BBVA | RESEARCH

China
Economic Outlook

1^{ST} QUARTER 2016 | ASIA UNIT

01
The intensification of some risk clusters with a global impact led to a further downward revision of world growth forecasts

02
A soft-landing was engineered in China last year while elevated financial market tensions loom large

03
We maintain our growth projections at 6.2% and 5.8% for 2016 and 2017 respectively while lower RMB exchange rate to 6.95 at the end of this year

04
Downside risks to our base scenario have markedly increased compared to three months ago, due to recent financial turmoil and escalating capital outflows

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Closing date: 16 February 2016

1 Editorial

A soft-landing was engineered in China despite elevated financial market tensions in 2015. In particular, Q4 GDP expanded at 6.8% y/y (BBVA: 6.8% y/y versus Consensus: 6.9% y/y), edging down from the Q3 outturn of 6.9% y/y and registering the lowest since Q1 2009. The growth deceleration is more pronounced in sequential terms as the seasonally adjusted quarter-on-quarter growth slowed down to 1.6% q/q sa in the fourth quarter from 1.8% q/q sa previously. For 2015 as a whole, GDP growth amounted to 6.9%, broadly in line with the government pre-set target of ‘around 7%’. That being said, economic growth is still on its projected trajectory of structural slowdown with no sign of a sudden stop.

The soft-landing came with continued economic rebalancing. The tertiary industry outperformed the primary and secondary industries, registering a growth rate of 11.7% in 2015 and accounting for 50.5% of the total GDP. In particular, a number of service sector indicators (such as catering revenue, box office revenue, software sales revenue etc.) showed that the rebalancing is tenable after taking into account price effects.

Nevertheless, financial tensions were reignited in China’s equity and currency markets at the start of 2016. Importantly, the RMB exchange rate becomes anchorless again as the authorities intentionally let the currency go weaker early January, which has almost nullified all the previous efforts by the authorities to stabilize investors’ expectations in the aftermath of last August’s devaluation. As a consequence, the pressure of capital outflows mounted again as both firms and households scrambled to exchange the USD.

Lurking behind China’s recent financial turmoil are policy blunders and uncertainties along the way of financial liberalization. In particular, the FX market panic reflects the authorities’ policy quandary. After the August devaluation and the depreciation at the start of 2016, the authorities have effectively shattered the old regime of FX policy in which the RMB was loosely pegged to the USD. On the other hand, it is much more difficult and time-consuming to introduce a new FX policy regime, and more importantly, establish its credibility to the public and market.

After comparing important characteristics of a few available options, we conclude that it’s better for the authorities to link the RMB exchange rate to a basket of currencies under current circumstance. The authorities still need to do more work to establish the credibility of the new FX policy regime as soon as possible. Toward this end, it is imperative for the authorities to do better communications, clamp down illicit capital outflows and demonstrate their commitment to press ahead with other key structural reforms.

We maintain our growth projections of 6.2% and 5.8% for 2016 and 2017 respectively, while highlight the rising risks in financial markets and their adverse spill-over effect to the real economy. On inflation, we lower our forecast for 2016 CPI inflation to 1.7% and for 2017 to 2.0% considering the deflation risk. Downward pressure on price levels comes from sluggish commodity prices, weak investment demand and the rising number of “zombie companies”. We modestly lower our baseline projection of the CNY/USD exchange rate to 6.95 at the end-2016 and then further depreciate toward a level of 7.1 by end-2017.

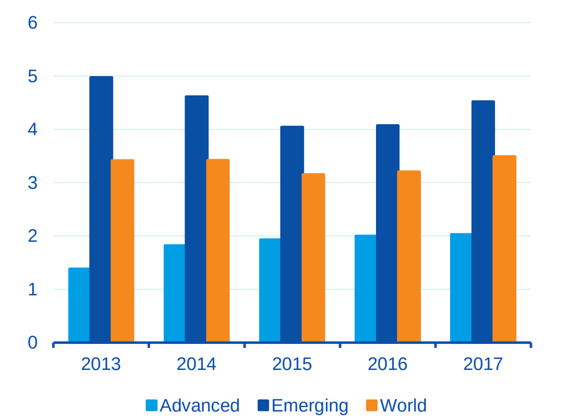
Both fiscal and monetary policies are expected to be pro-growth. On the monetary policy front, we envisage that the PBoC will implement two asymmetric interest rate cuts (cumulatively 50 bps) and four RRR cuts (cumulatively 200 bps) in 2016, likely coupled with other unconventional QE-like measures. On the fiscal front, the thrust should be to substantially expand the central government’s fiscal deficit in support of growth. We forecast that the ratio of fiscal deficit to GDP will substantially rise up to -4% in 2016 and -3.5% in 2017.

2 A global outlook of anaemic and more fragile growth

The intensification during the last quarter of 2015 of some of the risk clusters with a global impact led to a further downward revision of world economic growth forecasts for this year. The transition to a lower growth pattern in China, with economic reforms and changes to key objectives such as the exchange rate, is being accompanied by bouts of intense financial volatility and falling commodity prices. All this leads to a much less favourable global panorama for large commodity-exporting economies such as Russia or Brazil, but also for those perceived as more vulnerable financially.

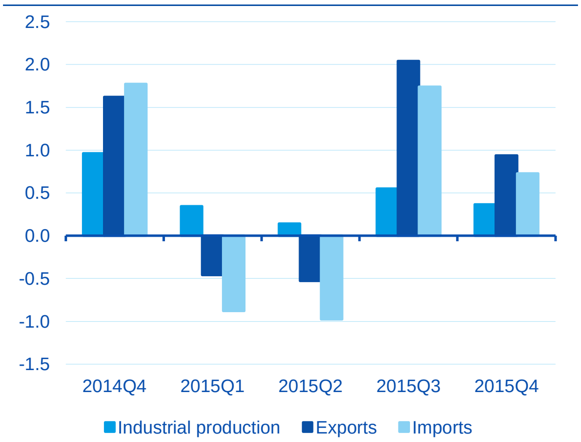
Although the level of activity seen in the second half of 2015 is consistent with quarterly growth of 0.75% in world GDP, above those seen in the first half of the year, the leading indicators (confidence indices) and the increase in financial stresses point to more moderate growth in early 2016 than was foreseen three months ago, as reflected in our estimates for the first few months of the year1. If this trend is confirmed, world GDP will grow by just 3.2% in 2016, repeating the advance of 2015 and postponing the recovery to 2017 when it should reach rates of around 3.5%. This lower growth rate, still the lowest since 2009, reflects slackening demand in the emerging economies, particularly those of Latin America, which look like contracting for two years in a row. Recovery in the developed economies is still fragile, and highly dependent on the eventual impact of the slowdown in world trade and the increase in financial instability on industrial output, corporate capital expenditure decisions and consumer spending. With the US growing at 2.5% and the euro zone by less than 2%, the tenuous improvement in activity in the developed economies as a whole will not be enough to offset emerging markets' expected relatively poor performance.

Figure 2.1
World GDP, % YoY



Source: BBVA Research and IMF

Figure 2.2
World industrial output and trade of goods, % quarterly rates



Source: BBVA Research and CPB

The recent behaviour of the financial markets is largely explained by doubts about the strength of the world economic cycle. Activity indicators continue to show the greatest degrees of deterioration concentrated in manufacturing and trade: as to the former, world output grew by less than 2% YoY (the lowest rate since 2012), while in the case of exports, weighed down by developments in the US and emerging Asia, the increase on the previous year was less than 1% (figures to October 2015 in both cases). Activity in services,

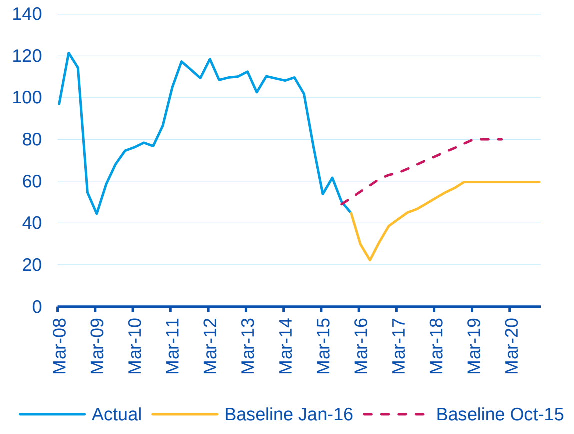
1: Estimate based on the BBVA Research global activity indicator (GAIN). Details of methodology at http://bit.ly/1nl5RIn which until now had benefited from the recovery of private consumption in the major developed economies, is also starting to show signs of less dynamism.

