BBVA | Research

China Economic Outlook

2nd QUARTER 2017 | ASIA UNIT

Contents

Closing date: **27 April 2017**

1. Global outlook: growth is accelerating, with emerging long-term risks

Global GDP growth in the first quarter stood at 1.0% Q/Q, above the average level of 0.8% Q/Q since 2011. Behind this growth acceleration are the general improvements in confidence, the rebound of global trade, as well as monetary and fiscal stimulus in China. The performance of advanced countries remains positive: the US recovery appears firm while the European economy runs at a level above its potential.

The good performance of global economy is accompanied by further clarification of the US outlook. Now it seems that both anticipations of quick inflation pickup associated with prospective fiscal impulse, and projections of a rapid drift towards protectionism have been reduced, or at least being delayed. However, Trump's administration's failure to reform the healthcare system has highlighted the difficulties in pushing ahead other initiatives, such as those related to tax cuts or the infrastructure spending plan, and therefore reduced the likelihood of strong growth momentum in the short term.

Financial markets have remained calm in recent months, registering a low volatility despite high uncertainty. In this context, central banks are progressing gradually in the process of normalizing monetary policy. The Fed, which leads this process, maintains its gradual exit message which led us to project two additional interest rate hikes in the remainder of this year and another two hikes in 2018. At the same time, the Fed has started the discussion regarding how to tackle the third phase of the exit strategy, namely the reduction of its balance. We expect that it will not happen until next year and will be implemented in a passive way. The ECB is also more optimistic about growth, but still not very confident on the inflation side and will lag behind the Fed in terms of the exit pace. Looking ahead, the normalization of monetary policies is expected to increase financing costs globally.

All in all, our growth forecasts for 2017-18 are revised only marginally due to a good start of the year in Eurozone and China. We maintained our growth forecasts at 2.3% this year and 2.4% in 2018, due to the prospective acceleration of investment. Consequentially, our new growth rates of global growth are raised to 3.3% and 3.4% for 2017-18, both of which are 0.1 percentage point above our previous projections.

Risks are still biased downwards. On top of uncertainties associated with prospective measures implemented in the US, especially on Trump administration's trade policy, the electoral results in France or Italy also grab investors' concerns due to their implications for the stability of the euro area if the worst scenario, albeit still very unlikely, is to materialize. Other risks include the negotiations on Brexit (which have not started well), the multiple geopolitical risks or the ones associated with the normalization of monetary policy in major central banks, especially in the US.

2. Strong growth momentum dominates policy headwinds

The current economic recovery has proven stronger and more resilient than we previously expected. Despite the authorities' stepped-up efforts to cool down the property market, tighten monetary policy and curb shadow banking activities, Q1 growth accelerated to 6.9% YoY, beating market expectations (consensus: 6.8% YoY). With such a good start, 2017 annual growth rate would not deviate much from the newly set official target of around 6.5%.

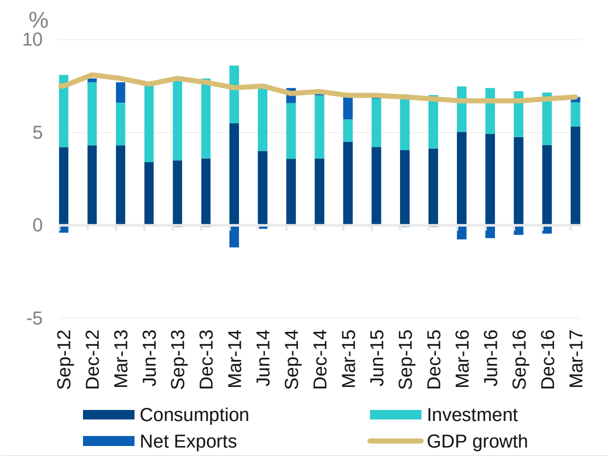
The resilience of the current recovery might derive from two factors: first, it occurs in the context of a global trade recovery. As such, the improved external environment gives an additional impetus to China's growth. Second, deleveraging has been going on for quite a few years in certain industries, especially in the private sector. Now a considerable proportion of firms are in a better position financially than they were two or three years ago.

Nevertheless, the ongoing recovery has mainly driven by large doses of policy stimulus rather than the supply-side reform as the authorities claimed. On the contrary, the authorities' have to rentlessly deploy tightening measures in the property market and the shadow banking sector so as to address the fast-rising financial vulnerabilites and defuse systemic risks, which in essence stem from the overuse of policy stimulus. These tightening efforts will unavoidably bring strong headwinds to growth in the second half of the year.

