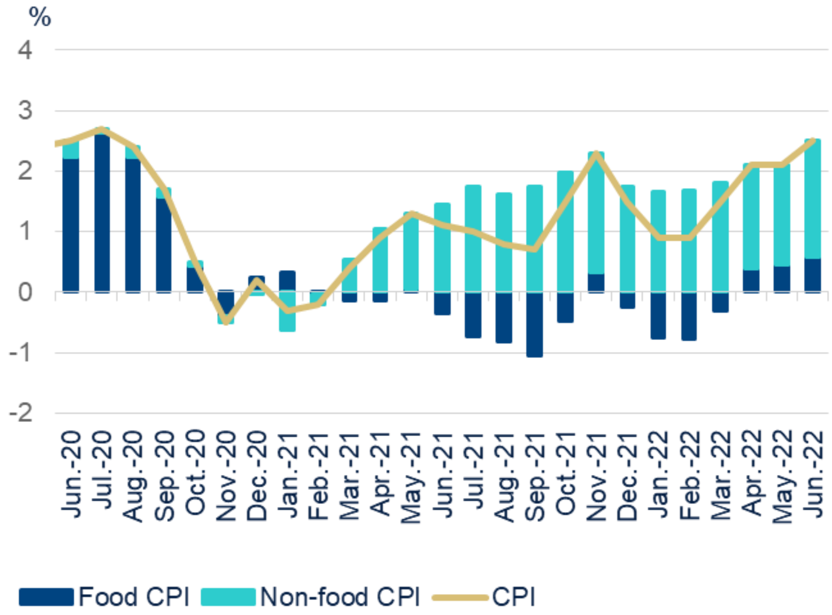
The recent competitive currency depreciation in Asia led by Japanese Yen depreciation also weighs on China's exports.

China's low inflation environment bears some changes, together with the US FED aggressive tightening, shrinking the room for easing monetary policy

CPI HAS INCREASED FROM PREVIOUSLY LESS THAN 1% TO 2.5% IN JUNE AND IS ANTICIPATED TO INCREASE FURTHER …



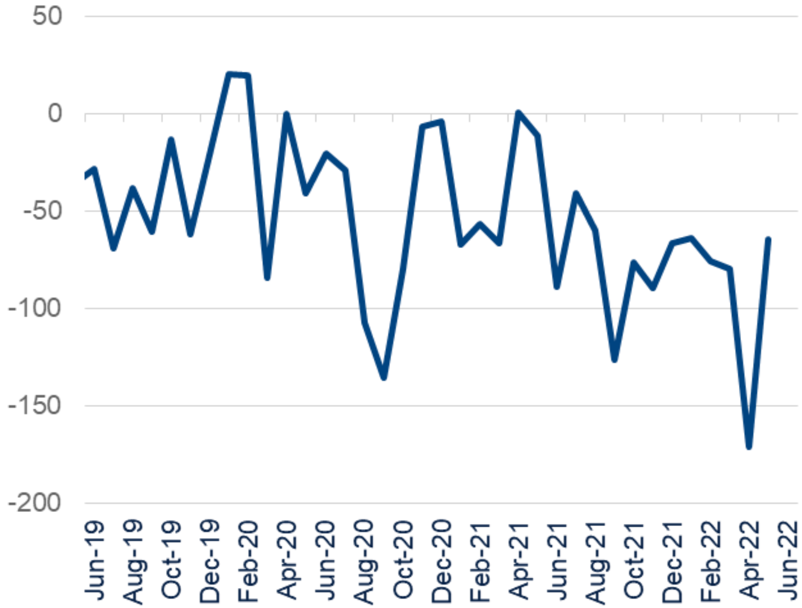
…AS PORK PRICE SHRINKS ITS NEGATIVE GROWTH AS THE EFFECT OF AFRICAN SWINE FLU CYCLE FADED



