BBVA Research

China

Economic Outlook

First Quarter of 2011

Economic Analysis

- After a brief lull, economic activity gathered pace again in late 2010 bringing full-year growth to 10.3%, ahead of expectations. Rising inflation and risks of overheating have prompted the authorities to implement more aggressive monetary tightening, along with further measures to cool property prices.
- Given the authorities' determination to achieve an economic soft landing, we are maintaining our 9.2% growth projection for 2011. At the same time, we are raising our inflation projection to 4.5%, with risks to the upside. Strong growth and a supportive fiscal stance make an abrupt slowdown unlikely.
- Our baseline assumes further monetary tightening, including two more frontloaded 25 bps interest rate hikes in 2011 and at least 100 bps increases in RRRs. We maintain our outlook for gradual currency appreciation, with the RMB at 6.30 per USD by 2011.
- Risks are tilted to overheating. Downside risks have receded, but are still present from the fragile outlook in industrial countries and possibility of more aggressive policy tightening.

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Summary

For much of the past year, the Chinese authorities have been trying to engineer a soft landing from the rapid growth set in train following the massive policy stimulus of late 2008 and 2009. That stimulus—which took the form of monetary easing and a large two-year fiscal package—helped the economy to sustain strong growth during the global economic downturn, and in the process pull the region out of recession. But it also unleashed a wave of bank lending and strong demand that the authorities are trying to put a break on, with only partial success so far.

Higher-than-expected GDP and credit growth, along with rising inflation, have prompted the authorities to implement an increasingly aggressive approach to monetary tightening. GDP growth accelerated in the fourth quarter of 2010, bringing full-year growth to 10.3%, ahead of expectations. Based on the authorities' determination to slow growth, we are maintaining our 9.2% GDP projection for 2011, in line with our expectations of a soft landing, while revising our inflation projection up to 4.5%, from 3.3% previously.

One of the more pressing issues is a significant rise in headline inflation, driven initially by weather-related rises in food prices, but more recently by non-food components as well. Inflation accelerated to 5.1% y/y in November, before moderating to 4.6% y/y in December, still well above the authorities' 3% target for 2010. The rise in non-food inflation suggests that underlying demand pressures have picked up, consistent with our estimates that the output gap is closed, and evidenced by rapid wage increases. For 2011, we expect inflation to rise above 5% through mid-year, before moderating to 3.6% by end-year on a moderation in growth and monetary tightening.

Policy tightening has taken the form of interest rate hikes and increases in required reserve ratios. Following a surprise rate hike last October, the PBoC raised its benchmark interest rate in December 2010 and February 2011 by 25 bps each time. The interest rate moves have been accompanied by further hikes in required reserve ratios (RRR), amounting to three 50bp increases in the fourth quarter alone, and an additional 50bp increase in January 2011. We expect two more rate hikes in 2011, and another 100bp increases in the RRR, likely to be front-loaded in the first half of the year. If inflation fails to abate as expected, monetary tightening could be even more aggressive.

Tightening measures are expected to be accompanied by further gradual currency appreciation and implementation of macro-prudential measures to cool the property market. We expect an additional 4-5% appreciation of the RMB against the USD during the course of 2011, with the possibility of even faster appreciation if export performance continues to hold up and if inflation does not subside as expected. In addition to higher down payment requirements, further measures to cool the property sector could include the expansion of property taxes. More generally, further efforts to restrain credit growth are likely, including the use of a differentiated reserve requirement on individual banks.

In contrast, fiscal policy is expected to remain supportive of growth, both to guard against risks to the external outlook and to further domestic policy goals. Though details of the 2011 budget will not be available until March, we anticipate the extension of several subsidy programs aimed at boosting private consumption, as well as an emphasis on public housing (10 million units) and infrastructure investment, including the expansion of China's high-speed railway network and water distribution facilities.

Profitability in the banking sector remained high during the first three quarters of 2010. While the monetary tightening measures of last year, particularly since the adoption of a more aggressive stance in the fourth quarter, are likely to suppress profitability going forward, the near-term outlook is unlikely to be affected significantly given still-strong credit growth and adequate net interest margins. Non-performing loans have declined further, and a number of banks successfully completed their capital raising plans in 2010.

