BBVA | RESEARCH

China Economic Outlook

First Quarter 2015
China Unit

- Global growth is recovering in a complex environment, due to the withdrawal of extraordinary monetary stimuli in the US, at the same time as geopolitical risks are accelerating. We slightly adjusted our 2015 GDP forecasting downward to 3.7%, on account of recent outturns.
- China's growth achieved a soft-landing in 2014 but it still was the lowest growth rate registered since 1991. Meanwhile, deflation risk is on the rise due to falling commodity prices and the deep-seated overcapacity problem in certain domestic industries.
- We maintain our growth projections of 7.0% for 2015 despite recently strong headwinds. The government is expected to lower this year's growth target while increases monetary loosening to combat deflation and sustain growth.
- Risks are still to the downside. Risks concentrate on the US interest rate hike and uncertainties of external environment, potential deflationary spiral, as well as a number of existing financial fragilities.

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Closing date: 16 February 2015

1 Summary

China's growth achieved a soft-landing again last year, with the help of the authorities' pro-growth measures. Nevertheless, the 2014 annual growth rate is only 7.4%, which missed the pre-set 7.5% target and registered the lowest level since 1991.

Domestic demand remained subdued, mainly due to the persistently sluggish property market as well as its adverse spill-over effects to other related sectors. The anemic demand has prompted the authorities to beef up their efforts of monetary easing, including a November cut of benchmark interest rates and the more recent reduction of required reserve ratio (RRR). In the meantime, the PBoC continued to use a series of unconventional policy tools to inject liquidity to the banking sector.

Deflation risk is on the rise as the growth rates of both headline CPI and PPI dipped further over the past few months. Apart from the sharp decline in falling commodity prices, the deep-seated overcapacity problem in certain industries continues to add pressure on domestic price levels. The increasing deflation risk is especially harmful for the corporate sector as subdued prices could exacerbate real financing costs on firms.

Structural reforms have maintained the momentum, in particular, for those in the financial sector. Nevertheless, capital outflows accelerated of late and exerted depreciating pressure on the RMB exchange rate despite an expanded trade surplus due to very weak imports (namely "recessionary trade surplus").

Looking ahead, we maintain our growth forecast of 7.0% for 2015 and project an even-lower growth rate of 6.6% in 2016. The lower figures are still consistent with our soft-landing scenario and the authorities' definition of "New Normal". The growth could be subject to strong headwinds at the beginning of the year and then will rebound mildly as the authorities' further loosening measures start to take effect and the external environment improves.

"New Normal" calls for "New Thinking" in policymaking. In addition to the widely-expected lower growth target, the authorities could give the market more positive surprises when announcing this year's key macro targets. For example, the current single-point target could be replaced by a clearly defined growth range. Moreover, the authorities could also introduce a lower bound for inflation rate in the face of rising deflation risk.

Despite its recent weak performance, we forecast that the RMB exchange rate will resume its mild appreciation later this year, sending the CNY/USD to 6.10 by end-2015. A number of factors will limit downward adjustment of the RMB exchange rate in the short run, including: an expanded current account surplus; the authorities' concerns of the depreciation-triggered capital flight and the need of pushing forward the RMB internationalization.

On the policy front, we project that the policy mix of this year could be described as "accommodative monetary policy, tight fiscal policy". On the monetary front, we anticipate two additional interest rate cuts (each of 25 bps) in the first half of 2015. We also project that the authorities will lower the RRR by another one to two times (50-100 bps) between now and the end of 2015. On the fiscal side, we forecast that the fiscal deficit as a percentage of GDP will be expanded to 2.5% in 2015 from 1.8% in 2014. However, the incoming fiscal consolidation of local governments could offset the central government's fiscal expansion.

Risks to China are still to the downside, concentrating on the uncertain external environment, increasing deflation risk and the existing financial fragilities.

2 Moderate global growth with increasing divergence between economic areas

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

The world economy will have closed 2014 with growth of close to 0.8% QoQ, according to our estimates, a similar pace to that in 3Q14[1]**,** and slightly stronger than in the first half of the year. A dynamic economic performance in the US has been offset by the weakness of the recovery in Japan and the euro area, and the progressive deceleration of China and other emerging economies.

In the EM block, the divergence between industrial activity and services indicators continues. The gradual improvement in private consumption, on the back of the stabilisation or increase in employment, has continued to feed through into the figures for retail sales and the confidence indices in the services sector. Meanwhile, the relative improvement in world trade in the first two months of 4Q14 has not yet translated into a substantial increase in industrial production. In general, the EMs are seeing the fall in commodity prices in a scenario where there is already a trend towards more moderate growth in China. Altogether, we estimate that global GDP will have grown 3.3% in 2014, 10bp more than in 2013, with a slight increase in the DMs' contribution vs. the three previous years, and the EMs continuing to decelerate.

One of the novelties in the global economic scenario in recent months is the very sharp fall in the oil price and its uneven impact on different countries, depending on whether they are net importers or exporters. Overall, we think the global impact of cheaper oil should be positive in terms of growth, inasmuch as the reduced burden on household and corporate income in oil-importing countries (such as the US, the euro area and China) offsets the reduced activity in the principal producer countries. However, even lower prices or levels like those at present for Brent, around USD50/bbl, for an extended period could generate geopolitical and/or financial tensions that might compromise global stability.

In fact, **the increased volatility in financial markets, which has now reached the same level as in mid-2013 according to the BBVA Financial Tensions Index, is another of the highlights of the quarter,** and one the EMs and the DMs have in common as a consequence of two factors. First, the combination of the geopolitical crisis between Russia and Ukraine with the fall in commodity prices, which has raised doubts on the economic development of many EMs. Second, the uncertainty around the Fed's rate-hiking cycle, especially when the ECB is introducing QE measures and there is an increasing political debate on the most appropriate balance of policies to strengthen the region's recovery.

The correction in the oil price also accentuates the risks of a global scenario of too low inflation, at least until the second half of 2015. In addition to the recent general decrease in inflation, common to all the principal geographies (the average for the US, the euro area, Japan and China was 1% in 2014), there has been the steep fall in industrial production and import prices. Although so far the translation of the fall in energy prices to core inflation and salaries appears to be contained, the sharp adjustment in medium-term inflation expectations and the all-time lows in long-term interest rates reveal the degree of uncertainty that exists about the rate of recovery of the global cycle and the capacity of the central banks to restore inflation to levels compatible with their objectives.

In this context of low inflation and moderate economic growth, **monetary policies remain accommodative in tone, although the biases differ** (with the Fed and the Bank of England on the one side, and the ECB

1: Estimate based on the BBVA Research GAIN indicator; for details of the methodology, see: http://bit.ly/1nl5RIn

and the PBoC on the other). The new oil-price scenario gives the most important central banks room for manoeuvre to delay or reduce the intensity of the upward path of benchmark interest rates.

Momentum in the US recovered over the course of 2014, and particularly in 2Q and 3Q, with QoQ GDP growth slightly above 1%. The strength of domestic demand and the stabilisation of residential construction are key to the US growth model. With net job creation of around 200k a month and an unemployment rate at year-end 2014 of 5.6%, wage increases will continue to support household consumption. The lower oil, and eventually, fuel prices are also helping to free-up disposable income for spending on other consumer goods.

