BBVA | Research

China Economic Outlook

3rd QUARTER 2017 | ASIA UNIT

Contents

1. Global outlook: The positive global environment tends to stabilize 3

2. Music still goes on 5

3. Growth slowdown amid financial deleveraging in the long run 13

4. Financial sector vunerabilities persist 16

Closing date: **20 July 2017**

1. Global outlook: The positive global environment tends to stabilize

Robust, steadier global growth, with some rebalancing among the major areas

The world economy accelerated in recent quarters and has approached growth rates of 1% QoQ, although it tends to stabilize. Confidence levels, especially in the advanced economies, remain high, while the recovery in world trade seems to have slowed down somewhat in April and May. In line with this, there has also been an uptick in industrial activity and global investment.

This positive dynamic responds, primarily, to the effect of the stimulus provided by China´s economic policy, which has boosted its growth and with it, that of other Asian countries and the rest of the world. In addition, the global cycle has also benefited from the extremely accommodating monetary policies of most advanced countries, fiscal policies that have recently become neutrals or expansionary and relatively modest commodity prices. All this has come amid a calm environment in the financial markets, which have not suffered in a persistent way by the sources of political stress.

The recovery, which is mainly affecting the advanced economies, is accompanied by less dynamism in the United States, offset by an improvement in Europe, both in terms of activity and the political scenario – the new American administration's difficulties in adopting measures against overcoming electoral obstacles in Europe. On the other hand, the emerging economies have dperformed less promisingly, with a slower than expected exit from the recession in Latin America (LatAm), and in a more diverse way, due to differing levels of dependence on commodity revenues.

This environment of positive growth is currently being partnered by only modest inflation levels. While the risks of deflation appear to have passed, the abundance of liquidity in the markets, as a result of very expansive monetary policies, has not been transformed into an acceleration in price increases (wages or core inflation). The remaining high level of unused capacity of resources could be behind this restraint - especially in the labour force - that seems to curb any significant acceleration of wages and core inflation, while in recent months the delay and some reversals in oil prices (7% on average between 1Q17 and 2Q17) have held back expectations and general inflation rates.

Favourable environment in financial markets and normalisation of monetary policies

The stance in the financial markets has been upbeat, with volatilities at historic lows despite the persistent economic, political and geo-political uncertainty, as well as the correction to expectations of a fiscal impulse in the USA. As a result, long term interest rates have remained anchored, and the appreciation of the dollar has slowed. This, together with a favourable economic environment, has boosted equities, which favours emerging markets. On the other hand, European assets, including the euro, have also become more appealing. Following the French elections and a context in which growth in the developed world is more favourable to Europe, capital flows into the eurozone have taken an about-turn.

The big question is whether the markets are being too accommodating, particularly bearing in mind that the major central banks are moving forwards into the normalisation process. In this context, central banks have begun to take steps to prepare the market for a gradual withdrawal of stimuli. For example, the US Federal Reserve (Fed) has twice raised interest rates during the course of the year, by a total amount of 50 basis points (bps), and has communicated and detailed a phasing-out plan for its balance sheet (another rise of 25 bps, probably in December, with the initiation of a "passive" reduction in the balance sheet, probably starting in October). However, in the absence of robust growth and with very contained price and wage inflation, market expectations are not aligned with those of the Fed (they are more bearish).

The European Central Bank (ECB) is holding interest rates unchanged (the refi rate at 0% and deposit rate at a negative level of -0.40%) and the asset purchasing programme (currently at 60bn euros a month). However, it is more confident about the strength of growth and believes that the risk of deflation has disappeared, giving rise to the first changes in communication (forward guidance). In June, the ECB eliminated the downward bias it had on Interest rates, which is interpreted as a first step in the long process of normalisation. Moving forward, it is expected that the September meeting will announce a reduction in the pace of asset purchases (tapering) that would be effective as for January 2018. Assuming that the central bank does not change the sequence in its exit process, interest rate rises will not take place until late 2018. Here, a good communications strategy is key to avoiding jitters in the financial markets, especially since they have been somewhat sceptical about any imminent normalisation.

While global growth forecasts remain at 3.3% for 2017 and 3.4% for 2018, they have been revised upwards both in China (in both years) and in Europe (in 2017) due to a better than expected first half of the year, while slightly correcting the US forecast downward. In LatAm, deteriorating commodity prices this year and increased domestic uncertainty in several countries make the exit from the recession slower than expected. These forecasts imply that in the coming quarters emerging economies should regain ground in respect to the advanced countries and China, which have spearheaded the recent upturn.

Likewise, the supports that have led to the recent acceleration will continue to be present, albeit with slight variations: monetary policies will gradually enter a process of normalisation, while fiscal policies will remain relatively neutral or expansionary; oil prices, which have delayed their progression towards long term equilibrium levels (USD60/bbl) due mainly to the rise in supply (from producer countries such as Libya, Nigeria and the US), are set to continue to chart their rising course; finally, the flurry of politically-related events (elections in Germany and Italy, Brexit negotiations, initiatives geared towards greater integration in the European Union, the political calendar in the United States, and the electoral cycle in LatAm in 2018) could influence economic confidence and the markets situation, although these seem to be having less lasting impact.

2. Music still goes on

Notwithstanding the authorities' stepped-up efforts to cool down the property market and curb shadow banking activities, the Chinese economy continued its good performance in the second quarter with a GDP outturn of 6.9% YoY, flat with the Q1 outturn and higher than the market consensus of 6.8% YoY. On a sequential term, growth has significantly picked up to 1.7% QoQ from 1.3% QoQ in Q1, suggesting that the ongoing recovery is robust and tenable. Thus, we raise our 2017 growth forecast to tally with the official target of 6.5% from 6.3%, reflecting the good outturns in the first half of the year and the resilience of the world's second largest economy .

Compared with Q1, growth in Q2 was mainly buoyed by investment and net exports. In particular, investment's contribution to growth is much larger than in Q1 and net exports' contribution to growth turned positive as from Q1 2017. (Figure 2.1) The upbeat growth momentum could derive from several factors: First, it is occurring in the context of a global trade recovery. As such, the improved external environment and long trend of RMB depreciation that started in 2015 have given an additional impetus to China's growth. Second, the PBoC fine-tuned the pace of the ongoing financial deleveraging, maintaining comparatively easing credit conditions in the second quarter through unconventional monetary tools (see our China Economic Watch: Financial deleveraging: two steps forward; one step back). Third, the rebalancing of the economy, especially the thriving service industry and high-tech-oriented sectors, together with the progress of urbanization, provided a new growth engine for the economy.