Over the past year, risks have swung between weaker growth from fragilities in the global economy and overheating from rapid credit growth. While we would not dismiss risks to the global economy, it is clear now that overheating risks have won out. The main risk in the near term is to the inflation outlook, especially if commodity and food prices stay high. Relative to three months ago, risks of asset price bubbles, especially in the property sector, have receded somewhat on tightening measures of the government. That said, liquidity is still high, and speculative behaviour may continue. Downside risks to the outlook stem from the possibility of a weaker external environment, and the threat of more aggressive monetary tightening.

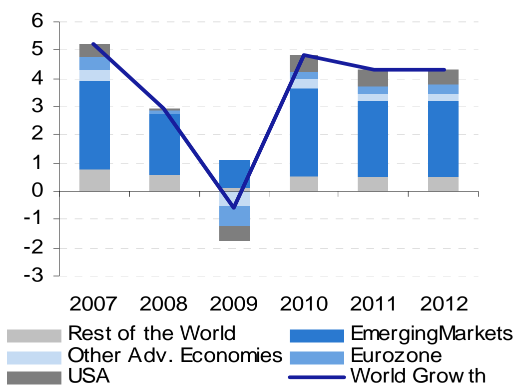
1. Global outlook: decouplings at play

Before turning to China, we review the Global Economic Outlook. Readers who wish may go directly to Section 2 (page 7) on China.

The global economy will continue on divergent paths

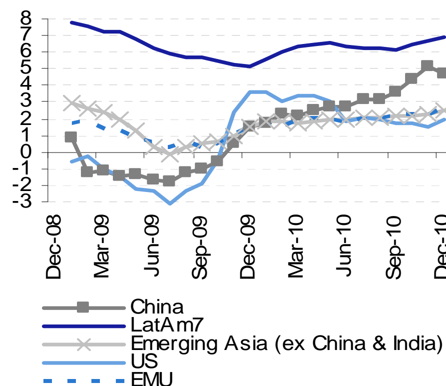
After closing 2010 with a growth rate of 4.8%, the global economy is expected to decelerate slightly to 4.4% both in 2011 and 2012, a better performance than anticipated 12 months ago. This is explained by an improved outlook for advanced economies, due to (i) better growth expectations for the US after the fiscal stimulus, and (ii) stronger performance in core European countries, which have decoupled from those of the periphery. In fact, even though financial market tensions in Europe worsened during the last quarter of 2010, economic activity in the region as a whole accelerated, showing–at least temporarily–a degree of decoupling as well between the financial and the real side. Overall, the pattern of global economic growth remains broadly unchanged as the main engine of dynamism continues to be the emerging world, led by Asia as discussed below (China and India in particular, see Chart 1), with developed economies continuing to lose ground.

Chart 1
Global GDP growth and contributions



Source: BBVA Research

Chart 2
Inflation



Source: Datastream and BBVA Research

All these decouplings have three important implications for the outlook. First, the divergence between growth in advanced and emerging economies will continue to induce markedly different macroeconomic policies going forward. Monetary policies will remain highly accommodative in the US and Europe, fuelling a search for yield elsewhere (in emerging markets and increasingly in commodities as well). At the same time, signs of overheating are starting to emerge in some countries in Asia and Latin America, pushing authorities to consider tightening policy faster than previously envisioned given incipient inflationary pressures, especially in Asia (Chart 2). The resulting incentives for capital inflows into emerging economies will intensify policy dilemmas already present in both regions, between tightening policy to ensure a soft landing and preventing sudden and sharp exchange rate appreciations.

Second, the growth divergence between the US and EMU will–together with financial risk–put downward pressure on the euro and, perhaps more significantly, will keep drawing market attention to the relative difficulty of the EMU to grow out of their high public debt levels. This is one of the elements–together with the different size of central banks' bond-purchase programs and the turmoil around economic governance in Europe–that explains why markets have not reacted significantly to a further postponement of fiscal consolidation in the US.

Finally, the increasing decoupling within the EMU will start straining the conduct of a common monetary policy for the region, already torn between an incipient risk of inflation, especially in core countries, and the need to continue supporting financial stability, especially–but not exclusively–in peripheral economies.

Growth in the major advanced economies has picked up, but fragilities remain

As we anticipated, the US did not fall into a double dip, and the chances of that happening in the future have faded since the summer. Four main factors have contributed to the change in sentiment regarding the outlook for growth in the US. First, better macro outturns at the end of 2010 signaled that household consumption was more resilient than was feared. Second, decisive action by the Federal Reserve, implementing an additional round of asset purchases (QE2), provided support for bond prices in

particular, and asset prices in general. Third, reduced uncertainty and increased business confidence is expected to benefit investment. Finally, and perhaps more important, a new fiscal stimulus package, approved at the end of 2010, will provide a significant boost to economic growth. We have thus adjusted our growth forecast for 2011 by 0.7 percentage points, to 3.0%.

