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China Economic Outlook

Second quarter 2015
Asia Unit

- The global growth gradually slowed in the first quarter of 2015 towards a 3% annualized rate while the differentiation among geographical areas and sectors of activity remains.
- China's growth continued its downward trend as Q1 GDP growth reached the lowest level since 2009. Meanwhile, deflation risk is on the rise.
- We maintain our growth projections of 7.0% for this year in anticipation that more pro-growth measures, including some QE-like ones, are to be deployed.
- Risks are still to the downside, concentrating on the potential deflationary spiral, accelerating capital outflows and continuing sluggish property market.

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Closing date: May 7, 2015

1 Summary

The downward trend of growth has continued in the first quarter. In line with our expectation, GDP growth slowed down to 7.0% y/y in Q1 from 7.3% y/y of Q4 2014, registering the lowest growth rate since 2009 Q1. In sequential terms, the slowdown in growth momentum appeared more significant as Q1 GDP slid to 1.3% q/q sa from 1.5% q/q sa of the previous quarter.

By category, manufacturing activities seemed to lose steam whereas the service sector held up well. In particular, a booming stock market substantially boosted the output of the financial sector although its sustainability remains a concern.

A confluence of growth headwinds led to the slowdown: first, persistent external uncertainty, arising from the imbalanced recovery in advanced countries, continued to weighed on China's exports; second, the enforcement of the new budget law has led to fiscal consolidation at the local government level and thereby depressed aggregate demand; third, the recently implemented easing measures, including two interest rate cuts and two RRR cuts, failed to lift credit growth in support of domestic demand as the increasing pressure of capital outflows interrupted the transmission mechanism of monetary loosening. Furthermore, the property market didn't show any signs of improvement in the first quarter.

Deflation risk is on the rise. The persistent decline of PPI is likely to be translated into additional downward pressure on consumer prices. Moreover, a number of factors could exacerbate the price stability, including the potential burst of property bubble, the over-capacity in certain industries, the high debt level of the corporate sector and the ageing of population.

The policy mix is becoming more growth supportive. With the rising hard-landing and deflation risks, we see scope for some additional interest rate cuts, amounting to a total of 75 bps in the second and third quarters. These could also be accompanied by a cumulative 100-bps reduction in the RRR, most likely in the third quarter. On the fiscal front, we deem that this year's budget deficit (2.3%) is not sufficient to offset the fiscal consolidation at the local government level. In addition to enhancing the efficiency of fund use, the authorities are also likely to expand the fiscal deficit late this year.

Moreover, it is reported that the PBoC is gearing up to implement some QE-like measures. We believe that one important goal of them is to help local governments to issue municipal bonds to replace their vast amount of existing debt. In terms of operational forms, the PBoC could allow banks to use municipal bonds as collaterals to obtain long-term liquidity or instruct policy banks to buy municipal bonds. Another possibility is for the PBoC to directly refinance commercial banks as it did to policy banks last year.

We don't think that these QE-measures will have a significant impact on our projected trajectory of the RMB exchange rate this year. China's success of promoting Asian Infrastructure Investment Bank, together with its efforts of including the RMB in the IMF's Special Drawing Rights (SDR) is anticipated to sustain the currency during the rest of the year.

On balance, the implementation of above pro-growth measures can help China's economy to engineer a soft-landing in our base scenario. We therefore maintain our 2015-2016 growth projections of 7.0% and 6.6% respectively. In the meantime, we lower our average inflation projection to 1.7% for 2015 from 2.2% previously, due to recent price index outturns and the increasing deflation risk, while keep 2016 inflation projection unchanged at 2.5%. Risks to China are still to the downside, concentrating on the increasing deflation risk, accelerating capital outflows, and the continuously sluggish property market.

2 World growth is suffering from the slowdown in the emerging economies

The available economic indicators point to **a gradual slowdown in world growth in the first quarter of 2015 towards a 3% annualised rate**[1], a few tenths below the figure in 2H14 (between 3.3% and 3.6%). The slowdown in the US economy, the lower dynamism of China, and the decline in activity in certain key emerging economies (such as Russia and Brazil, though not India) account for the bulk of the slowdown worldwide, which have not been offset by the relatively better performance of the eurozone and the United Kingdom.

The differentiation among geographical areas and sectors of activity remains in the pattern of world growth at the start of 2015. On the one hand, consolidation of growth among the developed countries contrasts with the almost general loss of steam among the emerging countries, which is more intense in Asia and Latin America than in Eastern Europe, according to the business confidence, industrial production and foreign trade indicators. On the other hand, the improvement in private consumption, as gauged by the recovery in household disposable income within a context of lower energy prices, job-creation and increased financial wealth, is giving support to the services sector in the major developed economies (mainly in the eurozone), while the gains in industrial production and investment are more tepid. These developments could be due to the doubts about the sustainability of the recovery in private consumption, which is delaying industry's decisions on investment and production.

The fact that global activity has performed slightly worse than expected in 1Q15 and the impact of the weakness of the domestic demand, the stabilisation of commodity prices at low levels and the Fed rate hike on key emerging economies lead us to revise our world growth forecast for 2015 to 3.5%, 0.1pp less than forecast in January and only 0.1pp more than the 2014 figure[2]. In 2016, world GDP should record an average growth of 3.9%, partly as a result of the expansive monetary policies in the developed countries, which ought to achieve their best registered figure since 2010. The emerging economies should, within a scenario of a trend of gradual slowdown in China, manage to reverse the current decline thanks to the positive spill-overs from the developed economies, the steady increase of commodity prices and a cycle of interest rate hikes by the Fed that will be more gradual than in previous episodes.

The progressive rise in commodity prices, in line with BBVA Research forecasts, and the **reinforcement of loose monetary policies** have been two of the most remarkable elements in the economic global picture in recent months. The base effect of the former **has helped to contain the fall in inflation rates in certain geographical regions, mainly in developed countries, which, together with the change in the tone of monetary policies, has anchored the inflation expectations discounted by markets. Both of these, however, have failed to inhibit financial volatility indicators from continuing to tick upwards, although from very low levels and only gradually**. This appears consistent with a context of uncertainty about the strength of economic recovery, the timing and the intensity of Fed rate normalisation and the distortions caused by ECB balance-sheet expansion on the price levels of those financial assets with the greatest weight in the portfolios of economic agents.

