BBVA | RESEARCH

China Economic Outlook

4TH QUARTER 2015 | ASIA UNIT

01
Global GDP has grown more slowly than we forecast and at a similar rate to that observed at the beginning of the year.

02
China's growth edged down to 6.9% y/y in Q3, with remarkable deterioration in growth quality.

03
We marginally raise our GDP projection to 6.9% for 2015 due to Q3 outturn while keep our 2016 projection of 6.2% unchanged.

04
Risks to China's growth are still on the downside, chief among which is the mounting pressure on capital outflows

Index

Closing date: November 13, 2015

1 Editorial

China's economy averted a hard-landing in the third quarter despite abrupt market disruptions stemming from the mid-year stock market selloffs and the August RMB devaluation. Q3 GDP growth edged down to 6.9% y/y from 7.0% in Q2 while in sequential terms, the pace of growth modestly picked up to 1.8% q/q sa in Q3 from 1.7% q/q sa previously. Nevertheless, recent activity indicators, in particular the persistent downtrend of industrial production, confirm that market turmoil did take a toll on the real economy as we envisioned three months ago and derailed a recovery which would otherwise be achieved with the authorities' stepped-up easing efforts since November 2014.

Growth quality has been deteriorating remarkably. The financial sector continues to one of largest drivers for GDP growth, which, we suspect, is associated with the rollover of gigantic debt burden accumulated in local governments and the corporate sector over the past several years. Meanwhile, more evidences indicate that the number of "zombie enterprises" in the economy has increased remarkably. Their production activities might be indistinguishably included in the official statistics but don't yield the products meeting market demands.

The unexpected devaluation of the RMB exchange rate in August has great knock-on effects on the financial markets around the world, which reinforced investors' pessimism for the RMB exchange rate and China's economic outlook. Although a flurry of market interventions have helped to stabilize the exchange rate for the moment, the related capital outflows pose a material threat to the financial stability.

Another collateral damage of the currency devaluation is that it has put new constraints on monetary policy tool. After introducing the depreciating expectation of the RMB to the market, the Central Bank found it difficult to reduce market interest rates deeper to spur growth as it could lead to the acceleration of capital exodus. As such, the authorities have to resort to fiscal tools to sustain growth.

We raise our 2015 GDP projection to 6.9% for 2015 (versus: 6.7% previously) due to better-than-expected Q3 GDP outturn while keep our 6.2% forecast for 2016 unchanged. On inflation, we maintain our forecast for 2015 CPI inflation at 1.6% and for 2016 at 2.0%. Downward pressure on price levels comes from sluggish commodity prices, weak investment demand and the rising number of "zombie enterprises".

We adjust our baseline projection of the exchange rate in that the CNY/USD exchange rate will stabilize around 6.45 at the end-2015 and then depreciate toward a level of 6.8 by end-2016. The volatility of the RMB exchange rate is set to increase accordingly. The very likely inclusion of the RMB in the IMF's currency basket of Special Drawing Right (SDR) has largely been priced in by the market.

Both fiscal and monetary policies need to be pro-growth. On the monetary policy front, we envisage the PBoC will implement two additional RRR cuts of cumulative 100 bps in the rest of the year, likely coupled with other QE-like measures. On the fiscal front, the thrust should be to avoid sharp fiscal consolidation at the local government level. Apart from infrastructure investment, the authorities are likely to cut tax rates for the corporate sector and increase public spending on social welfare.

In the recently concluded Fifth Plenum, the core members of Chinese Communist Party discussed the formulation of China's 13th Five Year Plan (FYP) for the period 2016-2020. The new FYP proposes a social, economic and environmental blueprint for China and provides some related action plans, which are broadly consistent with the official reform promises elaborated in the third plenum of November 2013. Unfortunately, the authorities still seem to hold an ambiguous stance toward the much-needed SOE reform plan and continue to overemphasize on maintaining a relatively higher growth rate (above 6.5% average for next five years), which could add more uncertainties to the country's long-term growth outlook.

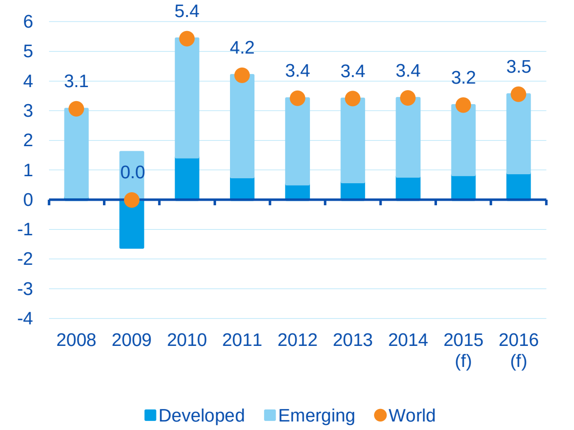
2 Slower global growth in 2015 and a limited improvement in 2016

According to our estimates[1], **global GDP has grown more slowly than we forecast and at a similar rate to that observed at the beginning of the year (+0.6% QoQ, +2.4% YoY)**, making four consecutive quarters of growth below the 2010-14 average. **At a global level, activity has performed worse than expected in the past few months, mainly due to the ongoing deceleration in the principal emerging economies**, in a context in which doubts over the strength of the economic cycle and the financial stability of China have triggered a significant spike in financial tensions and further corrections in commodity prices.

The balance of the first half of the year and the negative bias in the available activity indicators for the third quarter in geographies such as the US, Latin America and Mexico have been accompanied by a **downward revision of the growth forecasts for the principal emerging economies for the full year.** As a result, global GDP growth could close 2015 at an annualised 3.2% (0.2% less than we forecast three months ago), the lowest since 2009 (see Figure 2.1). The gradual recovery of the developed block will not be sufficient to offset the moderation in the emerging, given that the latter will grow barely 4% compared with average growth in the five previous years of more than 5.5%.

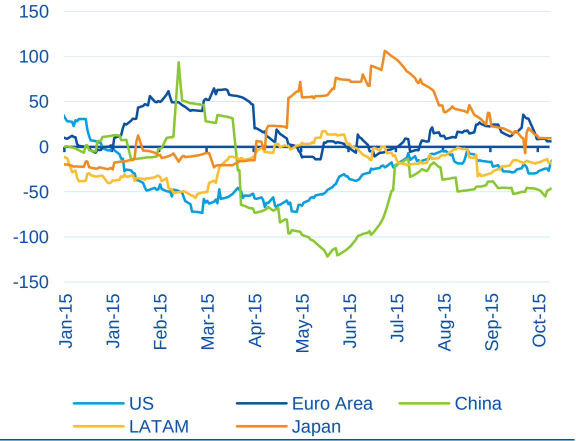
The outlook for 2016 is slightly more favourable (global growth could recover to 3.5%, 0.3% below our forecast three months ago), sustained by a better relative performance of both the developed and the emerging economies. Nevertheless, **the recent intensification of some of the risk spots with greater impact at a global level**, such as the deceleration of the manufacturing sector in China and its repercussions on the commodity cycle and world trade, **increases the uncertainty and accentuates the downside risks** for the recovery of those countries which are more dependent on external demand and savings. **The potential deterioration in the medium-term growth outlook of developed economies such as the US is another factor to take into account in the outlook for global growth.**

