

Economic Outlook

China/Asia

Second Quarter 2013
Economic Analysis

- **The global economy continues to pick up, but with increasing divergence across regions.** Growth in the euro area remains weak, with recovery delayed to 2014, while momentum is more resilient in the US and Asia. We expect global growth of 3.3% in 2013 and 3.9% in 2014, slightly below previous projections.
- **Asian economies continue to grow amidst a gradually improving external environment and accommodative policies.** However, with the pace of growth in early 2013 somewhat slower than expected, we have lowered our 2013-14 Asia-Pacific growth projections slightly, to 5.4% and 5.8%, respectively.
- **In China, although Q1 GDP growth disappointed to the downside, we have maintained our 8.0% growth projection for 2013-14.** External demand is improving, and subdued inflation provides room for policies to remain supportive.
- **Risks to the outlook are tilted to the downside due to weaker-than-expected growth outturns and a still-fragile external environment.** In China, rising domestic financial fragilities pose a constraint on further policy easing. Elsewhere in the region, currency tensions from the weakening yen, capital inflows, and asset price bubbles pose challenges to policymakers.

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Summary

After bottoming out in 2012, Asian economies continue to grow amidst a gradually improving, but still weak, external environment and accommodative domestic policies. However, the pace of growth in the first half of 2013 has been somewhat lower than expected, especially in China (see below), India, and the region's more export-dependent economies. In contrast, growth among the economies of Southeast Asia (ASEAN), particularly Indonesia, the Philippines, and Thailand, remain a bright spot.

The most significant regional development over the past quarter has been the Bank of Japan's announcement on April 4 of a massive step-up in its quantitative easing campaign. While the strategy entails risks, on balance it appears to be working so far as measured by Japan's rising consumer and business confidence, inflation expectations, and the performance of equity markets. Elsewhere in Asia, except for the ASEAN economies, monetary policies remain on an easing bias, with additional cuts likely in India, and possibly Korea and Australia.

Our growth outlook for the region continues to envisage a gradual improvement in growth momentum based on a further strengthening of the external environment. As a result, our growth and inflation projections for 2013-14 remain broadly unchanged from our last *Outlook* published in February, except for India where we have lowered our GDP projection by around 0.5% in each of 2013-14, to 5.7% and 6.4% respectively. For the Asia-Pacific region we expect growth of 5.4% in 2013, up from 5.2% in 2012.

In China, first quarter GDP growth disappointed to the downside, falling to 7.7% y/y from 7.9% y/y in Q4 on weak private investment. Moreover, the new leadership's willingness to implement fresh stimulus measures has been called into doubt due to the buildup of domestic financial fragilities that are themselves the legacy of previous efforts to stimulate growth.

Notwithstanding these concerns, on balance we believe that growth in China remains on track to reach 8.0% in 2013 and 2014 as previously projected. The external environment continues to improve gradually, and subdued inflation provides room for fiscal and monetary settings to remain growth-supportive, as indicated by the new leadership.

While inflation has trended up from its low of last October, it remains subdued at 2.4% y/y, well within the authorities' 3.5% target range. Stable or falling commodity prices and low producer price inflation should help keep inflationary pressures at bay, and we are revising down our 2013 average inflation projection to 3.0% from 3.3% previously. We do, however, expect inflation to rise gradually during the year on stronger demand, rising food prices, and base effects to 3.8% by end-2013, and to stay at around 4.0% in 2014.

While China's policies will remain growth supportive, further stimulus measures are constrained by a buildup in domestic financial fragilities. Fiscal policy will underpin growth through continued infrastructure spending, public housing construction, and selected tax cuts. On the monetary front, we expect interest rates to remain on hold during the rest of 2013, although the PBoC may adjust liquidity through open market operations and adjustments in the RRR. We expect the RMB to continue appreciate to around 6.10 per USD by end-2013.

Scope for additional policy easing is constrained by the buildup in local government debt, acceleration of shadow banking activities, and ongoing rise in property prices. The authorities have implemented policies to curb a further buildup in these fragilities.

Weaker-than-expected growth outturns and the still-fragile external environment pose downside risks to the outlook in China and the rest of Asia. In the event that external demand remains weak, there is room for further policy support in most Asian economies, although the scope is somewhat limited, especially in China where concerns of domestic financial fragilities have increased. Within the region, downside risks emanate from geopolitical concerns, and from macro risks of currency tensions due to the weakening of the yen, and prospects of appreciation pressures and asset bubbles from capital inflows.

1. Growing divergences in the global economy

Before turning to Asia and China, we review the *Global Outlook*. Readers may go directly to the sections on Asia, if they wish, by turning to page 7.

Over the last three months, threats to the global recovery have receded, but with growing divergences in growth across the major areas (Chart 1). In particular, there is growing disparity between the performances of the US on the one hand and the eurozone on the other, where weakness has reached the core economies. Due to downward revisions to our growth outlook for the eurozone, we have revised down our growth forecasts for the world economy to 3.3% in 2013 and 3.9% in 2014, from 3.6% and 4.1% respectively.

There has been only a limited response in global financial markets to risk events such as the uncertainty over long-term fiscal policy in the US, political paralysis in Italy, and the turmoil in Cyprus (Chart 2). Indeed, risk premiums have fallen in the eurozone on the implicit support from the ECB's OMT programme and abundant global liquidity. Nearly all assets are benefiting from this change in perception, with the exception of credit risk indicators in the eurozone's banking sector.

Consumption and monetary expansion drive growth in the US

An improvement in US job creation and the financial condition of households is leading to stronger private spending. In all, we maintain our growth forecasts for the US economy in 2013 and 2014 of 1.8% and 2.3%, respectively. Despite uncertainty regarding the fiscal cliff and sequester (automatic public spending cuts), private spending has been resilient. Moreover, quantitative easing (QE) is likely to continue until there is significant improvement in labour market prospects. Although some of the data at the start of the year could have prompted an early withdrawal of stimuli, the most recent information shows that the American economy is still far from sufficiently robust growth rates, so monetary policy will continue to be a support for growth.

The euro zone stagnates and the ECB springs into action

The newest element in the eurozone is the spread of weak activity from peripheral economies to the centre, particularly France, but also Germany and Holland. In France, uncertainty regarding tax policy and fiscal consolidation, together with the lack of reforms, is undermining confidence. Similarly, Germany's confidence indicators have been on a renewed downward trend since April, and exports are suffering, despite resilient demand from emerging countries. Holland has also been heading for recession as a result of falling investment and household consumption, and despite the positive performance of its exports. Finally, on the eurozone's periphery there has been strong appetite for risk, in particular for peripheral sovereign debt, thanks to the ECB's OMPT program and abundant global liquidity, especially after Japan implemented a new round of monetary easing.

A deterioration in confidence surveys confirms activity is losing momentum, and there is growing debate about the right level of fiscal consolidation without undermining economic activity. Recent statements by the European Commission supporting Spain's postponement of its 3% public deficit target until 2016 are in line with a greater emphasis on the quality and composition of the adjustment rather than on the fast achievement of targets at the expense of possible negative effects on growth.

Overall, our scenario involves a downward revision of eurozone growth forecasts. We estimate a fall of -0.1% in GDP in 2013 and a rise of 1% in 2014, 0.4 and 0.3 percentage points, respectively, below the forecasts in our February publication. Risks continue to be tilted to the

downside, and against a backdrop of spreading weak activity and inflation below the target, the ECB cut its refi rate by 25 basis points to 0.50%. However, the impact of rate cuts on the real economy may be limited.

In Asia, doubts linger about the strength of China's growth

As detailed in the remainder of this Outlook, the Chinese economy lost some steam in the first quarter of 2013 on weaker than expected investment due, in part, to uncertainty over policies to tackle an increase in domestic financial fragilities. However, the change in the growth model towards a more consumption-oriented economy continues. With inflation also lower than expected, pressure for tighter monetary conditions has eased. As a result, the authorities have room for manoeuvre. Our forecast for China's growth remains unaltered at 8% for 2013-14.

In Japan, the economy will benefit from a package of aggressive stimulus policies. Among them is the massive quantitative easing, whose size amounts to around 25% of Japan's GDP (each of the QE implemented by the Fed represented an average of 10% of US GDP), aimed at changes in inflation expectations and boosting growth. This monetary boost will be more effective if it is accompanied by fiscal measures and structural reforms. Thus our growth forecast for the Japanese economy for 2013 and 2014 remain at an above-consensus 1.7%.

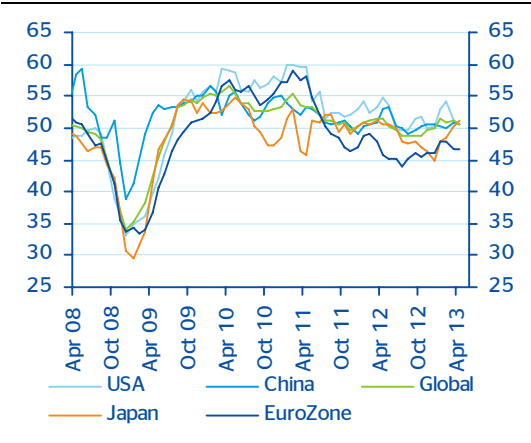
It is difficult to quantify the impact of predict how investors will react. For example, if the policy is successful in promoting growth and confidence at a national level, it could generate greater net capital inflows globally (instead of outflows). In addition, its impact at a domestic level in Japan is also uncertain, as the Bank of Japan's policy involves some risks: strong volatility in sovereign bonds (JGB), risks for bank's balance sheets and the costs of debt for the government when nominal yields grow, provided the Bank of Japan is successful in complying with its inflation target of 2%. However, the new monetary easing provides arguments in favour of domestic investors increasing moving capital abroad.

