



BBVA Research

China Economic Outlook

Second quarter 2019

Creating Opportunities

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Closing date: **17 April 2019**

1. Soft landing of the global economy

World growth has slowed down more than expected over recent months, increasing fears of a hard-landing of economic activity. In this context, the Fed and the ECB have altered their roadmap and have announced new monetary stimulus measures. Similarly, China has implemented additional expansive policies, both of a fiscal and monetary nature. This reaction by the economic authorities in the main economies brings about a milder slowdown of world growth. However, an unforeseen reduction in dynamism in the Chinese economy, a new wave of protectionist measures and the disorderly exit of the UK from the European Union, among other risks, could trigger more negative scenarios.

Global economic activity has slowed down, with a particularly weak performance in exports and the manufacturing sector

Having grown at an average of 1% QoQ since 2016, the preliminary data suggest that world GDP could reach 0.8% QoQ in the first quarter of this year. This would mean that, despite a slight improvement in world growth with respect to the last two quarters of last year (0.7% QoQ), economic dynamism continues to be below that of previous years.

A number of factors have contributed to the slowdown in global activity, particularly; i) the structural deceleration of the Chinese economy, now that its indebtedness has stopped increasing ; ii) trade protectionism; iii) in Europe, high uncertainty as well as certain specific—and probably temporary—events, such as the effects of the new European regulations on emissions in the automotive sector; and iv) the cyclical moderation in the US, amid a context where the effects of fiscal stimulus are losing strength.

The factors underlying world slowdown have affected activity, mainly in terms of exports and manufacturing. The weakness in these sectors has been partially offset, for the time being, by the relative strength of private consumption, which remains supported by the dynamism of the labor markets and low inflation.

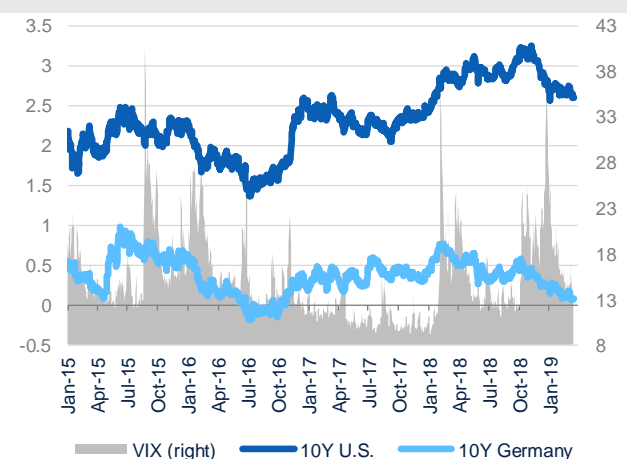
The downturn in growth has led to an unexpected turn in US and Eurozone monetary policy

The more negative tone of the world economy has generated concerns, as well as an increase in financial volatility. Against this backdrop, and given that inflationary pressures continue to be under control, the Fed and the ECB have reacted by giving their policies a sharp turn in their communication about the assessment of the environment and the expected path for their policies. The US monetary authority has significantly adjusted its tone and strategy towards a more accommodating monetary policy. In this regard, as well as revealing it will be "patient" when considering additional interest rate rises, the Fed has announced that its balance reduction process will end sooner than expected, by September of this year, at a level of around 17% of GDP (between 3.5 and 3.8 trillion dollars). The prudence shown by the North American central bank, as well as low inflationary pressures, may cause rates to remain stable, or even to be cut, if activity data reveal a further and significant deterioration of economic growth. Still, there would be room for a final increase of 25 bps, to 2.75% by the end of 2019, if the moderation in growth proves to be mild and constrained (previously, two rate increases were expected in 2019 resulting in reference rates reaching 3%).

As for the ECB, the change towards a more expansive policy has translated into a delay in interest rate rise expectations and the announcement of a new round of liquidity auctions. As for the former, the ECB has delayed its rate increase expectations from summer 2019 to at least the end of the year. On the other hand, the monetary authority announced a new series of targeted longer term refinancing operations (TLTRO-III), to be carried out between September 2019 and March 2021. In this context, rate forecasts have been adjusted, with a first rise in deposit rates expected by June 2020 and that of the official reference rate by December 2020. Moreover, more details about the new TLTRO are expected to be announced in June

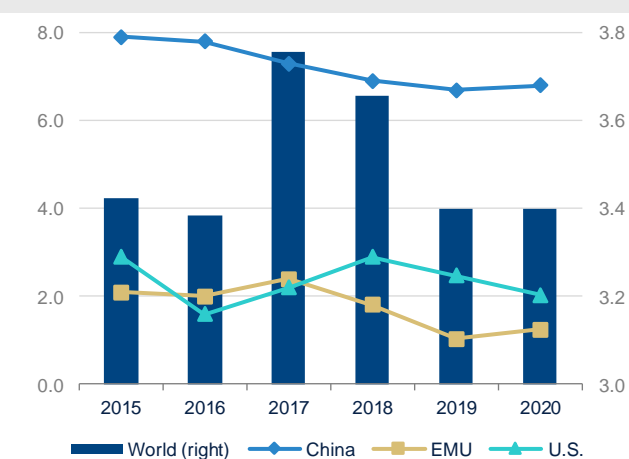
China has also reacted to the increasing concern about the slowdown of the economy. Specifically, local authorities have confirmed a tax cut, focused on VAT, of 2 percentage points of GDP, as well as an increase in public deficit, from 2.6% of GDP in 2018 to 2.8% of GDP in 2019. Signs of greater monetary easing are also evident. In this regard, two additional cuts of 25 bps in the reference interest rates, as well as two reductions in the bank reserve requirements in the second and third quarters, are envisaged.

Figure 1.1 Sovereign debt yields and equities market volatility (VIX) (%)



Source: Haver and BBVA Research

Figure 1.2 Annual GDP growth: 2015 - 2020 (*) (%)



(*) Forecasts from 2019 onwards.
Source: BBVA Research

Weaker global growth is affecting financial market performance

The deteriorating outlook of global activity and the associated reduction in inflation expectations, along with the central banks' more prudent approach, have led to a sharp drop in the yields of 10 year bonds in the US and Germany (see Figure 1), supporting the view that they will remain at significantly low levels for a long period of time. This adjustment has led to the flattening of yield curves, which has given rise to additional doubts regarding economic growth.

