China Economic Outlook

Fourth quarter 2018

Asia Unit

Creating Opportunities

Index

1. Global economy: Global growth is moderating slightly and risks are intensifying 3

2. Growth slowdown has prompted the authorities to shift policy stance to pro-growth 6

3. Trade war escalation and China's easing measures to support growth 15

4. Growth risks intensified 20

Closing date: **25 October 2018**

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1. Global economy: Global growth is moderating slightly and risks are intensifying

The global economy continues to show positive data, but in an environment of growing uncertainty. The inertia in world growth has continued in the last three months, prolonged by the effect of the fiscal stimulus on the US economy and certain stability in the Chinese and European economies in a context of deceleration. However, the protectionist escalation between the US and China has intensified, while the appreciation of the US dollar has been reflected in an increase in financial tensions in emerging economies which, although with a clear differentiation between countries, has meant a major adjustment in those that are more vulnerable (such as Turkey and Argentina). In this context, both the Federal Reserve (Fed) and the European Central Bank (ECB) continue to make progress in normalising monetary policy, which means a gradual tightening of monetary conditions that will continue to put pressure on emerging economies in the coming quarters. Despite this, it does not seem that we are facing a systemic crisis in these countries. Faced with a global scenario of relative continuity with a slight slowdown in 2019, the main risk in the short term is still protectionism, the effect of which could be felt in the coming year.

Slight moderation in global growth in the second half of 2018 and lower synchronisation

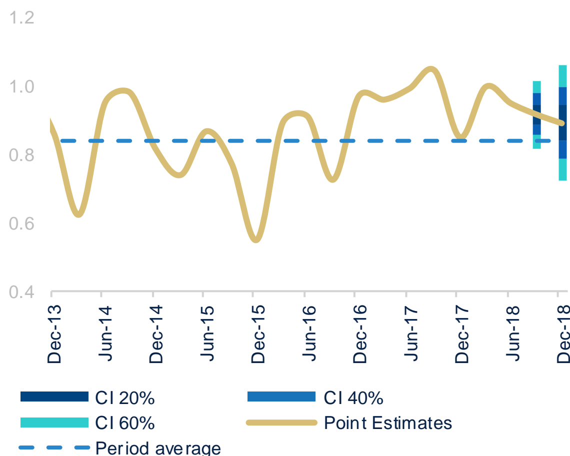
Data available up to September suggest that **global growth would have again slowed down in the third quarter of the year** (BBVA-GAIN: 0.92% QoQ after 0.95% in 2Q18) (see Figure 2.1) and **regional differences would have intensified**. The strength of the US economy contrasts with the moderation in China and the eurozone and, above all, with the significant adjustments observed in the emerging economies most vulnerable to the increase in financial tensions.

The **growth of the industrial sector is very moderate** and still does not recover from the poor performance at the beginning of the year. This behaviour **seems more to reflect the worsening outlook for domestic demand in emerging countries than the solid improvement in global trade** up to August, with the good export performance of Asia-Pacific countries being particularly noteworthy. However, it is still early for the trade data to reflect the possible negative effects of the protectionist escalation that has developed in recent months between the US and China; on the contrary, they may have been positively affected by the advancement of some trade exchanges in the face of the threat of new tariff increases.

Confidence indicators up to August also point to a gradual moderation in global growth, **although they remain at high levels**. The deterioration in confidence in the manufacturing sector is due to worsening employment expectations and foreign orders, affected by uncertainty about trade relations and the need for some emerging economies to reduce their external deficit levels and thus affect some advanced economies, mainly Germany and Japan. Expectations about the evolution of the services sector have also deteriorated, although they remain well above the historical average, partly supported by the strength of domestic demand in developed economies. In particular, retail sales suggest that the downward trend in household spending in recent months has come to a halt and continues to grow at a relatively robust pace, so **consumption will likely continue to support global growth**.

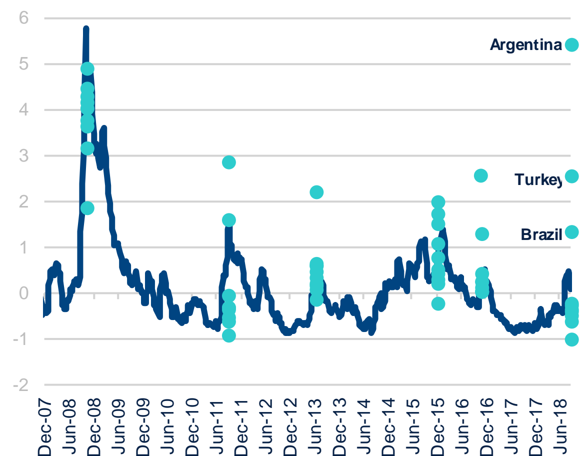
With regard to price trends, **the rise in inflation before the summer has moderated** more recently due to the evolution of commodity prices. **Core inflation remains contained**, but is expected to rise gradually as a result of robust domestic demand in advanced economies and the translation of currency depreciations to prices in emerging economies.

Figure 1.1 World GDP growth
(QoQ, %)



Source: BBVA Research

Figure 1.2 BBVA index of financial tensions for emerging economies



Source: BBVA Research

The normalisation of monetary policy, together with increased uncertainty, will keep on adding pressure on emerging economies

Despite confirming the signs of global economic moderation in the last quarter, **global inertia remains positive, especially in developed economies, and reinforces the** ongoing **normalisation process** of the main central banks in the coming quarters, which will further affect **financial conditions in emerging markets**. In this environment, the feeling of risk aversion among investors has continued for another quarter, **particularly affecting the most vulnerable emerging countries** (those with the greatest external financing needs and high foreign currency indebtedness) (see Figure 2.2), while developed countries continued to benefit from an environment generally free of financial tensions.

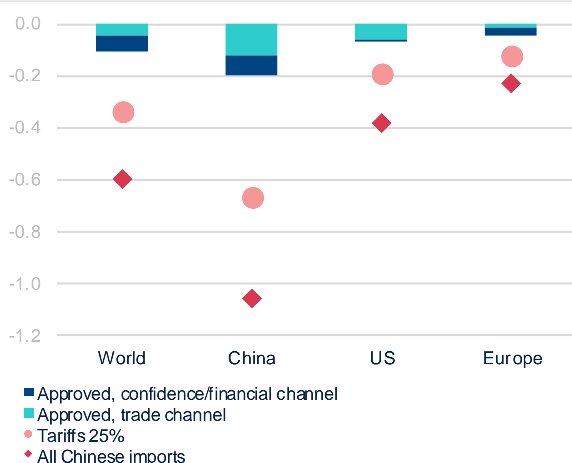
In this context, **Argentina and Turkey suffered in particular**, and their currencies depreciated by 30% and 24%, respectively, while their risk premia increased markedly. However, **tensions eased after monetary and fiscal measures were taken.** On the other hand, trade tensions continue, but with limited effects so far on markets during the quarter, which has been helped by the fact that **China has so far stabilised its currency and curbed the slowdown in growth** through economic policy stimuli. The other focus in the markets has been **Europe,** and for a twofold reason. Firstly, the **risk linked to Italy** increased during the summer and following the government's fiscal proposal - which deviates from the path marked by Europe - with the consequent extension of the Italian risk premium (up to 300 basis points), but with a very limited contagion in the other peripheral countries. Secondly, the ***impasse* at which the *Brexit*** negotiations are stuck has increased the likelihood of a non-deal exit from the EU.

The **tightening of global financing conditions will most likely continue over the forecast horizon**. On the one hand, **the Fed goes on with the normalisation of its monetary policy.** After the cumulative increase in its intervention rate of 75 basis points so far this year (currently at 2.25%), we expect a **rise of more than 25 basis points to 2.5% by the end of this year and to 3.25% by the end of 2019**. Concerning **the ECB, it has reaffirmed and begun its exit strategy** (see below). Coupled with this, **the upward pressure on the dollar against major currencies** has been maintained, driven by the flight to quality and an increasingly favourable interest rate differential.

