BBVA Research

China Economic Outlook

September 2023

Creating Opportunities

BBVA Research

01

Global economy: rate hike comes to an end

Main messages

Recent developments

The global economy is easing at different paces across regions: incoming data are more favorable in the US, slightly worse than forecast in the EZ and negative in China. Still, even though rate tightening cycles seem to be over, persistent inflation amid tight labor markets paved the way for the Fed and the ECB to maintain a hawkish tone, while leaving doors open for further hikes, if inflation proves to be more persistent than expected.

Growth outlook

A soft-landing is expected, with global growth declining from 3.5% in 2021 to around 2.9% (+0.0pp) in 2023 and 3.0% (+0.1pp) in 2024. In the US, resilient domestic demand paves the way for higher growth forecasts and makes a recession unlikely. In China, growth prospects deteriorated significantly and risks augmented, but extra measures are expected to support confidence and prevent a hard-landing. In the Eurozone, a timid GDP expansion, slightly below previous forecasts, is now anticipated.

Inflation and rates outlook

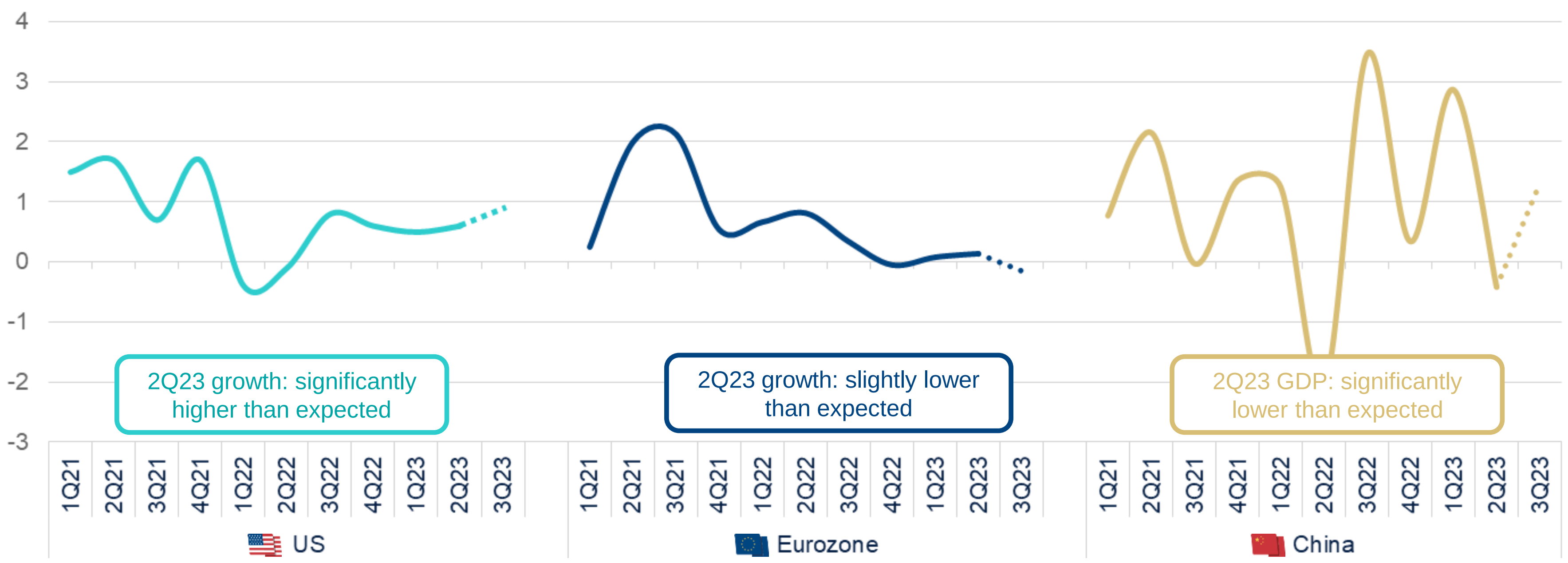
Inflation is likely to continue slowing ahead, allowing the Fed and the ECB to skip further rate hikes over the next few months. Still, it will continue above targets, and upward risks will remain alive, making rate cuts unlikely in the short-run and favoring a reduction of central bank balances.

Risks

Recession and financial instability episodes driven by persistent inflation (on second-round effects, higher oil prices, etc) and contractionary monetary policy are still possible. A sharper deceleration of China, geopolitical tensions and US presidential elections are also a source of risks.

GDP growth is losing momentum, mainly in China, but also in the Eurozone; labor markets and excess savings are still supportive, especially in the US

GDP: REAL GROWTH (*)
(Q/Q %)

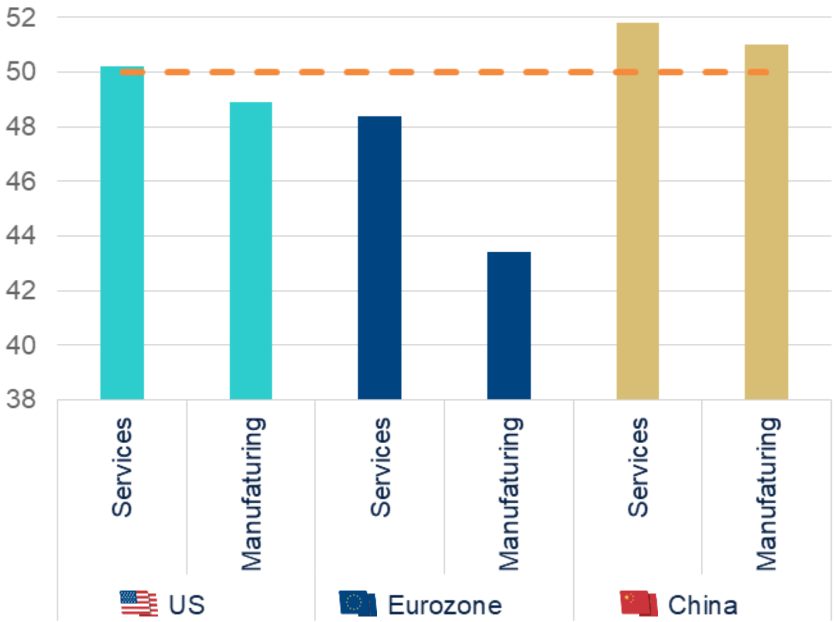


(*) BBVA Research growth estimation for 3Q23.
Source: BBVA Research based on data from Haver.

The service sector is losing some of its strength, adding to the weakness in manufacturing; labor markets remain robust despite the recent moderation

PMI INDICATORS: MOST RECENT FIGURES (*)

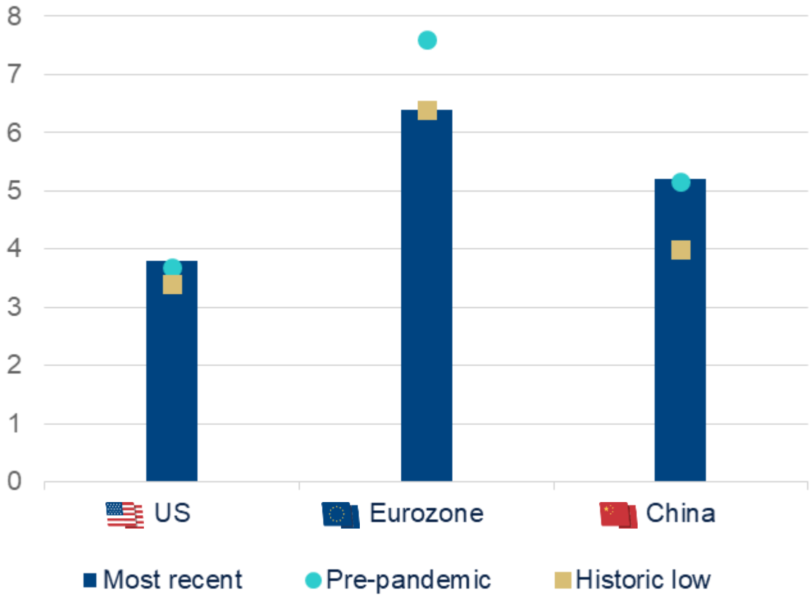
(MORE THAN 50: EXPANSION; LESS THAN 50: CONTRACTION)



(*) Most recent data: Aug/23 in China. Sep/23 in the US and in the EZ.
Source: BBVA Research based on data from Haver.

UNEMPLOYMENT RATE (*)

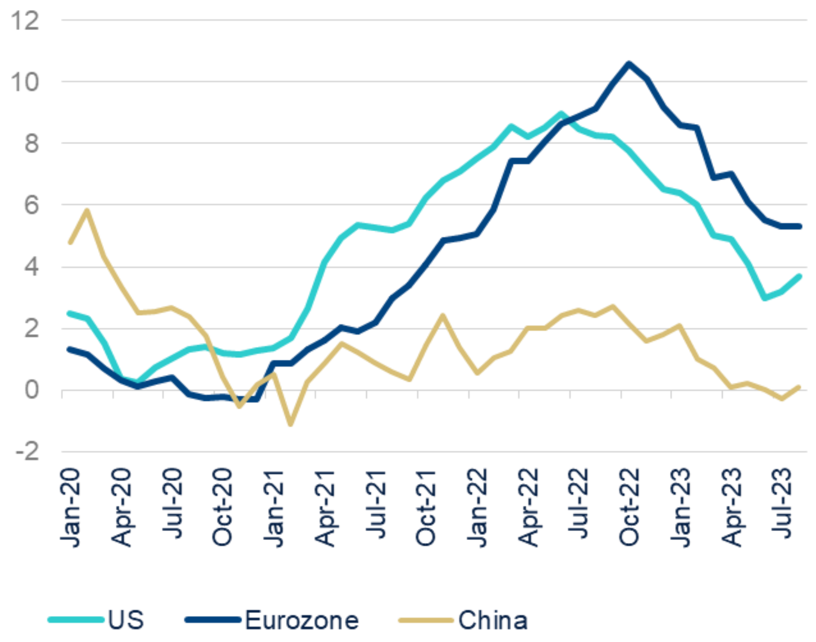
(% OF THE LABOR FORCE)



(*) Most recent data: Aug/23 in the US, Jul/23 in China and in the EZ. Pre-pandemic: 2019 average. Historic low: lowest level since Jan/04
Source: BBVA Research based on data from Haver.

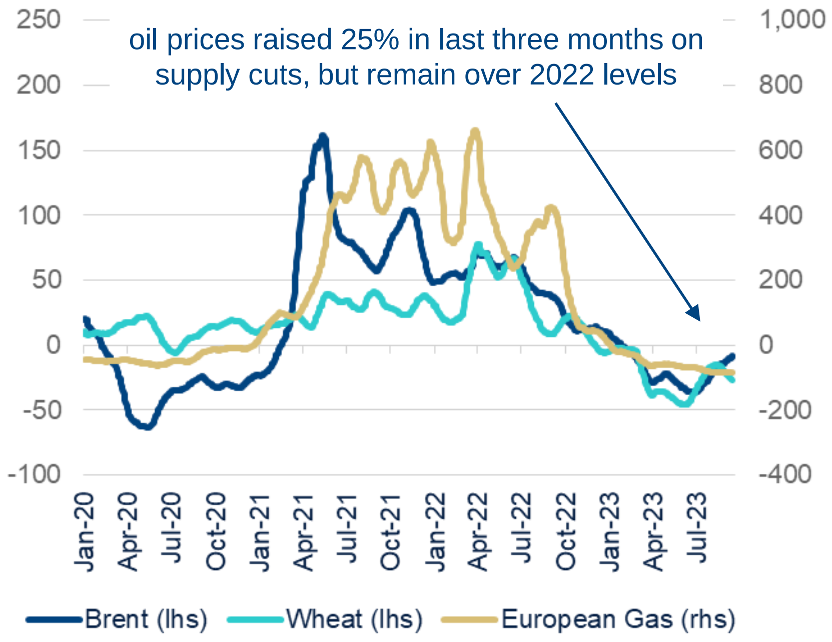
Inflation has been slowing thanks to base effects, easing of bottlenecks and declining commodity prices (despite the recent oil upward trend)

INFLATION: CPI
(Y/Y %)



Source: BBVA Research based on data from Haver.

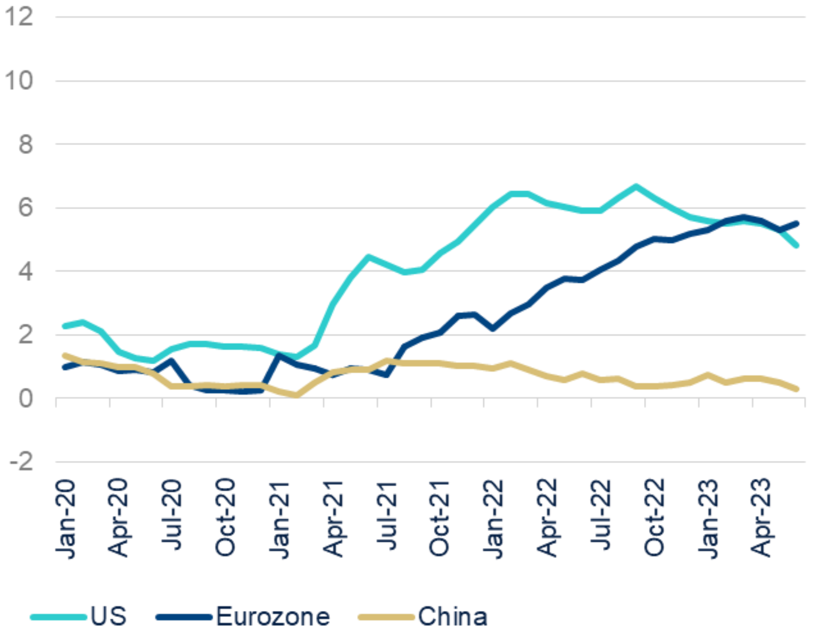
COMMODITY PRICES
(Y/Y %, 30-DAYS MOVING AVERAGE)



Source: BBVA Research based on data from Haver.