Rebound is broad-based and in full swing

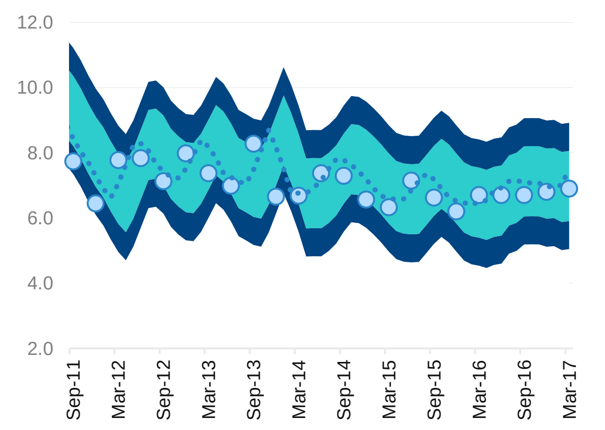
Q1 GDP edged up to 6.9% YoY from 6.8% YoY in Q4 last year, beating market expectations (Bloomberg consensus: 6.8% YoY; BBVA MICA model forecasting: 6.9% YoY). (Figures 2.1 and 2.2).

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

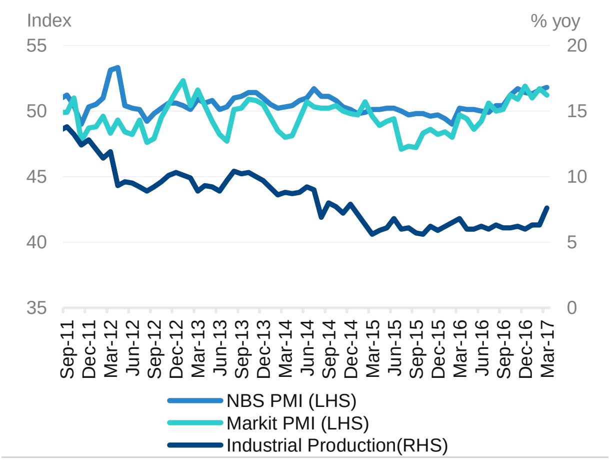
Seperately, growth of industrial production in March jumped to 7.6% YoY from 6.3% YoY in January-February (consensus: 6.3% YoY) (Figure 2.3), underpinned by the improvement of the manufacturing sector whose output accelerated to 8.0% YoY in March compared with 6.9% in January-February. The aggregate output of the mining sector also rebounded to -0.8% YoY from -3.6% previously. The continuing recovery has reinforced firms' confidence and prompted them to accelerate production. Moreover, firms' profitability has also picked up of late, in particular for the upstream industries. (Figure 2.4)

The demand side picked up again in March after a lull at the turn of the year. In particular, retail sales growth picked up from 9.5% YoY in January-February to 10.9% YoY (consensus: 10.3% YoY). (Figure 2.5) By category, auto sales in March posted better-than-expected growth of 8.6% YoY despite the recent expiry of the tax exemption for passenger car purchases.

Growth in urban fixed asset investment also increased to 9.2% YTD YoY in March from the previous figure of 8.9% YTD YoY (consensus: 8.3% YTD YoY). Moreover, private investment, which we have been concerned about, picked up to 7.7% YTD YoY in March from 6.7% YTD YoY previously. By category, infrastructure FAI growth remained steady although it dropped to 23.5% YTD YoY in March from 27.4% YTD YoY in January-February. FAI in the manufacturing sector continued to improve in March, to 4.9% compared with 3.8% in January-February. Interestingly, real estate FAI YoY held steady, despite the authorities' tightening of measures on the property market. (Figure 2.6)

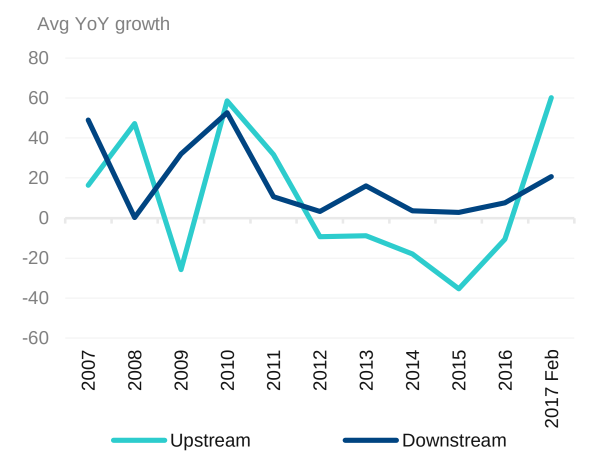
All in all, the latest indicators of economic activity show signs of significant improvement on both the supply and the demand side. The impulse of current recovery seems stronger and more persistent than expected.

