April 17, 2017

INTERNATIONAL ECONOMIC REPORT

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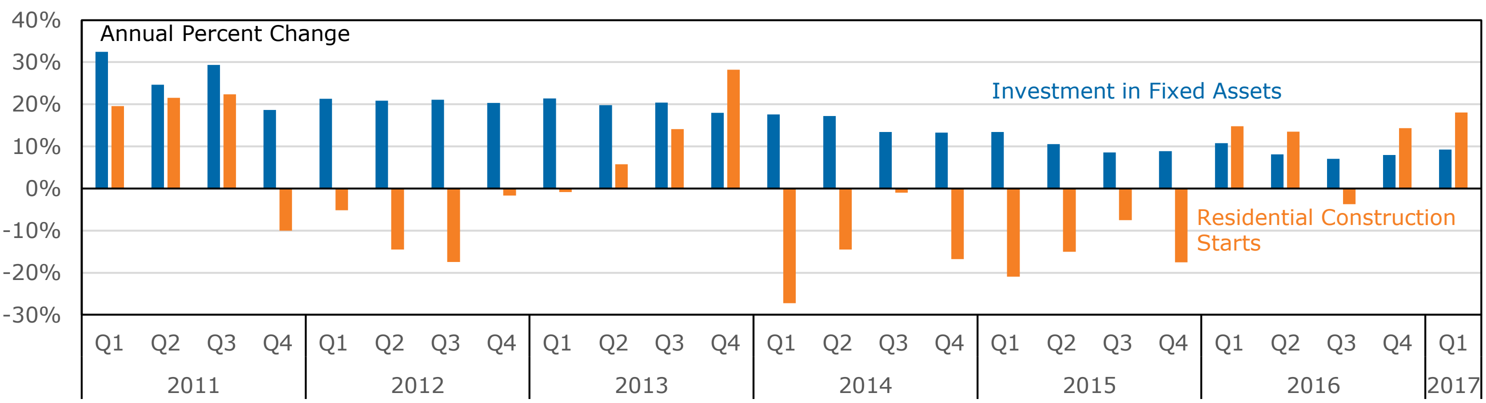
CHINESE INDUSTRIAL ACTIVITY AND HOUSING INVESTMENT BUOY REAL GDP; CREDIT GROWTH MODERATES TO A MORE SUSTAINABLE PACE

SUMMARY

- Real GDP grew 6.9 percent in year-ago terms in the first quarter of 2017, up from 6.8 percent in the prior quarter. Nominal GDP growth was the fastest in five years.
- Stronger fixed investment and residential construction supported industrial production in the first quarter.
- Nominal GDP and credit grew at roughly the same rates in the first quarter, ending a long period in which credit growth outpaced that of output. If this becomes a trend, longstanding concerns about the sustainability of China's growth model will seem less urgent. However, China's fiscal deficit is still large.
- After 6.9 percent real GDP growth in the first quarter, PNC Economics' forecast for real GDP to grow only 6.5 percent in all of 2017 looks conservative, but it could still be correct if China trims its fiscal deficit.

China's economy grew solidly in the first quarter of 2017, supported by stronger industrial activity and residential real estate investment. Chinese real GDP grew 6.9 percent in year-ago terms, up from 6.8 percent in the fourth quarter of 2016 and 6.7 percent in the prior three quarters. In nominal or not-inflation-adjusted terms, real GDP grew 11.8 percent in the first quarter of 2017, the fastest pace since the first quarter of 2012, when real GDP grew 8.1 percent. By major sector, growth in the secondary, or industrial, sector picked up to 6.4 percent in year-ago terms from 6.1 percent a quarter earlier. Partially offsetting this, growth of the tertiary, or services, sector slowed to 7.7 percent in year-ago terms from 8.3 percent in the prior quarter. The first quarter's faster headline real GDP growth seems inconsistent with the tertiary growth slowing by more than industrial growth accelerated, especially since the tertiary sector is larger than the industrial sector; the aggregate growth rate should be a weighted average of the growth rates of the economy's sectors. One way to make sense of inconsistencies in China's GDP accounts is to cross-check against other economic indicators, like early 2017's increase in commodity prices, which