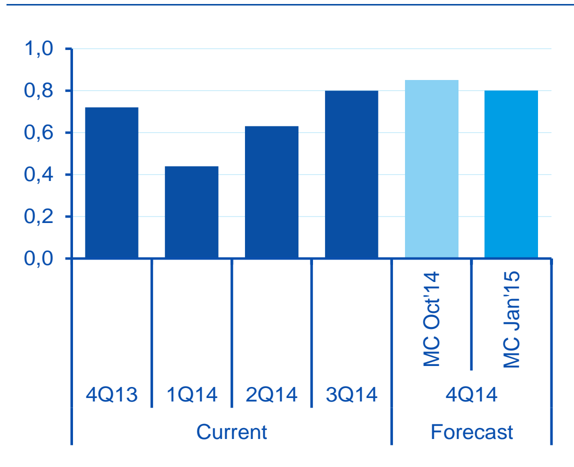
As a result of the good performance in previous quarters, and in spite of a more moderate figure for GDP growth in the fourth quarter, **US growth could reach 2.4% in 2014 and up to 2.9% in 2015, in both cases beating the mid-year targets.** The combination of stronger growth and lower inflation (the headline rate will be below 2% until 2016) will accentuate the **Fed's dilemma when it comes to start its monetary normalisation process,** in a context in which the global appreciation of the dollar favours more moderate inflation. Our forecast for the first increase in the fed funds rate remains in 3Q15.

Of the large economic areas, the **eurozone** is the one which is most likely to have to deal with a scenario of inflation that is too low for too long. In addition to the negative surprises on consumer prices, the area has only a **moderate economic growth profile, in line with expectations.** Assuming GDP growth reaches around +0.2% in 4Q14, supported by a similar increase in activity in Germany and France and a better relative performance than Spain, our estimate for the eurozone is +0.8% YoY.

For the eurozone, we maintain our forecast for growth of 1.3% for 2015, supported by the fall in the price of oil, the accumulated depreciation of the euro in recent months and the relaxation of monetary conditions thanks to ECB actions. The less restrictive nature of fiscal policy in the peripheral countries is also an element to take into account, as well as the so-called "Juncker Plan", designed to favour investment, and the first fruits of which are expected in the second half of this year.

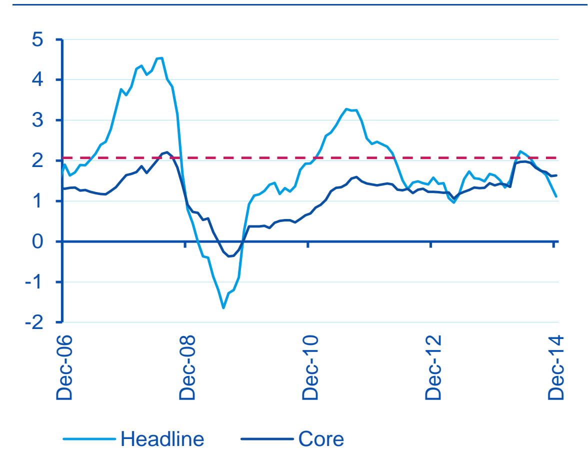
Altogether, and in spite of the support offered by economic policies and lower oil prices, the risks to world growth in 2015 remain to the downside. The risks presented by geopolitical tensions have been joined by risks associated with the effectiveness of the monetary policies introduced to increase inflation expectations and – in the case of the Fed in particular - to establish a strategy for withdrawing stimulus that does not erode the EMs' financing conditions to such an extent that this restricts their growth.

Figure 2.1
Global GDP based on BBVA-GAIN, %, QoQ



Source: BBVA

Figure 2.2
Global inflation, % (*)



(*) Calculated as the simple average of inflation in the US, the euro area, Japan and China.
Source: BBVA Research and Haver Analytics

3 A soft-landing with a missed growth target

China's fourth quarter GDP growth came out at 7.3% y/y, flat with that of the previous quarter and broadly in line with the market expectation (Consensus: 7.2% y/y). In sequential terms, growth in Q4 remarkably decelerated to 1.5% q/q sa from 1.9% q/q sa in Q3. For 2014 as a whole, a soft-landing is achieved although the annual growth rate is 7.4%, which missed the pre-set growth target of 7.5% and registered the lowest level since 1991.

The lackluster domestic demand in Q4 has prompted the authorities to beef up their efforts of monetary easing. The People's Bank of China (PBoC) cut the benchmark interest rates in November, the first time since July 2012. On the top of it, the PBoC lowered the required reserve ratio (RRR) by 50 bps for all banks in early February, the first time of a universal RRR cut since May 2012. In the meantime, the PBoC continued to use a series of unconventional policy tools to inject liquidity to the banking sector, including the selective RRR cut (which came together with the universal RRR cut but only targeting rural banks), the medium-term liquidity facility (MLF) and reverse repo. We envision that the cuts in interest rates and the RRR will usher in a new series of monetary easing measures in the coming months, including both the conventional and unconventional ones.

Structural reforms maintained the momentum in Q4. Particularly in the financial liberalization, the authorities unveiled their plans of establishing the long-awaited nationwide deposit insurance scheme; inaugurated the "Shanghai-Hong Kong Stock Connect" program to allow investors in Hong Kong and foreign countries to directly invest in China's onshore stock markets; and expanded the permissible floating range of deposit rates to 20% (vs. 10% previously) above the benchmark deposit rates. The Ministry of Commerce is proposing an overhaul of the Foreign-Investment Law which aims to open more sectors to foreign investment. The authorities are also seeking to replicate the Shanghai free trade zone (FTZ) in other places. On the front of fiscal reform, the State Council has recently announced the plan to overhaul the urban pension system by equalizing the benefit plans between the retired employees in public and private sectors.

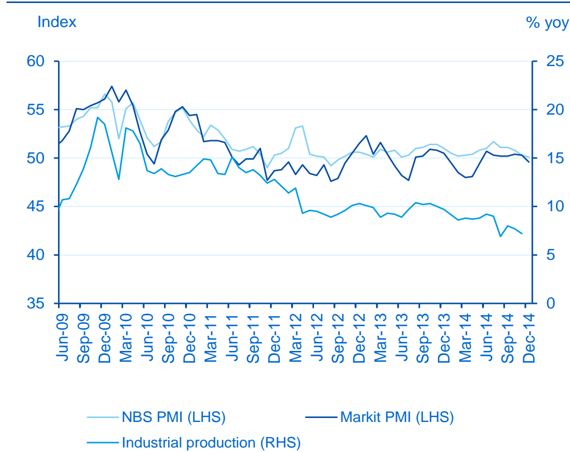
Growth headwinds are on the rise

Economic activities continue their downtrend. Industrial production growth rebounded to 7.9% y/y in December, from 7.2% of the previous month. However, the December outturn is still below its long-term trend. The NBS PMI for January 2015 came in at 49.8, which is lower than both the market consensus of 50.2 and the previous month's reading of 50.1, registering a 28-month lowest. The HSBC China Final Manufacturing PMI also declined to 49.7, which is below the watershed level of 50.0 as well, and down from the December's final reading 49.8. Taken together, manufacturing activities further slow the pace amidst of intensified growth headwinds. (Figure 3.1)

On the demand side, retail sales growth picked up slightly to 11.9% in December in nominal terms (11.5% in real terms), led by the outperformance of some durable goods such as communication equipment and construction-related decoration materials. On the other hand, the consumption of luxury goods and services remained weak due to the ongoing anti-corruption campaign. (Figure 3.2)

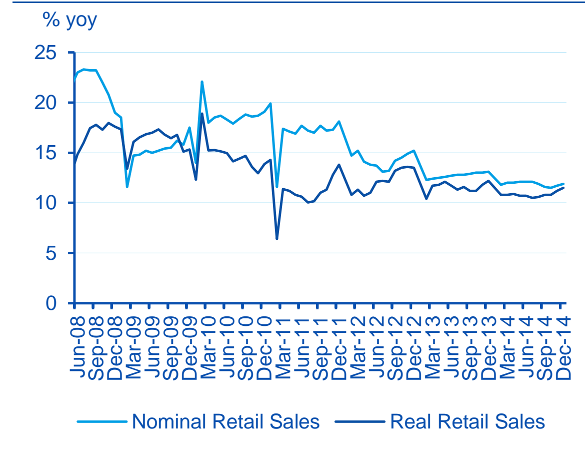
Investment moderated further in Q4. In terms of investment in different sectors, a small pick-up was shown in manufacturing sector while real estate and infrastructure investment decelerated further in December (Figure 3.3).