Monetary easing favors risk taking

Financial markets are still dominated by flows from central banks. Against that backdrop, long-term rates on US and German bonds have fallen in recent months. The ensuing dash for yield in a less risk averse environment (partly because of the ECB actions) has also prompted a sharp fall in yields on government bonds in the periphery of Europe to levels not seen since 2010. In this context, there have been capital inflows to emerging fixed-income markets, especially the most liquid (Turkey, Brazil, Mexico), anticipating capital outflows from Japan after its QE program was announced, which includes purchases of public debt by the central bank of Japan.

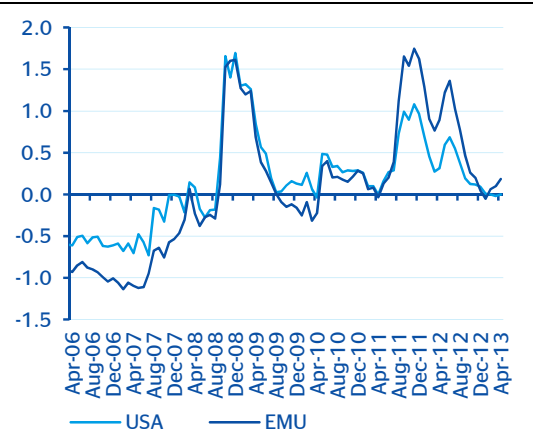
As a result, the euro has been resilient to cyclical weakness in the area. In particular, the lower probability of high-risk scenarios and a less accommodative monetary policy vis-à-vis other central banks have led to euro strength. In the absence of major risk events in Europe and no surprises in the QE exit strategy by the Fed, the euro could continue trading in its current range of 1.30 to 1.32 dollar per euro until the end of this year. This does not rule out episodes of dollar appreciation of the dollar as a result of changes in the cyclical-risk balance and different central-banks reactions.

Chart 1
Confidence Indicators (PMI)



Source: Markit and BBVA Research

Chart 2
BBVA Financial Tension Indicator

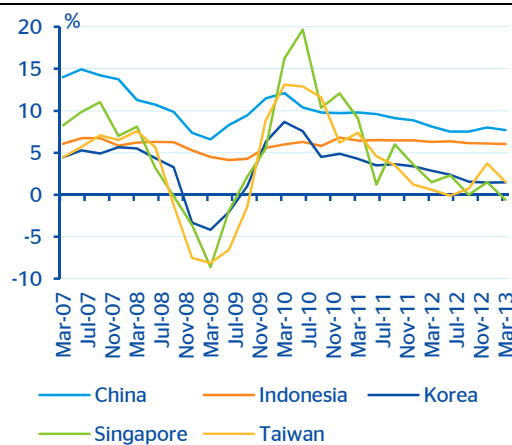


Source: BBVA Research

2. A tepid pickup in Asia

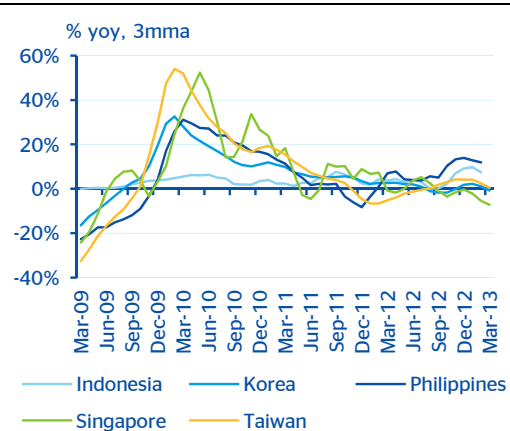
After bottoming out in 2012, Asian economies continue to grow amidst a gradually improving, but still weak, external environment and accommodative domestic policies (Charts 3 and 4). That said, the pace of growth in the first half of 2013 has been somewhat lower than expected, especially in China (as detailed in the next section), India, and the region's more export-dependent economies. In contrast, growth among the economies of Southeast Asia (ASEAN), particularly Indonesia, the Philippines, and Thailand, remain a bright spot, propelled by strong domestic demand and capital inflows.

Chart 3
Growth dipped unexpectedly in Q1...



Source: Haver and BBVA Research

Chart 4
Industrial production



Source: Haver and BBVA Research

The Bank of Japan shakes things up

Arguably, the most significant regional development over the past quarter has been the Bank of Japan's announcement on April 4 of a massive step-up in its quantitative easing campaign (Box 1). A more expansionary monetary policy stance had been widely expected following last December's election of Prime Minister Shinzo Abe and his emphasis on charting a new policy course toward reinvigorating growth and ending inflation, based on a "3-arrow" strategy of fiscal stimulus, monetary expansion, and structural reforms. Nevertheless, the magnitude of the expansion announced by the BOJ's new Governor Haruhiko Kuroda came as a surprise – a doubling of the monetary base over the coming two years – and unleashed renewed depreciation pressures on the yen (Chart 5).

The policy has generated criticism among sceptics who stress potential risks of instability in Japan's bond market (especially given the extremely high public debt level of over 200% of GDP), difficulties in controlling inflation once it begins to rise, challenges in managing an exit strategy and, most immediately, negative spillovers from currency depreciation on Japan's trading partners. While such risks cannot be dismissed, on balance the policy appears to be working so far as measured by rising consumer and business confidence, inflation expectations, and the performance of equity markets (given the usual lags, it is still too early to assess the impact on economic activity). Moreover, with the exception of Korea, Japan's most significant regional trade competitor, unease with yen depreciation has been muted, especially after the G20's endorsement of Japan's policy approach. To achieve a more enduring positive impact on Japan's domestic economy, which in turn would be beneficial for regional growth, it will be necessary to follow through on the government's plans for medium-term fiscal consolidation and structural reforms to stimulate growth.

Disappointing growth outturns in China, India and the export-dependent economies...

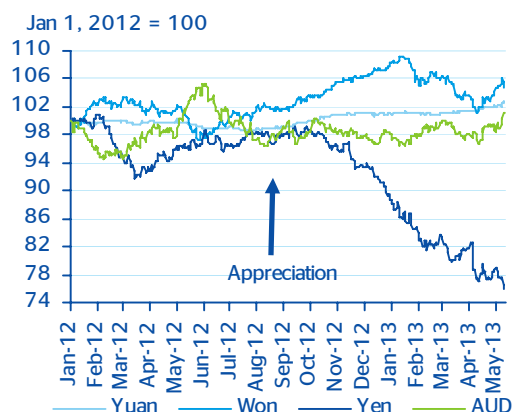
While still on an improving trend after bottoming out in Q3 2012, recent growth outturns in much of the region have disappointed to the downside. In China, although government spending and exports held up well, Q1 GDP growth came in weaker-than-expected at 7.7% y/y due to sluggish private investment which, in turn, may have been due to uncertainties about the policy stance of the incoming new leadership. Meanwhile, growth continues to underperform in India, falling to a decade low of 4.5% y/y in Q4 2012, bringing full-year growth for 2012 to 5.1%, well below the 7.5% recorded in 2011. Recent activity indicators on industrial production and vehicle sales suggest that sluggish growth momentum has continued into 2013, prompting the Reserve Bank of India to cut interest rates three times this year by a cumulative 75bps. In addition to the weak global environment, the factors for the growth slippage are due to a number of inter-related domestic issues, including logjams in policy reforms, persistent inflation, and vulnerabilities from “twin” current account and fiscal deficits. Encouragingly, the government has begun to address these issues by emphasizing fiscal consolidation and stepping up the pace of policy reforms (see Economic Watch, *Taking Stock of Policy Reforms*).

The export-dependent economies of Korea, Taiwan, and Singapore have also performed somewhat below expectations so far in 2013. In particular, Q1 GDP growth in Taiwan and Singapore, of 1.5% and -0.6% y/y respectively, fell short of expectations due to sluggish exports. In Korea, Q1 GDP came in slightly above expectations, at 1.5% y/y, but weak private consumption growth due to a high burden of household debt and sluggish exports continue to weigh on growth momentum, prompting the new government of President Park Geun-hye to implement new fiscal stimulus measures estimated to simulate growth by 0.3% in 2013.

...while ASEAN continues to shine

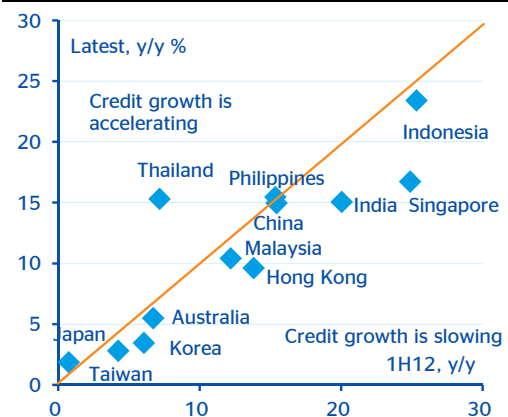
Growth momentum in the ASEAN economies remains strong, underpinned by robust domestic demand and continued strong credit growth (Chart 6), capital inflows, and intraregional trade. The Philippines, which recorded the second-highest GDP outturn in Asia in 2012 (6.8%), earned its second invest-grade upgrade in early May from S&P which followed a similar move by Fitch in late March. For its part, Indonesia continues to grow strongly with Q1 GDP of 6.0% on rising investment and FDI inflows, which reached a record \$6.7 billion in Q1, despite investor concerns about uncertainty over domestic fuel price increases and signs of nationalistic policy trends on the trade and investment fronts. Thailand also continues to perform strongly on public spending as it bounces back from the disruptive floods of early 2012.