Figure 2.1
World GDP: annual growth (%). Forecasts 2015-16



Source: BBVA Research

Figure 2.2
Economic Surprise Index
Positive (+) / negative (-) surprises



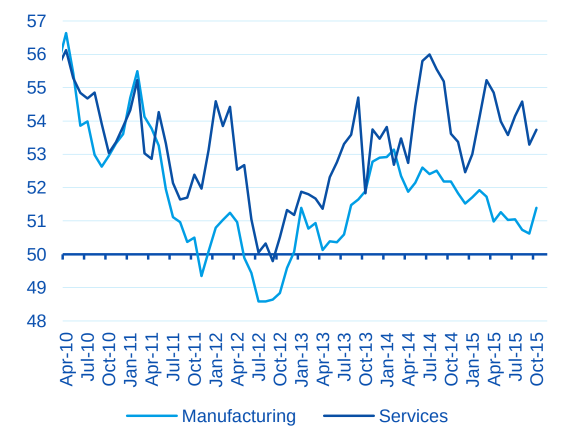
Source: BBVA Research and Citigroup

1: Estimate based on BBVA Research's global activity indicator. Methodology detailed at http://bit.ly/1nl5RIn

In contrast to other recent episodes, the intensity of the deceleration in the emerging block is the determining factor in the loss of momentum of world growth. The Economic Surprise Indices (Figure 2.2) for China, which is growing at less than 7% YoY, and Latin America, in contraction, are reflected in negative level practically since the beginning of the second half of 2015. For the time being, the recovery in domestic demand and the continuation of easing monetary conditions are limiting the impact of the correction in the emerging block on the principal developed economies, and in particular on the eurozone. However, **the moderation of the business sentiment indicators in recent months, together with the stabilisation of growth in the US at slightly lower levels than we anticipated, are evidence that the differentiation between the economic blocks is starting to narrow**, and that the risk of contagion could increase if the momentum of the recent deterioration in the emerging countries continues.

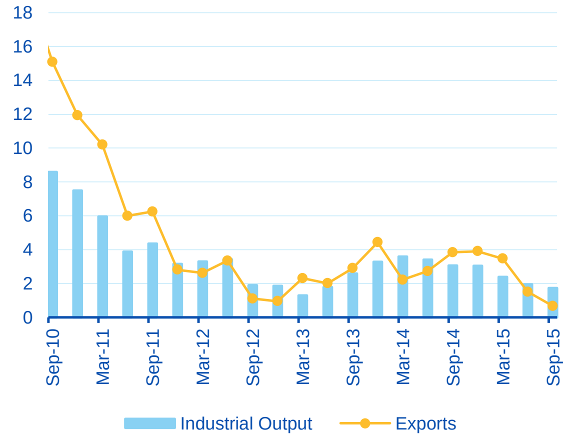
The divergence between the evolution of activity in the industrial and services sectors, which is favourable to the latter, is equally representative of the nature of the moderation of the global economic cycle. The progressive deceleration of the business confidence index for the manufacturing sector, which in September was close to levels compatible with a stagnation of activity, is in contrast to the services business confidence indicator, which remains in the expansion zone. This is reflected in global industrial production growth of less than 2% YoY in August (the slowest pace of growth since the beginning of 2013) and in a sharp deceleration of goods exports (in August, these were barely higher than a year ago). In contrast, retail sales growth in the US and in the eurozone have managed to stabilise at around 2% YoY (although, in the first case, this is a deceleration compared to the pace of growth in mid-2014), and in China, retail sales growth has also stabilised at 10%. This performance has been driven by the support provided by domestic demand in the developed economies block, partly thanks to help from factors such as the correction in the oil price and falling interest rates, and the increased weight of services in the demand of some emerging economies, such as China.

Figure 2.3
World manufacturing and services PMIs



Source: BBVA Research and Markit

Figure 2.4
World: industrial output and exports of goods (% YoY, quarterly frequency) at August 2015 (latest available data)



Source: BBVA Research and CPB

All in all, **the stabilisation of commodity prices at low levels and the sustained rise in financial tensions** in the emerging economies - accompanied by heavy capital outflows, sharp currency depreciation and a widening of sovereign spreads - are **evidence that the balance of global risks is still to the downside.**

3 A soft-landing with deteriorating growth quality

A soft-landing is engineered despite elevated market tensions in the third quarter. Q3 GDP expanded at 6.9% y/y (versus 7.0% in Q2), falling below 7.0% y/y for the first time since the first quarter of 2009 when the Global Financial Crisis (GFC) was at its height. In sequential terms, the pace of growth saw a modest pick-up to 1.8% q/q sa in the third quarter from 1.7% q/q sa previously. (Figure 3.1)

Growth quality is deteriorating remarkably. In particular, the financial sector still contributes to a disproportionately large share to the GDP growth, which, we suspect, is associated with the rollover of gigantic debt accumulated in local governments and corporate sector. Meanwhile, more evidences confirm the rising share of “zombie enterprises” in the economy. Their production activities might be indistinguishably included in the official statistics but don’t yield the products meeting market demands.

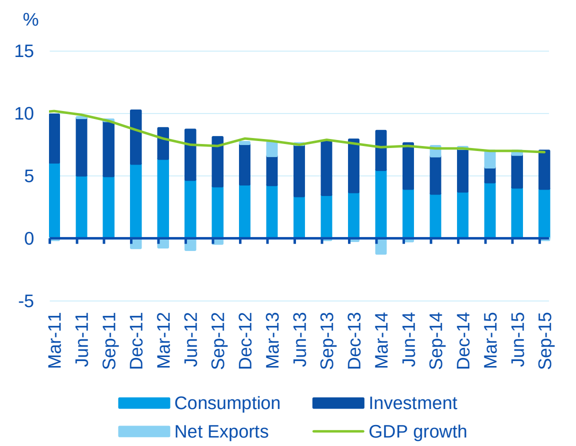
These “zombie enterprises” also add new downward pressure on the aggregate price level as they are undercutting the prices of their products in the market, which in turn increases the risk of falling into a debt-deflation spiral. Indeed, the rollover of their enormous debt is quite credit-consuming. As a consequence, the growth rates of credit and aggregate output has diverged further.

In August the PBoC announced the new mechanism for RMB fixing price formation accompanied with 2% currency devaluation. Although the move is aimed to promote exchange rate flexibility, it actually triggered a vicious cycle of currency depreciation and capital flight. Through a flurry of heavy-handed market interventions, China’s authorities have managed to stabilize the RMB exchange rate and contain the capital outflows. However, the risk of capital flight is set to surge from onwards.