Figure 3.1
China's manufacturing activities have moderated



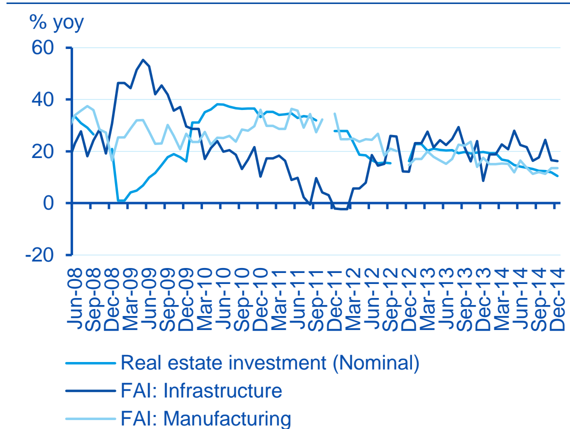
Source: NBS, CEIC and BBVA Research

Figure 3.2
Retail sales growth was marginally increasing



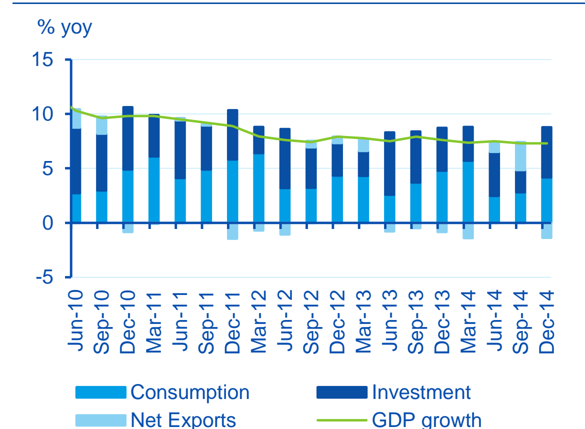
Source: NBS, Wind and BBVA Research

Figure 3.3
Real estate and infrastructure FAIs were in the downward trend in Q4



Source: NBS, CEIC and BBVA Research

Figure 3.4
Growth momentum has moderated in 2014



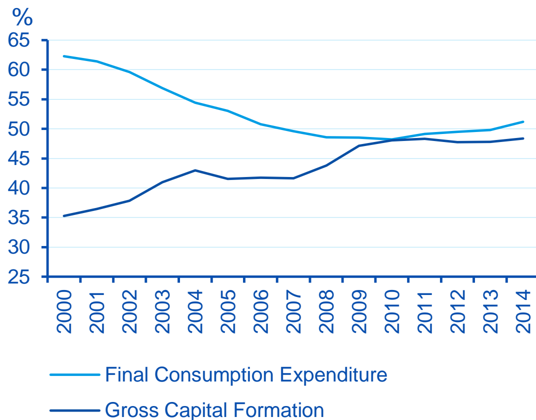
Source: NBS, Wind and BBVA Research

Signs of rebalancing are the silver lining of the slowed growth

Detailed analysis of the 2014 GDP components show that the consumption's contribution to GDP growth edged up to 3.79%, surpassing both investment and net export. In contrast, the contributions of investment and net exports are 3.59% and 0.02% respectively, out of 7.4% GDP growth. (Figure 3.4 and 3.5) Moreover, industry structure has further improved in 2014 as the service sector accounted for 48.2% of the total output, increasing by 1.3 ppt from the previous year. In the meantime, the contribution of the secondary industry (including manufacturing, mining, construction and utility sectors) decreased to 42.6% of GDP in 2014 from 44.2% in 2013. In short, China's industrial structure is rebalancing from manufacturing-oriented towards service-oriented as domestic consumption has become the most important growth engine. (Figure 3.6)

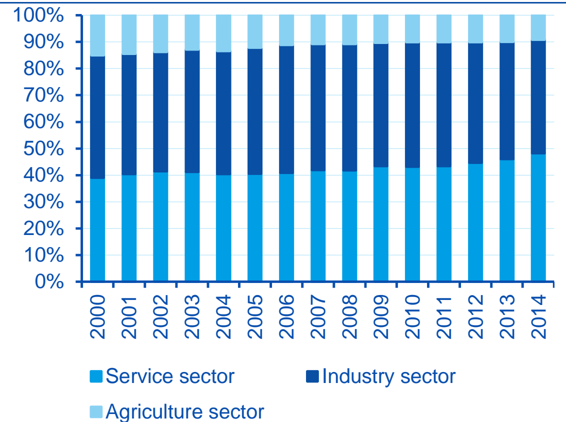
One important driver behind the ongoing rebalancing toward domestic consumption and the service sector is the solid income growth. According to the NBS, household income growth in real term grew by 8.0% last year, exceeding the growth rate of real GDP (Figure 3.7). In the meantime, the minimum wage was revised in many provinces last year, on average 9.5% from their 2013 levels.

Figure 3.5
Economic rebalance towards consumption driven



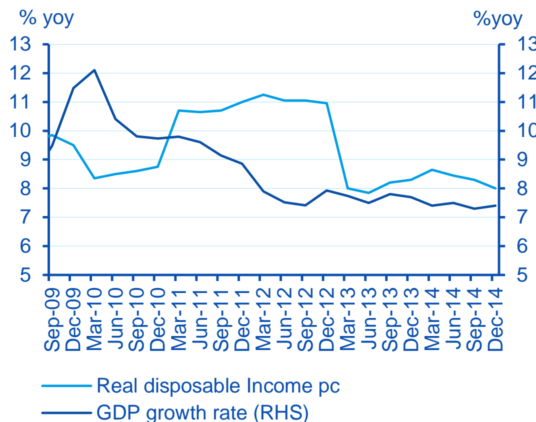
Source: NBS, CEIC and BBVA Research

Figure 3.6
The share of the service industry rose further



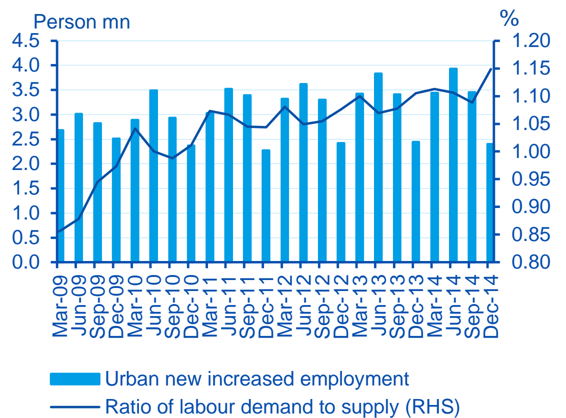
Source: NBS, Wind and BBVA Research

Figure 3.7
Income growth surpassed GDP growth, achieving the government's target



Source: NBS, CEIC and BBVA Research

Figure 3.8
The labor market was still in a good shape

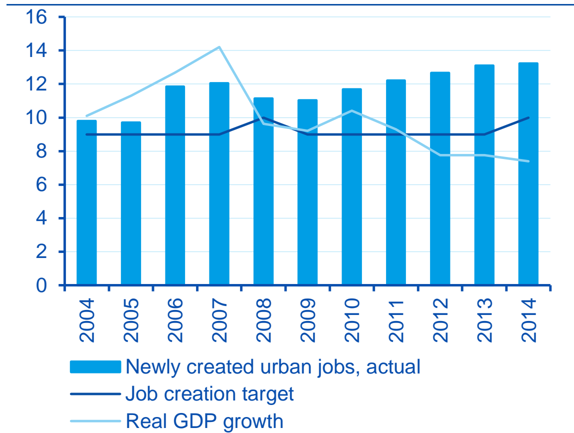


Source: NBS, Wind and BBVA Research

The labor market was in good shape. The urban registration unemployment rate stayed at 4.1% in Q4 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 5.1%, a health level taking into account of real growth rate. The ratio of demand to supply in the labor market even ticked up in the fourth quarter (Figure 3.8), reflecting the tightness of the labor market. For 2014 as a whole, the newly increasing urban employment population reached 13.22 million, substantially above the authorities' target of 10 million. (Figure 3.9)

