China Economic Outlook

1st QUARTER 2018 | ASIA UNIT

Index

1. Solid, sustained global growth in 2017 3

2. China staged a growth recovery in 2017 4

3. Entering "great moderation" with optimism 14

4. Risk to the downside 17

Closing date: **24 January 2018**

1. Solid, sustained global growth in 2017

World economic growth consolidated in late 2017 at reasonably solid rates of around 1% QoQ, reflecting improved results in all major areas and showing signs of continuing in good health over the coming quarters. Support from economic policy, above all in developed economies, eventually had a clear impact on the real economy, with a recovery of investment that gained traction with support in the form of increased demand and an upturn in international trade, factors which have also driven the recovery of the industrial sector. Meanwhile, private consumption continues to perform well in advanced economies, while gaining momentum in emerging economies. Forecasts and market confidence in many such economies have also been favoured by the higher commodity prices, as well as by financial markets, which continue to encourage the influx of capital. Confidence indicators continue to improve, the result of strong economic performance and reduced short-term risk, with forecasts pointing to an ongoing positive panorama. World growth may increase by 0.4% to 3.7% in 2017, 0.2% more than was forecast three months ago.

Over the past three months, there have been further reasons to remain optimistic in the key areas. Throughout 2017, recovery in the U.S. was accompanied by growth rates that were higher than expected, while the labour market has also continued to strengthen. Tax reforms were finally passed, which may slow cyclical recovery. Nevertheless, they will not have a significant impact in the long-term. Meanwhile, recent Federal Reserve appointments point to an unchanged monetary policy, which should be reflected by a very gradual approach to normalisation. In China, the measures passed by the authorities stabilised the economy while also implementing structural reforms and approving an economic strategy that focuses more on getting fiscal imbalances under control and less on meeting growth targets. Finally, the Eurozone recorded higher than forecast growth in 2017, backed by an improved economic climate and stronger internal demand which is benefitting from less political uncertainty. This scenario of increased growth and higher demand was accompanied by subdued inflation, despite the expansionary measures adopted by major central banks and the gradual reduction in idle capacity in developed economies. Doubts nevertheless remain as to whether factors underpinning the weakness of inflation are transitory or permanent, whether globalisation, the flexibility of labour markets, low inflation forecasts or increased productivity lie behind the slower reaction of prices to increased economic activity. Doubts also exist as to whether or not there will continue to be a lack of clear signs of increased inflationary pressure, at least for now. Increased growth and higher oil prices should push inflation up in the short term, facilitating advances in the normalisation of central bank policy in developed economies, while many emerging economies still have room for manoeuvre when it comes to using monetary policy to bolster growth.

2. China staged a growth recovery

The Q4 GDP growth outturn came at 6.8% y/y, marginally surprised the market to the upside (Bloomberg consensus: 6.7% y/y). Altogether, China's GDP grew by 6.9% in 2017(Bloomberg consensus: 6.8%), higher than the 2016 reading of 6.7%. That being said, the second largest economy in the world has successful staged a growth recovery last year, synchronized with the rest of the world, despite a number of headwinds from the prudential monetary policy, stepped-up efforts of financial tightening as well as the production disruption caused by some supply-side reforms.

Underpinned the headline figures are a number of favourable factors, including: (i) Economic rebalancing is continuing as the tertiary industry (mainly the service sector) expanded at a pace (8% y/y) faster than the other two industries and the aggregate output. On the demand side, consumption expenditure's contribution to GDP growth reached 4.1%, well above that of investment (2.2%); (ii) A persistent global recovery in 2017 has buoyed China's exports. As a consequence, the net export's contribution to growth reached 0.6%, compared to its 2016 reading 2016 reading of -0.4%. (iii) "New Economy" has grown to become a new growth engine. The recently stellar rise of FinTech, information technology, E-commerce and new energy has helped to offset the adverse impact from financial tightening and supply-side disruption. (iv) Private investment picked up to 6.0% y/y in 2017, up from 4.2% in the previous year as the confidence of the private sector substantially improved.

Meanwhile, the authorities continue their efforts to overhaul the regulatory framework of financial sector so as to clamp down shadow banking activities and ensure the financial stability. They also vow to deepen the supply-side reform and enforce environmental policies to improve growth quality as they promised in the 19th Party's Congress concluded last November. We expect these initiatives to weigh on growth for the short term while benefit the economy in the long run. That being said, the higher-than-expected 2017 GDP growth can give more policy room for manoeuvre so that they can meet their targets of reining in debt growth to maintain financial stability on one hand while averting any sharp growth dip on the other hand.

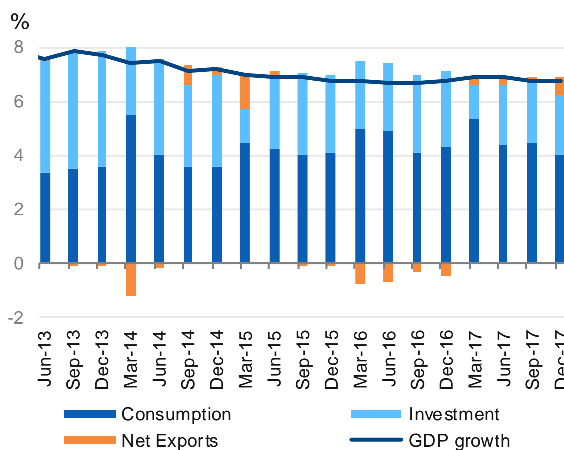
In the medium to long term, the economy will enter into a "Great Moderation" period, featuring by: (i) marked reduction in the volatility of output and inflation; (ii) a protracted period of a slower but sustainable growth and economic rebalancing; and (iii) less interventions through monetary or fiscal stimulus. Key to the materialization of our estimated growth track is the progress of on-going structural reforms on various fronts. The authorities need to address the debt issue in the corporate sector and press ahead with SOEs reforms. Moreover, they need to walk a fine line between containing systemic risks in the financial sector and maintaining growth. (Please see our recent Economic Watch: From Great Miracle to Great Moderation.)

