

China Economic Outlook

First Quarter 2020

Hong Kong, January 2020



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Closing date: January 22, 2019

1. Decreased uncertainty paves the way for stabilizing global growth

The easing of trade tensions between the US and China, and the disappearance of the risk of a disorderly Brexit in the short term (though still existing for late 2020) have contributed to a fall in economic uncertainty. This has paved the way to curb the slowdown in growth and stabilize the global economy, even though protectionism will continue to affect world trade, and the geopolitical and structural risks remain high. In addition, the stabilization prospects for global growth have been bolstered by the relative strength of activity in the US and by the upward surprises in growth data in China and in the Eurozone. Similarly, **economic policy has continued to support activity, and will continue to do so in the coming quarters, at least in the major world economies.** After recent monetary stimulus measures, both the US Federal Reserve and the ECB are expected to keep interest rates at current low levels for a prolonged period of time, while China will take additional fiscal and monetary stimulus steps. Greater optimism about the global environment has also led to a clear improvement of financial markets. As a result, following a steady worsening in the outlook for the global economy throughout 2019, **growth forecasts for China and the Eurozone are now being revised slightly upward, while prospects for gentle moderation in the US continue.**

Global environment: a more positive tone in recent months, following the decline seen in much of 2019

2019 was a year marked by a slowdown in growth worldwide. According to BBVA Research estimates, the world economy grew by 3.2% over the year, the lowest rate since 2009 (between 2010 and 2018, the average expansion of global GDP was 3.8%), and 0.4 percentage points below 2018 growth.

The decrease in growth in 2019 was largely due to the structural slowdown of the Chinese economy and the cyclical moderation in the US, especially after the effects of the fiscal stimulus adopted in 2018 faded. The escalating protectionism added to these factors and helped to drive global growth downwards. Investment and exports weakened, in contrast to the relatively strong performance of private consumption, bolstered by the relative strength of labor markets, low inflation and counter-cyclical policies adopted in the main regions.

Economic policy has played a key role in mitigating risks. The fiscal stimulus launched in China and, to a lesser extent, in the Eurozone and, above all, the Fed's monetary stimulus prevented further moderation of growth in 2019. In addition, these measures were fundamental to limiting volatility in financial markets.

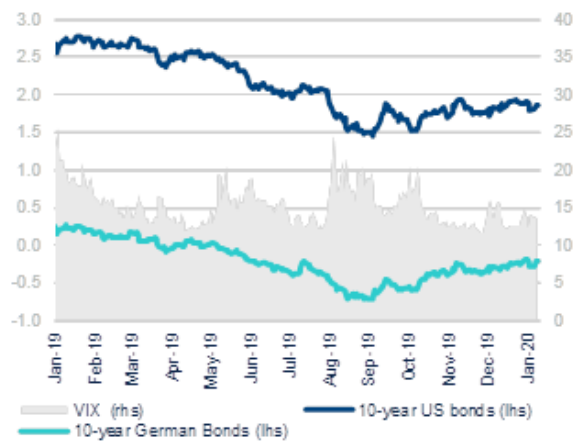
Despite the complexity of the economic and geopolitical context, some positive news in recent months have helped to clarify the picture. Notably, they include an **improvement in the tone of conversations between the US and China, which have reached a "phase one" trade deal.** The US has agreed not to impose new tariffs and to halve those introduced in September of last year (on USD 120 billion of Chinese exports), while China has agreed to increase purchases of goods produced by the US (mainly agricultural products) and has promised better protection of intellectual property rights, among other measures.

The agreement itself does not significantly reduce tariffs. China's average import rate for US products will remain at around 21% (compared to 8% at the start of 2018), while the average tariff levied by the US on Chinese products will only fall from 21% to about 19% (compared to around 3% just two years ago). **In addition, there are risks related to the implementation of the announced measures, and a permanent solution to the structural and technological issues still seems far off. However, it is good news that, at least temporarily, changes the negative dynamics of relations between the two countries and can strengthen the confidence of economic agents.**

The trade agreement between the US and China, progress made toward resolving Brexit, US economic data, and the upward surprises in growth in China and the Eurozone have generated some optimism in financial markets, despite recent concerns about the rise in geopolitical tensions between the US, Iran and Iraq. Thus, financial volatility has declined, sovereign debt yields have rebounded (see Figure 2.1), the stock markets are trending upwards, and the appetite for risk has grown, which in turn has favored some emerging markets' assets.

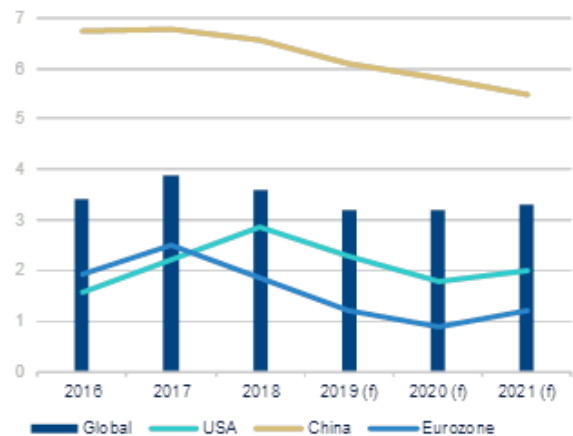
Recent developments have also prompted both the Fed and the ECB to keep their benchmark interest rates steady in recent months (at 1.7% and -0.50%, respectively), rather than announcing additional cuts.

Figure 2.1. **SOVEREIGN DEBT YIELDS AND STOCK VOLATILITY (%)**



Source: BBVA Research based on Haver

Figure 2.2. **GLOBAL GDP GROWTH: 2016-2021 (%)**



(f) Forecast.
Source: BBVA Research

After growing 3.2% in 2019, the global economy will expand 3.2% in 2020 and 3.3% in 2021, less than in previous years

After slowing its pace in 2019, global growth is likely to remain at 3.2% in 2020 and to gradually accelerate to around 3.3% in 2021. While the strategic rivalry between the US and China will continue to generate tensions, and other regions may be affected by new protectionist measures, global uncertainty is expected to remain lower than in 2019, enabling the global slowdown process to end. These growth forecasts are also dependent upon keeping geopolitical tensions in check, in addition to other risks threatening the world economy. Specifically, the BBVA Research scenario assumes that recent tensions between the US, Iran, and Iraq will have no permanent negative impact on the global environment. In particular, oil prices are expected to stabilize at about USD 61 per barrel over the next two years, below the average value recorded in 2019 (USD 64) or the current price (USD 68). This expected reduction in crude oil prices is based on a gradual improvement in global demand and a forecast increase in supply from non-OPEC countries. Should an escalation of instability in the

Middle East drive oil prices up to USD 70 a barrel and keep them at these levels throughout 2020, global growth over the next biennium could be undermined by between one and two tenths, with Europe suffering the greatest impact.

The prospects for stabilization are likewise backed by the view that economic policy will continue to support activity in most regions. Specifically, in a setting of limited inflationary pressures, **both the Federal Reserve and the ECB are expected to maintain current rates throughout 2020 and 2021**, although additional stimulus measures cannot be ruled out in either case in the event of further decline of the outlook, nor are rate hikes out of the question in the US if inflation rises more than expected. Furthermore, fiscal policy will act as a stimulus in the Eurozone and, primarily, in China, where there will be more public investment in infrastructure than expected three months ago. This will be compounded by the Chinese central bank's monetary expansion measures, although they will be limited by the recent rebound, largely temporary, in inflation. Thus, official interest rates are forecast to drop in the coming months, from 4.1% to 3.9% and bank reserve requirements are expected to fall again.

In the US, prospects remain for a slight slowdown toward near-potential growth rates: after 2.9% growth in 2018, the economy grew 2.3% in 2019 and will expand by about 1.8% in 2020 and 2.0% in 2021 (see Figure 2.2). Thus, the growth cycle that began in 2010 will continue, in a setting in which political upheaval could increase with the November 2020 presidential elections, despite the risk of recession, which, at any rate, has shrunk in recent months.

In China, the economy will continue to slow down moving forward, but at a more pace than previously expected. Specifically, forecasts point to a growth rate of around 5.8% in 2020, three tenths lower than in 2019, and 5.5% in 2021. The improvement in the forecast for 2019 (+0.1pp) is due to the fact that growth slowed somewhat less than expected in recent months, while the adjustment of the 2020 forecast (+0.2pp) was prompted by the agreement with the US and the improved outlook for the future relationship between the two economies, as well as the decision to intensify the use of fiscal policy as a stimulus tool for activity. In any case, the risks associated with a disorderly deleveraging of the economy continue to exist.

