Research

China Economic Outlook

December 2022

Creating Opportunities

BBVA Research

01

Global economy: recession risk on the rise

Main messages

Economic activity

Economic activity is expected to lose steam over 2023. Global growth is forecast to reach 2.3% in 2023 -an unusually low level- after having grown 6.3% in 2021 and around 3.3% in 2022. Aggressive monetary tightening coupled with still significant price pressures, amid a war in Ukraine and increasing hurdles to free-trade, will likely weaken labor markets and private consumption, which have been holding up relatively well so far. Uncertainty is high and risks are tilted to the downside: a sharper-than-expected activity deceleration could pave the way for a global recession.

Inflation

The ongoing easing of commodity prices and bottlenecks reinforces the prospects that inflation will slow down ahead, favored by positive base effects. In the US, actually, inflation is already falling. Although, in the Eurozone, price pressures continue to build, inflation is still expected to soon peak, assuming that expectations and second-round effects remain under control. Still, inflation will remain well above targets, at least throughout 2023. Risks of more persistent price increases remain alive.

Monetary policy

The interest-rate hiking cycle is likely to come to an end in early 2023, both in the US and the EZ. Policy rates are forecast to converge to around 5% in the former and 2.75% in the latter. However, there will be scarce room for monetary easing till the end of 2023. Moreover, a quantitative tightening is set to remain in place in the US and to be launched next year in the EZ.

Financial volatility

Declining global liquidity, high interest rates and dollar strength could continue spurring volatility and significant corrections in financial markets. Stress episodes, such as those recently observed in the UK and in crypto markets, and even a financial crisis could emerge ahead, specially if inflation and interest rates end up being higher than expected.

Economic activity has weakened throughout 2022, amid high inflation, sharp monetary tightening and financial volatility, while still exhibiting resilience

RECENT DEVELOPMENTS IN THE WORLD ECONOMY

EASING BUT STILL RESILIENT GROWTH

Easing growth on monetary tightening, price pressures, effects of the war and covid in China.

But activity has shown resilience: robust labor markets, (declining) reopening effects.

SHARP MONETARY TIGHTENING

Fed: has started a quantitative tightening and sharply hiked interest rates, but monetary tightening has still some way to go.

ECB: rates are moving up, bank lending conditions have been tightened and a quantitative tightening is being prepared.

China: moderately expansionary policies.

HIGH INFLATION

US inflation is trending down as commodity prices and bottlenecks ease and interest rates move up.

In Europe, pressures continue to build up amid more widespread and frequent price rises.

Expectations remain broadly under control, also in China, where inflation remains relatively low.

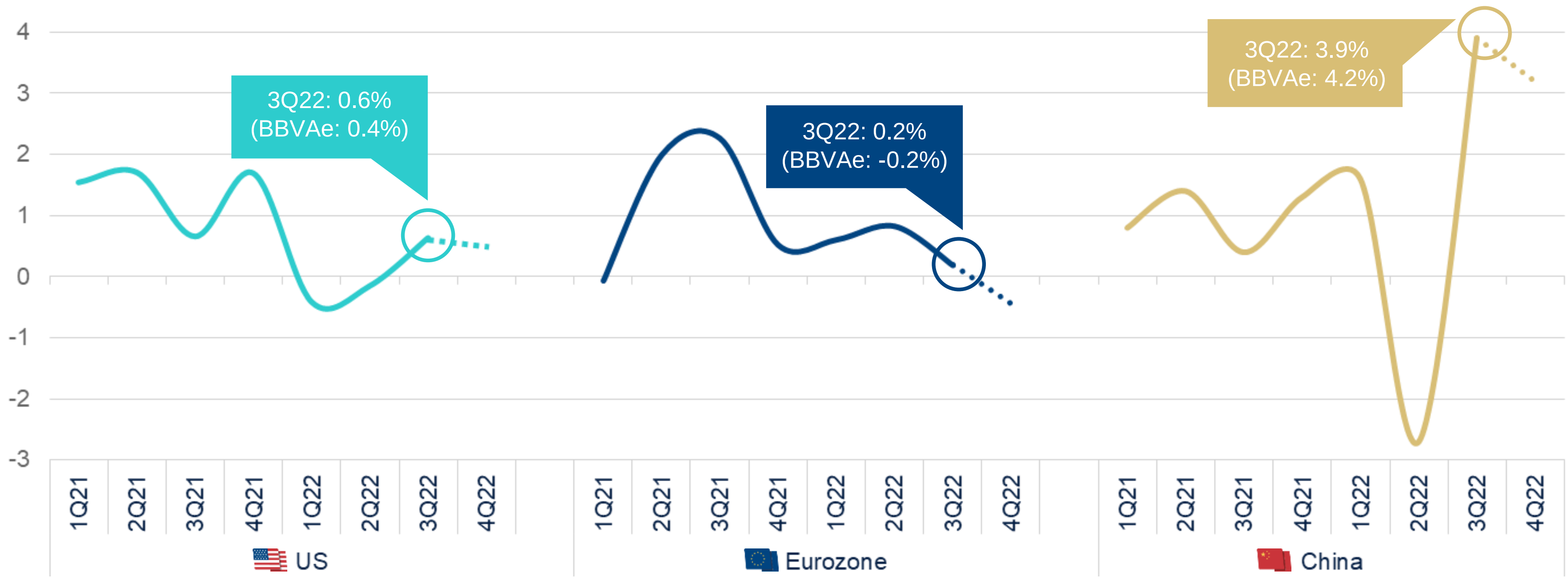
FINANCIAL VOLATILITY

Declining liquidity, higher rates and dollar strength have sparked volatility and corrections across financial markets and countries.

Financial turmoil has emerged in some specific cases,
such as in the UK and in crypto markets.

Growth has lately surprised upwards in the US and the EZ, despite the negative trend, and downwards in China, mostly due to covid and real estate tensions

GDP GROWTH (*)
(QOQ %, SEASONALLY ADJUSTED)

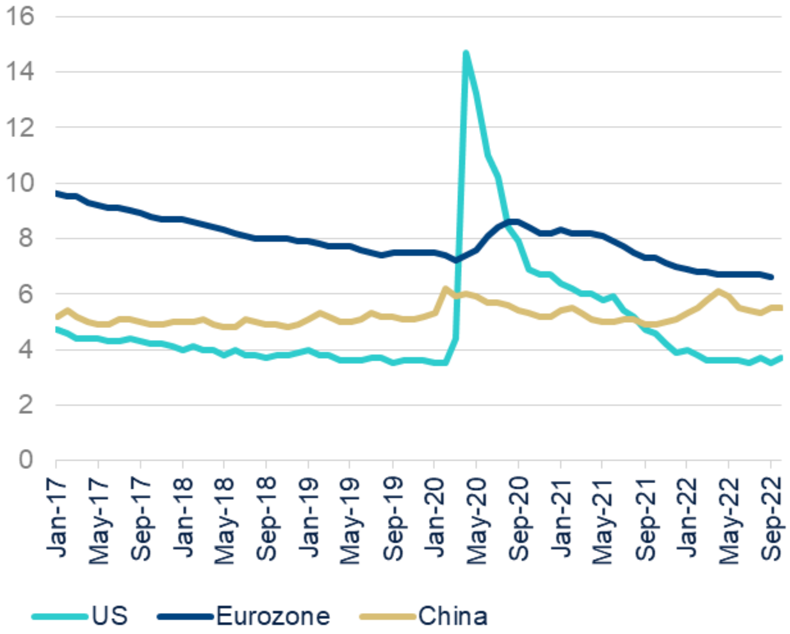


(*): BBVA Research estimates for the 4Q22
Source: BBVA Research based on data from Haver.

The labor market strength and the (fading) effects of the post-covid reopening continue to support private consumption in the US and in the Eurozone

UNEMPLOYMENT RATE

(%)

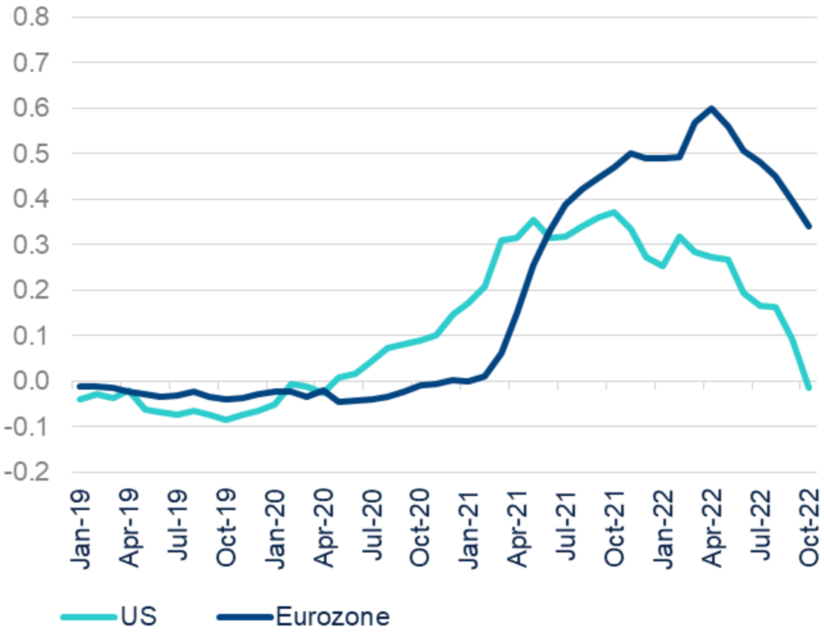


Source: BBVA Research based on data from Haver.

- Tight labor markets, mainly the US: unemployment is at record-low levels, job vacancies remain very high and wages are growing at a faster pace (but below inflation).
- Accumulated savings and pent-up demand seem to be still supporting demand, although at a declining pace.
- Private consumption has been holding up well, better than investment, despite easing signs: it grew 0.5% QoQ in 2Q22, 0.3% QoQ in 3Q22 in the US; 1.0% QoQ in 2Q22 in the Eurozone.
- In China, domestic demand shows a relatively downbeat tone given covid concerns and property markets tensions.

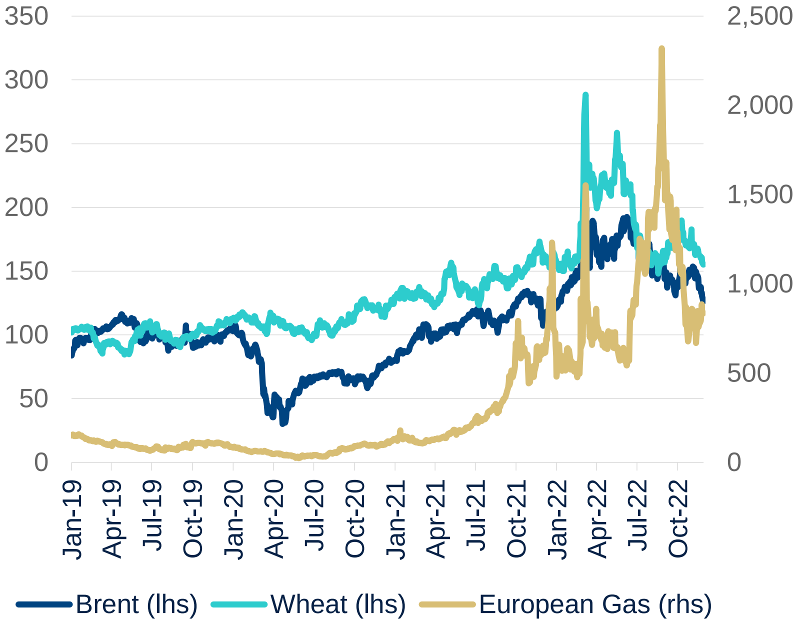
Growth slowing has contributed to easing bottlenecks and commodity prices; gas prices have fallen on high reserves and saving measures in the EU

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



Source: BBVA Research

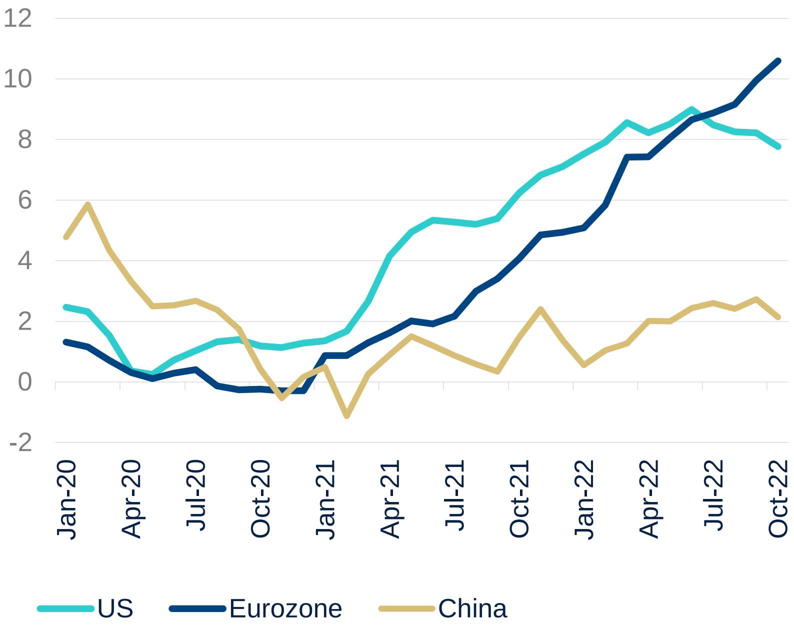
COMMODITY PRICES
(INDEX: 2019 AVERAGE = 100)