Signs of growth moderation in Q4 although soft-landing achieved in 2017

The Q4 GDP outturn (6.8% y/y) marginally exceeded market expectations at 6.7% y/y. Sequentially, GDP expanded at 1.6% q/q, compared with 1.8% q/q in the third quarter. (Figure 2.1) In particular, our MICA model yields a monthly GDP estimate at 6.9%, basically in line with the Q4 GDP outturn. (Figure 2.2) By category, the contribution of consumption to GDP growth reached 4.06%, dominating the investment's contribution at 2.21% and net exports' at 0.63%. The net exports make a positive contribution to the total GDP growth compared with its negative reading in 2016, thanks to the continuing improving external environment.

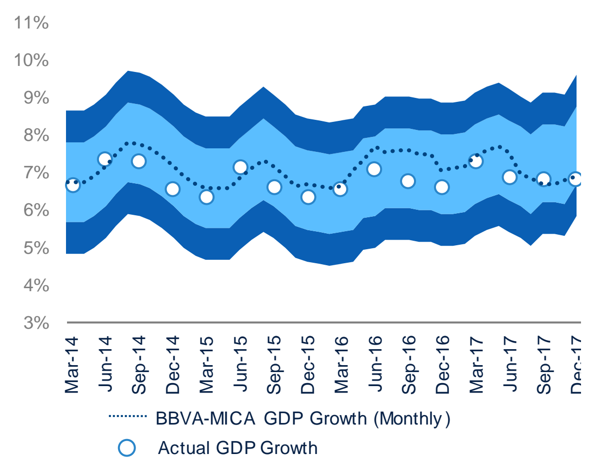
Despite the economy's stronger-than-expected performance in 2017 as a whole, a batch of activity and credit indicators released recently indicate that growth was moderating in the last quarter of 2017. That being said, the growth, even though it is resilient subject to a number of policy headwinds from both supply and demand sides, might continue the moderating trend this year.

Figure 2.1 Economic rebalancing is continuing



Source: BBVA Research and CEIC

Figure 2.2 BBVA MICA model for GDP forecasting



Source: BBVA Research and CEIC

On the supply side, activity indicators are quite sluggish in December. Industrial production marginally increased to 6.2% y/y from 6.1% y/y previously (consensus: 6.1% y/y). Meanwhile, the different indicators of producers' sentiment sent mixed signals. China's official manufacturing PMI decreased to 51.6 in December from 51.8 in the previous month (Consensus: 51.6). While the Caixin China Manufacturing PMI, which includes a survey sample tilting toward SMEs and exporters, picked up to 51.5 in December (versus consensus 50.7) from 50.8 in the previous month (Figure 2.3)

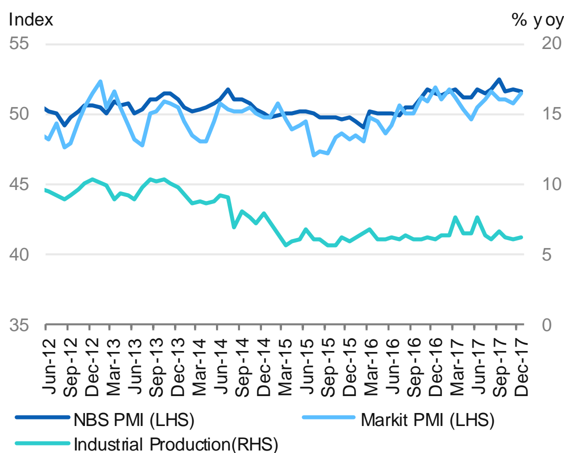
The divergence between the official PMI and Caixin PMI as well as the anemic growth in industrial production confirmed our assessment that some growth headwinds such as the RMB appreciation and the enforcement of environmental policy tend to have a greater adverse impact on growth. Overall, the supply-side reform and the enforcement of environmental policy have led to production disruption.

Both supply and demand sides are subject to growth headwinds

The demand side is also subject to downward pressure. Retail sales growth slowed down significantly to 9.4% y/y in December from 10.2% y/y in the previous month (consensus: 10.2% y/y). (Figure 2.4) The slowdown was led by auto sales, which grew by 2.2% y/y in December compared to a 6.4% y/y growth in July, mainly due to the expiration of fiscal subsidy for passenger car purchase. The only silver lining is the rapid growth of online sales, surging 28% y/y in 2017 as a whole, significantly surpassing the aggregate retail sales growth at 10.2% in 2017.

