BBVA Research

# China Economic Outlook

December 2023

Creating Opportunities

Research

01

# Global economy: rate hike comes to an end

# Main messages

**Recent developments**

Growth and inflation have been trending downwards, favored by the recent tightening of monetary conditions. The moderation of commodity prices is also allowing inflation to ease, while providing some support to growth. Still expansive fiscal policy and resilient labor markets are backing activity, but making the disinflation process more difficult. Markets have exhibited a positive tone lately, but remain subject to volatility, especially considering that uncertainty remains very high.

**Growth outlook**

A further deceleration of the global economy is likely moving forward, as monetary conditions will remain tight, fiscal policy will eventually become less expansive, labor markets will continue losing steam and excess savings are set to decline further. However, a deep recession will likely be avoided. Global growth is forecast to decline from 3.4% in 2022 to around 3.0% in both 2023 and 2024.

**Inflation and rates outlook**

Inflation is also expected to keep easing, continuing its slow convergence to the targets. That will provide some relief to central banks, which are unlikely, however, to embark on interest rate cutting cycles before the middle of 2024: the Fed and the ECB are expected to revise rates gradually down from Jun/24 and Sep/24, respectively, while they continue to reduce liquidity levels.

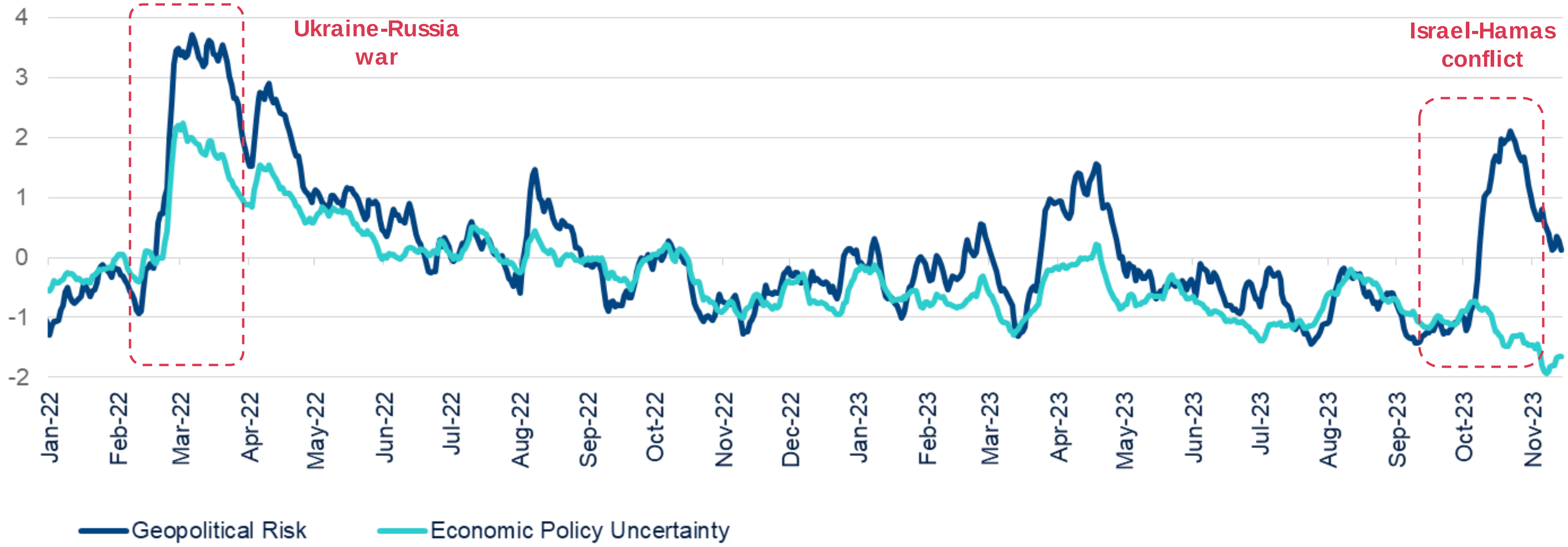
**Risks**

Recession and financial stress episodes are still possible given tight monetary conditions, high inflation and growth deceleration. Geopolitical uncertainty is also a source of concern, particularly after the beginning of the Israel-Hamas conflict. Another risk is a hard-landing in China.

# Geopolitical risks have increased on the Israel-Hamas conflict, but economic policy uncertainty has remained relatively low

## GEOPOLITICAL RISK AND ECONOMIC POLICY UNCERTAINTY IN G3 REGIONS (*)

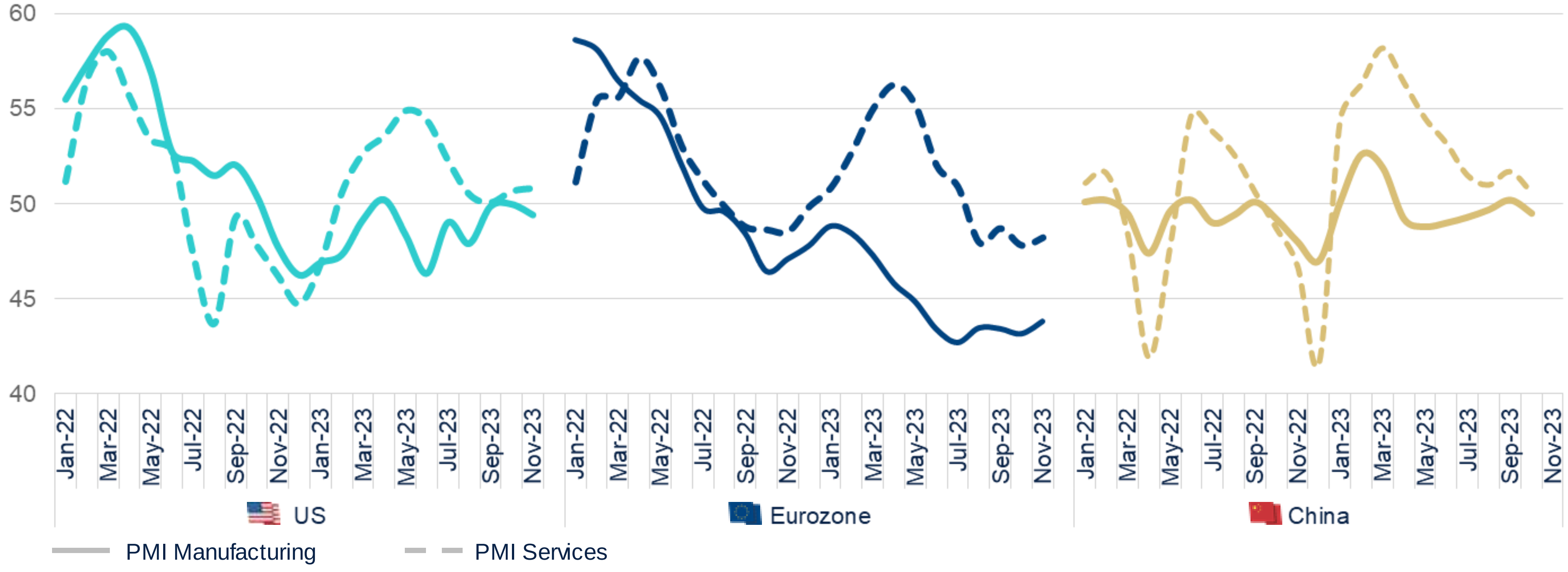
(INDEXES: AVERAGE SINCE 2019 EQUALS TO 0, 28-DAY MOVING AVERAGE)




(*): US, Eurozone and China.
Source: BBVA Research Geopolitics Monitor.

# Growth continues to trend down, mainly in the eurozone: services are still losing momentum, adding to the weakness in manufacturing

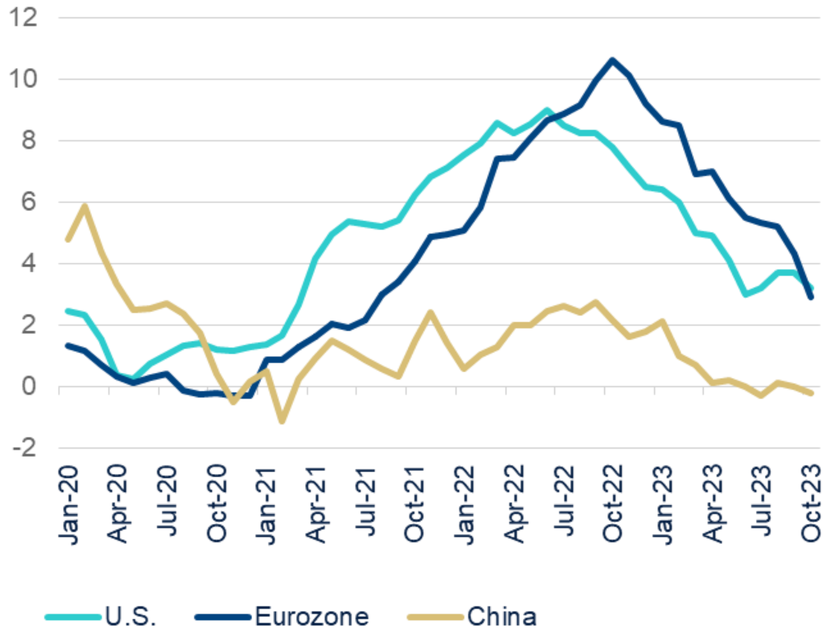
## PMI INDICATORS
(MORE THAN 50: EXPANSION; LESS THAN 50: CONTRACTION)




Source: BBVA Research based on data from Haver.

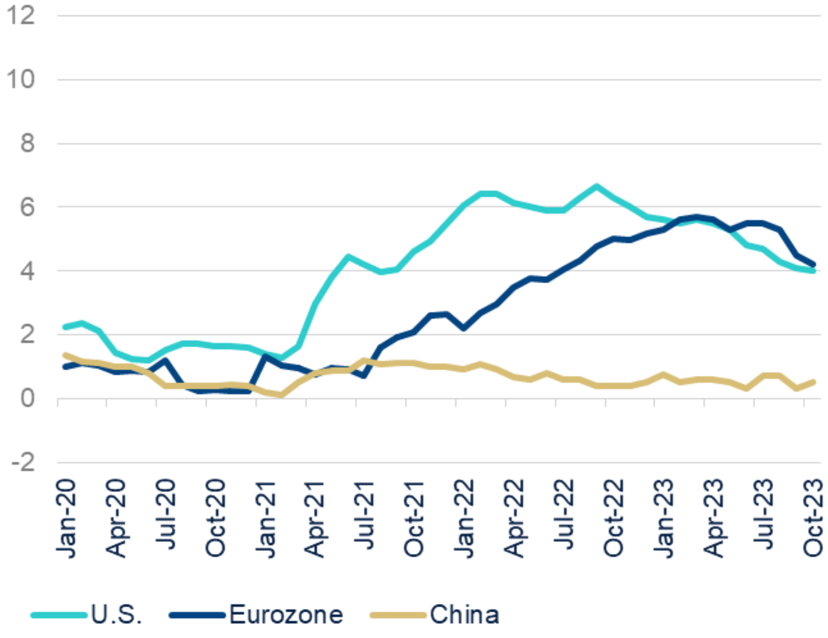
# Inflation is also slowing: after the significant decompression of headline figures, there are clearer signs of moderation in (still high) core measures

## INFLATION: CPI
(Y/Y %)




Source: BBVA Research based on data from Haver.

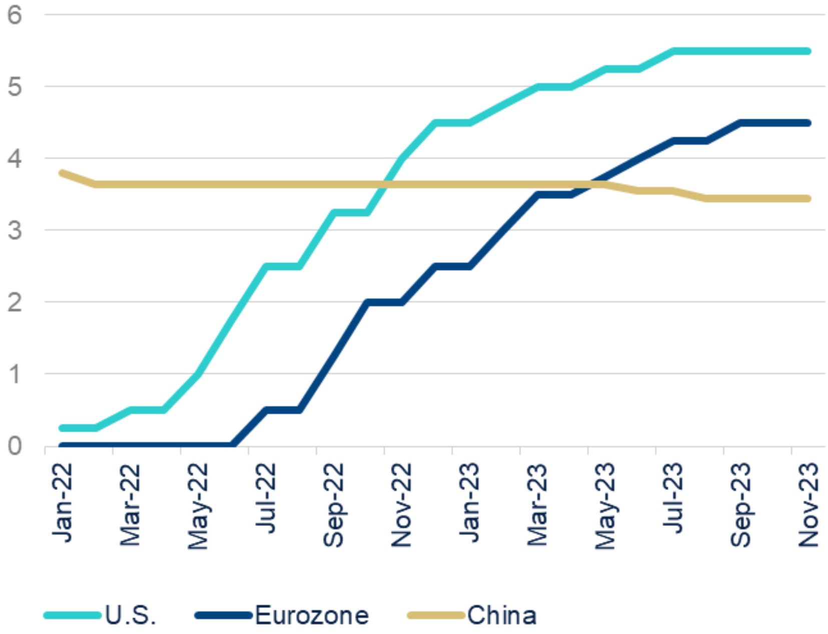
## CORE INFLATION: CPI
(Y/Y %)




Source: BBVA Research based on data from Haver.

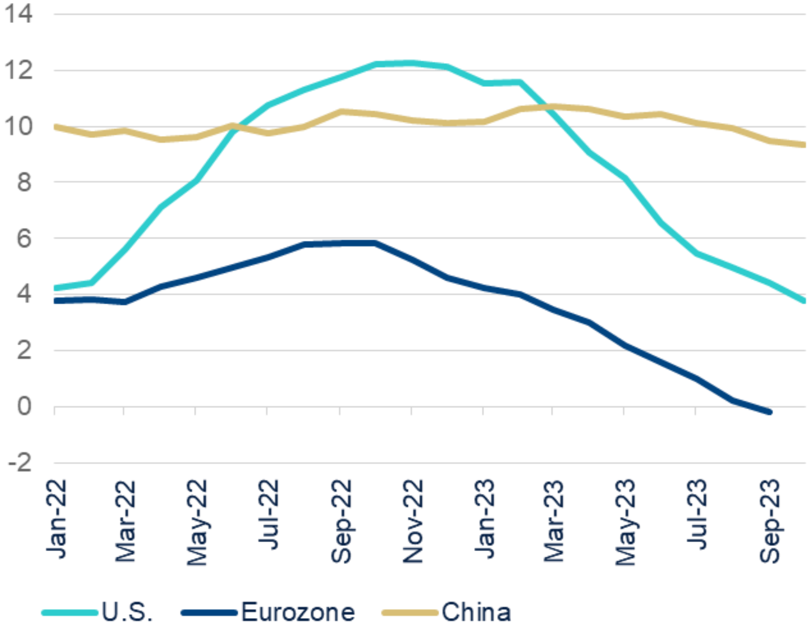
# Growth and inflation are easing following the aggressive interest rate hiking cycles -which seem to be over now- and also on the decline of excess savings

## POLICY INTEREST RATES (*)
(%)




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

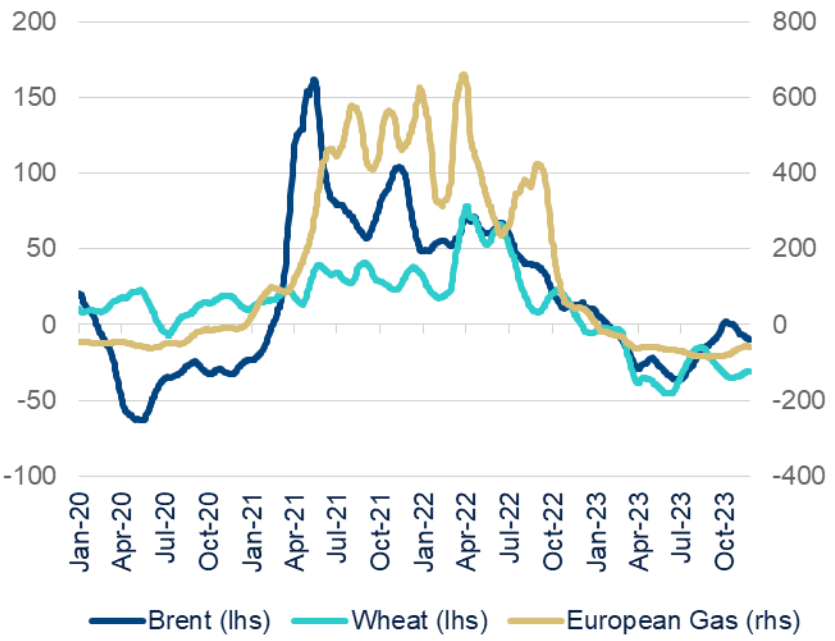
## LENDING BY COMMERCIAL BANKS
(YOY %)




Source: BBVA Research based on data from FRED and ECB.