Manufacturing and investment continued their downtrend

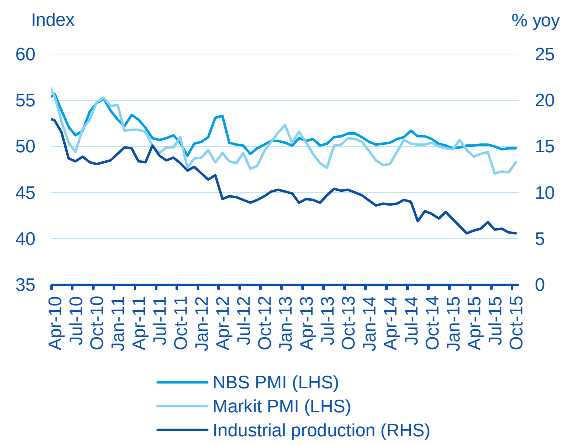
Industrial production growth slowed to 5.6% y/y in October, below market expectations of 5.8% and the last month’s reading of 5.7% (Figure 3.2). On the demand side, retail sales growth in October marginally rose to 11% y/y (consensus 10.9% y/y) from 10.9% y/y in the previous month (Figure 3.3). Investment was also sluggish as its YTD growth edged down to 10.2% in October (consensus: 10.2% y/y) from its previous month’s reading of 10.3%. By categories, infrastructure investment, boosted by the authorities’ easing measures, has partly offset the weak growth in real estate and manufacturing investment. (Figure 3.4)

Figure 3.1
Growth slowdown continued in Q3



Source: NBS, CEIC and BBVA Research

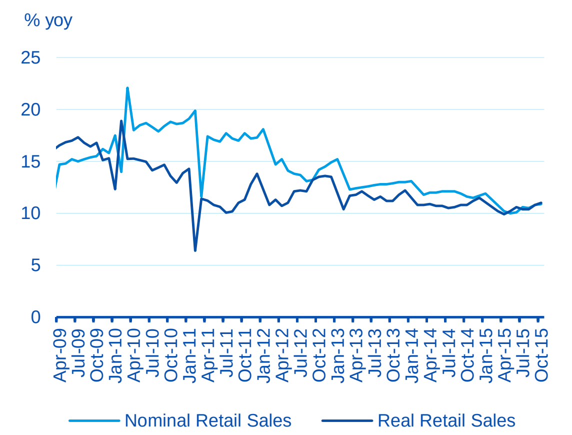
Figure 3.2
Manufacturing activities remained lackluster



Source: CEIC and BBVA Research

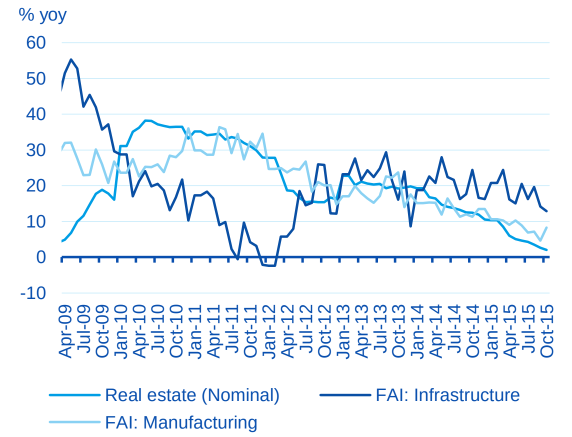
The leading PMIs don't bode well for the growth outlook either. Caixin China PMI (the former HSBC PMI), marginally increased to 48.3 in October from its September reading of 47.2, but still below the watershed level of 50 (Market Consensus: 47.6). Meanwhile, the official NBS PMI of October is unchanged at 49.8, below market expectations (consensus: 50.0). (Figure 3.2)

Figure 3.3
Retail sales held up in Q3



Source: NBS, CEIC and BBVA Research

Figure 3.4
Real estate investment continued to trend lower



Source: NBS, Wind and BBVA Research

Deteriorating growth quality overshadowed the economic rebalancing

The silver lining is that the economy is still on track to shift away from investment to consumption. The tertiary industry continued to outperform the primary and secondary industries, registering a growth rate of 8.6% y/y in 3Q 2015 (versus 4.1% y/y and 5.8% y/y for the primary and secondary industries, respectively). In terms of the three sectors' volume to GDP ratio, service sector contributed 51.4% while industrial sector 40.6% and agriculture sector 8%. (Figure 3.5)

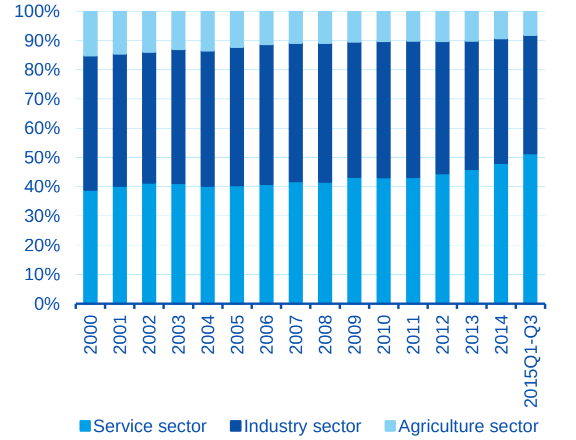
Strong consumption and booming service sector are underpinned by a healthy labor market. In the first three quarters of 2015, the newly increasing employment reached 10.66 million, exceeding the authorities' annual target of 10 million. The more reliable survey unemployment rate marginally picked up to 5.2% in September; mainly due to the newly graduated college students joined the labor force in August and September. In the meantime, the ratio of demand to supply in the labor market ticked up from the last quarter, reflecting the tightness of the labor market. (Figure 3.6)

However, the quality of growth is deteriorating remarkably. First, the financial sector remained as one of the largest growth driver to GDP. Its share of total GDP has grown steadily over the past several years to 8.7% in the first three quarters of 2015. (Figure 3.7) We suspect that the large contribution of the financial sector to the GDP is associated with debt service of gigantic size of existing debt accumulated in local governments and corporate sector over the past several years. Certainly the financial sector is unable to continue its extraordinary performance forever and sustain headline GDP growth if the economy is entering into the necessary deleveraging phase.

Second, the economic slowdown has substantially aggravated financial distress of firms. Our estimates show that firms' debt stress ratios have risen to new highs among listed firms (20% quintile listed firms). (Figure 3.8) Consequentially, more and more debt-laden enterprises can only repay the interest on its debts but not reduce its debts, which we henceforth refer to "zombie enterprises". They are concentrated in the industries with serious over-capacity problem. Under normal circumstances, these "zombie enterprises" should be squeezed out of the market through competition. However, they are in operation thanks to the government's bailouts through implicit guarantees or subsidies. The production activities of "zombie enterprises" might be indistinguishably included in the official statistics but don't yield the products meeting market demands.

