BBVA Research

China Economic Outlook

October 2022

Creating Opportunities

BBVA Research

01

Global economy: recession risk is on the rise

The persistence of inflation forces central banks to front-load interest rate hikes, contributing to both financial volatility and recession fears

RECENT DEVELOPMENTS IN THE WORLD ECONOMY

GROWTH MODERATION

On inflation, monetary tightening, the UKR war and covid (mostly in China), despite labor markets' relative strength.

DISRUPTION IN GAS MARKETS

Sharp rise in prices in Europe due to remarkable Russia's supply cuts.

COMMODITIES (EX-GAS)

Prices are high, but declining on weaker growth prospects.

SUPPLY BOTTLENECKS

Still at high levels, but easing, mainly in the US.

STILL HIGH INFLATION

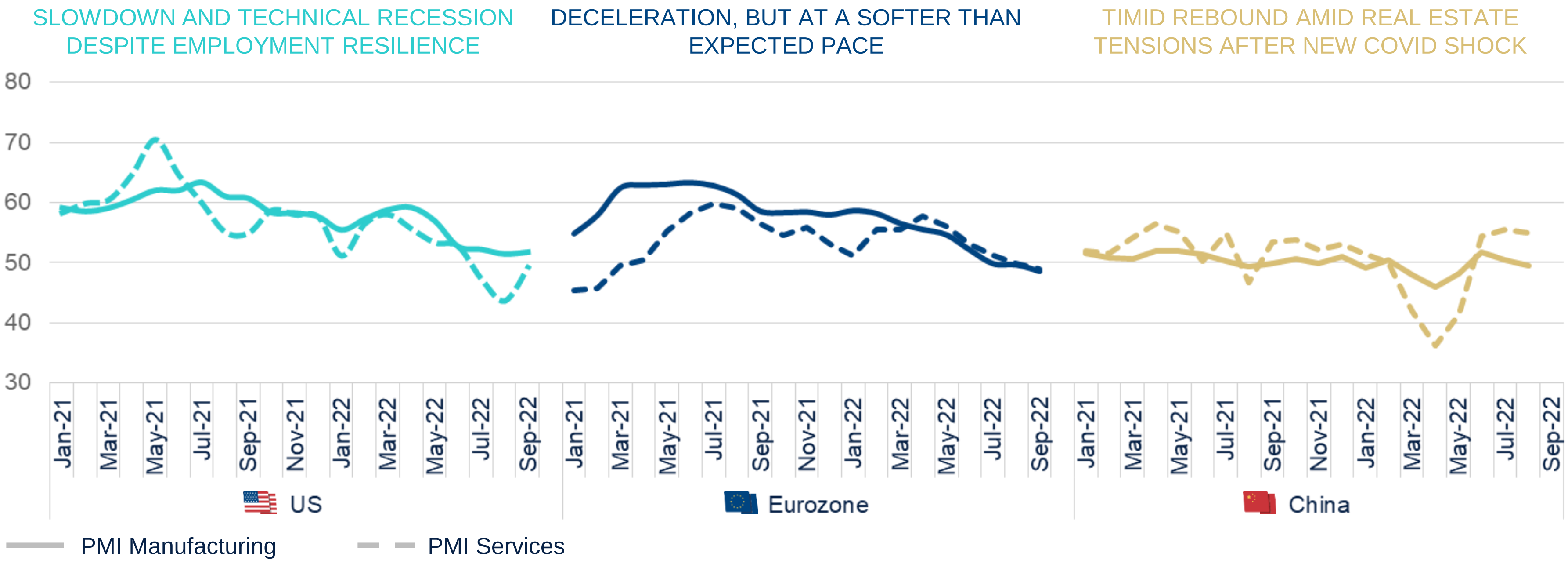
Inflation continues to surprise upwards, but moderation signs suggest it may soon peak.

FRONT-LOADING OF INTEREST RATES HIKES

Faster and sharper monetary tightening than expected as central banks' commit to price stability.

Growth is losing momentum as reopening effects fade and inflation, monetary tightening, gas disruptions in Europe and covid in China weigh negatively

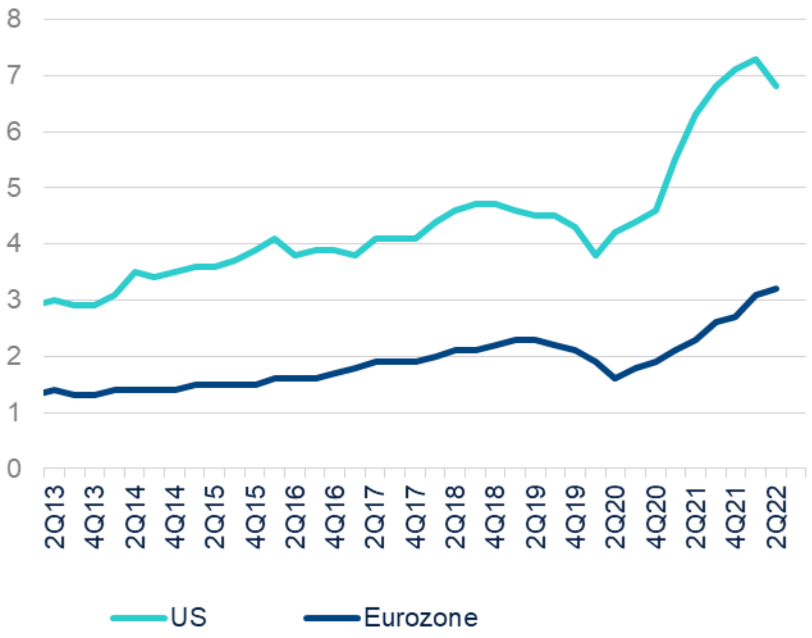
PMI INDICATORS
(MORE THAN 50: EXPANSION; LESS THAN 50: CONTRACTION)



Source: BBVA Research based on data from Haver.

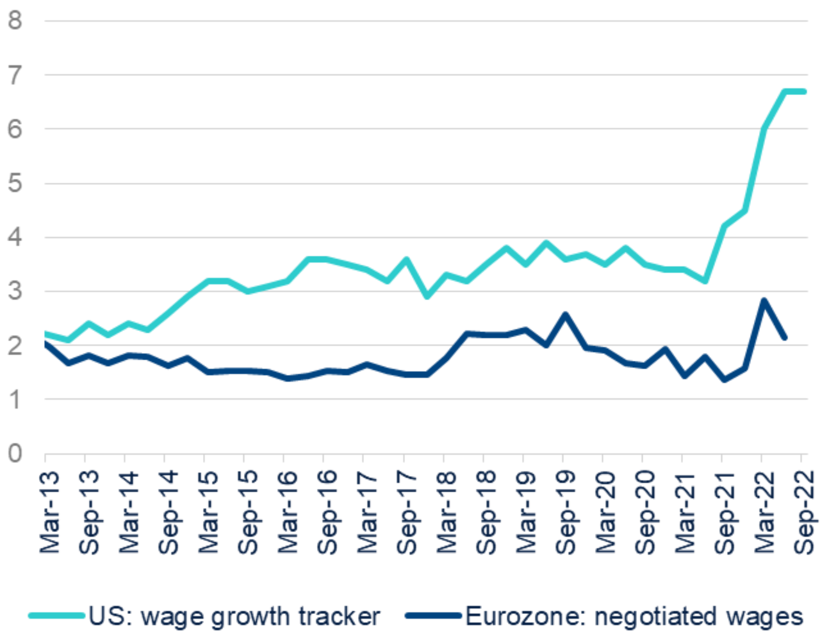
Labor markets exhibit strength despite the ongoing activity deceleration; wages are growing, but at a slower pace than inflation

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.

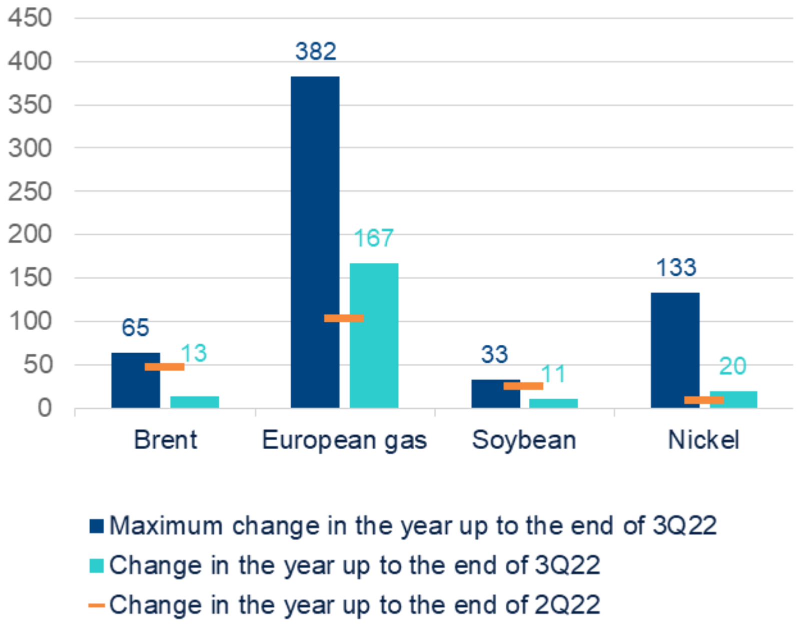
WAGE GROWTH INDICATORS
(% YoY, QUARTERLY DATA)



Source: BBVA Research based on Atlanta Fed and ECB data

Gas prices have skyrocketed on Russia's supply cuts, but other commodity prices have eased recently in line with concerns on global moderation

COMMODITY PRICES
(%)

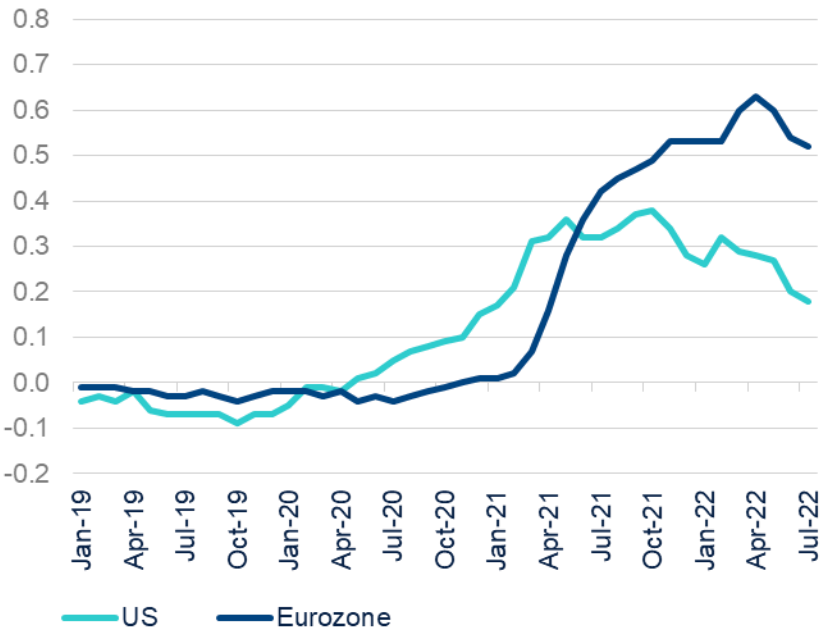


Source: BBVA Research based on data from Haver.

- Natural gas prices in Europe jumped 31% in the 3T22 on decreasing supply from Russia.
- Oil, food and metal prices eased from the middle of the year on worse prospects for global demand; supply issues prevented a sharper correction.
- Brent prices declined 23% over the 3T22 despite the announced production cut by the OPEC and the EU embargo on Russia's oil exports.
- The recent deal to unlock Ukraine grain exports has helped to drive down prices.

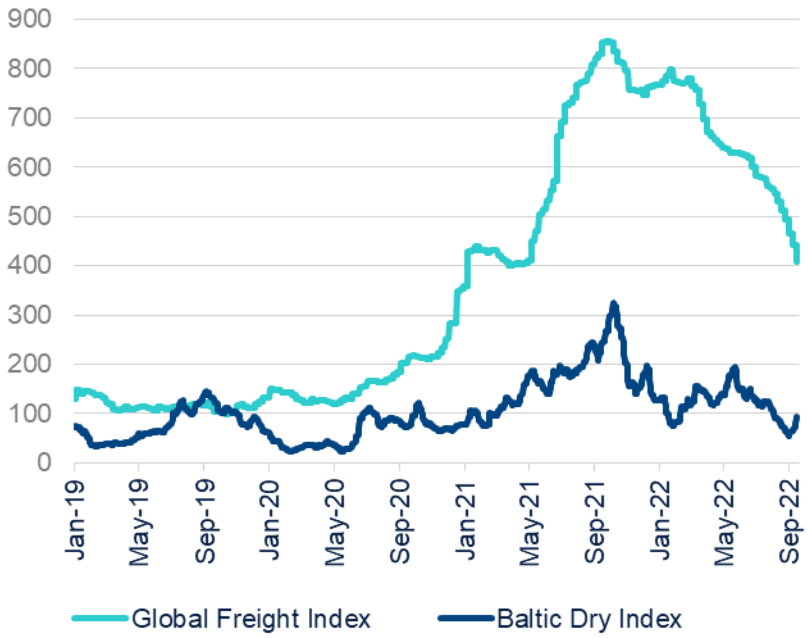
Bottlenecks are easing, but remain at very high levels, mainly in Europe

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



Source: BBVA Research.

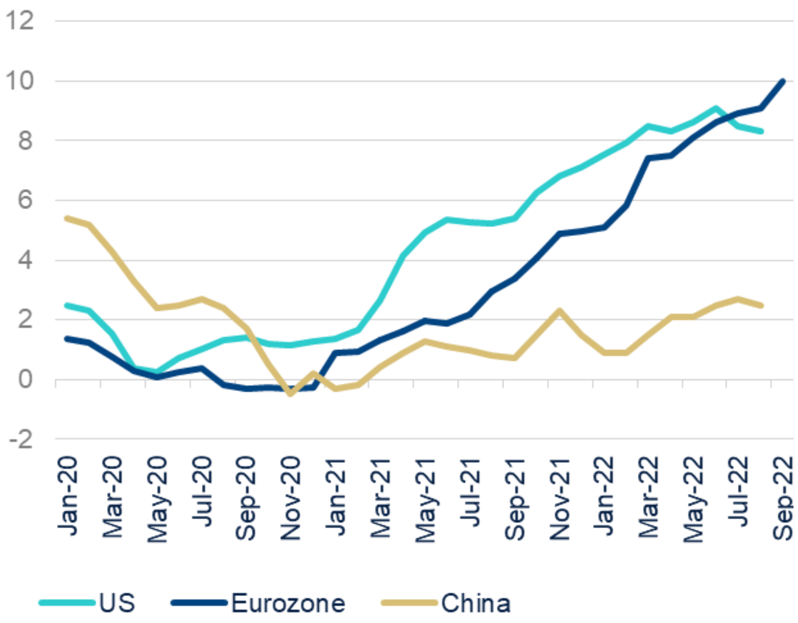
CONTAINER FREIGHT RATES: GLOBAL AND BALTIC
(INDEX: 2012 = 100)



Source: BBVA Research based on data from Haver.