Figure 2.3 PMIs and IP indicate that economic stabilisation continues



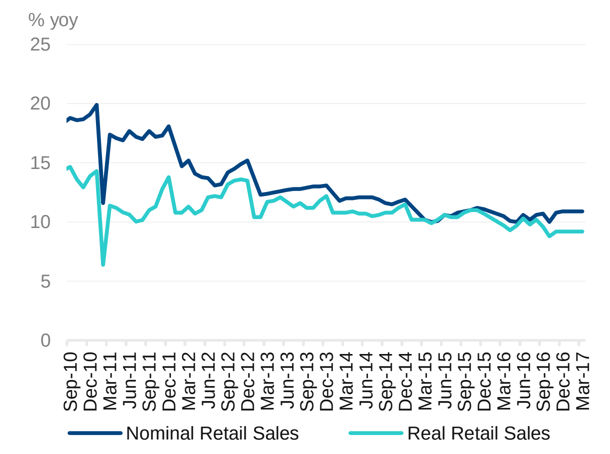
Source: BBVA Research and CEIC

Figure 2.4 Profit in the upstream sector rebounded significantly



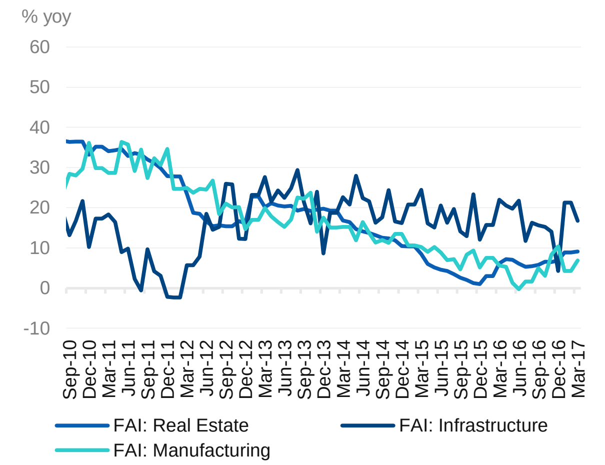
Source: BBVA Research and CEIC

Figure 2.5 Retail sales have been steady



Source: BBVA Research and CEIC

Figure 2.6 Manufacturing investment picked up in March

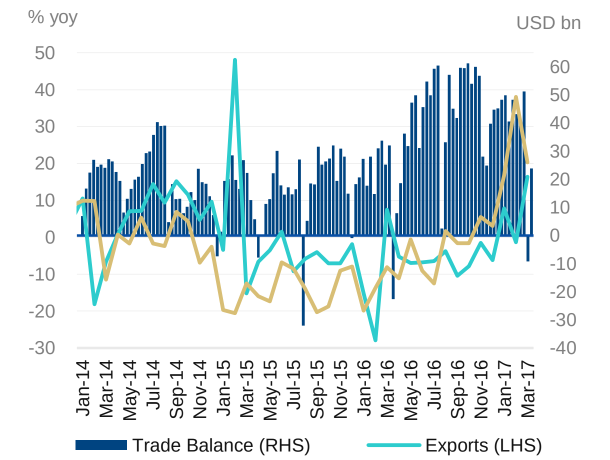


Source: BBVA Research and CEIC

Exports were boosted by the improved external environment

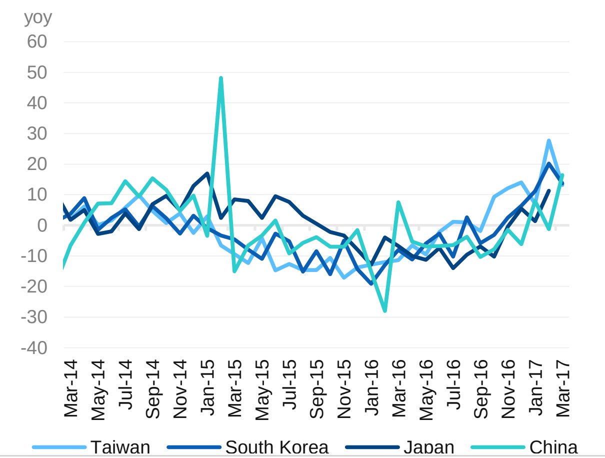
China's trade data in March are in line with the global trade recovery. In USD terms, imports in March registered a year-on-year growth of 20.3% (versus consensus: 15.5% YoY; February: 38.1% YoY) thanks to buoyant domestic demand. (Figures 2.7 and 2.8) More importantly, export growth in March accelerated to 16.4% YoY (consensus: 4.3% YoY) from a sluggish -1.3% in February. As a result, the balance of trade turned positive again in March, at USD 23.9 bn compared with February's deficit of USD -9.2 bn. For the first quarter as a whole, exports and imports grew by 8.3% YoY and 24.1% YoY respectively, while the trade surplus in the first quarter stood at USD 66 bn.

Figure 2.7 Both exports and imports registered strong growth in the first quarter



Source: BBVA Research and CEIC

Figure 2.8 China's exports are finally in step with those of other major exporters



Source: BBVA Research and CEIC

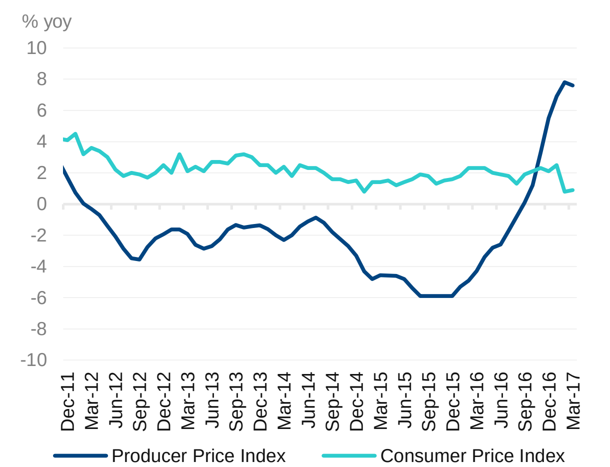
