BBVA | RESEARCH

China Economic Outlook

Second Quarter 2014
Economic Analysis

- **Global growth should accelerate in 2014, with downside risks still present** from QE tapering and turmoil in emerging markets. We have slightly lowered our global growth projections to 3.4% in 2014 and 3.8% in 2015 on account of recent outturns.
- **Growth momentum in China slowed in Q1,** primarily on sluggish investment demand. The authorities have shown a greater tolerance for somewhat lower growth, seeking to push for structural reforms and to contain financial risks.
- **Our growth projections for China are trimmed to 7.2% from 7.6% in 2014 and to 7.0% from 7.5% in 2015.** The financial fragilities continue to act as headwinds to short-term growth. The focus now is on implementing the reforms announced at November's Third Plenum.
- **Risks are still to the downside.** With the deepening of structural reforms, the authorities need to draw a fine line between sustaining short-term growth and boosting long-term growth potential.

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Summary

In the first quarter of 2014, growth momentum slowed at a quicker-than-expected pace primarily due to subdued investment. GDP growth decelerated from previous 7.7% y/y in Q4 2013 to 7.4% y/y in Q1 2014, the lowest in six straight quarters and also below the government's 7.5% full-year target.

During the annual meeting of the National People's Congress, last March, a set of key macroeconomic targets for 2014 (including a 7.5% growth target and a 3.5% inflation target) were announced. At the same time, however, the authorities have increased their tolerance to somewhat lower growth, as a necessary condition to push for structural reforms and contain financial risks, On the other hand, a number of mini stimulus measures were introduced to underpin the near-term growth within a "reasonable" range, which we interpret to be a band between 7% and 7.5% growth rate.

We have revised down the full-year growth for 2014 to 7.2% from 7.6% previously, below the official target of 7.5%. The downward revision takes into consideration the relatively negative economic data outturn and the authorities' greater tolerance of economic slowdown. In any event, the downward revision remains moderate given the authorities' announcement of "prudent monetary and proactive fiscal" policies, which has been materialized in the way of a "mini" stimulus fiscal package of about 0.3-0.4% of GDP thus far. In the same vein, our GDP growth projection for 2015 has also been lowered to 7.0% from 7.5% previously given the short term negative impact of the reforms as well as the crackdown on shadow banking and too rapid indebtedness. Still, over the medium term, we expect growth to slow down gradually to 6.5% by 2018.

In the meantime, the government will press ahead with key structural reforms, following the blueprint announced in the Third Plenum last November. In particular, we expect further progress in urbanization (especially "Hukou" system reform), financial sector (steps toward interest rate liberalization and the implementation of a deposit insurance scheme, and greater private entry into the banking sector), market pricing for utilities and natural resources, more market access for private and foreign investors and a further reduction in the government's intervention in the market.

Risks are still tilted to the downside, concentrating on elevated financial fragilities and uncertainties about the implementation of their reform agenda. As the debt-fuelled growth model comes to an end, the authorities need to find new growth drivers and ensure a smooth transition between the old and new growth regimes. Moreover, the uncertain impact of US QE tapering on China's capital flows is likely to exert downward pressure to the growth outlook

1. Global recovery continues

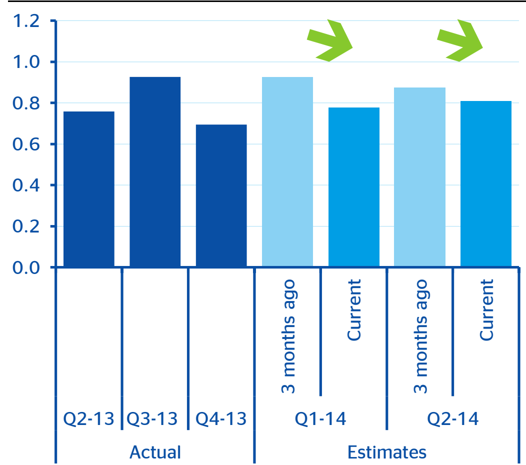
Before turning to China, we review the Global Outlook. Readers may go directly to the sections on China, if they wish, by turning to page 7.

The global economic cycle remains robust

According to our estimates, in the first quarter of 2014 global GDP has accelerated very slightly to around 0.8% QoQ and, according to our global activity indicator (BBVA-GAIN), we expect this pace to be maintained for the first part of the year (Figure 1.1). In the wake of this sustained global recovery is the cyclical improvement in the DMs, which has offset the deceleration in some EMs in Asia and Latin America. Meanwhile, in the last few months the financial markets have performed very differently in the two regions (Figure 1.2), and with more differentiation between the EMs. Capital flows, asset prices, interest rates and financial tension indicators have fundamentally performed in line with the outlook for rate hikes in the UK, but have also been affected to a greater or lesser extent by geopolitical risk events in Eastern Europe and China's slowdown expectations. Altogether, tightening financial conditions have differed in each economy as a function of the degree of external vulnerability and financial integration. This is all related to higher deficits on current account, dollar-linked liabilities and flexible exchange rates.

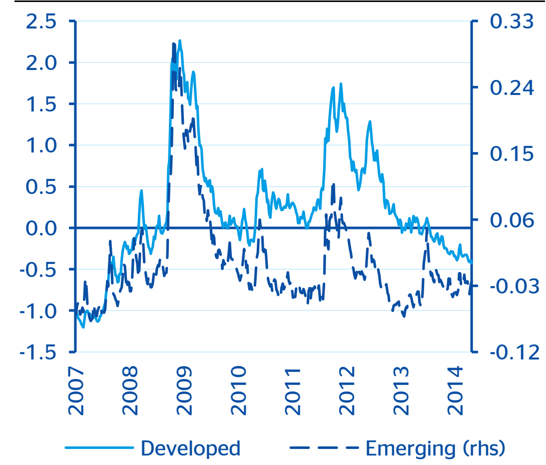
The global scenario is a result of a combination of the policies introduced domestically but having cross-border implications, not only in terms of more or less demand for goods and services (international trade), but also in the extent to which they help to alter global risk-aversion, which is reflected in the volatility of capital flows and/or the prices of financial assets and raw materials.

Figure 1.1
Global growth (%, QoQ) based on BBVA-GAIN



Source: BBVA Research and IMF

Figure 1.2
BBVA Research Financial Tensions Index in DMs and EMs



Source: BBVA Research

To sum up, our assessment of the global scenario has a downward bias compared with our valuation three months ago, which is reflected in the adjustments to our forecasts. After growing at 3.0% in 2013, global GDP will start to accelerate again in 2014 and 2015 at around 3.4% and 3.8% respectively, figures that demonstrate both the variations in growth expectations in diverse regions and the increased, although slight, contribution to global growth by the developed economies. Although there have been no significant changes in either the US or the eurozone, the downward pressures in our forecasts are above all visible in

the EMs in 2014 and 2015, in both Asia and Latin America. In this context, there are still short- and medium-term downside risks to our forecast.

The US overcomes the impact of an unusually cold winter

US GDP has been affected by the impact of unusually adverse weather conditions. In the labour market, employment has increased by an average of 178,000 jobs in 1Q14, in line with the print in 4Q13, and the unemployment rate has fallen to 6.7% of the labour force, a smaller than expected fall because the increase of the population available to work. As a result, the Fed has pressed ahead with the announced moderation in its balance-sheet expansion. In this context, we are expecting the Fed to complete its exit from the asset-purchase programme towards the end of the year, and the market to focus on a possible change in inflation trends as it anticipates the start of interest-rate hikes in a scenario of a gradual acceleration in GDP growth. Growth in 1Q14 reached 0.1% SAAR. The leading indicators point to a slightly more robust start to the second quarter than to the first.

