China Economic Insight

2016

Contents

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Executive Summary

Recent Developments

- **Real GDP growth has fallen steadily in recent years**, eroded by slower growth in private investment and weak external demand, which has prompted the government to support the economy through public investment and easier monetary policy
- **The current account surplus declined** from 3.0% of GDP in 2015 to 2.2% of GDP in the first nine months of 2016, mainly due to a decline in exports from 21.7% of GDP to 20.5%
- **Inflation has trended up** from 1.4% in 2015 to an average of 2% year-on-year in the first nine months of 2016 on rising food prices and rents
- **Fiscal stimulus increased in mid-2015 in response to slowing growth**, leading to a budget deficit up from 0.9% of GDP in 2014 to 2.7% in 2015 and the first nine months of 2016
- **Banks are struggling with tighter liquidity** as deposit growth slows and credit growth picks up as well as rising non-performing loans

Macroeconomic Outlook (2016-18)

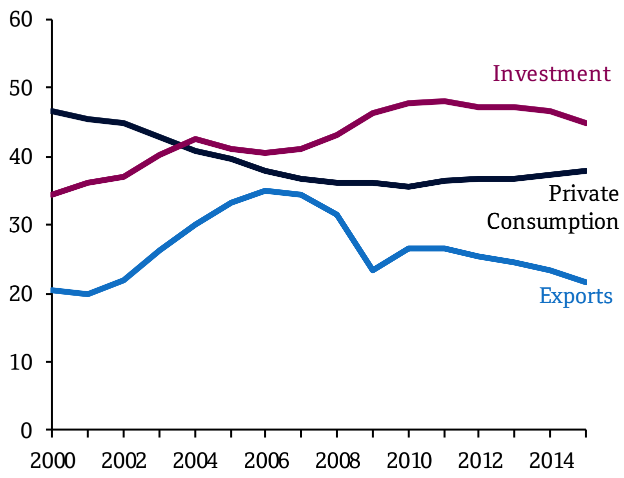
- **Growth is expected to slow from 6.7% in 2016 to 6.1% in 2018** on weaker investment growth as concerns about mounting corporate debt and overheating property prices force the government to scale back stimulus
- **The current account surplus is expected to decline** from 2.1% of GDP in 2016 and 1.0% in 2017, mainly as a consequence of the secular decline in exports
- **In 2016, we expect inflation to rise to 2.1%**, driven by the weaker exchange rate as well as higher food and housing prices, but **inflation should stabilise to 2.0% in 2017 and 1.9% in 2018** as these factors normalise
- **The budget deficit should widen from 3.0% of GDP in 2016 to 3.4% in 2017** due to pro-consumption measures, such as social security spending, but a pull-back in public investments should help consolidate the budget deficit to 3.2% of GDP
- **Bank deposit growth is expected to slow** from 11.7% in 2016 to 11.3% in 2018 on lower nominal GDP growth and as capital outflows persist while **credit growth is expected remain high**, leading to tighter liquidity

Background

Strong investment drove growth over the last 30 years, but China is now transitioning to consumption-led growth

After more than 30 years of high speed growth, China became the world's largest economy in 2014. Investments in infrastructure and manufacturing and a focus on the external sector have been the main drivers of growth in recent decades. In the 2000s, privatisation, low labour costs and opening up to foreign investment drove economic expansion. In 2008, a USD600bn stimulus further boosted investment growth as exports slowed due to the global recession. This growth model has now become unsustainable: over-investment and weak global demand have led to excess capacity and high levels of debt (215% of GDP at the end of Q3 2016) from traditional and shadow banks. As a result, in 2013, the government announced a shift from investment to consumption, supported by policies to bring down the private savings rate which, at 38%, is one of the highest in the world.

Consumption, Investment and Exports
(% of GDP)

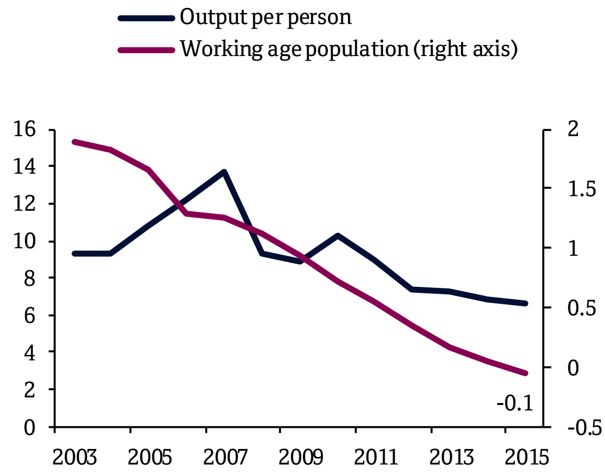


Sources: International Monetary Fund (IMF) and QNB Economics

Slower labour force growth is dragging on GDP and inefficient investment has held back productivity

Working age population growth contracted by 0.1% in 2015, the first negative reading since 1951. This has been a steady drag on economic growth. The slowdown is a result of China's one-child policy, which was introduced in the late 1970s and changed at the beginning of 2016 to a two-child policy, but this reversal will take time to impact labour force growth. Since peaking in 2007, productivity growth has declined due to excess capacity, inefficient investment and regulatory burdens. To offset the slowdown, China has relaxed urbanisation regulations and invested in megacities like the Jingjinji region (Beijing and its satellites), which has a 110m population. This should ease the path of workers from the fields to more productive factory jobs. Although this has not yet turned productivity growth around, there is room for further urbanisation. China's urbanisation rate was 56% in 2015, compared to, for instance, Japan's rate of 94%.

