

China's Economic Outlook

- **The Chinese economy is firmly on a recovery path, assisted by the government's stimulus efforts and successful containment of the initial COVID-19 outbreak.**
- **The outlook is clouded by two substantial risks: a potential new large wave of COVID-19 infections and an escalation of tensions between the US and China.**
- **Fiscal and monetary policies will remain growth-supportive, yet we see limited scope for further stimulus announcements unless the economic recovery suffers a setback.**

ECONOMIC GROWTH OUTLOOK

The Chinese economy is leading the global recovery, reflecting the fact that it was the first to enter into and emerge out of the COVID-19 shock. China's real GDP rebounded in the second quarter of 2020 after the first quarter slump caused by virus-related lockdowns and disruptions of activity; real GDP grew by 3.2% y/y following a 6.8% drop in the January–March period (chart 1). In quarter-over-quarter terms, the economy more than offset the first quarter declines.

The industrial sector is leading the economic recovery with output already above year-earlier levels (chart 2). Similarly, electricity production and rail freight traffic volumes have rebounded, while Chinese exports are showing nascent signs of revival. The sectoral breakdown of the second quarter GDP confirms the dynamics; the secondary sector—i.e. industry—was driving the rebound with a 4.7% y/y growth in Q2. The tertiary sector—services—recorded a more muted gain of 1.9% y/y. This partially reflects the fact that consumer confidence has been slower to strengthen, causing retail sales to trail the overall recovery (chart 2).

We expect China's economic rebound to continue in the second half of 2020, assisted by fiscal and monetary stimulus measures, with the nation's real GDP growth estimated to average 2.1% y/y in 2020 as a whole. The forecast represents an improvement from our April and June projections of 1.6% y/y expansion. Pent-up demand and base effects will likely push the growth rate to 8.5% y/y in 2021.

The economic outlook continues to be highly uncertain. Another large wave of COVID-19 infections continues to be a significant downside risk considering persistent challenges to contain the virus outbreak in many parts of the world. Meanwhile, the bilateral China-US relationship has continued to deteriorate following China's decision to impose the National Security Law on Hong Kong. Indeed, the conflict has evolved from a trade and technology dispute and now includes ideological overtones. We expect tensions to remain elevated ahead of the US presidential election in November 2020. Moreover, given the still-soft economic backdrop, we assess that it will be challenging for China to meet its purchase commitment of US goods as agreed in the "phase one" trade deal in mid-January. By the end of June, China's year-to-date purchases amounted to 23% of the 2020 target of USD 170 billion.

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Chart 1

China's Real GDP Growth

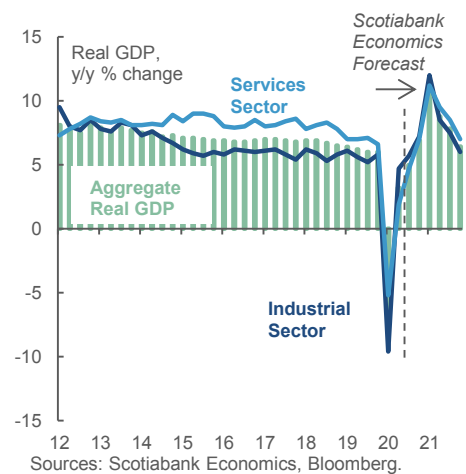
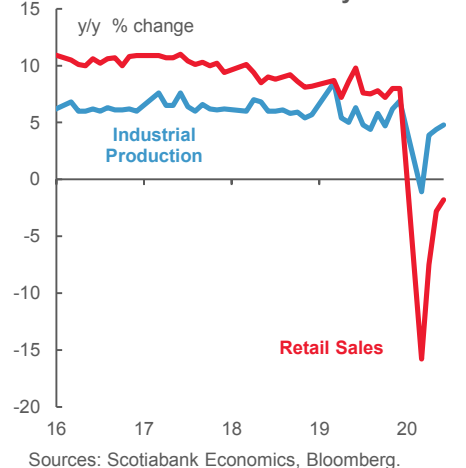


Chart 2

China's Recovery



Public spending will play a key role in supporting the economy's recovery; indeed, the Chinese administration has highlighted that fiscal policy will be more proactive in the second half of 2020. In May, the National People's Congress raised the 2020 fiscal deficit target to 3.6% of GDP from 2.8% in 2019 and continued with a targeted approach to fiscal stimulus that underpins businesses via tax and fee cuts and social insurance savings. In addition, notable public outlays that largely fall outside of the government's headline deficit have been announced: the government will issue an additional CNY 1 trillion of special treasury bonds (equivalent to 1.0% of GDP) for public health initiatives, while the 2020 issuance target for special purpose local government bonds—to be used for funding of infrastructure projects in areas such as transportation, utilities facilities, and rural development—was raised to CNY 3.75 trillion (equivalent to 3.8% of GDP) from CNY 2.15 trillion in 2019. Correspondingly, approvals for infrastructure projects have accelerated recently, leading to a pickup in fixed asset investment (chart 3). We assess that the Chinese administration has further fiscal space left should the economy need an additional boost.

