BBVA | RESEARCH

China Economic Outlook

Fourth Quarter 2014
China Unit

- Global growth is recovering slowly in a complex environment, pending the withdrawal of extraordinary monetary stimuli in the US, at the same time as geopolitical risks are multiplying. We slightly adjusted our 2015 GDP forecasting downward to 3.7%, on account of recent outturns.
- China's growth further moderated in Q3. The lackluster domestic demand has prompted the authorities to implement additional stimulus measures to revive real estate market and boost growth momentum.
- We maintain our growth projections of 7.2% for 2014 and 7.0% for 2015. Headline inflation is expected to rise gradually while the RMB could appreciate by 2-3% next year. Moreover, policy stance will remain "pro-growth" as the authorities continue to press ahead with long-term structural reforms.
- Risks are still to the downside. Risks concentrate on uncertainties surrounding the US monetary policy normalization, the sluggish real estate market as well as the debt overhang of local governments.

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Closing date: 7 November 2014

1 Summary

China's growth moderated further in the third quarter to 7.3% y/y, slightly down from 7.5% y/y in the previous quarter, while above market expectations (BBVA: 7.0% y/y versus Consensus: 7.2% y/y). Domestic demand remained lackluster due in large part to the persistently sluggish property market as well as its adverse spill-over effects to other related sectors. Meanwhile, a surprisingly strong performance in the export sector and the authorities' stimulus policies partly offset the anemic domestic demand.

Weak domestic demand has prompted the authorities to ramp up their loosening efforts. Latest easing policies included: (i) lowering mortgage rates to revive housing demand, (ii) injecting liquidity to the banking sector through Medium-term Lending Facility (MLF) as well as (iii) cutting tax for SMEs. These new stimulus measures, together with the previously implemented ones, are expected to underpin the economy and alleviate the hard-landing risk in the near future although they are unable to change the moderating trend of economic growth in the medium-and-long term.

Structural reforms forged ahead in several important aspects. First, the State Council promulgated new rules on local government debt management early October, which reaffirmed the central government's "no bail-out" principle toward debt obligations of local government; second, the Chinese Communist Party's Fourth Plenum concluded with an ambitious and welcomed plan to overhaul the country's legal system and establish the rule of law; last, the authorities piloted "the mixed ownership reform" in six large state-owned enterprises (SOEs), seeking to partially privatize the SOEs and enhance their corporate governance.

Looking ahead, we believe that our 7.2% growth projection of 2014 is achievable although it is lower than the official target of 7.5%.We also maintain our 2015 growth projection of 7.0% on account of increasing uncertainties of external demand, the anemic property market, other financial fragilities and growth headwinds. Nevertheless, the authorities still has adequate policy buffers to engineer a soft-landing next year. Given their increasing tolerance of economic slowdown, the authorities are likely to lower 2015's growth target to 7.0% from this year's 7.5%, leaving more room for pushing forward structural reforms.

Meanwhile, headline inflation is projected to gradually rise from 1.9% at end-2014 to 3.0% at end-2015, with an annual average of 2.9% for next year. Despite recently strong exports, the RMB's appreciation against USD is to be limited (our forecast is 6.10 per USD at the end of the year) between now and the end-year as pressure of capital outflows are on the rise. For 2015 as a whole, we anticipate that the surplus under the current account will widen as the other major economies gradually recover while the capital account could shift to small deficit from surplus. Nevertheless, additional 2-3% (pent-up) appreciation against the USD is anticipated in 2015 as the exchange rate of the RMB is moderately undervalued by 5-8%.

On the policy front, the authorities will keep the overall policy stance pro-growth. Although the authorities seem to commit to their "targeted easing" mode in the rest of 2014, they may revert to conventional monetary tools next year, to bolster growth. We project that the PBoC will cut banks' required reserve ratios (RRRs) by up to 200 basis points in 2015, coupled with other unconventional monetary policies such as the MLF, rediscount window or refinancing programs. We don't rule out the possibility of interest rate cuts next year although we are skeptical of their real effectiveness and are concerning about their side effects. On the fiscal side, we expect the central government to keep its fiscal deficit at 2.5% of GDP in support of growth. Additional easing might be implemented to offset the prospective consolidation at the local government level.

Risks to China are still to the downside, concentrating on the uncertainty surrounding the normalization of US monetary policy, the continuously sluggish domestic real estate market, the potential deflation risk as well as a number of existing financial fragilities.

2 A slower global recovery in a complex environment

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 5

From a medium-term perspective, since the beginning this cycle has been different from previous cycles. Six years on from the deepest crisis since World War II, we can say that, in general terms, per capita income in the developed economies is growing more slowly than in any other recovery in the second half of the 20th century. This is partly due to the high levels of private indebtedness built up in the previous expansion, resulting in debt service obligations that are restricting spending and investment decisions.

Altogether, this cycle is still compatible with an improvement in GDP growth in the coming quarters, although at a slower rate than we were forecasting three months ago. According to our calculations, global GDP will expand by 3.2% in 2014, the same as in 2013, and by 3.7% in 2015. These estimates are 0.2pp lower than our previous forecasts and are **subject to downside risk**. The global scenario is still pending the withdrawal of - extraordinary and sustained - monetary stimuli in the US, at the same time as **geopolitical risks are multiplying.** In addition, China is faced with the challenge of managing the slowdown in its economy, while at the same time reducing its financial vulnerabilities and rebalancing growth towards domestic demand; and the euro area is still facing downside risks to growth and inflation.

All in all, the economic policy is growth-supportive, especially as regards central bank provision of liquidity, but the **recent spike in financial volatility is a sign of the uncertainties surrounding the present economic recovery.** In terms of demand policies, **we expect fiscal policy to be less restrictive in the US and the euro area in 2014-15,** as a consequence of both discretionary decisions and the room for manoeuvre offered by more favourable funding conditions, which are in turn thanks to supportive monetary policy.

The Fed and the ECB will continue to play a crucial role in our forecast global economic scenario. In the most probable scenario, the Fed will continue guiding the perspectives for interest rates and shrinking its balance sheet in accordance with data prints on the recovery and inflation, with a bias towards erring on the side of patience. From the ECB, we expect communication consistent with anchoring policy rates for as long as necessary, and the implementation of balance-sheet expansion measures in addition to those already put into practice or announced. As well as the limitless provision of long-term liquidity for European banks, the availability of even cheaper funding if these funds are used to increase the flow of credit to the economy and the announced asset purchases, there is a significant increase in the probability of euro area sovereign bond purchases, provided that expectations for long-term inflation continue to de-anchor. Finally, **the banking sector asset quality review and balance-sheet stress test** was a positive. This process has given the market more and more homogenous information on the European banking sector and introduces the implementation of common supervision in the euro area. All of this is a necessary condition for allowing the flow of bank credit to meet solvent demand.

However, central bank support cannot be permanent: their ability to stimulate demand is waning because households and companies form their expectations and make their spending, saving and investment decisions taking into consideration, for example, their expectations for central bank policies. And the capacity for the latter to surprise is increasingly limited, particularly if the anchor of the price stability target is maintained. **The demand-led policies allow downward phases in the economic cycle to be offset, but other types of measures need to be implemented at the same time,** with a less immediate but more lasting impact. These policies should improve the efficiency of allocating resources – employment and capital – which are going to be less abundantly available than in the past. Employment, due to population ageing; capital, due to the regulatory changes in financial intermediation and the high levels of debt in the economy, which make it more expensive. **The efficient use of productive factors is not fostered by expansive demand policies. What we need is more measures that boost underlying capacity for growth.**

3 Moderated growth prompted new easing efforts

Third quarter GDP growth came out at 7.3% y/y, slightly down from 7.5% y/y in the previous quarter, while above our projection and market expectations (BBVA: 7.0% y/y versus Consensus: 7.2% y/y). In sequential terms, aggregate output expanded at a pace of 1.9% q/q sa, down from 2.0% q/q sa in Q2, pointing to a moderation in growth momentum. Domestic demand was affected by the persistently sluggish property market as well as its adverse spill-over effects to other related sectors. In the meantime, a surprisingly strong performance in the export sector during Q3 and the authorities' previously unveiled stimulus policies helped to avert a sharp fall in aggregate output.