Altogether, we are maintaining our forecast for US growth at 2.5% in 2014, and the same in 2015. The forecast has upside risks if the improvement in confidence provides additional incentive to corporate investment and job-creation.

Improving prospect for the eurozone

On the European side, growth in the eurozone in the latter part of 2013 was driven by the recovery in exports, which has also favoured the improvement in investment. Looking at the first quarter of 2014, our short-term models point to an acceleration of around 0.5% QoQ, although the boost from the external sector could moderate in the coming months due to: i) euro appreciation, with a slight impact on growth but clearly differentiated by country; ii) the reduced demand from China, also with diverging direct effects; and iii) geopolitical risks in the East if the crisis in Ukraine continues.

We maintain our forecasts for the eurozone in 2014 at 1.1%, and 1.9% in 2015, in a scenario of contained financial tensions and fiscal and monetary policies that do not put a brake on growth. In this gradual recovery, domestic demand will play a growing part, with accelerating investment and enhanced consumption, in line with the steadiness of the labour market in 2014 and then job-creation in 2015. As already established, this scenario requires progress on the achievement of an effective banking union, starting with the maximum transparency of bank balance sheets through asset quality reviews under common regulations and stress tests under common adverse scenarios.

More uncertainties for Japan

Of the developed economies, there is slightly more uncertainty about the growth outlook for Japan, which has had a QE programme underway since January 2013, together with fiscal stimuli to return to having inflation and favouring consumption and investment. The recent tax increases on consumption to control the public deficit could put the recovery in private demand at risk, although there are still some offsetting measures to take, including an even more intense monetary expansion. Altogether, we have revised downwards our outlook for growth in 2014 by four basis points to 1.1%, and we are maintaining our estimate for 2015 at 1.3%**.**

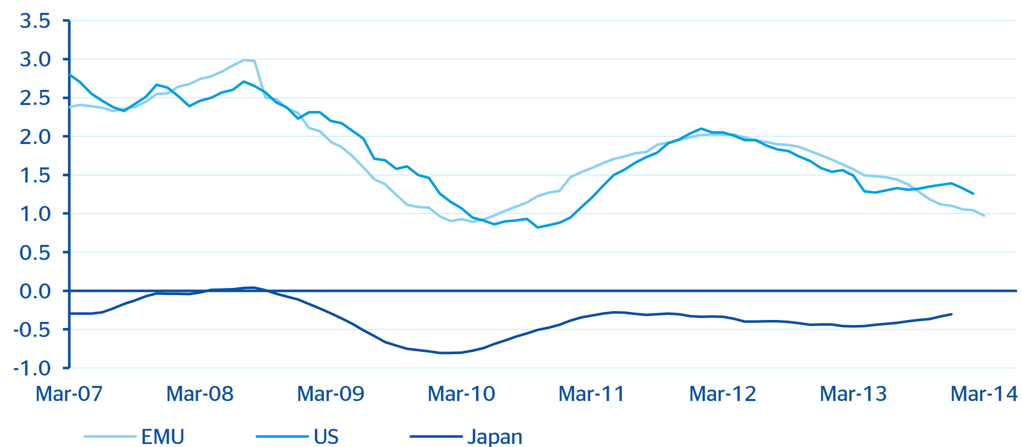
Disinflation has become more relevant for developed economies

In the developed economies, the period of low inflation or disinflation continues, as evidenced by various optimised indicators[1] (Figure 1.3). While in Japan the inflationary tensions indicator is rising – although still in negative territory – as a result of the above-mentioned policies and it

1: For more information about trimmed means see, for example, Spain Economic Outlook from February 2014, available at:
http://www.bbvaresearch.com/KETD/fbin/mult/1402_Spain_Economic_Outlook_tcm348-426396.pdf?ts=2942014.

remains anchored in the US, in the eurozone it is still falling and is now around 1%. According to our base scenario, it is likely close to its lows and the perspective of an increase is sound. Nonetheless, although we are not expecting deflation, the vulnerability to negative shocks, global or domestic, with an impact on prices is comparatively high. The vulnerability comes not only from the level and the downward trend of inflationary tensions, but also from the financial situation of the private sector, with very high levels of debt in at least some of the economies in the region and a banking sector that is in the process of reinforcing its capacity to lend, as described above. A negative shock that could result in a change in inflationary expectations would increase the probability that the ECB would take additional measures, from providing long-term liquidity to the banking sector with no restrictions, to lowering reference rates or making selective purchases of high-quality private-sector debt assets

Figure 1.3
Inflationary tensions indicators in developed economies
Trimmed means from baskets of personal consumption prices in the US and from CPI in Japan and the eurozone



Source: BBVA Research and Dallas Fed

Emerging markets are facing external and internal headwinds

The normalisation of US monetary policy of quantitative measures and interest-rate expectations is resulting in a rebalancing of financial portfolios at a global level, which is having a relevant impact on funding conditions and asset prices in the EMs. This contagion is nothing new, but has raised its head again in a new environment: with more financial integration in the EMs and an extraordinarily lax monetary policy in the US. Symmetrically, the exit from this exceptional period will also have an impact on the financial variables.

In this latter group, we are also starting to see concerns about the economic slowdown in China since the Chinese New Year, given the increased emphasis that the authorities are now placing on reducing vulnerabilities – via medium-term macro-prudential policies – rather than in sustaining growth in the short term.

2. Growth slowed due to policy constraints

Growth momentum continued to moderate in Q1 2014, at a quicker-than-expected pace, on subdued investment. GDP growth decelerated from previous 7.7% y/y in Q4 2013 to 7.4% y/y in Q1 2014 (Figure 2.1), the lowest in six straight quarters and also slightly below the government's 7.5% full-year target. Barring the exit of the stimulus package last year, investment was particularly affected by the government's efforts to push for key structural reforms, to curb financial fragilities and to tackle over-capacity and pollution problems. The authorities have shown a greater tolerance of economic slowdown (in order to better push forward structural reforms and contain financial risks), by indicating they can accept a small (downward) deviation from the 7.5% growth target as long as employment remains healthy. In lieu of the recent economic development and the nuanced policy stance, we revised down our 2014 full-year growth projection to 7.2% from 7.6%.

The slowdown has indeed raised another round of pessimistic sentiment in the market again, concerning a possible economic hard-landing triggered by rising financial risks and housing market bubbles. However, while partly sharing the market's concerns, we do not expect any immediate economic hard-landing, financial crisis or a collapse in the national real estate market (see our China 2014 Real Estate Outlook). The 7.4% growth rate in Q1 still remains within the "reasonable" range that the government stressed, which include an upper bound of 3.5% inflation and a bottom line of 7.0% GDP growth (instead of 7.5%). Meanwhile, most recent monthly indicators for March and April are showing signs of stabilization, thanks to the government's timely policy fine-tuning and improved exports.