However, weaknesses have not disappeared. Real estate markets remain feeble and are still prone to negative surprises. Household income is still sluggish given that the speed of the recovery will not be sufficient to significantly reduce unemployment rates. Furthermore, credit growth and securitization processes remain subdued. While none of this should derail the recovery, it may contribute to a scenario in which an additional negative shock could harm the economy. For now, this outlook of gradual economic recovery with low inflationary pressures on the demand side, should permit monetary policy to remain accommodative for an extended period.

Moreover, the lessons from the sovereign crisis in Europe should not be forgotten. Granted, the new fiscal package at the end of 2010 had the benefit of boosting growth in the short-run, at the time when doubts about a double dip were still in the air. But one should not overestimate the strength and persistence of the factors that have prevented a negative reaction from bond markets to a further delay of fiscal consolidation in the US. Central bank bond purchases and the turmoil in Europe (and thus flight to quality to US bonds) are by nature short-run factors that will disappear in the medium run, and before that happens, the US will need to show a clear commitment to fiscal consolidation.

Institutional and economic reforms in Europe will be crucial

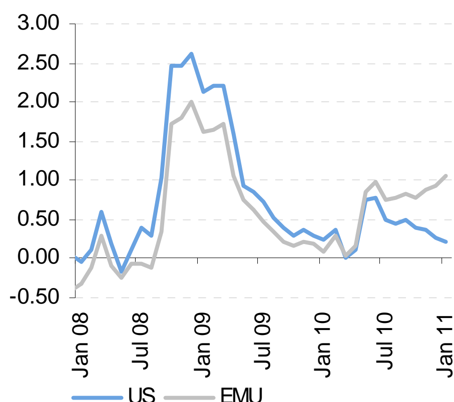
Since October 2010, financial tensions in Europe have surged again (Chart 3), especially in peripheral countries. Concerns about fiscal sustainability and financial sector losses have resurfaced, leading to widening sovereign spreads and funding pressures. However, contrary to the episode in May, financial spillovers to other countries in Europe and outside the EU were more limited.

The increase in financial market tensions was triggered by two events. First, markets were uncertain about the ability of European institutions to deal with sovereign debt crises. Private investors were spooked by the proposal that they would bear losses on possible restructurings after 2013, and the likelihood that haircuts on existing debt would be needed to restore fiscal sustainability. The second trigger was increasing doubts about the credibility of stress tests, given the need to support Irish banks shortly after they were deemed adequately capitalized. These two triggers developed amid the background of concerns about the capacity of some peripheral countries like Portugal and Ireland to fulfill their fiscal deficit targets and doubts about the ability of some European economies to generate enough growth momentum to make their debt burden sustainable.

The fragility of the recovery in financial markets after the summer highlights that markets are increasingly focused on sovereign solvency problems in some countries, rather than just liquidity concerns. This stresses the need for a comprehensive solution, both for solving this crisis, as well as establishing a sound crisis prevention and resolution mechanism for the future. For future crisis prevention, fiscal coordination needs to be reinforced, providing for shock absorbers for idiosyncratic shocks in individual countries, but also reinforcing surveillance both in the fiscal front and in the macroeconomic dimension (including preventing the build-up of private sector imbalances). For crisis resolution, a clear and transparent mechanism that defines those who will bear losses needs to be put in place, to avoid excessive market volatility due to uncertainty, but probably at this stage is extremely important to guarantee an adequate transition mechanism.

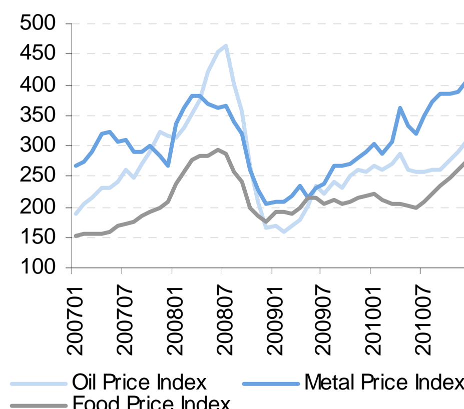
As pointed out above, financial spillovers from this recent episode have been rather limited, including those to core countries in Europe. Thus, growth in the EMU as a whole was stronger than anticipated, especially due to positive outturns in Germany and other core European countries. However, this decoupling between financial tensions in peripheral countries and real economic activity in Europe will not last if a comprehensive governance reform is not agreed soon and countries do not continue pushing economic reforms to reduce fiscal vulnerabilities, restructure the financial system and increase potential growth. What is agreed at the next European Council in March will be key in this respect.