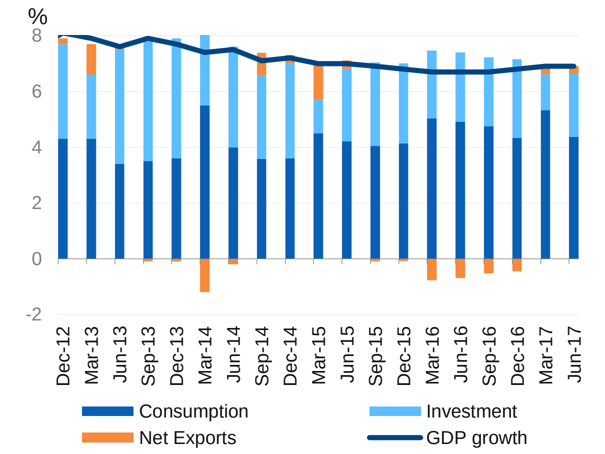
However, the economy is still subject to a number of uncertainties. For instance, the current stronger-than-expected growth momentum could embolden the authorities to push forward their deleveraging campaigns in both the financial sector and industries with overcapacity. On July 16th, China's authorities concluded their two-day National Financial Work Conference. As the main message of the conference, the authorities announced the establishment of a Financial Stability Development Committee under the State Council, which focuses on coordinating Central Bank and other three regulators (now in charge of banking, the securities market and insurance) to form a unified regulatory umbrella. Meanwhile, the conference confirmed the leading role of the PBoC in implementing macroprudential policy and maintaining financial stability. That being said, the authorities will continue its prudent stance of monetary policy with a tightening bias and deploy more measures to crack down on rampant shadow banking activities and debt overhang.

The deleveraging measures will consequentially drag on growth over the medium and long term. First, M2 in June already decreased to a historical low for the past twenty years, which will influence corporate financing, especially borrowing by SMEs. Second, a lot of bond issuance has been delayed due to the tighter regulation, affecting the bond issuers' financial conditions. Third, as the authorities have been deleveraging the financial sector, the interbank rate has risen and become more volatile, influencing the liquidity conditions of banks and corporations. All these might weigh on growth over the next couple of years.

The recovery is broad-based

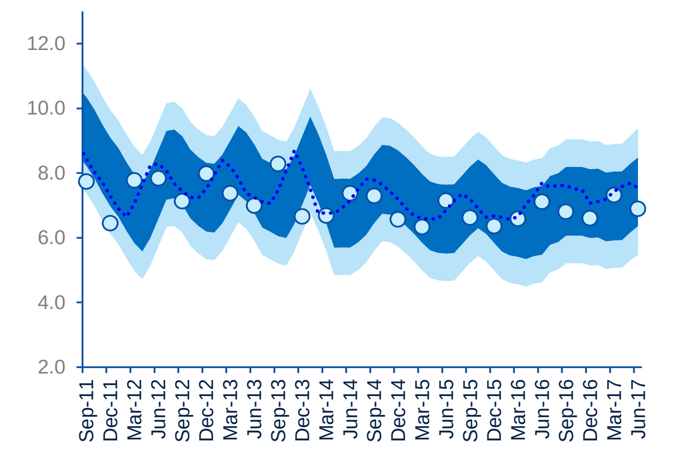
2017 Q2 GDP reached 6.9% YoY, flat with Q1 outturn and higher than the market consensus of 6.8% YoY. The QoQ growth rate also accelerated to 1.7%, higher than the previous reading of 1.3% QoQ. Our BBVA MICA model forecast is 7.0% YoY, basically in line with the current strong growth momentum. (Figures 2.1 and 2.2)

Figure 2.1 Growth momentum is stronger than expected



Source: BBVA Research and CEIC

Figure 2.2 BBVA MICA model for GDP forecasting



Source: BBVA Research and CEIC

China's official NBS manufacturing PMI picked up significantly to 51.7 in June from 51.2 in May, well above market expectations (Consensus: 51). Following the same trend, the Caixin China Manufacturing PMI, which includes a survey sample tilting toward SMEs and exporters, increased to 50.4 in June from 49.6 in the previous month (Consensus: 49.8). (Figure 2.3) The soaring NBS and Caixin PMI outturns were mainly driven by surging external demand and comparatively easing credit conditions in June, again reflecting the stronger-than-expected growth momentum.

Separately, growth in industrial production in June jumped to 7.6% YoY from 6.5% YoY in the previous month (consensus: 6.5% YoY) (Figure 2.3), underpinned by the improvement in the manufacturing sector and robust external demand. The continuing recovery has reinforced firms' confidence and prompted them to accelerate their stocks and production. Moreover, firms' profitability has also picked up, in particular for the upstream industries. (Figure 2.4)

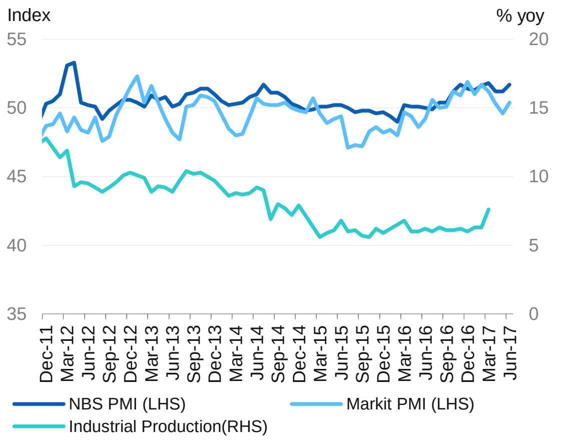
The demand side picked up in June as well. In particular, retail sales growth accelerated to 11% YoY from 10.7% YoY in May (consensus: 10.6% YoY). (Figure 2.5) By category, auto sales in June posted better-than-expected growth of 5.2% YoY (compared with 0.7% YoY in May) despite the expiration of the tax exemption for passenger car purchases in Q1 of this year.

Growth in urban fixed asset investment is in line with the previous reading of 8.6% YTD YoY (consensus: 8.5% YTD YoY). Moreover, private investment, which we have been concerned about, picked up to 7.2% YTD YoY in June from

6.8% YTD YoY previously. By category, infrastructure FAI growth accelerated to 17.3% YTD YoY in June from 13.1% YTD YoY in May, suggesting the continuing fiscal spending to stimulate growth. FAI in the manufacturing sector continued to improve in June, with the outturn of 6.7% compared with 5.6% in May, suggesting the robust external and domestic demand. In addition, real estate FAI YoY dipped to 4.3% YoY in June from 4.6% YoY previously, mainly due to the authorities' tightening measures on the property market. (Figure 2.6)

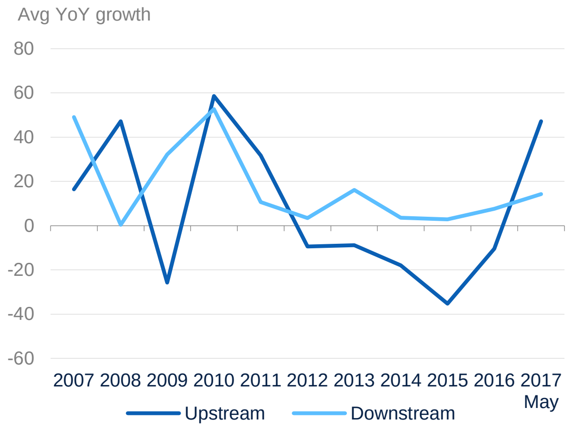
All in all, the latest indicators of economic activity show signs of significant improvement on both the supply and the demand side. Thus, the impetus of the current recovery seems stronger and more persistent than expected.