Even leaving the extent of China's slowdown out of the equation, the fact that the major emerging economies are all being affected by the persistent fall in commodity prices (with only a few net oil-importing countries likely to benefit from cheaper energy) has contributed to increasing risk aversion on a global scale. Moreover, a further source of uncertainty has arisen in the form of the Chinese yuan, a reserve currency with an exchange rate more subject to market forces since the summer of 2015 and on which the authorities are not succeeding in anchoring market expectations. In this situation, the capital outflows that the emerging economies have been suffering since the beginning of 2015 are rivalling those seen in 2013, when the markets had factored in an interest rate hike by the US Federal Reserve which in the end did not take place. As shown by the persistent withdrawal of capital, across the board, with very little discrimination among economies, the nature of the current episode is such that it may have more serious consequences for access to financing and for the growth rate of those economies that are most reliant on external savings.

The fall in prices of the major commodities since mid-2014, most marked in the case of oil, and the adjustments to China's manufacturing sector have created an entirely new growth scenario for emerging markets as a whole. The downward revision of medium-term forecasts of the price of oil bears testimony to this. Compared with the $100 a barrel at which Brent crude was trading in 2014, our forecasts put the expected price for 2016 at an average of around $30, recovering gradually to around $55 in 2018.

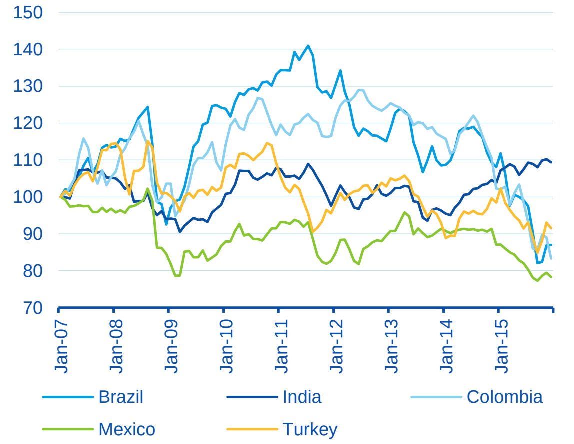
Until the spring of 2015, the excess supply was due to increased US output, plus the change in OPEC policy from late 2014, with no cuts in production in response to falling prices. Since September 2015, production has started to decrease, especially in the US and other non-OPEC countries where production costs and increased leverage are beginning to take their toll. However, there is still excess supply equivalent to 1.2% of world consumption. Added to this resistance of supply to a lower price environment, more recently we have started to see a context of financial instability and risk aversion that is symptomatic of a gradual lowering of expectations of demand. All these factors have accelerated the falling prices in the last part of 2015 and early 2016. In the medium term, as excess supply dwindles, there should be a gradual increase in prices, albeit less intense than that forecast in a scenario in which the world economy were to regain more vigorous growth rates than the current ones.

Figure 2.3
Oil prices (Brent, dollars per barrel)



Source: BBVA Research and Bloomberg

Figure 2.4
Real effective exchange rate (base 100 = January 2007). Increases means appreciation



Source: BBVA Research and BIS

3 Growth deceleration is still on track while financial turmoil has escalated again

A soft-landing was engineered in China despite elevated financial market tensions in 2015. In particular, Q4 GDP expanded at 6.8% y/y (BBVA: 6.8% y/y versus Consensus: 6.9% y/y), edging down from the Q3 outturn of 6.9% y/y and registering the lowest since Q1 2009. The growth deceleration is more pronounced in sequential terms as the seasonally adjusted quarter-on-quarter growth slowed down to 1.6% q/q sa in the fourth quarter from 1.8% q/q sa previously. For 2015 as a whole, GDP growth amounted to 6.9%, broadly in line with the government pre-set target of 'around 7%'. (Figure 3.1) That being said, economic growth is still on its projected trajectory of structural slowdown with no sign of a sudden stop.

The soft-landing came with continued economic rebalancing. The tertiary industry outperformed the primary and secondary industries, registering a growth rate of 11.7% in 2015 and accounting for 50.5% of the total GDP. In particular, a number of service sector indicators (such as catering revenue, box office revenue, software sales revenue etc.) showed that the rebalancing is tenable after taking into account price effects.

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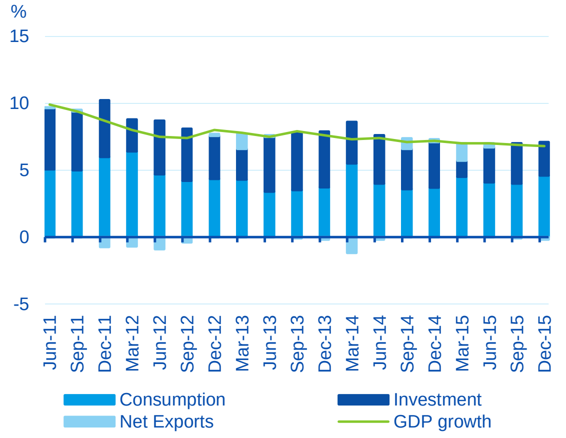
Real economic activities achieved a soft-landing in 2015

Deceleration was led by the manufacturing sector and investment

Growth of industrial production declined to 5.9% y/y in December from 6.2% y/y in the previous month, slightly below the market consensus of 6.0% y/y. (Figure 3.2) It indicates that the pressure on the manufacturing sector is still large due to the prevalent overcapacity problem in some upstream industries, namely steel & iron, cement, coal mining, etc. On the demand side, retail sales growth modestly softened to 11.1% y/y in December (consensus: 11.3% y/y) from 11.2% y/y in the previous month (Figure 3.3), maintaining a steady trend through the full year of 2015. On the other hand, the growth rate of urban fixed asset investment dipped to 10.0% YTD y/y in December (Consensus: 10.2% YTD y/y; Prior: 10.2% YTD y/y). Excluding price factors, urban fixed asset investment grew by 12.0 % in 2015, down from 14.9% in 2014. The largest drag of investment is the real estate sector, in which high-level inventory and pessimistic market expectations keep hindering new investment in development. (Figure 3.4)

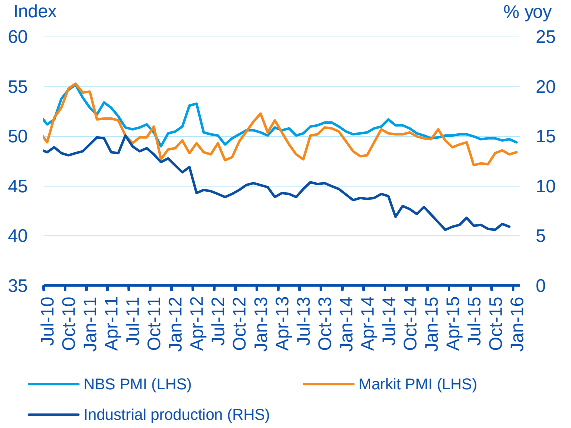
Latest PMIs suggest that no quick recovery is in sight. Caixin China PMI (the former HSBC PMI), marginally rebounded to 48.4 in January from its December reading of 48.2, but still below the watershed level of 50 (Market Consensus: 48.1). Meanwhile, the official NBS PMI of January came at 49.4, down from the previous month's reading 49.7 and below market expectations (Consensus: 49.6). (Figure 3.2) The discrepancy between the Caixin PMI and NBS PMI could be due to the fact that the former is based on a survey sample tilting towards Small-and-medium Enterprises (SMEs) and exporters. Generally, these SMEs and exporters become comparatively active in the run-up to the Chinese New Year (CNY) to get their orders shipped.