The contrast in the monetary strategies of the ECB and the Fed will continue to shape the direction taken by capital flows and, by extension, the behaviour of financial variables. The ECB's liquidity injection from buying-up government bonds has reinforced the correction in long-term interest rates among

1: Estimate based on BBVA Research's global activity indicator (GAIN). Details of the methodology can be found at: http://bit.ly/1nl5RIn
2: The impact on the world GDP estimate of the revision of India's National Accounts should be particularly noted. Indian economic growth moved from 5.0% to 7.2% in 2013-14, which raises world GDP growth by between 0.1 and 0.2pp, an upward change which is also included in the forecasts.

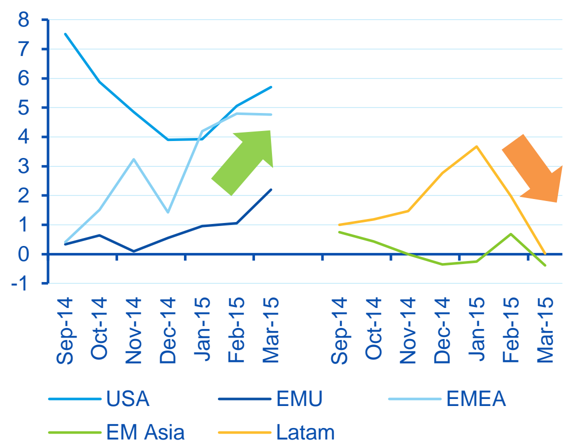
the developed nations and, to a greater extent, in the Eurozone, and has magnified the euro's depreciation relative to its main exchange currencies (it stands at close to parity against the dollar).

This trend is likely to remain until the Fed implements the first increase in fed funds. The **most likely scenario is that the first rise in the Fed funds rate will occur before or in September 2015**, but could be put off if the recovery is not as strong as desired. Unlike with other rounds of Fed monetary normalisation (the last of which began in mid-2004), US core inflation and price expectations for the longer term are at significantly lower levels and well below the central bank's target, and there is greater doubt over world growth. For these reasons **the rate hike process is likely to be gradual, with a target level of no more than 1.5% at the end of 2016**.

Thus it will be the Fed's communication strategy regarding the pace of the forthcoming hikes which shapes the rally for yields in the bond market and the degree of financial volatility. The scale of any capital outflows from the emerging countries will therefore hinge on Fed monetary policy, though also on local factors associated with the point in the cycle and the vulnerabilities of each country, especially when the volatility from the first or first few hikes wears off. Thus, as in terms of growth, major divergences in the course taken by exchange and interest rates among the emerging countries are to be expected.

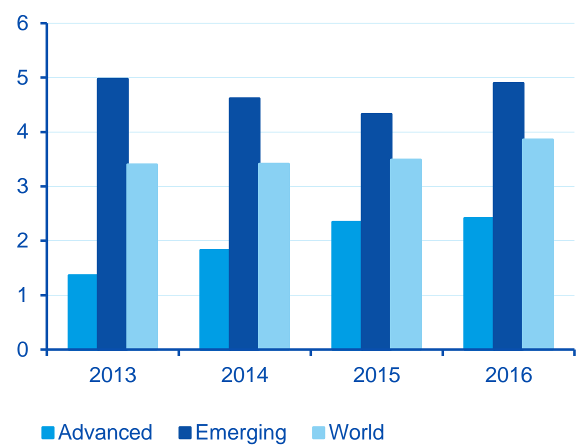
On balance, and although economic policies will continue to be accommodative, **the risks to the downside persist for world growth**. The most significant of these rests with the extent of the slowdown in China and the spill-overs coming from the beginning of the Fed's rate normalisation process. The deflationary pressures associated with the oil price, geopolitical tensions and any failure of the ECB to reactivate inflation expectations in the Eurozone are risks that, despite appearing less likely and less significant in terms of expected impact than some months ago, cannot be ruled out. Finally, a risk which still lurks in the wings is that of a failure to reach agreement between the Greek government and the European institutions and the IMF on how to refinance its debt servicing obligations.

Figure 2.1
Manufacturing PMI (deviation from the 50 point mark — activity holding)



Source: BBVA Research and Haver

Figure 2.2
World GDP: forecast annual growth 2015-16 (%)



Source: BBVA Research

3 Tepid growth amidst strong headwinds

Q1 GDP growth slowed down to 7.0% y/y from 7.3% y/y previously, which, albeit in line with BBVA and market expectations, registered the lowest reading since 2009 Q1. (Figure 3.1) In sequential terms, the growth rate slid to 1.3% q/q sa from 1.5% q/q sa of Q4 2014. Overall, growth is losing steam at a faster-than-expected pace despite the loosening monetary measures implemented since November, including two interest rate cuts, two RRR cuts as well as other targeted initiatives.

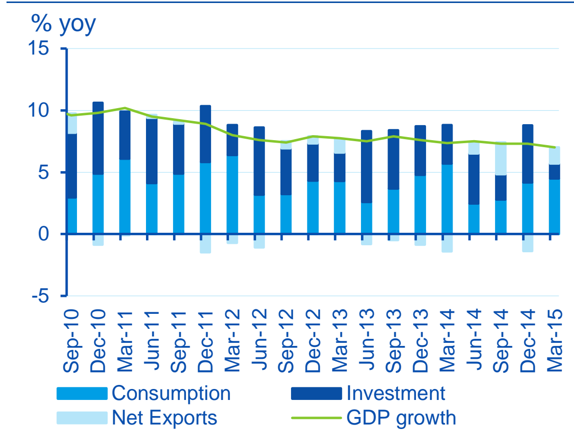
A confluence of growth headwinds contributed to the slowdown: first, persistent external uncertainty, arising from the imbalanced recovery in advanced countries, continued to weighed on China's exports; second, the enforcement of the new budget law has led to fiscal consolidation at the local government level and thereby depressed aggregate demand; third, the recently implemented easing measures, including two interest rate cuts and two RRR cuts, failed to lift credit growth in support of domestic demand as the increasing pressure of capital outflows interrupted the transmission mechanism of monetary loosening. Furthermore, the property market didn't show any signs of improvement in the first quarter.

