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China outlook 2017: property bubble, RMB, and growth forecasts

The Chinese government faces a policy dilemma in 2017. We believe they will achieve the 6.5% growth target with strong fiscal easing. But this requires further credit expansion, which would exacerbate the risk of property bubble and intensify capital outflows. We expect FX reserves to fall to US$ 2.8trn in 2017 and 2.4trn in 2018, and USDCNY will depreciate to 7.4 by end-2017 and 8.1 by end-2018 (6.9% and 17.1% from the current level of 6.92). We see macro risks rising beyond 2017, with 50% chance that growth will drop below 6% for a full year sometime between 2018 and 2020.

The property bubble

We believe this is the most important macro issue in China (see our report *China's property bubble* issued on Sept 28). Land sales accounted for 36% of local government revenue so far this year, and mortgage loans accounted for 43% of new RMB loans (63% in July to Oct). Policies tightened in this sector, property and land sales dropped in Oct, but land auction premium remained high in some cities (Figure C1). This shows some developers continue to expect sharp property price inflation to come.

In the next few months we believe the government will put further pressure on developers by tightening broad credit growth (Figure C2). Property sales and investment growth will likely slow further in 2017Q1. Local government land revenue may weaken by 2017Q2. We expect the monetary policy stance to shift towards easing in 2017Q2, to avoid further slowdown in the property sector and fiscal revenue.

17% RMB devaluation by 2018

RMB depreciated by 6.4% against USD so far in 2016, while the DXY index for the US dollar appreciated by 2.8%. Taking DB forecasts for other currencies, our forecast implies 2.1% and 12.1% depreciation against the PBoC basket in 2017 and 2018, respectively. The depreciation against our proprietary RMB basket would be 1.4% in 2017 and 7.5% in 2018.

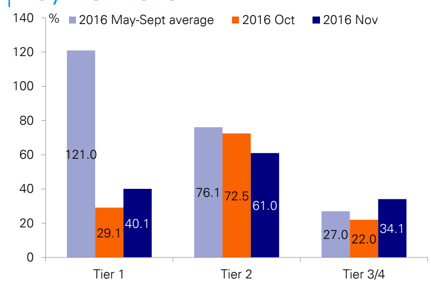
We expect the pace of RMB depreciation to pick up in 2018. This is because we expect FX reserves to fall below US$ 3trn by 2017Q1 and US$2.5trn by 2018Q3. We believe the rise of capital outflows in Q3 this year is the beginning of a structural trend. It reflects a change of expectation among onshore investors and corporates on RMB outlook, partly due to their concerns on the property bubble. The rate hikes in the US will likely exacerbate the outflow pressure (Figure C3).

Stable growth in 2017, higher risks beyond

We expect China's economy to grow 6.5% in 2017 and 6.0% in 2018.Fiscal policy will likely be loosened in 2017 as quasi fiscal spending pushes up growth of infrastructure investment. On monetary front, the PBoC may keep the benchmark interest rates stable, but loosen credit supply in 2017Q2 to mitigate the slowdown in property sector. CPI inflation will likely pick up to 2.5% in 2017 from 2.1% in October 2016.

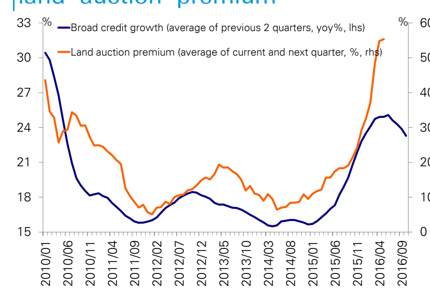
Risks to our growth and inflation outlook in 2017 are tilted to the upside, while risks to our rate and RMB forecasts are balanced. We see macro risks to rise beyond 2017. The debt to GDP ratio is set to go up. The property bubble will impose more macro risks, the US rate hikes will further constrain the policy room for PBoC, and the excessive liquidity onshore will likely drive inflation up eventually.

Figure C1: Land auction premium, May-Nov 2016



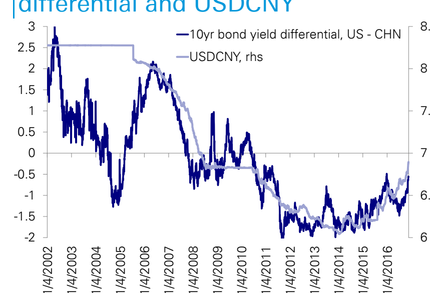
Source: Deutsche Bank, CREIS
Note: All land sales go through public auctions in China. Land premium is defined as (final price – starting price) / starting price.