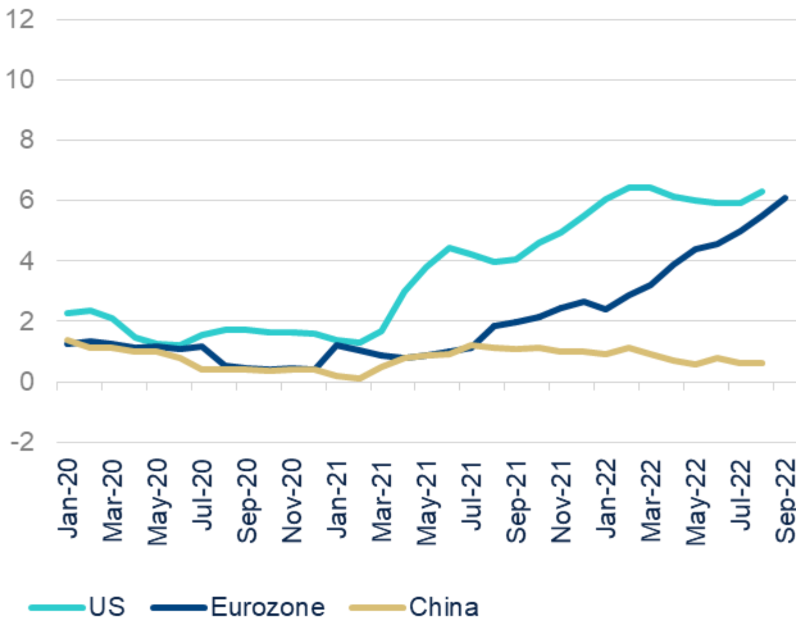
Inflation remains very high and continues to surprise to the upside, but there are increasing signs of moderation

INFLATION: CPI
(Y/Y %)



Source: BBVA Research based on local statistics.

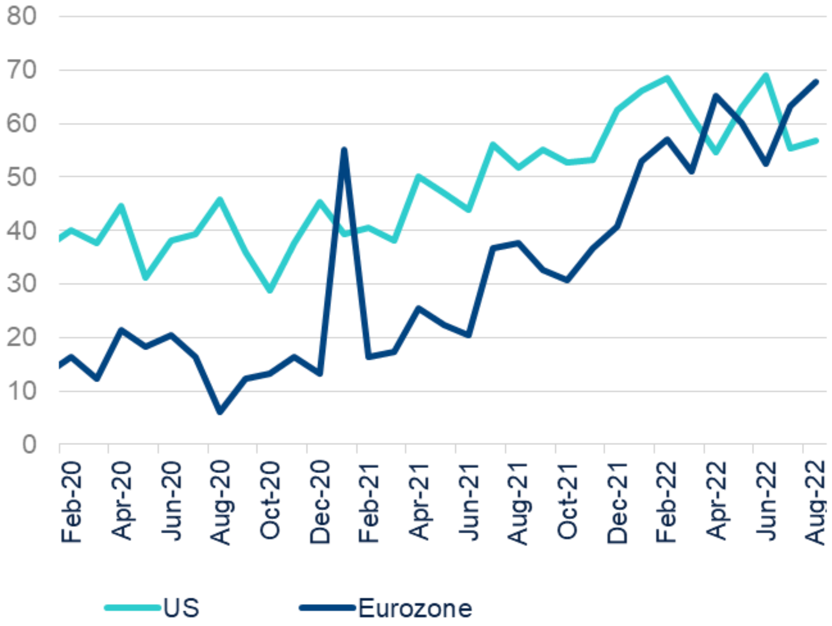
CORE INFLATION: CPI
(Y/Y %)



Source: BBVA Research based on local statistics.

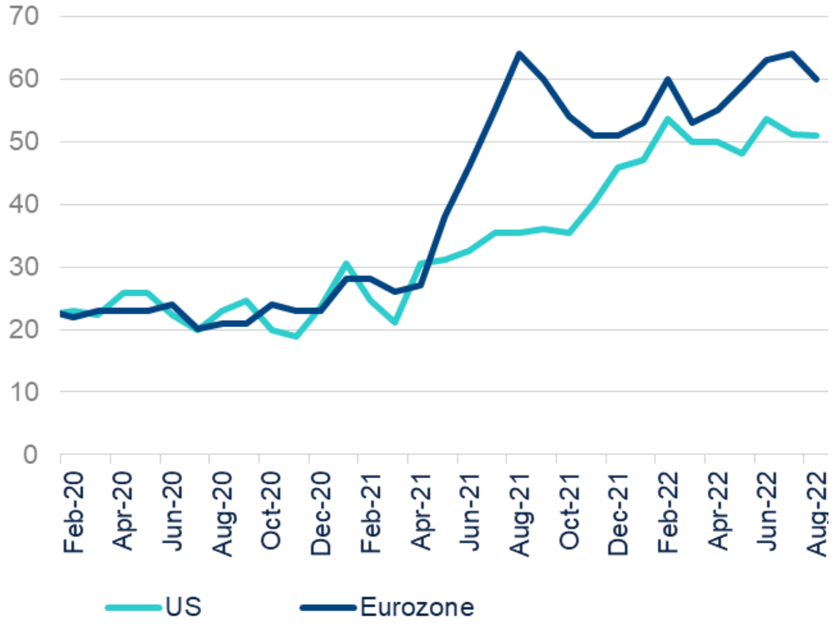
Price adjustments have become more widespread and also more frequent

ITEMS OF THE CPI BASKET WITH ANNUALIZED MONTHLY INFLATION HIGHER THAN 4%
(SHARE OF TOTAL 2-DIGIT CPI ITEMS)



Source: BBVA Research based on local statistics.

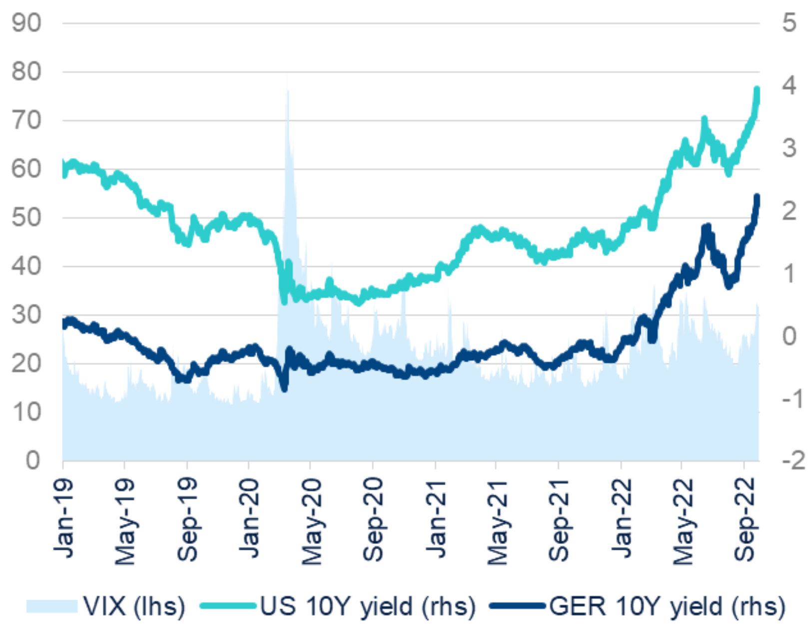
ITEMS OF THE CPI BASKET WITH THREE CONSECUTIVE MONTHLY PRICE RISES
(SHARE OF TOTAL 2-DIGIT CPI ITEMS)



Source: BBVA Research based on local statistics.

The front-loading of interest rate hikes has generated financial volatility; sovereign bond yields moved sharply up and the US dollar strengthened

10Y SOVEREIGN YIELDS AND VOLATILITY
(YIELDS: %, VOLATILITY: VIX INDEX)



Source: BBVA Research based on data from Haver.

- A hawkish Fed has adjusted interest rates, so far, in the year to date by 300bp to 3.25% and has paved the way for extra tightening ahead.
- The ECB has abandoned negative rates; refi rates have reached 1.25% and are set to increase further ahead; a new asset-purchase program (TPI) will help to address fragmentation risks within the region.
- Most currencies have weakened against the dollar, reinforcing inflationary pressures and the risk of financial stress.
- Volatility, sovereign yields and risk premia have increased quickly on prospects of tighter monetary policy, war-related uncertainty and the recent financial stress in the UK.

A further deterioration of macroeconomic prospects: higher inflation, tighter monetary policy and weaker growth than previously expected

BBVA RESEARCH CENTRAL SCENARIO: MAIN ASSUMPTIONS AND IMPACTS

MONETARY TIGHTENING

Interest rates remain higher for longer as central banks remain committed to low inflation

DISRUPTIONS IN GAS MARKETS

Russia's supply cuts keep prices close to current levels, but saving measures, flows from alternative sources and inventories prevent large shortages

COMMODITIES (EX-GAS)

Prices decline on decelerating global demand, but supply restrictions keep prices relatively high

SUPPLY BOTTLENECKS

Bottlenecks continue to ease gradually as the effects of ongoing shocks wane away

SHARP GROWTH SLOWDOWN

Global growth is forecast to ease sharply from 6.2% in 2021 to 3.2% (-0.2pp) in 2022 and 2.4% (-0.1pp) in 2023. Mild recessions in the Eurozone, due to gas disruptions, and in the U.S., due to interest rate hikes. Low growth, but no hard-landing in China.

INFLATION MODERATES SLOWLY

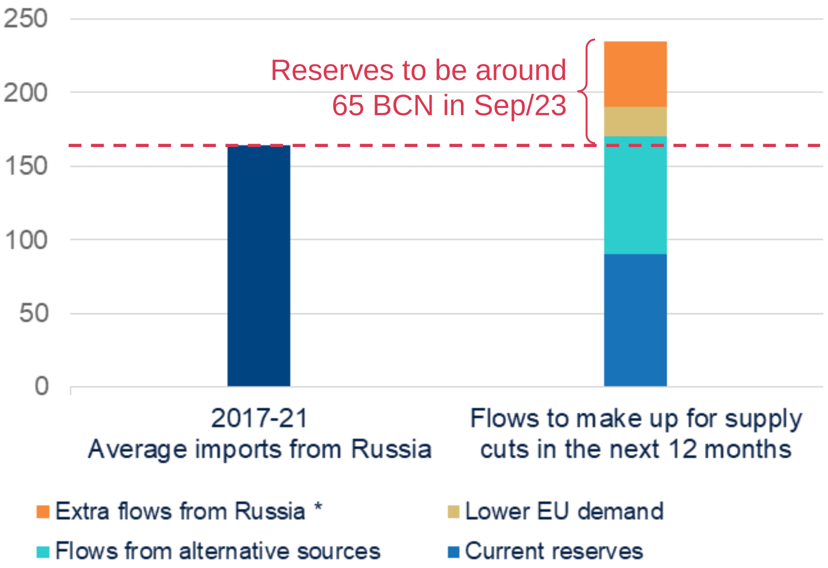
It remains above targets at least till 2024, but eases from 2023 as current shocks lose steam, monetary tightening reigns on expectations and no significant second-round effects emerge.

FINANCIAL VOLATILITY

Strong dollar, high risk premia, capital outflows from EM.

European gas markets: relatively-high reserves, saving measures and flows from alternative sources are likely to prevent significant shortages ahead

EU GAS: AVERAGE IMPORTS FROM RUSSIA AND FLOWS TO MAKE UP FOR SUPPLY CUTS IN THE NEXT 12 MONTHS (BCM: BILLION CUBIC METERS)

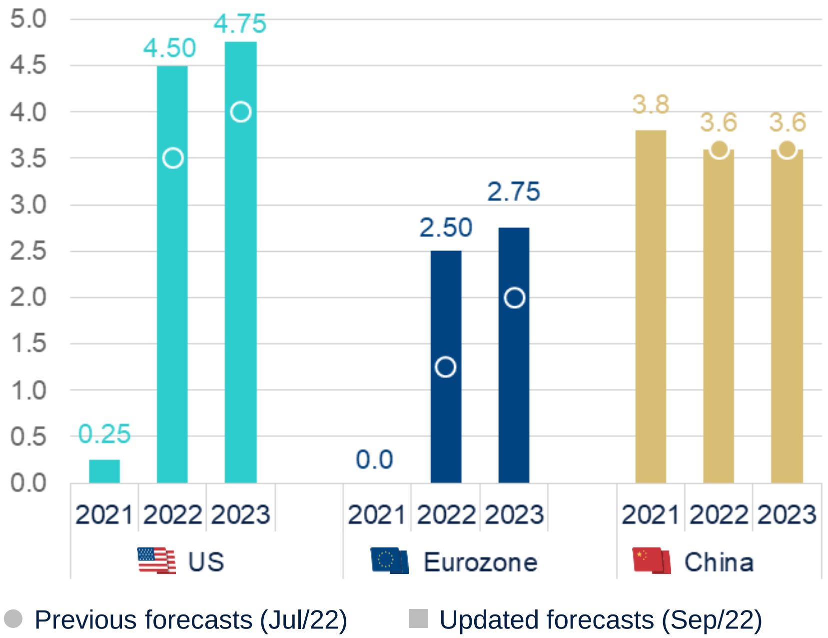


* Assuming imports from Russian remain at the current levels: around 40 BCM (25% of total supply), through pipelines inTürkiye and Ukraine and LNG shipments, but not through Nord Stream and Belarus pipelines.
Source: BBVA Research based on data by, Bruegel, EUROSTAT, ENTSOG (European Network of Transmission System Operators for Gas).

- Baseline scenario: high gas prices (close to current levels), without gas shortages as flows from other sources, inventories and saving measures are likely to offset supply cuts over 2023-24, at least if imports from Russia remain at current levels and winter temperatures are close to historical averages.
- If Russia further cuts pipeline supply, there would be enough gas for the 2023 winter, but extra rationing would be needed in 2024.
- If Russia cuts liquified natural gas (LNG) provisions, the impact would not be very significant: LNG markets are global and circular, meaning that the EU would end up importing LNG from other producers.