Growth forecasts for 2019 and 2020 have been revised slightly in the Eurozone. After ending 2019 with a 1.2% (+0.1pp) increase, growth is expected to reach 0.9% (+0.1pp) in 2020 and 1.2% in 2021. The positive surprises in activity indicators in recent months, as well as the eliminated risk of a no-deal Brexit at the end of January, have contributed to the upward revisions, although this risk could increase in late 2020.

2. Growth modestly recovered at end-2019

The 2019 Q4 GDP growth came out at 6.0% y/y, flat with the previous month's reading and Bloomberg consensus. The 2019 whole year GDP growth reached 6.1%, the lowest growth rate for the past three decades, but it is within the authorities' growth target of "6-6.5%". On sequential term, the economy grew by 1.5% q/q, flat with that of Q3 and higher than the market consensus at 1.4% q/q. That means, Chinese economic growth has slightly recovered in the last quarter of 2019, although it continued its medium-to-long term slowdown trend amid unsettled trade war and domestic structural obstacles.

There are several positive factors for the current round of growth recovery. Chief among them is the signing of China-US phase-one trade deal which achieved a temporary truce for the ever-escalating China-US trade war. Other pro-growth tailwinds include: (i) the temporary truce of China-US trade war might substantially improve domestic confidence of both producers and consumers; (ii) the previously implemented stimulus measures, in particular the RMB 2 billion tax cut in 2019, have started to take effect; (iii) the stabilization of global economy, together with the reduced US tariffs contained in the phase-one trade deal, has lent more support to China's export sector.

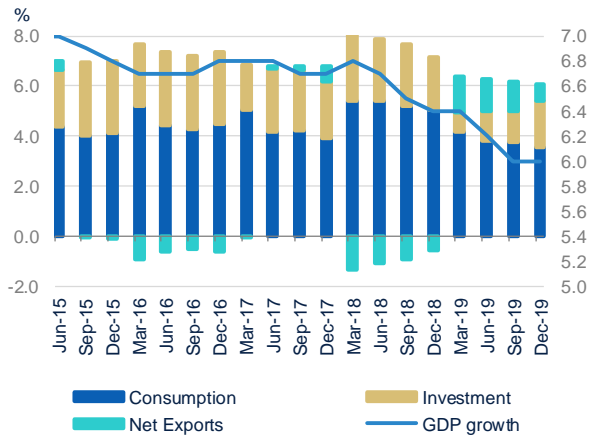
Besides these tailwinds above, the authorities have implemented a series of easing monetary and fiscal measures starting from 2H 2018 to avert growth slowdown. On monetary policy side, the main monetary easing measures in 2019 include two RRR cuts, lowering the LPR by three times to 4.15% at end-2019 and facilitating Small and Medium Enterprises (SMEs) financing. Fiscal easing measures include RMB 2 trillion tax cut package, special-purpose local government bond of RMB 2.15 trillion to provide funds for local governments to expand infrastructure projects, and allowing local government special bonds to be used as equity for projects, etc. On balance, the policy easing measures in this round are accommodative but quite measured, which means the authorities are striking a balance between stimulating growth and maintaining the debt level.

However, more uncertainties might happen in the second half of this year as the US presidential campaign is bound to heat up toward the November election, which could be compounded by the progress of trade talks in next stages. Moreover, China is still subject to a series of domestic structural problems such as serious overcapacity in certain industries, the indebtedness of the corporate sector and the shrinking room of monetary and fiscal policy. All of them will exert certain downward pressure on China's growth going forward.

The modest recovery at end-2019 is broad-based

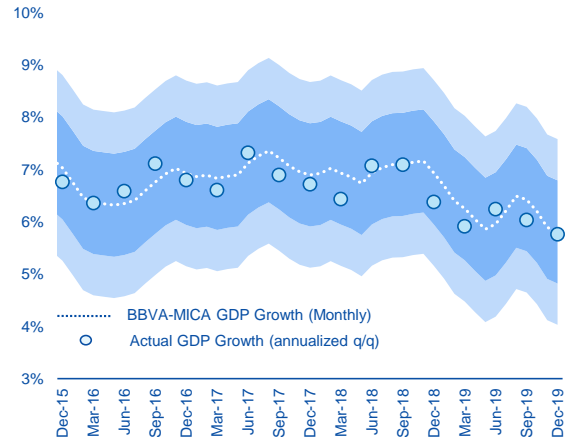
The 2019 Q4 GDP growth came out at 6.0% y/y, flat with the previous month's reading and Bloomberg consensus. The 2019 whole year GDP growth reached 6.1%, the lowest growth rate for the past three decades, but it is within the authorities' growth target of "6-6.5%". On sequential term, the economy grew by 1.5% q/q, flat with that of Q3 and higher than the market consensus at 1.4% q/q. Our BBVA MICA model yields an estimate of 6.1% y/y in the fourth quarter based on a series of high frequency data (compared with 6% estimation for Q3), in line with the growth recovery. (Figure 2.1 and 2.2)

Figure 2.1 **GDP GROWTH RATE IN Q4 2019 REMAINED AS OF Q3**



Source: BBVA Research and CEIC

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

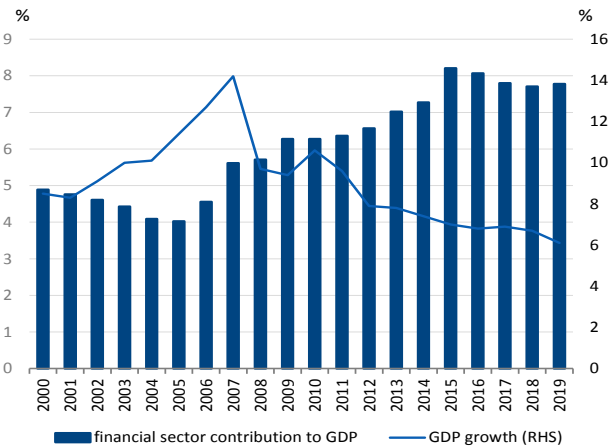


Source: BBVA Research and CEIC

By category, for Q4 2019, the contribution of consumption to GDP growth reached 3.53%, slightly lower than the previous quarter's reading at 3.75%, 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 1.23% in Q3 to 1.9%. However, the contribution of net exports to GDP decreased to 0.67% from 1.22% in Q3, due to the faded effect of exports front-loading behavior.

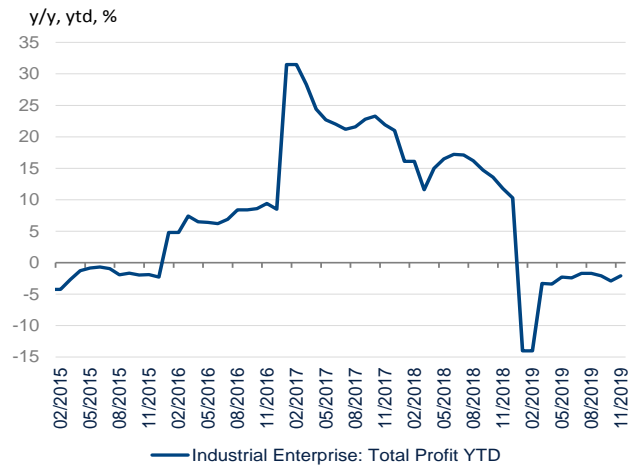
Regarding the growth quality, it to some degree deteriorated in 2019. In particular, financial sector's growth rate reached 9.2% in 2019 from 8.9% in 2018, while its contribution to GDP increased to 7.8% in 2019 from 2018 reading at 7.7%, which reflects that the size of financial sector is expanding while of real activities is shrinking. Actually, in the past years, financial sector's contribution to GDP has been increasing over time while GDP growth has been declining. Meanwhile, firm profit decelerated significantly in 2019 to -2.1% ytd y/y (Jan to Nov 2019) from 10.3% ytd y/y at end-2018. (Figure 2.3 and 2.4)

Figure 2.3 **FINANCIAL SECTOR'S CONTRIBUTION TO GDP HAS BEEN INCREASING OVER TIME...**



Source: BBVA Research and CEIC

Figure 2.4 **...WHILE FIRM PROFIT HAS BEEN DECLINING**



Source: BBVA Research and CEIC

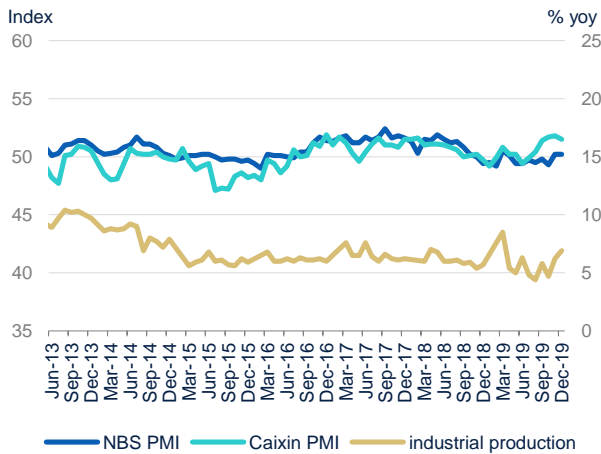
The economic recovery is broad-based in December as all of the economic indicators are better than the previous readings and the market consensus.

