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China Economic Outlook

1ST QUARTER 2017 | ASIA UNIT

01
The global environment improved in the last several months of 2016 and continued improving in early 2017.

02
In China, economic activities continued to gain traction through the fourth quarter, enabling the authorities to meet their full-year target of 6.5-7.0% in 2016.

03
The authorities have recently fine-tuned their policy stance and put more emphasis on maintaining the stability of the exchange rate and housing market.

04
Downside risks include: uncertainties from Trump's policies on China; currency depreciation; indebtedness of the corporate sector and shadow banking

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Closing date: 15 February 2017

1. Global outlook: improved growth with the emerging long-term risks

The global environment improved in late 2016 and continued improving in early 2017. However, the uncertainties of the growth prospect seem to have elevated compared to three months ago. Global GDP is expected to expand by 0.9% q/q in Q4 2016, somewhat higher than the Q3 reading of 0.8%.

The improvement of global growth was mainly driven by developed countries as US economy started to recover in mid-year and the European managed to push up its expansion pace (1.5% y/y) above its potential GDP growth rate. The economic performance varies a lot among Latin American countries. Overall, the global economy grew by 3% in 2016, below the 3.3% reading in 2015, but has trended up throughout the year.

Despite the recent recovery, the growth prospect for 2017 and 2018 is fraught with uncertainties, chief among which is the economic policy of the new US administration. Fiscal stimulus and deregulation measures have been announced in a number of areas, which was positively received by the markets. Since Trump's victory, 10-year US interest rates have risen by 63 basis points to 2.50%, with a global drag effect (both in Europe and in emerging markets). The stock indices have surged globally (+ 6.6% in the USA, + 8.5% in Europe).

However, the rise of protectionist measures (including withdrawal of the TPP trade agreement in Asia, many doubts about the TTIP with Europe and requests for renegotiation of NAFTA, with announcements of possible tariff increases), can seriously damage international trade in the medium-and-long-term and affect confidence in the near future. As for the fiscal impulse, its magnitude has yet to be defined and how it will materialize (greater expenditure on infrastructure or, more likely, tax breaks in corporation tax) remains uncertain. Above all, it can stimulate activity or generate more Inflation, given that the US economy appears to be close to potential growth. Therefore, since the beginning of the year, the optimism is moderating and the markets have been slightly corrected. Going forward, the decoupling between the high uncertainty over economic policy and the low volatility at the aggregate level seems very unlikely.

The magnitude of inflationary pressures is another question to the global outlook. Raw material prices have picked up stronger than expected over past few months, following the agreement of OPEC and the improvement of economic activity. The Brent price was around $ 56 / barrel in early 2017 although we expect a somewhat slower transition to its long-term equilibrium level ($ 60 / barrel, which is to be reached by the end of 2018). The base effects of energy price are pushing annual inflation at rates closer to the inflation targets of central banks. As deflationary risks now seem to give way to inflationary pressures, the monetary policy reactions of central banks need to be watched carefully.

2. Recovery continues with signs of moderation

After a policy-driven pickup in mid-2016, economic activities continued to gain traction through the fourth quarter, enabling the authorities to meet their full-year growth target of 6.5-7.0% in 2016. The soft-landing of the world's second largest economy was mainly due to a number of pro-growth policy initiatives front-loaded last year, which effectively sustained domestic demand amid the gloomy external environment. Moreover, the authorities' persistently easing efforts through the long period of economic downturn, which started with an interest rate cut in late 2014, have provided time and levers for firms to adjust their balance sheets and restore financial strength. Although the deleveraging of the corporate sector is still halfway, a considerable proportion of firms, in particular private ones, have been in a much better position financially than a year ago.

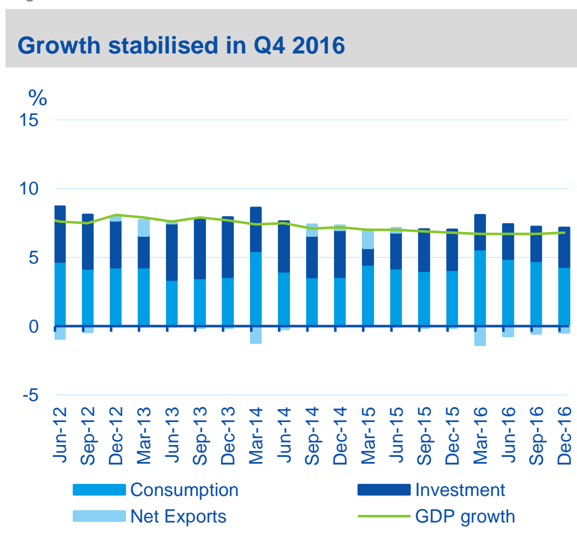
On the other hand, a number of financial fragilities have been aggravated by policy stimulus. Starting from the last quarter of 2016, the authorities had to fine-tune their policy stance in a bid to contain systemic financial risks. That said, the growth prospect is subject to huge uncertainty as some tailwinds of policy stimulus are set to fade away or even be reversed to headwinds. The moderation in growth could be underway as evidenced by slowed PMI outturns at the beginning of the new year.

