A soft-landing with a missed growth target

China’s fourth quarter GDP growth came out at 7.3% y/y, flat with that of the previous quarter and broadly in line with the market expectation (Consensus: 7.2% y/y). In sequential terms, growth in Q4 remarkably decelerated to 1.5% q/q sa from 1.9% q/q sa in Q3. For 2014 as a whole, a soft-landing is achieved although the annual growth rate is 7.4%, which missed the pre-set growth target of 7.5% and registered the lowest level since 1991.

The lackluster domestic demand in Q4 has prompted the authorities to beef up their efforts of monetary easing. The People’s Bank of China (PBoC) cut the benchmark interest rates in November, the first time since July 2012. On the top of it, the PBoC lowered the required reserve ratio (RRR) by 50 bps for all banks in early February, the first time of a universal RRR cut since May 2012. In the meantime, the PBoC continued to use a series of unconventional policy tools to inject liquidity to the banking sector, including the selective RRR cut (which came together with the universal RRR cut but only targeting rural banks), the medium-term liquidity facility (MLF) and reverse repo. We envision that the cuts in interest rates and the RRR will usher in a new series of monetary easing measures in the coming months, including both the conventional and unconventional ones.

Structural reforms maintained the momentum in Q4. Particularly in the financial liberalization, the authorities unveiled their plans of establishing the long-awaited nationwide deposit insurance scheme; inaugurated the “Shanghai-Hong Kong Stock Connect” program to allow investors in Hong Kong and foreign countries to directly invest in China’s onshore stock markets; and expanded the permissible floating range of deposit rates to 20% (vs. 10% previously) above the benchmark deposit rates. The Ministry of Commerce is proposing an overhaul of the Foreign-Investment Law which aims to open more sectors to foreign investment. The authorities are also seeking to replicate the Shanghai free trade zone (FTZ) in other places. On the front of fiscal reform, the State Council has recently announced the plan to overhaul the urban pension system by equalizing the benefit plans between the retired employees in public and private sectors.

Growth headwinds are on the rise

Economic activities continue their downtrend. Industrial production growth rebounded to 7.9% y/y in December, from 7.2% of the previous month. However, the December outturn is still below its long-term trend. The NBS PMI for January 2015 came in at 49.8, which is lower than both the market consensus of 50.2 and the previous month’s reading of 50.1, registering a 28-month lowest. The HSBC China Final Manufacturing PMI also declined to 49.7, which is below the watershed level of 50.0 as well, and down from the December’s final reading 49.8. Taken together, manufacturing activities further slow the pace amidst of intensified growth headwinds. (Figure 3.1)

On the demand side, retail sales growth picked up slightly to 11.9% in December in nominal terms (11.5% in real terms), led by the outperformance of some durable goods such as communication equipment and construction-related decoration materials. On the other hand, the consumption of luxury goods and services remained weak due to the ongoing anti-corruption campaign. (Figure 3.2)

Investment moderated further in Q4. In terms of investment in different sectors, a small pick-up was shown in manufacturing sector while real estate and infrastructure investment decelerated further in December (Figure 3.3).
Signs of rebalancing are the silver lining of the slowed growth

Detailed analysis of the 2014 GDP components show that the consumption’s contribution to GDP growth edged up to 3.79%, surpassing both investment and net export. In contrast, the contributions of investment and net exports are 3.59% and 0.02% respectively, out of 7.4% GDP growth. (Figure 3.4 and 3.5) Moreover, industry structure has further improved in 2014 as the service sector accounted for 48.2% of the total output, increasing by 1.3 ppt from the previous year. In the meantime, the contribution of the secondary industry (including manufacturing, mining, construction and utility sectors) decreased to 42.6% of GDP in 2014 from 44.2% in 2013. In short, China’s industrial structure is rebalancing from manufacturing-oriented towards service-oriented as domestic consumption has become the most important growth engine. (Figure 3.6)
One important driver behind the ongoing rebalancing toward domestic consumption and the service sector is the solid income growth. According to the NBS, household income growth in real term grew by 8.0% last year, exceeding the growth rate of real GDP (Figure 3.7). In the meantime, the minimum wage was revised in many provinces last year, on average 9.5% from their 2013 levels.

The labor market was in good shape. The urban registration unemployment rate stayed at 4.1% in Q4 while China’s survey unemployment rate, which is a more reliable indicator of unemployment but before was not open to the general public, stood at 5.1%, a health level taking into account of real growth rate. The ratio of demand to supply in the labor market even ticked up in the fourth quarter (Figure 3.8), reflecting the tightness of the labor market. For 2014 as a whole, the newly increasing urban employment population reached 13.22 million, substantially above the authorities’ target of 10 million. (Figure 3.9)
The strong job growth is due to the accelerating development of service sector, which creates more job opportunities compared with the industrial sector. Actually, the total new job creation has been increasing overtime, although the manufactory employment is decreasing according to the Q4 PMI manufactory employment component (47.9 in January 2015 vs. 48.1 in December 2014).