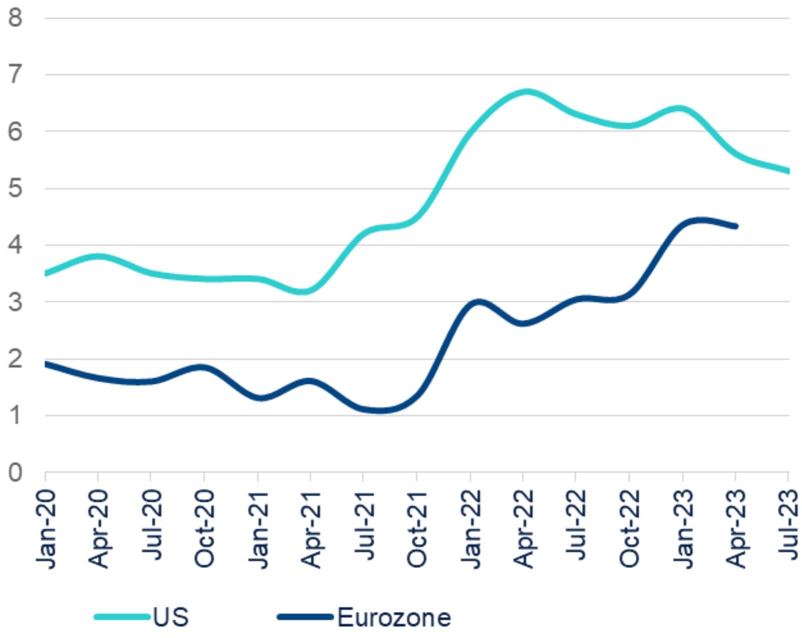
Core inflation remains sticky at high levels, also fueled by (limited) some second-round effects

CORE INFLATION: CPI
(Y/Y %)



Source: BBVA Research based on data from Haver.

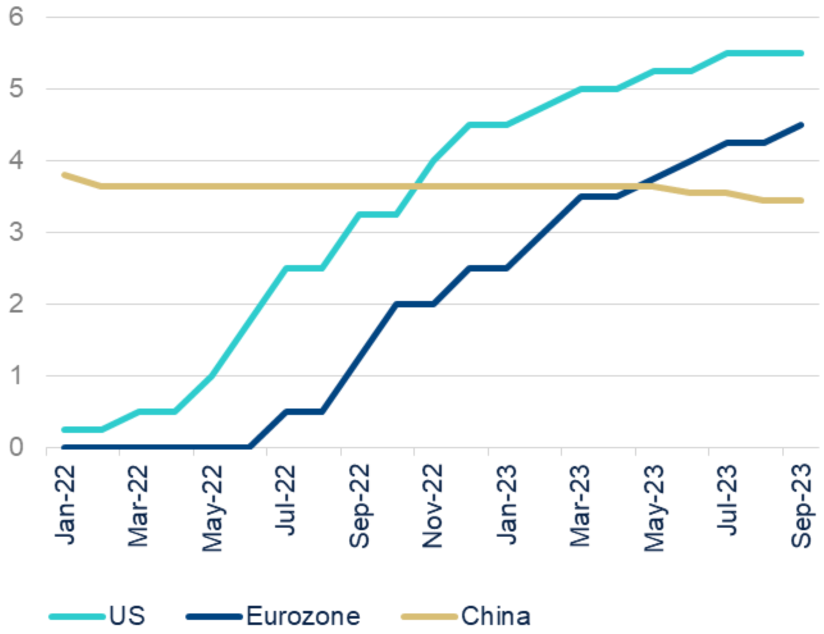
WAGE GROWTH (*)
(Y/Y %, QUARTERLY DATA)



(*) US: Atlanta Wage Tracker; 3Q23 data represents data for Aug/23 only. EZ: negotiated wages.
Source: BBVA Research based on data from the Fed and Eurostat.

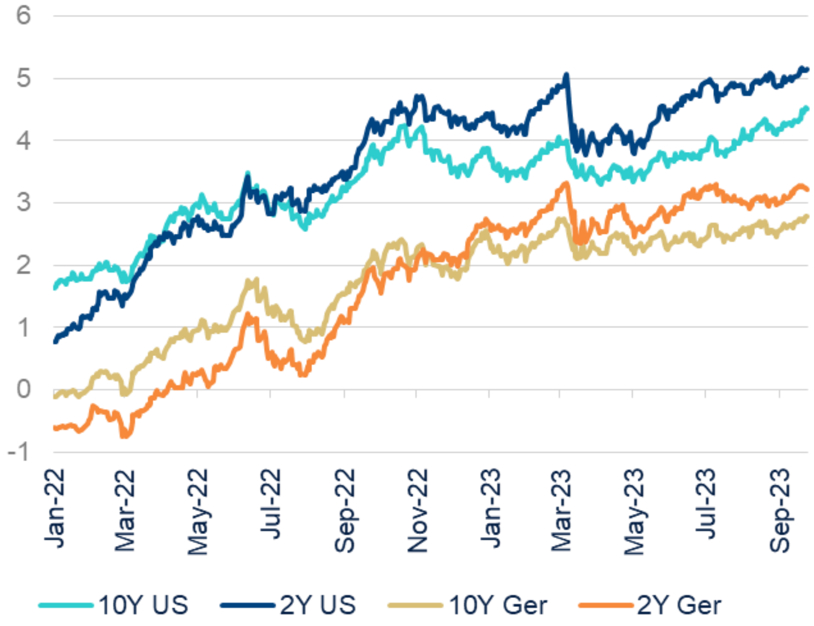
Fed and ECB rate hike cycles seem to be over, but doors are open for extra raises if inflation surprises upwards; PBoC: (small) rate cuts to back growth

POLICY INTEREST RATES (*)
(%)



(*) Refi rates in the case of the ECB.
Source: BBVA Research based on data from Bloomberg.

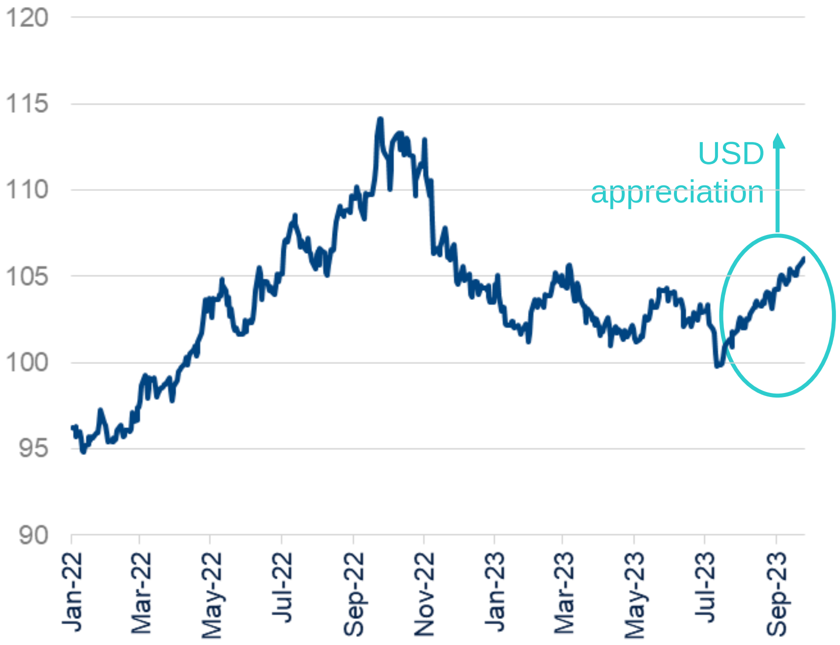
US AND GERMAN SOVEREIGN YIELDS: 2Y AND 10Y
(%)



Source: BBVA Research based on Bloomberg.

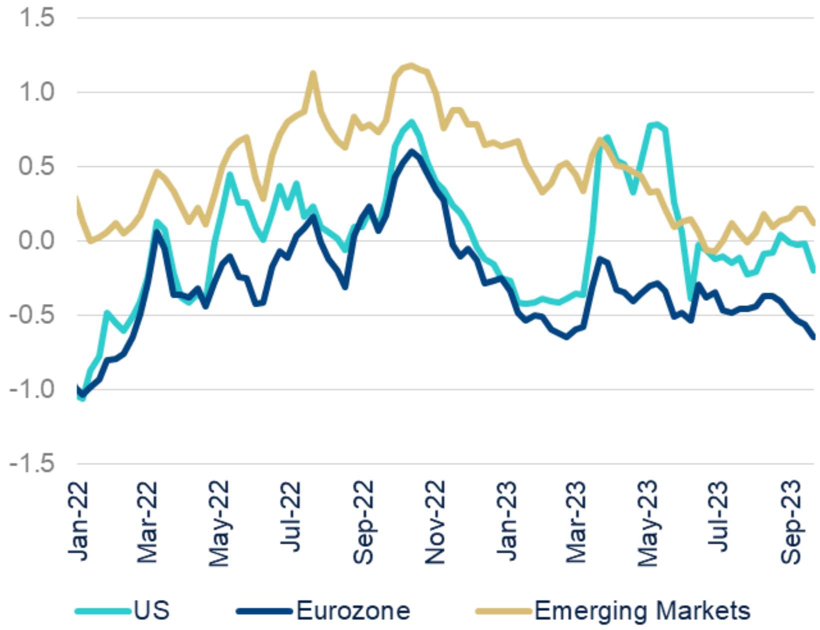
Despite higher interest rates and a stronger US dollar, financial tensions remain relatively low; the US banking turmoil has eased

US DOLLAR INDEX: DXY
(%)



(*) Refi rates in the case of the ECB.
Source: BBVA Research based on data from Bloomberg.

BBVA RESEARCH FINANCIAL TENSIONS INDEX
(INDEX: HISTORIC AVERAGE = 0)



Source: BBVA Research based on Bloomberg.

Global growth is likely to soft land while monetary policy will remain restrictive for a longer than usual period to help inflation ease towards targets

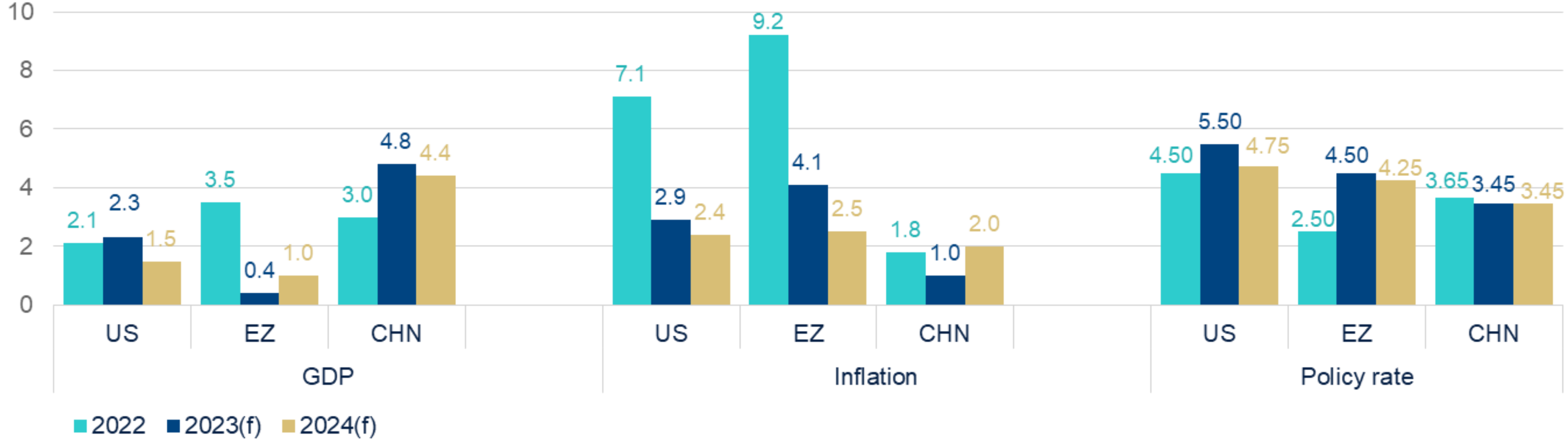
BBVA RESEARCH BASELINE SCENARIO: GDP GROWTH, INFLATION AND POLICY INTEREST RATES (*)

(GDP GROWTH: %, INFLATION: YOY %, EOP, POLICY INTEREST RATES: %, EOP)

Global growth: from 3.5% in 2022 to 2.9% (+0.0pp) in 2023 and 3.0% (+0.1pp) in 2024

Inflation will remain high, but will trend down as demand weakens and given no extra supply shocks

Monetary tightening cycle is likely over in the US and the EZ, but rate cuts are not around the corner

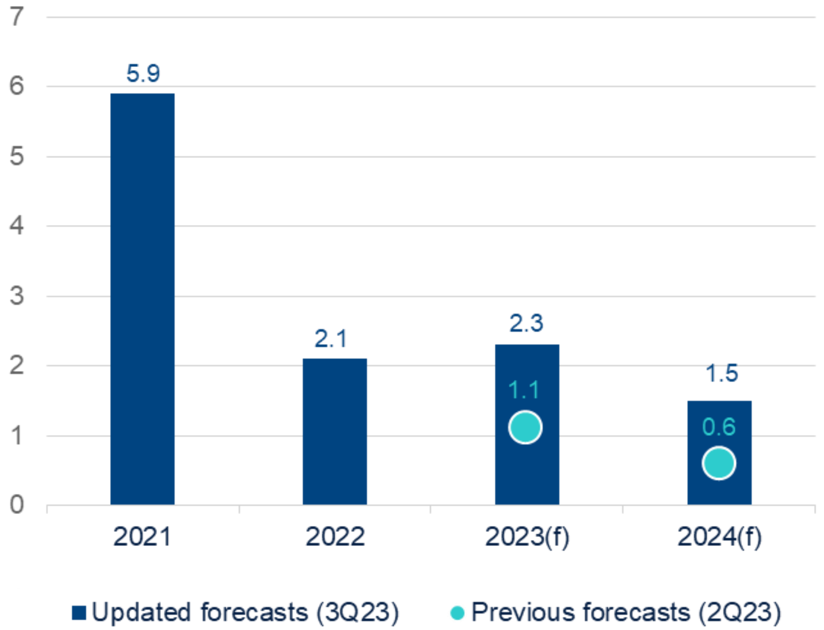


(*) In the case of the Eurozone, interest rates on refinancing operations.
Source: BBVA Research based on Bloomberg data.

