

China

Economic Outlook

2ND QUARTER 2016 | ASIA UNIT



- 01 The downward adjustment in world growth and the slump of financial markets have halted.
- 02 Green shoots emerged in China due to growth stimulus.
- 03 We slightly revise up our 2016 full-year projection to 6.4% from 6.2% previously.
- 04 Downside risks still hover around while pro-growth policy stance is set to maintain.

Index

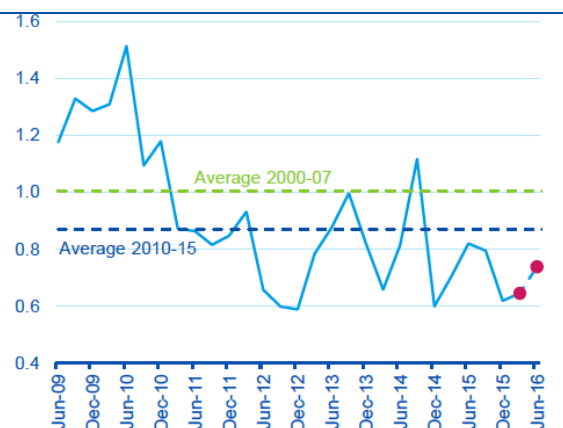
1 Global outlook: low and fragile economic growth	3
2 China's growth rebounds following policy stimulus	4
3 Slowdown is set to continue in 2016	6
4 Risks are tilting toward the downside	9
5 Tables	10

Closing date: 16 May 2016

1 Global outlook: low and fragile economic growth

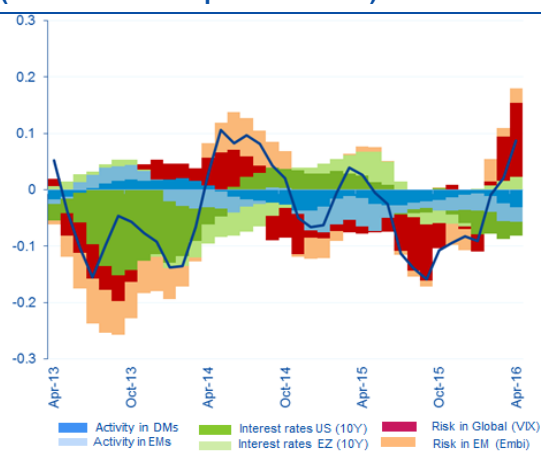
The global economy has improved over the last three months, as the downward trend in world growth and the slump in the financial markets have both halted. However, the improvement in recent months is limited. The pace of global growth in the first part of 2016 will be between 2.6% and 3.0% YoY, still falling short of the average of 3.2% over the 2011-15 period. Another reason for caution is the deceleration in global trade, where the growth in goods and services is at its lowest levels since the collapse at the end of 2008.

Figure 1.1
World GDP, % q/q. Q1 and Q2 forecasts 2016 based on BBVA-GAIN



Source: NBS, CEIC and BBVA Research

Figure 1.2
Global factor of capital flows decomposition (FAVAR model of portfolio flows)



Source: CEIC and BBVA Research

The big central banks finally helped to restore the situation in the Emerging Financial markets and the risk of a dramatic adjustment in the exchange rate, once capital outflows have been curbed, has also been mitigated. As regards the Fed, the perspective of very slight interest rate hikes relies on the lack of immediate pressure from prices or wages and the effects of the complex global scenario on employment in the US. While FED and ECB policies helped to prompt a sharp recovery in capital flows (Figure 1.2) the truth is that most of the recovery is stemming from the risk appetite components which could be very volatile. Thus unless fundamentals improve over time we will continue to be exposed to periods of volatility

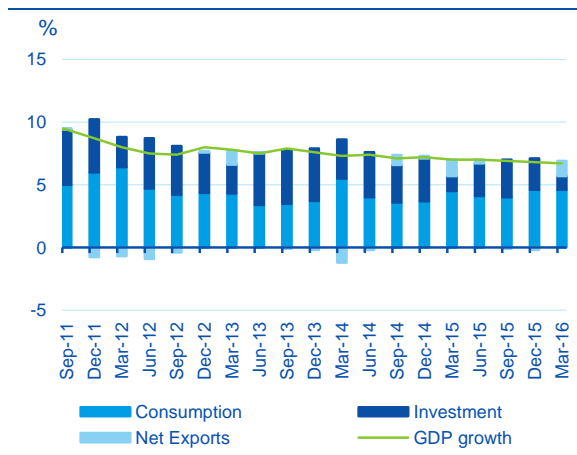
The evolution of commodity prices, particularly oil, has also been positive in the last quarter. Prices have increased from levels so low that large dollar-indebted corporations from emerging markets were having troubling servicing their debt. This in turn triggered deterioration in markets and a negative wealth effect on spending in oil importing economies.

