



BBVA Research

China Economic Outlook

Second quarter 2018

Asia Unit

Creating Opportunities

Index

1. Growth rate holds firm, but risks of protectionism intensify	3
2. Robust growth in the first quarter of 2018	4
3. Will Trump’s trade war disturb the domestic reforms set by “Two Sessions”?	12
4. External risks are on the rise	16

Closing date: **12 April 2018**

1. Growth rate holds firm, but risks of protectionism intensify

The global economy is currently being subject to divergent forces. The new fiscal stimulus measures approved by the US administration will prolong the favourable phase of the world economic cycle, which has so far been supported by high levels of confidence and the positive tone of industrial activity and international trade, which also benefit China and Europe. On the other hand, the increased vulnerability of the US public accounts brought about by these fiscal stimulus measures, combined with the prospect of financial markets facing greater volatility than in 2017, make this scenario more uncertain. Added to this is the ratcheting up of protectionist rhetoric in the US, which has started to find expression in specific measures. All these are in a context of normalisation of monetary policies following years of exceptional stimulus measures, which may also give rise to additional doubts.

Data available for the first two months of the year suggests that **global growth in the first quarter will show a similar rate to the average for 2017 (1% QoQ)**. Specifically, our BBVA-GAIN model predicts that world GDP growth in 1Q will have reached 0.97% QoQ, meaning that activity will have resumed its trend following the stumble recorded at year-end 2017 due to slowing growth in the three main regions (China, the euro zone and more particularly the US).

This growth is favoured firstly by the **good performance of world trade**. According to our BBVA-Trade indicator in January¹, and especially during February, trade in real terms grew significantly, regaining the dynamism seen in 2016 after the moderation observed last year. The main contributor to this development was export growth in the emerging economies, and in particular - in February - in the Asian countries (mainly China and India). A second factor underpinning 1Q growth is the **sustained solid expansion of industrial output**. Here too, the emerging countries stand out, led by China and India, with Latin America also showing acceptable growth despite the hiccups in its two biggest economies, Mexico and Brazil. In the developed countries, the US gained traction, though this was partly offset by the weakness of the euro zone.

However, **retail sales measured in real terms weakened in December and January**, in both developed and emerging countries, undoing the fledgling recovery of the previous two months² and confirming the scenario of a slow recovery in consumption. As for the more leading indicators of confidence, **PMIs, both manufacturing and services, are close to their all-time highs, although we are starting to see signs of limitations to further expansion**, mainly in the manufacturing sector. This scenario plays out in a context in which inflation, especially the **core measure, has increased very gradually**. We are likely to see greater pressures, though still contained, in the next few months.

As for commodities, **oil prices paused their rising trend in the face of both higher volatility on the financial markets and higher expectations for production in the US**, although they recently settled in a range of US\$60 to US\$65 a barrel. Despite the foregoing, **market fundamentals do not suggest significant changes**, so we are holding our forecasts for the average price of oil at US\$60 a barrel for WTI and US\$65 for Brent, for this year and next. On the demand side, global economic growth will continue to support higher prices; but against this, the expected increase in non-OPEC production will make it difficult to keep prices above US\$60 a barrel for too long. **In the medium term, uncertainty comes mainly from the impact of reduced investment in the sector** and its effect on future supply capacity, which might likely provide greater support for prices.

1: This is also verified by the CPB World Trade Monitor, January 2018, prepared by CPB Netherlands Bureau for Economic Policy Analysis - <https://www.cpb.nl/en/figure/cpb-world-trade-monitor-january-2018>

2: The limited data available for February suggest that retail sales in developed countries will have held steady or fallen again, whereas emerging markets could show some growth since China and the rest of emerging Asia show signs of a slight uptick during the month.

2. Robust growth in the first quarter of 2018

Q1 economic indicators are robust. In particular, the outturns of trade, industrial production and investment are better than expected. However, growth headwinds remain in place, mainly from domestic tightening policy initiatives and trade skirmishes with the US, which, in our baseline scenario, is unlikely to evolve into a full-blown trade war between the largest country economies in the world. That being said, the growth is most likely to moderate through the rest of the year. Thus, we maintain our 2018 growth projection of 6.3% y/y, compared with the official target growth rate at 6.5% and the Bloomberg consensus at 6.5%.

The NPC and CPPCC (also known as “two sessions”) were concluded in the middle of March. The meetings set up a series of economic targets of this year. In addition, it announced the authorities’ monetary and fiscal policy stance. Some government agency reform agenda, together with the new appointments of government officials, was also promulgated during the meeting.

Regarding the policy side, monetary policy will continue to be prudent with some tightening bias this year and the authorities will continue to push forward financial deleveraging in order to prevent systematic financial risks. Fiscal policy will remain expansionary to offset the financial tightening and capacity reduction. However, the government announced to reduce fiscal budget to a certain degree so that fiscal budget to GDP ratio will be around 2.6%, which is 0.4% lower than the previous arrangement in 2017.

Fears of a trade-war between the US and China are escalating, as the US President Trump has implemented a series of restrictive measures on China’s exports to the US since the beginning of the year and China also stroke back with levying tariff on imports from the US. A ‘tit for tat’ protectionist trade rhetoric between the two countries has unnerved investors and rattled financial markets amid concerns that the current trade skirmish, if it escalates into a full-blown trade war could upend global growth momentum and threaten financial stability.

The risk of full-blown trade war with the US is not in our base scenario although trade skirmishes between two largest country economies could linger for quite a while. Based on our estimation of value-added exports of China to the US, these skirmishes should not have a large impact on China’s growth and even its gigantic export sector. But a more worrisome situation is Trump’s trade war might disturb the domestic reform progress. As re-emphasized in the “two sessions”, the authorities will continue to push forward the financial deleveraging and de-capacity in the real sector. The market worries that if the authorities might change their policy stance and stimulate domestic demand again if they exaggerate the change of a full-blown trade war.

All in all, we expect China and the US will eventually reach an agreement to avert a trade war despite recently escalated rhetoric. Moreover, China needs to push forward deleveraging in over-capacity industries as well as other important items on its reform agenda including SOE reforms, financial regulatory framework etc. to strengthen the domestic demand in the long term.