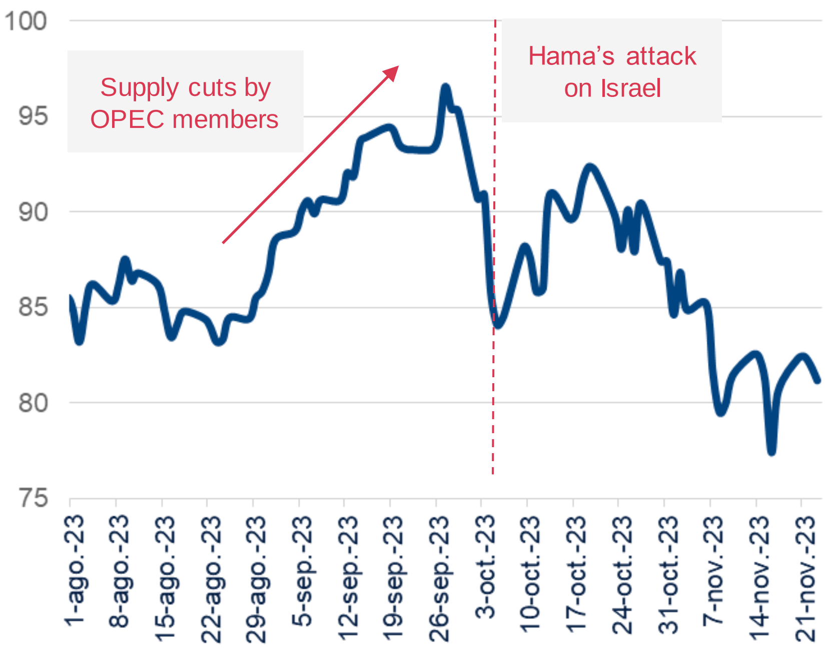
# More contained commodity prices (despite Middle-East tensions) are also allowing inflation to ease, while providing some support to economic activity

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




Source: BBVA Research based on data from Haver.

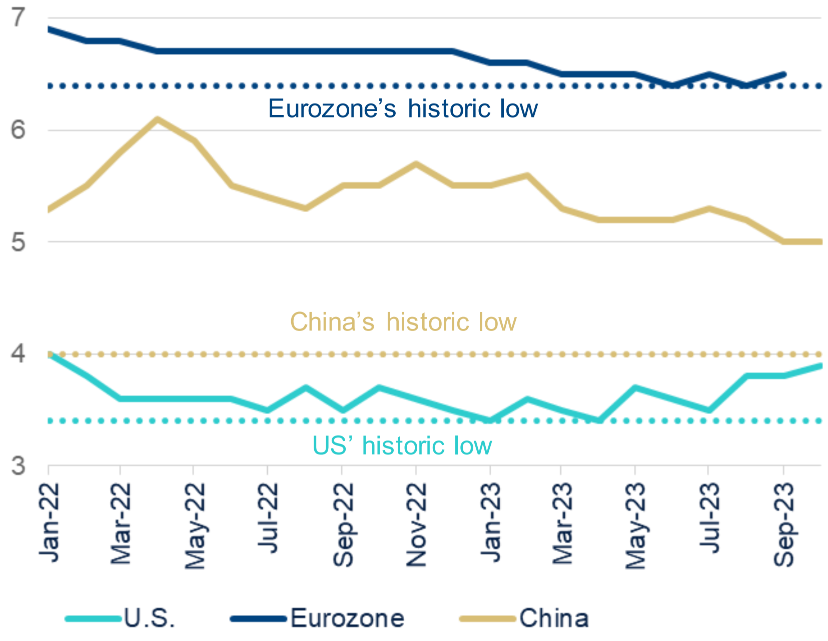
## BRENT PRICES
(USD PER BARREL)




Source: BBVA Research based on data from Haver.

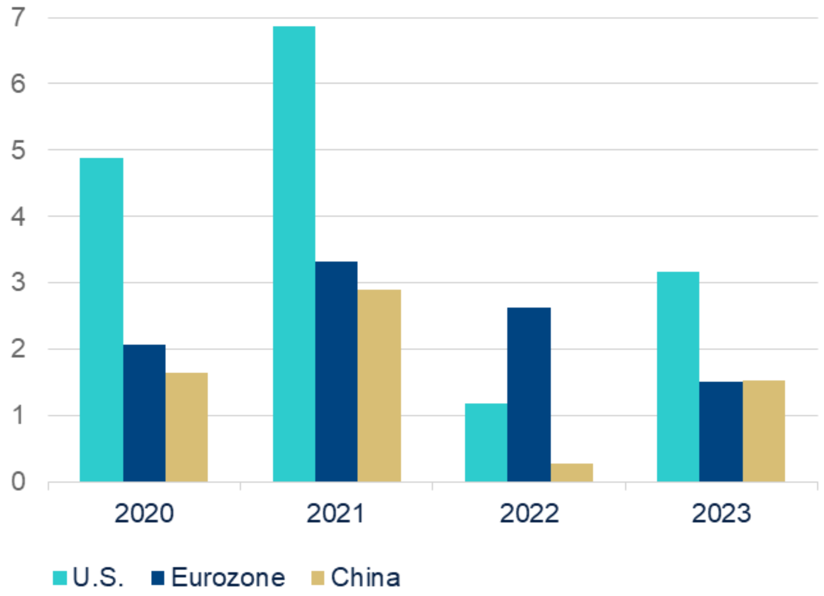
# Labor markets and fiscal policy are still supporting growth, helping to prevent recessions while contributing to keep inflationary concerns alive

## UNEMPLOYMENT RATE
(% OF THE LABOR FORCE)




(*) Historic low: lowest unemployment rate since Jan/04.
Source: BBVA Research based on data from Haver.

## "EXCESSIVE" FISCAL STIMULUS (*)
(% OF GDP)

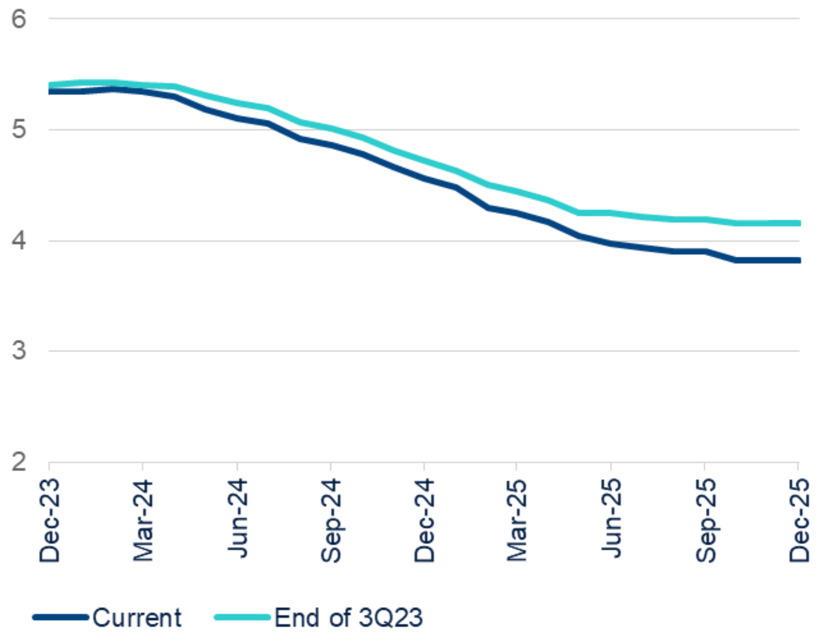



(*) "Excessive" fiscal stimulus: difference between the cyclically-adjusted primary balance and the equilibrium primary balance (calculated as the average relationship between the cyclically-adjusted primary balance and GDP growth in the 2001-2023 period).
Source: BBVA Research based on data from the IMF and AMECO.

# Despite the still hawkish tone exhibited by the Fed and the ECB, markets are now pricing an early and more aggressive monetary easing cycle

## FED: IMPLICIT RATE IN FUND FUTURES

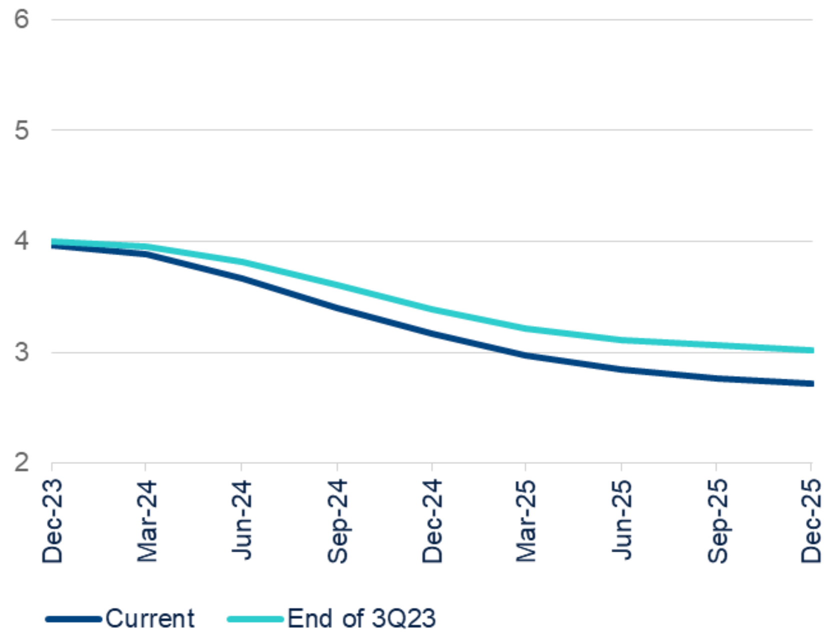
(%)




Source: BBVA Research based on Bloomberg.

## ECB: IMPLICIT RATE IN 3-MONTH EURIBOR FUTURES (*)

(%)

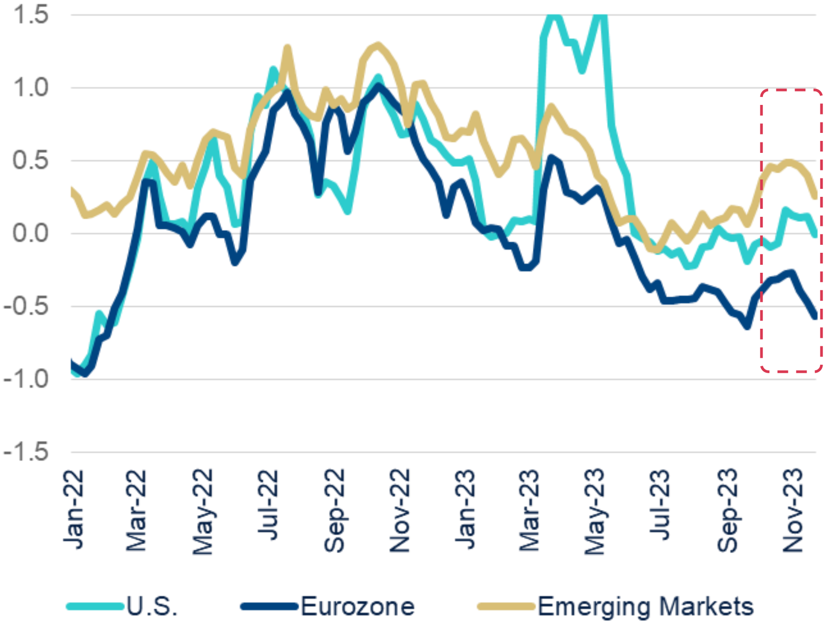



Source: BBVA Research based on Bloomberg.

# Financial tensions and sovereign yields have fallen with optimism on inflation and early monetary easing cycle, but markets remain subject to volatility

## BBVA RESEARCH FINANCIAL TENSIONS INDEX

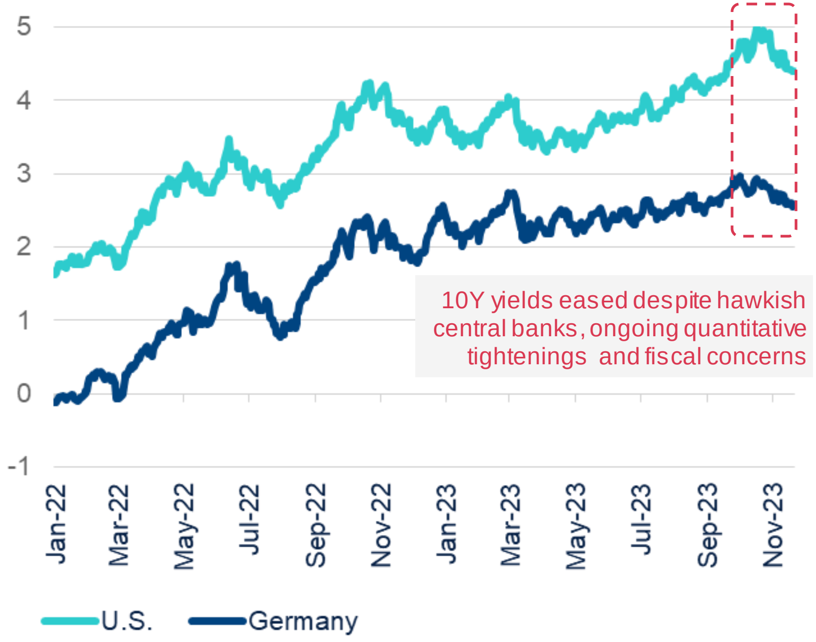
(INDEX: HISTORIC AVERAGE = 0)




Source: BBVA Research based on Bloomberg.