The better-than-expected GDP outturn in the third quarter could disguise the weaknesses of the economy. For instance, some significant discrepancy resurged in September between China's reported exports (to Hong Kong) and Hong Kong's reported imports (from China), implying that Q3 export figure might be subject to certain upward biases caused by exporters' mis-invoicing behaviors. In addition, some monthly activity indicators and credit data also suggested that growth momentum in Q3 could be weaker than the headline figure showed. In particular, July credit data surprised the market to the down side as both new bank loans and the total social financing fell dramatically from the previous month. The August industrial production significantly decelerated to 6.9% y/y from July's 9.0%, a record low since Dec 2009.

The lackluster domestic demand in Q3 has prompted the authorities to beef up their loosening efforts and unveil new stimulus initiatives. First, to boost anemic housing demand, the People's Bank of China (PBoC) and China Banking Regulatory Commission (CBRC) took steps at the end of September to lift some existing tightening measures on the property market and encourage banks to extend more mortgage loans with lower interest rates. (Details in the Box) Second, the PBoC continued to deploy unconventional policy tools to inject liquidity of up to RMB 700 billion into the banking sector in September and October, which was equivalent to reducing the RRR by 50-100 basis points. Third, in order to better support the Small-and-Medium Enterprises (SMEs), the central government extended the tax exemption period of SMEs to end-2015 when it expired at end-September. Moreover, the government expanded the scope of the tax exemption program to include all the SMEs with monthly sales revenue below RMB 30,000 (compared to the ones below RMB 20,000 previously).

As we anticipated in our last issue of China Outlook three month ago, structural reforms gained traction in the second half of the year. During the third quarter, the authorities kicked off a pilot program of "the mixed ownership reform" on six large state-owned enterprises (SOEs), seeking to partially privatize the SOEs and enhance their corporate governance. The pilot program is expected to be expanded to include more SOEs in the next couple of years, which was deemed to be another significant cornerstone of China's structural reforms.

At the beginning of October, the State Council promulgated a set of new rules for local government debt management. Chief among them was the central government's "no-bailout" principle toward debt obligations of local governments. It is a welcome development because these new rules not only provided a long-term solution for the debt overhang of local governments but also initiated the long-awaited overhaul of the fiscal relationship between the central and local governments.

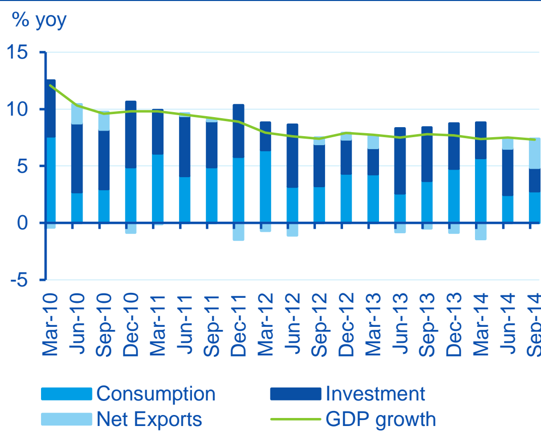
Moreover, the Chinese Communist Party's Fourth Plenum in October concluded with an ambitious but necessary plan to overhaul the country's legal system and establish the rule of law. In particular, the Plenum proposed to establish a wide range of new mechanisms that protect the integrity of the constitution and ensure the impartiality of the judicial system.

Growth further moderated in the third quarter

China's third quarter GDP growth came out at 7.3% y/y, slightly down from 7.5% y/y in the previous quarter (Figure 3.1) while above market expectations (BBVA: 7.0% y/y versus consensus: 7.2% y/y). In sequential terms, Q3 GDP expanded at a pace of 1.9% q/q sa, decreasing from 2.0% q/q sa in Q2. Detailed analysis of expenditure components shows that net exports contributed to 2.5% out of 7.3% GDP growth in the third quarter, substantially higher than its contribution in the second quarter (0.8% out of 7.5% GDP growth). Accordingly, the contribution of investment declined to 2.1% in Q3 from 4.0% in Q2 while consumption's contribution edged up to 2.8% from 2.5% in the previous quarter.

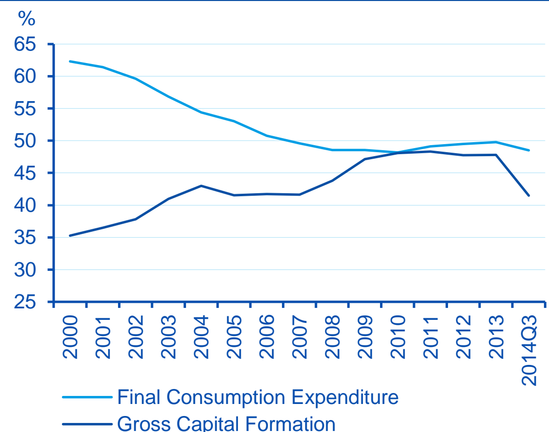
The trend of economic rebalancing is mixed. The rising share of service sector in total GDP confirmed the trend that domestic demand is tilting toward consumption rather than investment, (Figure 3.2 and 3.3) which should be considered as welcome news. On the other hand, the current account surplus widened again, thanks to the exceptionally strong exports, which indicated that Q3 growth was external demand driven instead of domestic demand driven. (Figure 3.4) In sum, the ongoing rebalancing between consumption and investment is coupled with a deteriorated imbalance between domestic and external demand.

Figure 3.1
Growth momentum has further moderated in Q3



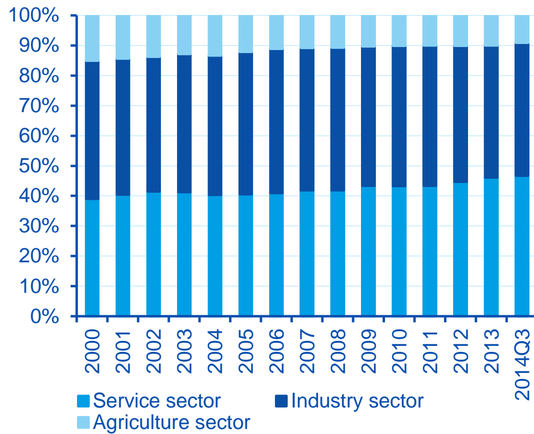
Source: NBS, CEIC and BBVA Research

Figure 3.2
Gradual rebalance towards consumption driven



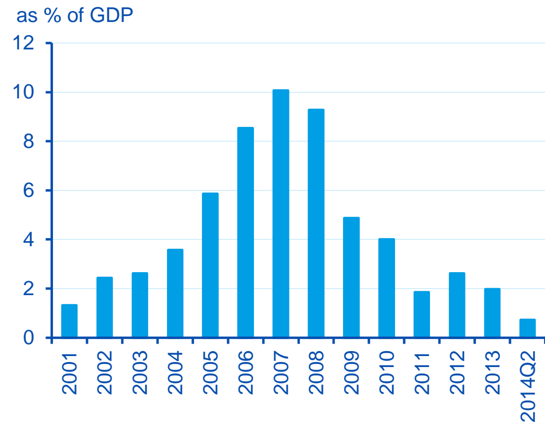
Source: NBS, Wind and BBVA Research

Figure 3.3
The share of the service sector rose further



Source: NBS, CEIC and BBVA Research

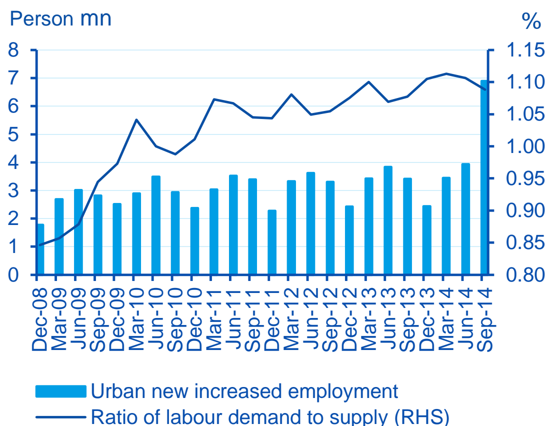
Figure 3.4
The current account surplus expanded