Good news also came from the country's largest trading partner, the US. President Trump seems to have abandoned his campaign rhetoric of accusing China of currency manipulation after his meeting with China's President Xi. Now the Trump administration seems ready to start a series of bilateral negotiations (embodied in the 100-day plan) to correct the US' huge trade deficit with China. President Trump even implies that the US is willing to soften its previously firm stance on the bilateral trade relation in exchange for China's important support on certain geopolitical issues. In conclusion, the eased tension between the US and China could largely benefit China's external sector and introduce additional upward surprise to our GDP projection for this year.

Gap between CPI and PPI remained

CPI and PPI have shown quite different dynamics in the first quarter. Headline CPI inflation was sluggish in February and March while the PPI registered its record high of 7.8% in February since 2008 before it moderated to 7.6% YoY in March. (Figure 2.9) It was mainly dragged down by weak food prices, while non-food prices steadily edged up. It remains to see whether sluggish food prices are transitory or not. In this respect, we suspect that the fine-tuning monetary policy has exerted certain downward pressure on food prices. On a positive note, inflation risk seems to be tamed this year although we expect food prices to rise up gradually in the coming months (Figure 2.10).

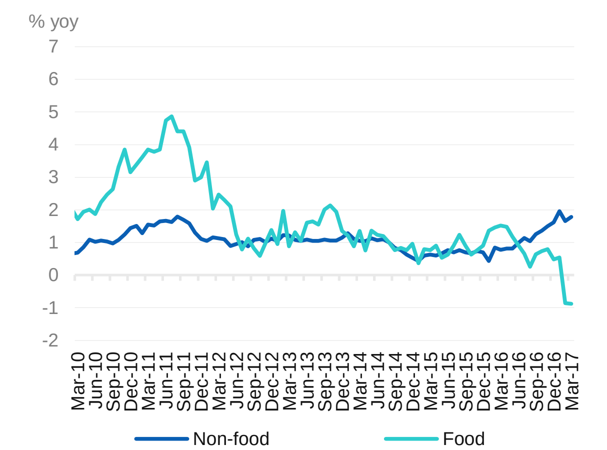
The rising PPI was mainly due to rebounding commodity prices and, to a lesser extent, the deleveraging process in certain industries with over-capacity, which reduced supply and thus pushed up prices. As the impulse of commodity prices spike seem to recede of late, the Feberary outturn of PPI could be the peak within the year. Looking ahead, CPI and PPI could show further convergence in the remainder of the year.