Chart 5
The yen depreciates against regional currencies



Source: Bloomberg and BBVA Research

Chart 6
Credit growth is slowing across the region



Source: CEIC and BBVA Research

With tame inflation monetary policies stay supportive to counter external headwinds

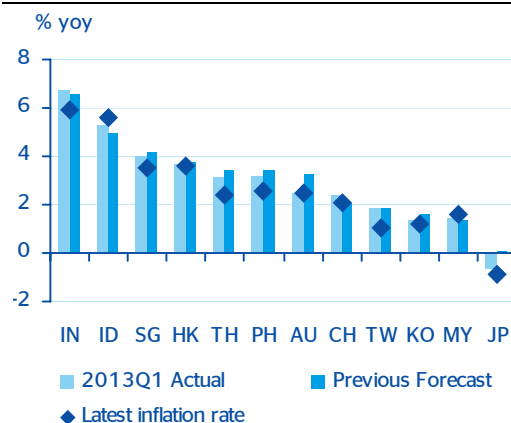
With inflation at or below target ranges, monetary policies are on an easing bias for the most part, but with heterogeneity across the region (Charts 7 and 8). As noted above, the BOJ has pulled out all the stops with its latest quantitative easing steps. China has been on hold since mid-2012 as it guards against domestic financial fragilities. The Reserve Bank of Australia cut rates by 25bp on May 7 after staying on hold this year as it assessed the impact of its previous 175bps cumulative rate cuts during November 2011-December 2012. For its part, the Bank of Korea also cut rates by 25bps on May 9, after staying on hold since October last year, in view of sluggish growth momentum and low inflation (1.2% y/y in April, well below the official 2.5-3.5% target range). Looking ahead, we expect another rate cut from the Reserve Bank of India, on top of the 75bps cuts so far this year, on signs of stabilizing inflation (6.0% y/y in March). Though not in our baseline, the chances of a rate cut in Thailand are also increasing given strong capital inflows that have been putting upward pressure on the currency. In contrast, the next move in monetary policies in the Philippines and Indonesia may be to tighten given strong growth momentum and increasing signs of overheating.

Growth outlook remains intact, but with downside risks and challenges from capital inflows

Consistent with our recent quarterly Outlooks, our baseline continues to build in a gradual improving trend in growth momentum. Supportive policy stances and a further improvement in the external environment should sustain growth during the rest of the year. As a result, our growth and inflation projections for 2013-14 remain broadly unchanged from our last Outlook published in February, except for India where we have lowered our GDP projection by around 0.5% in each of 2013-14, to 5.7% and 6.4% respectively (Table 3). As a result, for the Asia-Pacific region we expect growth of 5.4% in 2013, up from 5.2% in 2012.

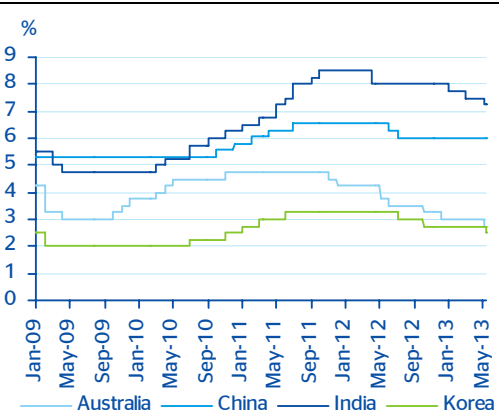
Risks to the outlook, however, have shifted to the downside due to the weaker-than-expected outturns in early 2013, especially in China, and downgrades to the growth outlook for the EU. Policymakers will have to walk a fine line between supporting growth in view of continued sluggish external demand, while paying due regard to risks of overheating. Lax global liquidity conditions, boosted by the BOJ's aggressive quantitative easing, are adding tailwinds to capital inflows, posing challenges in economies where asset bubbles are a risk, such as the in the property sectors of Hong Kong and Singapore. Upward pressures on regional currencies are likely to be met by a combination of intervention and macro prudential measures.

Chart 7
Inflation has generally been lower than expected



Source: CEIC and BBVA Research

Chart 8
Monetary policies are on an easing bias



Source: CEIC and BBVA Research

Box 1: Abenomics and its impact on Asian economies

The three pillars of Abenomics

"Abenomics" has become the term used to describe the strategy advocated by Prime Minister Shinzo Abe to revive Japan's sluggish economy. The strategy involves three pillars: quantitative easing, near-term fiscal stimulus with medium-term consolidation, and structural reforms. Monetary easing has gained the most attention so far, following the establishment of a 2% inflation target, and the Bank of Japan's April 4 announcement, under its new Governor Haruhiko Kuroda, of a massive step up in quantitative easing to end persistent deflation (Chart 9). The plan aims to double the monetary base over two years through the monthly purchase of longer-term government bonds from the average maturity of three to seven years at a pace equivalent to around 12% of GDP per year, doubling the pace by the US Fed's easing (6.5% of GDP per year). Monthly purchases would amount to USD 600-700 billion per year (around 2/3 of the scale of purchases of the Fed), resulting in an increase in the BoJ's holdings of total JGBs to 20% by the end of 2014 (Chart 10).

On the fiscal side, last January the government launched a ¥10.3tn stimulus package (2.1% of 2012 GDP) with a focus on public works. On the structural reform front, the strategy has yet to be fully articulated (details may be released after upper house elections in July), with the emphasis so far on the labor market and deregulation of sectors such as agriculture and services. So far, the most concrete steps have been to expand free trade agreements, including through Japan's participation in the Trans-Pacific Partnership.

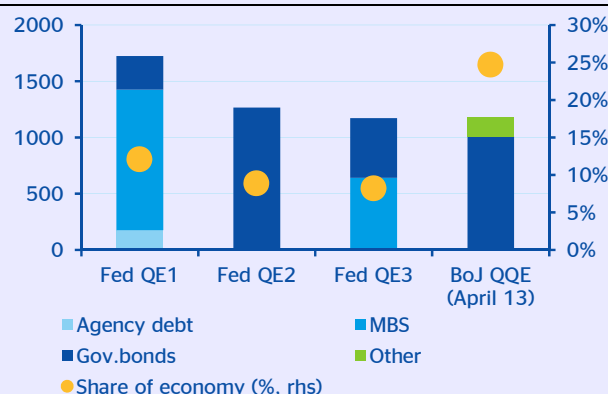
There remains much skepticism of whether the strategy will work to revive growth, especially given the difficulties Japan has had in the past with failed stimulus measures (see "Box: Japan: new government seeks to jump-start economy" in our last quarterly [Asia Outlook](#)), and difficulties in pushing through the structural reform agenda, without which fiscal and monetary policies alone will likely fail. Having said that, the strategy so far has succeeded in boosting consumer and business confidence, and bringing about a steep rise in the stock market and long-sought depreciation of the yen (Chart 5).

Impact on Asia's capital inflows: wait-and-see

The BoJ's purchase of government bonds will result in a crowding out of domestic investors, who currently hold 90% of the stock of JGBs, resulting in capital outflows seeking higher returns. The process is expected to be accompanied by huge capital outflows from Japan to other Asian countries and the rest of the world. To date, however, such flows have not yet been observed, and to the contrary, the data so far point to net capital inflows (Chart 11) and purchases of Japanese equities.

Chart 9

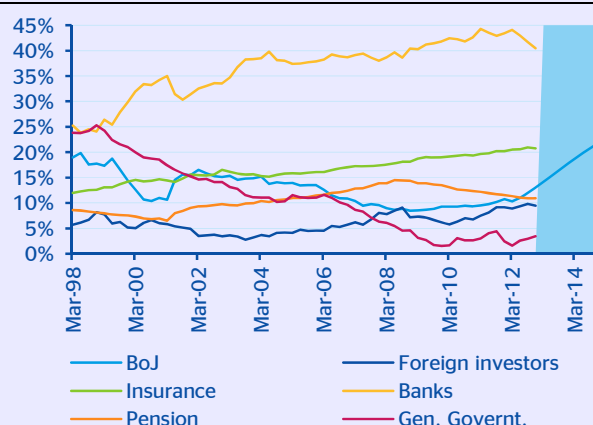
Successive QE rounds (bn USD), Fed and BoJ



Source: Haver and BBVA Research;

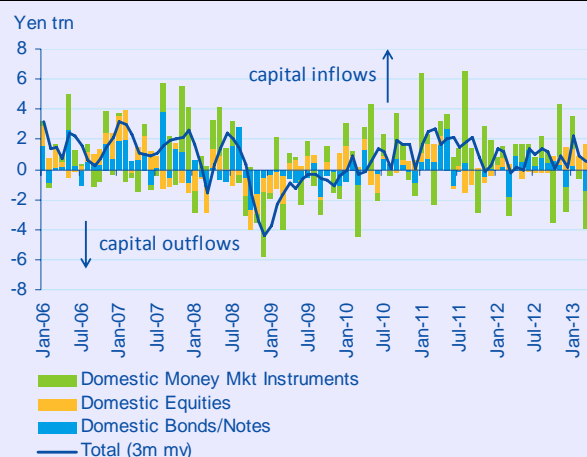
Chart 10

JGB holders* since 1998



* Including T-bills and FILP bonds; Government sector include fiscal loan fund while excluding public pension funds which is included in pensions
Source: Haver and BBVA Research;

Chart 11
Net Purchase and sales of domestic securities by non-residents (trn yen)



Source: Haver and BBVA Research;

The impact on Asian exporters: winners (Philippines, Thailand) and losers (Korea)

The impact of Abenomics for Asian exports is double-edged. On one hand, a pickup in Japanese economic growth should lift Japan's import demand from Asian trading partners. On the other hand, in the near term a weaker yen will make their exports less competitive, both in the Japanese market and in third-country markets. To explore the impact so far, we examine the weight of Asian exports to Japan (Table 1). ASEAN countries have a relatively large trade exposure to Japan, of around 10-20% of total exports. North Asian economies exports a smaller share to Japan (typically less than 10%), but they may compete more fiercely in third-markets, especially in autos (Korea), electronics (Korea and China), and components (Taiwan).

