

## Reopening vs resurgence

The easing of lockdown measures is helping economies recover from the deepest slump in a generation. But the virus is far from contained. Our economic monthly looks at whether the recovery will remain on track while our podcast focuses on one of the worst hit countries- Brazil. Plus, as the EU and UK battle it out over Brexit, is a trade deal slipping away?

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Report | 2 July 2020

# July Economic Update: From yesterday to tomorrow

The reopenings have led to a sharp rebound in activity, but new localised Covid-19 outbreaks have cast a renewed cloud over the global economic outlook for the second half of the year. Discover the latest views and ideas from ING's economists and strategists in our July update



Source: Shutterstock

## Inside this edition

### US: The wrong direction

- Covid-19 infections and hospitalisations are on the rise in many states, leading to fears that the recovery could falter in response to renewed restrictions and consumer caution. In the absence of a vaccine, the Federal government will need to provide more support to keep the economy on the recovery track

### Eurozone: a deceptive 'V'

- Recent indicators point to a V-shaped recovery, but that won't last very long. With the European Central Bank trying to appease the German Constitutional Court further rate cuts look unlikely, though an increase in the Pandemic Emergency Purchase Programme is still in

the cards

### **China: Covid-19 adds pressure to exports**

- Domestically-driven growth has been faster than foreign-driven exports and manufacturing. It seems that occasional Covid-19 clusters have not disrupted domestic demand too much. As such, we have revised our PBoC policy forecast to no more rate cuts for the rest of 2020

### **Asia: India and Indonesia riding up the Covid-19 curve**

- First China, now India and Indonesia – two more of Asia's largest economies face their worst recession in decades, thanks to Covid-19. But the divide in the market's perception is reflected best by the performance of their respective currencies. The rupiah is one of the best performers in the EM space while the rupee hasn't been appreciating very much since the rally started

### **Latin America: Recession deepens fiscal challenges**

- Covid-19 continues to spread across Latin America but, given the mounting economic costs of stay-at-home orders, governments are easing social isolation guidelines. Robust economic policy responses should help lessen the recession but will leave behind severe fiscal challenges that should alter intra-region relative performance post-pandemic

### **FX: Markets leave lockdowns behind them**

- This month, we've been tasked with looking at the effects of lockdown exits on FX markets. The truth is there that does not seem to be a strong relationship there. Instead, FX markets are being driven by the abundant liquidity story. As summer progresses, however, we expect US elections to make their mark. Both themes are dollar negative, in our opinion

### **Rates: Warning signs that equities might have it all wrong**

- Most financial instruments are present values of a discounted stream of future income. For equities that is earnings. For core bonds, it is coupons, plus principal payback. For high yield, a spread is added to compensate for the non-systemic risk. The equity discount is upbeat. The rates discount is ominous. The HY one is in between. Something must give

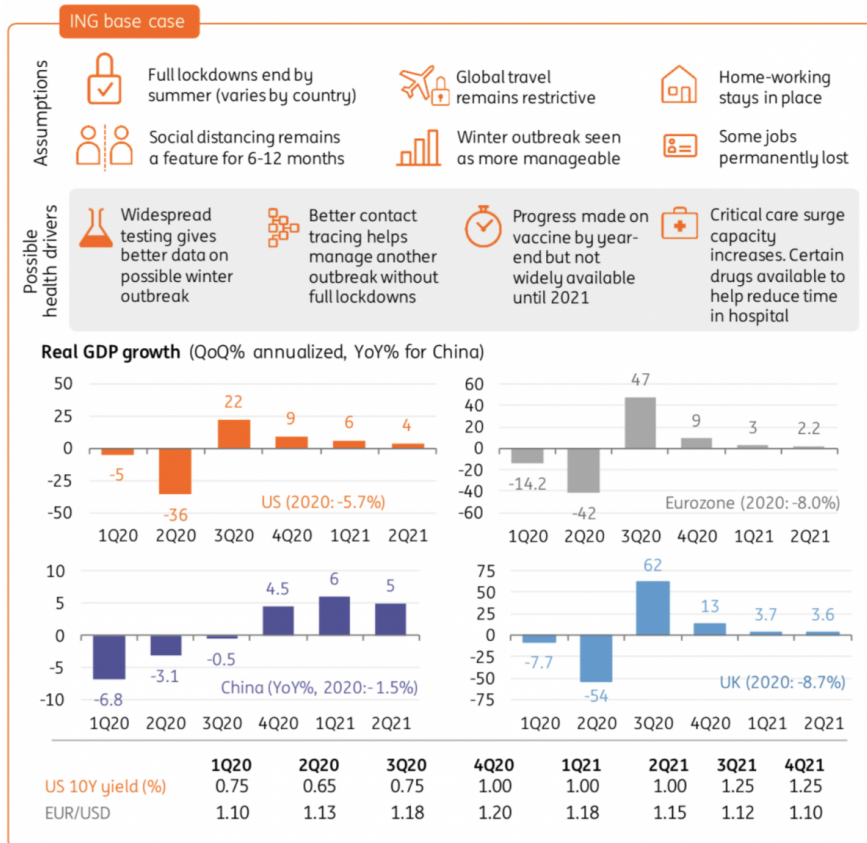
### **US Politics: Troubling times for Mr President**

- President Trump is languishing in the polls both nationally and in the swing states that are key to winning the electoral college and re-election. Democrat rival Joe Biden is keen to keep this a referendum on Donald Trump, but the President has other ideas and is going on the offensive