Figure 3.1
Growth slowdown continued in Q4 2015



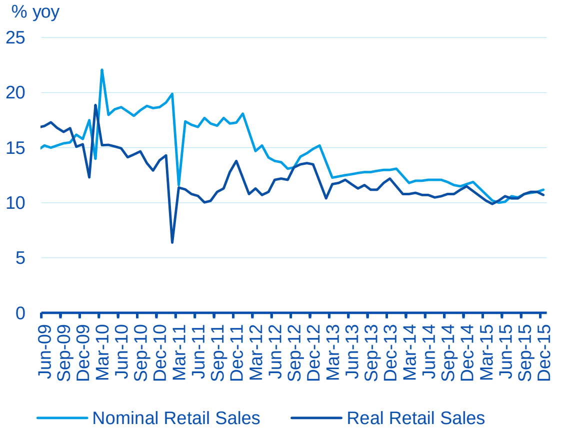
Source: NBS, CEIC and BBVA Research

Figure 3.2
Manufacturing activities remained lackluster



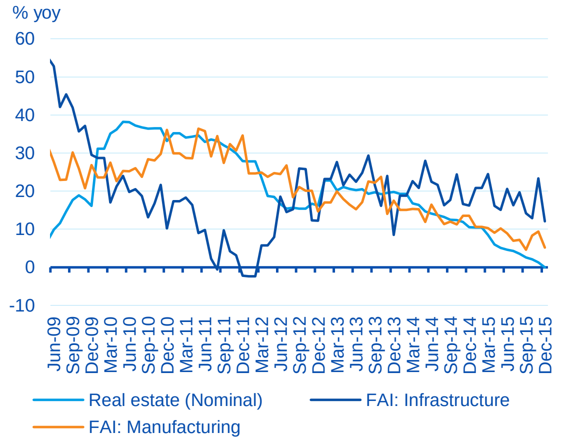
Source: CEIC and BBVA Research

Figure 3.3
Retail sales maintained a steady trend through the year…



Source: NBS, CEIC and BBVA Research

Figure 3.4
.. while investment was dragged down by the real estate sector



Source: NBS, Wind and BBVA Research

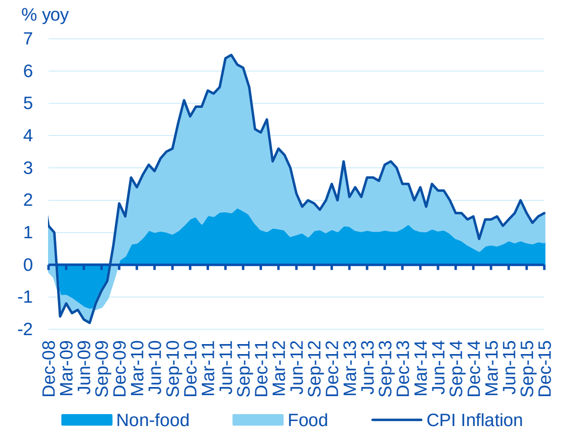
Deflation risk is on the rise

December headline CPI inflation came in at 1.6% y/y, broadly in line with the market consensus of 1.6% and marginally higher than the previous reading of 1.5%. However, headline CPI has markedly slowed down in recent months on a broad basis. Barring seasonal factors, the pickup CPI growth in December was mainly due to the frigid weather in most areas of the country which reduced the supply of agricultural products (Figure 3.5).

PPI contracted to -5.9% y/y (consensus: -5.9% y/y) in December, flat with its November reading but a bit lower than the market consensus -5.8%. It has been in negative territory for 46 consecutive months. The protracted deflation in PPI is mainly led by domestic price declines in several upstream industries including gas exploitation, oil refinery, iron & steel, non-ferrous metals and coal, etc., in which “zombie companies” abound. (Figure 3.6)

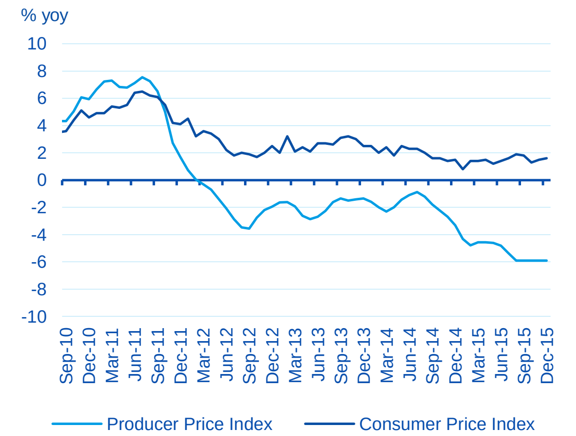
On top of pass-through effects from negative PPI inflation outturns, several other factors are expected to weigh on price levels in the economy, including the recent stock market crash, the high leverage of the corporate sector as well as continuing sluggishness in global commodity prices.

Figure 3.5
CPI picked up marginally in December but deflation risk still exists…



Source: CEIC and BBVA Research

Figure 3.6
… while PPI inflation has been in the negative territory for 46 months

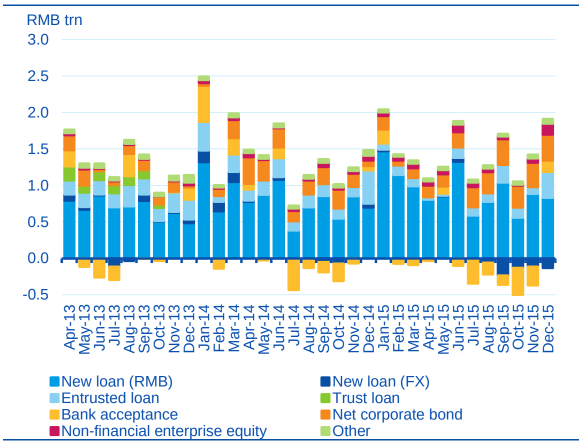


Source: CEIC and BBVA Research

Pickup in shadow banking activities boosted December credit outturns

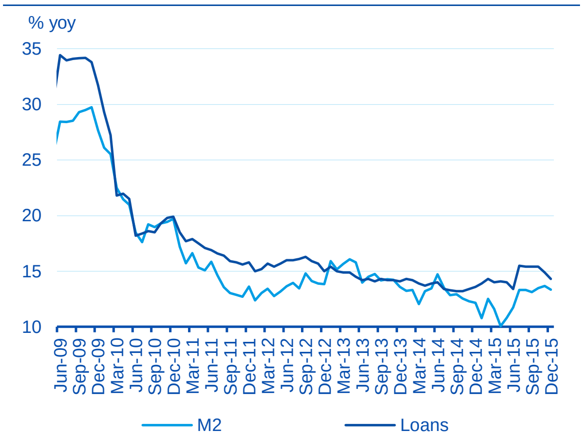
In December, both M2 growth and new RMB loans fell below market expectations and their previous readings. The traditional bank loans (indicated by new RMB loans) declined significantly to RMB 597.8 billion (Consensus: RMB 700.0 billion) from RMB 708.9 billion of the last month. (Figure 3.7) In addition, M2 growth dropped to 13.3% y/y (Consensus: 13.6% y/y) from 13.7% y/y in November. (Figure 3.8) However, the total social financing (TSF), an indicator gauging the broader credit condition including bank loans, bond and equity issuance as well as certain types of shadow banking activities, surged significantly to RMB 1820.0 billion in December from RMB 1018.1 billion in November (Consensus: RMB 1150.0 billion). In particular, banks' off-balance-sheet lending increased significantly, including trust loan, entrusted loan etc., so did the direct financing such as corporate bond and equity issuance.