Source: BBVA Research based on data from Bloomberg

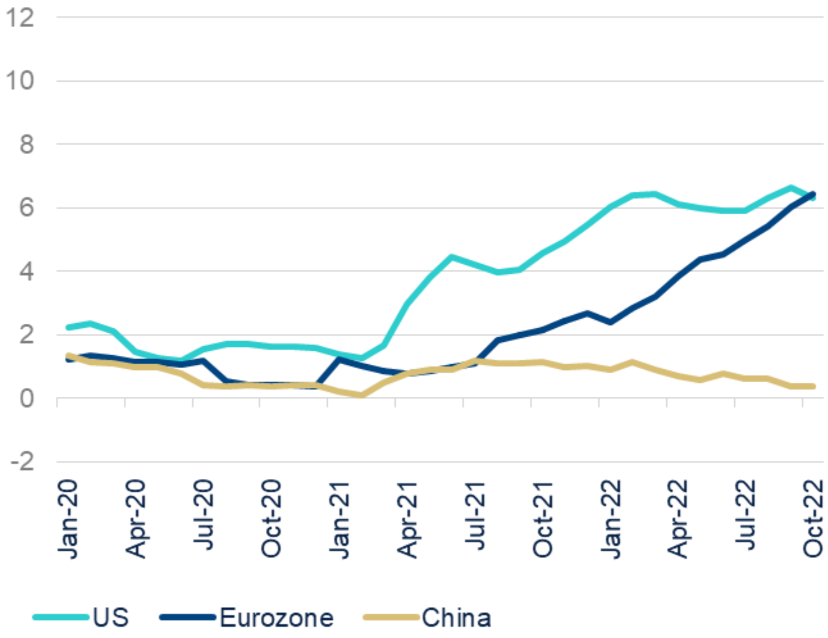
Inflationary pressures have continued to build in the Eurozone, started to recede in the US and remained under control in China

INFLATION: CPI
(Y/Y %)



Source: BBVA Research based on data from Haver.

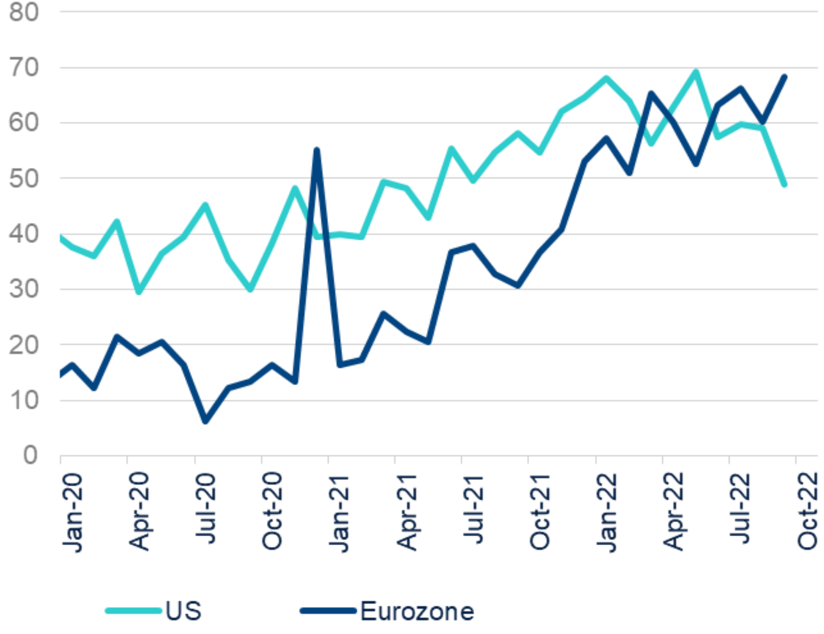
CORE INFLATION: CPI
(Y/Y %)



Source: BBVA Research based on data from Haver.

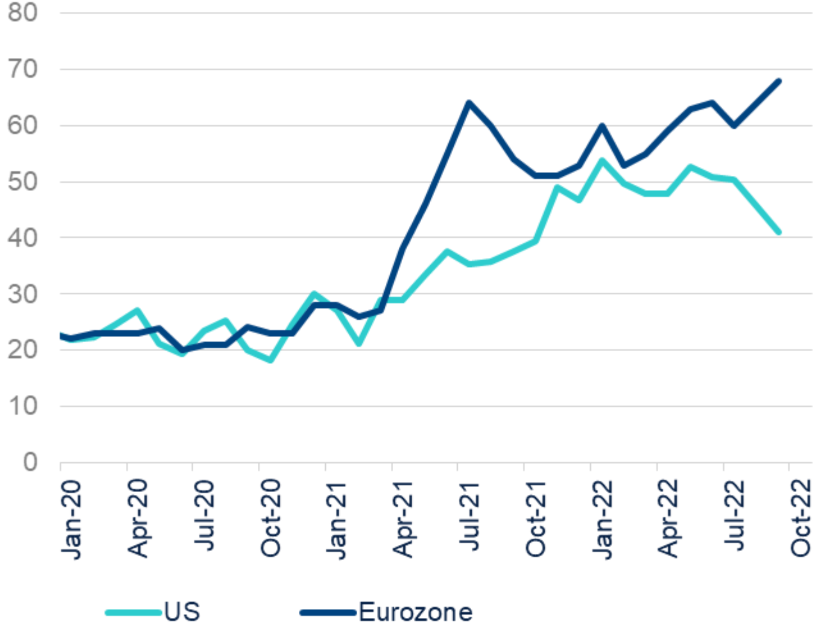
Price adjustments are still becoming more widespread and more frequent in the Eurozone, while the situation continues to improve in the US

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)

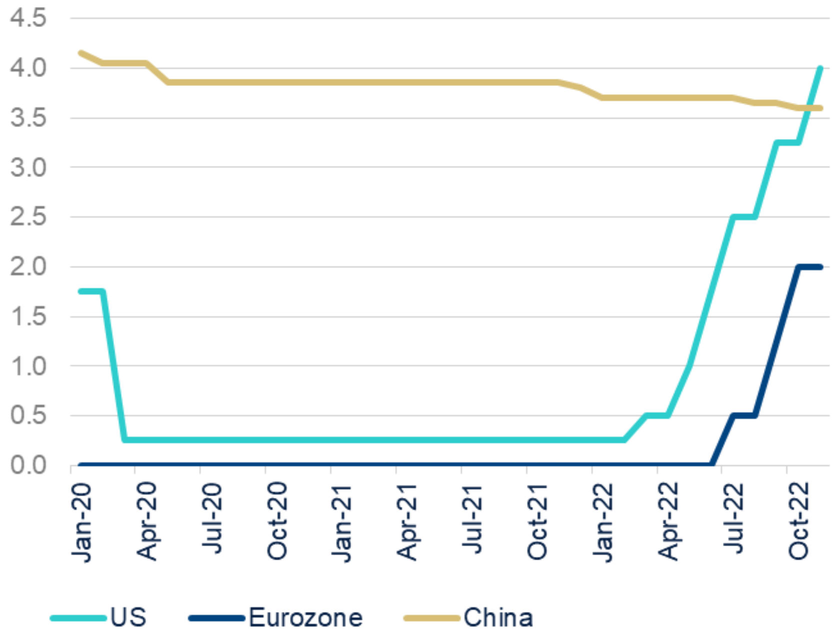


Source: BBVA Research based on local statistics.

Policy rates are high and still rising; market rates have stabilized recently on prospects of a less hawkish Fed following lower inflation in the US

POLICY INTEREST RATES

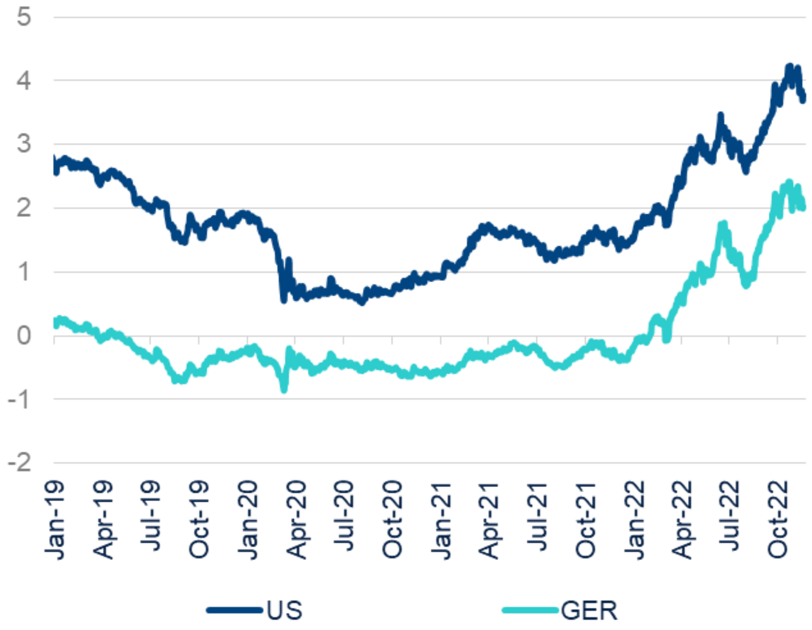
(%, END OF PERIOD)



Source: BBVA Research based on data from Haver.

MARKET INTEREST RATES: US AND GERMANY 10-YEAR BOND YIELDS

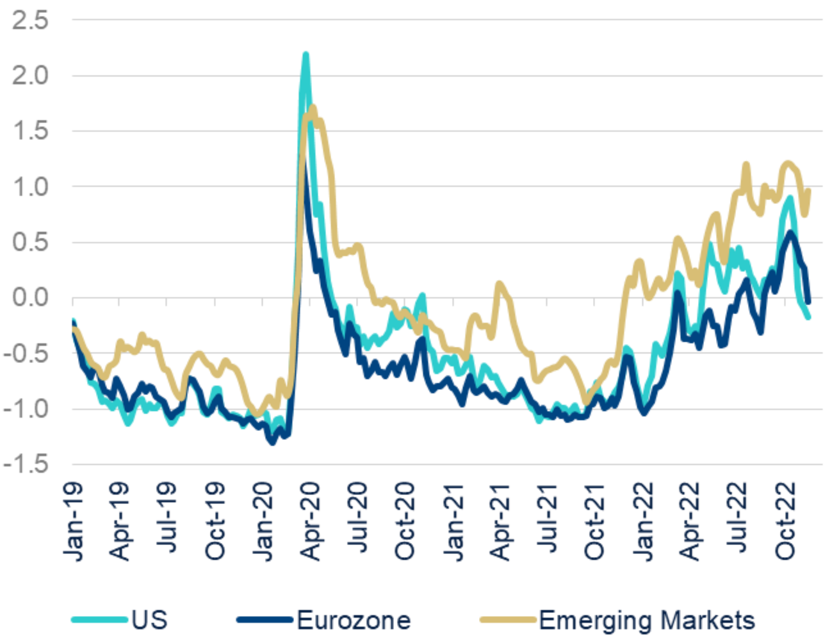
(%)



Source: BBVA Research based on data from Haver.

Declining liquidity, higher rates and dollar strength have sparked volatility and corrections in financial markets, but a more upbeat tone has prevailed lately

BBVA RESEARCH FINANCIAL TENSIONS INDEX
(INDEX: AVERAGE SINCE 2006 = 0)



Source: BBVA Research.

- Financial volatility has increased across markets over the last months, despite some recent improvement.
- Low liquidity in sovereign bond markets is also a source of volatility and concerns.
- Most currencies have weakened against the USD, which is 11% up since Dec/21, although it has lost 4% in the last month.
- Leveraged loans, high-yield bonds and tech stocks, among others, have gone through large corrections.
- Emerging countries have faced capital outflows, while the EZ peripheral risk remains under control despite some increases.
- Stress has emerged in some specific cases, such as in the UK and in crypto markets.

A sharp growth deceleration, with (mild) recessions in the US and the EZ, is likely over 2023 as interest rates and inflation will remain at high levels

BBVA RESEARCH CENTRAL SCENARIO: MAIN ASSUMPTIONS AND IMPACTS

GROWTH TO SLOW DOWN SIGNIFICANTLY

Global growth to ease from 6.3% in 2021 to 3.3% (+0.1pp) in 2022, 2.3% (-0.1pp) in 2023, and to bounce back to 3.3% in 2024.

Energy prices to soon push the EZ into a recession, but gas shortages are not expected.

A mild recession by the mid-23 is likely in the US.

Growth to remain relatively weak, despite a likely recovery in China.

MONETARY TIGHTENING: STILL NOT OVER

Policy rates will continue to raise, but likely at a more gradual pace as inflation/growth lose steam.

Once they peak in 1Q23, rates are likely to remain unchanged at least till the end of 2023.

Rate increases will be complemented by quantitative tightening

Pro-growth measures to remain in place in China.

INFLATION TO EASE WHILE REMAINING HIGH

Inflation expected to slow as commodities prices and bottlenecks continue easing.