### **CEE: Gradual recovery but no deflation**

- It seems that Central and Eastern European economies are through the worst and a gradual recovery lies ahead. Despite the sharp fall in growth, there aren't any deflationary pressures as these economies were running hot prior to the Covid-19 crisis. All this is likely to translate into limited monetary easing ahead, but Poland remains very dovish

## ING's base case



Source: ING

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## US jobs: Don't believe the hype

Another big upside surprise for payrolls of 4.8mn while the unemployment rate plunges to 11.1%. Great news, but it doesn't tell the whole story. 31.5mn people are claiming unemployment benefits and employment is still 15 million lower than February. Moreover, with states dialling back on re-openings the July jobs report could be far more sobering

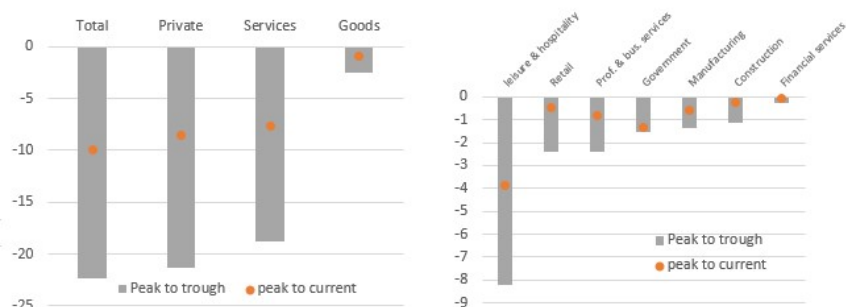


**4.8mn** June increase in US payrolls

### Payrolls power on

The June jobs report showed payrolls rose 4.8mn, well above the 3.23mn consensus figure while May's payrolls gain was revised up to 2.699mn from 2.51mn. Fantastic. It shows how the re-openings have allowed businesses to get into gear and bring workers back. Leisure and hospitality was the biggest contributor, jumping 2.088mn, with retail up 740k, but there were gains everywhere including 903k for trade and transport and 568k for education and healthcare.

## Payrolls change since 1940 and the level of employment 2000 onwards



Source: Macrobond, ING

## Ignore the unemployment rate and wage data

The household survey shows the unemployment rate dropping further to 11.1% from 13.3%, having peaked at 14.7%. But that is not the true state of affairs and it isn't just down to confusion over how to fill out the response form. If you dig into the jobless claims report you find that the total number of people claiming unemployment benefits in all programs rose 916.7k in the week of 13 June (coincidentally the week of the June jobs report data collection), taking the total number of claimants to 31.49mn. This is nearly double the 17.75mn "officially" unemployed based in the jobs report. Remember you have to be actively looking for work to be classified as "officially" unemployed, but you don't need to do so in order to claim benefits right now – hence the 11.1% figure is grossly understating the true picture

Rounding out the numbers we have average hourly earnings falling 1.2% month on month, which again reflects the distortions when you don't mix-adjust the data. Millions of relatively low-paid people now earning a wage will automatically drag down the average hourly earnings rate so this number should be ignored – just like the unemployment rate.

## July jobs jitters?

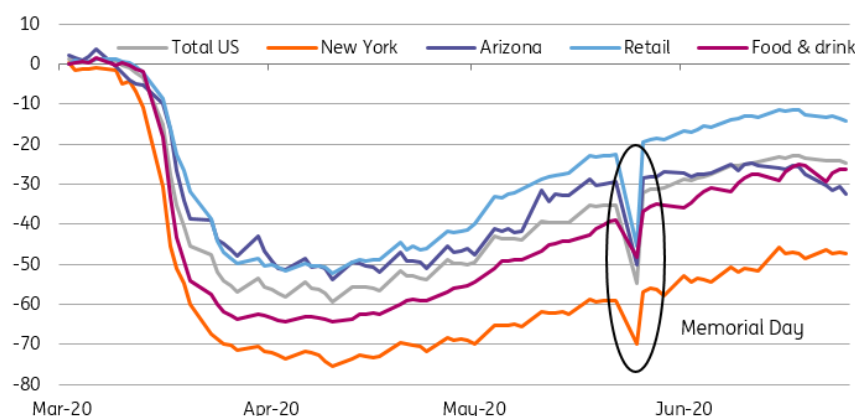
Even after today's strong payrolls growth we have to remember that total employment is still 14.66mn lower than it was in February. So far extended unemployment benefits, including the US\$600 per week Federal boost, are supporting incomes, but there are questions as to what happens after 31 July when this is currently scheduled to end?

Moreover, we are becoming nervous about the July jobs figure, which could disappoint markets. Today's initial claims (1.425mn versus 1.35mn consensus) and continuing claims (19.29mn versus 19mn consensus) are remaining sticky with the initial claims figure, even today with the re-openings, more than double the worst weekly reading of any period during the Global Financial Crisis.

Meanwhile, the Homebase data report suggests the small business sector has been shedding jobs since 18 June. One possible explanation is that many small businesses that took advantage of the loan forgiveness aspect of the Paycheck Protection Program have exhausted the money. In this regard, the National Federation of Independent Businesses reported 14% of members that took advantage of the scheme are expecting to fire staff in coming weeks given demand has not

returned to pre-Covid levels.