A soft-landing underpinned by policy stimulus

Q4 GDP edged up to 6.8% y/y from 6.7% in the previous quarter, broadly in line with expectations (Bloomberg consensus: 6.7% y/y; BBVA MICA model forecasting: 6.9% y/y). (Figure 2.1 and 2.2) In the sequential term, GDP grew at 1.8% q/q in Q4, slightly faster than the Q3 reading of 1.7% q/q. For 2016 full year, GDP growth turned out to be 6.7%, meeting the authorities' range target of 6.5%-7.0%.

Figure 2.1

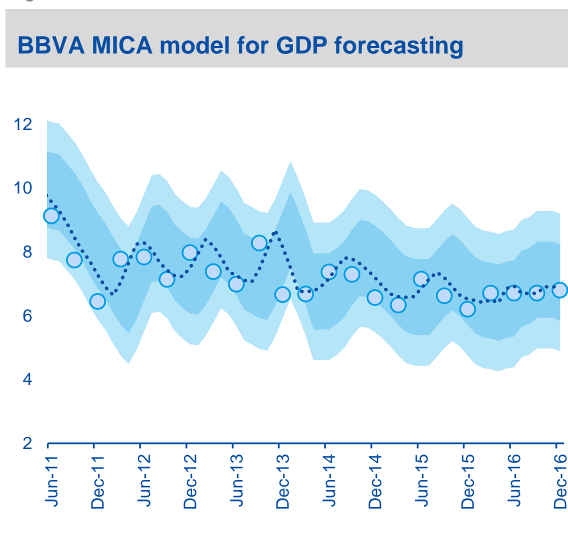
Growth stabilised in Q4 2016



Source: BBVA Research and CEIC

Figure 2.2

BBVA MICA model for GDP forecasting



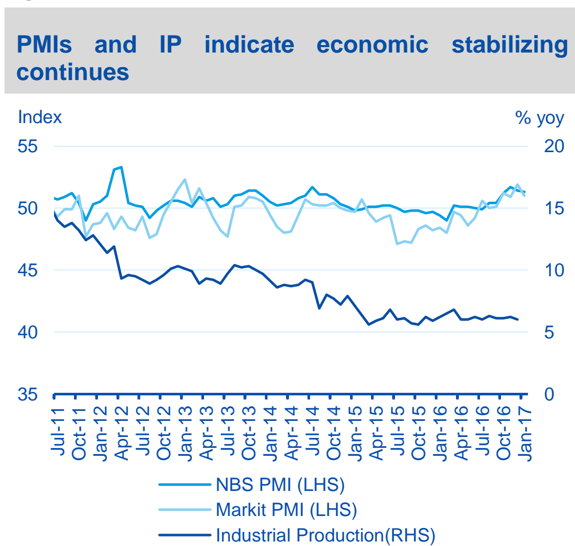
Source: BBVA Research and CEIC

Growth of industrial production in December marginally decelerated to 6% y/y from 6.2% y/y in November (consensus: 6.1% y/y) (Figure 2.3). This indicates that the manufacturing sector is stabilizing, as deleveraging of sectors with over-capacity is still in progress. On the demand side, retail sales picked up from 10.8% y/y of the previous month to 10.9% y/y (consensus: 10.7% y/y), underpinned by strong auto sales. Previously, the authorities offered a full exemption of sales tax for passenger car purchases during the period between October 2015 and December 2016. In addition, the growth rate of urban fixed asset investment dropped marginally to 8.1% ytd y/y from the previous month's reading at 8.3% ytd y/y (consensus: 8.3% ytd y/y). Moreover, private investment, which we have been concerned about, picked up slightly from 3.1% ytd y/y previously to 3.2% ytd y/y. By categories, infrastructure FAI y/y growth dropped significantly due to the high base effect, while manufacturing FAI y/y growth improved significantly this month. Interestingly, real estate FAI y/y held steady in December despite the authorities' tightening of measures on the property market.