Wages are likely to grow more than in the past, but less than inflation.

Large second-round effects to be prevented.

Monetary tightening to reign in on expectations.

FINANCIAL VOLATILITY TO REMAIN IN PLACE

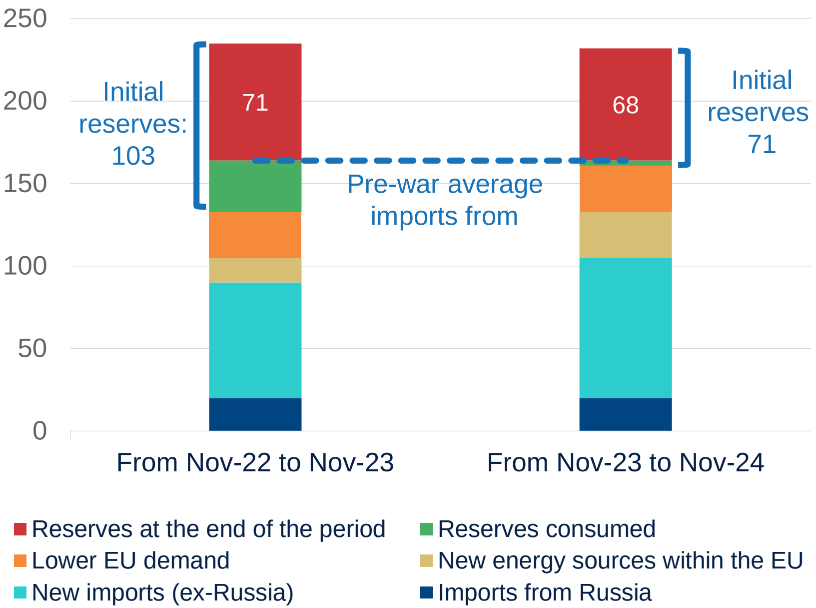
Inflation easing to take some pressure off central banks.

But lower global liquidity and high interest rates to continue supporting the USD and bond yields.

Volatility is set to remain relatively high and stress episodes should not be ruled out.

Gas markets: high reserves, saving measures and flows from alternative sources will prevent shortages in 2023, and, possibly, also in 2024

EUROPEAN GAS: BASE SCENARIO FOR SUBSTITUTION OF RUSSIAN IMPORTS (*)
(BCM: BILLION CUBIC METERS)



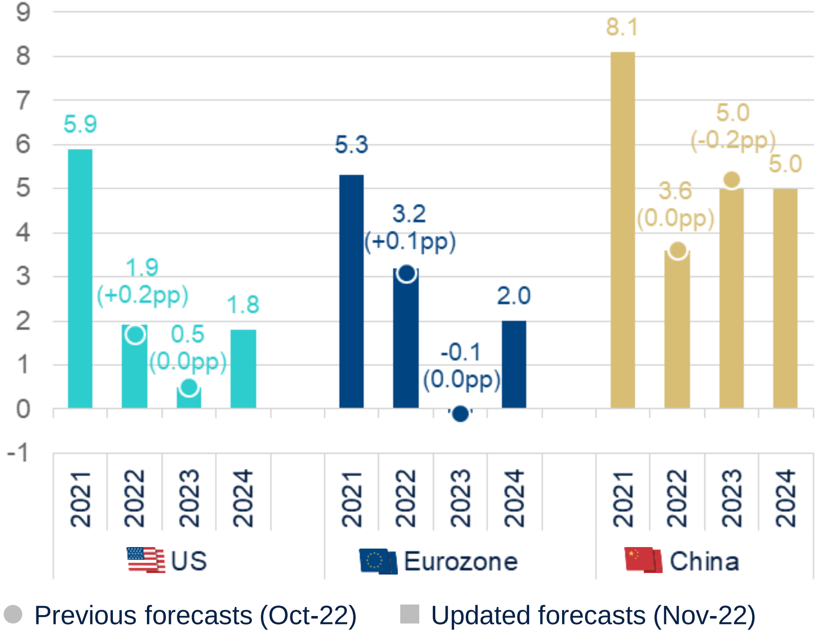
(*) Current reserves: 103 BCM. Imports from Russia ahead: 20 BCM/year. Assumed demand reduction: 7% lower than the pre-war (2017-21) average.
Source: BBVA Research.

- Base scenario: gas prices settle below record highs, but above current levels, with no shortages over 2023-24 even if Russia halves current provision (40 bcm/year) from now on.
- The main risk is that Russia cuts gas exports to zero: reserves could fall below 50 bcm in Nov/23, potentially insufficient to match the needs for the winter of 2024.
- This risk scenario implies that Russian liquified gas would likely be available to other buyers, meaning that Europe could find new supplies elsewhere.
- Scenarios ahead will depend on weather conditions and global demand for gas, on top of flows from alternative sources and saving measures in Europe.

Growth to stagnate before going back to potential levels in 2024 in the US and EZ in 2023, and to converge to 5%, with downside risks, in China

GDP: ANNUAL GROWTH IN REAL TERMS (*)

(%)



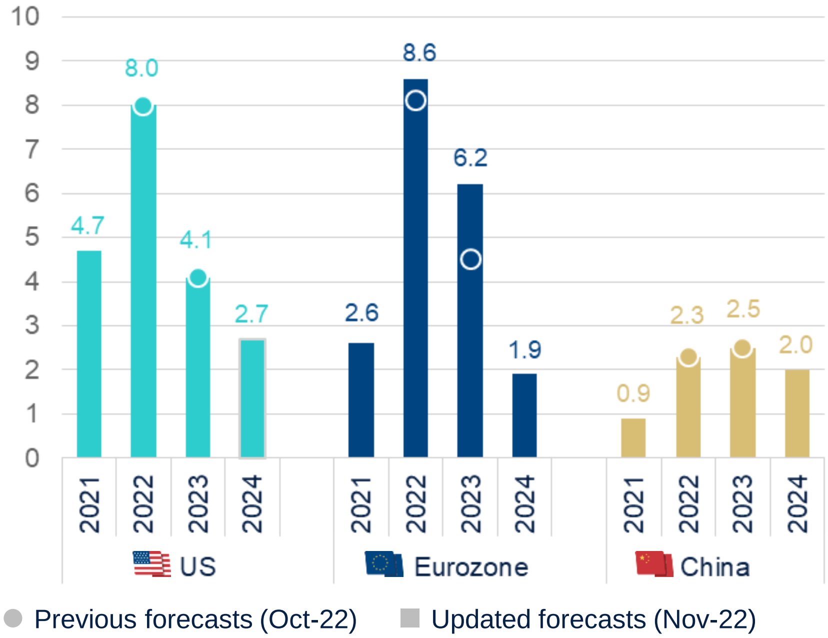
(*) Forecast change in parentheses.
Source: BBVA Research.

- 2022 GDP forecasts revised slightly up in US and EZ, in line with upward 3Q22 surprises.
- Deceleration prospects remain broadly unchanged: monetary tightening and price pressures will eventually hit harder labor markets and private consumption.
- A mild recession is likely over the next few quarters in the EZ, although gas shortages are not anticipated, and by mid-2023 in the US.
- In China, growth is still expected to recover, supported by infrastructure investment, but 2023 GDP forecast has been revised down.
- The recent measures to ease covid policies and support to the real estate sector are insufficient to significantly reduce concerns about weak growth.

Inflation will decline more quickly in the US than in the EZ, at least in 2023, as the shock imposed by the war will continue affecting mainly the latter

INFLATION:CPI

(Y/Y %, PERIOD AVERAGE)

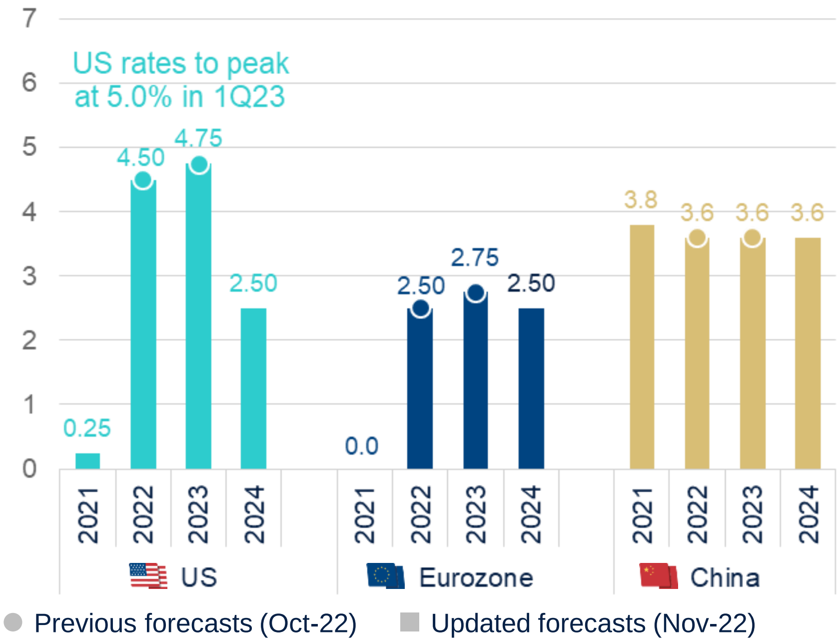


Source: BBVA Research.

- Inflation is set to continue slowing in the US as ongoing shocks wane and demand weakens, but it will be above the 2% target for some time.
- In the EZ, inflation is likely to soon peak, but forecasts have been revised up as the effects of more widespread price revisions, higher wage growth (to be around 4% ahead) and a weaker euro offset lower than expected energy prices.
- Inflation expectations are expected to remain broadly anchored both in the US and in the EZ.
- In China, inflation will continue at low levels largely on declining commodity prices, increasing imports from Russia and subdued demand.
- Inflation forecasts still have an upward bias.

The interest-rate hiking cycle is likely to come to an end in early 2023 in the US and the EZ, but there will be scarce room for monetary easing before 2024

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 and the ECB will continue raising rates , but probably at a softer pace than in the last few months: policy rates to reach 5.0% in the US and 2.75% (with an upside bias) in the EZ in 1Q23.
- A long pause is likely afterwards: inflation above targets should prevent rate cuts before Dec/23.
- Although rate hiking cycles should be soon over, a quantitative tightening is set to remain in place in the US and to soon start in the EZ.
- A non-expansionary fiscal policy is likely in the US, but not necessarily in the EZ.
- In China, controlled inflation will allow policy rates to remain low, but significant monetary stimulus are not anticipated.

Risks: multiple factors, such as long-lasting inflation or new war-related shocks, could trigger a global recession or a financial crisis

MAIN SHORT-TERM RISKS TO THE WORLD ECONOMY

PERSISTENT INFLATION AND HIGHER RATES

UKRAINE WAR AND GEOPOLITICS

HARD-LANDING IN CHINA

SOCIAL TENSIONS AND POPULISM

GLOBAL RECESSION

Growth in G3 economies could weaken more than expected, pushing emerging markets and the global economy into a recession. In particular, if inflation refrains from easing significantly (due to new supply shocks or monetary policy mismanagement, for example), a stagflation scenario could also emerge.

FINANCIAL CRISIS

Declining global liquidity, higher Fed rates, financial volatility and a strong USD could trigger sharp corrections and financial turmoil. Risks are higher in some segments: leveraged loans, high yield debt markets, shadow banking, dollar indebted agents and EM countries, real estate in some DMs, etc.

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02

China: A bumpy recovery amid disordered “zero Covid” relaxation

Main messages

A bumpy recovery

Chinese economy has experienced a bumpy recovery amid a seemingly disordered relaxation of “zero Covid” and a housing market adjustment, as main indicators dropped significantly again in November after their temporary bounce-back previously. GDP figures have confirmed the slowdown pattern from 4.8% y/y in Q1 to 0.4% y/y in Q2 to 3.9% in Q3. We maintain our 2022 prediction at 3.6% (IMF: 3.3%, Bloomberg consensus: 3.4%) and 2023’s growth at 5%.

Main risks

The economy was dragged by two main risks: (i) The disordered “Zero Covid” policy exit, which raised people’s fear of affection thus has postponed them to go out for economic activities; (ii) Real estate crash: although recently the authorities have promulgated “16-point Plan” to support housing market, its effectiveness is still challenging ahead.

Deflation risk

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. Deflation risk, particularly the negative PPI, appears.

20th National Congress

The 20th National Congress of CCP draws a long-term blueprint of Chinese economy: (i) It emphasizes “high quality growth” and a new growth model which not only focuses on headline GDP figure, but also on a balanced growth with common prosperity, carbon neutrality, technology advancement, supply-chain self-sufficiency and national security etc. (ii) In order to achieve “socialist modernization” target in 2035 (GDP or GDP per capita doubles), annual GDP growth has to reach 4.7% during 2020-2035.

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 ↓

Two main risks: disordered relaxation of "Zero Covid" and real estate crash.

Household and enterprises' balance sheet "recession"

POLICY

Accommodative monetary and fiscal policy, without deluge of massive stimulus;

Relaxation of "zero Covid" and housing stimulus.