The performance of the supply side recovered after the US-China announced the accomplishment of long-awaited phase-one deal, rebuilding the producers' sentiments. Regarding the PMI surveys, the NBS PMI, which tilts towards large and medium size SOEs, remained at the previous level of 50.2 which is above the watershed level of 50. Meanwhile, Caixin PMI whose sample tilts toward SMEs, although decelerated marginally from 51.8 to 51.5 in December, it is still above the watershed level. Industrial production surprisingly rebounded to 6.9% y/y in December from 6.2% y/y in the previous month (consensus: 5.9% y/y). (Figure 2.4)

On demand side, the growth of retail sales in December remained at 8% y/y as of the previous month. (Figure 2.5) In particular, the auto sales growth picked up from its previous negative growth to 1.8% y/y in December, reflecting the gradual recovery of auto market after it reached the trough in 2019 due to the faded effect of previous auto tax cut. The online shopping growth still maintained its momentum, reaching the fast speed of growth at 19.5% y/y for 2019, compared with 19.7% ytd y/y for November.

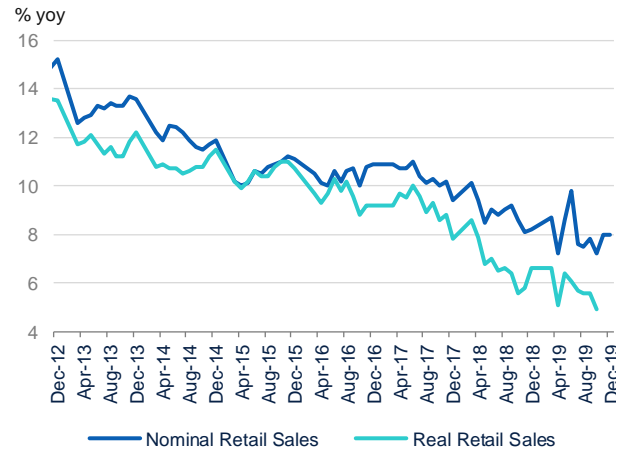
Performance of fixed asset investment also picked up in December, increasing to 5.4% ytd y/y from 5.2% ytd y/y in the previous month (Bloomberg consensus: 5.2% ytd y/y). Manufacturing investment picked up to 3.1% ytd y/y from 2.1% ytd y/y in the previous month, indicating that the phase-one deal with the US helped the recovery in confidence to stimulate producers to expand their capacity. At the same time, the authorities' easing efforts have boosted the investment in the property sector and infrastructure sector. In particular, the growth rate of infrastructure investment rebounded to 3.3% ytd y/y in December, while real estate investment remained at a comparatively high level at 9.4% ytd y/y in November. (Figure 2.6 and 2.7)

Figure 2.4 **PMI ABOVE THE WATERSHED LEVEL OF 50 WHILE IP REBOUNDED**



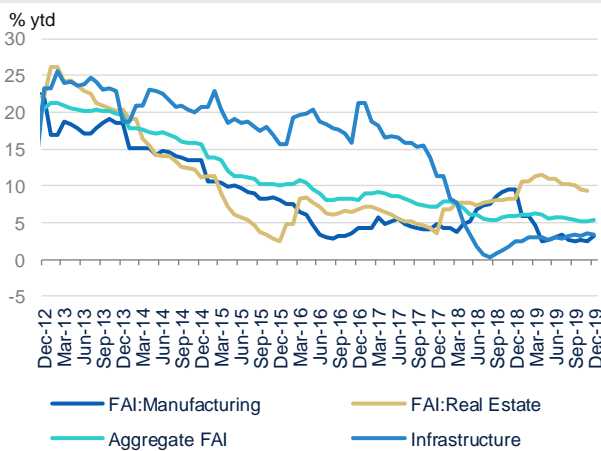
Source: BBVA Research and CEIC

Figure 2.5 **RETAIL SALES GROWTH REMAINED AS OF THE PREVIOUS MONTH**



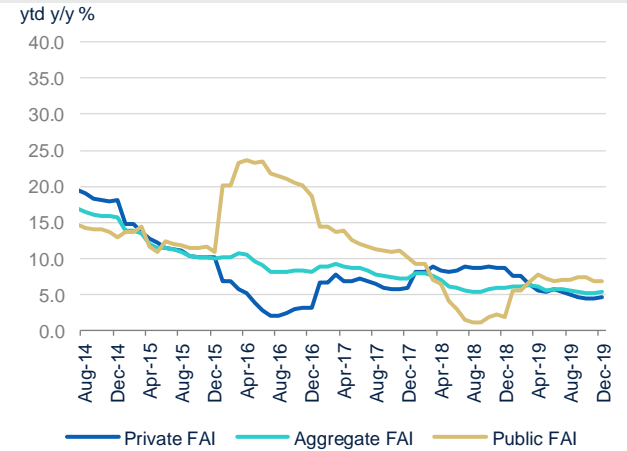
Source: BBVA Research and CEIC

Figure 2.6 **FAI ALSO PICKED UP FROM THE PREVIOUS READING**



Source: BBVA Research and CEIC

Figure 2.7 **...WHILE INVESTMENT WAS BOOSTED MOSTLY BY PUBLIC INVESTMENT**



Source: BBVA Research and CEIC

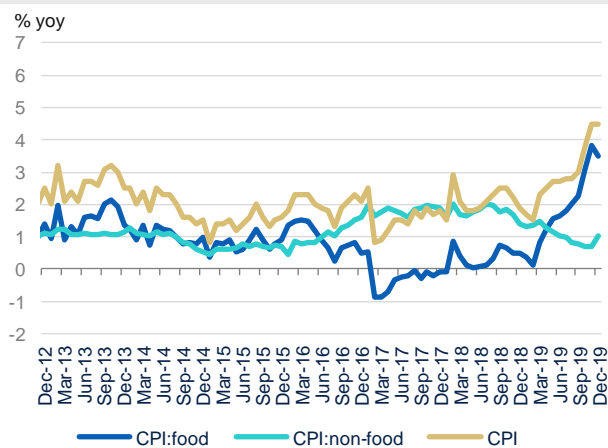
Inflation picked up on rallying pork prices

Headline CPI inflation of December 2019 came out at 4.5% y/y (consensus: 4.7% y/y), flat with the outturn in the previous month, which is the highest record since January 2012. The persistently high CPI was primarily driven by the impact of African Swine Flu (ASF) which has lasted throughout 2019. The rampant ASF led to the substantial supply reduction in pork and thereby contributed to the rise of food prices. In the meantime, PPI picked up slightly to -0.5% y/y in December from -1.4% y/y of the previous month, but still in the negative territory, in line with higher prices of oil and other raw materials in recent months.