Central banks will keep the focus on inflation despite increasing signs of growth weakening: interest rates will remain higher for longer

MONETARY POLICY INTEREST RATES*
(%, END OF PERIOD)



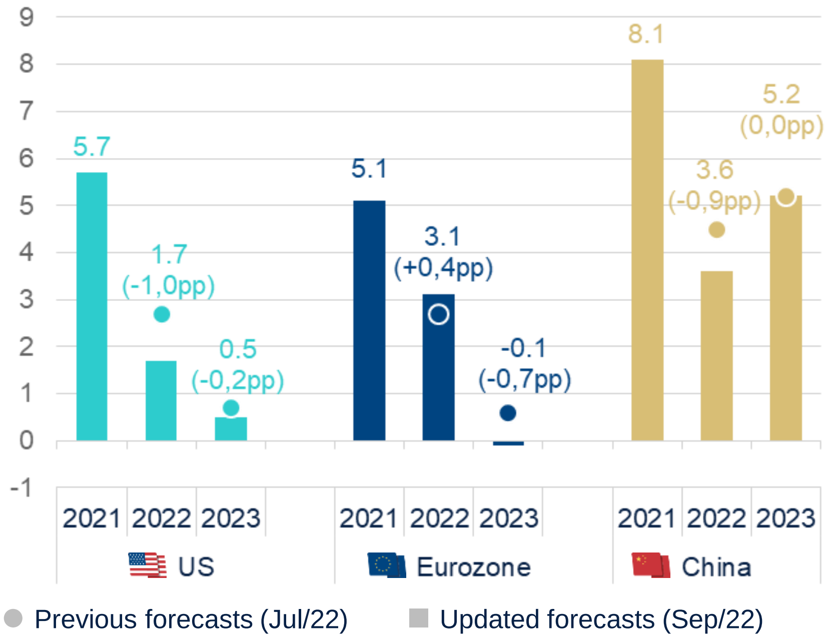
* In the case of the Eurozone, interest rates on refinancing operations.
Source: BBVA Research based on Bloomberg data.

- The Fed is likely to raise rates to 4.75%, and to keep them at that contractive level till the end of 2023 in order to engineer a slowdown of the economy, and of labor markets in particular, for inflation to converge to 2%.
- The ECB is expected to hike refi rates to 2.75%, well above neutral levels, pressured by high inflation and a more aggressive Fed, and despite the bleak growth prospects.
- Fiscal policy will be more supportive in the EZ than in the US, mostly through NGEU funds and the suspension of fiscal rules until 2023.
- In China, policies are expected to continue exhibiting a moderately expansionary tone.

Global growth will ease significantly ahead on price pressures, rising interest rates, gas disruptions in Europe and idiosyncratic problems in China

GDP: ANNUAL GROWTH IN REAL TERMS

(%)

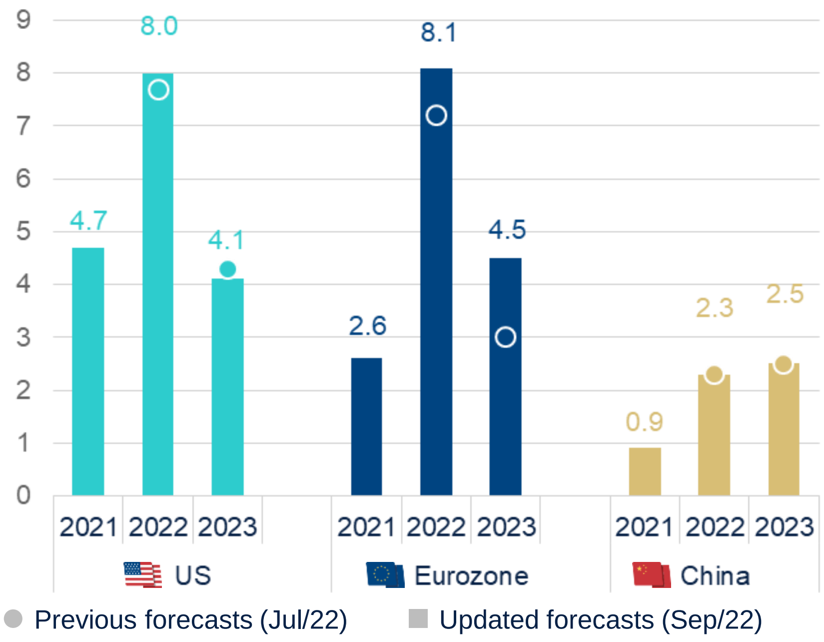


* Forecast change in parentheses.
Source: BBVA Research.

- In the US, growth is revised downwards on (surprising) GDP contractions over 1H22 and higher Fed rates; a recession coupled with a labor market easing is likely by mid-2023.
- In the EZ, positive incoming data supports an upward revision of 2022 growth, but a sharper easing ahead is expected on gas disruptions and higher rates; a recession is likely over the next few quarters.
- Recessions in the US and the EZ are set to be mild given the relative strength in balance sheets of households, firms and banks.
- In China, 2022 growth revised down on the impact of new covid waves and real estate tensions; a recovery is expected in 2023.

Inflation will remain high (more than expected) and well above central bank targets, but is still forecast to trend downwards from 2023 onwards

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



Source: BBVA Research.

- Inflation forecasts are revised to the upside, in line with evidence of more widespread and more frequent price adjustments and, in the case of the Eurozone, with prospects of higher gas prices and a weaker Euro.
- Still, recent moderation signs (mainly in the US), reinforce the view that inflation will ease ahead as current shocks lose strength and monetary conditions continue to be tightened.
- While inflation's convergence to the target will take a relatively long time, expectations are forecast to remain broadly anchored.
- Growth deceleration is expected to reduce the room for relevant wage increases, making significant second-round effects unlikely.

Risks: in the current context , a sharper slowdown in global growth and financial turmoil episodes cannot be ruled out

MAIN SHORT-TERM RISKS TO THE WORLD ECONOMY

PERSISTENT INFLATION
Second-round effects, new shocks or policy mismanagement could further spur inflation, requiring higher interest rates

UKRAINE WAR AND GEOPOLITICS
A deterioration of the war and new geopolitical conflicts; significant gas shortages in Europe are among the main risks

HARD-LANDING IN CHINA
“Zero-covid” policy coupled with real estate tensions and other local problems could pave the way for weaker growth in China

SOCIAL TENSIONS AND POPULISM
Macro weakness, political polarization, among other reasons, could trigger social unrest and populist policies

SHARPER GROWTH DECELERATION
Global growth could decelerate faster and more significantly than expected, increasing the odds of a global recession

FINANCIAL TURMOIL
Higher policy rates and risk aversion could trigger financial crises, in particular in debt and EM markets

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02

A bumpy recovery amid “zero Covid” and real estate crash

Main messages

A bumpy recovery

Chinese economy has experienced a bumpy recovery after Shanghai lockdown lifted, as main indicators dropped again in July after their temporary bounce-back in May. GDP figures have confirmed the slowdown pattern from 4.8% y/y in Q1 to 0.4% y/y in Q2; we lowered our 2022 prediction from 4.5% to 3.6% (IMF: 3.3%, Bloomberg consensus: 3.4%) and anticipate growth will bounce back from Q2 trough in Q3 and Q4. The recovery path will be similar to that of Wuhan lockdown that supply-side will surpass demand-side recovery.

Main factors dragged growth

(i) China still sticks to “Zero Covid” policy which hindered consumption and supply side recovery; (ii) Real estate crash: main housing indicators staying in negative territory for the past half year, which adversely spilled over to its upstream and downstream sectors. It also triggered regional financial instability, such as home-buyers mortgage boycotts and small banks’ bankruptcy; (iii)The historical high temperature encumbered hydroelectricity production, leading to restricted electricity usage in summer. (iv) The authorities gave up the 5.5% growth target which was set in March 2022 “two sessions” before Shanghai lockdown, indicating monetary and fiscal stimulus will become more prudent instead of a deluge of massive stimulus going forward.

Main messages

Low inflation environment persists

China's low inflation environment persists due to the sluggish domestic demand, a declining global commodity price and the expansion of commodity imports from Russia. China's CPI cycle is almost equivalent to pork cycle, as pork price turns to positive from negative growth, CPI is anticipated to increase to around 3% at year end.

Factors determining economic recovery path

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

Weak policy transmission mechanism due to weak sentiments

ECONOMY

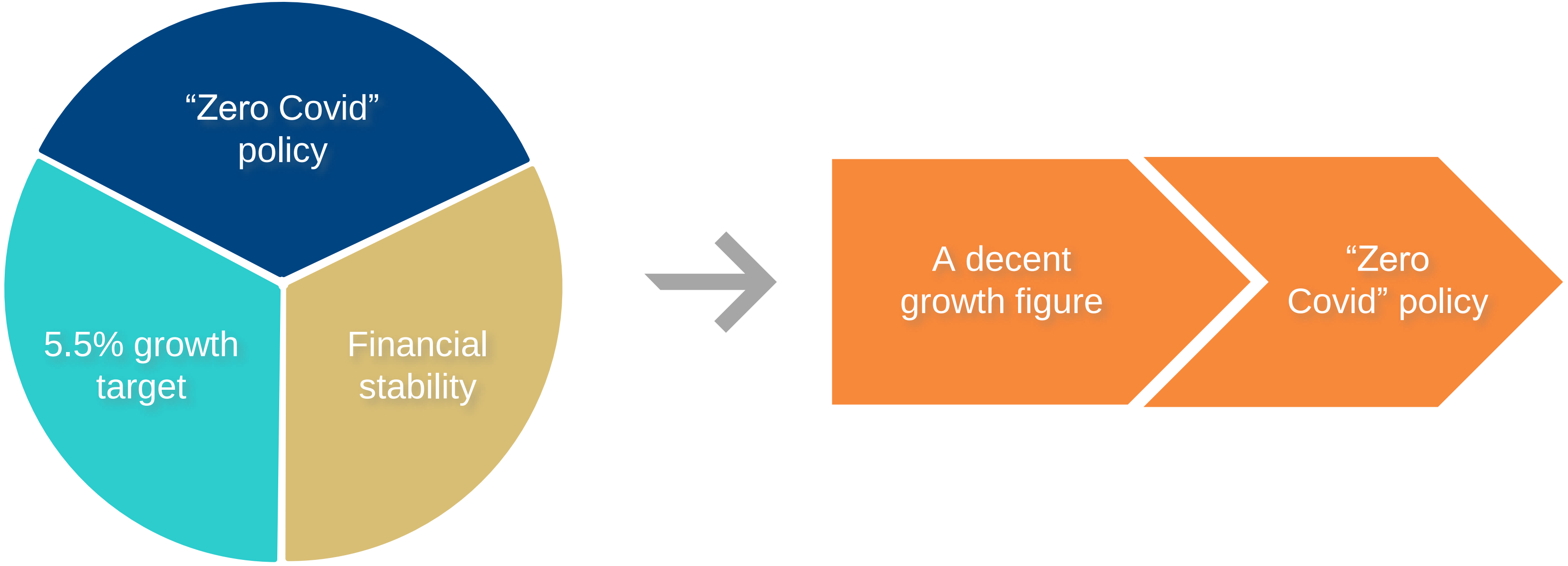
- Industrial production: "zero Covid" ↓
- Consumption: "zero Covid" ↓
- Fixed asset investment
  - FAI: real estate: Housing market crash ↓ ↓
  - FAI: manufacturing ↑ ? ↓
  - FAI: infrastructure ↑
- Exports ↑ ? ↓

POLICY

- "Zero Covid"
- +
- Accommodative monetary and fiscal policy, without deluge of massive stimulus

- Household and enterprises' balance sheet "recession" offsets policy easing efforts;
- Weak policy transmission mechanism due to weak sentiments.

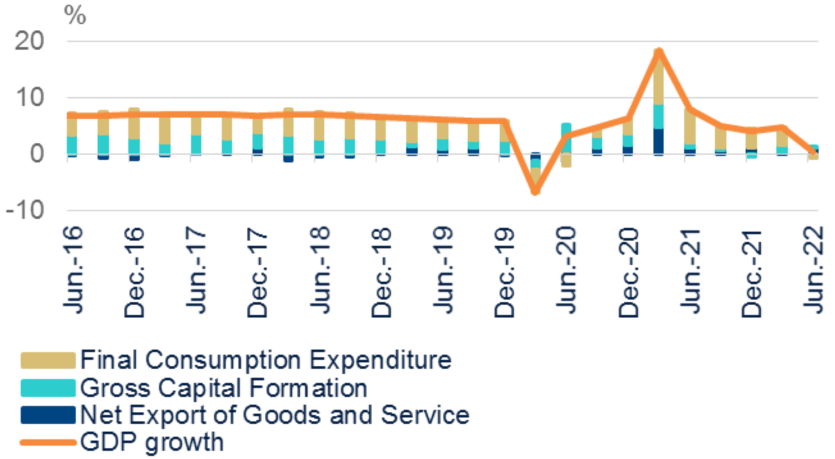
China’s policy setting: from “Trilemma” to “Dilemma”



Without the 5.5% growth target, a deluge of massive monetary and fiscal easing seems not necessary, thus financial stability is not the priority concern.

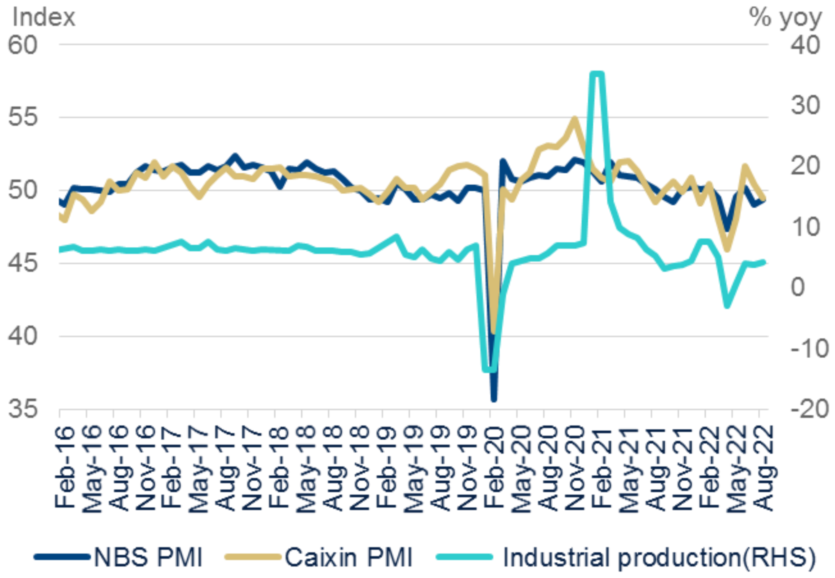
A bumpy recovery path after Shanghai lockdown was lifted

GDP GROWTH DIPPED FROM 4.8% IN Q1 2022 TO 0.4% IN Q2, EXPECTED TO BOUNCE BACK IN Q3 AND Q4



Forecast	2022Q1	2022Q2	2022Q3 (F)	2022Q4 (F)
Y/Y%	4.8	0.4	4.5	5.2
Q/Q%	0.65	-2.76	5	2.5

