China Economic Outlook

4Q20
COVID-19 entails a recession for the global economy
GDP has plummeted in the first half of the year, broadly in line with expectations

Emerging Countries: average of Argentina, Brazil, India, Indonesia, Mexico, Russia and Turkey.
Source: BBVA Research based on Haver data.
Faster-than-expected recovery since April, with increasing signs of moderation in the last few months

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

Source: BBVA Research based on Haver data.
Central banks reinforce their commitment to maintain and, if needed, to increase the monetary stimulus

The Fed has revised its strategy:
- more flexible inflation target (average of 2%)
- focus on reaching full employment
- willingness to keep interest rates low for a longer period and expand asset purchases.

The ECB exhibits concerns on low inflation (hence on the recent exchange rate appreciation)...

... it deems adequate to maintain the monetary stimulus in place and it is ready to further use all its tools.

Source: BBVA Research based on Fed and ECB data
In the Eurozone, NGEU funds provide an essential economic support; in the US there exists uncertainty about further fiscal stimulus

FISCAL STIMULUS AND CREDIT PROGRAMS (*) (% OF GDP)

- **Eurozone**
  - **Credit Guarantee Funds**: National measures and Other supranational programs
  - **Fiscal Stimulus**: NGEU

- **USA**
  - **Credit Facilities**: Further measures?
  - **Fiscal Stimulus**: National measures

- **NGEU**: 5.4% of regional GDP (with grants representing more than 50%):
  - Conditioned support to growth as from mid-2021 onwards
  - A step towards fiscal integration
  - Support for the euro as a global currency
  - Bonds issued to fund NGEU will be a possible precedent of an eurobond.

- **Fiscal stimulus in the US**:
  - Waning effects of some of the previous measures
  - Political environment complicates having a new fiscal package before elections.

(*) Fiscal stimulus: expenditure increases and tax cuts, excluding resources used in credit programs. In the case of the Eurozone, national level measures represent the average stimulus launched in Germany, France, Italy and Spain while supranational measures include the EIB measures and the SURE. Credit Programs: in the case of US it includes the fed credit facilities. For the Eurozone it represents the average of Credit Guarantee Funds in Germany, France, Italy and Spain.

Source: BBVA Research based on local data.
Slight upward adjustment in global growth forecasts

<table>
<thead>
<tr>
<th></th>
<th>Actual 2020 (%)</th>
<th>Actual 2021 (%)</th>
<th>Previous (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>-2.9</td>
<td>5.4</td>
<td>-3.1</td>
</tr>
<tr>
<td>USA</td>
<td>-4.6</td>
<td>3.8</td>
<td>-5.1</td>
</tr>
<tr>
<td>China</td>
<td>-8.0</td>
<td>7.5</td>
<td>-8.5</td>
</tr>
<tr>
<td>Eurozone</td>
<td>-8.5</td>
<td>5.2</td>
<td>-5.8</td>
</tr>
</tbody>
</table>

Source: BBVA Research.
More balanced risks

Upside risks

- Earlier-than-expected vaccine distribution and/or new treatments favoring:
  - sharper confidence recovery
  - lower global risk aversion.
- Additional fiscal and monetary stimulus.
- Stronger recovery in China.
- Improvement in global governance.

Downside risks

- Increase of infections and lower effectiveness of vaccines and treatments.
- Second-round effects of the pandemic:
  - corporate bankruptcies
  - public debt sustainability.
- Financial stress, capital outflows from EMs.
- Geopolitical, political and social tensions.
- De-globalization.
China is leading the global recovery
Main messages

The strong Q3 GDP growth at 4.9% y/y indicates the V-shape recovery continues in China. Due to China’s “first-in, first-out” of Covid-19, Chinese economic growth will be the only positive growth among the main economies this year, the only silver lining amid the global recession.

The uneven recovery feature that the supply side lags behind the demand side has been mitigating in Q3 as the economy further normalizes. In particular, the demand side of retail sales and fixed asset investment has joined the supply side recovery showing reassuring signs of a pickup.

Exports have surprisingly shown a strong resilience amid the global recession, supported by the pandemic-related shipments; however, we need to be cautiously positive on its sustainability.