US: growth resilience signs make a recession unlikely ahead, postponing the prospects for the beginning of the easing cycle to mid-2024

US: GDP GROWTH

(%)

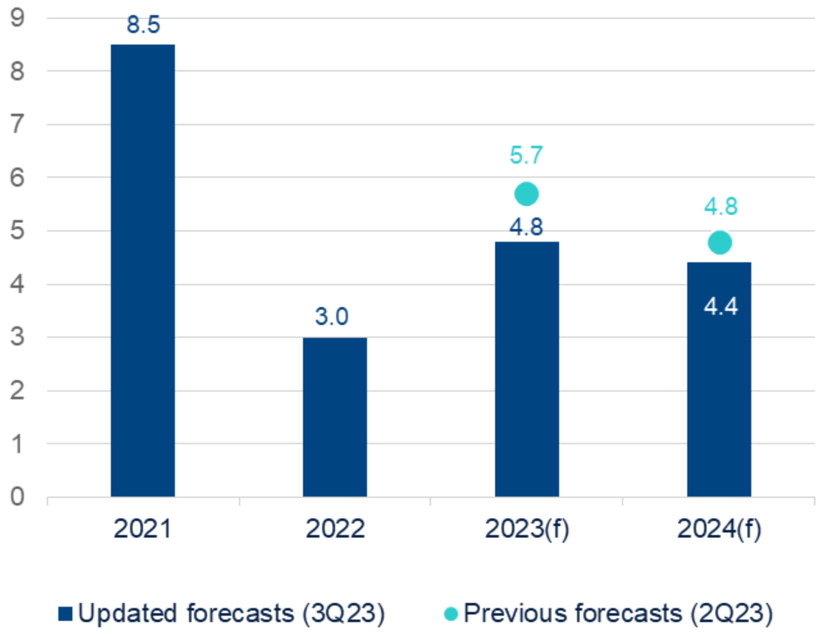


(f): forecast.
Source: BBVA Research

- GDP forecasts revised up on robust domestic demand: solid consumption and resilient investment (boosted by housing market recovery as well as IRA and CHIPS acts).
- Inflation expected to reach 2.9% in Dec/23 and 2.4% in Dec/24; upside risks are still relevant.
- Fed: inflation improvement will prevent extra rate rises (but a hike is still possible in 4Q23); an easing cycle from Jun/24 is likely to take rates to 4.75% in Dec/24.
- Risks: a recession or financial stress on tight monetary conditions and persistent inflation, presidential elections.

China: prospects deteriorated significantly and risks increased given increasing structural challenges, but a gradual growth slowdown is still likely

CHINA: GDP GROWTH
(%)

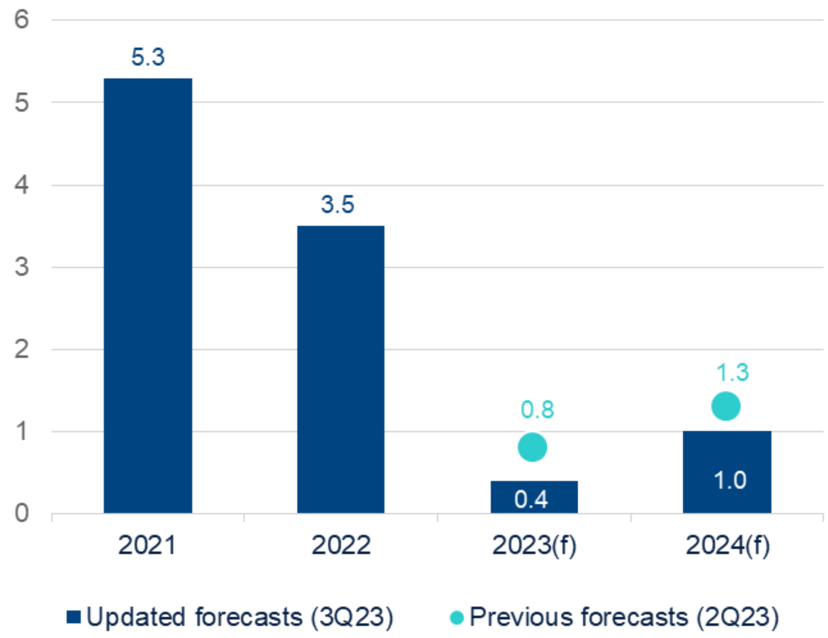


(f): forecast.
Source: BBVA Research

- Generalized deceleration on weak confidence, real estate crunch, 2021 “regulatory storms” and global slowdown.
- Still, the most likely scenario is that further targeted monetary, fiscal and regulatory measures sustain growth and drive inflation up.
- Although a soft-landing is still expected, GDP forecasts have been revised down on incoming data and a costly (but controlled) addressing of real estate imbalances.
- Structural challenges: balance-sheet recession and deflation, US-China confrontation, middle-income trap, unfavorable demographics, etc.

Eurozone: persistent inflation, despite weaker GDP growth, is likely to force the ECB to maintain policy rates at restrictive levels for long

EUROZONE: GDP GROWTH
(%)



(f): forecast.
Source: BBVA Research

- Growth revised down on incoming data amid a deceleration of China, whose effects will be mostly offset by higher US growth.
- Fiscal policy is still supportive, but will likely become more targeted and less expansionary onwards.
- Average inflation forecasts revised up: 5.7% in 2023, 3.0% in 2024 on service stickiness, rebound in oil prices.
- ECB: rates are likely to remain at current levels until Dec/24; increasing focus on liquidity reduction measures.
- Risks: higher energy prices, more persistent inflation, stagflation, China’s deceleration.

Risks: the soft-landing scenario could be potentially derailed by problems in China and the effects of the still high inflation and interest rates

MAIN RISKS

Recession and financial stress on tight monetary conditions

- mainly under more persistent inflation (on labor tightness, second-round effects, higher energy prices, etc.)

A hard-landing in China

- due to real estate problems, low confidence, US-China confrontation, deflation, etc.
- potential financial spillovers

MAIN UNCERTAINTIES

- **Geopolitical and political tensions**
- **US-China rivalry and deglobalization**
- **Climate change and energy transition**
- **Social tensions and populism**

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02

China: growth slowdown and housing market crash

Creating Opportunities

Main messages

Growth

There is a reversion of economic outlook between US, EU and Japan v.s. China at the beginning of 2023 compared with now. Chinese economic recovery came to a halt in Q2 as the effect of reopening from “zero Covid” has been fading over time. 2023 Q2 GDP moderated to 6.3% y/y, to remove the base effect, 2022 and 2023 two-year Q2 average growth is only 3.35%, much lower than two-year Q1 average 4.7%. The ongoing economic slowdown is broad-based, from both supply and demand side, dragged by sluggish consumption (risk-aversion: “scar effect” of pandemic lockdown and regulatory storms), sluggish exports and real estate crash, indicating weak market sentiments of households and enterprises in the post-pandemic time. Based on the recent data outturns, we significantly cut our 2023 GDP forecast from 5.7% to 4.8% (BBG consensus: 5.1%) and 2024 from 4.8% to 4.4%.

Debate

(1) Long-term debate: There is recently a hot debate on whether China will enter into “Japanization” and “balance sheet recession”. Although apparently Chinese economy currently is combined with deflation, weak household and enterprises sentiments and housing price sliding, we do not think China is “Japanized” by analyzing the fundamental differences between the two economies at the different stages. (2) Short-term debate: whether China will go into “hard-landing” and recession?

Politics

The high-level China-US communications including the visit of Yellen, Blinken and Kissinger to Beijing paved the way to Xi-Biden talk at end of this year, although the conflicts remained as the US recently promulgagted new bans on US’s investment to China’s semiconductor, AI and microelectronics etc.

All economic indicators in July are below market expectations and previous readings

ECONOMY

- Industrial production ↓
- Retail sales ↓
- Fixed asset investment
  - Real estate: ↓
  - Manufacturing: ↓
  - Infrastructure: ↓
- Exports ↓

Credit data: ↓

Industrial profits: ↓

Employment: ↓

Inflation: ↓

The only silver lining is: (1) the EV production and (2) the tourism and restaurant consumption.

KEY RISKS

(1) Weak sentiments: sluggish private investment and household consumption.

(2) Deflation.

(3) Real estate crash.

(4) High unemployment rate at young age.

(5) Weak exports and sliding FDI.

POLICY

Expansionary monetary and fiscal policy; but calls for more aggressive easing and to deploy more policy room at central government level.

A long-term debate: Will China enter into “Japanization” and “balance sheet recession”? (1)

- The definition of **“balance sheet recession”** by Japanese-American economist Richard C. Koo occurs when high levels of private sector debt cause households and enterprises to focus on saving by paying down debt rather than spending or investing, causing growth to decline. Under the situation, the target of enterprises transfers from “profit maximization” to “debt mininization”. It happens usually after asset bubble burst. Recent example is Japan's recession since 1990s.

- From policy perspective, monetary policy cannot work-no matter how low the interest is, household and enterprises reluctant to borrow (Keyesian: “liquidity trap” theory). Only expansionary fiscal policy works by creating extra demand.

- The definition of **“Japanization”** is a situation when a country's economy falls into a sustained period of stagnant growth and deflation, in reference to the problems of Japan's economy since the early 1990s.

A hot debate: Will China enter into "Japanization" and "balance sheet recession"? (2)

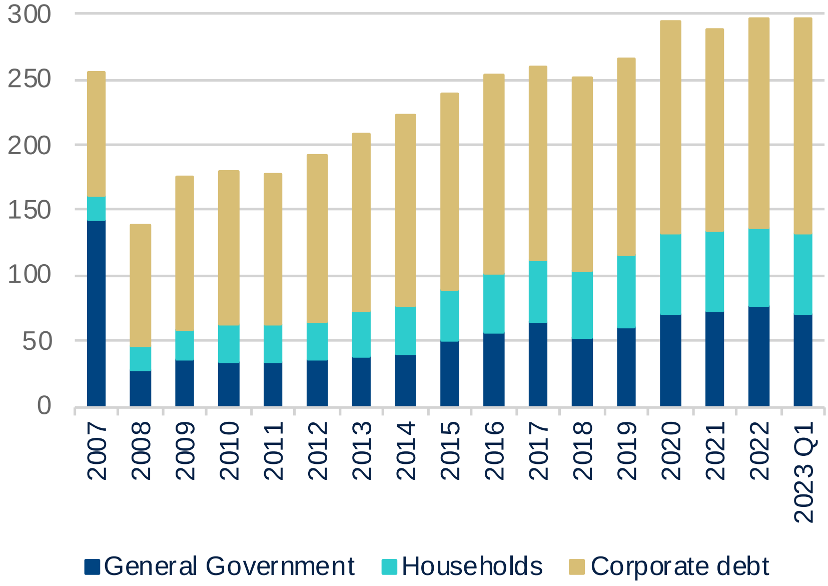
However, China is not entering into Japan-type of "balance sheet recession", let alone "Japanization", although in the short-term it appears to be some similarities:

1. "Balance sheet recession" is usually caused by large-scale asset bubble burst, like Japan's real estate and stock market crash in 1990s, but China does not have experienced this. (see graphs next page).
2. China's this round of property crash was completely policy-driven going back to 2021's swiping housing regulationary storms. There are still policy room for housing market bounce-back.
3. China's enterprises and households have not entered into "proactive deleveraging" process, the previous "deleveraging" was driven by policy compelling. (see graphs next page)
4. From 2008 to March 2023, China's leverage ratio for non-financial enterprises increased from 95.2% to 167%. Although leverage ratio for non-SOE declined, it was completely driven by previous "deleveraging" campaign to remove over-capacity in heavy industry and real estate regulation, such as "three red lines".
5. China did not enter into "liquidity trap" and China's policy rate (policy room) is still high compared with main economies. Unlike Japan, China has never applied zero or negative policy rate or QE-type of monetary measures. In the past, the PBoC has always conducted "prudent" monetary policy with financial stability concern. That means, China still has large policy room in term of monetary policy.
6. Chinese enterprises' exposure to real estate is very small compared with the situation in Japan.
7. Compared with Japanese economy in 1990s, China is still a developing country to catch up with other advanced economies: Chinese labor market is more flexible to adjust compared with Japan's permanent employment system, technology advancement and high-end manufacturing will also provide new growth opportunities.

Some evidences: China is different from Japan and far from “Japanization” (1)

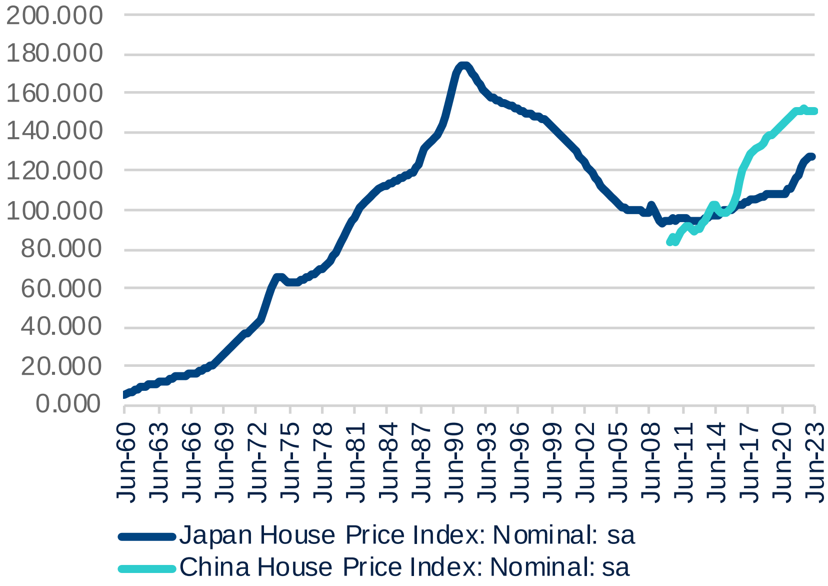
THERE IS NO EVIDENCE OF SUDDEN DROP OF CHINA’S LEVERAGE RATIO IN CORPORATE, GOVERNMENT OR HOUSEHOLD

As % of GDP



CHINA’S HOUSING PRICE IS REGULATED BY THE GOVERNMENT, THERE IS NO SHARP DROP COMPARED WITH JAPAN IN 1990S

index, 2015=100



Source: CEIC and BBVA Research.

