Research

Creating Opportunities

China Economic Outlook

Third Quarter 2019

Hong Kong, July 2019

Index

1. Global environment marked by trade tensions and the reaction of the central banks

In recent months, the rise of protectionism has intensified and trade tensions have increased. **Although the USA and China announced a truce during the last G20 summit that provided an opportunity to resume negotiations, doubts about a final agreement will not go away easily and will continue to slow down global growth**. In this context, with continued low inflation and very present growth risks, **the central banks have changed their position and seem to be inclined to reduce interest rates again**. This shift by monetary authorities is expected to offset the negative effect of increased trade tensions and stabilise global growth, although at lower levels than in previous years.

The escalation of protectionism remains a source of uncertainty, even after the latest trade truce between the USA and China

Over the past few months, we have seen how trade disputes have intensified, which has been further exacerbated by tensions in the area of technology. The US government announced new tariff increases from 10% to 25% on imports from China worth USD 200 billion, and threatened to extend them to all other imports (an additional USD 230 billion). It also added Huawei to a blacklist of companies, thereby blocking business transactions. For its part, China responded with tariffs of 25% on imports from the USA worth USD 60 billion. However, **at the most recent G20 summit, a truce was declared** (although tariff increases have not been rolled back), thereby cooling tensions and allowing negotiations to be resumed. In any case, although the worst-case scenario has been avoided, the intensity and extent of the issues being disputed suggest that it won't be easy to come to a trade agreement, and that tensions between the two countries will continue in the future.

Despite new monetary stimuli, there is a strong safe-haven effect in the financial markets

The high uncertainty generated by trade tensions strongly increased risk aversion in the markets, in such a way that the VIX rose significantly to around 20 (+7 bp) during the first half of May, triggering an adjustment in world stock markets of an average of 6%. All of this increased the safe-haven demand and, together with the more accommodating attitude of the central banks, caused the ten-year German bond yield to reach a historic low, and the ten-year US bond yield to fall to lows seen in 2016 (see Graph 1.1). However, the reduced level of safe-haven asset yields and the confidence that the action from central banks will sustain growth have generated a search for alternative yields, which has resulted in both an increase in the stock markets (the S&P 500 has once again reached historically high levels) and in the bonds of emerging countries and peripheral European countries. In any case, the lack of a generalised risk appetite continues to be felt.

In a context of high uncertainty and low inflation, trade tensions have led central banks to reassess their policy

To counter the negative effects of increased protectionism and the concern on the global markets, **the Federal Reserve and the ECB (in this order) have indicated their intention to adopt new stimulus measures** as insurance against increasingly likely risk scenarios and to counteract the continued decline in long-term inflation expectations. The Federal Reserve made changes to its 19 June meeting statement that set the stage for the start of interest rate cuts. It warned that inflation could fall below the 2% target, changed the description of its growth rating from 'solid' to 'moderate' and, faced with trade threats and political uncertainty, changed its approach from patience to close monitoring. For its part, the ECB has reinforced its accommodating stance on monetary policy, approving a new liquidity provision programme (LTRO-III) and delaying its commitment to maintain interest rates at current levels from the end of 2019 to the middle of 2020. In addition, it has noted that it has a range of instruments to combat the risks of low growth and inflation, including reducing deposit rates and revitalising the bond purchase programme (QE), which is a development on previous communications.

For its part, **China announced that it had a lot of room to adjust its monetary policy if the trade conflict intensified.** In fact, cuts to loan rates and the banks' required reserve ratio (RRR) are expected. It also announced that it will use USD 43 billion in rediscount quotas and standing lending facilities (SLFs), and that it will begin accepting interbank certificates of deposits and bank certificates as collateral for small banks to support liquidity. **As regards fiscal policy,** there will be increased debt issuance by local governments and a USD 14.5 billion training plan for those individuals who have lost their jobs due to the slowdown.

World growth continues in a slight downwards trend

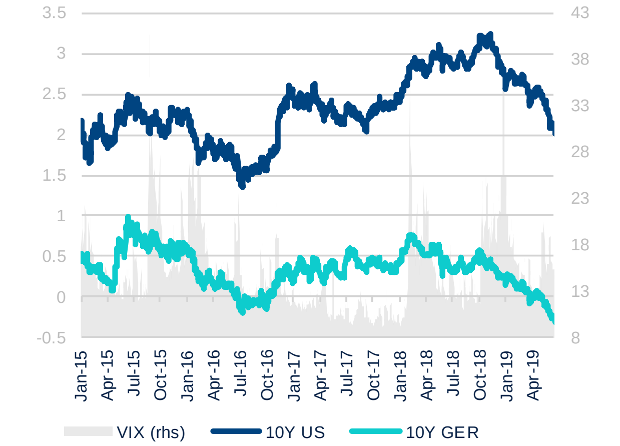
In the second half of 2018, world growth was below the average of previous years. This is due, in large part, to the poor performance of exports, which have remained virtually stagnant since the middle of last year and have mainly affected the manufacturing industry. **Activity data shows how the industrial sector has continued to slow down from the beginning of the year to April,** despite a good March. **This trend will most likely continue,** as manufacturing PMIs continued to fall in May and June, tumbling into contractive territory. However, **growth in the first quarter of 2019 regained some momentum**, although it remained below average. For the rest of the year, there is a risk that weak manufacturing and exports will end up infecting the services sector, which remains relatively robust, supported by the strength of employment and low inflation. In this regard, **our BBVA-GAIN model suggests a stable quarterly growth of around 0.8% at the global level,** in line with our forecast (3.3%) for 2019 annual growth.

The scenario for growth remains almost unchanged, but downside risks are rising

The base scenario incorporates the **assumption that the USA and China will eventually come to a trade agreement, possibly towards the end of the year**, thus cooling trade tensions, although not eliminating them. It is also expected that there will be no significant increase in tensions between the USA and Europe (the US threat to increase automobile tariffs still looms). **In principle, the UK leaving the EU should not have any significant impact** on the global economy. In addition, with regard to the crude oil market, a slight reduction in Brent prices is anticipated (from around USD 68 per barrel in the second quarter of the year to around USD 62 and USD 55 at the close of 2019 and 2020, respectively) owing to the increase in supply from the USA and the fall in demand, which more than offsets the OPEC production cuts.