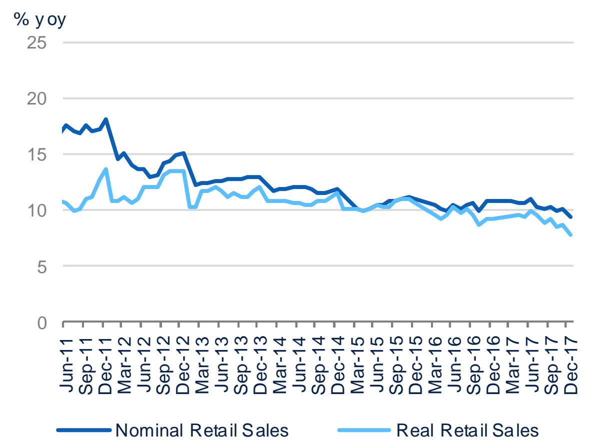
Demand-side weakness is also reflected by sluggish fixed asset investment which remained at 7.2% ytd y/y, the same with the previous reading (consensus: 7.1% ytd y/y), indicating investment was constrained by financial tightening. Moreover, the slowdown in investment is quite diverging among different categories as real estate and infrastructure sectors declined significantly while manufacturing investment displayed some pick-up. This is quite policy-led as the authorities had the end-year budget constraint thus lowered infrastructure investment. Moreover, the tightening measures on housing market continued. (Figure 2.6) The good news is that the growth of private investment increased to 9.2% ytd y/y in December from 4.8% ytd y/y previously, which is in line with the manufacturing investment pick-up as well as the Caixin PMI surpassing NBS PMI in December. (Figure 2.5)

Figure 2.3 Decoupling between PMIs and industrial production



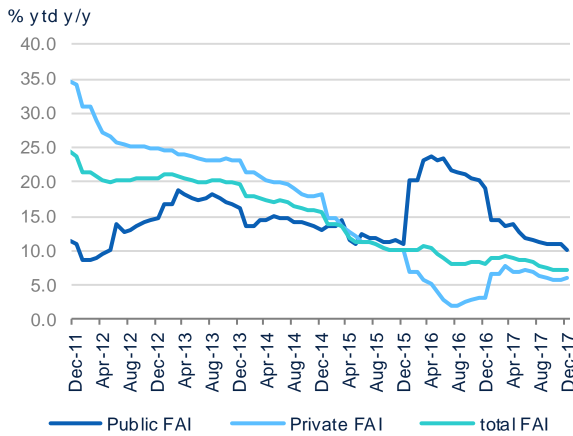
Source: BBVA Research and CEIC

Figure 2.4 Both real and nominal retail sales declined in December



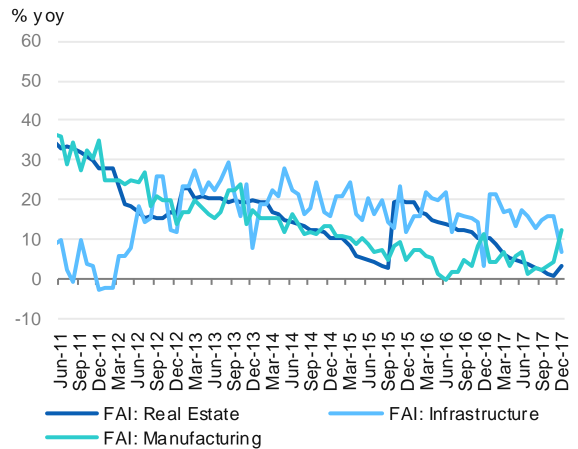
Source: BBVA Research and CEIC

Figure 2.5 Private and Public investment display the trend of converging



Source: BBVA Research and CEIC

Figure 2.6 Infrastructure investment has Softened due to the end-year budget constraint



Source: BBVA Research and CEIC

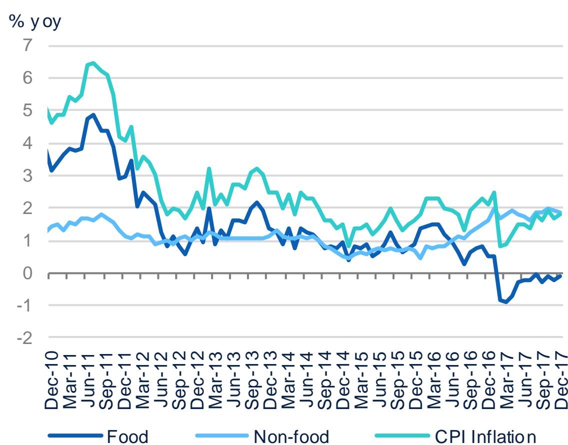
The effect of supply-side shocks on price indictors will continue

Headline CPI inflation picked up marginally to 1.8% y/y in December from 1.7% in the previous month, above market consensus of 1.7%.The uptick in CPI inflation was driven by food prices as their negative contribution to year-on-year price increase narrowed in December. Moreover, non-food price also increased, supported by the high crude oil price (Figure 2.7)

CPI and PPI started to converge in December, which we believe is not sustainable.