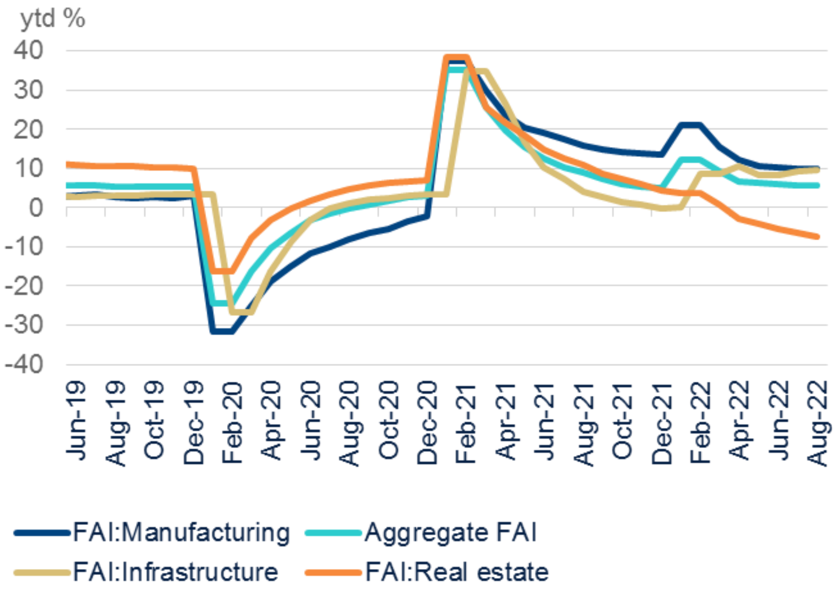
PMIS AND INDUSTRIAL PRODUCTION DIPPED IN JUL AFTER A REBOUND IN MAY, INDICATING A BUMBY RECOVERY AFTER SHANGHAI LOCKDOWN LIFTED



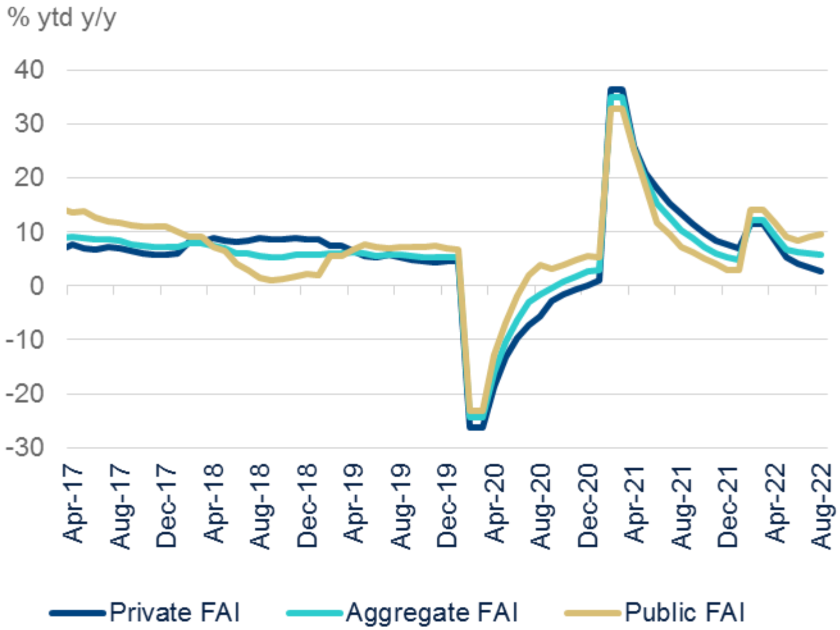
Source: BBVA Research.

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

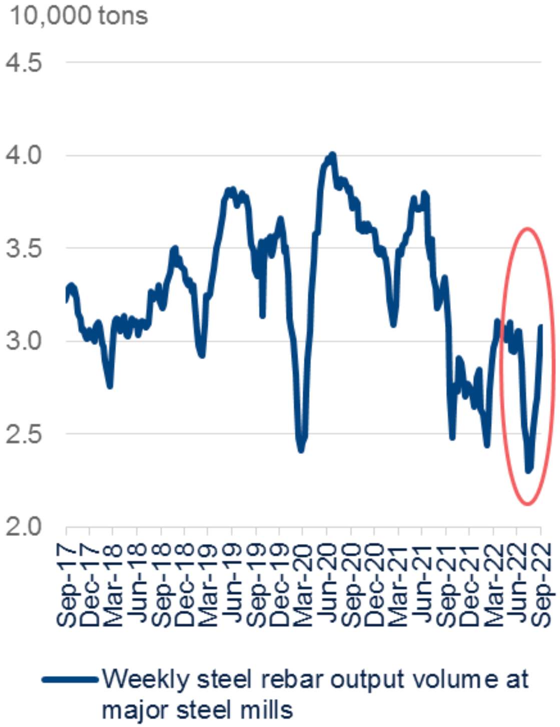


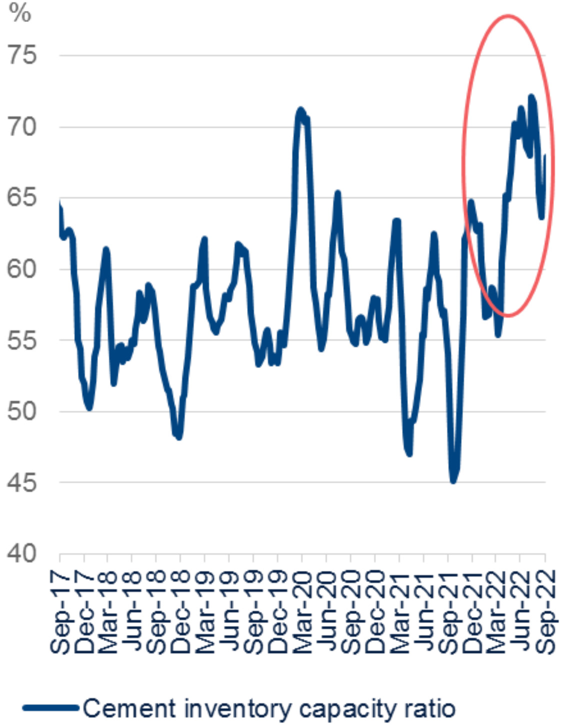
PUBLIC FAI LED THE INVESTMENT RECOVERY DUE TO THE FISCAL STIMULUS



Source: CEIC and BBVA Research.

High frequency indicators related to infrastructure also support a steady pick-up of infrastructure investment

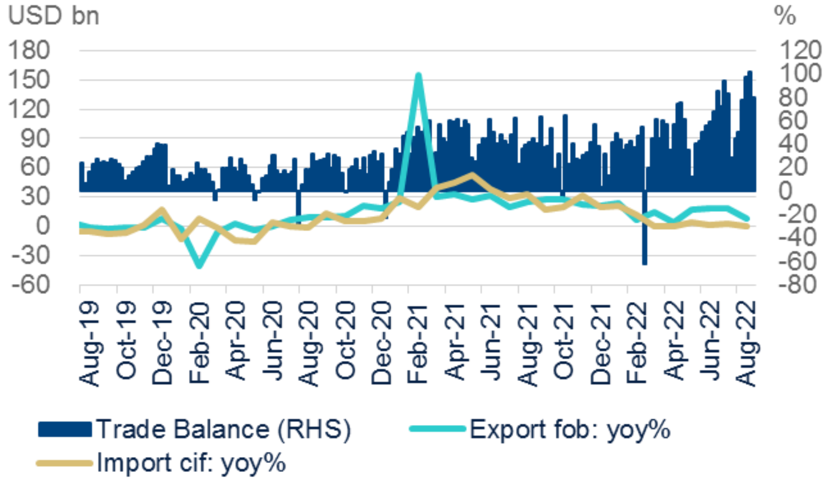




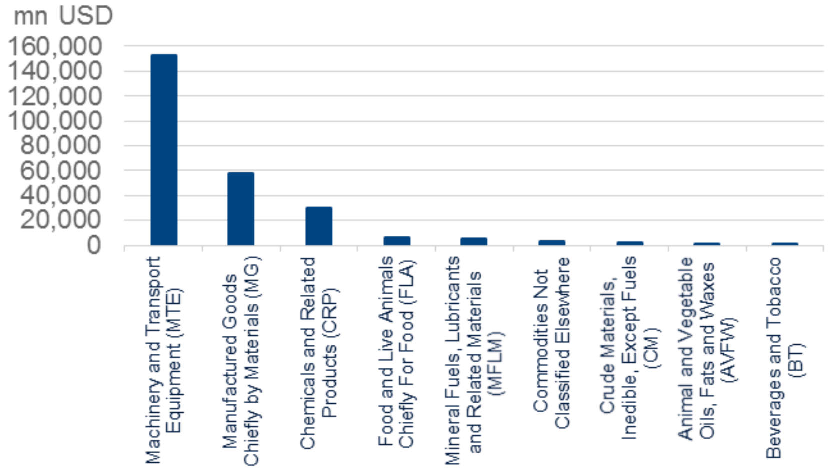
Source: BBVA Research and WIND.

China's exports decelerated due to growth slowdown and possible recession in the US and EU, indicating China's current account "normalization"

EXPORT DIPPED FROM 18% IN JULY TO 7.1% AND IMPORTS DIPPED FROM 2.3% TO 0.3% IN AUG, SHRINKING TRADE BALANCE AT USD 79.4 BN



EXPORTS REVERTED TO MANUFACTURING TRADE ORIENTED, AS MEDICAL AND VIRUS-RELATED EXPORTS SIGNIFICANTLY SLOWED

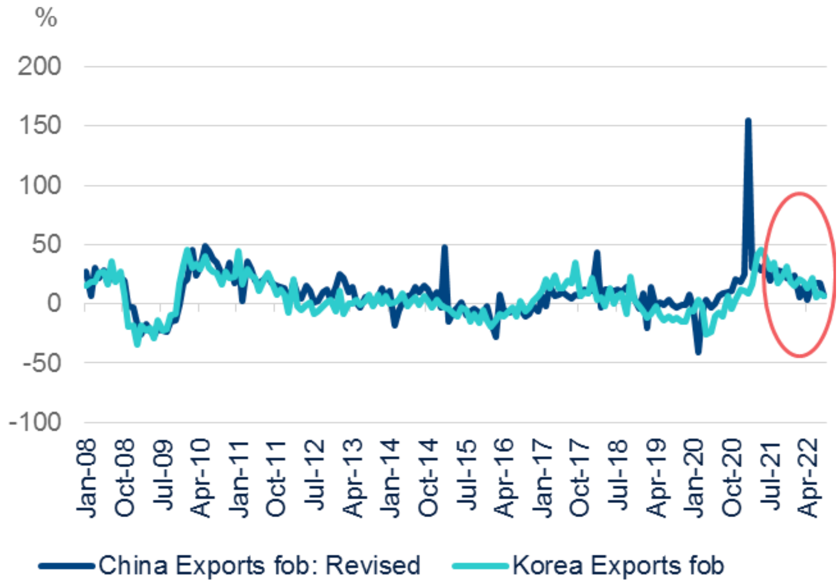


Source: CEIC and BBVA Research.

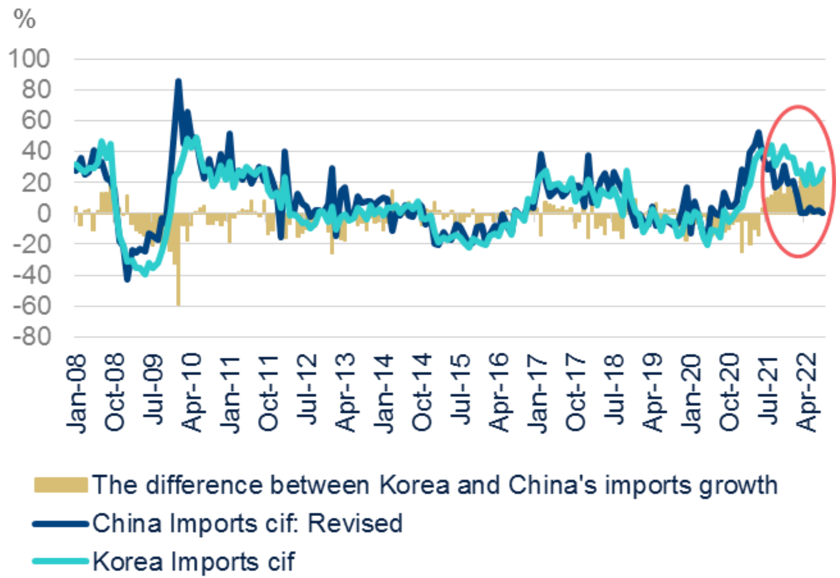
The ongoing competitive currency depreciation in Asian countries led by sharp JPY depreciation may weigh on China's exports.

A comparison of trade sector for Asia's two manufacturing countries: China and Korea

BOTH CHINA AND KOREA'S EXPORTS GROWTH DECLINED RECENTLY, REFLECTING WEAK GLOBAL DEMAND



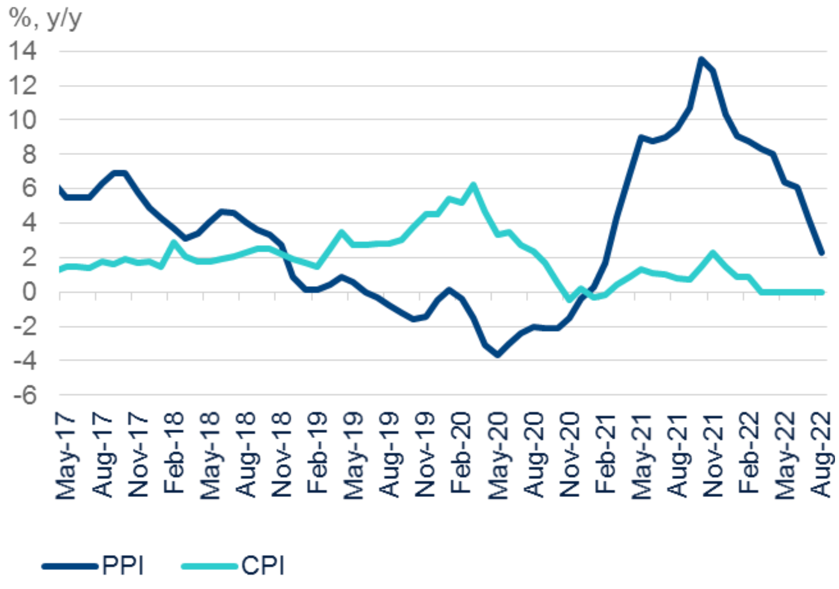
CHINA'S IMPORTS GROWTH DIPPED MUCH FASTER THAN KOREA, INDICATING CHINA'S SLUGGISH DOMESTIC DEMAND



Source: CEIC and BBVA Research.