Figure C2: Broad credit growth and land auction premium



Source: Deutsche Bank, CREIS, WIND

Figure C3: US-China bond yield differential and USDCNY



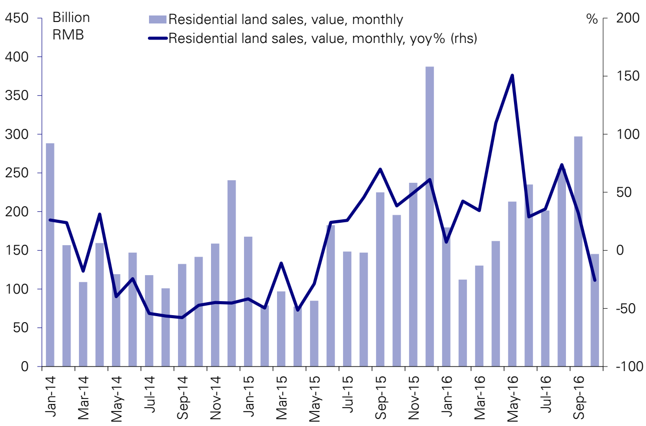
Source: Deutsche Bank, WIND
Note: The bond yield differential is the US 10 year government bond yield minus China 10 year government bond yield

China Outlook 2017

The property bubble is spreading to more cities

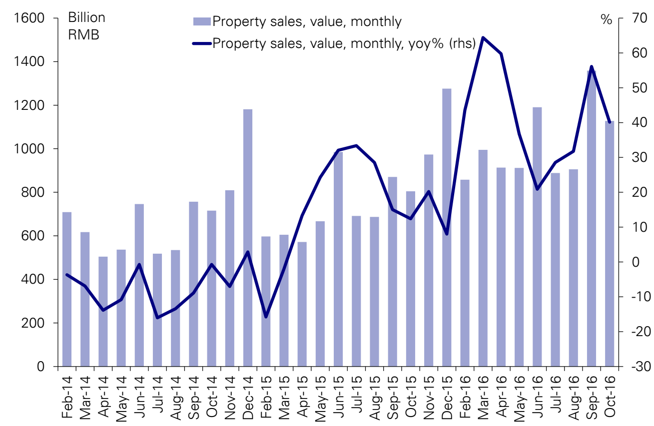
We highlighted the risk of property bubble in many tier 2 cities in a series of reports since Sept 28. The government tightened policies in early October. In particular, developers' financing channels are tightened. Residential land sales dropped to RMB 145 billion in October from 297 billion in September (-25.8% yoy in Oct, 32.1% in Sept, Figure 1). Property sales also slowed to 40.1% yoy from 56.1% (Figure 2).

Figure 1: Residential land sales: value and growth



Source: Deutsche Bank, CREIS

Figure 2: Property sales: value and growth



Source: Deutsche Bank, WIND

But the battle between the government and developers is far from over. Indeed land auction premium remained high in tier 2 cities after policy tightening started (Figure 3). In November we've seen another wave of record high land auctions in some tier 2 cities such as Tianjin, Fuzhou, and Nanjing. Apparently some developers still hold the view that property prices will rise significantly from the current level.

In the next few months we believe the government will put further pressure on developers by tightening broad credit growth. The broad credit growth is the key driver of land premium (our report China's property bubble on September 28 has more discussion on this issue). It has been trending down recently (Figure 4).

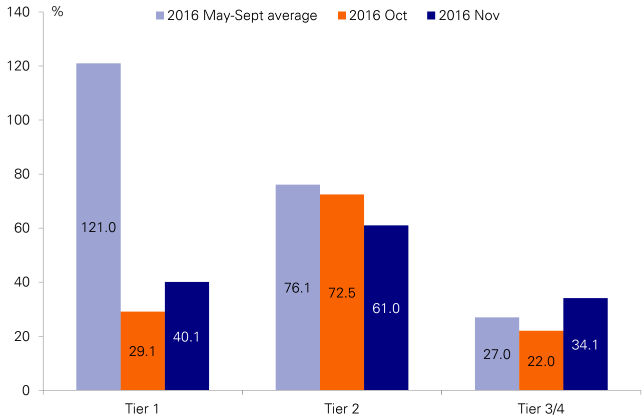
Policy may loosen in Q2

We expect growth to slow to 6.2% yoy in 2017Q1 mainly due to the slowdown in the property sector. The government will face a difficult choice between achieving the growth target of 6.5% and containing risks in the property sector. We think they will choose growth and start another round of policy easing by Q2 after economy shows signs of weakness.