The 20th National Congress of Chinese Communist Party draws the blueprint for China's long-term outlook

The Congress will secure a stable political transformation to President Xi's 3nd, five-year term as the president and General Secretary of CCP. Xi also announced the 6-person standing committee of Poliburo (the core decision-makers) with all his loyalist previous subordinates, cementing consolidation of power. The lack of protentional successor for President Xi indicates that Xi will continue his 4th 5-year term and may "rule for life" after his 3nd term, as 5 out of 6 members of the standing committee of the Poliburo will reach above 68 after their 5-year term.

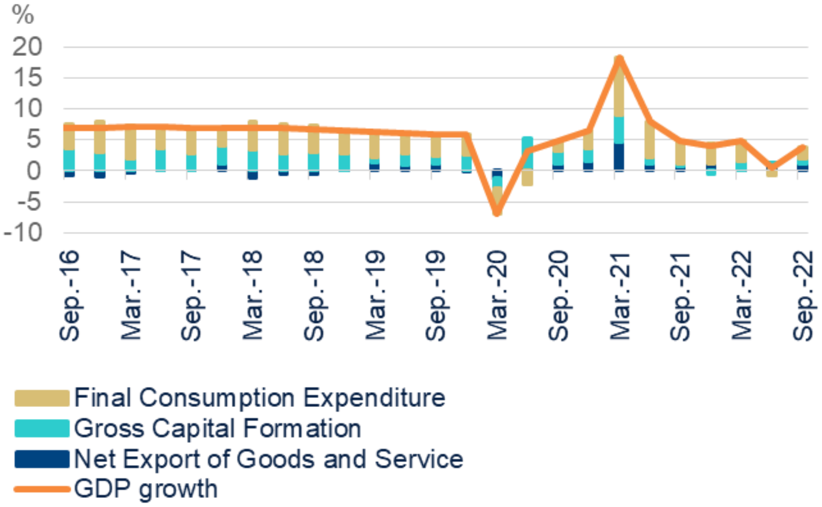
The blueprint to develop China's economy in the long-term in "two steps": (i) 2020-2035, to achieve "socialist modernization" (GDP or GDP per capita doubles to catch up with mid-level developed countries); (ii) 2035-2050, to accomplish China as a "great modern socialist country". We calculate that to achieve "GDP doubled" target by 2035, annual GDP growth has to reach 4.7% for 2020-2035.

The new economic model: which emphasizes not only the headline growth figures but also a more balanced growth including national security, carbon neutrality, common prosperity, the continuation of opening-up policy and market economy, supply-chain self-sufficiency and technology advancement.

Taiwan issue and international relations: Our baseline scenario is the geopolitical risk of Taiwan will be contained and the current situation is set to maintain, as the Congress emphasizes peace as the main theme of the time; but confrontations in trade, ideology, geographic, tech fronts with the US and other western countries will continue to counter China's global influence. Xi's hardlines and centralization of the power panic the foreign investors.

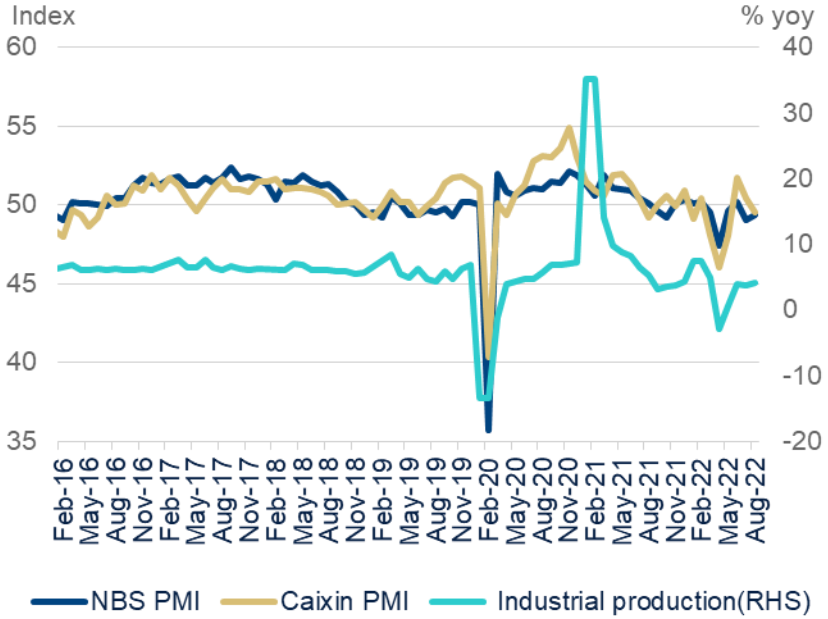
A bumpy V-shape recovery amid disordered “zero Covid” relaxation

THE GROWTH DIPPED FROM 4.8% IN Q1 2022 TO 0.4% IN Q2 AND BOUNCED BACK TO 3.9% IN Q3



Forecast	2022Q1	2022Q2	2022Q3	2022Q4 (F)
Y/Y%	4.8	0.4	3.9	5.3
Q/Q%	0.65	-2.8	4.4	3.2

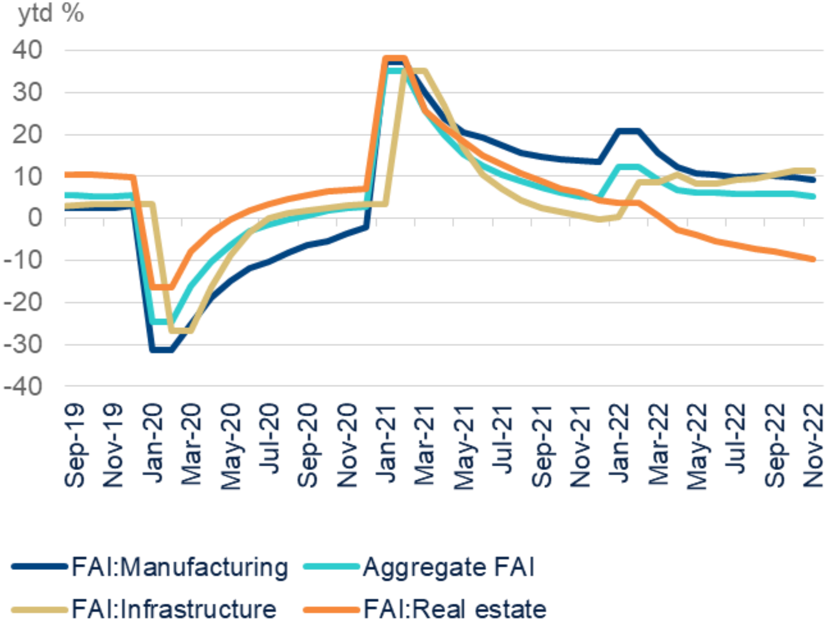
BOTH NBS AND CAIXIN PMI DIPPED IN NOVEMBER; IP ALSO TUMBLED TO 2.2% IN NOV FROM 5%



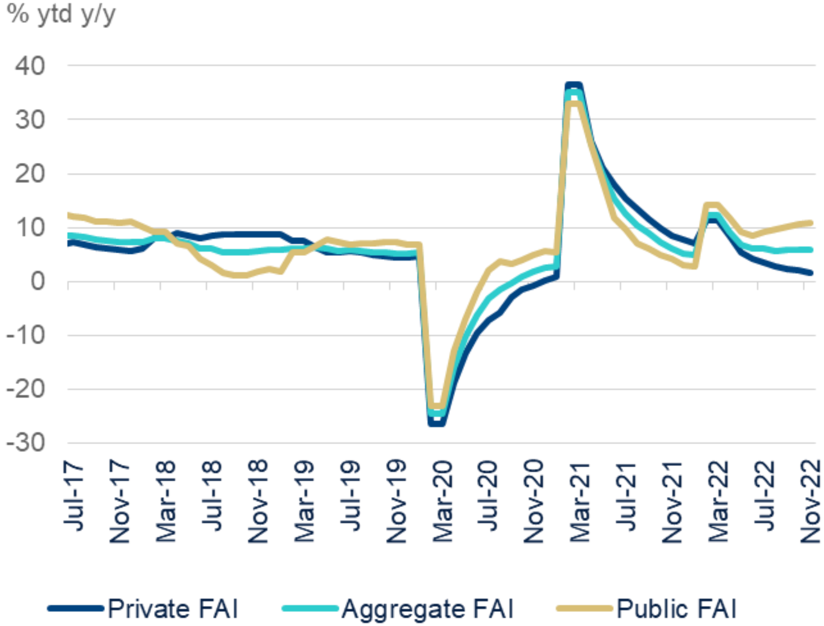
Source: CEIC and BBVA Research

FAI: Infrastructure investment ticked up due to fiscal stimulus, manufacturing FAI fares well might be dragged by export dip; real estate continued negative growth

INFRASTRUCTURE FAI PICKED AMID EXPANSIONARY LOCAL GOVERNMENT BOND ISSUANCE; REAL ESTATE FAI REMAINED NEGATIVE



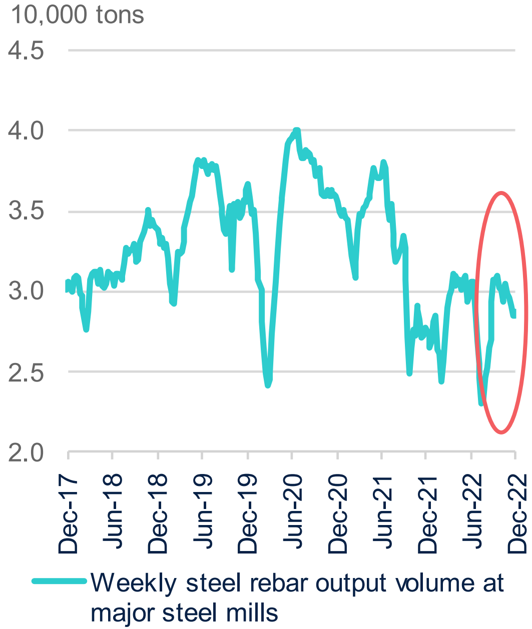
PUBLIC FAI LED THE INVESTMENT RECOVERY DUE TO THE FISCAL STIMULUS

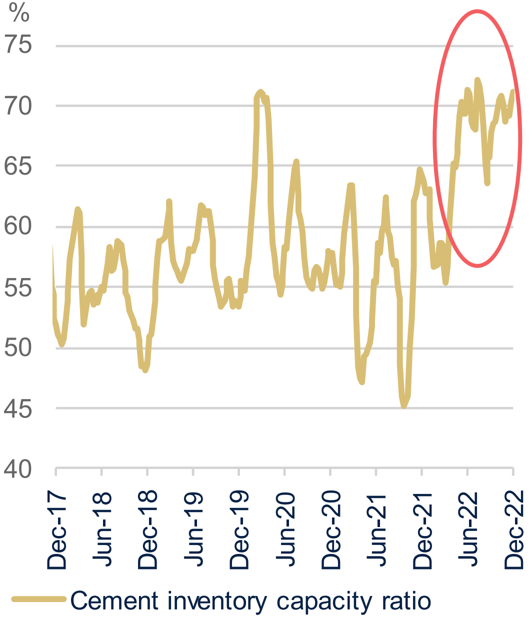


Source: CEIC and BBVA Research.

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

INFRASTRUCTURE RELATED HIGH-FREQUENCY INDICATORS SHOW STRONG GROWTH ON INFRASTRUCTURE ACTIVITIES

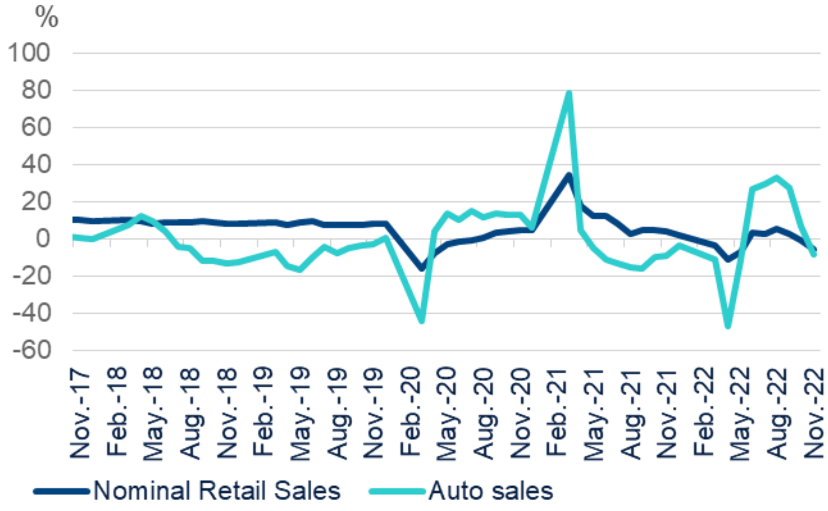




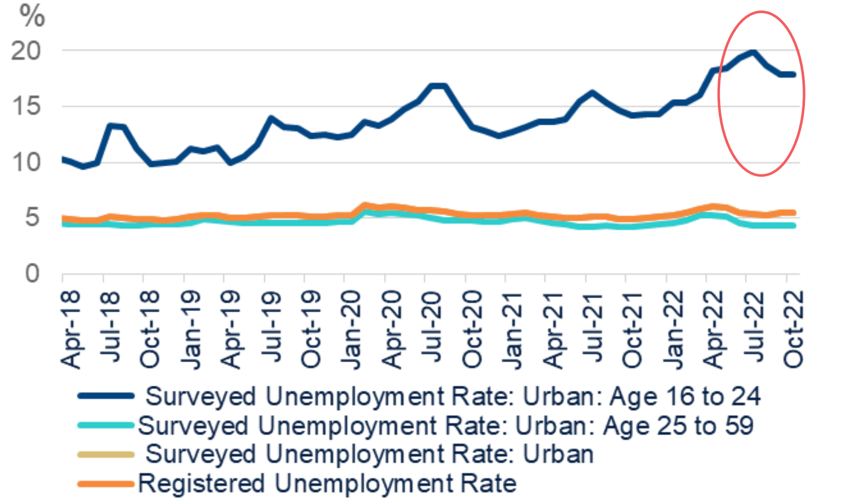
Source：WIND and BBVA Research.