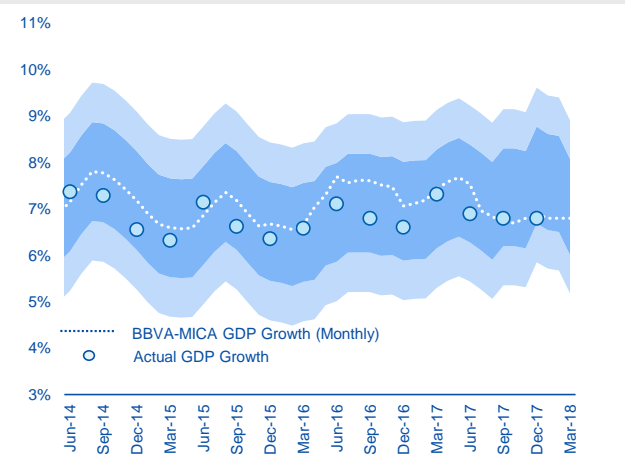
Q1 Activity indicators point to a robust start of the year

Q1 economic indicators are robust. In particular, the outturns of trade, industrial production and investment are much better than expected. Our MICA model yields a monthly GDP estimate of 6.8% y/y, in line with the Q4 GDP outturn which was 6.9% y/y. (Figure 2.1) However, growth headwinds remain in place, mainly from domestic tightening policy initiatives and trade skirmishes with the US, which, in our baseline scenario, is unlikely to evolve into a full-blown trade war between the largest country economies in the world. That being said, the growth is most

likely to moderate through the rest of the year. Thus, we maintain our 2018 growth projection of 6.3% y/y, compared with the official target growth rate at 6.5% and the Bloomberg consensus at 6.5%.

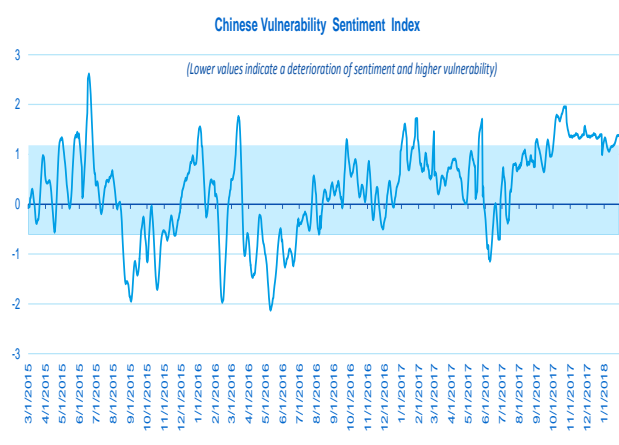
Meanwhile, our China vulnerability sentiment index remains stable in Q1, as the recently held NPC and CPPCC meetings (known as “two sessions”) in Beijing helped to settle the political uncertainties. In addition, the better-than-expected 2017 growth and the ongoing policy conduct to avoid financial risks also helped to anchor investors’ sentiment. (Figure 2.2)

Chart 2.1 BBVA MICA model for GDP forecasting



Source: BBVA Research and CEIC

Chart 2.2 China vulnerability sentiment remains stable



Source: BBVA Research and CEIC

On the supply side, activity indicators indicated a robust momentum in growth during January-February (as the NBS reports the data outturns of the first two months combined). Industrial production significantly picked up to 7.2% y/y from 6.6% y/y of the last December (consensus: 6.2% y/y). Meanwhile, the different indicators of producers’ sentiment of March were mixed. China’s official manufacturing PMI significantly increased to 51.5 in March from 50.3 in the previous month (Consensus: 50.6). While the Caixin China Manufacturing PMI, which includes a survey sample tilting toward SMEs and exporters, slowed down to 51 in March (versus consensus 51.7) from 51.6 in the previous month (Figure 2.3). The divergence between the official PMI and Caixin PMI could reflect some headwinds to China’s export sector including the unexpectedly sharp RMB appreciation in Q1 and trade skirmishes with the US.

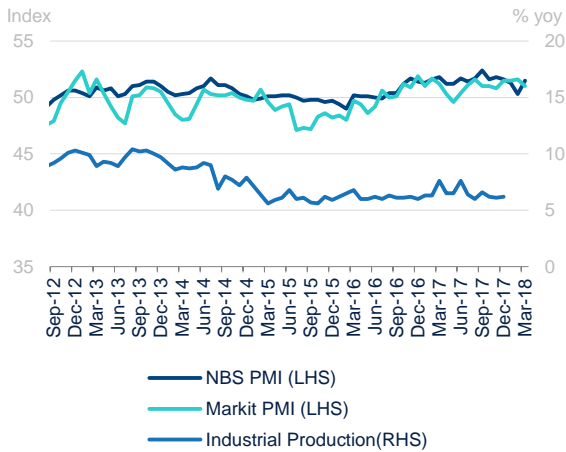
Both supply and demand sides sent some mixed signals of the economy

The demand side has mixed signals. Retail sales growth slowed to 9.7% y/y in January-February from 10.2% y/y in the previous month (consensus: 9.8% y/y). (Figure 2.4) The slowdown was led by auto sales, which grew by 1% y/y in February compared to a 5.2% y/y growth in July before the expiration of fiscal subsidy for passenger car purchase. The silver lining is the rapid growth of online sales, surging 35.6% y/y in the first two months of this year, substantially surpassing the aggregate retail sales growth at 9.7%, indicating

that the rising new economy leads growth.

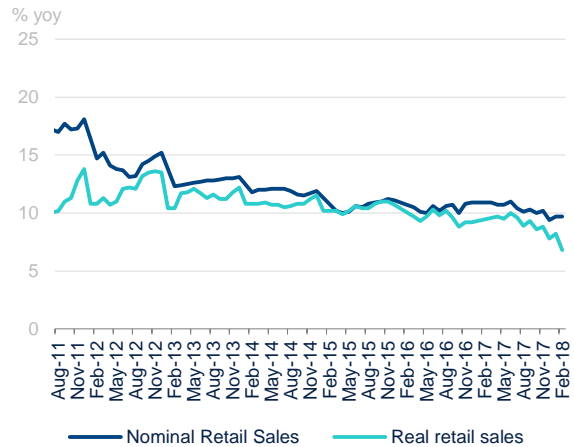
Meanwhile, fixed Asset Investment increased to 7.9% ytd y/y from 7.2% ytd y/y (consensus: 7% ytd y/y), indicating investment regains its momentum at the beginning of the year. (Figure 2.5) In addition, the growth of private investment increased to 8.1% ytd y/y in January-February from 6% ytd y/y previously. (Figure 2.6).