## US AND GERMAN SOVEREIGN YIELDS: 10Y

(%)




Source: BBVA Research based on Bloomberg.

# A soft landing of both growth and inflation is likely to pave the way for cautious rate-cutting cycles, which are closer now but are not imminent yet

## BBVA RESEARCH BASELINE SCENARIO

### Growth and inflation slowdown

Growth and inflation will ease on extra demand weakening, given no extra supply shocks, but risks are still significant

### Cautious central banks

Fed and ECB rates have peaked but are unlikely to be cut before Jun/24; anyway, quantitative tightening will continue

### Financial volatility

Volatility will remain in place on high interest rates, still hawkish central banks and large uncertainty

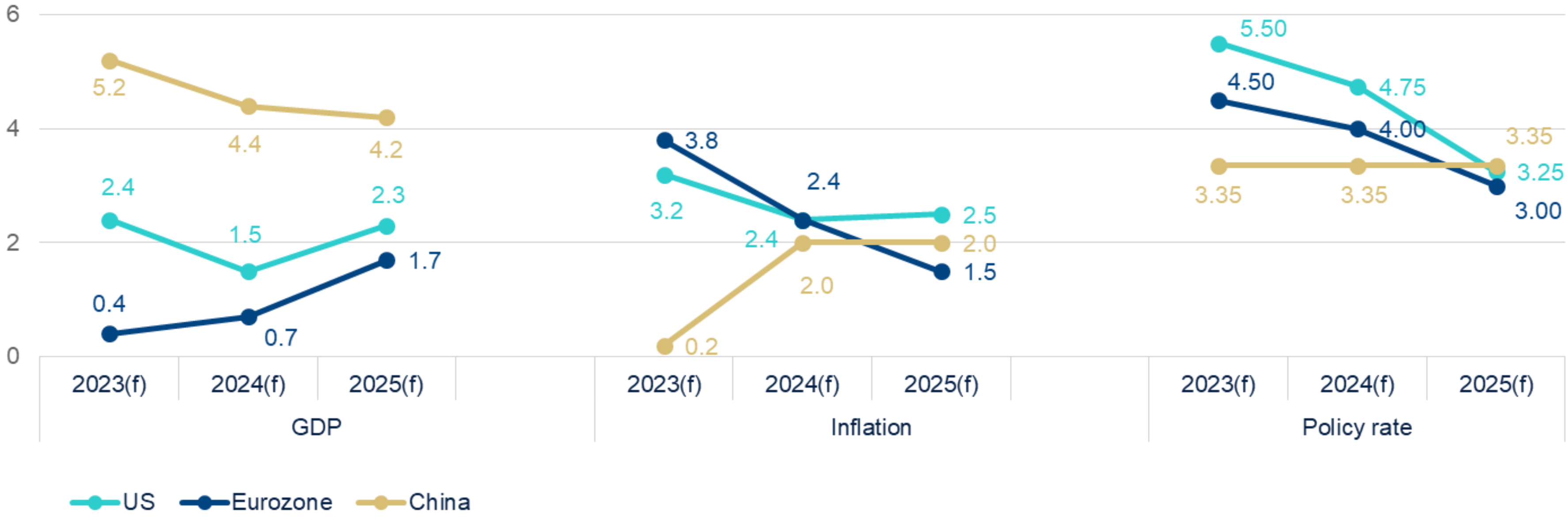
### Geopolitical tensions

Rising risks, but large economic effects are not assumed; Middle-East conflict to have limited impact on energy prices

# Global growth will be relatively low, while inflation and policy rates will decline without converging to pre-pandemic (ultra-low) levels over the next two years

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

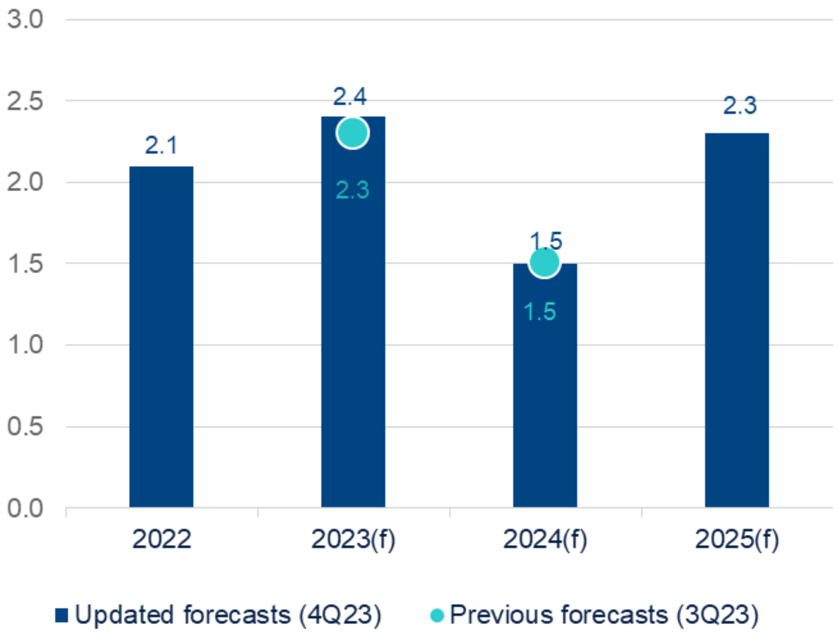
(GDP GROWTH: %; INFLATION: YOY %, END OF PERIOD, POLICY INTEREST RATES: %, END OF PERIOD)




(*) Global GDP growth is forecast to ease from 3.4% in 2022 to around 3.0% (+0.1pp) in 2023, 3.0% (0.0pp) in 2024 and 3.3% in 2025, below the 2000-2022 average (3.6%).
(**) In the case of the Eurozone, interest rates on refinancing operations.
(f): forecasts
Source: BBVA Research based on Bloomberg data.

# US: solid domestic demand supports 2023 growth; high interest rates (despite eventual rate cuts from June) likely to weigh more on growth in 2024

## US: GDP GROWTH
(%)

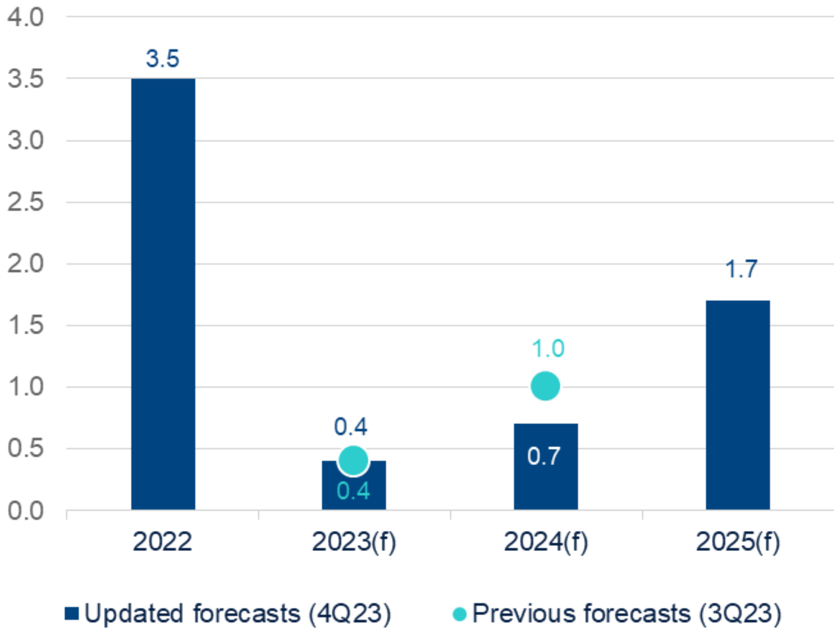



(f): forecast.
Source: BBVA Research

- 2023 growth revised up, despite moderation signs: consumption backed by still significant excess savings and strong labor markets; manufacturing is benefiting from bottleneck normalization.
- Growth to ease in 2024 mainly on the lagged effect of the recent monetary tightening.
- Inflation to keep falling as labor markets come into a better balance.
- Fed: the most likely is a pause with gradual cuts from Jun/24; fears of incomplete convergence to the 2% target to prevent earlier cuts.
- Risks: recession or financial stress on high rates, presidential elections and expansive fiscal stance.

# Eurozone: milder growth and lower inflation favor a reduction of ECB policy rates from September, somewhat earlier than previously expected

## EUROZONE: GDP GROWTH
(%)

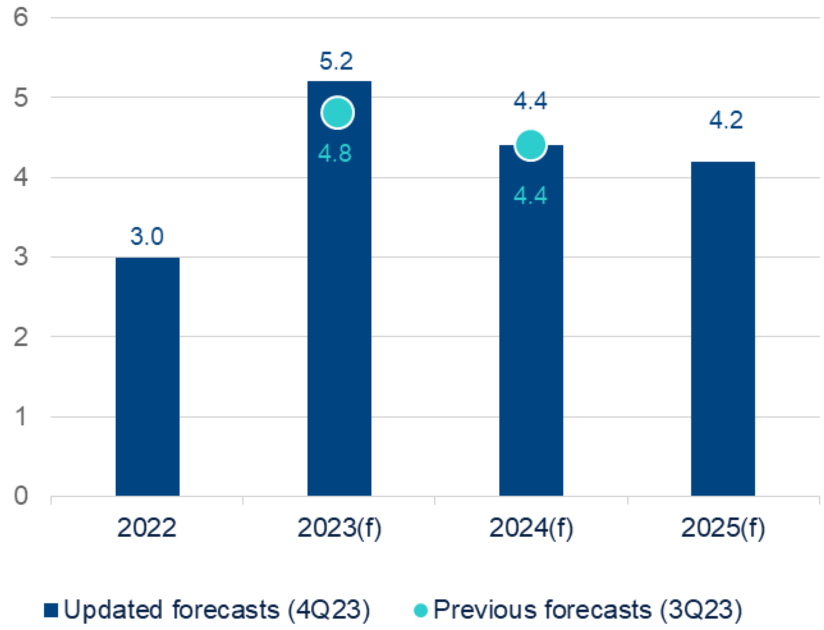



(f): forecast.
Source: BBVA Research

- GDP forecasts: unchanged in 2023 but revised down in 2024; recent data suggest a (minor) recession in 2H23.
- Inflation forecasts revised down: pressures from energy prices, fiscal policy and labor markets to be offset by sharper core disinflation, in line with incoming data.
- ECB: rate cuts from Sep/24, when the disinflation process will be clearer; balance sheet reduction will continue, with focus on PEPP reinvestment and new operational framework.
- Risks: stagflation and competitiveness problems on high energy prices, sovereign debt tensions.

# China: recent data reinforce the view that a hard-landing will likely be avoided, but growth is set to ease in 2024-25 as structural challenges remain in place

**CHINA: GDP GROWTH**
(%)




(f): forecast.
Source: BBVA Research

- 2023 GDP was revised upwards in line with incoming data showing that demand improved somewhat after series of stimulus policies were adopted to avoid a hard-landing.
- Growth is likely to weaken ahead and hard-lading is still a risk as real estate tensions, large local government debt and other structural problems (middle-income trap, ageing, US confrontation etc.) remain in place.
- Inflation remains close to zero, but is forecast to converge to 2% on more supportive policies and some confidence improvement.
- Risks: sharp growth deceleration, deflation and balance-sheet recession, geopolitical tensions.

# Risks: tensions in the Middle-East add to the concerns about the potential consequences of high inflation and interest rates and a hard-landing in China

| Inflation and high interest rate risks | Financial tensions risks | Growth deceleration risks |
|---|---|---|
| Higher energy prices on **Middle-East or Ukraine conflicts** | **Risk-off** and financial volatility | **Stagflation,** mainly in the EZ and other energy net-importers |
| Strong demand on **public spending** (scarce fiscal consolidation) | Tensions in **sovereign debt markets** | **Recession,** including (but not only) in the US |
| Strong demand on **private spending** (labor tightness, etc.) | Tensions in **private debt markets** | **Hard-landing in China,** with balance-sheet recession and deflation risks |

# Uncertainty on series of economic, political, geopolitical and climate factors

| Economic uncertainty | Political uncertainty | Geopolitical uncertainty | Climate uncertainty |
|---|---|---|---|
| **Inflation** and macro policy mix | **US presidential** elections | **Israel-Hamas** conflict | **El Niño effects** mainly on S. America |
| **Monetary tightening** impact, neutral level | **Political tensions** in DMs and EMs | **Ukraine-Russia** war | **Climate disruptions** and weather shocks |
| **Fiscal consolidation** | **Populism** and social unrest | **US-China rivalry:** deglobalization, Taiwan | **Energy transition** policies |

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02

# China: the economy shows some bottomed-out signals

# Summary

**Growth**

China's 2023 Q3 economic activities are better-than-expected and stronger than Q2 outturns amid policy support, showing some bottomed-out signals after Q2's dipping. Q3 GDP bounced back to 4.9% y/y, higher than the market consensus 4.4% y/y and our forecast 4.1% y/y. 2022-2023 two-year average Q3 GDP achieved 4.2% y/y, also higher than Q2 two-year average at 3.3% y/y. The bottomed-out was mostly from retail sales, the industrial production also fares well and the exports shrinks its decline. However, the recovery has not got a solid foundation-real estate crash and local government bond still remain the main risks and these two issues are highly correlated.

**Debate**

Look forward, the weak market sentiments of households and enterprises in the post-pandemic time have not been completely reversed. Based on the recent Q3 data, we raise our 2023 GDP forecast from 4.8% to 5.2%, (BBG consensus: 5.1%: IMF 5.4%) and maintain 2024 at 4.4%. That means, China will achieve the government's "around 5%" growth target in 2023.

(1) Long-term debate: whether China will enter into "Japanization" and "balance sheet recession"? China's long-term challenge is not "Japanization" but "mid-income trap". (2) Short-term debate: Whether China will go into "hard-landing"? China will achieve soft-landing in this round of slowdown, but the future growth will be "L-shape" instead of "V-shape"'.

**Geopolitics**

The high-level China-US communications including the recent Xi-Biden meeting during APAC, the visit of Yellen, Blinken and Kissinger to Beijing as well as China's Foreign Affairs Minister Wang Yi's meet with Biden etc. signal the moderation of China-US relationship. But the confrontations in terms of trade war, tech war and finance war will remain in the long term.

# Most October economic indicators are higher than market expectations and previous readings, except for the real estate investment and exports

## ECONOMY

Industrial production ↑

Retail sales ↑

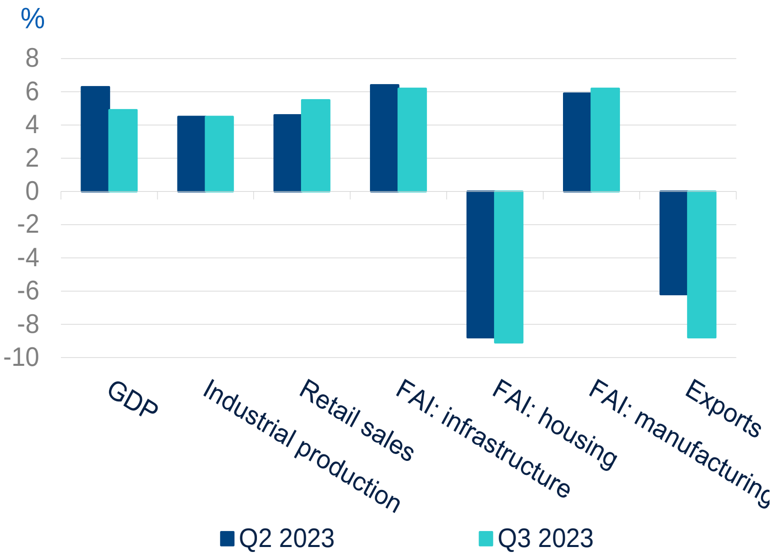
Fixed asset investment ↓

Real estate: ↓

Manufacturing: ↑

Infrastructure: ↑

Exports ↓




## KEY RISKS

(1) Weak sentiments for enterprises and households.