In any event, the change by the Fed and the ECB towards a more accommodating monetary policy and a certain optimism regarding the results of the US-China trade negotiations have supported the stock markets, partially offsetting the negative effects of cyclical deterioration. However, if the economic activity continues to disappoint, the financial markets will find it hard to maintain their recovery. Finally, with regard to the equity market volatility, this is most likely to remain relatively low over the coming months, with a VIX between 15 and 18, supported by the prudent approach of the central banks, and below the levels of the last months of the previous year (see Figure 1).

Global growth is expected to reach 3.4% both in 2019 and in 2020

The new economic stimuli support an orderly moderation of world growth. Global GDP, which grew by 3.7% in 2018, would grow to 3.4% in 2019 and to 3.4% in 2020 (see Figure 2). The soft landing of the world economy is subject to the US and China managing to reach a trade agreement in the second quarter of the year, which is fundamental in reducing uncertainty and preventing an additional deterioration of international trade. Moreover, another important condition in this scenario of gradual moderation of growth is that the UK's exit from the European Union (brexit) does not significantly disrupt the relations between the two regions. Lastly, the probable upcoming reduction in oil prices due to dwindling demand and a growing supply in the US will help to maintain inflationary pressure under control, and provide room for manoeuvre for the central banks to execute their monetary policy (the price of a barrel of Brent is expected to fall from around 65 dollars in the first quarter of the year to close to 62 and 55 dollars by the end of 2019 and 2020, respectively).

In the US, growth will continue to gradually lose momentum, moving towards potential rates. In particular, US GDP is estimated to grow by 2.5% in 2019 and by 2.0% in 2020, in the wake of the expansion of 2.9% of 2018. Although the growth forecasts for the country remain unchanged, the trend is downward and the risk of recession continues to be significant, given the possibility of greater slowdown in investment, high financial vulnerabilities and the more negative tone of the global scenario, among other factors.

In Europe the downturn in activity, mainly in exports and in the industrial sector, has continued longer than expected. Moreover, the uncertainty regarding the outcome of the brexit situation, as well as that regarding the US threat to increase tariffs on vehicles produced in the region, remains high. In this context, growth forecasts for the Eurozone have been revised downwards, from 1.4% to 1.0% in 2019, and from 1.4% to 1.3% in 2020, with a downward bias.

As for China, the trade agreement with the US is expected to be formalised and recent stimuli are expected to succeed in supporting domestic demand, which would enable GDP to grow by 6.0% in 2019 and by 5.8% in 2020, in line with previous forecasts. Thus, these more expansive policies reduce the risk of a sharper growth deceleration, but at the cost of hindering the reduction of the country's structural problems, such as its high leverage levels.

The further slowdown of world growth will bring about additional difficulties for the economic activity of emerging countries. Nonetheless, the more expansive policies of the main economies could take some pressure off exchange rate markets and increase the room for maneuver of monetary policy in emerging economies markets.

In this context, the slowdown in growth will further reduce inflationary pressures, both in developed and in emerging economies. This will be further helped by the expected drop in oil prices.

2. Growth stabilization is in sight

After six months of uneasiness caused by external trade tensions, China's economy proved its resilience indicated by the 2019 Q1 GDP figure along with a series of other activity indicators, surprising the market to the upside. In particular, the growth rate of GDP in the first quarter kept flat with last year's Q4 reading at 6.4% y/y, above the market consensus of 6.3% y/y. In sequential terms, the growth in Q1 expanded at 1.4% on a quarterly basis, slightly lower than that of Q4 2018 (1.5% q/q).

Good growth figure in Q1 has largely relieved people's concern of a hard-landing in China this year, which was prevalent in the market three months ago. Even before the official announcement of Q1 GDP, some market observers and policymakers had already tiptoed to recalibrate their pessimistic assessment of China's growth outlook. The IMF, in their recently revised World Economic Outlook, raised China's 2019 GDP growth by 0.1ppt to 6.3% while it generally lowered other major economies' growth projections.

Lurking behind good growth outturns is the authorities' swift turnaround of policy stance on both external and domestic fronts. After the outbreak of trade war with the US in the second half of 2018, Chinese authorities actively sought to ease the tension through a variety of channels. At last, the meeting between President Trump and Xi during the G20 summit at Buenos Aires provided an opportunity for these two national leaders to converge their stances. In the following months, the delegations of these two countries have undertaken several rounds of high-level trade negotiations and made significant progress. The US government has already halted their plan of imposing more tariffs on Chinese exports to show their willingness to reach a trade deal with China.

On domestic front, China's authorities halted their deleveraging campaign in response to faster-than-expected slowdown. Instead, they unveiled a new stimulus package to offset strong downward pressure of the trade war on growth. Starting from the second half of 2018, a number of monetary easing initiatives have been deployed to boost credit to the real sector, including cuts in Required Reserve Ratio (RRR) and large-scaled inter-bank liquidity injection through various central bank facilities (TMLF, MLF etc.). (Refer to our [China Economic Outlook: First quarter 2019](#))

On top of monetary easing, the authorities have, for good reasons, put more emphasis on fiscal measures in the current round of growth stimulus. At the recently concluded National People's Congress, the government pledged to cut tax and social insurance fee by RMB 2 trillion aggregately this year, which is equivalent to 2.2% of GDP. The tax cut program is spearheaded by the reform in both personal income tax and VAT, effective from January and April respectively. The authorities also relax their regulations on local government borrowing so that they have more funds to support infrastructure investment at localities.

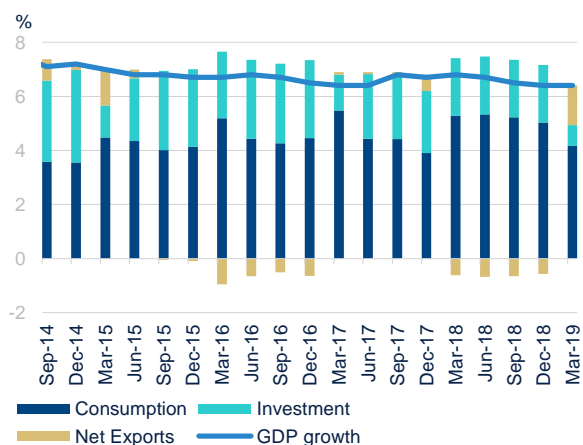
The better-than-expected data outturns in the first quarter have made our 6.0% full-year growth projection subject to certain upside risk. However, we reckon that the fundamentals of China's economy are not as solid as the headline figures showed. The lingering impact of the US-China trade war hasn't been fully reflected in the data yet. Moreover, some structural factors will likely continue to weigh on growth if policy stimulus is withdrawn too early. That being said, it is unlikely to see a quick rebounding of growth in the coming months.