Chart 3
BBVA Financial Stress Index



Source: BBVA Research

Chart 4
Commodity prices



Source: BBVA Research

Commodity prices will level off, but inflation is a concern in emerging economies

Commodity prices have surged across the board in recent months, reaching all-time highs in the case of some metal prices (Chart 4). This is consistent with what seems to be the beginning of a long-term upward trend in commodity prices driven by surging demand from emerging economies, but there are other short-run factors that have contributed to the recent surge, at least in some commodity classes. For instance, the very fast increase in food prices in the past two months is to a great extent the effect of one-time supply-side factors (weather disturbances), which should wind down during the rest of 2011. Moreover, given ample global liquidity conditions, investors have piled into commodities as an asset class, increasing financial premia across the board.

Going forward, we expect commodity prices in general to level off around current readings. In the case of food prices this will be the result of normalizing crops in 2011. For metals, elevated inventories will start to weigh on prices. Only in the case of oil do we expect a tight market to continue pushing prices slightly higher in 2011 but gradually easing afterwards. This easing will be helped by a likely reduction in financial tensions in Europe, which should shift investment flows away from commodities into other assets with more contained risk premia. Nevertheless, risks are tilted to the upside, as strong demand, especially in Asia, will continue to support an upward trend in prices in the medium run.

The increase in commodity prices has been responsible, in part, for the increase in inflation observed in emerging economies at the end of 2010 (Chart 2). In particular, the increase in food prices has had a direct and important first-round effect on higher inflation in a number of countries–especially in Asia as discussed below–with the risk of feeding into overall inflation. However, going forward, the expected leveling of food prices will mean that this factor should become less important in determining headline inflation. Although the risk has also increased in developed countries, it is smaller than that in emerging economies, given that food prices have a smaller weight on CPI and ample unused capacity and anchored inflation expectations will help keep inflation pressures in check.

More worrying for emerging economies is the realization that rapid growth and strong capital inflows in Asia and Latin America are starting to generate overheating pressures, through inflation but also evident in rapid credit growth and rising asset prices. Indeed, we expect Asian economies to continue growing strongly, although in our opinion authorities will be able to steer them to a soft landing and avoid overheating, although that is surely a more pronounced risk than three months ago. Driven by domestic demand and high commodity prices, Latin America is also poised to grow strongly in 2011, converging to potential growth of around 4% in the region. As mentioned before, the biggest challenge for both regions will be to manage strong capital inflows. We expect policy to continue tightening in most countries, while at the same time imposing more administrative controls to limit those inflows and prudential measures to limit credit growth, especially in Asia.

2. China: momentum still strong

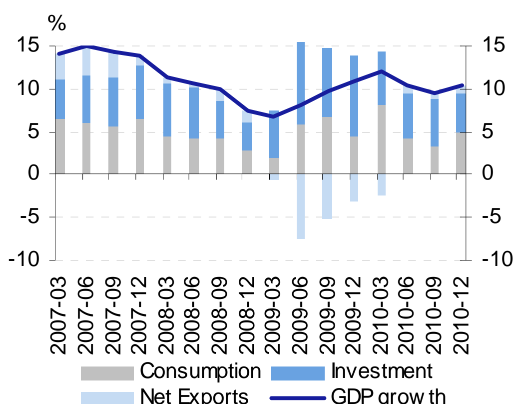
For much of the past year, the Chinese authorities have been trying to engineer a soft landing from the rapid growth that was set in train following the massive policy stimulus of late 2008 and 2009. That stimulus—which took the form of monetary easing and a large two-year fiscal package—helped the economy to weather the global economic downturn, and in the process pull the region out of recession. But it also unleashed a wave of bank lending and strong growth momentum that the authorities are trying to put a break on, with only partial success so far. In particular, higher-than-expected GDP and credit growth, along with rising inflation in recent months, have prompted the authorities to implement an increasingly aggressive approach to monetary tightening. Based on the authorities' determination to slow growth in line with a soft landing, we are maintaining our 9.2% GDP projection for 2011, while revising our inflation projection up to 4.5% (from 3.3% previously).