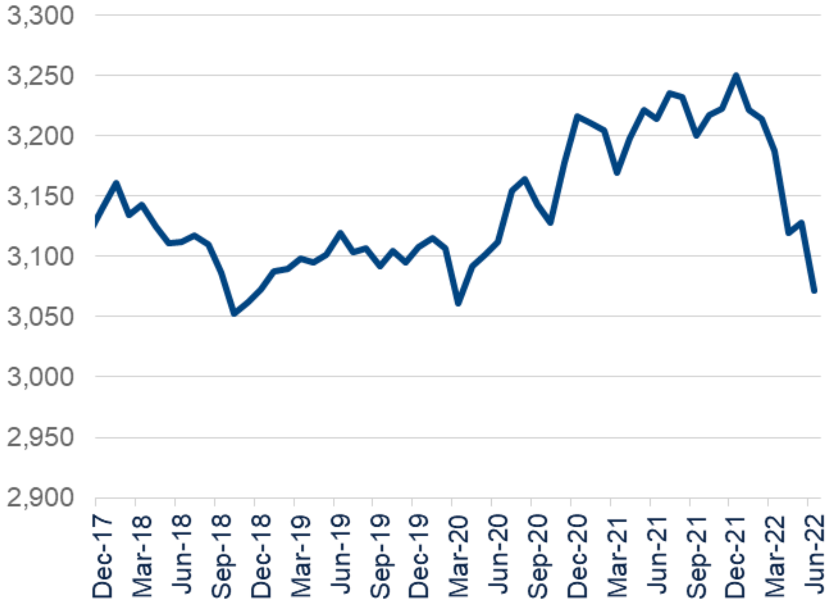
Source: CEIC & BBVA Research.

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 AMID US ARRESSIVE TIGHTENING "SEARCHING-FOR-YIELD"
(ESTIMATED PORTFOLIO OUTFLOW USD BN)



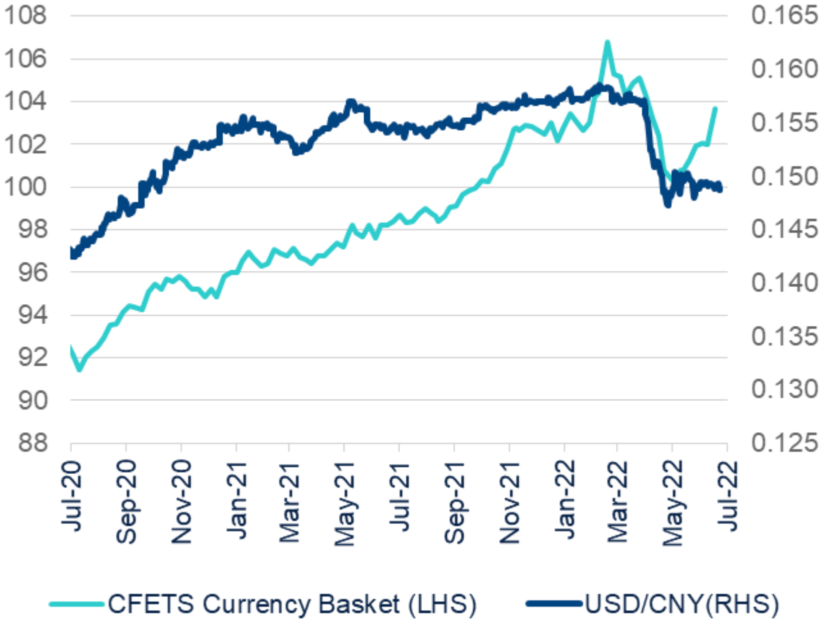
FOREIGN RESERVES TRENDED DOWN RECENTLY AMID PORTFORLIO OUTFLOWS (USD BN)



Source: CEIC & BBVA Research.

RMB to USD exchange rate is set to depreciate in 2022 due to the diverging and unsynchronized monetary policy between China and the US

RMB EXCHANGE RATE IS SET TO DEPRECIATE IN 2H 2022 AND TWO-WAY FLUCTUATION IS ANTICIPATED



Source: CEIC & BBVA Research.

- After a sharp RMB depreciation accumulatively by 6.75% in April and May, RMB exchange rate stabilized around 6.7 recently.
- A confluence of macroeconomic fundamentals could explain the fast RMB sharp depreciation in April-May, including the diverging monetary policy between China and the US, the Omicron flare-ups and Shanghai lockdown, the shrinking China's current account and accelerating capital outflows, etc.
- In addition, it is going hand-in-hand with the tumbling Japanese Yen and the competitive depreciation among Asian countries.
- We expect RMB to USD exchange rate will depreciate to 6.8 at end-2022.

03

China’s unsynchronized monetary and fiscal policy

Main messages

The recent stimulus package

The authorities had a significant policy turnaround from 2021 regulatory storms to expansionary measures in 2022 after Shanghai's lockdown. The highlights of the stimulus package for 2022 include: (i) Monetary policy: following recent three RRR cuts and two LPR cuts, 1-2 more RRR cuts anticipated together with targeted easing to support SMEs and pandemic-affected sectors. (ii) Fiscal policy: local government bond issuance speeded up in 1H to support infrastructure investment and will early release 2023 quotas; larger-scale tax cuts and fee reduction (RMB 2.5 trn); postpone social insurance payment for SMEs. (iii) Supportive measures in real estate by lowering the interest rate for home-buyers and housing developers.