We are encouraged by some positive signs in structural rebalancing. In particular, service sectors continue to outpace manufacturing sectors in Q1 after surpassing the latter in 2013, while consumption has become the main driver of GDP growth, ahead of investment and net exports (Figure 2.2 and 2.3). At the same time, the current account surplus shrank to 0.3% of GDP in Q1, the lowest reading since Q1 2011, pointing to an economic rebalancing towards domestic-demand (Figure 2.4). As to the financial risks, shadow bank lending and overall credit growth have been moderating through March, thanks to the authorities' greater clampdown efforts.

On the policy front, the authorities in March's annual National People's Congress announced a set of key macro targets for 2014 (including a 7.5% growth target and a 3.5% inflation target), and pledged to maintain growth-supportive policies. Ever since, the government has introduced a number of mini stimulus measures to underpin the economy, including: (i) accelerating public infrastructure spending and social housing construction, (ii) extending more subsidies to SMEs; (iii) cutting red tape for exports; (iv) allowing more market access to private and foreign investors, and (v) easing monetary conditions (weaker currency, lower interbank rates, and selective RRR cuts for rural banks). We estimate that the aggregate size of this stimulus fiscal package amounted to 0.3-0.4% of GDP. They are not only aimed to underscore near-term growth but also to facilitate structural rebalance and boost long-term growth potential.

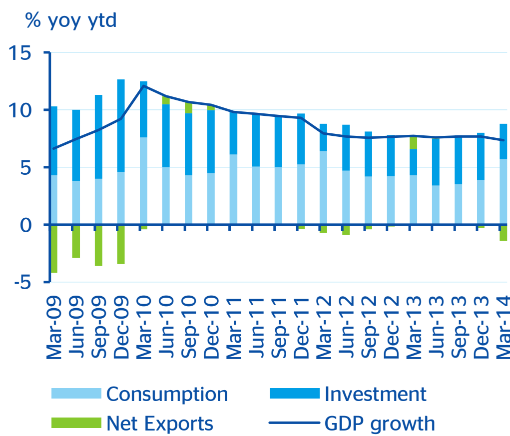
The authorities, following the reform blueprint announced in the Third Plenum last November, continued to press ahead with key reforms. In response to the recent economic slowdown, the authorities especially prioritized reform items more instrumental to near-term growth outlook, in particular on financial liberalization. For example, the People's Bank of China (PBoC) widened the RMB's daily trading band and enhanced two-way flexibilities of the exchange rate in mid-March. The central bank also relaxed regulations on cross-border fund flows of multinational corporations, alluring more multinationals to expand their investment in China. Nevertheless, not all the ongoing reforms are beneficial to the near-term growth momentum although their implementation will help to bolster longer-term growth potential and boost near-term sentiment. For example, the ongoing anti-corruption campaign has inevitably repressed

the demand for high-end consumer goods and services. The authorities therefore need to tread a fine line between pushing forward long-term structural reforms and sustaining near-term growth. (Box 1)

Growth slowed in Q1 2014

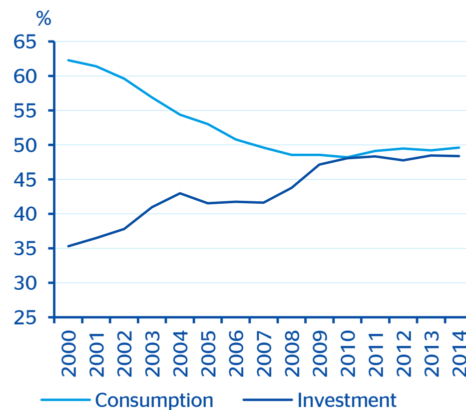
Q1 GDP of 2014 slowed to 7.4% y/y from 7.7% of the previous quarter. In sequential terms, (which are less reliable) officially reported quarterly GDP growth fell to a seasonally adjusted 1.4% (5.7% annualized), the lowest since Q2 2012, from 1.7% in Q4 2013 (7.0% annualized). The deceleration of GDP growth in Q1 was mainly due to slowing investment as the "mini-stimulus" measures of 2013 expired and the government is gearing up to tackle the over-capacity and to curb shadow bank lending). According to the National Bureau of Statistics (NBS), the contribution of consumption to growth (y/y basis) amounted to 5.7 ppts, followed by investment (3.1 ppts), while the contribution of net exports stood at -1.4 ppts.

Figure 2.1
Growth momentum continues to moderate



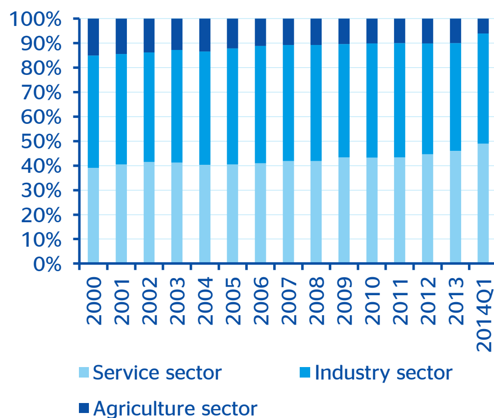
Source: NBS, CEIC and BBVA Research

Figure 2.2
But rebalancing toward consumption resumes



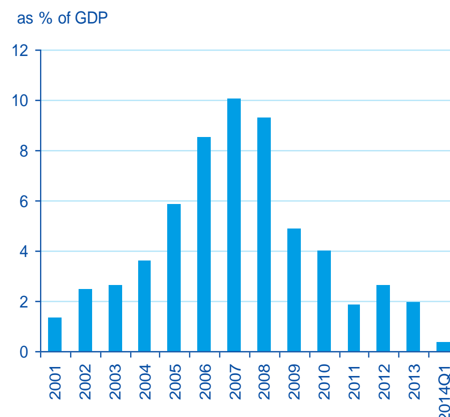
Source: NBS, Wind and BBVA Research

Figure 2.3
...as the share of the service sector rises further



Source: NBS, CEIC and BBVA Research

Figure 2.4
... and the current account surplus declines to minimal

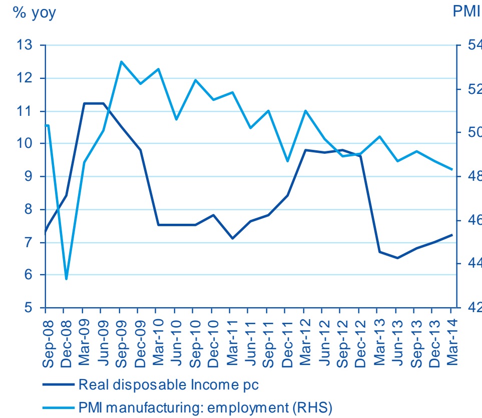


Source: NBS, Wind and BBVA Research

Figure 2.5
The labour market has held up relatively well

Source: CEIC and BBVA Research

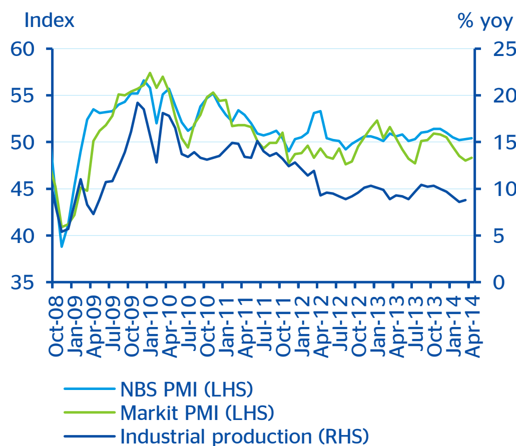
Figure 2.6
...despite of soft wage growth