Both manufacturing activities and investment were sluggish…

Economic activities continued their downward trend in Q1, especially in the manufacturing sector. The growth of industrial production declined to 5.6% y/y in March, reaching its lowest level since November 2008. The deceleration of industrial production was broadly based but more on the sectors with overcapacity problems, such as mining, chemicals and steel & iron. Although the NBS PMI for April (50.1) still remained in the expansion territory, the HSBC Manufacturing PMI slumped to 48.9 in April from its March reading of 49.2. The divergence between the NBS and HSBC PMIs suggests that the SME and exporters, which are believed to account for a larger proportion in the HSBC survey sample, are under mounting pressures. (Figure 3.2)

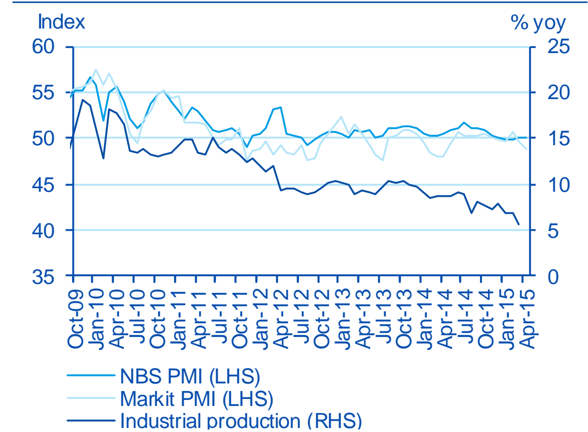
On the demand side, retail sales growth in March slowed down to 10.2% y/y, compared to 10.7% y/y in the previous month. In real terms, the performance of consumption in Q1 still looked solid despite the fact that intensified anti-corruption campaign continued to weigh on the consumption of luxury goods and services. (Figure 3.3) On the other hand, investment dipped further as its YTD growth rate decreased to 13.5% in March from 13.9% YTD y/y in Jan-Feb. The authorities' stepped-up efforts of boosting infrastructure investment failed to arrest the downward forces of investment in the real estate and manufacturing sectors (Figure 3.4).

Figure 3.1
Growth is losing steam in Q1



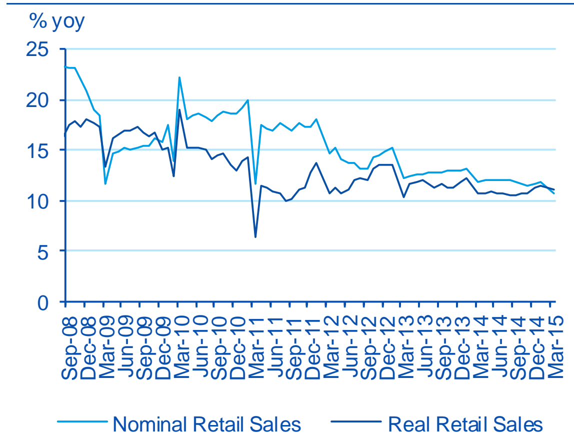
Source: NBS, CEIC and BBVA Research

Figure 3.2
Manufacturing activities were anemic



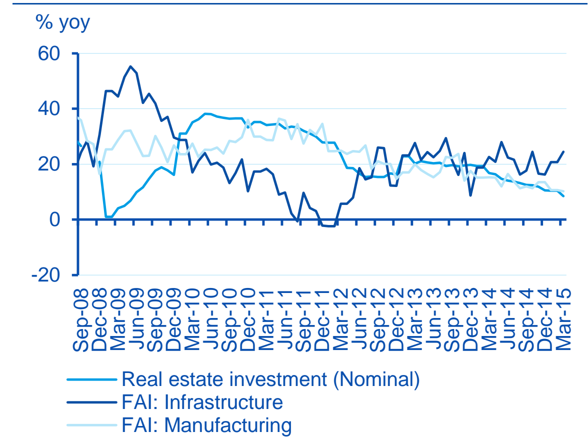
Source: CEIC and BBVA Research

Figure 3.3
Retail sales fared well



Source: NBS, CEIC and BBVA Research

Figure 3.4
Real estate investment continued downtrend



Source: NBS, Wind and BBVA Research

…while the service sector was lifted by a booming stock market

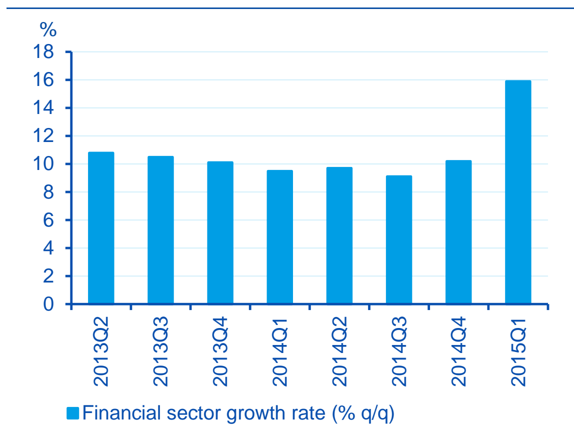
According to the NBS, the growth rate of the tertiary industry amounted to 7.9% y/y in Q1, substantially outperforming the primary and secondary industries (3.2% y/y and 6.1% y/y respectively). Moreover, among the sub-sectors of the tertiary industry, the growth of financial sector output accelerated to 15.9% y/y in Q1 (Figure 3.6), significantly higher than its previous readings and contributing the largest part of the service sector. The extraordinary performance of the financial sector is believed to be related with the recent run-up of China's A-share stock market (Figure 3.7). The booming stock market has drawn a vast amount of people to participate in the market. For example, during Q1 the number of investment accounts in the A-share market increased by 8.35 million, exceeding the full-year growth of 6.25 million in 2014. As investors became more and more active in the market, their demand for relevant service (mainly provided

by security firms) has grown exponentially, which, under the NBS current methodologies, are counted as the output of the financial sector.

Apart from the financial sector, several other service sectors also fared well, including information technology, software, leasing, research, education etc. Aggregately, they registered a 9.0% q/q growth in the first quarter. In sum, China's economic structure is continuing to tilt towards the service sector. (Figure 3.7)

Nevertheless, it remains a concern whether the financial sector could continue its extraordinary performance in future and sustain the growth to the extent as it did in the first quarter. That being said, the recovery in the manufacturing activities is still indispensable to China's economic soft-landing.