Source: NBS, Wind and BBVA Research

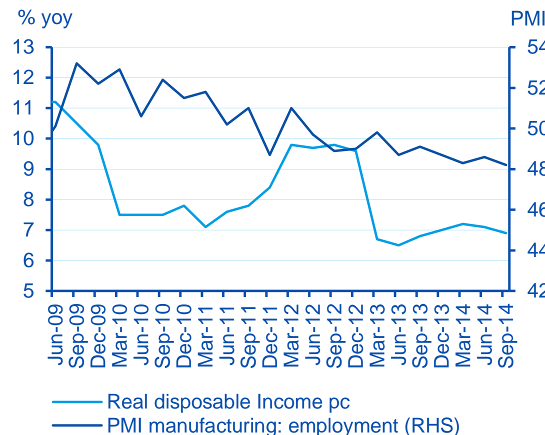
The labor market was still in good shape. The urban registered unemployment rate stayed at 4.07% in Q3 while China's survey unemployment rate, which is a more reliable indicator of unemployment but before was not open to the general public, stood at 5.0%, flat with its average from January to August. In the meantime, the ratio of demand to supply in the labor market remained high (Figure 3.5). However, the PMI sub-component of the employment has softened and wage growth has slowed (Figure 3.6), both of which were driven by the sluggish manufacturing activity in Q3.

Figure 3.5
The labor market was still in a good shape



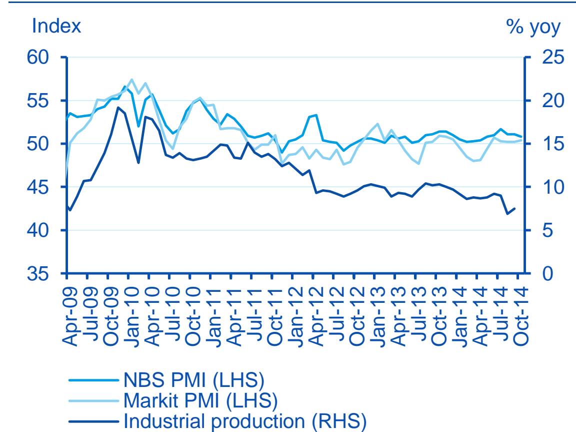
Source: CEIC and BBVA Research

Figure 3.6
The wage growth has decreased marginally



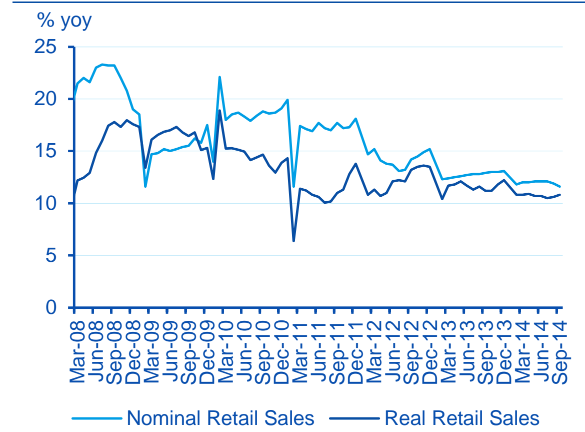
Source: CEIC and BBVA Research

Figure 3.7
China's manufacturing activities have moderated



Source: CEIC and BBVA Research

Figure 3.8
Retail sales growth was marginally decreasing



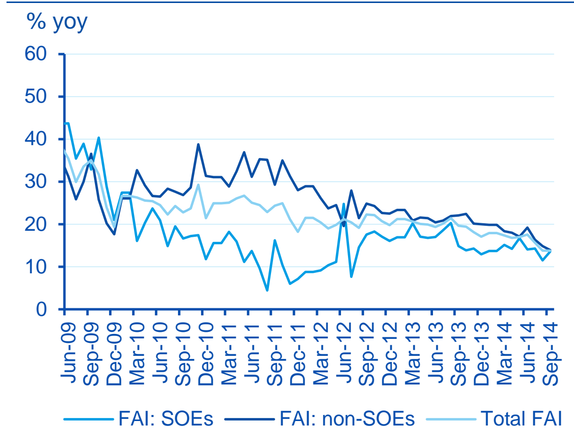
Source: CEIC and BBVA Research

Economic activities moderated in Q3. Industrial production growth rebounded to 8.0% y/y in September, from 6.9% in the previous month, which was registered the lowest reading since December 2009. The September outturn is however still below its long-term trend. (Figure 3.7) In October, the official PMI edged down to 50.8 from the last month's reading 51.1, pointing to a further weakening of growth momentum even though the whole manufacturing sector remained in an expansion territory.

On the demand side, retail sales softened slightly in September (Figure 3.8), likely driven by a combination of slower income growth (Figure 3.6) and the continuing anti-corruption campaign. The latter particularly weighed on the sales of luxury goods and restaurant businesses.

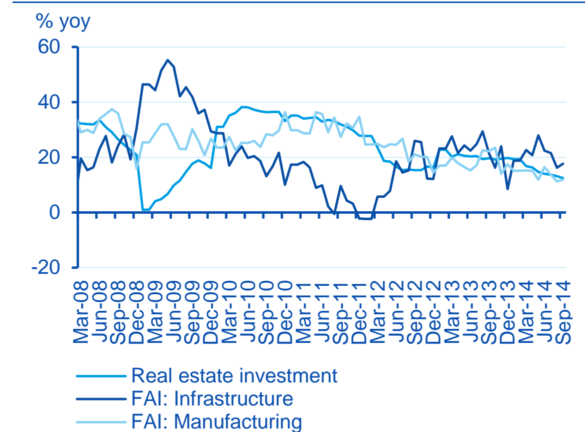
Investment decelerated in Q3 significantly. The fixed asset investment (FAI) of non-SOE was declining through the entire Q3 while SOEs FAI rebounded in September thanks to the authorities' stimulus polices (Figure 3.9). In addition, small upticks were also seen in investment in infrastructure and manufacturing sectors in September although real estate investment dipped further at the same time (Figure 3.10).