A “recessionary trade surplus” emerged...

After seeing their ups and downs in the fourth quarter of 2014, both exports and imports growth rates unexpectedly dropped to the negative territory in January. Exports growth rate declined to -3.3% y/y (Consensus: 5.9% y/y) while imports fell by -19.9% y/y (Consensus: -3.2% y/y). A couple of factors lurk behind the weaker-than-expected January trade data: First, the fast growth of exports and imports in January 2014 led to an unfavorable base effect for this year’s outturns; second, the recent sharp decline in international commodity prices substantially weighed on China’s total imports. (A further analysis of oil price decreasing and its influence on Chinese economy could be found in the BOX.)

After adjusting the above factors, we estimate that the growth rates of exports and imports in January are 0.03% and -0.14% respectively. That being said, the trade data in January still reflects negative impacts of the intensifying external uncertainties and sluggish domestic demand.

Weak exports, together with much weaker imports, yielded a record high trade surplus of USD 60.0 bn in January, compared with a surplus of USD 49.6 bn in the previous month. However, it is a “recessionary trade surplus” - which results not from rising exports but rather from falling imports due to weak domestic demand (Figure 3.10) Moreover, the processing imports underperformed other imports, indicating that the rising labor cost has started to affect China’s competitiveness in the processing trade. (Figure 3.11) The commodity imports of various classifications displayed the increasing trend in Q4: oil and iron ore demand has edged up marginally in Q4 after a decline in Q3 mainly due to the global oil price decreasing, whereas copper picked up significantly after its bottom in Q3. (Figure 3.12)
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Figure 3.11
Processing imports and commodity imports were lackluster due to the sluggish domestic demand

Source: NBS, CEIC and BBVA Research

Figure 3.12
Commodity imports displayed diversifying paths

Source: NBS, Wind and BBVA Research

...with a deficit in the capital account

Moreover, the balance of capital account swung to a deficit of USD 96 bn in 2014 from a surplus of USD 182.8 bn in the previous year. As a strong US recovery is in sight, the Fed is poised to hike interest rates in the second half of this year. It has largely spawned the appreciating expectation of the USD. As a consequence, more and more Chinese enterprises chose to hold the USD denominated assets in anticipation of a strong “Greenback”. Such a trend of “asset dollarization” has resulted in the ever-increasing portfolio outflows in China’s Balance of Payment (BOP). Meanwhile, the authorities’ financial liberalizing efforts have made outward FDI much easier than before. In 2014, the aggregate size of China’s outward FDI was almost equivalent to its recipient FDI, sending the deficit in the capital account to a higher level. (Figure 3.13)

Figure 3.13
Capital outflow became significant in Q4

Source: CEIC and BBVA Research

Figure 3.14
Deflation risk in China might be on the rise

Source: CEIC and BBVA Research
Deflation risk looms large

Inflation remained at a low level in most time of last year and dipped further in January. In particular, the headline CPI decreased significantly to 0.8% y/y in January from 1.5% y/y in December (Figure 3.14), the lowest reading since November 2009. Low inflation outturns are broad-based: the food price inflation decelerated on falling commodity prices while housing rentals slowed in parallel to the subdued property market.

Producer price inflation (PPI) plummeted to -4.3% y/y in January from -3.3% in December. Indeed, the time for PPI staying in a negative territory has lasted for 35 months. Apart from weak commodity prices in the international market, the overcapacity problem in some domestic industries continued to weigh on firms’ wholesale prices (Figure 3.15).

The increasing deflation risk is especially harmful for the corporate sector. Indeed, the real interest costs on firms are equivalent to the gap between the nominal interest rates and inflation rate. Lower inflation (or deflation) could therefore increase firms’ real financing costs if the nominal interest rates remain the same. A worse case is that deflation could trigger the devastating downward debt-deflation spiral which eventually leads to waves of firm defaults. The authorities should loosen monetary policy in a more proactive way to battle inflation.

The RMB exchange rate has been volatile

After a lull of strengthening in Q3, the RMB exchange rate started to depreciate again (Figure 3.16). To date, the RMB has depreciated by 1% against the USD since end-September and by 1.8% against USD since its highest point in Q4. The current level of CNY/USD is around 6.24. Nevertheless, the RMB has still maintained a relatively strong trend against other currencies such as Euro and JPY (Figure 3.17), which registered larger depreciation against the USD in the fourth quarter of 2014. In terms of NEER and REER, the RMB have appreciated by 4.8% and 5.4% as of end-December, respectively, compared with the end-September, which can partly explain the recent weakening trend of China’s shipments to these trade partners.
In the meantime, the RMB exchange rate volatility has significantly risen, in line with the authorities’ intention to enhance the two-way flexibility of the exchange rate to reduce speculative money inflows.