Figure 2.3 PMIs and IP picked up, indicating strong growth momentum



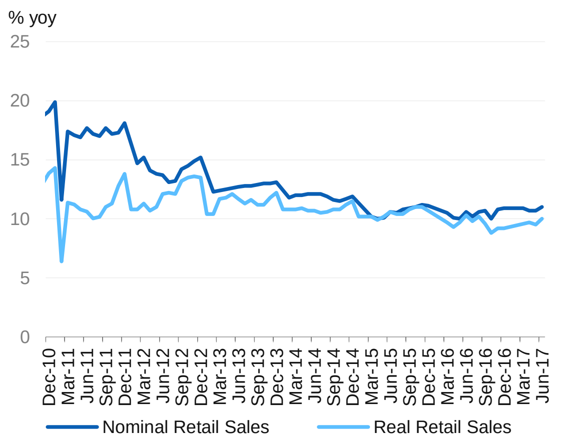
Source: BBVA Research and CEIC

Figure 2.4 Profit in the upstream sector rebounded significantly



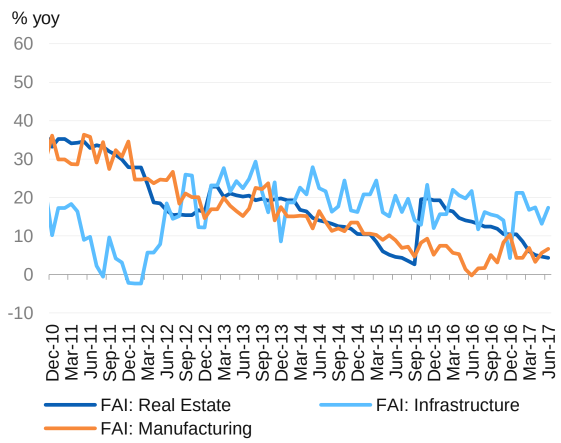
Source: BBVA Research and CEIC

Figure 2.5 Retail sales have been steady



Source: BBVA Research and CEIC

Figure 2.6 Manufacturing and infrastructure FAI picked up in June while real estate FAI decreased



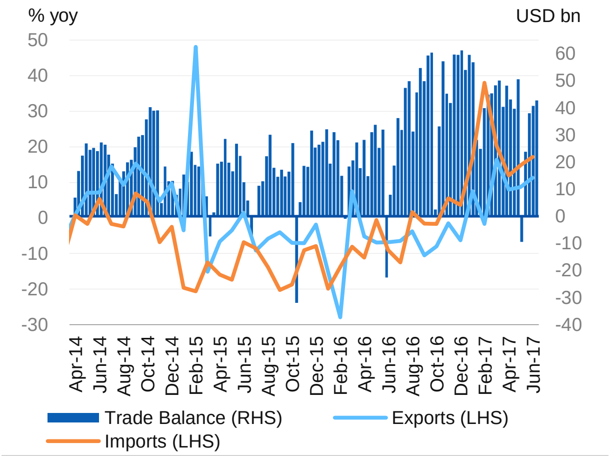
Source: BBVA Research and CEIC

Both exports and imports are stronger than expected

China's stronger-than-expected trade data in June are in line with the global trade recovery and robust demand both from home and abroad. In USD terms, imports registered a year-on-year growth of 17.2% (vs consensus: 14.5% YoY; May: 14.8% YoY) thanks to strong growth momentum domestically. (Figures 2.7 and 2.8) More importantly, export growth in June accelerated to 11.3% YoY (consensus: 8.9% YoY; May: 8.7% YoY). As a result, the balance of trade expanded in June to USD 42.8 billion, compared with USD 40.79 billion in the previous month.

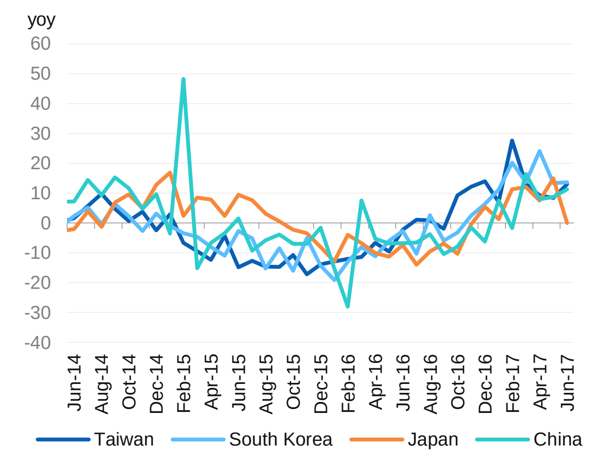
Good news also came from the country's largest trading partner, as tensions with the US appear to be easing after 100-day trade talks which signalled some progress toward addressing the deficit run by the U.S. However, from the imports perspective, we are sceptical that the current pace of imports can be sustained for much longer given the increasing headwinds to China's economy from policy tightening and a cooling housing market. In addition, the stronger RMB exchange rate recently might also drag on exports in the short term.

Figure 2.7 Both exports and imports registered stronger-than-expected growth in June



Source: BBVA Research and CEIC

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



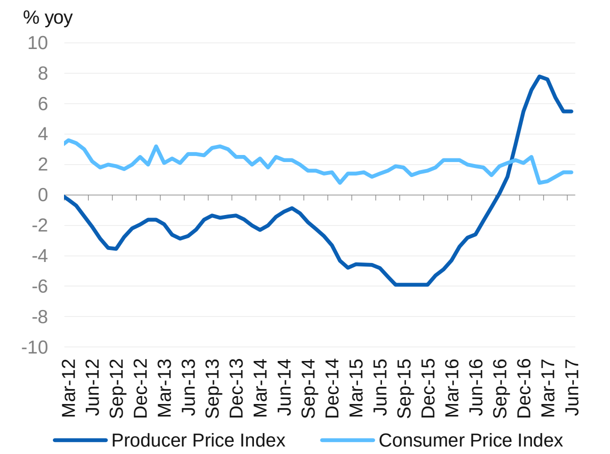
Source: BBVA Research and CEIC

Gradual converging of CPI and PPI

CPI and PPI started to converge in the second quarter. Headline CPI inflation remained subdued and its June reading remained the same as that of the previous month at 1.5% YoY. (Figure 2.9) The subdued CPI was mainly due to the deflated food prices, while non-food prices steadily edged up. It remains to see whether sluggish food prices are transitory or not. From this respect, we suspect that the ongoing prudent monetary policy with some tightening bias has exerted a certain downward pressure on food prices. From a positive perspective, inflation risk seems to have been subdued this year, leaving room for the unconventional monetary policy to play its role, such as injecting money through MLF and SLF to maintain liquidity conditions for financial institutions (Figure 2.10).