Figure 3.9
Investment displayed different patterns in forms of SOE and non-SOE



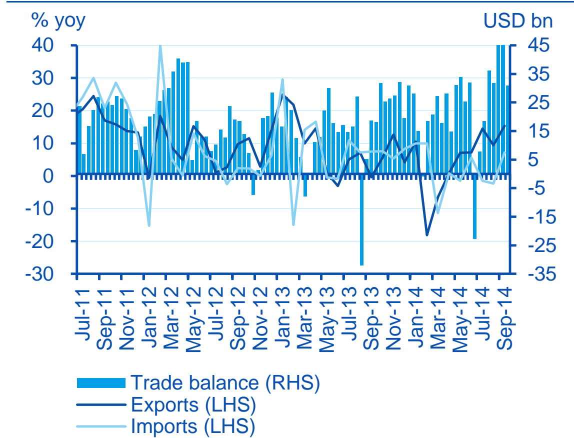
Source: CEIC and BBVA Research

Figure 3.10
Real estate, manufacturing and infrastructure FAIs were in the downward trend in Q3



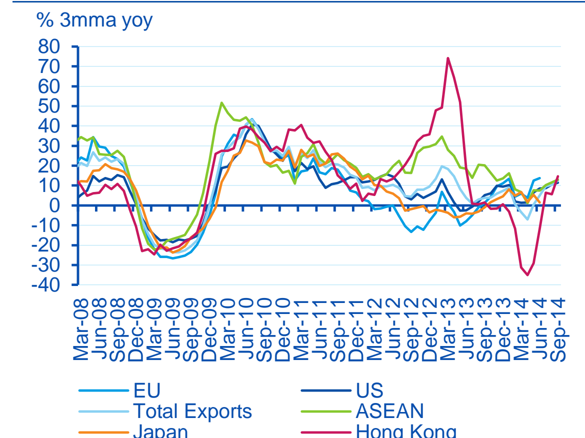
Source: CEIC and BBVA Research

Figure 3.11
The external demand boomed up in Q3 which underpinned the economic growth



Source: CEIC and BBVA Research

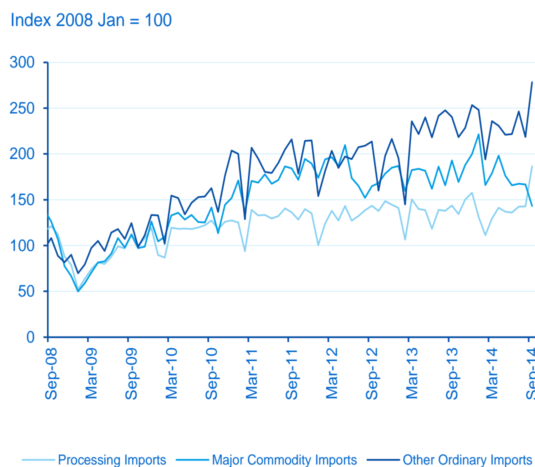
Figure 3.12
The trade figure distortion was mainly with Hong Kong



Source: CEIC and BBVA Research

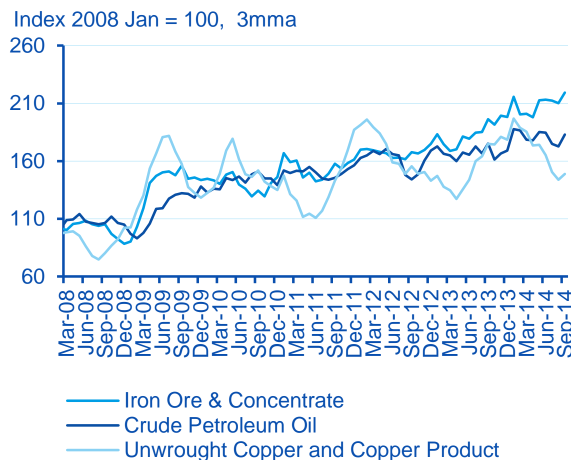
Exports picked up significantly to 15.3% in September from 9.4% of the previous month, above the market consensus of 12.0%. Several factors have contributed to the better-than-expected export growth: first, the economies have been in the recovery trend in the advanced countries, especially the US, where the unemployment rate and inflation have been moving toward the Fed's long-run policy targets at a faster than-expected pace; second, the lower base in September 2013 helped to boost the export growth this September; third, although the RMB started to resume appreciation in Q3, it still has not reached the previous high of 6.10 RMB/USD in February, which, together with the export-boosting measures implemented early this year, contributed to the pick-up in exports. (Figure 3.11)

Figure 3.13
Domestic demand and re-exports are helping imports while commodity imports are sluggish



Source: CEIC and BBVA Research

Figure 3.14
Commodity imports displayed diversifying paths



Source: CEIC and BBVA Research

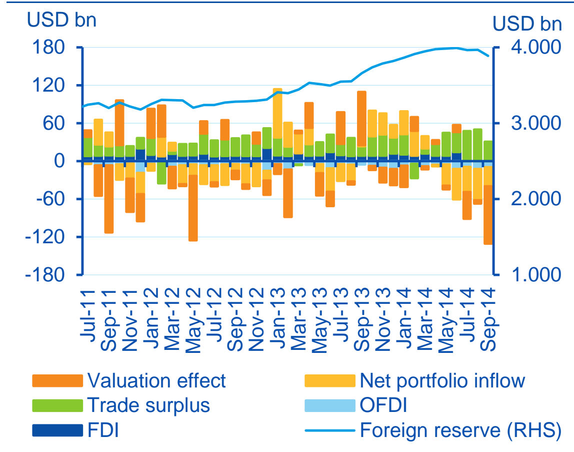
However, the excellent performance in the export sector might be exaggerated by the resurge of mis-voicing exports between China and Hong Kong. According to Hong Kong's custom statistics, the import from China was $23.35 billion in September, significantly lower than China's reported $37.6 billion exports to Hong Kong. The gap between the shipments reported by China and Hong Kong widened to 61% compared to a range of 27-40% registered in January to August, 2014 (Figure 3.12).

Imports also gave an upside surprise to the market in September, rising to 7.0% from -2.4% of the last month, due to a confluence of factors: first, in terms of the price effect, the recently stronger performance of the RMB may spur the import growth; second, according to the detailed breakdown of imports reported by the China's Customs, the processing-trade related imports has significantly increased, coinciding with the release of new products by Apple. (Figure 3.13)

The commodity imports displayed diversifying paths: oil and iron ore demand has edged up slightly at the end of Q3 after a decline in July, whereas copper continued to dip (Figure 3.14) due to the weakened demand from relevant industries that were plagued by over-capacity problems. As a consequence, trade surplus shrank to USD 30.9 billion in September from USD 31.6 billion USD in June. So did the foreign reserves, which declined to 3.89 trillion USD at end-September from 3.99 trillion USD at end-June.

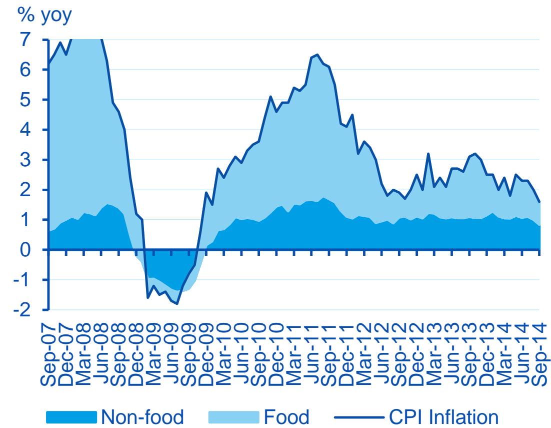
Moreover, the capital account posted a deficit of 81.6 billion USD in Q3, while the net FDI inflow was 43.9 billion USD. The co-existence of deficit capital account and net FDI inflow indicated that the US QE tapering and the increasing concerns over China's economic outlook led to a considerable amount of portfolio outflow from China. (Figure 3.15)