Stabilization is led by the supply side

The 2019 Q1 GDP growth came out at 6.4% y/y, flat with the previous reading. Our BBVA MICA model yields an estimate of 6.2% y/y in first quarter based on a series of high frequency data. (Figure 2.1 and 2.2) By category, the contribution of consumption to GDP growth reached 4.17%. Surprisingly, the contribution of net exports to GDP

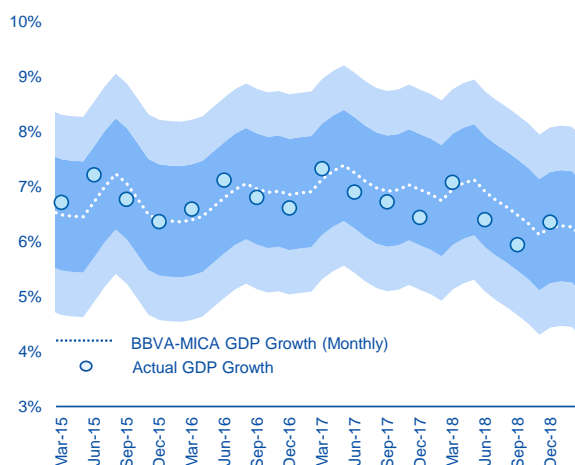
increased to 1.46% from -0.57% in 2018, which is mainly due to sluggish imports in the first quarter while the contribution of investment stands at 0.77%.

Figure 2.1 Growth rate in Q1 2019 is flat with the previous quarter at 6.4%, with positive contribution of net exports



Source: BBVA Research and CEIC

Figure 2.2 BBVA MICA model for monthly GDP forecasting



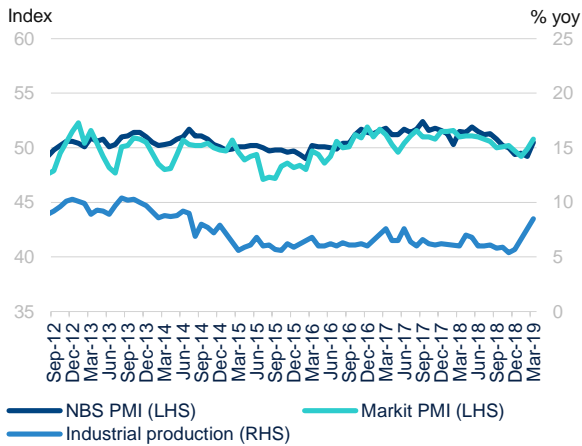
Source: BBVA Research and CEIC

Comparatively, the performance of the supply side is better as the progress in the US-China trade talks helped to improve producers' sentiment. (Figure 2.3) Moreover, the implemented easing measures, on both fiscal and monetary fronts, have relaxed the financing constraints of firms. Industrial production surprisingly rebounded to 8.5% y/y in March from 5.3% y/y in January-February (consensus: 5.9% y/y). To exclude the Chinese New Year (CNY) effects, which are distortions generated by the different timing of CNY from year to year, we directly compare the value of industrial production of the entire first quarter to that over the same period a year ago. The year-on-year growth rate is 6.5% y/y, which is still higher than the 2018 average of 5.8%. Meanwhile, both official manufacturing PMI and Caixin PMI rebounded above the watershed level of 50 in March. Generally China's outturns of activity indicators in the first quarter are subject to the Chinese New Year (CNY) effects, which are distortions stemming from the different timing of CNY from year to year. All in all, the good performance of GDP in the first quarter is largely led by the supply side.

On demand side, the growth of retail sales picked up to 8.7% y/y in March from 8.2% in January-February. (Figure 2.4) For the first quarter as a whole, the total value of retail sales grew by 8.3% y/y, suggesting that domestic consumption has somewhat stabilized after the slump in the second half of last year. Importantly, the auto sales declined by -3.4% y/y in the first quarter, largely narrowed from -12.5% in the fourth quarter of last year. It reflected that consumer confidence improved in tandem with producer confidence.

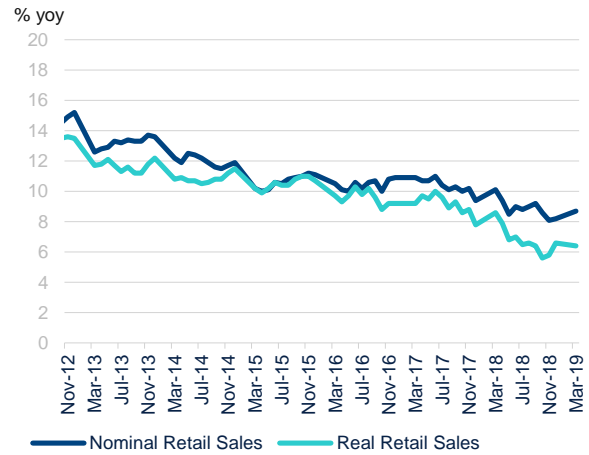
Performance of investment is mixed in the first quarter. Manufacturing investment extended its weakness at the beginning of the year, indicating that the recovery in confidence is not entrenched to stimulate producers to expand their capacity. At the same time, the authorities' easing efforts have boosted the investment in the property sector. (Figure 2.5) The growth rate of infrastructure investment rebounded strongly in the first quarter, thanks to easing measures. Although the stabilization of investment is welcomed, the composition of current recovery is not very healthy as investment in infrastructure projects always leads to the rise of debt level due to their weak profitability.