By CPI categories, the pork price rocketed at 97% y/y in December, compared with 112% in the previous month. The only silver lining is that pork price month-on-month growth declined by 5.6%, thanks to a series of policy initiatives unveiled to control the pork price, including: (i) to release the pork reserve of supply of the central government, (ii) to increase pork imports from the US and other trade partners; and (iii) to expand hog supply etc. Other categories of CPI remained tame, i.e. the non-food price increased only by 1.3% y/y in December, with the whole year rising by 1.4%. (Figure 2.8 and 2.9)

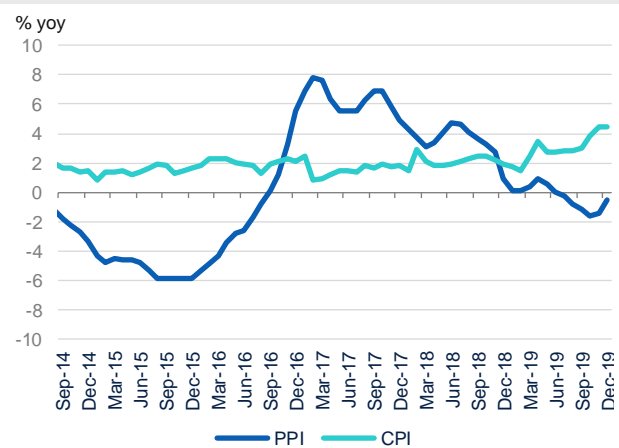
Looking ahead, we predict 2020 CPI will increase to 3.4%, with a peak in Q1 due to the low base of Q1 2019. However, due to the authorities' continuing efforts of expanding pork supply, the pork price could be eased in 2H to some degree. On the other hand, PPI inflation could rise further thanks to the up-beating global oil price and other raw materials for industries. Moreover, the authorities' hold-on of the previous deleveraging campaign amid growth slowdown will support the PPI in the short-to-medium term.

Figure 2.8 **CPI ROCKETED ON FOOD PRICES RALLY**



Source: BBVA Research and CEIC

Figure 2.9 **PPI STILL REMAINED IN THE NEGATIVE REGION**



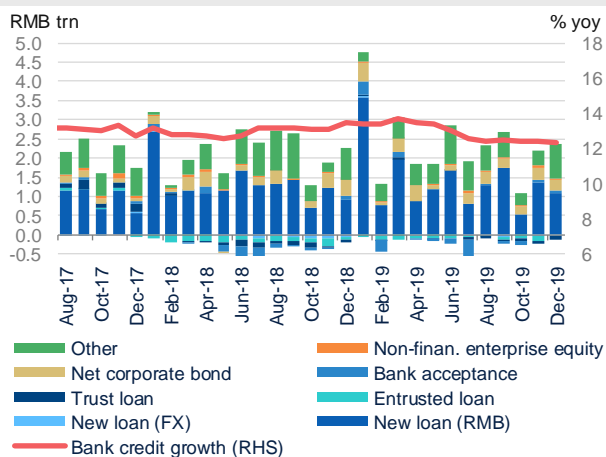
Source: BBVA Research and CEIC

Monetary easing helped to boost credit growth

In response to the growth slowdown amid the unsettled trade war with the US, the authorities unveiled a number of monetary measures to stimulate domestic demand starting from 2H 2018. More importantly, in order to solve the monetary policy transmission problem, one important move is the PBoC dropped the previous benchmark lending rate as the monetary policy rate and set the Loan Prime Rate (LPR) as the new target rate, which is expected to smooth the transmission mechanism. In 2019, the main monetary easing measures include two RRR cuts, lowering the LPR by three times to 4.15% at end-2019 and facilitating Small and Medium Enterprises (SMEs) financing.

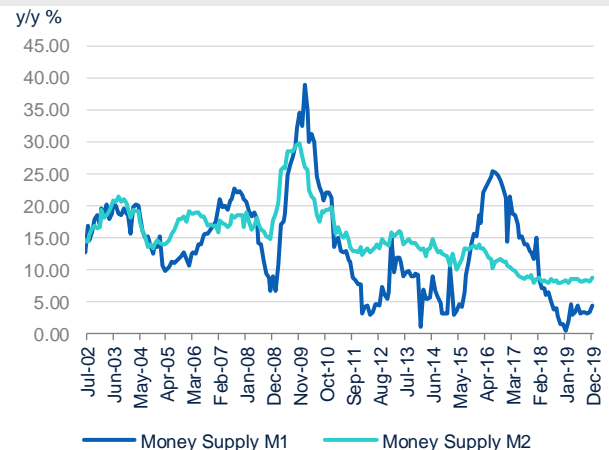
These implemented pro-growth initiatives tended to lend strong support of credit growth. In this respect, total social financing (TSF) which is a broader gauge of total credit in the economy including both bank loans and other forms of shadow banking activities registered a visible growth. In particular, total social financing accelerated from RMB 1,754.7 billion to RMB 2,100 billion (Consensus: 1,650 billion) in December, although new yuan loans decreased slightly from RMB 1,388.1 billion to RMB 1,140 billion (Consensus: RMB 1,200 billion). (Figure 2.10) Altogether, M2 growth picked up significantly to 8.7% y/y from the previous month's reading of 8.2% y/y. (Figure 2.11)

Figure 2.10 **TOTAL SOCIAL FINANCING INCREASED IN DECEMBER**



Source: BBVA Research and CEIC

Figure 2.11 **BOTH M1 AND M2 WERE BOOSTED BY PRO-GROWTH MEASURES**



Source: BBVA Research and CEIC

No expectation of large scale housing market easing measures

The authorities have still insisted the standard line that “houses are for habitation, not for speculation” and reiterated their stance of containing housing prices throughout the country in order to avoid another round of housing bubbles amid easing measures. Generally speaking, housing prices stabilized in Q4, with a slower growth rate compared with that of Q3 2019. Meanwhile, the prices varied significantly from tier-1 to tier-3 cities.

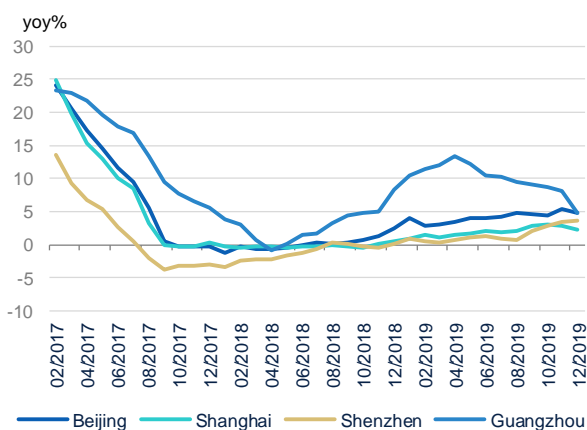
In particular, for tier-1 cities, the average of tier-1 cities’ price increased by 3.8% y/y for newly constructed commodity residential housing in December, compared with 4.9% y/y in the previous month; while for tier-2 and tier-3 cities, the price growth rate declined to 7.3% y/y and 6.7% respectively from 7.9% and 7% y/y in the previous month, but still much higher than that of the tier-1 cities.

Among the 70-city sample provided by the NBS, less and less cities reported month-on-month increase on their housing prices than that of in Q3. Specifically, there are 50 cities reported housing price increasing in December, compared with 63 cities in June and 53 cities in September, indicating a gradual housing price slowdown nationwide. (Figure 2.12 and 2.13)

The only silver lining of housing market in 2019 is the real estate investment which increased from 8.3% ytd y/y at end-2018 to 9.0% ytd y/y at end-2019. However, other key real estate indicators recorded a significant slowdown. In particular, property developer land purchases by volume, which is a leading indicator for the property sector, has slumped to -11.4% y/y ytd in 2019, a sharp contraction from 14.2% in 2018, indicating the housing market needs a longer time to bottom-out. In addition, declining residential sales, floor space started and floor space completed might indicate the real estate investment has already come to the peak and will slow soon. (Figure 2.14 and 2.15)

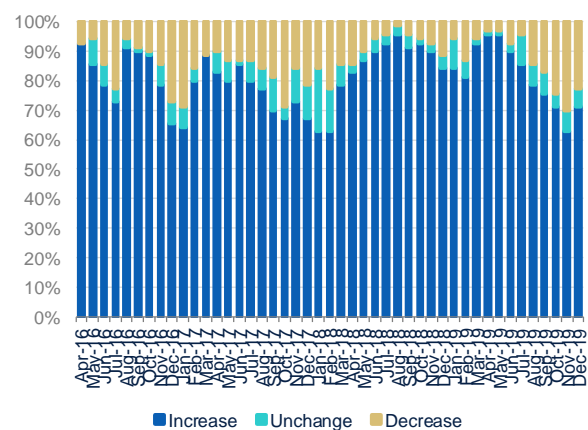
Traditionally, housing market is always a counter-cyclical adjustment tool to boost domestic demand in both related household consumption such as home appliance and investment in the property sector amid the growth slowdown. However, it adds to policymakers’ concern of asset bubbles and could further hinder the authorities from doing more policy easing. Looking ahead, we do not expect a large scale of housing market easing measures in 2020. The authorities could maintain its tightening measures for longer this time, thanks to their belief that the property sector should be tightly controlled to achieve social stability and harmony. This was made evident by Beijing’s conscious decision to exclude property markets from its current easing. Thus, the guideline of “houses are for habitation, not for speculation” will maintain in 2020.