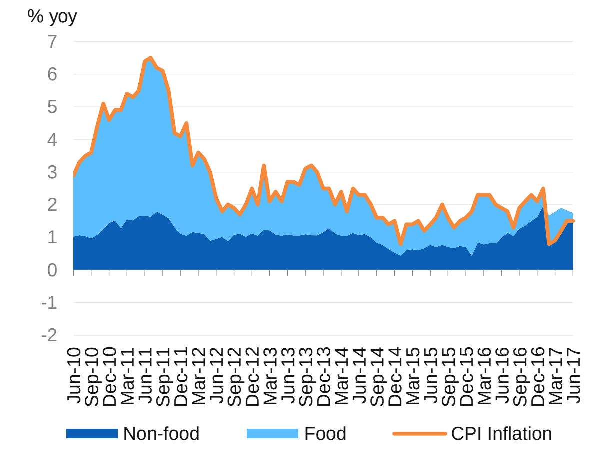
On the other hand, PPI started to decrease from its peak at 7.8% YoY in February. The June outturn of PPI remained the same as that of the previous month, both at 5.5% YoY. The decreasing PPI was mainly due to the downward trend of global commodity prices after hitting a peak in February. In addition, the slowdown of PPI is also in line with the contained manner of the de-leveraging in the real sector. Looking ahead, CPI and PPI could show further convergence during the rest of the year.

Figure 2.9 The gradual converging of CPI and PPI



Source: BBVA Research and CEIC

Figure 2.10 The subdued CPI is mainly due to sluggish food prices



Source: BBVA Research and CEIC

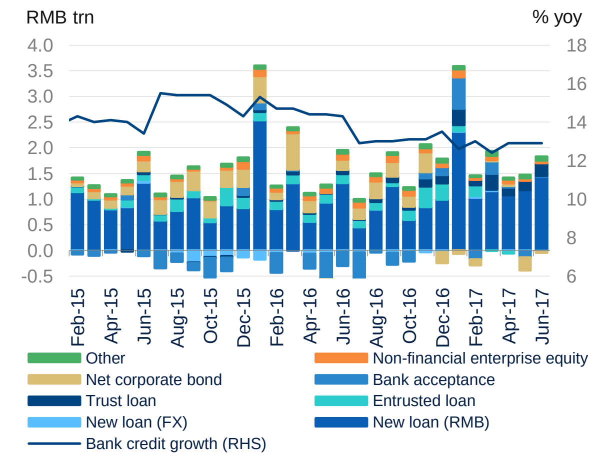
Significant divergence of growth in M2 and total social financing indicates financial deleveraging is taking effect

The authorities adjusted their monetary policy stance at the end of 2016 from accommodative to prudent, intrinsically with some tightening bias to curb shadow banking activities and other financial vulnerabilities. In practice, the PBoC even guided market interest rates to a higher level through the newly established corridor system. The effects of the monetary policy tightening continued in June, as M2 growth dipped to the historical low to 9.4% YoY, compared with the previous month's reading at 9.6% YoY (consensus: 9.5% YoY), which is the lowest reading during the past 20 years. (Figure 2.12)

By contrast, both new yuan loans and total social financing were much higher than the market expectation, significantly diverging from the M2 growth slowdown. In particular, total social financing increased to RMB 1,780 billion (prior: RMB 1,062.5 billion; consensus: RMB 1,500 billion). In addition, new yuan loans also significantly picked up to RMB 1,540 billion in June, compared with RMB 1,110.6 billion in the previous month (consensus: RMB 1,300 billion). (Figure 2.11) As M2 mainly includes new yuan loans, interbank business, forex sales by banks and commercial banks' security investment etc, given the strong outturn of new yuan loans, the significant divergence between M2 growth and total social financing indicated that the financial deleveraging has been taking effect so that interbank business has shrunk to a large extent. On the other hand, the improved growth momentum has increased firms' demand for funds in the second quarter, pushing up the growth of both new yuan loans and total social financing. This suggested that while financial deleveraging is pressing ahead, the transition from tightening monetary policy to the real economy has not emerged yet. And more importantly, as the regulations are strengthened, more and more off-balance-sheet lending has been moved back onto the formal balance sheet.

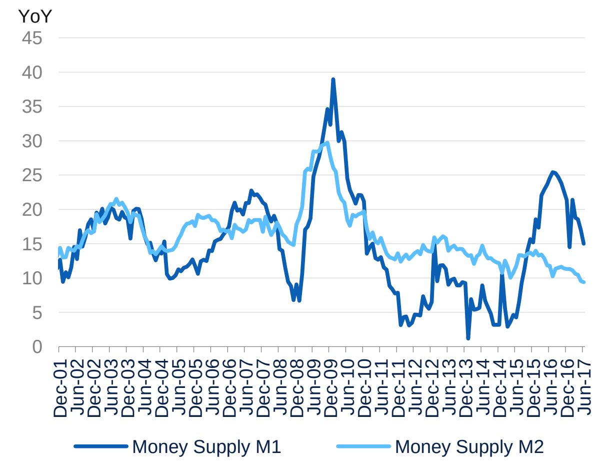
All in all, we believe that the ongoing macro-prudential measures and financial deleveraging may continue to drag on M2 growth during the rest of this year. Moreover, the stronger-than-expected new yuan loans and total social financing might decrease as well with some time lags as we believe the current boost of bank loans is temporary, which is mainly due to the issuing of previously accumulative loan contracts and moving the off-balance-sheet lending onto the balance sheet. Altogether, the effect of financial deleveraging on economic growth might finally emerge in the future.

