BBVA | RESEARCH

China
Economic Outlook

3rd QUARTER 2016 | ASIA UNIT

01

Global aggregate data have partially improved or have slowed their decline. But Brexit led to downward adjustment of our Europe's growth prediction.

02

Growth moderated as Q2 GDP growth maintained at the same rate as the previous quarter, but headwinds still ahead.

03

We maintain our 2016 full-year projection at 6.4% and 2017 at 5.8%; we lower RMB exchange rate prediction, reflecting adverse spillover of Brexit.

04

Downside risks still hover around while easing measures are set to continue in the rest of 2016.

Index

Closing date: 16 August 2016

1 Global outlook: economic growth improved slightly

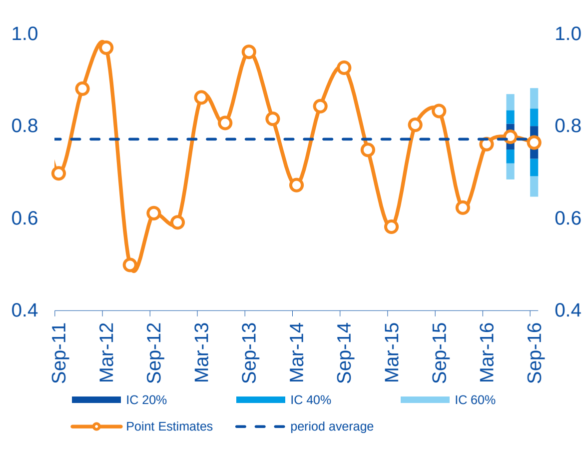
In the last three months the global economy has continued the moderate trend of previous quarters, with growth rates of around 3%, well below the pre-crisis rates. In this period, global aggregate data have partially improved or have slowed their decline but one of the risks mentioned for mid-year has materialized – the result in favour of Brexit in June – which leads us to lower our forecasts in Europe. On the other hand, the quarter was also marked by the Fed's delay in normalizing interest rates amid doubts about the situation of the US economy, its long-term growth and global risks.

Global economic data have improved slightly

Our initial estimates based on the BBVA-GAIN indicator for the second quarter (0.78% QoQ) suggest that global growth remained close to the average for the past five years. Thus, and as in the first quarter, the world economy is finding it difficult to achieve more than limited growth. The most recent indicators seem to confirm this diagnosis. Industrial production shows a neutral trend changing only in April and May, when it was slightly positive. This situation results from the behaviour of the emerging economies, specifically the Asian ones, as developed countries show no signs of recovery. **Confidence indicators give rather more grounds for optimism,** with impetus seen in June as a result of developed countries' responses, while **our indicator of global trade in goods shows strong momentum in June, after months of weakness.**

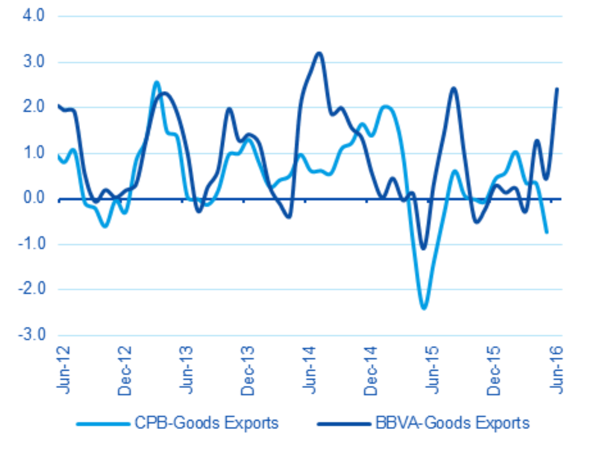
This, together with a reduction of financial stresses in both developed and emerging countries, leads us to forecast a third quarter quite similar to the first two**.** Indeed, our BBVA-GAIN indicator estimates that the global momentum in the third quarter will again be around the growth trend of recent years (0.76% QoQ), which is consistent with a global growth for 2016 of the order of 3.1%.