Some evidences: China is different from Japan and far from “Japanization” (2)

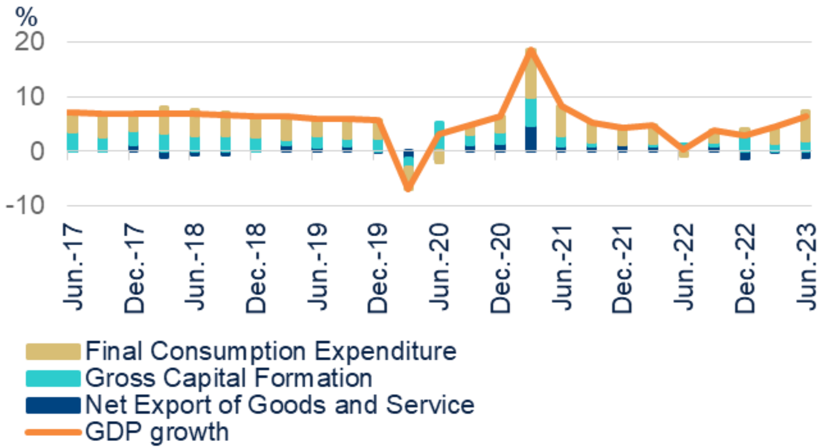
ENTERPRISES’ EXPOSURE TO REAL ESTATE
(ALL LISTED FIRMS EXCLUDING FINANCIAL INSTITUTIONS AND REAL ESTATE FIRMS)

Country	Variable	Period	Mean	Std Dev	10th percentile	Median	90th percentile
Japan	Land value / Total asset	1985-1990	19.30%	11.9%	6.5%	17%	35%
	Land value / Total sales	1985-1990	27.30%	28.20%	6.90%	19.90%	53.80%
China	Land value / Total asset	2013-2015	2.60%	5.60%	0.10%	0.80%	6.50%
	Land value / Total sales	2013-2015	7.30%	26.80%	0.10%	1.50%	13.50%
China	Land value / Total asset	2016	2.40%	6.3%	0.06%	0.6%	5.2%
	Land value / Total sales	2016	10.40%	73.6%	0.1%	1.2%	12.6%
	Land value / Total asset	2020	1.70%	10.6%	0.08%	1.1%	9.66%

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

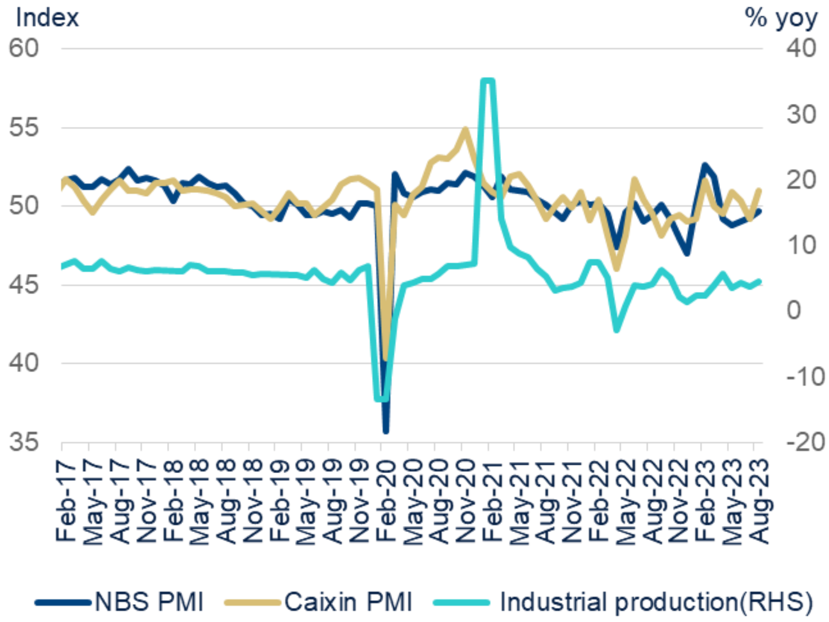
2023 Q2 growth was much lower than expected, 22-23 two-year Q2 average dipped to 3.4%, from two-year Q1 average of 4.7%

2023 Q2 GDP MODERATED TO 6.3%, CONSIDERING BASE EFFECT, LOWER THAN Q1 AVERAGE



Forecast	2023Q1	2023Q2	2022Q3(F)	2023Q4(F)
Y/Y%	4.5	6.3	4.1	4.5
Q/Q%	2.8	-0.4	1.3	1.3

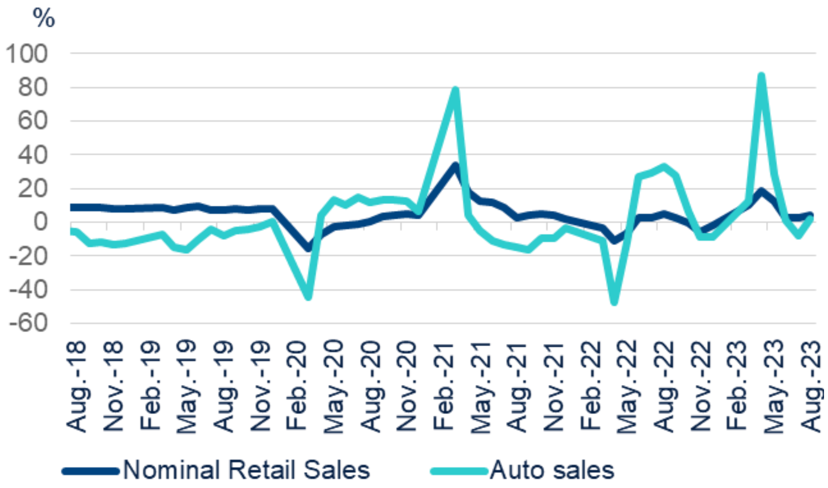
NBS PMI REMAINED BELOW-50 FOR THE PAST MONTHS; INDUSTRIAL PRODUCTION FURTHER MODERATED TO 3.7% FROM 4.4%



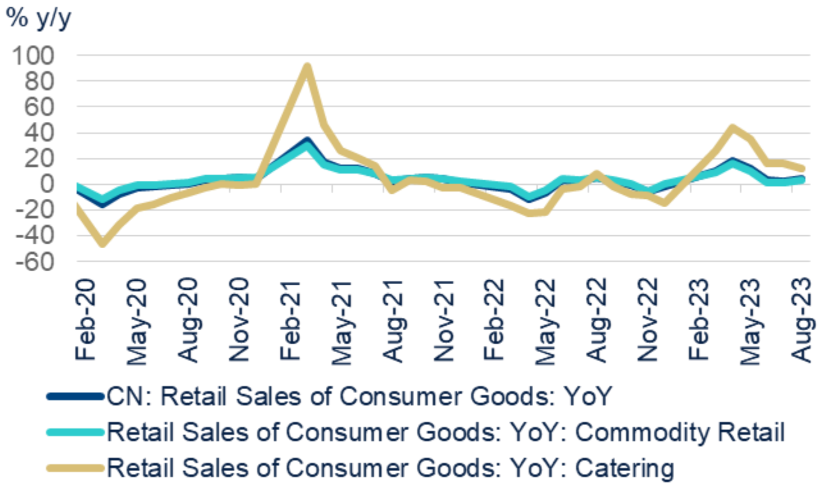
Source: CEIC and BBVA Research.

Retail sales dipped as reopening effect fades, dragged by durable goods consumption; while the service consumption remains resilient

RETAIL SALES SIGNIFICANTLY MODERATED TO 2.5% IN JULY FROM THE PEAK 18.4% IN APRIL; AUTO SALES ALSO DROPPED TO -1.4%



RETAIL SALES GROWTH IN CATERING SECTOR IS STILL SIGNIFICANTLY HIGHER THAN OTHER SECTORS

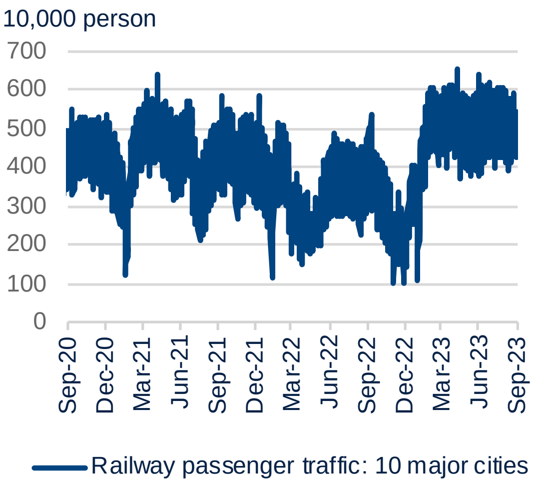


Source: CEIC and BBVA Research.

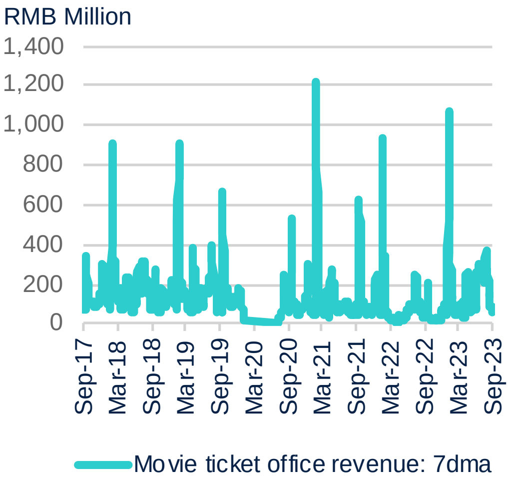
The "consumption revenge" effect on "contact" and "gathering" sectors persists, mainly including restaurant service (+16%), tourism, movie, conferences and exhibitions, transportation, catering etc.
But durable goods such as automobiles, electronic products are lackluster.

High frequency indicators of service sector show that “contact” service sector still resilient

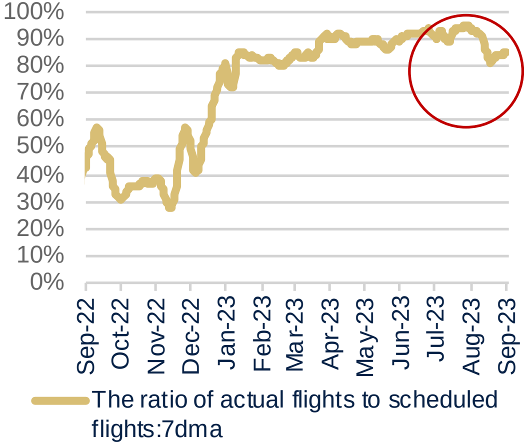
PEOPLE MOBILITY BY TRAIN REMAINS RESILIENT



MOVIE TICKET OFFICE REVENUE ALSO BOUNCE BACK AFTER REOPENING



AIRLINE INDUSTRY GOES BACK TO PRE-COVID LEVEL

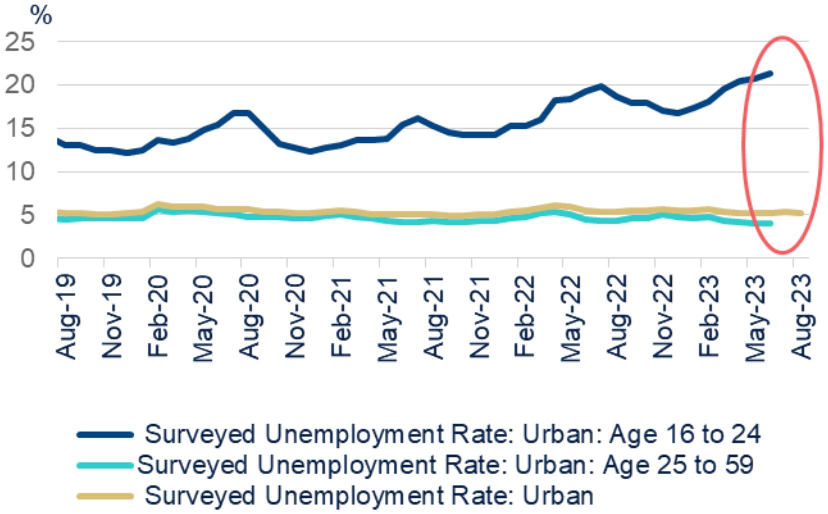


Source: WIND and BBVA Research.

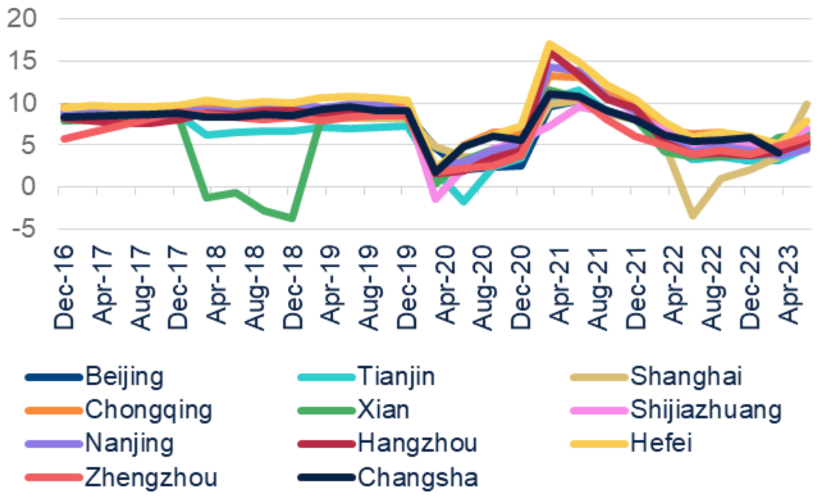
The pandemic impact seems disappear in China, e.g. no. of people taking subway and summer travel surpassed pre-pandemic time in 2019.

Retail sales deteriorated by increasing unemployment (16-24 group), weak income expectation, wealth effect of housing price sliding

UNEMPLOYMENT RATE REMAINED HIGH FOR YOUNG GENERATION: ABOVE 20%



INCOME GROWTH OF CAPITAL CITIES IN EACH PROVINCE HAS NOT RECOVERED TO PRE-PANDEMIC LEVEL

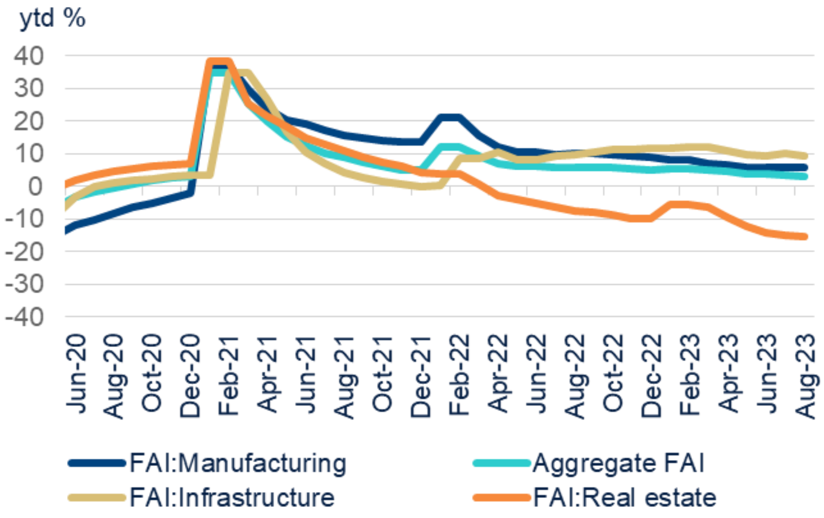


Source: CEIC and BBVA Research.