China's seesaw policy

Chinese policy has always been swing like seesaw in the process of application: the long-term goals have always give way to short-term growth priority. In the long term, China will stick to the "new growth model" of "three pillars": common prosperity, self-sufficient technology and carbon neutrality. However, in 2022, China has to reverted to "old" growth engineS, i.e. infrastructure, real estate and exports to stimulate growth, and to tuned down the long-term goals this year.

How to finance the fiscal gap in 2022?

(i) To transfer payments of the profits gained by the PBoC and the SOEs at the central government level to Ministry of Finance; (ii) To issue special government bond to support infrastructure investment is also an option; (iii) The transfer from 2021's residual fiscal budget to 2022; (iv) to early release the local government bond issuance quota of 2023 in 2H 2022 and most recently to set up a state infrastructure investment fund worth 500 billion yuan ($74.69 billion) to spur infrastructure spending.

China's macro "policy seesaw" in different stage of pandemic time, unsynchronized with the main economies in the world

Expansionary monetary and fiscal policy in pandemic time

Pandemic period I

Regulatory storms, real estate crackdown, and policy normalization

Precious "Time window" of pandemic dissipation

Regulatory storms, real estate crackdown, and policy normalization

Pandemic period II

January 2020: outbreak of Covid-19 in Wuhan

May 2020: the Covid-19 pandemic contained in China

February 2022: Shanghai lockdown

Present

A summary of 2022 stimulus package (1)

1. FISCAL STIMULUS POLICY

- To expand tax reduction to RMB 2.64 trillion for 2022 (RMB 140 billion expansion), particularly for SMEs, pandemic-hit enterprises;
- To postpones social insurance payment for pandemic-hit SMEs with financial difficulties to year-end, with the total amount of postponed payment at RMB 320 bn.
- Speed-up local government bond issuance in 1H 2022, in a bid to stimulate infrastructure investment which used to be the growth engine for Chinese economy
- To expand State's Financing guarantee fund to RMB 1 trillion in a bid to support SME financing.
- To early release the local government bond issuance quota of 2023 in 2H 2022;
- Most recently to set up a state infrastructure investment fund worth 500 billion yuan ($74.69 billion) to spur infrastructure spending.

2. EXPANSIONARY MONETARY POLICY

- Banks should extent the housing and automobile mortgage payment for individuals and also capital and interest repayment for SME financing to year-end who face difficulties by the lockdown measures
- To shorten the acceptance period for commercial notes from 1 year to 6 months.
- To support platform economy enterprises to be listed in foreign stock exchange.
- Except for the recent three RRR cuts and two interest rate cuts, more cuts are also anticipated in the rest of the year.

A summary of 2022 stimulus package (2)

3. TO STABILIZE SUPPLY CHAIN AND PRODUCTION

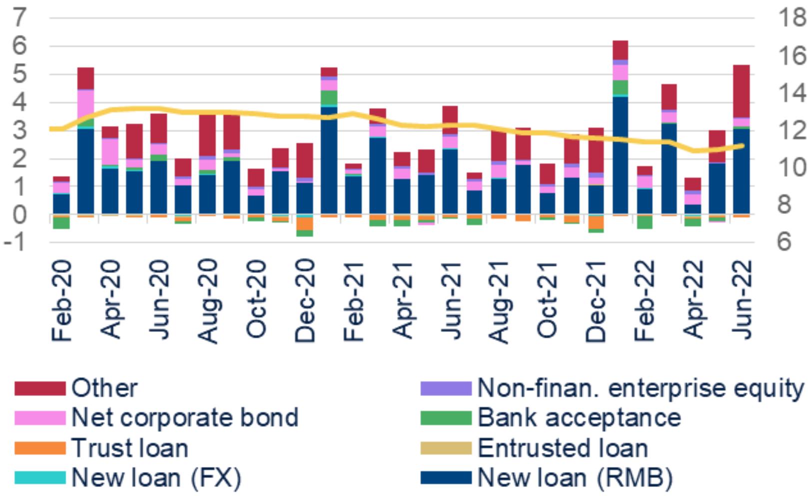
- To optimize “work resumption” policies and secure the production resumption for strategic enterprises.
- To cancel the transportation restrictions for the low-risk regions and to secure supply-chain unobstructed by unreasonable restrictions. To increase RMB 150 billion urgent lending to airplane sector, and to support them to issue RMB 200 billion bond.