However, the PMI outturns at the beginning of this year pointed to a moderated momentum in growth. The official NBS PMI for January declined to 51.3 (Bloomberg consensus: 51.2) from 51.4 in December 2016 while the Caixin China PMI (the former HSBC PMI) decelerated to 51 (consensus: 51.8) from its December reading of 51.9 (Figure 2.3). Apart from the Chinese New Year effects, the decrease in PMI outturns could also reflect weak fundamentals in the Chinese economy. Moreover, the authorities now seem to be taking hold of the monetary policy easing on increasing concerns over the high leverage in the financial sector and the exchange rate stability. That said, in the absence of loosening credit conditions, the recovery, which we believe is being led by firms' restocking could come to an end earlier than expected.

Figure 2.3

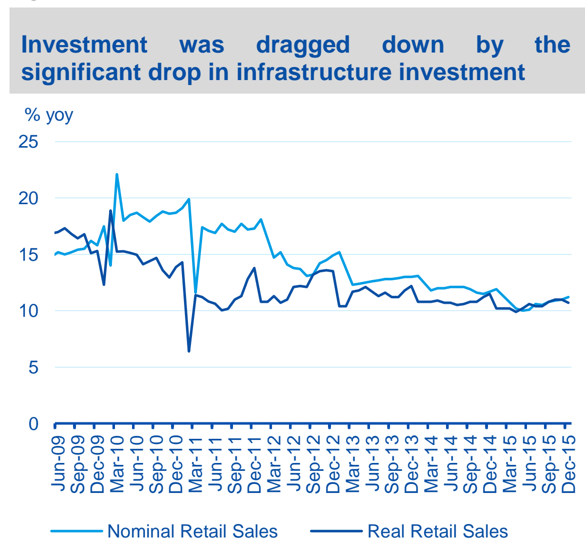
PMIs and IP indicate economic stabilizing continues



Source: BBVA Research and CEIC

Figure 2.4

Investment was dragged down by the significant drop in infrastructure investment



Source: BBVA Research and CEIC

Domestic demand boosted imports but narrowed trade balance

The growth in both exports and imports decelerated in December, which, as a consequence, narrowed the trade balance. In particular, exports dipped by -6.1% y/y in December, significantly below the last month's

outturn of -1.6% y/y and the market expectations (Consensus: -4% y/y). Worse-than-expected exports can be attributed to a continuing sluggish external demand amid the rising uncertainties about global economic prospects. In particular, exports to EU and Japan remained sluggish while exports to US remained relatively resilient. In the meantime, imports dropped to 3.1% y/y in December from 4.7% y/y in November (Consensus: 3% y/y), reflecting that the previous pick-up in imports was not sustainable as domestic demand was dragged by policy tightening on housing market. Altogether, the trade surplus narrowed to USD 40.82 billion in December, compared with USD 44.23 billion in the previous month (Consensus: USD 47.55 billion). (Figure 2.5)

For 2016 as a whole, export growth decelerated from -2.9% in 2015 to -7.7% in 2016, and import growth improved from -14.3% in 2015 to -5.6% in 2016 on the back of recovering energy prices. Thus, the current account to GDP ratio in 2016 reached 2.4%, lower than the previous year's reading of 3%. The shrinking current account to GDP ratio in 2016 indicated the global uncertainties and the weak external demand.

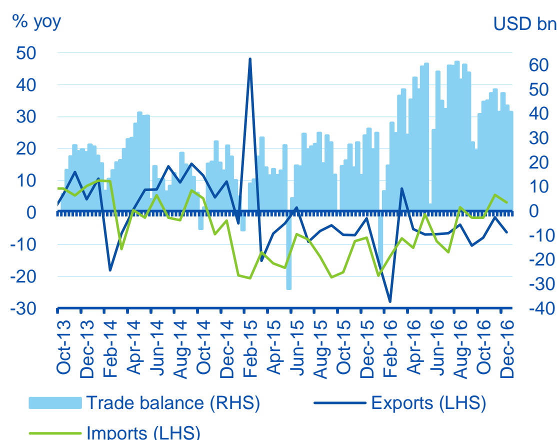
PPI continued its uptrend while CPI inflation was tame

Deflation pressure has disappeared. Headline CPI inflation remained steadily above 2% y/y in the last quarter of 2016 (Figure 2.6) while the PPI picked up significantly to 5.5% y/y in December (consensus: 4.6% y/y) after it turned positive in September. The rising PPI was mainly due to rebounding commodity prices and, to a lesser extent, the deleveraging process in certain industries with over-capacity, which reduced supply and thus pushed up prices.

The return of inflationary pressure is a double-edged sword. On one hand, the positive price signals could stimulate firms to accelerate their production and build up their inventory levels. On the other hand, higher inflationary pressure will limit the authorities' room for policy easing.