Figure 2.9 The gap between CPI and PPI has somewhat narrowed in March



Source: BBVA Research and CEIC

Figure 2.10 Tamed CPI is mainly due to sluggish food prices



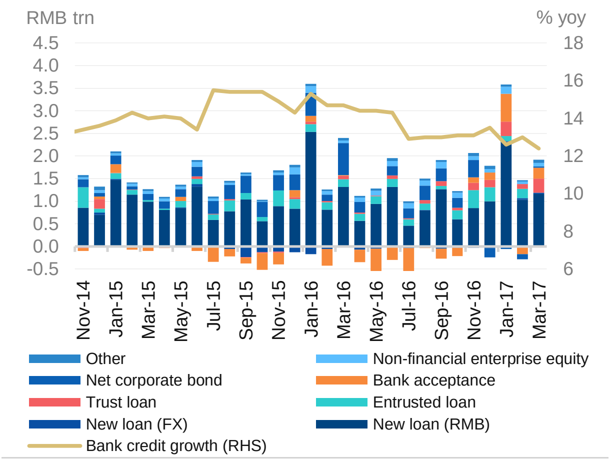
Source: BBVA Research and CEIC

Prudent monetary policy and tight regulations start to effect

The authorities adjusted their monetary policy stance at the end of 2016 from accommodative to prudent. In practice, the PBoC even guided market interest rates to high levels so as to stem capital outflows and facilitate the deleveraging in China's ballooning financial sector. The effects of the policy adjustment started to be seen in the first quarter as both credit growth and the growth in the money supply slowed significantly. (Figures 2.11)

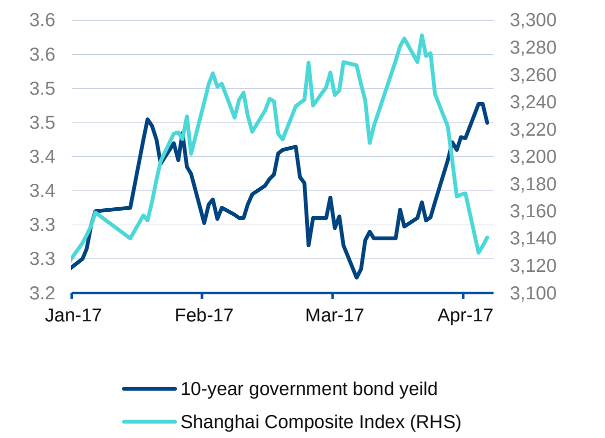
However, the improved growth prospects have increased firms' demand for funds. In the face of tightening credit conditions, many firms have to resort to the shadow banking sector to meet their financing needs. As a result, trust loans, entrusted loans and bank acceptance bills, which are important forms of credit extension in the informal banking sector, rebounded in March. We note that these three forms of informal (shadow) banking activities were not the primary targets of recently implemented macro-prudential measures. On the contrary, these macro-prudentail measures targeted the tremendous size of wealth management products issued by banks and non-banking financial institutions, which have huge exposure to domestic capital markets. The implementation of these macro-prudential measures have already increased financial tension in bond and stock markets. (Figures 2.12)

Figure 2.11 Bank credit growth slowed in March…



Source: BBVA Research

Figure 2.12 Finanical tensiosn rises in capital markets.



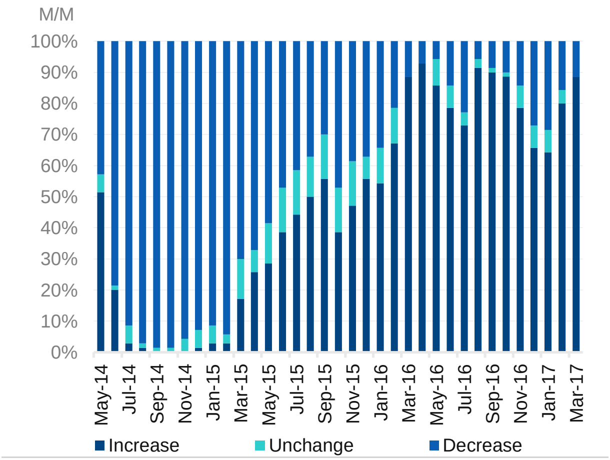
Source: BBVA Research

Housing market: purchasing power has shifted to smaller cities

The tightening measures on the property market have effectively moderated price increases and frozen the trading volume in Tier I cities (Figure 2.13). However, investors' enthusiasm for residential property has not cooled as the authorities intended. Instead, the house buying spree shifted to smaller cities and boosted local housing prices. It has prompted more local governments to deploy tightening measures aimed at cooling down their local housing markets in the past two or three months.