Growth momentum still strong, with hints of moderation

After a brief lull in the third quarter of 2010, economic activity gathered pace once again in late 2010 (Chart 5). GDP growth in Q4 rebounded to 9.8% y/y from 9.6% y/y in Q3 (or an estimated 12.1% q/q, seasonally adjusted annualized rate), bringing full-year growth for 2010 to 10.3%, up from 9.1% in 2009. On the demand side, according to preliminary data, the main contributors to annual GDP growth in 2010 were consumption and investment; at 3.9% and 5.6% respectively.

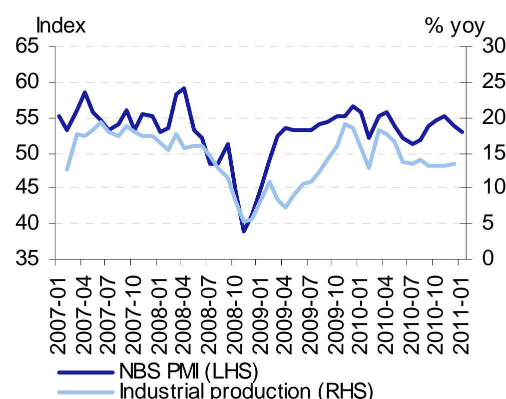
Inflation accelerated to 5.1% y/y in November, before falling back to 4.6% y/y in December, but still well ahead of the authorities' previous 3% target. While headline inflation has been driven mainly by rises in food prices, non-food components have been picking up as well.

Chart 5
GDP growth remains uncomfortably strong…(Contribution to GDP)



Source: CEIC and BBVA Research

Chart 6
…although recent PMI and industrial production readings show a moderating trend



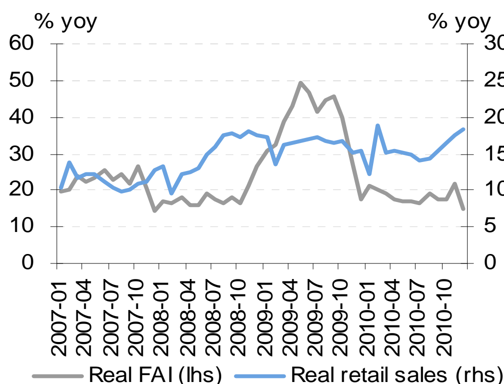
Source: CEIC and BBVA Research

Despite the pickup in GDP growth, signs of some moderation are evident, suggesting that the authorities' tightening measures may be working to achieve a soft landing (Chart 6). In particular, the official (NBS) Purchasing Managers' Index (PMI) showed bigger-than-expected declines in December 2010 and January 2011, following four consecutive months of stronger-than-expected outturns and five straight months of increases. Importantly, the readings have remained firmly in the expansion zone (+50), indicating that growth is moderating, but not falling off a cliff, which has helped allay market concerns about a hard landing for the Chinese economy. Further confirmation is found in recent industrial production readings, which stabilized at 13.5% y/y in December, in line with expectations.

On the demand side, indicators continue to show strength. December retail sales grew faster-than-expected at 19.1% y/y indicating robust consumer spending (Chart 7), and providing further evidence of a rebalancing of economic growth toward private consumption. The resilience of retail sales, however, may be in part due to government initiatives to boost consumption, including subsidies for automobile purchases and incentives programs for home appliances; indeed, the strong reading for December may have been influenced by a rush of automobile purchases in Beijing prior to implementation of restrictions on auto purchases in that city effective from January 2011 designed to ease traffic congestion. Meanwhile, investment indicators are also continuing to show strength, with urban fixed asset investment for December registering robust growth of 24.5% y/y, in line with expectations.

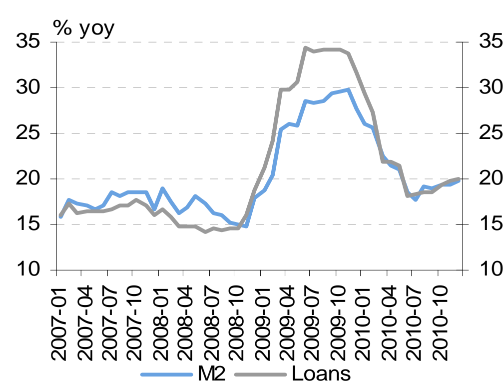
Credit and M2 growth exceeded their annual targets in December (Chart 8). New loans continued to be extended at a rapid pace through December, amounting to RMB 7.95 trillion, and exceeding the annual target of RMB 7.50 trillion. As such, full-year credit growth came to 19.9%, down from 31.7% in 2009, but ahead of the authorities' original target of 18.8%. M2 growth for December was 19.7% y/y, also above the authorities' annual target of 17.0%.