Figure 2.5

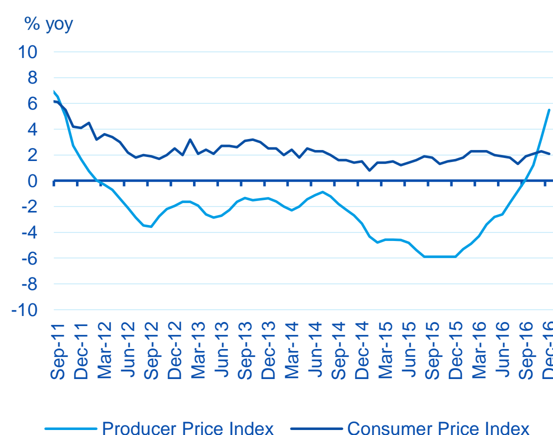
Exports and imports slowed down, leading to narrowing trade balance



Source: BBVA Research and CEIC

Figure 2.6

PPI growth picked up significantly while CPI remains steady



Source: BBVA Research and CEIC

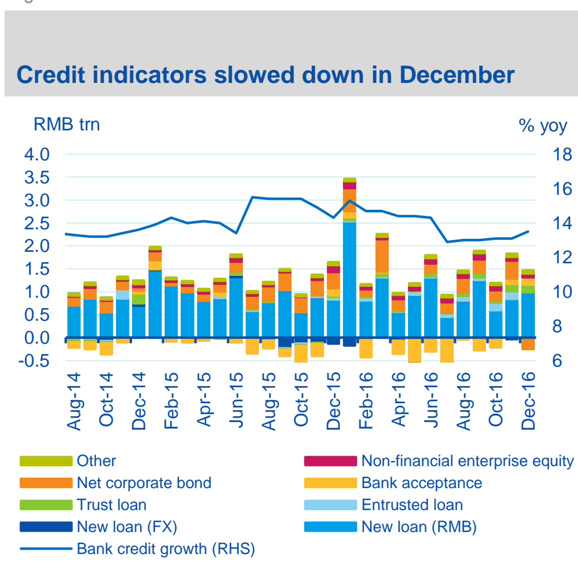
Loosening monetary stance was fine-tuned to neutral

Credit growth and money supply have been steady, underpinned by revived demand in the corporate sector. However, both total social financing (TSF) and M2 growth decelerated slightly in December, indicating that the authorities have deliberately fine-tuned their loosening stance so as to curtail shadow banking activities and cool down the overheated housing markets in a number of cities. (Figure 2.7)

Moreover, the PBoC deliberately guided market interest rates to high levels so as to stem capital outflows and facilitate the deleveraging in China's ballooning financial sector. It will further tighten credit conditions and add more headwinds to growth in the coming months.

Figure 2.7

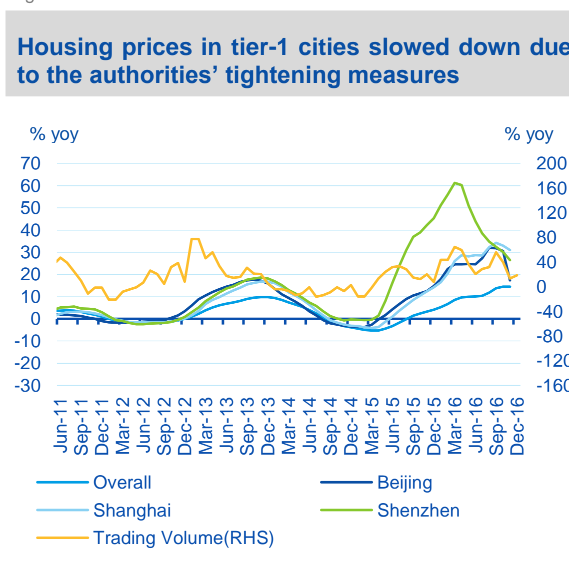
Credit indicators slowed down in December



Source: BBVA Research

Figure 2.8

Housing prices in tier-1 cities slowed down due to the authorities' tightening measures



Source: BBVA Research

No hard landing in housing market

The property market started to cool down after the authorities implemented a flurry of tightening measures in Q4 2016. The measures include increasing the down-payment rate, restricting second home purchases and expanding the land supply, etc. As a result, the trading volume of property has stagnated while price growth of residential property in tier-1 cities including Beijing, Shanghai and Shenzhen decelerated substantially. (Figure 2.8)

The good news is that the authorities' tightening efforts have not led to an abrupt correction in the property market nationwide. The housing prices in most of cities continued to rise at a moderate pace. Moreover, investment in the real estate sector still registered positive growth in Q4, which could help the real estate sector and the entire economy to engineer a soft landing in the coming years.