## Homebase: Hourly employees that day vs. the median for that day of the week for the period Jan 4, 2020 – Jan 31, 2020 (% difference)



Source: Macrobond, ING

## Structural issues suggest a long road to recovery

The bigger issue is that the spike in Covid-19 cases means several states are announcing renewed containment measures with others delaying their phased re-opening. Many businesses (leisure and hospitality in particular) may take the view that it simply isn't viable for them to stay open, which will only add to the problems in the jobs market.

Furthermore, given the downturn in global economic activity, many manufacturing and professional service firms may also not need as many staff as they face up to the new economic environment of weaker corporate profits and higher debt levels. This is before we consider the longer term structural issues facing specific sectors such as transport, retail, commercial real estate, hospitality. So, while today's jobs report gives a good headline, there are huge headwinds which mean a full recovery in the jobs market is a very long way off.

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## Post-Brexit trade deal still possible despite rollercoaster talks

Despite the latest round of UK-EU talks ending a day early, it's too early to conclude that the chances of a trade agreement are falling. We still narrowly suspect a deal will be forthcoming, but the economic impact will still be significant when the transition period ends later this year



Source: Shutterstock

British Prime Minister Boris Johnson (R) and European Commission President Ursula von der Leyen meeting earlier this year

### UK-EU trade talks have hit a new low

Brexit talks have always been a bit of a rollercoaster and now appears to be no exception.

Two weeks on from the UK and EU's joint commitment to 'intensify' talks, the latest round of negotiations have ended a day early, with EU chief negotiator Michel Barnier signalling that "serious divergences remain".

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*But most commentators, ourselves included, still feel that a free-trade agreement can be feasibly signed this year*

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So should we take from this that the chances of a deal being struck are fading? We don't think so, although it does go to highlight that the chances of no trade agreement are higher than the probability of 'no deal' was last October.

There's little doubt that the timeline for talks is highly compressed by usual trade negotiation standards. And Covid-19 has only added further strain, with reports that civil servants previously allocated to trade have been reallocated to the coronavirus response.

But most commentators, ourselves included, still feel that a free-trade agreement can be feasibly signed this year. That's because ultimately it all boils down to a narrow set of issues, and despite those promises of intensified talks a few weeks back, the amount of negotiating time available is not really the core problem.

## Compromise is possible but not guaranteed

Compromise is undoubtedly possible. [We've written many times about fishing](#), which is the most obvious of the more contentious issues that seem fudgeable.

Even on state aid - the issue that is the crux of the impasse - a number of potential compromises have been proposed. The [FT summarised](#) some of them this week, including one that would see both sides mutually agree to a set of principles for subsidies, potentially overseen by independent regulators.

Another way forward, mooted in [The Spectator](#) a few weeks back, could involve the UK signing up to the EU's level playing field requests initially - but importantly signalling that it could move away from them in the future, in the knowledge that the EU would respond with tariffs.

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*The real issue with state aid is that there is a fundamental difference in the way both sides view the issue*

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This is undoubtedly unusual - it's hard to think of an example of a country signing up to a free-trade agreement, with the expectation that it would diverge from it in future years. It also has the potential to be pretty unstable, and the EU will seriously question how this divergence can be reasonably monitored. Enforcement mechanisms associated with trade deals tend to be geared more towards isolated breaches rather than fundamental shifts in approach.

But despite some potential avenues of compromise, the real issue with state aid is that there is a substantial difference in the way both sides view the issue. The UK, in particular, wants greater autonomy to aid the recovery from Covid-19, and rightly-or-wrongly state aid has come into sharper focus as the government has responded to the virus.

## There are growing concerns about firms' preparedness for changes in trade terms

The upshot is that a deal is still probably, narrowly, the most likely outcome. But either way, we shouldn't expect to see much movement until closer to the de facto October deadline.

From the perspective of markets though, the much bigger question should be what impact all of this will have on the economy - and the likelihood is that the effect will be large.

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### *A large chunk of businesses are unlikely to be fully prepared*

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The UK government has said it will [apply light-touch checks](#) to goods arriving from the EU early-on, reflecting the reality that customs processes and associated hiring are unlikely to be ready for the new volume of checks required when the transition period ends.

That may cushion some of the initial impact, although of course there are likely to be full checks on entry to the EU, and this has the potential to cause initial disruption at the ports on both sides of the channel.

The bigger issue though is that a large chunk of businesses are unlikely to be fully prepared. This time last year, it was estimated that there were [240,000 firms](#) who only export to the EU - and the risk is that with Covid-19 occupying companies' resources at the moment, many won't have the capacity to prepare for life outside the single market/customs union.

The risk is particularly acute for small-medium enterprises, many of whom won't have the margin to absorb the additional costs associated with customs clearance, transport costs and if there's no deal, tariffs.

## **The UK is at risk of a slower post-virus recovery**

The jury is out on exactly how this will play-out at a macro level, and we'll be writing more about this in the coming weeks. Some have made the argument that the sheer hit to GDP from coronavirus will mask the hit when the transition period ends later this year.

That's probably true to some extent - and perhaps in a more optimistic post-virus scenario (for instance one where a vaccine is found later this year), it's possible that the negative impact from Brexit is partially offset by further relaxation in social distancing.

Still, it's worth remembering that the sectors likely to be most affected by UK-EU trade disruption - the likes of manufacturing for example - are not necessarily the same as those hit by Covid-19, which has affected the likes of recreation and hospitality most heavily.