CHART 1: HOUSING CONSTRUCTION BUOYED INVESTMENT & GDP GROWTH IN EARLY 2017



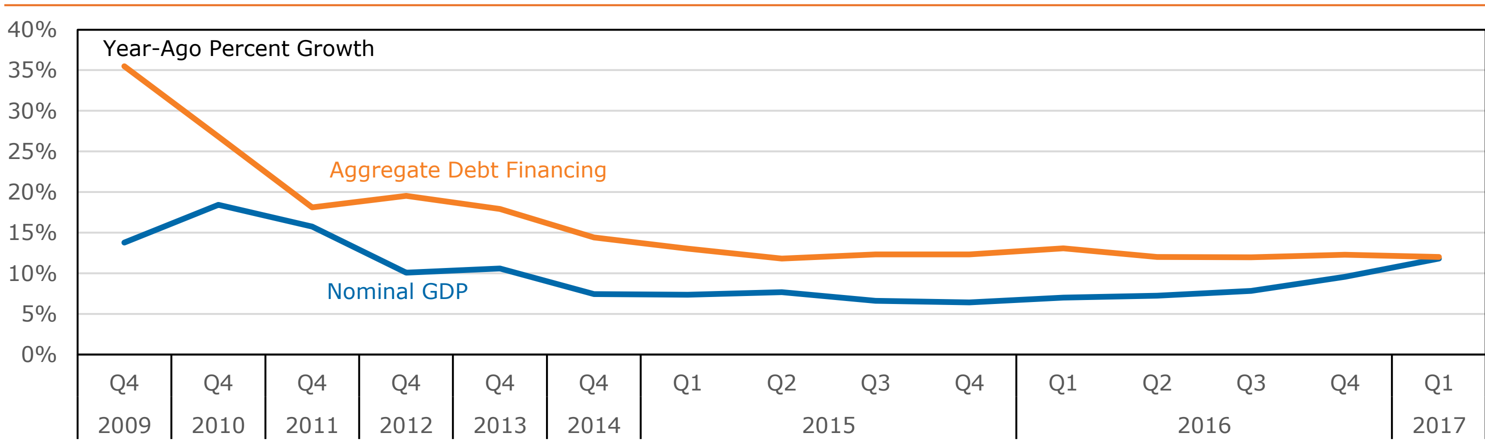
Sources: NBS, CEIC, The PNC Financial Services Group signaled stronger demand, or separately-measured surveys of investment and business sentiment. These collectively suggest that, if the GDP accounts are inconsistent, they most likely understate the industrial sector's acceleration. The tertiary sector's slowdown is easier to explain: Real estate sales moderated. Commercial housing sales grew 25.1 percent by value and 19.5 percent by floor space sold in the first quarter of 2017, markedly slower than their 54.1 percent and 33.1 percent respective annual increases in the first quarter of 2016.

As noted above, investment strengthened in the first quarter. Nominal investment in fixed assets rose 9.2 percent from a year earlier, faster than the 8.1 annual growth in all of 2016. Real estate investment strengthened by even more, growing 9.1 percent in the first quarter after 6.9 percent in 2016, boosted by the first quarter's 18.1 percent year-ago increase in residential construction starts (See Chart 1). After running down inventories in 2014, 2015 and 2016, real estate developers are accelerating construction, a development that will support global commodity demand in the near term.

Chinese credit growth was moderate in the first quarter. Aggregate debt financing to the nonfinancial economy grew 12.0 percent on the year in March, close to nominal GDP growth, ending a long period in which credit grew faster than output (See Chart 2). The gap between nominal GDP growth and credit growth is frequently cited as quantitative evidence that China's growth model is unsustainable. If early 2017's convergence of credit and output growth becomes a trend, this vulnerability in the country's economic growth model will seem less urgent. China might not have the luxury of waiting for such a trend to take hold, though: The People's Bank of China is timing increases in its quasi-policy rate, the reverse repo rate, against US federal funds rate hikes to curb capital outflows. A large increase in Chinese effective interest rates could squeeze Chinese companies' cash flows or increase stresses on the financial system, even if debt growth remains more moderate. With US interest rates likely to rise significantly faster over the next 12 to 18 months than in 2015 or 2016, the possible spillover to Chinese financial conditions is a clear downside risk to the country's economic outlook. In addition, Chinese policymakers have been compensating for less expansionary credit growth with more expansionary fiscal spending: The central government's fiscal deficit was 4.0 percent of GDP in the twelve months through March, up from 3.7 percent a year earlier.

PNC Economics' current forecast is for Chinese real GDP growth to slow to 6.5 percent in 2017 from 6.7 percent in 2016. This might be too conservative after the pickup in growth in the first quarter of 2017, but Chinese growth could easily slow if the central government trims its fiscal deficit in the next few quarters. PNC Economics also expects the Chinese government to continue to guide the yuan weaker against the US dollar to 7.3 per dollar by year-end 2017 and 7.5 per dollar by year-end 2018. China's capital outflows slowed in early 2017 as the government tightened capital controls, making this managed depreciation policy easier to sustain. Nevertheless, a freely-floating and subsequently weaker yuan is still a key tail risk to the outlook.

CHART 2: DEBT GROWTH HAS MODERATED TO A SUSTAINABLE PACE



Sources: PBoC, NBS, CEIC, The PNC Financial Services Group
Note: Aggregate debt financing includes all aggregate financing to the nonfinancial economy except equity financing

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