The fiscal policy easing is well expected in the market. We expect growth of infrastructure investment will pick up to 23% in 2017 from 17.6% ytd in 2016. Indeed we have witnessed a wave of PPP projects built up in the Ministry of Finance's database.

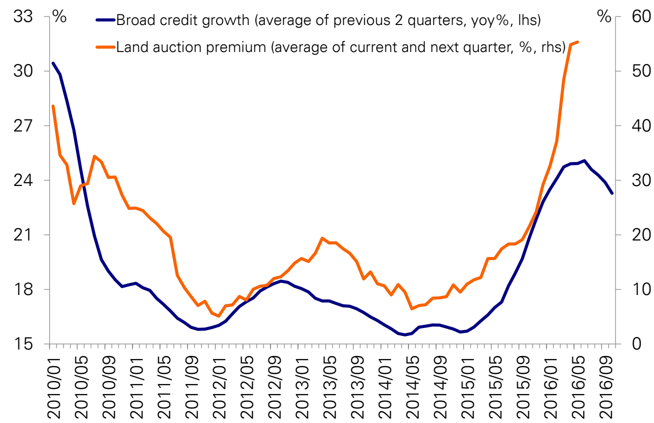
The question is whether infrastructure by itself is sufficient to keep growth above 6.5%. We think it is challenging, because property sector and fiscal revenue are closely linked. Land sale revenue accounted for 35.8% of local government revenue this year. If the current trend in land sales continues, local

Figure 3: Land auction premium, May-Nov 2016



Source: Deutsche Bank, CREIS

Figure 4: Broad credit growth and land auction premium



Source: Deutsche Bank, CREIS, WIND

government will experience a large contractionary fiscal shock in 2017, as they did in H1 2015. They will face difficulty in financing the infrastructure projects. For more discussion on the link between land sales and local government revenue, please see our report China's unexpected fiscal slide, Jan 5 2015.

The other issue on the government's mind is probably the risk of leveraged developers. Our research shows that if property prices stay at September level, about 23% of land sales in China between July 2015 and early Sept 2016 may face loss. If policy tightening continues into H2 2017, property prices may drop, some of the developers who bought land at expensive prices may face trouble.

If policy in the property sector eases in 2017Q2, the property bubble will likely become bigger in H2 2017, and impose macro risks in 2018. We therefore cut our GDP forecast for 2018 to 6.0% and expect more RMB depreciation.

17% RMB devaluation by 2018

We changed our forecast for RMB on September 28 and expect it to depreciate to 7.4 and 8.1 against the US dollar by the end of 2017 and 2018, respectively (6.9% and 17.1% depreciation from the current level of 6.92). It depreciated by 6.4% ytd in 2016, while the DXY index for the US dollar appreciated by 2.8%. Taking DB forecasts for other currencies, our forecast implies 2.1% and 12.1% depreciation against the PBoC basket in 2017 and 2018, respectively. The depreciation against our proprietary RMB basket would be 1.4% in 2017 and 7.5% in 2018.

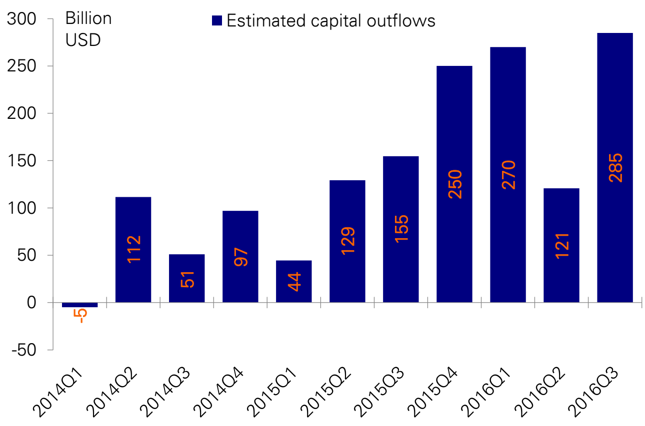
Our relatively bearish view on RMB is because we expect capital outflows will lead to decline of FX reserves. We expect FX reserves to fall below US$ 3trn by 2017Q1 and US$2.5trn by 2018Q3, assuming the same run pace as in Aug-Oct this year. We think the government has the ammunition to keep depreciation of RMB against the US dollar around 7% in 2017 (similar to 2016), but they will need to tolerate faster depreciation in 2018 to avoid further decline of reserves.