We, therefore, feel the UK is at greater risk of a slower overall recovery, and the change in trade terms could add further pressure to unemployment, which is unfortunately already showing signs of rising as businesses begin to adapt to the post-Covid landscape. This is one reason why we don't think the economy will return to pre-virus levels until 2022, at the very earliest.

In the near-term, all of this also has the potential to add further downside for the pound. Our FX team reckons the lack of an imminent breakthrough in negotiations could push EUR/GBP to 0.92 this summer. [You can read our FX strategist Petr Krpata's full analysis here.](#)

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## GBP: The ongoing disappointment

EUR/GBP broke through our quarter-end target of 0.91. We see more downside to sterling and expect EUR/GBP to trade above 0.92 this summer. As UK-EU negotiations are unlikely to progress, more risk premium can be priced into GBP. We also note the structural change in GBP sensitivity to risk post Brexit referendum



Source: iStock

### The biggest G10 FX underperformer

GBP remains the biggest G10 FX underperformer- the worst performing G10 currency both this month and this quarter and EUR/GBP has reached our quarter-end target 0.91.

Here we review various GBP drivers, gauge what is priced in and conclude that more downside still lies ahead for GBP. We expect EUR/GBP to reach and breach the 0.9200 level this summer.

Prime minister Boris Johnson's speech today does not alter much GBP prospects as (a) the infrastructure spending was expected, as was outlined in the March budget, (b) the UK-EU trade negotiations remain the key driving factor behind GBP.

## Risk premium present but not extreme yet

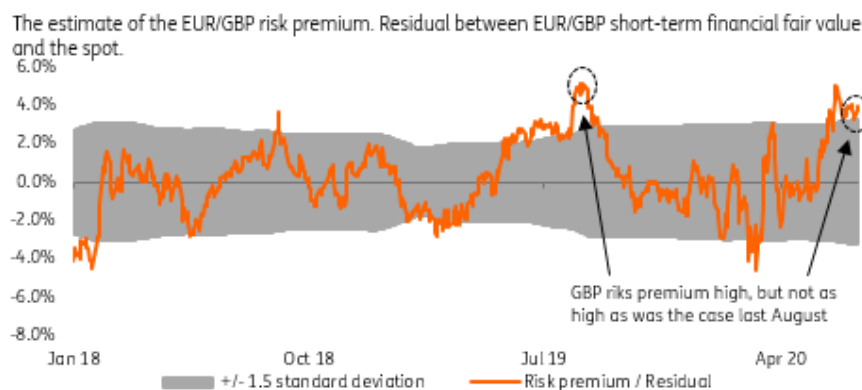
Following GBP's meaningful underperformance, a fair degree of risk premia is currently priced into sterling - around 4% according to our short term EUR/GBP financial fair value model (Figure 1).

This contrasts with the state of affairs in mid-May when we viewed the market as inadequately pricing in the uncertainty related to the UK-EU trade outlook (see [GBP: Market too complacent on transition risk](#)). While the GBP risk premium has risen since then (it's currently worth around 4% vs no risk premium priced in at the time) it still remains below the levels observed in August 2019, during the heightened uncertainty over the Brexit outlook (the GBP risk premium exceeded 5% back then).

As the UK government refused to request the extension of the transition period and the form of the UK-EU trade deal (if there is one) remains uncertain, there is scope for meaningful GBP risk premium to increase further, to the levels seen in August last year.

Hence, our forecast for further GBP weakness and EUR/GBP breaching the 0.92 level this summer, consistent with an additional 1% rise in the risk premium.

### Figure 1: Risk premium creeping back into sterling



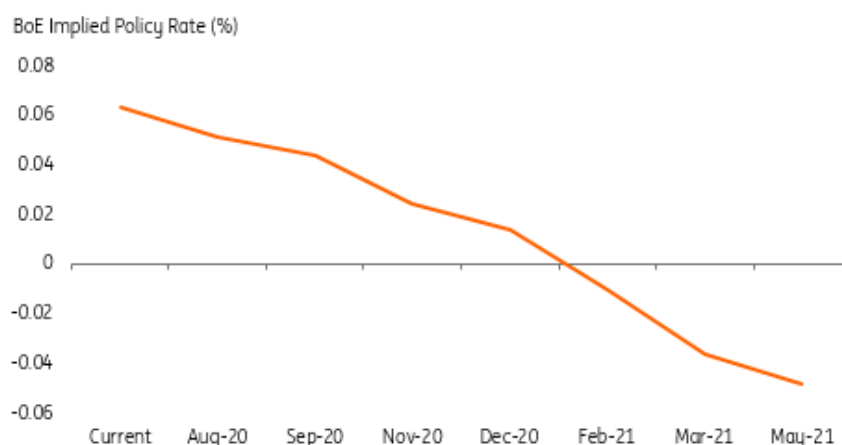
Source: ING

## Limited reasons to price out the possibility of BoE negative rates

As the outlook for the UK-EU trade negotiations - the main driver of GBP - remains veiled in uncertainty, there is little scope for the market to price out the non-negligible odds of the Bank of England negative interest rates.

As Figure 2 shows, the market is pricing in the policy rate below zero in early next year. Unless the UK-EU trade negotiations surprise on the upside (which is unlikely in summer months), there will be little impetus for the market to change the probability distribution of the negative rates outcome. This, in turn, means limited room for a GBP rally.