The brighter global scenario is limited in scope and is fragile, however. It does not involve fundamental changes in the factors which cause a background of low growth with exposure to many different sources of uncertainty. Another reason for caution is the deceleration in global trade, where the growth in goods and services is at its lowest levels since the collapse at the end of 2008.

2 China's growth rebounded on policy stimulus

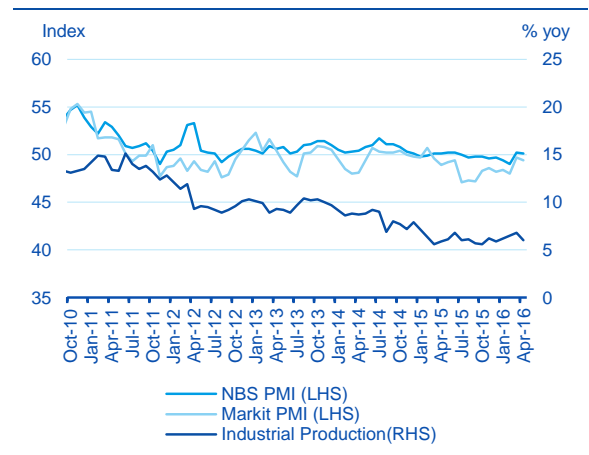
Green shoots emerged in Q1 after the financial tension at the beginning of this year, due to both the authorities' stepped-up efforts of growth stimulus and the Fed's dovish stance of monetary policy normalisation. In particular, Q1 GDP expanded at 6.7% y/y (BBVA: 6.5% y/y versus Consensus: 6.7% y/y), marginally down from the Q4 2015 outturn of 6.8% y/y and registering the lowest level since Q1 2009. Nevertheless, it is still in line with a soft landing scenario amidst escalating financial turmoil early this year. (Figure 2.1) The latest activity indicators (including PMI and Industrial Production) suggest that the recovery of growth continued in April, albeit moderated from March. (Figure 2.2)

Figure 2.1
Structural slowdown of growth continued but some green shoots emerged in Q1 2016



Source: NBS, CEIC and BBVA Research

Figure 2.2
PMIs and IP indicate some recovery signs of the economy



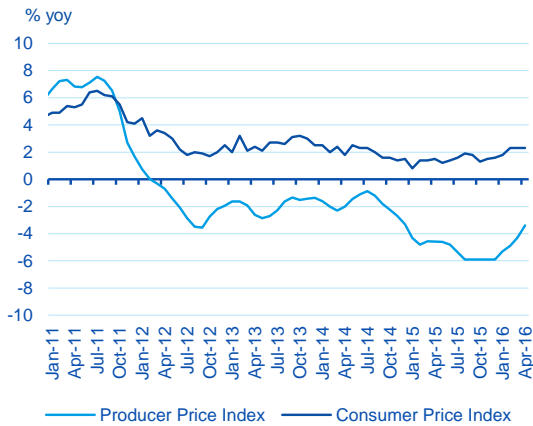
Source: CEIC and BBVA Research

Inflation picked up while credit binge added to concerns regarding leverage

Inflation picked up significantly. April headline CPI inflation came in at 2.3% y/y, flat with the market consensus and the previous reading. The rise in the CPI was due to the bad weather, which reduced the supply of agricultural products, and to the authorities' demand-stimulating measures (Figure 3.3). The PPI rebounded on sequential terms although their year-on-year growth rates were still in negative territory. The suggestion is that the authorities' easing measures have taken effect.