Uncertainty about protectionist escalation remains high. Although trade tensions between the U.S. and some areas have eased for the time being, the agreement with Mexico and Canada has yet to be ratified and negotiations on the automotive sector with Europe will be reopened after the US mid-term elections in November. Meanwhile, **some of the US protectionist threats towards China have already materialised**, with their respective countermeasures by the Asian country. The US has approved a 10% tariff increase for Chinese imports worth US$200 billion, in addition to the US$50 billion worth of Chinese products with 25% tariffs. China, on the other hand, has reacted by increasing its tariffs to 10% for US imports worth US$60 billion dollars, in addition to the increase of tariffs up to 25% on products worth US$50 billion dollars. **The impact on GDP of these measures** (see Figure 2.3), together with those already approved for steel and aluminium imports, **through the trade channel is limited** (around 0.1% of GDP for China). However, to this direct impact, **other indirect effects** (lower confidence among economic agents, impact on financial markets) could **also be added**, especially for China and emerging economies. These are difficult to estimate but could additionally subtract around 0.1 pp from growth.

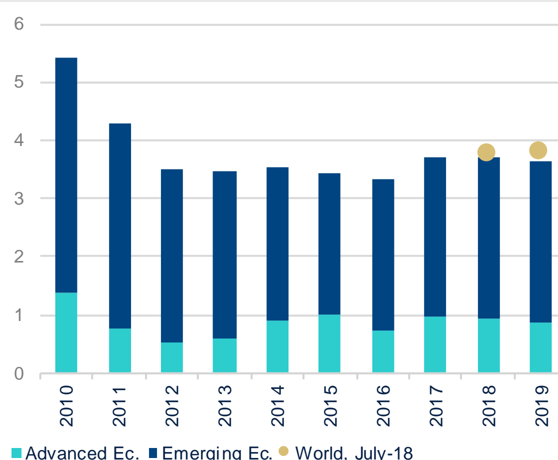
Negotiations with China are likely to resume by the end of the year, and if they do not meet US demands (particularly on intellectual property rights), **the 10% tariff approved in September could rise to 25% from January 2019 on**. In this scenario, and assuming that China reacts with the same rise, **the impact on growth would already be much more significant**, possibly subtracting around 0.7 pp from the growth of the Chinese economy and 0.2 pp from that of the US (and thus -0.3 pp from world GDP and around -0.1 pp from Europe's). While the Chinese authorities are willing to implement policies to support growth, a trade war affecting all their trade exchanges could derail the global recovery.

Figure 1.3 Effect on GDP growth due to US tariff hikes and the response of other countries (2018-19, pp)



Source: BBVA Research

Figure 1.4 Forecasts of world GDP growth (% YoY)



Source: BBVA Research

2. Growth slowdown has prompted the authorities to shift policy stance to pro-growth

2018 Q3 GDP moderated to 6.5% y/y, down from the previous reading at 6.7% y/y and the market consensus at 6.6% y/y. This suggests that Chinese economy further moderated amid the escalation of trade war with the US and domestic deleveraging.

The faster-than-expected growth slowdown has prompted the authorities to reverse their previous neutral stance of monetary policy to pro-growth so as to offset domestic and external headwinds to the economy. Nevertheless, the authorities remain vigilant on a number of financial vulnerabilities including the indebtedness in China's corporate sector and shadow banking activities. Therefore, the monetary easing has thus far been measured and targeted. In the meantime, more expansionary fiscal initiatives have been or are to be deployed to engineer a soft-landing of growth. The thrust of these fiscal initiatives is a welcomed and long-awaited tax cut package which includes the adjustment of personal income tax, VAT and import tax etc. All in all, we project that growth in 2018 can meet the official target of 6.5% even with certain upside risk.

Faced with two important growth headwinds, namely, the trade dispute with the US and domestically cyclical downtrend from previous policy tightening at the same time, the authorities have implemented a series of easing measures in a bid to sustain growth and engineer a soft-landing. The easing initiatives on the monetary front include: (i) lowering the reserve requirement ratio (RRR); (ii) guiding the new interbank policy rate (DR007) to a low level; and (iii) conducting certain TLTRO-like programs to encourage banks to extend more credit towards SMEs.

On the front of fiscal policy, a tax cut package becomes clearer over the horizon. The authorities announced new reforms of personal income tax in October, which are expected to become effective from January 1st, 2019. The reforms feature the introduction of various deductible items to personal income tax, which are expected to benefit the middle class particularly. Moreover, the authorities have indicated that an aggressive cut in VAT is under the pipeline. If implemented as expected, the VAT cut is able to rev up investment significantly.

Apart from the adjustment on tax rates, the central government selectively gives green light to bond issuances of local governments so that they can secure the financing for necessary infrastructure projects. Even on financial regulations, a number of recently unveiled policy papers are friendlier to the financial market than expected. Some senior government officials, including the PBoC governor Yi Gang, indicated that the priority now is to stabilize the leverage ratio of the economy rather than deleveraging immediately.

Despite the authorities' renewed efforts to boost the economy, the escalation of trade frictions between China and the US continues to pose materialized threat to the soft-landing of the Chinese economy. In September, The US President Trump finally announced the imposition of 10% punitive tariff rate on China's exports of USD 200 billion. He further threated to increase the tariff rate to 25% from January 1st, 2009 if both sides fail to reach any agreement by then.

We envisage that the China-US trade tension can hardly ease before the midterm election in the US. That being said, bilateral negotiations are likely to resume toward the end of the year. It seems that China's leadership has already unified their stance and formulated sensible strategies for the incoming negotiations. They are willing to work with the US to solve the trade disputes but unlikely to yield to the US unreasonable demands. Having said that, the negotiations between two largest country economies in the world are set to be a difficult and lengthy process.

Altogether, in our baseline scenario, the China-US trade frictions will slightly trim China's GDP by 0.2-0.3%. However, if the trade war escalated to a full-blown level next year, it will have much larger impact on the economy in both countries and have a negative spillover effect to all other regions on the global value chain. According to the IMF forecasts, China's GDP size will be 1.6% lower in 2019 than it otherwise would be, if the US slaps tariffs on all Chinese imports while it would probably cut the GDP of the United States by more than 0.9% in 2019. Given its large adverse impact on Chinese economy and the global growth, we anticipate China and the US will eventually reach an agreement to avert a full-blown trade war between the two largest economies.

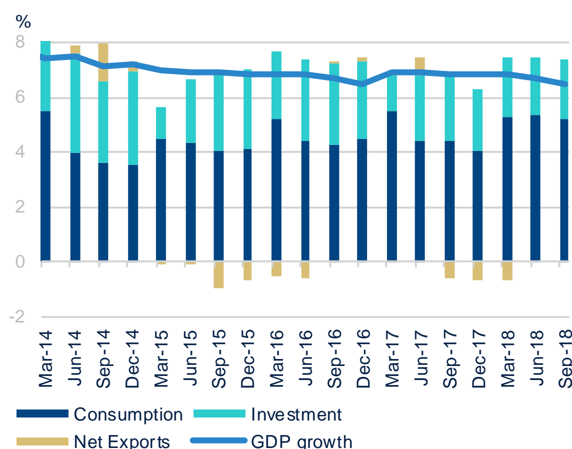
The largest challenge to China's authorities is to strike a balance between maintaining a decent growth rate and consolidating the existing achievements of deleveraging, or put differently, stabilizing the debt level of the economy at a sustainable level. Meanwhile, the authorities need to continue to press ahead with key structural reforms including SOE reforms and the deepening of the domestic market opening-up.