Figure 3.5
The financial sector performed impressively…

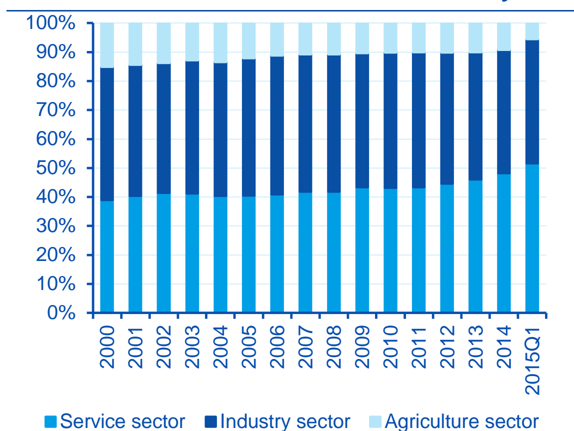


Source: CEIC and BBVA Research

Figure 3.6
… thanks to a booming stock market

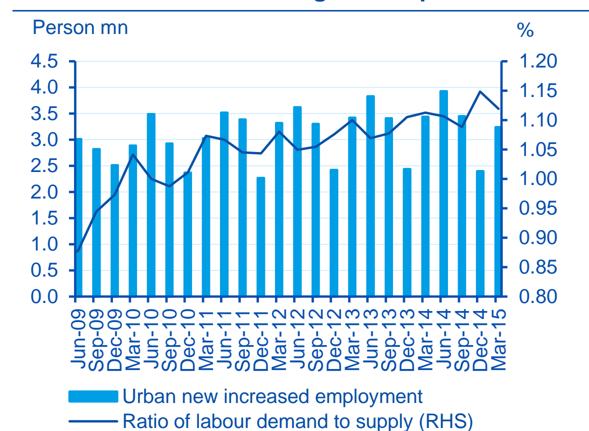
Source: CEIC and BBVA Research

Figure 3.7
The share of the service sector rose steadily



Source: CEIC and BBVA Research

Figure 3.8
The labor market was in a good shape



Source: CEIC and BBVA Research

The labor market was still healthy…

The labor market was in good shape in Q1. The urban registration unemployment rate even edged down to 4.05% in Q1 from the previous quarter's reading of 4.09%. In the meantime, the ratio of demand to supply in the labor market even ticked up from the last quarter, reflecting the tightness of the labor market. (Figure 3.8)

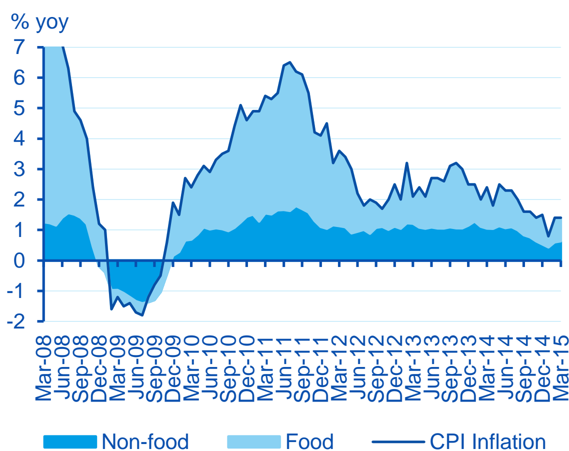
…while deflation risk is intensifying

March headline CPI came out at 1.4% y/y, remaining above 1.0% for a second month since it plummeted to 0.8% y/y in January. Low inflation outturns are broad-based: the food price increase decelerated on falling commodity prices while housing rentals slowed in parallel to the subdued property market. (Figure 3.9).

On the other hand, the PPI growth rate dropped further to -4.6% y/y (versus: -4.3% y/y in January). The period of PPI staying in a negative territory has lasted for 37 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 3.10).

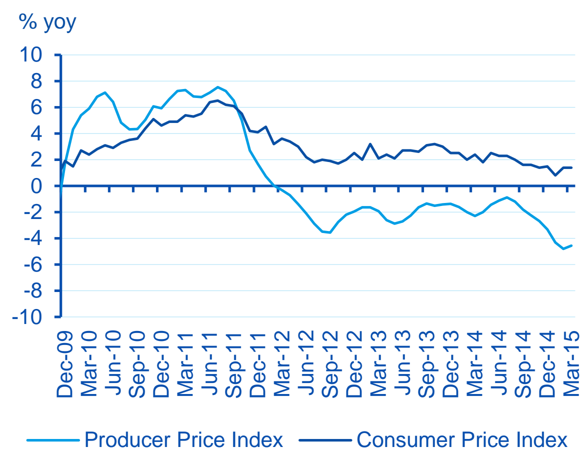
On top of the pass-through from the PPI, several factors could also aggravate the deflation risk in China including the potential burst of property bubble, the over-capacity in certain industries, the high debt level of the corporate sector and the ageing of population. On the positive side, the disinflation could give the central bank more levees to ease monetary policy in support of growth.

Figure 3.9
Deflation risk is on the rise



Source: CEIC and BBVA Research

Figure 3.10
PPI inflation remained in the negative territory



Source: CEIC and BBVA Research

What is behind the economic slowdown?

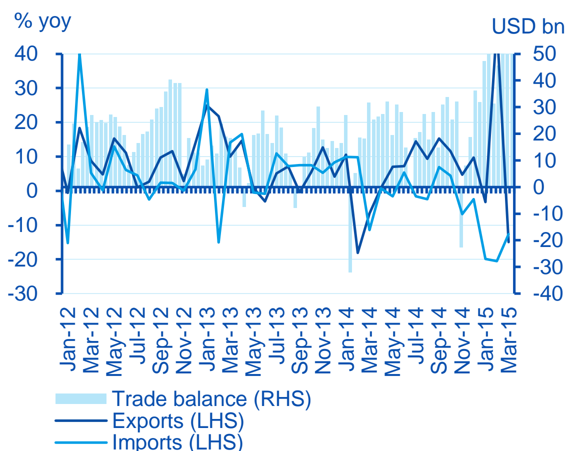
External uncertainty and a strong RMB weighed on the export sector

March trade data were disappointing as both exports and imports substantially fell short of market expectations. In particular, March exports registered a year-on-year decline of -14.6% y/y (consensus: 8.2% y/y) while imports contracted by -12.3% y/y (consensus: -11.3% y/y). For Q1 as a whole, exports increased by 4.7% y/y while imports declined by -17.6%. (Figure 3.11)