Labour force growth and productivity
(%, year on year)

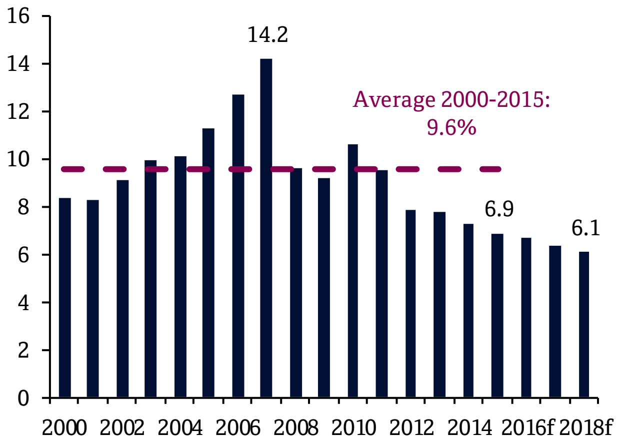


Source: National Bureau of Statistics (NBS), UN Population Statistics and QNB Economics

China's growth will be eased to a more sustainable rate

China grew by an average annual rate of 9.6% in 2000-15. The transition to a more consumer-led economy entails a gradual easing of growth to a more sustainable rate. Growth peaked at 14.2% in 2007, but has slowed since, although it remains one of the highest in the world at 6.9% in 2015 and is not expected to fall below 6.1% in 2016-18. China's new leadership has taken action to enhance growth (financial liberalisation, exchange rate liberalisation, tax breaks for small and high-tech companies, fiscal stimulus, monetary easing, encouraging urbanisation and reforming SOEs) and rein in corruption and shadow banking. Further reforms are expected to increase openness and trade links and encourage private sector development. Reforms will also need to address goals of reducing pollution, driving innovation and diversifying export-oriented cities.

Real GDP Growth
(%, year on year)



Source: NBS and QNB Economics

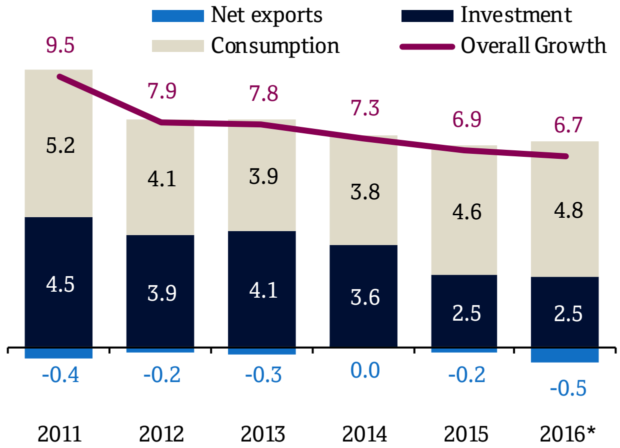
Recent Developments

Slowing growth has prompted the government to take measures to support the economy

Real GDP growth has fallen steadily in recent years, eroded by slower growth in private investment and weak external demand. Past excessive investment has led to overcapacity and the government is now trying to transition the economy away from a reliance on investment. However, over 2015-16, the government has taken a number of measures to prevent a "hard landing" for the Chinese economy, such as looser monetary policy, higher infrastructure spending and regulatory support for the real estate sector. These measures have stabilised investment growth and successfully supported the shift to consumption. For example, retail and motor vehicle sales growth are high at 10.0% and 19.3% respectively, year on year in October 2016. But stimulus measures have also had a number of unwelcome side effects including rising debt and concerns about a housing market bubble.

Contributions to Real GDP Growth

(percentage points and % over a year earlier)



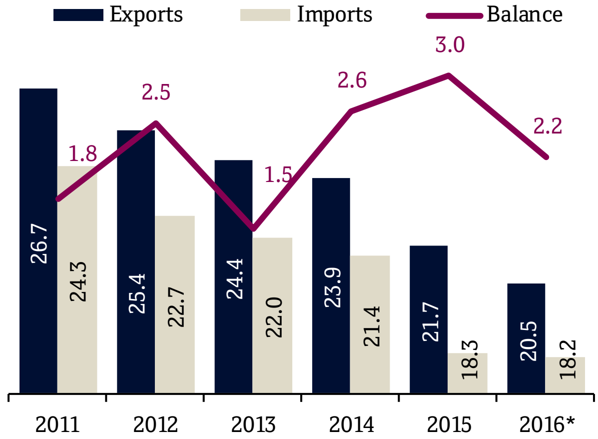
Sources: NBS, Haver Analytics, QNB Economics
* First nine months