While it may be too early to gauge the impact of the yen's weakness given the usual lags in the impact of exchange rate changes on trade flows, it is nevertheless instructive to see how trade flows have evolved so far (Chart 12). In Q1, Korea and Indonesia's exports to Japan lost momentum, in contrast to the Philippines and Malaysia. Thus, it appears that the yen weakness has had a negative impact on Korean and Indonesian exports to Japan, but has a positive impact on exports from the Philippines and Malaysia, with only minor impacts elsewhere. The result of implies that Korea has suffered

from the weaker yen so far, probably due to its head-to-head competition in auto parts, vehicles, and electronics. For Indonesia, the decline may simply be due to the effect of falling commodity prices on its export values.

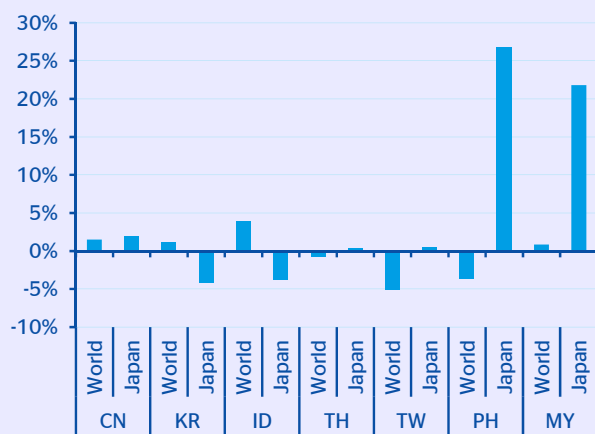
The impact on Asian exporters may appear more in third countries where these countries compete. On the other hand, a lower yen may lower input costs of Asian countries through cheaper imports from Japan. While important, these effects are beyond the scope of this box.

Table 1
Asia's exports to Japan

As of 2012	Exports to Japan / Total Exports	Total Exports / GDP	Exports to Japan / GDP
Malaysia	12%	75%	9%
Thailand	10%	63%	6%
Taiwan	6%	60%	4%
Korea	7%	48%	3%
Germany	2%	42%	1%
China	7%	25%	2%
Indonesia	16%	22%	3%
Philippines	19%	21%	4%
United States	5%	10%	0%

Source: CEIC and BBVA Research;

Chart 12
Change of export growth rate (q/q s.a.) (2013Q1/2012Q4-2012Q4/2012Q3)



Source: Haver and BBVA Research;

3. China faces headwinds from policy constraints and external uncertainties

After a challenging year in 2012 when GDP growth fell to 7.8%, the lowest in over a decade, confidence that a hard landing would be avoided improved when data began showing that growth had bottomed out in Q3. The upturn in growth was due to policy stimulus, a recovery in the property sector, and stabilization in exports. More recently, however, that confidence has been tested again on signs that the pickup has lost steam. In particular, GDP growth in Q1 2013 fell to 7.7% y/y from 7.9% y/y in Q4, on weak private investment. Moreover, the new leadership has signalled a greater tolerance for lower growth as its willingness to implement fresh stimulus measures has been called into doubt due to the build-up of domestic financial fragilities that are themselves the legacy of previous efforts to stimulate growth.

Notwithstanding these concerns, on balance we believe that growth remains on track to reach 8.0% in 2013 and 2014 as projected in our previous *Outlook* in February. While it is true that recent activity indicators paint a mixed picture of growth momentum, we believe the economy remains on a modest recovery trajectory. The external environment continues to improve gradually, and subdued inflation provides room for fiscal and monetary settings to remain growth-supportive, as indicated by the new leadership's policy pronouncements.

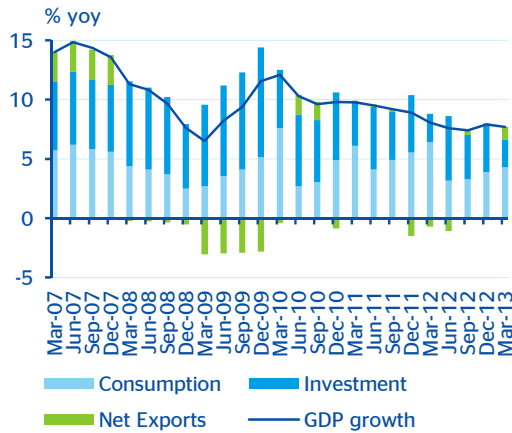
A mixed picture of momentum as the economy loses steam

First quarter GDP growth disappointed to the downside, dipping to 7.7% y/y from 7.9% y/y in Q4 2012 (Chart 13). On a sequential, seasonally adjusted basis, officially reported quarterly growth slumped to 1.6% (6.6% annualized), the slowest pace since Q1 2012 (however, the sequential data are somewhat unreliable given data quality and seasonal adjustment issues). The decline in growth appears to be due to weaker-than-expected manufacturing and real estate investment.

According to the National Bureau of Statistics (NBS), in year-over-year terms domestic consumption (including of the government) led growth in Q1, contributing 4.3 ppts, followed by investment (2.3 ppts) and net exports (1.1 ppts). From this perspective, investment was the weak spot, as its contribution fell from 3.9 ppts in 2012. Meanwhile, the contribution from net exports was positive, swinging from a negative contribution (-0.4 ppts) to growth in 2012, on stabilizing external demand. While the pace of public infrastructure spending continued, overall investment, including inventory accumulation, appears to have weakened due in part to weaker sentiment from expectations of policy tightening as the authorities' emphasized the objectives of preventing an acceleration in housing prices and curbing the growth of local government debt and shadow bank lending. The fragile external economy may also have contributed. On the output side, the share of the service sector continues to rise (Chart 14) – a sign of economic rebalancing, along with the recent decline in the current account deficit and gradual pickup in the consumption-to-GDP ratio.

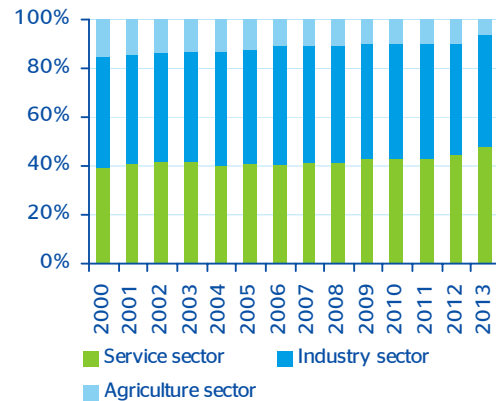
Despite the slowdown, the labor market remains strong. Urban unemployment remained at a relatively low 4.1% in Q1 as the economy created 3.4 million new jobs. According to data from the Ministry of Human Resources and Social Security, the labor demand-supply ratio rose to 1.1 in Q1 (Chart 15), another sign of a tight labor market.

Chart 13
Growth dipped unexpectedly in Q1...



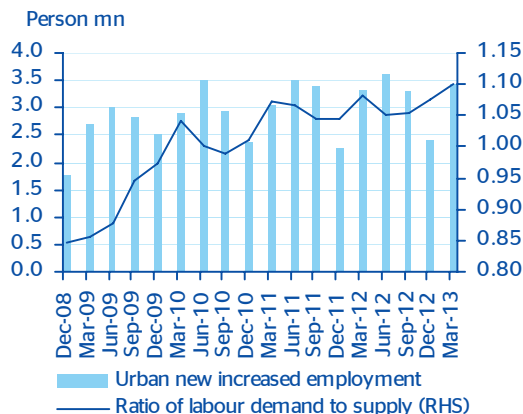
Source: NBS, CEIC and BBVA Research

Chart 14
The share of the service sector is rising



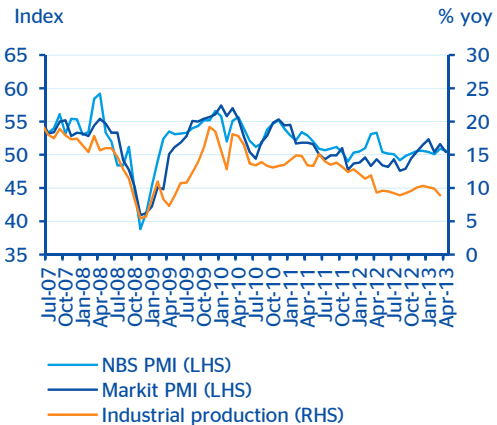
Source: NBS, Wind and BBVA Research

Chart 15
The labour market remains tight



Source: CEIC and BBVA Research

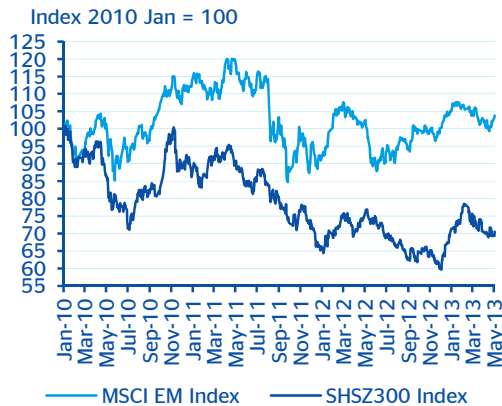
Chart 16
Industrial production has decelerated



Source: CEIC and BBVA Research

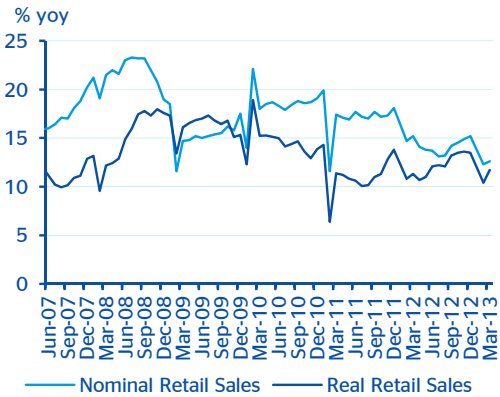
Recent monthly activity indicators also reflect a mixed picture of growth momentum. On the supply side, industrial production has continued to decelerate, and PMI outturns have been softening, albeit still within the 50+ expansion zone (Chart 16). While industrial profits declined in March, for the whole quarter of Q1 they rose to 12.1% ytd in Q1 from 5.3% in 2012. Nevertheless, the stock market has disappointed on concerns about the profit outlook (Chart 17). On the demand side, the year-on-year growth of retail sales has fallen (Chart 18), perhaps due in part to government efforts to clamp down on lavish spending by public officials, but it is still at a healthy level. Meanwhile, as noted above, private investment has slowed by more than expected, while public infrastructure investment (close to 20% of total investment) has held up well (Chart 19).