## Figure 2: Market pricing probability of negative rates



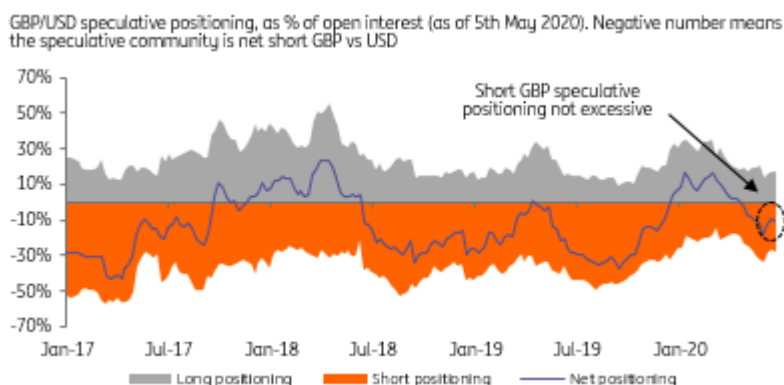
Source: ING, Bloomberg

## Market is short sterling, but not excessively

The speculative community remains short GBP, with only CAD exerting higher speculative shorts among the G10 currencies reported by CFTC (see [FX Positioning: Shorting North America](#)). Still, sterling shorts remain well below the levels observed during the third quarter last year (Figure 3), when Brexit concerns peaked.

Given the overriding importance of the UK-EU trade negotiations as an idiosyncratic GBP driver, the possible negative outcome from the trade negotiations would likely lead to an increase in short positioning, which is by no means stretched by historical standards.

## Figure 3: Sterling speculative shorts not excessive



Source: CFTC

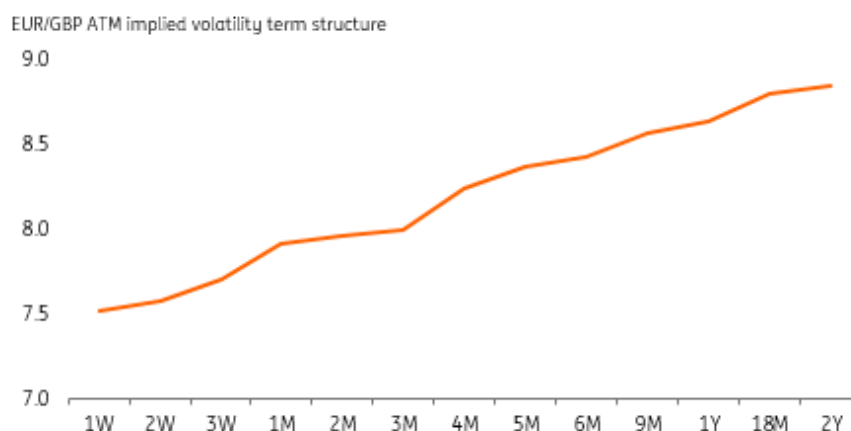
## No material signs of stress in the option market

The options market does not appear to show any material signs of stress.

The EUR/GBP implied volatility term structure is ordinarily upward sloping (Figure 4), with limited kinks visible in the term structure. This suggests the market does not appear to pencil in the negative outcome with a meaningful probability, in turn increasing the potential for more

meaningful GBP weakness if UK-EU trade negotiations fail.

## Figure 4: The GBP option market not showing signs of stress



Source: ING, Bloomberg

## Structural change in GBP sensitivity to risk post Brexit referendum

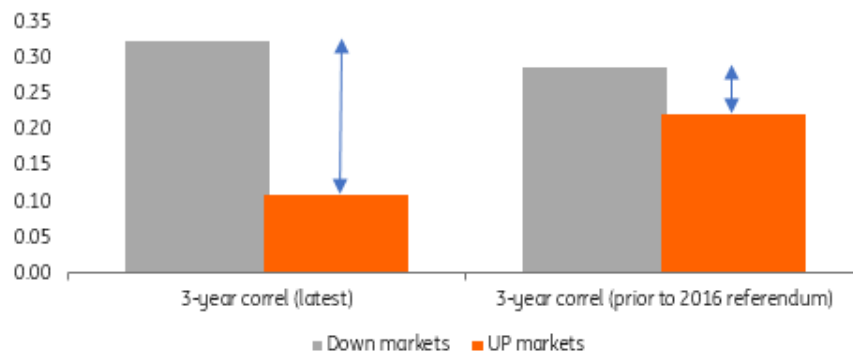
The importance of Brexit as a driver of GBP is clearly seen in the altered sterling correlation with risk (gauged by MSC world).

While sterling (vs the euro) is currently three times more sensitive to falling markets vs rising markets (meaning that GBP suffers proportionally more in falling markets than it benefits in rising markets), prior to the Brexit referendum the difference in sensitivities was even more (as Figure 5 shows). This explains why GBP has not fully benefited from the rallying global stock markets this quarter.

In our view, the Brexit factor shifted the positive spillovers from the global drivers into sterling further into the background.

## Figure 5: Structural change in GBP sensitivity to risk post Brexit referendum

GBP (vs EUR) correlation with risk (gauged by MSCI World). Latest 3-year correlation vs 3-year correlation prior to the Brexit referendum. We measure GBP correlation with risk during falling markets (MSCI World index is down) vs rising markets (MSCI World index is up). Daily changes



Source: ING, Bloomberg

Overall, while some risk premium is evident in sterling (more so in the spot market than in the options market), more can be priced in if the uncertainty about the outcome of the UK-EU trade negotiations prevail / the outlook deteriorates. This means EUR/GBP is likely to push through the 0.9200 level this summer, with clear upside risks. While we expect some form of a UK-EU trade deal to be agreed by October this year (and GBP to recovery by year-end), a high degree of uncertainty prevails and we prefer to focus on the near-term outlook – which we view as GBP negative.