The current account surplus fell on weak external demand

The current account surplus declined from 3.0% of GDP in 2015 to 2.2% of GDP in the first nine months of 2016, partly due to a decline in exports from 21.7% of GDP to 20.5%. This was due to weaker global demand for Chinese manufactures and a decline in the prices for key products, such as aluminium, fertilisers and electrical goods. Additionally, spending by Chinese travelling overseas has increased as rising household incomes have boosted outbound tourism. Goods imports fell slightly as a result of lower commodity prices and as the manufacturing sector needed fewer inputs and machinery in response to weaker demand. But the overall decline in imports was too small to offset the sharper fall in exports. Although the depreciating exchange rate would have supported net exports, it was insufficient to offset the impact of weaker external demand and lower prices of China's exports.

Current Account

(% of GDP)



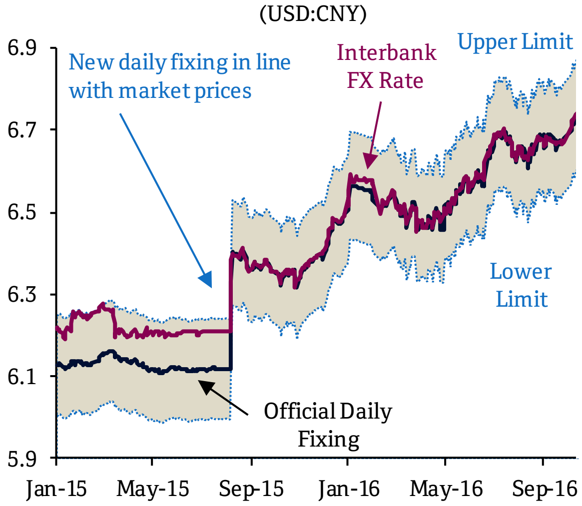
Sources: NBS, IMF, QNB Economics
* First nine months

The weakening of the CNY against the USD has led to capital flight

In early 2015, the PBoC set the exchange rate each day. Interbank rates were permitted to deviate from the daily fixing by +/- 2% and traded close to the upper limit due to pressure from capital outflows. In August 2015, the PBoC adjusted the daily fixing to take account of market prices, leading to a 4.7% devaluation over three days. Then, in December 2015, the authorities adopted a currency basket, delinking CNY from USD that was appreciating on anticipated Fed rate hikes. Rising US rates, expected further CNY weakening and slower Chinese growth led to capital flight with a decline in international reserves from USD3.84tn at end-2014 to USD3.33tn at end-2015 and to USD3.12tn in October 2016. Capital flight peaked in December 2015- January 2016 with international reserves falling by USD108bn and USD99bn respectively. However, worries about slowing growth and the exchange rate have eased slightly during the remainder of 2016.

Exchange Rate

(USD:CNY)



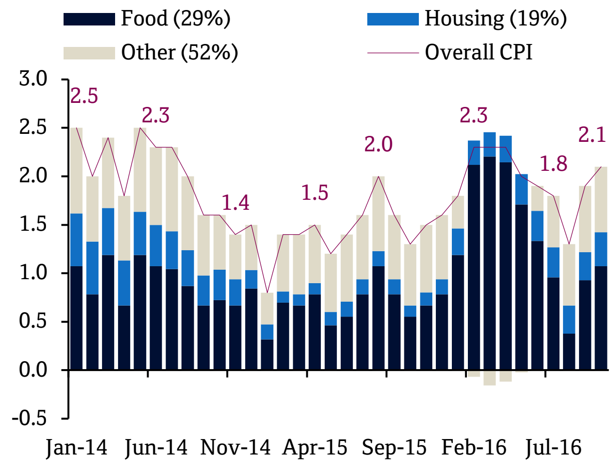
Sources: Bloomberg and QNB Economics

Inflation is below target but trending upward

Inflation has trended up from 1.4% in 2015 to an average of 2% year-on-year in the first nine months of 2016. Food constitutes around 30% of the CPI basket and increased nearly 5% year-on-year in the first nine months of the year, compared to 2.3% in 2015. Both global and domestic factors were at play. Following a 15% contraction in global food prices in 2015, the trend has reversed with global food prices rising by 5.9% in the first nine months of 2016. Domestically, unusually cold weather and supply shortages have pushed up the price of vegetables and pork, respectively. Housing is the second largest component of the CPI basket and rising property prices appear to be feeding through to rents. Housing inflation has risen to 1.5% so far this year compared to 0.7% in 2015. Despite its recent pick-up, inflation remains below the 3% inflation target.