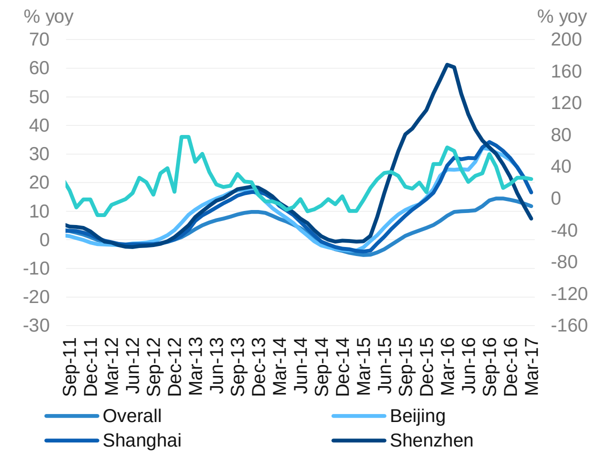
On the positive side, a buoyant property market could help to sustain investment in the real estate sector and lend support to growth. Nevertheless, ballooning housing prices will pose a threat to financial stability in the long run if the prospective correction proceeds in a disorderly way.

Figure 2.13 More cities showed price increases in March



Source: BBVA Research

Figure 2.14 Housing prices in tier-1 cities decelerated due to the authorities' tightening measures

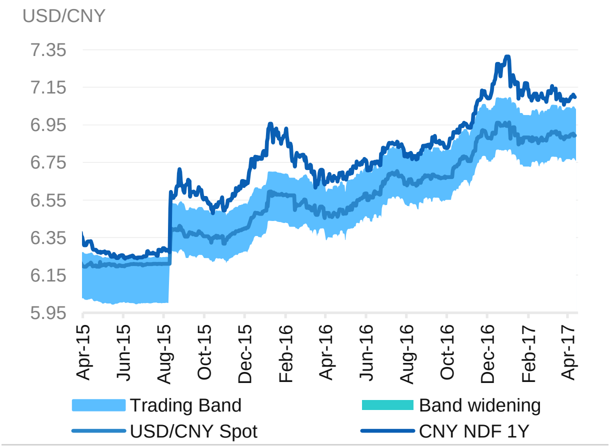


Source: BBVA Research

Stabilised RMB and moderated capital outflows

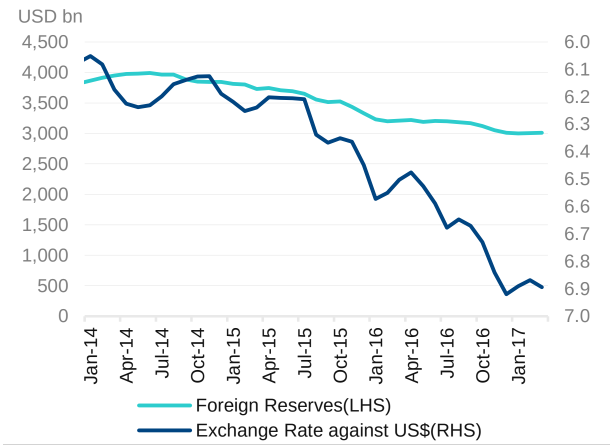
The RMB exchange rate has somewhat stabilised of late, mainly due to the weakened momentum of the USD. (Figure 2.15) Foreign reserves also recovered part of their lost ground in February and March (Figure 2.16) due to favourable valuation effects and slower capital outflows, although its latest level is still below the year-end 2016 level. We estimate that capital outflows continued at around USD 60-70 billion in the first quarter. That said, capital flows could accelerate in the coming months after the external uncertainties escalate again.