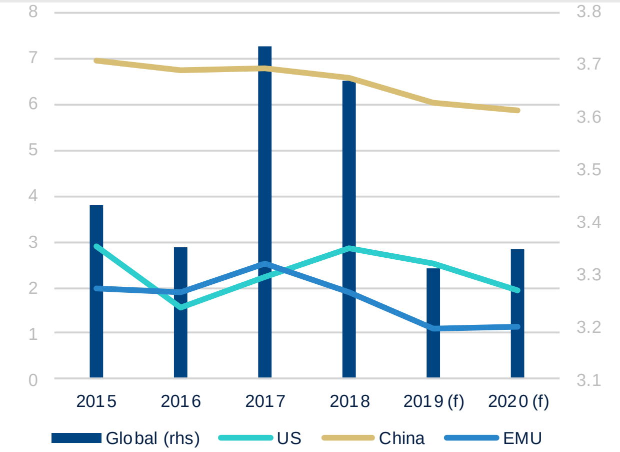
Lastly, **it is expected that monetary stimuli will offset the effects of prolonged trade tensions and potential future shocks**, although both factors operate through different channels, with trading uncertainty being a negative supply factor and monetary stimuli being a positive demand stimulus. Global growth would therefore stabilise, but at lower levels than in previous years. We therefore maintain the forecast **that global GDP, which climbed 3.8% in 2018, will grow by 3.3% in 2019 and by 3.4% in 2020** (see Graph 1.2).

Figure 1.1. **SOVEREIGN DEBT YIELDS**



Source: Bloomberg and BBVA Research

Figure 1.2. **ANNUAL GDP GROWTH 2015–2020 (*)** (%)



(*) Forecasts as of 2019.
Source: BBVA Research

In the USA, growth should gradually lose momentum, moving towards its potential growth rates. In particular, **US GDP is estimated to grow by 2.5% in 2019 and by 2.0% in 2020, in light of the 2.9% growth recorded in 2018.** In order to sustain economic expansion at the risk of lower growth and low inflation, the **Federal Reserve is in a position to start an expansion cycle in 3Q19**, **reducing its rates by up to 75 bp** over the next few quarters, and then keeping them stable until 2022.

In Europe, growth will be more modest owing to weak industry and high uncertainty (trade and Brexit). It is therefore expected that **the ECB will strengthen its forward guidance and further reduce deposit rates (-10 bp in 3Q19),** leaving them unchanged until the end of 2021. In addition, it is anticipated that a staggered deposit system will be adopted, and, if the situation worsens, that quantitative easing (QE) measures will be re-implemented. Therefore, **the scenario for Europe remains the same with very few changes**. With the strong data from the first quarter, **growth has been revised upwards in 2019 by one tenth to 1.1%** and, owing to the persistent weakness of the industrial sector and the greater uncertainty, there has been a **slight downwards revision for 2020 of one tenth to 1.2%.**

In China, more fiscal stimulus measures are expected (tax cuts and growth of regional government debt) that, along with loan interest rate cuts, bank swaps and specific medium-term credit, among other measures, can sustain the country's growth, therefore countering the negative effect of the trade war. These stimulus measures **will help GDP to grow by 6.0% in 2019 and 5.8% in 2020, in line with previous forecasts.**

Although the view of the global economy does not differ much from what was published in the previous edition of this report, the risks to this global scenario are relatively higher due to the escalation of protectionism and its potential impact at the global level. An expansion in trade tensions to other sectors and countries is also not to be ruled out, as US tariff threats to the automobile sector are still pending. There is also an increased risk that the USA will enter an economic downturn, while political risks in Europe remain relevant (Brexit and fiscal policy in Italy). Lastly, China's stimuli stop the country's deleveraging process and therefore increase its vulnerability in the medium and long term.

2. Worsening structure added growth worries

The Q2 GDP growth slowed to 6.2% y/y (versus 6.4% y/y in Q1), the lowest growth rate for the past three decades, in line with the market consensus. On sequential terms, the economy grew by 1.6% q/q, slightly higher than that of Q1 at 1.5% q/q.

Although slightly higher than our expectation (BBVA forecast: 6% in Q2), the structure of growth in Q2 was weak: first, the contribution of consumption to growth is slower than the previous quarter’s reading while the investment contribution looms large, indicating growth is still led by the authorities’ stimulus measures in infrastructure investment which might easily lead to debt overhang again; second, although the credit data in June are broadly higher than the previous month’s reading, the ratio of long-term lending which is the driving force of enterprises activities is quite low; third, the recent takeover of Baoshang Bank is an alarm call on Chinese banking system, thus the risk appetite of banks and investors will deteriorate further to make it increasingly difficult for the authorities to boost growth at the moment.

The only silver lining is the better-than-expected June economic activity indicators. However, the good June outturns might highly depends on the seasonal effect as well as the “front-loading” behavior of the VAT cut implementation starting from April 1st.

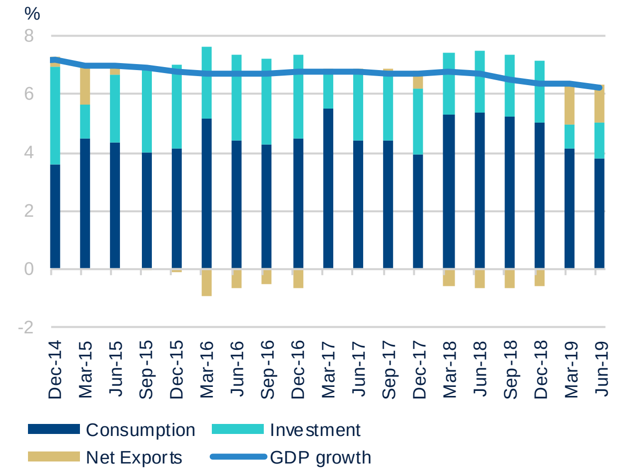
Altogether, growth slowdown in Q2 is widely expected amid the unsettled trade war with the US and some domestic structural obstacles. After the unanticipated escalation of trade dispute early May, the two sides managed to ease their tensions after their national leaders met at Osaka G20 meeting in June. However some long-term damages to China’s economy have been made and appear to be irreversible. Together with some structural problems, the trade dispute with the US is likely to weigh on China’s growth in the next couple of years.