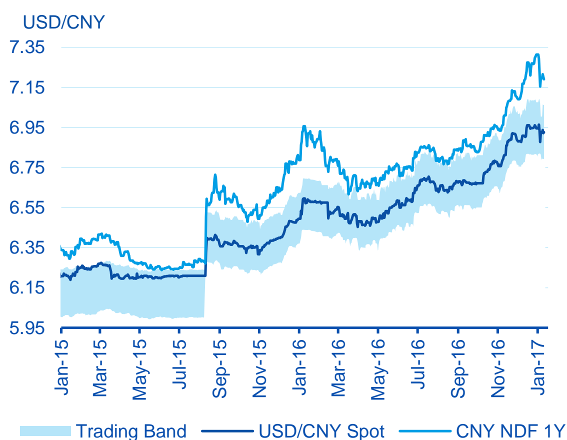
Volatile RMB and continuing capital outflows

Just like other currencies, the RMB has experienced large up-and-downs after the US presidential election. The USDCNY was once very close to the level of 7.0 toward the end of 2016 but thereafter it rebounded by around 2% as the impact of the advent of President Trump faded. (Figure 2.13)

In the meantime, funds continued to flow from China as evidenced by the persistent decline in foreign reserves. In particular, foreign reserves fell below USD 3 trillion in January despite the relatively favorable valuation effects of the softened USD. As a response, the PBoC has continuously deployed new measures to limit capital outflows and attract more capital inflows. (Table 1) Looking ahead, averting a vicious circle of currency depreciation and capital flight is set to remain at the top of the authorities' agenda (Figure 2.14).

Figure 2.9

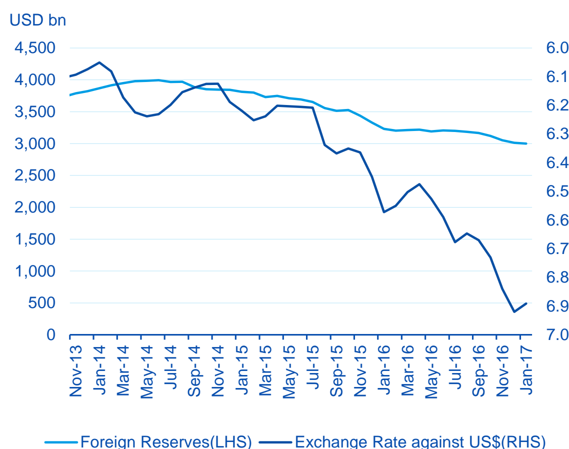
CNY appreciated sharply, due to PBoC's intervention and pendulum of DXY in January



Source: BBVA Research and CEIC

Figure 2.10

Foreign reserves have been decreasing in the past months as RMB depreciation continued



Source: BBVA Research and CEIC

Table 1

Selected measures to "encourage inflows and restrict outflows"

Time	Measures
October, 2016	The PBoC forbade Chinese residents to use UnionPay to buy insurance except for the tourism-related insurance. Moreover, each UnionPay transaction cannot be more than USD 50,000.
November , 2016	The SAFE tightened the approval procedures of outward FDI by domestic firms. Domestic firms making OFDI more than USD 5 million must report to SAFE (compared with USD 50 million threshold previously).
January, 2017	Starting from January 1, 2017, the PBoC requires individuals to reveal their usage when exchanging FX, although the USD 50,000 quota per year remains unchanged.
January , 2017	Starting from July 2017, banks and other financial institutions in China are required to report all domestic and overseas cash transactions of above RMB 50,000 (around USD 7,201), compared with RMB 200,000 previously. In addition, banks need to report any overseas transfers by individuals of USD 10,000 or more.
January, 2017	The State Council promulgated a series of policies to encourage foreign investment to China, including the creation of an environment for fair competition for foreign investors etc.

Source: BBVA Research and the website news

3. The authorities are poised for lower growth

Due to the recent pickup in growth momentum, we have slightly raised our 2017 growth projection to 6.0% from 5.8% previously while keeping our 2018 growth projection at 5.2% (Figure 3.1). We maintain our assessment that China's economy remains on its slowdown trajectory in the medium term due to rising financial fragilities, the slow progress of structural reforms and the shrinking working-age population.

Our 6.0% growth projection for 2017 is below the market consensus (Bloomberg consensus: 6.5%). We envision that policy support of this year will be weaker than that of last year thanks to both the expiration of some stimulus measures and the authorities' growing concerns of rising financial fragilities. For example, the exemption of sale tax for passenger car purchases, which substantially boosted the auto market last year, has expired from at the start of 2017. After signs of housing bubbles emerged in Q3 2016, the authorities started to curtail the growth of mortgage loans and reinstate the restriction of second home purchase in a number of cities.