On top of the intrepid economic recovery in advanced countries, the lackluster performance of the export sector also stemmed from the RMB's relative strength against other currencies except for the USD. In

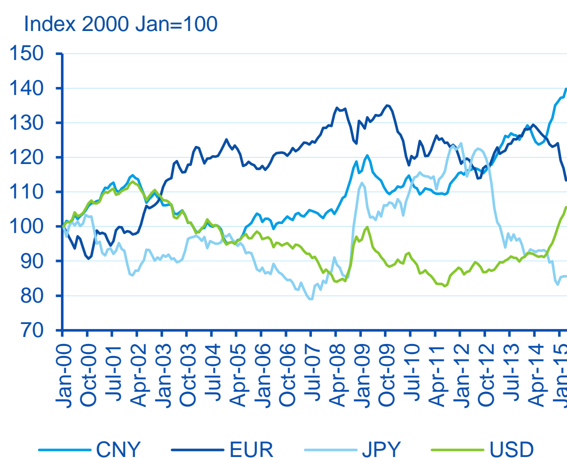
particular, the JPY has depreciated against the RMB by around 17% since March 2014, which largely weakened the competitiveness of China's shipments to the country (Figure 3.12). The sharp depreciation of the Euro since December had a similar impact on China's exports.

Figure 3.11
Both exports and imports are disappointing in recent months



Source: CEIC and BBVA Research

Figure 3.12
In terms of NEER, EURO and JPY depreciated substantially



Source: CEIC and BBVA Research

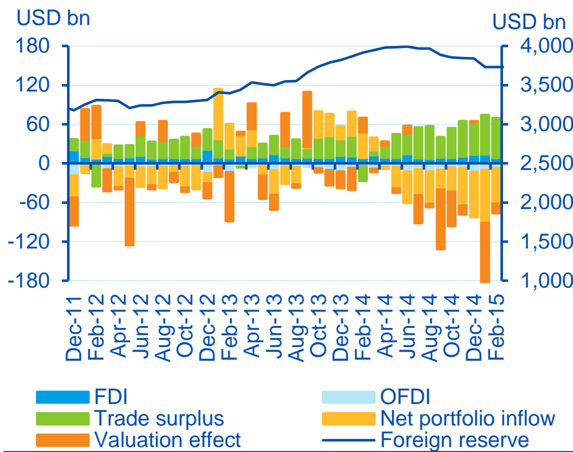
Increasing capital outflows obstructed the transmission of monetary easing

The sluggish growth has prompted the authorities to beef up their efforts of policy easing. In particular, the People's Bank of China (PBoC) cut the benchmark interest rates again in February, the second time since last November. Both the one-year benchmark lending and deposit rates were trimmed by 25 bps (to 5.35% and 2.5% respectively), while the PBoC further expanded the permissible floating range of customer deposit rates to 30% (versus 20% previously) above the benchmark deposit rates. Moreover, the PBoC lowered the required reserve ratio (RRR) twice through April: one is by 50 bps in early February, which was the first time of a universal RRR cut since May 2012; and the other one is by 100 bps in April. In the meantime, the PBoC continued to use the selective RRR cut, which came together with the universal RRR cut in April, to support rural banks and SME lenders. Moreover, it is reported that a Chinese version of Quantitative Easing (QE) is in the pipeline although the details of it has yet to be revealed.

However, the accelerated capital outflows, which were fuelled by the expectations of the Fed's policy rate lift-up, not only led to the decline in foreign reserves (Figure 3.13) but also obstructed the functioning of the transmission mechanism of monetary policy. In particular, capital outflows forced the authorities to keep the interbank rate at a comparatively high level (Figure 3.14) in order to curb the further outflows. As a result, the easing effects of the RRR and interest rate cuts cannot pass through to the real sector and reduce the funding costs of the household and corporate sectors as intended.

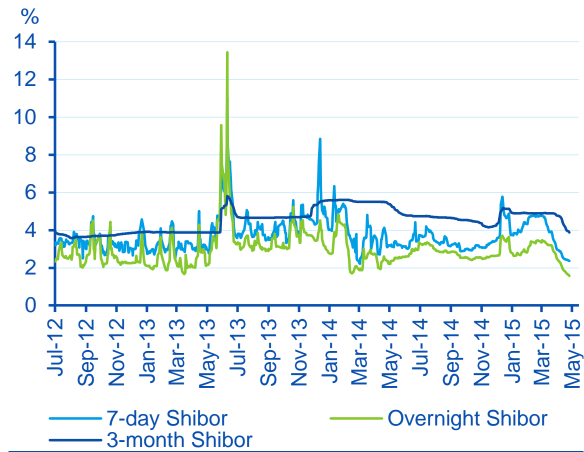
The abovementioned effect was mirrored by a slower-than-expected credit growth in March, when new bank loans declined to RMB 0.99 trillion from RMB 1.04 trillion in February. In this respect, the central government's clampdown on the Local Government Financial Vehicles (LGFVs) and shadow banking activities also dragged down the growth of total social financing, which dipped to RMB 1.18 trillion from RMB 1.35 trillion in February. (Figure 3.14) Moreover, M2 growth decelerated to 11.6% y/y in March (which was below the official target of 12%) from 12.5% y/y in the previous month. (Figure 3.15)

