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CHINA UPDATE

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CHINA LIKELY TO TIGHTEN RESTRICTIONS ON CAPITAL OUTFLOWS AS US INTEREST RATES RISE IN 2017 AND 2018

Growth is continuing on trend, but with a big shift away from heavy industry in 2016

Chinese growth continues on trend. Real GDP grew 6.8 percent in year-ago terms in the fourth quarter of 2016, up a hair from 6.7 percent in the third. Real GDP grew 6.7 percent in the full year of 2016, slower than 2015's 6.9 percent or 2014's 7.3 percent (See Chart 1). The industrial core of China's economy is cool. Industrial value added – real GDP from industry – grew 6.0 percent in 2016 (slow for China), with steel industry value added falling 13.1 percent and mining GDP falling 1.0 percent. Fixed asset investment in mining and industry likewise fell, by 20.4 percent and 2.2 percent, respectively, in 2016 – second consecutive annual declines for both industries. Overall investment in fixed assets grew by the slowest in 2016 since the year 2000. Foreign trade was a small net drag on Chinese growth in 2016: While real exports grew modestly, up 2.8 percent from 2015, real imports grew faster, 3.6 percent. Partially offsetting the drag from heavy industry and trade, real GDP in auto manufacturing surged 15.5 percent on the year in 2016 on record domestic vehicles sales of 27.9 million. Fixed asset investment by auto manufacturers grew 4.4 percent, and investment in basic infrastructure grew even faster: Capex in water conservancy, highway transport, and air transport grew 20.4 percent, 15.1 percent, and 20.6 percent, respectively, last year. A pickup in real estate sales and investment likewise is supporting headline growth. Property developers sold 22.5 percent more floor space in 2016 than 2015, and construction starts grew 8.1 percent on the year, their first annual increase since 2013.

Real GDP growth likely to slow to 6.5 percent in 2017 and 6.3 percent in 2018

An expansionary fiscal policy and neutral monetary policy will likely support real GDP growth of about 6.5 percent in 2017 and 6.3 percent in 2018. The central government's fiscal deficit rose to 3.8 percent of GDP in 2016 from 3.4 percent in 2015, the largest deficit relative to the size of the economy since at least 1996; the deficit is funding higher infrastructure spending. Monetary policy, by contrast, is becoming less aggressive. Chinese policymakers set the price and quantity of domestic credit independently, and while they cut the price in 2016 – effective interest rates fell – they also cut supply. Broad credit aggregates grew 12.3 percent in 2016, down from 2015's 12.7 percent to the slowest rate since 2005. The "financing gap" – the degree to which credit grew faster than real GDP, a metric widely cited in 2014 and 2015 as evidence of a faltering Chinese

CHART 1: GROWTH DRIVERS SHIFT FROM INDUSTRY AND EXPORTS TO AUTO, INFRASTRUCTURE, AND HOUSING

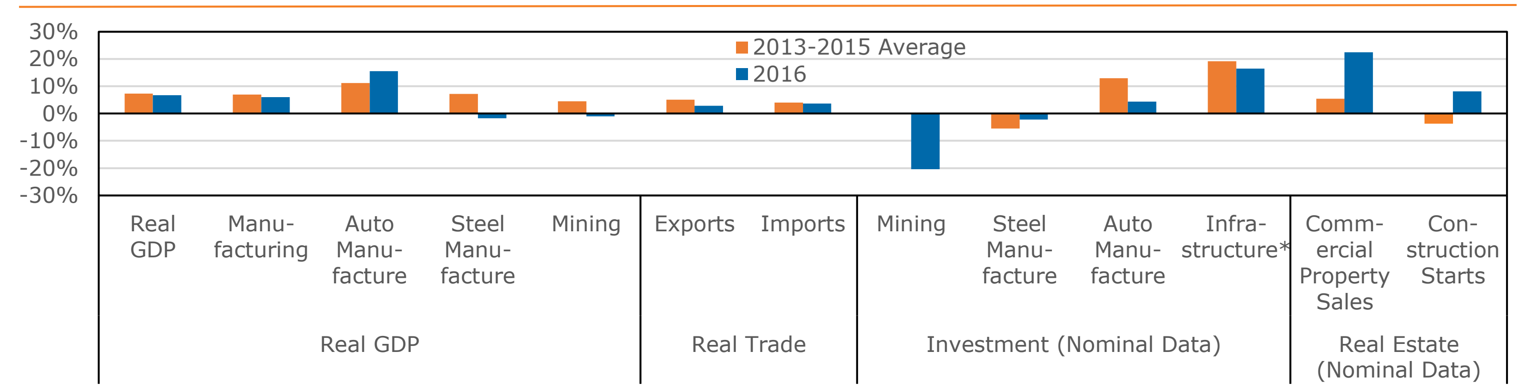

Chart sources: National Bureau of Statistics, CEIC, The PNC Financial Services Group

Faster than expected increases in US interest rates could force China to allow the yuan to freely float

growth model – fell faster than overall credit growth in 2016, since nominal GDP growth accelerated to 8.0 percent from 2015's 7.0 percent.