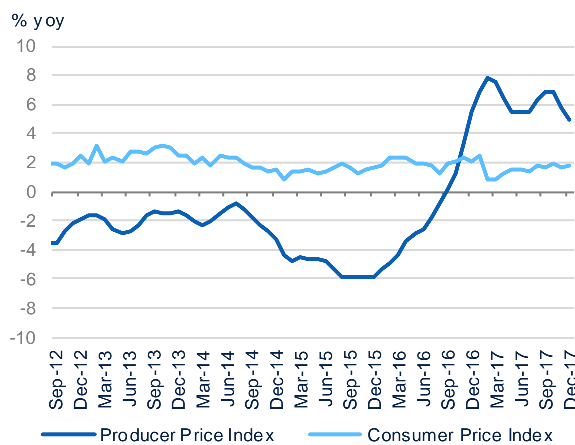
On the other hand, PPI decreased significantly to 4.9% y/y in December from 5.8% in the previous month (Consensus: 4.8%), which is the lowest within the year, mainly driven by the base effect. (Figure 2.8) That being said, CPI and PPI were converging in December. However, in the future, we predict the policy-led disruptions of supply side will bolster up PPI and widen their gap again. That means, we believe the rigidity of PPI will be high in this year given the on-going supply side reform and production reduction for environmental protection. Moreover, we forecast CPI will only modestly increase to around 2.3% in this year driven by a gradual recovery of food price and a high energy price.

Figure 2.7 CPI picked up marginally in December



Source: BBVA Research and CEIC

Figure 2.8 PPI and CPI started to converge in December



Source: BBVA Research and CEIC

Monetary prudence helped to contain credit boom

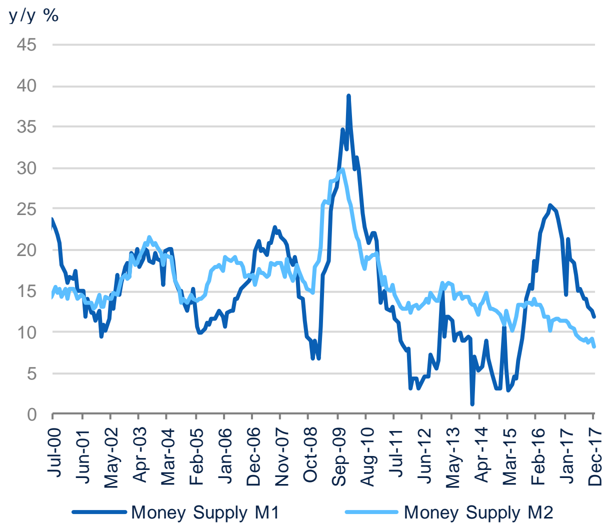
Starting from end-2016, the authorities fine-tuned their monetary policy stance from "accommodative" to "prudent". In practice, the PBoC even guided market interest rates to a higher level so as to curb shadow banking activities and contain credit boom. These measures have maintained the effect through the year as M2 growth dipped to its historical low of 8.2% y/y in December, compared with the previous month's reading at 9.1% YoY (consensus: 9.2% YoY). (Figure 2.13)

Credit data outturn dropped to a historical low in December.

Meanwhile, the growth of new loans and total social financing also decreased significantly in December. In particular, total social financing declined to RMB 1,140 billion (prior: RMB 1,619.6 billion; consensus: RMB 1,500 billion) in December and New yuan loans also dropped to RMB 584.4 bn (prior: RMB 1,120 billion; consensus: RMB 1,000 billion). (Figure 2.14)

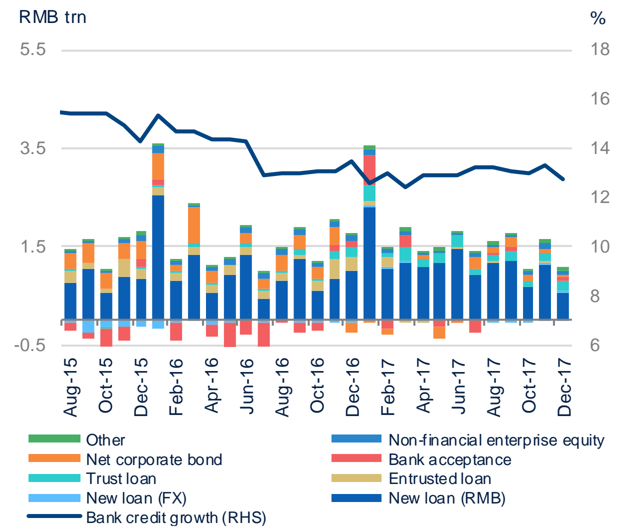
The low credit data in December reflected the effect of financial sector deleveraging as banks shrank their shadow banking business. Moreover, the end-year Macro Prudential Assessment also played a role on low credit expansion as banks lowered their lending in December. On the other hand, enterprises and household also had lower capital demand due to the ongoing corporate deleveraging and housing market tightening. We believe this is quite temporary as it is mainly driven by seasonal effect. We predict M2 growth will maintain at a moderated level in 2018 given the financial tightening continues.

Figure 2.9 M2 growth dipped significantly in December



Source: BBVA Research and CEIC

Figure 2.10 Shadow banking activities shrank



Source: BBVA Research and CEIC

Prudent monetary policy and regulatory tightening continued in the aftermath of the 19th Party's Congress. The recent regulatory changes are shown in the following table. These regulatory changes touched upon a lot of areas in the financial sector, in particular the ones related to shadow banking activities: the cooperation business between banks and trust companies, entrust loans and wealthy management products, etc. All of them are regarded as key elements in China's ballooning shadow banking activities. Moreover, the regulators have also tightened the regulations on bond trading so as to severe the linkage between shadow banking activities and the bond market. The authorities have become tougher on third-party payment institutions as many shadow banking activities are now disguised as Fintech businesses. Overall, these tightening measures can be considered as the embodiment of the new regulatory principle set in the recently concluded 19th Party's Congress. We expect them to bring negative but manageable shocks to China's financial market, in particular the bond market, in the next couple of years.