We believe the rise of capital outflows in Q3 is the beginning of a structural trend (Figure 5). It reflects a change of expectation among onshore investors and corporates on RMB outlook. Note that the rate hike in the US was not the key driver of record high capital outflows in Q3, as the expectation for rate hike didn't change much from Q2 to Q3. We think the key driver was the concern on property bubble.

Capital outflows may have intensified in Q4, as the US election led to a sharp rise of US treasury yields and expectation for more rate hikes in 2017 and 2018.

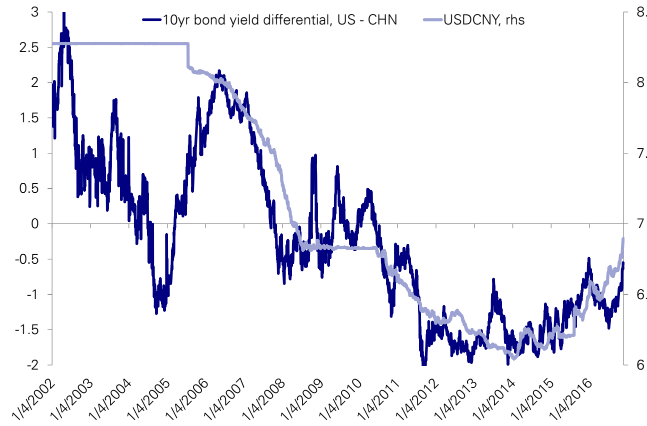
The gap between the 10 year government bond yields in China and the US narrowed. The gap may narrow further and potentially flip signs in the future as the Fed raises rate and China keep rate stable (Figure 6).

Figure 5: Estimated capital outflows



Source: Deutsche Bank, WIND

Figure 6: 10y bond yield differential and USDCNY



Source: Deutsche Bank, WIND
Note: The bond yield differential is the US 10 year government bond yield minus China 10 year government bond yield

The Chinese government will continue to tighten capital controls. We think it may help to delay such outflows, but unlikely to reverse the trend. As the PBoC Governor Zhou Xiaochuan said in a February interview, capital controls are less effective for countries like China with a large current account, and they are less effective for containing capital outflows than inflows. We believe capital controls may become less effective in 2018 as households and corporate may develop ways to evade them.

Stable growth in 2017, higher risks beyond

We expect China's economy to grow 6.5% in 2017 (Figure 7). Fiscal policy will likely become more expansionary in 2017 as quasi fiscal spending pushes up growth of infrastructure investment. On monetary front, we no longer expect any rate cut in 2017, but the PBoC may loosen credit supply in Q2 to mitigate the slowdown in property sector. We continue to expect two RRR cuts in 2017,

Figure 7: Selected economic indicators, China

	Real GDP, yoy%	CPI, yoy% period avg.	M2, yoy% eop	Fixed asset inv., nominal, yoy%	Retail sales, nominal, yoy%	Industrial prod., real, yoy%	1-yr deposit rate	USDCNY, eop
2014	7.3	2.0	12.2	15.7	12.0	8.3	2.75	6.12
2015	6.9	1.4	13.3	10.0	10.7	6.1	1.50	6.49
2016F	6.6	1.9	11.9	8.3	10.5	6.0	1.50	6.80
2017F	6.5	2.5	12.8	8.8	10.8	5.8	1.50	7.40

Source: Deutsche Bank, WIND

though we acknowledge that the PBoC may choose to release liquidity through open market operations instead of explicit RRR cuts. We think CPI inflation will likely pick up to 2.5% in 2017 from 2.1% in October 2016.

We launched a probability-based approach to forecast China's economy in Jan 2016. We provide an update on these probabilities for next year (Figure 8).

- Risks to our 2017 growth forecast are tilted slightly to the upside (baseline: 6.5%). We see 60% chance that growth will be 6.5% to 7%, 35% chance between 6% to 6.4%, and 5% chance it drops below 6%. We believe the political commitment for achieving growth target of 6.5% is still very high, hence our relatively stable forecast.