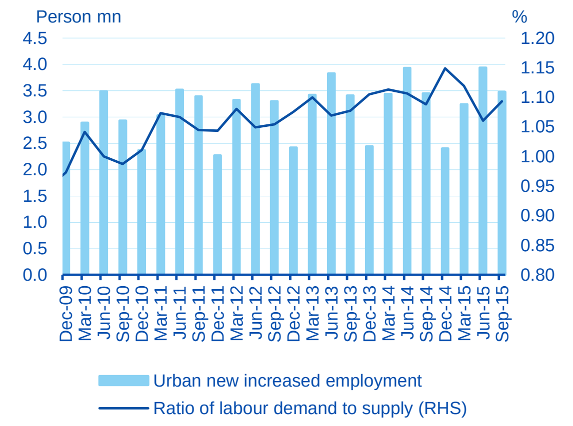
The rise of "zombie enterprises" problem is due in large part to both the stalled reforms in some key areas and the authorities' obsession with maintaining a high growth rate. In particular, the pace of the SOE reform has significantly lagged behind scheduled. As a result, a considerable number of SOEs have turned into "zombie enterprises" when growth significantly decelerated. Meanwhile, the authorities' overemphasis on headline growth rates could make local governments reluctant to exit these inefficient enterprises because it could mean an immediate drop in aggregate output. As a consequence, it prolongs the period of eliminating obsolete production capacity and increases the systemic risk of the entire financial system.

Figure 3.5
Service sector led Q3 economic growth



Source: CEIC and BBVA Research

Figure 3.6
The labor market was in a good shape in spite of the economic slowdown

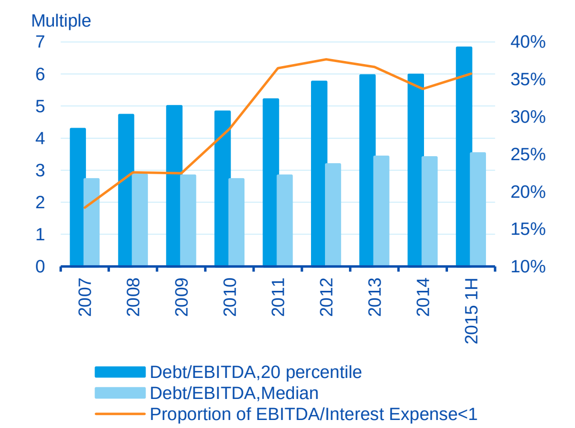


Source: CEIC and BBVA Research

Figure 3.7
Financial sector's share of GDP has increased steadily in the recent years

Source: CEIC and BBVA Research

Figure 3.8
Corporate debt increasing among the "zombie enterprises"



Source: CEIC and BBVA Research

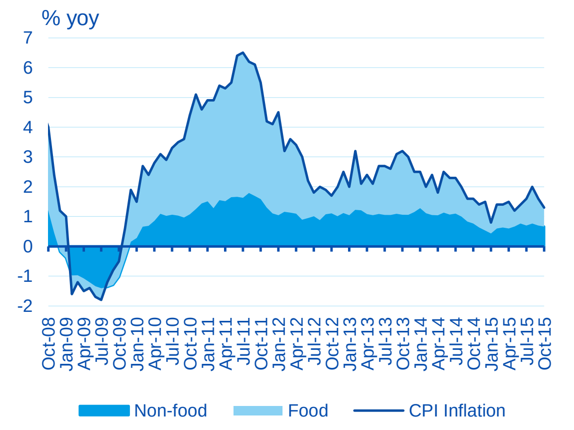
Deflation risk is on the rise

October headline CPI inflation came in at 1.3% y/y, lower than both the market consensus of 1.5% and the previous reading of 1.6%. The main reason for CPI decreasing was due to the shrinking of the previous increasing range of pork and vegetables' prices (Figure 3.9).

PPI contracted further to -5.9% y/y (consensus: -5.9% y/y) in October, similar to that of the previous month; in turn registering its 44 consecutive month of negative growth. The protracted deflation in PPI is mainly led by domestic price declines in several upstream industries including gas exploitation, oil refinery, iron & steel, non-ferrous metals, coal, etc., in which "zombie enterprises" are prevalent. (Figure 3.10)

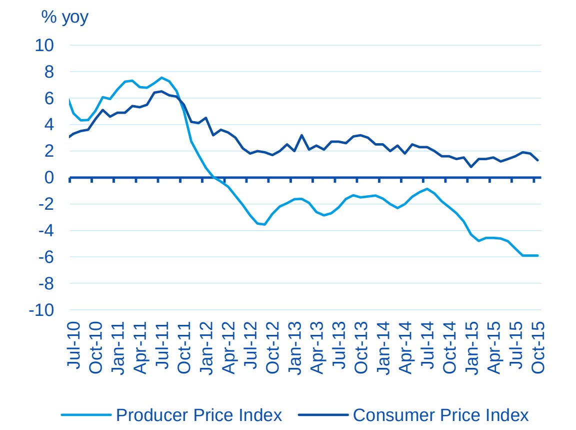
On top of the pass-through effect from negative PPI inflation outturns, several key factors also contribute to deflationary pressures in China, including declining property prices, the recent stock market crash, the high leverage of the corporate sector as well as sluggish commodity prices.

Figure 3.9
CPI decreased again after its temporary pick-up in August…



Source: CEIC and BBVA Research

Figure 3.10
… while PPI inflation has been in the negative territory for 44 months



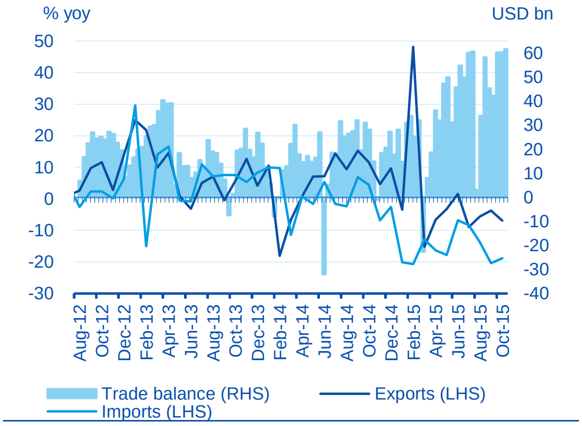
Source: CEIC and BBVA Research

Recessionary trade surplus reflected weak domestic demand

The exports of October seemed not to be boosted by the recent sharp depreciation of the RMB exchange rate yet. Exports registered a year-on-year decline of -6.9% y/y (consensus: -3.2%), a further slowdown compared to the September outturn of –3.7% y/y. Meanwhile, imports slid by -18.8% y/y (consensus: -15.2% y/y) from -20.4% y/y in September. As a result, trade surplus persisted at USD 61.64 bn in October, compared to USD 60.34 bn in the previous month (Figure 3.11).