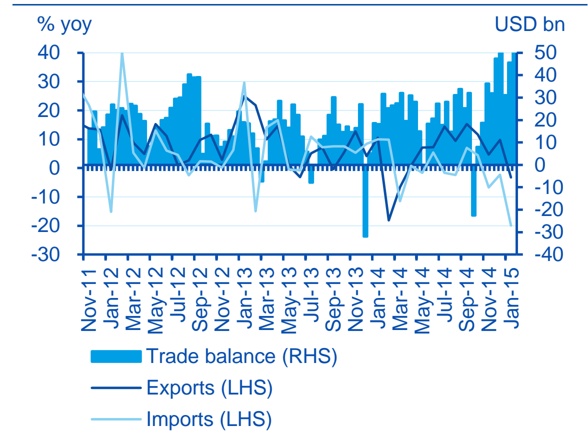
The strong job growth is due to the accelerating development of service sector, which creates more job opportunities compared with the industrial sector. Actually, the total new job creation has been increasing overtime, although the manufactory employment is decreasing according to the Q4 PMI manufactory employment component (47.9 in January 2015 vs. 48.1 in December 2014).

Figure 3.9
Job creation is strong due to the accelerating service sector, albeit GDP growth is decreasing



Source: NBS, CEIC and BBVA Research

Figure 3.10
Exports and imports are very volatile in recent months



Source: NBS, Wind and BBVA Research

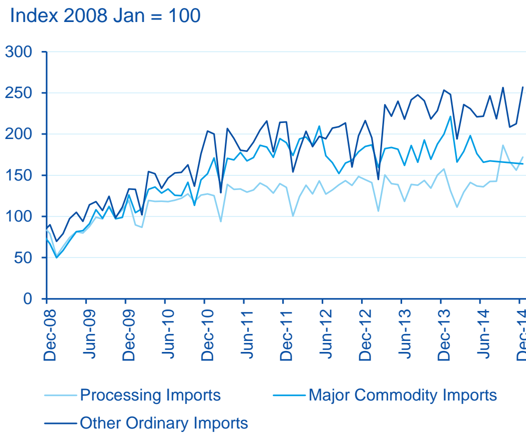
A "recessionary trade surplus" emerged…

After seeing their ups and downs in the fourth quarter of 2014, both exports and imports growth rates unexpectedly dropped to the negative territory in January. Exports growth rate declined to -3.3% y/y (Consensus: 5.9% y/y) while imports fell by -19.9% y/y (Consensus: -3.2% y/y). A couple of factors lurk behind the weaker-than-expected January trade data: First, the fast growth of exports and imports in January 2014 led to an unfavorable base effect for this year's outturns; second, the recent sharp decline in international commodity prices substantially weighed on China's total imports. (A further analysis of oil price decreasing and its influence on Chinese economy could be found in the BOX)

After adjusting the above factors, we estimate that the growth rates of exports and imports in January are 0.03% and -0.14% respectively. That being said, the trade data in January still reflects negative impacts of the intensifying external uncertainties and sluggish domestic demand.

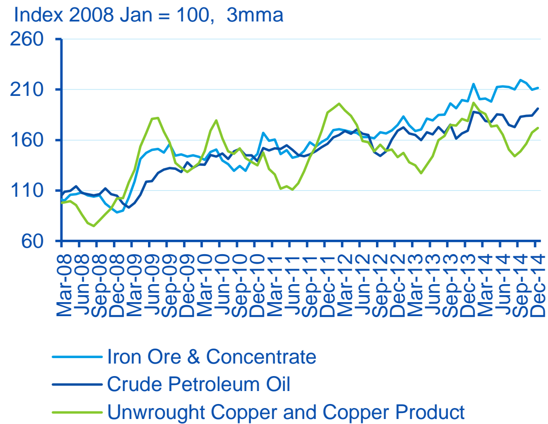
Weak exports, together with much weaker imports, yielded a record high trade surplus of USD 60.0 bn in January, compared with a surplus of USD 49.6 bn in the previous month. However, it is a "recessionary trade surplus" - which results not from rising exports but rather from falling imports due to weak domestic demand (Figure 3.10) Moreover, the processing imports underperformed other imports, indicating that the rising labor cost has started to affect China's competitiveness in the processing trade. (Figure 3.11) The commodity imports of various classifications displayed the increasing trend in Q4: oil and iron ore demand has edged up marginally in Q4 after a decline in Q3 mainly due to the global oil price decreasing, whereas copper picked up significantly after its bottom in Q3. (Figure 3.12)

Figure 3.11
Processing imports and commodity imports were lackluster due to the sluggish domestic demand



Source: NBS, CEIC and BBVA Research

Figure 3.12
Commodity imports displayed diversifying paths

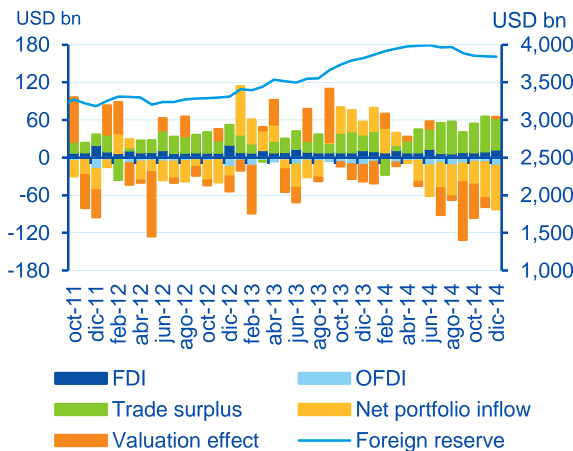


Source: NBS, Wind and BBVA Research

…with a deficit in the capital account

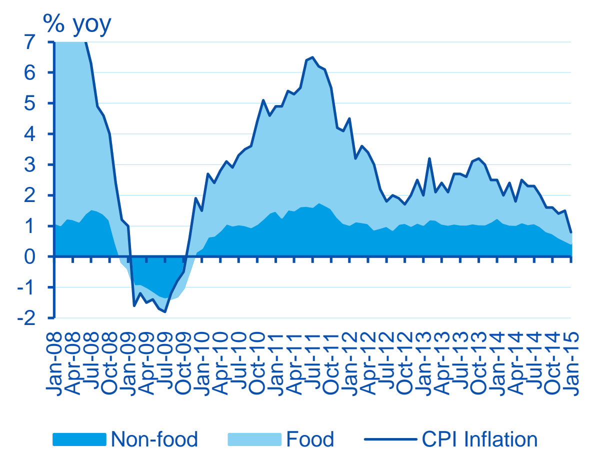
Moreover, the balance of capital account swung to a deficit of USD 96 bn in 2014 from a surplus of USD 182.8 bn in the previous year. As a strong US recovery is in sight, the Fed is poised to hike interest rates in the second half of this year. It has largely spawned the appreciating expectation of the USD. As a consequence, more and more Chinese enterprises chose to hold the USD denominated assets in anticipation of a strong "Greenback". Such a trend of "asset dollarization" has resulted in the ever-increasing portfolio outflows in China's Balance of Payment (BOP). Meanwhile, the authorities' financial liberalizing efforts have made outward FDI much easier than before. In 2014, the aggregate size of China's outward FDI was almost equivalent to its recipient FDI, sending the deficit in the capital account to a higher level. (Figure 3.13)

Figure 3.13
Capital outflow became significant in Q4



Source: CEIC and BBVA Research

Figure 3.14
Deflation risk in China might be on the rise



Source: CEIC and BBVA Research

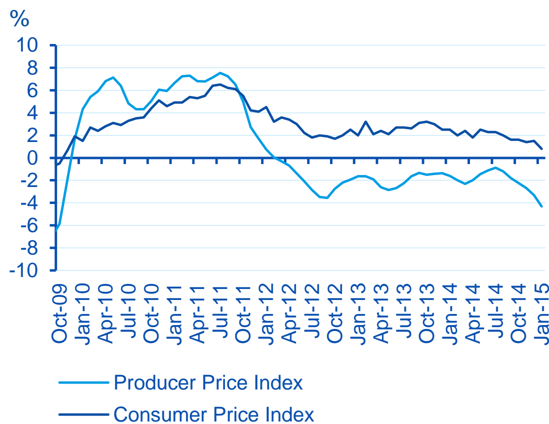
Deflation risk looms large

Inflation remained at a low level in most time of last year and dipped further in January. In particular, the headline CPI decreased significantly to 0.8% y/y in January from 1.5% y/y in December (Figure 3.14), the lowest reading since November 2009. Low inflation outturns are broad-based: the food price inflation decelerated on falling commodity prices while housing rentals slowed in parallel to the subdued property market.

