3. Growth slowdown amid financial deleveraging in the long run

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

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

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

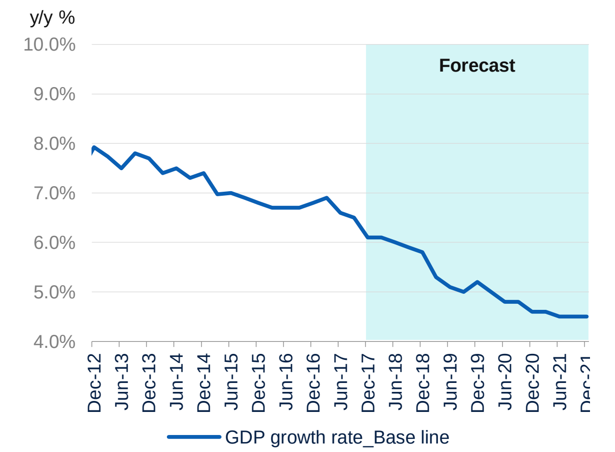
Our baseline Vector Autoregressive (VAR) model, which includes China's M2 growth, GDP growth and CPI as endogenous variables, shows that a decrease of one percentage point in M2 growth leads to 0.16% slowdown in GDP, suggesting that financial deleveraging might drag on growth. We therefore believe that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

We lowered CPI and PPI predictions

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

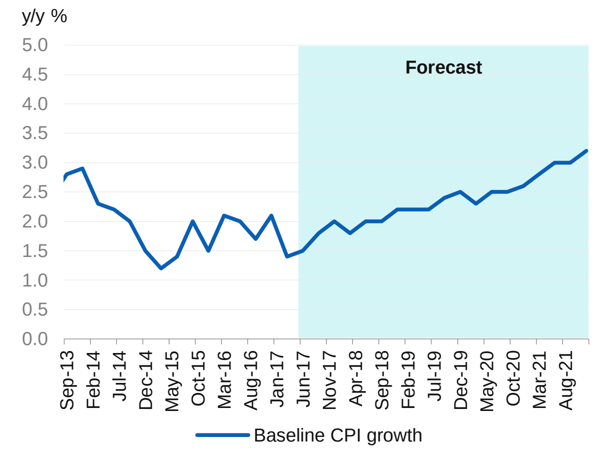
In the meantime, the CPI and PPI seem to be converging over time. The previously fast-rising PPI is expected to slow its pace in the coming months as commodity prices have reached their peak in February after accelerating sharply since mid-2016. Moreover, the authorities have also revealed that they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

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



Source: BBVA Research and CEIC

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



Source: BBVA Research and CEIC

Policy mix tilts towards tight regulations

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

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

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

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

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

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

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

Table 3.1 Baseline Scenario

Baseline Scenario

	2016	2017 (F)	2018 (F)	2019 (F)	2020 (F)	2021 (F)
GDP (%, YoY)	6.7	6.5	6.0	5.2	4.8	4.5
Inflation (average, %)	2	1.7	2	2.3	2.5	3
Fiscal balance (% of GDP)	-3	-3.5	-3.5	-4	-4	-4
Current account (% of GDP)	2.5	2.3	2.4	2.5	2.5	2.5
Policy rate (%)	4.35	4.35	4.1	3.6	3.6	3.6
Exchange rate (CNY/USD)	6.95	7	7.2	7.8	7.3	7

Source: BBVA Research

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