Figure 3.15
Both trade surplus and foreign reserves shrank



Source: CEIC and BBVA Research

Figure 3.16
Deflation risk might be on the rise



Source: CEIC and BBVA Research

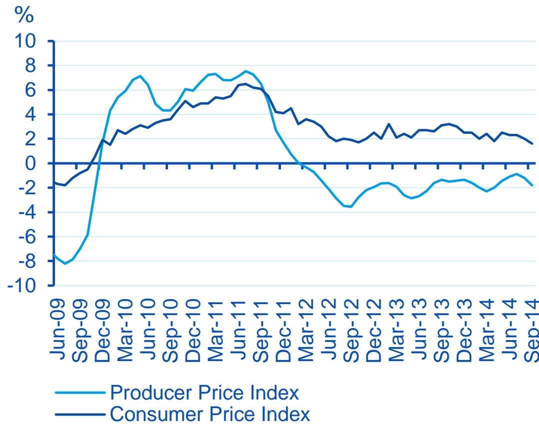
Inflation remained tame

Inflation decreased to 1.6% y/y in September (Figure 3.16) from 2.0% y/y in August, which was the lowest inflation since August 2010. Low inflation outturns through Q3 are broad-based and mainly due to weak domestic demand. For instance, the food price inflation decelerated from 3% y/y in August to 2.3% y/y in September, driven by both the ongoing anti-corruption campaign and plummeting commodity prices. The housing rental also slowed as the property market froze: rental index only gained 1.6% y/y in September, down from 1.9% y/y in the previous month.

Meanwhile, producer price inflation (-1.8% y/y in September) still stayed in negative territory which has lasted for 31 months, partly due to the overcapacity problems in several specific industries (Figure 3.17). A combination of persistent price decline and still elevated financing costs seriously eroded the profitability of the corporate sector and thereby limited their capacity to make additional investment.

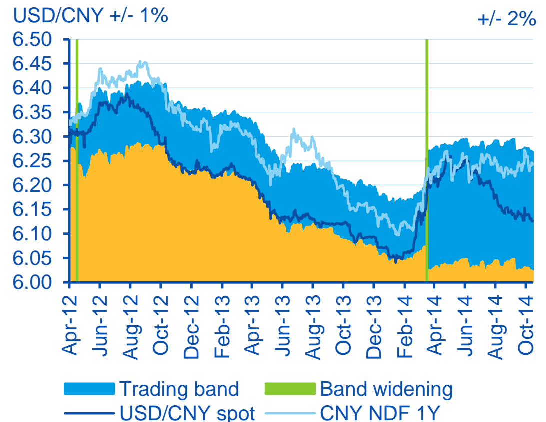
On the positive side, slowed inflation provided more room for policymakers to loosen monetary policy. Moreover, given that the demographic pattern is set to further squeeze labor supply, labor income as well as inflation are expected to trend up in the medium-and-long term. We therefore believe that the deflation risk (measured by CPI) is still low although the PPI can dip further in the near future.

Figure 3.17
PPI inflation was still in the negative region



Source: CEIC and BBVA Research

Figure 3.18
The RMB has resumed appreciation on the upbeat export outlook

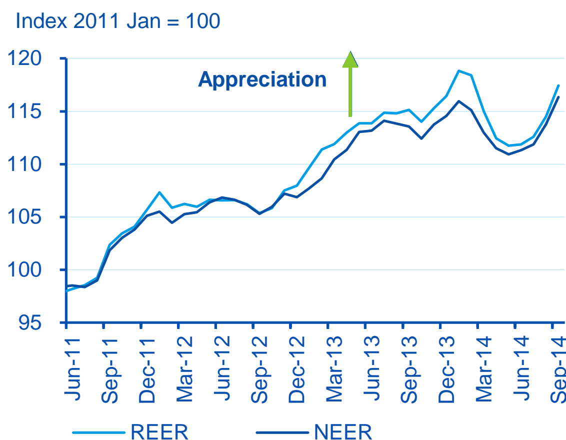


Source: CEIC and BBVA Research

The RMB resumed appreciation in Q3

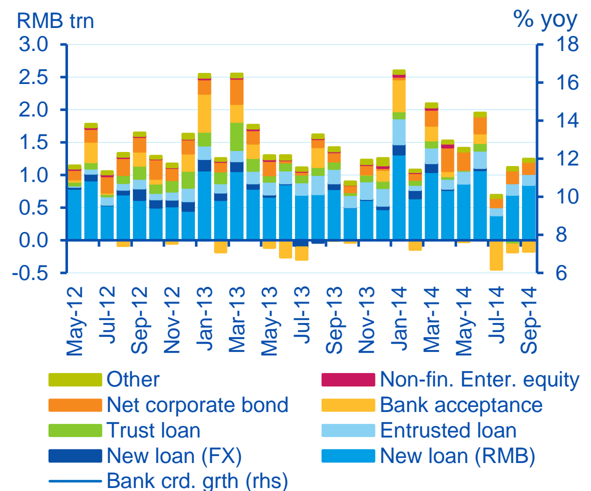
RMB has started to appreciate in Q3 after its weakening trend since the PBoC widened the currency's daily trading band to +-2% from +-1% in March (Figure 3.18). To date, the RMB has appreciated by 1.8% against the USD since end-June, with its current level at around 6.13. However, the RMB has not fully recovered its lost ground yet. In the meantime, the NEER and REER have appreciated by 4.5% and 5.0% as of end-September, respectively, compared with the end-June, mainly due to the rapid appreciation of USD during Q3. (Figure 3.19) The resumed appreciation of the RMB could be largely ascribed to strong exports. In the meantime, the exchange rate volatility has significantly risen, in line with the authorities' intention to enhance the two-way flexibility of the exchange rate to reduce speculative money inflows.

Figure 3.19
The nominal and real effective exchange rates appreciated



Source: Bloomberg and BBVA Research

Figure 3.20
Credit growth has been volatile in Q3 but finally stabilized in September



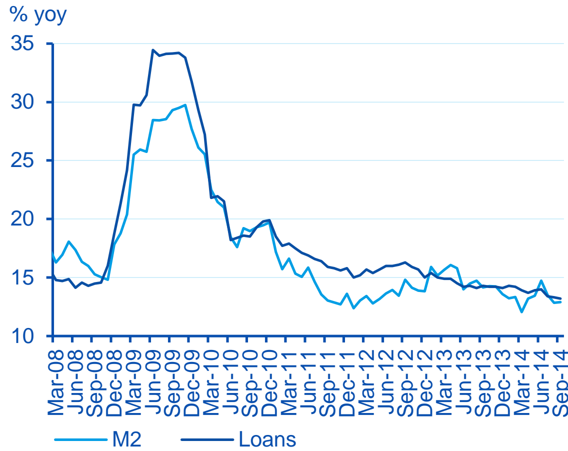
Source: BIS, CEIC and BBVA Research

Credit growth became volatile in Q3 while interbank market stayed stable

After a significantly downside surprise in July, credit growth rebounded in August and further stabilized in September. Both new bank loans and the total social financing, which is a broad gauge of credit capturing bank loans and shadow banking activities, rollercoastered through Q3, largely due banks' "mid-year window dressing" (which tends to raise credit data in June while lower it in the following month). Accordingly, year-on-year growth of M2 stabilized to 12.9% in September, compared with 12.8% in August and 13.5% in July. (Figure 3.20 and 3.21)

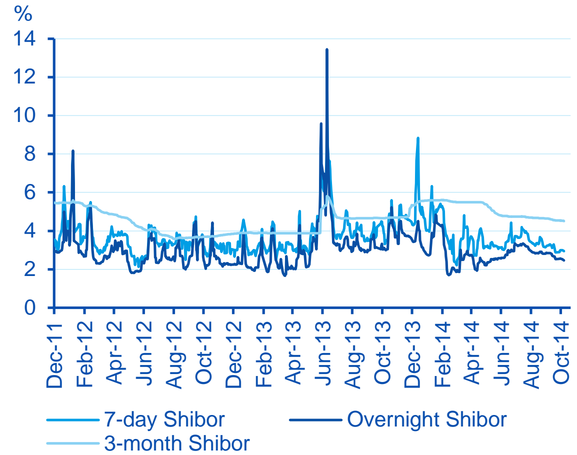
In terms of the inter-bank market, the Shibor rate has kept stable since the significant credit crunch of June 2013. Recently, the rates at short-tenors (including overnight Shibor, 7-day Shibor and 3-month Shibor) all stabilized at low levels. The stable interbank market may be partly due to the twice PBoC's fund injections during Q3 (Figure 3.22). The first time was to inject liquidity of up to RMB 500 billion into the five largest state-owned banks in September and the second time was to inject additional 200 billion RMB to 20 listed commercial banks in October through the Medium-term Lending Facilities (MLF). Altogether, they were equivalent to reducing the RRR by 50-100 basis points, effectively accommodating liquidity demand in the banking sector.