Chart 17
China's stock market has underperformed



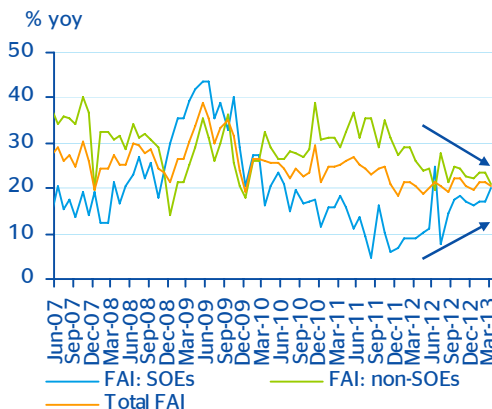
Source: Bloomberg and BBVA Research

Chart 18
Retail sales decelerated in Q1



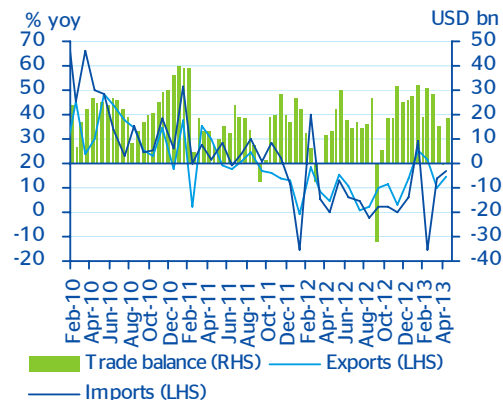
Source: CEIC and BBVA Research

Chart 19
Continued public investment has offset weakness in private investment



Source: CEIC and BBVA Research

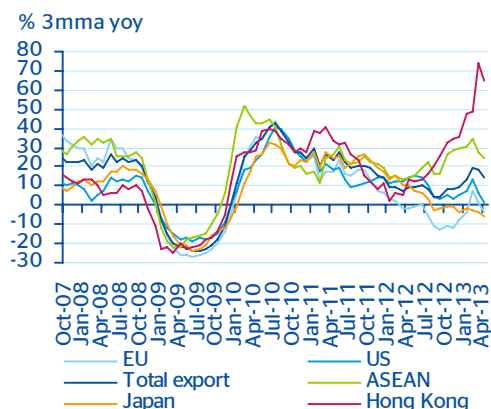
Chart 20
The trade account remains in surplus



Source: CEIC and BBVA Research

On the external front, exports have performed surprisingly well, rising by 18.4% y/y in Q1, while imports rose by 8.4% (Chart 20), a trend that continued in April (export growth of 14.7% y/y and imports growth of 16.8%). The surprisingly strong outturn for exports, however, casts doubt on the accuracy of the underlying data. In particular, the strong performance is due almost entirely to an increase in exports to Hong Kong (Chart 21), which is not matched by corresponding data on the Hong Kong side (Chart 22). This raises the possibility that over-invoicing to disguise capital inflows may be the underlying cause of the apparent surge in Q1 exports. Meanwhile exports to other destinations picked up in Q1, including to the EU, US and ASEAN. Given the evolution of imports (Chart 23), the overall trade surplus widened to USD 43 billion in Q1, as did the current account surplus, to USD 55.2 billion or 2.9% of GDP (Chart 24).

Chart 21
Exports to key markets have improved, although the surge to HK is questionable



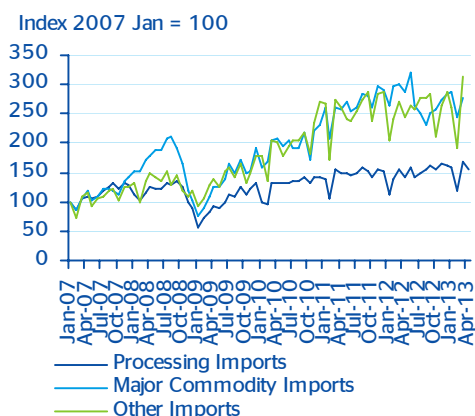
Source: CEIC and BBVA Research

Chart 22
The divergence in matching data between China- Hong Kong bilateral trade has widened



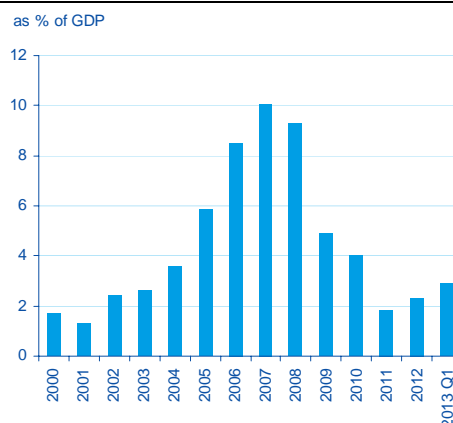
Source: CEIC and BBVA Research

Chart 23
Commodity imports have flattened on declining prices



Source: CEIC and BBVA Research

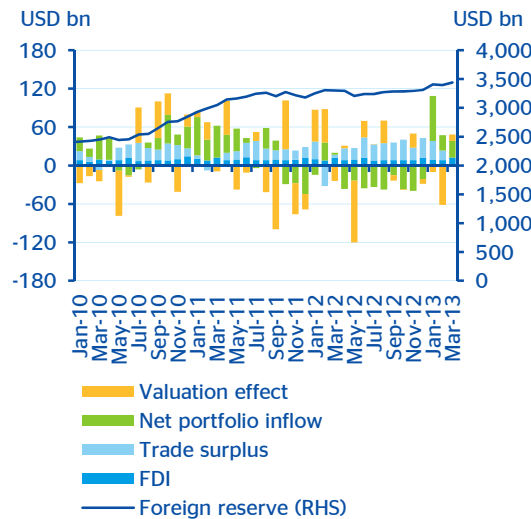
Chart 24
The decline in the current account surplus has bottomed out



Source: CEIC and BBVA Research

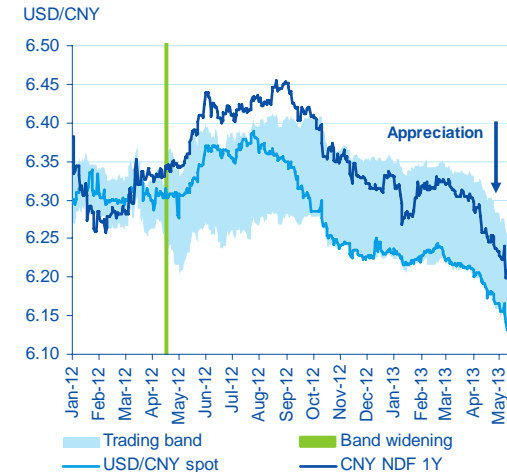
As a result of these developments, the overall balance of payments posted a surplus of USD157.0 billion surplus in Q1, with a rise in foreign exchange reserves to 3.44 trillion USD (Chart 25). After accounting for the current account surplus and net FDI inflows 29.4 billion, we estimate other capital inflows of USD 72.4 billion, a reversal of the outflows of the previous year, likely attracted by improving growth prospects and expectations of currency appreciation.

Chart 25
FX reserves are rising again on higher capital inflows



Source: CEIC and BBVA Research

Chart 26
RMB appreciation has accelerated in recent months



Source: Bloomberg and BBVA Research

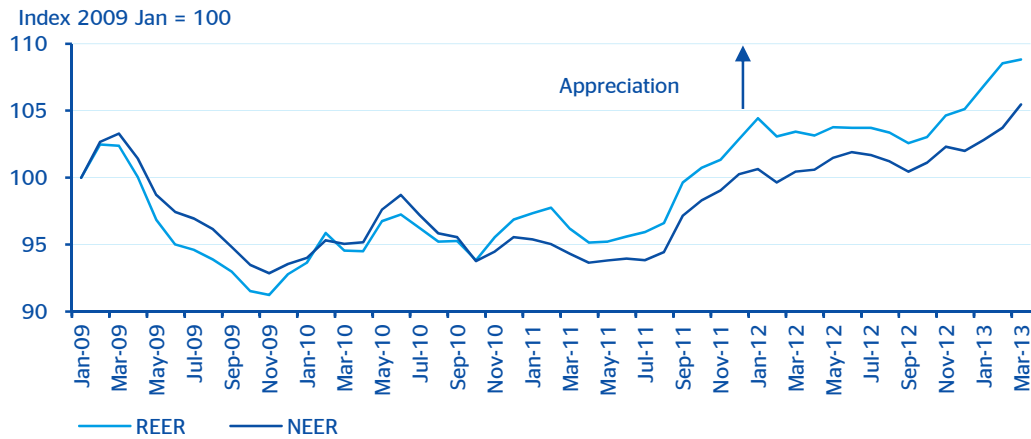
Appreciation of the RMB continues

The RMB has continued to appreciate, with a cumulative strengthening of 1.5% against the USD through mid-May (Chart 26). The pace of appreciation has been even faster in nominal and real effective terms given the rise in the value of the USD against other currencies, especially the Japanese yen (Chart 27). As an indication of appreciation pressures, the spot rate has continued to trade toward the strong end of the daily trading band, and the PBoC's daily fixings have been set at progressively stronger levels. The pace has been in line with, or even slightly ahead of our projection of a 2-3% rise against the USD for full-year 2013.