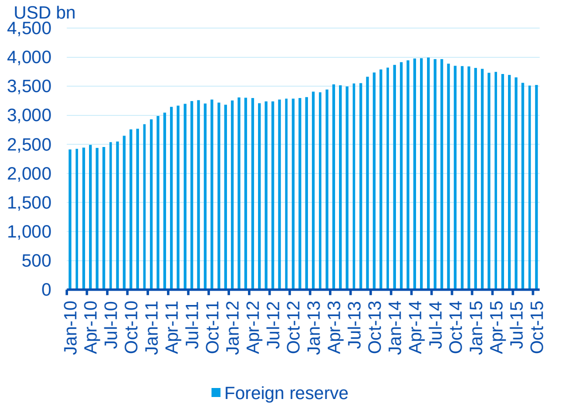
China's recessionary trade surplus is due in large part to a sluggish domestic demand, which has not shown any significant improvement despite the authorities' stepped-up easing efforts. That said, on a positive note, the trade surplus can aid policy efforts towards restoring the stability of RMB exchange rate in the wake of unexpected devaluation in August. China's trade surplus has helped offset a widening capital account deficit driven by rapid capital outflows, and in turn contained the rise in external financing requirements and thus stem the fast decline in foreign exchange reserves. Thanks to the trade surplus, China's foreign reserves still amounted to a respectable USD 3525 bn as of end-October, marginally increasing by USD 11.5 bn from its end-September level. (Figure 3.12)

Figure 3.11
Recessionary trade surplus has continued through October



Source: CEIC and BBVA Research

Figure 3.12
Recessionary trade surplus helps contain foreign reserve depletion amid sharp RMB depreciation



Source: CEIC and BBVA Research

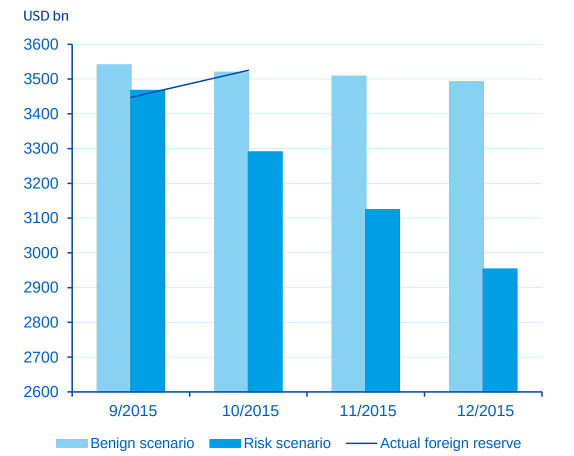
Capital outflows is tilting towards the “benign” scenario of our projection

The increasing risk of capital outflows, which was triggered by the stock market crash and a sharp depreciation of the RMB, remains as the prime risk to the country’s financial stability. In such a context, it is good to see that foreign reserves marginally picked up to USD 3,526 billion from USD 3,514 billion at end September. (Figure 3.12)

In our previous *Economic Watch*, we constructed two scenarios to forecast China’s foreign reserves: (i) under the risk scenario, we predict that foreign reserves will significantly decline to USD 2,953 billion at the end of this year due to a toxic mix of accelerated portfolio outflows, the flow-back of overseas RMB, and the residents’ increasing willingness to hold FX deposits; (ii) under the “benign” scenario”, we predict foreign reserves to decline modestly to USD 3,492 billion as of end-2015. The October foreign reserves outturn suggests that the current pace of capital outflows is tilted towards a benign scenario of our prediction. (Figure 3.13)

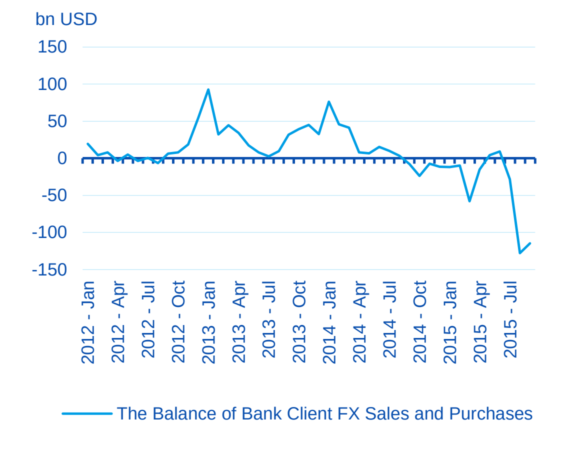
However, the indicator of Balance of Bank Client FX Sales and Purchases (BBCFSP) shows that it is too early to conclude a victory of the PBoC in arresting capital outflows. The BBCFSP is defined as the gap between the amount of client FX sales to banks and that of client FX purchases from banks. It registered a deficit of RMB -730 billion (equivalent to USD -115 billion) in September, compared to RMB -807 billion (USD 127 billion) in August. But it still hovered around its historical low level (Figure 3.14).

Figure 3.13
Our prediction of foreign reserves under benign and risk scenarios



Source: CEIC and BBVA Research

Figure 3.14
Balance of FX Sales and Purchases shows that the pressure on BOP remains high

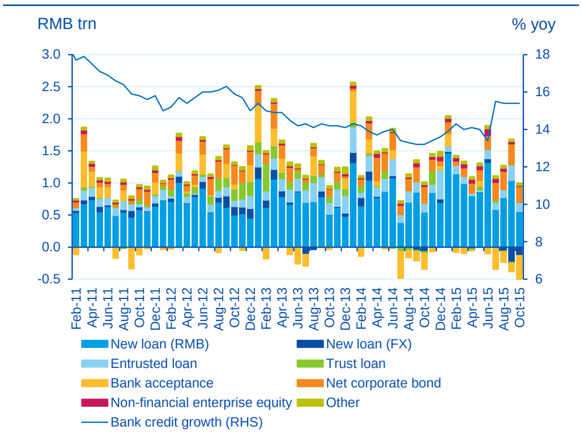


Source: CEIC and BBVA Research

Credit picked up modestly due to monetary easing measures

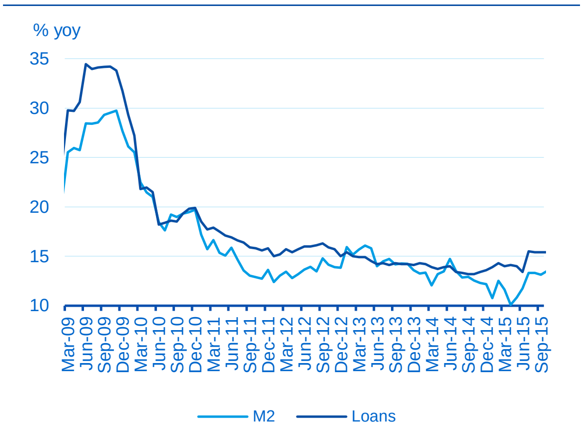
Sluggish growth, the stock market crash and the sharp RMB depreciation has prompted authorities to beef up their efforts of policy easing. The People's Bank of China (PBoC) has been beefing up their efforts of monetary loosening since November 2014. So far, the authorities have implemented five interest rate cuts and four RRR cuts. More importantly, the most recent easing measures on October 23th were accompanied by an interest rate liberalizing measure - the liberalizing measure-the deposit rate ceiling was lifted off completely, indicating the completion of interest rate liberalization.