Figure 3.7
Total Social Financing significantly picked up in December…



Source: CEIC and BBVA Research

Figure 3.8
… while M2 growth marginally slowed from the last month reading



Source: CEIC and BBVA Research

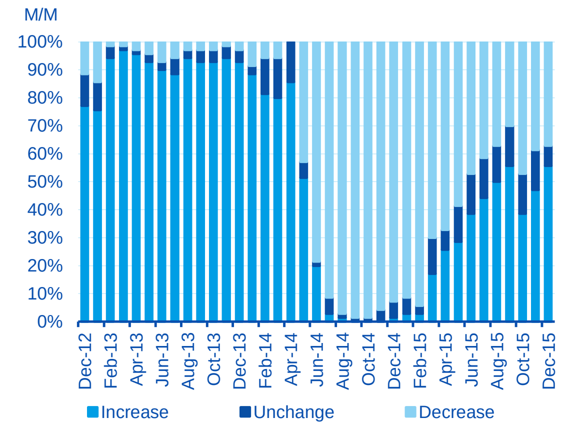
This phenomenon that firms are increasingly reliant on the shadow banking sector and capital market to meet their financing mirrors banks' heightened risk-aversion against the backdrop of persistent growth deceleration. For the positive side, the better-than-expected credit growth will serve to stabilize the short-term growth and alleviate investors' fear of a hard-landing.

A policy-induced rebound in the property market

The property market has showed further signs of improvement in Q4. Housing prices have picked up in more cities due to interest rate cuts and the removal of some purchase restrictions which were deployed through the course of last year. As revealed by the NBS, 39 out of 70 cities reported a month-on-month increase in December, compared to 33 cities reporting in the previous month (Figure 3.9). The property trading volume marginally picked up in Q4, compared to the previous quarter (Figure 3.10). Recently the authorities have further stepped up their efforts to facilitate the de-stocking of residential properties by lowering the minimum down payment requirement to 20% of home value from 30% previously in most of the cities.

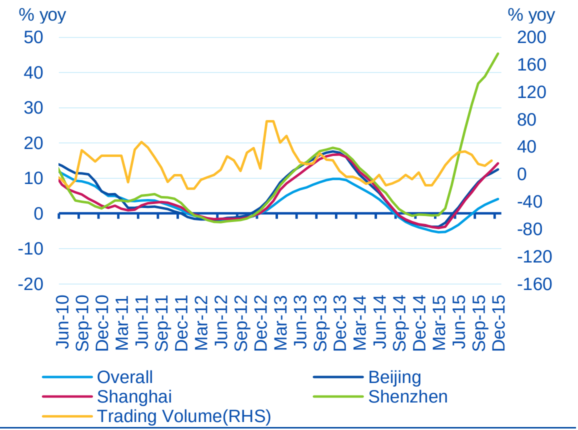
The recent rebound in housing sales has made it clear that housing demand in China is not collapsing. However, due to the enormous amount of property stock, especially in the second and third-tier cities, the reaction of the supply side has been muted. So far the pickup in housing sales fails to lift up the slowing pace of land sales and real estate investment. We estimate that the ongoing de-stocking in the property market will last for another couple of years to normalize the inventory level.

Figure 3.9
More cities reported housing price increase in December



Source: NBS and BBVA Research

Figure 3.10
Trading volume and housing prices have bottomed out in Q4, especially in Shenzhen



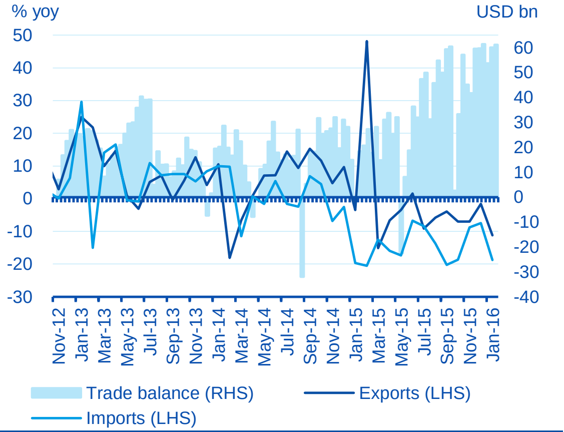
Source: NBS, CEIC and BBVA Research

Recessionary trade surplus reflected weak domestic demand

The exports of January significantly dropped down, despite of sharp RMB depreciation. Exports registered a year-on-year decline of -11.2% y/y (Consensus: -1.8%) in January, a significant decreasing compared to the last month's outturn of -1.4% y/y. Meanwhile, imports declined sharply to -18.8% y/y (Consensus: -3.6% y/y) from -7.6% y/y in the previous month. As a result, trade surplus expanded to USD 63.29 bn in January, compared to USD 60.9 bn in the previous month (Figure 3.11). The lackluster January trade data indicate that global economy remains weak; while on the other hand, sluggish domestic demand is expected to afflict imports in the near future despite the authorities' stepped-up easing efforts.

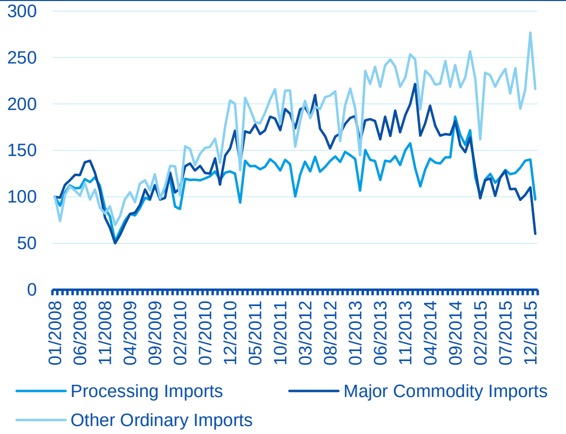
In particular, the growth rate of processing imports is far below other ordinary imports. (Figure 3.12) In addition, the pickup in commodity imports in Q4 suggests that domestic producers are taking advantage of currently lower commodity prices to build up their stocks. (Figure 3.13)

Figure 3.11
January trade data is significantly below the market consensus and the prior readings



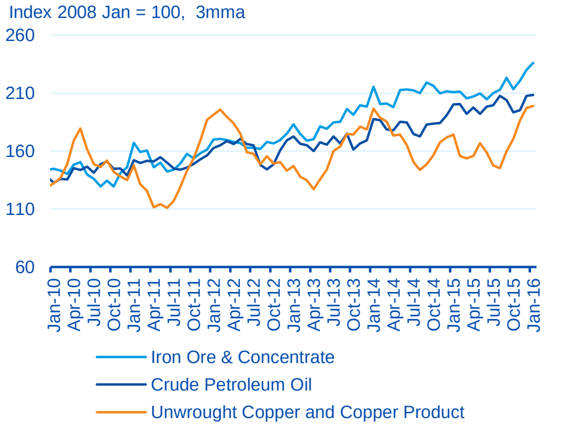
Source: CEIC and BBVA Research

Figure 3.12
Weak domestic demand led to the recessionary trade surplus…



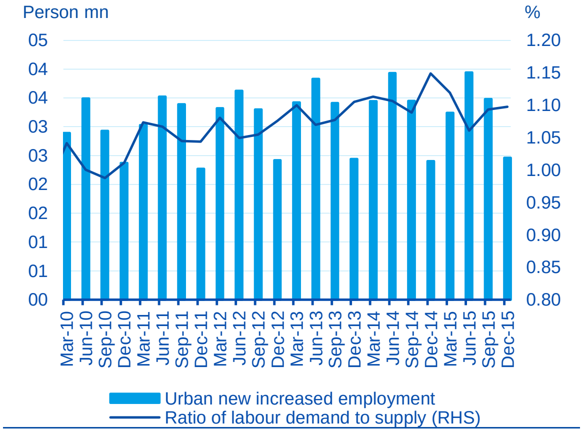
Source: CEIC and BBVA Research

Figure 3.13
The volume of some commodity imports held well



Source: CEIC and BBVA Research

Figure 3.14
Labor market is still in good shape



Source: CEIC and BBVA Research

Labor market is still in good shape despite the economic slowdown

The labor market is still healthy although the economic slowdown trend continues, which contributes to the expanding service sector and the undergoing urbanization that provide more labor demand. In 2015, the total newly increasing employment reached 13.1 million, significantly exceeding the authorities' annual target of 10 million. The more reliable survey unemployment rate marginally edged down to 5.01% in December. In the meantime, the ratio of demand to supply in the labor market is still above 1 in Q4 2015. Taking into account seasonal variation of this indicator, we can conclude that the labor market is still tight. (Figure 3.14) However, it is noted that the unemployment rate is a lag indictor for economic situation. The number of layoffs is bound to rise if the authorities will take more effective initiatives to exit part of overcapacities in certain industries this year as they pledged.