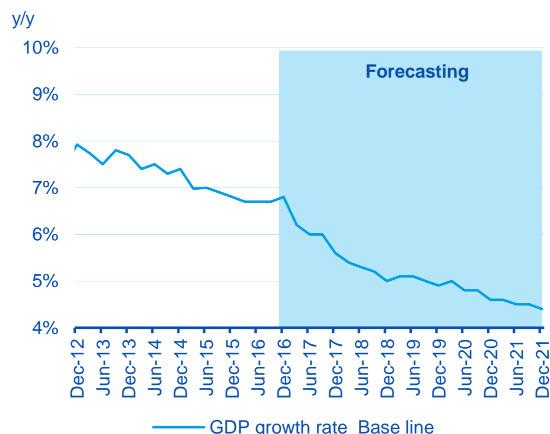
On the front of monetary policy, the central bank has indeed fine-tuned its policy stance and guided the market interest rates to a higher level to mitigate the pressure of currency depreciation as well as curbing shadow banking activities of non-banking financial institutions. The authorities also vowed to implement tougher regulations to curb the expansion of China's ballooning financial sector, which in 2016 accounted for around 8.4% of GDP, significantly higher than many countries like the US (7.2%), Japan (4.4%), South Korea (2.3%) and Germany (4.1%).

More importantly, the authorities have indicated a greater tolerance of the lower growth rate in the recently concluded Central Economic Working Meeting (CEWM). The communique of the CEWM shows that the authorities will place a lot of emphasis on maintaining financial stability while downplaying the importance of headline growth rate. We anticipate that the authorities will lower their official growth target to 6.0-6.5% in 2017, which is to be announced at the National Congress Meeting in March.

Regarding inflation, we maintain this year's CPI projection at 2.7% (Figure 3.2). We predict that CPI will have a steady growth this year, as both the supply and demand side are expected to remain relatively stable. Moreover, the transmission from soaring PPI growth to CPI could be limited as final demand is expected to get less policy support. Meanwhile, the significant improvement in PPI is broadly in line with our expectations, and is set to continue through the next couple of quarters.

Figure 3.1

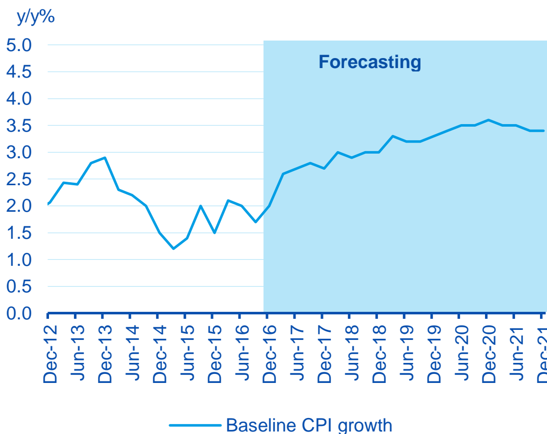
We have raised our 2017 GDP forecasting to 6.0% from 5.8% previously



Source: BBVA Research and CEIC

Figure 3.2

We maintain our CPI forecasting at 2.7% this year



Source: BBVA Research and CEIC

RMB will continue its gradual depreciation trend in 2017 while the floating regime will be the ultimate choice

Cumulatively, the RMB has depreciated by 7.0% in 2016, extending the cumulative depreciation of the currency to 12% since the one-off devaluation of August 2015. Although it gradually picked up in the first few days of the new year, thanks to the authorities' stepped-up intervention measures, the headwinds of RMB depreciation still exist in 2017. A mild depreciation of 4-5% against the USD envisaged in our base scenario will bring CNYUSD to around 7.2 by the end of 2017. (Figure 3.5)

As the depreciation is primarily driven by domestic forces rather than external shocks, our 2017 projection of the exchange rate is, to a certain extent, immune to the performance of the USD. That being said, a stronger-than-expected USD can introduce more volatility to the RMB exchange rate; accelerate the depletion of foreign reserves and prompt China's authorities to implement more restrictive measures on capital flows. Nevertheless, the authorities will be reluctant to allow the depreciation to exceed 5% to guard against market panic.

We believe that the authorities will finally achieve the "clean float" they intended, but failed, to achieve in the first place when they devalued the "redback" in August 2015. The floating of the RMB could take place in the second half of 2018. Although a certain degree of currency overshooting is inevitable (we have estimate that the CNYUSD could reach the level of 7.8 sometime late 2018), it will ultimately go back to the natural equilibrium level. Thus, the final floating of the exchange rate regime will help China's economy restore its external balance and push up the exchange rate in the long run.