Figure 2.15 CNY appreciated sharply, due to PBoC's intervention and pendulum of DXY in January



Source: BBVA Research and CEIC

Figure 2.16 Foreign reserves have been decreasing in the past months as RMB depreciation continued



Source: BBVA Research and CEIC

3. Growth outlook is robust with modest moderation

Upward revision to growth outlook

The recent upbeat data indicate that growth momentum might be stronger than we expected, which will probably continue into the second quarter. Equally important is the fact that the authorities have set a growth target of around 6.5% for 2017, reflecting the fact that their tolerance of a slowdown in growth might not be as great as we anticipate. We have therefore raised our 2017 growth projection to 6.3% from 6.0% and our 2018 projection to 5.8% from 5.2%. (Figure 3.1) That being said, the current growth momentum, with the aid of fiscal support, is able to help the economy navigate a soft-landing in the remainder of the year. However, China's growth rate is set to gravitate to a level in line with its fundamentals in the medium term.

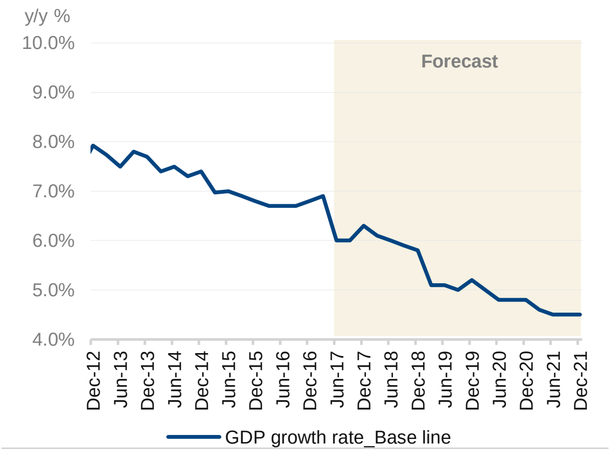
Our 6.3% growth projection for 2017 is still below the market consensus (Bloomberg consensus: 6.5%). We envisage the mix of neutral monetary policy and the stepped-up tightening efforts to curb shadow banking activities will unavoidably bring headwinds to growth and moderate the currently strong momentum, most likely in the second half of the year. Accordingly, the growth rates of the first two quarters are unlikely to continue in the second half of the year.

Inflation will rise gradually

Regarding inflation, we have lowered our 2017 monthly average projection of CPI from 2.7% to 2.3% (Figure 3.2) due to lower-than-expected food prices at the beginning of the year. We anticipate that non-food prices will remain firm through the entire year, while food prices are expected to rebound in the second half of the year due to the low base during the same period of last year. All in all, headline inflation will gradually pick up from less than 1% currently to around 3.3% by year-end.

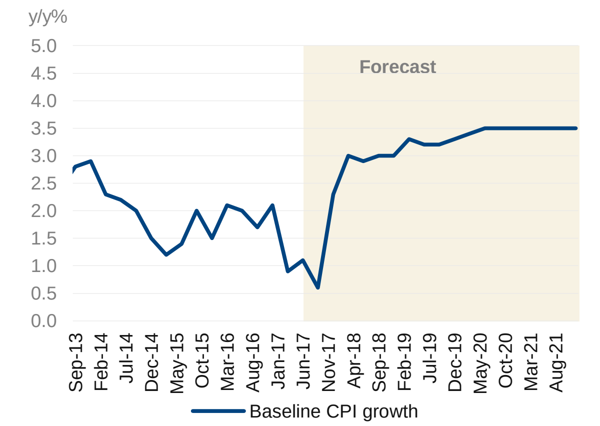
In the meantime the fast-rising PPI is also expected to slow its pace in the coming months as commodity prices seem to have reached a plateau after rebounding sharply since mid-2016. Moreover, the authorities have also revealed that they will take the lessons of last year and cautiously strike a balance between demand and supply sides in deploying measures to eliminate overcapacity in sectors such as coal, iron and steel. That being said, supply-side reform policies, albeit still on the authorities' agenda, will generate much less noise than last year to price signals. We therefore expect the PPI to gradually slow from the current 7.6% to around 4.5% by year-end, giving a yearly average of 6%.

Figure 3.1 We have raised our 2017 GDP forecast to 6.0% from 5.8% previously



Source: BBVA Research and CEIC

Figure 3.2 We have lowered our CPI forecast to 2.3% this year



Source: BBVA Research and CEIC

The policy mix: prudent monetary policy, expansionary fiscal policy and more measured supply-side reform

Regarding monetary and fiscal policies, our predictions at the beginning of the year (see our Q1 China Outlook) still apply. A prudent monetary policy is consistent with the authorities' emphasis on maintaining financial stability and curtailing the rising risks, from housing bubbles to shadow banking activities. With a newly established "corridor system" of interest rates (see our previous report: China Monetary Policy: New Framework New Stance), the authorities can even introduce a certain bias on the tightening side. At the same time, more regulations on shadow banking activities and the property sector are expected to be unveiled on top of the existing ones, which could additionally tighten credit conditions and weigh on growth.