Figure 2.11 Significant divergence between M2 and total social financing in June



Source: BBVA Research and CEIC

Figure 2.12 M2 decreased to the historical low



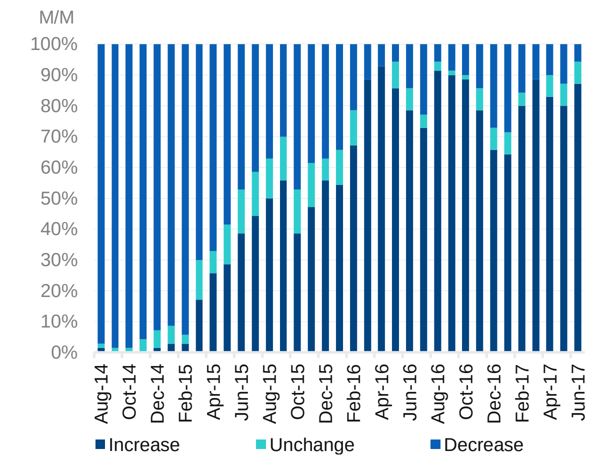
Source: BBVA Research and CEIC

Housing price decelerated in big cities due to tightening measures

The tightening measures on the property market have effectively moderated price increases and frozen the trading volume in Tier 1 cities (Figure 2.14). However, investors' enthusiasm for residential property has not cooled the way the authorities intended. Instead, the house buying spree has shifted to non-tier-1 cities and boosted local housing prices, which actually pushed up the overall housing prices over the country. It also has prompted more local governments to deploy tightening measures aimed at cooling down their local housing markets in the past two or three months. (Figure 2.13)

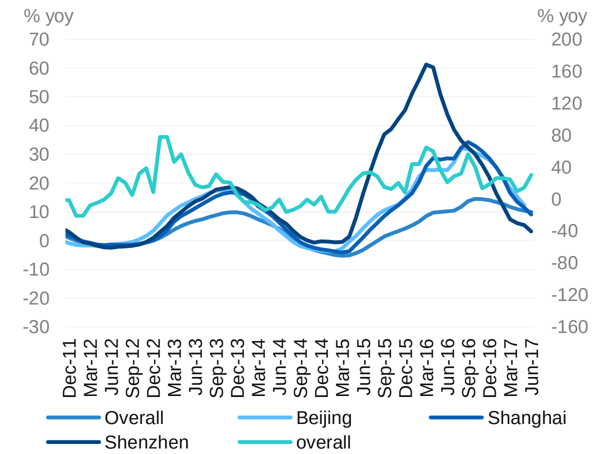
The ongoing tightening measures in tier 1 cities and the existing large stocks in small cities also dragged on real estate investment. In particular, real estate FAI YoY dipped to 4.3% YoY in June from 4.6% YoY previously. As the real estate sector and its related sectors constitute a large proportion of the economy, we believe that the current round of housing market tightening will encumber growth in the medium term.

Figure 2.13 Housing price decreasing only happened in big cities while price in small cities still picked up



Source: BBVA Research

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



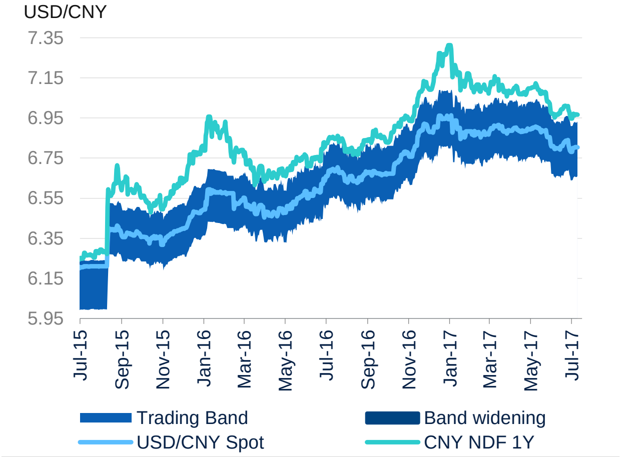
Source: BBVA Research

RMB exchange rate picked up and foreign reserves increased

The RMB exchange rate has picked up somewhat recently, mainly due to the weaker momentum of the USD and the authorities' tighter capital control measures. Moreover, the recent fine-tuned RMB exchange rate policy also contributed by introducing some counter-cyclical factors to the middle-price pricing mechanism. Accumulatively, the CNY to USD exchange rate appreciated by 1.3% from the beginning of the second quarter until now (Figure 2.15) At the same time, similar to the first quarter, foreign reserves recovered part of their lost ground in June, reaching USD 3056.8 billion, compared with USD 3053.6 billion in May. (Figure 2.16) The pick-up of foreign reserves is mainly due to favourable valuation effects and slower capital outflows. We estimate that capital outflows continued at around USD 54.5 billion in June, much slower than USD 85.1 billion in the previous month.

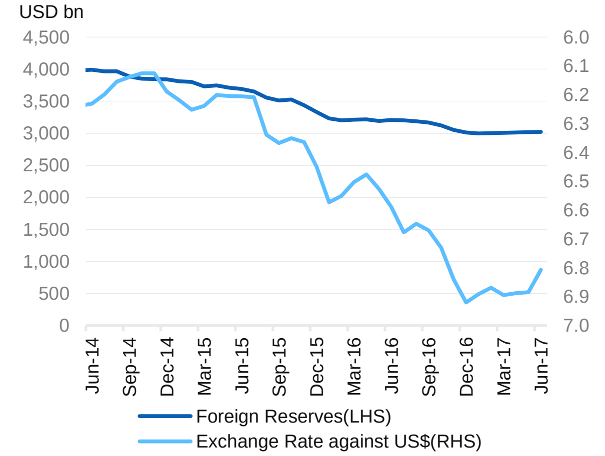
The recent foreign reserve pick-up reflected the effect of the authorities' policies of "promoting inflow and tightening outflow". In particular, the domestic portfolio-diversification-led capital outflow has still continued, although it has moderated given the authorities' stricter capital control. On the other hand, if we break down the capital inflow items, we find that the retrieval of financial institutions' overseas deposits and foreign deposits in China improved significantly. Moreover, three recently-implemented policy initiatives also encouraged capital inflow: the Bond Connect programme, the MSCI inclusion of China's stock maket and the announcement of ECB to include RMB in its reserve assets. All in all, under the recent circumstances, we predict that the increase in foreign reserves and moderating of capital outflow could continue in the following months.

Figure 2.15 CNY appreciated recently, due to the weakening of USD and tight capital control



Source: BBVA Research and CEIC

Figure 2.16 Foreign reserves stopped their downward trend in June



Source: BBVA Research and CEIC

3. Growth slowdown amid financial deleveraging in the long run

Upward revision of short-run GDP while long-run slowdown is set to continue

The recent upbeat data outturn in June indicated that growth momentum might be stronger than the market expected. Equally important is the fact that the authorities have set a growth target of around 6.5% for 2017, reflecting that their tolerance of a slowdown in growth might not be as great as we anticipated. Altogether, we have raised our 2017 growth projection to 6.5% from 6.3% previously and our 2018 projection to 6% from 5.8%. (Figure 3.1) Our 6.5% growth projection for 2017 is in line with the market consensus and the official target now (Bloomberg consensus: 6.5%).

