Macro Monthly Letter

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Economic outlook for China

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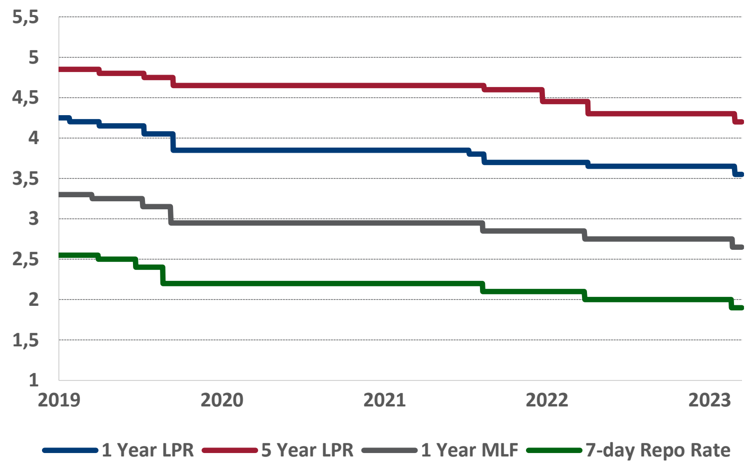
China's economic reopening at the start of the year was accompanied by expectations that the recovery would proceed along similar lines to those of other countries, with a strong surge in consumer spending led mainly by the service sector. However, recent data shows that domestic demand remains weak. Indicators of retail sales, industrial production and credit have missed forecasts, offering scope for more stimulus such as the recent easing of monetary policy.

Last month, China's central bank (PBOC) cut its main policy rate as well as other interest rates that serve as benchmarks for medium- and long-term loans (Figure 1). Although the rate cuts will lower borrowing costs, there are doubts as to whether the monetary easing implemented so far will stimulate the economy enough to improve China's growth outlook for the years ahead.

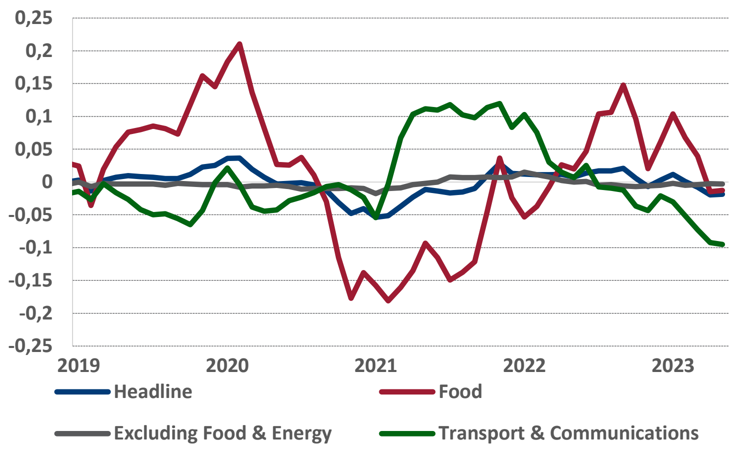
Figure 1: China - Policy Interest Rate (%)



Source: PBOC, BOCOM BBM

China is in a very different place from other countries in this reopening. While most countries had to embark on monetary tightening cycles to try to contain spiraling inflation, in China inflation fell to 0.2% in the last reading, well below the 2% level seen in the last decade, thanks to the more benign behavior of energy and food prices (Figure 2). Although low inflation allows for more monetary stimulus, it also confirms the view that regularization of supply rather than rising demand has been the main driver of China's reopening.