A broad-based slowdown in Q2 with some up-tick in June

The 2019 Q2 GDP growth came out at 6.2% y/y (versus 6.4% y/y in Q1), the lowest growth rate for the past three decades, in line with the market consensus. On sequential term, the economy grew by 1.6% q/q, slightly higher than that of Q1 at 1.5% q/q. Our BBVA MICA model yields an estimate of 6.3% y/y in the second quarter based on a series of high frequency data, in line with the growth slowdown. (Figure 2.1 and 2.2)

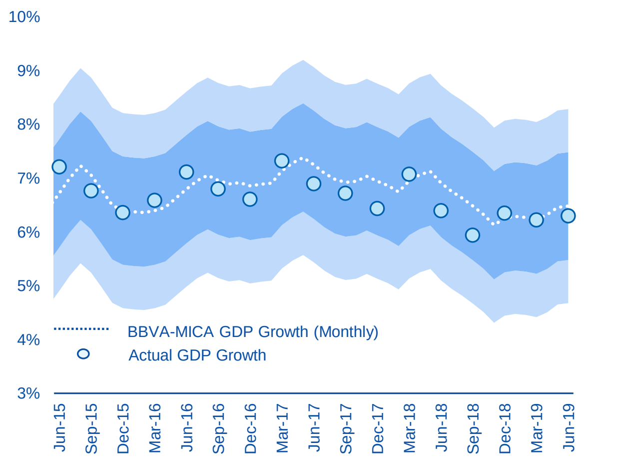
By category, the contribution of consumption to GDP growth reached 3.79%, lower than the previous quarter’s reading at 4.17%, indicating a lower consumer’s willingness amid economic uncertainties. On the other hand, due to the authorities’ stimulus measures on investment, the contribution of investment to GDP growth increased from 0.77% in Q1 to 1.21%. However, the contribution of net exports to GDP decreased to 1.3% from 1.46% in Q1, as the trade war effect on exports intensified.

Figure 2.1 **GROWTH RATE IN Q2 2019 IS LOWER THAN Q1, THE LOWEST FOR THE PAST THREE DECADES**



Source: BBVA Research and CEIC

Figure 2.2 **BBVA MICA MODEL FOR MONTHLY GDP FORECASTING**



Source: BBVA Research and CEIC

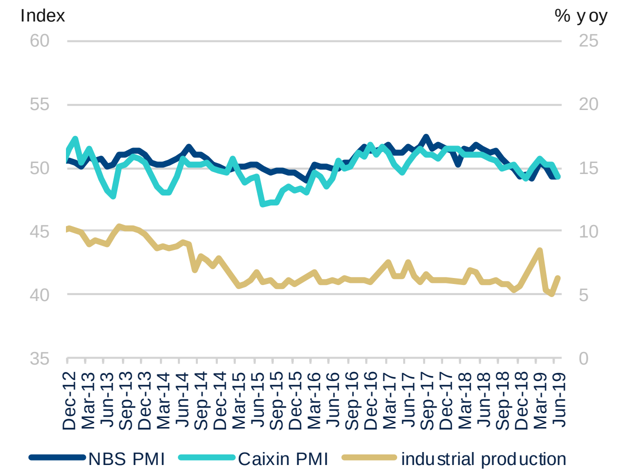
The Q2 GDP slowdown was mainly led by April and May, while the June outturns are actually better-than-expected. However, the good June outturns might highly depends on the seasonal effect as well as the “front-loading” behavior of the VAT cut implementation starting from April 1st.

The performance of the supply side worsened as the US-China trade war reignited in May, together with the domestic structural obstacles, dampening the producers’ sentiment. In particular, both official manufacturing PMI and Caixin PMI were below the watershed level of 50 in June, both dipping to 49.4. Due to the seasonal effect, industrial production surprisingly rebounded to 6.3% y/y in June from 5% y/y in May (consensus: 5.2% y/y). (Figure 2.3)

On demand side, the growth of retail sales in June picked up to 9.8% y/y in June from 8.6% in the previous month. (Figure 2.4) Importantly, the auto sales significantly increased by 17.2% y/y in June, largely higher than the 1H average growth rate at 1.2%. It reflected that the authorities’ stimulus measures on auto consumption to boost economic growth have taken effect.

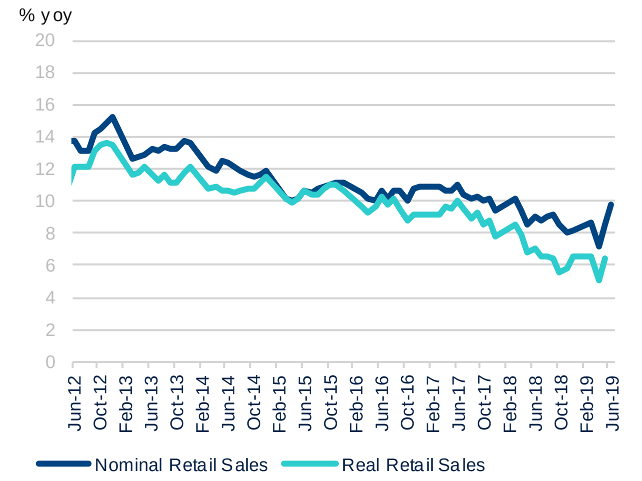
Performance of investment is quite mixing by category in the second quarter. Manufacturing investment extended its weakness in Q2, indicating that amid the unsettled trade war with the US, the recovery in confidence is not entrenched to stimulate producers to expand their capacity. At the same time, the authorities’ easing efforts have boosted the investment in the property sector. The growth rate of infrastructure investment rebounded strongly in the second quarter, thanks to the fiscal easing measures in infrastructure construction. 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 2.5 and 2.6)