Chart 7
Investment and consumption indicators remain strong



Source: CEIC and BBVA Research

Chart 8
M2 and credit growth are off previous peaks, but are still strong



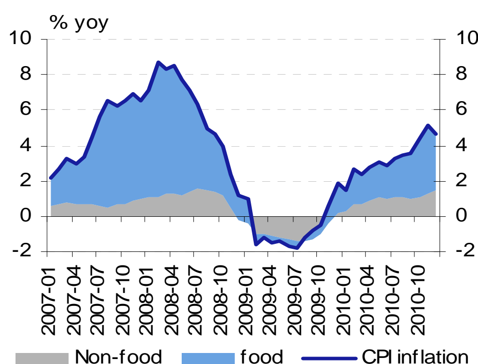
Source: CEIC and BBVA Research

On the external front, exports have showed surprising resilience. Export and import growth remained brisk through the end of 2010, growing by 31.3% and 38.7%, respectively for the year. The outturns resulted in a slightly smaller, but still substantial, trade surplus for 2010 of USD 183.1 billion (3.4% of GDP), down from USD 196.1 billion in 2009. A closer examination of the pattern of trade reveals an increasing share with other emerging markets, although China's largest trade partners remain the US and EU, with a combined share of about 40%. Trade volumes are increasingly rapidly with ASEAN economies, India, and Brazil by 37.5%, 42.4% and 47.5% respectively in 2010.

CPI inflation has been rising on a further increase in food prices

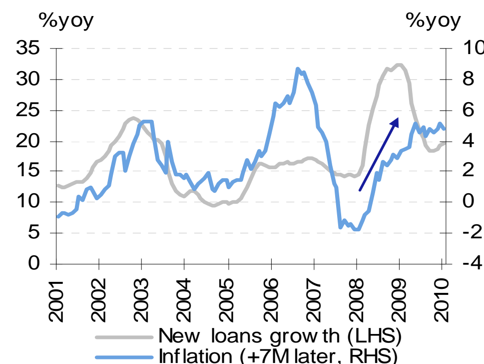
One of the more concerning trends has been a significant rise in headline inflation, driven initially by weather-related rises in food prices, but more recently by non-food components, particularly housing costs (Chart 9). The rise in non-food inflation suggests that underlying demand-side inflationary pressures have picked up, consistent with our estimates that the output gap is closed, as well as evidence of rapid wage increases and lax liquidity (Chart 10). Inflation accelerated to 5.1% y/y in November, before moderating to 4.6% y/y in December due to favourable base effects and a decline in food prices following government administrative measures to slow price rises (December food price inflation declined to 9.6% y/y from 11.7% y/y in the previous month). As such, inflation accelerated to well above the authorities' 3% target for the year. Given underlying pressures, they have raised their inflation target to 4% in 2011 (see Section 3). Producer price inflation has also showed signs of a pickup, although it eased to 5.9% y/y in December from 6.1% y/y of November.

Chart 9
CPI inflation continue to rise on food prices and global commodity prices



Source: CEIC and BBVA Research estimates

Chart 10
New loans increased rapidly in 2009, contributing to inflation with a lag…



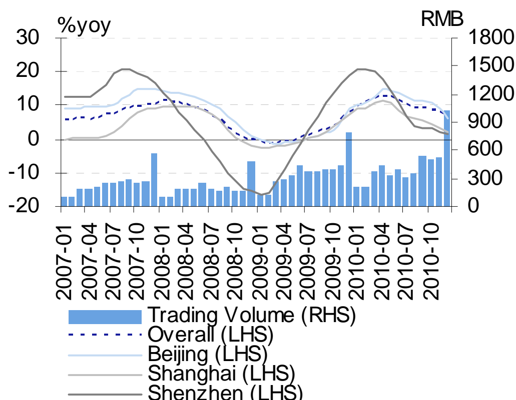
Note: Based on projected Inflation for 2011.
Source: CEIC and BBVA Research.