Tumbling retail sales due to disordered relaxation of "Zero Covid", increasing unemployment and worsening income expectations

RETAIL SALES SLOWED FROM -0.5% TO -5.9% AS PEOPLE ARE AFRAID OF GOING OUT AFTER "ZERO COVID" EASED



…ALSO DUE TO INCREASING UNEMPLOYMENT (5.5%) AND LOWER INCOME EXPECTATION; 16-24 AGE UNEMPLOYMENT IS EXTREMELY HIGH ABOVE 20%

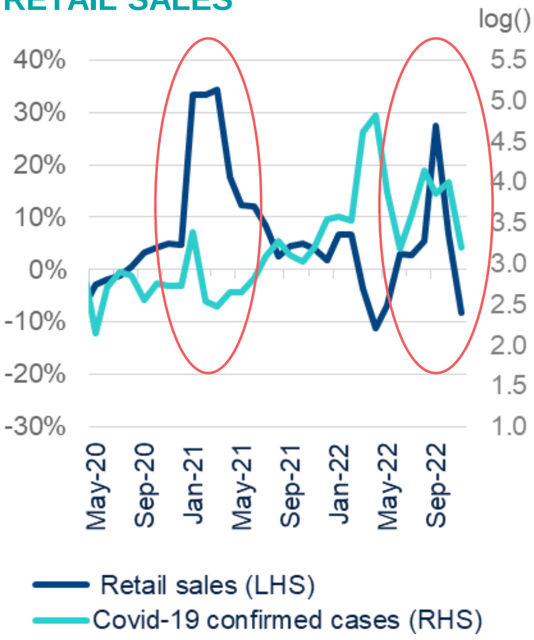


Source: CEIC and BBVA Research.

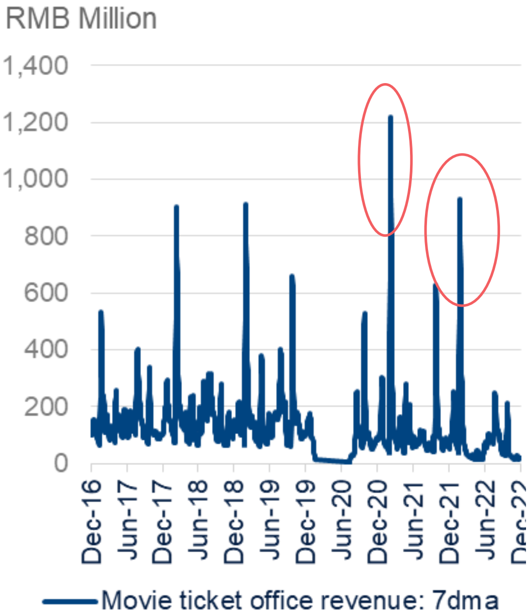
Due to "zero Covid" restrictions, the Golden Week (Oct 1-7) travelers declined by -18.22% y/y , only 60.7% of that of 2019; tourism income declined by -26.2% y/y, only 44.2% of that of 2019.

"Zero Covid" business cycle and the retail sales cycle: high frequency indicators

CONFIRMED COVID CASES HAVE NEGATIVE CORRELATION WITH RETAIL SALES



MOVIE TICKET OFFICE REVENUE HIGHLY CORELATED WITH LOCKDOWN MEASURES

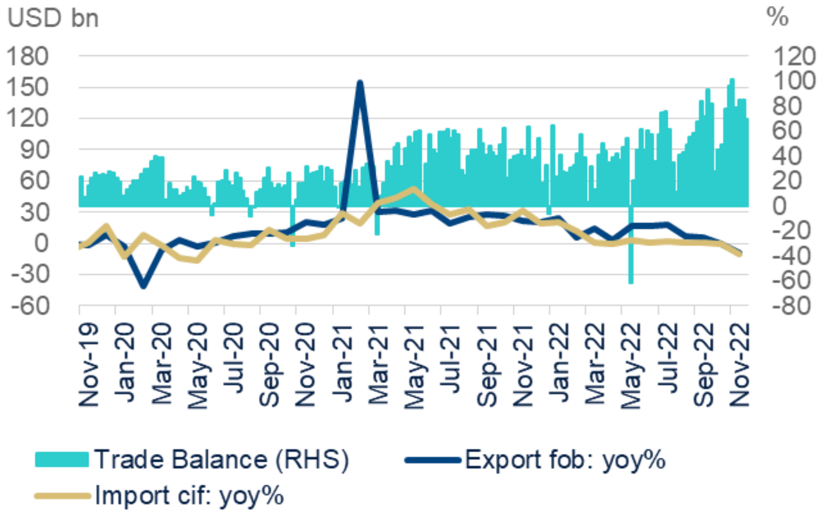


…WHICH ALSO DRAGGED AIRLINE RECOVERY

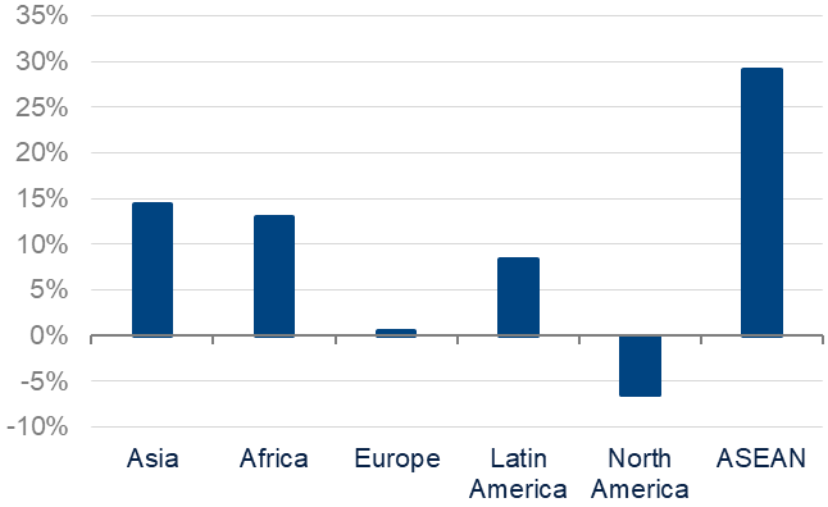
Source: CEIC and BBVA Research.

China’s exports decelerated due to growth slowdown in US and EU, indicating a significant tumbling from double-digit growth in pandemic time

EXPORT DIPPED TO -8.7% IN NOV; IMPORTS DIPPED FROM TO -10.6%



CHINA’S EXPORTS GROWTH TO THE NORTH AMERICA FIRST TIME DIPPED TO NEGATIVE

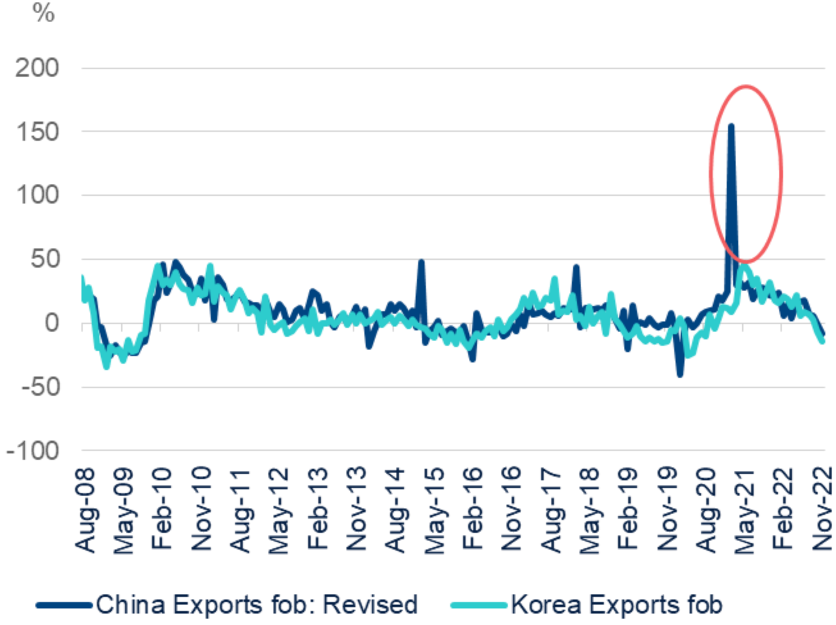


Source: CEIC and BBVA Research.

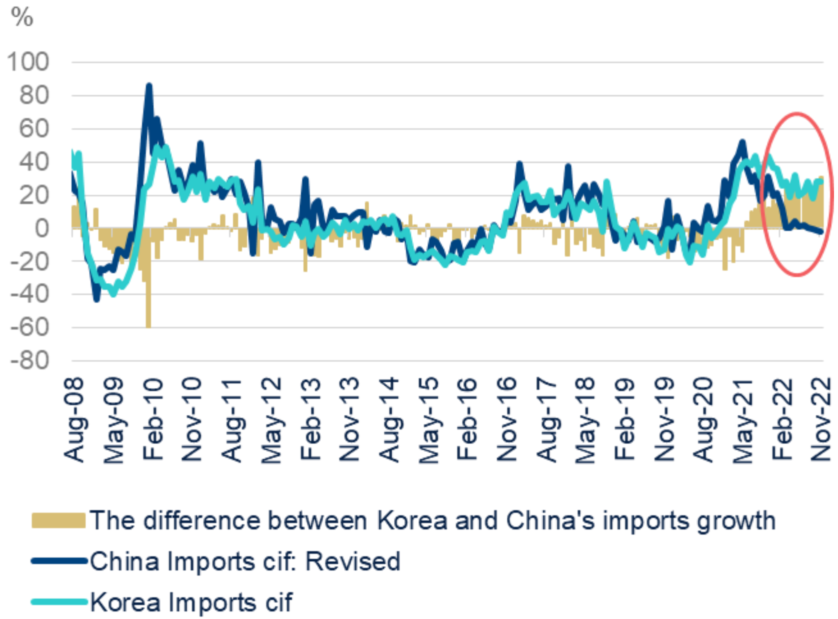
The ongoing competitive currency depreciation in Asian countries led by sharp JPY depreciation also weigh on China’s exports.

A comparison of Asia's two manufacturing countries: China vs. Korea

BOTH CHINA AND KOREA'S EXPORTS GROWTH DECLINED RECENTLY, REFLECTING WEAK EXTERNAL DEMAND FROM US AND EU



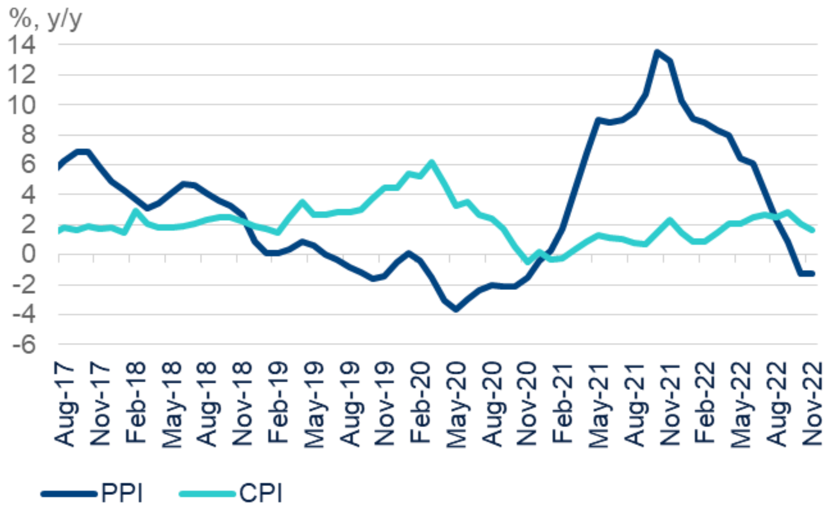
CHINA'S IMPORTS GROWTH DIPPED MUCH FASTER THAN KOREA, INDICATING CHINA'S SLUGGISH DOMESTIC DEMAND



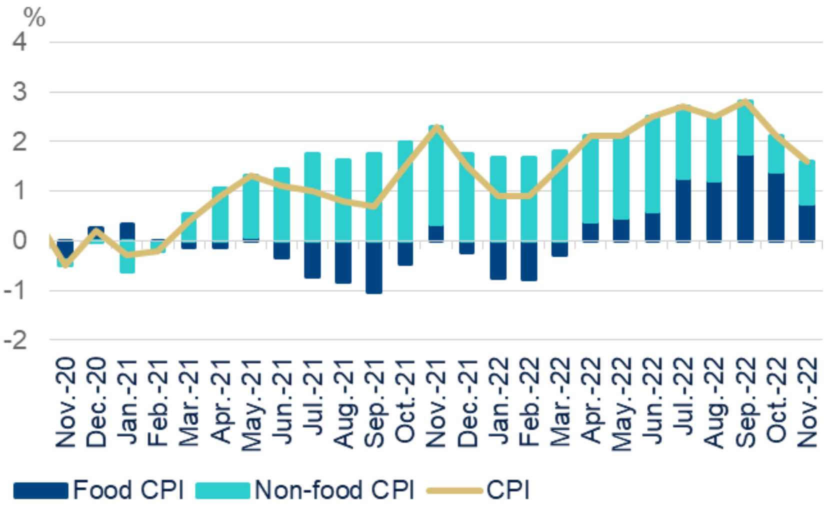
Source: CEIC and BBVA Research.