Q3 activity indicators point to a growth slowdown

The 2018 Q3 GDP outturn moderated to 6.5% y/y, lower than the previous reading at 6.7% and the market consensus at 6.6%. Such a trend is in line with our MICA model estimates. (Figure 1 & 2) Sequentially, GDP expanded at 1.6% q/q, lower than 1.8% q/q in the previous quarter. By category, the contribution of consumption to GDP growth reached 5.23%, dominating the investment's contribution at 2.13% and net exports' at -0.66%. Although the net exports made a negative contribution to Q3 GDP growth, it is mainly due to strong imports relative to still solid exports. That being said, the prospected negative impact from China-US trade tensions haven't been fully reflected on shipment figures yet at the current stage. However, growth figure will further dip is the effect of trade war fully materialized. (Figure 2.1)

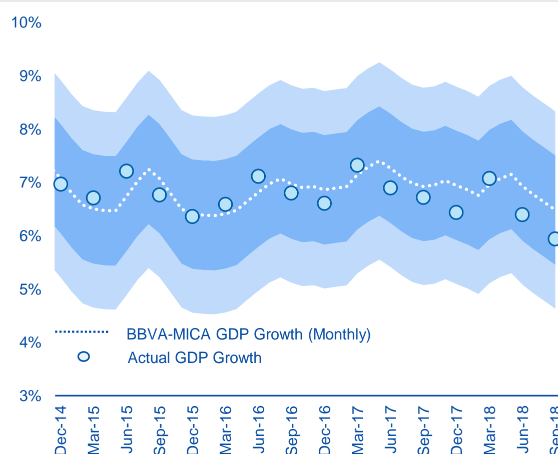
The lackluster performance of Q3 economy is broad-based, amid ever-intensifying headwinds from both cyclical forces relating to previous financial deleveraging campaign and the recently escalated trade tensions with the US. The latter has already exerted negative impact on domestic by dampening investors and consumers' confidence even before its damaging impact on exports fully shows up.

Chart 2.1 Growth moderated in Q3, with trade sector contributes negative to growth



Source: BBVA Research and CEIC

Chart 2.2 BBVA MICA model for monthly GDP forecasting



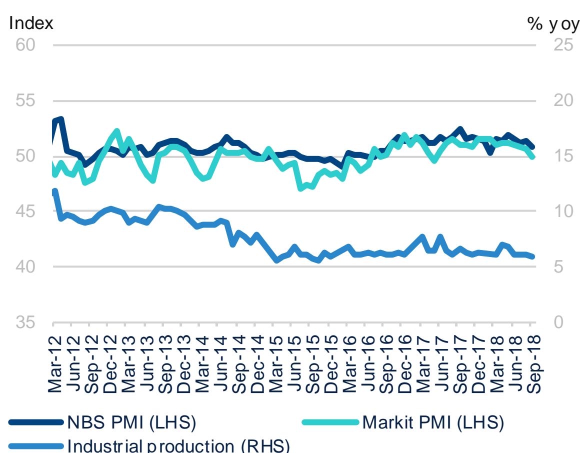
Source: BBVA Research and CEIC

From the perspective of supply side, industrial production declined from 6.1% y/y in September to 5.8% y/y (consensus: 6% y/y). Meanwhile, the different indicators of producers' sentiment of September also hinted growth

moderation. China's official manufacturing PMI decreased to 50.8 in September from 51.3 in the previous month (Consensus: 51.2), while the Caixin China Manufacturing PMI, which includes a survey sample tilting toward SMEs and exporters, moderated to 50 in September (versus consensus 50.5) from 50.6 in the previous month (Figure 2.3). The slowdown of both the official PMI and Caixin PMI reflected headwinds to China's export sector amid the escalating trade war with the US as well as the lackluster domestic demand.

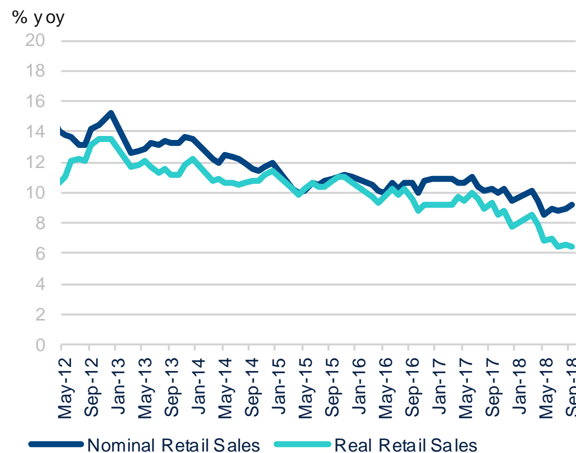
Retail sales hovered around in a territory below double-digit growth through the entire Q3. In real term, the performance was even worse. In September, retail sales growth slightly rebounded to 9.2% y/y from the previous month's reading of 9% y/y. (Figure 2.4) The slowdown was led by auto sales growth, which had a negative expansion at -7.1% y/y in September due to the expiration of fiscal subsidy for passenger car purchase. The silver lining is the rapid growth of online sales, surging 27.7% y/y in January-September. Overall, we believe that the abovementioned growth headwinds dampened consumers' confidence and slowed consumption growth.

Chart 2.3 Both industrial production and PMIs suggested a growth moderation



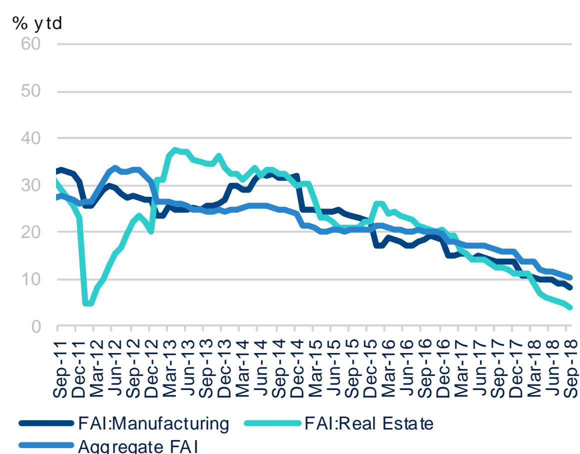
Source: BBVA Research and CEIC

Chart 2.4 Retail sales increased marginally but still stayed in a relatively low level



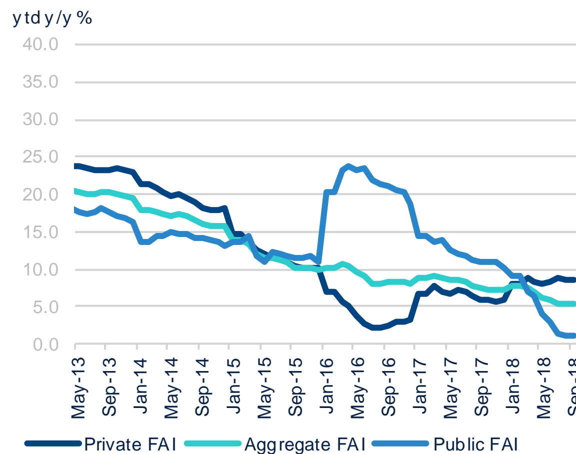
Source: BBVA Research and CEIC

Chart 2.5 FAI also moderated from the previous reading



Source: BBVA Research and CEIC

Chart 2.6 Public investment picked up marginally due to the authorities' easing fiscal measures