Chart 2.3 Decoupling between PMIs and industrial production



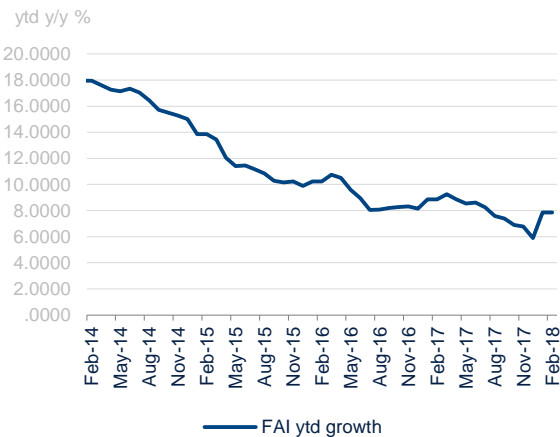
Source: BBVA Research and CEIC

Chart 2.4 Both real and nominal retail sales declined in December



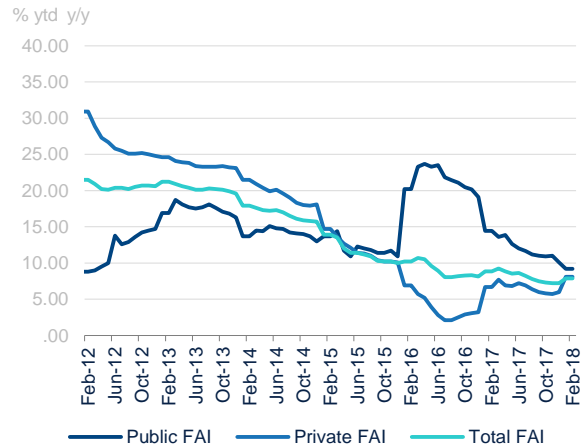
Source: BBVA Research and CEIC

Chart 2.5 Infrastructure investment has Softened due to the end-year budget constraint



Source: BBVA Research and CEIC

Chart 2.6 Private and Public investment display the trend of converging



Source: BBVA Research and CEIC

CPI up and PPI down

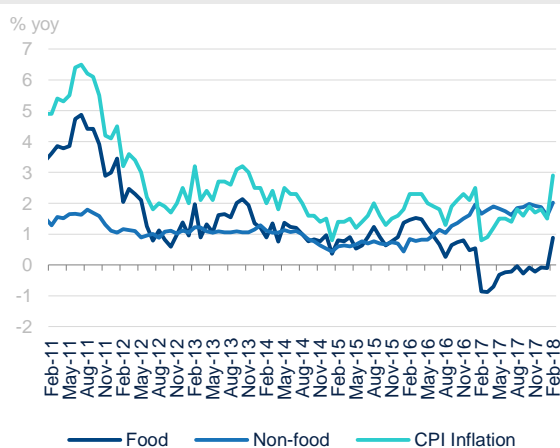
Headline CPI inflation picked up significantly to 2.9% y/y in February from 1.5% in the previous month, above market consensus of 2.5%. The uptick in CPI inflation was driven by food prices as their negative contribution to year-on-year price increase narrowed, mainly due to Chinese New Year (CNY) effect (the Chinese New Year of 2018 fell in February while the CNY of 2017 was in January) and bad weather. (Figure 2.7) In March, the CPI is expected to drop after the dissipation of the seasonal effect.

Convergence of CPI and PPI is set to continue this year

On the other hand, PPI decreased significantly to 3.7% y/y in February from 4.3% in the previous month (Consensus: 3.8%), as the shock from supply-side disruption eased off. (Figure 2.8) That being said, CPI and PPI were converging in February. In the future, we predict the convergence of PPI

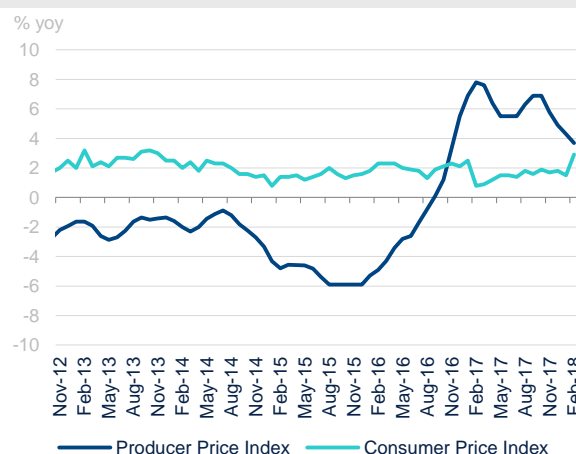
and CPI will continue this year. CPI is expected to trend up gradually after the food-prices rebound from the previous low level. Meanwhile, the PPI will gradually slow its pace as the supply-side reform dissipates. Thus, supply-side shocks caused by overcapacity elimination are likely to have diminishing marginal impact on price levels as investors have already factored it into their expectations.

Chart 2.7 CPI picked up significantly mainly driven by seasonal effect



Source: BBVA Research and CEIC

Chart 2.8 PPI and CPI started to converge



Source: BBVA Research and CEIC

Monetary prudence continues with nuanced changes in regulatory tightening

The continuing prudent monetary policy with tightening bias has maintained the effect to contain credit boom. M2 growth marginally increased to 8.8% y/y from 8.6% y/y in January (consensus: 8.7% YoY), which remains at a comparatively low level. (Figure 2.9).

Credit data outturn dropped significantly in February

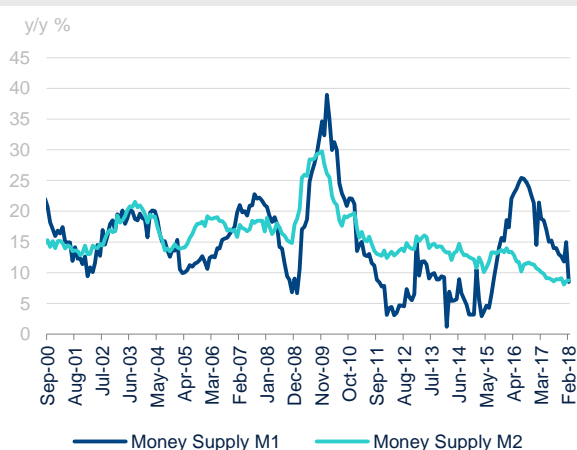
Meanwhile, the growth of new loans and total social financing also decreased significantly in February from the January readings. This is partly due to the seasonal effect, as the new yuan loans and total social financing always picked in January as banks release the lending quota at the beginning of the year. But they are still lower than the last year February readings. In particular, total social financing declined to RMB 1,170 billion (prior: RMB 3,060 billion; consensus: RMB 1,066.5 billion) in February and New yuan loans also dropped to RMB 839.3 bn (prior: RMB 2,900 billion; consensus: RMB 900 billion). (Figure 2.10)

The low credit data in February also reflected the effect of financial sector deleveraging as banks were forced to reduce their shadow banking activities off their balance sheets. (Figure 2.10) Meanwhile, enterprises and household also had lower capital demand due to the ongoing corporate deleveraging and housing market tightening. We predict M2 growth will maintain at a moderated level in 2018 as the financial tightening continues this year as indicated by the recently closed “two sessions”.