Producer price inflation (PPI) plummeted to -4.3% y/y in January from -3.3% in December. Indeed, the time for PPI staying in a negative territory has lasted for 35 months. Apart from weak commodity prices in the international market, the overcapacity problem in some domestic industries continued to weigh on firms' wholesale prices (Figure 3.15).

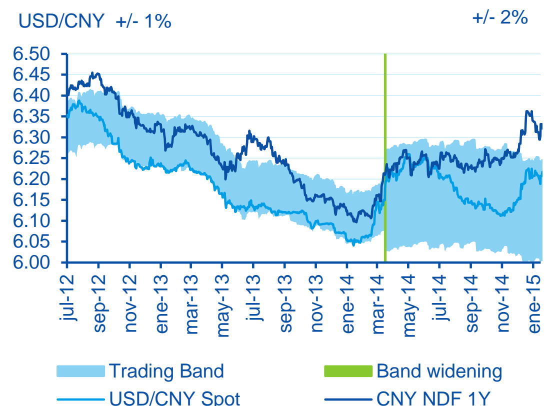
The increasing deflation risk is especially harmful for the corporate sector. Indeed, the real interest costs on firms are equivalent to the gap between the nominal interest rates and inflation rate. Lower inflation (or deflation) could therefore increase firms' real financing costs if the nominal interest rates remain the same. A worse case is that deflation could trigger the devastating downward debt-deflation spiral which eventually leads to waves of firm defaults. The authorities should loosen monetary policy in a more proactive way to battle inflation.

Figure 3.15
PPI inflation was still in the negative region



Source: CEIC and BBVA Research

Figure 3.16
The RMB exchange rate has been volatile in Q4



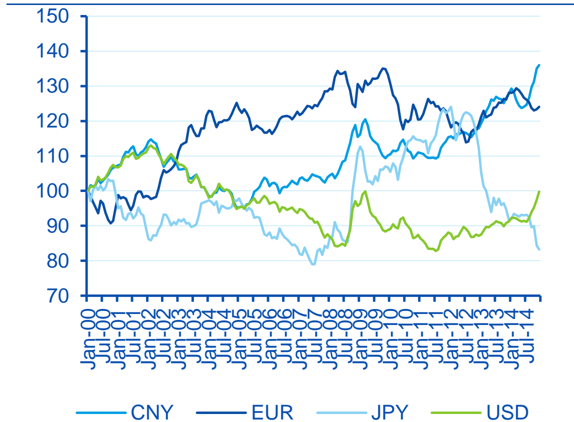
Source: CEIC and BBVA Research

The RMB exchange rate has been volatile

After a lull of strengthening in Q3, the RMB exchange rate started to depreciate again (Figure 3.16). To date, the RMB has depreciated by 1% against the USD since end-September and by 1.8% against USD since its highest point in Q4. The current level of CNY/USD is around 6.24. Nevertheless, the RMB has still maintained a relatively strong trend against other currencies such as Euro and JPY (Figure 3.17), which registered larger depreciation against the USD in the fourth quarter of 2014. In terms of NEER and REER, the RMB have appreciated by 4.8% and 5.4% as of end-December, respectively, compared with the end-September, which can partly explain the recent weakening trend of China's shipments to these trade partners.

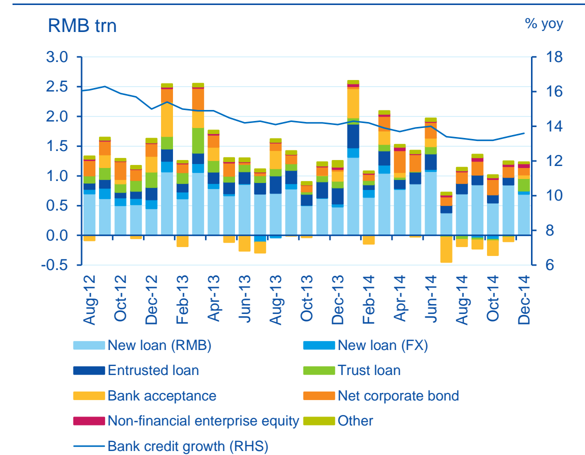
In the meantime, the RMB exchange rate volatility has significantly risen, in line with the authorities' intention to enhance the two-way flexibility of the exchange rate to reduce speculative money inflows.

Figure 3.17
The comparison of NEER of RMB and other currencies



Source: CEIC and BBVA Research

Figure 3.18
Credit growth has been volatile in Q4



Source: CEIC and BBVA Research

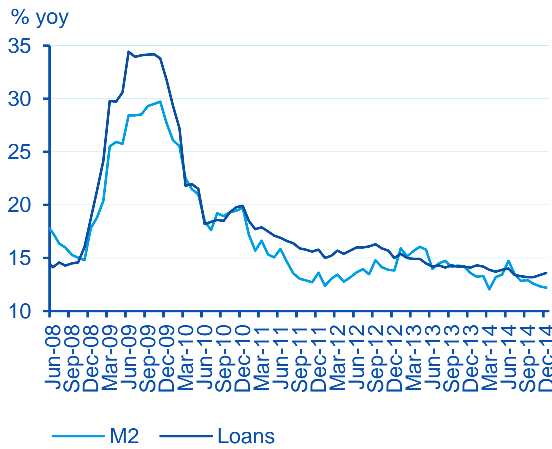
Credit growth down; stock prices up

Credit growth slowed down and became volatile. After a dip in December (697.3 billion RMB), new bank loans rebounded to 1470.0 billion in January, but still below its long-term trend. The total social financing experienced a similar trend, as the regulators continued to curb the growth of high-risk shadow banking activities. (Figure 3.18) Significantly, M2 growth dropped to 10.8% y/y (Consensus: 12.1%) in January from 12.2% y/y in December, reaching the lowest level in the past decades. (Figure 3.19) We believe that the sharp decline of M2 is mainly due to the slowed FX inflows under the capital account, which has led to the diminishment of foreign reserves as well.

Interestingly, China's A-share stock market unexpectedly soared up in December, which seemed to deviate from the economic fundamentals. In our view, the run-up of the stock market was catalyzed by a string of policy actions as the authorities are striving to spur growth and push for long-term structural reforms. First, the "Shanghai-Hong Kong Stock Connect" was inaugurated in November, opening a new channel for investors in Hong Kong and Shanghai to explore investment opportunities in their counterparties' stock markets. Second, the PBoC cut the policy rates in November, surprising the market by scrapping the authorities' previous pledge of no-big-stimulus. Third, the China Banking Regulatory Commission (CBRC) indicated to permit wealth management products (WMPs) to tap into the stock market. Given the gigantic size of WMPs (more than USD 2 trillion now), investors have a good reason to celebrate on the potentially booming demand for stock shares. (Figure 3.20)

In summary, the run-up of the stock market didn't come along with any visible improvement in fundamentals. In particular, we perceived that some speculative investors have significantly increased their leverage in the run-up by margin finance. It has already prompted the regulators to tighten relevant restrictions of the security firms' margin finance business.