4. SUPPORTIVE MEASURES FOR CONSUMPTION AND HOUSING MARKET REGULATORY FORBEARANCE

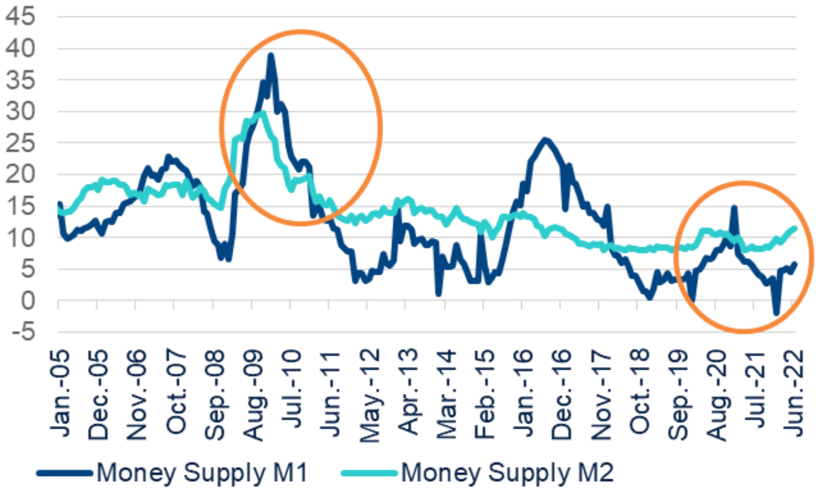
- Comsumer voucher program (multiplier=3.5-17);
- To release the previous restrictive measures for automobile purchase and to reduce the car purchase tax by RMB 60 billion aggregately.
- To reduce the mortgage interest rate for home-buyers to 20bps below LPR and a series of real estate supportive measures according to the different situations in different cities/regions.

Easing monetary and fiscal policy to stimulate growth, but stimulus "*at all costs*" is of low probability due to shrinking policy room and debt overhang concern

1-2 MORE RRR CUT IN 2022 ANTICIPATED, TOGETHER WITH TARGET CREDIT EXPANSION FOR SMES, PANDEMIC AFFECTED SECTORS



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

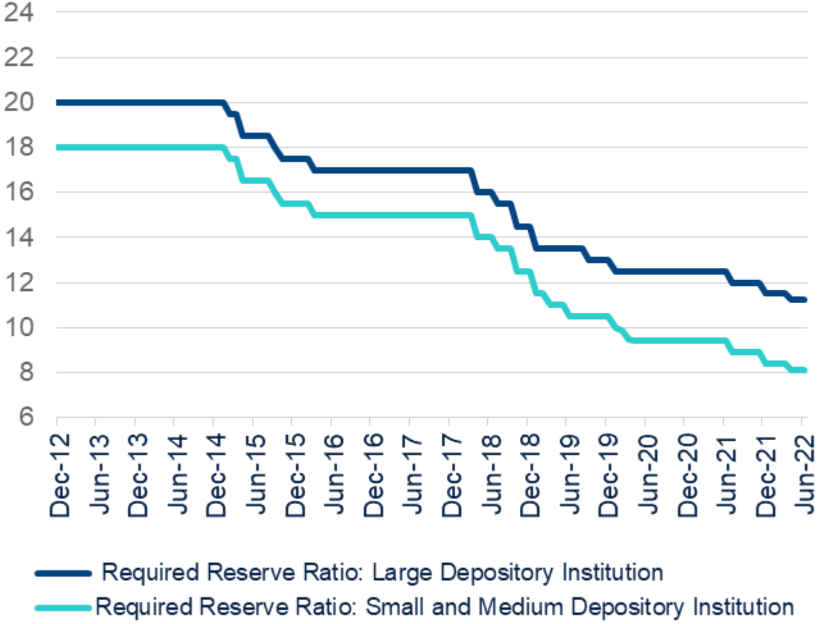


Source: CEIC & BBVA Research.

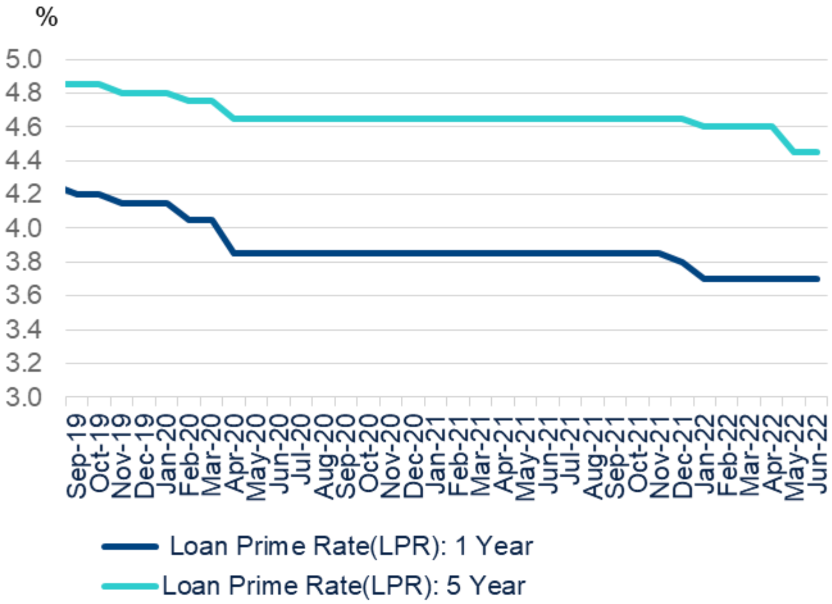
Although the PBoC pressed ahead with monetary easing, credit data of April still remained weak, indicating a weak monetary policy transmission mechanism due to weak sentiments both from credit demand and supply side amid growth slowdown.