Figure 1
World GDP: observed GDP growth and forecasts based on BBVA-GAIN (%, QoQ)



Source: BBVA Research

Figure 2
World: volume of global trade, Goods. BBVA Research and CPB index (%, QoQ)

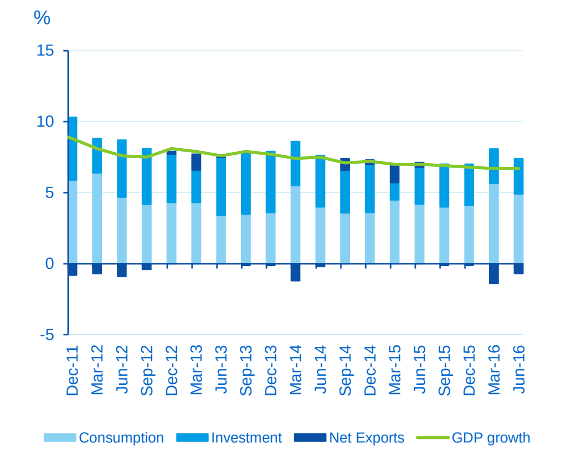


Source: BBVA Research and CPB

2 Growth moderated in Q2 but headwinds still ahead

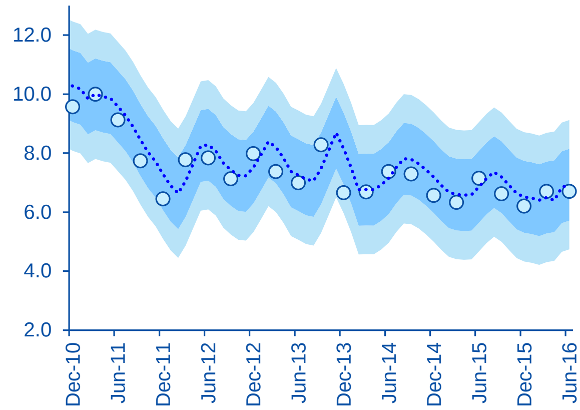
Despite that the authorities have fine-tuned the pace of monetary easing over the concerns of the potential financial risks, growth seems still resilient in the past quarter. In particular, Q2 GDP came out at 6.7% y/y, slightly better than expectations (BBVA MICA model forecasting: 6.6% y/y; Bloomberg consensus: 6.6%) and flat with the Q1 reading. (Figure 2.1 and 2.2)