There have been escalating US-China tensions in almost every fronts in the past months; however, the November US president election remains the game changer to the future China-US relationship.
Growth remains strong momentum in Q3

GROWTH PICKED UP SIGNIFICANTLY IN Q3 FROM 3.2% Y/Y IN Q2 to 4.9% Y/Y, CONTINUING THE V-SHAPE RECOVERY

PMIS REMAINED IN THE EXPANSIONARY TERRITORY FOR 7 MONTHS AND INDUSTRIAL PRODUCTION ALREADY WENT BACK TO PRE-COVID GROWTH

Source: CEIC and BBVA Research.
The uneven feature that demand side recovery lags behind production side has been largely mitigating in Q3

**RETAIL SALES PICKED UP SIGNIFICANTLY TO 3.3% IN SEPTEMBER FROM 0.5% PREVIOUSLY, THE SECOND CONSECUTIVE MONTH IN THE POSITIVE TERRITORY**

**AUTO SALES RECOVERY SUPPORTED RETAIL SALES, REFLECTING STRONG COMPETITIVE DEMAND IN POST-COVID TIME**

Source: CEIC and BBVA Research.
Real estate and infrastructure FAI supported the investment recovery, while manufacturing FAI remained negative.

**MANUFACTORY INVESTMENT STILL IN NEGATIVE TERRITORY, LAGING BEHIND REAL ESTATE AND INFRASTRUCTURE, AMID WEAK GLOBAL DEMAND**

**PUBLIC FAI INSTEAD OF PRIVATE FAI LED THE INVESTMENT RECOVERY, DUE TO THE FISCAL STIMULUS OF LOCAL GOVERNMENT BOND ISSUANCE**

Source: CEIC and BBVA Research.
Exports surprisingly showed strong resilience amid weak global recession, while we need to be cautious about its sustainability.

**EXPORT GROWTH OF JAN-SEP ONLY DIPPED BY -0.8%, FORECAST TO BE BACK TO 0.5% GROWTH FOR 2020 YEARLY AVERAGE**

**GLOBAL ECONOMIC RECOVERY AND MEDICAL SUPPLY CHAIN RELOCATION MIGHT DRAG ON EXPORTS GROWTH IN THE FUTURE**

Source: CEIC and BBVA Research.
The authorities have no intention to stimulate growth by housing, more regulatory measures expected on the heating housing market.

HOUSING PRICE SIGNIFICANTLY PICKED UP AFTER COVID CONTROLLED, AS THE PREVIOUS LIQUIDITY INJECTION CHASING LIMITED FINANCIAL ASSETS

THERE ARE INCREASING NUMBER OF CITIES THAT REPORTED HOUSING PRICE INCREASING IN POST-COVID (M/M GROWTH)

Source: CEIC and BBVA Research.
Housing sales and investment in post-COVID time showed a strong recovery

THE GROWTH RATE OF LAND SALES AND RESIDENTIAL BUILDING SOLD PICKED UP...

...WHILE REAL ESTATE INVESTMENT ALMOST WENT BACK TO PRE-COVID GROWTH LEVEL

Source: CEIC and BBVA Research.
Deflation becomes the new concern amid global recession

HEADLINE CPI TRENDS DOWN AS FOOD PRICE DECLINED DUE TO THE EASE OF AFRICA SWINE FLU AND THE SUMMER FLOODS IN RECENT MONTHS

PPI REMAINED IN NEGATIVE REGION FOR THE PAST WHOLE YEAR AMID SLUGGISH COMMODITY PRICE, RAISING THE DEFLATION CONCERN

Source: CEIC and BBVA Research.
China has attracted capital inflows in the past months due to large interest rate differentials with the advanced economies.

**NET CAPITAL OUTFLOWS HAS BEEN LARGELY DRIVEN BY VALUATION EFFECT DUE TO DXY INDEX DEPRECIATION, WHILE CAPITAL INFLOWS INCREASED**

