Economic Analysis

China's growth outlook is subject to mounting headwinds in Q1

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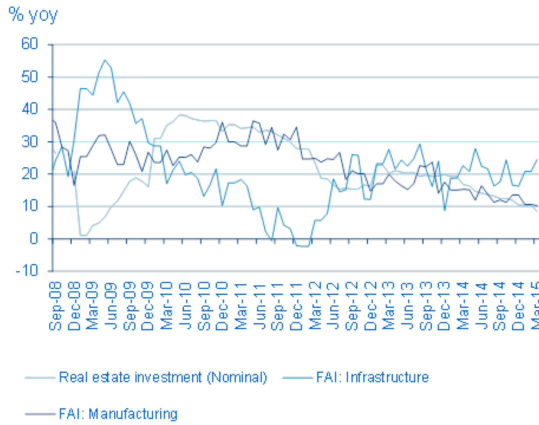
China's 2015 first quarter GDP growth slowed down to 7.0% y/y from 7.3% y/y of last quarter, which is in line with our and market expectations (BBVA: 7.0% y/y versus Consensus: 7.0% y/y) but still registered the lowest growth rate since1990. In sequential terms, Q1 GDP expanded at a pace of 1.3% q/q sa, decreasing from 1.5% q/q sa of Q4 2014. A number of important activity indicators in March were also released today, among which industrial production, urban fixed asset investment and retail sales all fell short of both market expectations and the last quarter's readings. In particular, the growth of industrial production declined to 5.6% y/y in March, which is merely higher than the record low of 4.0% y/y in Jan-Feb of 2009 under the hardest hit of the Global Financial Crisis (GFC). Putting together, the Q1 GDP outturn and March activity indicators point to mounting headwinds to China's growth, which stem from the sluggish property market, overcapacity in some industries, the effects of fiscal consolidation at the local government level as well as the short-term policy uncertainty ahead of the National People's Congress (NPC) in March. Looking ahead, we anticipate the authorities to deploy more pro-growth measures to sustain domestic demand and prevent a hard-landing scenario. Given the authorities' ample policy options, the 7.0% official target is still achievable with the enhanced policy support.

- **Industrial production and fixed asset investment were dragged by anemic domestic demand.** The growth rates of industrial production and investment in March were below both market expectations and their previous readings. The deceleration of industrial production was broadly based but more pronounced on the sectors with overcapacity problems such as mining, chemicals and steel & iron. Following a similar trend of the industrial production, urban fixed asset investment decreased to 13.5% YTD y/y (Consensus: 13.9% YTD y/y) from 13.9% YTD y/y in Jan-Feb (Consensus: 13.9% YTD y/y). The authorities' beefed-up efforts of boosting infrastructure investment failed to arrest the downward forces caused by lacklustre investment in the real estate and manufacturing sectors. (Figure 1) In the meantime, retail sales growth slowed down to 10.2% y/y, compared to 10.7% y/y in the previous month, below the consensus of 10.9% y/y (Figure 2).
- **Mounting headwinds are weighing on the full-year growth outlook.** Although the Q1 GDP outturn is still in line with the official 7.0% target, the below-expected activity indicators in March suggested that the economy is losing the momentum at a pace faster than people's projection. The trend looks disappointing given that the Q1 and March outturns for GDP and activity indicators came on the back of a series of easing measures since last November including two 25-bps interest rate cuts and one 50 bps cut in the required reserve ratio (RRR). In view of it, we would like to highlight the downside risk to our full-year GDP growth rate 7.0%, due to the recently weakening growth momentum.
- **Looking ahead, we anticipate more pro-growth measures to be deployed to spur domestic demand.** On the front of monetary policy, the PBoC are likely to cut interest rates by additionally three times (cumulatively 75 bps) and trim the RRR by another 100bps during the rest of the year. (Previously we projected only a 25bps interest rate cut and a 50 bps RRR cut) The PBoC will also increase the usage of targeted policy tools to ensure liquidity adequacy in the banking system in a bid to lower financing costs for firms, including selective RRR cuts, direct refinancing to banks, reverse repo, short or medium term lending facilities and other innovative measures. On the fiscal front, the central government should expand their fiscal deficit significantly from the budgeted 2.3% of GDP. Furthermore, the central government is likely to enhance its support for local governments to lessen their financing burden and thereby enable them to maintain their pace of spending. In this respect, the Ministry of Finance (MOF) could

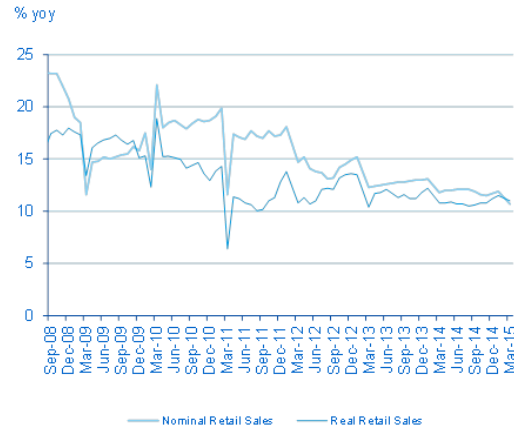
allocate extra quotas, on top of the existing RMB 1 trillion limit for this year, to local governments to replace their high-yield bearing debt with low-cost municipal bonds.

Figure 1
Slowing FAI led by anemic investment in the real estate and manufacturing sectors



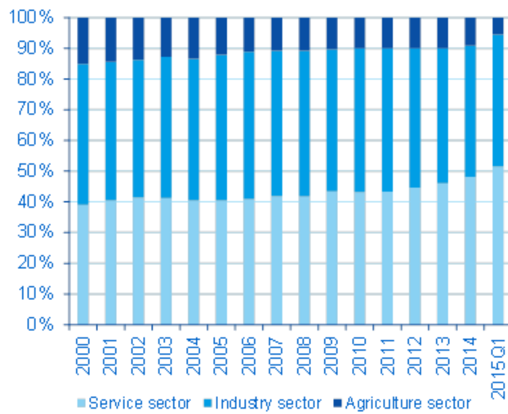
Source: CEIC and BBVA Research

Figure 2
Retail sales moderated but still held up in Q1



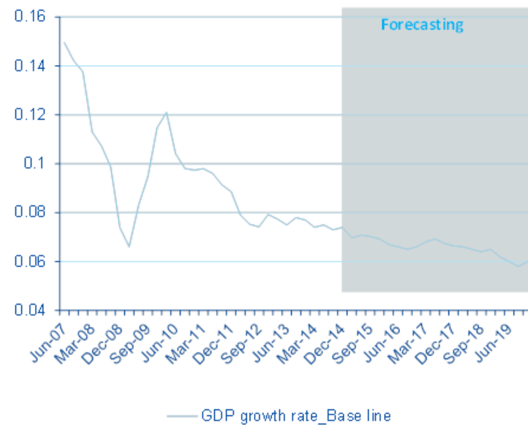
Source: CEIC and BBVA Research

Figure 3
Q1 GDP outturns show economic rebalancing is on the track



Source: CEIC and BBVA Research

Figure 4
2015 GDP is projected to expand by 7.0% with the downside risk



Source: CEIC and BBVA Research

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