Figure 3.13
Capital outflows led to diminished FX reserves



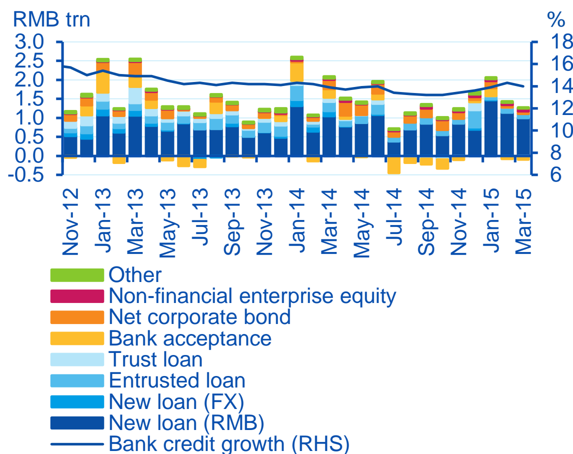
Source: CEIC and BBVA Research

Figure 3.14
The interbank rate stays high



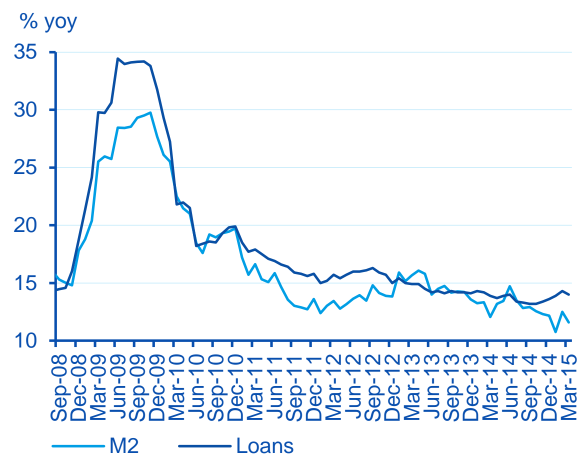
Source: CEIC and BBVA Research

Figure 3.15
Total Social Financing moderated in Q1…



Source: CEIC and BBVA Research

Figure 3.16
… along with M2 and bank loans



Source: CEIC and BBVA Research

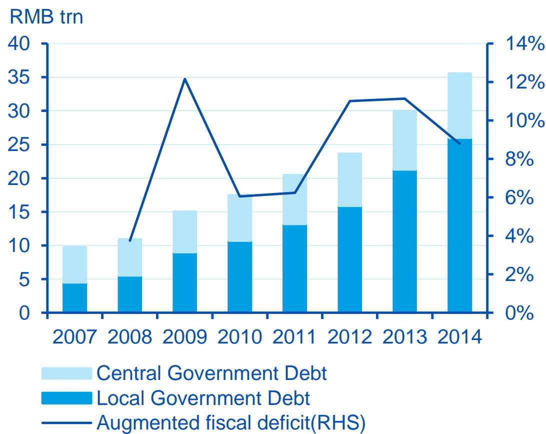
Fiscal consolidation of local governments emerged

As part of structural reforms, the authorities amended the Budget Law in 2014 to effectively regulate local government debt. The new law is to be implemented from this year, which forbids local governments to borrow from banks or non-banking financial institutions but allows them to issue municipal bonds to replace the vast amount of existing debt. In this year's National People's Congress (NPC), the authorities announced a plan to replace RMB 1 trillion of existing local government debt this year.

As analyzed in our last issue of China Economic Outlook, the enforcement of the new Budget Law will unavoidably led to a sharp fiscal consolidation given that local governments used to heavily rely upon borrowing to support their expenditure on infrastructure investment and social wellbeing. As we estimated, the fiscal deficit of local governments hovered around 6-7% of GDP over the past several years. (Figure

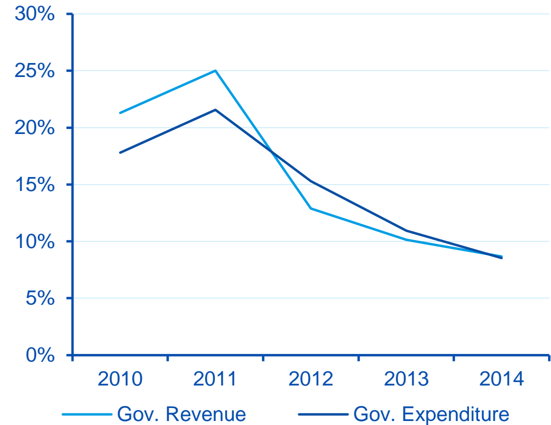
3.17) Although the central government announced that it will expand its fiscal deficit to 2.3% of GDP this year (from 1.8 % of GDP in 2014), it is far from adequate to offset the fiscal consolidation at the local government level. What complicated the case is that the central government's fiscal revenue also declined significantly amid the economic slowdown, constraining the government's spending capacity. (Figure 3.18)

Figure 3.17
Local governments' used to borrow too much



Source: NBS and BBVA Research

Figure 3.18
Fiscal revenue decelerated amid slower growth

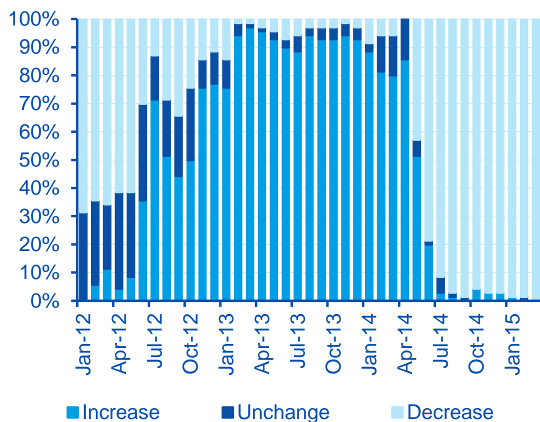


Source: NBS, CEIC and BBVA Research

No positive signals appeared in the property market yet

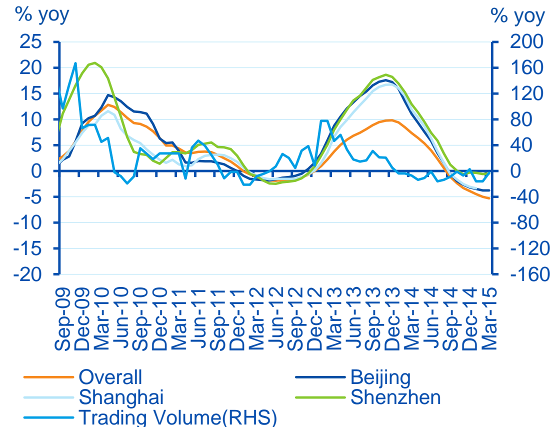
The property market showed no signs of improvement in Q1, thus downbeat expectations of the property market and the high inventory level in many cities continued to weigh on housing prices and transactions. As revealed by the NBS, no city exhibits a year-on-year increase in March, although there is merely one city shown price increasing in January. (Figure 3.19) Moreover, the property trading volume went back to the negative territory in Q1, compared to a positive reading in last December (Figure 3.20). We believe that housing market, in a medium term, will continue to be a significant drag factor of economic growth.