Figure 3.19
M2 and bank loan growth have stabilized in Q4



Source: CEIC and BBVA Research

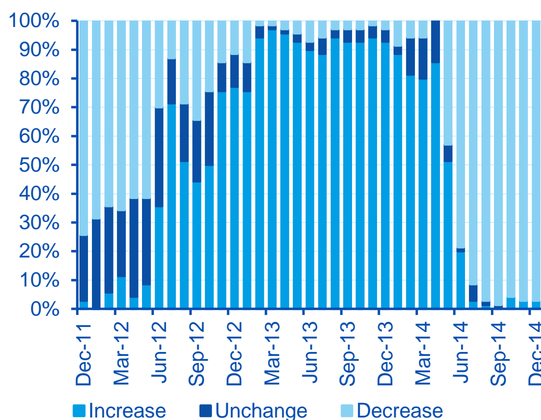
Figure 3.20
A-share stock index peaked in Q4, deviating from the economic fundamentals

Source: CEIC and BBVA Research

Signals of stabilization are shown in a few large cities

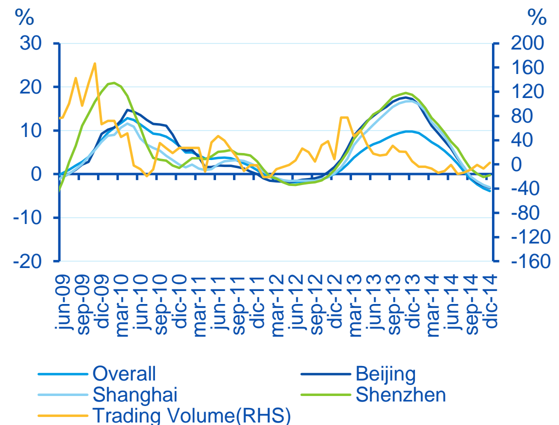
The property market showed some positive signs of improvement of late, although downbeat expectations of the property market and the high inventory level in many cities continued to weigh on housing prices and transactions. As revealed by the NBS, the housing prices in a few cities (especially the tier I cities) started to exhibit a year-on-year increase in November and December. (Figure 3.21) The property trading volume picked up to 2.9% y/y in December as well, compared to a streak of negative year-on-year growth in the previous 11 months (Figure 3.22). We believe that the positive signals of the property market of Q4 resulted from the authorities' stimulus policies in Q3, including relaxing the housing purchase restrictions and encouraging banks to extend more mortgage loans with lower interest rates.

Figure 3.21
A couple of tier 1 cities reported housing price increasing in Q4



Source: NBS and BBVA Research

Figure 3.22
Housing prices and trading volume have shown positive signals in Q4



Source: NBS, CEIC and BBVA Research

Structural reforms are still on the track

Structural reforms have broadly maintained the moment in Q4 2014, in particular for financial liberalizing measures.

First, the authorities unveiled their plan to establish the long-awaited nationwide deposit insurance scheme. The proposal of the deposit insurance scheme reinforced people's confidence in that the new leadership will honor their pledge of pushing forward financial liberalization reforms. It is believed that the introduction of the insurance scheme will relatively benefit larger banks, in particular the listed ones given that depositors are likely to favor these "too-big-to-fail" ones.

Second, the "Shanghai-Hong Kong Stock Connect" program was successfully inaugurated on November 17, opening a new channel for investors in Hong Kong and foreign countries to explore opportunities in their Chine' stock markets. It constituted another milestone of China's capital account liberalization. After its inception, the fund flows under the program have shown that Hong Kong's investors' interest in Shanghai's stock market substantially surpassed the other way around, partly due to the long-time closeness of China's stock market.

Third, the PBoC's interest rates cut in November came with an expansion of the permissible floating range of deposit rates from 10% to 20% above the benchmark deposit rates. As a result, the effective deposit rates (the highest rates that banks can offer to their depositors) will remain at 3.3% unchanged. This movement constituted an additional step in interest rate liberalization and reaffirms the authorities' resolution to push forward structural reforms.

Fourth, the authorities will dramatically expand the coverage of Free Trade Zone (FTZ) in Shanghai and try to replicate it in more places nationwide. In particular, the new FTZ in Shanghai will be enlarged to include the city's important commercial center and financial district. In the meantime, the authorities decide to develop three new FTZs in Guangdong, Fujian and Tianjin provinces, seeking to replicate Shanghai's experience.

Fifth, the Ministry of Commerce is proposing an overhaul of the Foreign-Investment Law in January 2015 that attempt to embrace foreign investors with a greater enthusiasm. A central element of the revised law is the ministry's intention to address a legal loophole that is to allow foreigners to freely buy shares of companies in restricted industries. If the bill is passed in the National Congress Party, China will become a much more attractive place for foreign companies to do business.

Sixth, the State Council, China's cabinet, announced a long-awaited plan in January 2015 that will equalize the dual-track urban pension system, in which employees in private sector (including SOEs) have a lower level of retirement benefits than government employees but need to do a higher level of contribution. The plan is aimed to equalize the contribution and benefits for employees in both public and private sectors. Despite the enhancement of the fairness for the urban pension system, the reform can benefit the government's fiscal situation by lessening its contingent liability.

In summary, the Chinese authorities have painstakingly pushed forward structural reforms on different fronts as they pledged in their reform blueprint of November 2013. Under the "New normal" economic scenario, we believe that these structural reforms will benefit China's economic growth in the long-run. Moreover, we anticipate that more structural reform measures will be promulgated in 2015.

BOX: Will falling energy prices help China in its soft-landing strategy?

In short, they won't, at least not directly. Under our current baseline scenario, which calls for crude prices just under 70 USD/b in 2015 (Figure 1), we project a neutral impact on Chinese GDP (+0.0% in 2015). The impact will be more significant if prices remain significantly below our baseline scenario, around 50 USD/b (+0.1% in 2015).

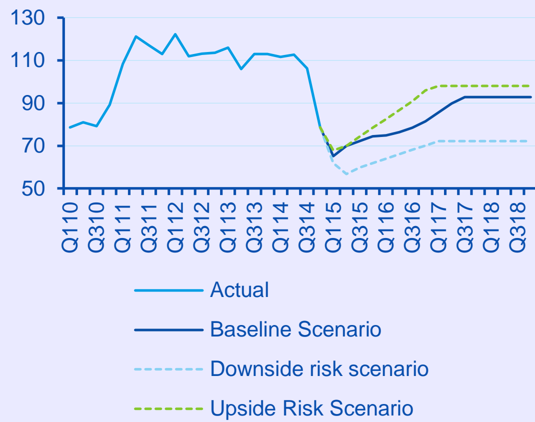
China's large size of economy helps to buffer exogenous shocks. China imported 236 USD billion worth of oil in 2014, making it the largest oil importer in the world. However, these accounted for only 12% of its total imports, a relatively low proportion. Furthermore, evidence shows that China may have been taking advantage of lower oil prices to boost its strategic reserves, which previously stood at only 90 days, further dampening any effect that the lower oil prices may have had on its trade surplus. More importantly, China's economy remains coal-oriented, with coal accounting for over two thirds of its energy mix (Figure 2). One similar example is that coal prices have fallen 40% in the last two years, and yet this has not impacted GDP in any significant way.