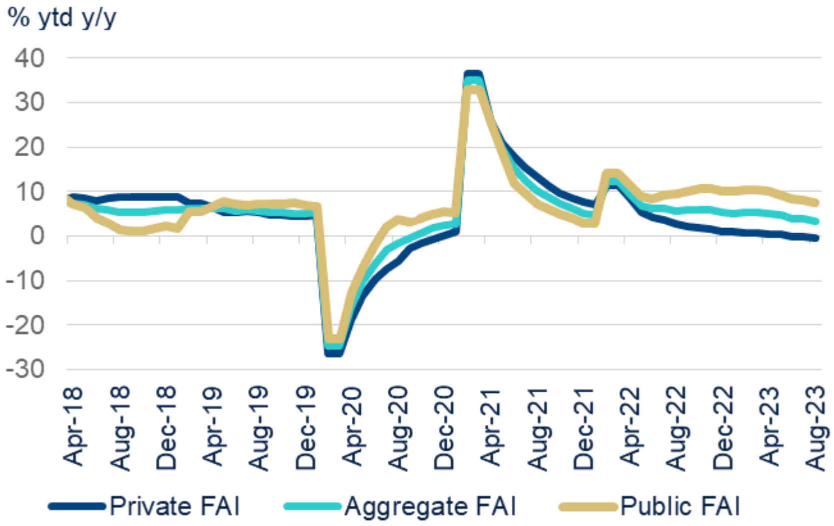
(1) Income and employment deteriorated in housing related sector, exports, private firms, finance industry and tech firms. Lot of recent news of cutting people and compensations in these sectors amid deflationary environment.
(2) China has never conducted direct subsidies to households during pandemic time like US and EU.

FAI: aggregate FAI further moderated dragged by housing investment

FAI FURTHER MODERATED TO 3.4% YTD Y/Y FROM 3.8%；HOUSING INVESTMENT DIPPING TO -8.5% YTD Y/Y



THE MULTIPLIER EFFECT OF PUBLIC FAI TO PRIVATE FAI REMAINS LACKLUSTER

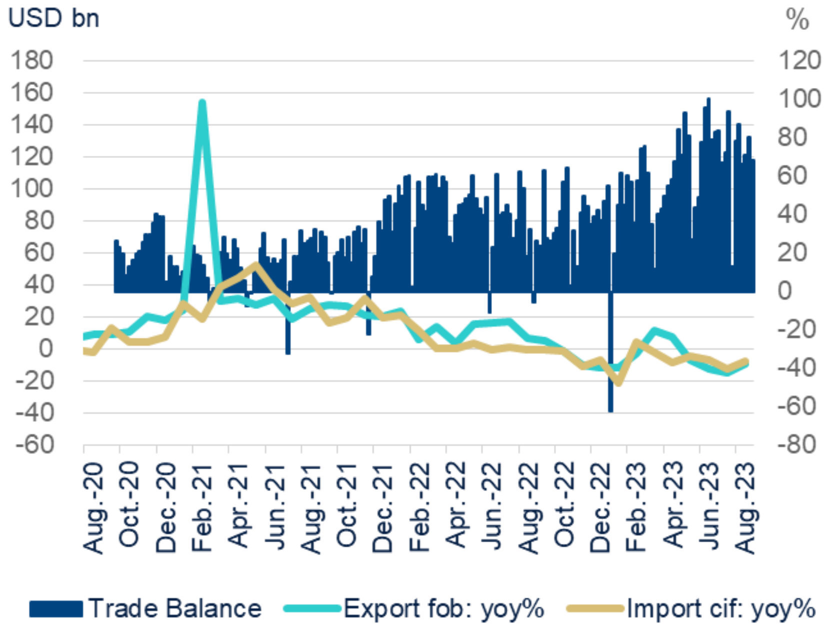


Source: CEIC and BBVA Research.

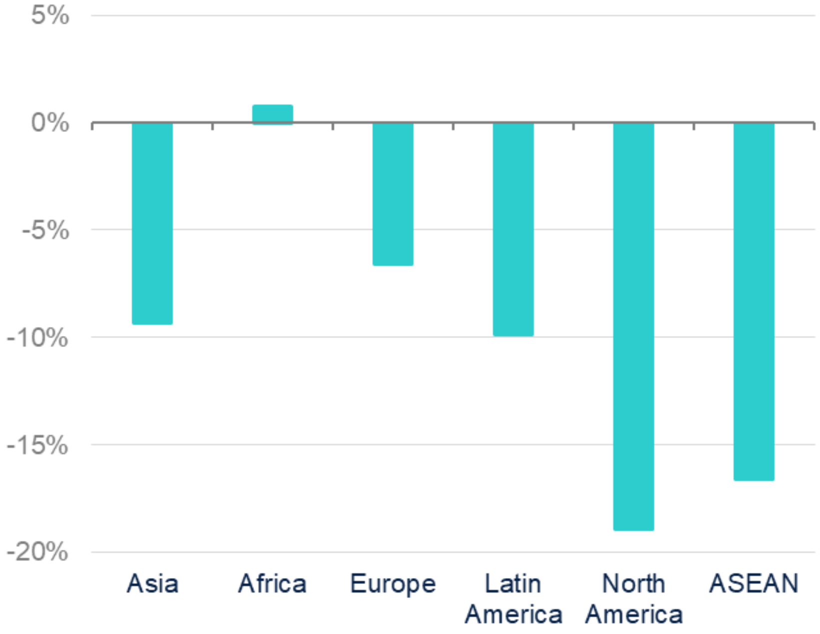
Reasons for a sliding private investment: (1) Deflationary environment and dipping enterprises profits weakened sentiments for private firms; (2) Policy uncertainties triggered by previous “regulatory storms” in 2021 also have negative impact on private investment.

Export sector significantly drags growth amid weak external demand

EMPORTS SLOWED FROM -12.4% TO -14.5% IN JULY, IMPORTS ALSO EXPANDED ITS DECLINE TO -12.4% FROM -6.8%



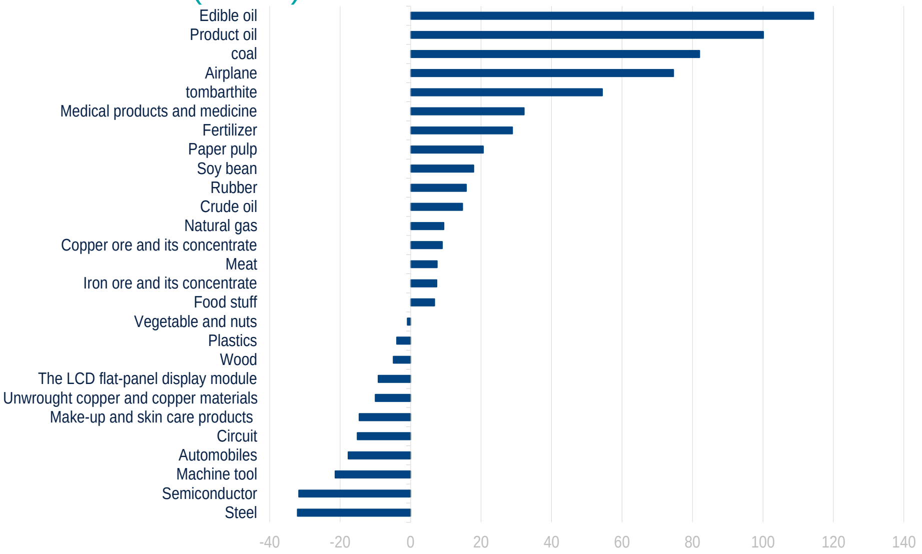
CHINA'S EXPORTS GROWTH TO MOST REGIONS RECORDED NEGATIVE IN JULY



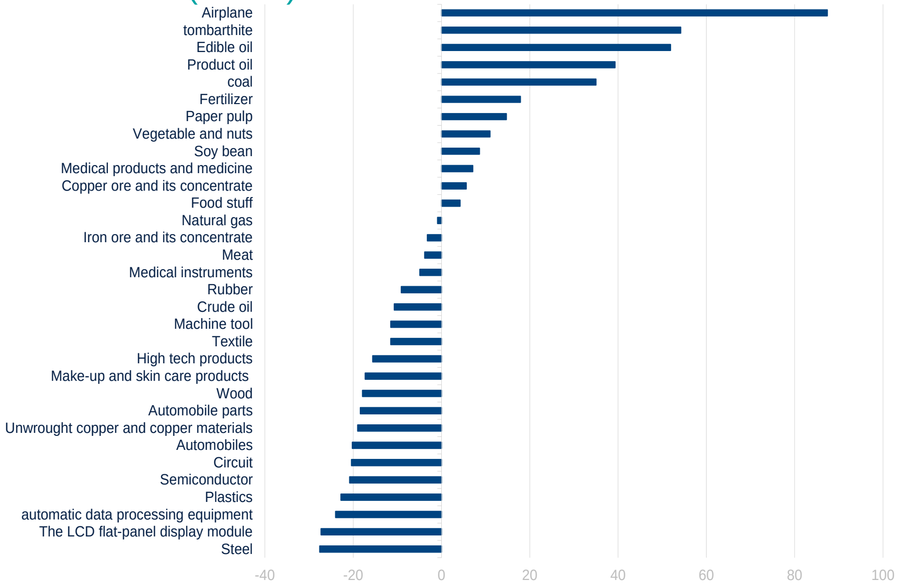
Source: CEIC and BBVA Research.

The new trend of China's foreign trade (1)

CHINA'S IMPORTS GROWTH: BY SECTOR AND BY VALUE (% Y/Y)



CHINA'S IMPORTS GROWTH: BY SECTOR AND BY VOLUME (% Y/Y)



Source: General Administration of Customs of People's Republic of China

Trend 1: the recent import data show that China continues to import large amount of commodities and agricultural products, but import much less high-tech intermediate goods (such as semiconductors, unicircuit, machine tool, LCD display module etc.) and high-tech final goods (such as automobile and electronic products) which experienced double-digit decline.

The new trend of China’s foreign trade (2)

SUMMARY OF NEW GREEN PROJECTS OF COPPER REFINING

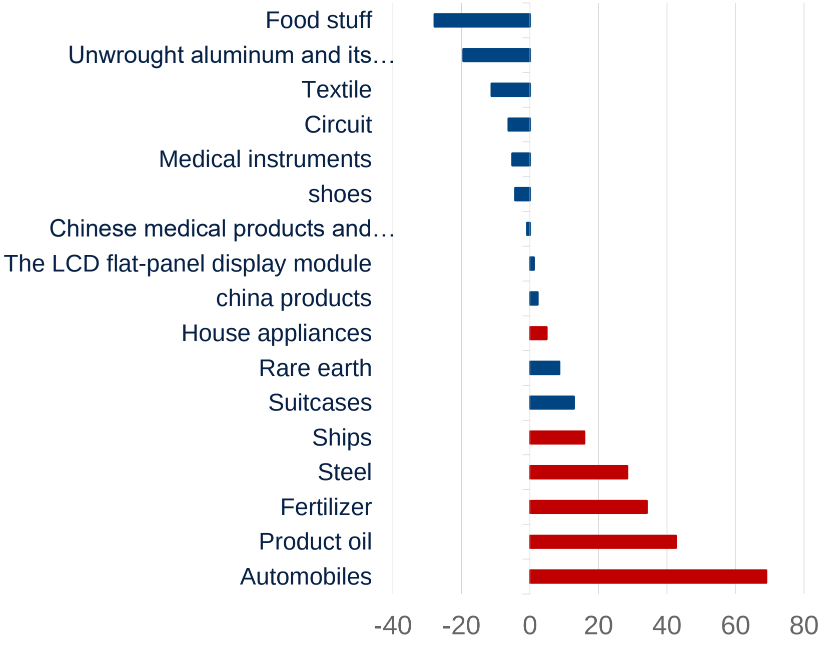
Company name	Newly developed refining capacity (10 thouthand tons)	raw materials	Lauch time
Daye Nonferrous Metals Group	40	copper concentrates	14-Feb-23
Guo Run Copper. (Shandong Yantai)	8	copper concentrates	Q2 2023
Baiyin Nonferrous Group Co.	20	copper concentrates	Jun-23
Zhongtiaoshan Non-ferrous Metals Group Co.,	18	copper concentrates	Oct-23
Jiangxi Copper Company Limited	10	copper concentrates	1H 2023
Sum	**96**		

Source: BBVA Research and summary of commodity research reports.

Trend 2, another feature of China’s forced Import substitution industrialization (ISI) is that China started to import more of raw materials (such as agricultural goods, copper ore and concéntrate etc.) and commodities but less of refined commodities (such as copper products and unwrought copper, steel, plastics, rubber etc.).

The new trend of China's foreign trade (3)

CHINA'S EXPORTS GROWTH: BY SECTOR AND BY VOLUME (% Y/Y)



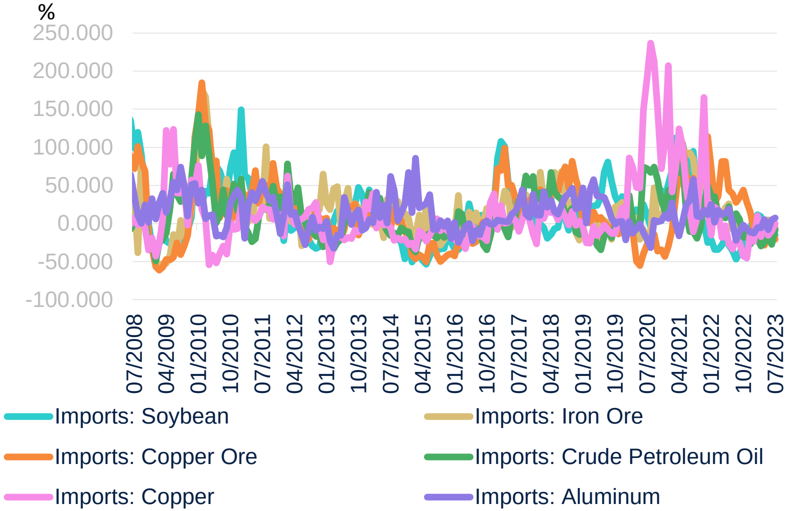
Source: General Administration of Customs of People's Republic of China.

Trend 3:

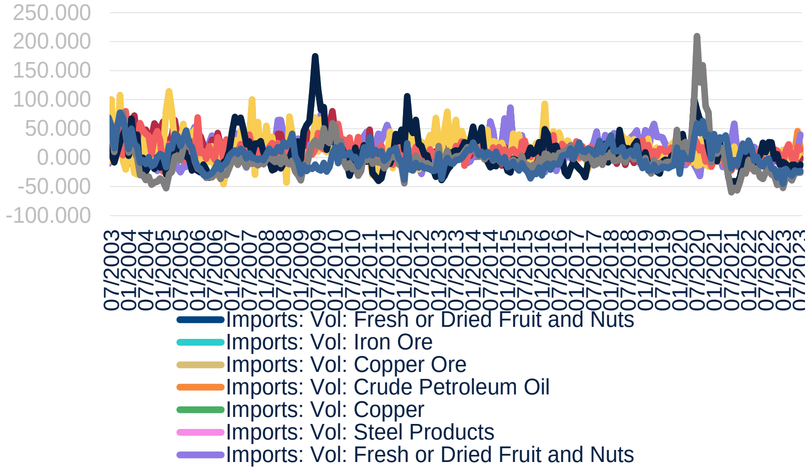
China has started to export more high-tech related products to different geographics, the most stunning performance is China's Electronic Vehicles (EV) exports which takes a large share in global EV trade even in the background of weak external demand. Under the value chain relocation outside of China and "China+1" strategy, the lower-end manufacturing exports from China is significantly declining while high-end exports is ramping up, indicating higher-end enterprises still chooses China for manufacturing due to China's special advantages.