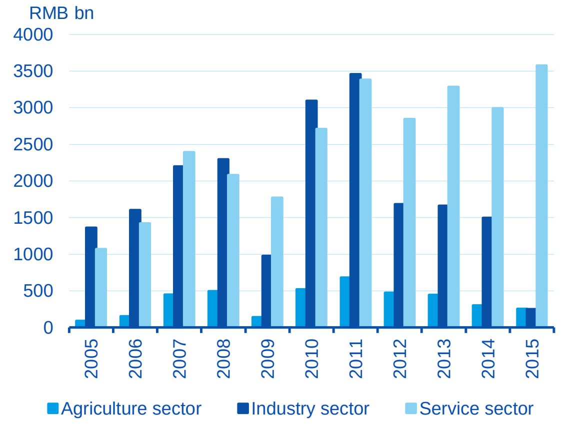
Economic rebalancing has been set in motion

The economy is still on track to shift away from investment to consumption. The tertiary industry continued to outperform the primary and secondary industries, registering a growth rate of 11.7% in 2015 (versus 4.3% y/y and 0.9% y/y for the primary and secondary industries, respectively). In terms of the three sectors' shares to GDP, the service sector accounts for 50.5% while the industrial and agriculture sectors account for 40.5% and 9.0% respectively. In addition, the contribution of the service sector to GDP increase has been significantly higher than those of the industrial and agriculture sectors since 2012, indicating that the economic rebalancing is gathering pace in recent years. (Figure 3.15)

It is true that this year's exceptional performance of the service sector has been boosted by the financial sector, whose share of the total GDP has grown steadily over the past several years to 8.5%. We suspect that the large contribution of the financial sector is associated with debt service of gigantic borrowings by local governments and corporate sector over the past several years. In addition, the fast-growing financial sector is also driven by foaming capital markets. All in all, such a magnitude of its contribution to the GDP is unlikely to be sustainable as equity bubbles are bursting and the economy is entering into the necessary deleveraging phase.

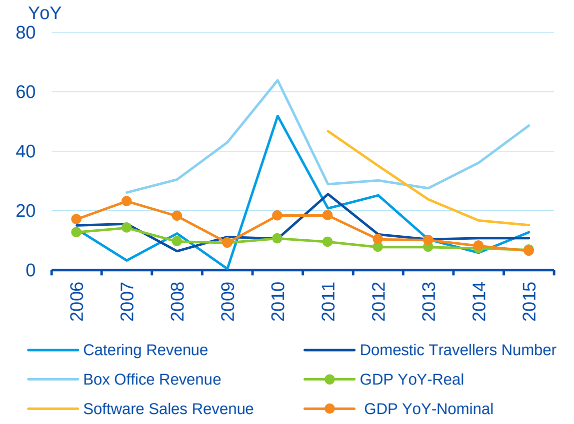
Nevertheless, we believe that the trend of economic rebalancing is at once visible and tenable. To illustrate such a trend we compared the performance of a bunch of service sectors with the nominal and real GDP growth, including the growth rate of catering revenue, box office revenue, software sales revenue and the domestic traveller's number. (Figure 3.16) In our opinion, the rebalancing is more related with the wealth accumulation of households and urbanization process over the past several years. Moreover, as young generation which was born in the era of "reform and opening" (namely after 1980) start to join the labor force and have their revenues, they tend to have a stronger penchant for consumption than their parents.

Figure 3.15
Service sector's contribution to GDP increase is significantly higher than other sectors



Source: CEIC and BBVA Research

Figure 3.16
Some service sector indicators outperformed the nominal and real GDP growth



Source: CEIC and BBVA Research

Rising financial market turmoil accelerated capital outflows

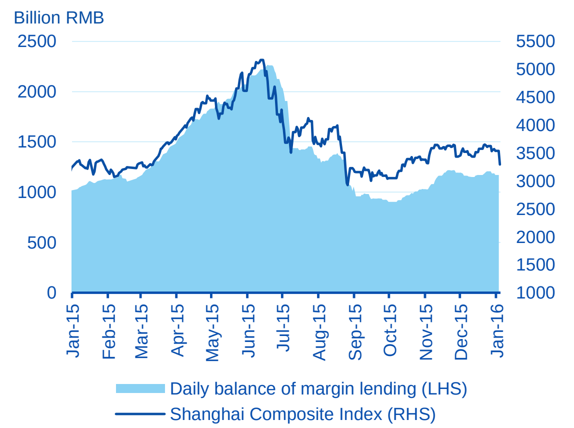
China's financial markets welcomed the New Year with another round of stock market selloffs. The CSI 300 index, which is the benchmark equity index in China's domestic stock market and consists of large-capitalization listed firm in Shanghai and Shenzhen stock exchanges, dipped by -7% by at the opening of the trading session and triggered the newly implemented 'circuit breaker' rules. (Figure 3.17)

Under the 'circuit breaker' rules, a ±5 % movement in the CSI 300 will trigger a 15-minute halt for the trading of stocks, options and index futures, while a move of ±7 % will close the market for the rest of the day, which was intended to alleviate the market panic and prevent the irrational 'herding' behaviors of investors. However, the rules have two fatal flaws: (i) the first threshold (±5 %) is set too low given the high volatility of China's stock market and (ii) the gap between the first threshold (±5 %) and the second threshold (±7%) is too narrow. As a result, the "circuit breaker" was triggered on two out of the first four trading days at the start of the year, forcing the authorities to indefinitely suspend this mechanism on January 8th.

In the meantime, the RMB exchange rate stumbled again after a lull of stabilization since the unexpected devaluation in August. The onshore CNY/USD once declined to 6.59 in early January (accumulative 1.5% depreciation in the first month of 2016), registering the lowest level since November 2010. In the offshore RMB market CNH/USD saw a deeper depreciation and led to a record low of 6.69. In addition, the gap between the CNH and CNY exchange rates significantly widened in January before it fell back to a normal level on the central bank's heavy interventions (See our recent Economic Watch). (Figure 3.18)

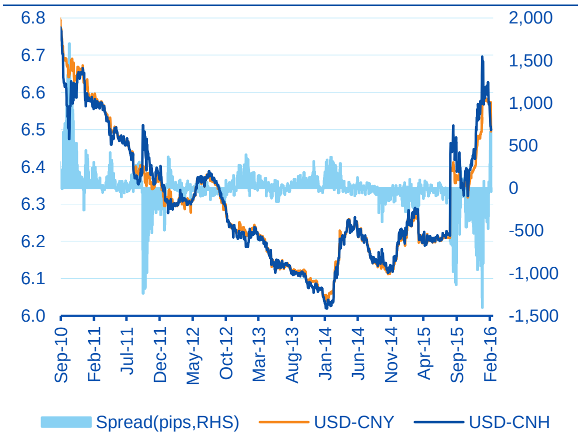
The FX and stock market selloffs also had strong contagious effect to global financial markets. (see our previous China Economic Outlook) Due to their tight economic and financial linkages with China, the emerging Asian economies bear the brunt of China's financial turmoil. (Figure 3.19 and 3.20)

Figure 3.17
Equity market selloff reappeared early January due to the ill-designed "circuit breaker" rules