Figure 2.12 **THE NEWLY CONSTRUCTED COMMODITY RESIDENTIAL PRICE IN TIER 1 CITIES STABILIZED IN Q3**



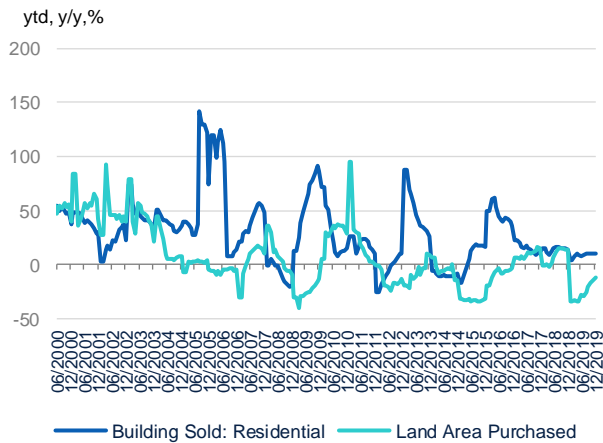
Source: BBVA Research and CEIC

Figure 2.13 **LESS CITIES REPORTED HOUSING PRICE INCREASING IN Q4 THAN THAT OF Q3**



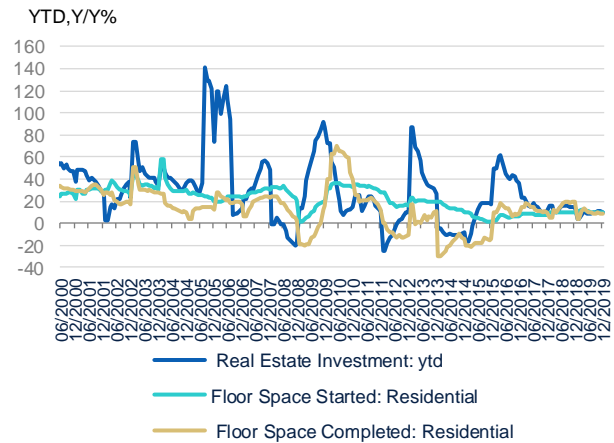
Source: BBVA Research and CEIC

Figure 2.14 **LAND SALES REMAIN NEGATIVE,**



Source: BBVA Research and CEIC

Figure 2.15 **REAL ESTATE INVESTMENT IS THE ONLY SILVER LINING IN 2019**

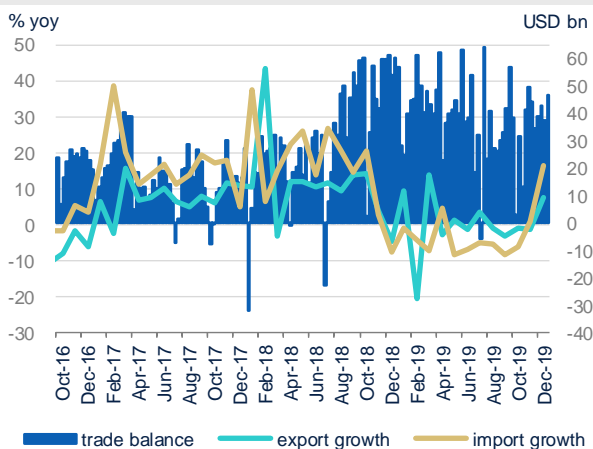


Source: BBVA Research and CEIC

Recovery of exports and imports, rocketing RMB exchange rate after the phase-one deal

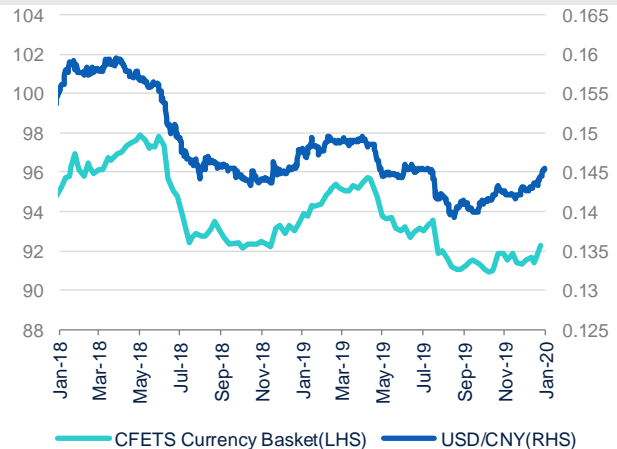
Both exports and imports recovered significantly in December due to the achievement of phase-one deal by the US and China. In particular, exports increased significantly to 7.6% y/y in December from -1.3% y/y in the previous month (Bloomberg consensus: 2.9% y/y), while imports growth also accelerated largely to 16.3% y/y from 0.8% previously (Bloomberg consensus: 9.6% y/y). Altogether, the trade balance in December expanded from USD 36.72 billion to USD 46.79 billion (Bloomberg consensus: USD 45.7 billion). The combination of recovery of both imports and exports is expected to last for the following months as the buying US products request in phase-one deal will boost imports significantly while the tariff release in phase-one deal promotes exports. (Figure 2.16)

Figure 2.16 **EXPORTS AND IMPORTS RECOVERED AFTER PHASE-ONE DEAL**



Source: BBVA Research and CEIC

Figure 2.17 **RMB APPRECIATED SIGNIFICANTLY AFTER THE PHASE ONE DEAL ANNOUNCED**



Source: BBVA Research and CEIC

The RMB to USD exchange rate has appreciated significantly right after the phase-one deal was announced in December 2019. Accumulatively, RMB to USD exchange rate appreciated by 4%, from the peak at 7.18 in September to 6.89 at the current stage. That means, the RMB exchange rate went back to below 7 which is an important psychological level of the FX market participants. Based on this, the US immediately announced to lift the label of “currency manipulator” on China on January 14th, 2020, further pushed up the RMB to USD exchange rate.

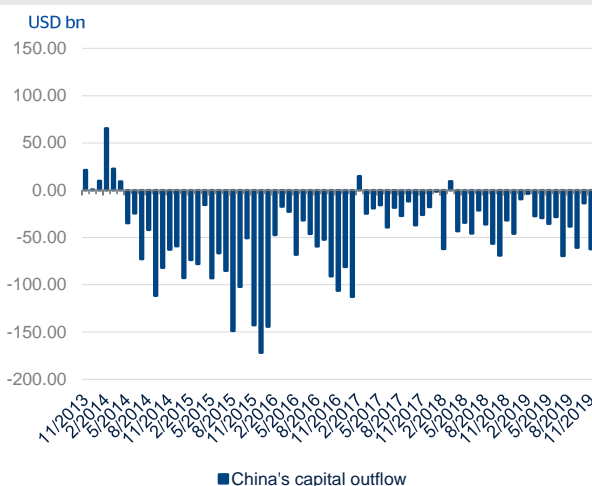
In 2020, we believe that the RMB to USD exchange will still depend on the China-US trade talk progress. In our baseline scenario, in 1H 2020, two sides will focus on implementing the phase-one deal items, leading the RMB to USD exchange rate into an appreciating trend. However, any trade war escalation possibly in 2H 2020 might lead to a sharp depreciation of RMB exchange rate again. (Figure 2.17)

Capital outflows still manageable

Based on our capital outflow estimation model, the November capital outflow reached RMB 62.35 billion, larger than the October’s outflow of RMB 13.69 billion. The accelerating capital outflow is mostly due to the foreign reserve change in November (November: USD -10 billion; October: USD 13 billion) and increasing valuation effect (November: USD 9.87 billion; October: USD -16.66 billion). (Figures 2.18) On the other hand, foreign reserves marginally increased to USD 3,107.92 billion in December from USD 3,095.59 billion in November. (Figure 2.19)