Commodity and agricultural imports from Latam is weakened but without a sharp drop amid growth slowdown

TREND OF CHINA'S COMMODITY AND AGRICULTURAL IMPORTS: BY VALUE



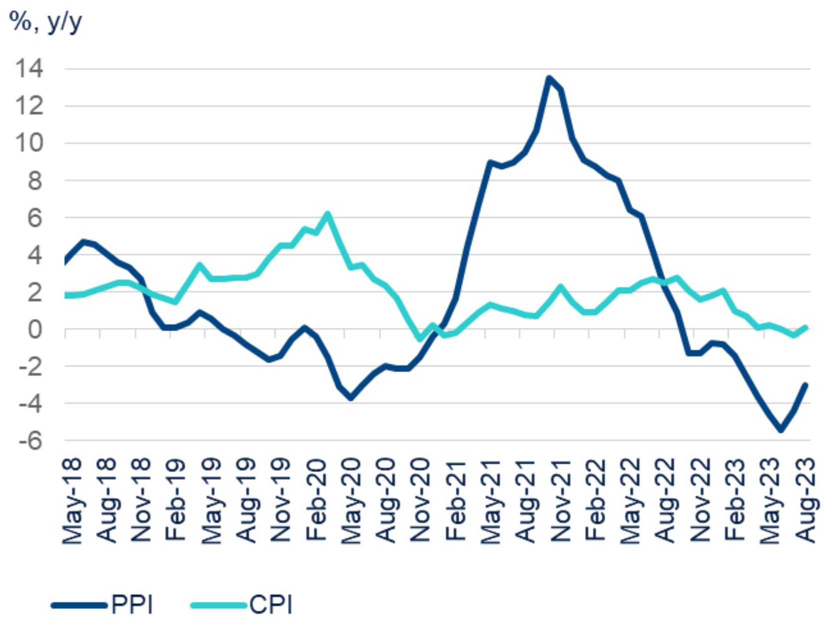
TREND OF CHINA'S COMMODITY AND AGRICULTURAL IMPORTS: BY VOLUME



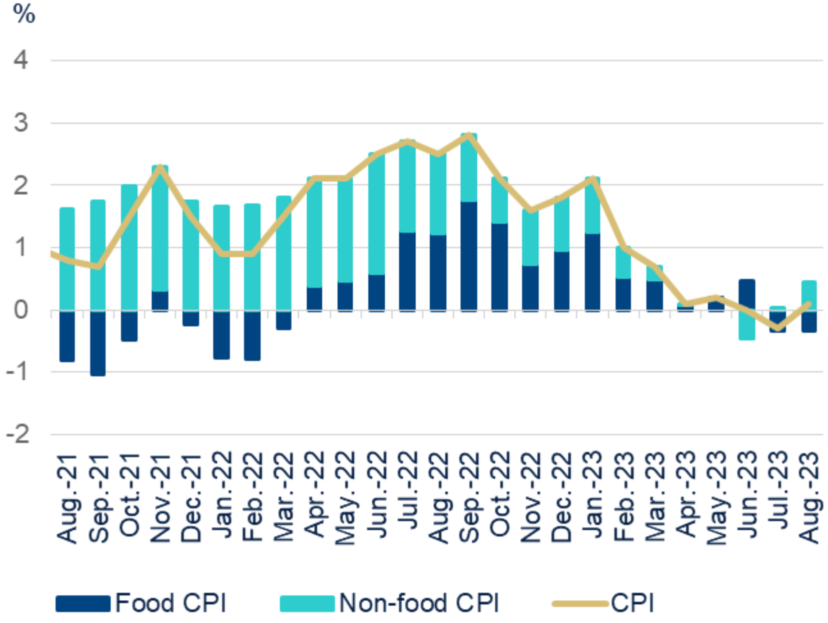
Source: CEIC and BBVA Research.

China's deflation environment is not easy to reverse

CPI DECELINED TO -0.3% IN JULY BUT SLIGHTLY PICKED UP TO 0.1% IN AUGUST



CPI WENT DOWN TOGETHER WITH THE PORK PRICE, NEGATIVE PPI AND PARTICULARLY WEAK DOMESTIC DEMAND

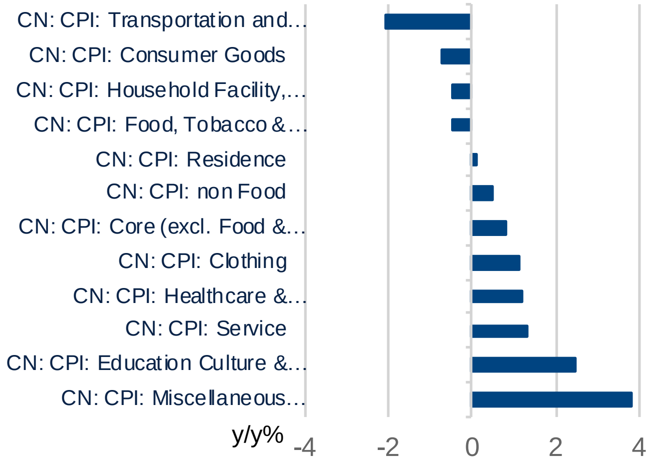


Source: CEIC and BBVA Research.

Understanding China's deflation deeper

CHINA'S PPI IS SYNCHRONIZED WITH GLOBAL PPI AND COMMODITY PRICES

DECOMPOSING CPI BASKET: WHICH SECTORS CONTRBUTE TO DEFLATION?



Source: CEIC and BBVA Research.

(1) Weak domestic demand.

(2) Sliding global commodity prices and transmission effect from a negative PPI to CPI. (imported deflation)

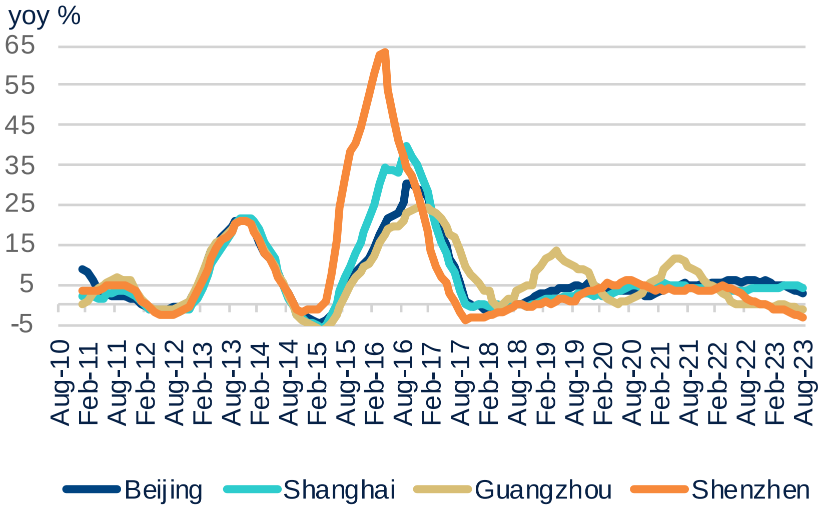
(3) Supply-demand gap after pandemic: a large rebound of supply and smooth logistics VS. a weak and unsustainable demand recovery.

(4) High base effect and seasonality.

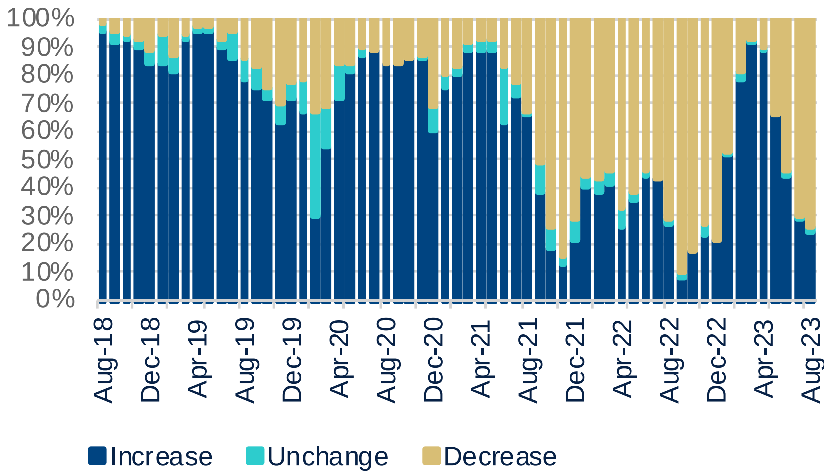
To reverse the deflation, it calls for reversing the expectation for households and private enterprises amid more policy support, such as distributing consumption coupon and injecting subsidies to households.

China's housing market crash was mainly dragged by supply side not demand side

HOUSING PRICES IN TIER-1 CITIES REMAIN RESILIENT



MORE CITIES REPORTED HOUSING PRICE DECREASE IN 70-CITY SURVEY

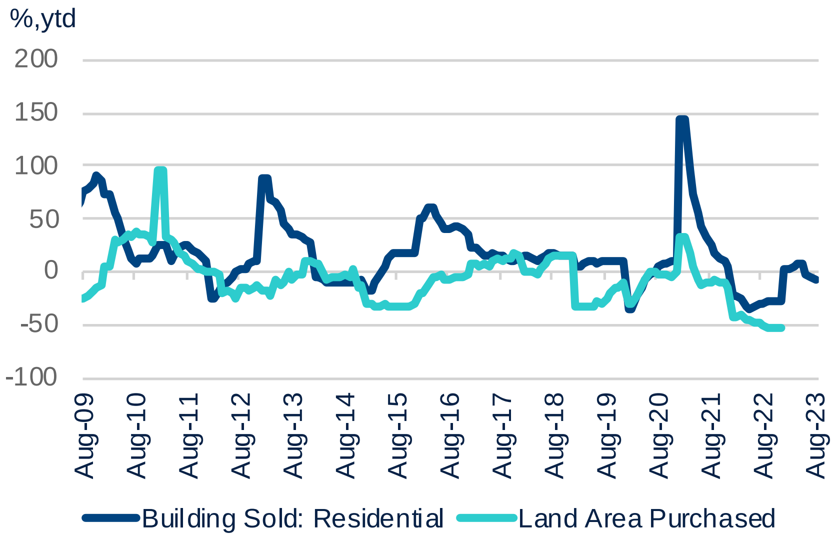


Source: CEIC and BBVA Research.

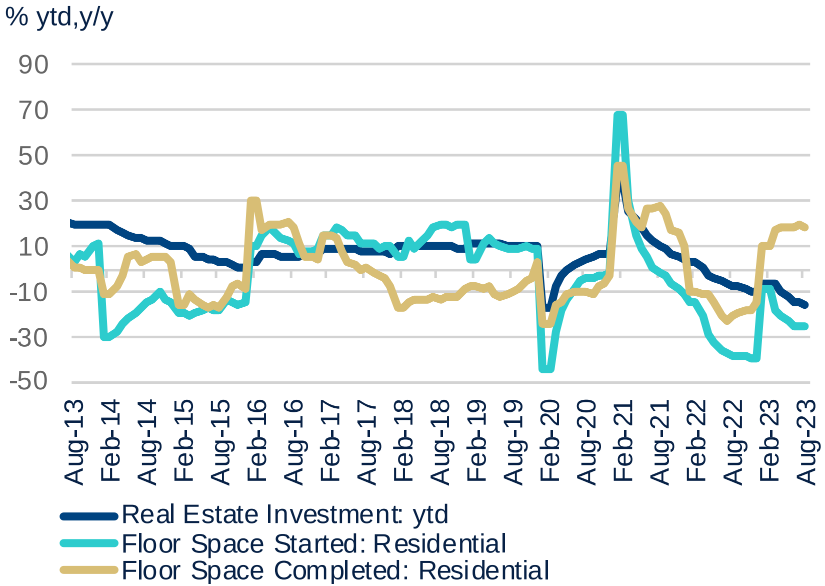
The most recent default case of Country Garden Holding (with billions of USD loss, USD 200 billion unpaid bills, 1 million nondelivered houses, twice default of interests paid to banks and sliding stock price) which is China's one of the largest developers indicates that China's housing market crash amplifies and may have even worse adverse spillover effect to other industries and growth.

Housing activity indicators continue dipping

LAND PURCHASED (3-QUARTER PRIOR INDICATOR) GROWTH REMAINED -53%; BUILDING SOLD ALSO DIPPED TO -7%



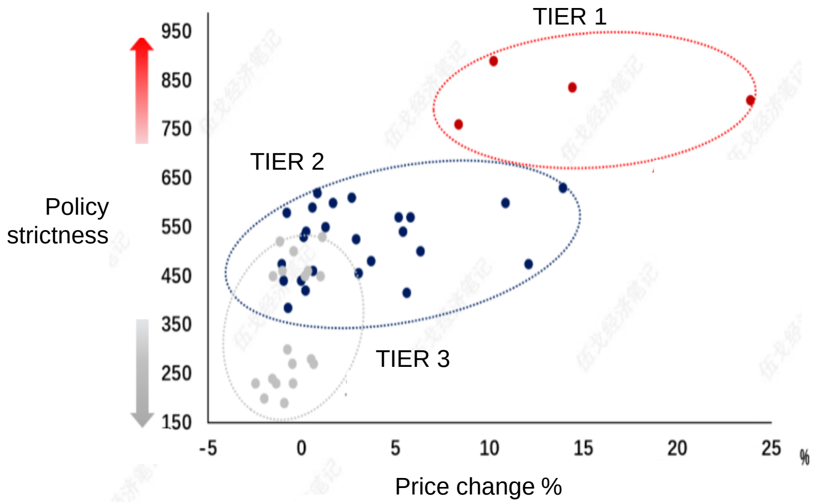
FLOOR SPACE COMPLETED PICKED UP AMID THE POLICY "ensuring timely deliveries of pre-sold homes" VS. NEGATIVE FLOOR STARTED AND HOUSING INVESTMENT



Source: CEIC and BBVA Research.