(2) Deflation.

(3) Real estate crash.

(4) High unemployment rate at young age.

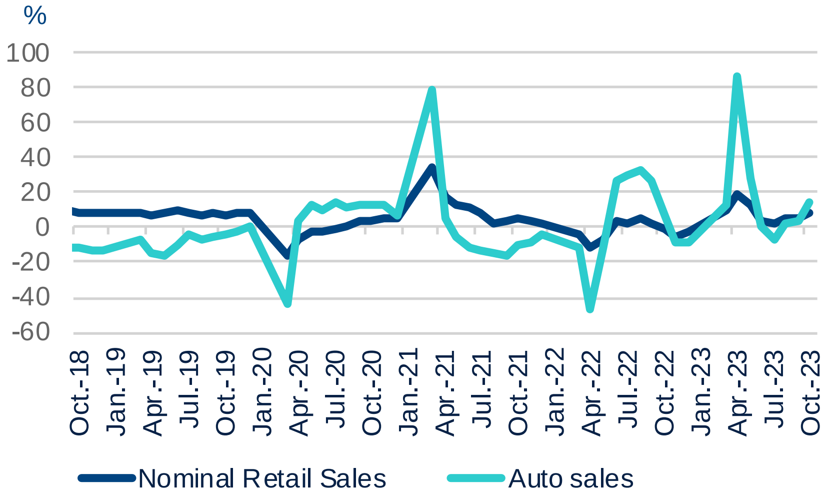
## POLICY

**Monetary policy:**
2 RRR cuts and 2 LPR cuts in 2023.

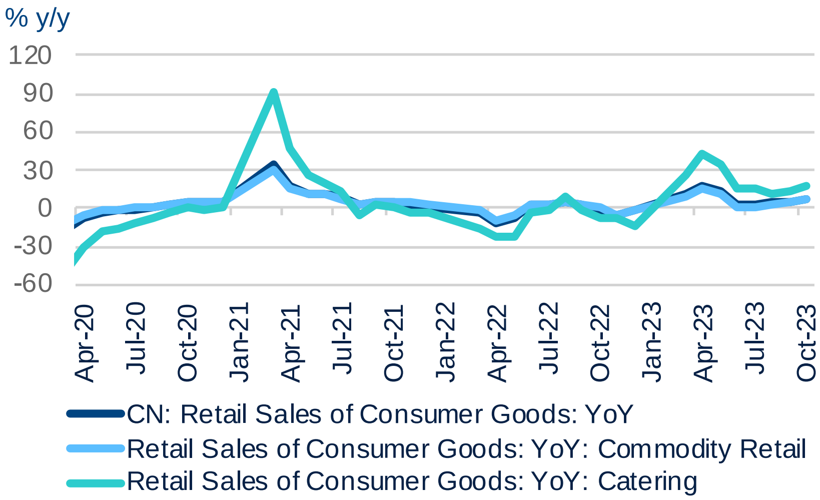
**Fiscal policy:**
Newly announced extra RMB 1 trillion government bond issuance, increasing 2023 fiscal deficit to 3.8% from 3% previously set.

# Retail sales improved to 7.6% from 5.5%, supported by catering sector with “contact” and “gathering” features

## RETAIL SALES SIGNIFICANTLY IMPROVED TOGETHER WITH INCREASING AUTO SALES



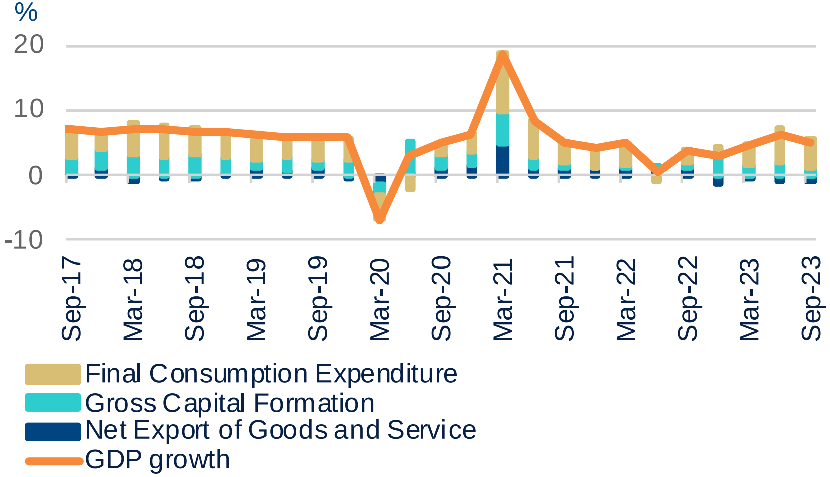

## RETAIL SALES GROWTH IN CATERING SECTOR IS STILL HIGHER THAN OTHER SECTORS




“Consumption revenge” effect on “contact” and “gathering” sectors persists, particularly during “October Golden Week” mainly including restaurant, tourism, movie, conferences and exhibitions, transportation, catering etc.
Durable goods such as automobiles, electronic products also show some resilience.

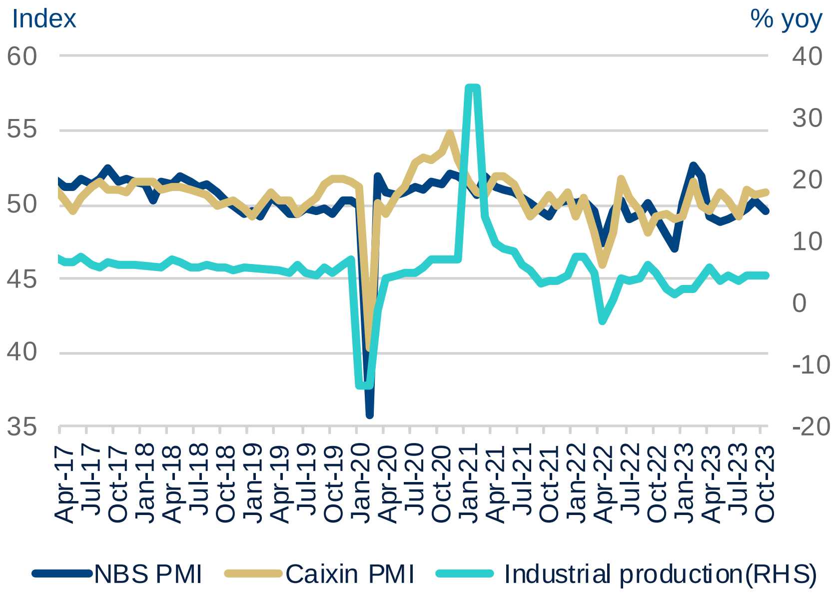
# 2023 Q3 GDP bounced back to 4.9%, showing some bottomed-out signals; supply side shows robust recovery

## 2023 Q3 GDP BEATS CONCENSUS, 2022-23 TWO YEAR Q3 AVERAGE ACHIEVED 4.2%, HIGHER THAN Q2 AVERAGE AT 3.35%



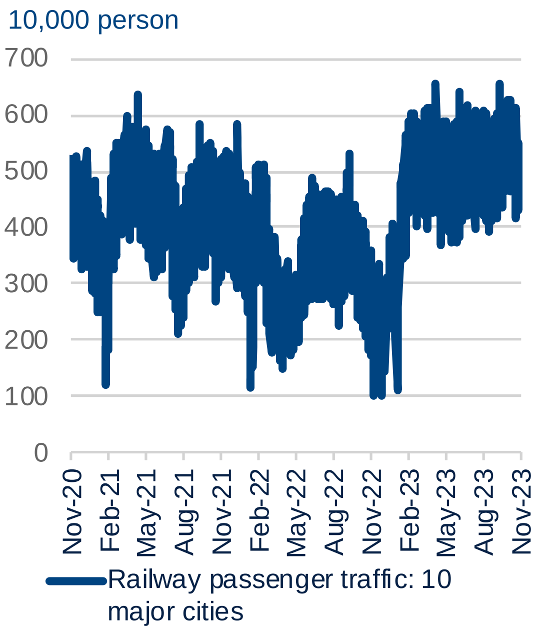

| Forecast | 2023Q1 | 2023Q2 | 2022Q3 | 2023Q4(F) |
|---|---|---|---|---|
| Y/Y% | 4.5 | 6.3 | 4.9 | 5 |
| Q/Q% | 2.8 | 0.1 | 1.4 | 1.3 |

## NBS PMI FELL BACK TO 49.5 IN OCT FROM 50.2 IN SEP; INDUSTRIAL PRODUCTION INCREASED TO 4.6% FROM 4.5% IN OCTOBER

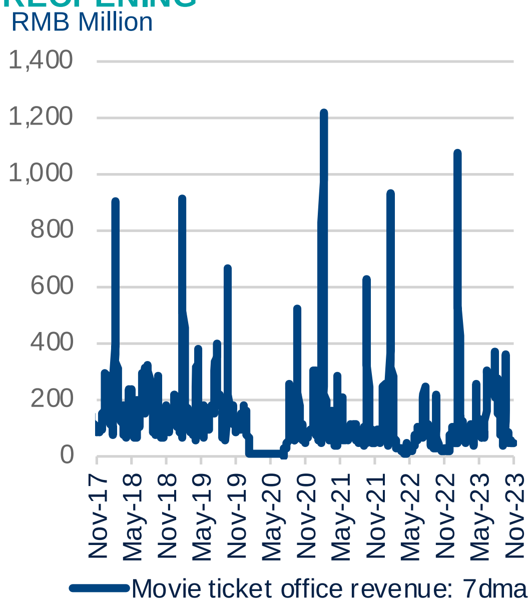


# High frequency indicators of service sector also displayed the service sector normalization

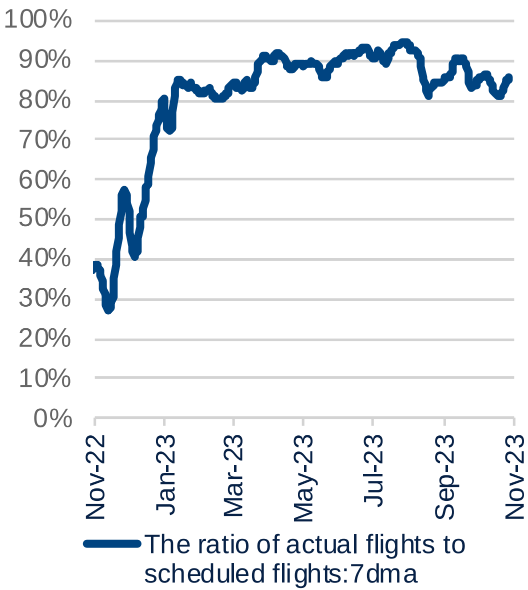
## PEOPLE MOBILITY BY TRAIN SIGNIFICANTLY INCREASED




## MOVIE TICKET OFFICE REVENUE ALSO BOUNCE BACK AFTER REOPENING



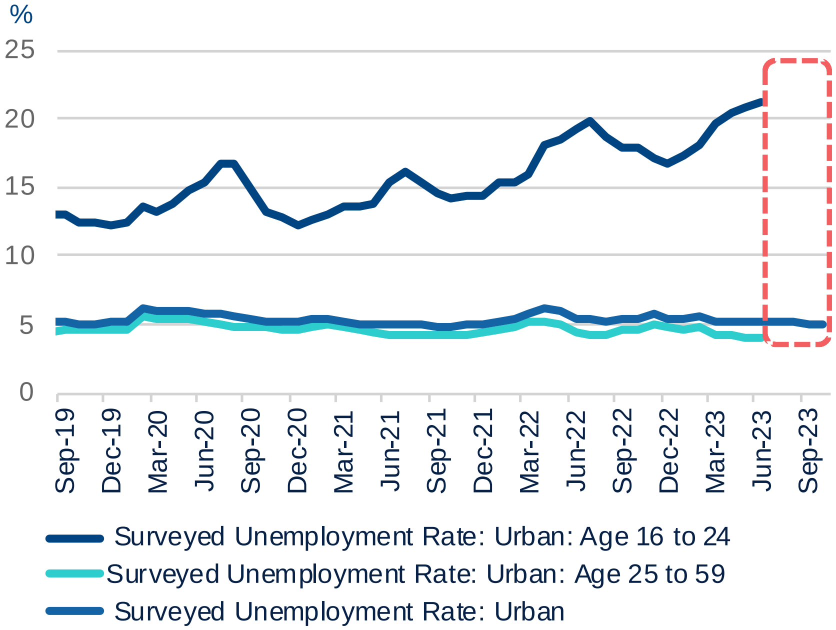

## AIRLINE INDUSTRY GOES BACK TO PRE-COVID LEVEL



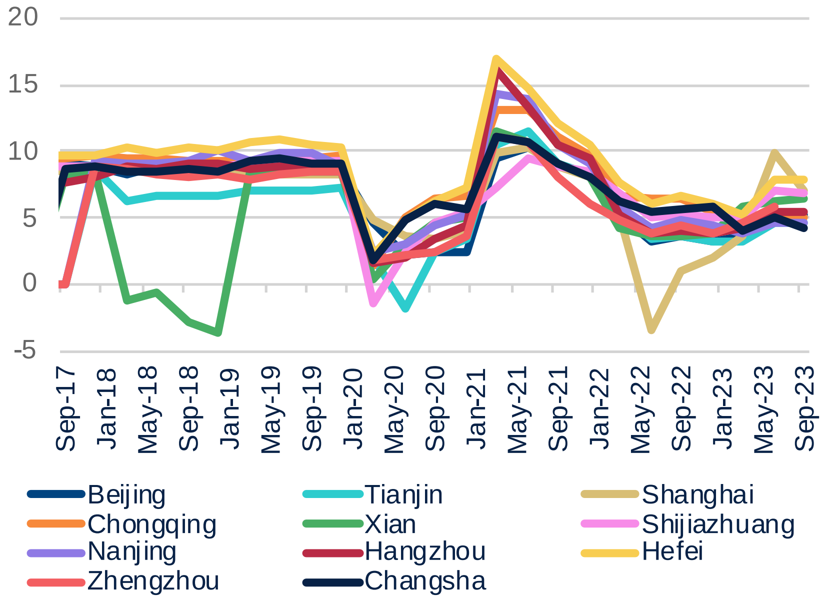

Source: WIND and BBVA Research.