Credit growth down; stock prices up

Credit growth slowed down and became volatile. After a dip in December (697.3 billion RMB), new bank loans rebounded to 1470.0 billion in January, but still below its long-term trend. The total social financing experienced a similar trend, as the regulators continued to curb the growth of high-risk shadow banking activities. (Figure 3.18) Significantly, M2 growth dropped to 10.8% y/y (Consensus: 12.1%) in January from 12.2% y/y in December, reaching the lowest level in the past decades. (Figure 3.19) We believe that the sharp decline of M2 is mainly due to the slowed FX inflows under the capital account, which has led to the diminishment of foreign reserves as well.

Interestingly, China’s A-share stock market unexpectedly soared up in December, which seemed to deviate from the economic fundamentals. In our view, the run-up of the stock market was catalyzed by a string of policy actions as the authorities are striving to spur growth and push for long-term structural reforms. First, the “Shanghai-Hong Kong Stock Connect” was inaugurated in November, opening a new channel for investors in Hong Kong and Shanghai to explore investment opportunities in their counterparties’ stock markets. Second, the PBoC cut the policy rates in November, surprising the market by scrapping the authorities’ previous pledge of no-big-stimulus. Third, the China Banking Regulatory Commission (CBRC) indicated to permit wealth management products (WMPs) to tap into the stock market. Given the gigantic size of WMPs (more than USD 2 trillion now), investors have a good reason to celebrate on the potentially booming demand for stock shares. (Figure 3.20)

In summary, the run-up of the stock market didn’t come along with any visible improvement in fundamentals. In particular, we perceived that some speculative investors have significantly increased their leverage in the run-up by margin finance. It has already prompted the regulators to tighten relevant restrictions of the security firms’ margin finance business.
Signals of stabilization are shown in a few large cities

The property market showed some positive signs of improvement of late, although downbeat expectations of the property market and the high inventory level in many cities continued to weigh on housing prices and transactions. As revealed by the NBS, the housing prices in a few cities (especially the tier I cities) started to exhibit a year-on-year increase in November and December. (Figure 3.21) The property trading volume picked up to 2.9% y/y in December as well, compared to a streak of negative year-on-year growth in the previous 11 months (Figure 3.22). We believe that the positive signals of the property market of Q4 resulted from the authorities’ stimulus policies in Q3, including relaxing the housing purchase restrictions and encouraging banks to extend more mortgage loans with lower interest rates.
Structural reforms are still on the track

Structural reforms have broadly maintained the moment in Q4 2014, in particular for financial liberalizing measures.

First, the authorities unveiled their plan to establish the long-awaited nationwide deposit insurance scheme. The proposal of the deposit insurance scheme reinforced people’s confidence in that the new leadership will honor their pledge of pushing forward financial liberalization reforms. It is believed that the introduction of the insurance scheme will relatively benefit larger banks, in particular the listed ones given that depositors are likely to favor these “too-big-to-fail” ones.

Second, the “Shanghai-Hong Kong Stock Connect” program was successfully inaugurated on November 17, opening a new channel for investors in Hong Kong and foreign countries to explore opportunities in their Chine’ stock markets. It constituted another milestone of China’s capital account liberalization. After its inception, the fund flows under the program have shown that Hong Kong’s investors’ interest in Shanghai’s stock market substantially surpassed the other way around, partly due to the long-time closeness of China’s stock market.

Third, the PBoC’s interest rates cut in November came with an expansion of the permissible floating range of deposit rates from 10% to 20% above the benchmark deposit rates. As a result, the effective deposit rates (the highest rates that banks can offer to their depositors) will remain at 3.3% unchanged. This movement constituted an additional step in interest rate liberalization and reaffirms the authorities’ resolution to push forward structural reforms.

Fourth, the authorities will dramatically expand the coverage of Free Trade Zone (FTZ) in Shanghai and try to replicate it in more places nationwide. In particular, the new FTZ in Shanghai will be enlarged to include the city's important commercial center and financial district. In the meantime, the authorities decide to develop three new FTZs in Guangdong, Fujian and Tianjin provinces, seeking to replicate Shanghai’s experience.

Fifth, the Ministry of Commerce is proposing an overhaul of the Foreign-Investment Law in January 2015 that attempt to embrace foreign investors with a greater enthusiasm. A central element of the revised law is the ministry’s intention to address a legal loophole that is to allow foreigners to freely buy shares of companies in restricted industries. If the bill is passed in the National Congress Party, China will become a much more attractive place for foreign companies to do business.

Sixth, the State Council, China’s cabinet, announced a long-awaited plan in January 2015 that will equalize the dual-track urban pension system, in which employees in private sector (including SOEs) have a lower level of retirement benefits than government employees but need to do a higher level of contribution. The plan is aimed to equalize the contribution and benefits for employees in both public and private sectors. Despite the enhancement of the fairness for the urban pension system, the reform can benefit the government’s fiscal situation by lessening its contingent liability.

In summary, the Chinese authorities have painstakingly pushed forward structural reforms on different fronts as they pledged in their reform blueprint of November 2013. Under the “New normal” economic scenario, we believe that these structural reforms will benefit China’s economic growth in the long-run. Moreover, we anticipate that more structural reform measures will be promulgated in 2015.
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