Therefore pro-growth fiscal policy initiatives have to be deployed to sustain growth throughout the year. Although the authorities announced a conservative fiscal budget deficit of -3.0% (compared with our -3.5%) at the National People's Congress in March, we believe that the final deficit will be larger if we take into account adjustments for some extra-budget items. Apart from infrastructure investment, the authorities seemingly aspire to put more "supply-side reform" flavours into the package, such as lowering payroll tax.

The authorities will deepen the campaign of overcapacity elimination in some sectors as one of important elements in their package of supply-side reform. Drawing lessons from last year's experience, the authorities have pledged to better balance demand and supply in the process of eliminating production capacity to avoid abrupt contraction in supply. The new targets of capacity elimination in the iron, steel and coal sectors are lower than those achieved last year (Table 3.1). More importantly, the authorities pledged to allow market forces to play the pivotl role in eliminating obsolete capacity this year. We therefore believe that they will have a milder impact on price signals than we saw last year.

Figure **3.1** 2017 targets of overcapacity elimination

	Coal	Iron & Steel
2015 total capacity	5.7 billion metric tons	1.2 billion metric tons
2015 production	3.75 billion metric tons	804 million metric tons
Over-capacity Part	1.95 billion metric tons	396 million metric tons
2016 targets	250 million metric tons	45 million metric tons
2016 results (reported by Chinese premier in March)	290 million metric tons	65 million metric tons
2017 targets	150 million metric tons	50 million metric tons

Source: BBVA Research

Gradual currency appreciation

Currency depreciation is expected to remain limited during the first half of the year due to the relatively benign external environment, and then pick up in the second half of the year, amounting to 4-5% against the USD for the full-year (slower than the pace of around 7% last year). This would bring the exchange rate to RMB 7.15 per USD by the end of 2017.

We believe that a “clean float” remains the authorities’ final aim of exchange rate reform. The floating of the RMB could take place in the second half of 2018. When it happens, the exchange rate could overshoot to 7.8 but it will ultimately go back to its long-term equilibrium level of around 7.

Figure **3.2** Baseline Scenario

Baseline Scenario						
	2016	**2017 (F)**	**2018 (F)**	**2019 (F)**	**2020 (F)**	**2021 (F)**
GDP (%, YoY)	6.7	6.3	5.8	5.2	4.8	4.5
Inflation (average, %)	2	2.3	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	7.2	7.8	7.3	7	7

Source: BBVA Research

4. The risk of trade war gives way to the risk of real war

All the financial vulnerabilities remained, including (i) housing bubbles; (ii) the vicious spiral of currency depreciation and capital outflows; (iii) indebtedness of the corporate sector; and (iv) rampant shadow banking activities. Although the shift of monetary stance and newly deployed regulatory efforts have somewhat slowed their momentum, the gigantic “stock” of these fragilities still poses material threats to the country’s financial stability. We expect that these financial fragilities will live with the economy until the authorities have made real breakthroughs in some key areas such as reform of SOEs and the overhaul of the financial regulatory framework.

Two external risks have experienced some dramatic changes over the past few weeks. First, China’s president Xi and US president Trump held their first in-person meeting at Mar-a-Lago estate in Palm Beach, Florida in early April. After the meeting President Trump openly changed his rhetoric of labelling China a currency manipulator and even opening a trade war. Instead, the US and China agreed to implement a 100-day plan through bilateral negotiation so as to address the trade deficit problem. Many analysts, including us, expect that China will expand its imports from the US and further open its domestic market to US investment. If this materialises, both China and the US will benefit from these agreements in the long run.

Secondly, geopolitical tensions rose again in the Korean Peninsula after North Korea was seen to be gearing up to carry out new tests of nuclear weapons and ballistic missiles. The Trump administration has reacted firmly by deploying more combat units to the region. If a war really did break out in the Korean Peninsula, China would suffer greatly. Even in a benign scenario where no nuclear weapons were used or leaked, China might still need to take in millions of refugees from North Korea. Moreover, China’s trade with South Korea and Japan would also be likely to be adversely affected if the war extended beyond North Korea’s borders.

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