The key tail risk to the Chinese economy in 2017 and 2018 is that, as US interest rates increases accelerate, China's capital outflows could pick up as well, stressing the financial system. China's foreign reserves have already fallen by a trillion U.S. dollars – one quarter of their peak total – between mid-2014 and early 2017 under the country's managed exchange rate regime, due to falling net exports, weaker inflows of foreign direct investment, growing expectations of yuan depreciation, and rising US interest rates. China's financial regulators are tightening restrictions on capital outflows, but as long as the economic drivers of a strong US dollar hold – a tightening US job market, expansionary US fiscal policy, and rising US interest rates – China must choose between spending foreign reserves to manage its exchange rate, or allowing it to freely float and depreciate sharply, risking the US Treasury Department labeling China a "currency manipulator."

If China's regulators choose to hold on to their remaining reserves to cushion against future global shocks or as a "rainy day fund" to someday restructure non-performing loans, the yuan would freely float, and could suddenly depreciate 10-20 percent. This forecast is counterintuitive for Americans accustomed to thinking of China's currency as manipulated to be artificially weak. But, just as China's steady accumulation of foreign reserves in the first decade of the 21st century signaled the yuan was undervalued, China's loss of foreign reserves since mid-2014 signals that the yuan is overvalued – stronger than if its price were determined by supply and demand in a free market (See Chart 2). A yuan free float would benefit China and global growth in the long run. Chinese growth and inflation would accelerate as competitiveness improved, and rising imported prices would reduce the size of China's overhang of debt relative to its economy. But a yuan float would be painful in the short run, fueling global financial volatility, and lowering global commodity prices, inflation expectations, and interest rates. The late-2015 to early-2016 capital markets "monsters under the bed" episode, in which fears about knock-on effects of Chinese instability fueled a few sweaty-palmed months of financial tension, was a preview of how a yuan float would play out. In the base case, China is more likely to muddle through 2017 by tightening restrictions on capital outflows and making a measured spend of foreign reserves, limiting the yuan's depreciation to 7.4 per dollar by the end of 2017 from its current 6.9 per dollar.

A trade war would add to Chinese growth risks but is unlikely to cause a recession: Exports to the US are 3.5 percent of Chinese GDP

Potential US tariffs on Chinese imports would increase downside risks to Chinese growth, but probably not cause a recession. Chinese exports to the United States accounted for less than 20 percent of all Chinese exports or just 3.5 percent of Chinese GDP in 2016, down from 7.4 percent in 2006. A 20 percent decline in Chinese exports to the United States would reduce Chinese real GDP growth by a manageable 0.7 percentage points. China could be expected to retaliate against US tariffs by imposing countervailing tariffs on US exports to China, and by discouraging Chinese state-owned businesses (and their suppliers and customers) from buying American. A China-US trade war would be a "lose-lose" proposition for both the Chinese and US economies.

CHART 2: FALLING FOREIGN RESERVES WARN THAT THE YUAN IS STRONGER THAN A FREE MARKET WOULD DICTATE

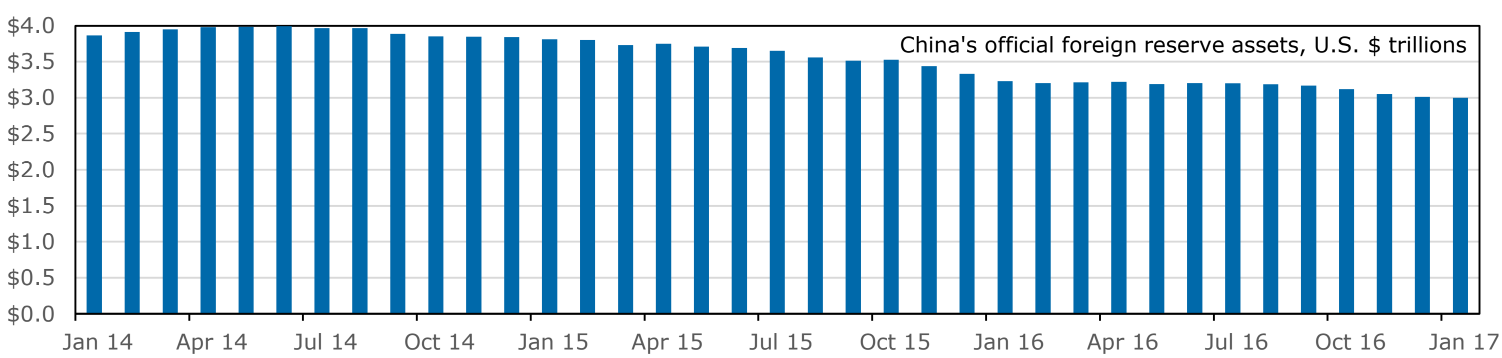

Chart sources: People's Bank of China, CEIC, The PNC Financial Services Group

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