# Retail sales improved among: (i) unemployment rate declined (ii) excess savings reléased and (iii) income expectation gradually improved

## UNEMPLOYMENT RATE DECLINED FROM 5.2% TO 5% IN SEP (16-24 UNEMPLOYMENT RATE WILL NOT BE RELEASED DUE TO DATA QUALITY ISSUE)

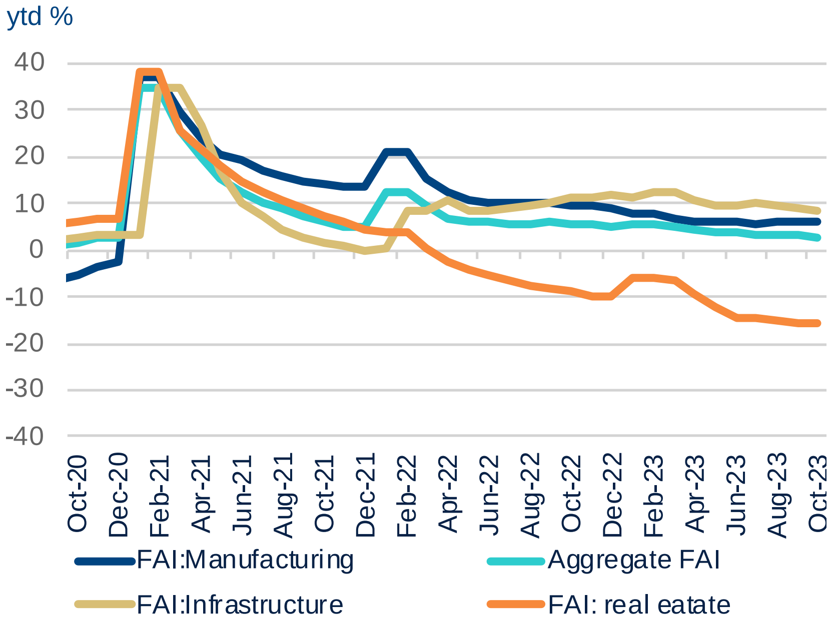



## INCOME GROWTH IN BIG CITIES STARTED TO CONVERGE TO PRE-PANDEMIC LEVEL

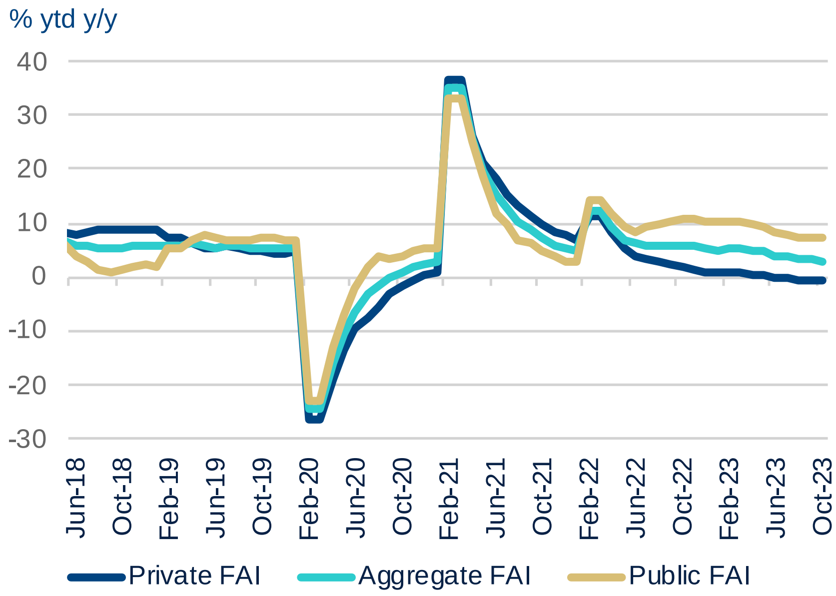


# Investment: aggregate FAI further moderated which was dragged significantly by housing investment

## FAI FURTHER MODERATED TO 2.9% YTD Y/Y FROM 3.1%; HOUSING INVESTMENT DIPPED TO -9.1% YTD Y/Y



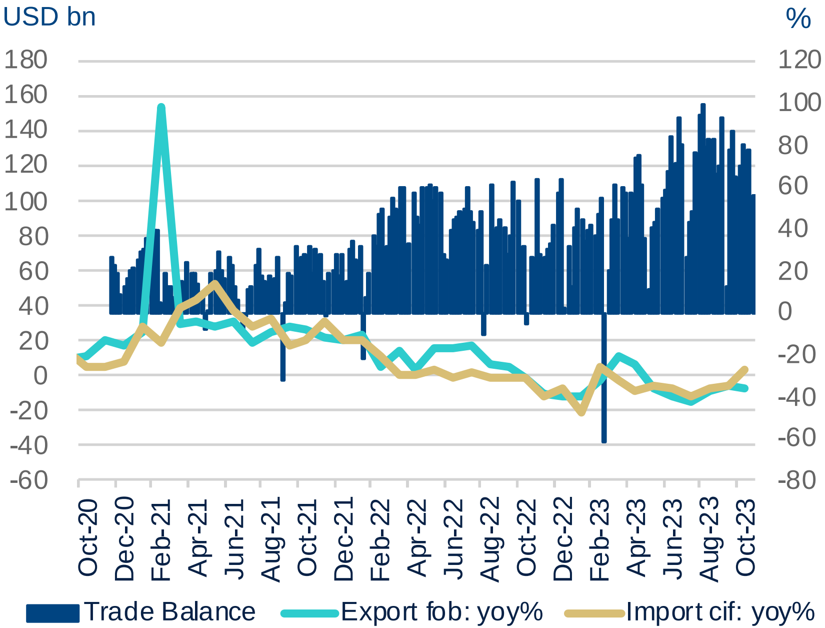

## THE MULTIPLIER EFFECT OF PUBLIC FAI TO PRIVATE FAI REMAINS LACKLUSTER



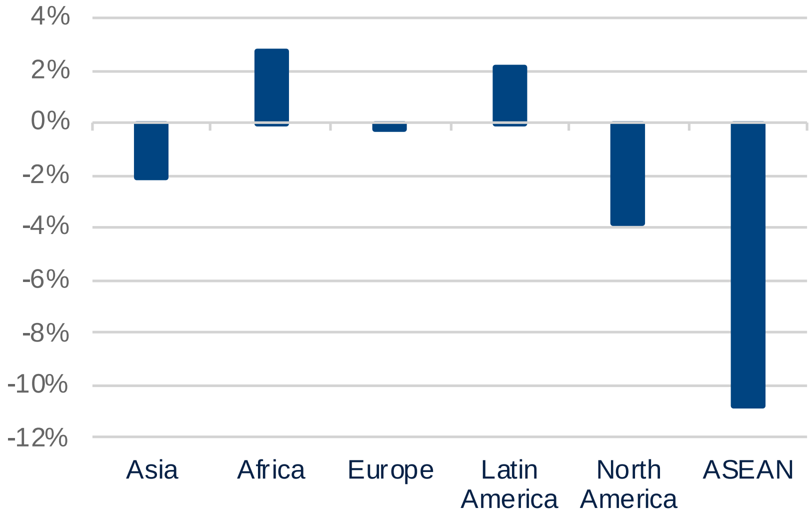

Source: CEIC and BBVA Research.

# Exports throughout the year remains weak

## EXPORTS EXPANDED ITS DECLINE TO -6.4% FROM -6.2%, IMPORTS IMPROVED TO 3% FROM -6.2%



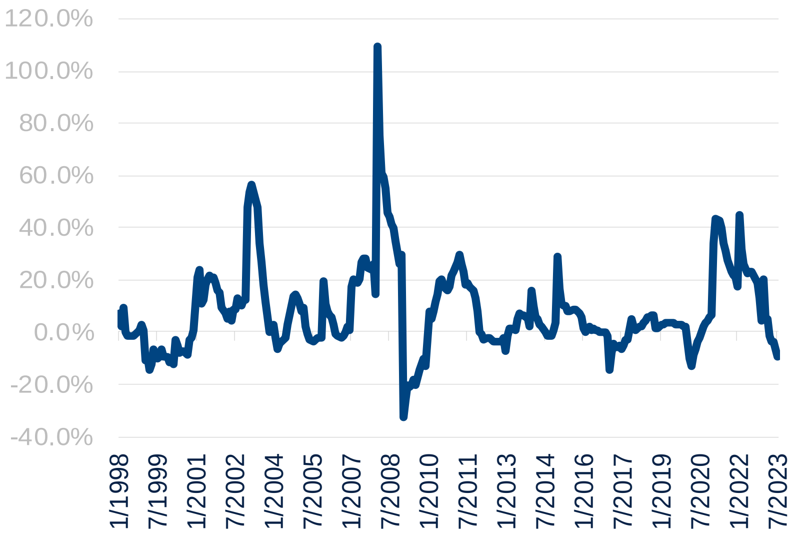

## CHINA'S EXPORTS GROWTH DROPPED MOSTLY IN ASEAN AND NORTH AMERICA



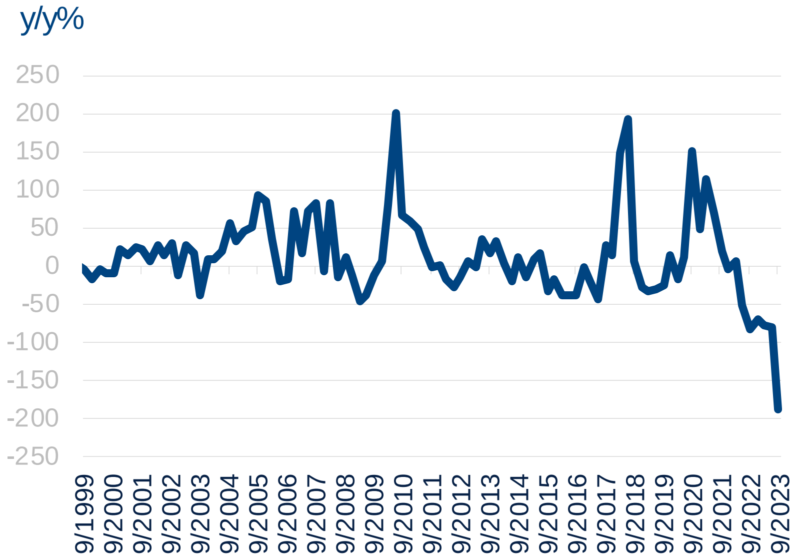

Source: CEIC and BBVA Research.

# China’s FDI inflows also dipped to historical low due to weak sentiments

## MINISTRY OF COMMERCE FDI UTILIZATION DATA SHOW THAT THE CURRENT FDI DROP IS COMPARABLE WITH 2020, 2017 AND 1998



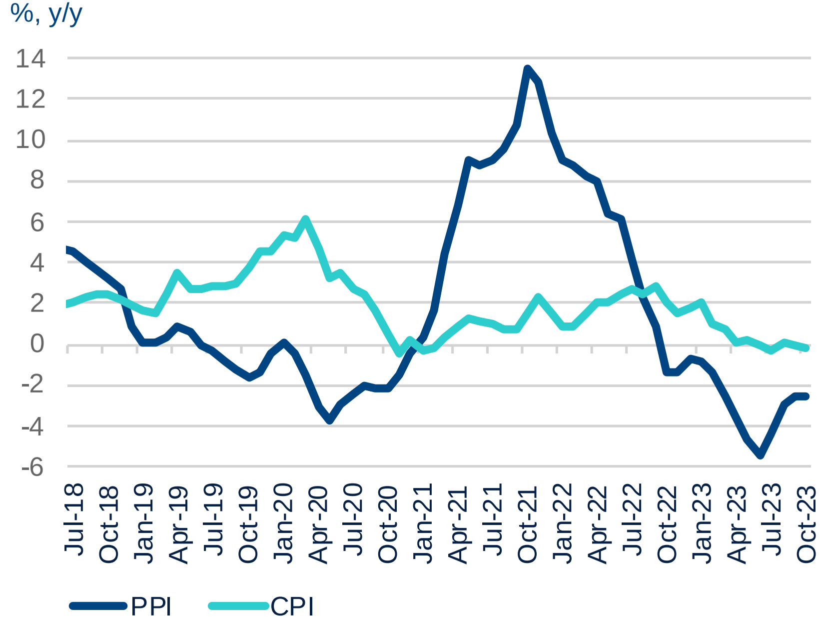

## THE LIABILITY SIDE OF FDI IN BOP SHOWS FDI INFLOWS REACHED HISTORICAL LOW (SAFE DATA)



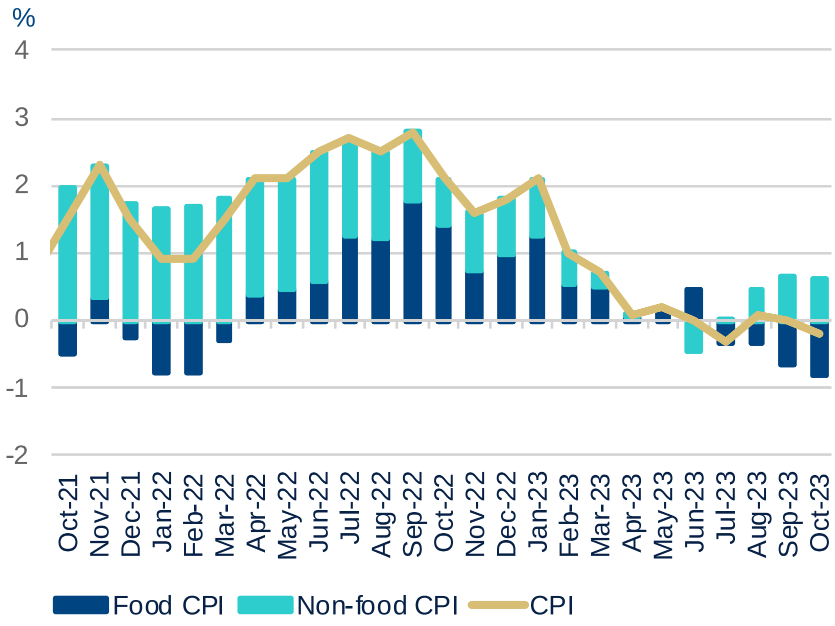

Although there are discrepancies between SAFE and Ministry of Commerce data for FDI, we cannot rule out the fact that FDI inflow has been dipping recently. Reasons include: (1) Weak sentiments for foreign investors amid China’s growth slowdown. (2) Global supply-chain relocation outside of China, nearshoring and China+1 strategies.