The authorities appear uncomfortable with the strength of the recent appreciation pressures, and in early May, the PBoC announced new measures to address hot money inflows. These include an increase in the required level of USD holdings in relation to banks' outstanding loans (effectively limiting the scope of banks to go short against the USD), and strengthened monitoring of illegal capital inflows through trade and other channels. It remains to be seen how effective these measures will be, as an initial weakening in the spot rate after the announcement has been followed by renewed appreciation pressures.

The authorities are also continuing to push ahead with increase RMB internationalization and exchange rate flexibility. The share of China's trade settled in RMB has increased to above 10%. Most recently, in April the authorities reached agreement with Australia for the AUD to trade directly with the RMB, the third such currency after the USD and the JPY. A subsequent announcement by the Reserve Bank of Australia that it will allocate 5% of its foreign exchange reserves in Chinese treasury bonds has further boosted internationalization prospects. We also anticipate a further widening of the daily trading band, which was widened last May to plus/minus 1.0%.

Chart 27

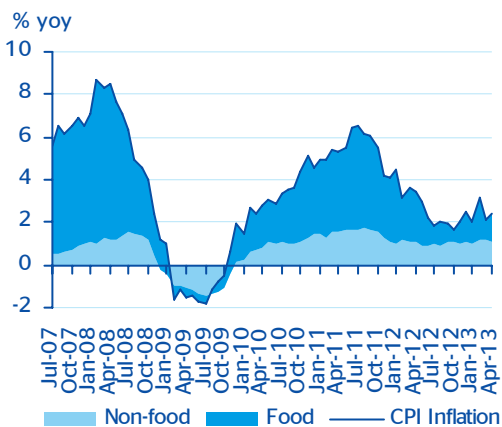
The nominal and real effective exchange rates have appreciated

Source: BIS, CEIC and BBVA Research

Inflationary pressures remain at bay

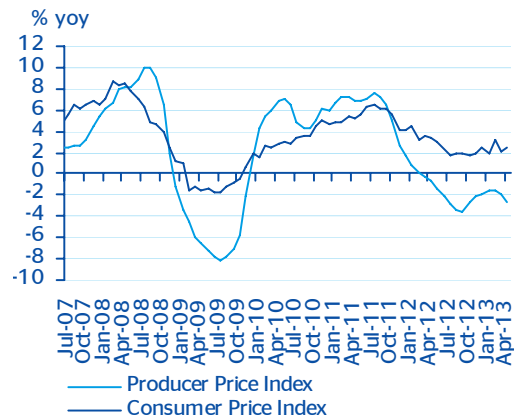
Inflation remains subdued, at 2.4% y/y in April from 2.1% in March. While inflation has trended up after bottoming out at 1.7% y/y last October (Chart 28), falling food prices have kept overall inflation well within the authorities' 3.5% comfort level. Meanwhile, producer price inflation has remained negative (-2.6% y/y in April) due, among other things, to lower commodity prices, which should help keep inflation pressures at bay in the period ahead (Chart 29).

Chart 28

Inflation remains subdued on lower food prices

Source: CEIC and BBVA Research

Chart 29

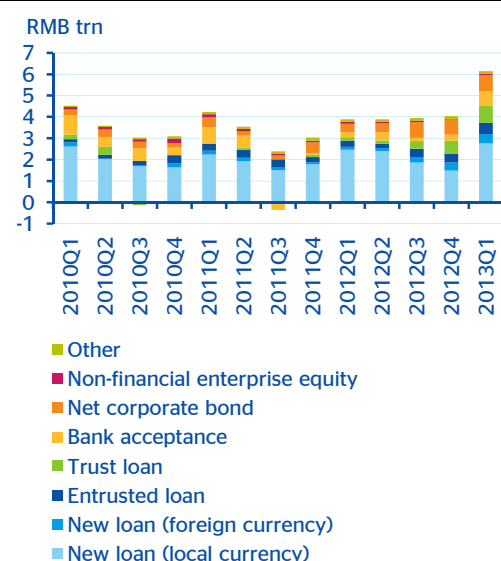
...and producer prices are still falling

Source: CEIC and BBVA Research

Accommodative monetary conditions and strong credit growth

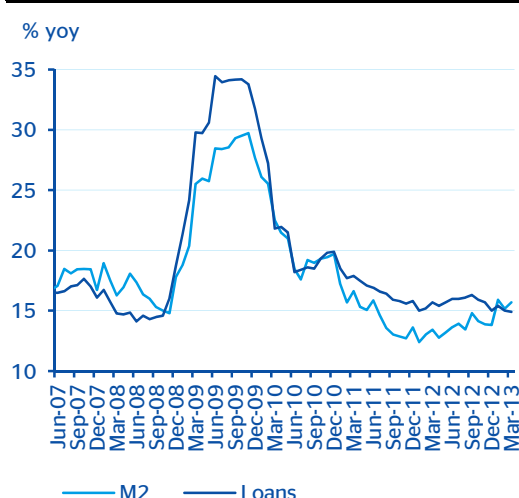
M2 and credit growth remain strong. Of special note has been a surge in “total social financing” (TSF), a broad aggregate that includes both bank and non-bank credit, which rose by 58% y/y in Q1 (Chart 30). New increased RMB bank loans, accounting for 44.8% of TSF in Q1 on a flow base, amounted to 2.76 trillion RMB, broadly in line with the authorities’ informal RMB 9.0 trillion target 2013. Meanwhile, M2 growth quickened to 15.7% y/y in Q1 from 13.8% in Q4 (Chart 31).

Chart 30
“Total social financing” surges



Source: CEIC and BBVA Research

Chart 31
M2 growth accelerates and loans stabilize



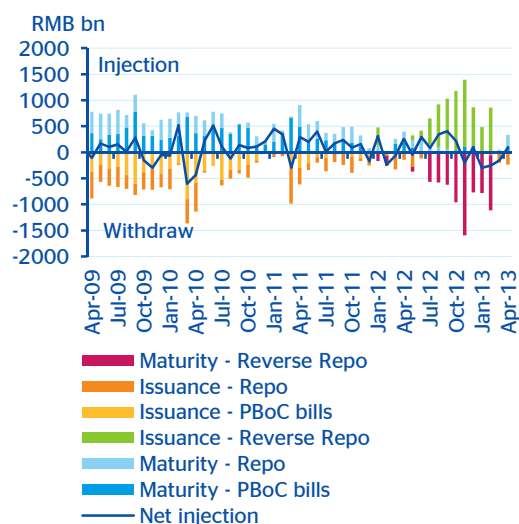
Source: Wind and BBVA Research

The pickup in credit growth in Q1 is at odds with the slowdown in real activity, and could partly reflect a policy-driven push to accelerate lending to spur economic growth. On the demand side, it could also reflect an increase in forthcoming investment (especially the pickup in non-bank finance). The rapid pace of growth of non-bank credit, particularly the component comprising shadow bank lending, is of concern given the relatively weak regulation and transparency of that sector.

Meanwhile, interest rates and reserve requirement ratios have been on hold since the back-to-back cuts in May and June 2012. The PBoC has become increasingly active in managing liquidity actively through open market operations, in line with plans to foster the development of a market-based monetary policy transition mechanism (Charts 32 and 33).

Chart 32

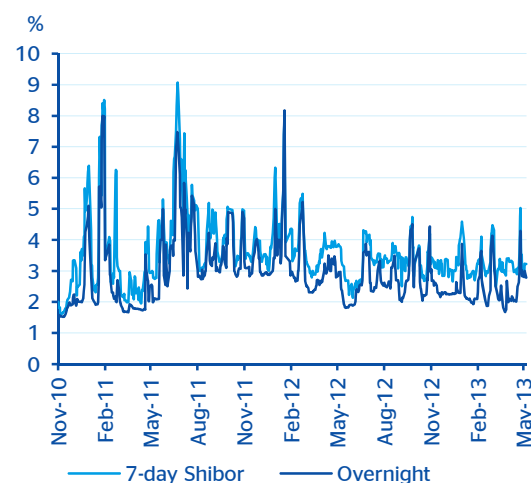
The PBoC is increasingly managing liquidity through open market operations...



Source: CEIC and BBVA Research

Chart 33

...and has succeeded in stabilizing interbank rates



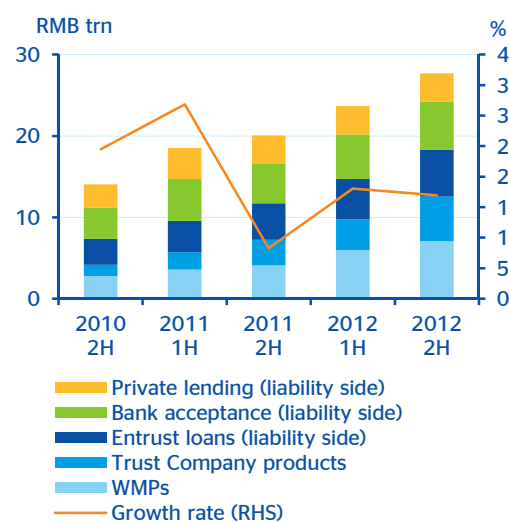
Source: Wind and BBVA Research

A rise in financial fragilities poses constraints to policy easing

After stabilizing in 2011 from tighter regulations, domestic financial fragilities have been increasing again with the pickup in shadow bank lending (Chart 34; also see our China Banking Watch: [An Update on China's Shadow Banking Activity](#)), a further build-up of local government debt, and an acceleration in housing price increases (see below). Local government debt rose to around RMB 16.5 trillion (32% of GDP) as of end-2012, which, together with the stock of central government debt, has led to a slight increase in total public debt to 57% of GDP according to our estimates (Chart 35). The authorities have acknowledged the rise in these financial fragilities and their intention to curb them in order to reduce risks posed to financial stability. In April guidelines were issued to regulate banks' lending to Local Government Financing Vehicles (LGFVs). In addition, measures have been implemented to rein in banks' issuance of wealth management products (WMPs).