Some nuanced changes emerged at the front of regulatory tightening as the authorities sought to ensure the smoothness through the course of financial deleveraging. In particular, the authorities continued to keep high pressure on bank-related shadow banking activities while enhance banks’ capacity to withstand shocks from

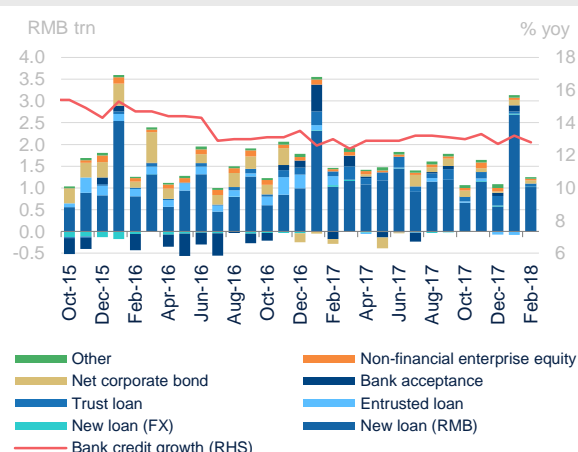
regulatory tightening by applying certain forbearance and encouraging banks to replenish their capital. Those measures include: (i) The “two sessions” did not set any figure target for M2, as the ongoing financial deleveraging might make the M2 more volatile. (ii) CBRC deployed regulatory forbearance by easing rules requiring lenders to set aside provisions against losses on bad loans and reducing the minimum NPL coverage ratio from 150% to 120%; in addition, CBRC also reduced the minimum LLR cover of total loans from 2.5% to 1.5%. (iii) PBoC encouraged banks to issue CoCo bonds to supplement capital ahead of the tighter international regulatory standards of TLAC that will come into effect from January 1st, 2019.

Chart 2.9 M2 growth marginally picked up in February



Source: BBVA Research and CEIC

Chart 2.10 Shadow banking activities shrank



Source: BBVA Research and CEIC

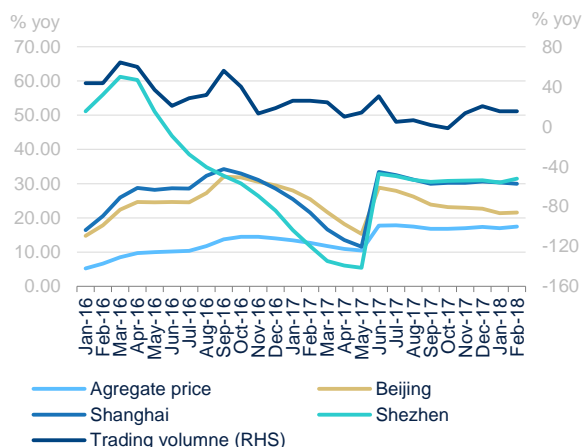
Housing markets continued to be sluggish due to the tightening measures

The tightening measures on the property market have effectively moderated price increases and frozen the trading volume in Tier 1 cities³ (Figure 2.11). Although the housing price seems like to pick up a bit from the regional trough starting from mid-2017, it still remains at a sluggish level. On the other hand, there are still much more cities reporting housing price increasing than the cities reporting decreasing, mainly are smaller cities. (Figure 2.12) However, as more local authorities started to deploy tightening measures in cities other than tier 1, housing bubbles seem to ease further. We predict that housing price will be staying in the moderation region this year.

On top of imposing home purchase restrictions, the authorities also use financial tools to contain housing bubbles, such as increasing the interest rate of mortgage loans. Moreover, the authorities particularly forbid home buyers from borrowing short-term loans to pay for their down payment, in a bid to keep household leverage at a manageable level. Altogether, although the housing market tightening measures helped to ease housing bubble and maintain financial stability, we believe that housing market cooling down will drag on growth this year.

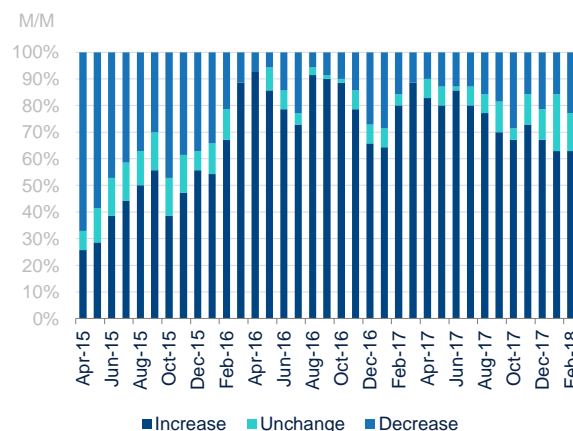
3: Starting from January 2018, NBS has cancelled the statistical indicators for the sales price of affordable housing and only compiled and released the sales price index for newly constructed commercial residential buildings. No sales price index for newly constructed residential buildings was compiled.

Chart 2.11 Housing price maintained at a low level due to the tightening measures...



Source: BBVA Research and CEIC

Chart 2.12 ...although still more cities reported price increasing, mainly are small cities



Source: BBVA Research and CEIC

Strong exports supported growth but it will slow down due to the rising trade war risk

The performance of the trade sector has been very volatile in January and February due to Chinese New Year effects. The growth of exports (in USD terms) surprisingly increased to 44.5% y/y (versus consensus: 11% y/y) from the previous reading of 11.1% in February, while imports significantly dropped to a year-on-year growth of 6.3% (versus consensus: 8% y/y; prior: 36.8% y/y). As a result, the balance of trade expanded to USD 33.74 billion in February from USD 20.35 billion in the previous month. (Figure 2.13)

Importantly, the rising trade tension between China and the US has projected more uncertainties to the prospect of the external sector in the near future. Moreover, we believe the recently sharp appreciation of the RMB exchange rate could weigh on China's exports to a certain extent.