Expansionary fiscal policy will continue while the monetary stance becomes more prudent

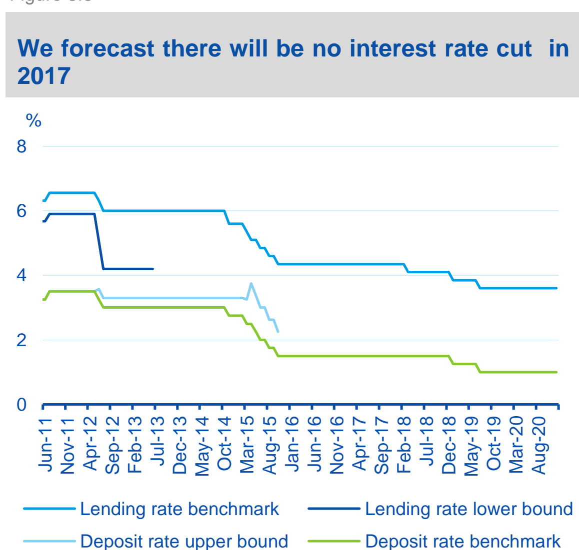
The rising potential financial risks and the pressure of currency depreciation limit the loosening of monetary policy. The PBoC now tends to guide market interest rates to a higher level so as to facilitate the deleveraging of the financial sector. All in all, the monetary policy stance will remain neutral in 2017 (Figure 3.5).

The fiscal policy is expected to play a larger role in growth-boosting. The fiscal policy has already displayed a clear signal of fiscal easing in 2016. The fiscal budget of 2016 was -3%. And the actual fiscal deficit to GDP ratio was -3.8%, although the government-released ratio was still -3%, thanks to the authorities' accounting adjustment by the budget stabilizing fund and government's carry-over fund, etc. Looking ahead, we predict a more expansionary fiscal budget in the following year, which could reach -3.5% (Figure 3.6).

Moreover, the thrust of fiscal expansion is expected to shift to reduce firms' tax rates and employment cost. It is reported that the authorities are considering to further lower the total payroll tax (in China which includes pension fund, medical insurance, and unemployment insurance) and the VAT tax rates.

Figure 3.5

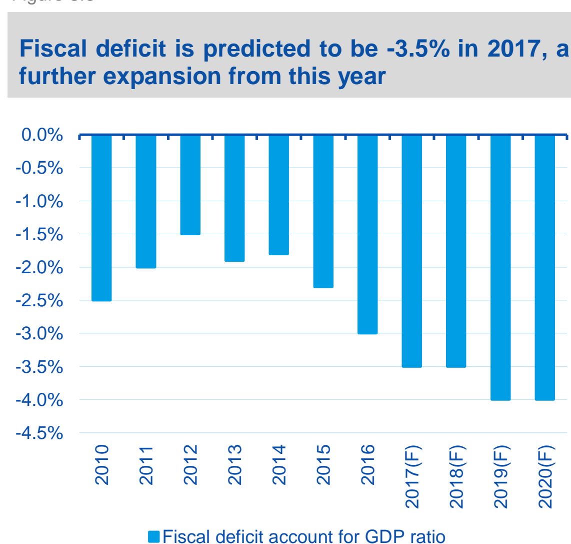
We forecast there will be no interest rate cut in 2017



Source: BBVA Research and CEIC

Figure 3.6

Fiscal deficit is predicted to be -3.5% in 2017, a further expansion from this year



Source: BBVA Research and CEIC

Table 3.1

Baseline Scenario

	2016	2017 (F)	2018 (F)	2019 (F)	2020 (F)	2021 (F)
GDP (%, YoY)	6.7	6.0	5.2	5	4.8	4.5
Inflation (average, %)	2.0	2.7	3	3.3	3.5	3.5
Fiscal balance (% of GDP)	-3	-3.5	-3.5	-4	-4	-4
Current account (% of GDP)	2.5	2.3	2.4	2.5	2.5	2.5
Policy rate (%)	4.35	4.35	4.1	3.6	3.6	3.6
Exchange rate (CNY/USD)	6.95	7.3	7.8	7.3	7	7

Source: BBVA Research

4. Economic uncertainties under the US President Trump

The largest global uncertainties of 2017 are from the potential policies to be applied by newly elected US President Donald Trump. Downside risks in China to our base scenario include: (i) uncertainties from Trump's policies on China; (ii) continuing currency depreciation and capital outflows; (iii) indebtedness of the corporate sector; and (iv) shadow banking activities.

First, the market believes that trade wars between the US and China might be unavoidable under the new US President Donald Trump. Trump has pledged to use "every lawful presidential power to remedy trade disputes" with China, including tariffs. He once broached a tax of 45% on Chinese imports, then denied bringing it up. Moreover, Trump has expressed interest in labelling China a currency manipulator. Although it's still far from clear how plans will shape up under Trump, who on the campaign trail blasted trade deals with China that generated record U.S. deficits, what is clear is China will retaliate against any protectionist steps by Trump, for instance, through the World Trade Organization (WTO).