<table>
<thead>
<tr>
<th>Month</th>
<th>USD bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar-16</td>
<td></td>
</tr>
<tr>
<td>Jun-16</td>
<td></td>
</tr>
<tr>
<td>Sep-16</td>
<td></td>
</tr>
<tr>
<td>Dec-16</td>
<td></td>
</tr>
<tr>
<td>Mar-17</td>
<td></td>
</tr>
<tr>
<td>Jun-17</td>
<td></td>
</tr>
<tr>
<td>Sep-17</td>
<td></td>
</tr>
<tr>
<td>Dec-17</td>
<td></td>
</tr>
<tr>
<td>Mar-18</td>
<td></td>
</tr>
<tr>
<td>Jun-18</td>
<td></td>
</tr>
<tr>
<td>Sep-18</td>
<td></td>
</tr>
<tr>
<td>Dec-18</td>
<td></td>
</tr>
<tr>
<td>Mar-19</td>
<td></td>
</tr>
<tr>
<td>Jun-19</td>
<td></td>
</tr>
<tr>
<td>Sep-19</td>
<td></td>
</tr>
<tr>
<td>Dec-19</td>
<td></td>
</tr>
<tr>
<td>Mar-20</td>
<td></td>
</tr>
<tr>
<td>Jun-20</td>
<td></td>
</tr>
<tr>
<td>Sep-20</td>
<td></td>
</tr>
</tbody>
</table>

**FOREIGN RESERVES HAS BEEN TRENDS UP IN THE PAST MONTHS**

- Sharp drop of foreign reserve after 2015 "811" reform
- Recent foreign reserve still stable

Source: CEIC and BBVA Research.
Large capital inflows and RMB appreciation triggered the concern of financial stability

RMB TO USD EXCHANGE RATE HAS ENTERED INTO A SOFT APPRECIATION TREND AS DXY DEPRECIATED

CHINESE STOCK MARKETS ALSO OUTPERFORMED OTHER MARKETS AMID STRONG GROWTH RECOVERY

Source: CEIC and BBVA Research.
Fiscal and monetary policy normalization in 2H
And the outlook of the 14th Five Year Plan
Main messages

Chinese authorities are trying to normalize the previous easing monetary and fiscal measures in 2H 2020 amid better-than-expected growth recovery.

Taking lessons of RMB 4 trillion stimulus package after 2008-09 GFC which created asset bubbles and high macro leveraging ratio in the past 10 years, the authorities have no intention to over-stimulate the economy this time.

The new growth model of “dual circulation” with the focus of “internal circulation” will be the main strategy of Chinese authorities to deal with the new global circumstances.

The 14th Five Year Plan which will be announced in the coming 5th session of 19th Poliburo meeting will be the blueprint of the next five years. We expect the new Five Year Plan to focus on: (i) Around 5% growth target or no explicit target, focusing on economic rebalancing and quality of growth; (ii) To press ahead structural reforms in various perspectives and opening-up policies; (iii) Technology advancement, labor productivity improvement and land reform etc.
M2 and total social financing has stabilized as the monetary policy normalized in 2H

MONETARY POLICY NORMALIZATION IN 2H DOES NOT NECESSARILY MEAN THE TIGHTENING CYCLE WILL START SOON

M2 GROWTH MARGINALLY PICKED UPTO 10.9% IN SEPTEMBER FROM 10.4% PREVIOUSLY, INDICATING STILL ACCOMMODATIVE MONETARY POLICY STANCE

Source: CEIC and BBVA Research.

Source: Wind & BBVA Research.
The PBoC took a conservative step on LPR and MLF cut in Q2 and Q3, and no interest rate cut is anticipated in the rest of 2020 and 2021.

The DR007 has been trending up since May 2020 under the newly formed corridor framework, indicating monetary policy normalization.

The PBOC maintained LPR at 3.85% since April 2020, and it is expected of no LPR cut in the following months.

Source: BBVA Research and CEIC.
No anticipation of RRR cuts in the rest of the year amid monetary policy normalization

TWO RRR CUTS IN Q1 AND ONE IN Q2 DURING THE PANDEMIC PERIOD, WHILE NO ANTICIPATION OF FURTHER RRR CUTS IN THE REST OF YEAR

Source: Haver & BBVA Research.
Fiscal policy will continue to roll-out the previous announced measures in “two sessions”, while no further fiscal stimulus anticipated.

**TAKING LESSONS OF CENTRAL GOVERNMENT DEBT TO GDP RATIO INCREASING DUE TO RMB 4 TRILLION STIMULUS AFTER 2008-09 GFC, THIS TIME IS DIFFERENT**

**SHRINKING GOVERNMENT REVENUE AND INCREASING EXPENDITURE MAKE PRESSURE ON FISCAL BUDGET, CALLING FOR A HALT OF NEW STIMULUS**

Source: CEIC and BBVA Research.
What do we expect of the 14th Five Year Plan which will be announced in the coming Poliburo meeting (Oct 26-29)?