# China's deflation environment is not easy to reverse

## CPI GOES BACK TO NEGATIVE REGION AT -0.2%, PPI DIPPED TO -2.6% FROM -2.5% PREVIOUSLY

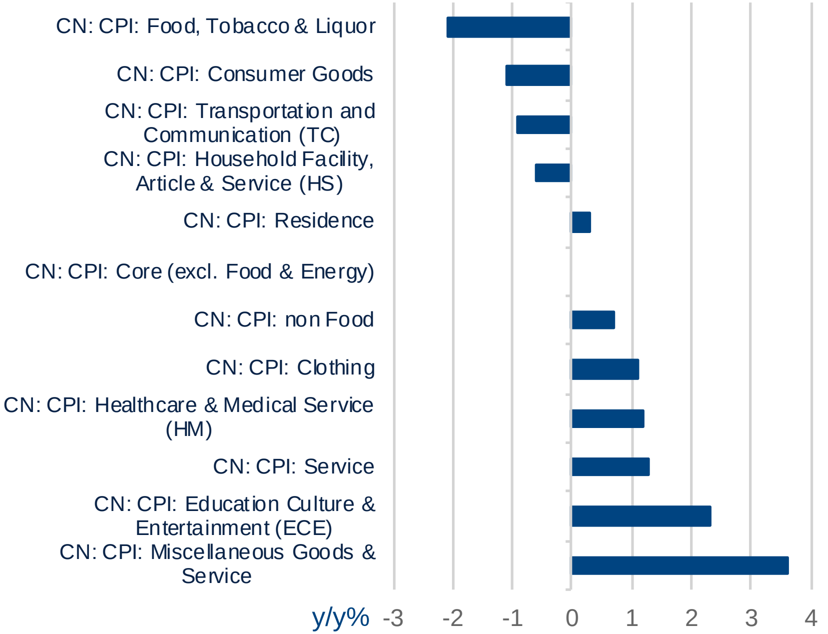



## CPI WENT DOWN MOSTLY DRAGGED BY FOOD CPI, WHILE NON-FOOD CPI FARES WELL

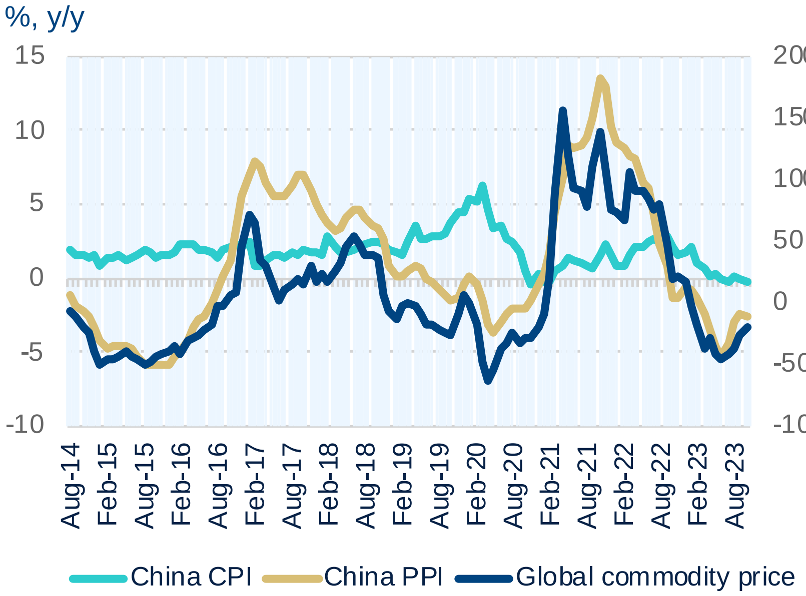


# PPI shrinks its decline together with global commodity price increasing, which helps to improve industrial profits

## DECOMPOSING CPI BASKET: WHICH SECTORS CONTRIBUTE TO DEFLATION?

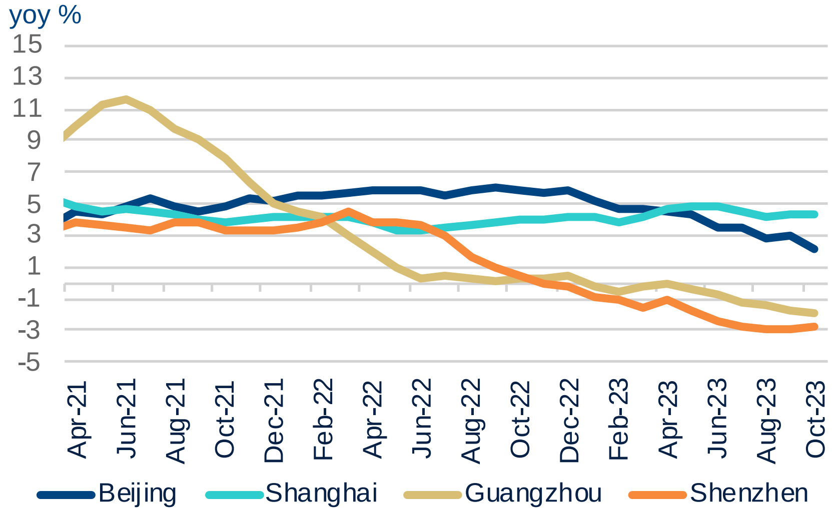



## CHINA'S PPI IS SYNCHRONIZED WITH GLOBAL PPI AND COMMODITY PRICES

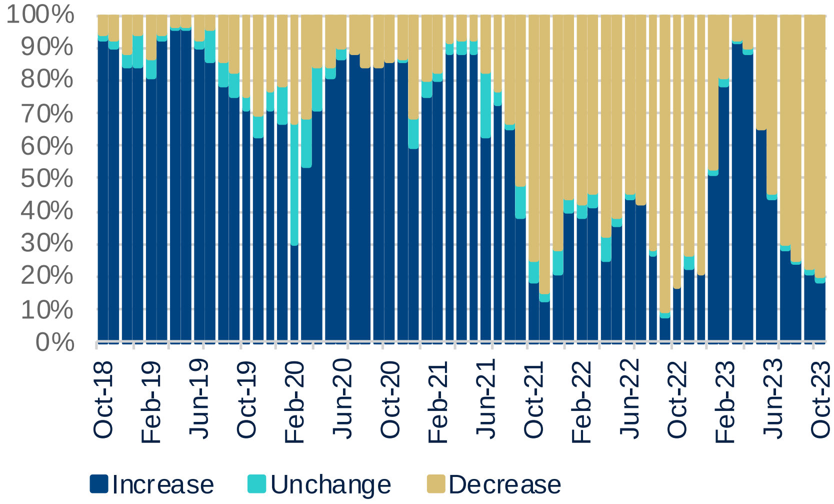


# China's housing problem is mainly from the supply side, but not demand side; and mostly focus on tier-3 and 4 cities but not in tier-1 cities

## HOUSING PRICES HOLDS WELL IN TIER-1 CITIES, THE PRICE PERCENTAGE CHANGE RANGE IS WITHIN -3% TO 5%




## MOST CITIES REPORTED HOUSING PRICE DECREASE IN 70-CITY SURVEY

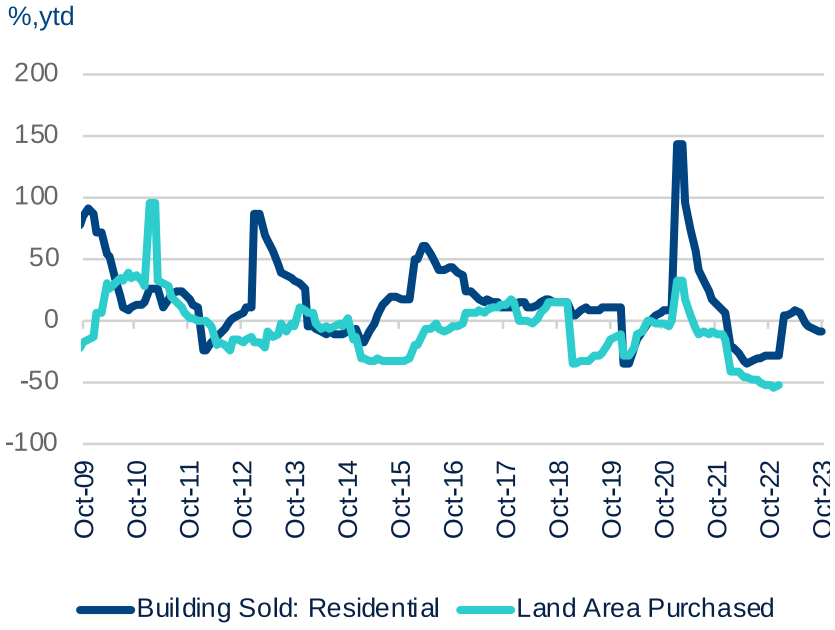



Source: CEIC and BBVA Research.

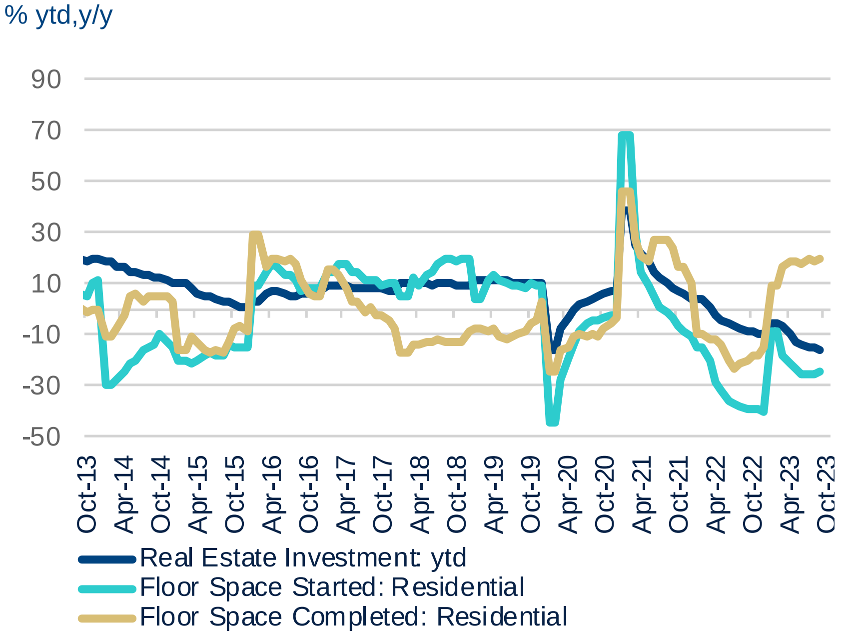
The default cases include the largest two private housing developers-Evergrande and Country Garden and spillover to other smaller private developers. All of them adopt "high-leverage" and "diversification" strategy which is not sustainable particularly under the authorities' housing regulations "three red línes" in 2021.

# Some housing activity indicators bottomed out due to the recent housing market stimulus measures, but housing sales and investment remain sluggish

## BUILDING SOLD REMAINED NEGATIVE GROWTH, SO DID LAND SALES GROWTH



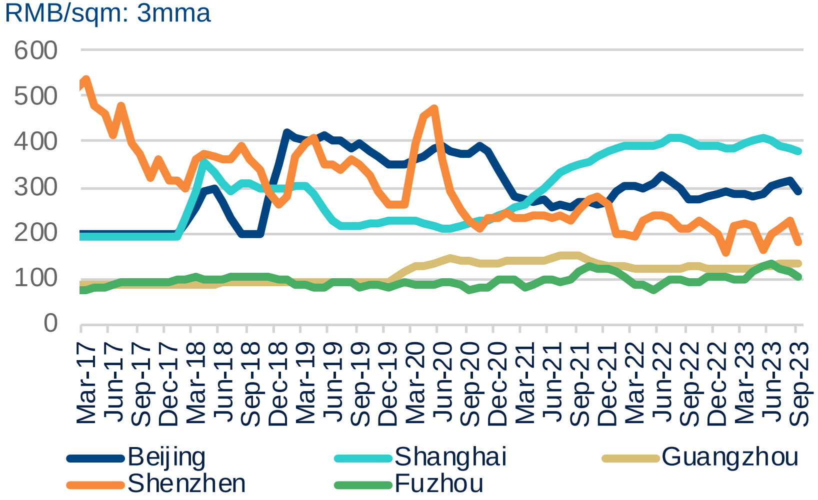

## FLOOR SPACE COMPLETED PICKED UP AMID THE POLICY "ensuring timely deliveries of pre-sold homes"; FLOOR STARTED ALSO BOTTOMED OUT



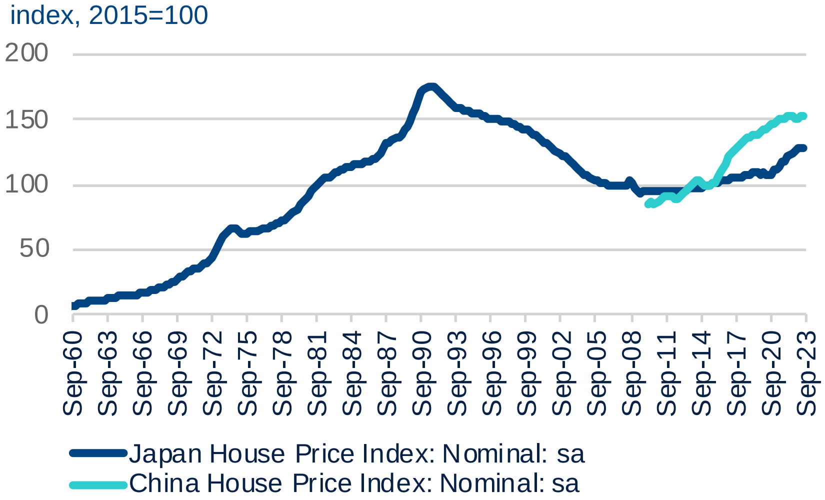

Source: CEIC and BBVA Research.

# Some positive signals on housing sector from the demand side…

## RISING RENT PRICE IN BIG CITIES INDICATES HOUSING DEMAND STILL STRONG, BUT DELAYING THEIR PURCHASE




## UNLIKE JAPAN IN 1990S, CHINA'S AGGREGATE HOUSING PRICE LEVEL (NOT %) HAVE NOT DIPPED




Households started to buy housing from state-owned enterprises instead of private developers which reflects the rigidity demand remains; and 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?

# Real estate contagion effect: ongoing real estate adjustment will not lead to systemic financial risk (I/II)

## STRESS TEST OF THE IMPACT OF HOUSING PRICE FALL ON FOUR DIFFERENT SECTORS

| Sectors | Scenarios | |
|---|---|---|
| | Housing prince decreases by 10% | Housing Price decreases by 30% |
| **Government** | Local government revenue decreases by RMB 0,84 trillion, indicating it has RMB 0.84 trillion credit gap to maintain the current fiscal expenditure. | Local government revenue decreases by RMB 2.52 trillion, indicating it has RMB 2.52 trillion credit gap to maintain the current fiscal expenditure. |
| **Banking sector** | Bank´s NPL increased from 1.92% at end-2020 to 2.07% after one year and increased to 3.36% after three years. | Bank´s NPL increased from 1.92% at end-2020 to 2.39% after one year and increased to 6.16% after three years.[3] |
| **Enterprises** | Stock market value will evaporate RMB 98.14bn; book value of enterprises´ real estate investment will decrease RMB 39.1bn. | Stock market value will evaporate RMB 294.4bn; book value of enterprises´ real estate investment will decrease RMB 117.3bn |
| **Household** | Household wealth per capita decreases by RMB 18 thousand; Aggregate household wealth decreases by RMB 25.2trn | Household wealth per capita decreases by RMB 54 thousand. Aggregate household wealth decreases by RMB 75.6trm |

Source: BBVA Research.