RMB valuation regime: from capital-account-based to current-account-based

The RMB exchange rate experienced a sharp appreciation recently against the backdrop of a sluggish USD. Accumulatively, the RMB has appreciated by 9.6% against the USD since end-2016 and by 3% since the beginning of this year. As a result, the CNYUSD exchange rate has reached the historical low since the failed exchange rate reform of August 2015. It is also noted that the RMB appreciation during this period is not only against the USD but also against the CFETS currency basket, which was introduced in November 2015 as a benchmark of the RMB exchange rate. (Figure 2.14)

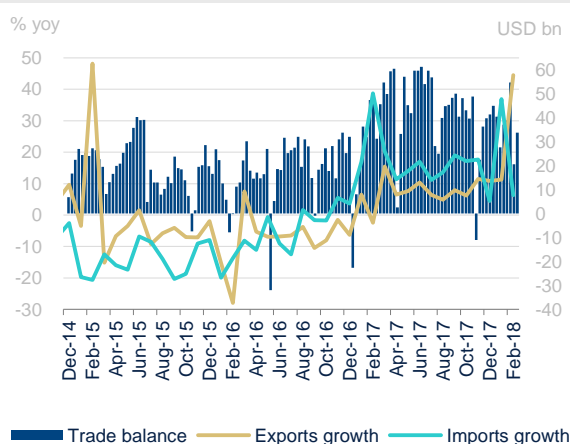
We substantially revised our RMB exchange rate prediction to 6.55 from 7.4 at year end

In addition to the weak performance of the USD, the strong rebound of the RMB exchange rate also benefits from the ever-increasing restrictions under the capital account. In particular, the authorities, starting from July 2017, took steps to control overseas investment of a number of high-profile financial conglomerates, including Anbang, Wanda, HNA etc. Moreover, the better-than-expected the macro economy also supported the RMB exchange rate. It seems like the current RMB appreciation could moderate

the flare-up tension of the trade war between the US and China to a certain extent, while some market experts also interpret it as the authorities' strategy to compromise to the US in order to avoid the escalation of the trade war.

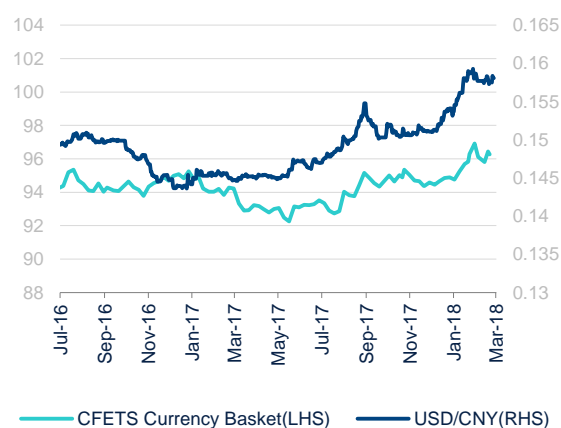
With the capital account under tight grip, the recent movements of RMB mainly reflect current account changes. Based on the above, we revise our end-year RMB exchange rate projection to 6.40 from 6.75 previously, reflecting both recent strong CNY exchange rate and the new policy tendency.

Chart 2.13 RMB to USD appreciated significantly in the recent months



Source: BBVA Research and CEIC

Chart 2.14 Divergence of exports and imports at the year end



Source: BBVA Research and CEIC

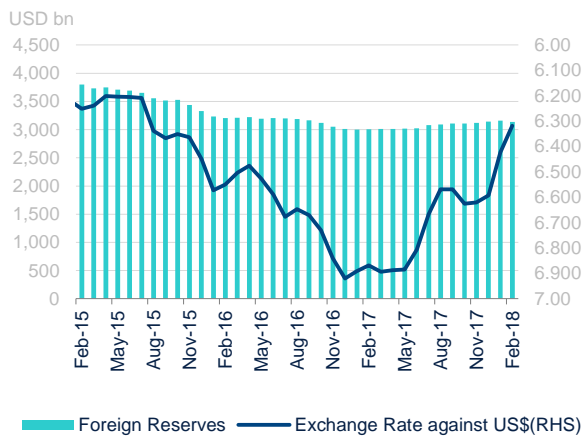
Temporary decline of foreign reserve could not be over-interpreted

Foreign reserves decreased to USD 3,134.48 billion in February, down from USD 3,161.46 billion in the previous month, the first time of declining from 12-month growth in a row. (Figure 2.15) In particular, we estimate that capital outflows amounted to USD 41.7 billion in February, up from USD 25.14 billion in the previous month. (Figure 2.16).

Under the strong RMB exchange rate, we expect foreign reserve will revert to increase in the future

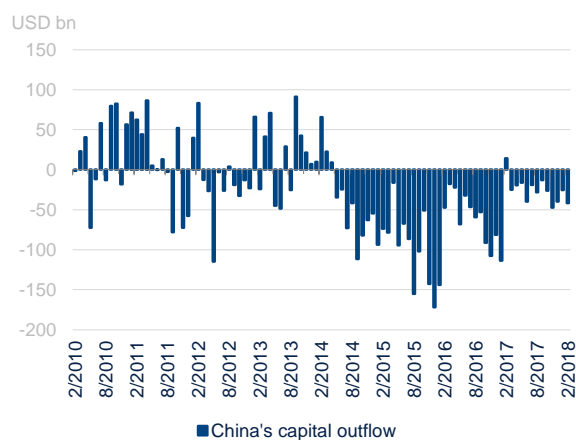
However, there is no need to over-interpret the temporary foreign reserve decline in February. One possible reason might be that the authorities have steadily relaxed OFDI in order to support the “One Belt One Road” initiatives. Altogether, we believe the “two –way” change of foreign reserve and capital outflow will be the main pattern in the future.

Chart 2.15 RMB to USD appreciated significantly in the recent months



Source: BBVA Research and CEIC

Chart 2.16 Divergence of exports and imports at the year end



Source: BBVA Research and CEIC

3. Will Trump’s trade war disturb the domestic reforms set by “Two Sessions”?

We maintain our forecasting for GDP growth while rising CPI prediction

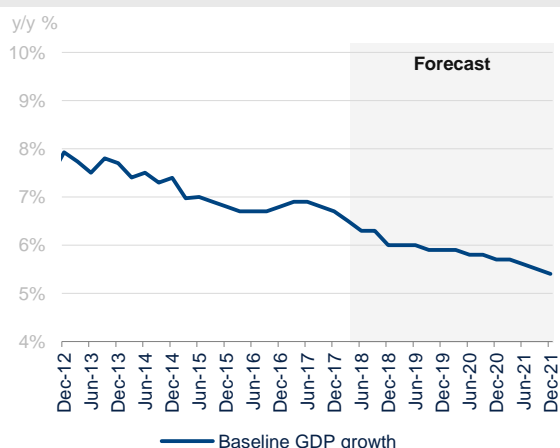
China’s 6.9% growth in 2017 was actually better-than-expected, although the market predicts growth moderation under the framework of financial deleveraging and industrial de-capacity. However, we continue our forecast that signs of moderation will emerge this year due the authorities’ continuing policy tightening, including monetary prudence and regulatory efforts to curb shadow banking activities and overheating property market, together with the de-capacity in the real sector.

Accordingly, we maintain our 2018 growth forecast at 6.3% and 2019 forecast at 6%, reflecting the strong 2017 growth and mitigated financial risks. However, they are still somewhat lower than the market consensus (Bloomberg consensus: 6.5% for 2018 and 6.2% for 2019) and the authorities’ growth target of 2018 is 6.5% as well. Nevertheless, we anticipate that the authorities broadly maintain the policy mix this year over the concern of financial stability, in particular, a prudent monetary policy and a comparatively easing fiscal policy.