Source: CEIC and BBVA Research

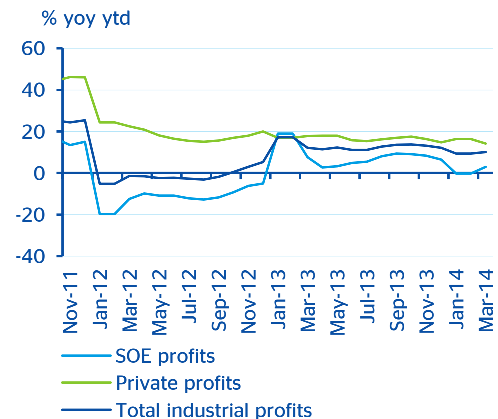
Despite a slowdown in growth, the urban registered unemployment rate stays low at about 4.1%. Official data also shows that 3.44 million new jobs were created in urban areas in Q1, and the ratio of demand to supply in the labor market remains high (Figure 2.5). Nonetheless, PMI subcomponents of the labor market have softened lately (Figure 2.6), likely driven by sluggish manufacturing activity and anemic investment (Figures 2.7 and 2.8).Taken together, the mixed signals of the labor market underscore challenges faced by the government to ensure stable employment as the economy is slowing down due to both structural and cyclical reasons.

Figure 2.7
China's manufacturing activities are stabilizing despite remaining sluggish



Source: CEIC and BBVA Research

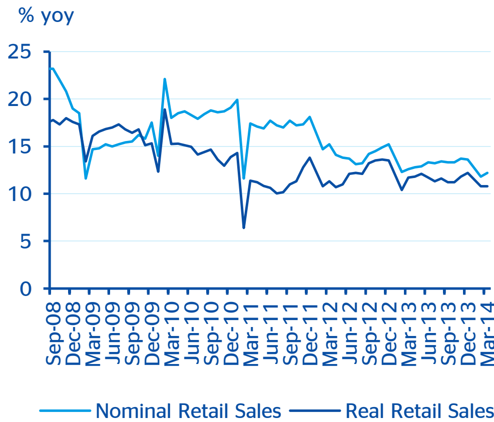
Figure 2.8
...so do industrial profits



Source: CEIC and BBVA Research

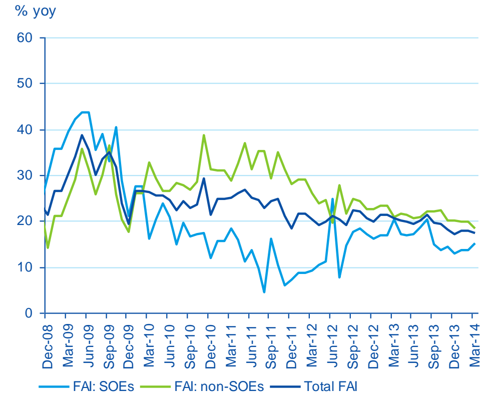
On the demand side, recent high frequency data points to a pickup in private consumption (Figure 2.9), declining investment (in particular private investment, Figure 2.10), and a gradually improving external sector. While retail sales may have recovered from the headwinds of slower income growth and the government's anti-corruption campaign, overall investment has been sluggish, which has been exacerbated by weaker real estate and manufacturing investment. For the latter, the over-capacity problem and, on a flip side, high debt levels continue to infect part of enterprises, which was aggravated by the government's efforts to tighten lending standard for a number of industries such as steel, shipbuilding and cement. (See our previous report about China's corporate debt).

Figure 2.9
Retail sales growth is picking up after a sharp decline early in the year



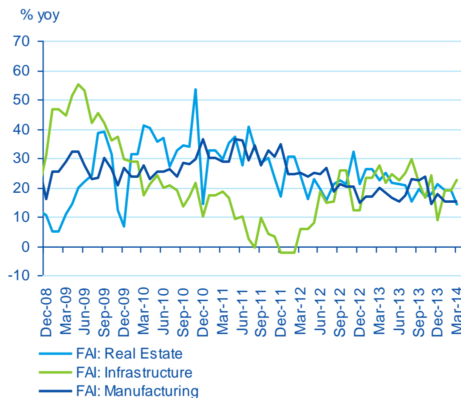
Source: CEIC and BBVA Research

Figure 2.10
... while private investment decelerates further



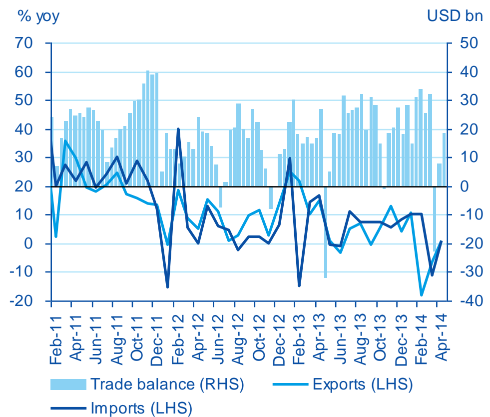
Source: CEIC and BBVA Research

Figure 2.11
...as weaker real estate and sluggish manufacturing investment



Source: CEIC and BBVA Research

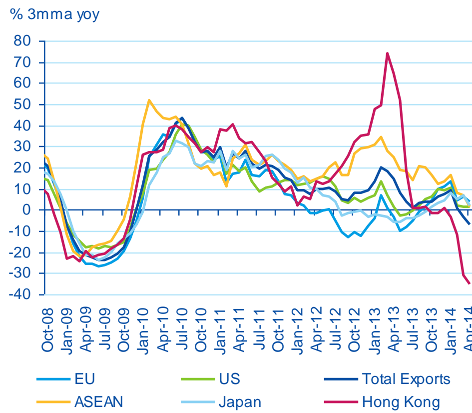
Figure 2.12
The fragile external sector is recovering gradually



Source: CEIC and BBVA Research

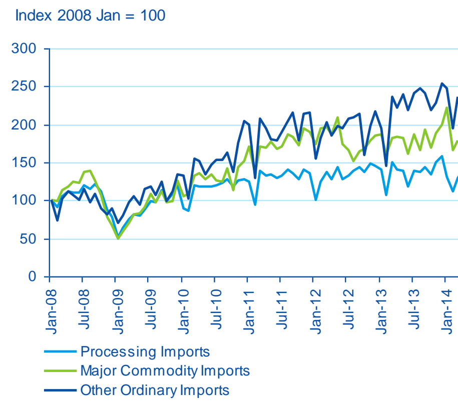
The performance of the external sector deserves more scrutiny. The headline exports data varied dramatically across months in the first quarter, partially due to the lunar New Year holidays. Aggregately, total exports in Q1 declined by -4.7% y/y, compared to a year-on-year growth of 7.5% in Q4 2013. It is however noted that the official export data during the period from mid-2012 to mid-2013 was inflated by some exporters' over-invoicing behaviours (especially via Hong Kong, Figure 2.13), aimed to take advantage of the RMB's interest and exchange rate differentials between onshore and offshore markets. After excluding the distortion of over-invoicing, we estimate that the underlying export growth rate is a few percentage points higher than the official headline figures, at about 2.1% y/y in Q1 (official: -4.7%). That said, China's exports have fared better than shown by the headline data, thanks to gradually recovering demand from the advanced economies (especially the US and EU).