Deflation risk is on the rise, due to weak domestic demand, sliding global commodity price and expansionary imports from Russia

CPI REMAINED DECELERATED TO 1.6% IN NOVEMBER WHILE PPI DROPPED TO NEGATIVE



…DUE TO WEAK DOMESTIC DEMAND, PARTICULARLY A LOWER FOOD CPI

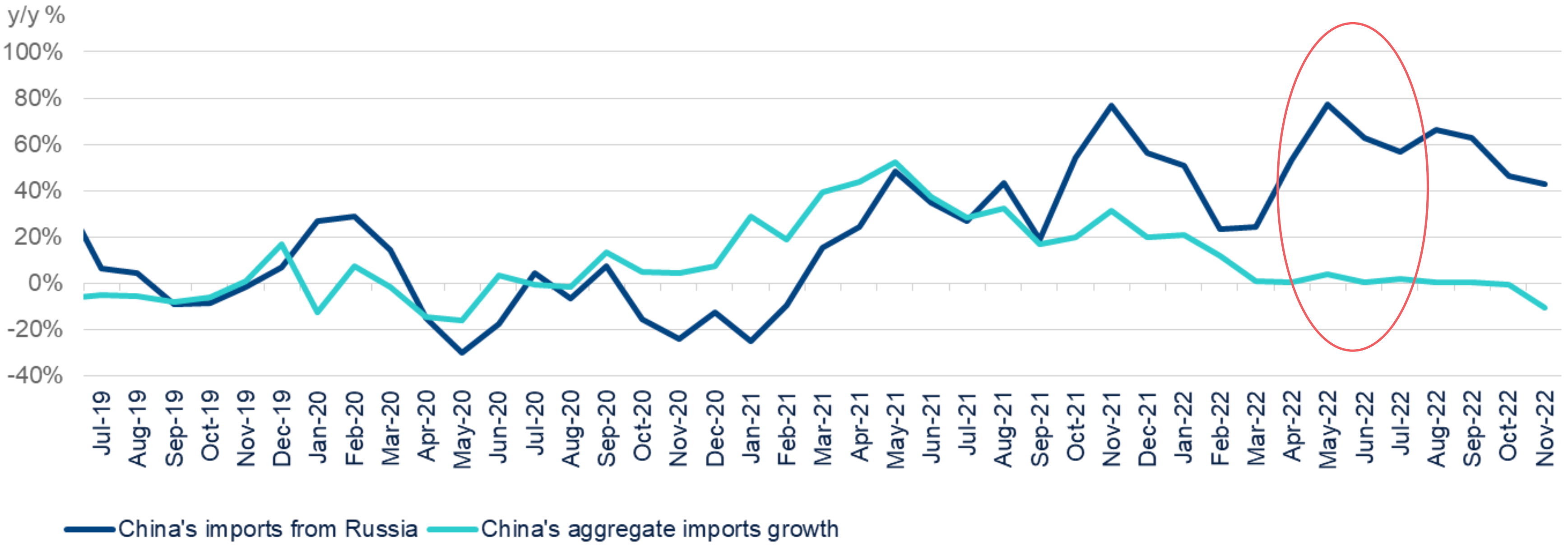


Source: CEIC and BBVA Research.

The reversion pattern of CPI and PPI are benefit for the downstream enterprises.

Why China maintains such a low PPI at 0.9% amid global inflation hike? (1)

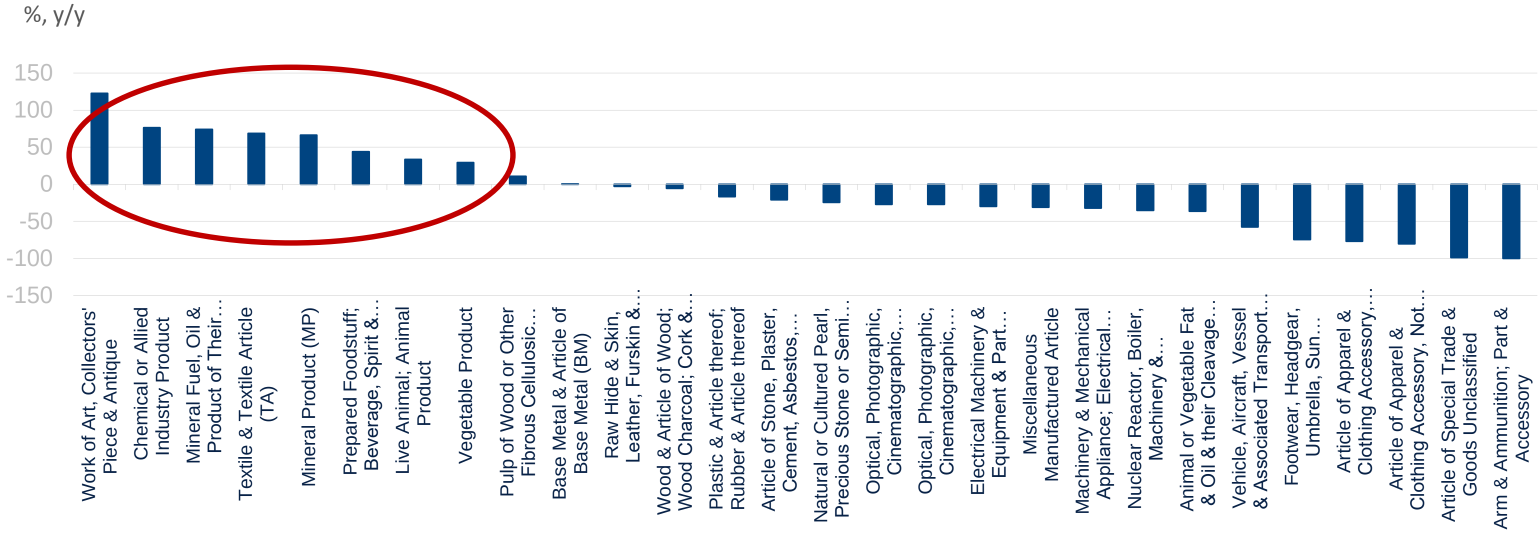
CHINA'S IMPORTS FROM RUSSIA REACHED 60%, MUCH LARGER THAN 0.3% AVERAGE IMPORTS GROWTH



Source: CEIC and BBVA Research.

Why China maintains such a low PPI at 0.9% amid global inflation hike? (2)

BY SECTOR, THE HIGHEST GROWTH OF CHINA'S IMPORTS FROM RUSSIA FOCUS ON ENERGY AND AGRICULTURAL PRODUCTS, VARING FROM 50-130% GROWTH

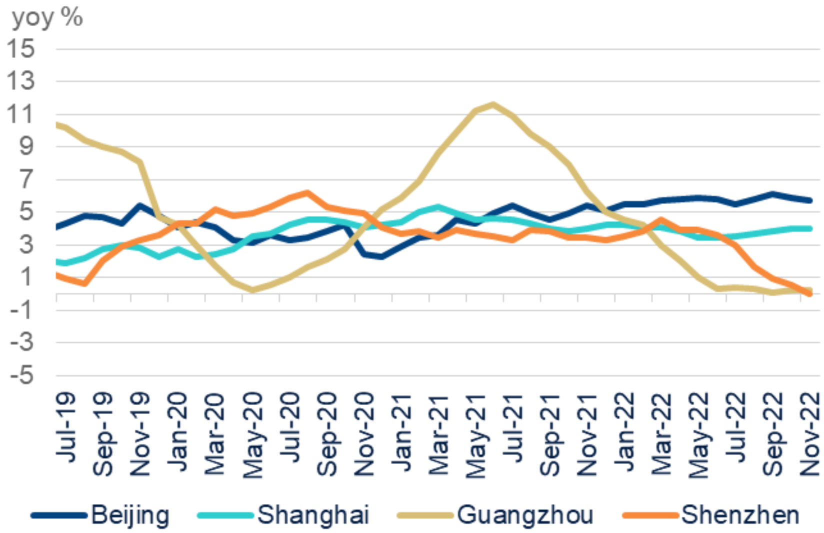


Source: CEIC and BBVA Research.

Conclusion: 1. China significantly expanded imports of agricultural and energy goods from Russia to maintain a low PPI; 2. The global commodity price also dropped recently to reflect the recession fear in US and EU.

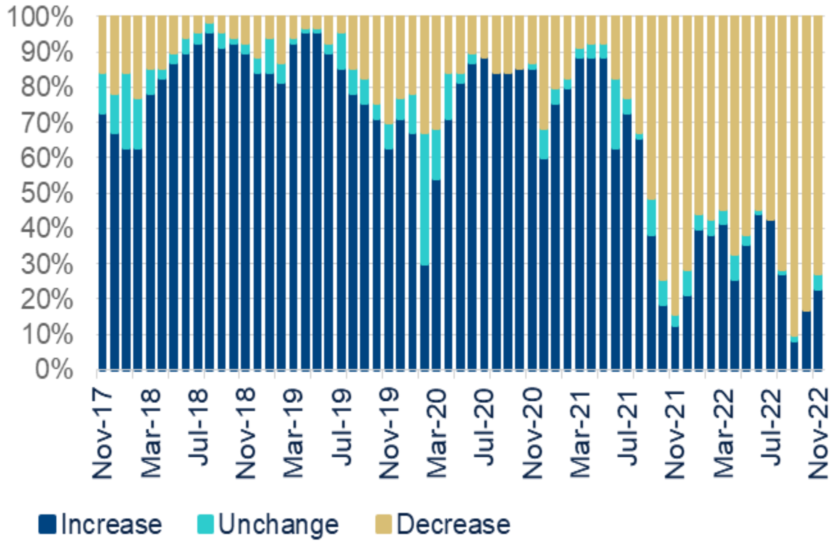
Recent real estate sector stimulus is trying to support a soft-landing(1)

HOUSING PRICES DROPPED DOWN IN MAIN LARGE CITIES



Source: CEIC and BBVA Research.

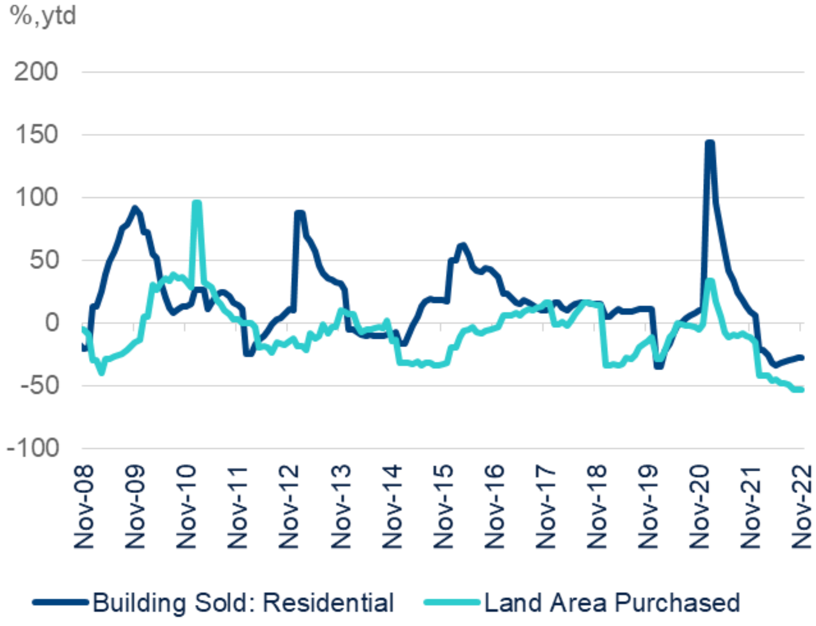
MORE AND MORE CITIES REPORTED HOUSING PRICE DECREASE



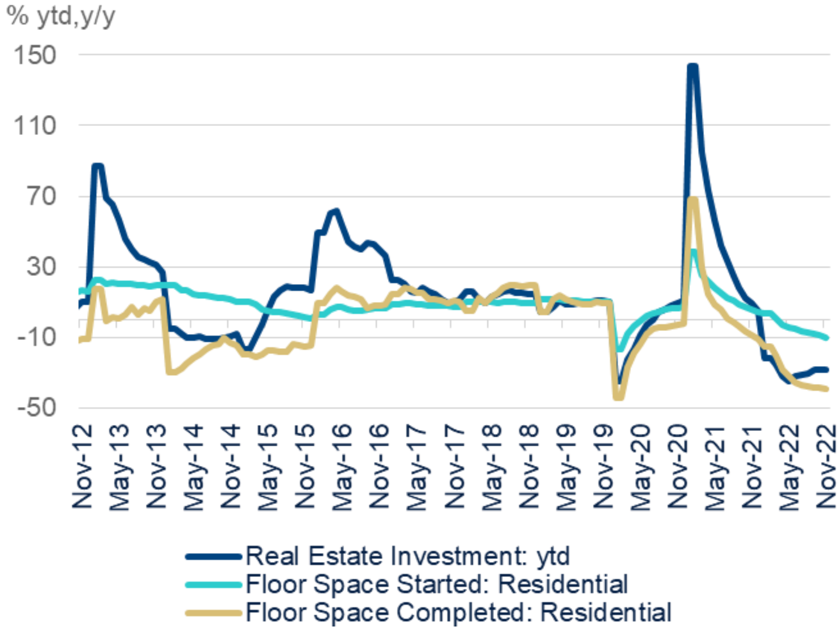
The recent real estate policy stimulus, namely “16-Point Plan”, is anticipated to secure a housing market soft-landing in 2023. It is a comprehensive Plan which not only to support State-owned developers, but also private developers; not only to support demand side but also supply side which various kinds of financial tools.