By categories, we predict consumption will contribute to around 4.5% (versus: 4.1% in 2017) for GDP growth, dominating investment’s contribution of 1.6% (versus: 2.2% in 2017) and net export’s contribution at 0.2% (versus: 0.5% in 2017) in this year.

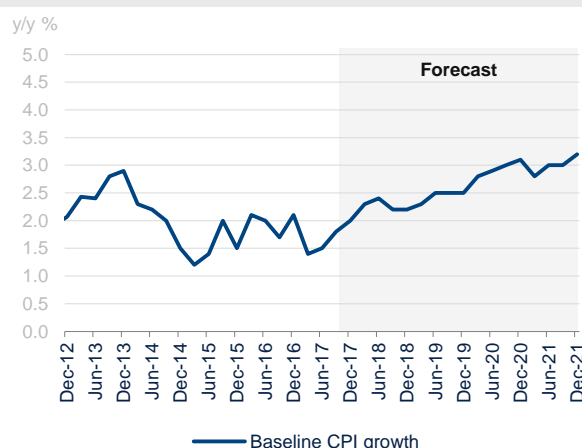
Regarding inflation, we marginally increase our 2018 monthly average projection of CPI to 2.3% in 2018 and 2.5% in 2019 (Bloomberg: 2.3% for 2018 and 2.3% for 2019) mainly due to food prices pick up (Figure 3.2). Looking ahead, the CPI and PPI will finally converge in the long term. CPI is expected to trend up gradually after the food-prices rebound from the current low level. Meanwhile, the PPI will gradually slow its pace as the supply-side reform dissipates. That being said, supply-side shocks caused by overcapacity elimination are likely to have diminishing marginal impact on price levels as investors gradually factor it into their expectations.

Chart 3.1 We maintain our 2018 GDP forecast at 6.3% and 2019 GDP at 6%



Source: BBVA Research and CEIC

Chart 3.2 We marginally raise our CPI forecast to 2.3% for 2018 and to 2.5% for 2019



Source: BBVA Research and CEIC

Table 3.1 Economic indicators forecasting

	2016	2017	2018 (F)	2019 (F)	2020 (F)	2021 (F)
GDP (% YoY)	6.7	6.9	6.3	6	5.8	5.5
Inflation (average, %)	2	1.7	2.3	2.5	3	3
Fiscal balance (% of GDP)	-3	-3	-3	-4	-4	-4
Current account (% of GDP)	2.5	1.4	1.3	1.3	1.2	1.2
Policy rate (%)	4.35	4.35	4.35	4.1	3.6	3.6
Exchange rate (CNY/USD)	6.95	6.5	6.4	6.55	6.6	6.7

Source: BBVA Research and CEIC

“Two Sessions” and policy outlook of 2018

On March 5th, 3,000 newly elected Chinese lawmakers convened at Beijing for about 10 days of parliamentary pageantry, the National People’s Congress (NPC). The NPC runs alongside a meeting of China’s top political advisory body, the Chinese People’s Political Consultative Conference (CPPCC). Together they’re known as “two sessions”. The “two sessions” were concluded in the middle of March. The meetings set up a series of economic targets of this year, in addition, it announced the authorities’ monetary and fiscal policy stance this year. Some government agency reform agenda, together with the new appointments of government officials, was also promulgated during the meeting.

First, the authorities set a series of economic targets for 2018, including:

- Growth rate: Around 6.5 percent this year, the same as in 2017.
- Income growth per capita will be almost together with the GDP growth rate.
- CPI: Around 3%, which is the same as of the previous target which should be treated as a cap as in the past.
- M2: No specific target figure announced this year as the ongoing financial deleveraging could make M2 growth more volatile.
- Unemployment rate: below 5.5% for the urban survey unemployment rate; below 4.5% for registered urban unemployment.
- Capacity cut: China to cut steel capacity by 30 million tons this year; to remove 150 million tons coal capacity

Regarding the policy side, monetary policy will continue to be prudent with some tightening bias this year and the authorities will continue to push forward financial deleveraging in order to prevent systematic financial risks. Fiscal policy will remain expansionary to offset the financial tightening and capacity reduction. However, the government announced to reduce fiscal budget to a certain degree so that fiscal budget to GDP ratio will be around 2.6%, which is 0.4% lower than the previous arrangement in 2017.

Moreover, China will implement some tax cut and will steadily push forward the legislative procedures of property tax. In addition, the authorities will lower import tariffs for vehicles and some consumer goods; will cut taxes for enterprises by 800 billion yuan (120 billion USD) this year and will lift thresholds for levying personal income taxes,

without elaborating. Some other tax cut measures were also announced after the “two sessions”, including to cut value-added tax in manufacturing sector from 17% to 16% and to cut value-added tax in transportation, construction and telecommunication from 11% to 10%, with the estimated total amount RMB 240 billion in a year and will be implemented in May 2018.

In addition, some new changes also include restructuring government agencies. These changes include:

- Consolidated CBRC and CIRC into a new regulatory agency CBIRC and will be led by Guo Shuqing, who was also appointed as the deputy governor and Party Chief of the PBoC.
- The previous deputy PBoC governor Yi Gang was appointed as the new governor of PBoC.
- Both Yi Gang and Guo Shuqing will report to Liu He, the newly appointed vice premier for financial and industrial policy and a trusted adviser to Xi on economic matters.
- The local tax bureaus (LTBs) are to be emerged into the state tax bureaus (STBs), with the State Administration of Taxation taking the lead on tax system administration, with input from local governments.

First, the combination of CBRC and CIRC is aimed at resolving existing problems such as unclear responsibilities and cross-regulation. It gives authorities more clout as the government begins the second year of a crackdown on risks in the financial system such as riskier types of financing and shadow banking. The new merged entity will report directly to the State Council, although the function of making important laws and regulations of the CBRC and CIRC have been transferred to the People’s Bank of China (PBOC) as the central bank takes on a bigger role.

Second, by nominating Yi Gang as the new PBoC governor, China’s authorities, in particular President Xi and his close economic advisor Liu He, sent a strong signal that China will continue to push forward financial opening and liberalization as well as to link the domestic financial sector to the world. Meanwhile, Yi Gang’s long experience at the PBoC with close cooperation with the retired governor Zhou Xiaochuan can ensure the market of monetary policy continuity at the central bank level. Indeed, Yi Gang was educated in the US for his master and PhD degree and was a professor in the US. At his first speech as the PBoC governor, he clearly put forward his three primary tasks: (i) maintaining a prudent and neutral monetary policy stance; (ii) pressing ahead with the reform and opening of domestic financial sector; and (iii) containing financial vulnerabilities to avert financial risks.