**Growth target:** lower the growth target to around 5% or no explicit target, to pursue economic rebalancing and quality of growth.

**Financial market liberalization:** including RMB internationalization, interest rate liberalization, exchange rate marketization, capital account opening.

**Technology advancement:** increasing investment in “New Infrastructure”, i.e. big data, 5G, AI, block chain, cloud computing, etc.

**The “dual circulation” model with the focus of “internal circulation” will be the new strategy to lead through the new Five Year Plan.**

**To continue press ahead structural reforms in SOE reform, factor market reform, Hukou system and land reform, etc.**

**To continue the opening-up policy, including Free Trade Zone trials, financial market opening, attracting FDI, etc.**

**Financial stability and prevention against financial risks:** including deleveraging on corporate debt and implicit local government debt, controlling housing bubbles etc.

**Environmental protection and Green economy.**
“Dual circulation” with the focus of “internal circulation” growth model becomes the authorities’ new policy focus

The “dual circulation” growth model with a focus on “internal-circulation” is the new strategy for Chinese authorities in coping with new global circumstances. More importantly, it will become the policy focus to guide the 14th Five Year Plan.

The “internal-circulation” has at least three important meanings: (i) “consumption internal-circulation”: domestic market comes first amid the global pandemic, indicating China needs to focus on stimulating domestic demand in the near-term. (ii) “supply-chain internal-circulation”, to strengthen China’s grip on supply chain and reduce the reliance on foreign suppliers in key technology field amid the decoupling of China and the US. (iii) “metropolitan area construction and factor mobility”: five metropolitan area constructions, together with Hukou reform to provide mobility to attract people to the five city metropolitan areas.

“Dual circulation” focuses on connecting the internal and external circulations in three perspectives: (i) international trade: to enhance trade ties with One Belt One Road countries, regional trade in Asia, and Europe. (ii) financial liberalization: RMB internationalization, interest rate liberalization, capital account opening and exchange rate marketization. (iii) opening-up policies: financial market opening, i.e. increasing the share of foreign capitals to total bond and stock market value to 5-10% from current 2-3%, increasing the presence of foreign financial institutions in mainland China, and expanding free trade zone trials etc.
Projections
Main messages

Looking ahead, the main downside risk is the uneven recovery path and the sustainability of the strong export growth. In addition, how to manage large capital inflows and RMB appreciation is also challenging for Chinese authorities.

We forecast GDP growth will further improve to 6% y/y in Q4, concluding the whole year GDP growth to 2.2% (IMF forecast: 1.9%). We upward adjusted 2021 GDP growth to 7.5% from 5.5% previously (Bloomberg consensus: 8%; IMF: 8.2%), reflecting low base effect of 2020 and better-than-expected growth.

Inflation is likely to slow down through the rest of the year due to the significant easing of African Swine Flu and summer floods. More worries are surrounding deflation pressure as PPI has remained in negative territory for a year.

No anticipation of interest rate cut and RRR cut in the rest of 2020 and 2021.

RMB to USD exchange rate has entered into soft appreciation trend, and we predict it to be 6.7 at year end.
### Economic indicators forecasting

#### BASELINE SCENARIO

<table>
<thead>
<tr>
<th></th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP (%)</td>
<td>6.1</td>
<td>2.2</td>
<td>7.5</td>
<td>5.5</td>
</tr>
<tr>
<td>CPI (%)</td>
<td>2.9</td>
<td>3</td>
<td>2.5</td>
<td>2.8</td>
</tr>
<tr>
<td>Interest rate (LPR, %)</td>
<td>4.1</td>
<td>3.85</td>
<td>3.85</td>
<td>3.85</td>
</tr>
<tr>
<td>RMB/USD exchange rate</td>
<td>7.0</td>
<td>6.7</td>
<td>6.7</td>
<td>6.7</td>
</tr>
<tr>
<td>Fiscal deficit to GDP (%)</td>
<td>-4.9</td>
<td>-6.5</td>
<td>-5.5</td>
<td>-4.5</td>
</tr>
</tbody>
</table>
China Economic Outlook

4Q20