Real estate indicators all registered historical low

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

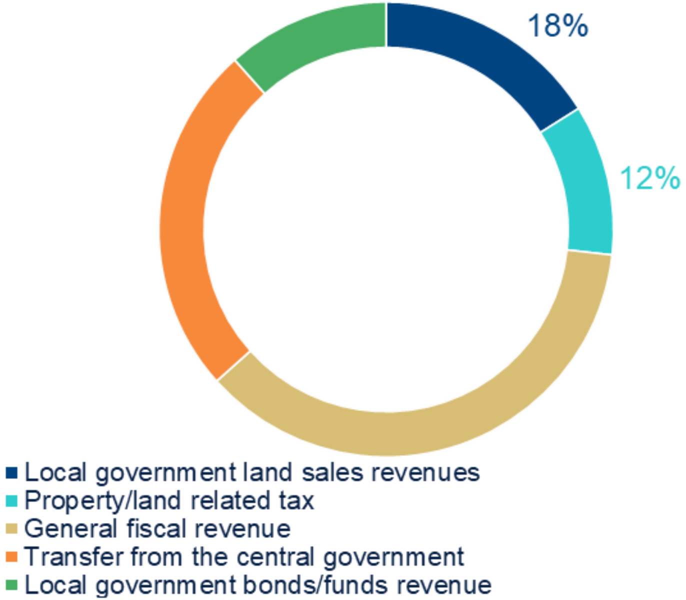


Source: CEIC and BBVA Research.

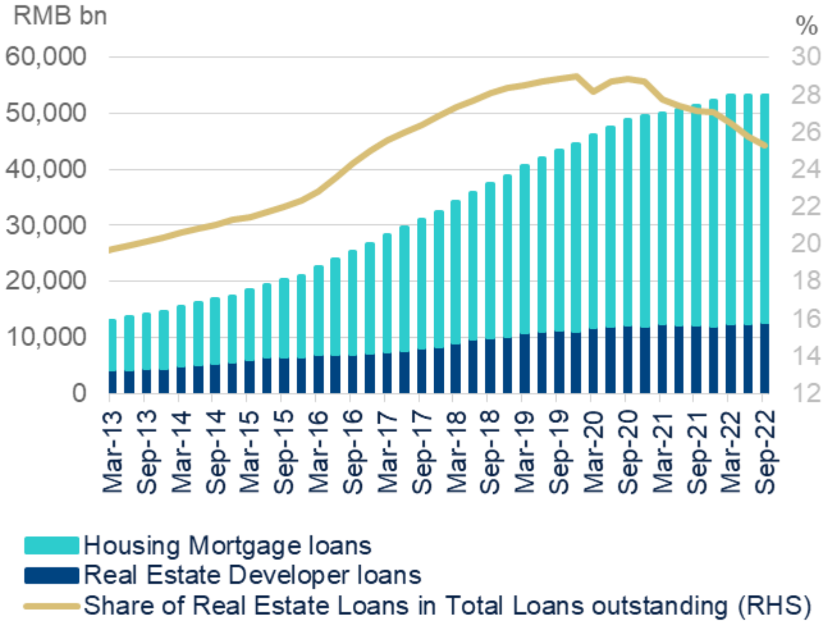
Stress test for China’s housing sector:

Gauging different economic sectors’ exposure to the real estate sector (1)

GOV: PROPERTY AND LAND RELATED REVENUE CONTRIBUTES 30% TO LOCAL GOVERNMENT’S TOTAL REVENUE



BANKS: SHARE OF REAL ESTATE LOANS TO BANKS’ TOTAL LOANS DECLINED AT PEAK 29% TO 26%



Source: CEIC and BBVA Research.

Stress test for China's housing sector:
Gauging different economic sectors' exposure to the real estate sector (2)

HOUSEHOLDS: HOUSING TAKES MORE THAN 70% IN HOUSEHOLDS' TOTAL ASSETS

Source: CEIC and BBVA Research.

CHINESE ENTERPRISES' EXPOSURE TO REAL ESTATE
(ALL LISTED FIRMS EXCLUDING FINANCIAL INSTITUTIONS AND REAL ESTATE FIRMS)

Country	Variable	Period	Mean	Std Dev	10th percentile	Median	90h percentile
Japan	Land value /Total asset	1985-1990	19.3%	11.9%	6.5%	17%	35%
	Land value /Total Sales	1985-1990	27.3%	28.2%	6.9%	19.9%	53.8%
China	Land value /Total asset	2013-2015	2.6%	5.6%	0.1%	0.8%	6.5%
	Land value /Total Sales	2013-2015	7.3%	26.8%	0.1%	1.5%	13.5%
China	Land value /Total asset	2016	2.4%	6.3%	0.06%	0.6%	5.2%
	Land value /Total Sales	2016	10.4%	73.6%	0.1%	1.2%	12.6%
China	Land value /Total asset	2020	1.7%	10.6%	0.08%	1.1%	9.66%

Source: Serdar Dinc and Patrick M McGuire (2004), WIND, BBVA Research.

Stress test for China's housing sector:

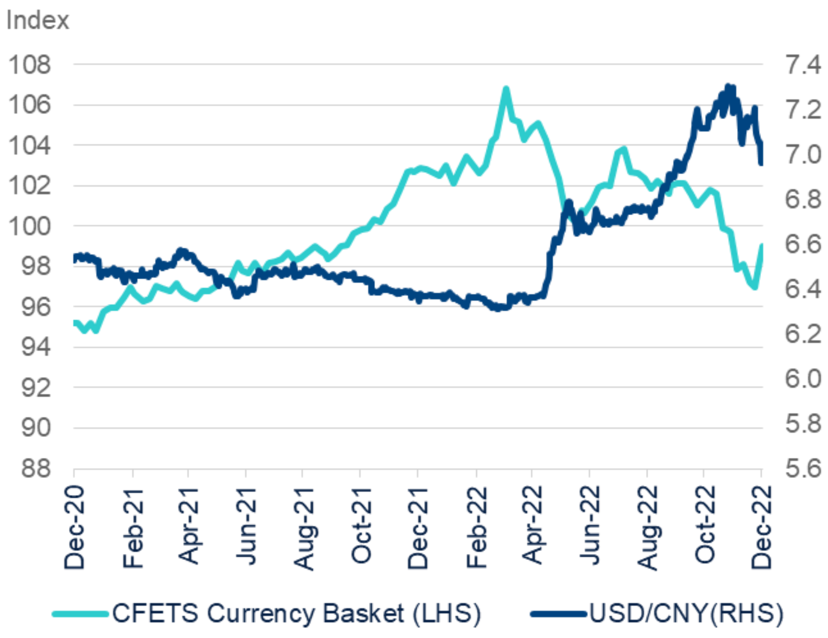
The impact of housing price fall (10% or 30%) on the four main economic sectors

Sectors	Scenarios	
	Housing price decreases by 10%	Housing price decreases by 30%
Government	Local government revenue decrease by RMB 0.26 trillion, indicating it has RMB 260 billion credit gap to maintain the current fiscal expenditure.	Local government revenue decrease by RMB 0.78 trillion, indicating it has RMB 0.78 trillion credit gap to maintain the current fiscal expenditure.
Banking sector	Banks' NPL increased from the current 1.74% to 2.07% after one year and increased to 3.36% after three years.	Banks' NPL increased from the current 1.74% to 2.39% after one year and increased to 6.16% after three years. [1]
Enterprises	Stock market value will evaporate RMB 267.5 bn; book value of enterprises' real estate investment will decrease RMB 39.3 bn.	Stock market value will evaporate RMB 802.5 bn; book value of enterprises' real estate investment will decrease RMB 118 bn.
Household	Household wealth per capita decreases by RMB 11 thousand; Aggregate household wealth decreases by RMB 15.2 trn.	Household wealth per capita decreases by RMB 34 thousand. Aggregate household wealth decreases by RMB 46.9 trn.

[1] More detailed analysis of this stress test about housing price slowdown on banking sector could be found in Zhang Ming, W Wei and X. Chen (2017), "Will housing price slowdown lead to banking crisis", Ping An Securities Research Department, Chinese version

RMB to USD exchange rate bounced back recently due to the relaxation of "zero Covid" and the moderation of US FED hike

RMB EXCHANGE RATE BROKE THE PSYCOLOGICAL LEVEL OF 7 BUT BOUNCED BACK RECENTLY

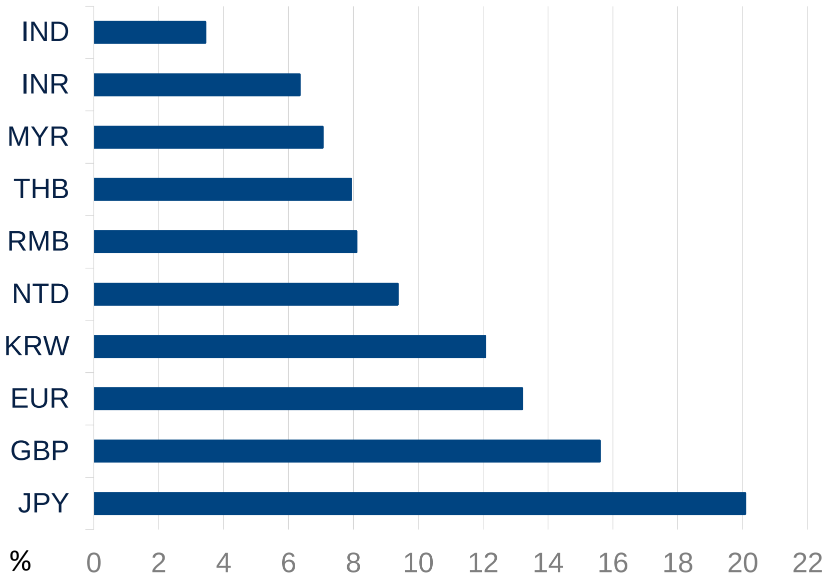


Source: CEIC & BBVA Research.

- 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 concerning 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. 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 bounced back recently due to the relaxation of "zero Covid" and the moderation of US FED hike(2)

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

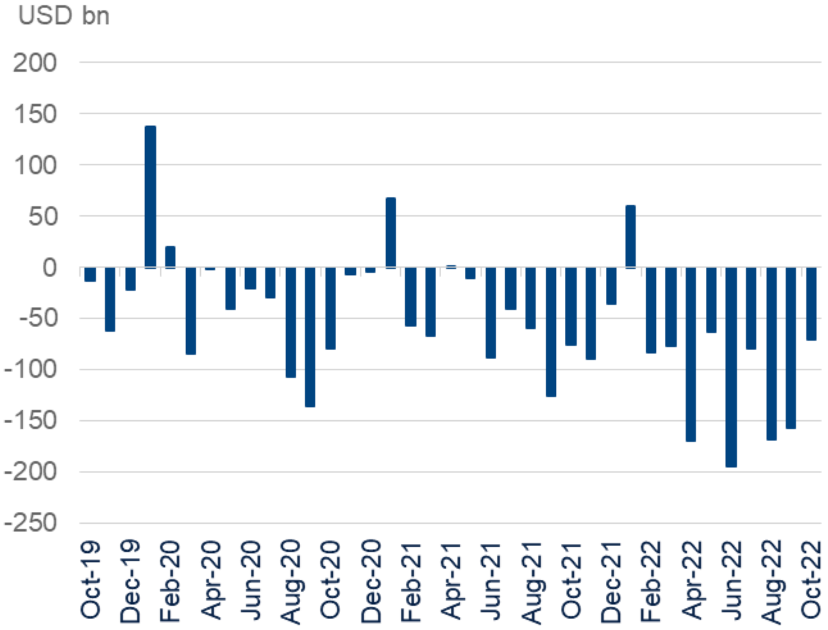


Source: CEIC and BBVA Research.