CPI Inflation and Contributions

(pps contribution to overall CPI, estimated weights in brackets)



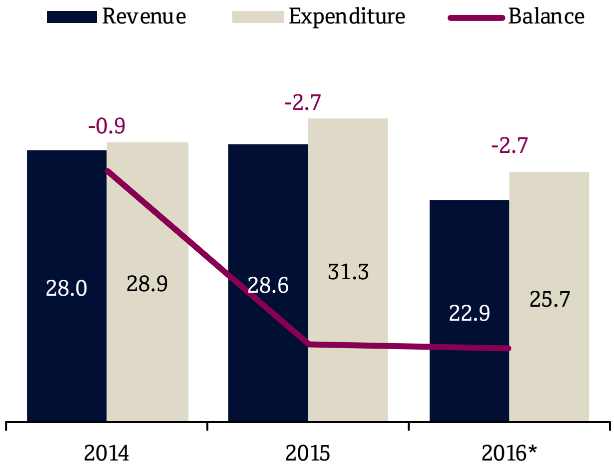
Sources: NBS, Haver Analytics and QNB Economics estimates

Fiscal policy is expansionary to support growth

In response to slowing growth, the government increased fiscal stimulus in mid-2015 leading to a budget deficit increase from 0.9% of GDP in 2014 to 2.7% in 2015 and the first nine months of 2016. In 2015, the stimulus mainly came from higher infrastructure spending while in 2016, the government replaced business tax with VAT on services. This led to a 20% decline in business tax revenue and reduced total revenue from 28.6% of GDP in 2015 to 22.9% in the first nine months of 2016. Over the first three quarters of 2016, spending as a share of GDP expanded modestly on a year-on-year basis, helped by a 21% increase in public investment. However, significant spending is off-budget. The IMF forecasts for the "augmented" fiscal deficit (including off budget items such as local government transfers to SOEs and spending financed by land sales) increased from 7.8% of GDP in 2015 to 8.4% in 2016. Central government public debt was moderate at 43% of GDP in 2015, but this omits the debt of local government and SOEs.

General Government Budget

(% of GDP)



*First nine months of the year

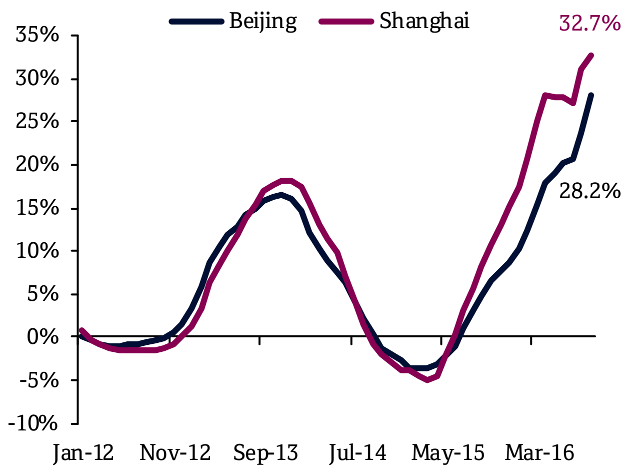
Sources: IMF, NBS, Haver Analytics and QNB Economics

The property market has been overheating

The property market has been through a number of cycles recently as the authorities tinker with regulations. During late 2014 and early 2015, concerns rose about falling prices. The authorities adopted measures to support prices and address high inventories, including property tax cuts, lower down-payments and relaxed restrictions on second-home and non-resident purchases. These measures helped drive a strong reversal in house prices in 2015-16. In September 2016, the weighted average house price in 100 cities rose 16.6% year on year with increases concentrated in Tier-1 cities like Beijing and Shanghai. With the rapid price growth, officials are unwinding some supportive policies, including higher down-payments and new restrictions on second-home purchases in specific cities. However, the government is wary of over-correcting the property market, given that the real-estate and construction sectors contribute 13% of GDP and indirectly provide demand for major industries such as steel, cement and household appliances.

Price of New Residential Buildings

(% change, year on year)