Figure 2.3 **PMIS DIPPED BELOW THE WATERSHED LEVEL OF 50 WHILE IP REBOUNDED IN JUNE**



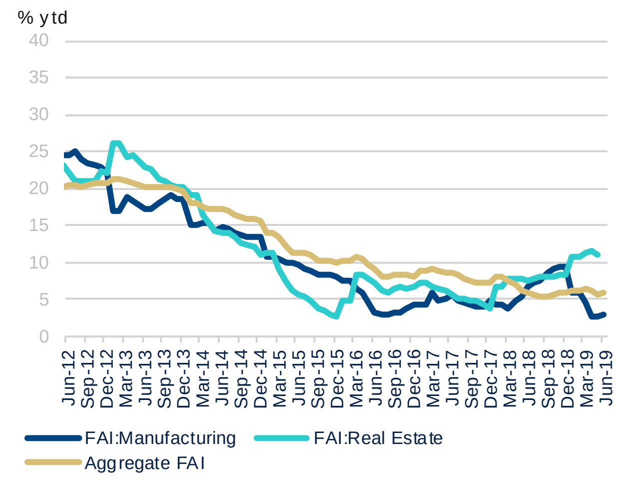
Source: BBVA Research and CEIC

Figure 2.4 **RETAIL SALES ALSO INCREASED IN JUNE**



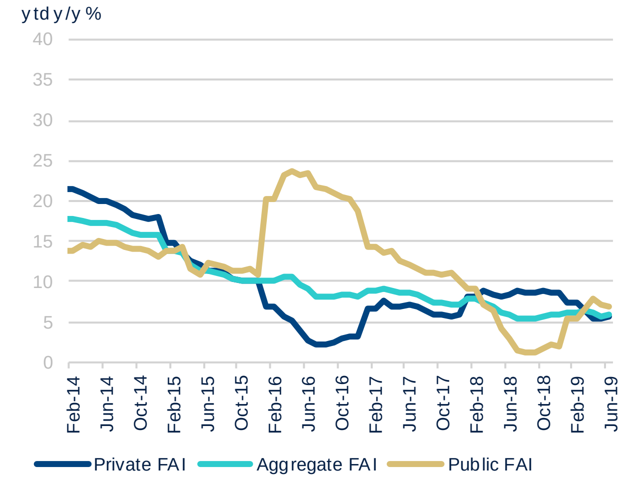
Source: BBVA Research and CEIC

Figure 2.5 **MANUFACTURING INVESTMENT REMAINED WEAK…**



Source: BBVA Research and CEIC

Figure 2.6 **…WHILE INVESTMENT WAS BOOSTED BY PUBLIC INVESTMENT**



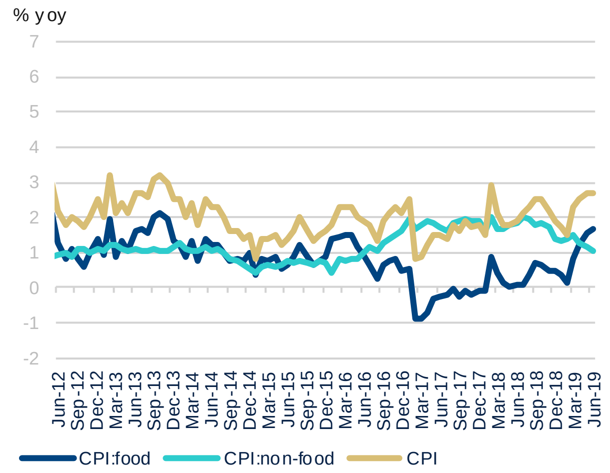
Source: BBVA Research and CEIC

Inflation picked up on increasing food prices

Headline CPI inflation increased as the non-food price declining cannot offset the rocketing food price (mainly pork price caused by African Swine Fever). In June, CPI remained at a relatively high growth rate at 2.7% y/y as of the previous month. The rampant African Swine Fever led to the substantial supply reduction in pork and thereby contributed to the rise of food prices, which grew by 8.3% y/y in June (compared with 4.7% in 1H). At the same time, non-food prices were still tame with a growth rate of 1.4% y/y, lower than the 1H average of 1.6%. (Figure 2.7)

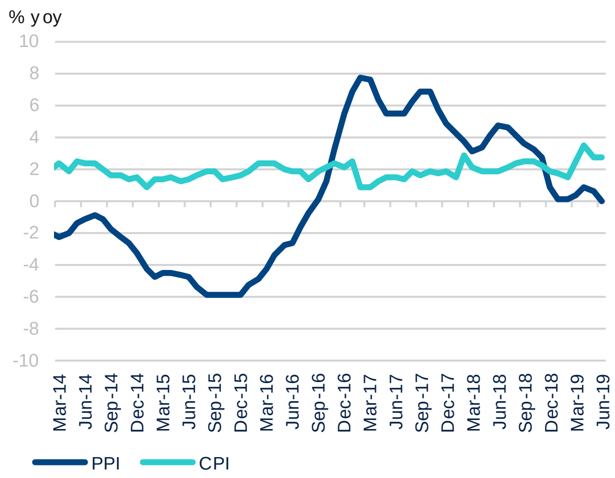
Meanwhile, PPI growth significantly slowed to 0% from 0.6% in the previous month, in line with the authorities' hold-on of the previous deleveraging campaign amid growth slowdown. The government reported that the capacity utilization in Q1 amounted to 76.4%, marginally lower than 76.8% in the first quarter of the last year.

Figure 2.7 **CPI PICKED UP ON FOOD PRICES**



Source: BBVA Research and CEIC

Figure 2.8 **PPI SIGNIFICANTLY SLOWDOWN TO 0%**



Source: BBVA Research and CEIC

Monetary and fiscal easing helped to boost credit but the structure problem still exists

In response to the growth slowdown amid the unsettled trade war with the US, the authorities unveiled a number of monetary and fiscal measures to stimulate domestic demand. These measures mainly include monetary easing measures such as RRR cut, lowering the market lending rates (such as DR007, lending prime rate, etc.) and facilitating Small and Medium Enterprises (SMEs) financing. On the other hand, fiscal easing measures include a series of tax cut, expanding local government bond issuance, allowing local governments to use local government special bonds as equity capital to borrow from markets and planning to issue Special Construction Bond (SCB) to support infrastructure investment etc.

These implemented pro-growth initiatives 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 a visible growth through the second quarter. In particular, new yuan loans increased from RMB 1,180 billion to RMB 1,660 billion (Consensus: RMB 1,700 billion) and total social financing also accelerated from RMB 1,395.2 billion to RMB 2,260 billion (Consensus: 1,900 billion). (Figure 2.9) Moreover, M2 growth maintained at 8.5% y/y as of the previous month. (Figure 2.10)

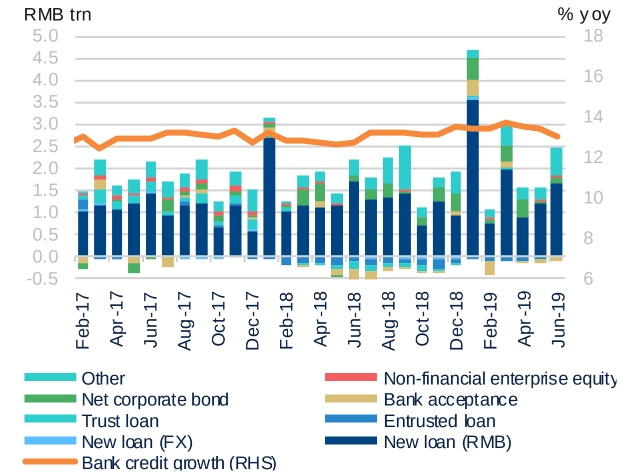
Although the total credit has increased in Q2, some structural problems still existed. First, corporate long-term lending which is deemed to be the driving force of corporate long-term investment declined in 1H. In particular, compared with 1H 2018, long-term corporate lending's increasing declined by RMB 240 billion while short-term lending and notes financing's growth increased by RMB 1.29 trillion. Second, among the new yuan loan increasing in 1H, 37% is household's mortgage loans. The high percentage of household mortgage loan and the short-term notes financing together with low long-term financing indicated the credit is still not flowing into the real economy due to the dampened market sentiments amid unsettled trade war.