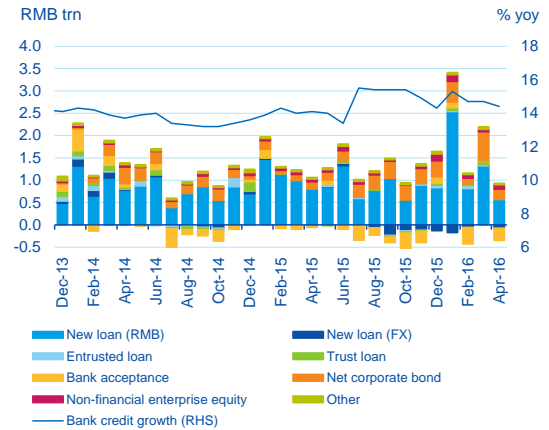
Total social financing, a broad gauge of credit including bank loans, bond issuance and shadow banking activities, surged to RMB 2340 billion in March from RMB 824.5 billion in the previous month (Consensus: RMB 1400 billion). In addition, M2 growth rose to 13.4% y/y (Consensus: 13.5% y/y) from 13.3% y/y in February. (Figure 2.4) The credit figures suggest the authorities' stepped-up easing measures to support short-term growth took effect in March. However, the credit expansion could aggravate the indebtedness problem of the corporate sector.

Figure 2.3
CPI and PPI picked up significantly due to the higher demand triggered by easing measures



Source: CEIC and BBVA Research

Figure 2.4
Total Social Financing picked up significantly in Q1 as well...

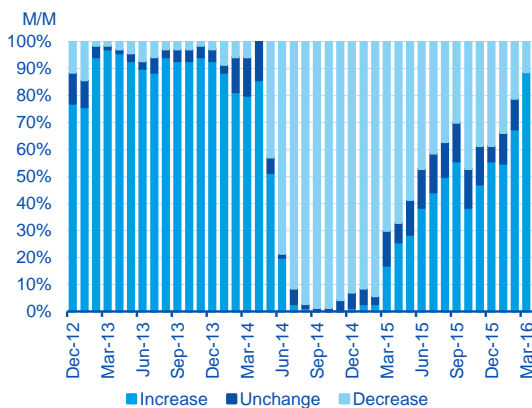


Source: CEIC and BBVA Research

Overheating signs appeared in the property market

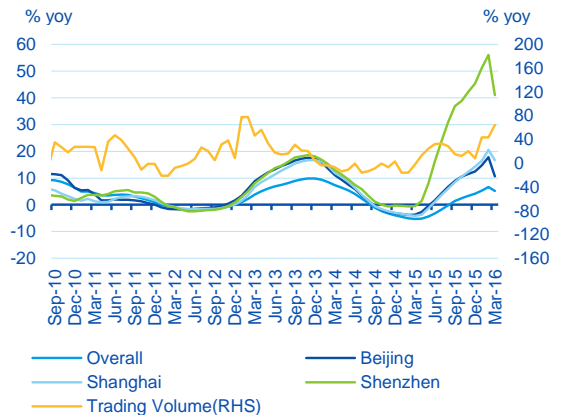
Meanwhile, the property market was bumped up significantly in Q1 2016, at the beginning this was mainly due to interest rate cuts and the removal of some purchase restrictions in order to de-stock the residential property (Figure 2.5 and 2.6), adding concerns of housing bubbles. As such, local governments in a few big cities have to reinstate some tightening measures on their housing markets to stem the run-up of property prices.

Figure 2.5
More cities reported housing price increases in March



Source: NBS and BBVA Research

Figure 2.6
Housing prices picked up significantly but slowed in March due to intervention by the authorities