However, in the medium to long run, we believe the growth slowdown is unavoidable. The economy is still subject to a number of uncertainties externally and domestically. The stronger-than-expected growth momentum could reinforce the government's confidence in pursuing stricter regulations to correct the existing financial vulnerabilities, such as debt overhang, shadow banking and housing bubbles, which grew rapidly with the previous implementation of distortionary growth-stimulating policy initiatives. The deleveraging measures, both in the financial and real sector, will consequentially drag on growth over the medium and long term.

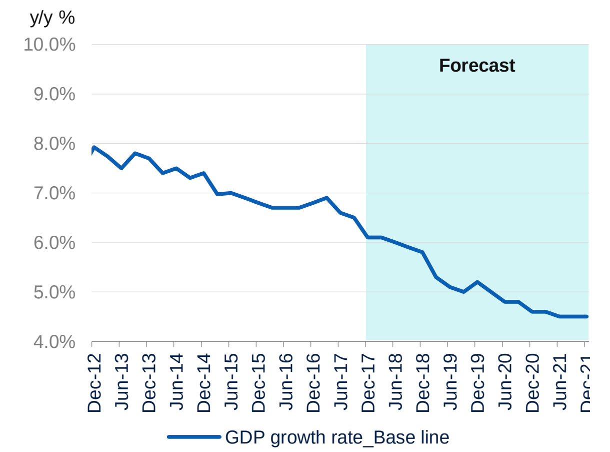
Our baseline Vector Autoregressive (VAR) model, which includes China's M2 growth, GDP growth and CPI as endogenous variables, shows that a decrease of one percentage point in M2 growth leads to 0.16% slowdown in GDP, suggesting that financial deleveraging might drag on growth. We therefore believe that China's secular slowdown will continue over the next couple of years as the ongoing financial deleveraging continues its pace.

We lowered CPI and PPI predictions

Regarding inflation, we have lowered our 2017 monthly average projection of CPI from 2.3% to 1.7% (Figure 3.2) due to the deflated food prices in the recent months. We anticipate that non-food prices will remain firm through the entire year, while food prices are expected to remain subdued in the second half of the year. In addition, the ongoing regulatory tightening could keep CPI inflation at bay.

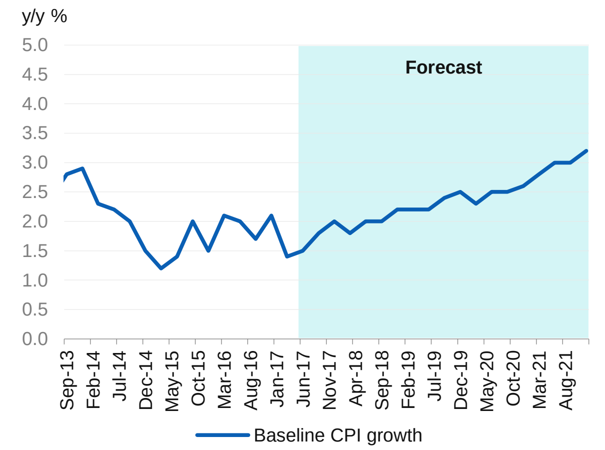
In the meantime, the CPI and PPI seem to be converging over time. The previously fast-rising PPI is expected to slow its pace in the coming months as commodity prices have reached their peak in February after accelerating sharply since mid-2016. Moreover, the authorities have also revealed that they will take on board 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 said, supply-side reform policies, while still on the authorities' agenda, will be conducted in a more contained manner, thus generating much less noise than last year to price signals. We therefore expect the PPI to gradually slow its pace to around 4.5% by year-end, giving a yearly average of 6%.

Figure 3.1 We have raised our 2017 GDP forecast to 6.5% from 6.0% previously



Source: BBVA Research and CEIC

Figure 3.2 We have lowered our CPI forecast to 1.7% this year from 2.3% previously



Source: BBVA Research and CEIC

Policy mix tilts towards tight regulations

A prudent monetary policy with tightening bias is consistent with the authorities' emphasis on maintaining financial stability and curtailing the rising risks in the National Financial Work Conference which was concluded this month, such as housing bubbles, debt overhang and shadow banking activities. At the same time, more regulations on shadow banking activities and the property sector are expected to be unveiled on top of those in place, which could lead to an additional tightening of credit conditions and weigh on growth.

Under the framework of policy tightening, some unconventional monetary instruments have also been implemented, in order to maintain liquidity in the banking sector (see our previous China Economic Watch: Financial deleveraging: two steps forward; one step back). In the future, considering the RMB exchange rate and financial sector deleveraging, we do not think the PBoC will apply interest rate cuts or RRR cuts during the rest of this year. By contrast, more unconventional tools, such as Standing Lending Facilities (SLF) and Medium-term Lending Facilities (MLF) will continue to be implemented. Based on the international experience, the central bank is likely to control the short-term interest rate and let the market determine the yield curve. Thus, we predict that more short-term liquidity tools (such as SLF and 7-day pledged repo rates) might be implemented as against the medium-term or long-term tools (such as MLF).

By contrast with the prudent monetary policy, 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% prediction) 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" elements into the package, such as lowering payroll tax.

Currency depreciation in the long term and potential exchange rate regime change

Several factors contributed to the recent RMB exchange rate pick-up. Apart from the downward adjustment of USD and tighter capital controls, the PBoC has recently fine-tuned its exchange rate policy by introducing some counter-cyclical factors to the mid-price pricing mechanism. It has de facto rolled back the RMB exchange rate regime to a soft peg against the USD prior to the August reform in 2015. Moreover, the newly-launched Bond Connect programme, the inclusion of China's stock market into MSCI index and the fact that the RMB is to be included in ECB's foreign reserves, all attracted capital inflow and led to the recent RMB appreciation.

Although RMB exchange rate displayed some appreciation trend, the long term depreciation for the currency is expected to remain in place in the following years to the domestic economic rebalancing and the Fed interest rate hike process. We predict the exchange rate will go back to 6.95-7 per USD by the end of 2017, which is a similar level to that of the beginning of this year, after its temporary appreciation during the middle of the year. (Table 3.1)

We believe that a "clean float" remains the authorities' ultimate goal of exchange rate reform. The floating of the RMB might take place in the second half of 2018, as we predicted. When it happens, the exchange rate could overshoot to 7.8 but ultimately go back to its long-term equilibrium level of around 7.