Figure 2.3 IP growth surprised the market to the upside



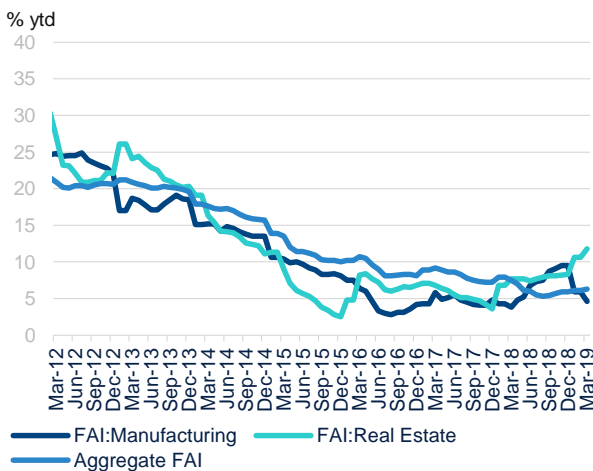
Source: BBVA Research and CEIC

Figure 2.4 Retail sales stabilized in March



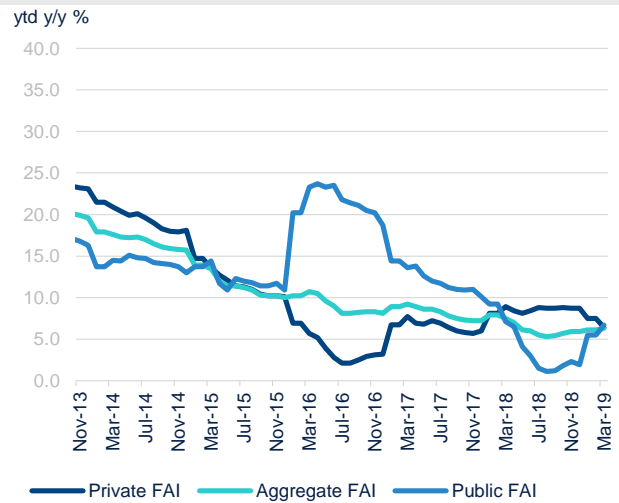
Source: BBVA Research and CEIC

Figure 2.5 Manufacturing investment remained weak...



Source: BBVA Research and CEIC

Figure 2.6 ...while infrastructure investment was boosted by policy easing



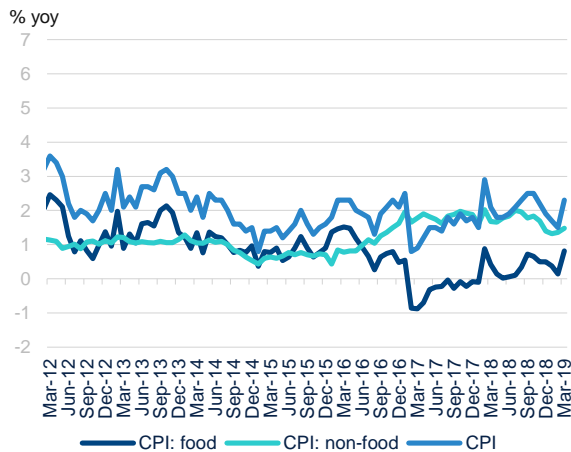
Source: BBVA Research and CEIC

Inflation picked up on food prices

Headline CPI inflation was volatile during the first quarter due to CNY effects. In March, CPI quickly picked up to 2.3% y/y from 1.5% y/y in the previous month. Apart from the effects of CNY, the rampant African Swine Flu led to the substantial supply reduction in pork and thereby contributed to the rise of food prices, which grew by 4.1% y/y in March. At the same time, non-food prices were still tame with a growth rate of 1.5% y/y, up from 1.4% in February. (Figure 2.7)

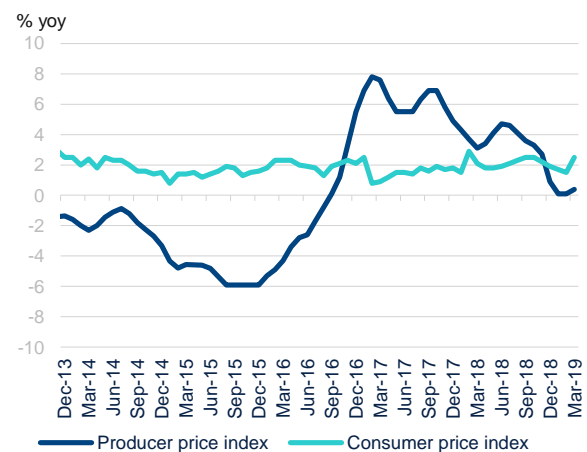
Meanwhile, PPI growth edged up to 0.4% y/y in March from 0.1% in the previous month, in line with the observed recovery in industrial production. The government reported that the capacity utilization in Q1 amounted to 75.9%, the second highest level for the first quarter since 2013.

Figure 2.7 CPI picked up on food prices



Source: BBVA Research and CEIC

Figure 2.8 PPI edged up on higher capacity utilization



Source: BBVA Research and CEIC

Monetary and fiscal easing helped to boost credit

In response to fast growth slowdown, the authorities swiftly shifted their tightening stance of monetary policy and unveiled a number of monetary and fiscal measures to stimulate domestic demand. In our [last quarter's China outlook](#), we summarized the main policy initiatives unveiled by the authorities till January. In February-March, the central bank used different facilities (MLF, TMLF etc.) to inject liquidity to the interbank market, urging banks to transmit reduced financing costs to their borrowers. The authorities also encourage banks to replenish capital through the issuance of perpetual bonds, which was acknowledged by Chinese banking regulator as qualified tier-1 capital. In so doing, the authorities seek to push banks to improve their risk appetite after the capital replenishment increased their capacity to absorb potential losses.

On the fiscal front, the Chinese government set a fiscal deficit target of -2.8% of GDP for 2019 at the recently concluded National People's Congress. The figure is slightly expansive than the deficit target of 2018, which stood at -2.6%. However, this year's budget deficit will mainly support the authorities' announced tax cut plan of RMB 2 trillion in 2019. At the same time, the central government substantially increased the bond issuance quota of local governments, from RMB 2.18 trillion to RMB 3.08 trillion (an increase of more than 40% y/y), in a bid to support local governments' activities in infrastructure investment and social-wellbeing spending. Since the bond issuance of local governments belongs to the items of extra-budget activities, its significant expansion will not be reflected in the -2.8% fiscal budget. That being said, the augmented fiscal impulse in 2019, which is defined as the year-to-year difference of augmented fiscal deficits including both official fiscal deficit and extra-budget activities, could exceed 1% of GDP.

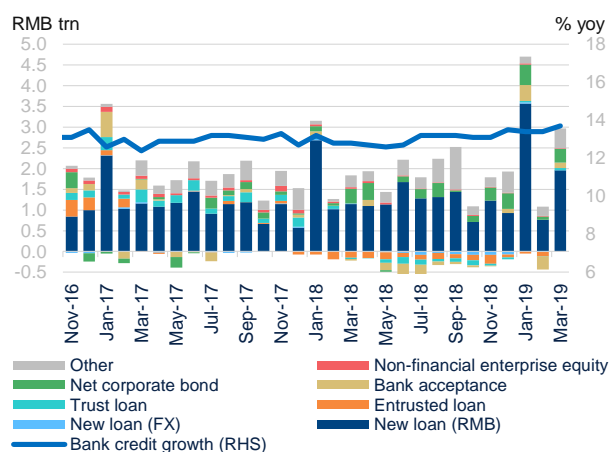
These implemented pro-growth initiatives, as well as people's improving sentiment due to the positive progress in US-China trade talks, tended to lend strong support of credit growth. In this respect, both bank loans and the total social financing (TSF), which is a broader gauge of total credit in the economy including both bank loans and other forms of shadow banking activities, registered visible growth through the first quarter although their outturns varied a lot from month to month due to the CNY effects.