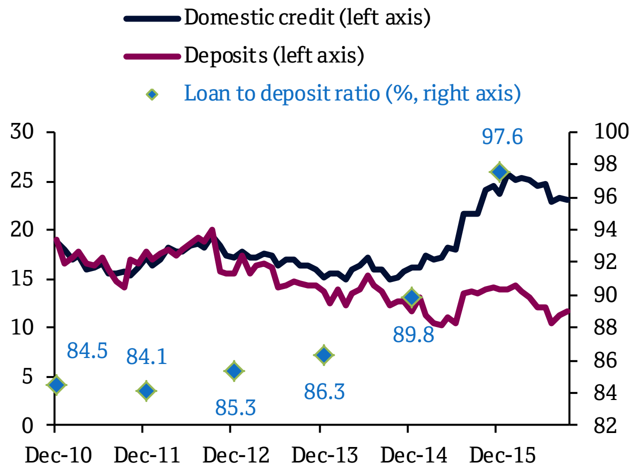


Sources: NBS, Haver Analytics and QNB Economics

Banks are struggling with tighter liquidity and NPLs

Deposit growth slowed to 11.3% year on year in August from 13.9% at end-2015 due to slower GDP growth and capital outflows. Credit growth rose to 23.2% year on year in August helped by looser monetary policy, rising corporate debt, government borrowing to finance fiscal stimulus, and credit expansion through shadow banks. As a result, the loan-to-deposit ratio rose to 103% in August, increasing reliance on wholesale funding. Non-performing loans (NPLs) rose from 1.2% at the end of 2014 to 1.8% at the end of Q2 2016, which is low but excludes "special mention loans" (loans overdue but not yet considered non-performing), that take the rate to 5.5%. The figure could be even higher due to concerns about unrecognised impaired loans in SOEs. Return on equity fell from 17.6% at end-2014 to 15.2% in Q2 2016 as profits were hit by rising NPLs, higher funding costs (on tighter liquidity) and low lending rates. Banks are well capitalised with a capital adequacy ratio of 13.1% in June 2016.

Banking Sector

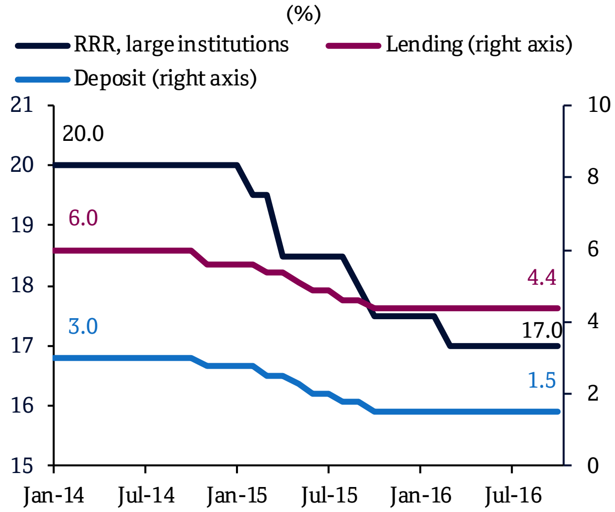


Sources: NBS, Haver Analytics and QNB Economics

Monetary policy is accommodative to support growth and ease liquidity in the banking sector

Low inflation and slowing growth have led the PBoC to ease policy. The PBoC uses a variety of monetary tools to keep CNY stable and foster growth. In 2015, the PBoC cut benchmark lending and deposit rates five times by a total of 125 bps and cut the required reserve ratio (RRR) three times by a total of 150bps. However, after the removal of the deposit rate cap in October 2015, the PBoC has shifted from the use of interest rates, as these have become less effective, to required bank reserve ratios and direct liquidity injections. In 2016, the PBoC has kept interest rates stable and cut the RRR by a further 50bps, while it has injected CNY1.6tn per month on average in 2016, compared to CNY0.7tn in 2015.

Required Reserve Ratio and Policy Interest Rates
(%)

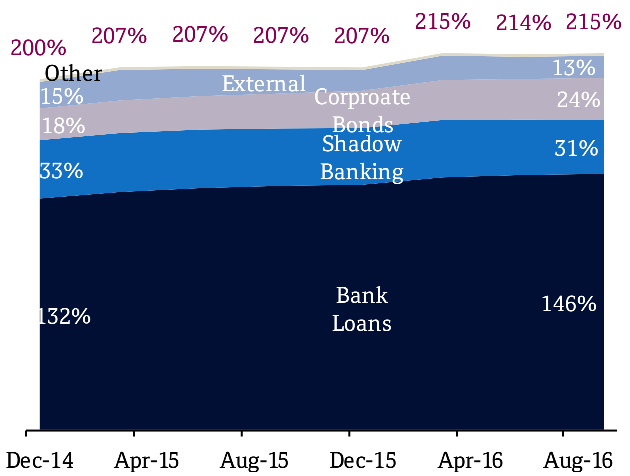


Sources: Bloomberg and QNB Economics

Stimulus is increasing the risk of a credit bust

China's total debt rose to 215% of GDP in Q3 2016 from 200% at end-2014, a comparable level to other countries that experienced painful credit busts such as Spain (2008), Thailand (1997) and Japan (1992). Corporate credit is the bulk of China's debt at 160% of GDP, which is mainly bank loans to local government and SOEs. Since the financial crisis, the authorities have stimulated the economy by funnelling financing to SOEs for investment in strategic industries. In 2015-16, easier monetary policy and higher public investment extended these policies. There are concerns about the sustainability of this debt. Excess capacity is evidence that investment has not been efficiently allocated and is leading to falling corporate profitability and rising NPLs, particularly in SOEs. Counterbalancing this, the authorities have reined in financing through shadow banking and external debt has been repaid early in anticipation of CNY depreciation. The government is also planning to reform SOEs by closing factories in sectors operating above capacity, recognising losses, privatising and changing management.

Total Debt*
(% GDP)



Sources: PBoC, Haver Analytics and QNB Economics

* Includes external debt and total social financing (TSF) less equity. TSF includes lending to the nonfinancial economy such as bank loans, trust loans and bank acceptances.