Table 3.1 Baseline Scenario

Baseline Scenario

	2016	2017 (F)	2018 (F)	2019 (F)	2020 (F)	2021 (F)
GDP (%, YoY)	6.7	6.5	6.0	5.2	4.8	4.5
Inflation (average, %)	2	1.7	2	2.3	2.5	3
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	7.2	7.8	7.3	7

Source: BBVA Research

4. Financial vulnerabilities persist

Domestically, risks from financial vulnerability still persist, mainly including debt overhang in the corporate sector and rampant shadow banking activities. Although the shift of the monetary stance and newly deployed regulatory efforts have somewhat slowed their momentum, the gigantic “stock” of these frailties still poses a material threat to the country’s financial stability. On the other hand, the ongoing deleveraging in the real economy and financial sector, with its original intention of mitigating the above risks, might drag on growth as well. Altogether, the authorities need to find a balance and choose an appropriate pace between pushing forward the deleveraging progress and maintaining a sustainable growth momentum.

In terms of the corporate debt problem, the soft budget constraint with the implicit guarantee from the government makes the SOEs continue their borrowing from the state-owned banks. Investment efficiency has fallen, evidenced by the over-capacity in some typical sectors. At the micro level, corporate data show that the financial performance of corporates has deteriorated steadily, lowering the asset quality of financial institutions. The corporate debt problem and ultimately the SOE reform should be addressed urgently with a comprehensive strategy, such as proactively recognising losses in the financial system, burden sharing, corporate restructuring and governance reform, hardening budget constraints, and facilitating market entry.

In addition, the surge in shadow banking is impairing China’s debt problem and posing additional risks to the financial sector, as the credit boom has been driven in part by shadow banking finance products used to funnel credit to local governments and businesses that have difficulties in getting regular bank loans. At the current stage, the financial intermediate chain, which indicates the time taken from the capital providers to the ultimate users, has been lengthening over time, suggesting an increasingly sophisticated structure of shadow banking activities. Thus, as these off-balance sheet activities are not subject to banking regulations, any collapse from the final investment destination of shadow banking, such as housing, non-standard credit assets (NSCA), bond, derivatives and money market instruments etc., will lead to systematic risks for the financial sector.

On the other hand, as the authorities have already expressed their concers on debt overhang and shadow banking, a series of measures to curb the above risks have been implemented. However, the market is also worried about the extent to which these tightening measures in the real economy and the financial sector might drag on growth in the medium and long run. For instance, M2 growth, due to the tightening measures, decreased to a historical low for the past twenty years in June.

External shocks come mainly from Fed’s interest rate hikes and Trump’s trade protectionism. In addition, populism in Europe is also adding uncertainty to the economic outlook. As the US normalisation of monetary policy is on the way, we predict the RMB depreciation and capital outflow will continue in the medium term, also in view of the continuing economic slowdown in China. Moreover, the US-centric trade policies of the new US administration will also deterioriate China’s external demand, hence the recent idea of depending on external demand to stimulate growth might not be realistic.

IMPORTANT DISCLOSURES

The BBVA Group companies that have participated in preparing or contributed information, opinions, estimates, forecasts or recommendations to this report are identified by the location(s) of the author(s) listed on the first page as follows: 1) Madrid, London or Europe = Banco Bilbao Vizcaya Argentaria, S.A., including its E.U. branches (hereinafter called 'BBVA'); 2) Mexico City = BBVA Bancomer, S.A. Institución de Banca Múltiple, Grupo Financiero BBVA Bancomer (hereinafter called 'BBVA Bancomer'); 3) New York = BBVA Securities, Inc. (hereinafter called "BBVA Securities"); 4.) New York Branch = BBVA, New York branch; 5.) Lima = BBVA Continental; 6.) Bogota = BBVA Colombia S.A.; 7.) Santiago = BBVA Chile S.A.; 8.) Hong Kong = BBVA, Hong Kong branch, 9.) Istanbul = Garanti Securities.

For recipients in the European Union, this document is distributed by BBVA, a bank supervised by Banco de España and by Spain's Stock Exchange Commission (CNMV), and registered with Banco de España with number 0182.

For recipients in Hong Kong, this document is distributed by BBVA, which Hong Kong branch is supervised by the Hong Kong Monetary Authority.

For recipients in Mexico, this document is distributed by BBVA Bancomer, a bank supervised by the Comisión Nacional Bancaria y de Valores (Mexico's SEC).

For recipients in Peru, this document is distributed by BBVA Continental, a bank supervised by the Superintendencia de Banca, Seguros y Administradoras Privadas de Fondos de Pensiones.

For recipients in Singapore, this document is distributed by BBVA, which Singapore branch is supervised by the Monetary Authority of Singapore.

For recipients in the USA, research on products other than swaps, or equity securities and equity derivatives prepared by BBVA, is distributed by BBVA Securities, a subsidiary of BBVA registered with and supervised by the U.S. Securities and Exchange Commission and a member of the Financial Industry Regulatory Authority ("FINRA") and the Securities Investor Protection Corporation. U.S. persons wishing to execute any transactions should do so only by contacting a representative of BBVA Securities in the U.S. Unless local regulations provide otherwise, non-U.S. persons should contact and execute transactions through a BBVA branch or affiliate in their home jurisdiction.

Research on swaps is distributed by BBVA, a swaps dealer registered with and supervised by the Commodity Futures Trading Commission ("CFTC"). U.S. persons wishing to execute any transactions should do so only by contacting a representative of BBVA. Unless local regulations provide otherwise, non-U.S. persons should contact and execute transactions through a BBVA branch or affiliate in their home jurisdiction.

Research prepared by BBVA on equity securities and equity derivatives is distributed by BBVA to "major U.S. institutional investors" based on an exemption from registration provided by Rule 15a-6 of the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act"). BBVA is not a registered broker-dealer in the United States and is not subject to U.S. rules on preparing research or independence of research analysts.

BBVA and BBVA Group companies or affiliates (art. 42 of the Royal Decree of 22 August 1885 Code of Commerce), are subject to the BBVA Group Policy on Conduct for Security Market Operations which establishes common standards for activity in these entities' markets, but also specifically for analysis and analysts. This BBVA policy is available for reference on the following website: www.bbva.com.

Analysts residing outside the U.S. who have contributed to this report may not be registered with or qualified as research analysts by FINRA or the New York Stock Exchange and may not be considered "associated persons" of BBVA Securities (as such term is construed by the rules of FINRA). As such, they may not be subject to FINRA Rule 2241 or 2242 restrictions on communications with subject companies, public appearances and trading of securities held in research analysts' accounts.

BBVA is subject to Internal Standards of Conduct on the Security Markets, which detail the standards of the above-mentioned overall policy for the EU. Among other regulations, they include rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. These Internal Standards of Conduct on the Security Markets are available for reference in the 'Corporate Governance' section of the following website: www.bbva.com.