For EUR/GBP to reach the 0.95 level, what we would need to see is in our view either (a) a sharp rise of the uncertainty about the future of the UK-EU trade relationship, or (b) another collapse in global risk assets (as we have seen in March), which would make GBP vulnerable, or (c) the Bank of England embarking on negative rates.

On the latter, we estimate that two 25 basis point rate cuts would push short-term EUR/GBP fair value higher by 4-5 big figures.

At this point, none of the above are our base case, hence our call for EUR/GBP trading around 0.92 this summer

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# Coronavirus: Saving differently, not equally

Covid-19 has caused massive disruption. The way we spend and save is no exception. But experiences are divided. Those with household savings are more likely to say they are saving more while in lockdown, than those without a rainy-day fund



The impact of a near Europe-wide lockdown is likely to highlight the imbalance between savers and non-savers.

Our latest ING International Survey looks at spending and saving patterns pre- and post-lockdown. Coronavirus has impacted the financial circumstances of Europeans to varying degrees, meaning people are having quite different experiences. During lockdown, non-savers and those among the lower tier of savers are more likely to say they are now saving less, compared to those with funds put aside. And while day to day spending and saving feels like it's changed quite dramatically since we started staying home more, there has been no noticeable change in the percentage of people with no savings at all, a quarter of European households still say they have no savings. It is those with lower levels of financial flexibility who are more likely to be faring poorly now.

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## Listen: Brazil's Covid crisis

With 1.4 million coronavirus cases and over 60,000 deaths, Brazil now ranks as the second worst hit country in the world, after the United States. But its economy will not suffer from the pandemic as much as some of its neighbours in the region, as ING's Gustavo Rangel explains in this podcast



The political response to the health crisis in Brazil has been controversial. But sharp cuts in interest rates and generous fiscal policy have helped to soften the economic blow. [In this podcast](#), ING's Chief Economist for Latin America, Gustavo Rangel, discusses the outlook for Brazil and the wider region with Senior Editor Rebecca Byrne.

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## Listen: Recovery, reflation and the market response

In this ING economic update, our experts discuss the outlook for the US, UK and European economies and the likely trajectory of global financial markets, as lockdown measures ease



Source: Shutterstock



## Listen: Recovery, reflation and the market response

ING's Chris Turner, Carsten Brzeski, James Knightley and James Smith give their verdict on where the global economy is headed and how markets will react as green shoots of recovery start to appear.

[Watch video](#)

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# China Quarterly Update: Technology v bricks and mortar

Lockdowns and social distancing measures are short-term issues for the Chinese economy as a result of the Covid-19 pandemic, but solutions for the recovery affect structural growth. The government has chosen to bet on advanced technology but the quick answer as always is old school infrastructure projects using bricks and mortar. So, debt is on the rise



## Covid-19's impact on the Chinese economy

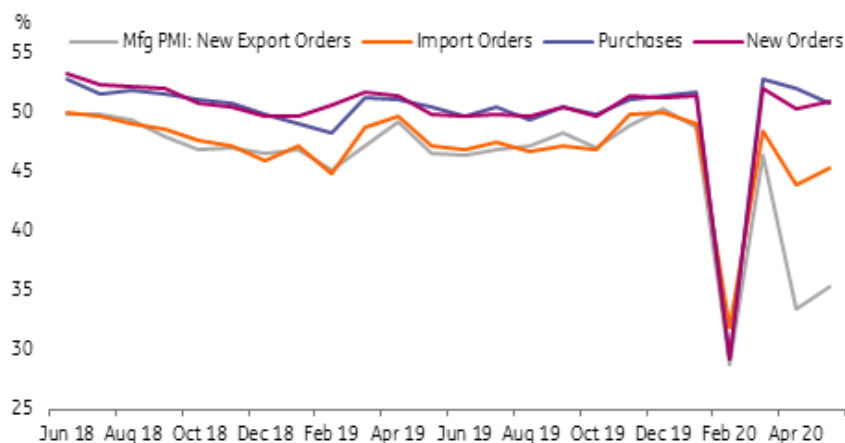
The Covid-19 health pandemic has had at least two major effects on the Chinese economy:

- External demand has been weak, and is likely to continue to be so, as a result of Covid-19 lockdown and social distancing measures, and therefore impacting China's export orders and hurting manufacturing and export businesses.
- Domestic demand in terms of retail sales has been subdued due to social distancing measures.

Covid-19 also makes the US-China 'phase-one' trade agreement less promising. Though China and the US seem to have agreed to uphold the agreement, there are risks that China may import fewer agricultural products from the US.

China will now require food importers to declare that agricultural products have not been contaminated by Covid-19 and this might prompt America to accuse China of not following through on the agreement quickly enough. China has argued that the slow progress is a result of Covid-19.

## China's manufacturing PMI breakdown



Source: CEIC, ING

## Another important imminent risk: The technology war

Apart from Covid-19, more Chinese technology firms have been included in the US 'unreliable entity list' in 1H20, which restricts US companies from selling products and services to Chinese tech firms. Some western countries have joined the US banning specific Chinese tech companies, especially if the technology is 5G infrastructure and smartphone-related. It means Chinese technology companies will experience deteriorating sales to foreign companies.