China could retaliate against Trump would be to allow the RMB to free-float. If the U.S. slapped punitive trade tariffs on products deemed important to China's massive working-class labour market, China could weaken the currency and make it impossible for U.S. competitors to compete on price outside of the U.S. However, China is currently looking for a compromise solution, arguing that more can be gained by the two countries working together than by engaging in a trade war, as Chinese President Xi Jinping said in Davos. But it is clear that the authorities will not capitulate to U.S. pressure if Trump actually triggers it.

In addition, financial risks are likely to increase as more corporate defaults occur and as the bank non-performing loan ratio continues to rise with the advance of the deleveraging process. Defaults have now spilled over to state-owned enterprises (SOEs) which were long deemed to be safe assets with the government's implicit guarantees. The large-scale corporate defaults might lead to another round of turbulence in financial markets, especially the bond market. Moreover, shadow banking is growing rapidly, thriving on regulatory arbitrage and prevalent financial repression. Although the authorities continue to implement regulatory measures, off-balance sheet lending through banks' so-called "debt receivables" and convoluted borrowing structures by local government financing vehicles (LGFVs) have created a system that is rather murkier than before. In particular, they are carried on by obtaining bridging loans from banks, which were more straightforward than using LGFVs to borrow from shadow banking institutions.

5. Tables

Table 5.1

Macroeconomic Forecasts: Gross Domestic Product

(Annual average, %)	2012	2013	2014	2015	2016	2017
United States	2.2	1.7	2.4	2.6	1.6	2.1
Eurozone	-0.8	-0.2	1.1	1.9	1.6	1.5
Germany	0.7	0.6	1.6	1.5	1.8	1.5
France	0.2	0.6	0.7	1.2	1.2	1.3
Italy	-2.9	-1.7	0.2	0.6	0.7	0.9
Spain	-2.9	-1.7	1.4	3.2	3.3	2.5
United Kingdom	1.3	1.9	3.1	2.2	1.9	0.6
Latam *	2.8	2.8	0.7	-0.4	-1.3	1.5
Mexico	3.8	1.6	2.2	2.5	1.8	2.2
Brazil	1.9	3.0	0.1	-3.8	-3.0	0.9
Eagles **	5.3	5.4	5.3	4.6	4.8	4.9
Turkey	2.1	4.2	3.0	4.0	2.7	3.5
Asia Pacific	5.8	5.8	5.6	5.5	5.5	5.1
Japan	1.7	1.4	-0.1	0.6	0.6	0.8
China	7.8	7.8	7.3	6.9	6.6	6.0
Asia (ex. China)	4.3	4.3	4.2	4.3	4.4	4.5
World	3.5	3.3	3.4	3.2	3.0	3.2

* 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: 4 November 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	1.2	2.0
Eurozone	2.5	1.4	0.4	0.0	0.2	1.4
Germany	2.1	1.6	0.8	0.1	0.3	1.6
France	2.2	1.0	0.6	0.1	0.2	1.3
Italy	3.3	1.2	0.2	0.1	-0.1	1.1
Spain	2.4	1.4	-0.1	-0.5	-0.3	1.7
United Kingdom	2.8	2.6	1.5	0.1	0.7	2.2
Latam *	7.7	9.4	12.1	17.4	33.1	59.2
Mexico	4.1	3.8	4.0	2.7	2.8	3.5
Brazil	5.4	6.2	6.3	9.0	8.9	5.1
Eagles **	6.1	6.1	5.0	5.0	4.4	4.6
Turkey	8.9	7.4	8.2	8.8	7.7	7.0
Asia Pacific	3.8	3.8	3.1	2.2	2.4	3.0
Japan	-0.1	0.4	2.7	0.8	-0.1	0.8
China	2.6	2.6	2.0	1.4	2.0	2.7
Asia (ex. China)	4.7	4.7	4.1	2.9	2.7	3.3
World	4.4	4.1	3.8	3.8	4.9	7.2

* 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: 4 November 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	0.90	0.90
EUR-USD	1.29	1.33	1.33	1.11	1.11	1.11
GBP-USD	1.59	1.56	1.65	1.53	1.34	1.22
USD-JPY	79.77	97.45	105.82	121.07	107.85	111.75
USD-CNY	6.31	6.20	6.14	6.23	6.63	7.00

Forecast closing date: 4 November 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	0.75	1.25
Eurozone	0.75	0.25	0.05	0.05	0.00	0.00
China	6.00	6.00	5.60	4.35	4.35	4.35

Forecast closing date4 November 2016.
Source: BBVA Research and IMF

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