Third, the reform of merging LTBs and STBs holds out the promise of much more user-friendly tax compliance in future, as the complexities of the existing dual tax system create many challenges for taxpayers. It remains to be clarified whether there will also be a rebalancing of the allocation of tax revenue between local and central government, in parallel with this administrative reform.

Last but not least, the “two sessions” also removed the two-term limit for the presidency in the constitution, paving the way to Xi Jinping to remain the power beyond 2023. Such an eye-catching move will undoubtedly incur negative comments from the international community and domestic liberal elite, but given the current political landscape in China, it is unimaginable for it to lead to any social unrest or political instability. Above all, the regime change at the top leader level should not lead to the change in the Party’s goal of achieving prosperous economy and its pre-set agenda. We therefore tend to interpret it as neutral to our pre-set China’s scenario. That being said, China is still able to maintain a decent growth rate at least over the next decade.

The rising “trade war” risk and its potential impact on China

Fears of a trade-war between the US and China are escalating. A ‘tit for tat’ protectionist trade rhetoric between two of the world’s dominant economies has unnerved investors and rattled financial markets amid concerns that

the current trade skirmish, if it escalates into a full-blown trade war could upend global growth momentum and threaten financial stability.

The US President Trump has implemented a series of restrictive measures on China's exports to the US since the beginning of the year. On top of imposing the tariffs on China's exported solar panels, washing machines, aluminium foil, steel and aluminium in the previous months, the US also announced a list of 1,333 Chinese products exported to the US on which the US administration plans to levy 25% punitive tariff. Total value of these Chinese exports amounted to USD 50 billion in 2017.

China stroke back swiftly by announcing its retaliatory list of US exports with the same value of USD 50 billion and vowed to take "whatever it takes" to defend national interest.

Although both sides still appeared to play tough at the current stage, we deem that the chance of them to reach some agreement to avert a full-blown trade is still large. In particular, China has offered to buy more semiconductors from the US by diverting some purchases from South Korean and Taiwanese manufacturers, in an effort to help reduce annual USD 375 billion merchandise trade surplus with the US. Moreover, China also promised to further open China's financial services sector and reduce Chinese tariffs on imported cars.

That being said, the risk of full-blown trade war with the USD is not in our base scenario although trade skirmishes between two largest country economies could linger for quite a while. In theory, these skirmishes should not have a large impact on China's growth and even its gigantic export sector. For example, direct steel export from China to the US is not large, taking around 3.2% of the US total steel imports.

A more worrisome situation is Trump's trade war might disturb the domestic reform progress. As re-emphasized in the "two sessions", the authorities will continue to push forward the financial deleveraging and de-capacity in the real sector. The market worries that if the authorities might change their policy stance and stimulate domestic demand again if they exaggerate the change of a full-blown trade war. Fortunately, the authorities haven't shown any sign in this respect.

All in all, we expect China and the US will eventually reach an agreement to avert a trade war despite recently escalated rhetoric. Moreover, China needs to push forward deleveraging in over-capacity industries as well as other important items on its reform agenda including SOE reforms, financial regulatory framework etc.

4. External risks are on the rise

External risks are on the rise recently. The external demand is subject to headwinds from rising trade protectionism from the US. Although till now there is still no specific clue whether the trade war will actually happen, market sentiments have already turned negative regarding China's exports and exchange rate etc.

At the current stage, although the moves have fuelled fears that the situation could escalate into a full-blown trade war between the world's two largest economies, Chinese authorities, together with their US counterparts, have been actively seeking for solutions to avoid the trade war with the US. The current negotiations are surrounding the following perspectives: the US wants Beijing to reduce tariffs on American cars, increase spending on US semiconductors and provide greater access to the Chinese financial sector; also, the US wants China to do a lot more to open up its vast economy to US businesses and bring down the massive trade deficit between the two countries; in addition, Trump has set a target of cutting the deficit in goods with China by USD 100 billion. Thus, the probability of the trade war is actually depending on the negotiation result of the two sides.

By calculating the value-added part of China's exports to the US, we estimate that among the USD 50 billion amount of China's exports to the US which are subject to Trump's tariff imposing, around USD 30 billion are value-added production in China (other USD 20 billion are from the upstream countries which have supply chain with China). This will lead to around 0.45% GDP decreasing with a rough assumption that net exports to the US will decrease by tariff-subjective amount.

We expect China will respond the trade protectionist measures in a relatively limited fashion which would limit the scope of the conflict of the two largest economies, although we need to cautiously watch the progress of this issue these days.

In addition, the large-scale US tax cuts have enhanced the U.S. position against other industrialized economies. And the US FED interest rate hike, although most part of which has been priced in among the market participants, might trigger rebalancing of the global monetary policy stance and a following-up interest rate hike globally as widely discussed in the market.

Risks regarding on growth are also from the domestic policy side. The on-going deleveraging in the real economy and financial sector, with its original intention of mitigating the over-capacity and financial instability respectively, might drag on growth in the medium term. These policy measures mainly include supply-side deleveraging as well as cooling down the housing market and shadow banking. Altogether, the authorities need to find a balance and choose an appropriate pace between pushing forward the deleveraging progress and maintaining a sustainable growth momentum. In this respect, market participants should guard against the risk of over-tightening stemming from the overconfidence of policymakers or the uncoordinated policy conduct among monetary, fiscal and supply-side policy initiatives.

IMPORTANT DISCLOSURES

The BBVA Group companies that have participated in preparing or contributed information, opinions, estimates, forecasts or recommendations to this report are identified by the location(s) of the author(s) listed on the first page as follows: 1) Madrid, London or Europe = Banco Bilbao Vizcaya Argentaria, S.A., including its E.U. branches (hereinafter called 'BBVA'); 2) Mexico City = BBVA Bancomer, S.A. Institución de Banca Múltiple, Grupo Financiero BBVA Bancomer (hereinafter called 'BBVA Bancomer'); 3) New York = BBVA Securities, Inc. (hereinafter called "BBVA Securities"); 4.) New York Branch = BBVA, New York branch; 5.) Lima = BBVA Continental; 6.) Bogota = BBVA Colombia S.A.; 7.) Santiago = BBVA Chile S.A.; 8.) Hong Kong = BBVA, Hong Kong branch, 9.) Istanbul = Garanti Securities.

For recipients in the European Union, this document is distributed by BBVA, a bank supervised by Banco de España and by Spain's Stock Exchange Commission (CNMV), and registered with Banco de España with number 0182.

For recipients in Hong Kong, this document is distributed by BBVA, which Hong Kong branch is supervised by the Hong Kong Monetary Authority.