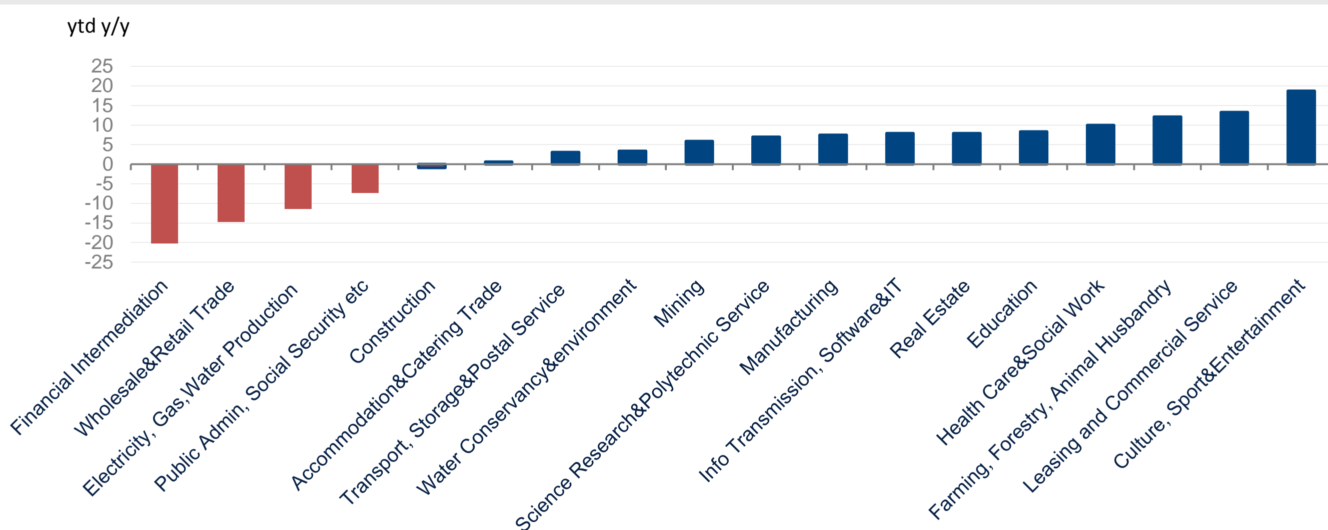


Source: BBVA Research and CEIC

Compared to retail sales, investment was hit by the growth headwinds to a larger extent. The current fixed asset investment (FAI) ytd y/y growth is still the historical low in the past decade. (Chart 2.5) In September the FAI marginally increased to 5.4% ytd y/y from 5.3% ytd y/y in the previous month (consensus: 5.3% ytd y/y), thanks to the authorities' recent easing efforts. The weak rebound is led by public investment, which bears the brunt of previously implemented tightening measures to rein in debt growth. In September, public investment picked up marginally to 1.2% ytd y/y from 1.1% ytd y/y in the previous month, suggesting the authorities' easing measures started to take. In the following months, we predict a further trending up of public FAI growth. Meanwhile, private FAI maintains at 8.7% ytd y/y, suggesting private investment is also sluggish. (Chart 2.6)

By sector, we find that the sectors leading FAI decreasing are concentrating on financial intermediation, whole sale and retail trade, electricity and gas etc. These findings again confirm our assessment that the growth headwinds of previously policy tightening and trade tensions with the US are the main culprits of recent investment slowdown. (Chart 2.7)

Chart 2.7 FAI growth: by sector



Source: CEIC and BBVA Research

Inflation remained tame

Headline CPI inflation picked up to 2.5% y/y in September from 2.3% in the previous month, in line with the market consensus. It is the highest growth rate for the past seven months. The CPI pickup is mainly due to the increasing food price because of bad weather effect and the high demand in golden week holidays. In particular, food price increased from 1.7% to 3.6% y/y, while non-food price marginally decreased from 2.5% to 2.2% y/y. (Figure 2.8)

Converging pattern of CPI and PPI is set to continue

On the other hand, PPI decreased significantly to 3.6% y/y in September from 4.1% in the previous month (Consensus: 3.5%). Given the trade war escalation with the US, the authorities transit their previous focus of deleveraging the over-capacity sector to "maintaining the leveraging level" of these sectors (indicated by the PBoC Yi's speech in IMF-World Bank conference in October). Together with the base effect, the PPI declined in September. (Figure 2.9)

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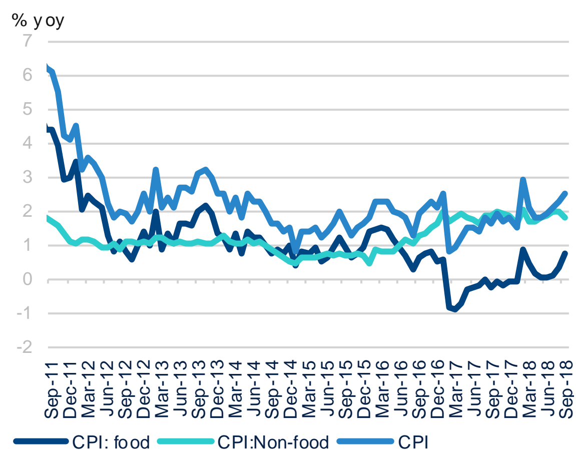
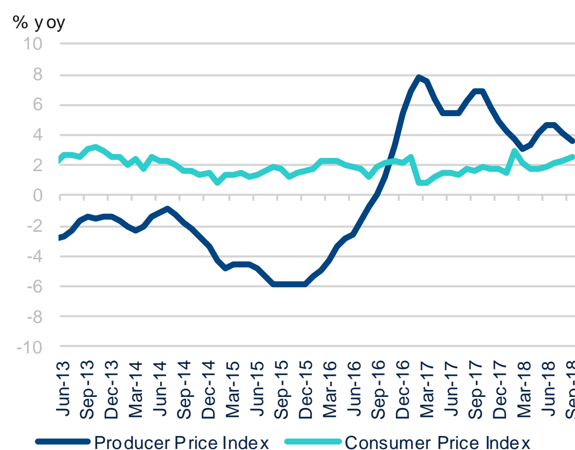
Looking ahead, in the medium to long term, CPI is expected to trend up gradually after the food-prices rebound from the previous low level. Meanwhile, the PPI will gradually slow its pace as the supply-side reform dissipates. Thus, supply-side shocks caused by overcapacity elimination are likely to have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

Chart 2.8 CPI picked up due to the increasing food price



Source: BBVA Research and CEIC

Chart 2.9 PPI and CPI displays converging pattern



Source: BBVA Research and CEIC

More easing monetary measures amid the trade war escalation

In front of the growth moderation amid the trade war and domestic deleveraging, the authorities transited their previous tightening stance to an easing manner to support the economic growth.

Total social financing, M2 and new yuan loans increased due to monetary easing

In particular, the growth of new yuan loans and total social financing expanded in September: total social financing increased to RMB 2,210 billion (prior: RMB 1,520 billion; consensus: RMB 1,553.5 billion) and New yuan loans also expanded to RMB 1,380 billion (prior: RMB 1,280 billion; consensus: RMB 1,358.7 billion). (Figure 2.10) On top of that, M2 growth also increased to 8.3% y/y from 8.2% y/y in the previously month (consensus: 8.3% y/y), indicating the PBoC injecting liquidity into the market to facilitate growth. (Figure 2.11)

The authorities also took measures to ensure the market has enough liquidity amid economic slowdown. In particular, the PBoC cut Reserve Requirement Rate (RRR) by 1% for most of financial institutions effective on October 15th. The move will inject a net 750 billion yuan (USD 109.2 billion) in cash into the banking system by releasing a total of 1.2 trillion yuan in liquidity, with 450 billion yuan of that to offset maturing medium-term lending facility (MLF) loans. The market believes that the timely RRR cut will help to stabilize market expectations and to offset the external shock to a certain degree. We expect another RRR cut in the fourth quarter of this year as the trade war might not be settled in a short term.

The credit data in September also reflected that shadow banking activities maintained at an inactive level although the authorities beef up their measures of monetary easing. In particular, trust loan, entrusted loan and bank acceptance all dipped to a negative y/y growth. (Figure 2.10) Meanwhile, enterprises and household also had lower capital demand due to the ongoing corporate deleveraging and housing market tightening measures. Altogether, we predict a gradual trending up of M2 growth, together with new yuan loans and total social financing in the rest of the year, due to the authorities' easing monetary measures.