Figure 2.13
Export growth is heavily distorted by trade with Hong Kong



Source: CEIC and BBVA Research

Figure 2.14
… as domestic demand and re-exports are helping imports

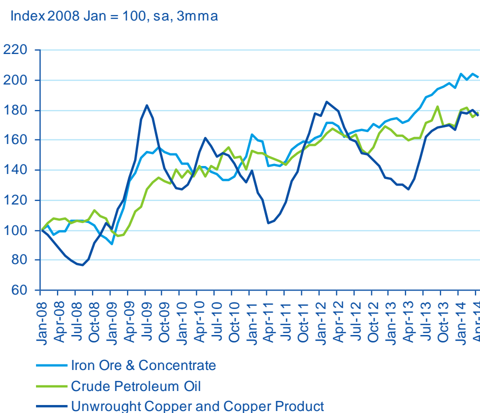


Source: CEIC and BBVA Research

Imports also picked up thanks to stable domestic demand as well as processing imports (used in the production of export goods) (Figure 2.14). Meanwhile, commodity imports continued to trend up gradually in recent months (Figure 2.15). Resilient commodity demand might stem from the stockpiling of domestic enterprises during the episode of lower commodity prices. On the other hand, some anecdotal evidence revealed that some commodity importers have been increasingly using imported commodities (especially copper and iron ore) to obtain cheap domestic credit.

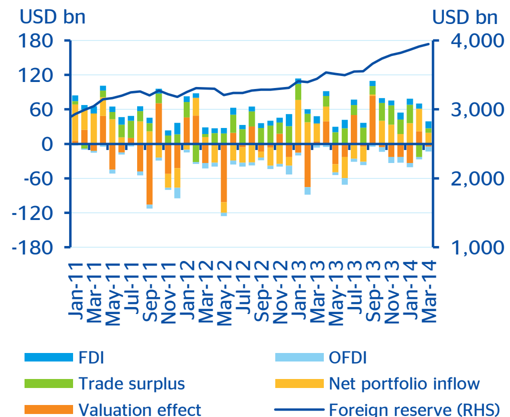
Despite that the trade surplus shrank to USD 7.6 billion in Q1 from USD 88.8 billion in Q4 2013, foreign reserves rose to 3.95 trillion USD at end-March from 3.82 trillion at end-December (Figure 2.16) on persistent FDI and portfolio inflows.

Figure 2.15
Commodity imports remain strong



Source: CEIC and BBVA Research

Figure 2.16
FX reserves accumulate on continued FDI and capital inflows

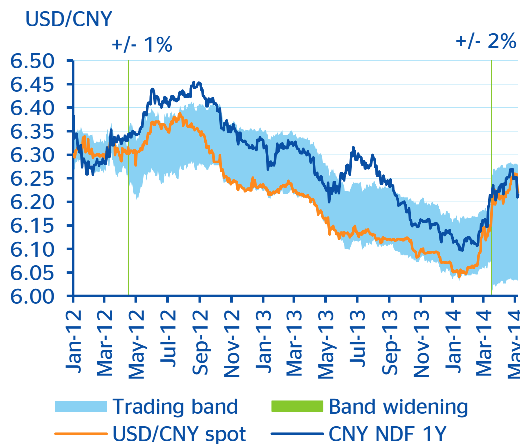


Source: CEIC and BBVA Research

RMB continues to fall after the widening of daily trading band

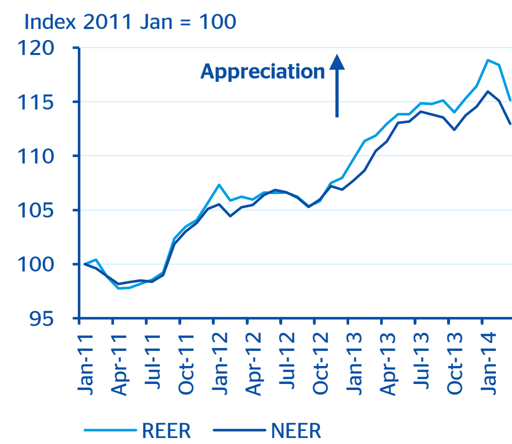
After appreciating by 3% against the USD in 2013, the RMB has reversed the appreciation course and depreciated since the beginning of this year. The RMB's weakening trend continued after the PBoC widened the currency's daily trading band to +-2% from +-1% on March 17 (Figure 2.17 and 2.18), in an effort to enhance the two-way flexibility of the exchange rate and step towards a market-oriented exchange rate system. Many observers believed that the PBoC initiated the deprecation course in February by intervening in the FX market. Indeed, since mid-March, the depreciation has become more self-sustained as the spot rate was constantly traded in the weaker side of the daily trading band after signals of growth slowdown and the shrinking current account surplus surfaced. To date, the RMB depreciated by 3.0% against the USD, and the NEER and REER declined 1.4% and 1.1% respectively; meanwhile, the exchange rate volatility has significantly risen.

Figure 2.17
RMB started to decline sharply since February



Source: Bloomberg and BBVA Research

Figure 2.18
The nominal and real effective exchange rates also declined

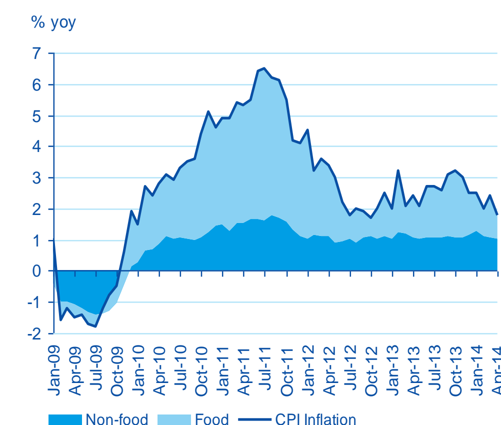


Source: BIS, CEIC and BBVA Research

Inflation remains benign

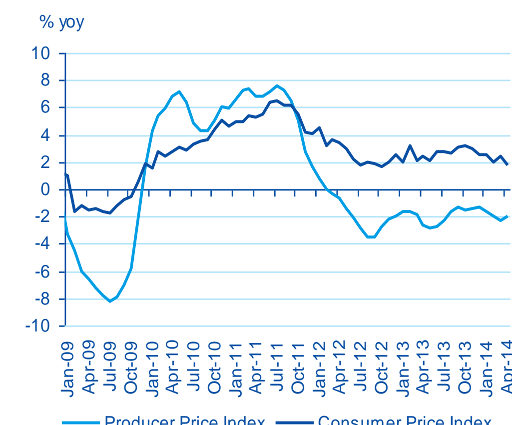
Inflation remains benign, at 1.8% y/y for April (Figure 2.19), within the government's 3.5% target, thanks to low prices of both food and non-food items. Meanwhile, producer price inflation stayed in negative territory (-2.0% y/y in April), pointing to sluggish manufacturing activities (Figure 2.20). The benign inflation provides room for monetary policy easing if necessary.