Date	Regulators	Target	Key elements
11/17/2017	PBoC	Asset management business (including wealth management products)	Imposing a new regulatory leverage ratio on asset management products and breaking implicit guarantees provided by product distributors
12/1/2017	PBoC	Online micro-lending firms	Unauthorized entities and individuals are not allowed to conduct a lending business.
12/22/2017	CBRC	Bank-Trust cooperation businesses	Clamping down on irregularities of Bank-Trust cooperation businesses
12/29/2017	CBRC	Asset Management Company	The CBRC circulated the Capital Rule for Asset Management Companies (AMCs): Core CAR>=9%;Tier I CAR>=10%; and Total CAR>=12.5%.
1/2/2018	PBoC	Required Reserve Ratio of Third-Party Payment institutions	Raising the RRR of Third-Party Payment institutions to 50% from the current 20%
1/3/2018	PBoC, CBRC, CSRC and CIRC	Bond trading	Banning the practice of using other institutions' accounts to participate in bond trading for the purpose of regulatory arbitrage and putting limits on repo and reverse repo business for different types of financial institutions.
1/5/2018	CBRC	Large-scale exposure of Commercial Banks	Stipulating banks' maximum exposure for a single client: outstanding loan <=10% of total capital etc.
1/5/2018	CBRC	Equity Transaction in commercial bank	Clamping down on connected transactions between commercial banks and their major shareholders.
1/6/2018	CBRC	Entrusted loans	Clamping down irregularities of entrust loan business (company-to-company loan with a bank as the monitor)

Housing markets continued to cool down due to the tightening measures

The tightening measures on the property market have effectively moderated price increases and frozen the trading volume in Tier 1 cities (Figure 2.15). As more local authorities started to deploy tightening measures in cities other than tier 1, housing bubbles now seem to ease further. However, there are still much more cities reporting housing price increasing than the cities reporting decreasing, mainly are smaller cities. (Figure 2.16) On top of imposing home purchase restrictions, the authorities also use financial tools to contain housing bubbles, such as increasing the interest rate of mortgage loans. Moreover, the authorities particularly forbid home buyers from borrowing short-term loans to pay for their down payment, in a bid to keep household leverage at a manageable level.

Altogether, although the housing market tightening measures helped to ease housing bubble and maintain financial stability, we believe that housing market cooling down will drag on growth this year.

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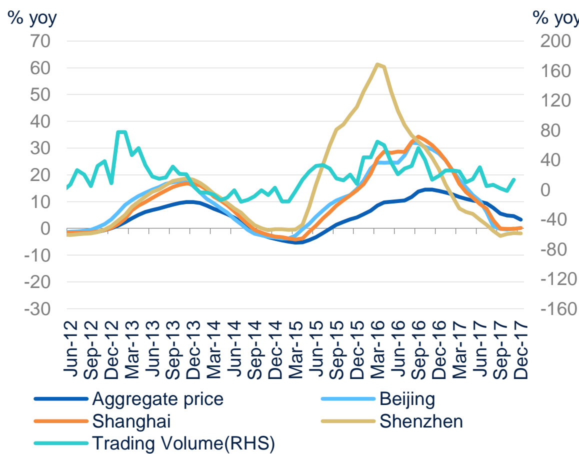
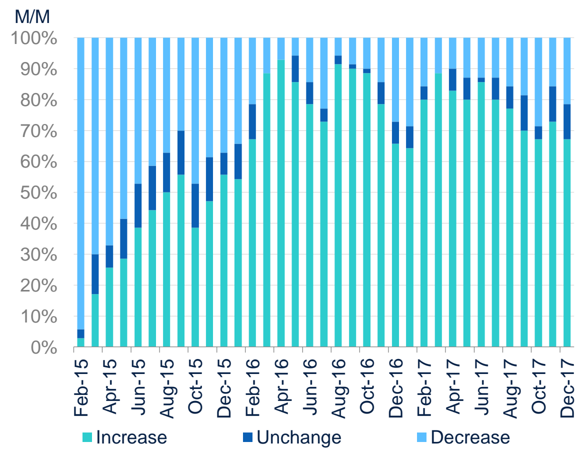
Figure 2.11 Housing price maintained at a low level due to the tightening measures



Source: BBVA Research and CEIC

Figure 2.12 Mega-cities report remarkable price decline due to tighter regulations



Source: BBVA Research and CEIC

Divergence of exports and imports at end-year

In December, the growth of exports (in USD terms) marginally decreased to 10.9% y/y (versus consensus: 10.8% y/y) from the previous reading of 11.5% while imports significantly dropped to a year-on-year growth of 4.5% (versus consensus: 15.1% y/y; prior: 17.6% y/y). As a result, the balance of trade expanded to USD 54.69 billion in December from USD 38.98 billion in the previous month. (Figure 2.10)

Due to the continuing recovery of global economy, exports at the end-year still maintained at a relatively high level. On the other hand, the significant drop of imports was mainly due to: (i) a production reduction for environmental protection in winter; (ii) a high inventory and (iii) a high base effect. Given the significant appreciation of RMB to USD exchange rate in December, it seems that it has not transmitted to exports and imports yet. However, we believe a continuing currency appreciation might push up imports while decrease exports in the short term.