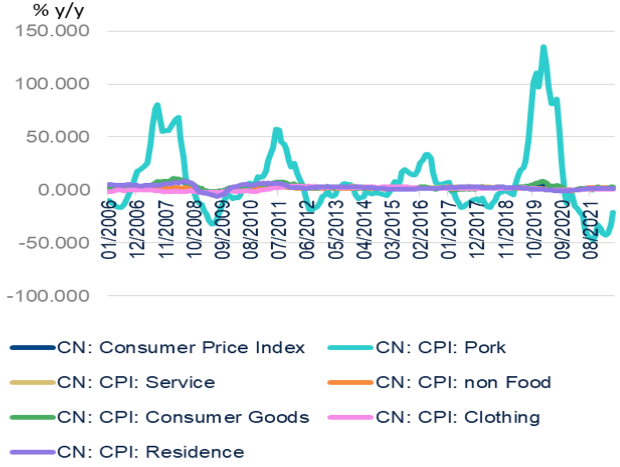
Low inflation environment persists, due to sluggish domestic demand and declining global commodity price

CPI DECLINED FROM 2.7% IN JULY TO 2.5% IN AUG; PPI DECELERATED TO 2.3% FROM 4.5% IN PREVIOUS MONTH



Source: CEIC and BBVA Research.

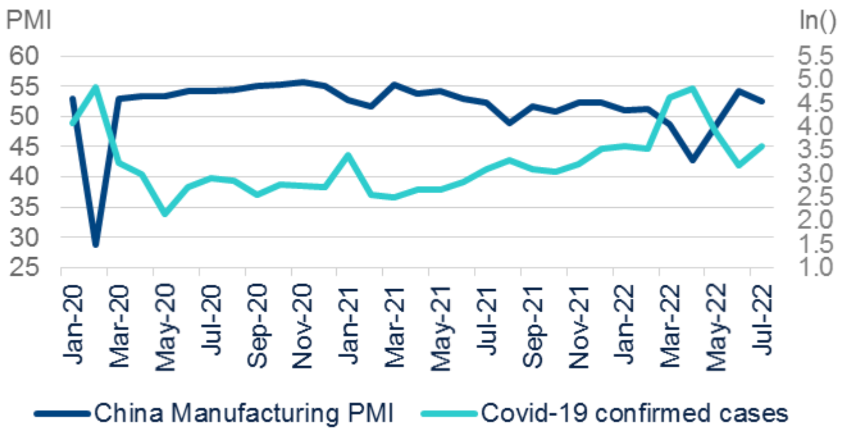
AS PORK PRICE TURNED TO POSITIVE FROM NEGATIVE GROWTH, THE MARKET EXPECTS A NEW START OF "PORK CYCLE"



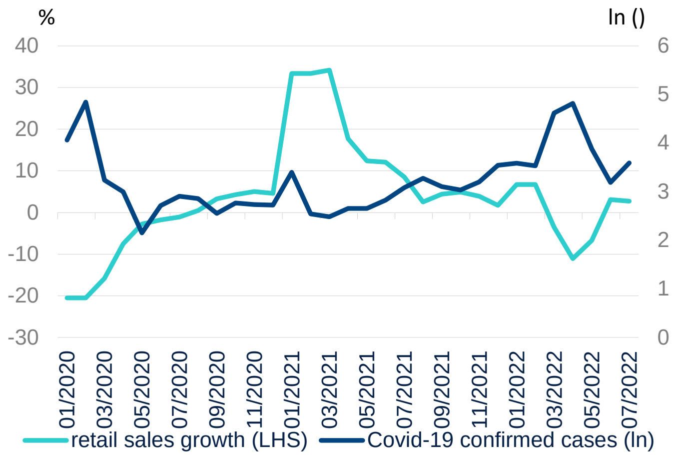
China's CPI cycle is equivalent to pork cycle: Pork CPI has the largest volatility, contributing most to CPI y/y% change; Pork price takes around 3% of the CPI basket.

Main risk 1: “Zero Covid” policy has significantly dragged on growth from both supply and demand side

FROM SUPPLY SIDE, THE CONFIRMED COVID CASES HAVE A CLEAR NEGATIVE CORRELATION WITH PMI FIGURES



FROM THE DEMAND SIDE, THE CONFIRMED COVID CASES ALSO HAVE NEGATIVE CORRELATION WITH RETAIL SALES FIGURES

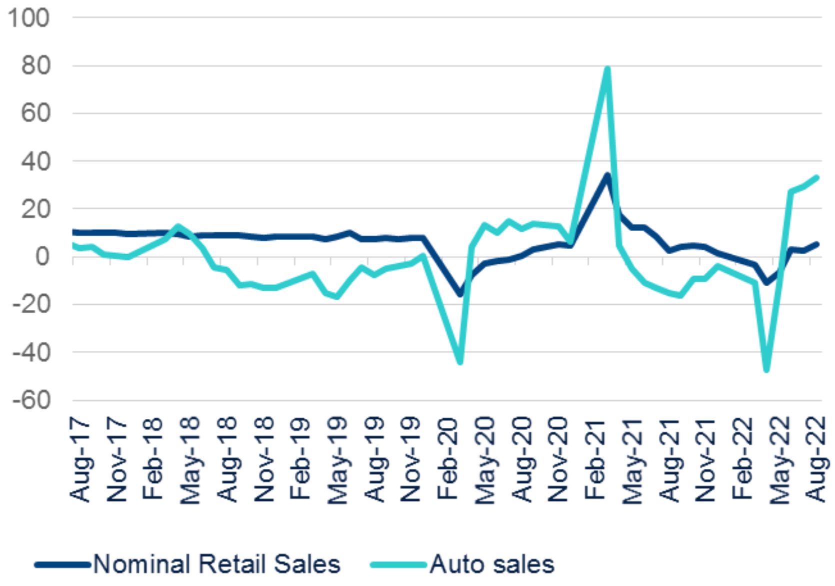


Source: CEIC and BBVA Research.

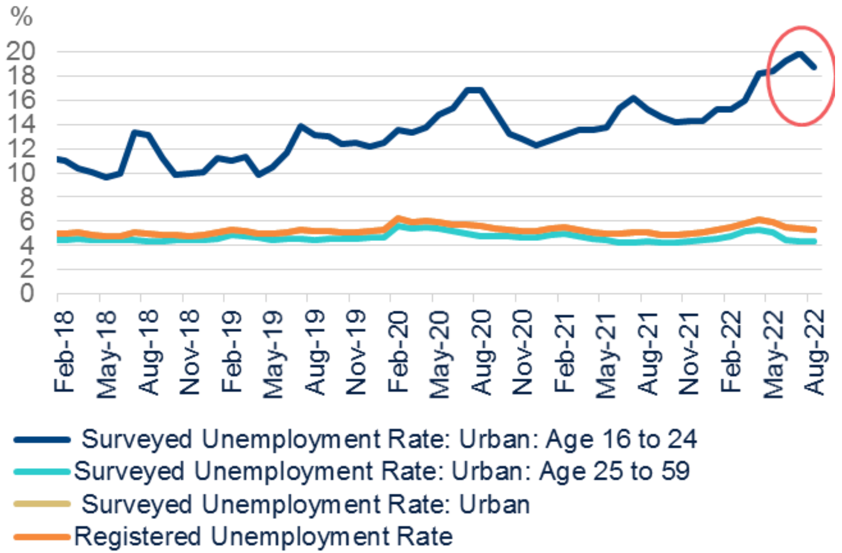
- Around 70 cities are in lockdown and semi-lockdown; recently, large cities such as Chengdu and Shenzhen locked down for at least 3 days.
- The market believes “Zero Covid” policy may bear some change after 20th National Congress of CCP and winter flu peak, but we expect the change will be very gradual and progressive.

Main risk 1: Retail sales lagged behind the supply side recovery due to the "Zero Covid", increasing unemployment and worsening income expectations

RETAIL SALES DECLINED AGAIN AFTER MAY'S BOUNCE, LAGGED BEHIND THE SUPPLY SIDE RECOVERY…



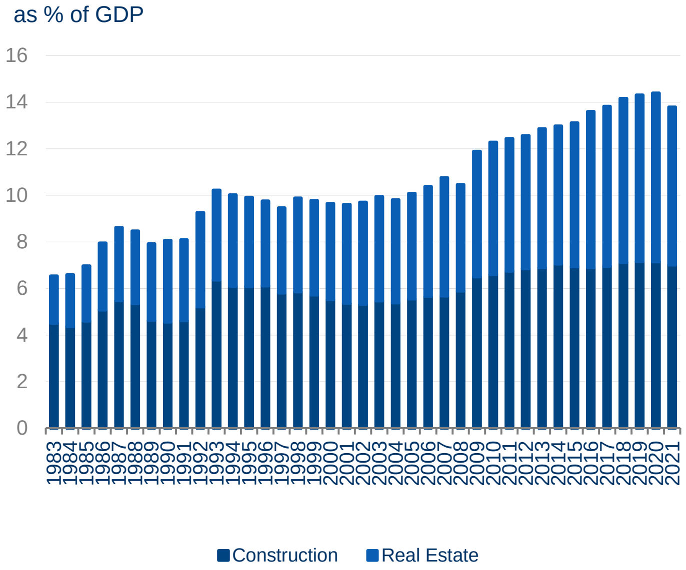
…DUE TO THE INCREASING UNEMPLOYMENT AND LOWER INCOME EXPECTATION; 16-24 AGE UNEMPLOYMENT IS EXTREMELY HIGH AT AROUND 20%



Source: CEIC and BBVA Research.

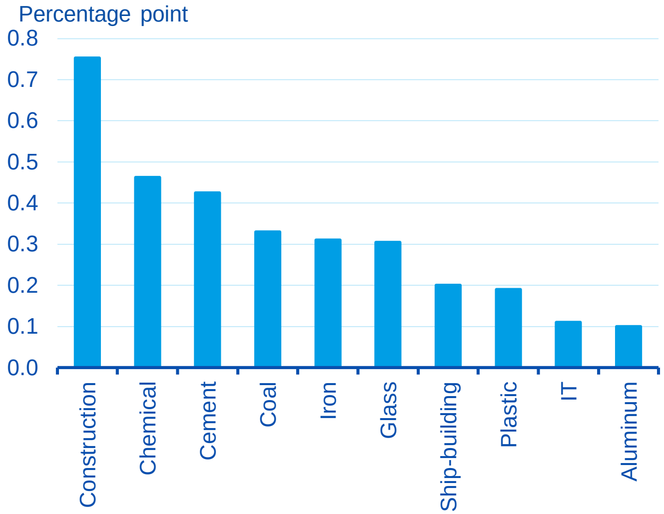
Main risk 2: Real estate crash dragged on growth and imposed financial stability risks to China (1)

IF ONLY CONSIDERING DIRECT EFFECT, HOUSING TAKES 14% OF TOTAL GDP; INDIRECT EFFECT IS AROUND 28-30%



Source: CEIC and BBVA Research.

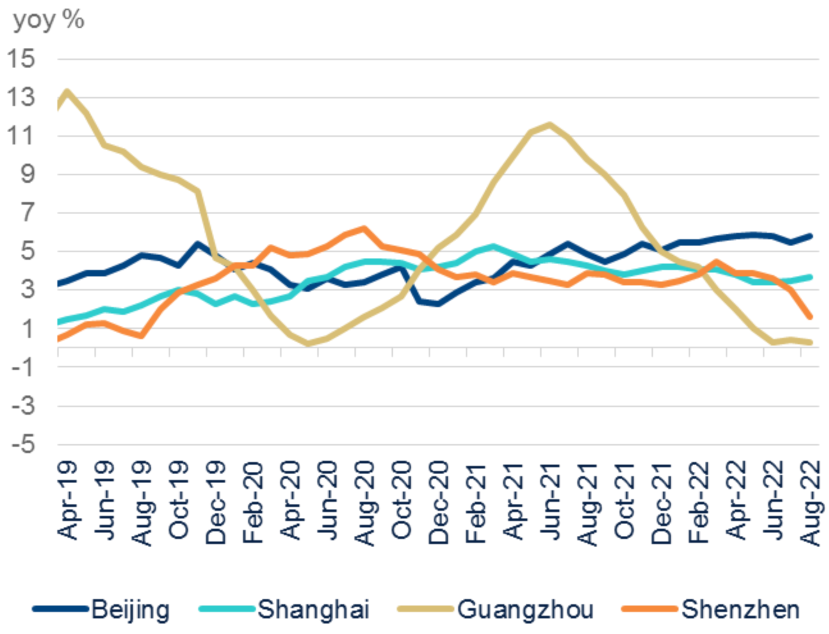
THE IMPACT OF 1 S.D SHOCK OF HOUSING PRICE CHANGE ON OTHER RELATED SECTORS BASED ON SVAR



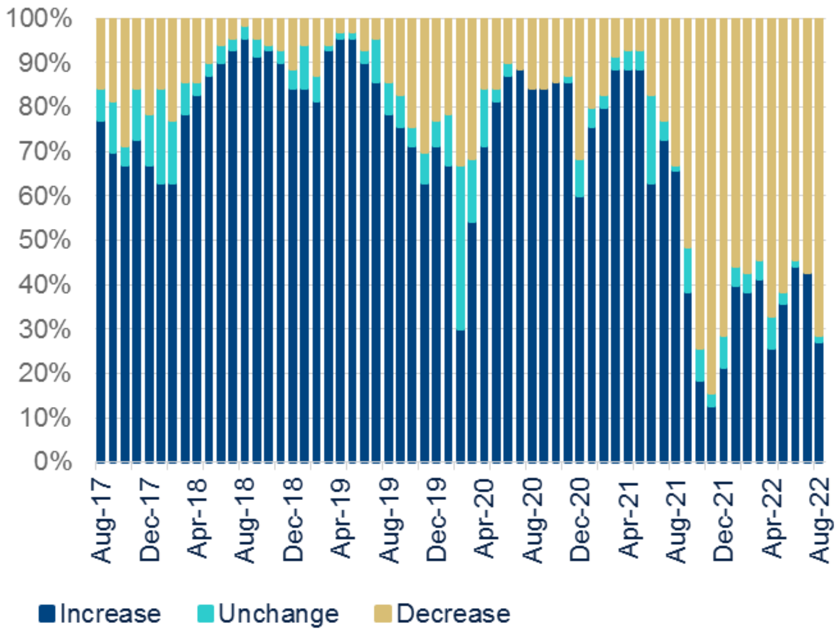
Source: Hong Kong Monetary Authority working paper and BBVA Research

Real estate crash dragged on growth and imposed financial stability risks to China (2)

HOUSING PRICES DROPPED DOWN IN MAIN LARGE CITIES



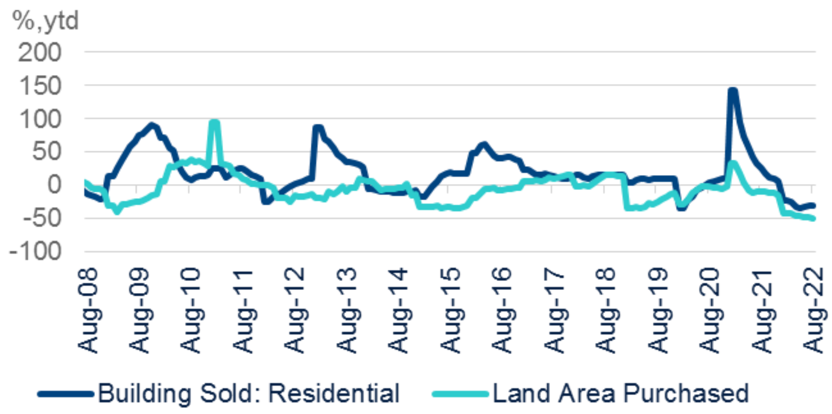
MORE AND MORE CITIES REPORTED HOUSING PRICE DECREASE



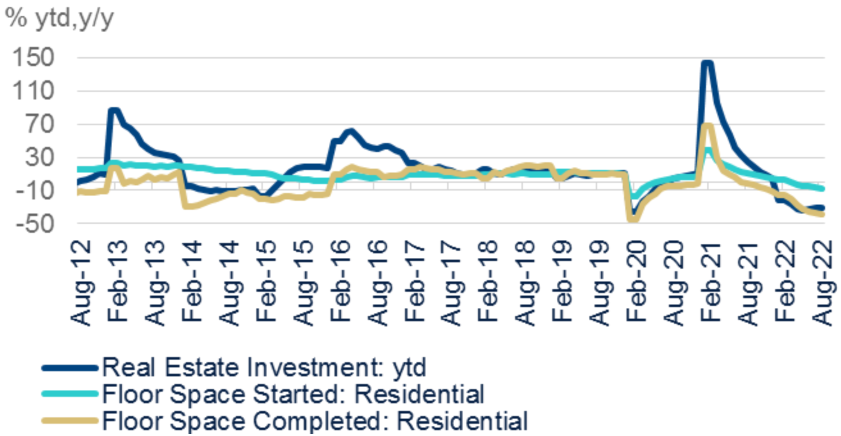
Source: CEIC and BBVA Research.