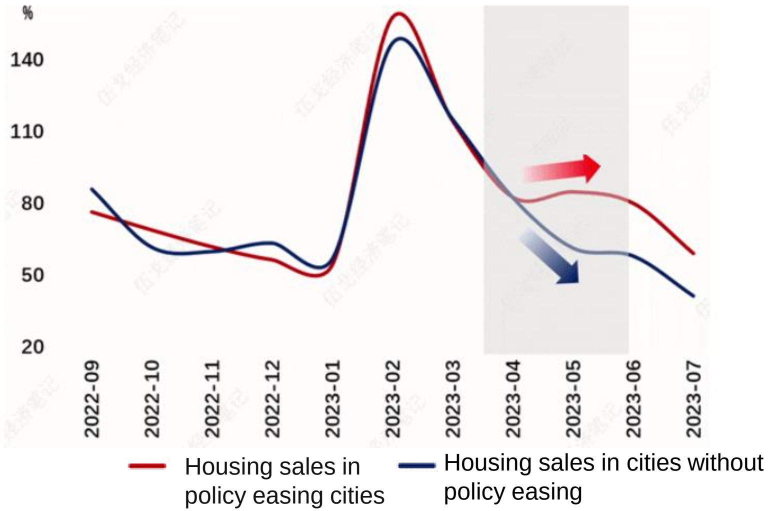
China still has policy room for real estate market

THE ELASTISITY OF HOUSING PRICE RELATED TO STRICTNESS OF POLICY IN DIFFERENT TIERS OF CITIES IS DIFFERENT



Source: BBVA Research and macro report of Changjiang Securities.

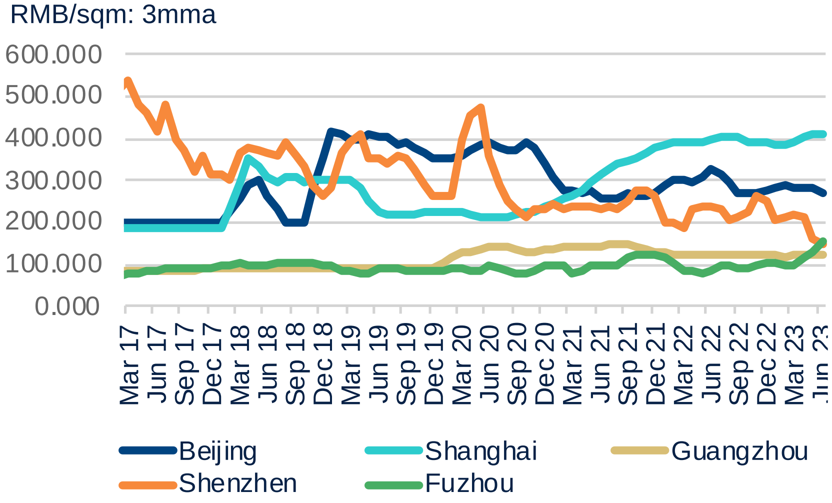
EASING HOUSING MEASURES (REMOVE 2ND HOUSE PURCHASE, CUT DOWNPAYMENT RATIO) IS EFFECTIVE



There are still some policy room for housing market: (i) to remove the “purchase constraint” in tier-1 and tier-2 cities by removing 2nd house purchase, cutting down-payment ratio, cutting rate for existed mortgage; (ii) to allow foreigners to hold Chinese properties; (iii) local governments to purchase tier-3-and-4 cities’ housing inventories to transfer them into public house for migrant workers etc.

Some positive signals on housing sector…

RISING RENT PRICE IN BIG CITIES INIDICATES HOUSING DEMAND STILL THERE, BUT HOUSEHOLDS DELAY THEIR PURCHASE



Source: CEIC and BBVA Research.

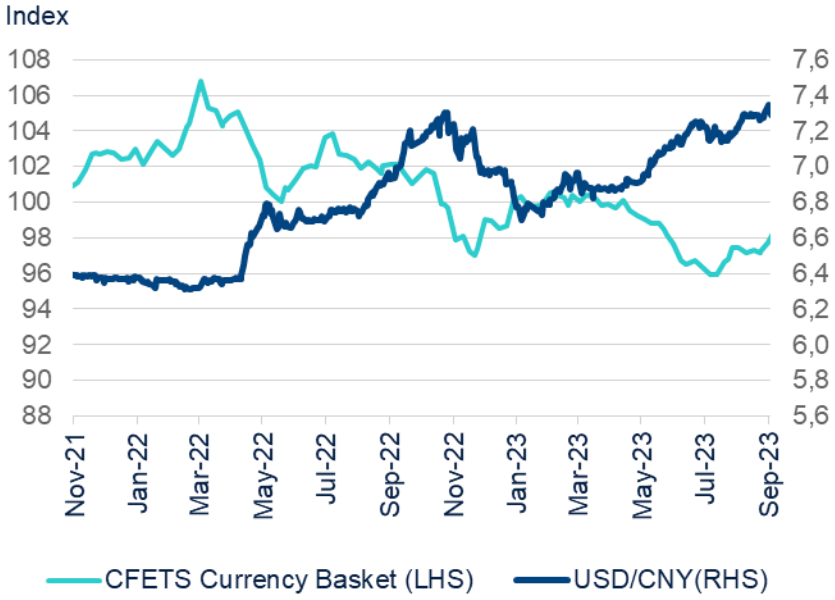
HOME-BUYERS CHANGED THEIR PREFERENCE FROM BUYING HOUSES FROM PRIVATE DEVELOPERS TO STATE-OWNED DEVELOPERS

Rank	Developer	Ownership	Residential housing sales (2023 Jan-June): bn RMB
1	Poly Real Estate	State-owned	236.6
2	Vanke	State-owned	201.8
3	China Overseas	State-owned	178.4
4	China Resources	State-owned	170.2
5	China Merchants Shekou Industrial Zone	State-owned	166.3
6	Country Garden	Private	160.9

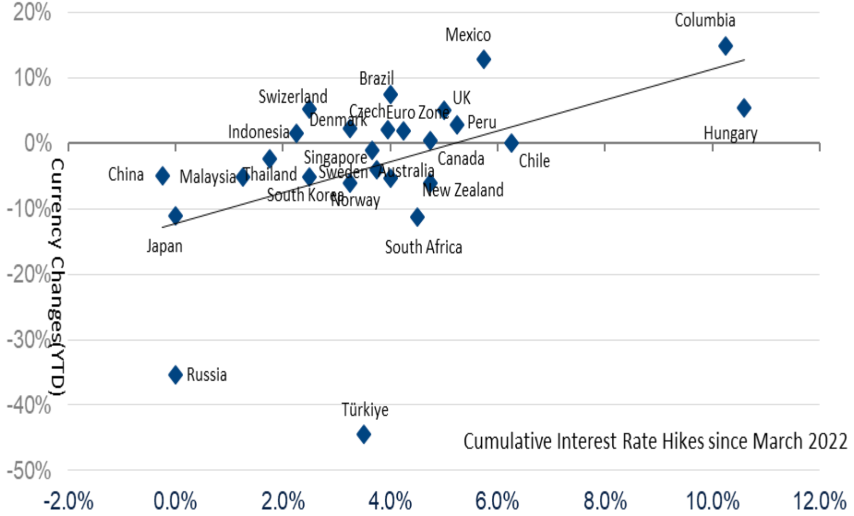
Households started to buy housing from state-owned enterprises instead of private developers reflects the intrinsic issue of China's real estate is the institutional issue. SOE developer has soft-budget constraint and is not subject to any default risk as it could be bailout by government. One direction of housing market is to bailout and nationalize the private developer to circumvent adverse spillover?

RMB exchange rate is significantly dragged by recent rate cut, diverging monetary policy with the US and growth slowdown

RMB EXCHANGE RATE DEPRACIATED TO 7.3, THE HIGHEST LEVEL SINCE THE US HIKED THE RATE



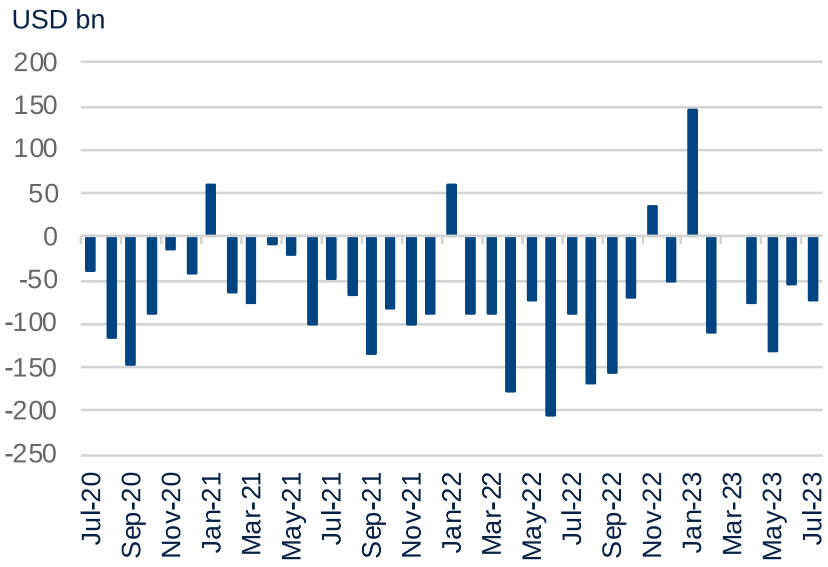
EXCHANGE RATE PERFORMANCE IS TIGHTLY CORRELATED WITH INTEREST RATE HIKES



Source: CEIC and BBVA Research.

RMB exchange rate outlook: identifying short-term, mid-term and long-term

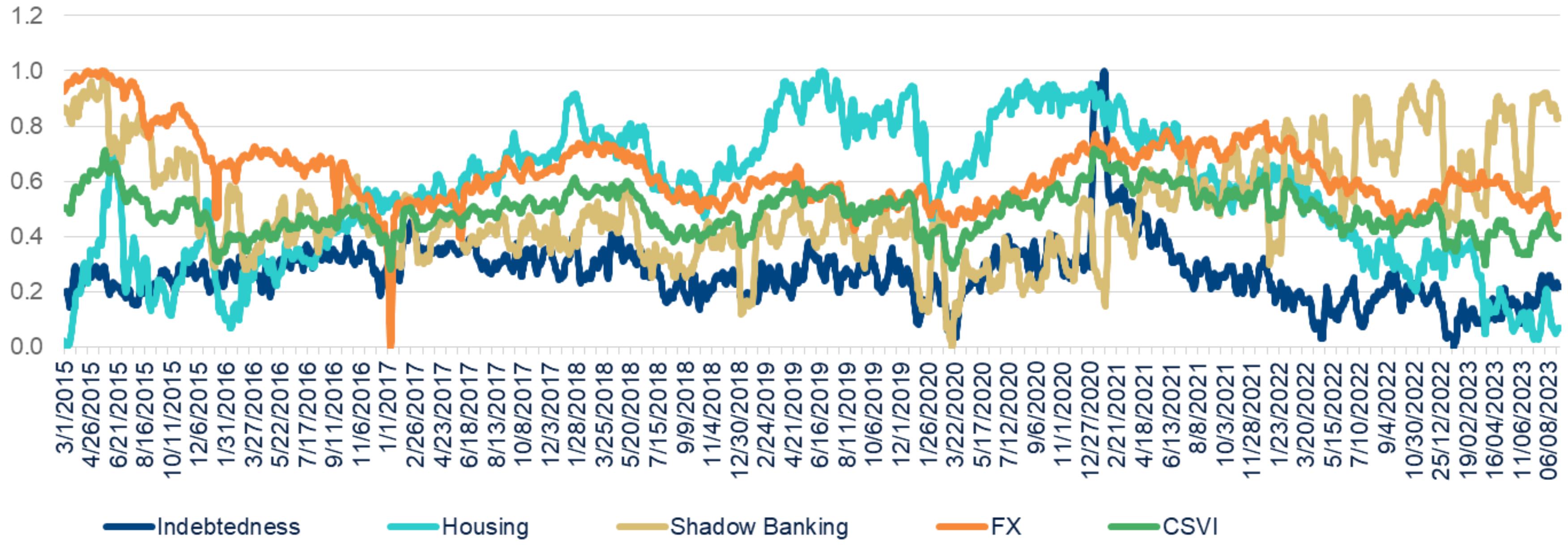
ESTIMATED CAPITAL OUTFLOWS= FOREIGN RESERVE CHANGE-TRADE BALANCE-NET FDI-VALUATION EFFECT



Source: CEIC and BBVA Research.

- In short term, the dominant factor of RMB is the diverging monetary policy between US and China. “High for longer” in US and possible further LPR cut in China will further enlarge interest rate difference, giving pressure to RMB.
- Other short-term factors that drive RMB depreciation include: (i) dipping exports and shrinking current account; (ii) Capital outflows accelerated; (iii) dipping Chinese stock price; (iv) economic slowdown. (v) US raises USD 1 trn new debt, shrinking USD liquidity.
- PBoC’s recent intervention to RMB: (1) Aug 18, raise RMB mid-price by 70 bps and Aug 28, raise it again by 27 bps. (2) Raise macro-prudential parameter of overseas USD financing for domestic enterprises. (3) Issued RMB 0.95 bn bond in offshore market.
- End-2023 revised to 7.2, end-2024 revised to 6.9 (Bloomberg: consensus: 7.1 and 6.7). The mid-term reversion of RMB depends on the timing of US rate cuts in 2024.
- Long term will be a different story: (i) natural interest rate should be equivalent to its natural growth rate. China's potential growth is still higher than the US (China 3.5%, US 1-1.5%), providing a justified support for portfolio inflows and a stronger RMB. (ii) A prerequisite of RMB internationalization is appreciation expectation.