Figure 3.21
M2 and bank loan growth have stabilized at the end of Q3



Source: CEIC and BBVA Research

Figure 3.22
The interbank liquidity has kept stable after the previous crunches

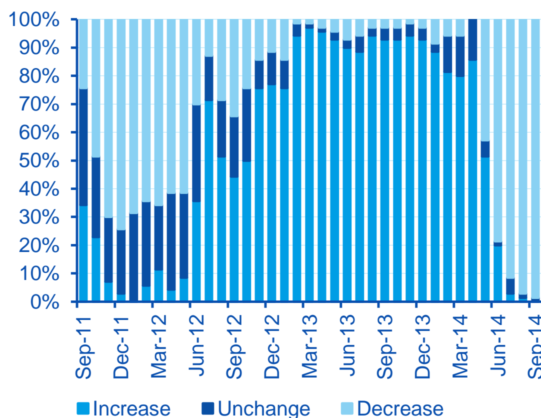


Source: CEIC and BBVA Research

The sluggish real estate market has prompted the government to issue stimulus policies

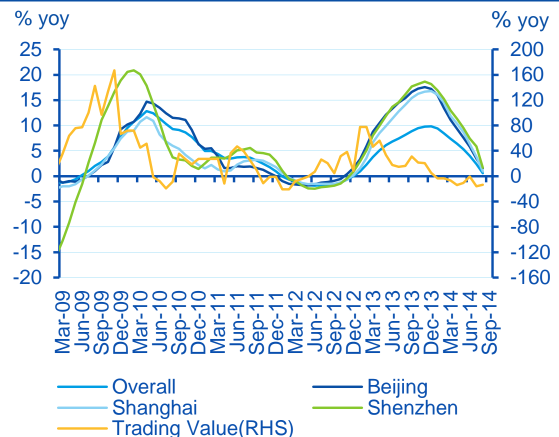
The property market showed no sign of improvement in the third quarter. Downbeat market expectations over slowing GDP growth and oversupply problems in many cities continued to weigh on housing prices and transactions, especially in small cities. Banks' cautious stance against mortgage loans further dampens housing demand. As revealed by the NBS, no city (among 70 reported ones) registered a year-on-year price increase in September, substantially down from 56 cities half a year ago. (Figure 3.23) The property market transactions are sluggish as well, with its year-on-year growth rate stood at around -10%. (Figure 3.24) To revive the housing demand, the authorities have recently lifted some existing tightening policies on the property market and encouraged banks to extend more mortgage loans with lower interest rates. (See the Box).

Figure 3.23
A majority of cities reported housing price decline



Source: NBS and BBVA Research

Figure 3.24
Housing prices and transactions are sluggish



Source: NBS, CEIC and BBVA Research

Structural reform forged ahead in Q3

As we anticipated in our last issue of China Outlook three month ago, structural reforms gained traction in the second half of the year. First, China's State Council promulgated a set of new rules to regulate local government debt. Chief among them is the central government's "no-bailout" principle toward debt obligations of local governments. Furthermore, an unspecified transition period (which was later reported to be one year by a number of domestic news media units) will be given to local governments before their full compliance with the new rules. Overall, we consider it a positive development because these new rules not only provide a long-term solution for the debt overhang of local governments but also initiate the long-awaited overhaul of the fiscal relationship between the central and local governments. Nevertheless, operational uncertainties in the transition period could discourage banks or other funding sources from extending new credit to local governments, which could lead to growing liquidity risks and weigh on short-term growth outlook.

Second, the Chinese Communist Party's Fourth Plenum in October revealed the Party's plan to overhaul the country's legal system and establish rule of law. The new leadership vowed to establish a wide range of new mechanisms to protect the integrity of the constitution and ensure judicial impartiality. Although the conclusions asserted that the Chinese Communist Party should keep a tight grip on the judicial system, it also conveyed a strong message of reform, encouraging the development of a 'constitutional government'. In this respect, the document proposed the establishment of a wide range of new mechanisms that protect the integrity of the constitution. Another highlight in the conclusions is their emphasis on concrete mechanisms and policies over abstract principles, for example, to minimize local authorities' intervention in trials, a series of cross-regional courts will be established to strengthen their impartial stance versus local government interests.

Third, the authorities kicked off an important pilot program of six large state-owned enterprises (SOEs), seeking to partially privatize the SOEs and thereby enhance their corporate governance. In particular, China National Building Materials Group and China National Pharmaceutical Group Corporation (Sinopharm) would be the first two central SOEs to undertake "mixed ownership reforms", which means transferring control of state capital to state-owned investment holding companies that will only focus more on capital management while has less influence on day-to-day operation of the SOEs. The pilot program is expected to be expanded to include more SOEs, which was deemed to be another significant cornerstone of China's structural reform.

Box 1. New stimulus measures targeting the property market

As part of the authorities' efforts to revive the sluggish housing demand and buttress the economy, the People's Bank of China (PBoC) and China Banking Regulatory Commission (CBRC) jointly unveiled a number of stimulus measures on Sep 30th, 2014. The thrust of new measures is to lift some existing tightening policies on the property market and encourage banks to extend more mortgage loans at lower interest rates. In this box, we first analyze the importance of the real estate sector to the entire economy; then, we review the tightening measures previously imposed on the property market and finally, we examine the recent new easing policies and assess its effectiveness.

The importance of the real estate sector in China

The real estate sector has become one of the important sectors in China's economy as the country started its decades-long urbanization process in late 1990s. Headline statistics shows that property investment accounted for around 15% of the total GDP in China by 2012, which is even higher than other countries' peaks in the booming years of housing bubbles. In the meanwhile, mortgage and property development loans together accounted for around 20% of total bank loans in 2013, compared with less than 15% in early 2005.

The above headline figures could underreport the importance of the real estate sector to the entire economy by omitting its spillover effects on other related sectors. By adopting the input-output analysis, Hong Kong Monetary Authority (HKMA) estimated in its Half Year Financial Stability Report (March 2014) that a 1% percentage fall in the real estate sector could lead to a fall of 0.32 ppt in the economy's total value-added output in 2010. By-sector analysis further identified a number of sectors which are most vulnerable to the fluctuation of the real estate sector, including Iron and steel, construction materials, and chemical sectors.