Chart 34

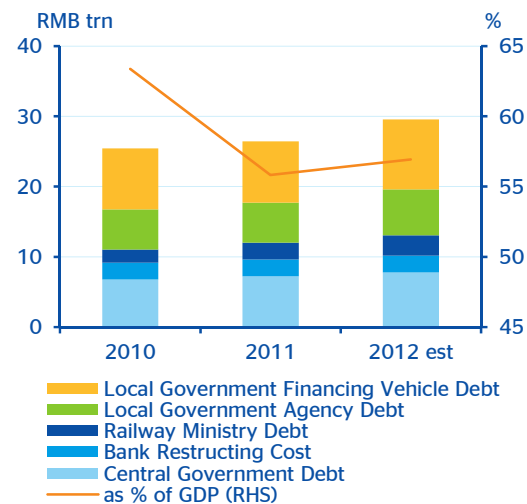
Shadow banking activities have risen...



Source: Wind, CEIC and BBVA Research

Chart 35

Gross public debt increased in 2012

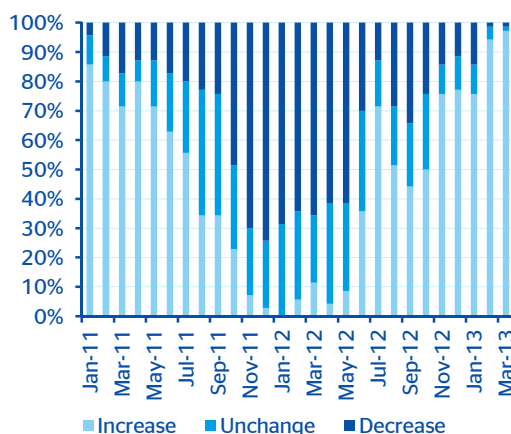


Source: CEIC and BBVA Research estimates

The real estate sector heats up again

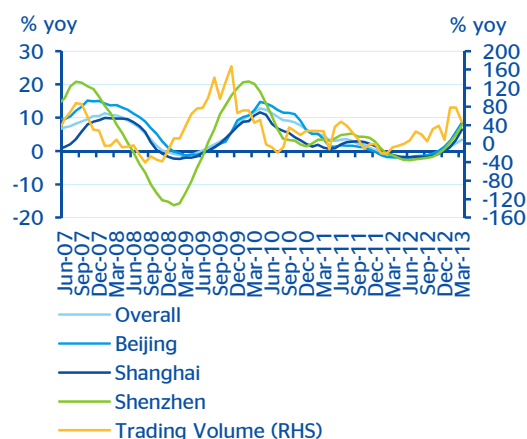
Despite further restrictions to curb speculation and maintain housing affordability, the property market has turned up on stronger liquidity and an improvement in investor sentiment. While price increases have been most pronounced in Tier-one cities, a majority of medium and large cities reported an increase in housing prices during Q1 (Charts 36 and 37). We estimate that nation-wide property prices increased by 3.4% y/y in Q1 from 0.4% y/y in Q4. Rising prices have also been accompanied by a surge in sales volumes. The central government has responded to the upturn by announcing tighter guidelines on the implementation of housing policies on local governments and the implementation of a 20% capital gains tax on the sales of second-hand homes. As discussed in our [2012 Real Estate Outlook](#) we do not view the present level of housing prices as a bubble, given strong underlying demand fundamentals.

Chart 36
More cities report rising housing prices



Source: NBS and BBVA Research

Chart 37
... with sales volumes surging



Source: NBS, CEIC and BBVA Research

4. China's growth to continue on supportive policies, with downside risks

Downside risks to our 8.0% GDP growth projection in 2013 and 2014 have increased due to the unexpected loss of momentum in Q1. Moreover, concern about the buildup of domestic financial fragilities may be a constraint on the scope for additional policy easing to support growth. Nevertheless, subdued inflation provides room for policies to remain growth supportive, and with the economy still on an expansion path and the external environment expected to improve further, we believe our baseline projection remains achievable.

The new leadership team was officially installed in March, and has signalled that it will maintain the existing stance of "prudent monetary policy and proactive fiscal policy." Key macro targets were set in the National Congress Meeting in March, including GDP growth of 7.5% (unchanged from the target in 2012, average inflation of 3.5% (down from the 2012 target of 4.0%), and a fiscal deficit of 2.0% of GDP (broadly unchanged from 2012 target of 2.1%, but slightly higher than the estimated outturn of 1.6% of GDP after accounting for 0.5% of GDP in revenue transfers from 2011). At the same time, the authorities have placed a renewed emphasis on the quality of growth, entailing economic rebalancing and environmental awareness, measures to close the widening income gap, and policies to curb financial risks.

New leadership team stresses policy continuity, while signalling a tolerance for lower growth

The new leadership team of President Xi Jinping and Premier Li Keqiang has stressed it will maintain policy continuity through a supportive policy stance and continued economic reforms. With a renewed focus on the quality and sustainability of growth, however, the authorities are increasingly showing a willingness to allow growth to fall below previous expectations, all the more so given the still-strong labor market and indications that potential growth is slowing, as discussed in our previous [China Outlook](#). They are also walking a fine line between sustaining growth in the short term, while taking care not to exacerbate domestic financial fragilities that could have negative consequences in the medium-term.

In the near term, there is still scope to adjust policies to sustain growth at or above the official 2013 target. In particular, fiscal spending can be brought forward to boost investment and consumption, and macro-prudential policies to address domestic financial fragilities can be relaxed at the margin. On the monetary front, barring a more significant loss of growth momentum, we do not anticipate further interest rate cuts through 2013 under our baseline, and under present circumstances any tightening is likely to be postponed to 2014 at the earliest. In the meantime, the PBoC may adjust liquidity through open market operations and cuts in the RRR depending on capital inflows and domestic conditions.

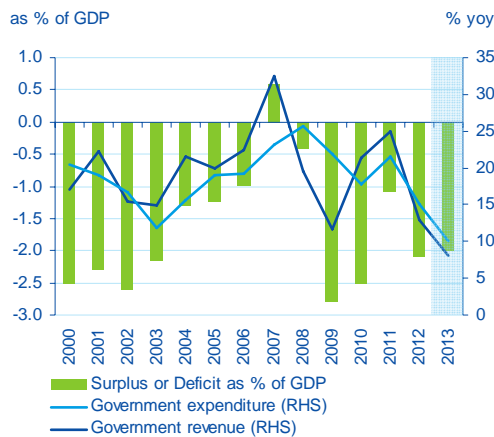
The authorities have repeatedly stressed that they are going to press ahead with an agenda of market-oriented reforms, covering energy pricing, urbanization, financial sector liberalization, and income redistribution. On the financial front, the authorities plan to press ahead with interest rate liberalization and further exchange rate flexibility, through a possible widening of the daily trading band of the RMB. Regarding the liberalization of the capital account, they are taking steps to allow individual overseas investment and additional cross-border capital flows denominated in RMB. We expect that further details of the authorities' policies are likely to be announced in the third or fourth quarter at the Communist Party's next Annual Meeting.

Fiscal policy will underpin growth

The government's fiscal deficit target of 2.0% of GDP is broadly similar to the 2012 outturn of 2.1% after accounting for 0.5% of GDP in revenue transfers from 2011 (Charts 38 and 39). It is underpinned by a 10% increase in expenditures, outpacing a projected 8% growth in revenues. Spending will focus on continued infrastructure, and public housing construction, and will be complemented by selected tax cuts.

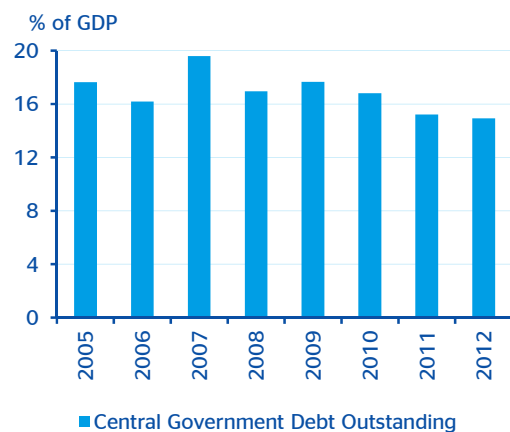
Separately, the ongoing program of public housing construction continues to be an important pillar of overall infrastructure spending and efforts to maintain housing affordability. For 2013 the government has set the full-year target to build 6.3 million units of public housing with completion of 4.7 million units. In comparison, in 2012 7.81 million units were started, with completion of 6.01 million (5 million for target).

Chart 38
Fiscal policy remains growth-supportive



Source: CEIC and BBVA Research

Chart 39
... thanks to low official public debt level



Source: CEIC and BBVA Research

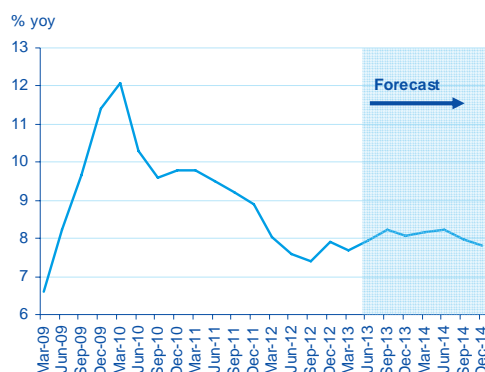
Modest pickup to resume during the rest of 2013

With policies remaining growth supportive, and with an ongoing improvement in the external environment, we expect growth momentum to increase gradually during the remainder of the year, from 7.8% y/y in H1 to 8.2% in H2 (Chart 40). As such, our previous baseline 8.0% growth projection for 2013 and 2014 remains intact, albeit subject to downside risk from external uncertainties and policy constraints due to the buildup of domestic fragilities. Our baseline for 2013 envisages a pickup in private investment spending after the weak Q1 outturn, broadly stable consumption, and steady export growth of around 8-10% for the full-year.