For 2017 as a whole, total exports increased to 8% y/y in terms of US Dollar, compared with -7% y/y in 2016; total imports increased to 16.7% y/y in terms of US Dollar, compared with -5.3% in 2016. We predict that exports will maintain a sustainable growth in 2018, mainly due to the US tax cut effect following with a worldwide tax reduction, as well as a continuing global growth recovery. On the other hand, we predict a modestly slower growth rate of imports compared with that of 2017, due to the continuing deleveraging in financial sector and in the over-capacity industries.

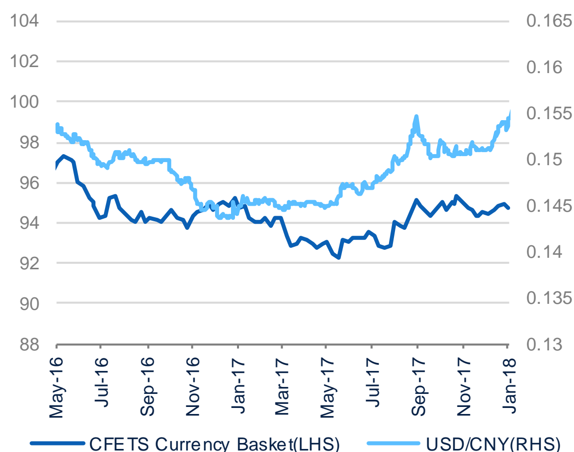
The unexpected RMB appreciation

The RMB exchange rate experienced a sharp appreciation recently on the backdrop of a sluggish USD. Accumulatively, the RMB has appreciated by 5.3% against the USD since the beginning of the third quarter of 2017 and by 0.9% since the beginning of the New Year. It is noted that the RMB appreciation during this period is not only against the USD but also against the CFETS currency basket. (Figure 2.9) Despite the persist weakness of the USD, the strong

The RMB appreciation will push up the imports while weighed on exports

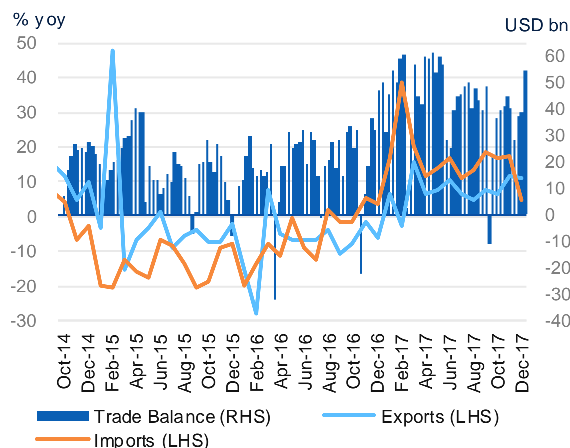
rebound of the RMB also benefits from the ever-increasing restrictions under the capital account. Moreover, the recent recovery of the macro economy also supported the RMB exchange rate.

Figure 2.13 RMB to USD appreciated significantly in the recent months



Source: BBVA Research and CEIC

Figure 2.14 Divergence of exports and imports at the year end



Source: BBVA Research and CEIC

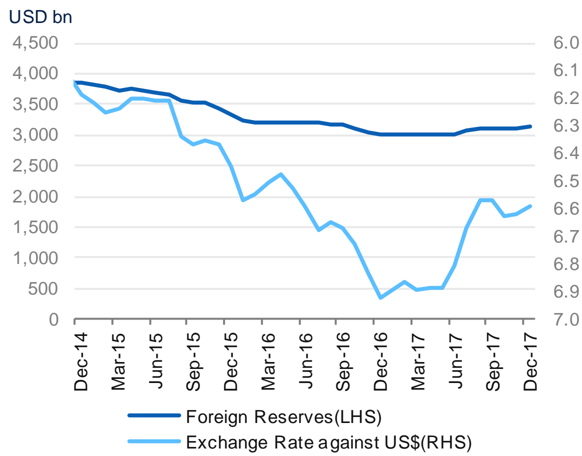
Risks to BOP eased mainly due to the recent RMB appreciation and the authorities' measures

Foreign reserves continued to grow in the fourth quarter and reach USD 3.14 trillion at end-December, up from USD 3.12 trillion in the previous month. (Figure 2.11) Barring the favourable valuation effects of non-USD foreign reserves over the past several months (mainly due to a depreciation of USD), the narrowed capital outflows due to strict regulation measures also contributed to the growth of foreign reserves. In particular, we estimate that capital outflows amounted to USD 39.7 billion in December, down from USD 47.3 billion in the previous month. (Figure 2.12)

The increase in foreign reserves and moderating of capital outflow could continue in the following months.

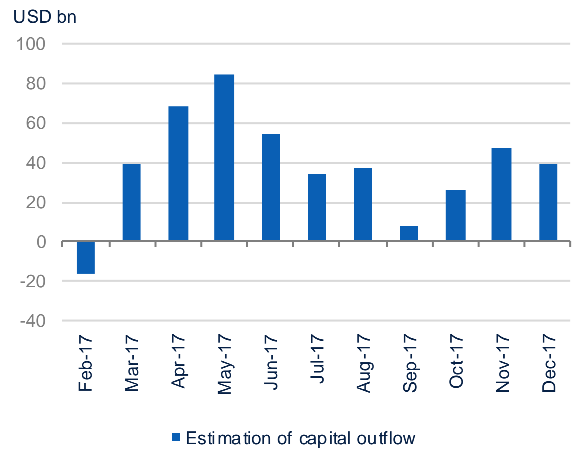
The recent sharp RMB appreciation, together with the authorities' measures of "restrict capital outflows and promote capital inflows", will continue to mitigate risks to China's Balance of Payment (BOP) and help to avert a vicious spiral of currency depreciation and capital flight.