Figure 2.1
Growth seems resilient in Q2 2016



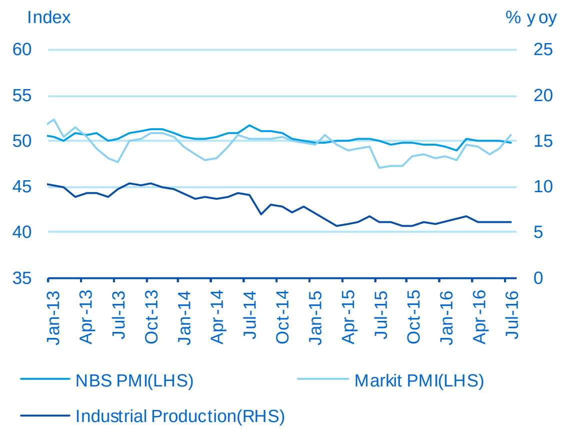
Source: NBS, CEIC and BBVA Research

Figure 2.2
BBVA MICA model for GDP forecasting



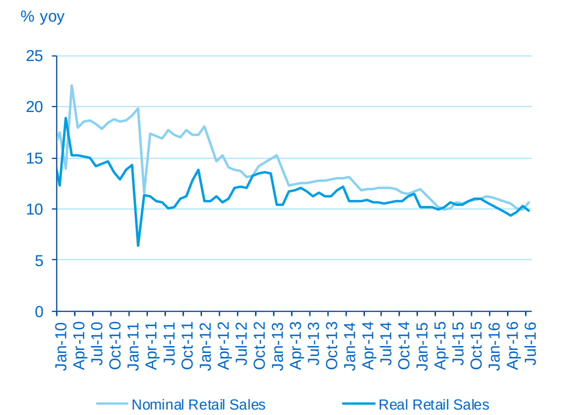
Source: CEIC and BBVA Research

Figure 2.3
PMIs and IP indicate economic slowdown continues



Source: NBS, CEIC and BBVA Research

Figure 2.4
Retail sales maintained a comparatively steady trend …



Source: CEIC and BBVA Research

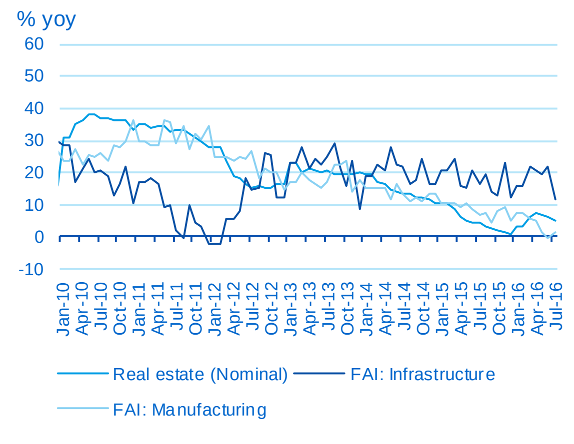
Latest PMIs suggest that growth headwinds still remain. The official NBS PMI of July came at 49.9, marginally below the watershed level and down from the previous month's reading 50.0, which is also below the market expectations (Consensus: 50.0). Caixin China PMI (the former HSBC PMI), however, surprisingly rebounded significantly to 50.6 in July from its last month's reading of 48.6. (Figure 2.3) The large discrepancy between the Caixin PMI and NBS PMI could be due to the fact that the former is based on a survey sample tilting towards SMEs and exports firms, which tends to be volatile.

Other activity indicators have exhibited a similar trend with PMIs. Growth of industrial production decreased to 6.0% y/y in July from 6.2% y/y in the previous month, lower than the market consensus of 6.2% y/y. (Figure 2.3) It indicates that the pressure on the manufacturing sector is still large due to the prevalent overcapacity problem in some upstream industries, such as steel & iron, cement, coal mining, etc. On the demand side, retail sales growth decelerated to 10.2% y/y in July (consensus: 10.5% y/y) from 10.6% y/y in the previous month (Figure 2.4). On the other hand, the growth rate of urban fixed asset investment significantly dipped further to 8.1% YTD y/y in July (Consensus: 8.9% YTD y/y; Prior: 9% YTD y/y). The large drag of investment concentrates on all the three sub-sectors: infrastructure, real estate and manufacturing, in which high-level inventory and pessimistic market expectations keep hindering new investment. In particular, the floods in the eastern regions should be the main reason of infrasturecture investment slowdown this month. (Figure 2.5)

Inflation held up

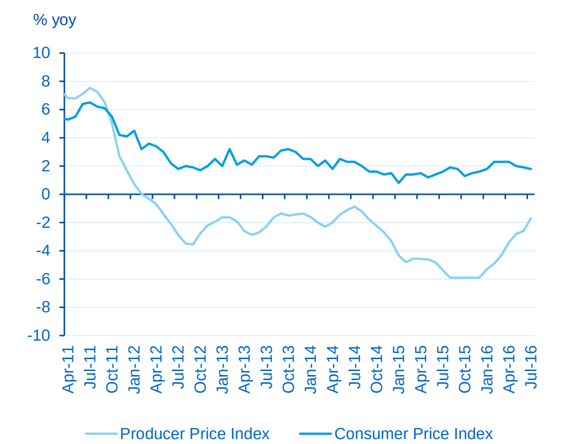
Inflation, especially PPI, picked up significantly. July headline CPI inflation came out at 1.8% y/y, flat with the market consensus and marginally lower than previous reading of 1.9% y/y. The stable growth of CPI was due to the floods in the eastern regions in the recent months, which reduced the supply of some agricultural products (Figure 2.6). The PPI rebounded on sequential terms to -1.7% y/y (consensus: -2%% y/y), significantly increased from -2.6% y/y in the previous month, although their year-on-year growth rates were still in negative territory. The rising PPI was mainly due to the deleveraging process in some certain over-capacity industries, which decelerated the supply thus pushed up the related industrial prices.