In the longer term, it means fewer technological exchanges between China and more advanced economies. China has decided to dedicate more resources to advanced technology research and development so that it can be self-reliant going forward.

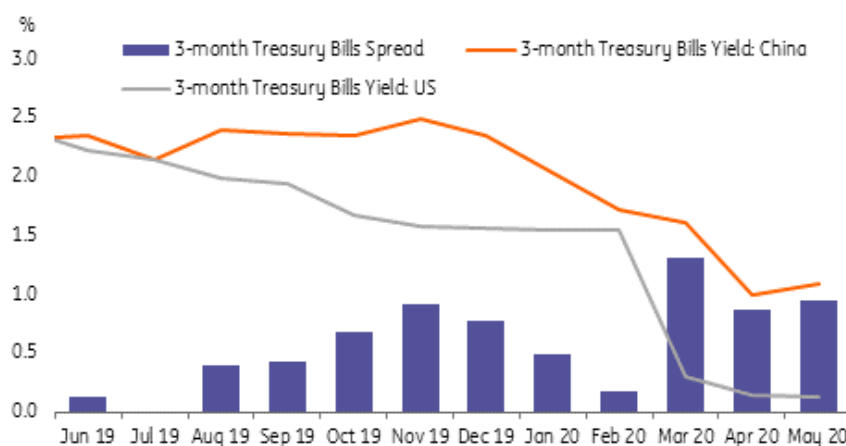
## Positive structural factors

- China's new foreign investment law, which in principle means that foreign companies will receive the same treatment as their Chinese counterparts, has come into effect since 1 January 2020.
- To move towards a technologically advanced economy, the government has set a scheme of "new infra", which contains 5G infrastructure, Artificial Intelligence, Industrial Internet of Things (IIoT), big data centres, ultra-high voltage connectors, and high-speed rails. China has also built its own 'unreliable entity list' that can block out foreign companies from doing business with domestic firms. But at the time of writing this report, the unreliable entity list has not yet been triggered.
- Massive capital outflows aren't a big concern. China's capital account is not completely open, which is why there are no substantial capital outflows. Even if there was a demand for fund outflows, there are very few channels to do this. On the other hand, the cross border fund regulator (SAFE) has introduced policies that welcome more capital inflows in 2020, e.g. the quota system for foreign asset investments in China has changed to a post-investment

registration system, which means there is no limit of inflows into China. Moreover, the sovereign yield spread between China and the US has been positive, which has been an attractive factor for multinational companies operating in China.

- Interest rate liberalisation in progress. The People's Bank of China has created the loan prime rate to replace the benchmark lending rate. But there is still a long way to go to reform the whole process so that the central bank relies on only one short term interest rate as its policy rate. Before the interest rate liberalisation process is complete, the CNY exchange rate cannot be expected to be free-float.

## China-US sovereign bond yield spread



Source: CEIC, ING

## Negative structural factors

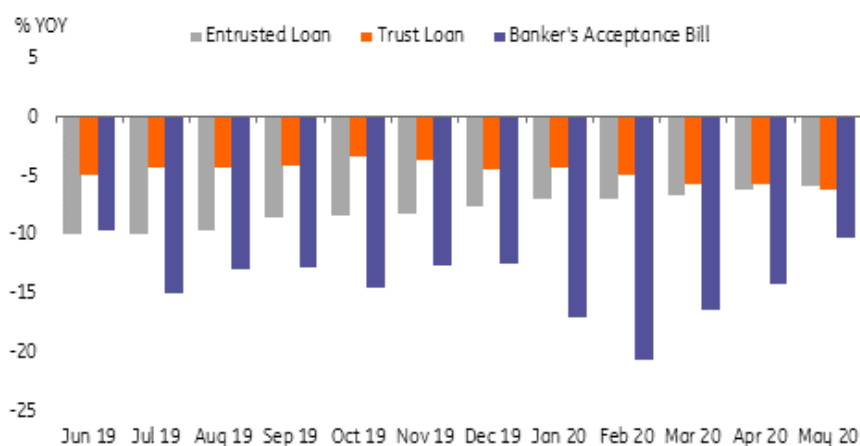
- China's fiscal position continues to deteriorate. Government debt per GDP increased to 54% in 2019 from 49%. This amount excludes debt of local government special bonds, which is categorised as corporate bonds by its credit nature of no guarantee from the local governments. Bricks and mortar infrastructure projects are mostly funded by the issuance of local government special bonds. If the debt of local government special bonds is included then government debt per GDP rises to 102% in 2019 from 88% in 2018, and is expected to rise to 110% in 2020.
- Led by the US, the western world is increasingly reluctant to let China become a technology giant. It is likely that China will continue to build its own technical capacity. But in the meantime, there could be a shortage of advanced semiconductor chips, which dampens Chinese technology product competitiveness.
- An ageing population is a real problem for China. The government is addressing this by moving more residents from rural to urban areas, but the progress is slow.