Figure 2.15 Foreign reserves recorded several months of growth



Source: BBVA Research and CEIC

Figure 2.16 Estimates of Capital outflows



Source: BBVA Research and CEIC

3. Entering "great moderation" with optimism

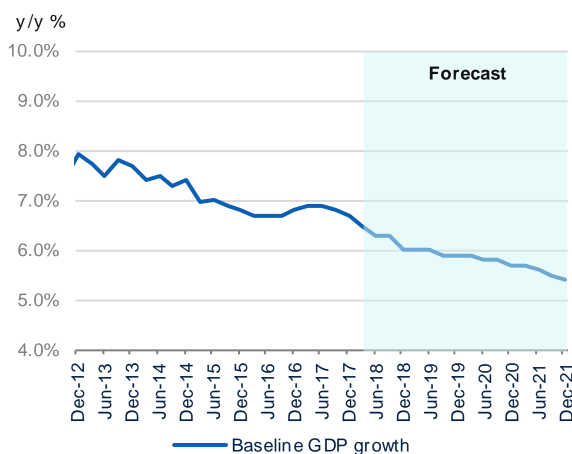
Some upward revision of short-run GDP

China's growth has exhibited some new developments in the second half of 2017 and the final GDP growth outturn is actually better-than-expected. However, signs of moderation emerged in the 2H of 2017 due to a number of policy tightening including monetary prudence, regulatory efforts to curb shadow banking activities and overheating property market. On the other hand, these policy initiatives have helped to mitigate several tail risks to the economy and financial stability, increasing the likelihood of a soft-landing scenario for the world's second largest economy.

Accordingly, we raise our 2018 growth forecast to 6.3% from 6% previously and maintain 2019 forecasting at 6%, reflecting the strong 2017 growth and mitigated financial risks. However, they are still somewhat lower than the market consensus (Bloomberg consensus: 6.5% for 2018 and 6.2% for 2019). Nevertheless, we anticipate that the authorities broadly maintain the policy mix in the next couple of years over the concern of financial stability. In addition, we believe that the growth will be mainly driven by domestic consumption this year. Specifically, we predict consumption will contribute to around 4.5% (versus: 4.1% in 2017) for GDP growth, dominating investment's contribution of 1.6% (versus: 2.2% in 2017) and net export's contribution at 0.2% (versus: 0.5% in 2017).

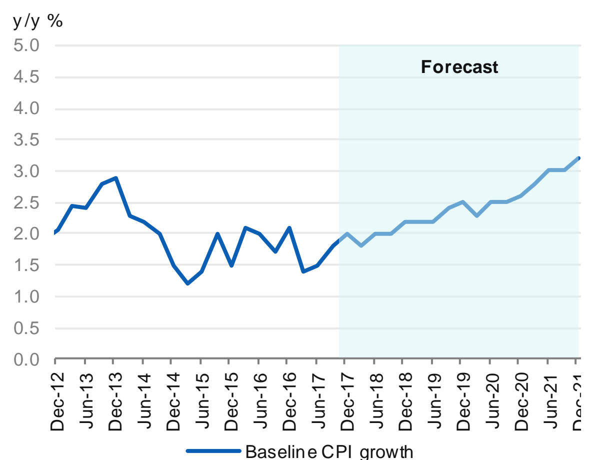
Regarding inflation, we remain our 2018 monthly average projection of CPI at 2% in 2018 and 2.3% in 2019 (Bloomberg: 2.3% for 2018 and 2.2% for 2019) due to lower-than-expected food prices in the last year (Figure 3.2). Looking ahead, the CPI and PPI will finally converge in the long term. CPI is expected to trend up gradually after the food-prices rebound from the current low level. Meanwhile, the PPI will gradually slow its pace as the supply-side reform proceeds. That being said, supply-side shocks caused by overcapacity elimination are likely to have diminishing marginal impact on price levels as investors gradually factor it into their expectations.

Figure 3.1 We have raised our 2018 GDP forecast to 6.3% from 6% previously



Source: BBVA Research and CEIC

Figure 3.2 We keep our CPI forecast at 2% for 2018 and 2.3% for 2019



Source: BBVA Research and CEIC

Mild currency depreciation will continue with a measured pace

The recent strong performance of the RMB has made us revise our projections of the exchange rate in the short term, mainly in the pace but not in the direction. We anticipate that the exchange rate will depreciate to 6.6 at end-2018 from end-2017 outturn at 6.5 with a very mild pace. Such a trajectory means a relatively stable value against the CFETS currency basket, which has become the important anchor of the RMB given that the authorities still need a competitive export sector to offset any negative shock to the economy in the course of policy tightening. (Table 3.1) At the same time, the weak US dollar has given China's authorities more room to introduce more two-way movements to the RMB exchange rate. That being said, the volatility of USDCNY is set to rise this year.

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 2019, which could make the exchange rate overshoot to 7.4 during a short period but ultimately go back to its long-term equilibrium level of around 6.8.