Figure 2.5
… while investment was dragged down by the real estate and manufacturing sector



Source: NBS, CEIC and BBVA Research

Figure 2.6
PPI picked up significantly mainly due to the de-leveraging process



Source: CEIC and BBVA Research

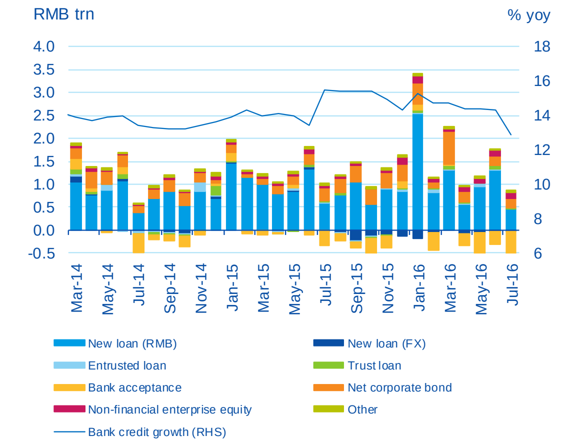
Credit growth decelerated significantly in July

Credit indicators in July decelerated significantly, reflecting the authorities' policy fine-tune by slowing the pace of monetary easing, taking into account of the potential financial risks. In particular, total social financing, a broad gauge of credit including bank loans, bond issuance and shadow banking activities, stalled sharply to RMB 487.9 billion in July from RMB 1,629.3 billion in the previous month (Consensus: RMB 1,000 billion). In addition, M2 growth also dropped to 10.2% y/y (Consensus: 11% y/y) in July, from 11.8% y/y of the previous month. New yuan loans also dipped to RMB 463.6 billion (consensus: RMB 850 billion;

prior: RMB 1,380 billion) (Figure 2.7). Although the credit expansion slowed its pace in July, we still predict more easing measures will be implemented in the rest of this year, in face of the significant slowdown of the activity indicators in July.

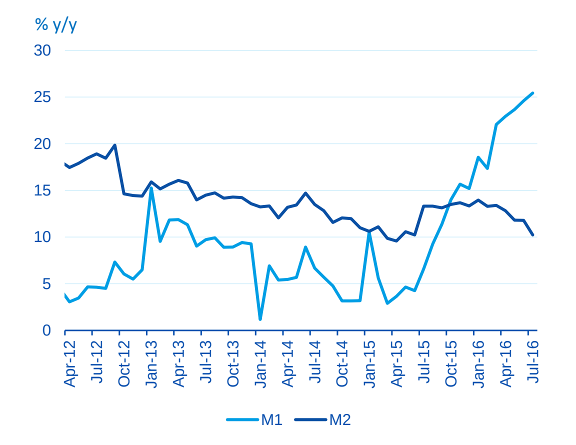
Another interesting issue is the large divergence of M1 and M2 growth in the recent months. As of July, M2 expanded at 10.2% yoy, lower than the annual target of 13% while M1 increased to 24.8% yoy. This reflects in face of economic slowdown, instead of starting new investment, corporates prefer to hoard cash and investing in short-term financial products etc. (Figure 2.8)

Figure 2.7
Credit indicators slowed down significantly as the authorities fine-tuned their easing measures



Source: CEIC and BBVA Research

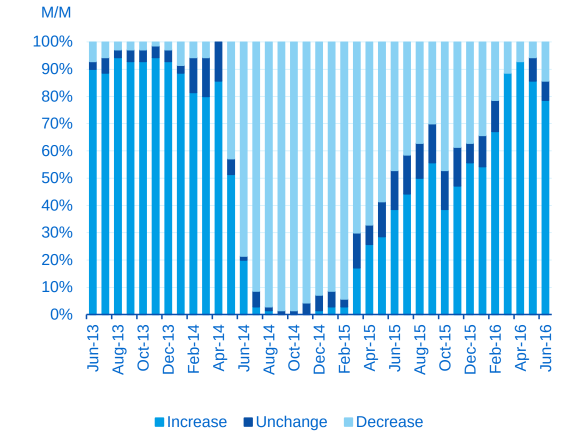
Figure 2.8
Diverging of M1 and M2 growth in the recent months



Source: CEIC and BBVA Research

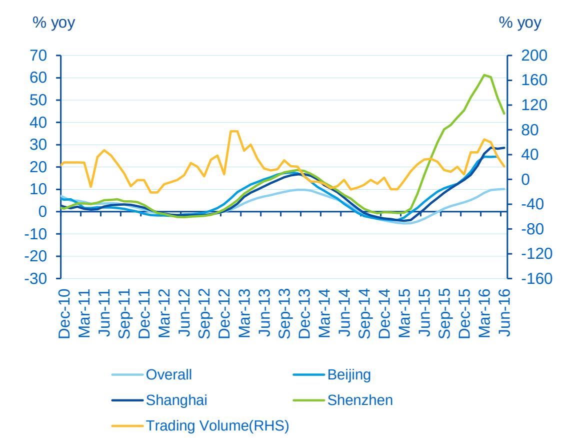
Overheating continued in the property market