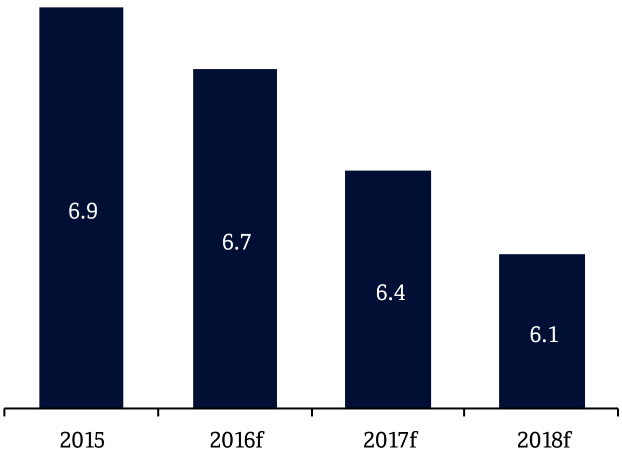
Macroeconomic Outlook (2016-18)

Growth is expected to slow on weaker investment growth and less policy support

Real GDP growth is expected to slow to 6.7% in 2016 from 6.9% in 2015 as weak external demand, falling private investment growth and the shrinking labour force more than offset support from the government through public investment and easier monetary policy. Beyond that, we expect growth to continue to slow to 6.4% in 2017 and 6.1% in 2018 as concerns about mounting corporate debt and overheating property prices force the government to scale back stimulus, leading to slower public investment, tighter policy and the introduction of measures to cool property prices. Recovering external demand is expected, but this will only partly offset tighter government policy. In addition, there are significant risks to exports if Trump proves to be as protectionist as he was on the campaign trail. In any case, China may benefit from US isolationism, for example, by establishing the Free Trade Area of Asia Pacific (FTAAP) as a response to the US exit from TPP.

Real GDP Growth

(% change, year on year)



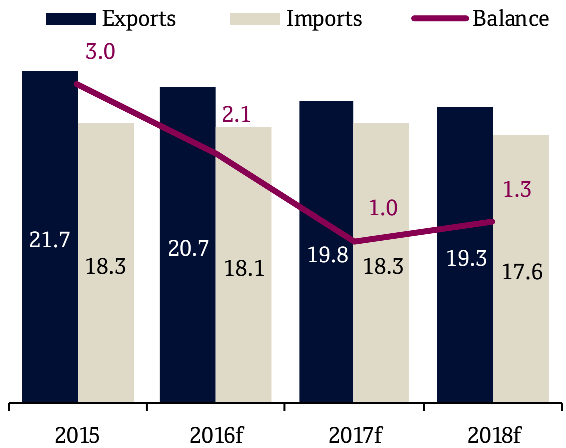
Sources: NBS, Haver Analytics and QNB Economics forecasts

The current account surplus is expected to narrow, mainly due to the secular decline in exports

The current account surplus is expected to decline from 3.0% of GDP in 2015 to 2.1% in 2016 and 1.0% in 2017. Exports are in secular decline due to slowing global trade and China's rebalancing away from export-driven growth towards domestic consumption. Meanwhile, imports are projected to rise in 2017 as outbound Chinese tourism grows on rising incomes, the exchange rate strengthens on a trade weighted basis and as oil prices are expected to recover. In 2018, we expect the current account surplus to increase as imports fall. Around 40% of imports are connected to China's investment programme and slower investment, therefore, reduces imports significantly. As investment slows in 2018 we expect this to reduce imports as a share of GDP.

Current Account

(% of GDP)

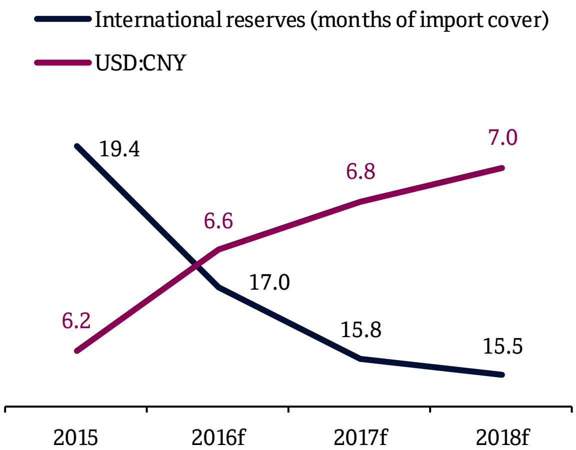


Sources: IMF, NBS, Haver Analytics and QNB Economics forecasts

We expect CNY to continue weakening against USD

After weakening around 7% against a trade weighted basket of currencies in 2016, we expect the authorities to maintain broad stability of CNY in 2017-18. China faces a balancing act in 2017-18 of maintaining currency stability and further liberalising the capital account. Supporting the currency comes at the cost of drawing down reserves while the liberalisation of the capital account, in line with official policy, could lead to a much more aggressive CNY depreciation. We expect the USD to appreciate against China's trade partners over 2017-18 due to tighter monetary policy in the US and estimate a depreciation of CNY against USD of around 3% per year. We expect drawdowns of international reserves to moderate as the currency is forecast to be more stable in 2017-18 than it was in 2016. We expect reserves to remain sizable at over 15 months of import cover.