Figure 2: China - Inflation (YoY, %)

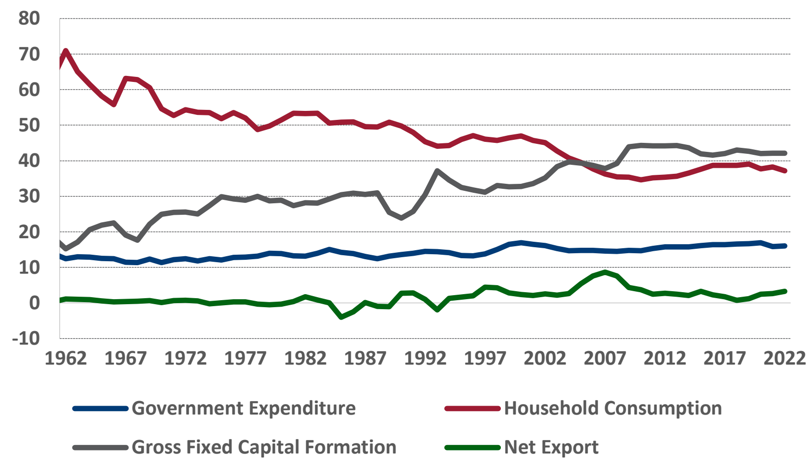


Source: NBS, BOCOM BBM

The real estate market is an example. It continues to face difficulties, even with supporting measures. Both housing starts and home sales are sharply down compared with last year.

Conjunctural factors, such as the persistently low level of consumer confidence and low household spending propensity, are important to explain the recent evolution of activity, but there are structural obstacles to growth based on household consumption and domestic demand in China. Household consumption accounts for only 40% of GDP, and a large proportion of the economic growth seen in recent decades was due to investment in gross fixed capital formation (GFCF), as in the case of expansion of the real estate sector (Figure 3).

Figure 3: China - GDP Composition (%)



Source: NBS, BOCOM BBM

China is expected to transition gradually to an economy in which consumer spending is a more significant driver of growth than GFCF, as did South Korea or Japan, for example. Meanwhile, additional stimulus measures are expected to prioritize investment in technology and renewable energy to the detriment of more support for the real estate sector. Electric car subsidies awarded last year, for example, were able to stimulate production and boost sales, and there is room for more stimulus in this direction.

Less favorable prospects for Chinese economic growth present challenges for Brazil. China is the world's second-largest economy and the prime destination for Brazilian exports, such as soybeans and iron ore. A more pronounced economic slowdown in China has implications for Brazil's trade balance, for its real economic earnings (via commodity prices and the terms of trade), and for tax revenue.

In Brazil, economic activity continues to decelerate following a good first quarter for the agricultural sector. We have updated our inflation forecast to 4.7% in 2023 and 3.6% in 2024, in light of wholesale deflation, which will help slow the rise in prices of food and manufactured goods and will be passed along to services and core inflation, decreasing inflation inertia next year. The sharp fall in inflation expectations in response to the decision to leave the inflation target on 3% provides an opportunity for the Central Bank of Brazil to begin lowering its policy rate. We have revised down our projection for the year-end Selic to 11.75%. Our other macroeconomic projections are shown in the table below.

ECONOMIC FORECASTS	2019	2020	2021	2022F	2023F	2024F
GDP Growth (%)	1.2%	-3.3%	5.0%	2.9%	2.0%	1.0%
Inflation (%)	4.3%	4.5%	10.1%	5.8%	4.7%	3.6%
Unemployment Rate (eoy ,%)	11.1%	14.2%	11.1%	7.9%	8.8%	9.3%
Policy Rate (eoy, %)	4.5%	2.0%	9.3%	13.75%	11.75%	9.0%
External Accounts						
Trade Balance (US$ bn)	27	32	36	44	60	42
Current Account Balance (US$ bn)	-68	-28	-46	-56	-39	-50
Current Account Balance (% of GDP)	-3.6%	-1.9%	-2.8%	-2.9%	-1.8%	-2.3%
Fiscal Policy						
Central Government Primary Balance (% of GDP)	-1.3%	-9.8%	-0.4%	0.6%	-1.1%	-1.2%
Government Gross Debt (% of GDP)	74.3%	86.9%	78.8%	72.9%	76.6%	81.4%