Figure 2.9
More cities reported housing price increases in June



Source: NBS and BBVA Research

Figure 2.10
Housing prices declined in some tier-1 cities due to the intervention by the authorities



Source: NBS, CEIC and BBVA Research

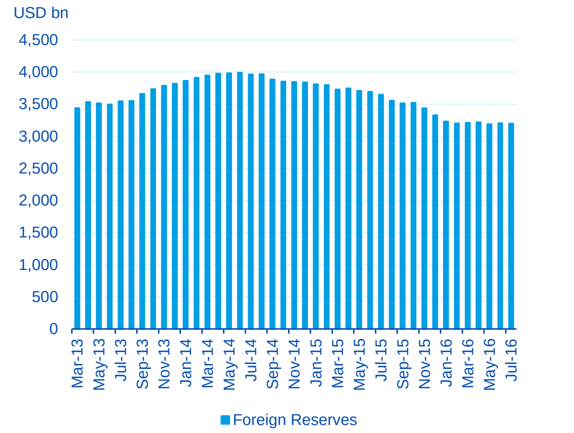
Meanwhile, the property market continued its over-heating in Q2 2016, following the soaring housing prices and transactions in Q1 (Figure 2.5 and 2.6), adding more risks of housing bubbles. In Q2, the number of cities that reported housing price increasing is significantly more than the decreasing number. As such, local governments in a few big cities, especially Shenzhen, have to reinstate some tightening measures on their housing markets to stem the run-up of property prices. (Figure 2.6)

Capital outflow continues and RMB exchange rate depreciated significantly after Brexit

Portfolio outflows continued in July, mainly due to strong headwinds on the external shock of Brexit. Political uncertainty after Brexit may trigger global investors to undergo a reorientation of their portfolio strategies towards safe havens, which could exert further depreciatory pressure on the RMB and aggravate capital outflows. In particular, foreign reserve declined to USD 3,201.1 billion in July from its previous month's reading 3,205.2 USD billion (Consensus: USD 3,200 billion). (Figure 2.7) Taking into account the valuation effect, we estimate the portfolio outflow in July is USD 57.6 billion, compared to USD 40 billion in the previous month.

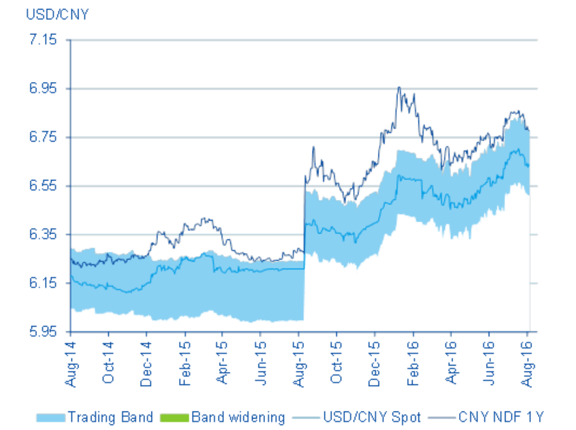
We deem that stable expectation of RMB exchange rate is the key to maintain the capital outflows at an acceptable level. The RMB hovers around a level of almost five-year low against the USD right after Brexit. That being said, the PBoC needs to guard against the rising risk from Brexit and keep capital outflow in check in the coming months.