Main risk 2: Real estate crash dragged on growth and imposed financial stability risks to China (3)

LAND PURCHASED (3-QUARTER PRIOR INDICATOR) GROWTH HAVE BEEN NEGATIVE AROUND -50% FOR PAST MONTHS…



…SO DID FLOOR COMPLETED, BUILDING SOLD AND REAL ESTATE INVESTMENT WHICH STAYED AROUND -30% GROWTH



Source: CEIC and BBVA Research

- As a high leverage industry, without the continuous support of housing sales, together with the “three red lines” on developers’ lending behaviour imposed in 2021, it is almost certain the developers’ default risk is on the rise.
- A historical low land area purchased growth (3-quarter leading indicator) implies more and more private developers may exit the market, imposing long-term risk for economic growth.

Main risk 2: Real estate crash dragged on growth and imposed financial risks to China (4)

A summary of the recent real estate risks:

I. Mortgage boycotts reached around 300 properties.

II. The percentage of default developers increased from around 3% in Evergrande case in June 2021 to 15% now.

III. By end-July 2022, 26.5% of private developer-issued bonds in the domestic markets are defaulted, amount to 100 USD billion;

IV. More than USD 25 billion of developer-issued bonds defaulted in the offshore market over the past two years, which has de facto blocked the overseas funding for Chinese property developers.

V. Real estate crash also spilled over to banking sector, as some village banks went bankruptcy.

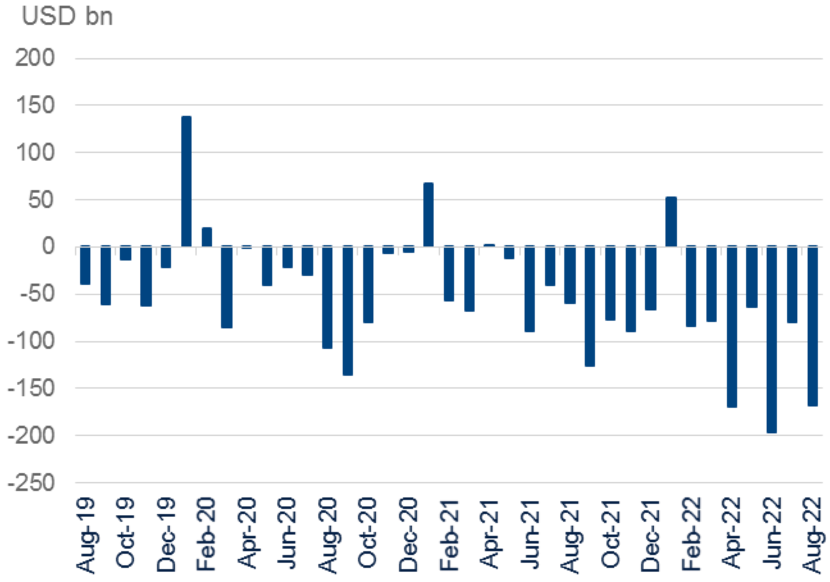
Main risk 2: Real estate crash dragged on growth and imposed financial risks to China (4)

Reasons and solutions:

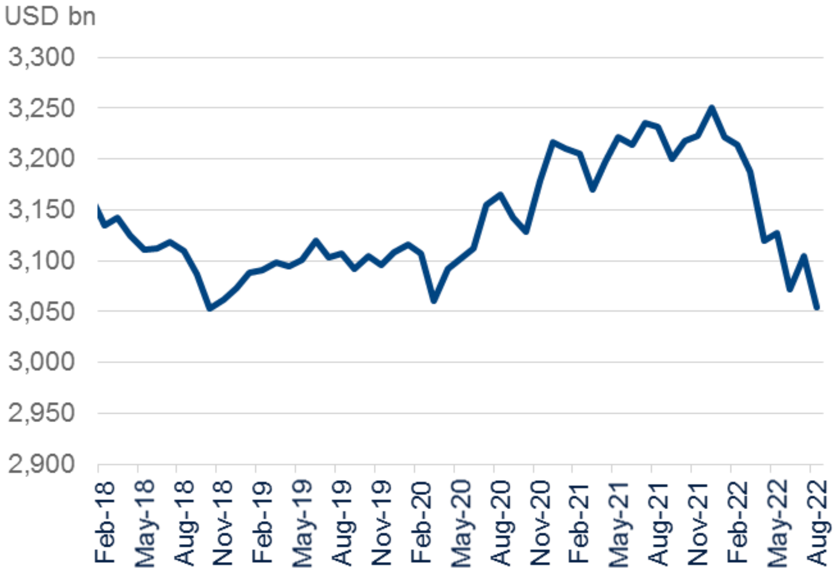
- Chinese authorities cracked down the housing market in 2021, taking use of the precious time-window to press ahead “common prosperity” and regulatory reforms.
- As long as the housing price increase expectation (lasted for the past 20 years) is broken, it is difficult to re-build market sentiments, no matter how low the interest rate is.
- Lower income expectation and high unemployment rate particularly in age 16-24 group (20%), significantly deteriarate house demand.
- Although the authorities eased housing policy from demand and supply side, as the principle of “housing is to live not to speculate” remains, a soft-landing will take some time.
- Solutions: Many measures have been taken for defaulted developers: debt restructuring, to sell quality assets to pay back the debt, bankruptrcy liquidation, equity transfer etc. Monetary policy also plays some role by cutting 5-year LPR, but could not be the only tool.
- A coordinated policy interventions by different ministers and departments should be implemented to secure a soft-landing.

The fastest pace of capital outflows stem from the spillover effect of FED aggressive tightening measures

ACCELERATING CAPITAL OUTFLOWS AMID US ARRESSIVE TIGHTENING AS CAPITAL IS "SEARCHING-FOR-YIELD"



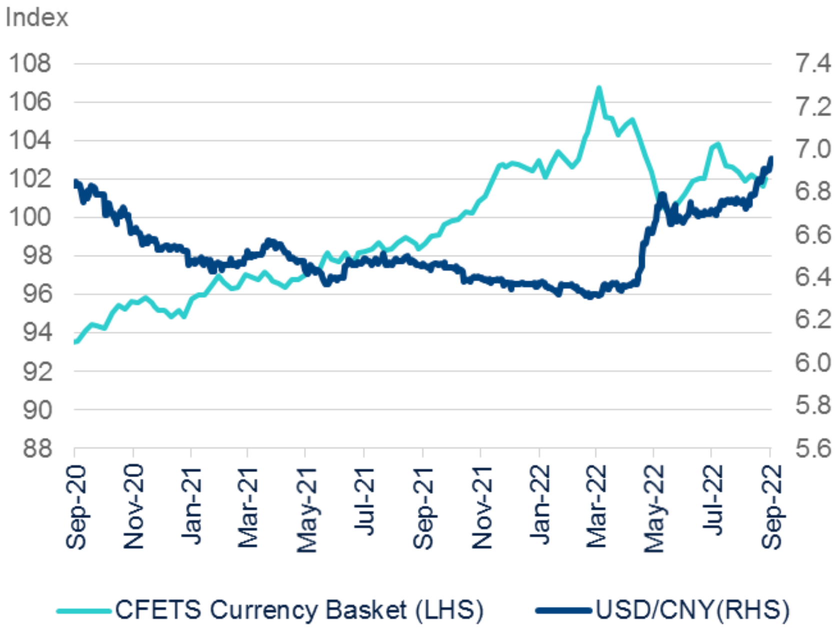
FOREIGN RESERVES TRENDED DOWN RECENTLY AMID TRADE BALANCE SHRINKING AND PORTFORLIO OUTFLOWS (USD BN)



Source: CEIC & BBVA Research.

RMB to USD exchange rate is set to depreciate due to the diverging monetary policy between China and the US (1)

RMB EXCHANGE RATE RECENTLY BROKE THE PSYCOLOGICAL LEVEL OF 7

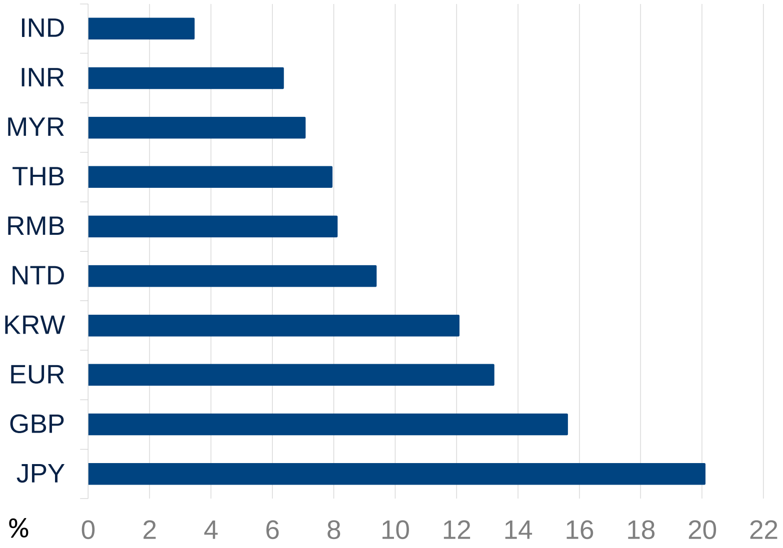


Source: CEIC & BBVA Research.

- The bottom line is there will not be a sharp depreciation risk for RMB after the authorities gave up the 5.5% growth target which indicates there won’t be a deluge of massive monetary stimulus and suggests the authorities' concern of financial stability.
- Amid the FED hike cycle, capital flows for China depend more on China's long-term economic fundamentals (“zero-Covid” progress, economic recovery, 20th CCP Congress etc.) instead of the temporary reversion of China-US bond yields.
- The total foreign capital for China's bond and stock takes account for a very limited proportion of total market value (bond 3% and stock 5%), and since China has an almost closed capital account, portfolio flows are subject to limited quotas such as QFII, Shanghai-HK Connect etc. RMB may not be determined by capital flows as much as other EMs.
- From the natural interest rate perspective in a longer term, as in the general equilibrium a country's natural interest rate should be equivalent to its natural growth rate. China's potential growth is higher than the US (China 4-4.5%, US around 2%), providing a justified support for long-term attractions for capital inflows.

RMB to USD exchange rate is set to depreciate due to the diverging monetary policy between China and the US (2)

AMONG THE MAIN AM AND EM CURRENCIES, RMB DEPRECIATED MODESTLY SINCE JANUARY 2022



Source: CEIC and BBVA Research.

- Depreciation pressure is not only for RMB, but for all EM currencies AM currencies that have a slower pace of rate hike than the FED (JPY, GBP, Euro etc.) , and among all EM currencies, RMB probably depreciated modestly due to capital control measures.
- We predict RMB to USD exchange rate will be tightly related to USD DXY trend. Based on our forecast of FED interest rate hike path, RMB will depreciate to 7.1 at end-2022, 7 at end-2023 and 6.9% at end-2024.

Research

03

China’s unsynchronized policy with the main economies

Creating Opportunities

Main messages

No deluge of massive stimulus

Monetary and fiscal policy remain easing stance but is anticipated to become more prudent to avoid a deluge of massive stimulus after the authorities gave up the 5.5% growth target which was set in 2022 “Two Sessions” before Shanghai lockdown.

Monetary policy

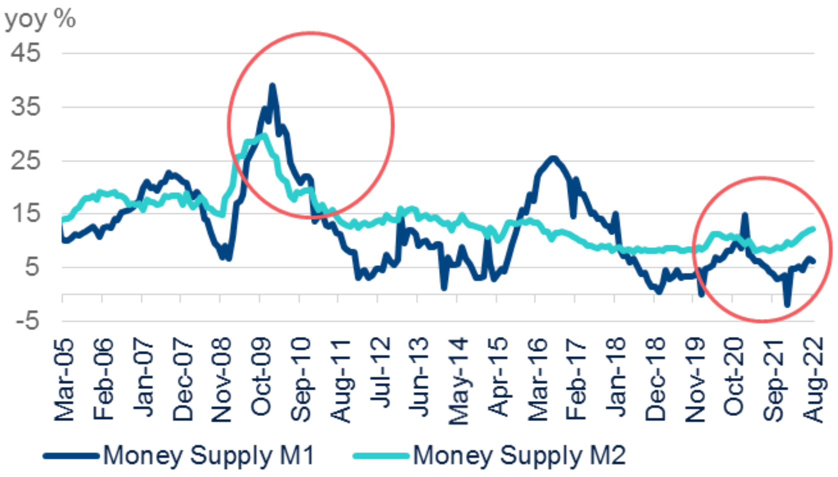
Following 3 RRR cuts and 2 LPR cuts, the PBoC again cut MLF, Repo rate in August by 10 bps and cut one-year by 5 bps and five-year LPR by 15 bps asymmetrically. But the cut does not suggest a start of a massive easing cycle amid the FED hike, as the PBoC has to closely monitor RMB exchange rate and capital outflows. Monetary policy will be more relying on quantity tools, such as RRR cuts and targeted easing measures.

Fiscal policy

Fiscal policy focuses on local government bond issuance; the quota was used up in 1H to support infrastructure investment with the total amount of RMB 5.25 trillion; larger-scale tax cuts and fee reduction to RMB 2.5 trillion; social insurance payment postponed and State’s Financing Guarantee Fund expansion, etc.