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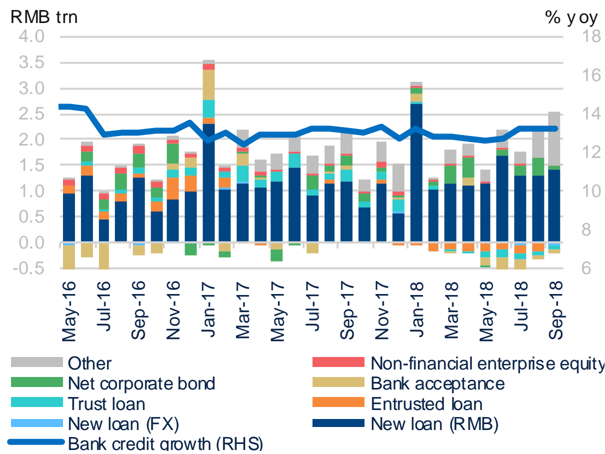
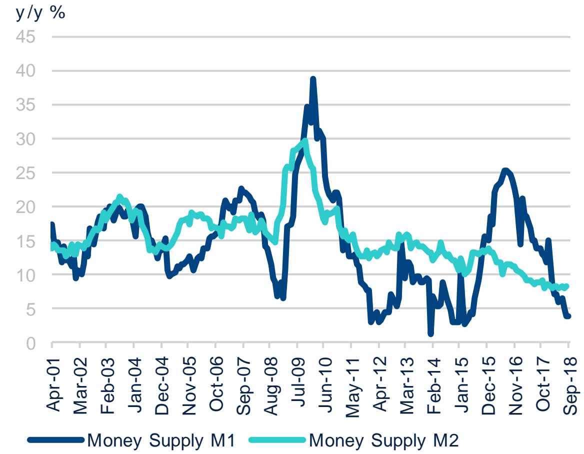
Chart 2.10 Total social financing and new yuan loans increased significantly due to the recent easing measures



Source: BBVA Research and CEIC

Chart 2.11 M2 increased due to the easing monetary measures

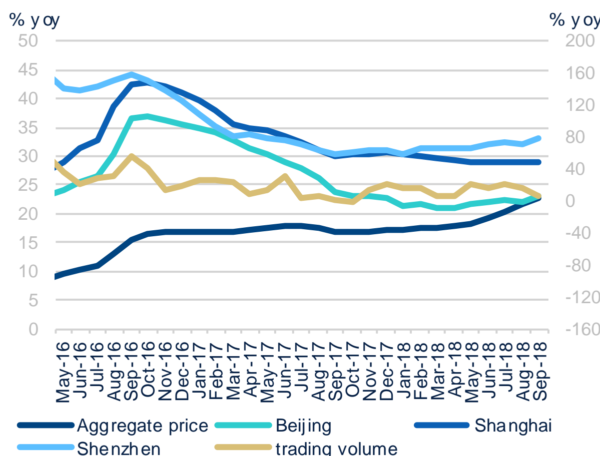


Source: BBVA Research and CEIC

Housing price moderated in tier-1 cities while price growth slowed in other cities

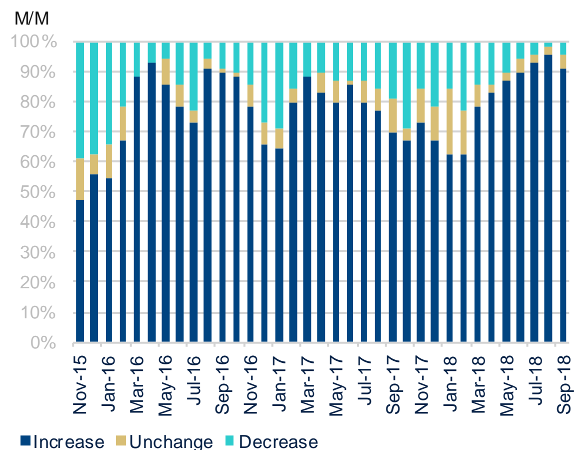
Housing price in big cities tended to decelerate in September, so did the trading volumes.[1] (Figure 2.12) On the other hand, at the national level, the number of cities that reported housing price increasing also declined. (Figure 2.13) The housing market moderation suggests the authorities' tightening measures to contain the previous run-up housing price have taken some effect recently.

Chart 2.12 Housing prices in big cities moderated



Source: BBVA Research and CEIC

Chart 2.13 At nationwide level, the number of cities reporting housing price increasing declined



Source: BBVA Research and CEIC

1: 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.

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 also drag on growth this year, adding more uncertainties to the economic outlook amid escalating trade war and domestic deleveraging.

Trade surplus surprisingly increased due to a not-fully-materialized trade war effect and weak RMB exchange rate

As the exporters are speeding up their orders with the US in order to avoid further rounds of tariff imposing, it seems like the effect of trade war on Chinese economy has not fully materialized yet. In addition, RMB exchange rate has been depreciating in the recent month, approaching the psychological level of 7, offsetting the trade war effect as well.

In particular, the growth of exports (in USD terms) significantly increased to 14.5% y/y (versus consensus: 8.2% y/y) from the previous reading of 9.1% y/y, while imports dropped to a year-on-year growth of 14.3% from previously 19.9% y/y (versus consensus: 15.3% y/y). As a result, the balance of trade expanded to USD 31.69 billion in September from USD 26.65 billion in the previous month. (Figure 2.14)

However, as the further rounds of tariff are ultimately imposed, we predict that the trade war effect on hurting Chinese economy will finally materialize. That means, there will be a cliff drop of exports probably early next year. Regarding the current account, the only silver line is that the depreciation of the RMB exchange rate, which might help to maintain the exports to a certain in the following months, although it has negative effects on importers.

External shock and domestic growth slowdown weigh on the RMB exchange rate

The RMB exchange rate experienced a sharp depreciation recently against the pickup of US Dollar index. Accumulatively, the RMB has depreciated by 10.2% against the USD from its strongest level in March and by 6.6% since the beginning of this year. It is also noted that the RMB depreciation 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 2.15)

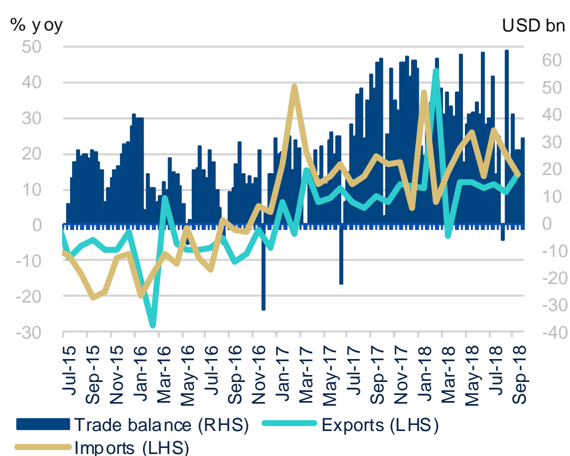
In addition to the strong performance of the USD, the depreciation of the RMB exchange rate is mainly due to the escalation of the trade war with the US as well as the US interest rate hike. In addition, domestic growth slowdown also plays a fundamental role on RMB depreciation.

The authorities have intervened the FX market to make sure RMB exchange rate will not dip too sharply

Some market participants believe that the current RMB depreciation should be one of the authorities' retaliatory measures for the US trade war. However, we do not consider the Yuan exchange rate as a suitable weapon for trade war. Its side effect could be too painful. As we witnessed in 2015-2016, a sharp currency depreciation could lead to large-scale capital outflows and pose material threats to the financial stability. We don't think the authorities will risk financial stability for retaliating the US punitive tariff. Moreover, at the current stage China has no appetite to escalate the trade war to a currency war with the US. It is in China's interest to keep this trade tension at a limited scale.