By categories, both bank loans and bond issuance, in particular the bond issuance by local governments, exhibited a strong increase in the first quarter. The latter especially benefited from the authorities' significant increase of quota for local government bonds as described previously. In the first quarter of 2019, local governments have already issued bonds of RMB 1.2 trillion, which greatly boosted the total social financing over the same period. (Figure 2.9)

The implemented pro-growth initiatives helped to increase the money supply. M2 growth steadily rose from 8.1% y/y in December of 2018 to 8.6% y/y at end-March while M1 growth rebounded to 4.6% y/y in March from 1.5% y/y of last year. (Figure 2.10)

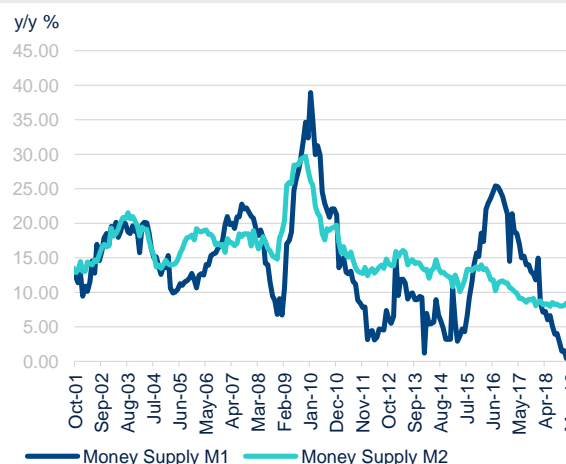
Despite these encouraging headline figures, anecdotal evidence shows that the transmission problem of monetary easing remains unaddressed since banks are still showing reluctance to extend credit to borrowers in face of still dim outlook. The recent pickup in credit might only reflect their front-loading behaviors under the authorities' pressure. There is a material risk of a slump in credit growth if banks run out of available projects at hand.

Figure 2.9 Total social financing increased thanks to bank lending and local government bond issuance



Source: BBVA Research and CEIC

Figure 2.10 both M1 and M2 were boosted by pro-growth measures



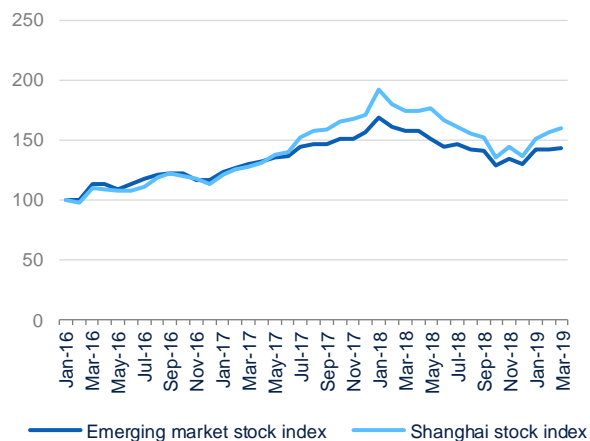
Source: BBVA Research and CEIC

Asset prices were boosted by monetary easing and sentiment improvement

The monetary easing and sentiment improvement also led to a strong rebound in asset prices. In China's A-share market, the market index rose by almost 30% in the first quarter of 2019, outperforming the global emerging market index. (Figure 2.19)

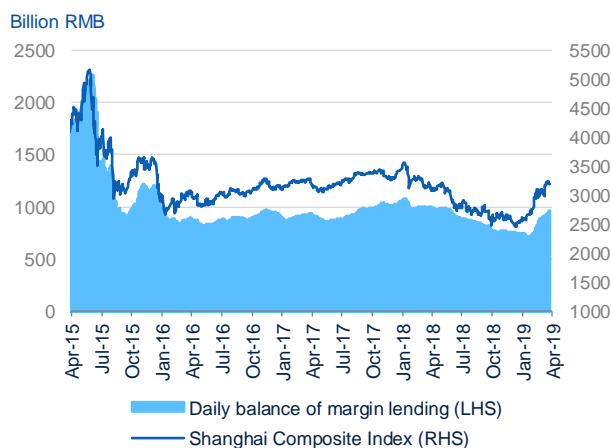
The fast run-up of Chinese stock market is a correction of previously extreme pessimism priced in the stock market when China and the US confronts with each other in trade areas. However, as the market booming seems to take root, more investors started to worry about the risk of overheating in the stock market. One signal in this respect is the increasing amount of margin lending in the stock market. (Figure 2.20) To a certain extent, the current market situation is reminiscent of the previous episode of financial turmoil in 2015, when the pro-growth measures and investors' over-speculation jointly led to a boom and bust cycle in the stock market. Fortunately, the authorities have shown their vigilance about the bubble risk this time. It is reported that they are trying to slow the market booming by clamping down illegal finance in the stock market.

Figure 2.11 Shanghai stock index has outperformed the emerging market index in the past months



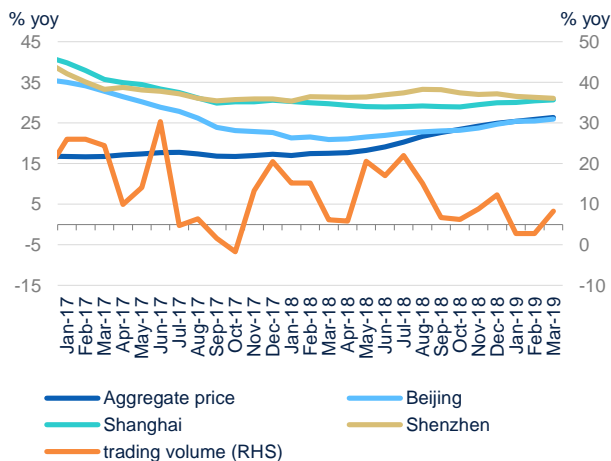
Source: BBVA Research and CEIC

Figure 2.12 Margin lending is on the rise



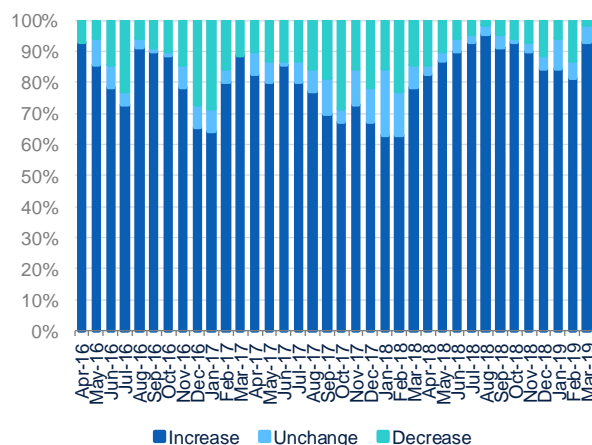
Source: BBVA Research and CEIC

Figure 2.13 Trading volume in housing market bottomed out in Q1



Source: BBVA Research and CEIC

Figure 2.14 More cities reported a year-on-year increase of housing prices in March