Except the problem of the credit structure, the recent takeover of Baoshang Bank also delivered an alarm call on Chinese banking system. In May, the CBIRC took control of Baoshang Bank due to the bank's serious credit risks, which we believe stem from its active involvement in shadow banking and other risk-taking activities. The move highlights the long struggle of some smaller regional lenders in China, which suffer from deteriorating asset quality, inadequate capital buffers, and poor internal controls and corporate governance. It is reported that another regional bank, Hengfeng Bank, is suffering the similar problem and could become the next target of the authorities' takeover. Given that Hengfeng bank ranks 20th in terms of its asset, more repercussions are anticipated if it materializes.

The outbreak of Baoshang Bank takeover sent a shock through the interbank market, it has caused jitters among investors about the health of China's banks, especially among the small banks. It is reported that 18 banks haven't report their up-to-date annual financial statement. As a result, Negotiable Certificate of Deposit (NCDs) market is now under great pressure. To react the issue, the central bank injected RMB 430 billion short-term liquidity in the week following the Baoshang bank takeover. (Figure 2.11 and 2.12)

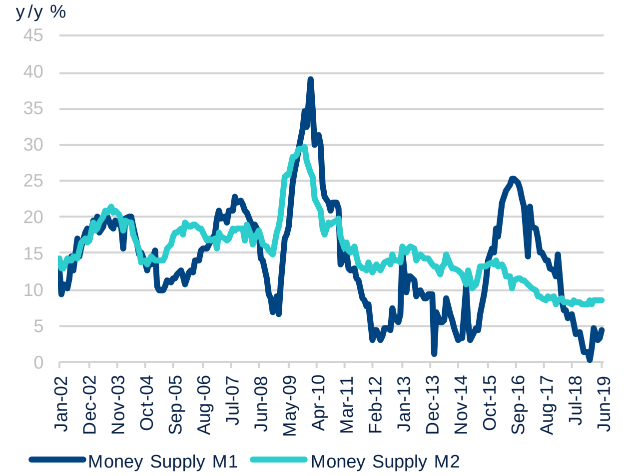
More importantly, in cleaning up the Baoshang Bank, the authorities indeed break the implicit guarantee for financial institutions. To China's giant financial system, it constitutes a regime change. It remains to be seen how Chinese financial institutions find a new way to survive with the evaporation of the government's implicit guarantee, especially amid the persistent economic downturn and ever-increasing external uncertainties.

Figure 2.9 **TOTAL SOCIAL FINANCING AND NEW YUAN LOANS INCREASED**



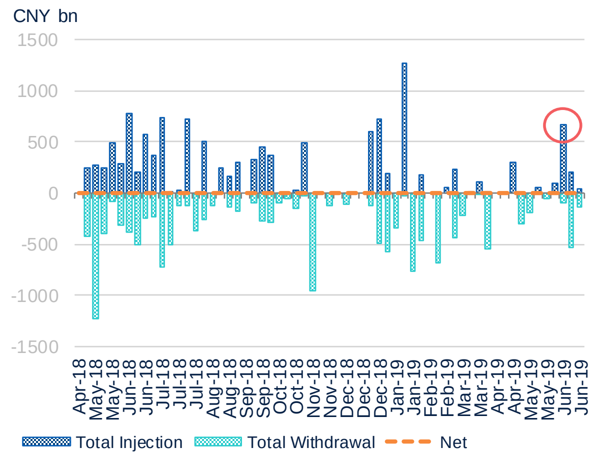
Source: BBVA Research and CEIC

Figure 2.10 **BOTH M1 AND M2 WERE BOOSTED BY PRO-GROWTH MEASURES**



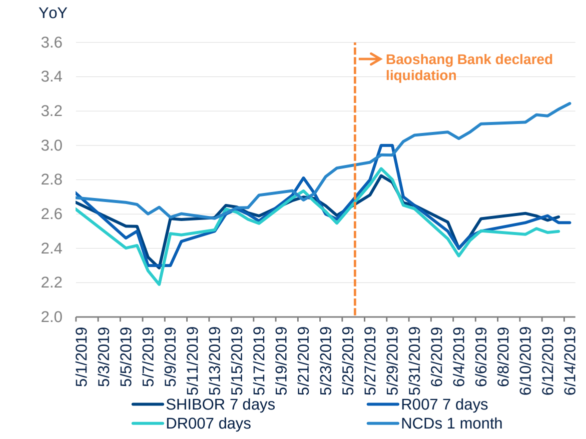
Source: BBVA Research and CEIC

Figure 2.11 **CHINA PBOC WEEKLY OPEN MARKET OPERATION AND ITS REACTION TO BAOSHANG BANK EVENT**



Source: BBVA Research and CEIC

Figure 2.12 **SOLVENCY RISK IS RISING AMONG SOME SMALL CITY AND RURAL COMMERCIAL BANKS**



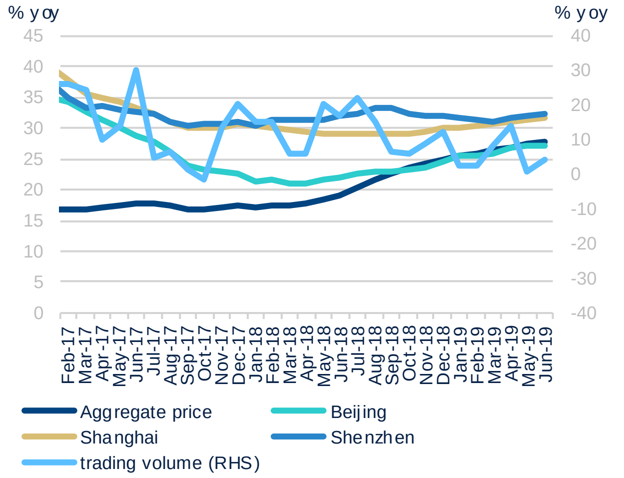
Source: BBVA Research and CEIC

Housing prices were boosted by easing measures

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. Under this circumstance, property investment resumed its momentum again in Q2.