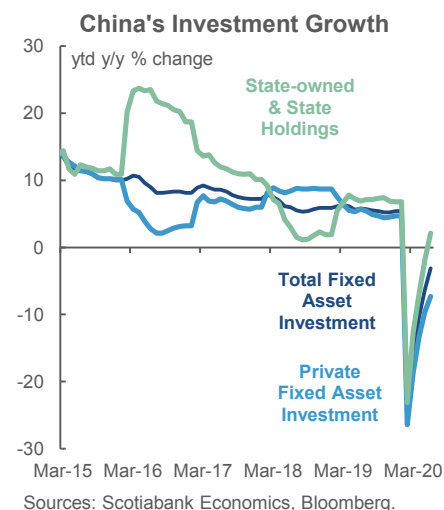
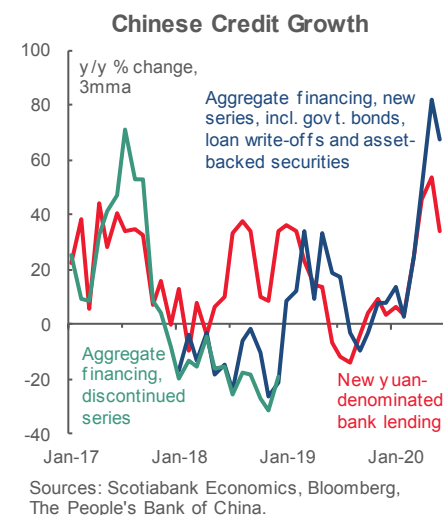
MONETARY POLICY, INFLATION AND YUAN OUTLOOK

Accommodative monetary conditions will remain in place over the foreseeable future, complementing the government's fiscal stimulus efforts. Nevertheless, we see limited additional monetary easing by the People's Bank of China (PBoC) as the economy is on the path to recovery. Chinese benchmark Loan Prime Rates (LPR) have remained unchanged since April when the 1-year LPR was lowered by 20 basis points to 3.85%. The rate has been cut by 40 bps since August 2019. Similarly, we expect banks' reserve requirement ratios (RRR) to remain unchanged over the coming months unless the economic outlook deteriorates. The PBoC has lowered the RRR for major banks by 100 bps to 12.5% over the past year, with the latest cut in January. In addition to the conventional monetary easing steps, policymakers have also advised Chinese banks to lower their profit targets in order to support struggling companies via lower lending rates, reduced fees, and deferred loan repayments.

According to the PBoC, monetary policy will remain flexible and be more targeted in the second half of 2020, focusing on supporting enterprises and employment. Chinese policymakers have indicated that ample liquidity in the banking system will be maintained and that money supply and social financing will continue to grow faster than in 2019. Meanwhile, credit support will be enhanced for the manufacturing sector as well as for small and micro firms. These policy directions are apparent in bank lending and aggregate financing indicators, as growth rates have spiked in recent months (chart 4). Nevertheless, the PBoC's policymakers seem aware of the risks related to credit-fuelled recovery dynamics, such as rising speculative behaviour and inefficient credit allocation. Indeed, monetary authorities have recently emphasized their commitment to continuing to address and prevent financial risks. Against this backdrop, we expect the boom in credit growth to remain in place only during the early stages of the economy's revival.

China's headline inflation has eased notably in recent months on the back of smaller increases in food prices; annual inflation was 2.5% y/y in June compared with the January peak of 5.4%. We expect consumer price pressures to remain contained through 2020 with headline inflation forecasted to close the year at 1.7% y/y. Moreover, inflation further up the distribution chain remains non-existent, with annual producer price gains currently residing in negative territory; in June, the producer price index dropped by 3% y/y.

The Chinese yuan (CNY) has appreciated by around 3% against the US dollar (USD) since the end of May on the back of China's economic recovery and a broader weakening trend of the USD, dipping below the USDCNY7.0 mark. The CNY will continue to reflect developments in the US-China bilateral relationship over the coming months. Accordingly, the currency will likely lose some of its recent gains by year-end, yet the PBoC will prioritize yuan stability in the foreseeable future; we expect USDCNY to close the year at USDCNY 7.05.

Chart 3

Chart 4


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