Property price increases have drawn new measures to cool the sector

The authorities have continued to monitor property price developments closely to maintain housing affordability and to avert the risk of destabilizing price bubbles. While the pace of price increases has moderated, recent data show that the sector remains active. Price increases for December amounted to 6.4% y/y (or 0.3% m/m), down from 7.7% y/y in November (based on NBS data for the largest 70 cities), but still registering a fourth straight month-on-month increase. Sales volumes surged to RMB 2.06 billion in Q4, registering an increase of 24.9% y/y (Chart 11). Meanwhile, credit growth to the real estate sector continues to moderate in year-on-year terms, with loans to real estate developers moderating more than mortgage lending (Chart 12).

Chart 11

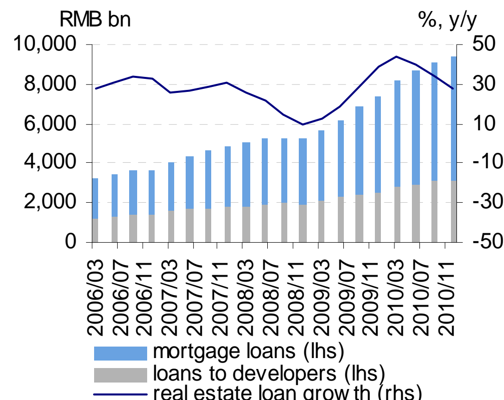
Activity in the property sector is moderating on tough government measures



Source: CEIC and BBVA Research

Chart 12

Real estate credits are decelerating, but loan growth still remains high



Source: CEIC and BBVA Research

The pace of activity has drawn further measures from the government to clamp down on the property sector. In October the authorities reduced the discount for mortgage interest rates (relative to the official benchmark) for first-home purchases by half, to 15% from 30% (the higher discount was launched in 2008 as part of the stimulus package). The reduction brings the minimum interest rates for first and second home purchases to 85% and 110% of the official benchmark lending rates. In November, the Ministry of Housing and Urban Rural Development announced restrictions on home purchase by foreigners to one unit for personal residence. More recently, in January 2011, down payment requirements were raised on second home mortgages from 50% to 60% (the down payment requirement for first-home mortgages remains at 30%). Mortgage loans for third home purchase were banned in late September. Also, in January local governments were urged to set stricter property price targets, and restrictions were imposed on purchases in certain cities and municipalities. Finally, a long-anticipated property tax was introduced in January 2011 on a pilot basis in Shanghai and Chongqing, applying to new purchases.

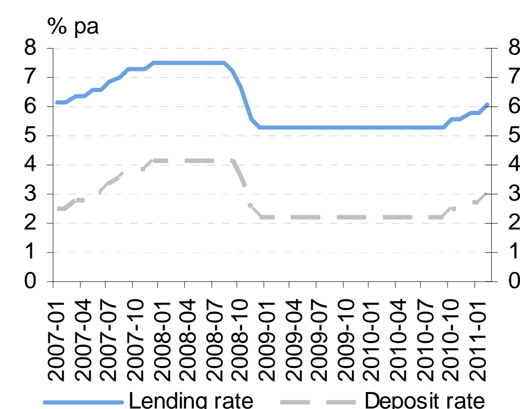
Tighter monetary policy, with supportive fiscal policy

The stronger-than-expected growth momentum, rising inflation and rapid credit growth have prompted the authorities to implement increasingly aggressive monetary tightening measures. Following a surprise rate hike last October, the PBoC hiked its benchmark interest rate in December 2010 and February 2011 by 25 bps each time (Chart 13). As was the case in October, deposit rates were raised by relatively more at longer maturities, resulting in an effective narrowing of net interest margins. Higher deposit rates are intended to increase real returns to savers, and to draw speculative funds away from the real estate market.

The interest rate moves have been accompanied by further hikes in required reserve ratios (RRR), amounting to three 50bp increases in the fourth quarter alone, and an additional 50bp increase in January 2011 (Chart 14). Compared with the previous hikes in first half of 2010, which exempted the rural and village-township banks (VTBs), the latest RRR hikes were applied to all the banks; they bring the RRRs for large banks to record high of 19%. The RRR has now been hiked seven times since early 2010, by a cumulative 350bps.

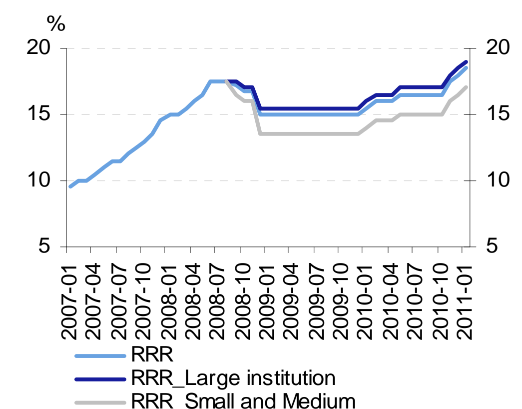
According to preliminary data, the overall budget deficit for 2010 amounted to 2.7% of GDP, slightly below than the original target of 2.8%, mainly due to the stronger-than-expected GDP growth, and compared to an outturn of 2.8% of GDP in 2009. In contrast to monetary tightening, the authorities plan to maintain a growth-supportive fiscal stance (see Section 3 below).