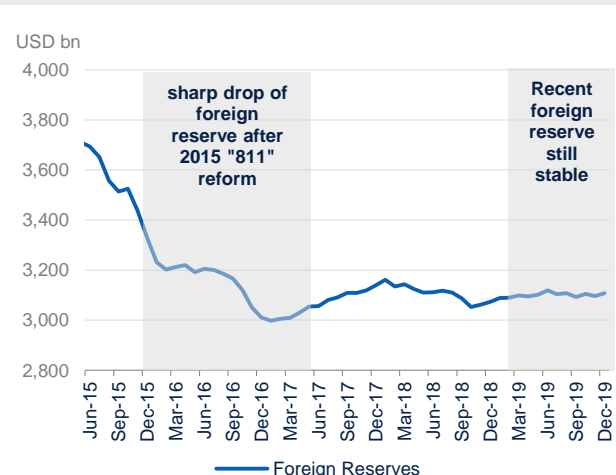
Altogether, we believe the capital outflow is still manageable: first, the RMB appreciation after the Phase-One deal announcement will support the capital inflows in the short term until the possible re-escalation in 2H 2020 dragging on RMB exchange rate; second, the PBoC still has implemented tight capital control, avoiding a large scale of capital flight outside the mainland China; third, the PBoC in the previous round of RMB depreciation due to the US-China trade war has not intervened the RMB by burning foreign reserve as what it did in the aftermath of 811 RMB reform in 2015. Thus, the capital outflows, although expanded in November, are expected to be still manageable in 2020.

Figure 2.18 **CAPITAL OUTFLOWS INCREASED IN NOVEMBER BUT STILL MANAGEABLE**



Source: BBVA Research and CEIC

Figure 2.19 **FOREIGN RESERVE MAINTAINS STABLE**



Source: BBVA Research and CEIC

3. Phase-one deal boosts growth outlook

A modest recovery in 1H 2020, with more uncertainties in 2H

The signing of China-US phase-one trade deal achieved a temporary truce for the ever-escalating China-US trade war. Although there exist grave suspicions in the market about the implementation of the deal, it does prevent the painful trade confrontations from spiraling to a calamity. We will dive in the details of the deal itself at a later stage. Here we focus on a broad picture of the Chinese economy and attempt to take stock of a number of tailwinds to growth in 2020, which, we believe, is to help China's economy to engineer a modest recovery in the coming months.

These pro-growth factors include: (i) the temporary truce of China-US trade war might substantially improve domestic confidence of both producers and consumers; (ii) the expansionary effect of previously implemented stimulus, in particular the RMB 2 billion tax cut in 2019, could be carried over to the new year of 2020; (iii) the stabilization of global economy, together with the reduced US tariffs contained in the phase-one trade deal, will lend more support to China's export sector; and (iv) the incoming construction of telecom 5G infrastructure might become a new growth engine.

However, more uncertainties might happen in the second half of the year as the US presidential campaign is bound to heat up toward the November election, which could be compounded by the progress of trade talks in next stages. Moreover, China is still subject to a series of domestic structural problems such as serious overcapacity in certain industries, the indebtedness of the corporate sector and the shrinking monetary and fiscal policy room. All of them will exert certain downward pressure on China's growth going forward.

On balance, we expect that growth will stabilize in 2020 despite of its long-term downtrend due to the structural problems in the economy. We therefore revise our prediction of 2020 GDP growth up to 5.8% from 5.6% which was set three months ago. Meanwhile, we maintain our growth forecast of 2021 at 5.6% as before. The pattern of growth might show a higher reading in 1H 2020 and a lower reading in the 2H when we envisage rising uncertainties in 2H. That being said, we project that GDP growth will be 5.9% y/y in Q1, 5.8% y/y in Q2 and Q3, and 5.7% in Q4.

We believe that our growth forecast is also in line with the government's intention to lower its official target this year. It is widely believed that a target of "around 6.0%" for 2020 is to be announced during the annual session of National People's Congress (NPC) in March 2020. Indeed, a growth rate of 5.8% could also meet one of Chinese authorities' preset long-term targets of doubling GDP between 2011 and 2020. This long-term target was downplayed by China's government over the past few years due to ever-increasing growth pressure. However, the recently concluded fourth national economic census revised 2018 GDP by 2.1%, making the target achievable even with a growth rate in 2020 lower than 6.0%.

More importantly, we anticipate the quality of growth to improve in 2020. In particular, we expect the financial sector to contribute a smaller share to GDP in 2020, which, on the flip side, reflects the prosperity of real activities. Meanwhile, firm profit decelerated significantly in 2019 to -2.1% ytd y/y (Jan to Nov 2019) from 10.3% ytd y/y at end-2018, which has a good chance to rebound this year due to low base effect.

Inflation pressure is likely to endure in 2020

In 2019, the outbreak of African Swine Fever (ASF) led to a disruption of pork production which sequentially pushed the annual average CPI up to a record high over the past year at 2.9%. In response, the authorities have implemented a series of policy initiatives to prop up pork production and mitigate supply-driven food inflation, including: (i) to release the pork reserve of supply by the central government, (ii) to increase pork imports from the US and other trade partners; and (iii) to expand hog supply etc.

Nevertheless, we are cautious about these measures' effectiveness in terms of arresting the fast increase in pork price. Thus far there doesn't exist effective ASF vaccine. That being said, the ASF could break out again at any time. Moreover, China produced and consumed almost the half of the world's pork production before the ASF outbreak. The outbreak of ASF last year is believed to halve China's pork production, making it impossible to meet such a large demand gap through imports.

Looking ahead, we predict 2020 CPI will increase to 3.4%, with a peak in Q1 due to the low base of Q1 2019. Although the higher CPI is driven by the supply side, its enduring feature will make monetary authorities be on the alert for potential spillover effects to other food and non-food categories in the consumption basket.

Accommodative but measured monetary policy

In 2019, the PBoC replaced its traditional benchmark lending rate with a more market-driven Loan Prime Rate (LPR), another step to deepening the reform of interest rate liberalization. (See our recent [China Economic Watch: LPR: China's market-based "policy" rate](#)) Recently, the PBoC stipulated that, starting from 1 March 2020, financial institutions should engage in negotiations with existing floating-rate loan clients to shift their pricing benchmark from the traditional lending rate to the LPR. In the meantime, the PBoC has been guiding the LPR to a low level in a bid to spur the subdued economy.

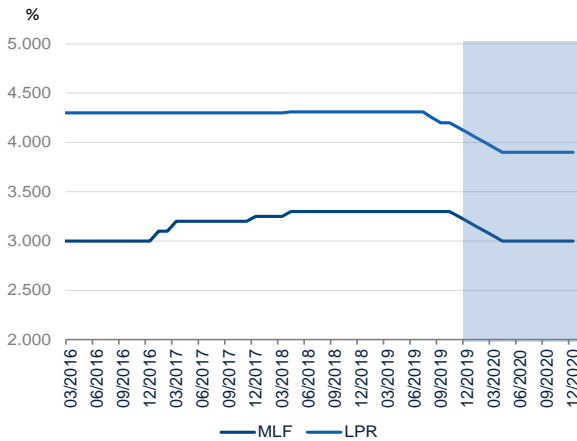
We expect the authorities will maintain their accommodative stance of monetary policy in 2020 as the downward pressure on growth, stemming from both external uncertainties and domestic structural problems, endures. Nevertheless, the monetary authorities are subject to a set of constraints for further monetary loosening. Chief among them is the indebtedness of the Chinese economy. According to the estimates of Bank for International Settlements (BIS), China's debt-to-GDP ratio surged to 254% as of end-2018 (our 2019 estimation: 261%) 2019 from 142% at end-2008. On top of debt-laden local governments and SOEs, China's household burden also experienced a fast rise over the past several years. In particular, the ratio of Chinese household loans to disposable income surged significantly to 86% in 2018 (our 2019 estimation: 89%) from 31% in 2008. Therefore, the authorities have to be very carefully when they use monetary easing to stimulate economy, so as not to aggravate the debt problem in the economy.

Moreover, the prospective shrinking current account surplus, due to the substantial increase in the purchase of US goods and services stipulated in the phase-one trade deal with the US, together with the supply-driven food inflation, will limit the room of policy loosening too.