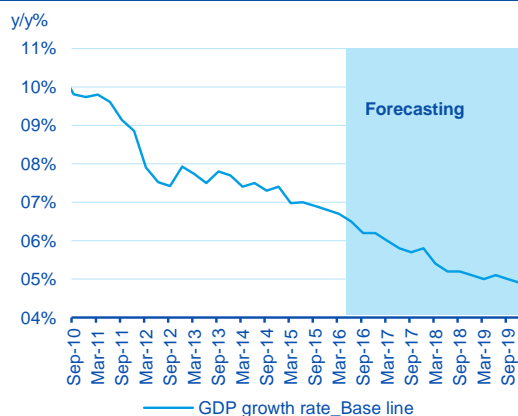


Source: NBS, CEIC and BBVA Research

3 Slowdown is set to continue in 2016

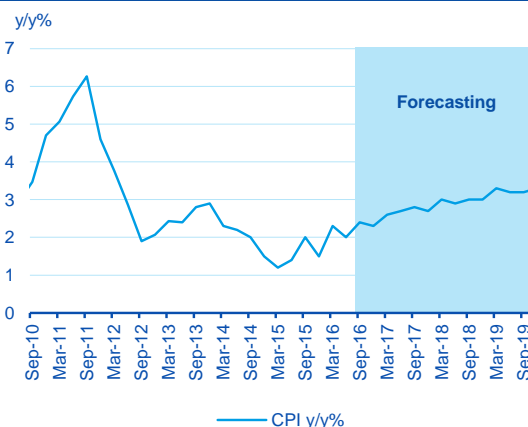
We have revised our 2016 full-year projection up slightly from 6.2% to 6.4%, reflecting the stronger-than-expected growth momentum of late. Nevertheless, we expect the ongoing growth recovery to be short-lived, as it has been primarily driven by the authorities' stepped-up efforts of counter-cyclical policy loosening. Meanwhile, a number of structural problems in the economy remain unaddressed and will continue to weigh on growth prospects in the next few years. We are therefore keeping our growth projection for 2017 unchanged at 5.8%, suggesting a protraction of the structural slowdown. (Figure 3.1) Due to recent strong outturns of inflation, we are revising this year's CPI projection upward from 1.7% to 2.3% while keeping next year's projection unchanged at 2.7%. (Figure 3.2)

Figure 3.1
We revised our 2016 GDP upward to 6.4%



Source: NBS and BBVA Research

Figure 3.2
We revised our inflation forecast upward



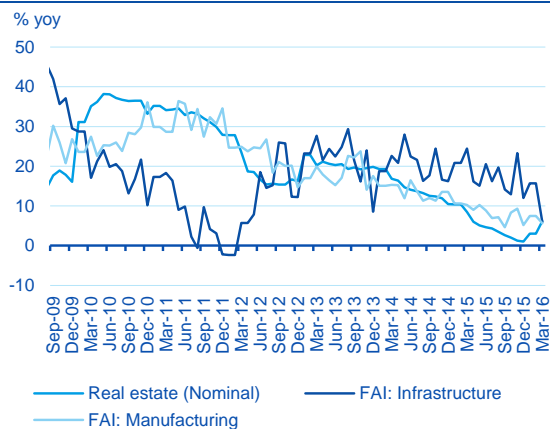
Source: NBS, CEIC and BBVA Research

Sluggish investment is the main drag on growth

On the demand side of the economy, investment is still subject to severe growth headwinds. The fixed asset investment can be further broken down into three categories: property investment, manufacturing investment and infrastructure investment. (Figure 3.3) Despite the recent improvement in the property market, investment in the real estate sector is still being afflicted by the over-supply problem in the second and third-tier cities. Indeed, around 70% of floor space under construction is concentrated in these cities. Given the high level of housing inventory in these regions, real estate developers still appeared conservative in acquiring lands from the government. As a result, the year-on-year growth of land sales remained in negative territory in the first quarter whereas the sold floor space surged up to 33% at the same time.

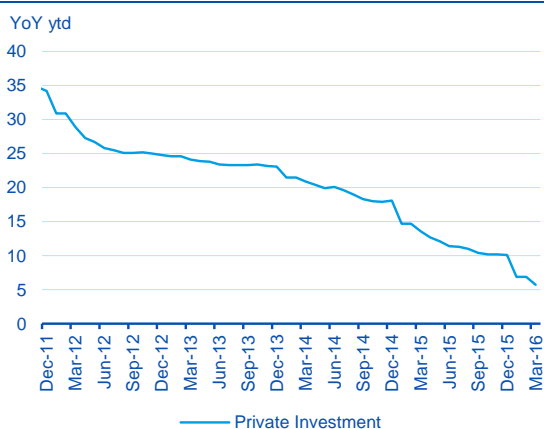
We expect this trend to continue over the next couple of years. The real estate developers could accelerate investment in their acquired land so as to lock in investment return as soon as possible. However, in the face of the increasing uncertainties surrounding the economic perspectives, the property developers, in particular private ones, are still reluctant to acquire new land to make more investment. Moreover, the authorities' concerns regarding housing bubbles have led to more tightening measures in China's mega-cities, which does not bode well for the nascent recovery in the property market.