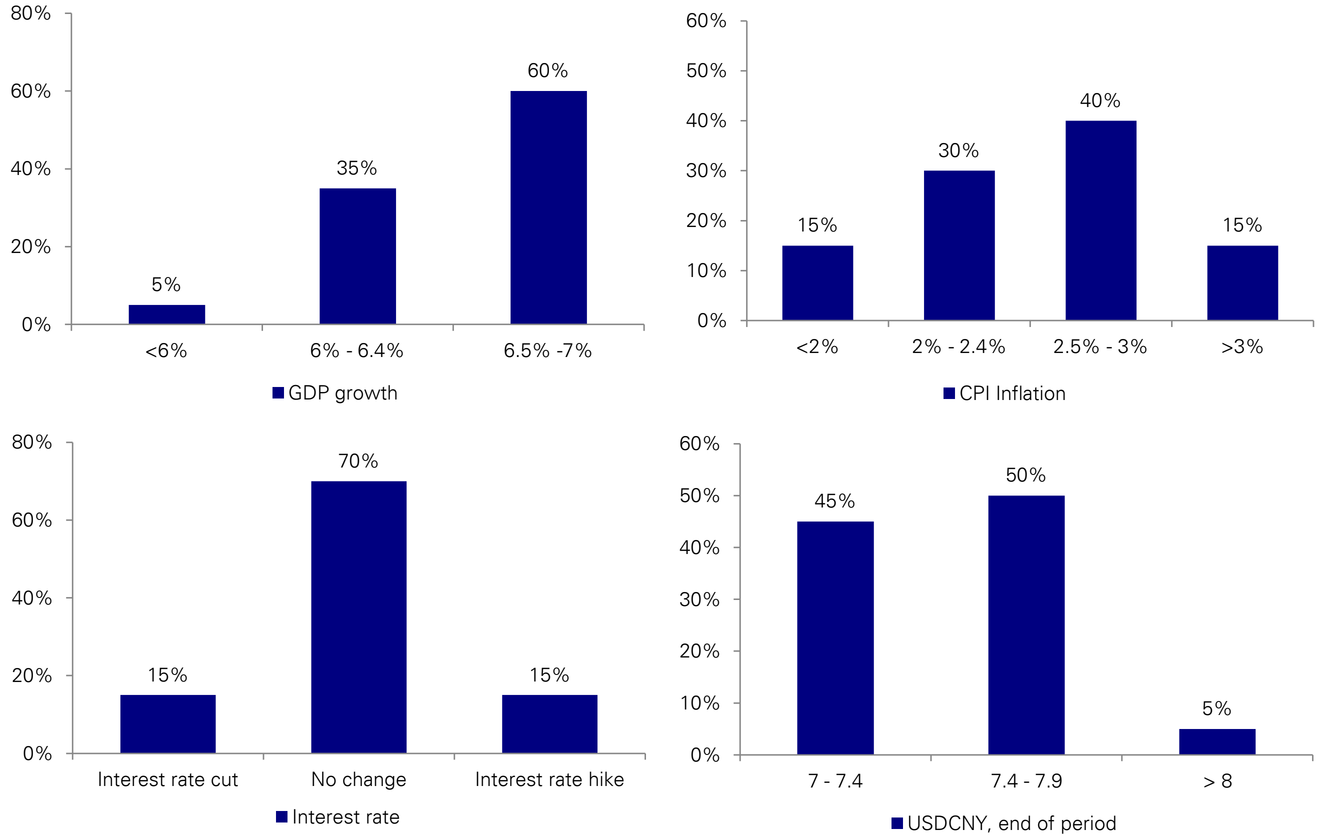
- Risks to our 2017 inflation forecast are tilted to the upside (baseline: 2.5%). Indeed we see inflation to be more uncertain in 2017. We assign 40% probability that it rises by 2.5% to 3%, 15% probability it rises more than 3%, 30% probability it goes up by 2% to 2.4%, and 15% probability it increases by below 2%.

- Risks to our interest rate forecast are balanced. We see 70% probability the benchmark rates remain unchanged in 2017, 15% probability of rate hike, and 15% probability of a rate cut.

- Risks to our RMB forecasts are balanced (baseline 7.4). We see 50% probability of USDCNY to be at 7.4 to 7.9, 45% probability from 7 to 7.4, and 5% probability it depreciates to 8 or above.

We see 50% of probability that growth may drop below 6% for a full year sometime between 2018 to 2020. Macro risks are set to rise beyond 2017. The fiscal and monetary easing in 2017 will likely push up leverage ratio, with aggregate debt rising to some 290% of GDP by the end of 2017. The property bubble will impose more macro risks, the US rate hikes will further constrain the policy room for PBoC, and the excessive liquidity onshore will likely drive inflation up eventually.

Figure 8: Probability forecasts for growth, inflation, 1 year deposit interest rate, and exchange rate in 2017



Source: Deutsche Bank

Appendix 1

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