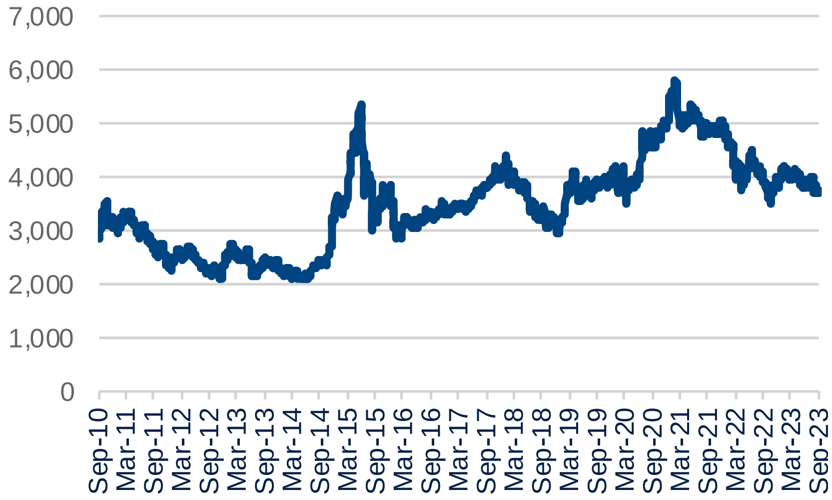
Big data analysis: China vulnerability index



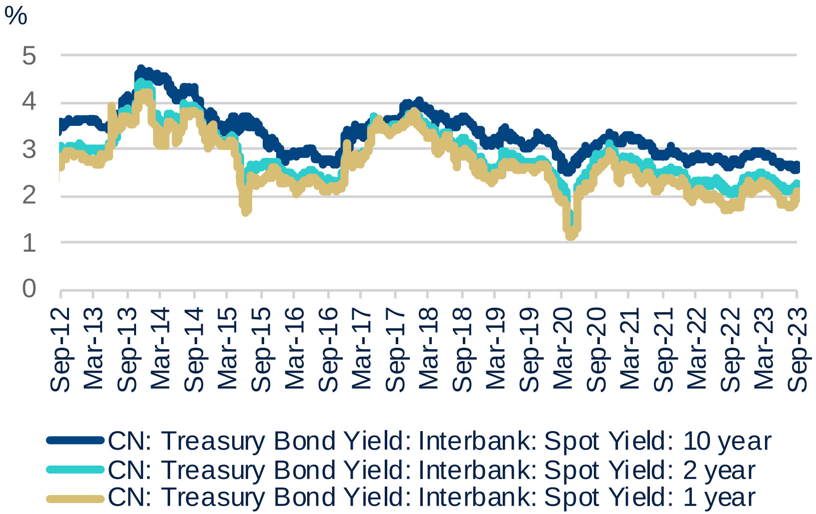
Source: Gdelta, Big Data and BBVA Research.

Financial markets underperformed, reflecting weak investors' confidence

SHANGHAI-SHENZHEN 300 INDEX CORRECTED FROM PREVIOUS HIGH AMID GROWTH SLOWDOWN



BOND YIELD MODERATED AMID INTEREST RATE CUT



Source: CEIC and BBVA Research.

In addition to less optimistic economic outlook, rising geopolitical risks also dampen investors' interest in China's assets.

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03

Policy stimulus set to help achieve soft-landing

Main messages

Monetary policy

Monetary and fiscal policy remain easing, but the current easing measures seem weaker-than-expected. To change “deflation” expectation and to break “balance sheet recession” call for more aggressive stimulus at the central government level, including further interest rate cuts, RRR cut, etc. Long-term structural reforms needed to stimulate consumption. Aggressive easing is better than gradual easing to reverse weak sentiments and economic malaise. However, the authorities will still be cautious to avoid a massive stimulus and flooding liquidities into the markets, taking lessons from RMB 4 trillion stimulus back to 08-09 GFC.

Fiscal policy

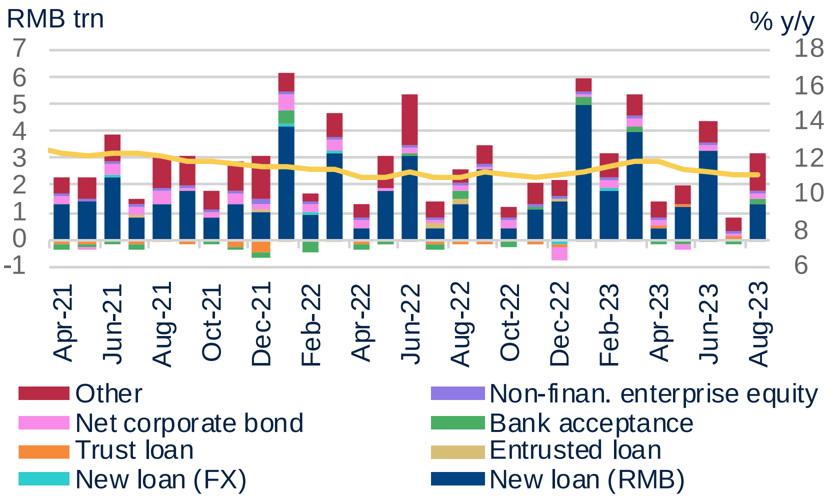
The current fiscal expansionary measures focus on extending tax and fee cuts for private firms (from 2023 to 2027), but has not promulgated a larger scale fiscal support for consumption (i.e. consumption coupon distribution) or infrastructure investment (larger scale local government bond or special infrastructure bond issuance), indicating the authorities have not fully deployed fiscal policy room.

Housing policy

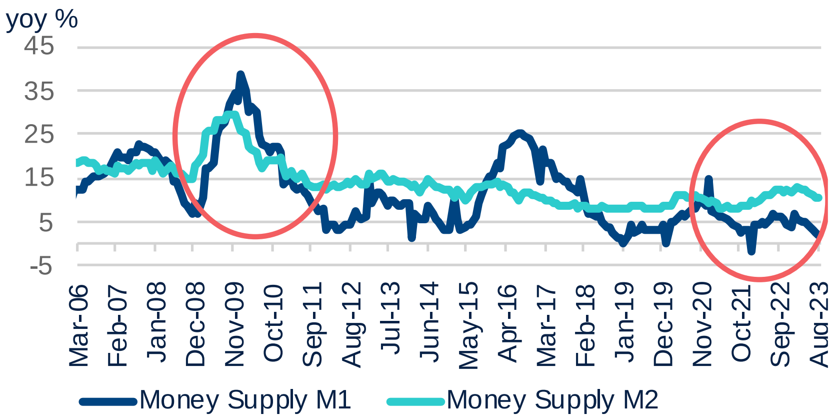
Housing policy is likely to be further relaxed to boost sales and investment in the sector. There are still some policy room for housing market that the authorities have already eased some of the “constraints” but have not fully utilized the policy room, such as (i) the authorities have recently already cut the down-payment ratio, cut the rate for existed mortgage and lowered the mortgage rate, etc.); (ii) The authorities could also allow foreigners (HK and overseas) to hold Chinese properties; (iii) it is suggested that local governments to purchase tier-3-and-4 cities’ housing inventories to transfer them into public house providing to migrant workers etc.

Monetary transmission mechanism is weak: credit expansion comes from policy side, not proactive "balance sheet" expansion by household and enterprises

TOTAL SOCIAL FINANCING AND NEW RMB LOANS BOUNCED BACK IN AUSGUT AMID MONETARY STIMULUS



…TOGETHER WITH M2 GROWTH

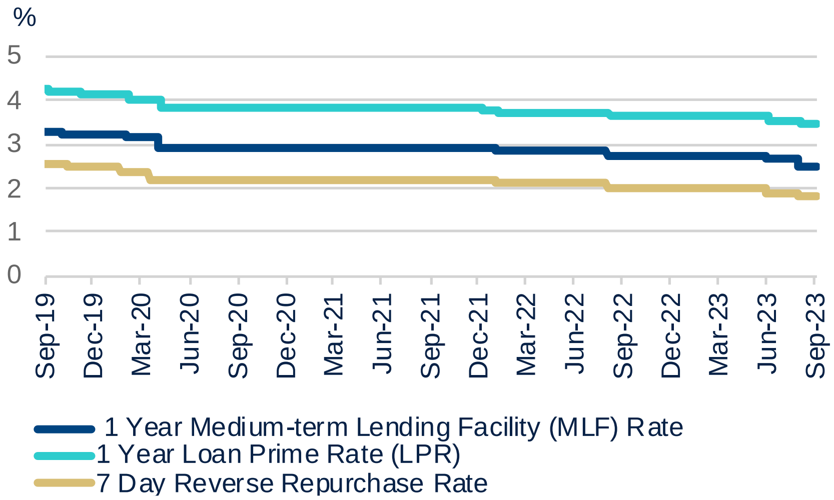


Source: CEIC and BBVA Research.

Despite the recent LPR cut, most of credit expansion went to SOEs, while the private investment remains lackluster. The repairment of enterprises' profits, consumers' confidence and their "balance sheets" are the key for a smooth transmission from loosening monetary policy to real economy.

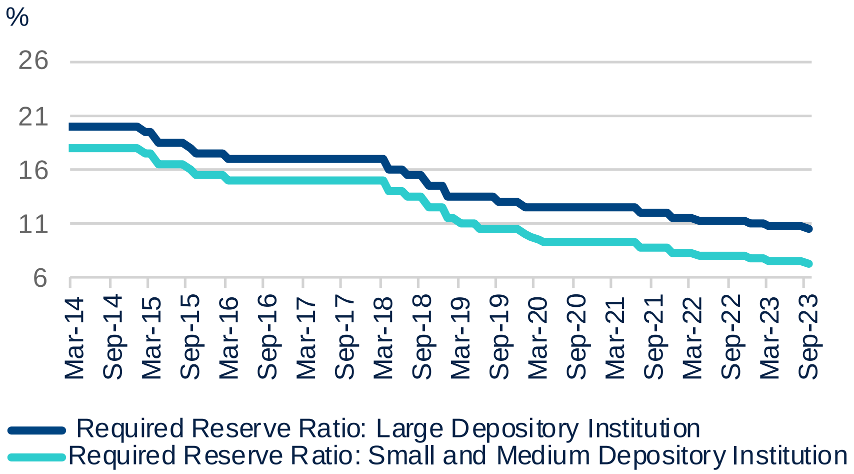
The PBoC restarts interest rate cut tool to stimulate growth amid FED hike cycle, as growth slowdown dominates the previous financial stability concern

CHINA UNEXPECTEDLY CUT ONE-YEAR LPR DURING FED HIKE CYCLE IN AUGUST, WE ANTICIPATE ANOTHER 10 BPS CUT AHEAD



Source: CEIC and BBVA Research.

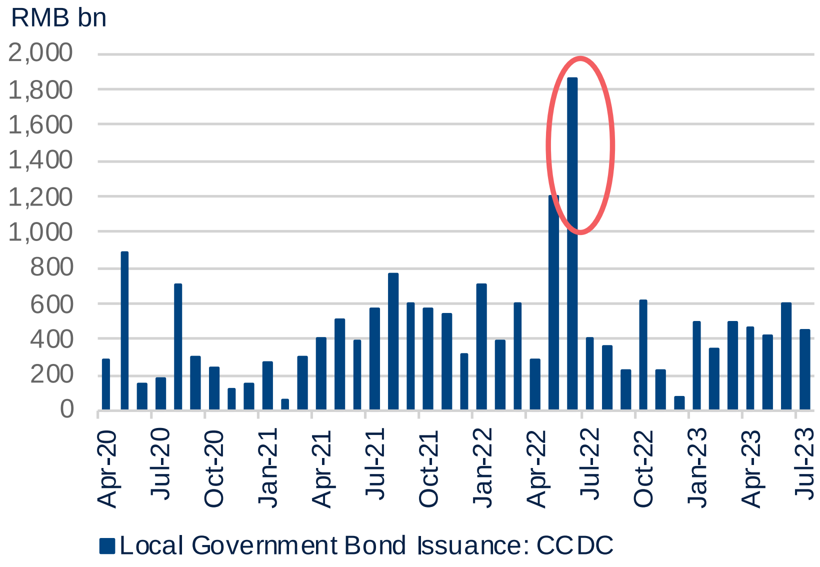
NOT ONLY BY MEANS OF PRICE TOOLS (RATE CUT), THE PBOC ALSO CUT RRR IN SEPTEMBER



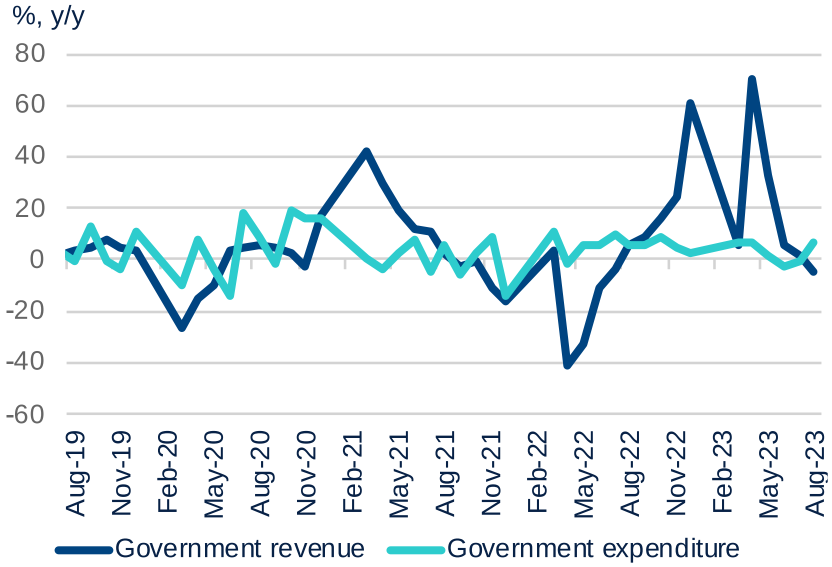
The LPR cut in August is asymmetric, the PBoC only cuts one-year LPR by 10 bps from 3.55% to 3.45% but maintained 5-year LPR (linked to housing mortgage), providing room for the interest rate cut for the storage of housing mortgage; moreover, it also considers banks' profitability.

Fiscal stimulus is anticipated to be more effective to revert economic malaise

THE AUTHORITIES ARE EXPECTED TO FURTHER EXPAND LOCAL GOVERNMENT BOND ISSUANCE



LOCAL GOVERNMENT FISCAL REVENUE WAS AFFECTED BY DIPPING LAND SALES



Source: CEIC and BBVA Research.

Forecast: China’s main economic indicators: Baseline scenario

	Baseline scenario						
	2019	2020	2021	2022	2023	2024	2025
GDP （%）	6.1	2.3	8.1	3	4.8 ↓	4.4 ↓	4.2 ↓
CPI （%）	2.9	2.6	0.9	2	0.5 ↓	2	2
PP I (%)	-0.3	-1.8	8.1	4.2	-3 ↓	0.7	1
Interest rate (LPR, %）	4.1	3.85	3.8	3.6	3.35 ↓	3.35 ↓	3.35 ↓
RMB/USD exchange rate	7	6.5	6.36	6.9	7.2 ↑	6.9 ↑	6.7

Forecast: China’s main economic indicators: Risk scenario

	Risk scenario						
	2019	2020	2021	2022	2023	2024	2025
GDP （%）	6.1	2.3	8.1	3.0	2.0	1.5	3.0
CPI （%）	2.9	2.6	0.9	2	-1.5	-0.5	2.0
PP I (%)	-0.3	-1.8	8.1	4.2	-4.0	-2.0	1.0
Interest rate (LPR, %）	4.1	3.85	3.8	3.6	1.5	1.0	0.5
RMB/USD exchange rate	7	6.5	6.36	6.9	7.8	8.0	7.5

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China Economic Outlook

September 2023

Creating Opportunities