Figure 2.19
Inflation remains within 3.5% target



Source: CEIC and BBVA Research

Figure 2.20
PPI inflation is still negative



Source: CEIC and BBVA Research

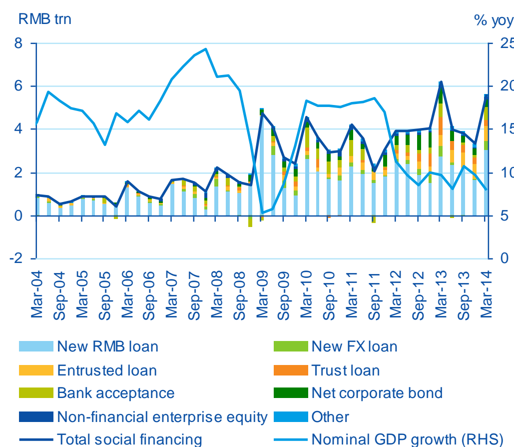
Credit growth slowed down and the money market stabilized

Credit growth has moderated as the authorities strive to curb credit growth and shadow bank lending (Figures 2.21 & 2.22). The "total social financing", a broadest gauge of credit, decreased by -18.8% y/y in March, while new bank loans were flat on a yearly basis. Similarly, M2 growth fell to 12.1% y/y in March from 13.3% y/y in February.

Inter-bank market rates have stabilized after the December crunch, thanks to the PBoC's short-term liquidity injection (Figures 2.23 & 2.24).The accommodative liquidity condition also served to mitigate financial risks. It is noted that the first bond default case of China's capital market (the Chaori Solar Company) emerged in early March while it hasn't caused any big movement in the money market.

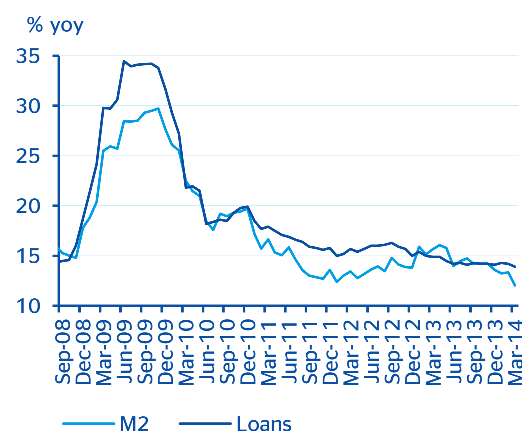
Notwithstanding the liquidity abundance at short tenors, long-term funding costs remained higher than a year ago. Banks might have become more conservative about managing long-term liquidity after witnessing two bouts of cash crunches last year. Moreover, the ongoing interest rate liberalization could also fuel banks' expectation of more expensive funding in future.

Figure 2.21
Shadow bank lending is slowing down



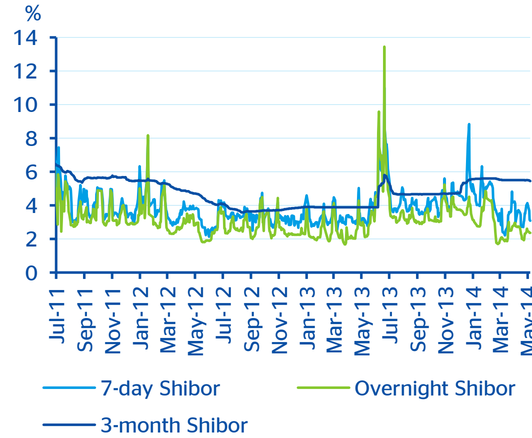
Source: CEIC and BBVA Research

Figure 2.22
...while M2 and bank loan growth moderate



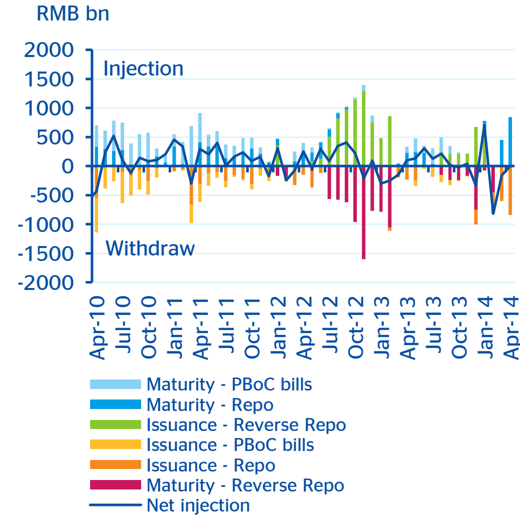
Source: Wind and BBVA Research

Figure 2.23
The interbank liquidity become more accommodative



Source: CEIC and BBVA Research

Figure 2.24
...despite net funding withdrawing by the PBoC

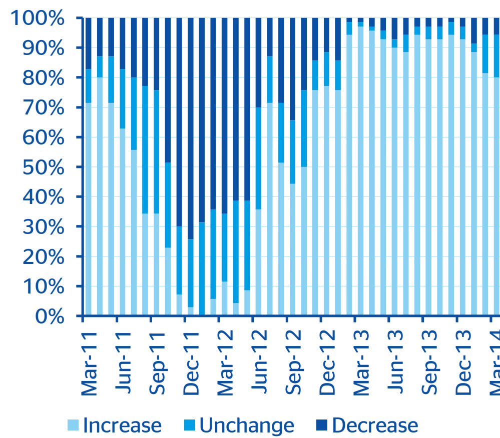


Source: Wind and BBVA Research

Real estate market is cooling with divergence across cities

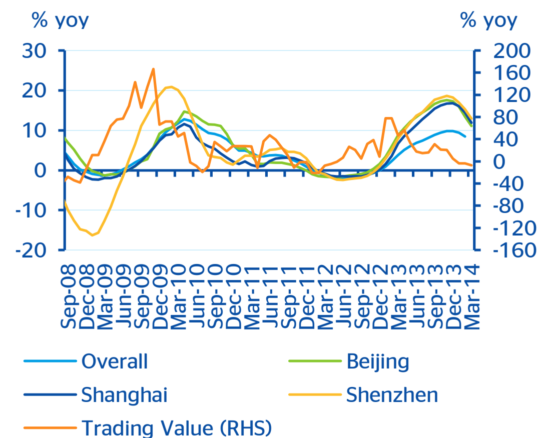
After rapid increases in 2013, property prices are cooling now on downbeat market expectations over slowing GDP growth and rising financial fragilities. Both prices and transactions in the housing market have moderated, as fewer cities are reporting price increases (Figures 2.25 and 2.26). We estimate that on a nationwide basis that overall property prices rose by 7.4% y/y in March, led by Tier 1 cities (9.0% y/y). Local markets in smaller cities are weighed on by sluggish demand and over-supply. This moderating trend should help to curtail price misalignments, which we estimate to have widened to 5-10% in 2013 (see our 2014 China Real Estate Outlook).

Figure 2.25
Fewer cities report rising housing prices



Source: NBS and BBVA Research

Figure 2.26
Housing prices and transactions are moderating



Source: NBS, CEIC and BBVA Research

Box 1.Taking stock of stimulus and reform measures

The weakening growth trend has prompted the authorities to unveil a set of short-term supportive measures to underpin the economy. Compared to the huge stimulus package implemented years ago, these new ones are not only smaller in size but also much more "targeted". For example, the authorities recently cut the RRR only for rural financial institutions rather than the whole banking system as in the past. Table B.1.1 below shows a detailed list of measures.

In the meantime, the authorities have been persistently pushing for the structural reforms announced in the Third Plenum last November, in particular prioritizing certain measures favouring near-term growth. In this respect, some financial liberalizing measures have been announced, such as the widening of the RMB daily trading band (to maintain a weaker currency) and certain relaxations of regulations under the capital account (to encourage foreign investment). Table B.1.2 below shows a detailed list of measures.