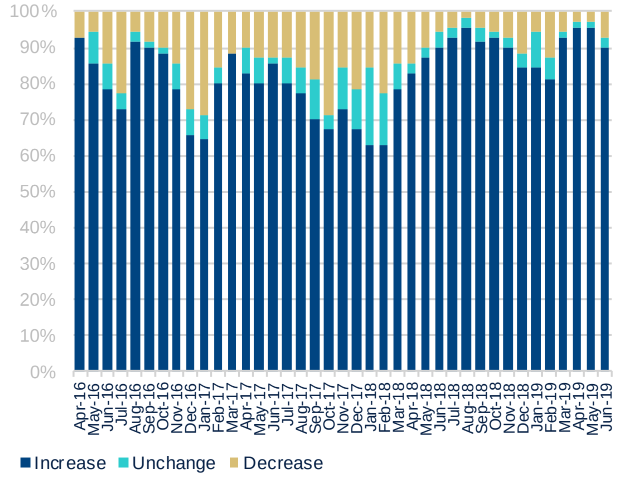
The housing market became active again in Q2. Aggregately, more cities reported year-on-year increase on their housing prices than that of in Q1. Specifically, there are 67 cities reported housing price increasing in both April and May and 63 cities in June (compared with 59, 57 and 65 in January to March). 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 added to policymakers' concern of asset bubble and could further hinder the authorities' from doing more policy easing. (Figure 2.13 and 2.14)

Figure 2.13 **BOTH THE HOUSING PRICES IN TIER-1 CITIES AND THE TRANSACTIONS IMPROVED**



Source: BBVA Research and CEIC

Figure 2.14 **MORE CITIES REPORTED HOUSING PRICE INCREASING IN Q2 THAN THAT OF Q1**

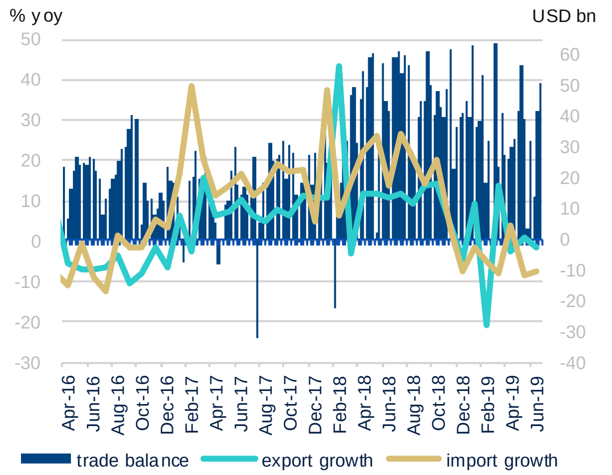


Source: BBVA Research and CEIC

Volatile external sector and a weak RMB exchange rate

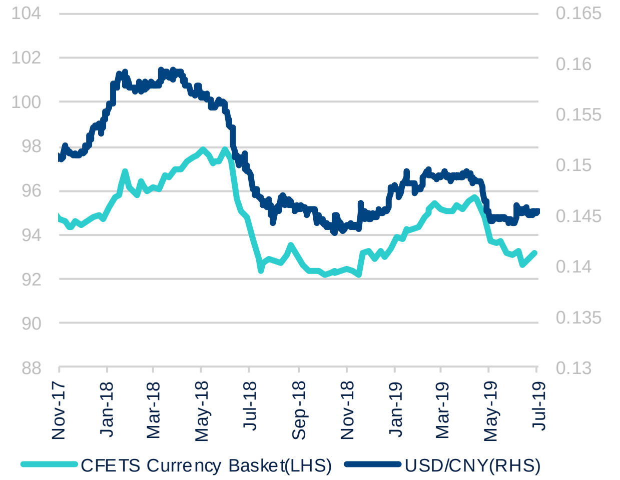
Chinese exports slowed significantly in the second quarter. Bundling up exports value of the three months of Q2 together, we find that exports value declined by 1.5% y/y amid the strong headwinds stemming from the reignite of China-US trade war as well as the faded effect of VAT rebate distortions. Moreover, imports growth dipped as well due to the weak domestic demand. In particular, imports growth in Q2 decelerated to -3.9%. (Figure 2.15)

Figure 2.15 **EXPORTS SLOWED SIGNIFICANTLY DUE TO REIGNITE OF TRADE WAR**



Source: BBVA Research and CEIC

Figure 2.16 **RMB APPRECIATED AFTER THE TRUMP-XI MEETING**



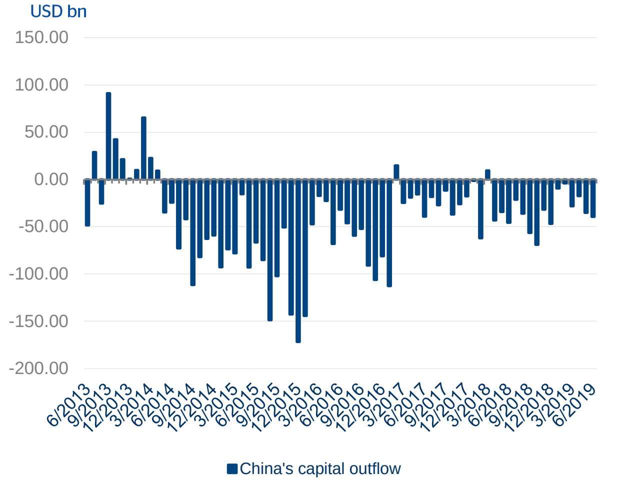
Source: BBVA Research and CEIC

The RMB exchange rate experienced an appreciation by 1.2% accumulatively right after the Trump-Xi meeting in G20 and then became stagnant within a narrow range centering on 6.85-6.9 from Trump-Xi meeting to now. The RMB exchange rate this year heavily depends on the China-US trade talk progress. In our baseline scenario, if two countries could reach a deal in the 2H, which we assign 2/3 possibility, we predict that the RMB exchange rate will appreciate to 6.7 at end-year. In our risk scenario, two countries failed to reach a deal (with 1/3 possibility), the RMB exchange rate is forecasted to hit 7 at end-year. (Figure 2.16)

Capital outflows accelerated but still manageable

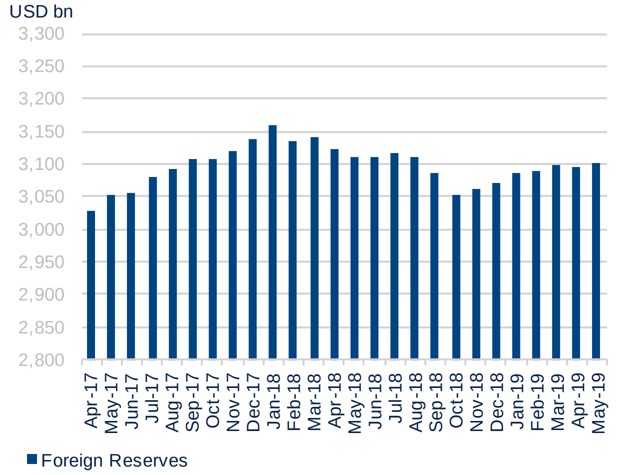
Thanks to the authorities' tenacious efforts to push for the opening of China's domestic capital market, China's equity and bond market was included in MSCI Emerging market Index and Bloomberg-Barclay Index in the first quarter of this year. It means that many passive investors around the world have 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. However, on the other hand, given that the trade war has still unsettled, market sentiments remain weak. Based on our capital outflow estimation model, the June outflow reached RMB 39.45 billion, larger than the May's outflow of RMB 35.25 billion. The accelerating capital outflow is mostly due to the expanding trade surplus in June (June: USD 50.98 billion; May: USD 41.73 billion). Thus, the capital outflow is still manageable at the current stage due to the authorities' capital control measures and a series of policies to attract capital inflows. (Figures 2.17) Accordingly, foreign reserves steadily increased to USD 3,119.03 billion in June from USD 3,101 billion in May. (Figure 2.18)