For recipients in Mexico, this document is distributed by BBVA Bancomer, a bank supervised by the Comisión Nacional Bancaria y de Valores (Mexico's SEC).

For recipients in Peru, this document is distributed by BBVA Continental, a bank supervised by the Superintendencia de Banca, Seguros y Administradoras Privadas de Fondos de Pensiones.

For recipients in Singapore, this document is distributed by BBVA, which Singapore branch is supervised by the Monetary Authority of Singapore.

For recipients in the USA, research on products other than swaps, or equity securities and equity derivatives prepared by BBVA, is distributed by BBVA Securities, a subsidiary of BBVA registered with and supervised by the U.S. Securities and Exchange Commission and a member of the Financial Industry Regulatory Authority ("FINRA") and the Securities Investor Protection Corporation. U.S. persons wishing to execute any transactions should do so only by contacting a representative of BBVA Securities in the U.S. Unless local regulations provide otherwise, non-U.S. persons should contact and execute transactions through a BBVA branch or affiliate in their home jurisdiction.

Research on swaps is distributed by BBVA, a swaps dealer registered with and supervised by the Commodity Futures Trading Commission ("CFTC"). U.S. persons wishing to execute any transactions should do so only by contacting a representative of BBVA. Unless local regulations provide otherwise, non-U.S. persons should contact and execute transactions through a BBVA branch or affiliate in their home jurisdiction.

Research prepared by BBVA on equity securities and equity derivatives is distributed by BBVA to "major U.S. institutional investors" based on an exemption from registration provided by Rule 15a-6 of the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act"). BBVA is not a registered broker-dealer in the United States and is not subject to U.S. rules on preparing research or independence of research analysts.

BBVA and BBVA Group companies or affiliates (art. 42 of the Royal Decree of 22 August 1885 Code of Commerce), are subject to the BBVA Group Policy on Conduct for Security Market Operations which establishes common standards for activity in these entities' markets, but also specifically for analysis and analysts. This BBVA policy is available for reference on the following website: www.bbva.com.

Analysts residing outside the U.S. who have contributed to this report may not be registered with or qualified as research analysts by FINRA or the New York Stock Exchange and may not be considered “associated persons” of BBVA Securities (as such term is construed by the rules of FINRA). As such, they may not be subject to FINRA Rule 2241 or 2242 restrictions on communications with subject companies, public appearances and trading of securities held in research analysts’ accounts.

BBVA is subject to Internal Standards of Conduct on the Security Markets, which detail the standards of the above-mentioned overall policy for the EU. Among other regulations, they include rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. These Internal Standards of Conduct on the Security Markets are available for reference in the ‘Corporate Governance’ section of the following website: www.bbva.com.

BBVA Bancomer is subject to a Code of Conduct and to Internal Standards of Conduct for Security Market Operations, which details the standards of the above-mentioned overall policy for Mexico. Among other regulations, it includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. This Code and the Internal Standards are available for reference in the ‘Grupo BBVA Bancomer’ subsection of the ‘Conócenos’ menu of the following website : www.bancomer.com.

BBVA Continental is subject to a Code of Conduct and to a Code of Ethics for Security Market Operations, which details the standards of the above-mentioned overall policy for Peru. Among other regulations, it includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. Both Codes are available for reference in the ‘Nuestro Banco’ menu of the following website: <https://www.bbvacontinental.pe/meta/conoce-bbva/>.

BBVA Securities is subject to a Capital Markets Code of Conduct, which details the standards of the above-mentioned overall policy for USA. Among other regulations, it includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers.

Exclusively for Recipients Resident in Mexico

BBVA Bancomer acts as a market maker/specialist in: MexDer Future Contracts (US dollar [DEUA], 28-day TIEs [TE28], TIE Swaps, 91-day CETES [CE91]), Bonos M, Bonos M3, Bonos M10, BMV Price and Quotations Index (IPC), Options Contracts (IPC, shares in América Móvil, Cemex, CPO, Femsas UBD, Gcarso A1, Telmex L) and Udibonos.

BBVA Bancomer, and, as applicable, its affiliates within BBVA Bancomer Financial Group, may hold from time to time investments in the securities or derivative financial instruments with underlying securities covered in this report, which represent 10% or more of its securities or investment portfolio, or 10% or more of the issue or underlying of the securities covered.

DISCLAIMER

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.

This report has been produced by the China Unit

Chief Economist for Asia

Le Xia

Xia.le@bbva.com.hk

Jinyue Dong

jinyue.dong@bbva.com.hk

Betty Huang

betty.huang@bbva.com.hk

Sumedh Deorukhkar

sumedh.deorukhkar@bbva.com

BBVA Research

Chief Economist BBVA Group

Jorge Sicilia Serrano

Macroeconomic Analysis

Rafael Doménech

r.domenech@bbva.com

Digital Economy

Alejandro Neut

robertoalejandro.neut@bbva.com

Global Macroeconomic Scenarios

Miguel Jiménez

mjimenezg@bbva.com

Global Financial Markets

Sonsoles Castillo

s.castillo@bbva.com

Long-Term Global Modelling and Analysis

Julián Cubero

juan.cubero@bbva.com

Innovation and Processes

Oscar de las Peñas

oscar.delaspenas@bbva.com

Financial Systems and Regulation

Santiago Fernández de Lis

sfernandezdelis@bbva.com

Digital Regulation and Trends

Álvaro Martín

alvaro.martin@bbva.com

Regulation

Ana Rubio

arubiog@bbva.com

Financial Systems

Olga Cerqueira

olga.gouveia@bbva.com

Spain and Portugal

Miguel Cardoso

miguel.cardoso@bbva.com

United States

Nathaniel Karp

nathaniel.Karp@bbva.com

Mexico

Carlos Serrano

carlos.serranoh@bbva.com

Middle East, Asia and

Big Data

Álvaro Ortiz

alvaro.ortiz@bbva.com

Turkey

Álvaro Ortiz

alvaro.ortiz@bbva.com

Asia

Le Xia

le.xia@bbva.com

South America

Juan Manuel Ruiz

juan.ruiz@bbva.com

Argentina

Gloria Sorensen

gsorensen@bbva.com

Chile

Jorge Selaive

jselaive@bbva.com

Colombia

Juana Téllez

juana.tellez@bbva.com

Peru

Hugo Perea

hperea@bbva.com

Venezuela

Julio Pineda

juliocesar.pineda@bbva.com

CONTACT DETAILS:

BBVA Research: Azul Street, 4. La Vela Building – 4th and 5th floor. 28050 Madrid (Spain). Tel.: +34 91 374 60 00 and +34 91 537 70 00 / Fax: +34 91 374 30 25 - bbvaresearch@bbva.com www.bbvaresearch.com