Table B.1.1
Mini-Stimulus measures

April 2	The State Council announced to unveil three major growth supportive measures, including 1) Raise the threshold for the existing preferential tax treatment for SMEs from current RMB 60,000 with an extension period (until end-2016); 2) Accelerate shantytown renovation; 3) Facilitate the investment in the railway construction (6,600 km of new railway lines for 2014) and set up a railway development fund (RMB 200-300 billion per year).
April 16	The State Council announced to extend the existing preferential tax treatment for people who are unemployed, fresh graduates, disabled to start their own business (until end-2016); all business hire people officially registered as unemployed for more than 1 year can have the preferential tax treatment.
April 22	The People's Bank of China (PBoC) announced to cut the reserve requirement ratio (RRR) for county-level rural commercial banks by 2.0 percentage points and that of rural credit cooperatives by 0.5 percentage point.
April 23	The State Council announced 80 major investment projects, mainly covering infrastructure (railway, harbo etc.) and clean energy sectors (hydropower, wind power etc.), to support growth momentum with a wider access for private and overseas investors.
April 30	The State Council announced to further streamline the administrative process to boost exports and imports; and design measures to promote the employment of college graduates.
May 2	It is reported that the China Development Bank (CDB) has signed to grant special loans to support shantytown reconstruction projects in several province and cities, aiming to support growth and solve housing affordability problem.

Table B.1.2
Structural Reforms

February 6	China Banking Regulatory Commission (CBRC) announced to allow private investors to set up rural commercial banks as part of rural development plans. The move is expected to increase competition in the financial industry.
February 19	Sinopec, the country's largest oil-refining company, announced to allow private investors to invest in up to 30% of its retail oil business, a step towards the mixed ownership model mentioned in the blueprint of the Third Plenum.
March 11	China Banking Regulatory Commission (CBRC) issued bank licenses to five banks owned by private capital in a pilot program, marking the opening of its banking sector to private investors.
March 15	The People's Bank of China (PBoC) announced the widening of the daily trading band of the RMB against the USD to +/- 2.0% (around the daily opening fixing rate) from +/- 1.0%, effective from March 17. In addition, the PBoC also raised the bid-ask spread for USD offered by foreign exchange-designated banks to their customers from the current level of 2% to 3%.
March 26	The CITIC Pacific, listed in HK, announced to buy all the assets of its Chinese state-owned parent CITIC Group, considered as another case on SOE reforms to private and foreign investors.
April 1	The National Development and Reform Commission (NDRC) announced to liberalize the freight pricing mechanism on one new railway line (Zhunchi Railway), paving the way for easing access of private sector investment.
April 1	The China Security Regulatory Commission (CSRC) issued policy guidance on the issuance of preference shares, which can provide new instruments for banks to replenish their core capital.
April 10	The China Securities Regulatory Commission (CSRC) announced to allow cross-border stock investment to designated companies listed in A-share market in Shanghai and H-share market in Hong Kong in 6 months.
April 25	The State Administration of Foreign Exchange (SAFE) announced to further relax cross-border fund transfer of multinational corporations so as to encourage these multinationals to expand investment in China. The new regulations will take effective on June 1, 2014.
April 30	Ministry of Finance (MoF) announced to include telecom sector into the current pilot VAT reform. The new scheme will take effect on June 1, 2014, following the expansion to the railway transportation and postal service sectors since the beginning of this year.

3. Reforms remain the top priority

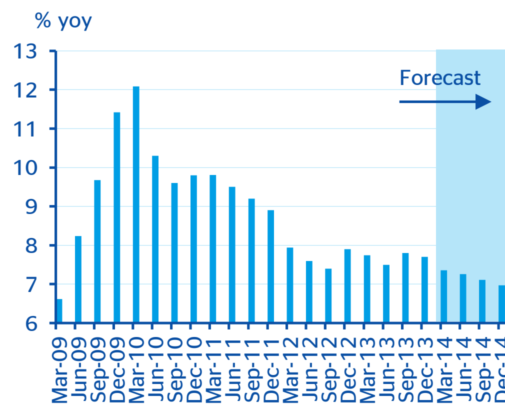
Given the anticipated growth-supportive policies and improving exports, the economy is likely to stabilize through the remainder of 2014. However, GDP growth, on a yearly basis, may decline gradually towards 7.0% from 7.4% y/y in Q1, due to base effects (Figure 3.1). The full-year growth for 2014, hence, is revised down to 7.2% from 7.6% previously, below the official target of 7.5%. The downward revision takes into consideration recent economic development and the authorities' revealed greater tolerance of economic slowdown as the government is striving to implement key reform, to tackle over-capacity and pollution problems and to curb financial fragilities. In the same vein, GDP growth projection for 2015 has also been lowered by a similar magnitude to 7.0% from 7.5% previously, while over the medium term we expect growth to slow down gradually to 6.5% until 2018.

We expect the policy stance for 2014 to stick to the mix of "prudent monetary and proactive fiscal" policies, as the "mini" stimulus continue to support near-term growth. In the meantime, the government will continue to push ahead key structural reforms, following the blueprint announced in the Third Plenum last November.

Inflation to rise gradually in 2014, still within the target

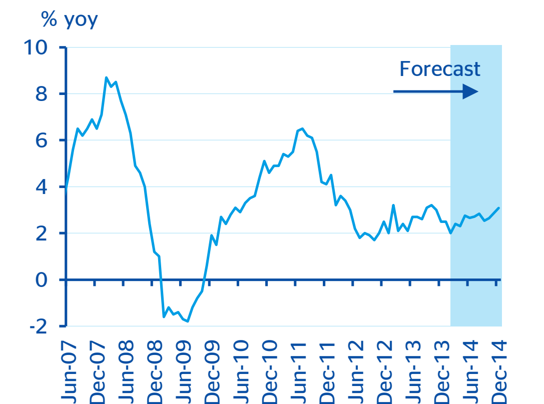
We expect benign inflation to continue during the rest of the year.(Figure 3.2) Our inflation projection for 2014 (period average) has been lowered significantly to 2.6% from 3.3% previously, compared with the outturn of 2.6% in 2013. Looking ahead, higher prices of food items and utilities, along with rising wages and base effects, are likely to push inflation modestly higher in the medium term.

Figure 3.1
GDP growth may decelerate gradually on base effects



Source: NBS, CEIC and BBVA Research estimates

Figure 3.2
Inflation to trend up gradually, but remain within the 3.5% comfort level



Source: NBS, CEIC and BBVA Research estimates

RMB to resume appreciation in the 2nd half of the year but with greater two-way flexibilities

After the RMB's sharp deprecation in Q1 due to a growth slowdown and the shrinking current account surplus, the appreciation pressure on the currency has diminished largely. Moreover, the authorities' greater tolerance of growth slowdown dictates that a quick rebound in Q2 is not in our sights given that recent supportive measures are only targeted to sustain growth at a "reasonable" range. That said, we expect the RMB to resume appreciation after the economy stabilizes in Q2. The currency is likely to appreciate by 2-3% against the USD from its current level in the second half of the year, bringing the RMB to around 6.10 RMB/USD by end-2014;

meanwhile, the two-way flexibility in the exchange rate can be expected to continue. In addition, the RMB internationalization is advancing as the authorities promote the use of the currency in trade settlements and investment flows, and as central banks around the world increasingly add the RMB to their reserve holdings.