Figure 2.11
Foreign reserve has been decreasing over time in the past months



Source: CEIC and BBVA Research

Figure 2.12
RMB to USD exchange rate reached historical low after Brexit

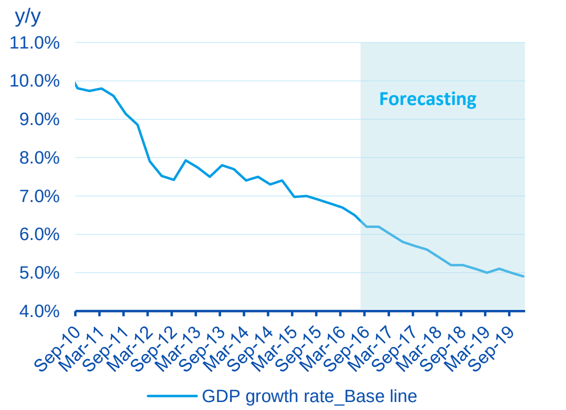


Source: CEIC and BBVA Research

3 Slowdown is set to continue in 2016 and 2017

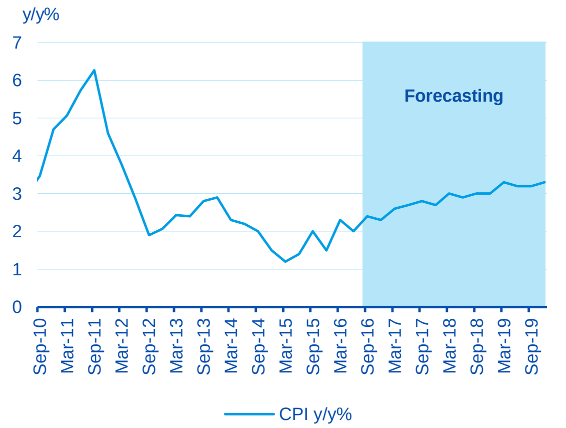
We maintain our 2016 full-year projection at 6.4% and 2017 projection at 5.8%, with the balanced risks going forward. (Figure 3.1) Growth slowdown in 2016-2017 will be led by the deceleration of fixed asset investment (FAI), especially the sharp decline in private FAI. Meanwhile, the long-term growth outlook looks dimmer due to the slow progress of structural reforms in some key areas (in particular SOE reforms). Regarding inflation forecasting, we maintain this year's CPI projection at 2.3% and next year's projection at 2.7%. (Figure 3.2)

Figure 3.1
We maintain our 2016 GDP forecasting at 6.4% and 2017 at 5.8%



Source: NBS and BBVA Research

Figure 3.2
We maintain our inflation predictions unchanged



Source: NBS, CEIC and BBVA Research

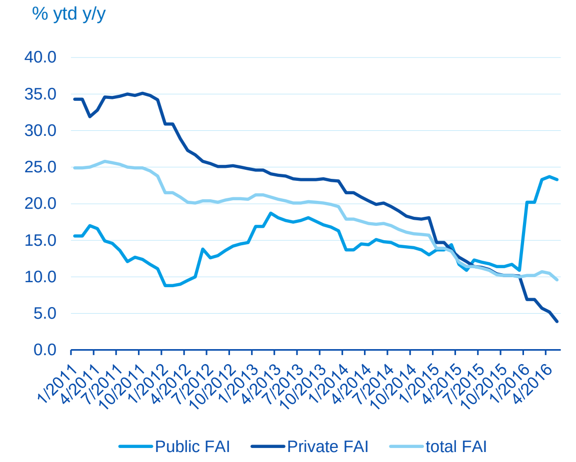
Sharp drop of private investment marks the beginning of deleveraging but FAI deceleration will be the main drag on future growth

Despite the authorities' beefed-up efforts of policy easing, China's fixed asset investment (FAI) has significantly decelerated in the recent months, in particular for FAI by private firms. Such a trend has raised people's concerns widely since FAI by private firms accounts for the lion's share of aggregate investment, 64% as of 2015. We think that the significant drop in private FAI growth mirrors private firms' adjustment of their balance sheets. Thus, decelerating FAI by private firms is likely to usher in China's deleveraging, which is imperative for the debt-laden corporate sector to restore its financial health. (See our recent Economic Watch: Private Investment Slowdown Marks the Start of China's Long-awaited Deleveraging)

The fixed asset investment can be further broken down into three categories: property investment, manufacturing investment and infrastructure investment. Among which, infrastructure investment is mostly funded by the public sector which is still expanding to support growth, while the private FAI decreasing discussed above is mainly concentrating on the manufacturing sector. In addition, the property investment is also lackluster. (Figure 3.4) Despite the recent improvement in the housing 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 property investment, instead, many of them are still taking a wait-and-see attitude.