Figure 2.17 **CAPITAL OUTFLOWS INCREASED IN Q2 BUT STILL MANAGEABLE**



Source: BBVA Research and CEIC

Figure 2.18 **FOREIGN RESERVE MAINTAINS IN Q2**



Source: BBVA Research and CEIC

3. Growth still searching for a bottom

We maintain our baseline growth projections at 6% for 2019

The better-than-expected economic growth in the first half of 2019 seems transitory. The renewed trade war with the US in Q2 is likely to exert adverse effects on China's economy over the medium-long term. Moreover, a number of domestic structural factors will continue to weigh on the growth. These growth headwinds are likely to offset the good data outturns in the first half of the year and drag the full-year growth toward our projections of 6.0% and 5.8% for 2019 and 2020 respectively. (Bloomberg consensus: 2019 GDP: 6.2%; 2020 GDP: 6%; the authorities' target: 6-6.5%)(Table 3.1)

Apparently, the main source of uncertainties surrounding China's economic prospect in 2H remains the unsettled trade war with the US. After the unanticipated escalation of trade dispute early May, the two sides reached a truce again after their national leaders met at Osaka G20 meeting at end-June. However, altercations continued between senior officials of both sides even in the aftermath of the G20 meeting, which raised people's doubt about whether they can achieve any deal in the remainder of the year.

According to the development of the US-China trade dispute our base scenario assumes that the truce between these two giant economies can be maintained through the rest of the year. It means that the US continues to impose 25% punitive tariffs on Chinese exports of around USD 250 bn while it won't extend the punitive tariffs to the rest of Chinese exports of around USD 300 bn.

There exists a upside surprise to our base scenario that a deal is reached by China and the US so that part or all the tariffs on Chinese exports are to be lifted. We would like to argue that there is only minor difference between the truce and the lift of tariff. Firstly, we expect that the breakup and bifurcation of global supply chain in high-tech sector is unavoidable after the US administration put a number of Chinese companies on their black list in early May and banned their US suppliers from selling key components to them. That means that the confrontation of these two countries in the high-tech sector will persist regardless of whether they manage to find a way to solve the current tariff dispute. It will have significant implications for China's growth in the long run. (See our previous China Economic Watch: Gauging the impact of US trade war on China: an input-output table analysis)

Secondly, President Trump's recent tariff threat to Mexico has demonstrated that a trade deal with China might not be binding at all. Now, a trade deal with the US seems insufficient to convince many Chinese producers not to move their production to other countries to avoid further punitive tariffs from the US.

In sum, some long-term damages to China's economy have been made and appear to be irreversible regardless of whether a trade deal is to be signed. As such, the only difference between the cases of signing a deal and maintaining the truce is equivalent to the pure impact of 25% tariffs on Chinese exports of USD 250 bn, which, according to our previous calculation, is very limited.

Policy focus shifts to strengthen transmission channel

On the policy front, China's authorities have already deployed a flurry of monetary and fiscal easing initiatives to offset domestic and external headwinds since the second half of 2018. These measures mainly include monetary easing measures such as RRR cut, lowering the market lending rates (such as DR007, lending prime rate, etc.) and facilitating Small and Medium Enterprises (SMEs) financing. On the other hand, fiscal easing measures include a series of tax cut on both corporate and personal income, expanding local government bond issuance, allowing local government special bonds to be used as equity for projects and planning to issue Special Construction Bond (SCB) to support infrastructure investment etc.

Despite the authorities' stepped-up efforts to support growth, the problem of policy transmission channel has become acute. In particular on the front of monetary policy, although the central bank has injected ample liquidity to the interbank market through various programs, banks' worsening risk appetite have prevented them from transmitting lowered financing costs to the borrowers in the economy. The high-profile takeover of Baoshang Bank has aggravated the situation as smaller banks and non-banking financial institutions found it increasingly difficult to obtain funds from the interbank market. As these smaller banks and non-banking financial institutions used to be important fund sources of SMEs, their fund squeeze will inevitably dent small borrowers.

Given the intensifying headwinds to growth emanating from the souring China-US trade relation and structural obstacles, the authorities need to make further efforts to boost the flagging economy. In the meantime, the authorities don't want to over-stimulate the economy through debt borrowing which could add long-term risks to China's financial stability. Therefore, strengthening transmission channel of monetary policy will be given higher priority in the second half of the year since it is to maximize the effects of implemented initiatives. In this respect, the authorities could consider applying certain regulatory forbearance to incentivize banks to extend credit to the real economy. Moreover, the authorities can help banks to replenish their capital so as to increase their capacity to absorb loss relating to the lending to SMEs.

On top of above measures, the authorities could consider the use of policy rate tool to boost the economy. In this respect, we predict that the policy rate, in particular the benchmark lending rate since it is directly linked to borrowers' financing cost (see our previous China Economic Watch: Putting the final piece into the new monetary policy framework: timing is the key), might be cut by 50 bps in the second half of the year. It is possible that the authorities might take the chance to optimize its framework of monetary policy conduct. In so doing, the authorities could establish a new benchmark policy rate and then lower its level.

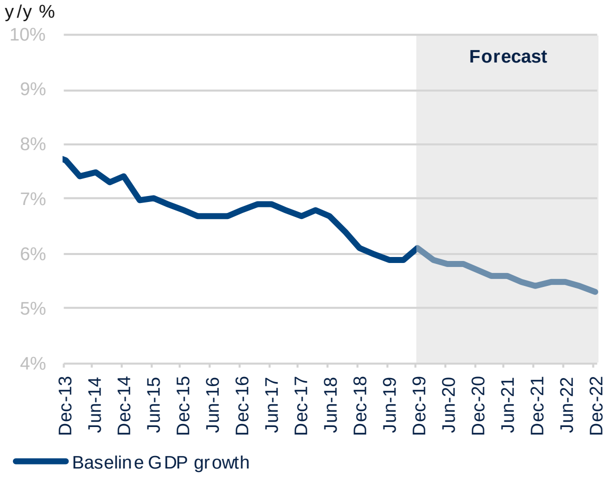
Inflation pressure is manageable despite the run-up of pork prices

In the second half of 2019, CPI is expected to trend up gradually mainly as the food-prices rebound significantly from the previous level mostly due to the recent outbreak of African Swine Fever (ASF) in China.