Figure 3.3
FAI in property market still afflicted by over-supply problem



Source: NBS and BBVA Research

Figure 3.4
...while the private investment is decreasing due to the housing stock is still high



Source: NBS, CEIC and BBVA Research

More worrisome is the investment in the manufacturing sector. Due to the persistent overcapacity problem, manufacturing firms have become increasingly prudent in their investment decisions. In the first quarter, the growth rate of private investment (the bulk of which go to the manufacturing sector) declined to 5.7%, suggesting that the situation had even deteriorated further despite the authorities' policy stimulus. (Figure 3.4)

All in all, we expect the improvement in infrastructure investment will not be able to offset the downward trend in the growth of property and manufacturing investment. As such, fixed-asset investment as a whole is likely to be the main drag on growth over the next couple of years.

Depreciation of the RMB will proceed at a slower pace

Thanks to the successfully launch of this new policy regime as well as the recent weakness of the USD, the authorities have substantially dampened market fears of any further large-scale depreciation of the RMB and slowed the pace of capital outflows. In our base scenario, we expect that the RMB will go weaker with respect to the USD over the next couple of years as the USD is to resume its strength on the Fed's prospective interest rate hikes. Nevertheless, based on the recently weaker-than-expected performance of the USD, we adjust our end-2016 projection of CNY/USD to 6.80 from 6.95 previously. However, we slightly revised our end-2017 projection of CNY/USD to 7.20 from 7.10 previously.

Table 3.1
Baseline Scenario:

	2013	2014	2015	2016 (F)	2017 (F)
GDP (% y/y)	7.7	7.4	6.9	6.4	5.8
Inflation (average, %)	2.6	2.0	1.4	2.3	2.7
Fiscal balance (% of GDP)	-1.9	-2.1	-2.3	-3.0	-3.5
Current account (% of GDP)	2.0	2.5	2.7	2.7	2.5
Policy rate (%)	6.00	5.60	4.35	4.10	3.60
Exchange rate (CNY/USD)	6.05	6.21	6.5	6.8	7.20

Source: BBVA Research

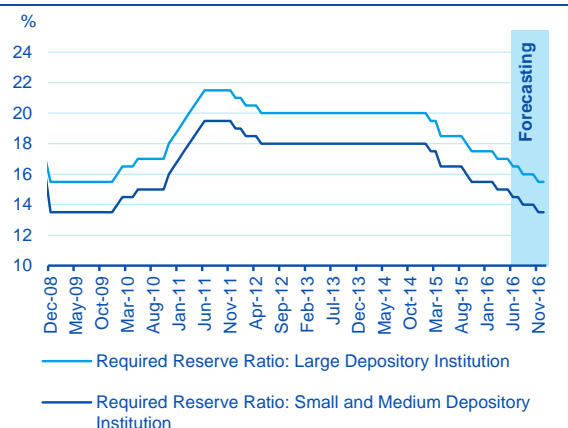
Loosening of monetary policy continues...

The authorities shifted their monetary policy stance to one of loosening in November 2014 as evidenced by a series of interest rate and RRR cuts. These easing measures have enabled the aggregate money supply to grow at a steady pace during the downturn in growth. In the National People’s Congress of March, the authorities announced this year’s M2 growth target at 13%, higher than last year’s target of 12%. That being said, the authorities will maintain the loosening stance regarding monetary policy throughout the year so as to achieve their growth target.