BBVA Bancomer is subject to a Code of Conduct and to Internal Standards of Conduct for Security Market Operations, which details the standards of the above-mentioned overall policy for Mexico. Among other regulations, it includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. This Code and the Internal Standards are available for reference in the 'Grupo BBVA Bancomer' subsection of the 'Conócenos' menu of the following website: www.bancomer.com.

BBVA Continental is subject to a Code of Conduct and to a Code of Ethics for Security Market Operations, which details the standards of the above-mentioned overall policy for Peru. Among other regulations, it includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. Both Codes are available for reference in the 'Nuestro Banco' menu of the following website: https://www.bbvacontinental.pe/meta/conoce-bbva/.

BBVA Securities is subject to a Capital Markets Code of Conduct, which details the standards of the above-mentioned overall policy for USA. Among other regulations, it includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers.

Exclusively for Recipients Resident in Mexico

BBVA Bancomer acts as a market maker/specialist in: MexDer Future Contracts (US dollar [DEUA], 28-day TIIEs [TE28], TIIE Swaps, 91-day CETES [CE91]), Bonos M, Bonos M3, Bonos M10, BMV Price and Quotations Index (IPC), Options Contracts (IPC, shares in América Móvil, Cemex, CPO, Femsa UBD, Gcarso A1, Telmex L) and Udibonos.

BBVA Bancomer, and, as applicable, its affiliates within BBVA Bancomer Financial Group, may hold from time to time investments in the securities or derivative financial instruments with underlying securities covered in this report, which represent 10% or more of its securities or investment portfolio, or 10% or more of the issue or underlying of the securities covered.

DISCLAIMER

This document and the information, opinions, estimates, forecasts and recommendations expressed herein have been prepared to provide BBVA Group's customers with general information and are current as of the date hereof and subject to changes without prior notice. Neither BBVA nor any of its affiliates is responsible for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, to undertake or divest investments, or to participate in any trading strategy. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. Other than the disclosures relating to BBVA Group, the contents of this document are based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA or any of its affiliates and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. To the extent permitted by law, BBVA and its affiliates accept no liability of any type for any direct or indirect losses or damages arising from the use of this document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, derivatives, options on securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances; investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying securities. Investors should also be aware that secondary markets for the said instruments may not exist. Before entering into transactions in futures, derivatives, or options, investors should review all documents on disclosures for risks of investing in options and/or futures at the following websites:

Options - http://www.finra.org/Industry/Regulation/Notices/2013/P197741

Futures - http://www.finra.org/Investors/InvestmentChoices/P005912

BBVA or any of its affiliates' salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. More specifically, this document is in no way intended for, or to be distributed or used by an entity or person resident or located in a jurisdiction in which the said distribution, publication, use of or access to the document contravenes the law which requires BBVA or any of its affiliates to obtain a licence or be registered. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

The remuneration system concerning the analysts responsible for the preparation of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons.

BBVA Hong Kong Branch (CE number AFR194) is regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission of Hong Kong. In Hong Kong this report is for distribution only to professional investors within the meaning of Schedule 1 to the Securities and Futures Ordinance (Cap 571) of Hong Kong. This document is distributed in Singapore by BBVA's office in this country for general information purposes and it is generally accessible. In this respect, this document does not take into account the specific investment goals, the financial situation or the need of any particular person and it is exempted from Regulation 34 of the Financial Advisors Regulation ("FAR") (as required in Section 27 of the Financial Advisors Act (Chapter 110) of Singapore ("FAA")).

Garanti Securities headquarters is in Istanbul, Turkey and is regulated by Capital Markets Board (Sermaye Piyasası Kurulu - SPK, www.spk.gov.tr). BBVA, BBVA Bancomer, BBVA Chile S.A., BBVA Colombia S.A., BBVA Continental, BBVA Securities and Garanti Securities are not authorised deposit institutions in accordance with the definition of the Australian Banking Act of 1959 nor are they regulated by the Australian Prudential Regulatory Authority (APRA).

General Disclaimer for Readers Accessing the Report through the Internet

Internet Access

In the event that this document has been accessed via the internet or via any other electronic means which allows its contents to be viewed, the following information should be read carefully: The information contained in this document should be taken only as a general guide on matters that may be of interest. The application and impact of laws may vary substantially depending on specific circumstances. BBVA does not guarantee that this report and/or its contents published on the Internet are appropriate for use in all geographic areas, or that the financial instruments, securities, products or services referred to in it are available or appropriate for sale or use in all jurisdictions or for all investors or counterparties. Recipients of this report who access it through the Internet do so on their own initiative and are responsible for compliance with local regulations applicable to them. Changes in regulations and the risks inherent in electronic communications may cause delays, omissions, or inaccuracy in the information contained in this site. Accordingly, the information contained in the site is supplied on the understanding that the authors and editors do not hereby intend to supply any form of consulting, legal, accounting or other advice. All images and texts are the property of BBVA and may not be downloaded from the Internet, copied, distributed, stored, re-used, re-transmitted, modified or used in any way, except as specified in this document, without the express written consent of BBVA. BBVA reserves all intellectual property rights to the fullest extent of the law.

BBVA | Research

This report has been produced by the China Unit:

Chief Economist for Asia
Le Xia
xia.le@bbva.com.hk

Jinyue Dong
jinyue.dong@bbva.com.hk

Betty Huang
betty.huang@bbva.com.hk

Sumedh Deorukhkar
sumedh.deorukhkar@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Macroeconomic Analysis
Rafael Doménech
r.domenech@bbva.com

Global Economic Situations
Miguel Jiménez
mjimenezg@bbva.com

Global Financial Markets
Sonsoles Castillo
s.castillo@bbva.com

Long term Global Modelling and Analysis
J. Julián Cubero
juan.cubero@bbva.com

Innovation and Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Financial Systems And Regulation
Santiago Fernández de Lis
sfernandezdelis@bbva.com

International Coordination
Olga Cerqueira
olga.gouveia@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Regulation
María Abascal
maria.abascal@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Spain and Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

United States
Nathaniel Karp
Nathaniel.Karp@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Middle East, Asia and Geopolitical
Álvaro Ortiz
Alvaro.ortiz@bbva.com

Turkey
Álvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

South America
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

FOR ANY QUERIES< PLEASE APPLY TO: BBVA Research: Calle Azul, 4. Edificio de la Vela - 4ª y 5ª plantas. 28050 Madrid, Spain. Tel.+34 91 374 60 00 and +34 91 537 70 00 / Fax+34 91 374 30 25 - bbvaresearch@bbva.com www.bbvaresearch.com

Legal deposit: M-31254-2000