Figure 3.15
Total Social Financing and new Yuan loans picked up in Q3



Source: CEIC and BBVA Research

Figure 3.16
M2 growth marginally slowed from the last month reading



Source: CEIC and BBVA Research

However, the authorities' market interventions, which are targeting both the mid-year stock market selloffs and the excessive market volatility caused by the August RMB devaluation, have changed the traditional relationship between different policy signals. For example, new Yuan loans declined to RMB 557 billion (consensus: 800 billion RMB) from RMB 1,050 billion in September while M2 growth surprisingly picked up to

13.5% y/y in October (consensus: 13.2% y/y) from 13.1% in September. (Figure 3.15 and 3.16) It is due to the fact that the PBoC has injected a large amount of liquidity into some non-banking financial institutions so that they can use the proceeds to support the stock market. All in all, we reckon that the credit growth is not satisfactory mainly due to the weak demand for investment.

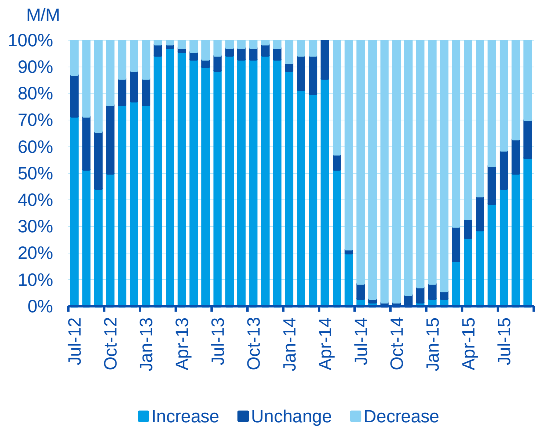
Property prices picked up in tier-1 cities, decoupling from slowing real estate investment

The property market has showed some signs of improvement in Q3, especially housing prices, which have picked up in big cities mainly due to the authorities' interest rate cuts and the removal of some purchase restrictions to stimulate housing demand. As revealed by the NBS, 39 out of 70 cities reported a month-on-month increase in September, compared to 35 cities reporting in the previous month (Figure 3.17). However, the price-increase is mainly concentrated in the tier-1 cities. On the other hand, the property trading volume marginally decreased in Q3, compared to the previous quarter (Figure 3.18).

The recent strong rebound in housing sales has made it clear that housing demand in China is not collapsing. While the trend for housing demand will evolve gradually, the correction on the supply side has been much more severe. As a result, the rebound in housing prices and sales has so far failed to lift up the slowing pace of land sales and real estate investment. Thus, we believe the central issue in China's current housing market is on the supply side not the demand side. The pickup in housing sales has helped accelerate destocking in 2015, but we estimate another one or two years are required before inventories normalize.

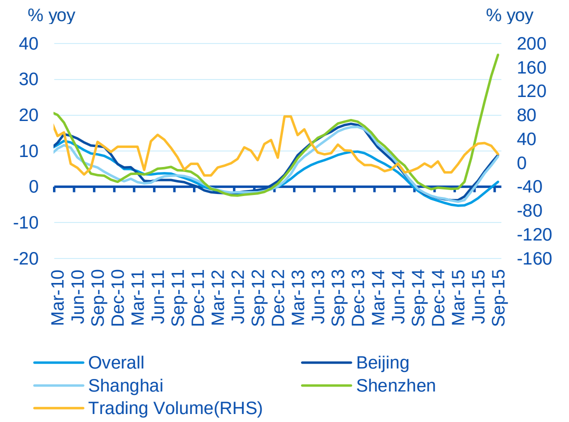
The above points have important implication for GDP growth over the next couple of years. While the property sector's contribution to GDP growth has already peaked in 2011, it is still a large part of the economy. (Figure 3.20) In this context, we believe that government policy will continue to support housing demand stem further downside risks.

Figure 3.17
Higher number of cities reported housing price increase in Q3



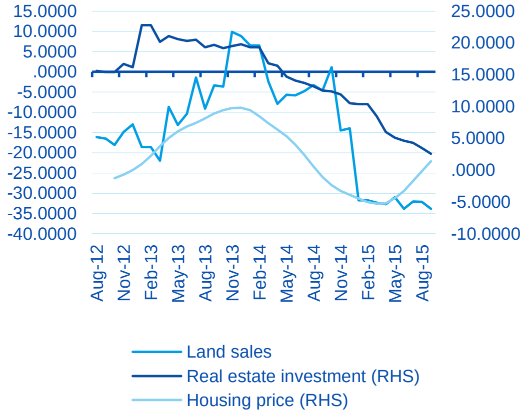
Source: NBS and BBVA Research

Figure 3.18
Trading volume and housing prices have bottomed out in Q3, especially in Shenzhen



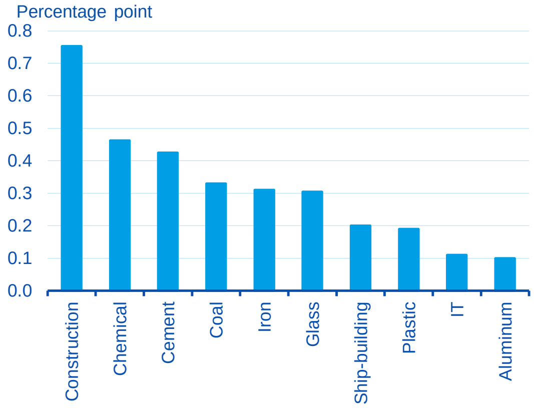
Source: NBS, CEIC and BBVA Research

Figure 3.19
Decoupling between housing price pickup and weak land sales/property investment



Source: NBS and BBVA Research

Figure 3.20
Property market's impact on other sectors



Source: Hong Kong Monetary Authority

4 Growth is set to dip further next year

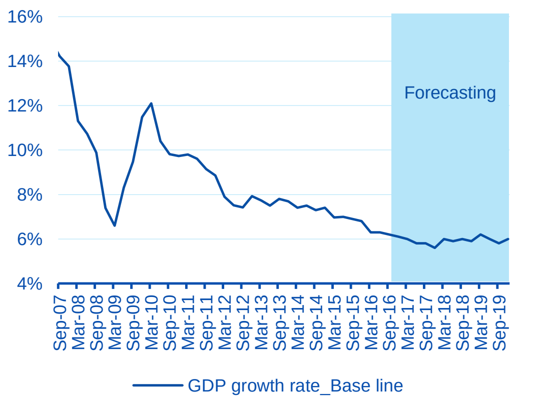
Despite better-than-expected GDP growth in Q3, the recent stock market crash, the sharp depreciation of RMB, along with a number of other growth headwinds will impede growth from bottoming-out in near future. Such a dim outlook has been confirmed by recent weak outturns of activity indicators such as October PMIs and industrial productions. Against this backdrop, the authorities are expected to implement more pro-growth measures to sustain the economy and avoid a hard-landing.

We revise up our 2015 GDP growth estimate to 6.9% y/y from the previous 6.7% to reflect the better-than-expected Q3 GDP outturn while maintaining our 2016 growth projection at 6.2% (Figure 4.1). In terms of GDP components, consumption is likely to continue its outperformance over investment and net exports. The consumption is expected to benefit from the still healthy labor market and the policy initiatives of encouraging consumption (the recent example of which is the sales tax cut of small cars introduced in October).