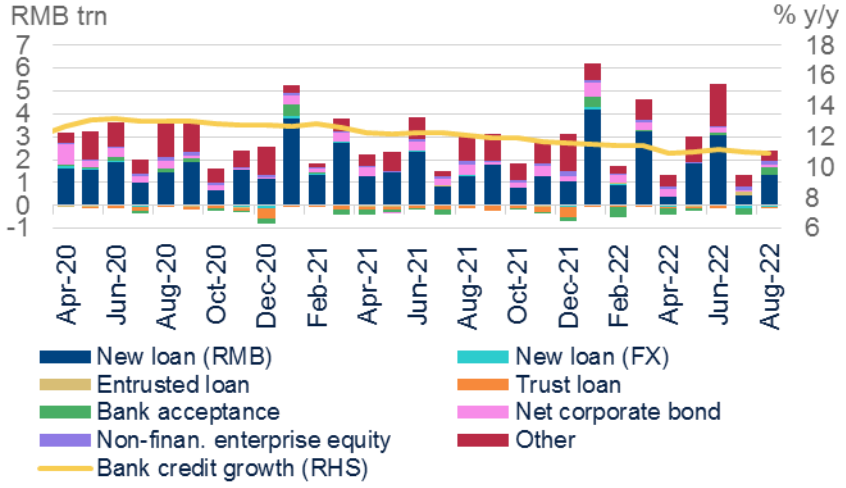
Easing monetary policy to accommodate growth, but not stimulus "*at all costs*" due to shrinking policy room and financial stability concern amid FED hike

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



Source: CEIC and BBVA Research.

DESPITE OF INTEREST RATE CUT, DUE TO WEAK MONETARY TRANSMISSION, CREDIT DATA REMAIN LACKLUSTER

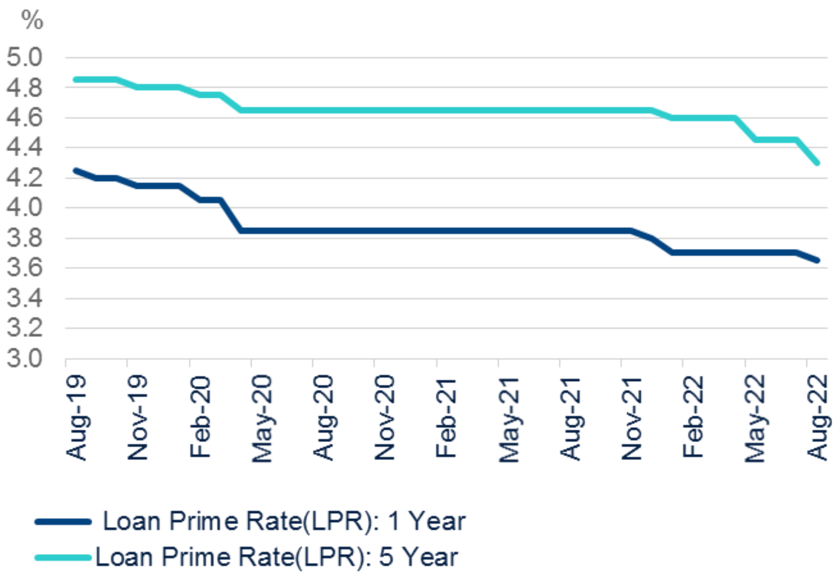


Source: CEIC and BBVA Research.

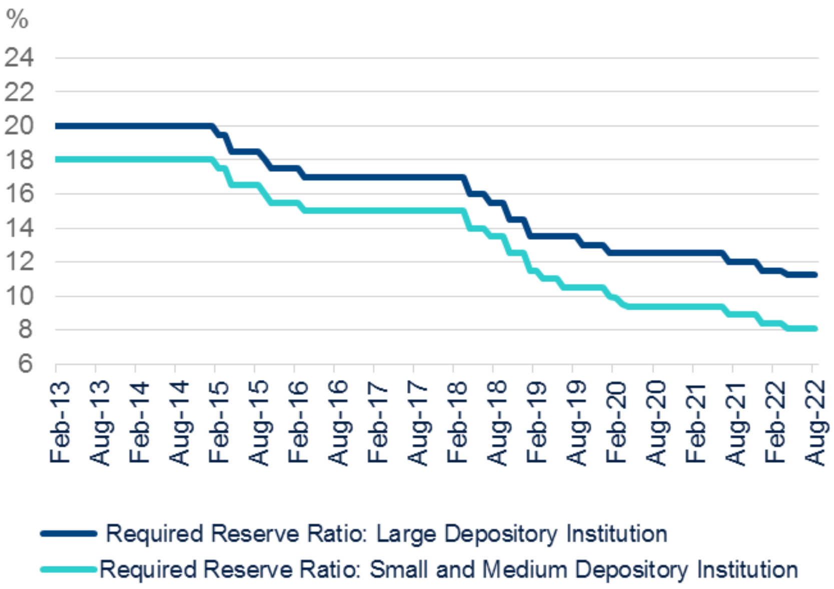
Although the PBoC cuts policy rate In August, credit data remained weak because of balance sheet "recession": enterprises and households significantly lowered their credit demand due to weak sentiments amid growth slowdown.

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

THE PBOC UNEXPECTEDLY CUT LPR ASYMMETRICALLY IN AUGUST: 1-YEAR LPR CUT BY 5 BPS WHILE 5-YEAR LPR CUT BY 15 BPS



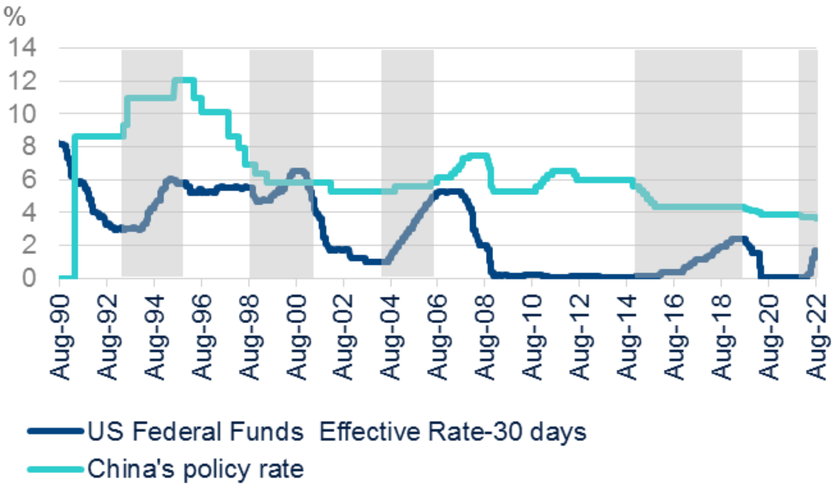
EXCEPT FOR THE RECENT THREE RRR CUTS, 1-2 MORE RRR CUTS ARE ANTICIPATED IN THE REST OF YEAR (%)



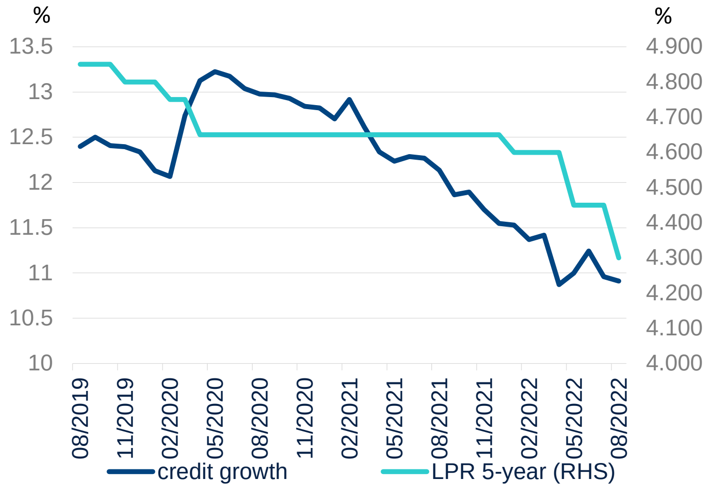
Source: CEIC & BBVA Research.

The PBoC needs to cautiously monitor RMB exchange rate, capital outflows and inflation to consider the possibility of future interest rate cuts

IN HISTORY, CHINA HAS NEVER CONDUCTED CONTINUOUS RATE CUTS DURING THE FED HIKE CYCLE



CHINA'S "LIQUIDITY TRAP": A LOWER LPR COEXISTS WITH A DIPPING CREDIT GROWTH FOR 13 MONTHS

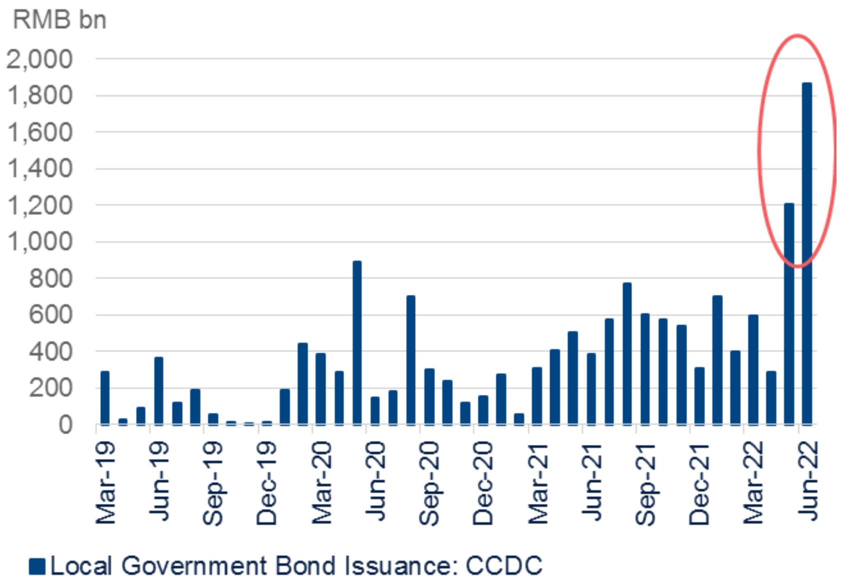


Source: CEIC & BBVA Research.

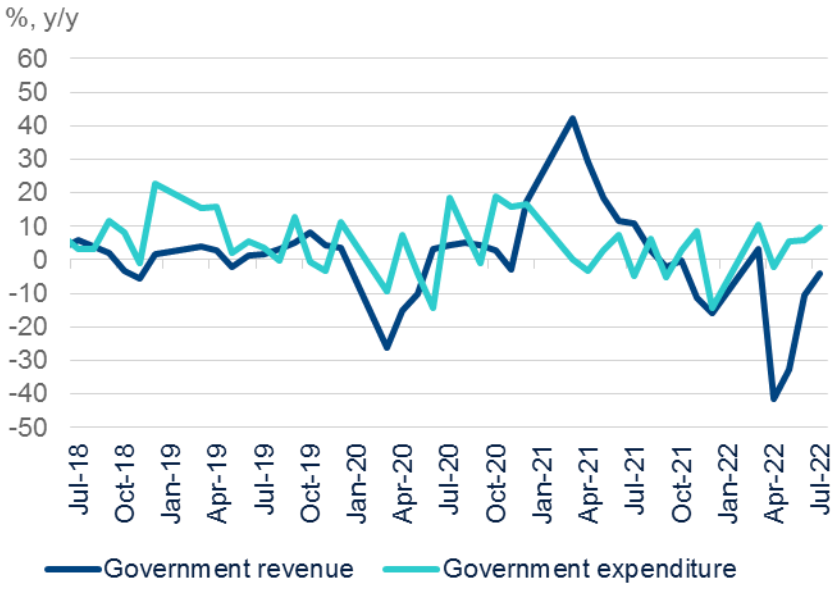
The interest rate cut in August does not suggest a start of massive monetary easing cycle; we expect at most one more cut in rest 2022 amid FED interest rate hike.

Fiscal stimulus focus on local government bond issuance to support infrastructure investment

THE AUTHORITIES HAVE USED UP THE LOCAL GOVERNMENT BOND ISSUANCE QUOTA IN 1H 2022 TO STIMULATE INFRASTRUCTURE INVESTMENT



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 & BBVA Research.

Measures of the fiscal stimulus

Local government bond issuance to support infrastructure investment is the main direction of fiscal stimulus at the current stage.

Issued all of 2022 local government bond quota in 1H 2022 with total amount RMB 5.25 trillion for funding infrastructure investment which used to be the main growth engine for Chinese economy.

To expand tax reduction to RMB 2.64 trillion for 2022 (RMB 140 billion expansion), particularly for SMEs, pandemic-hit enterprises;

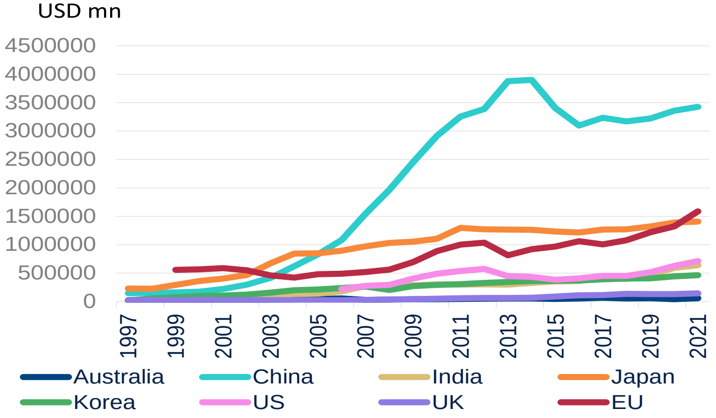
To postpone social insurance payment for pandemic-hit SMEs with financial difficulties to year-end, with the total amount of postponed payment at RMB 320 bn.

To expand State’s Financing Guarantee Fund to RMB 1 trillion to support SME financing.

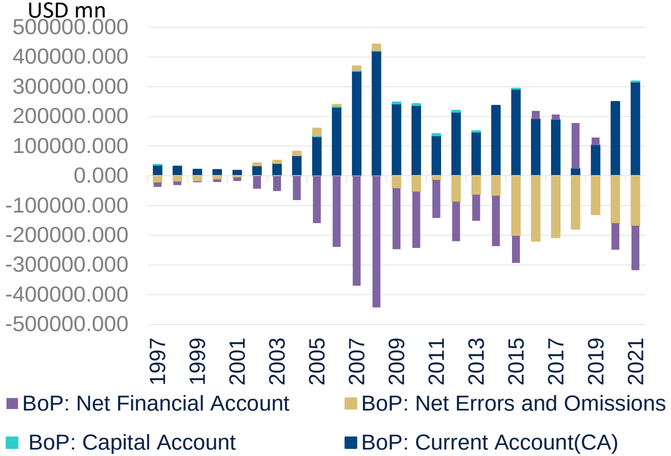
To promulgate 19 new policies to facilitate infrastructure investment and to issue RMB 300 bn bond through China Development Bank to support infrastructure projects.