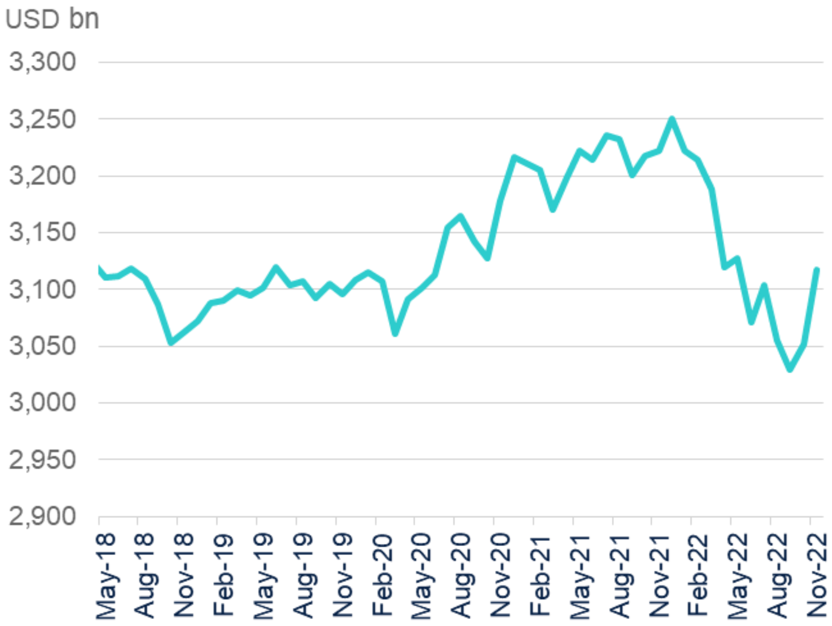
- Depreciation pressure is not only for RMB, but for all EM currencies AM currencies that have a slower pace of rate hike than the FED (JPY, GBP, Euro etc.) , and among all EM currencies, RMB probably depreciated modestly due to capital control measures.
- We predict RMB to USD exchange rate will be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

Accelerating capital inflows and foreign reserves due to “zero Covid” relaxation and an over-reacted stock market

ACCELERATING PORTFOLIO INFLOWS DUE TO THE OVER-REACTED STOCK MARKET OF “ZERO COVID” RELAXATION



FOREIGN RESERVES TRENDED UP AS WELL



Source: CEIC and BBVA Research.

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03

Prudent monetary policy and real estate stimulus

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

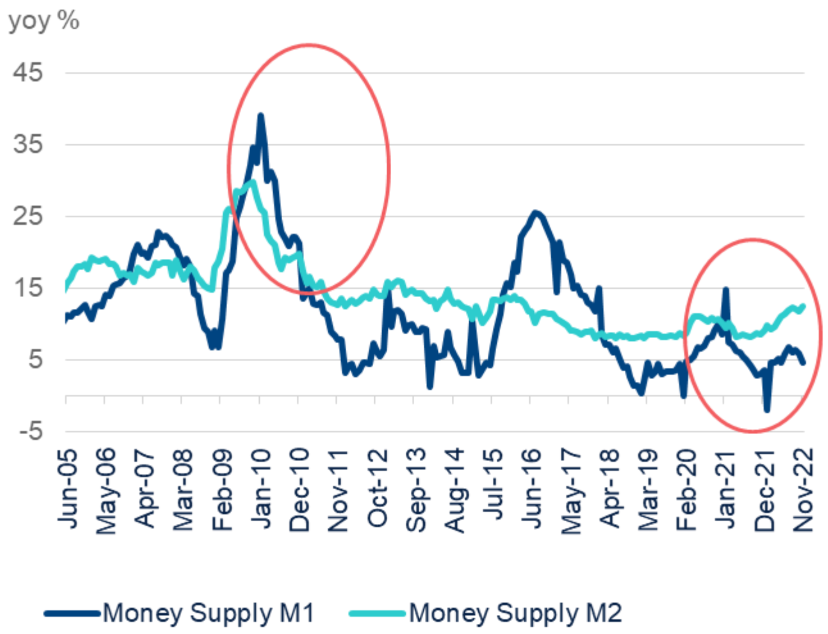
Following 3 RRR cuts and 2 LPR cuts, the PBoC again cut MLF, Repo rate in August by 10 bps and cut one-year by 5 bps and five-year LPR by 15 bps asymmetrically. But the cut does not suggest a start of a massive easing cycle amid the FED hike, as the PBoC has to closely monitor RMB exchange rate and capital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

Fiscal policy

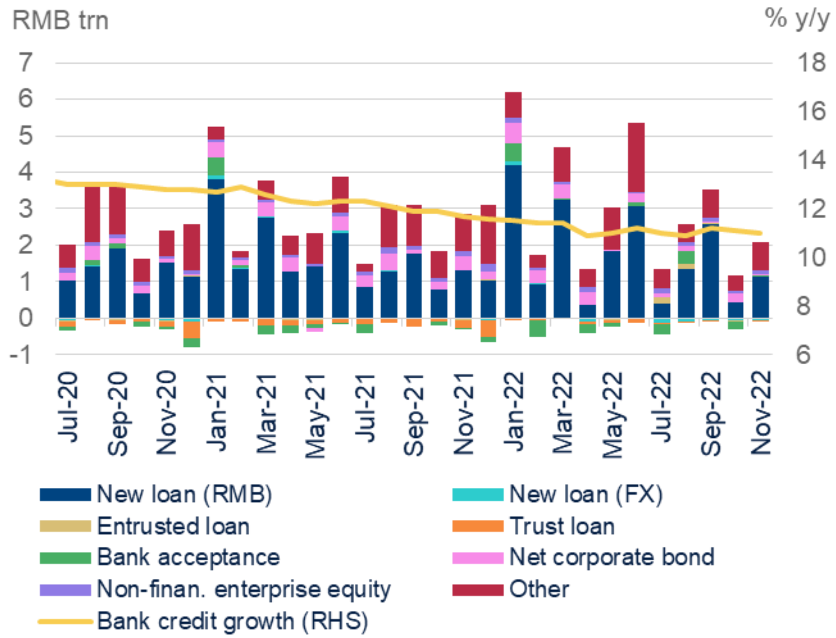
Fiscal policy focuses on local government bond issuance; the quota was used up in 1H to support infrastructure investment with the total amount of RMB 5.25 trillion; larger-scale tax cuts and fee reduction to RMB 2.5 trillion; social insurance payment postponed and State’s Financing Guarantee Fund expansion, 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 PICKED UP, REFLECTING THE RECENT EASING MONETARY STANCE (Y/Y)



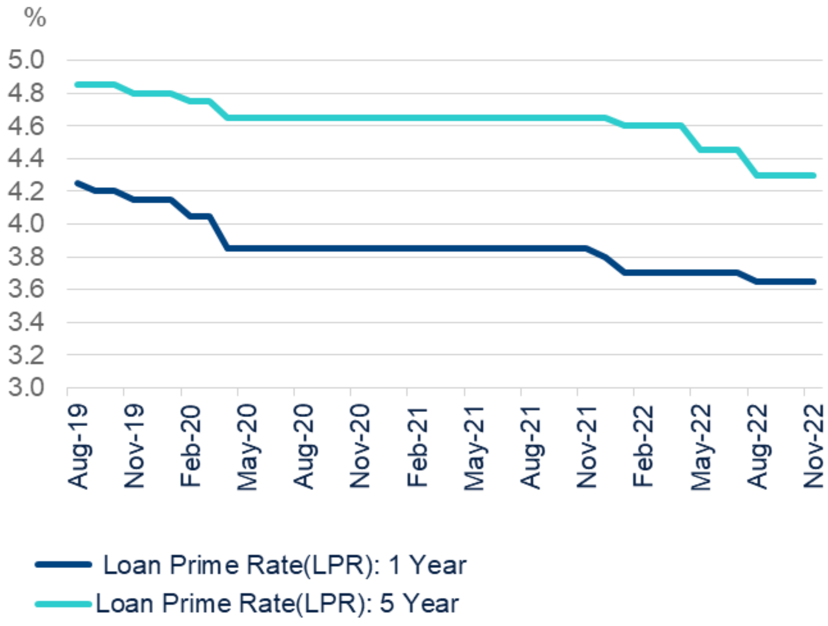
..SO DID THE CREDIT DATA



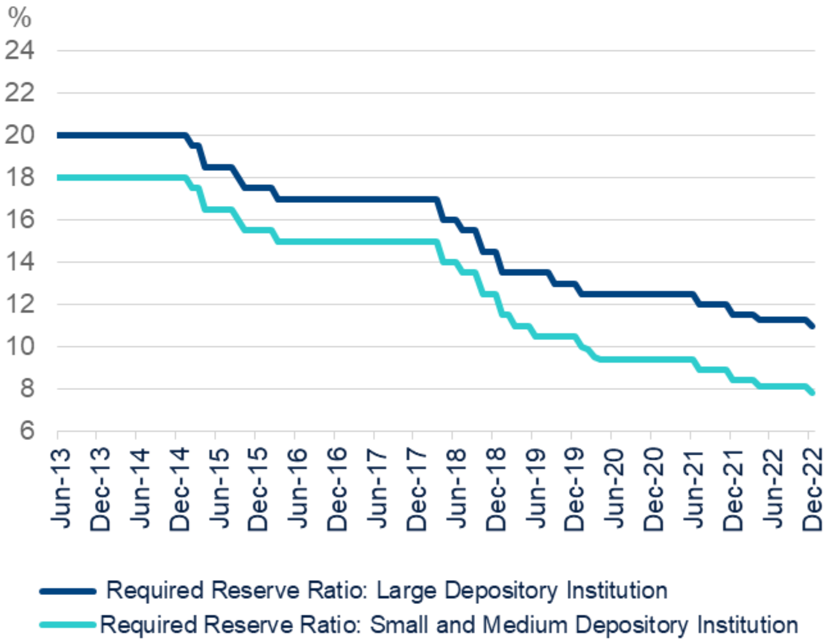
Source: CEIC and BBVA Research.

The PBoC adopts easing monetary measures to stimulate growth in 2022 but maintaining prudent stance amid FED hike

THE PBOC MAINTAINED LPR RECENTLY AFTER AUGUST’S CUT, AMID AGGRESSIVE FED HIKE



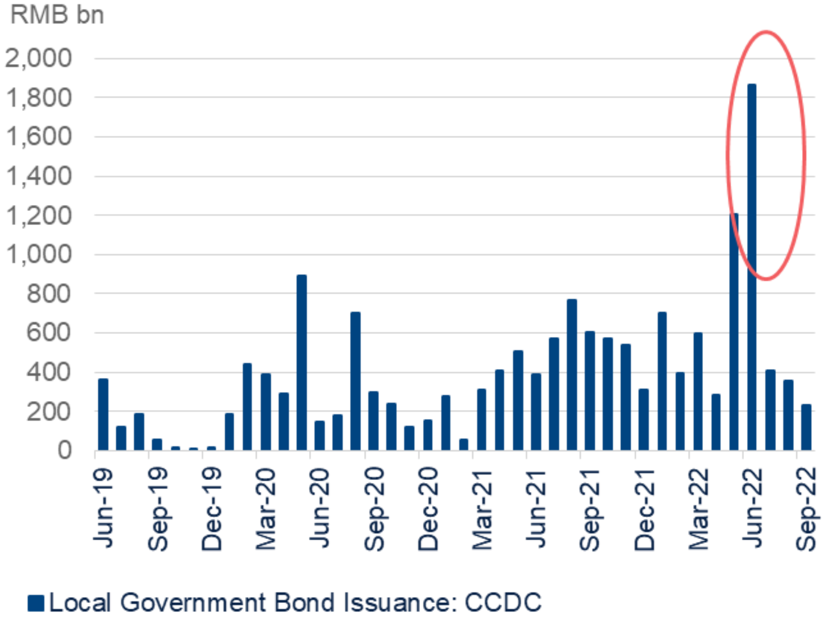
MORE QUANTITY TOOL INSTEAD OF PRICE TOOL WAS APPLIED, SUCH AS RRR CUT IN DECEMBER



Source: CEIC and BBVA Research.

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 TO STIMULATE INFRASTRUCTURE INVESTMENT



Source: CEIC and BBVA Research.

- Issued all of 2022 local government bond quota in 1H 2022 with total amount RMB 5.25 trillion for funding infrastructure investment.
- To promulgate "33+19" new policies to stimulate growth.
- To facilitate infrastructure investment by issuing RMB 800 bn bond through development banks, and RMB 600 bn special loans.
- 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 RMB 320 bn.
- To expand State's Financing Guarantee Fund to RMB 1 trillion to support SME financing.

Forecast: China’s main economic indicators

	Baseline scenario					
	2019	2020	2021	2022	2023	2024
GDP （%）	6.1	2.3	8.1	3.6	5	5
CPI（%）	2.9	2.6	0.9	2.1	2.5	2
PPI (%)	-0.3	-1.8	8.1	5.2	2.5	0.7
Interest rate (LPR, %）	4.1	3.85	3.8	3.6	3.6	3.6
RMB/USD exchange rate	7	6.5	6.36	7.1	6.9	6.7

Source: CEIC and BBVA Research

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Research

China Economic Outlook

December 2022

Creating Opportunities