Table 3.1
Baseline Scenario

	2011	2012	2013	2014 (F)	2015 (F)
GDP (%, y/y)	9.3	7.7	7.7	7.2	7.0
Inflation (average, %)	5.4	2.6	2.6	2.6	3.3
Fiscal bal (% of GDP)	-1.1	-2.1	-1.9	-2.5	-2.5
Current acct (% of GDP)	1.8	2.3	2.0	2.5	3.0
Policy rate (%, eop)	6.56	6.00	6.00	6.00	6.00
Exch rate (CNY/USD, eop)	6.30	6.23	6.05	6.00	5.85

Source: BBVA Research

Policies to focus on reforms

Despite a weaker economic outlook in 2014, the government is to continue to push ahead the implementation of key reforms, following the reform blueprint announced in the Third Plenum last November. In particular, we expect further progress in urbanization (especially "Hukou" system reform), financial sector (steps toward interest rate liberalization and the implementation of a deposit insurance scheme, and greater private entry into the banking sector), market pricing for utilities and natural resources, more access to the market by private and foreign investors, and the further reduction in the government's intervention in the market. In regards to domestic fragilities, priorities in 2014 are to address local government debt, to curtail shadow bank lending, and to address over-capacity and pollution issues. Moreover, the authorities might relax existing tightening measures against the property market in tier-II cities where housing bubbles has become less of a concern. In 2015, full interest rate liberalization is anticipated as the government continues to overhaul the fiscal system and reshape the central-local government relationship.

4. Risks are to the downside

Despite the fact that the outlook of global economy continued to improve over the past few months and tail risks have decreased with US self-sustained recovery momentum, and further progress in Europe toward banking union and measures by the ECB to maintain stability, risks to China are still to the downside, concentrating on elevated financial fragilities and uncertainties about the implementation of the reform agenda unveiled by the Third Plenum last November. Moreover, the uncertain impact of US QE tapering on China's capital flows tends to exert downward risks to the growth outlook.

Although GDP growth still remained within a "reasonable" range through Q1, the latest indicators of both domestic and foreign demand have shown that a quick rebound in growth momentum is not in sight, Most of people agreed that the debt-fuelled growth model, which has successfully sustained China's growth at a rapid pace since the 2008-09 global financial crisis, is likely to come to an end. Although the authorities have set out to find new growth drivers by pressing ahead with comprehensive reforms, there remains a question whether the authorities can ensure a smooth transition between the old and new growth regimes.

Another major concern is the property market, which accounted for a lion share of China's GPD growth over the past decade but has started to slow down. According to other countries' experience, the adjustment in the real estate market could occur in a very disruptive manner. Although we still believe the ongoing urbanization in China could sustain the real estate market from a long-term perspective, the authorities can not afford to ignore the tail risk of potential disruptions given its importance to the whole economy.

Moreover, financial stress remained due to the enormous "stock" of financial fragilities given the authorities' tightening efforts can at best prevent their further deterioration. That said, the financial system is still vulnerable to any external shock or policy missteps such as large-scale capital outflows or artificially-induced interest rate hikes in the money market.

The growing importance of China as a source of world demand in the last few years is beyond doubt. China's growth risk is therefore contagious to other countries; in particular the Asian economies which are most susceptible to a diminishment of Chinese demand, with the further addition to the list of a few commodity exporters, such as Chile. According to our estimates, the impact on world growth of each point of Chinese growth lost is around 4pp, principally as a result of lower demand from China itself.

5. Tables

Table 5.1
Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2011	2012	2013	2014 (F)	2015 (F)
United States	1.8	2.8	1.9	2.5	2.5
Eurozone	1.6	-0.6	-0.4	1.1	1.9
Germany	3.4	0.9	0.5	1.8	2.0
France	2.0	0.0	0.3	0.9	1.5
Italy	0.6	-2.4	-1.8	0.7	1.4
Spain	0.1	-1.6	-1.2	1.1	1.9
UK	1.1	0.3	1.7	2.8	2.4
Latin America *	4.1	2.6	2.3	2.3	2.5
Mexico	4.0	3.7	1.1	3.4	3.0
Brazil	2.7	1.0	2.3	2.0	1.6
EAGLES **	6.7	5.0	5.3	5.3	5.6
Turkey	8.5	2.4	4.0	1.5	5.1
Asia Pacific	6.1	5.2	5.2	5.0	5.2
Japan	-0.5	1.5	1.5	1.1	1.3
China	9.3	7.7	7.7	7.2	7.0
India	7.7	4.8	4.6	5.2	5.7
Hong Kong	4.8	1.5	2.9	3.7	3.9
Asia ex China	3.8	3.5	3.3	3.5	3.9
World	4.0	3.2	3.0	3.4	3.8

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela.
** Brazil, China, India, Indonesia, Mexico, Russia, Turkey.
Forecast closing date: 30 April 2014.
Source: BBVA Research

Table 5.2
Macroeconomic Forecasts: Inflation (Avg.)

(YoY% growth rate)	2011	2012	2013	2014 (F)	2015 (F)
United States	3.1	2.1	1.5	1.8	2.2
Eurozone	2.7	2.5	1.4	0.9	1.3
Germany	2.5	2.1	1.6	1.3	1.6
France	2.3	2.2	1.0	1.1	1.2
Italy	2.9	3.3	1.3	0.7	1.2
Spain	3.2	2.4	1.4	0.3	0.9
UK	4.5	2.8	2.6	1.9	2.0
Latin America *	8.1	7.6	8.9	11.8	10.8
Mexico	3.4	4.1	3.8	4.0	3.5
Brazil	6.6	5.4	6.2	6.4	5.8
EAGLES **	6.5	4.8	5.1	4.8	4.7
Turkey	6.2	8.7	7.6	8.2	5.3
Asia Pacific	4.9	3.4	3.5	3.6	3.8
Japan	-0.3	0.0	0.4	2.2	1.5
China	5.4	2.6	2.6	2.6	3.3
India	9.6	9.7	10.1	8.5	7.9
Hong Kong	5.3	4.1	4.3	3.6	3.5
Asia ex China	4.6	4.0	4.2	4.4	4.1
World	5.1	4.2	3.8	3.9	4.0

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela.
** Brazil, China, India, Indonesia, Mexico, Russia, Turkey.
Forecast closing date: 30 April 2014.
Source: BBVA Research

Table 5.3
Macroeconomic Forecasts: Exchange Rates (End of period)

		2011	2012	2013	2014 (F)	2015 (F)
Eurozone	USD/EUR	1.30	1.32	1.37	1.37	1.32
Japan	JPY/USD	76.9	86.8	104.9	115.0	120.0
China	CNY/USD	6.30	6.23	6.05	6.00	5.85
Hong Kong	HKD/USD	7.77	7.75	7.75	7.80	7.80
India	INR/USD	53.1	55.0	61.8	59.5	59.0

Forecast closing date: 30 April 2014.
Source: BBVA Research

Table 5.4
Macroeconomic Forecasts: Policy Rates (End of period)

(%)	Current	2012	2013	2014 (F)	2015 (F)
United States	0.25	0.25	0.25	0.25	0.50
Eurozone	0.25	0.75	0.25	0.25	0.25
Japan	0.10	0.10	0.10	0.10	0.10
China	6.00	6.00	6.00	6.00	6.00
Hong Kong	0.50	0.50	0.50	0.50	1.50
India	8.00	8.00	7.75	7.75	7.00

Forecast closing date: 30 April 2014.
Source: BBVA Research

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