Amid escalating geopolitical conflicts, what is China's optimal foreign reserve level? (1)

SINCE 2006, CHINA HAS HELD THE LARGEST AMOUNT OF FOREIGN RESERVE IN THE WORLD FOR THE PAST 16 YEARS…



…LED BY CHINA'S "TWIN SURPLUS" IN BOTH CURRENT AND CAPITAL ACCOUNT



Source: CEIC & BBVA Research.

- China has long-term ideological and technology confrontations with US. The recent Pelosi's visit to Taiwan further escalated China-US conflicts;
- Financial sanctions of western countries to Russia raised a lot of concerns of China's financial security, particularly on the potential freeze of China's foreign reserve, as large proportion of China's reserve is US bond.

What is China's optimal foreign reserve level? (2)

Category of demand	Composition: the optimal foreign reserve coverage	Linked to Chinese data (2021)
Payment demand	Coverage of 3 months' worth of imports	USD 714.1 billion
	Coverage of 100% short-term foreign debt	USD 1,128.9 billion
	Coverage of the profits of FDI to be remitted to foreign countries	USD 102.2 billion
	Coverage of total amount of ODI	USD 34.29 billion
	Coverage individual and household demand for foreign currency exchange for paying for outbound tourism and education etc.	USD 94.4 billion
Precautionary demand	To stabilize exchange rate volatility: (i) the regular routine intervention to FX markets, indicated by 10% of RMB total onshore transactions of interbank and over-the-counter business.	The total RMB onshore transaction amount is around USD 20 billion, 10% of which is USD 2 billion.
	To stabilize exchange rate volatility: (ii) the emergency demand for FX market intervention.	USD 100 billion is widely deemed to be enough to stabilize the FX market to avoid sharp currency depreciation in Russia currency crisis and HKD crisis in 1997;
	Preparing for external shocks to the domestic stock and bond markets: to cover the volume equivalent to all portfolio investment outflows from China, i.e. the total liabilities of China's stock and bond market.	USD 517.7 billion till end-2021 (around 5% of China's total market value of stock and bond market)

Based on the above metrics, we could get the conclusion that China's optimal foreign reserve level as of end-2021 is around USD 2,693.59 billion, which is USD 734.31 billion lower than the actual foreign reserve level at USD 3,427.9 billion at end-2021.

What is China’s optimal foreign reserve level? (3)

Except for reducing foreign reserve level to mitigate the potential risk, to diversify foreign reserve asset allocation and reduce USD-denominated assets is also an option; and China is in the progress of doing so.

The USD-denominated assets’ share to China’s total foreign reserve has declined significantly from 79% in 1995 (vs. global average of 59% in 1995), to lower than 60% in 2014-2016 (vs. 65% global average in 2014-2016);

Till end-June 2022, US bonds in China’s foreign reserves portfolio has been decelerating for 7 consecutive months, to USD 967.8 billion, the lowest amount for the past 12 years; the US bond only counts for around 26.9% of China’s total foreign reserve now.

However, to diversify China’s foreign reserve allocation highly depends on the evolution of global monetary system and of RMB internationalization. Together with the foreign reserve currency diversification among most economies in the world amid the trend of global monetary system de-dollarization, we foresee a more diversified foreign reserve composition but still with USD dominated in China’s foreign reserve portfolio in the foreseeable future.

05

Projections

Main messages

Growth

We lowered our 2022 GDP forecast significantly from 4.5% previously to 3.6% considering the recent bumpy recovery after Shanghai lockdown and housing market crash. (IMF: 3.3%, Bloomberg consensus: 3.4%). We maintain 2023 GDP forecast at 5.2%.

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 accelerating of pork price with the start of a new "pork cycle", and a trending-down PPI as China absorbed Russia's commodity exports to expand its commodity reserve together with a dipping global commodity price.

Interest rate

We predict at most one more one-year LPR cut in the rest of the year, leading this policy rate to 3.6% at end-2022 and expect 1-2 more RRR cuts in the rest of 2022.

RMB Exchange rate

RMB to USD exchange rate is anticipated to depreciate to 7.1 at end-2022 reflecting the recent interest rate cut and the recent breaking-7 trend, amid the diverging monetary policy between China and the US, a stronger USD DXY, slower exports, and capital outflows etc.

Forecast: China’s main economic indicators

	Baseline scenario				
	2019	2020	2021	2022	2023
GDP （%）	6.1	2.3	8.1	3.6	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	7.1	6.9

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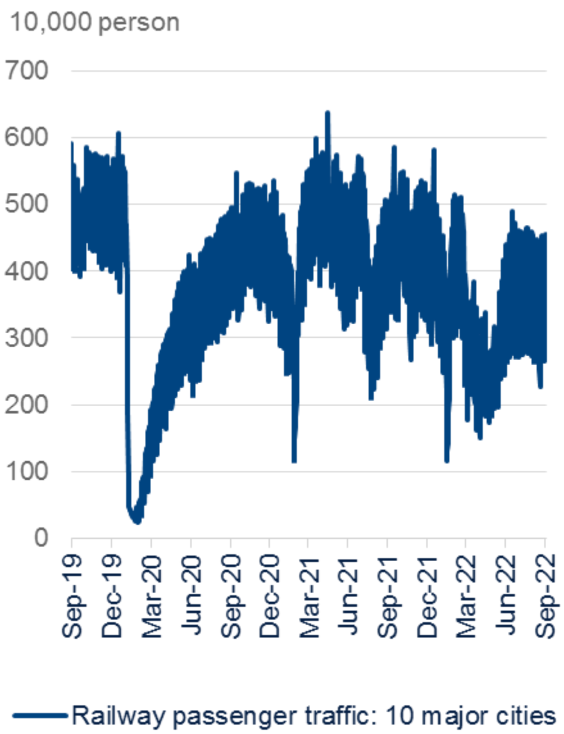
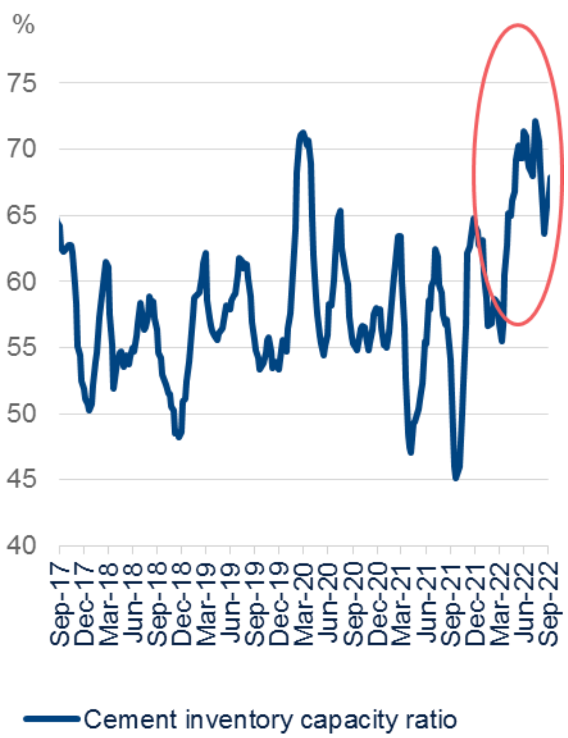
Appendix

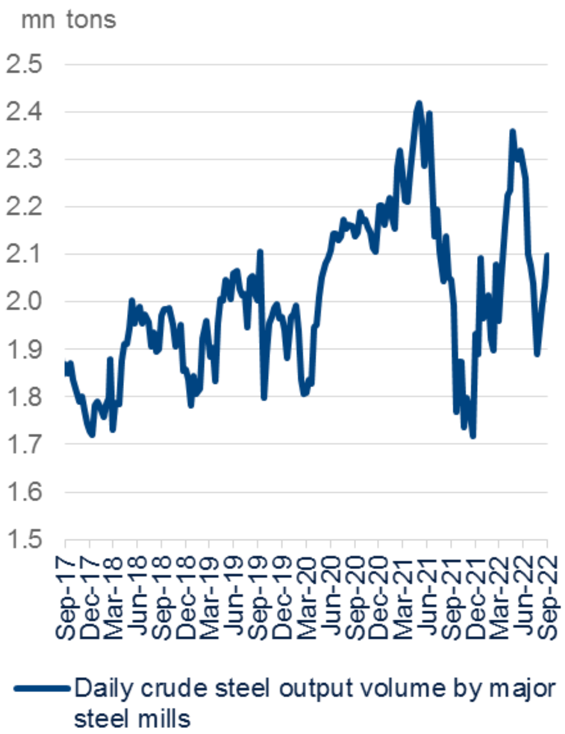
High frequency data tracker also pointed to a bumpy recovery from Shanghai lockdown (1)

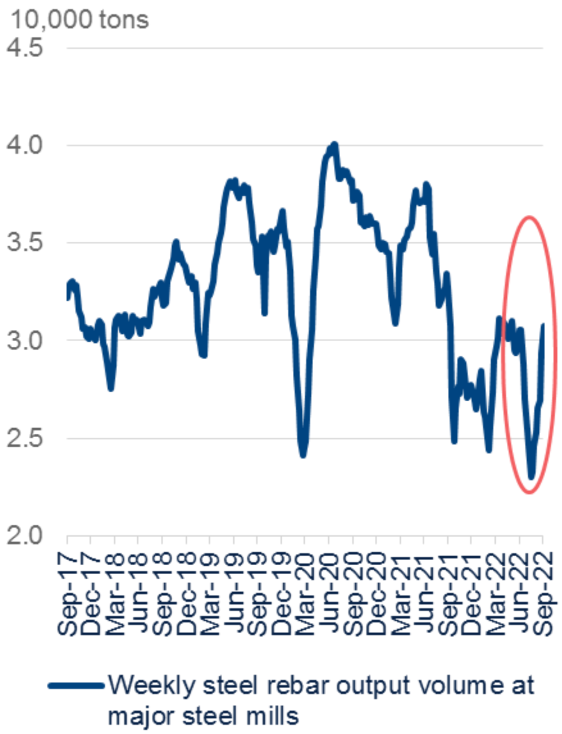


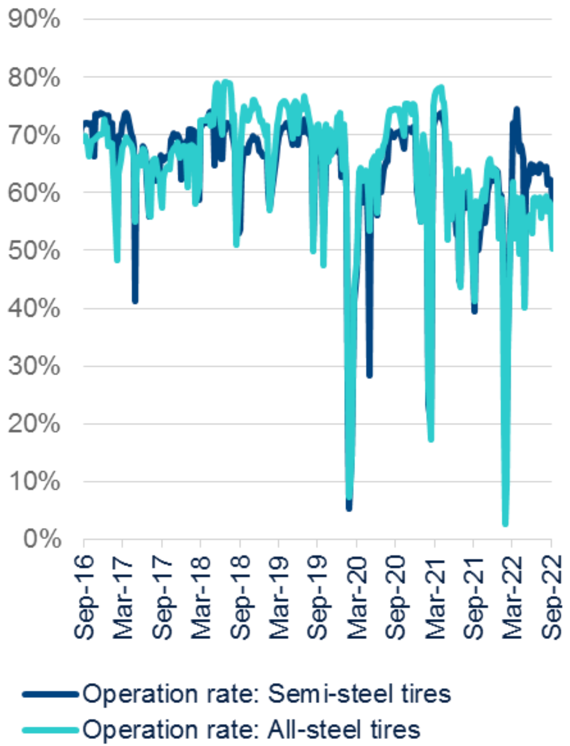


Source: WIND and BBVA Research.

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

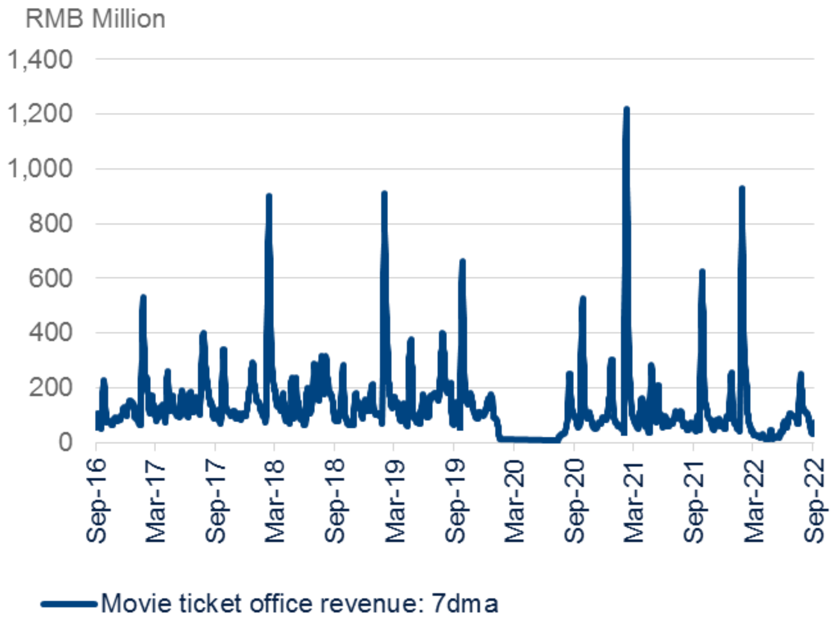


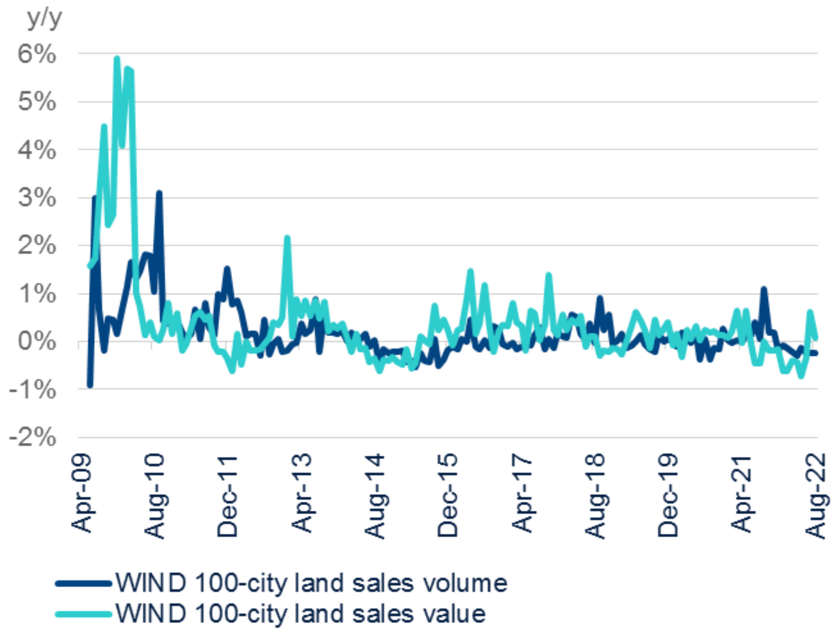




Source: WIND and BBVA Research..

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





Source: WIND and BBVA Research.

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China Economic Outlook

October 2022

Creating Opportunities