On the other hand, investment is subject to strong headwinds over the next couple of years. The increasing number of “zombie enterprises” will put additional downward pressure on price levels of manufacturing products which tends to squeeze the profit margin of “normal enterprises” and reduce their interest in making new investment to expand their production capacity. As mentioned in the previous section, property developers are currently de-stocking their vast amount of housing inventory while has less interest in acquiring new lands for development. As such, the real estate investment is set to slow further in the next year and will exert adverse impact on other related sectors. We envisage that the authorities will spend more on infrastructure to counter the anemic investment in both the manufacturing and property sectors.

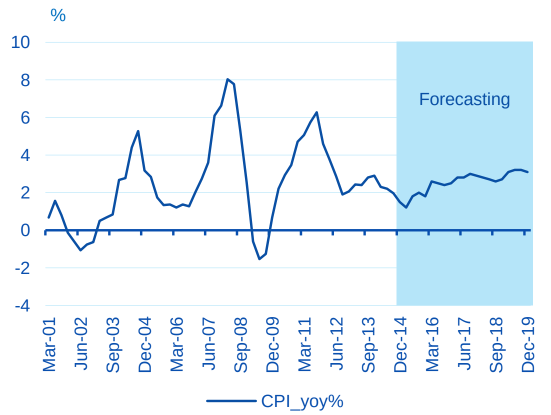
The external demand cannot be counted on to offset the weakening domestic demand. It is highly uncertain what impact the prospective US monetary policy normalization will bring onto the US and other economies. Meanwhile the woes of large commodity exporters are doomed to persist in the coming years. All these are not in favor of China’s exports. Furthermore, the RMB exchange rate, due to its lack of flexibility, has substantially appreciated against a number of major currencies other than the USD. It constitutes another headwind to China’s shipments.

Figure 4.1
We adjusted 2015 GDP growth to 6.9% based on the new outturns in Q3



Source: NBS, CEIC and BBVA Research estimates

Figure 4.2
Inflation will expected to steadily pick up over the following years



Source: NBS, CEIC and BBVA Research estimates

On inflation, we maintain our forecast for 2015 CPI inflation at 1.6% y/y and for 2016 at 2.0% y/y, reflecting the increasing deflation risk from falling commodity prices, weak investment demand and the persistent overcapacity in a number of domestic industries. On the other hand, a healthy labor market and solid growth of household income could lessen downward pressure on consumer prices. (Figure 4.2)

The authorities need to step up fiscal support

The authorities need to deploy more easing measures to spur growth and avoid a hard-landing scenario. On the monetary policy front, the prospective interest rate hike by US Fed and China's recent RMB devaluation may constrain the PBoC from trimming interest rates. Therefore, the central bank is more likely to rely on quantitative tools such as RRR cuts and a number of unconventional monetary policy tools (namely selective RRR cuts, short-and-medium term liquidity facility, the Central Bank refinancing to commercial banks, etc) to stimulate domestic demand. We expect two additional RRR cuts of 50 bps each time in the rest of Q4.

On the fiscal front, the thrust should be to avoid sharp fiscal consolidation at the local government level. The authorities are expected to further relax some tightening measures imposed on local government borrowing as well as to expand the central government's fiscal deficit in the last quarter of the year. In this respect, our forecasts of China's fiscal deficits are subject to certain upward risks. In addition to infrastructure investment, the authorities could consider more tax cuts for the corporate sector.

RMB exchange rate: further depreciation in next year

On August 11th, the Peoples' Bank of China (PBoC) announced a reform of the RMB exchange rate formation mechanism, seeking to increase the flexibility of the exchange rate. On the following date, the PBoC depreciated the fixing rate by 1.9% to 6.23 from the previous day's level of 6.12. The move has great knock-on effects on the financial markets around the world, which in return reinforced investors' pessimism for the RMB exchange rate and China's economic outlook. Through market intervention, China authorities have temporarily stabilized the RMB exchange rate within a narrow range of 6.35-6.40. The delay of the Fed's rate liftoff has given additional time for Chinese authorities to anchor investors' expectations and regain their confidence in China's long-term outlook during a relatively tranquil period of global financial markets.

However, the RMB is subject to certain depreciating pressure from the capital account in the next year if the authorities are to give more flexibility to the exchange rate as planned. Taking into account the RMB's sharp depreciation, we downward adjusted our baseline projection in that the CNY/USD exchange rate will stabilize around 6.45 at the end-2015 and at 6.8 by end-2016 (Table 4.1). The volatility of the RMB exchange rate is likely to increase accordingly.

Table 4.1
Baseline Scenario: Forecasting

	2012	2013	2014	2015 (F)	2016 (F)
GDP (%, y/y)	7.7	7.7	7.4	6.9	6.2
Inflation (average, %)	2.6	2.6	2.0	1.6	2.0
Fiscal balance (% of GDP)	-2.1	-1.9	-1.5	-2.5	-2.5
Current account (% of GDP)	2.3	2.0	2.5	2.5	2.4
Policy rate (%)	6.00	6.00	5.60	4.35	4.35
Exchange rate (CNY/USD)	6.23	6.05	6.21	6.45	6.8

Source: BBVA Research

5 What to expect from China's 13th Five Year Plan?

The members of the 18th Central Committee of the Communist Party convened in Beijing on October 26 to discuss the formulation of China's 13th Five Year Plan (FYP) for the period 2016-2020. Although the content of the 13th FYP may not be finalized until next March, after it is ratified by the National People's Congress, a series of official communiqués published last week will set the tone for China's economic policy making over the next five years. The implications are all the more important at this juncture, as China's growth is subject to increasing growth headwinds from the debt-laden corporate sector, volatile domestic financial markets and accelerated capital outflows.

Review of the 12th FYP

China's FYPs establish a social, economic and environmental blueprint for Chinese policy. The targets outlined within are determined by consensus through the plenary sessions of the Central Committee and the National Congress. The 12th Five Year Plan (2011-2015) has delivered on a number of fronts (Table 5.1). On the economic front, assuming a 6.9% y/y growth rate in 2015, this means that China's economy grew by an average 7.8% annually during the 12th FYP period, above the 7.0% target. China's rebalancing towards a service oriented economy is also underway, evidenced by the higher-than-expected service sector's share in aggregate output. Finally, the level of urbanisation in 2014 was 55.2%, surpassing the target of 51.5%.