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

EXCEPT FOR THE RECENT THREE RRR CUTS, 1-2 MORE RRR CUTS ARE ANTICIPATED IN THE REST OF YEAR (%)



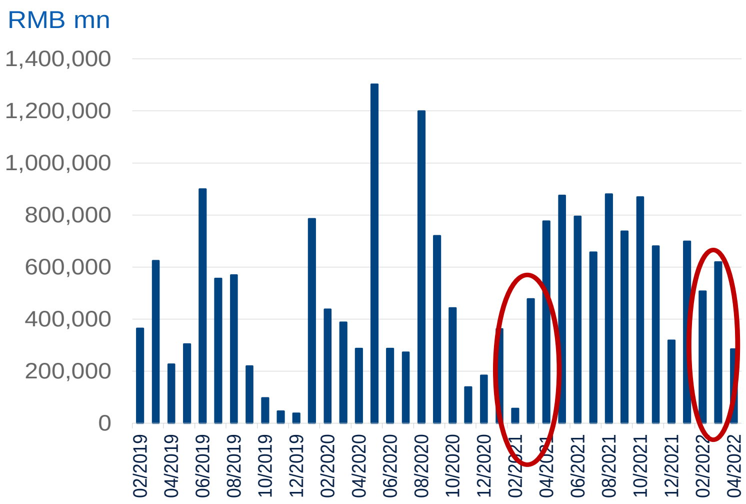
ON TOP OF TWO RECENT LPR CUTS, WE COULD NOT EXCLUDE THE POSSIBILITY OF FURTHER LPR CUT (%)



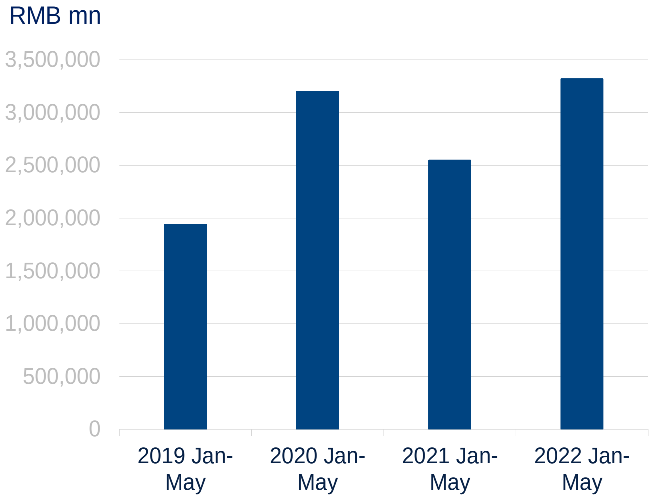
Source: CEIC & BBVA Research.

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

THE AUTHORITIES PLANNED TO EARLY RELEASE LOCAL GOVERNMENT BOND ISSUANCE QUOTA OF 2023 IN 2H 2022 TO STIMULATE INFRASTRUCTURE FAI



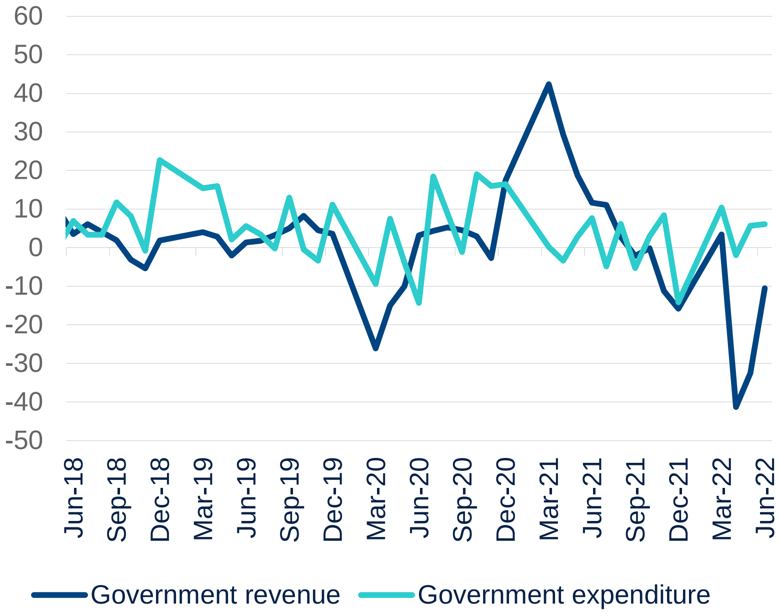
LOCAL GOVERNMENT BOND ISSUANCE FOR JAN-MAY 2022 IS EVEN HIGHER THAN THAT OF JAN-MAY 2020 WHEN PANDEMIC STARTED