It is also noted that the growth rate of the money supply accelerated in the first quarter, even exceeding the official annual target of 13%. This could lead to overheating and inflation risks. In view of this new development, the PBoC indicated that it would place its easing policy on hold for the moment. We anticipate that the PBoC will reinstate easing measures in the second half of the year, as the growth momentum tapers off again. Compared to three months ago when financial tension was at its peak, we have trimmed our expectation of interest rate cuts from 50bps to 25bps for this year. Meanwhile, we forecast three more RRR cuts (cumulative 75 bps) during the rest of the year. (Figure 3.5)

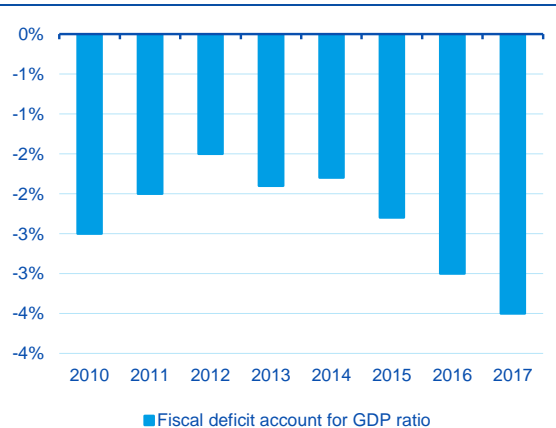
Moreover, a number of unconventional monetary policy tools (namely selective RRR cuts, short-and-medium term liquidity facility, the Central Bank refinancing to commercial banks, etc.) are to be increasingly used as China’s monetary policy framework is transitioning toward an “interest-rate-corridor” system. ([Our report about the PBoC’s new policy tools](#))

Figure 3.5
We forecast three more RRR cuts by end-2016



Source: NBS and BBVA Research

Figure 3.6
Fiscal deficit is set at -3% in 2016



Source: NBS, CEIC and BBVA Research

...while fiscal policy will become more aggressive

In the National People’s Congress of March, the central government announced that this year’s fiscal budget deficit will increase to -3% from -2.3% last year. In particular, the central government announced that the new VAT policies will be applied to the construction, real estate, financial and consumer services industries, through which the government can cut tax of around RMB 500 billion (around 0.7% of GDP) for these sectors. Moreover, the government will continue to streamline administrative procedures in the public service and reduce relevant charges for individuals and enterprises.

The central government will also try different ways of lending more support to local governments so that they can boost their economies more. First, the central government will expand the size of the local debt-swap programme to RMB 5 trillion this year from RMB 3 trillion last year. The programme will effectively reduce local governments’ interest payments for existing debt as well as refinancing risks. As such, local governments will be able to have more capacity to support local economies. Second, the authorities

increased their support for local economies through the balance sheets of policy banks. In practice, policy banks extend loans to certain infrastructure projects, circumventing the rule that local governments cannot directly borrow from banks. Third, the central government can apply regulatory forbearance (in respect of land acquisition and approval procedures) for local governments to accelerate infrastructure investment.

The structural reforms are slowing

On structural reforms, the authorities are likely to slow down their pace this year in view of escalating financial tension associated with previously enacted liberalising steps. Instead, the authorities will shift their priority to the upgrade of the framework of monetary policy and financial regulation. It is reported that a Central Financial Working Meeting is to be held in June to carve out the new regulatory and monetary policy framework which will be more suitable for the new environment after the completion of interest rate liberalization.

Such a change can be regarded as the authorities' reaction to the episodes of market turmoil in mid-2015 and the start of this year, which reflected the lack of coordination among different regulators. However, we are not sure whether the PBoC will solely become a super regulator or whether the authorities will set up a new committee above the existing regulators to coordinate their policy actions. In any case, we expect the PBoC to consolidate more regulatory powers and play a more important role under the new regulatory framework.

However, in a few key sectors, the pace of reforms could slow down. For example, in the 13th Five-Year Plan (2016-2020) endorsed in the National People's Congress, the authorities avoid mentioning capital account convertibility and RMB internationalisation. More importantly, the authorities appear to be behind the curve in the field of SOE reforms, which will have an adverse impact on the economy's potential growth over the long term.

4 Risks are tilting toward the downside

Downside risks to our base scenario still exist, mainly on the effects of the previous financial turmoil and escalating capital outflows. In addition, financial risks are likely to increase as more corporate defaults occur. Thus, policy inaction, uncertainty and blunders could exacerbate the situation and even trigger a hardlanding.

The combination of a potentially strengthening US dollar and a slowdown in domestic growth 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 and the sharp depreciation in the RMB. Thus, China's authorities would be faced with a policy dilemma between supporting growth on the one hand, and reducing the risk of abrupt capital outflows on the other.