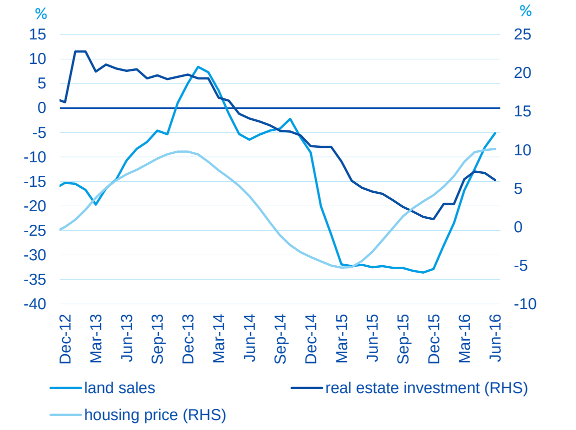
All in all, we expect the authorities' supporting in infrastructure investment will not be able to offset the downward trend in the property and manufacturing investment. As such, fixed-asset investment as a whole is likely to be the main drag on growth over the next couple of years.

Figure 3.3
Since early 2015, private and public investment have been diverging over time



Source: NBS and BBVA Research

Figure 3.4
FAI in property market still afflicted by over-supply problem in tier-2 and 3 cities



Source: CEIC and BBVA Research

Depreciation of the RMB will continue after Brexit

Right after Brexit, RMB to USD exchange rate depreciated significantly to a historical low since 2011. Accumulatively, RMB exchange rate depreciated by 1.2% in June. Although it gradually picked up in the recent week by the authorities' stepped-up measures, the headwinds of RMB depreciation still exist. We forecast that RMB to USD exchange rate will continue its "gradual-depreciation" trend in the rest of 2016 and the year follows.

The primary reason is the persistent divergence between China and US monetary policy. As growth deceleration continues, China needs to stick to its easing stance of monetary policy. In contrast, the US is expected to normalize its monetary policy from the previous QE mode over the next few years. In addition, the RMB depreciation trend could be reinforced by other external shocks such as Brexit which lead to "safe heaven" effect and the selling of emerging market assets including the RMB. In the short run, the Brexit has triggered the global capital flow to US and Japan, leading to the RMB to USD exchange rate depreciating. However, in the long term, we believe that domestic growth, exchange rate policy and economic rebalancing should be the fundamental factors in determining the RMB exchange rate.

To reflect the adverse spill-over effect of Brexit, we modestly adjust our end-2016 projection of CNY/USD to 6.85 from 6.8 previously and also revised our end-2017 projection of CNY/USD to 7.2 from 7.1 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	6.85	7.20

Source: BBVA Research

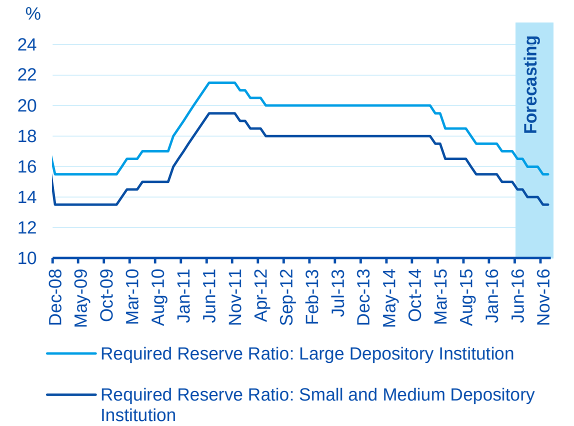
Expansionary monetary and fiscal policy will continue

The authorities shifted their monetary policy stance to be expansionary 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 growth slowdown. 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 throughout the year so as to achieve their growth target.

Taking into consideration of the potential financial risks led by soaring monetary expansion in Q1, the PBoC indicated that it would continue the monetary easing but at a slower pace. Thus, we observe that credit growth slowed down to a certain extent in Q2. But we anticipate the PBoC will reinstate easing measures in the second half of the year, as the growth momentum tapers off again. In particular, we predict another two RRR cuts and one interest rate cut in the rest of this year as Fed delays its rate hikes. (Figure 3.5)

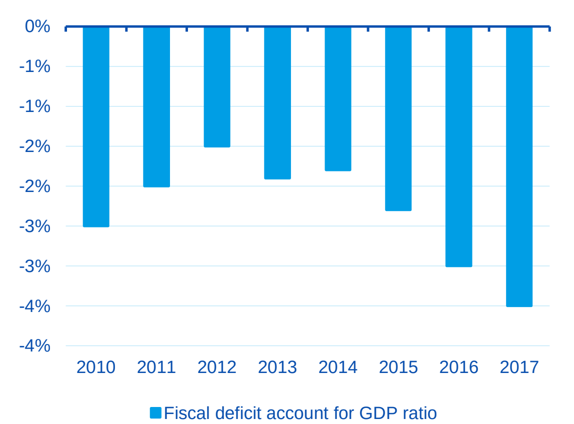
Moreover, a number of unconventional monetary policy tools (namely selective RRR cuts, short-and-medium term liquidity facility, the Central Bank refinancing to commercial banks, etc.) are to be increasingly used as China's monetary policy framework is transitioning toward an "interest-rate-corridor" system.