Tightening measures on property market

China's authorities maintaining a tightening stance against the property market during its boom period starting from April 2010 till June of 2013. In addition to the Hukou-related home purchase restrictions, the authorities implemented a number of initiatives to tighten credit to the mortgage appliers and real estate developers, including:(i) the minimum down payment for first-time home buyers was set at 30%;(ii) second home buyers were required to pay minimum 50% down payment while mortgage rates were raised to 1.1 times the benchmark mortgage rate compared to 0.8-0.85 times the benchmark rate for first-home buyers; (iii) banks were forbidden to provide mortgages for third-home (or beyond) purchase; and (iv) banks were required to implement restrictive standards for extending loans to the real estate developers.

New stimulus policies are set to boost the property market

Starting from Q3 of 2013, the sluggish property market has become the major risk to China's growth outlook, as it started to exert negative spillover effects on production activities in related industries. In a bid to stimulate the property market and maintain economic growth momentum, the authorities promulgated the new stimulus policies on Sep 30th, 2014.

Key points in the new measures on the property market include: (i) second-home buyers will be offered preferential terms of mortgage loans (specifically minimum 30% down payment requirement and up to 30% discount of the benchmark mortgage rate) as long as they have paid off their first-home mortgage; (ii) a ban on mortgages for third-home buying is to be lifted; (iii) banks will be allowed to issue Mortgage-base Securities (MBS) and special financial bonds (covered bonds) in support of mortgage loan extension; and (iv) more property developers will be allowed to issue bonds in the interbank bond market to raise funds.

The loosening measures on the property market are aimed to stimulate housing demand. We believe that these new stimulus measures can boost the demand by increasing the affordability of second-home purchase and will partially offset the downturn in the property market. However, we don't think that they are able to significantly revive the investment-driven demand for property and, as a consequence, lead to the overheating in the property market again.

However, two caveats are noteworthy with regard to the new stimulus measures for the housing market: first, the effectiveness of these stimulus measures are dependent on the general liquidity condition in the banking sector, which necessitates more liquidity injection by the central bank; second, it will take a longer period of time for the improvement in the property sector if any to pass through to other related industries. That said, it might not have an immediate impact on manufacturing activities in the fourth quarter of this year.

4 Economic slowdown is set to continue in 2015

Moderation but not hard-landing

China's economic growth is expected to stabilize further in Q4 and conclude the year with an annual growth of 7.2%, consistent with our projection three month ago. The recently adopted pro-growth measures can partially offset growth headwinds stemming from the anemic property market and intensified uncertainties of external demand.

As to the growth projection of 2015, we tend to maintain our previous forecast of 7.0%, (Figure 4.1) which, though further edges down from 2014, is in line with our soft-landing scenario of China's economy in the medium-and-long term. Our projection has been influenced by several factors. First, China's potential GDP is believed to be on a gradually moderating trend. Demographic changes, which are partially due to China's long implemented birth-control policy, no longer move in favor of China's economy as working-age population has started to peak. On the side of capital stock, the over-capacity problem is bound to plague several industries for a longer period which will hinder capital accumulation. More importantly, the growth of China's productivity, which used to be the engine of the stellar growth in past decades, could decelerate when the unavoidable but necessary economic rebalancing shifts labor from the manufacturing to the service sector.

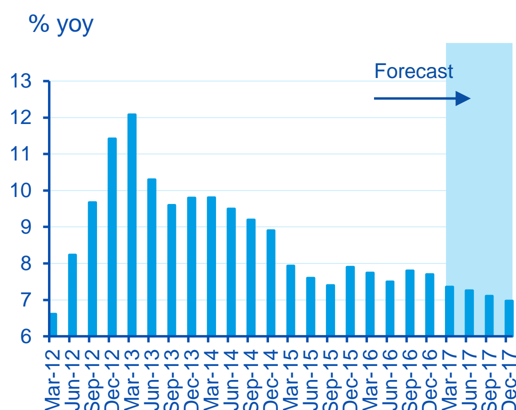
Second, the authorities still have sufficient room for additional policy maneuvering on top of the stimulus package implemented thus far in 2014. With banks' RRR standing at up to 20%, the PBoC could easily unleash more liquidity to ensure financial stability and spur bank lending. The PBoC have alternative options to further ease monetary policy such as interest rate cuts and other forms of unconventional policies as they have implemented this year. Moreover, China's central government still has a healthy balance sheet with a debt level of around 20% of GDP. It means that China's central government can keep its expansionary stance in support of growth as well as facilitate fiscal consolidation at the local government level.

Last but not least, China's authorities are now showing a greater willingness to tolerate relatively lower headline growth rate in the short term in exchange for long-term sustainability and high quality of economic expansion. Toward this end, the authorities are set to press ahead the structural reforms in the next couple years, which could bring some headwinds to growth.

By expenditure, domestic consumption is expected to be the main driver of growth next year amid the rebalancing of the economy. On the other hand, the deceleration of investment is likely to continue in 2015 in spite of the authorities' beefed-up efforts to support infrastructure investment. The external sector could provide further albeit still limited boost to aggregate demand as other major economies are expected to gain momentum gradually.

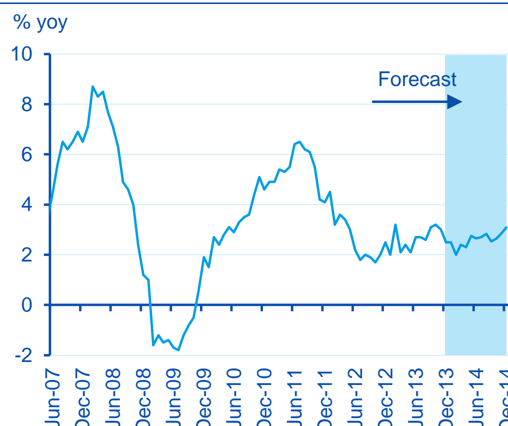
China's inflation is expected to remain tame through 2015, thanks to the overcapacity problem in upstream industries as well as the moderated economic outlook. In particular, we made slightly downward adjustment for our inflation projection to 2.1% for the full-year average of 2014 and 2.9% for 2015. (Figure 4.2)

Figure 4.1
GDP growth will be stabilizing in 2015



Source: NBS, CEIC and BBVA Research estimates

Figure 4.2
Inflation will be maintained within the 3.5% tolerance region



Source: NBS, CEIC and BBVA Research estimates

More balanced external position and renewed currency appreciation

The RMB has resumed its appreciation trend in Q3 as current account surplus widened on back of strong export performance. However, we suspect that the momentum of currency appreciation against the USD could come into a halt in the fourth quarter due to the prospective strength of the USD, which could be compounded by accelerated capital outflows stemming from investors' expectation of narrowing interest rate differential between the US and China. That said, the RMB is likely to approach our projected 6.10 CNY/USD at the end of the year, implying a modest appreciation of the currency between now and then.

Looking ahead, we still anticipate 2-3% pent-up appreciation of the RMB next year, based on our assessment that the RMB exchange rate is moderately undervalued by 5-8%. The bulk of the appreciation is likely to happen in the second of the year, pushing the exchange rate up to 5.95 CNY/USD at end-2015. The widened current account surplus (2.8% of GDP in 2015) will be the main driver of currency appreciation next year. On the other hand, more capital outflows could be seen in 2015, driven by both the Fed's interest rate hikes and China's liberalizing efforts of the capital account. All in all, China has a good chance to register a small deficit under its capital account next year, reversing its decade-long "twin surplus" under both the current and capital account.