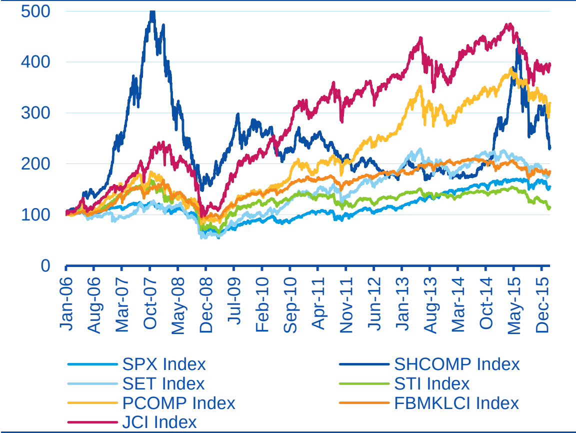
Source: WIND and BBVA Research

Figure 3.18
Widening differential between onshore and offshore FX markets



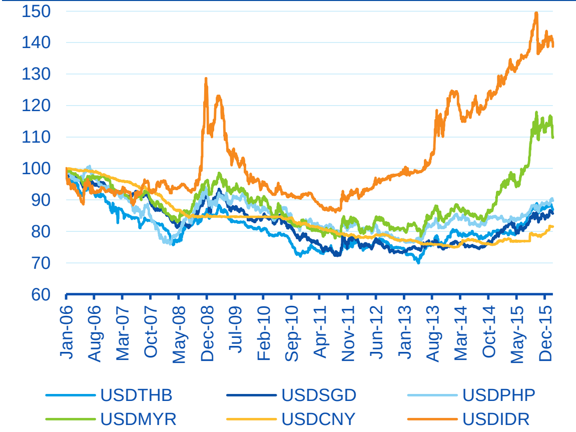
Source: Bloomberg and BBVA Research

Figure 3.19
Stock market selloff in China also led to market gyrations in emerging Asia…



Source: WIND and BBVA Research

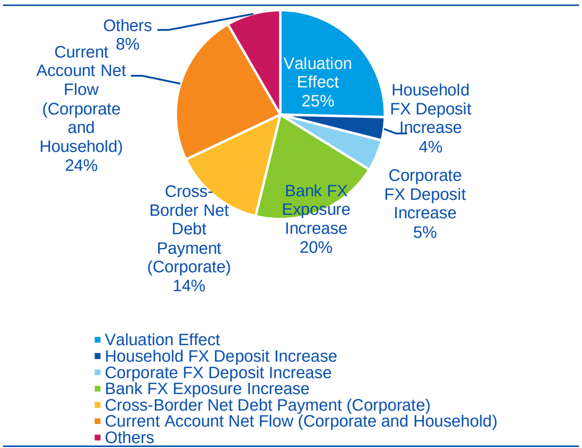
Figure 3.20
…so did the FX markets.



Source: Bloomberg and BBVA Research

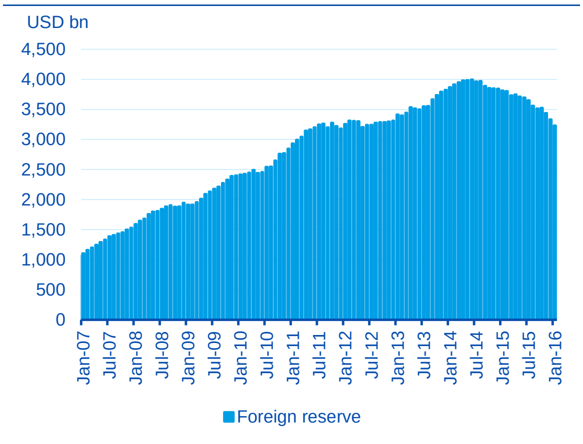
Escalating financial tensions have accelerated capital outflows and have nullified all the previous efforts to stabilize investors' expectations in the aftermath of last August's unexpected devaluation. As a consequence, both firms and households scramble to exchange for the USD so as to pay off their foreign debt and adjust the currency composition of their portfolios. (Figure 3.21) Accordingly, China's foreign reserves decreased significantly to USD 3,230.9 bn as of end-January (Consensus: USD 3,210 bn), dropping by USD 99.1 bn from its end-2015 level. (Figure 3.22)

Figure 3.21
Breakdown of foreign reserves loss



Source: CEIC and BBVA Research

Figure 3.22
Foreign reserves depletion since 2014



Source: CEIC and BBVA Research

4 Dispelling policy uncertainties is key to stabilize tumultuous financial markets

Policy uncertainties lurk behind financial turmoil

Rising financial turmoil and escalating capital outflows at the beginning of the year cannot be fully explained by economic fundamentals. Growth deceleration is still on its projected trajectory and there is no sign of significant deterioration in real activity indicators yet. Moreover, the continuing economic rebalancing and the authorities' pro-growth policy initiatives are expected to sustain growth before the economy find its new growth engines.

Lurking behind China's recent financial turmoil are policy blunders and uncertainties along the way of financial liberalization. To ensure smooth proceedings of inextricable financial reforms, the authorities need to strike a nuanced balance between giving more powers to market and maintaining the stability of its financial system.

The authorities were not well prepared for the relevant challenges and underestimated market forces in the first place. Unfortunately, not every policy misstep can be immediately reversed and forgiven by market participants just like the in-time suspension of "circuit breaker" rules after its four-day implementation. The authorities' mishandling of the exchange rate reform is far more costly. Indeed, after the unexpected currency devaluation last August, the authorities had spent a vast amount of foreign reserves to stabilize the exchange rate and avert a self-fulfilling cycle of currency depreciation and capital outflows. However, the authorities engineered another wave of currency depreciation at the beginning of this year, which has nullified all the previous efforts by the PBoC to stabilize people's expectations. Moreover, the authorities' poor communication did not help to prevent unnerved investors from flocking to deplete foreign reserves for different reasons, ranging from early payment of their USD denominated debt to diversification of their asset portfolios.

In essence, the FX market panic reflects the authorities' policy quandary. After the August devaluation and the depreciation at the start of 2016, the authorities have effectively shattered the old regime of FX policy in which the RMB exchange rate was loosely pegged to the USD. On the other hand, it is much more difficult and time-consuming to introduce a new FX policy regime, and more importantly, establish its credibility to the public than eradicating the old regime.

We have reasons to believe that the authorities intended to loosen their grip on the exchange rate and leave the price discovery to market. The direction is correct because a flexible exchange rate is not only a key element in China's mega project of financial liberalization but also will lay down foundations for pressing ahead with other important items on the country's reform agenda such as capital account opening and the RMB internationalization.

However, the current environment, surrounded by concerns over China's growth outlook and US monetary policy normalization, doesn't favor the implementation of such a FX policy regime change. After seeing their two previous attempts in this respect (last August and this January) achieve nothing but roil financial markets around the globe, China's authorities look as if they want to claw back for the moment.

Unfortunately, financial markets, once being agitated, cannot offer any respite. In face of strong depreciation expectations and accelerated capital exodus, the authorities have been forced to intervene in both the onshore and offshore FX markets to stabilize the exchange rate. They have also tightened certain restrictions under the capital account to crack down illicit capital flows across borders. However, these efforts, at the cost of burning through China's foreign reserves, could become futile if the authorities fail to establish a new and credible FX policy regime and manifest it to the public.

The authorities need to choose among unpalatable options

Regarding the new FX policy regime, the authorities now have three options with some variants for each.

- Option I: The authorities could have another one-off devaluation of the RMB value and maintain a peg with respect to the USD at the new level ;
- Option II: the authorities could link the RMB value to some index constructed from a basket of currencies, such as the BIS Effective Exchange Rate index, the SDR index or the recently constructed CFETS index;
- Option III: The authorities could give FX markets the full pricing power and achieve a clean float of the RMB as they intended to do in the first place.

All of three options appear unpalatable with different characteristics (Table 4.1).