Source: CEIC & BBVA Research.

How to finance the fiscal gap and large-scale infrastructure investment in 2022?

DUE TO LARGER FISCAL EXPENDITURE AND DIPPING FISCAL REVENUE, IT IS ESTIMATED THE FISCAL GAP WILL BE RMB 1-2.8 TRN IN 2022



Source: CEIC and BBVA Research

- First, to transfer payments of the profits gained by the PBoC and the SOEs at the central government level to Ministry of Finance to fill in the fiscal gap.
- Second, to issue special government bond to support infrastructure investment is also an option.
- Third, the transfer from 2021's residual fiscal budget to 2022 could also help to make up for the fiscal gap of this year.
- Fourth, to early release the local government bond issuance quota of 2023 in 2H 2022;
- And most recently to set up a state infrastructure investment fund worth 500 billion yuan ($74.69 billion) to spur infrastructure spending.

05

Projections

Main messages

Growth

We lowered our 2022 GDP forecast significantly from 5.2% previously to 4.5% while highlighting the downside risk, considering the economic slump due to Shanghai lockdown in Q2. It is lower than the authorities' 5.5% target but in line with the market predictions (IMF: 4.4%, Bloomberg consensus: 4.1%).

Inflation

Our forecasts of 2022 CPI and PPI stand at 2.3% and 5.2% respectively. The convergence of them reflects CPI trending up in 2022 due to the fading effect of African Swine Flu Cycle, and a trending down PPI as China took chance of Russia-Ukraine war to absorb Russia's commodity exports to expand its commodity reserve.

Interest rate

We cannot exclude the possibility of further LPR cuts in the rest of the year, and expect 1-2 RRR cuts in 2H 2022.

RMB Exchange rate

RMB to USD exchange rate is anticipated to depreciate to 6.8 at end-2022 amid the diverging monetary policy between China and the US, and a stronger USD DXY, slower exports, massive capital outflows etc.

Forecast: China’s main economic indicators

BASELINE SCENARIO

	2019	2020	2021	2022	2023
GDP （%）	6.1	2.3	8.1	4.5	5.2
CPI（%）	2.9	2.6	0.9	2.3	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	6.8	6.6

Decomposition of GDP forecast

(%)	2022	2023	2024	2025	2026	2027
GDP nsa	4.5	5.2	5	4.8	4.5	4.5
Private consumption nsa	4.5	5.2	5	5	4.5	4.5
Government Consumption nsa	4.6	5.6	5	5	4.5	4.4
GFCF nsa	4.5	5.3	5	5.2	4.4	4.4
Invent change (residual term)	6.2	4.5	4	2.9	9.6	6.35
Export	9	3.32	3.1	2.21	3.2	3.3
Import	10	3.35	2.8	3.2	3.1	3.1