## Policies to fight against the downward cycle

- Fiscal deficit as a percent of GDP is set by the 'Two Sessions' at over 3.6%. This is a flexible target compared to market estimates of 8% to 11%. The momentum of infrastructure stimulus seems to be slower than expected, particularly transportation infrastructure, which is one of the "new infra" projects. This could be a result of social distancing measures.
- Monetary policies can only supplement fiscal stimulus to help the economy recovery from

- Covid-19. As such, the central bank has adopted a targeted approach for SMEs and broad-based easing should be limited only.
- The silver lining is that we have not seen shadow banking activities make a comeback when there is a big need for credit growth to support infrastructure.
  - There have been no signs that the PBoC has used the depreciation of the yuan to boost exports as the reason behind dismal exports is very weak global demand. A slight depreciation of the yuan can't help exporters to get orders from foreign buyers. USD/CNY continues to move in tandem with the dollar index, and from time to time reacts to market news related to global Covid-19 cases, the technology war and the trade war.

## Shadow banking continues to shrink despite the need of credit to support infrastructure



Source: CEIC, ING

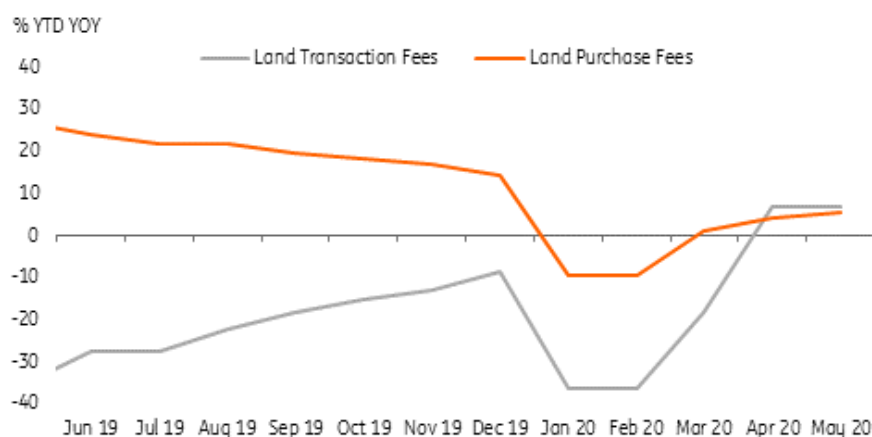
## Loan growth has been fast but may be not as effective

Chinese loan growth has continued rising in the first five months of 2020 at 11.06%YoY compared to 9.49% in 2019 to support economic growth.

However, loan growth does not always translate into economic growth. It seems that some loans have entered into asset markets, including some real estate projects (as land sales fees have increased), stock and bond markets, and structured deposits. The rest has gone to infrastructure projects even when progress has been slow. Ample liquidity will keep interest rates low. 3-month SHIBOR has fallen continuously to 1.453% per annum at the end of May 2020 from 3.02% at the end of 2019.

The central bank has invented an innovative re-lending program for SMEs. At the end of May, Chinese banks have offered relief on CNY3.9 trillion of loans since the outbreak of Covid-19 to SMEs. More, banks have postponed taking principal repayments on CNY 1.44 trillion in loans to almost 800,000 SMEs and pushed back CNY 65.4 billion in interest payments. Banks also rolled over CNY2.4 trillion in financing to SMEs [according to Bloomberg citing CBIRC officials](#). As such bank margins are expected to be squeezed in 2020.

## Land fees increase during Covid-19



Source: CEIC, ING

## Forecasts

### GDP forecast

- Policies in 2020 are likely to focus on rebuilding the economy, which include structural policies, e.g. the “new infra” scheme and cyclical policy of fiscal stimulus. But the high uncertainty brought by Covid-19, e.g. whether there could be a second wave of infection, locally and globally, has made the government decided not to set any GDP growth target for 2020. This decision was reached after GDP growth in 1Q20 was -6.8% after +6.0% in 4Q19.
- The PBoC applies a targeted approach for liquidity injection, but monetary policies can only help the economy to a limited extent. When small businesses have difficulty surviving due to loss of foreign orders, which could be longer than previously expected if social distancing measures continue globally.
- We maintain our forecasts for the Chinese economy at -1.5% in 2020.

### Interest rate forecast

- The PBoC is expected to continue its targeted easing approach. There should be more SME loans. This means broad-based easing is increasingly less likely.
- We expect there could be one more targeted RRR cut of 0.5 percentage points but unlikely to have an interest rate cut unless Covid-19 cases increase quickly and become difficult to be under control in China.

### USD/CNY forecast

- The PBoC has shown no preference for a weaker yuan even during bad times like this. The yuan has strengthened against the dollar in May as Covid-19 cases subside globally.
- We expect USD/CNY will continue to move with global Covid-19 trends, the technology and the trade war, which means volatility can be high.
- Our forecasts for USD/CNY remains unchanged at 7.05 by the end of 2020.

## Forecast table

China	2019					2020				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
GDP (% YoY)	6.4	6.2	6.0	6.0	6.2	-6.8	-3.1	-0.5	4.5	-1.5
CPI headline (% YoY)	1.8	2.6	2.9	4.3	2.9	5.0	2.6	2.2	1.9	2.9
PBOC 7-day reverse repo rate (% eop)	2.55	2.55	2.55	2.50	2.50	2.2	2.2	2.2	2.2	2.2
3M Shibor (% eop)	2.80	2.95	2.73	3.05	3.05	1.90	2.00	1.90	1.80	1.80
10-year T-bond yield (% eop)	3.07	3.20	3.14	3.10	3.10	2.60	2.90	2.95	3.00	3.00
Exchange rate (CNY per USD eop)	6.74	6.90	7.15	7.00	7.00	7.08	7.07	7.06	7.05	7.05

Source: ING

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