Source: BBVA Research and CEIC

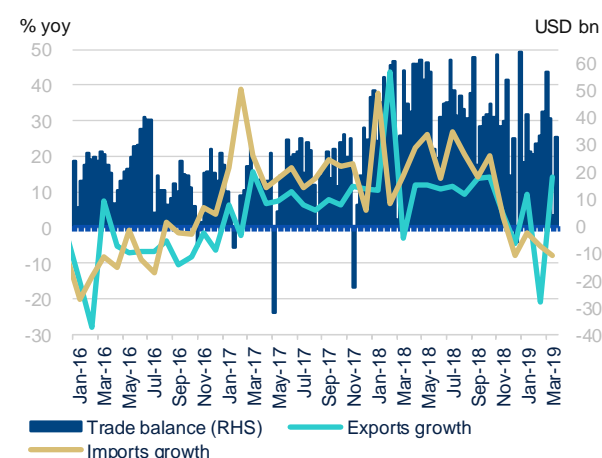
The housing market also benefited from the easing measures which have lowered the financing cost. Moreover, an increasing number of cities started to relax, albeit to a varying degree, their existing purchase restrictions imposed on the housing market so as to stimulate the property market.

The housing market became active again. In March, more cities reported year-on-year increase on their housing prices than in February. For the positive side, the rebounded housing market could help to boost domestic demand in both related household consumption such as home appliance and investment in the property sector. Meanwhile, it, as well as the booming stock market, added to policymakers' concern of asset bubble and could further hinder the authorities' from doing more policy easing.

Volatile external sector and a stable exchange rate

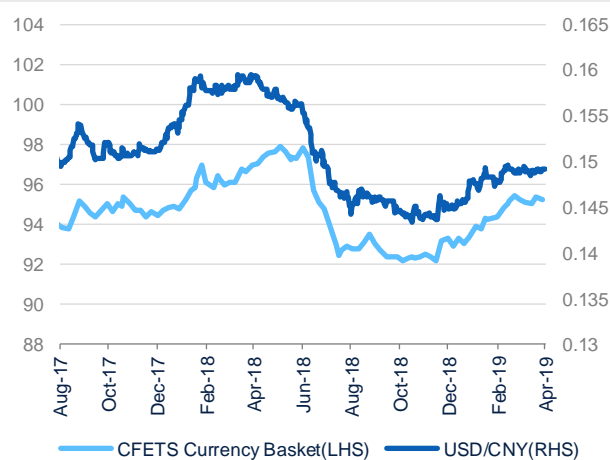
Chinese exports fared exceptionally well in the first quarter. Bundling up exports value of the first three months together, which is an effective way to exclude the CNY effects; we find that exports value grew by 1.4% in the first quarter, which is much better than expected given strong headwinds stemming from the ongoing China-US trade war war (Figure 2.15)

Figure 2.15 Exports are better than expected despite trade war effect



Source: BBVA Research and CEIC

Figure 2.16 RMB appreciated and then became stagnant



Source: BBVA Research and CEIC

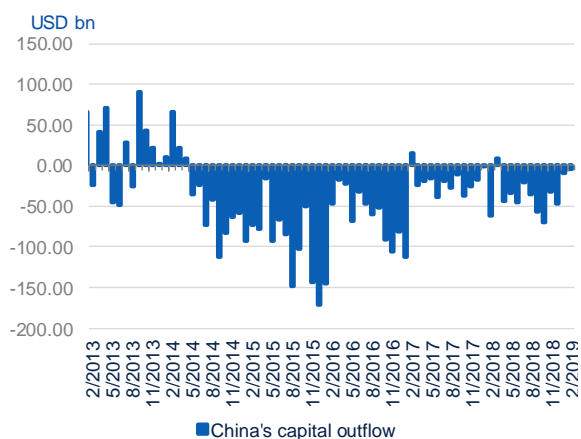
However, it is noted that the VAT cut, which was announced in March but to be effective from April, could bring additional distortions to Chinese exporters. Given that the tax rebate rate of exports is to be reduced in tandem with the VAT rate, some exporters might want to bring their shipments early to March so as to get the higher rebate. Such an explanation is also in line with the sluggish growth around the world we observed in the first quarter.

The RMB exchange rate experienced a recovery at the beginning of this year and then became stagnant within a narrow range centering on 6.70 for almost two months. The improvement early this year mainly mirrored the progress in trade talks between China and the US. (Figure 2.16)

Capital outflows stalled

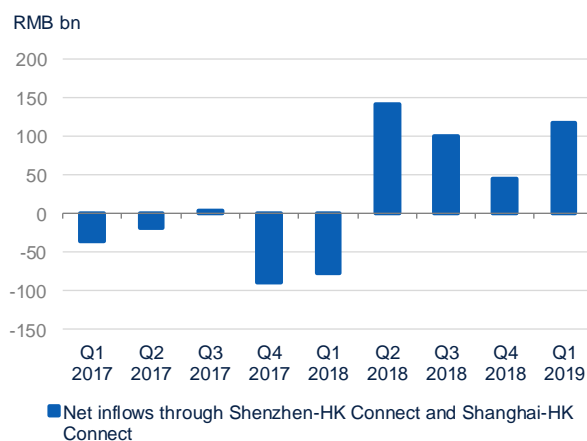
Allured by the rebounded market and improved sentiment, foreign investors came back to China again. More importantly, thanks to the authorities' tenacious efforts to push for the opening of China's domestic capital market, China's equity and bond market was included in MSCI Emerging market Index and Bloomberg-Barclay Index in the first quarter of this year. It means that many passive investors around the world have to increase their exposure to China's capital market so as to benchmark their portfolio to these Index. Such a positive shift has resulted in a considerable size of capital inflows over the past few months. As a result, the size of net capital outflows from China has significantly diminished. (Figures 2.17 and 2.18) Accordingly, foreign reserves steadily increased to USD 3,100 billion in March from USD 3,070 billion at the end of 2018.