Another challenge to long-term growth that has emerged is that financial risks are likely to increase as more corporate defaults occur and as the bank non-performing loan ratio continues to rise. In addition, the corporate defaults might lead to another round of turbulence in the financial markets, especially the bond market. However, at the current stage, we see systemic financial risks as manageable, given that the government is a large stakeholder in the financial sector and that general government debt is still at a manageable level.

5 Tables

Table 5.1

Macroeconomic Forecasts: Gross Domestic Product

(Annual average, %)	2012	2013	2014	2015	2016	2017
United States	2.2	1.5	2.4	2.4	2.5	2.4
Eurozone	-0.8	-0.2	0.9	1.5	1.6	1.9
Germany	0.6	0.4	1.6	1.4	1.7	1.8
France	0.2	0.7	0.2	1.2	1.3	1.6
Italy	-2.8	-1.8	-0.3	0.6	1.0	1.4
Spain	-2.6	-1.7	1.4	3.2	2.7	2.7
United Kingdom	1.2	2.2	2.9	2.3	1.8	1.9
Latam *	2.9	2.6	0.7	-0.5	-1.0	1.7
Mexico	4.0	1.4	2.1	2.4	2.2	2.6
Brazil	1.9	3.0	0.1	-3.9	-3.0	0.9
Eagles **	5.8	5.5	5.2	4.6	4.7	4.9
Turkey	2.1	4.2	3.0	4.0	3.9	3.9
Asia Pacific	5.8	5.8	5.6	5.5	5.3	5.1
Japan	1.7	1.5	0.0	0.5	0.8	0.8
China	7.7	7.7	7.3	6.9	6.4	5.8
Asia (ex. China)	4.3	4.3	4.2	4.3	4.4	4.5
World	3.4	3.3	3.4	3.1	3.2	3.4

* 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: 6 May 2016.

Source: BBVA Research and IMF

Table 5.2

Macroeconomic Forecasts: Inflation

(Annual average, %)	2012	2013	2014	2015	2016	2017
United States	2.1	1.5	1.6	0.1	1.3	2.0
Eurozone	2.5	1.4	0.4	0.0	0.2	1.3
Germany	2.1	1.6	0.8	0.1	0.0	1.2
France	2.2	1.0	0.6	0.1	0.1	1.3
Italy	3.3	1.2	0.2	0.1	0.1	1.3
Spain	2.4	1.4	-0.2	-0.5	-0.3	1.7
United Kingdom	2.8	2.6	1.5	0.1	0.7	1.6
Latam *	7.8	9.2	12.7	17.5	32.9	34.4
Mexico	4.1	3.8	4.0	2.7	2.8	3.1
Brazil	5.4	6.2	6.3	9.0	8.6	5.2
Eagles **	5.1	5.2	4.5	4.4	4.2	4.1
Turkey	8.9	7.5	8.9	7.7	8.1	7.8
Asia Pacific	3.8	4.0	3.3	2.2	2.7	3.1
Japan	0.0	1.6	2.7	0.8	0.7	1.5
China	2.6	2.6	2.0	1.4	2.3	2.7
Asia (ex. China)	4.7	5.1	4.4	2.9	3.0	3.5
World	4.4	4.2	3.9	3.8	5.0	5.4

* 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: 6 May 2016.

Source: BBVA Research and IMF

Table 5.3

Macroeconomic Forecasts: Exchange Rates

Annual Average	2012	2013	2014	2015	2016	2017
USD-EUR	0.78	0.75	0.75	0.90	0.91	0.89
EUR-USD	1.29	1.33	1.33	1.11	1.10	1.12
GBP-USD	1.59	1.56	1.65	1.53	1.49	1.66
USD-JPY	79.77	97.45	105.82	121.07	118.44	128.50
USD-CNY	6.31	6.20	6.14	6.23	6.63	6.99

Forecast closing date: 6 May 2016.

Source: BBVA Research and IMF

Table 5.4

Macroeconomic Forecasts: Official Interest Rates

End of period, %	2012	2013	2014	2015	2016	2017
United States	0.25	0.25	0.25	0.50	1.00	2.00
Eurozone	0.75	0.25	0.05	0.05	0.00	0.00
China	6.00	6.00	5.60	4.35	4.10	3.60

Forecast closing date: 6 May 2016.

Source: BBVA Research and IMF

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