Figure 3.19
Downward pressure on housing prices



Source: NBS and BBVA Research

Figure 3.20
Trading volume hasn't bottomed out yet



Source: NBS, CEIC and BBVA Research

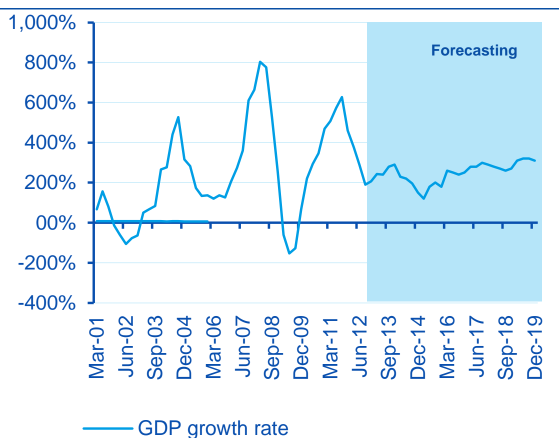
4 China's "Quantitative Easing" is in the pipeline

As noted above, growth has continued its downtrend in the face of a number of headwinds. The outturns of recent activity indicators also confirmed that the odds of seeing a quick and strong recovery are low. We anticipate the authorities to implement more pro-growth measures in the second quarter to sustain the economy and avert a hard-landing. In particular, the authorities need to offset the fiscal consolidation effects at the local government level and dispel the associated policy uncertainty which not only substantially dampened public spending but also held up private investment. In addition to more monetary easing and expansionary fiscal initiatives, it is also reported that the authorities have a plan to tackle these issues through certain QE-like measures. We will elaborate more on this point in the following section.

Overall, we maintain our 2015-16 growth projections unchanged at 7.0% and 6.6% respectively (Table 2). That being said, the balance of risks remains tilted to the downside. With the implementation of additional pro-growth measures in the second quarter, growth is likely to bottom out in the third quarter and further stabilize in the fourth quarter. In terms of GDP components, consumption is expected to continue its outperformance over the investment and net exports, benefiting from the steady growth of household income.

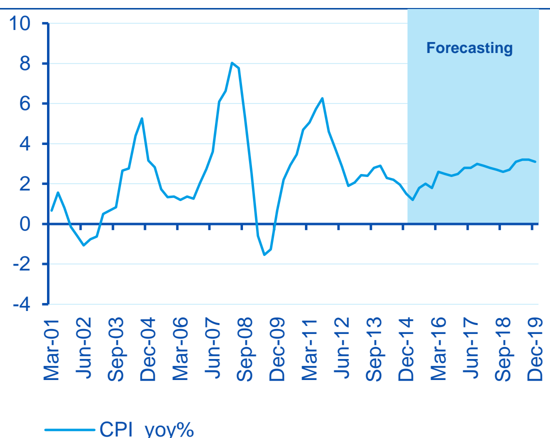
On inflation, we further lower our annual average projection to 1.7% for 2015 from 2.2% previously, reflecting the increasing deflation risk from falling commodity prices, weak investment demand and the persistent overcapacity in a number of domestic industries. A healthy labor market and solid growth of household income could lessen downward pressure on consumer prices.

Figure 4.1
GDP growth will moderate in 2015



Source: NBS, CEIC and BBVA Research estimates

Figure 4.2
Inflation is forecasted to be 1.7% in 2015



Source: NBS, CEIC and BBVA Research estimates

The policy mix is becoming more growth supportive

Our baseline continues to incorporate a further easing of the monetary stance. With the rise of the hard-landing and deflation risks, we see scope for some additional interest rate cuts, amounting to a total of 75 bps in the second and third quarters. These could also be accompanied by a cumulative 100-bps reduction in the RRR, most likely in the third quarter.

On the fiscal front, we deem that this year's budget deficit (2.3%) announced in March's National People's Congress is not enough. The authorities may have to expand the fiscal deficit later this year and enhance the efficiency of fund use. Moreover, certain QE-like measures in the pipeline could also help to offset the fiscal consolidation of local governments.

What's in the Chinese version of QE?

After the outburst of the Global Financial Crisis (GFC) of 2008-2009, a number of central banks in advanced countries including the US Fed, the BOE, the BOJ, and the ECB have adopted "Quantitative Easing" as the alternative loosening policy tool after their policy interest rates hit the zero lower bound. Now it is reported that the PBoC is gearing up to join the abovementioned peers to deploy certain QE-like measures although the exact forms of these measures haven't been affirmed yet. Below we provide three possibilities of China's incoming QE, among which the PBoC could adopt one or more.

First, the PBoC could allow banks to use the local government bonds as collaterals to obtain long-term funds from the central bank. As such, banks will have a great incentive to buy local government bonds and thereby ease the high funding costs of local governments. By this way, the PBoC not only provides more liquidity into the banking sector but also helps to solve the debt overhang of the local governments and mitigate the fiscal consolidation.

Second, the PBoC could utilize the balance sheets of policy banks to purchase local government bonds or other securities. Indeed, the central bank has already announced a plan to inject $32 billion into China Development Bank and $30 billion into Export-Import Bank of China from its foreign exchange reserves. As a return, the PBOC will become the second largest shareholder in the China Development Bank and the largest shareholder of the Exim Bank. Such an ownership structure will enable the PBoC to leverage the policy banks to achieve its own goals such as purchasing local government bonds and extending loans to infrastructure projects.

Third, the PBoC could extend its program of Pledged Supplementary Lending (PSL) to commercial banks. The PSL is a facility through which the central bank provides collateralized funding to financial institutions for lending to targeted sectors. Last year the PBoC piloted the PSL with China Development Bank. This year the PSL could be expanded to be eligible for commercial banks and provide them medium-term liquidity. To a large extent, the PSL for commercial banks bears a great resemblance to the LTRO enacted by the ECB.

Why it comes before the policy rate hits the zero lower bound?

One pronounced difference between China's potential QE and its precedents of other central banks is that its implementation could come before the policy rate hits the zero lower bound. Moreover, the RRR, the more conventional quantitative policy tool, still has ample scope for adjustment. The usage of quantitative tools has long been the norm for China's monetary policy. To date, the official intermediate target for China's monetary policy is still the M2 growth rate. In practice, the PBoC adjusts the RRR more often than interest rates.

Moreover, one important goal of these QE-like measures is to facilitate local governments to solve their debt overhang problem. As mentioned previously, local governments need to replace their existing debt with municipal bonds in the next few years. However, the depth of China's bond market is still limited. For example, the outstanding national treasury bonds only amounted to around RMB 10 trillion as of end-2014, far less than the estimated 25 trillion of local government debt. Even after excluding contingent debt, we project that local governments still need to issue around RMB15 trillion of municipal bonds over the next few years. Without the support of the central bank, the bond market cannot soak up such a bulk of bond issuances.