All in all, we expect that the central bank will prefer to use quantitative tools, including the adjustment of required reserve ratio (RRR), Medium-term Lending Facility (MLF) and other forms of open market operation; especially at the beginning of the year. Except for the one RRR cut in January, we envisage additional 2 cuts in the RRR (with each by 50 bps) to be enacted in the rest of the year. The PBoC will also guide the LPR to a lower level, most likely

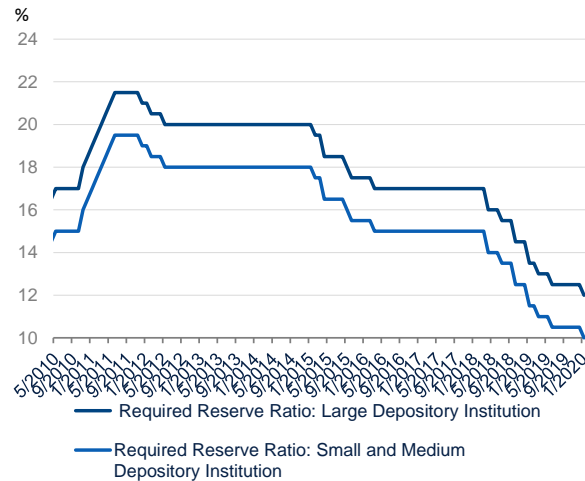
in the second half of the year when the majority of outstanding commercial loans finish their benchmark rate transition. Our end-year forecast of LPR is 3.9% for 2020, 20 bps lower than the current level (5 LPR cuts total).

Figure 3.1 WE EXPECT FIVE LPR CUTS IN 2020, LEADING LPR TO BE 3.9% AT END-2020



Source: BBVA Research and CEIC

Figure 3.2 WE ALSO PREDICT ANOTHER TWO RRR CUTS, EXCEPT FOR ONE CUT IN JAN



Source: BBVA Research and CEIC

Pro-growth fiscal measures continue to buoy growth

Since the second half of 2018, China’s authorities have started to lean more on fiscal measures, in particular those enacted by the central government, to spur growth, which, to a large extent, mirrored policymakers’ increasing concerns over the debt-laden balance sheets of Chinese firms and local governments. At the beginning of 2019, the authorities unveiled an unprecedented tax cut package, of which the authorities reported the realized tax cut amounted to RMB 2.36 trillion within the year.

In addition, the central government issued special-purpose local government bond (SPLGB) of RMB 2.15 trillion in 2019 to provide funds for local governments to expand infrastructure projects. They also relaxed the regulations of fund use for SPLGB so that the local governments can leverage SPLGB funds to construct more projects. In particular, the authorities have already front-loaded 1 trillion yuan (equivalent to around USD 142.07 billion) of the 2020 local government special bonds quota to December 2019. Thus, we expect the special-purpose local government bond will further increase to RMB 3.4 trillion in 2020.

We expect that the authorities will maintain an expansionary stance for fiscal policy in 2020. The fiscal balance to GDP ratio will likely to be expanded to around 3% this year from 2.8% last year. The authorities also promised to deploy more tax cuts in 2020, although the magnitude of new tax cut package must be smaller than that in 2019.

It is noted that the thrust of 2019 tax cut package is the overhaul of VAT and personal income tax system. Therefore, the effects of tax cuts in 2019 should be carried over to this year and continue to sustain the economy. It is all the more so because people’s fragile confidence could hold back consumption and investment in 2019. After

the inkling of the phase one trade deal with the US at the beginning of this year, the multiplier effect of 2019 tax cut package could become more visible in 2020.

The implications of phase-one deal on China's economy

The US and China signed the phase-one deal on January 16th in Washington DC, achieving a temporary truce. We summarize the main points of the phase-one deal as below:

- (i) Intellectual property: China agreed to beef up its intellectual property protections in several ways to make it easier for US companies to seek recourse in both civil and criminal proceedings for the theft of trade secrets, without disclosing confidential business information. The deal also includes stricter measures related to patents, trademarks and geographical indications to prevent piracy and counterfeiting.
- (ii) Technology transfer: China pledged not to force US companies to hand over their technology to its authorities in exchange for access to its market. In the deal, China said it would not force US companies to hand over technology in M&A and investment transactions when seeking licensing or other administrative approvals.
- (iii) Food and agriculture: China agreed to loosen some longstanding barriers to trade in food and agriculture — mostly related to health standards — that had applied to products including infant formula, poultry, beef, pork, rice and pet food. It also makes it easier for US grain producers to obtain biotech-related approvals for genetically modified crops.
- (iv) Financial services: China has pledged a series of measures to open its financial services sector to US competition, in areas ranging from banking services to credit ratings, electronic payment services, asset management and insurance. The US has also made some reciprocal promises to allow some Chinese financial services to receive non-discriminatory regulatory treatment in the US.
- (v) Macro and exchange rate policies: Both the US and China largely reaffirmed pledges made to the G20 and IMF not to devalue their currencies to benefit their exporters, in order to maintain a market-based exchange rate, and to publicly disclose their foreign exchange positions. They specifically noted that any alleged violations of the terms of the deal would be subject to enforcement, which could mean invoking consultations with the IMF or even imposing unilateral tariffs.
- (vi) Purchase: China agreed to buy \$200bn more in US goods than it did in 2017, the baseline before the start of the trade war, over the course of two years. The two-year total includes \$77.7bn in additional manufacturing purchases, from aircraft to cars, iron and steel to machinery and pharmaceuticals. It also includes \$52.4bn in purchases of energy products, like crude oil and liquefied natural gas, and \$32bn in purchases of farm goods including oilseeds, meats, grains and seafood. The deal also allocates \$37.9bn for the purchase of services, such as cloud computing, financial services, travel and tourism.
- (vii) Dispute settlement: The agreement creates a framework for top officials from both countries to meet regularly to try to address alleged violations. But if the dispute is not resolved after meetings involving China's vice-premier and the US trade representative, either side can impose punitive measures, such as tariffs, without a "counter-response", as long as the action was taken in "good faith."

The signing of phase one trade deal is welcome news to not only two signing sides but also the world economy in terms of easing the disruption of global supply chain and reinforcing public confidence. Unlike some observers to the US-China trade war, we don't doubt the seriousness of China's side to implement the items included in the deal. Indeed, some of elements in the deal such as the elimination of forced tech transfer, strengthening IP protection

and opening-up domestic market will benefit China's economy in the long run despite their short-term shocks to the country's domestic vested interest.

China's authorities have been aware of it well and already taken efforts to make progress in these areas. For example, Chinese government promulgated a new version of Foreign Investment Law in 2019, which has become effective from January 1, 2020, together with Regulations on Optimizing Business Environment and Negative List etc., indicating the authorities' willingness to leverage trade negotiations to push forward domestic reforms.

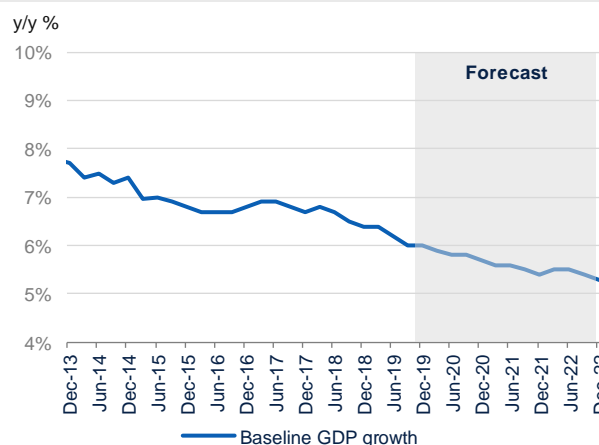
However, the implementation of the above elements in the deal is not easier to be verified, which is compounded by the truth that the authorities might need to amend more domestic laws and regulations to comply with the requirements listed in the deal. Another point of fragility comes from the special dispute solution mechanism of the deal, which relies on bilateral negotiations but lacks an impartial third party to arbitrate.

In our opinion, the core part of the phase-one trade deal is China's explicit targets of purchasing US products in the next couple of years. Compared to other elements in the deal, this part is easier to be verified, reducing the chance of causing new disputes. However, its implementation could exacerbate China's trade relations with other important trade partners, if they find a lot of export orders from China shift to the US because of the US-China trade deal ; or exert great knock-on impacts on some domestic sectors (in particular the agriculture); or even both.