Energy prices, from power to petrol, are all heavily regulated in China. The power sector and energy intensive industry are particularly notorious. Fuel prices are allowed to trail global oil prices more "freely", but they are ultimately still fixed by the government. Lower global oil prices thus help to reduce the fiscal burden on the government by reducing the cost of fuel subsidies. Furthermore, downward pressure on prices has enabled the government to implement several rounds of fuel consumption tax hikes in late 2014 and early 2015, in order to fight looming pollution concerns and cut emissions in China. The fuel consumption tax hikes may have the additional benefit of boosting government revenues and improving fiscal capacity. If reinvested wisely, these could even lead to double dividends, putting the momentum behind China's recovery in the near term, although this still remains to be seen.

One way in which lower oil prices will have a clear impact on the economy in the short term is by providing an environment which is conducive to more monetary policy easing, primarily through lower inflation (Figure 3). According to our estimates, lower crude prices could put downward pressure on inflation by -0.1% (baseline scenario) to -0.2% (downside risk scenario). The effects of lower oil prices could therefore be much larger if we factor in the secondary effects of further monetary easing fueled by low inflation rates.

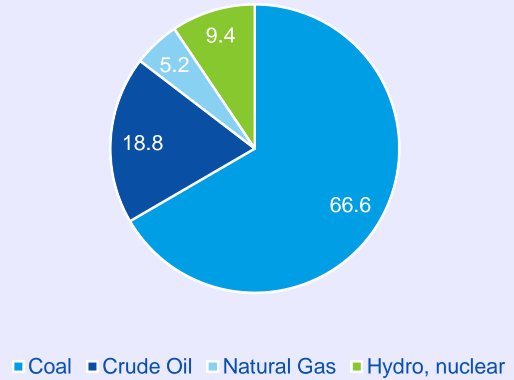
Lower oil prices will only have an impact on GDP if they continue to be persistently low for a prolonged period of time. Having said this, this could back-fire on the economy if it squeezes profits for China's dominant energy SOEs (particularly refining). Whereas China is in the process of rebalancing its economy towards more consumption, investments continue to contribute to a sizeable proportion of total GDP. Falling oil prices and lower oil consumption could squeeze energy SOE profits, in turn, impacting their decision to invest in new upstream, refining or downstream and distribution capacity (Figure 4). Lower SOE Fixed Asset Investments (FAI) may have adverse effects on China's recovery in the near term.

Figure 1
Oil price and price trajectory (USB/bbl)



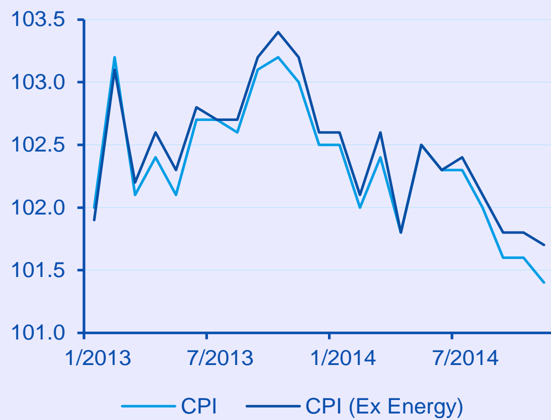
Source: BBVA Research

Figure 2
China's Energy Mix (2012)



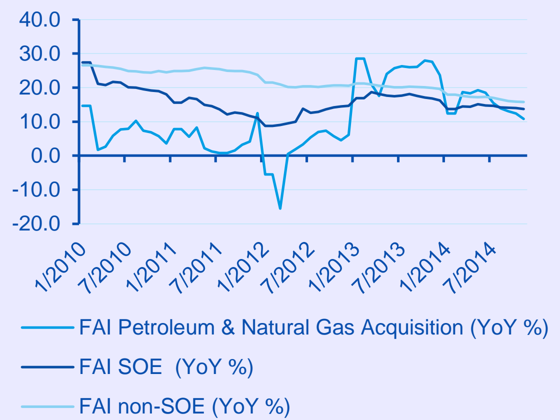
Source: NBS and BBVA Research

Figure 3
Lower energy prices have started to put some degree of downward pressure on CPI inflation



Source: CEIC, Bloomberg and BBVA Research

Figure 4
Slowing oil consumption and lower prices may affect SOE FAI



Source: CEIC and BBVA Research

4 Outlook in 2015: "New Normal" and "New Thinking"

As we elaborated in our last quarter's China Economic Outlook, the downtrend of China's economy is unlikely to reverse in the next couple of years. On top of some deep-seated structural factors such as prevalent financial repression and entrenched corporate governance deficiencies in state-owned enterprises (SOEs), a number of short-term headwinds could further dampen China's growth outlook and increase deflation risk, which include (i) the increasing external uncertainties about the US monetary policy normalization, Europe and Japan's fragile economic recovery as well as the volatile movements of international commodity prices; (ii) the depressed demand for luxury consumption due to the anti-corruption campaign; and (iii) the spill-over effects of subdued housing demand. In sum, the balance of risks remains tilted to the downside, which requires the authorities to implement more pro-growth measures to avert a hard-landing.

We therefore maintain our growth forecast of 7.0% for 2015 and project an even-lower growth rate of 6.6% in 2016. The growth could be subject to strong headwinds during the first half of 2015 and then will rebound mildly as the authorities' additional loosening measures start to take effect and the external environment improves. By expenditure, consumption is expected to make a larger contribution to GDP than investment and net exports as the slightly tight labor market continues to bolster household income. Moreover, the "recessionary trade surplus", which is set to last for a while, will boost net exports' contribution to this year's GDP. On the flip side, the share of investment in GDP is projected to decline further this year.

Meanwhile, we lower our average inflation projection to 2.2% for 2015, reflecting the increasing deflation risk from both falling commodity prices and the persistent overcapacity in some domestic industries. The tight labor market and solid growth of household income could to some extent lessen downward pressure on consumer prices.

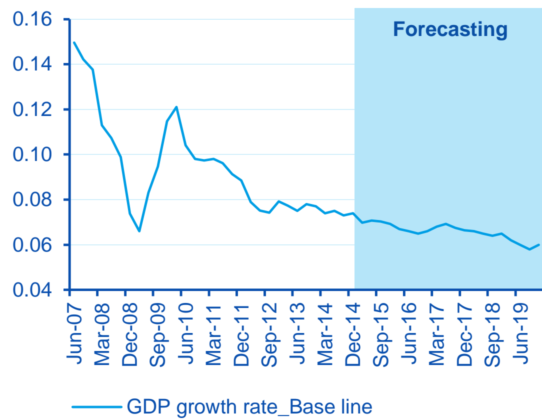
"New Normal" calls for "New thinking" in policymaking

The term of "New Normal", which seems to us more like a euphemism of growth slowdown, has been repeatedly mentioned by the authorities since May 2014, when President Xi Jinping used it to describe China's economic situation for the first time. It is noted that the current "New Normal" in China results from a cascade of both structural factors and cyclical factors as we summarized at the beginning of this chapter. That being said, the authorities need to upgrade their existing paradigm of economic policymaking so as to better accommodate demands from "New Normal". It might affect the setting of several key macro targets for 2015, in particular for economic growth and inflation rate, which are to be announced in the upcoming annual National People's Congress (NPC) in March.

In line with many other economists' views, we envisage that China's authorities will lower 2015 growth target to 7.0% from 7.5% for 2014. Moreover, we suspect that the authorities could alternatively provide a target range of GDP growth rate (likely to be 6.5%-7.5% for 2015 with its mid-point falling at 7.0%). Indeed, the authorities have on occasions indicated that the announced growth target of 2014 is not a strict floor but a mid-point of a permissible range. Manifesting the target range of growth at the beginning of this year will provide more levers for policymaking and better guide investors' expectations.