# Real estate contagion effect: ongoing real estate adjustment will not lead to systemic financial risk (II/II)

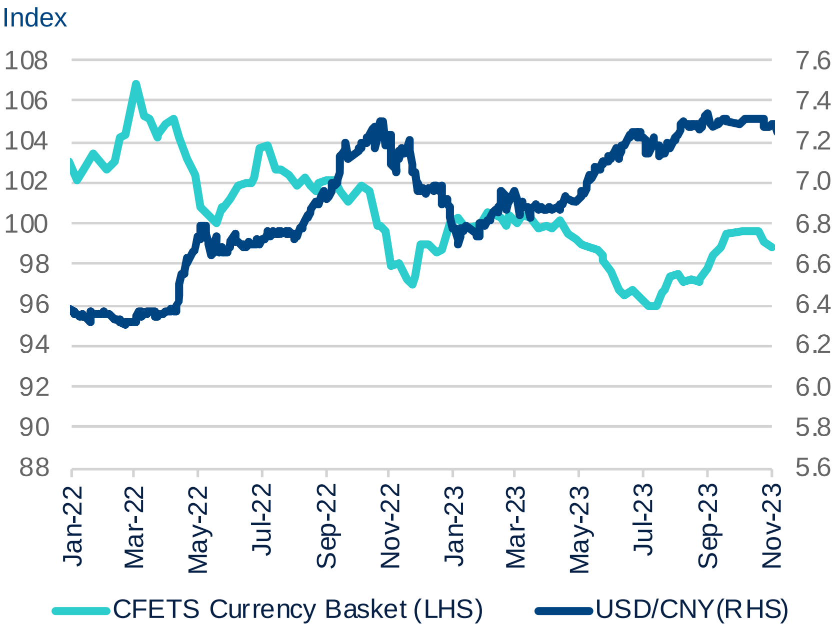
## COMPARISON OF ENTERPRISES' EXPOSURE TO REAL ESTATE

(All listed firms excluding financial institutions and real estate firms)

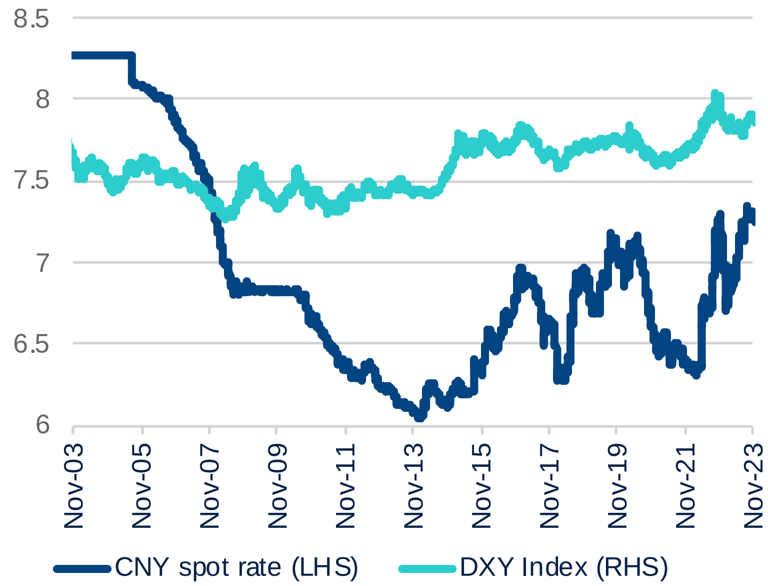
| Country | Variable | Period | Mean | Std Dev | 10th percentile | Median | 90th Percentile |
|---|---|---|---|---|---|---|---|
| Japan | Land value/Total asset | 1985-1990 | 19.3% | 11.9% | 6.5% | 17% | 35% |
| | Land value/Total Sales | 1985-1990 | 27.30% | 28.20% | 6.90% | 19.90% | 53.80% |
| China | 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 | 10.4% | 73.6% | 0.1% | 1.2% | 12.6% |
| China | Land value/Total asset | 2022 | 2.44% | 6.06% | 0.05% | 0.6% | 5.76% |
| | Land value/Total Sales | 2022 | 10.8% | 61.3% | 0.08% | 1.15% | 15.26% |

# RMB exchange rate is significantly dragged by the diverging monetary policy with the US but recently jumped to 7.1 from 7.3

## RMB EXCHANGE RATE JUMPED TO 7.1 AROUND DUE TO THE PAUSE OF US FED HIKE



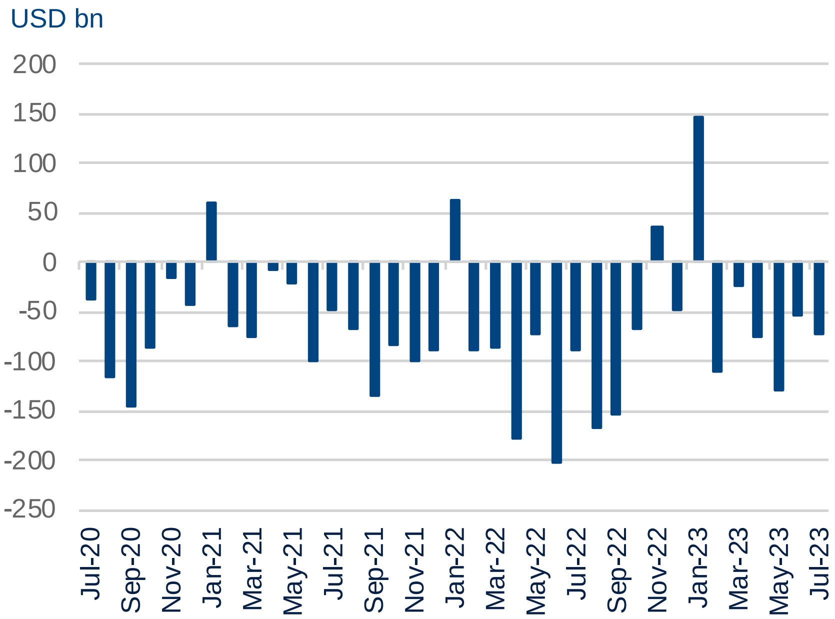

## THE MIRROR EFFECT OF RMB EXCHANGE RATE AND USD DXY PERSISTS



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

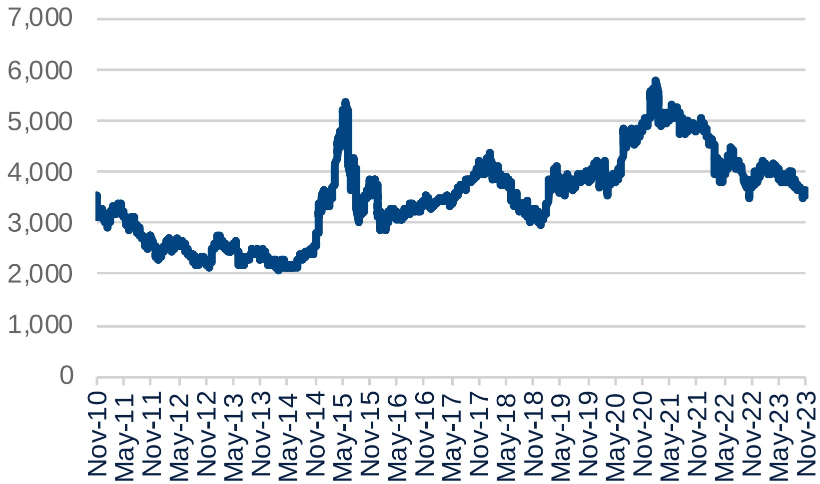
- In short term, the dominant factor of RMB is the diverging monetary policy between US and China. US FED's "high for longer" interest rate together with increasing USD DXY V.S. interest cut in China enlarges interest rate difference.
- Other short-term factors that drive RMB depreciation include: (i) China-US long-term bond yield reversion expanded (one-year and 10-year bond yield: -329bp, -189bp); (ii) dipping Chinese stock price vs. uptrending US stock accelerated capital outflows; (iii) dipping exports and shrinking current account; (iv) growth slowdown.
- PBoC's recent intervention to RMB/USD makes RMB stabilizing around 7.3: (1) Restart counter-cyclical factor mechanism: Aug 18, raise mid-price by 70 bps and Aug 28, raise 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 to reduce RMB liquidity. (4) Cut RRR for USD in mainland to increase USD liquidity.
- End-2023 revised to 7.1, end-2024 revised to 6.9 (Bloomberg: consensus: 2023: 7.25 and 2024: 6.95).
- 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. (ii) A prerequisite of RMB internationalization is appreciation expectation.

## CAPITAL OUTFLOWS ACCELERATED DUE TO US-CHINA LONG-TERM BOND YIELD REVERSION AND CONTRAST STOCK MARKET

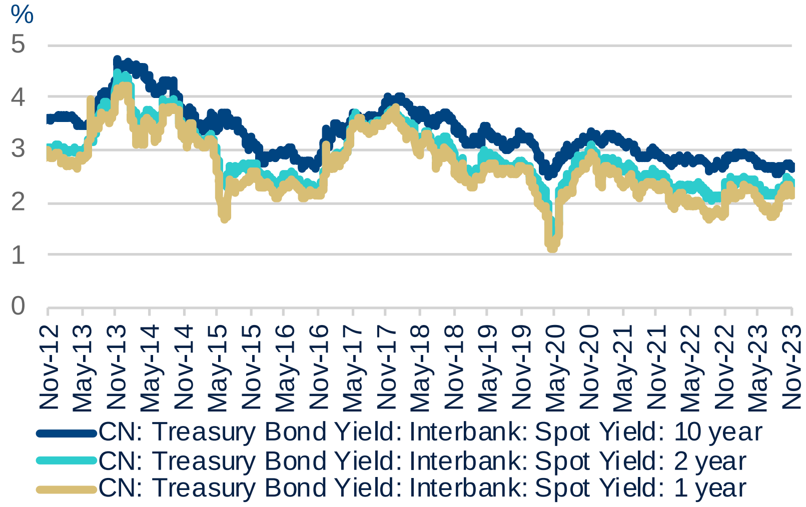


# Financial markets underperformed, reflecting weak investors' confidence

## 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 to support growth recovery. The monetary easing measures in 2023 include 2 RRR cuts and 2 LPR cuts, but the room for LPR cut will be limited due to the concerns of exchange rate depreciation and capital outflows.

**Fiscal policy**

The highlight of the recent fiscal easing includes the newly announced RMB 1 trillion special government bond increasing fiscal deficit from 3% to 3.8% which will stimulate infrastructure investment and help rebuild market sentiments.

**Xi-Biden meeting**

We summarize what were settled and what were unsettled during the Xi-Biden meeting and the outlook of China-US relationship.

**Central Government Finance meeting**

The recent Central Government Finance conference prioritizes real estate and local government debt issues. For the former, the meeting emphasized the equal treatment of private and state-owned housing developers; while for the latter local government debt issue, the meeting outlines a series of debt resolving method as well as to include implicit local government debt from off-balance-sheet back to balance sheet.

# Main take-aways of The Central Government Finance Conference on Oct 30-31 to guide the future 5 years' national strategy in financial sector

## The conference outlined the three perspectives of financial development strategy to serve the real economy:

(1) To always maintain robust monetary policy; pay more attention to cross-cyclical and counter-cyclical monetary policy and to enrich monetary policy tool box.

(2) To prioritize financial resources to promote technology advancement, high-end manufacturing, green economy, SMEs, balanced regional development together with national security, energy security.

(3) To focus on "technology finance", "green finance", "inclusive finance", "aging finance" and "digital finance".

## The conference also highlights the main financial risks from four perspectives:

(1) Local government debt; (i)To issue more central government debt to swap local government debt as China's central government debt level is still low and robust; (ii) To explicitly include off-balance-sheet borrowing (shadow banking, LGFV etc.) into the balance sheet. (iii) To reverse housing market malaise to support local government revenue.

(2) Real estate; To equally treat private and state-owned housing developers' financing demand; To enhance macro-prudential in real estate sector; To enhance regulations on developers.

(3) Financial markets; To prevent financial market's "cross-region", cross-market and cross-border contagion effect.

(4) Foreign exchange markets; To maintain RMB exchange rate two-way fluctuation within a reasonable range.

# Xi-Biden meeting: what were settled and what were unsettled?

## WHAT WERE SETTLED?

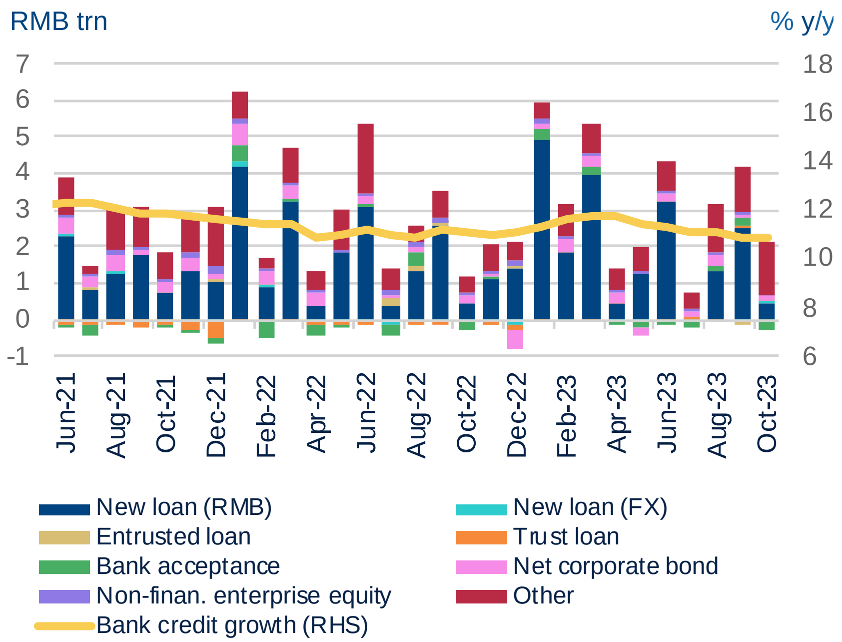
- First, the meeting claimed to try to make the China-US competitive relationship “rational and manageable” in the future.
- Second, the meeting paved the way for re-establishing contacts between the US and Chinese militaries as well as in other fields.
- Third, China and the US also clarified the potential cooperation in the fields of environment protection, anti-terrorism and global security etc.