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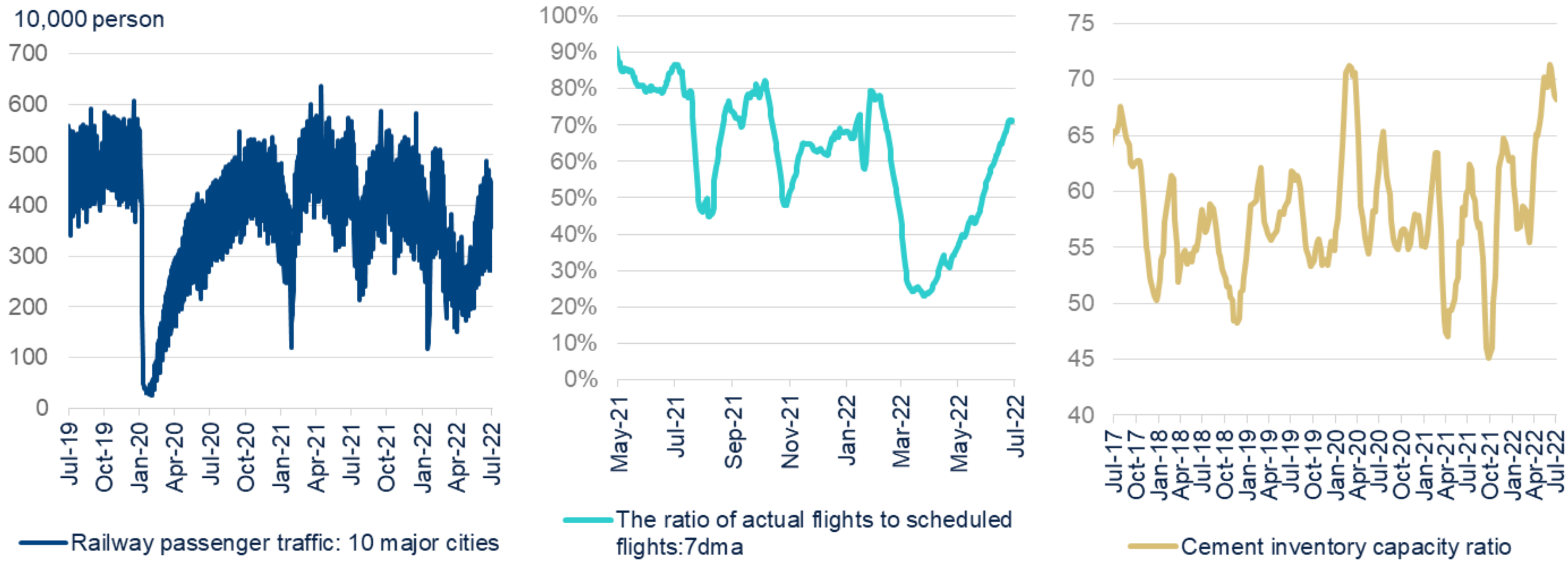
Appendix

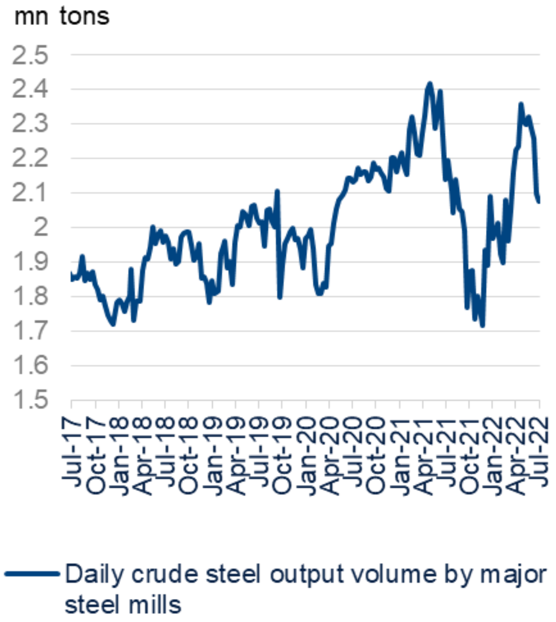
Creating Opportunities

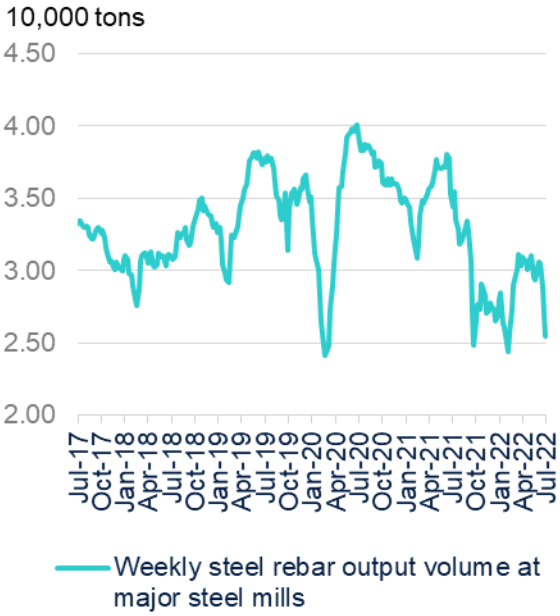
High frequency data tracker also pointed to a gradual recovery from Shanghai lockdown (1)