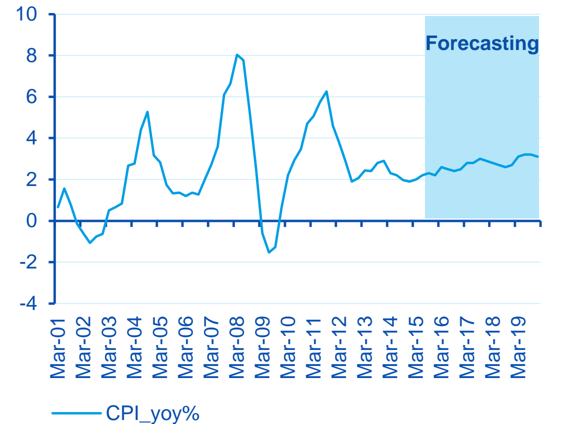
Regarding the target of inflation rate this year, we anticipate it to be lowered to 3.0% from 3.5% in 2014 due to currently strong downward pressure on prices. The target of inflation rate used to be a cap of actual CPI inflation. However, given the increasing deflation risk at home and abroad, the authorities should seriously consider the possibility of adding a floor target for inflation. In doing so, the authorities can better anchor people's inflation expectations and therefore avoid the materialization of deflation.

Figure 4.1
GDP growth will be stabilizing in 2015



Source: NBS, CEIC and BBVA Research estimates

Figure 4.2
Inflation is forecasted to be 2.2% in 2015



Source: NBS, CEIC and BBVA Research estimates

Accommodative monetary policy and tight fiscal policy

In stark contrast to the official statement of “prudent monetary policy and expansionary fiscal policy“, we project that the policy mix of this year should be better described as “accommodative monetary, tight fiscal”.

On top of the interest rate and RRR cuts in November and February, we anticipate two additional interest rate cuts (each of 25 bps) in the first half of 2015. We also project another one to two times of the RRR cuts (50-100 bps) between now and the end of 2015. In addition, more unconventional monetary policy tools are expected to be deployed in coordination with the cuts in interest rate and the RRR. They could take the forms of selective RRR cuts, the PBoC’s direct refinancing to banks, reverse repo, short or medium term lending facilities and other innovative measures. On balance, the stance of monetary policy in 2015 will be accommodative.

On the fiscal front, we insist on our previous judgment that the incoming fiscal consolidation at the local government level could largely offset the central government’s fiscal expansion. The new rules of local government debt (in force from this January with a one-year transition period) will put massive constraint on local governments’ financing capability, which in turn will reduce their investment in infrastructure. On the other hand, the central government still has a relatively healthy balance sheet which enables it to take on more debt to increase spending on infrastructure investment; agriculture related investment, urbanization, as well as tax privilege to Small and Medium enterprises (SMEs). We forecast that the fiscal deficit as percentage of GDP will be expanded to 2.5% in 2015, compared with 1.8% in 2014.

The RMB exchange rate: a “loose peg” against the USD is still in place

Despite the continuing economic slowdown and accelerating capital outflows, we do not foresee any large-scaled depreciation of the RMB exchange rate this year. In our base scenario, the CNY/USD exchange rate will rebound in the second half of the year as the economy stabilizes and the external uncertainties fade away. Our end-of-period projections of CNY/USD for 2015 and 2016 are 6.10 and 6.00 respectively.

A number of factors will limit the RMB exchange rate despite the short-term depreciation pressure from capital outflows and the strength of the USD. Firstly, the “recessionary trade surplus” not only increases the FX inflows under the current account but also raises China’s trade partner’s concern of currency manipulation, which could bring about higher political pressure for the currency appreciation. Secondly, the

fast growth of Chinese firms' overseas borrowings over the past several years has led to a buildup of currency mismatch risk for the private sector because most of these overseas debts are denominated in the USD. As a result, a sharp decline of the RMB exchange rate could further squeeze China's debt-ridden corporate sector and increase the odds of an economic hard-landing. The authorities must take a cautious stance on this issue and guard against any abrupt adjustment of the exchange rate. Lastly, China's authorities are striving to promote the international usage of the RMB as a national strategy. In particular, it is reported that China is now in the middle of negotiating with the IMF about the RMB's inclusion in the Special Drawing Rights (SDR). If succeeded, it will greatly enhance the RMB's position as a global currency and give a big boost to the RMB internationalization. Apparently, the authorities will avoid any violent movement of the RMB exchange rate at this juncture.

Table 4.1
Baseline Scenario: Forecasting

	2012	2013	2014	2015 (F)	2016 (F)
GDP (%, y/y)	7.7	7.7	7.4	7.0	6.6
Inflation (average, %)	2.6	2.6	2.0	2.2	2.5
Fiscal balance (% of GDP)	-2.1	-1.9	-1.8	-2.5	-2.5
Current account (% of GDP)	2.3	2.0	2.5	2.8	2.8
Policy rate (%)	6.00	6.00	5.60	5.10	5.10
Exchange rate (CNY/USD)	6.23	6.05	6.21	6.10	6.00

Source: BBVA Research

New breakthroughs of structural reforms could appear in 2015

In addition to putting the existing reform measures into practice, the authorities could push for new reform measures in the following areas:

Firstly, given the fact that the SOE reform has by far significantly lagged behind other areas, the authorities are likely to expedite it by unveiling new measures such as: (i) encouraging more private investment into SOE-dominated sectors (including telecommunications, energy, and infrastructure); (ii) improving SOEs' corporate governance to build up a professional management model; and (iii) expanding the current "mixed ownership" pilot program to more SOEs.

Secondly, the authorities could take advantage of currently subdued commodity prices to accelerate the pace of resource pricing reforms. In this respect, the authorities could gradually reduce their subsidies for water, electricity and fuel while avoid affecting people's living cost. Moreover, the government could put the spared subsidies to better use such as paying off existing debt or making more investment.

Last but not least, the authorities have started to cast their sight abroad and attempt to increase their engagement in infrastructure investment of other countries. One important lever is the recently emerged initiatives of "One Belt, One Road" initiatives (or the "New Silk Road Economic Belt" and the "21st Century Maritime Silk Road"), which aims to increase China's infrastructure investment in the participating countries. If implemented, it could substantially promote China's economic integration into the world economy and strengthen its influence in regional affairs. We envision that the first batch of "One Belt, One Road" projects could set in motion this year.

5 Risks are still to the downside

Risks to China are still to the downside, concentrating on the uncertain external environment, increasing deflation risk and the existing financial fragilities.

Starting from mid-2014, international oil prices have crashed due to the competitive supply increasing and global economic slowdown. In the meantime, the recovery of the Europe has been derailed by certain geopolitical risks while Japan's economy still appears fragile in the aftermath of last year's technical recession caused by consumption tax hike. On the other hand, the strong recovery in US could accelerate the Fed's pace of normalizing its ultra-loosening monetary policy and lead to violent capital movement across borders. On balance, the external environment has become more uncertain than three months ago.

Falling commodity prices worldwide added downward pressure to domestic consumer and producer prices, which was compounded by the long-lasting overcapacity problem in certain domestic industries. The debt level of the corporate sector, which is also one of existing financial fragilities, makes the economy extremely vulnerable to the potential debt-deflation spiral. Nevertheless, we believe that the authorities still have enough levers to combat deflation and maintain the financial stability.

Regarding other financial fragilities, the growth of the shadow banking activities continues to moderate thanks to the authorities' clampdown efforts. Moreover, the authorities also set out to clean up the "stock" of local government financing vehicles (LGFVs) debt by enforcing more restrictive laws on local governments' budget. However, these new regulations and rules could not only introduce short-term uncertainties to the market but also bring headwinds to growth by narrowing financing channels of financial institutions and local governments. The authorities need to take measured steps to ensure a smooth transition.

6 Tables

Table 6.1
Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2011	2012	2013	2014	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	7.4	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	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	2.5
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	2015 (F)
Eurozone	**USD/EUR**	1.39	1.29	1.33	1.33	1.13
Japan	**JPY/USD**	79.8	79.8	97.6	104.7	125.25
China	**CNY/USD**	6.46	6.31	6.20	6.17	6.16
UK	**GBP/USD**	0.62	0.63	0.64	0.61	0.76

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	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	5.60	5.10
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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