Table 4.1
Baseline Scenario: Forecasting

	2011	2012	2013	2014 (F)	2015 (F)
GDP (%, y/y)	9.3	7.7	7.7	7.3	7.0
Inflation (average, %)	5.4	2.6	2.6	2.1	2.9
Fiscal balance (% of GDP)	-1.1	-2.1	-1.9	-2.5	-2.5
Current account (% of GDP)	1.8	2.3	2.0	2.5	2.8
Policy rate (%)	6.56	6.00	6.00	6.00	6.00
Exchange rate (CNY/USD)	6.30	6.23	6.05	6.10	5.95

Source: BBVA Research

Policy stance will remain growth-supportive

We anticipate the policy stance to remain pro-growth in 2015. On the monetary front, we expect the PBoC to cut RRR by up to 200 basis points (likely in four times) next year, so as to spur bank lending and lower financing costs of corporate and households. Compared to the adjustment of RRR, interest rate cuts are less likely to be adopted because lending rates have already been liberalized, which renders the adjustment of the benchmark lending rate ineffective. Moreover, the reduction of deposit rate could incentivize depositors to put more money in the high-risk shadow banking activities for higher returns, running against the authorities' intention to curb the shadow banking sector and safeguard financial stability.

Some forms of unconventional monetary tools are expected to be deployed in 2015 too. For example, selective RRR could boost bank lending to specific sectors which the authorities deems important. The Medium-term Lending Facility (MLF) can help to maintain the liquidity adequacy of the banking sector, averting the repeat of cash crunch and market panic seen in June 2013. Furthermore, the PBoC can directly inject more long-term and stable funds by directly lending to banks or acquiring assets from their balance sheet, likely the mortgage loans as the authorities are keen to boost bank lending to the property sector. All in all, these unconventional policy tools are complementary to the conventional ones (primarily RRR cuts) to sustain growth next year. For more details of the PBoC's options of monetary tools, please refer to our last China Economic Outlook.

On the fiscal front, the case is a little sophisticated. At the local government level, we expect there will be certain consolidation as the authorities set out to tackle the debt overhang problem by implementing more stringent rules on borrowing of local governments. On the other hand, the central government still has a healthy balance sheet and is in a position to continue its expansionary stance, in order to offset the consolidation at the local government level. That said, the central government is likely to beef up their efforts to support infrastructure investment, particularly in shanty-town renovation programs, high-speed railways, water conservancy and environmental projects.

The authorities will press ahead with structural reforms as well. We expect that the birth control policy will be further relaxed next year to allow for second-child birth for all the couples. Regarding the local government debt management, we anticipate that the central government will unveil operational and coordinative policies and arrangements to facilitate the implementation of new rules. On the SOEs reform, the current "mixed ownership" pilot program could to be expanded to include more SOEs and additional reform modes. Moreover, the authorities could replicate the liberalizing policies of the Shanghai Pilot Free Trade Zone and Qianhai Free Trade Zone in other regions, in a bid to promote international trade. On financial liberalization, we expect that a national deposit insurance scheme is to be established by next year. At the same time, more bank licenses could be granted to private capital and foreign financial institutions. However, the cap of deposit rates is unlikely to be lifted next year. On the external side, the PBoC could further widen the daily trading band of the RMB and reduce their intervention of its exchange rate.

5 Risks are still to the downside

Risks to China are still to the downside, concentrating on the uncertainty surrounding the normalization of US monetary policy, the continuously sluggish domestic real estate market, the potential deflation risk as well as a number of financial fragilities.

Although the US Fed has official exited the QE, it still remains an open question how the ultra-low interest rate will continue. An unanticipated interest rate hike could bring enormous shocks to global financial assets and cause disruptive capital flows from the emerging markets back to the U.S. Regardless of its in-place restrictions under the capital account, China has found it increasingly difficult in detecting capital flows across its porous "Great Wall" which used to successfully immunize the country from influctuation of global capital movements. On the other hand, the monetary easing in Bank of Japan and European Central Bank may offset the influence of US QE tapering to some certain degree.

Based on our analysis in the Box, it could be too optimistic to expect the recently unveiled stimulus measures to have a pronounced impact on the property market. Against the backdrop of economic slowdown, housing has become less attractive than before as an investment vehicle for people to park their life savings, which could be compounded by higher expected returns offered by USD denominated assets. That being said, the property market could continue to hold back growth for a while.

More recently, persistently low inflation has added investors' worries about the deflation risk. Indeed, the recently weak CPI outturns were partially due to the sluggish commodity prices in the global market. The overcapacity problems in several upstream industries are at play too. All in all, deflation risk could be very devastating for China as its overall debt has remained at a high level.

The financial fragilities continue to pose risks to the financial stability and economic growth. The authorities' clampdown efforts has slowed the growth of the shadow banking activities but did less to unwind their vast-sized "stock". Moreover, new regulations of local government debt is bound to introduce more uncertainties at the early stage of unwinding LGFV debt, which could add more headwinds to growth by holding back local governments' infrastructure investment.

6 Tables

Table 6.1

Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2011	2012	2013	2014 (F)	2015 (F)
United States	1.8	2.3	2.2	2.0	2.5
Eurozone	1.6	-0.6	-0.4	0.8	1.3
Germany	3.7	0.6	0.2	1.3	1.4
France	2.1	0.4	0.4	0.4	1.1
Italy	0.6	-2.4	-1.8	-0.3	0.8
Spain	-0.6	-2.1	-1.2	1.3	2.0
UK	1.1	0.3	1.7	3.1	2.7
Latin America *	4.1	2.6	2.4	0.9	1.8
Mexico	4.0	3.7	1.3	2.5	3.5
Brazil	2.7	1.0	2.5	0.2	1.3
EAGLES **	7.0	5.4	5.3	4.9	5.3
Turkey	8.8	2.1	4.1	2.5	3.9
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
Asia ex China	3.8	3.5	3.4	3.5	3.9
World	4.1	3.4	3.2	3.2	3.7

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

Table 6.2

Macroeconomic Forecasts: Inflation (Avg.)

(YoY% growth rate)	2011	2012	2013	2014 (F)	2015 (F)
United States	3.1	2.1	1.5	1.9	2.2
Eurozone	2.7	2.5	1.4	0.5	1.0
Germany	2.5	2.1	1.6	0.9	1.5
France	2.3	2.2	1.0	0.7	0.9
Italy	2.9	3.3	1.3	0.3	0.7
Spain	3.2	2.4	2.4	0.0	1.0
UK	4.5	2.8	2.6	1.5	1.6
Latin America *	7.0	6.3	7.8	13.1	14.2
Mexico	3.4	4.1	3.8	4.0	3.4
Brazil	6.6	5.4	6.2	6.3	6.2
EAGLES **	6.6	5.1	5.3	4.8	4.6
Turkey	6.5	8.9	7.5	8.8	7.0
Asia Pacific	4.9	3.4	3.5	3.4	3.6
Japan	-0.3	0.0	0.4	2.2	1.5
China	5.4	2.6	2.6	2.2	2.9
Asia ex China	4.6	4.0	4.2	3.9	3.7
World	5.2	4.2	4.09	4.2	4.4

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

Table 6.3

Macroeconomic Forecasts: Exchange Rates (Annual Average)

		2011	2012	2013	2014 (F)	2015 (F)
Eurozone	**USD/EUR**	1.39	1.29	1.33	1.33	1.19
Japan	**JPY/USD**	79.8	79.8	97.6	104.7	115.3
China	**CNY/USD**	6.46	6.31	6.20	6.14	6.02
UK	**GBP/USD**	0.62	0.63	0.64	0.61	0.64

Forecast closing date: 30 October 2014.
Source: BBVA Research and IMF

Table 6.4

Macroeconomic Forecasts: Policy Rates (End of period)

(%)	2011	2012	2013	2014 (F)	2015 (F)
United States	0.25	0.25	0.25	0.25	0.50
Eurozone	1.10	0.75	0.25	0.05	0.05
Japan	0.10	0.10	0.10	0.10	0.10
China	6.56	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 October 2014.
Source: BBVA Research and IMF

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