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

Regarding the fiscal policy, it is expected to play a more important role against the backdrop of significant decline in private investment. The fiscal budget deficit is forecasted to be -3% of GDP in 2016 (Figure 3.6) while the application of regulatory forbearance on local government borrowing could lend additional support to growth.

Regulations on shadow banking activities

Overall leverage in the economy continues to rise as credit growth, measured by Total Social Financing (TSF), outpaces nominal GDP in the first half of 2016. Shadow banking activity has expanded further recently, although there has been notable variation among its components. By categories, assets under management by nonbank financial institutions have increased; there has also been a small upturn in trust loans and entrusted loans in the first half of the year, coinciding with increased lending to local government financing vehicles (LGFVs) and slower growth in corporate bond financing; by contrast, undiscounted bankers' acceptances have experienced a sharp decline in response to tighter regulations.

The rise in overall leverage and further expansion of shadow banking activity are pushing up financial risks. In particular, continued growth of banks' investment receivables is increasing the system's interconnectedness, as well as exposing mid-sized and smaller regional banks to liquidity and credit risks. Thus, the spillover risks from shadow banking activities to banking system are significant. In order to clamp down the risks of shadow banking, the authorities promulgated a series of regulatory policies in the recent months (Table 3.1).

Table 3.1
Recent regulations on shadow banking activities

Date	Key regulatory developments
January 2016	The CBRC steps up scrutiny of banks' bill finance operations by issuing a notice requesting banks to strengthen their internal controls, and thereby reduce risk of misuse of such transactions to circumvent bank regulatory requirements.
March 2016	The CBRC steps up scrutiny of distressed asset management companies to discourage them from engaging in transactions that conceal banks' credit risks through, for example, repurchase agreements. The CBRC issues directive to strengthen risk management practices of trust companies, including by limiting leverage on products for investment in the stock market.
April 2016	The CSRC proposes modifications to risk control indicators of securities firms to help address emerging risks in the industry. State Council reportedly begins one-year crackdown on internet finance platforms, including P2P lenders. PBoC and CBRC issue joint directive enhancing the scrutiny of banks' issuance and discounting of bills.
May 2016	The CBRC issues guidance on banks' loan-beneficiary rights transfers, to curb the practice of banks transferring loans off balance sheet without full risk transfer, and to enhance transparency of NPLs on their books. CSRC proposes to limits on fund companies in setting up subsidiaries.
July 2016	CSRC issues regulation to curb leverage of investments in the bond market by setting a cap on the financing ratios of structured asset management plans that invest in bonds.

Source: BBVA Research and Moody's Quarterly China Shadow Banking Monitor

4 Risks are tilting toward the downside

Downside risks to our base scenario still exist, mainly on the effects of the adverse spillover effect of Brexit as well as the domestic economic slowdown. In particular, risks include: (i) exchange rate depreciation and capital outflows after Brexit; (ii) indebtedness of the corporate sector; and (iii) deteriorating global trade environment which is led by Brexit.

The combination of a potentially strengthening US dollar, Brexit and a slowdown in domestic growth could continue to depreciate RMB to USD exchange rate thus trigger capital outflows. In particular, political uncertainty of Brexit may trigger investors to undergo a reorientation of their portfolio strategies towards safe havens, which could exert further depreciatory pressure on the RMB and aggravate capital outflows. Thus, China's authorities would be faced with a policy dilemma between supporting growth by monetary easing on the one hand, and reducing the risk of abrupt capital outflows on the other.

The second challenge to long-term growth 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.

Finally, one of the main channels through which Brexit could impact China is trade. Despite trade with the UK accounts for a relatively small proportion of China's total trade, the EU is still the country's largest trading partner. China's lackluster export performance will deteriorate further as eroding terms of trade, on the back of a weaker GBP and EUR, results in fewer orders from the China's largest trade partner.

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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