Exchange Rate



Sources: Bloomberg, PBoC and QNB Economics forecasts

Headline inflation should moderate in 2017-18, in line with an overall slowing economy

In 2016, we expect inflation to rise to 2.1%, driven primarily by spikes in food and housing. Inflation should stabilise to 2.0% in 2017 and 1.9% in 2018, thereby staying below the target of 3% over the forecast period. This will be owing to a number of factors. First, global food price inflation is expected to stabilise. While the World Bank forecasts food prices to increase by 1.7% in 2016 (a sharp turnaround from the 15% deflation seen in 2015), it projects food price inflation at 1.5% in 2017 and 2018. Second, we expect the property measures implemented in late September 2016 to help decelerate property price growth and lower housing inflation in 2017. The effect of the measures should fade by 2018. Third, we expect a broadly stable Nominal Effective Exchange Rate (NEER) over the forecast period to help stabilise inflation going forward.

The budget deficit should widen further in 2017 before consolidating in 2018

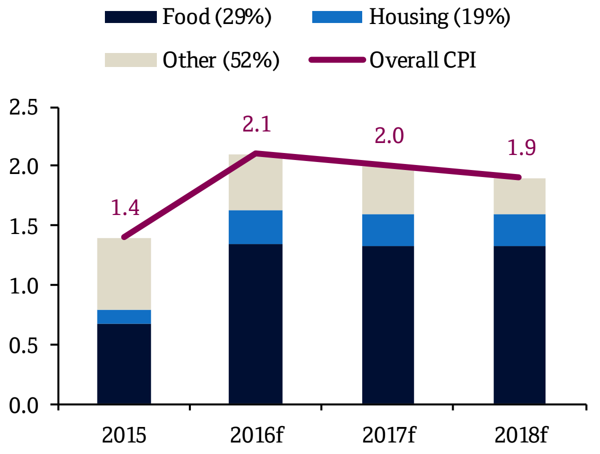
In 2016, we expect the budget deficit to widen to 3.0% of GDP from 2.7% in 2015. This is mainly owing to lower government revenue due to the implementation of new tax rules aimed at lowering the cost of doing business and stimulating the economy. In 2017, we expect fiscal policy to be influenced by China's on-going rebalancing from investment-driven to consumption-led growth. A focus on pro-consumption measures, such as social security spending, will expand the deficit further to 3.4% of GDP. We also anticipate a pull-back in public investments over 2017-18 as China attempts to address its mounting levels of debt. The pull-back in public investments should help consolidate the budget deficit to 3.2% of GDP. Public debt is expected to grow to 51.2% of GDP by 2018 from 45.8% in 2016.

Deposit growth is expected to slow while credit growth remains high, leading to tighter liquidity

Deposit growth is expected to slow gradually from 11.7% in 2016 to 11.3% in 2018 on lower nominal GDP growth and as capital outflows persist, although at more moderate levels. Credit growth is also expected to cool in 2017-18. In 2016, loose monetary policy, high public investment financed through local government borrowing and a growing fiscal deficit are expected to raise credit growth to 24%. This should reverse in 2017-18 as monetary policy is tightened, public investment is expected to be reined in and liquidity tightens. Liquidity is expected to tighten as credit growth outpaces that of deposits. The loan-to-deposit ratio is projected to exceed 120% by 2018. Profitability is likely to come under pressure with NPLs likely to continue rising as the economy slows. We expect the authorities to take measures to avoid excessive growth of the shadow banking system and capitalisation should remain relatively strong.

CPI Inflation

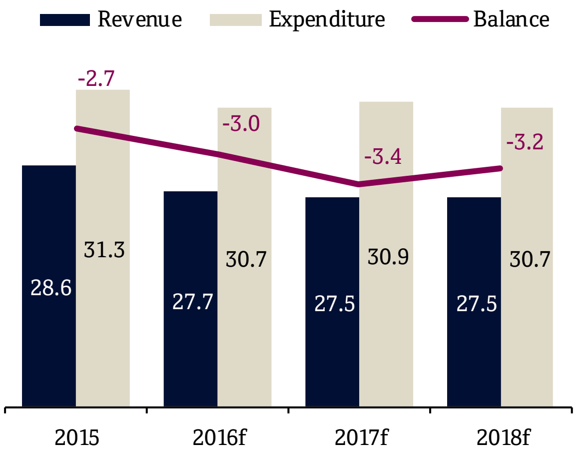
(pps contribution to overall CPI, estimated weights in brackets)