Table 4.1
Different Options for the new FX policy regime

	Option I (one-off devaluation)	**Option II (Linked to a basket of currencies)**	**Option III (Clean Float)**
Technical difficulties for implementation	High	Medium	Low
Requirements for coordination of capital flow restrictions	Medium-High	Medium-High	High
Financial market volatility	High	Medium	High
Impact on trade competitiveness	Neutral-Positive	Neutral	Positive
Impact on corporate financial condition	High	Medium	High
Degree of Loss in monetary policy independence	Medium-High	Medium	Low
Time to establish credibility of the new regime	Long	Medium	Short
Whether is the ultimate goal of FX reform	No	No	Yes

Source: BBVA Research

Technical difficulties for implementation

- In terms of technical difficulties for implementation, Option III and II should be relatively easy. The thorny issue for Option I is to find an appropriate level of devaluation. If the one-off devaluation appears too little compared to investors' expectations, they will continue to attack the new pegged level and cause more capital outflows.

Requirements for coordination of capital flow restrictions

- It is worth noting that all three options require for coordinative measures of reining in capital flows. It means that the authorities might need to roll back some of the liberalizing measures unveiled previously under the capital account, making the three options all the more unpalatable. In this respect, Option I and II appear to exceed Option III as we expect an announcement of a clean float will unavoidably cause more capital outflows in a short period. Therefore, more restrictive measures under the capital account need to be unveiled in coordination with the implementation of Option III.

Impact on trade competitiveness

- Unless a sharp one-off devaluation is to be enacted, Option I cannot significantly improve China's competitiveness in its exports. In this respect, an important side effect by implementing Option I is to incur international critiques of currency manipulation and lead to more trade disputes with large trade partners.

Option II can at least ensure that the country's competitiveness wouldn't weaken further against the trade partners whose currencies are included in the basket. Option III exceeds in this respect.

Financial market volatility

- Both Option I and III are likely to destabilize the FX market for the short run. Comparatively, Option II could have less disruptive impact on financial markets. This point has become increasingly important as financial markets around the world are now surrounded by great uncertainty and doubt.

Impact on corporate financial condition

- One primary concern for the RMB depreciation is the enormous amount of USD denominated debt borrowed by Chinese firms. Although the previously wild movements of the RMB exchange rate have prompted many borrowers to pay back their USD debt, a sharp plunge in the RMB value, caused by the implementation of either Option I or III, can still exacerbate the debt burden of these firms substantially, even putting many of them in financial distress.

Degree of Loss in monetary policy independence

- The authorities also worry about the loss of monetary policy independence if Option I or II is to be implemented. As the US interest rate hikes are set in motion, the PBoC might not be able to trim its interest rates for growth stimulus since it could lead to a narrowing of two countries' interest rate differential and trigger more capital flows away from China. Fortunately, the existing monetary policy framework in China can help to overcome it. For example, certain capital account restrictions can partially insulate the economy from external shocks like the US rate hikes. More importantly, China's authorities have other ammunitions than the interest rate tool for policy easing. They can deploy quantitative policy tools such as the reduction of banks' required reserve ratios (RRR) and implement expansionary fiscal policy to reinvigorate the economy if needed.

Time to establish credibility of the new regime

- It is much easier to shatter an old policy regime than introduce a new one, and more importantly, establish its credibility. There is no need to worry about this point if Option III is implemented. Investors can easily read the authorities' let-go stance. However, both Option I and II need longer periods to establish their own credibility. In particular, implementing Option I will mean that the authorities break their vows of no more one-off devaluations made after last August devaluation. It is natural for investors to have doubts about whether the authorities will commit to the new pegged level with all their heart.

Whether is the ultimate goal of FX reform

- We believe that the ultimate goal of China's exchange rate reform should be a clean float. A market-determined and flexible exchange rate is also the prerequisite for pressing ahead with other important financial reforms such as capital account opening and the RMB internationalization. That being said, both Option I and II look like intermediate arrangements which need to be reformed at some time in the future.

Apparently Option I is inferior to both the other alternatives in almost all areas except for boosting trade competitiveness. Comparatively, Option II is a more conservative but safer choice under current circumstances although it needs to transition to Option III at some time in the future.

The authorities now seem to lean toward Option II as revealed in a number of recent remarks by the PBoC's senior officials, including the Governor Zhou Xiaochuan. However, the authorities still need to do more work to establish the credibility of the new FX regime as soon as possible. Toward this end, it is imperative for the authorities to communicate their intention to the market in a clearer manner and to increase the transparency in the relevant mechanism as well as operational processes. To limit costs of foreign reserves loss during the process, the authorities could consider enforcing the existing restrictions under the capital account and even implementing additional macro-prudential measures to clamp down illicit capital outflows. More importantly, the authorities need to dispel policy uncertainty and show their commitment to press ahead with structural reforms, including not only financial liberalization but also other key ones such as SOEs reforms, fiscal system overhaul and land rights reform etc.

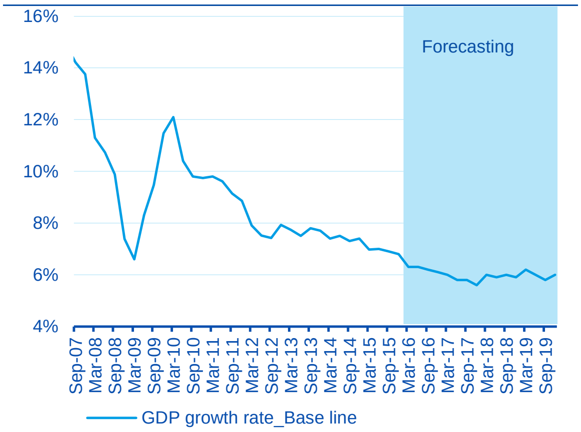
5 Slowdown is set to continue in 2016

Despite of the economic soft-landing in 2015, the recent stock market crash, the sharp depreciation of RMB, along with a number of other growth headwinds will impede growth from bottoming out in near future. The anemic trend of growth has been partly confirmed by recent weak outturns of January PMIs. Against this backdrop, the authorities are expected to implement more pro-growth measures, in particular via more expansionary fiscal measures, to sustain the economic growth and avoid a hard-landing in 2016.

We maintain our 2016 growth projection at 6.2% and 2017 at 5.8% (Figure 5.1). In terms of GDP components, the ongoing economic rebalancing is expected to bolster consumption. On the other hand, investment is still subject to strong headwinds including the prospective deleveraging in certain over-capacity sectors and les active property development due to the high-level inventory in the real estate sector. For the positive side, we envisage that the authorities will continue to spend on infrastructure investment to counter the anemic investment in both the manufacturing and property sectors.

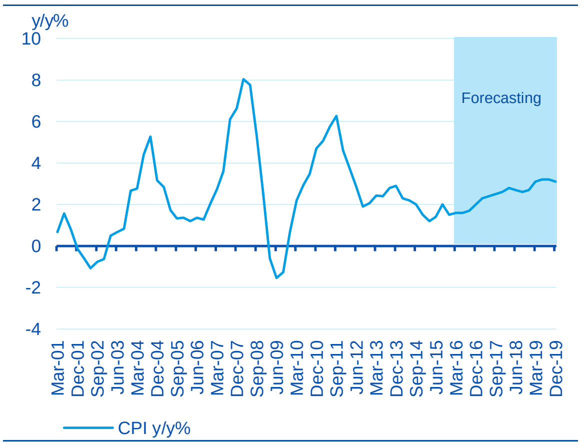
The external demand cannot be counted on to offset the weakening domestic demand. It is highly uncertain what impact the under-going US FED interest rate hike will bring onto the emerging economies. Meanwhile the sluggish global commodity prices are likely to continue in 2016. Thus, the headwinds to global growth and external demand are not in favor of China's shipments.

Figure 5.1
We maintain our 2016 growth forecasting at 6.2% and 2017 at 5.8%



Source: NBS, CEIC and BBVA Research estimates

Figure 5.2
Inflation is expected to steadily pick up over the following years



Source: NBS, CEIC and BBVA Research estimates

On inflation, we slightly lower our inflation forecast for 2016 to 1.7% y/y, reflecting the increasing deflation risk from falling commodity prices, weak investment demand and the persistent overcapacity in a number of domestic industries. On the other hand, a healthy labor market and solid growth of household income could lessen downward pressure on consumer prices. (Figure 5.2)

More aggressive fiscal stimulus is in the pipeline

The authorities need to deploy more easing measures to spur growth and avoid a hard-landing scenario. On the monetary policy front, the under-going interest rate hike by US Fed and the mounting concerns over the RMB depreciation may constrain the PBoC from trimming interest rates too aggressive. We project two asymmetric interest rate cuts in 2016, with each by 25 bps. The asymmetric nature of the rate cuts, which means only lending rates are to be trimmed while deposit rates remain intact, will avoid a further narrowing of the interest rate differential between China and the US and therefore reduce the chance of triggering more capital outflows.