Table 5.1
Performance of most important targets under the 12th FYP: Good overall but some questions remain

Category	Indicator	Target	Forecast
Economic growth	Average GDP growth	7.0%	7.8%
	Service sector's share of aggregate output	47.2%	58.4%
	Increase in urbanization rate	51.5%	55.2%
Research and education	R&D expenditure to GDP ratio	2.20%	1.98%
	Patents per 10,000 people	3.3	4.5
	Increase in coverage of nine-year primary education	3%	N/A
	Gross enrolment rate of secondary education	87%	93%
Resources and environment protection	Average loss of arable land	0%	0%
	Decrease in energy per unit GDP	16%	16%
	Total stock of forest	14.3 Bn m^3	15.2 Bn m^3
	Increase of non-fossil fuel's share in primary energy consumption	3.10%	2.0%
	Decrease in CO_2 emissions per unit GDP	17%	n/a
People's livelihood and population	Average increase in disposal income of urban residence	7%	7%
	Average increase in disposal income of rural residence	7%	7%
	Urban registered unemployment rate	5%	4%
	No. of people covered by urban basic pension system	357 million	n/a
	Construction of social housing	36 million units	n/a
	Total population	1.39 billion	1.37 billion
	Increase in life expectancy	1 year	1 year

Source: BBVA Research

Not everything has gone smoothly. In fact, China has paid a high price in order to meet its growth targets. Primarily, we believe that the authorities' commitment to put growth ahead of reform has brought about a number of structural problems. Amongst these, rising levels of indebtedness in the corporate sector – particularly SOEs – as well as incipient asset bubbles in the housing sector and equities market pose significant risks for the economy in the years to come.

Overemphasis on high growth target could delay necessary reforms

The new leadership has a mandate to double China's 2010 real GDP level by 2020, an ambition which requires an average growth rate of at least 6.5% y/y. While this growth rate is considerably below the previous target of 7%, it still looks high given the current headwinds. China needs relatively high levels of growth in order to generate sufficient employment, maintain order and avert falling into a middle income trap. But focusing on growth alone could aggravate things in the long run by diverting attention away from necessary structural reforms.

In October this year, the State Council issued a set of measures that aim to "modernize SOEs, enhance state assets management, promote mixed ownership and prevent the erosion of state assets". However these were underwhelming and generally lacked substance. The 13th FYP gives the authorities another chance to clarify their plan for reform, thereby reinforcing people's confidence. Some progress on this front has already been made since the Fifth Plenum. On November 4, the State Council unveiled guidelines to establish an investment firm to manage and restructure SOEs. The guidelines also mentioned, albeit not in detail, plans to curtail overcapacity amongst SOEs and dispose of inefficient assets. But again, this will not be possible if there is excessive pressure to maintain high growth rates.

Improvements in people's livelihoods in line with urbanization plans

Shortly after the conclusion Fifth Plenum, the government unveiled its "Opinion Concerning the Enactment of the 13th Five-Year Plan for Development of the National Economy and Society", where they unveiled an urbanization target of 60% by 2020. This is rate is still below that of developed economies (US 81%, Japan 93%), so China's on-going urbanization could still provide quite some impetus behind the economy in the midterm. But while China has managed to make some progress on this front, official figures can be misleading, as much of the urbanization process has happened through the redrafting of urban boundaries as opposed to migration to cities.

China's population is ageing, which not only leads to a tighter labour market, but also adds pressure on the country's welfare and pension systems. Not surprisingly, one of the outcomes of the Fifth Plenum was a relaxation of the "one-child" policy. According to the new plan, all couples will be allowed to have two children, but fertility rates, particularly in urban areas, have been falling consistently since the 1970s as a result of a greater female participation in both labour force and education; in combination with rising costs of rearing children. The move could fall short of addressing concerns related to China's demographic ailments unless it is accompanied by reforms to the *hukou* system.

The *hukou* system distinguishes between urban and rural citizens – Migrant workers are denied access to public health, education and other welfare services in urban areas and vice-versa. This situation created an inequitable distribution of the national welfare services which can't possibly favour population growth, not to mention the 60 million children that are left behind in the countryside while their parents seek better employment opportunities in cities. Relaxing the *hukou* system would expand labour force participation and would facilitate China's rebalancing towards consumption by freeing up savings and through upward pressure on migrant worker's wages.

Boosting "green economy" and promoting innovation

In keeping with the drive to shift towards slower growth of better quality, the 13th FYP could introduce an avenue for addressing looming pollution concerns. In addition to a coal consumption cap and more clarity regarding the establishment of a national emissions trading system in 2017, the 13th FYP will also result in more support for the development of China's green industries. According to the People's Bank of China and the United Nations Environment Programme, in order for all pledges under the 13th FYP to materialize, green infrastructure will require investments upwards of US$ 320 bn, with most of it being financed by the private sector.

Similarly, the 13th FYP will also elevate the importance of achieving higher levels of endogenous innovation in order to move up global value chains. We expect the support to follow the "Made in China 2025" plan, announced earlier this year. This plan seeks to pursue innovation-driven and green development, apply smart technologies and enable China to transition from being a manufacturer of quantity to one of quality.

Accelerating China's "going-out" policy in order to alleviate overcapacity

We anticipate that the 13th FYP could include the acceleration of the "One Belt, One Road" (OBOR) strategy as one of the targets. China has amassed an impressive amount of foreign reserves, equivalent to roughly USD 3.8 trillion in 2014. An estimated two-thirds of these reserves are held in USD denominated assets, primarily low-yielding government bonds and institutional bonds. Beijing could use foreign investments via the OBOR as an alternative to holding government debt securities. Finally, Chinese ODI is a relatively new phenomenon, so its global stock remains underrepresented compared to other major economies. In addition, the OBOR could help China to export part of its overcapacity, particularly in the construction, steel and equipment sectors.

Financial liberalization is likely to be completed over the next five years

One area where there has been significant progress is that of financial reform. Interest rate liberalization has been advanced very successfully, with the deposit rate ceiling completely lifted as of October this year, *in line with our expectations*. But reforms in the financial sector are still on-going. In particular, we expect that the 13th FYP will highlight the need to move towards a free floating currency and fully liberalize the convertibility of the RMB under the capital account by 2020. This would enable a more efficient allocation of capital; however rapid capital account liberalization is unlikely in the short term given the recent acceleration of capital outflows.

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6 Risks shift to the downside

Downside risks to China's growth mainly emanate from increasing capital outflows and lingering deflationary pressure. The combination of a strengthening US dollar and domestic growth slowdown could heighten capital outflows in the coming months. In particular, a strengthening US dollar could continue to act as a pull factor to induce investors to move away from risky assets in China, which seems all the more compelling in the aftermath of the stock market crash. Thus, China's authorities would be faced with a policy dilemma between supporting growth, and reducing the risk of abrupt capital outflows on the other hand.

Deflation risk is on the rise. PPI inflation has been in deflation for 43 consecutive months due to the prevalent overcapacity problem in several industries, which has been exacerbated by the slump in global commodity prices. Headline CPI went back to below 2% in September after its temporary jump in August, indicating that domestic demand is still sluggish. The authorities need to avert a debt-deflation spiral.

Another newly emerged challenge to the long-term growth is the authorities' capacity to push for reforms on different fronts while avoid making lethal policy errors. Both the market selloffs in June-July and the August RMB devaluation are related with the authorities' missteps or misjudgments. On the way lying ahead, the authorities need to accomplish formidable tasks such as SOE reforms and capital account opening. Any small mistake could lead to a calamitous collapse of the economy.

7 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	6.9	6.2
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	2.0
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	6.25	6.22
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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