Sources: NBS and QNB Economics forecasts

General Government Budget

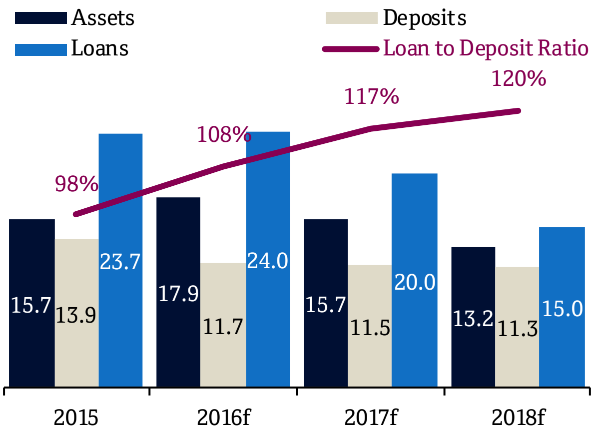
(% of GDP)



Sources: IMF and QNB Economics forecasts

Banking Sector

(% change, year on year)



Sources: PBoC and QNB Economics and forecasts

Macroeconomic Indicators

	2011	2012	2013	2014	2015	2016f	2017f	2018f
Real sector								
Real GDP growth (%)	9.5	7.9	7.8	7.3	6.9	6.7	6.4	6.1
Nominal GDP (tn USD)	7.5	8.6	9.6	10.6	11.2	11.4	12.0	12.8
GDP per capita (k USD)	10.0	11.0	11.9	12.9	14.1	15.3	16.5	17.9
Consumer price inflation (%)	5.4	2.6	2.6	2.0	1.4	2.1	2.0	1.9
External (% of GDP)								
Current account balance	1.8	2.5	1.5	2.6	3.0	2.1	1.0	1.3
Trade balance (goods and services)	2.4	2.7	2.4	2.5	3.4	2.6	1.5	1.7
Exports	26.7	25.4	24.4	23.9	21.7	20.7	19.8	19.3
Imports	24.3	22.7	22.0	21.4	18.3	18.1	18.3	17.6
Capital and financial account balance	3.3	-1.4	2.9	-1.5	-6.0	-3.9	-2.5	-1.6
International reserves (import cover)	19.6	18.7	20.3	22.6	19.4	17.0	15.8	15.5
Exchange rate USD:CNY (av)	6.5	6.3	6.2	6.1	6.2	6.6	6.8	7.0
Fiscal (% GDP, general government)								
Budget balance	-0.1	-0.7	-0.8	-0.9	-2.7	-3.0	-3.4	-3.2
Revenue	26.9	27.8	27.7	28.0	28.6	27.7	27.5	27.5
Expenditure	27.0	28.4	28.5	28.9	31.3	30.7	30.9	30.7
Public debt	33.1	34.0	36.9	39.8	42.9	45.8	48.9	51.2
Monetary								
M2 growth (%)	17.3	14.4	13.6	11.0	13.3	n.a.	n.a.	n.a.
Policy lending rate (%)	6.6	6.0	6.0	5.6	4.4	n.a.	n.a.	n.a.
Banking (%)								
Return on equity	20.4	19.8	19.2	17.6	15.0	n.a.	n.a.	n.a.
NPL ratio	1.0	1.0	1.0	1.2	1.7	n.a.	n.a.	n.a.
Capital adequacy ratio	12.7	13.3	12.2	13.2	13.5	n.a.	n.a.	n.a.
Asset growth	18.3	17.5	14.1	12.9	15.7	17.9	15.7	13.2
Deposit growth	17.7	15.4	13.8	11.7	13.9	11.7	11.5	11.3
Domestic credit growth	17.1	17.1	15.1	16.2	23.7	24.0	20.0	15.0
Loan to deposit ratio	84.1	85.3	86.3	89.8	97.6	108.3	116.6	120.5
Memorandum items								
Population (bn)	1.35	1.35	1.36	1.37	1.37	1.38	1.38	1.39
Growth (%)	0.48	0.50	0.49	0.52	0.41	0.40	0.40	0.39

Sources: Haver Analytics, Bloomberg, China Banking Regulatory Commission, IMF, PBoC, NBS and QNB Economics forecasts

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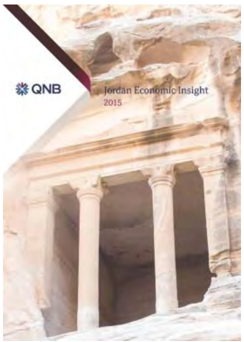
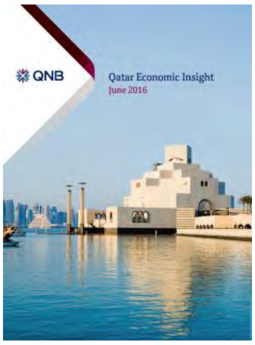


Jordan 2015

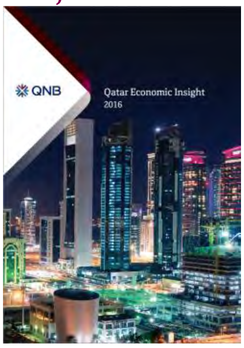
KSA 2013

Kuwait 2016

Oman 2013



Qatar - Jun 2016



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