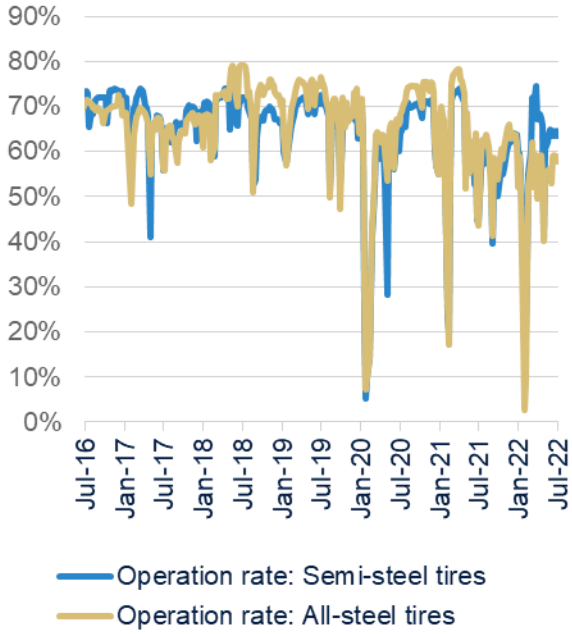


Source: WIND and BBVA Research.

High frequency data tracker also pointed to a gradual recovery from Shanghai lockdown (2)

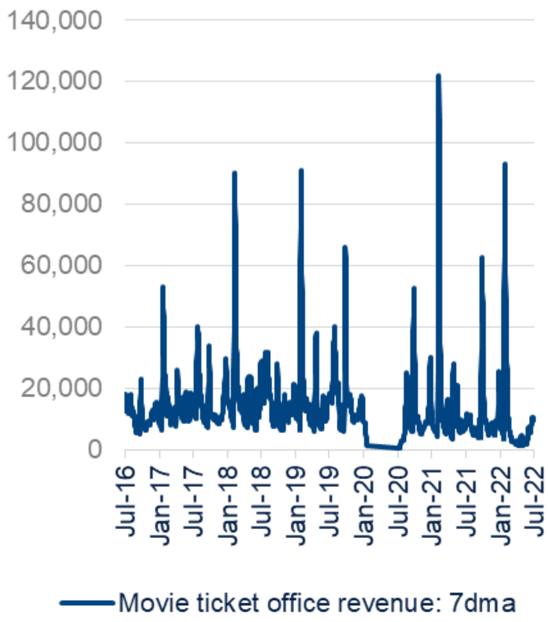


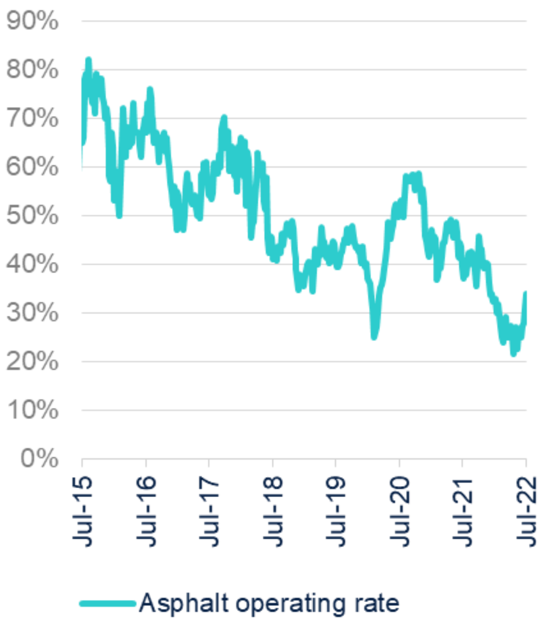


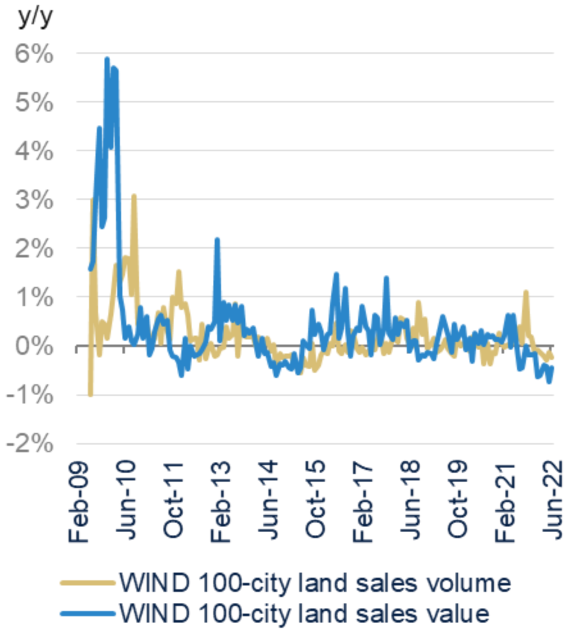


Source: WIND and BBVA Research.

High frequency data trackers: which indicators have not recovered yet?: consumption, construction and real estate







Source: WIND and BBVA Research.

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Creating Opportunities