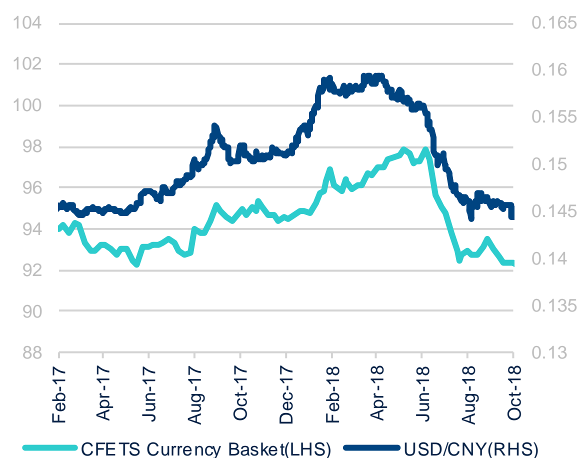
The PBoC has already taken a series of measures to intervene the FX market to maintain the exchange rate of RMB. We expect the Yuan exchange rate will maintain a weak trend in the coming months. But the authorities will ensure that it won't depreciate too sharply. The Yuan exchange rate could get the authorities' support at around the psychological level of 7 in the rest of the year.

Chart 2.14 Trade war added pressure to current account, although the effect has not been fully materialized



Source: BBVA Research and CEIC

Chart 2.15 RMB exchange rate dipped sharply amid trade war, FED rate hike, and domestic growth slowdown



Source: BBVA Research and CEIC

Capital outflows accelerated in the escalating trade war and growth slowdown

Foreign reserves declined to USD 3,087 billion in September from USD 3,109.72 billion in the previous month. Based on the outturns of trade balance, valuation effect and the foreign reserve, we estimate that capital outflows amounted to USD 56 billion in September, compared with USD 35.8 billion in the previous month. (Figure 2.16)

RMB depreciation and trade war escalation added more uncertainties to capital outflows

The ongoing depreciating RMB exchange rate and trade war escalation will add more risks for capital outflows. First is because the depreciating RMB will lead to the diversification behavior of investors to allocate more of their assets to safe heaven assets, thus, capital flight is unavoidable. Second, the yuan slide is also together with the current account shrink amid the trade war risk, further leading to capital outflow. Altogether, amid economic slowdown, weak RMB exchange rate and escalating trade war, we forecast a faster capital outflow in the rest of the year. However, the SAFE might in the future implement more capital account measures to avoid a sharp capital outflow.

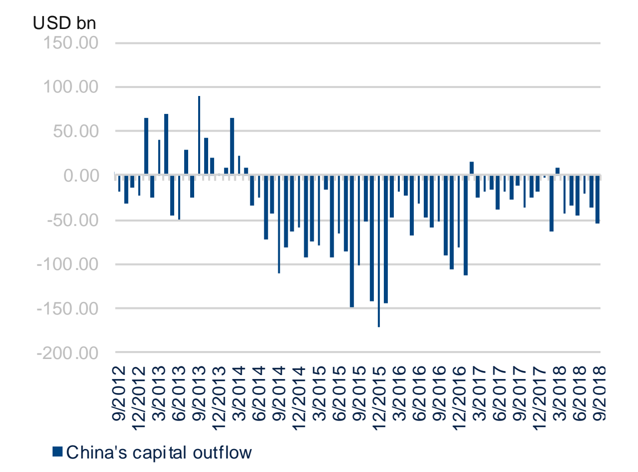
Stock market volatility and the authorities' interventions

China is currently under pressure in multiple fronts: the recent trade war escalation, together with growth slowdown, dragged China's stock market dipping to a four-year low. From the beginning of this year till now, the Shanghai Composite index has already dropped by 21.4% (Chart 2.17) While it's been a slower burn this time round

compared with the sharp declining in 2015-2016 financial turmoil, the steady losses show that sentiment toward Chinese equities hasn't recovered from the 2015-2016 crash yet. Turnover of the stock market is dwindling too, and some companies are finding themselves cut off from equity financing, forcing them to raise more debt.

Chinese authorities have beefed up their measures to circumvent a stock market collapse as in 2015-2016. Several measures have already been implemented. China's "National Team" of state-backed funds stepped in to add some energy to policy makers' reassurances. In addition, announced by CSRC (China Securities Regulation Commission), eleven securities brokerages have agreed to form an asset management scheme worth 100 billion yuan to inject funds into troubled companies facing the risk of forced sales of shares. On top of that, a number of high-level officials have voiced support for the stock market after it tumbled to a four-year low last week. Various financial regulators as well as the central bank have also promised to roll out other measures to stabilize the market.

Chart 2.16 RMB depreciation and escalating trade war added more uncertainties to capital outflows



Source: BBVA Research and CEIC

Chart 2.17 Shanghai Composite Index dipped to a four-year low

Source: BBVA Research and CEIC

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3. Trade war escalation and China's easing measures to support growth

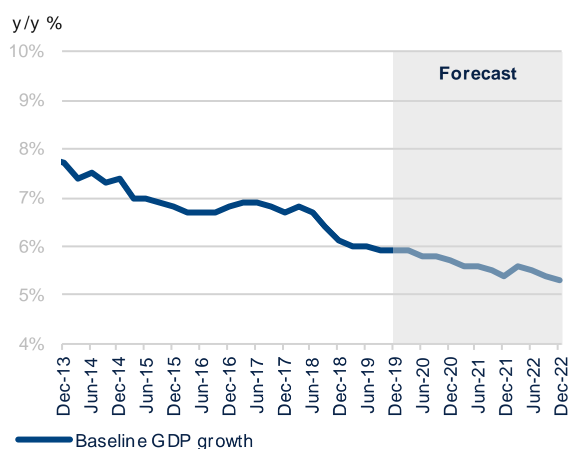
Trade tensions with the US continue to be the prime threat to growth over the medium term

Due to the trade war and the domestic deleveraging, growth slowdown continued in Q3, which is in line with our expectations. We maintain our 2019 GDP forecast at 6%, compared with the Bloomberg consensus at 6.3%. On the other hand, we slightly upward revised our 2018 GDP growth projection from 6.3% previously to 6.5% (Bloomberg consensus: 6.6%) simply due to the better-than-expected data outturn of 1H, in line with the official target of 6.5%. (Figure 3.1) The other reason for rising the 2018 growth forecast is due to the effect of the US trade war on China has not been fully materialized yet in this year, as exporters are still speeding up their orders with the US to avoid further round of tariff imposing indicated by the expansionary trade surplus data outturns.

Nevertheless, the authorities have already transited their previously tightening monetary measures to an easing manner, in a bid to offset the external risks and domestic deleveraging of over-capacities. At the same time, fiscal policy becomes more supportive for growth, including the ongoing tax cut package and speed-up of local government debt issuance to stimulate infrastructure investment.