The central bank is more likely to rely on quantitative tools such as RRR cuts and a number of unconventional monetary policy tools (namely selective RRR cuts, short-and-medium term liquidity facility, the Central Bank refinancing to commercial banks, etc) to stimulate domestic demand. We expect four RRR cuts of 50 bps each time in 2016.

On the fiscal front, the thrust should be to substantially expand the central government's fiscal deficit in support of growth. In this respect, we forecast the fiscal deficit of 2016 will reach -4% and will be -3.5% in 2017. The authorities are also expected to further relax some tightening measures imposed on local government borrowing. In addition to stimulate infrastructure investment to counter the slowdown of manufacturing and real estate investment, the authorities could consider more tax cuts for the corporate sector and more public spending on education, health care and R&D. (Table 5.1)

RMB exchange rate: further depreciation in 2016 and 2017

Through a series of market interventions, Chinese authorities have temporarily stabilized the RMB exchange rate at around 6.50. In addition, the central bank also narrowed down the onshore and offshore RMB gap by shutting down the potential arbitrage channels between the two markets. (See our recent Economic Watch)

In our base scenario, the RMB exchange rate will maintain broadly stable with respect to a basket currencies (CFETS index) over the next couple of years before the authorities choose a better time to float the currency. As such, the CNY/USD is likely to affect the USD's prospective strength relative to other composition currencies in the basket, such as Euro, Japanese Yen, British Pound, etc.

We therefore modestly lower our baseline projection in that the CNY/USD exchange rate will stabilize 6.95 by end-2016 and 7.1 by end-2017 (Table 5.1). The volatility of the CNY/USD is likely to increase accordingly.

Table 5.1
Baseline Scenario:

	2013	2014	2015	2016 (F)	2017 (F)
GDP (%, y/y)	7.7	7.4	6.9	6.2	5.8
Inflation (average, %)	2.6	2.0	1.4	1.7	2.5
Fiscal balance (% of GDP)	-1.9	-1.5	-2.3	-4.0	-3.5
Current account (% of GDP)	2.0	2.5	2.7	2.7	2.5
Policy rate (%)	6.00	5.60	4.35	3.85	3.85
Exchange rate (CNY/USD)	6.05	6.21	6.5	6.95	7.10

Source: BBVA Research

6 Risks are tilting toward the downside

Downside risks to our base scenario have markedly increased compared to three months ago, due to recent financial turmoil and escalating capital outflows. In the meantime, policy inaction, uncertainty and blunders could exacerbate the situation and even trigger a hard-landing.

The combination of a strengthening US dollar and domestic growth slowdown could heighten capital outflows in the coming months. In particular, a strengthening US dollar could continue to act as a pull factor to induce investors to move away from risky assets in China, which seems all the more compelling in the aftermath of the stock market crash and RMB sharp depreciation. Thus, China's authorities would be faced with a policy dilemma between supporting growth, and reducing the risk of abrupt capital outflows on the other hand.

Another newly emerged challenge to the long-term growth is the authorities' capacity to push for key reforms on different fronts while avoid making fatal policy errors. Apart from establishing a new and credit FX policy regime, the authorities also need to accomplish challenging tasks such as SOEs and land right reforms. In an environment with mounting uncertainty and doubt, even a small policy misstep could be magnified to cause a system-wide calamity.

7 Tables

Table 7.1
Macroeconomic Forecasts: Gross Domestic Product

(Annual average, %)	2012	2013	2014	2015	2016	2017
United States	2.2	1.5	2.4	2.5	2.5	2.4
Eurozone	-0.8	-0.3	0.9	1.5	1.8	2.0
Germany	0.6	0.4	1.6	1.5	1.9	1.8
France	0.2	0.7	0.2	1.1	1.4	1.7
Italy	-2.8	-1.8	-0.4	0.7	1.5	1.6
Spain	-2.1	-1.7	1.4	3.2	2.7	2.7
United Kingdom	0.7	2.2	2.9	2.2	2.0	2.0
Latam *	2.9	2.7	0.8	-0.5	-0.9	1.9
Mexico	4.0	1.4	2.1	2.5	2.2	2.6
Brazil	1.9	3.0	0.1	-3.8	-3.0	1.3
Eagles **	5.8	5.6	5.2	4.6	4.7	5.0
Turkey	2.1	4.1	2.9	3.6	3.9	3.9
Asia Pacific	5.7	5.8	5.7	5.5	5.2	5.2
Japan	1.7	1.5	0.0	0.6	1.0	0.7
China	7.7	7.7	7.4	6.9	6.2	5.8
Asia (ex. China)	4.1	4.3	4.2	4.3	4.4	4.6
World	3.4	3.3	3.4	3.2	3.2	3.5

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Bangladesh, Brazil, China, India, Indonesia, Iraq, Mexico, Nigeria, Pakistan, Philippines, Russia, Saudi Arabia, Thailand and Turkey.
Forecast closing date: 5 February 2016.
Source: BBVA Research and IMF

Table 7.2
Macroeconomic Forecasts: Inflation

(Annual average, %)	2012	2013	2014	2015	2016	2017
United States	2.1	1.5	1.6	0.1	1.3	2.0
Eurozone	2.5	1.4	0.4	0.0	0.2	1.4
Germany	2.1	1.6	0.8	0.1	0.1	1.3
France	2.2	1.0	0.6	0.1	0.2	1.4
Italy	3.3	1.3	0.2	0.1	0.0	1.4
Spain	2.4	1.4	-0.2	-0.5	-0.1	1.7
United Kingdom	2.8	2.6	1.5	0.0	0.8	1.6
Latam *	7.8	9.2	12.6	15.5	32.6	32.7
Mexico	4.1	3.8	4.0	2.7	2.7	3.2
Brazil	5.4	6.2	6.3	9.0	8.2	5.1
Eagles **	5.2	5.2	4.6	4.4	4.1	4.0
Turkey	8.9	7.6	8.9	7.7	9.5	7.9
Asia Pacific	3.8	4.0	3.3	2.3	2.6	3.1
Japan	0.0	1.6	2.7	1.0	1.0	1.6
China	2.6	2.6	2.1	1.4	1.7	2.5
Asia (ex. China)	4.8	5.2	4.4	3.0	3.4	3.6
World	4.5	4.2	3.9	3.7	5.0	5.3

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Bangladesh, Brazil, China, India, Indonesia, Iraq, Mexico, Nigeria, Pakistan, Philippines, Russia, Saudi Arabia, Thailand and Turkey.
Forecast closing date: 5 February 2016.
Source: BBVA Research and IMF

Table 7.3
Macroeconomic Forecasts: Exchange Rates

Annual Average	2012	2013	2014	2015	2016	2017
USD-EUR	0.78	0.75	0.75	0.90	0.93	0.89
EUR-USD	1.29	1.33	1.33	1.1	1.1	1.1
GBP-USD	1.59	1.56	1.65	1.53	1.54	1.65
USD-JPY	79.8	97.5	105.8	121.1	127.9	129.9
USD-CNY	6.31	6.20	6.14	6.30	6.95	7.10

Forecast closing date: 5 February 2016.
Source: BBVA Research and IMF

Table 7.4
Macroeconomic Forecasts: Official Interest Rates

End of period, %	2012	2013	2014	2015	2016	2017
United States	0.25	0.25	0.25	0.50	1.00	2.00
Eurozone	0.75	0.25	0.05	0.05	0.05	0.05
China	6.00	6.00	5.60	4.35	3.85	3.85

Forecast closing date: 5 February 2016.
Source: BBVA Research and IMF

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