Figure 2.17 Capital outflows shrank supported by the rebounded market and improved sentiment



Source: BBVA Research and CEIC

Figure 2.18 MSCI inclusion of China's A-share index largely attracted capital inflows



Source: BBVA Research and CEIC

3. Growth recovery is set to be mild and gradual

Certain upward risk to our baseline growth projections

In response to a steep growth slowdown in the second half of 2018, China's authorities have deployed a flurry of policy easing initiatives to offset domestic and external headwinds, on which we elaborate in the previous section. Encouragingly, some green shoots have appeared in the first quarter, in particular on the improved sentiment of investors and consumers. Nevertheless, it remains to be seen whether these green shoots are robust enough to withstand the test of next storm emanating from mounting uncertainties over the US-China trade negotiation as well as a number of domestically structural obstacles to growth recovery.

Due to the high certainties of the growth environment, we would like to maintain our GDP projections of 2019 and 2020 at 6% and 5.8% respectively, while flag certain upside risk to them. (Table 3.1) With a good start at the beginning of the year, Chinese policymakers are likely to adopt a wait-and-see stance in the coming months. As a result, the quarterly pattern of growth in 2019 could be flat if the authorities' policy supports become weaker in the second half of the year. Moreover, it is noted that our 2019 projection is slightly lower than market consensus and at the bottom of the government-set range target of 6.0-6.5%.

Our base scenario has already factored in some pro-growth measures which have been announced but haven't been put into practice. For example, the National Development and Reform Commission (NDRC) announced at the beginning of the year that they are going to launch more consumption subsidies to boost domestic demand. We anticipate that those measures are to be unveiled in the rest of the year.

Meanwhile, due to high uncertainties of growth environment, the authorities flexibly use the policy tools at hand to ensure a soft-landing on the one hand and avoid massive debt accumulation through policy stimulus on the other hand.

The contribution of net exports to GDP likely remains negative

In terms of expenditure components, the main drag of GDP growth in 2019 is most likely to be net exports due to both the lingering impact of China-US trade war and the cyclical weakening of global growth. After the outbreak of China-US tariff war in last summer, the ever-escalating uncertainties prompted Chinese exporters' to front-load their shipment to the US in a bid to avoid potential punitive tariffs.

This could lead to a significant slowdown in Chinese exports this year regardless of the easing tensions between two sides. The effects will be most likely to concentrate in the first half of the year, accentuating the pattern of a gradual recovery in the second half of the year.

Moreover, it is widely anticipated that the prospective US-China deal includes China's pledge to reduce its large trade surplus against the US through massive purchase of US products, most likely concentrating on agricultural and energy products etc. If implemented, the overall trade surplus of China, which now stands at 1.3% of GDP, will shrink further.

All in all, the contribution of net exports to GDP growth is likely to remain negative in the next couple of years although the gap could narrow from that in 2018. (Table 3.2)

Private consumption is set to lead the recovery

Compared with weak external sector, China's domestic demand, in particular private consumption, is expected to underpin growth in the next couple of years thanks to those easing measures, implemented or to be implemented, as well as the improved market sentiment.

The recently enacted cuts in both personal income tax and VAT are anticipated to increase household income and thereby boost private consumption. More fiscal measures are in the pipeline to boosting private consumption, particularly focusing on the areas of automobile, home appliance, green products, information, aging care and sports.

Meanwhile, the improvement of consumers' sentiment, mainly stemming from several rounds of fruitful bilateral trade negotiation between China and the US over the past months, is likely to enable private consumption to rebound from the sluggish level in the second half of the year. In this respect, the sales of automobile could benefit more from the improved sentiment on top of the renewed subsidies from the government.

Indeed, Chinese consumers might even dig deeper into their pockets if the ongoing bilateral trade negotiation between China and the US can lead to a better-than-expected deal. For example, it is recently reported that both sides are considering a mutual tariff reduction from the pre-trade-war level or even certain relaxation of the US ban on high-tech exports to China.

Some structural factors limit the pace of investment recovery

In 2018, the slowdown in investment also contributes to the weak performance of economy activities after net exports. Sluggish investment in the past year were caused by both tightening credit condition, which are associated with the authorities clampdown on shadow banking activities and local governments' excessive borrowing, and the unexpected escalation of trade tension with the US.

It is important for China's authorities to rev up investment this year so as to achieve their preset growth target. Indeed, a number of easing policy initiatives implemented since the second half of the 2018 are targeted to boost investment and offset the increasing downward pressure on the economy. In particular, the central government has substantially increased this year quota of bond issuances to RMB 3.08 trillion from RMB 2.18 in 2018. The majority of raised funds will be used by local governments to support infrastructure projects, which likely bucks the trend of sluggish infrastructure investment last year.

However, we also reckon that some structural deficiencies could continue to weigh on investment despite the policy loosening and the easing trade relation with the US. First, even a solution of China-US trade war in sight, the saga of last year will unavoidably make many exports reconsider moving their production capacity away from China so as to reduce potential disruptions stemming from the rising protectionism around the globe. This will exert a negative impact on investment in China's manufacturing sector. Second, the entrenched discrimination against private enterprises was still prevalent in China's credit market even though the policy stance has shifted to be loosening. Without the implicit guarantee from the authorities, private enterprises find it increasingly difficult to obtain credit from formal banks after the authorities clamp down the shadow banking sector. Last but not least, the authorities are still cautious about the possibility of relaxing the existing restrictions on property market, implying that a significant pickup in investment of the property sector is not likely in the short term.

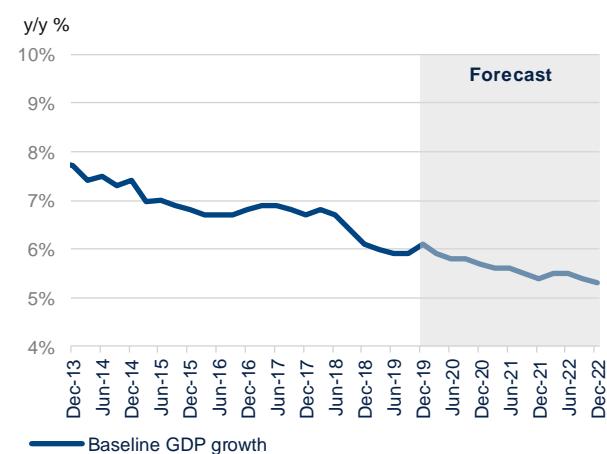
All in all, we do anticipate investment to contribute to a larger share of GDP this year amid the massive policy easing. However, several structural factors will inhibit a fast and significant rebound of investment in export and

property sectors. Consequentially, the expected gradual improvement in investment also determines that the growth recovery this year cannot exceed the official range target of 6.0-6.5%.