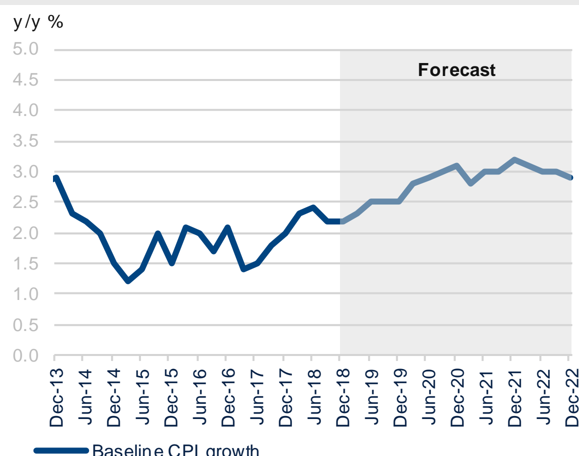
Regarding inflation, we maintain our 2018 projection of CPI at 2.2% in 2018 and 2.5% in 2019 (Bloomberg: 2.1% for 2018 and 2.3% for 2019). (Figure 3.2) Looking ahead, we expect that the CPI and PPI will finally converge in the long term. CPI is expected to trend up gradually after the food-prices rebound from the current 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 revised our 2018 GDP forecast from 6.3% to 6.5% due to better-than-expected GDP outturn in 1H



Source: BBVA Research and CEIC

Chart 3.2 Some downside risks on our CPI predictions as the growth moderation continues



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	6.5	6	5.8	5.5
Inflation (average, %)	2	1.7	2.2	2.5	3	3
Fiscal balance (% of GDP)	-3	-3	-2.6	-3	-3.5	-3.5
Current account (% of GDP)	2.5	1.4	1.1	0.8	0.7	0.6
Policy rate (%)	4.35	4.35	4.35	4.35	4.1	4.1
Exchange rate (CNY/USD)	6.95	6.5	6.85	6.6	6.7	6.7

(f) Forecast.
Source: BBVA Research and CEIC

Easing monetary and fiscal policy to support growth

The authorities changed their previous tightening stance to an easing manner and continue to intensify easing measures to support growth amid escalating trade war. The recent easing monetary and fiscal policies include the following perspectives:

From the monetary perspective, the authorities cut Reserve Requirement Rate (RRR) to maintain the market liquidity in October. In addition, the PBoC announced not to follow the US FED to hike the interest rate, and deliberately maintain the DR-007 which is the monetary policy rate as well as some other interbank lending rates at a comparatively low level, sending a strong signal of policy easing.

Moreover, the authorities also has implemented a series of policies to support Small and Medium Enterprises (SMEs), including highlighting the big banks' efforts to boost lending to cash-starved small firms, offering collateral waivers and setting loan targets to SMEs. To guide lending to small firms, authorities have issued directives to banks, arranged meetings between executives of banks and private firms, and doled out tax breaks for banks' "micro-loans", etc.

In the near future, we do not expect any changes on lending rate and deposit rate, as an interest rate hike following the US will slow down the economy to a further extent while an interest rate cut might further depreciate RMB exchange rate and to stimulate shadow banking growth again. In addition, after establishing the new corridor system of monetary policy framework, lending rate and deposit rate are not regarded as the policy rate any longer, thus their policy signaling role will be weakened. Thus, RRR cuts might be a better tool to maintain a sufficient liquidity in the market under the current circumstance.

From the fiscal perspective, the authorities implemented a series of tax cuts in various perspectives to reduce the costs and stimulate growth. These tax cut measures include: (i) To cut corporate value-added tax (VAT), in particular, starting from May 1, the tax rate will be lowered from 17% to 16% for manufacturing and some other industries, and from 11% to 10% for transportation, construction, basic telecommunication services, and farm produce. The VAT cuts are expected to save 240 billion yuan (USD 38 billion) in taxes this year. (ii) To reduce China's overall tariffs from most of trade partners, including the US. (iii) Starting from Oct 1st, the minimum threshold for personal income tax will be raised from 3,500 yuan (USD 510) to 5,000 yuan per month, or 60,000 yuan per year; (iv) To increase the rate of export tax rebates for some export products; (v) The amount that banks lend to small firms does not have to pay taxes on interest income; (vi) Foreign investors will not have to pay

enterprise or value added taxes on interest income earned in the domestic bond market for three years. Altogether, China's tax and fee cuts will boost the real economy through reducing corporate burdens and creating a stable and fair business environment. In addition, it will stimulate consumption by increasing households' wealth effect.

Regarding the effect of tax cut on GDP growth, there are some interesting research results in the Chinese literature. For instance, Li, Zhang and Lv (2018), based on the Instrument Variable method of Lee and Gordon (2005), found that lower the VAT by 1% will increase GDP growth by 0.45%, using Chinese county level data.[2] Another interesting finding is based on the SICGE model, which is a general equilibrium model developed by NDRC-Monash University. The results suggest that if China reduce manufacturing VAT rate from the previous 17% to 13%, GDP will increase by 0.7%.[3] Based on these findings, if next year, the authorities further reduce VAT by another 2%, together with the current cut of 1%, we could predict GDP will increase by 1.35%, which is approximately the percentage that the trade war might lower the GDP growth in scenario 4 (Table 2), suggesting that tax cut could offset the external shock of the trade war escalation to a large extent.

Except for the tax cuts, the authorities also urged local government bond issuance, in a bid to stimulate investment, as FAI has already dropped to a decade low in the recent months. For the fiscal policy ahead, we expect more easing measures will be announced to support growth. The authorities might finally add more deficits through the extra budget this year and the following year.

The escalation of China-US trade war and its impact on Chinese economy

The trade war with the US escalated recently, indicated by the following two important issues. One is that on top of 25% tariffs on China's USD 50 billion exports to the US which was already imposed, the US imposed 10% tariff on another Chinese USD 200 billion exports and claimed to increase to 25% tariff rate if no deal reached between two sides. The US also threatened to impose tariff on all of the Chinese exports to the US if China takes any retaliated measures. The other issue is that the US vice president Mike Pence made a speech accusing China of trying to undermine the US by targeting the American political system and "meddling in America's democracy" by employing power in more proactive and coercive ways. China fight back by claiming that Pence "made unwarranted accusations against China's domestic and foreign policies and slandered China by claiming that China meddles in U.S. internal affairs." These two events suggested that the trade war between China and the US might escalate to a much more comprehensive war-not only on trade, but also on political system, national security, financial system, etc.-or even something like the "cold war" as some market participants described.

We first of all attempt to evaluate the impact of tariff imposed by the US on Chinese exports from the perspective of global value chain in different scenarios listed in Table 3.2 below. In particular, we use the information from the joint OECD – WTO Trade in Value-Added (TiVA) database, which decomposes the value of final goods or services into the value added by each country. By applying the elasticity estimates provided by the World Bank, we estimate to what extent the tariff will affect China's exports. More details of the methodology could be found in our previous China Economic Watch: Reignited China-US trade war and its implication on global value chain. Based on our estimation, in the baseline scenario, the tariff imposed from the US targeting on USD 250 billion Chinese exports (25% tariff on USD 50 billion in the first round and 10% of tariff on USD 200 billion in the second round) will lead to USD 28.9 billion of export decreasing (1.3% decreasing of China's total exports) and if it increases to 25% tariff, it will lead to USD 55.5 billion exports declining (2.6% of total exports). It is noted that China's exports to US account for 20% of its total exports.

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[2] Li, Zhang and Lv (2018), "The research on the tax cut effects on economic growth", Economic Review, (in Chinese), 212, page 3-10

[3] SICGE model, developed by DNRC-Monash University, details could be found: http://www.sic.gov.cn/News/467/8530.htm

Table 3.2 Different scenarios of the impact of US tariff imposing on Chinese exports

Tariff imposing	Leading to exports decreasing	Percentage of total exports
25% tariff on USD 50 bn (already imposed)	USD 11.1 bn	0.5%
Scenario 1: 10% tariff on USD 200 bn (imposed in October 2018)	USD 28.9 bn	1.3%
Scenario 2: 25% tariff on USD 200 bn (starting in January 2019)	USD 55.5 bn	2.6%
Scenario 3: 10% tariff on all the rest exports (total USD 500 bn)	USD 55.5 bn	2.6%
Scenario 4: 25% tariff on all the rest exports (total USD 500 bn)	USD 122.1 bn	5.6%

Source:

Chinese authorities responded the trade war escalation in a timely manner, mainly focusing on pushing forward the opening-up policy and supportive monetary and fiscal measures. At the Summer World Economic Forum in September, Premier Li pledged to lower China's overall tariffs, remove unreasonable procedures in customs clearance and lower market access restrictions. In particular, China will reduce tariffs among most of its trading partners, including US, aiming to boost imports and lower consumers' costs amid trade disputes. The move indicates China's efforts to ease tensions with US and its determination of further opening up and structural reforms. Also it suggests China is trying to extend more sweeteners to other important trade partners so as to alleviate the pressure from the US. In this respect, we expect China to further open its domestic market to EU and Japan. (See our Economic Watch: What is our expectation of Bilateral Investment Treaty with the EU?)