Inflation outlook is relatively benign

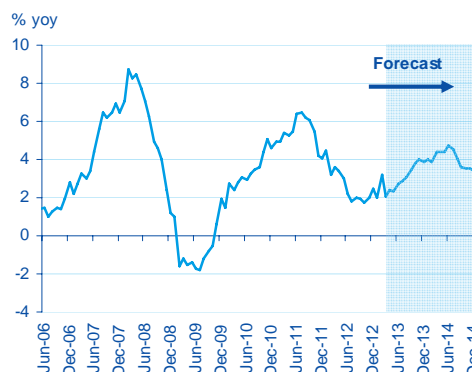
We are revising down our 2013 average inflation projection to 3.0% from 3.3% previously due to lower than expected food prices. That said, our projection continues to build in a gradual rise in inflation during the rest of the year on stronger demand, rising food prices, and base effects. Year-on-year inflation is likely to remain around 2.5% over the coming 1-2 months, rising to about 3.0% in Q3, and to 3.8% by end-2013 (Chart 41). Thereafter, we expect inflation to level off at around 4% in 2014, its expected long-term average.

Chart 40
Quarterly growth in 2013 is to pick up gradually



Source: NBS, CEIC and BBVA Research estimates

Chart 41
Inflation to remain benign despite trending up



Source: NBS, CEIC and BBVA Research estimates

RMB to continue appreciating on a gradual path

With the pace of RMB appreciation broadly in line with previous expectations, and the balance of payments in surplus, we are maintaining our currency outlook, amounting to 2-3% appreciation against the USD for the full-year 2013. This would bring the RMB to around 6.10 RMB/USD by end-year. We also expect two-way currency flexibility to be enhanced through a possible further widening of the daily trading band, which was widened in May 2012 to +/-1% from +/-0.5% previously. In addition, RMB internationalization is expected to advance in 2013 as the authorities continue to promote the use of the currency in trade settlements and, increasingly, investment flows. The latter would include the introduction of more RMB products in offshore markets as vehicles to channel RMB flows back to the Mainland.

Table 2
Baseline Scenario

	2010	2011	2012	2013 (F)	2014 (F)
GDP (% y/y)	10.4	9.3	7.8	8.0	8.0
Inflation (average, %)	3.3	5.4	2.6	3.0	4.0
Fiscal bal (% of GDP)	-2.5	-1.1	-2.1*	-2.0	-1.8
Current acct (% of GDP)	4.0	1.9	2.3	2.8	3.5
Policy rate (% eop)	5.81	6.56	6.00	6.00	6.50
Exch rate (CNY/USD, eop)	6.61	6.30	6.23	6.10	5.95

*preliminary outturn; includes adjust of 0.5% of GDP in revenues carried over from 2011.

Source: BBVA Research

5. Risks tilting again to the downside

Growth momentum in much of Asia has come in somewhat weaker than expected in Q1, posing new downside risks to the outlook. While the factors for the disappointing outturns vary by country, a common element is still sluggish external demand. As noted in the [Global Outlook](#), financial tail risks to the global economy have been reduced, but the outlook for growth remains uncertain, especially in the EU. In the event that external demand remains weak, there is room for further policy support in most Asian economies, although the scope is more limited, especially in China where concerns of domestic financial fragilities have increased.

Within the region, downside risks continue to emanate from geopolitical concerns, including the ongoing dispute between China and Japan, and the recent escalation between North Korea and its neighbors. In the macro area, risks of currency tensions persist due to the weakening of the yen and prospects of appreciation pressures from capital inflows. The latter have been exacerbated by the BOJ's quantitative easing and may complicate monetary management throughout the region, necessitating further macro prudential measures to limit risks of asset bubbles. Overheating is a risk in some of the ASEAN economies, especially in Indonesia and the Philippines. In India, which accounts for our largest growth projection downgrade, the momentum of reform will need to be watched closely.

In China, downside risks to the growth outlook have increased due to the loss of momentum in Q1 and an increasing awareness by policymakers of the constraints to policy easing in view of domestic financial fragilities which have increased again after declining in 2011 and early 2012. In this regard, recent measures to address these risks are welcome, although they could come at the cost of near-term growth. The new leadership will thus face the challenge of balancing these risks against the use of stimulus measures to sustain near term growth. In the meantime, the fragile global economy, in our view, remains the biggest risks to the near-term outlook.

6. Tables

Table 3
Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2010	2011	2012	2013 (F)	2014 (F)
United States	2.4	1.8	2.2	1.8	2.3
Eurozone	1.9	1.5	-0.5	-0.1	1.0
Asia-Pacific	8.2	5.8	5.3	5.4	5.8
Australia	2.6	2.5	3.6	3.0	3.4
Japan	4.7	-0.6	2.1	1.7	1.7
China	10.4	9.3	7.8	8.0	8.0
Hong Kong	6.8	4.9	1.4	3.5	4.0
India	8.9	7.5	5.1	5.7	6.4
Indonesia	6.2	6.5	6.2	6.3	6.8
Korea	6.3	3.7	2.0	2.7	4.0
Malaysia	7.2	5.1	5.6	4.8	5.2
Philippines	7.6	3.9	6.6	6.0	5.6
Singapore	14.8	5.3	1.3	2.3	4.0
Taiwan	10.8	4.1	1.3	3.5	4.2
Thailand	7.8	0.1	6.4	4.7	5.2
Vietnam	6.8	5.9	5.0	5.8	6.3
Asia ex China	6.8	3.5	3.6	3.8	4.3
World	5.1	3.9	3.2	3.3	3.9

Source: BBVA Research

Table 4
Macroeconomic Forecasts: Inflation (Avg.)

(YoY% growth rate)	2010	2011	2012	2013 (F)	2014 (F)
United States	1.6	3.1	2.1	2.1	2.2
Eurozone	1.6	2.7	2.5	1.6	1.5
Asia-Pacific	3.6	4.7	3.0	3.1	3.6
Australia	2.8	3.3	1.8	2.9	2.5
Japan	-0.7	-0.3	0.0	0.1	0.7
China	3.3	5.4	2.6	3.0	4.0
Hong Kong	2.3	5.3	4.1	4.2	3.6
India	9.6	9.2	7.7	6.6	6.1
Indonesia	5.1	5.4	4.3	5.1	5.5
Korea	3.0	4.0	2.2	2.6	3.3
Malaysia	1.7	3.2	1.7	2.6	2.7
Philippines	3.8	4.7	3.0	3.5	4.0
Singapore	2.8	5.2	4.6	3.4	4.0
Taiwan	1.0	1.4	1.9	1.8	1.9
Thailand	3.3	3.8	3.0	3.4	2.9
Vietnam	10.0	18.1	6.8	7.5	7.8
Asia ex China	3.7	4.3	3.3	3.2	3.4
World	3.7	5.1	4.1	3.9	4.0

Source: BBVA Research

Table 5

Macroeconomic Forecasts: Exchange Rates (End of period)

		2010	2011	2012	2013 (F)	2014 (F)
Eurozone	USD/EUR	1.34	1.30	1.32	1.32	1.30
Australia	USD/AUD	1.02	1.02	1.04	1.09	1.08
Japan	JPY/USD	81.1	76.9	86.8	109.0	116.0
China	CNY/USD	6.61	6.30	6.23	6.10	5.95
Hong Kong	HKD/USD	7.77	7.77	7.75	7.80	7.80
India	INR/USD	44.7	53.1	55.0	52.5	52.0
Indonesia	IDR/USD	8996	9069	9793	9400	9200
Korea	KRW/USD	1126	1152	1064	1060	1000
Malaysia	MYR/USD	3.06	3.17	3.06	2.90	2.80
Philippines	PHP/USD	43.8	43.8	41.0	40.0	39.0
Singapore	SGD/USD	1.28	1.30	1.22	1.20	1.19
Taiwan	NTD/USD	29.3	30.3	29.0	29.0	28.5
Thailand	THB/USD	30.1	31.6	30.6	30.0	29.5
Vietnam	VND/USD	19498	21034	20840	22000	22000

Source: BBVA Research

Table 6

Macroeconomic Forecasts: Policy Rates (End of period)

(%)	Current	2011	2012	2013 (F)	2014 (F)
United States	0.25	0.25	0.25	0.25	0.25
Eurozone	0.50	1.00	0.75	0.50	0.50
Australia	2.75	4.25	3.00	2.75	4.00
Japan	0.10	0.08	0.10	0.09	0.10
China	6.00	6.56	6.00	6.00	6.50
Hong Kong	0.50	0.50	0.50	0.50	0.50
India	7.25	8.50	8.00	7.00	6.50
Indonesia	5.75	6.00	5.75	5.75	6.00
Korea	2.50	3.25	2.75	2.50	3.00
Malaysia	3.00	3.00	3.00	3.25	3.50
Philippines	3.50	4.50	3.50	3.50	4.25
Singapore	0.40	0.45	0.40	0.40	0.40
Taiwan	1.88	1.88	1.88	1.88	2.13
Thailand	2.75	3.25	2.75	3.00	3.25
Vietnam	9.00	9.00	9.00	8.00	8.00

Source: BBVA Research

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