Inflation pressure is manageable

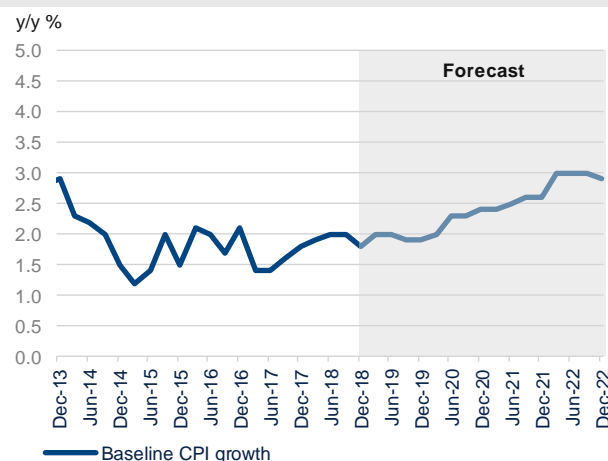
We slightly lower our 2019 projection of CPI from 2.3% to 2.1% (Bloomberg consensus: 2.1%). (Figure 3.2) The announced cut in VAT will have downward pressure on general price level. Given that the real size of VAT cut is close to our expectation three months ago, we don't need to make any change to our CPI projection on basis of the tax cut. In the second half of 2019, CPI is expected to trend up gradually after the food-prices rebound from the current level mostly due to the recent outbreak of African Swine Flu in China.

Figure 3.1 We maintain our 2019 and 2020 GDP forecasting at 6% and 5.8% respectively



Source: BBVA Research and CEIC

Figure 3.2 We slightly decreased our 2019 CPI prediction from 2.3% to 2.1%



Source: BBVA Research and CEIC

Table 3.1 Economic indicators forecasting

	2017	2018	2019 (f)	2020 (f)
GDP (% YoY)	6.9	6.6	6	5.8
Inflation (average, %)	1.7	2.1	2.3	2.5
Fiscal balance (% of GDP)	-3	-2.6	-2.8	-3
Current account (% of GDP)	1.4	0.4	0.2	0.1
Policy rate (%)	4.35	4.35	3.85	3.6
Exchange rate (CNY/USD)	6.5	6.88	6.7	6.7

(f) Forecast.

Source: BBVA Research and CEIC

Table 3.2 Economic indicators forecasting: decomposition by expenditure

	2017	2018	2019 (f)	2020 (f)
Real GDP (% YoY)	6.90	6.50	6.0	5.80
Private consumption	6.5	6.7	6.5	6.4
Public consumption	10.1	17.3	8	6
Investment	5	4.7	6.0	5.7
Domestic Demand (cont. pp)	6.34	7.07	6.30	5.90
Exports	9.4	3.5	2.1	3.8
Imports	7.2	7.0	3.9	4.6
External demand (cont. pp)	0.56	-0.57	-0.30	-0.11

(f) Forecast.

Source: BBVA Research and CEIC

A trade deal with the US is in sight...

The US-China trade relationship had a dramatic turnaround after President Trump and President Xi met during the Argentina G20 summit. Since then the delegations of both sides have been striving to reach a comprehensive trade deal to end the ongoing tariff war. Although a number of thorny issues still remain unsolved, it is reported that the two sides are now very close to reach a deal after several rounds of negotiation in Washington and Beijing.

Delving into a series of official statements about trade negotiation, we infer that the new China-US trade deal will push China to make profound changes on a wide range of issues including the practice of forced technology transfer, IP protection, non-tariff trade barriers, market access of service and agricultural sectors, the exchange rate etc.

We suspect that the two sides are still wrestling with each other on a couple of points: first, to what extent China needs to reduce its subsidies to its SOEs; second, how to establish an enforcement mechanism to ensure China will honor its promises to the US. Although the two sides will fight fiercely on these issues, we don't believe that they will thwart the signing of the final deal. At the last stage of the lengthy negotiation process, neither of them wants to abandon what they have achieved thus far.

... but it could put the RMB in a new quandary

However, the new trade deal between China and the US could exert a great impact on the rest of the world and lead to a deep adjustment in the current global trade system. As we analyzed previously, the new trade deal must include China's massive purchase of US products to reduce the trade imbalance between the two sides. However, such a bilateral correction will inevitably have two results. First, China's trade surplus as a whole will tend to shrink further. Second, China needs to reduce its purchase from other trade partners to ensure that the narrowing of trade surplus is not too steep.

These results have significant implications for China's Balance of Payment in the few years. On top of a narrowing surplus under the current account, China might face more trade disputes with various trade partners which suffer loss from the new US-China trade deal, which consequentially add further pressure on China's exports.

In theory, the best way to deal with this situation is to have a flexible exchange rate, which can help to relieve external pressure through currency devaluation. However, given the US long-lasting concern over China's currency manipulation, China might not be able to increase the flexibility of its exchange rate for the short term due to the US continuous pressure. As such, we expect the RMB exchange rate to fluctuate within a narrow range of 6.6-7.0 USDCNY through the remainder of the year. (Table 3.1)

4. Hard-landing risk has eased

The better-than-expected Q1 GDP figures have largely alleviated people's concern over a free fall in growth this year. We anticipate that consumer and market sentiment will continue to improve through the year as the chance of signing a trade deal between China and the US is increasing. This, together with the authorities' easing efforts, will help the economy stabilize at a level close to the official set target.

However, a number of growth headwinds still remain intact. The front-loading exports in 2018 will lead to a slowdown in the external sector in the first half of the year. If the scale is larger than expected, it will further weigh on growth. Relatedly, there still some uncertainties about the prospective trade deal between China and the US, which could aggravate the suffering of China's shipment. For example, some rumors have floated that the US government weighs an option of gradually phasing out the imposed punitive tariffs on China's exports so as to make sure that China will honor its promises contained in the new trade deal. If the US successfully forces China to accept this strategy, the suffering of China's external sector is set to last longer.

The headwinds also abound within the country. The property market in small cities suffered an oversupply problem in the past couple of years. The situation could worsen if growth pressure rises up. A bubble burst of housing market will cost household dearly and have enormously adverse impact on private consumption.

More importantly, the complex situation is testing China authorities' capability of policymaking. On the one hand, the authorities have to boost the economy through policy easing while they, on the other hand, needs to ensure the stimulus won't raise the general debt level too much. In this respect, the authorities need to walk a fine line between stimulus and debt sustainability management. Big policy missteps, which could happen in both directions, will take a heavy toll on China's economy.

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