Moreover, Premier Li also reiterated that China has no intention to weaken the RMB exchange rate to boost exports. That means, although the market force tends to weigh on the RMB in the face of rising trade war risk, the authorities, for the purpose of maintaining financial stability, will limit the magnitude and pace of depreciation to a comfortable extent.

On the front of domestic policy, the authorities will beef up financing support for infrastructure investment, in particular in western provinces. Moreover, a set of measures targeting to boost domestic consumption will be announced soon. The authorities revealed the planned tax policy reforms for both individual and corporate tax. The thrust is that the authorities would like to use tax cut to stimulate domestic demand. Regarding the disproportional credit squeeze on private enterprises, the central bank are calling up banks to apply equal treatment to both SOEs and private enterprises, which might suggests that China will accelerate domestic structural reforms.

All in all, China's policy response is in line with our expectation and is welcomed by the market. It shows China's authorities have somewhat calmed down from the unexpected tariff attack from the US and are formulating sensible strategies to deal with it. In a nutshell, a soft-landing of China's economy will give more bargaining power for China to reach a deal with the US.

Looking ahead, we expect more fiscal and monetary easing measures will be announced in order to offset the trade war effect. At the same time, China's authorities will actively seek to open constructive negotiations with the US through different channels. Nevertheless, we don't expect the bilateral negotiations to have any fruitful outcome before the November mid-term election and predict that the China-US trade war will last for the following months.

RMB exchange rate outlook

After the August 11th 2015 RMB exchange rate reform, RMB exchange rate is experiencing the second round of depreciation since April this year amid the trade war risk. In addition, the discrepancy between offshore and onshore RMB exchange rate expanded significantly in the recent month, indicating global investors' passive sentiments towards RMB depreciation. The drivers to the recent RMB sharp depreciations after the appreciation trend from April 2017 to April 2018 including the following factors: (i) Escalation of the trade war with the US; (ii) Strong DXY performance; (iii) Domestic economic slowdown; (iv) Easing monetary measures to offset trade war risks, leading the interest rate difference with the US expanded.

Since RMB to USD exchange rate is in the depreciation trend, an interesting question to ask is to what extent, the RMB depreciation could offset the tariff imposing effect. Actually, there are large amount of literature about the elasticity of exports and imports on RMB exchange rate. Thus, it is not easy to reach a precise common ground on this due to different methodology and different data sample. However, a widely cited paper on China's trade elasticity by Freud, Hong and Wei (2011) indicates that the elasticity of exports to the real exchange rate is close to unity (0.9).

Based on this, we estimate that real exchange rate of RMB (not its exchange rate against USD) should depreciate by 2.9% to the RMB basket currencies in order offset the impact of two batches of tariffs imposed by the US (the first batch is 25% on USD 50 billion Chinese exports and the second batch imposes 25% tariffs on USD 200 billion goods). Since the US started to impose tariffs on China's exports in July, the RMB's real exchange rate has already depreciated by around 4%. It reflects that the market has also priced in scenario 2 or 3 in Table 3.2 thus far. However, if the US wants to escalate the trade war to scenario 4, additional depreciation of the RMB exchange rate will be needed to offset the impact.

On the other hand, the authorities have taken a series of important steps to intervene the RMB exchange rate in a bid to maintain financial stability, including: (i) To increase in reserve requirements on sales of foreign exchange in forward transactions to 20 per cent from zero, in effect raising the costs of bets that the RMB will weaken further; (ii) Resume the counter-cyclical factor, which gives the bank more discretion in setting the renminbi's daily midpoint around which it trades against the dollar ; (iii) Led the RMB appreciation expectation by mass media, as the PBoC is concerned about the impact of "herding behavior", which risks violent market swings as one-way expectations build and trades become crowded; (iv) Restricted banks in FTZs to lend or borrow RMB to foreign banks through interbank accounts. (v) Tighter restrictions on capital account transactions, including stifled renminbi internationalization, curbed overseas investment and significantly slowed legitimate foreign exchange transactions for corporates and households. However, this time, the PBoC has not yet had to mobilize its USD 3 trillion in foreign exchange reserves to support the exchange rate while it burnt USD 1 trillion in the 18 months to the end of 2016 on defending RMB.

In the future, the PBoC might use the measures that were implemented during 2015 market turmoil, if the RMB exchange rate approaching the psychological level at 7 in the future, including capital control, intervene HK offshore market, using foreign reserve to defend etc.

Looking ahead, continuing depreciation pressure will be last for the following months, due to the unsettled trade war and domestic growth slowdown. In addition, FED interest rate hike will also add pressure on RMB. However, we do not think RMB exchange rate will depreciate above the psychological level at 7, due to the PBoC has more experience to intervene the market and does not want domestic financial turmoil again as 2015. Under the current circumstance, the equilibrium exchange rate should be in a range of 6.7-7. In the future, RMB exchange rate flexibility will be further enhanced, as exchange rate reform deepened. All in all, economic fundamentals of RMB exchange rate will dominate short-term arbitrage capital flow to determine RMB exchange rate in the short term.

4. Growth risks intensified

Trade war escalation with the US and domestic deleveraging weighing on growth are the two battles Chinese authorities are facing at the current stage. The policy challenge now becomes how to balance the easing measures to offset trade war effects and to stabilize China's debt level. Reflected by the Q3 growth moderation, growth headwinds are intensifying now.

Regarding the trade war escalation with the US, given that the US has already imposed two batches of tariffs on Chinese exports and threatened to impose tariffs on all of Chinese exports to the US if two sides could not reach a deal, we anticipate that the only possible time for the trade war to abate is after the US mid-term elections. Actually, based on the PBoC Chief Yi Gang's speech in the IMF-World Bank conference this month, China "has already prepared the worst of the trade war results", but on the other hand, "China still has policy room in fiscal and monetary front to maintain the growth rate domestically."

Given our analysis of Chinese ongoing fiscal and monetary easing measures in the previous part, we do not think a hard-landing of the economy is our baseline scenario, however, growth moderation will be long lasting. The negative impact of trade war only materialized at a very limited scale so far. Looking ahead, the effects of trade tensions on growth will become more and more pronounced if China can't solve the disputes with the US soon.

More importantly, it seems like the US expanded the conflicts with China not only in the trade war perspective, but also to a various fronts at the current stage such as military, national security, politics etc. For instance, the US announced to tighten the national security reviews of foreign investment on China to avoid China using FDI to steal the US intellectual property rights; also, the US controls the nuclear technology exports to China and raised concerns of spying activities by Chinese tech giants ZTE and Lenovo. Thus, some market participants even suspect that there will be a "cold war" exploding like what happened in late 1980s.

The only silver line is that the two sides are still keeping exchanging ideas, to seek to solutions to settle the problem. For instance, the PBoC Chief Yi Gang met the US Treasury Minister Mnuchin and FED Chair Powell in the IMF meeting; in addition, Chinese president Xi will meet Trump in G20 meeting in late November this year to further negotiate solutions. On top of that, China has also shown their willingness to further opening-up the domestic market to foreign investors, to narrow its surplus against the US, to increase protection of intellectual properties, and to reduce overall tariffs etc.

Domestically, the deleveraging in over-capacity industries 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 between avoiding a debt overhang and policy easing to offset trade war effect. The two battles at the same time bring about more challenges to Chinese authorities in policy-making. We believe that at the current stage, the authorities need to put the external risk at the first priority and to build up market sentiments through easing fiscal and monetary measures to support growth.

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