Looking ahead, we expect the phase-one trade deal could help to abate the ever-increasing trade tensions between these two largest country economies in the world. Despite the uncertainties and doubts about it, the outlook of the deal might not be as dim as many people think. Actually Trump administration has put due political capital in the signing of the deal. Reneging on the deal also means huge costs for President Trump and his team, in particular in the year of president election. Just think about how US farmers will react when they have made investment to expand product for the promised Chinese orders and then find the President tear up the deal again. That being said, the phase one trade deal could become a headwind to growth, at least throughout the year.

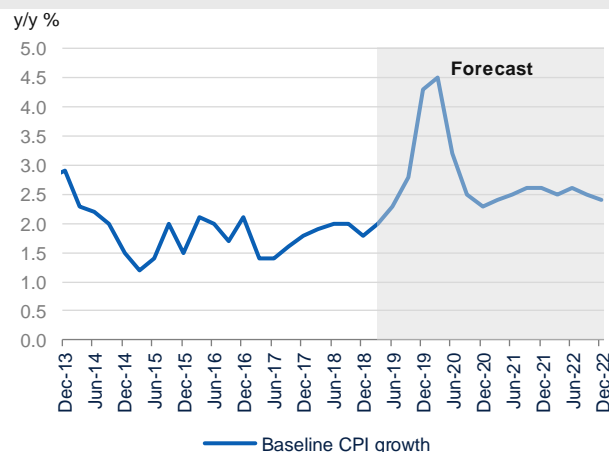
In the long run, we acknowledge that the following phase-two deal is still a far cry since it presumably consists of several thorny issues such as SOEs subsidies and invisible barriers to US internet giants. In addition, the tensions in other areas between China and the US could continue to escalate despite the signing of the phase one deal. For example, the US efforts to stop China from climbing up the supply chain in high tech sector is likely to persist, which could bring additional downward pressure on China's growth (Please refer to our [China Economic Watch: Gauging the impact of US tech war on China: an input-output table analysis](#)).

Figure 3.3 **WE MAINTAIN OUR 2020 GDP FORECAST AT 5.8%**



Source: BBVA Research and CEIC

Figure 3.4 **WE RAISE OUR 2020 CPI PREDICTION FROM 2.5% TO 3.4%**



Source: BBVA Research and CEIC

Table 3.1 **ECONOMIC INDICATORS FORECASTING**

	2017	2018	2019	2020 (f)
GDP (% YoY)	6.9	6.6	6.1	5.8
Inflation (average, %)	1.7	2.1	2.9	3.4
Fiscal balance (% of GDP)	-3	-2.6	-2.8	-3
Current account (% of GDP)	1.4	0.4	-0.1	-0.1
Loan Prime Rate (LPR) (%)	4.35	4.35	4.15	3.9
Exchange rate (CNY/USD)	6.5	6.88	7	6.9

(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	6.1	5.80
Private consumption	6.2	6.2	5.8	5.7
Public consumption	8.7	8.5	10	7
Investment	6.9	6.5	6.7	6.4
Domestic Demand (cont. pp)	6.98	6.61	6.30	5.90
Exports	11.6	3.9	2.9	2.8
Imports	11.8	4.05	3.3	3.6
External demand (cont. pp)	-0.12	-0.12	-0.20	-0.1

(f) Forecast. Source: BBVA Research and CEIC

Phase-one deal to confine the currency fluctuation within a narrow range

As part of the phase-one trade deal, the US government officially lifted China's currency manipulator label on January 14th, which was posted on China right after the RMB exchange rate plunged in August 2019. Moreover, the phase-one trade deal stipulates that China should refrain from currency devaluations to seek trade advantage and also increases transparency of information sharing about government foreign exchange operations such as currency market interventions.

Looking ahead, we believe that in 2020 the RMB exchange rate, in particular the one against the USD, will be still dominated by the China-US trade relations. In our baseline scenario elaborated in the previous section, we expect that the implementation of phase-one trade deal will lead to the improvement in both external environment and domestic confidence, which will facilitate growth stabilization and as a consequence, send the exchange rate to a modestly stronger level. However, we don't expect this round of appreciation will bring the exchange rate back to the level prior to the eruption of trade war for two reasons: first, a large part of previously imposed punitive tariffs on Chinese exports remain in place; second, the promised purchase from the US will further narrow China's surplus under current account, which we estimated to be lower than USD -18 billion or -0.11 % of GDP as of 2020. (See our [Economic Watch: China | When its current account turns deficit...](#))

In 2H 2020, new uncertainties could emerge surrounding China-US trade relations, adding more volatility to the exchange rate. For the positive side, China is likely to arrest the fast depreciation of the currency so as not to aggravate the trade relation with the US. On balance, we forecast the end-2020 CNYUSD stands at 6.9 while it fluctuates within a narrow range of 6.7-7.1 through the year.

4. Risks are still to the downside

Despite a modest recovery at end of 2019, the world's second-largest economy has yet to stabilize amid the trade war with the US and domestic structural obstacles. That explains why most economists remain sober about China's growth outlook as demand at home and abroad both weakened. Although we expect 1H 2020 will have some recovery due to the signing of phase-one deal, growth slowdown trend remains in the medium to long term.

The unsettled trade war between the US and China as the largest external shock remains the prime risk throughout 2020. Even though the phase-one deal was assigned recently, uncertainties around the future phases of trade talks in the 2H 2020 still remain. Beyond that, a tech war between the US and China will last for a longer time. Other possible risks include the rising leverage of local government debt and corporate debt due to the current round of easing monetary and fiscal measures, the shrinking room of monetary and fiscal policy and the outbreak of Wuhan coronavirus etc.

First, uncertainties of the future rounds of trade war talks still remain. As discussed in the previous section, although the US and China are now entering into a "deal" track from "bilateral tariff imposing", uncertainties of the future phases of deal remain, especially in 2H 2020. Firstly, US-China trade talk will become more politicized as Trump will use it as a tool to win his 2020 US president election in November 2020. Secondly, compared with the phase-one deal which includes some issues that are easier to solve, the future phases of the deals have more difficult items to negotiate, such as technology transfer, China's structural reform and SOE subsidies etc. Thirdly, China's authorities are fully aware of the risk that Trump might not successfully secure his second president term thus China's leaders might be reluctant to use their own political capital to reach a transitory deal with the current US administration in short term.

Second, the easing monetary and fiscal measures starting from 2H 2018 might lead to debt overhang problem again. According to the BIS statistic, Chinese overall Adjusted Credit to the Nonfinancial Sector to GDP ratio became 261.5% in Q2 2019, increasing significantly from its stabilizing ratio of 254.6% in 2018. The Washington-based Institute of International Finance (IIF) also estimated that in the first quarter of 2019, the total amount of corporate, household and government debt in China hit an eye-watering 303% of GDP. Although the authorities have said time and again that its borrowings are manageable, but policy levers are hampered by the risk that choking off further debt could accelerate the slowing of economic growth that is already underway. It remains a challenge for the authorities to strike a balance between stabilizing the debt level and stimulating growth.

Third, compared with the previous downturn business cycles, the monetary and fiscal policy room for Chinese authorities shrinks. On the monetary policy front, the above-stated debt overhang problem is the main constraint. Except for this, the deteriorating external sector, such as a shrinking current account to GDP ratio (expect to be negative in the future years), an accelerating capital outflow and a decreasing foreign reserve, also restricts monetary easing. In addition, the recent CPI rocketing becomes the new constraint of monetary policy. On the other hand, the main factor leading to the fiscal policy room shrinking is the declining of government revenues especially the land sales revenues amid growth slowdown.

Finally, the outbreak of Wuhan coronavirus becomes the new threat of the economy. In particular, deaths from China's new virus rose to 17 till now with more than 540 cases confirmed, increasing fears of contagion from an infection suspected to originate from illegally-traded wildlife. Contrasting with its secrecy over the 2002-03 SARS that killed nearly 800 people, the government has closed the Wuhan city this time and given regular updates to try to avoid panic as millions travel for the Lunar New Year. Although the outlook of the Wuhan coronavirus is uncertain at the current stage, its expansion in the future might pose more threat on Chinese economy.

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