However, we believe that the general price level is still manageable in the following perspectives: First, the announced cuts in VAT will have downward pressure on general price level. Second, the deceleration of Production Price Index (PPI), currently at the 0% y/y growth rate, could offset the food price run-up as the industrial related prices declined. There could be pass-through effects from the weak PPI to non-food prices as Chinese authorities have downplayed the previous de-leveraging campaign amid growth slowdown. Third, amid economic slowdown, the uncertainties of US-China trade war etc. might exert downward pressure on wage price and people's willingness to spend, leading to inflation declining to offset the rocketing pork price.

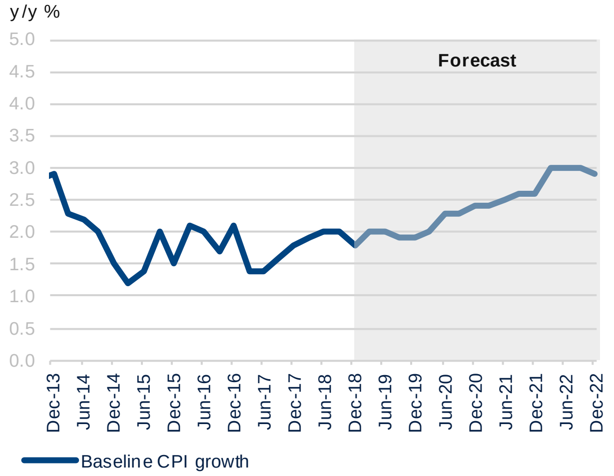
On balance, we maintain our CPI prediction of this year at 2.3% and 2.5% for 2020 (Bloomberg consensus: 2019: 2.3% and 2020: 2.3%). (Figure 3.2)

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 MAINTAIN OUR 2019 CPI PREDICTION AT 2.3%**



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	-0.1	-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

US-China relation outlook after Xi-Trump meeting in G20

Uncertainties regarding the bilateral negotiation still abound. China has hardened their stance on many trade related issues. Moreover, China's domestic propaganda machine has been mobilized to criticize the US over the past couple of months. Any significant concession to the US could incur domestic criticism. More importantly, China's authorities are fully aware of the risk that President Trump might not successfully secure his second term. As such China's leaders might be reluctant to use their own political capital to reach a transitory deal with the current US administration.

Regarding China's strategy in the second half of the year, China will become more assertive in the bilateral negotiation with the US. Meanwhile, China will closely watch the development of US domestic politics and adjust their strategy on an ongoing basis. China might even accept certain intermittent solution to deliberately prolong the process. For example, China might agree to meet certain request as long as the US lifts part of its punitive tariffs imposed on China. For the positive side, China could proactively and voluntarily tiptoe toward some US requests of market opening and IP protection since China's authorities accept the notion that these measures are also in China's own interest in the long run. Self-propelled reforms in these aspects will also help to minimize domestic pressure once a trade deal is made with the US.

The RMB exchange rate: market forces give way to policy dominance

The RMB exchange rate seems to reflect the Xi-Trump meeting in G20 positively so far. The CNY to USD exchange rate appreciated by 1.2% accumulatively right after the two presidents' meeting at end-June. We maintain our RMB to USD exchange rate prediction at end of this year at 6.7 in our baseline scenario.

The prospective combination of “deficit current account” and “two-way fluctuation of capital account” makes it challenging to maintain RMB exchange rate stability in the future. The shrinking of current account, mainly led by a declining trade surplus, together with a fluctuating capital account, will give more uncertainties to China's foreign reserve. (See our recent Economic Watch: China| When its current account turns deficit…)

Under this circumstance, Chinese authorities are likely to develop more new tools to maintain the exchange rate stability until they find a solution to end the trade dispute with the US. That being said, the RMB exchange rate is likely to fluctuate within a narrow range of 6.6-7 in the next six months. Of course, in the risk scenario of further escalation in trade dispute, the RMB to USD exchange rate might easily hit 7.

4. Risks are still to the downside

Despite better-than-expected GDP outturns in Q2, the growth stabilization could prove to be illusory and transitory if the eased tensions between China and the US are to escalate again in the second half of the year. Moreover, a number of domestic financial vulnerabilities and structural changes could weigh on growth and, under certain circumstance, even pose a material threat to the financial stability.

First, as discussed in the previous section, we assigned a one-third probability to the no-deal scenario in the second half of the year. Under this adverse scenario, the US administration could escalate their tariff actions by imposing additional tariffs on the Chinese imports of USD 300 billion which are not subject to punitive tariff yet. Or the US administration pushes the existing 25% tariff rates on certain Chinese imports to a higher level to increase pressure on China. The trade tensions could also spread to other areas and lead to more confrontations in high-tech sector, financial system and even geopolitics. Altogether, all uncertainties surrounding the trade issue between China and the US could have significant impact on market sentiments, asset prices and economic performance.

Second, China's declining exports due to the trade war suggest that the country's long-lasting current account surplus might turn deficit this year. The ongoing US-China trade tensions, the continuing expansion of service trade deficit, as well as the shrinking saving-investment gap due to aging population are all contributing to this profound change. It is set to bring new challenges to Chinese policymakers in maintaining domestic financial stability and pushing forward necessary financial liberalization reforms. (See our recent China Economic Watch: China| When its current account turns deficit…)

Third, the recent takeover of Baoshang Bank is an alarm call on Chinese banking system. In May, the CBIRC will take control of Baoshang Bank due to the bank's serious credit risks, which we believe stem from its active involvement in shadow banking and other risk-taking activities. The move highlights the long struggle of some smaller regional lenders in China, which suffer from deteriorating asset quality, inadequate capital buffers, and poor internal controls and corporate governance. It is reported that another regional bank, Hengfeng Bank, is suffering the similar problem and could become the next target of the authorities' takeover. Given that Hengfeng bank ranks 20th in terms of its asset, more repercussions are anticipated if it materializes.

More importantly, in cleaning up the Baoshang Bank, the authorities indeed break the implicit guarantee for financial institutions. To China's giant financial system, it constitutes a regime change. It remains to be seen how Chinese financial institutions find a new way to survive with the evaporation of the government's implicit guarantee, especially amid the persistent economic downturn and ever-increasing external uncertainties.

All in all, we still believe that China's authorities have adequate policy buffers to maintain the financial stability in the face of intensifying challenges. Nevertheless, any small policy missteps through this process could cost the financial sector dearly.

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Creating Opportunities

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