## WHAT WERE UNSETTLED?

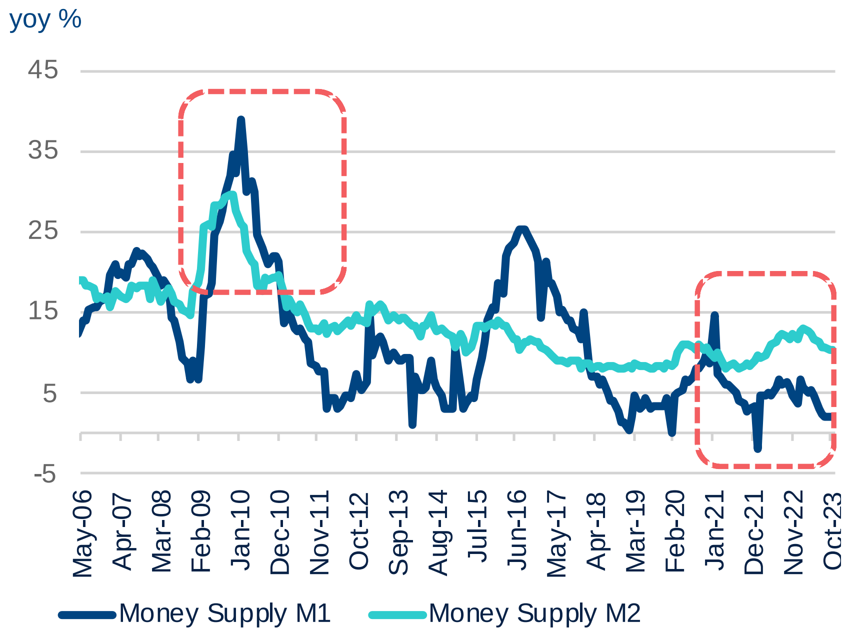
- First, the temporary stabilization of Sino-US relations after the meeting does not extend to tensions across the Taiwan Strait.
- Second, the tariffs and the technology embargo imposed by the US still remained.
- Third, the contrasting ideologies between China and the US indicate that a single summit had no hope of redressing for everything, thus the fundamentals of the relationship won’t change.

# Total credit growth bottomed out but monetary policy transmission mechanism still weak

## TOTAL SOCIAL FINANCING AND NEW RMB LOANS BOUNCED BACK

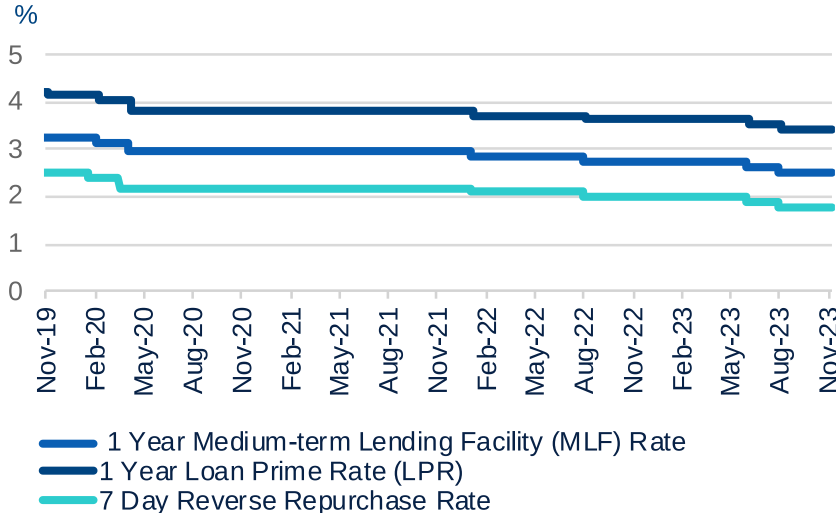



## …ALTHOUGH M2 MARGINALLY DECLINED

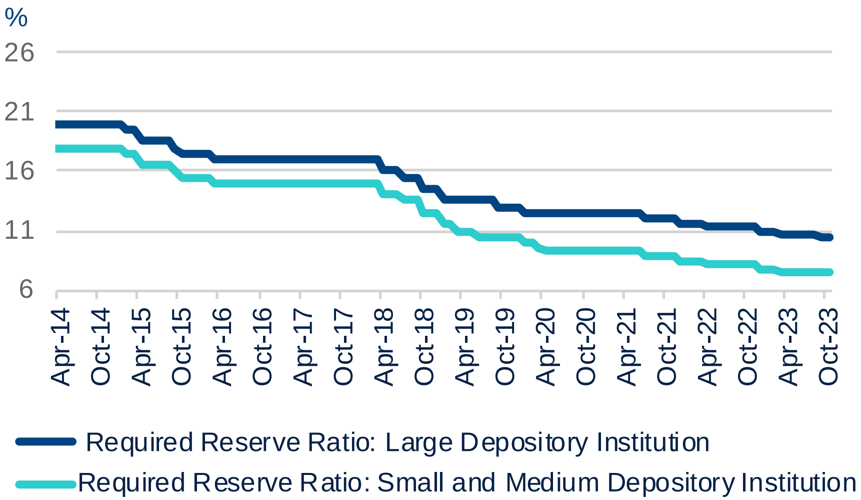


# The PBoC cut both RRR and LPR amid FED hike cycle, as growth slowdown dominates the financial stability concern

## CHINA CUT ONE-YEAR LPR DURING FED HIKE CYCLE TWICE TO STIMULATE GROWTH IN 2023



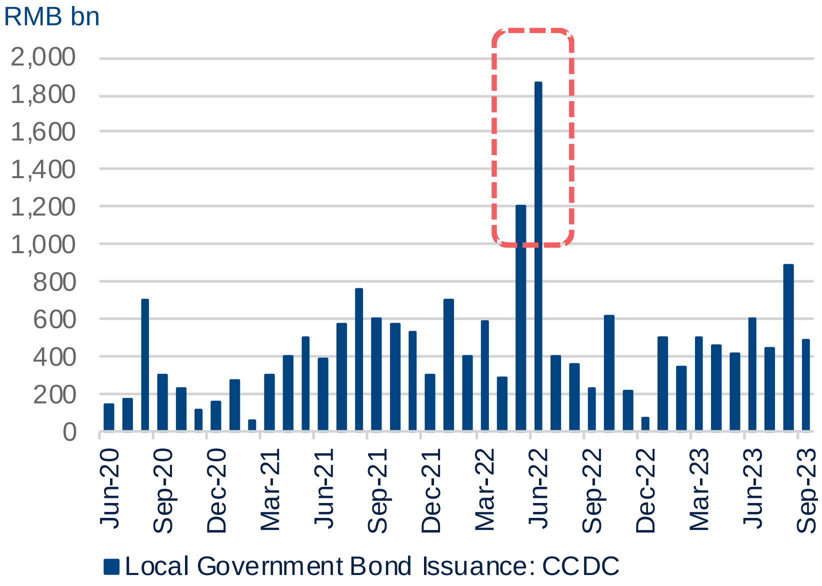

## CHINA ALSO CUT RRR RECENTLY IN SEPTEMBER




In the future, the possibility of RRR cut is more than LPR cut, because (1) China's interest rate is already very low and the large reversion of China-US interest rate give pressure to RMB exchange rate and capital outflows. (2) Further LPR cut will also give pressure to commercial banks' profitability. (2023 Q2 interest rate margin for banks historical low at 1.74%).

# Fiscal stimulus: the newly announced RMB 1 trillion special government bond increased 2023 fiscal deficit to 3.8% from 3%

## THE AUTHORITIES' EXTRA RMB 1 TRILLION GOV. BOND ISSUANCE WILL PARTIALLY SWAP LOCAL GOVERNMENT DEBT




The implications of extra RMB 1 trillion special government bond issuance:

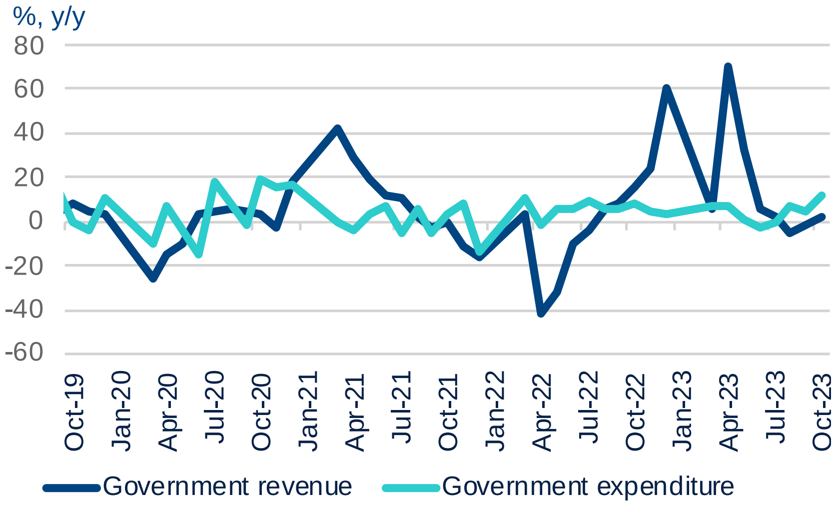
(1) The 3.8% new deficit is higher than normal year's 3% and even higher than 3.7% in 2020 in pandemic time, signaling the government's determination to support growth recovery.

(2) The main purpose is to support post-natural-disaster reconstruction, such as flood, earthquakes etc. and infrastructure investment.

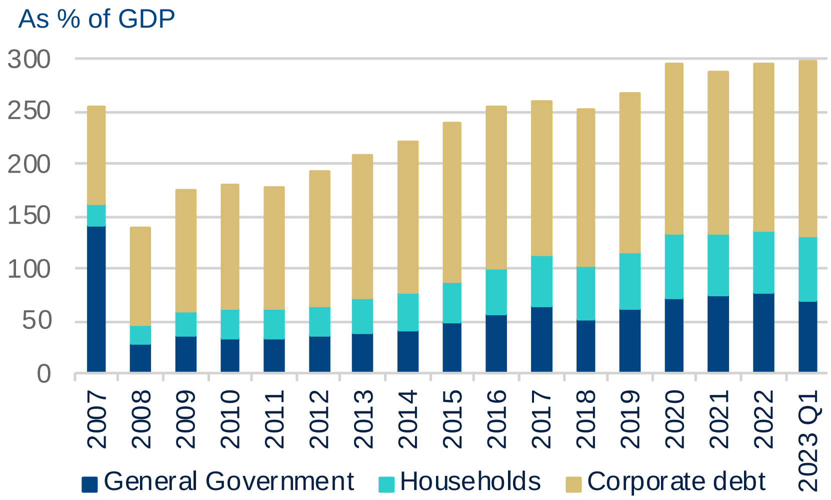
(3) It could also help to release the financing burden of local governments as the central government debt will be directly transferred to local government and will swap part of local government debt.

# Housing crash and local government debt are highly correlated; how to avoid entering into a vicious cycle

## LOCAL GOVERNMENT FISCAL REVENUE WAS SIGNIFICANTLY AFFECTED BY DIPPING LAND SALES



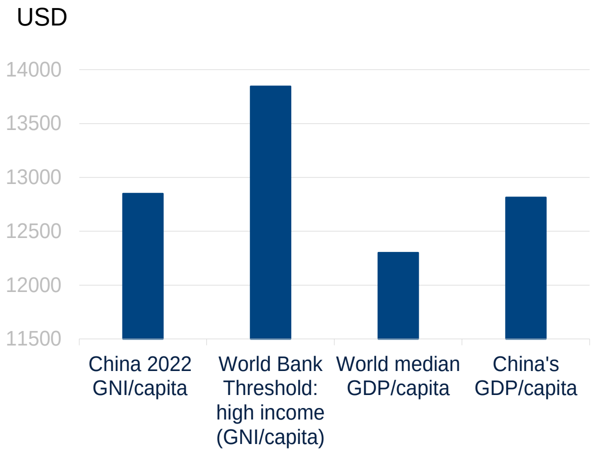

## CHINA'S CENTRAL GOVERNMENT DEBT LEVEL IS MORE SUSTAINABLE AND LIMITED THAN LOCAL GOV DEBT



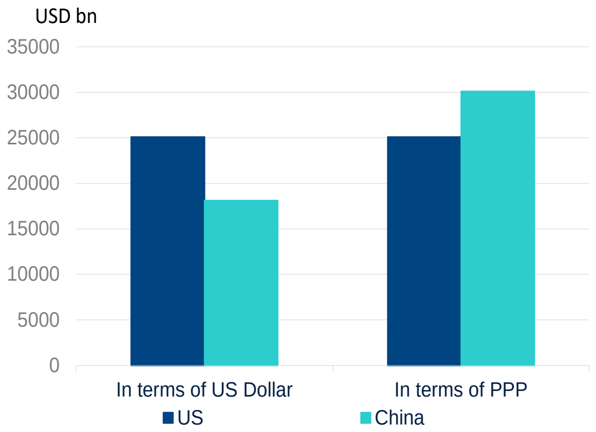

The direction to resolve local government debt issue: (1)To issue more central government debt to swap local government debt; (2) To explicitly include off-balance-sheet borrowing (shadow banking, LGFV etc.) into the government's balance sheet. (3) To reverse housing market malaise to support local government revenue.

# A more long-term issue: the biggest challenge is not "Japanization" but "middle income trap"

## CHINA IS DEFINED BY WORLD BANK AS UPPER MID-INCOME COUNTRIES IN 2022




## CHINA GDP TAKES 70% OF US; BUT IN PPP TERM, ALREADY SURPASSES US




- First, it requires China to maintain a decent growth rate and inflation rate in the next decades, among which, China's long-term "new growth model" to develop new economic growth opportunities is the key.
- Second, it requires China to continue to press ahead a series of structural reforms, particularly SOE and POE reform.
- Third, it needs to prioritize technology advancement.
- Finally, it requires the authorities to continue to concern about financial stability and to avoid large-scale bubble burst.

# A more long-term issue: China's challenges and opportunities

## Challenges

- Aging problem.
- Housing sector will be "L-shape" instead of "V-shape" recovery.
- Infrastructure investment's marginal return will decline.
- Local government debt and other financial vulnerability.
- Value chain relocation outside China.
- Geopolitical risks and the reshape of global order: the US and Taiwan.

## Opportunities

- The new growth engines: fast development of new energy sector and high-end manufacturing: electronic vehicles (EV) and solar energy panels etc.
- Largest domestic market.
- Complete infrastructure and the most complete manufacturing supply chain.
- High education level and technology advancement.
- Urbanization and development of metropolitan regions.
- People mobility from rural area to urban area.
- Further reform and opening-up policy.

# 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 | 5.2 ↑ | 4.4 | 4.2 |
| CPI (%) | 2.9 | 2.6 | 0.9 | 2 | 0.5 | 2 | 2 |
| PPI (%) | -0.3 | -1.8 | 8.1 | 4.2 | -3 | 0.7 | 1 |
| Interest rate (LPR, %) | 4.1 | 3.85 | 3.8 | 3.6 | 3.45 | 3.45 | 3.45 |
| RMB/USD exchange rate | 7 | 6.5 | 6.36 | 6.9 | 7.1 ↓ | 6.9 | 6.7 |

# China’s forecasting: decomposing GDP growth

| | Baseline scenario | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
| GDP (%) | 6.2 | 2.3 | 8.1 | 3.0 | 5.2 | 4.4 | 4.2 |
| Personal consumption | 6.27 | 1.70 | 7.90 | 1.50 | 6.50 | 4.80 | 4.00 |
| Government consumption | 8.50 | 1.60 | 10.00 | 1.00 | 7.00 | 4.50 | 4.00 |
| GCFC | 5.00 | 1.40 | 6.20 | 2.80 | 4.00 | 4.00 | 5.00 |
| Inventory Change | -0.80 | -12.30 | 2.50 | 5.80 | 2.20 | 2.20 | 5.00 |
| Export | -0.10 | 3.60 | 30.00 | 12.00 | -1.50 | 2.70 | 2.21 |
| Imports | -1.00 | -1.05 | 29.00 | 8.00 | -1.50 | 2.00 | 3.20 |

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# China Economic Outlook

December 2023

Creating Opportunities