China's QE can be crafted to be more targeted than the RRR or interest rate cuts. If the PBoC cut the interest rate and RRR too aggressively, it could have serious side effects such as worsening financial asset bubbles or pushing investors to the shadow banking activities for higher yields. The QE-like measures could to some extent avert the above side effects while achieving their goals of facilitating the replacement of local government or extending credit to some specific sectors.

The RMB exchange rate is expected to mildly appreciate in 2015

We believe that several reasons might support the RMB exchange rate in the rest of the year: First, the likelihood of the RMB to be included in the Special Drawing Rights (SDR) has been increasing as the International Monetary Fund (IMF) is reportedly is close to announced that the currency is now "fairly valued". Second, the progress of the China-led Asian Infrastructure Investment Bank (AIIB) has been very encouraging given that a large number of countries have applied to become its founding members, including all the European G-7 members. Now China is lobbying to include the RMB as one of denominating currencies for the AIIB.

The above issues will not only strengthen people's confidence in the RMB but also give the authorities more incentive to maintain a stable exchange rate. Therefore, we maintain our baseline projection that the CNY/USD exchange rate will rebound in the second half of the year and stabilize around 6.15 at the end of 2015. (Table 4.1)

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	1.7	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	4.60	4.60
Exchange rate (CNY/USD)	6.23	6.05	6.21	6.15	6.00

Source: BBVA Research

5 Risks are still to the downside

Downside risks to our base scenario grow larger compared to three months ago. China's growth momentum slowed further in the first quarter amid continued adjustments in the property markets. Capital outflow pressure could rise higher in case that the Fed could surprise the market by an early rate hike. Banks' asset quality continued to deteriorate although the shadow banking activities generally contracted due to the tightening regulations. Deflation risk is on the rise amid the ongoing deleveraging process.

The housing market is expected to remain sluggish in the mid-term, particularly in smaller cities where housing inventory has risen rapidly due to a sharp increase in property supply in the past few years. Moreover, the rising supply of affordable housing could aggravate the supply-demand imbalance. Developers' financial conditions have deteriorated, forcing them to cut prices more aggressively going forward.

Deflation risk is on the rise. Although CPI has picked up modestly in February and March, the PPI has been in the deflationary territory for more than three years thanks to sliding domestic demand and prevalent overcapacity problems in many sectors. Deflationary pressure could be exacerbated by the steep drop of commodity prices. Moreover, the intensifying anti-corruption campaign also lowered the price of luxury goods.

The combination of a significant strengthening of the US dollar and the slowed domestic growth has heightened volatility in capital flows in recent months. In particular, a strengthening US dollar could continue to act as pull factors to induce investors to move away from risk assets in China. Thus, China's authorities would be facing a policy dilemma between supporting growth and reining in deflationary pressure on the one hand, and reducing the risk of abrupt capital outflows on the other hand.

6 Tables

Table 6.1
Macroeconomic Forecasts: Gross Domestic Product

Average, %	2012	2013	2014	2015	2016
United States	2.3	2.2	2.4	2.9	2.8
Eurozone	-0.8	-0.4	0.9	1.6	2.2
Spain	-2.1	-1.2	1.4	3.0	2.7
UK	0.7	1.7	2.8	2.5	2.3
Latin America *	2.8	2.5	0.8	0.6	2.1
EAGLES **	5.8	5.6	5.3	4.9	5.3
Asia Pacific	5.7	5.9	5.7	5.8	5.8
Japan	1.8	1.5	0.0	1.3	1.2
China	7.8	7.7	7.4	7.0	6.6
Asia (exc. China)	4.1	4.5	4.3	4.9	5.0
World	3.4	3.4	3.4	3.5	3.9

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Bangladesh, Brazil, China, India, Indonesia, Iraq, Mexico, Nigeria, Pakistan, Philippines, Russia, Saudi Arabia, Thailand and Turkey.
Forecast closing date: 30 April 2015.
Source: BBVA Research and IMF

Table 6.2
Macroeconomic Forecasts: Inflation

Average, %	2012	2013	2014	2015	2016
United States	2.1	1.5	1.6	0.6	1.9
Eurozone	2.5	1.4	0.4	0.1	1.3
Spain	2.4	1.4	-0.2	-0.2	1.4
UK	2.8	2.6	1.5	0.3	1.7
Latin America *	7.8	9.2	12.6	13.5	13.5
EAGLES **	5.2	5.2	4.6	4.8	4.5
Turkey	8.9	7.6	8.9	7.3	7.2
Asia Pacific	3.9	4.1	3.3	2.7	3.3
Japan	0.0	1.6	2.7	1.0	1.6
China	2.6	2.6	2.0	1.7	2.5
Asia (exc. China)	4.8	5.2	4.4	3.5	3.9
World	4.5	4.2	3.9	3.8	4.1

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Bangladesh, Brazil, China, India, Indonesia, Iraq, Mexico, Nigeria, Pakistan, Philippines, Russia, Saudi Arabia, Thailand and Turkey.
Forecast closing date: 30 April 2015.
Source: BBVA Research and IMF

Table 6.3

Macroeconomic Forecasts: Exchange Rates (Annual Average)

		2012	2013	2014	2015	2016
Eurozone	**USD/EUR**	0.78	0.75	0.75	0.96	0.94
Japan	**JPY/USD**	79.8	97.5	105.8	124.3	131.7
China	**CNY/USD**	6.31	6.20	6.14	6.19	6.09
UK	**GBP/USD**	1.59	1.56	1.65	1.47	1.60

Forecast closing date: 30 April 2015.
Source: BBVA Research and IMF

Table 6.4

Macroeconomic Forecasts: Policy Rates (End of period)

(%)	2012	2013	2014	2015	2016
United States	0.25	0.25	0.25	0.50	1.50
Eurozone	0.75	0.25	0.05	0.05	0.05
Japan	0.10	0.10	0.10	0.10	0.10
China	6.00	6.00	5.60	4.60	4.60
Hong Kong	0.50	0.50	0.50	0.75	1.75
India	8.00	7.75	8.00	7.50	6.75

Forecast closing date: 30 April 2015.
Source: BBVA Research and IMF

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