Table 3.1 Baseline Scenario

	2016	2017	2018 (F)	2019 (F)	2020 (F)	2021 (F)
GDP (%, YoY)	6.7	6.9	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	-3	-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	6.5	6.6	7.4	6.9	6.8

Monetary and fiscal policy outlook

A combination of a prudent monetary policy with tightening bias and a fiscal easing is predicted to be the main framework of the macro policy in 2018. A prudent monetary policy is consistent with the authorities' emphasis on maintaining financial stability and curtailing the rising risks in housing bubbles, debt overhang and shadow banking activities. At the same time, more regulations on shadow banking 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.

Corresponding to the US interest rate hike in 2018, we do not think the PBoC will follow to increase the benchmark lending rate and deposit rate. This is because the current RMB exchange rate and low inflation environment do not urgently require an interest rate hike. Moreover, as the financial deleveraging is continuing, the market interest rate has a tendency to be high, which lowers the urgent need for interest rate hike in China. On the other hand, considering the capital flight risk due to the US interest rate hike, as China still has a closed capital account, the authorities could apply various regulatory measures to control capital outflows.

Under the framework of monetary policy tightening, some unconventional monetary instruments will also be implemented, in order to maintain liquidity in the banking sector. For instance, Standing Lending Facilities (SLF) and Medium-term Lending Facilities (MLF) will continue to be applied. 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).

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) for 2018, we believe that the final deficit will be larger if we take into account adjustments for some extra-budget items.

To correspond to the recent US large-scale tax cuts, the authorities seemingly aspire to cut tax accordingly, such as lowering payroll tax, etc. The influences of US tax cuts might trigger capital outflow and repatriation of profits to the US, also, it will strengthen the USD and put the depreciation pressure on RMB. Thus, we believe the corresponding tax cut in China is not avoidable.

China will enter "Great Moderation" period in the long term

We attempt to gauge China's potential GDP till 2035 using traditional Cobb-Douglas production function by forecasting total factor productivity (A), labor (L) and capital formation (K). In our model, we set the capital share at 34% while the labor share is 66%. We calculate the potential output according to the formula $y^* = A^* L^{*1-\alpha} K^{*\alpha}$, where A*, L* and K* are the Hodrick-Prescott filtered value of total factor productivity (TFP), labor and capital formation.

As the Chinese economy is set to shift from investment-driven to consumption-driven growth, we predict the capital growth will decelerate from 9.5% this year to 4% in 2035. At the same time, the aging population will unavoidably slow labor growth over the medium-long term. As such, we assume a flat labor supply from now to 2030 and afterwards, the labor supply will grow with an average rate at -0.2% between 2030 and 2035 (among which, "labor supply" is defined as working age population*participation rate*(1-unemployment rate)). We expect that the TFP will become the main driver of China's growth in the long term, although at the current stage, growth is more likely driven by capital accumulation. Nevertheless, the TFP level will broadly maintain its long-term trend and closer to the last two decades productivity growth. Based on our assumptions above, the potential GDP growth will gradually moderate from the current level of 6.5% to 5.1% in 2025 and then to 4.1% in 2035.

If China's growth track can follow its potential GDP we estimated above, it means that the economy will enter a period of Great Moderation over the next two decades as we had seen in US and other advanced countries during the 20 years in the run-up of the 2008-2009 Global Financial Crisis. Just like its precedent in advanced countries, this Chinese version of Great Moderation features in: (i) marked reduction in the volatility of business cycle fluctuations, especially the output and inflation; (ii) a protracted period of a slower but sustainable economic growth with economic rebalancing in contrast to the current credit-fuelled growth; and (iii) a lower degree of intervention in the economy.

4. Risks to the downside

Risks regarding on growth are mainly from the policy side. The on-going deleveraging in the real economy and financial sector, with its original intention of mitigating the over-capacity and financial instability respectively, might drag on growth in the medium term. These policy measures mainly include supply-side deleveraging as well as cooling down the housing market and shadow banking.

On the other hand, although the shift of the monetary stance and newly deployed regulatory efforts have somewhat slowed the momentum of shadow banking, the gigantic stock of these frailties still poses a material threat to the country's financial stability. In addition, debt overhang in the corporate sector is still not fully digested through deleveraging measures. 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 this respect, market participants should guard against the risk of over-tightening stemming from the overconfidence of policymakers or the uncoordinated policy conduct among monetary, fiscal and supply-side policy initiatives.

Meanwhile, external risks still abound. The still buoyant external demand is also subject to headwinds from rising populism and protectionism globally. The latest example is the large-scale US tax cuts. At the end of 2017, the US Senate narrowly approved a tax overhaul. The bill slashes the corporate tax rate to 21% from 35%, enhancing the U.S. position against other industrialized economies, which have an average corporate rate of 22.5%. Altogether, it will add USD 1.4 trillion over 10 years to the $20 trillion national debt.

The risks of the US tax cut to China include: (1) it might trigger capital outflow as the business environment of doing business in US becomes more favourable, which includes the repatriation of the US's overseas retained profits and the investment in China; (2) it might put depreciation pressure on RMB, leading to another round of financial instability; (3) the competitiveness of Chinese local enterprises will decrease as their cost is comparatively rising; (4) Global capital will reduce their FDI to China and more ODI might occur; (5) the spill-over effect of the US tax cut might lead to many other countries to follow, thus, China might further lose the competitiveness without applying corresponding measures. Although the market also argues that the influence of the US tax cut on China might be limited given the large volume of Chinese economy, the authorities need to pay close attention to this and come up with some corresponding measures to counter its adverse effects.

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