Chart 13
Three interest rate hikes so far…



Source: CEIC and BBVA Research

Chart 14
…accompanied by aggressive reserve requirement hikes



Source: CEIC and BBVA Research

Banking performance has been solid

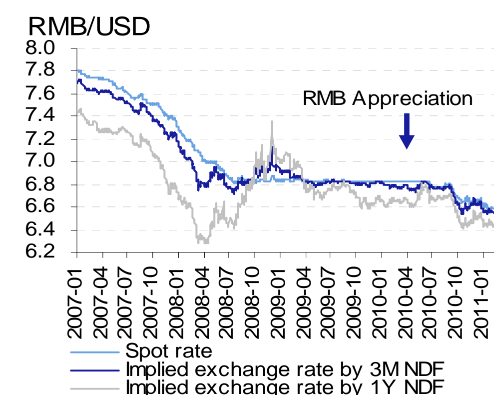
Profitability in the banking sector remained high during the first three quarters of 2010 (see *China Banking Watch*). While the monetary tightening measures of last year, particularly since the adoption of a more aggressive stance in the fourth quarter, are likely to suppress profitability going forward, in the near-term the outlook remains good given still-strong credit growth and adequate net interest margins. As regards asset quality, the non-performing loan (NPL) ratio declined further to a record low of 1.03% at end-September, due both to an increase in outstanding loans and a decline in the outstanding level of NPLs.

Mandatory capital requirements were raised last March to 11.5% for large banks (from 11.0% previously) and to 10% for other banks (8-10% previously). Together with rapid credit growth, the higher requirements led to capital raising needs for a number of banks, which were fulfilled successfully. Significantly, a number of large state-owned banks, including BOC, ICBC, and CCB, were successful in completing their capital raising needs, enabling them to exceed the new minimum capital adequacy ratios (CARs). Going forward, we project that a number of additional banks may have capital raising needs in 2011, amounting to a total of RMB 130 billion, considerably lower than RMB 510 billion raised by the banking system in 2010.

RMB appreciation has continued at a gradual pace, as foreign exchange reserves and international pressure continue to mount

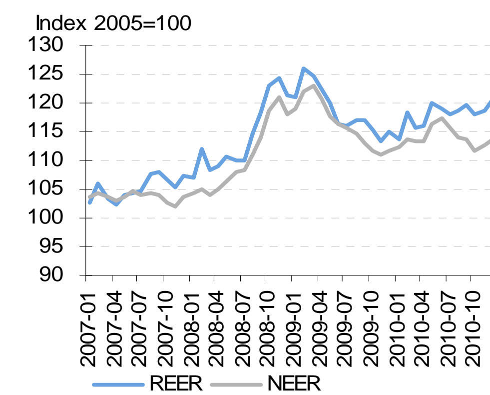
The RMB has appreciated by 3.7% since the adoption of the more flexibly currency arrangement last June (Chart 15). In nominal effective terms (NEER), however, the RMB has actually depreciated, although when the high inflation rate is taken into account, in real effective terms there has been some appreciation (Chart 16).

Chart 15
Gradual appreciation against the US dollar is continuing



Source: CEIC and BBVA Research

Chart 16
Appreciation of the nominal effective exchange rate has been limited so far



Source: NBS, BIS and BBVA Research

Meanwhile, foreign exchange reserves increased at an accelerating pace throughout the year, by USD 199 billion in Q4 (about the same as in Q3, but higher than in the first half of the year), boosting reserves to a record USD 2.85 trillion at end-year, equivalent to an increase of almost USD 0.5 trillion. Given the narrowing of the trade surplus, the rapid reserves accumulation points to an increase in capital inflows, some of which consist of hot money flows in anticipation of further RMB appreciation. After accounting for inflows from the trade surplus, valuation changes (due to currency fluctuations) and FDI inflows, we estimate hot money inflows of around USD 94 billion for the fourth quarter, substantially higher than in Q3 (USD 20 billion) as global risk aversion receded.

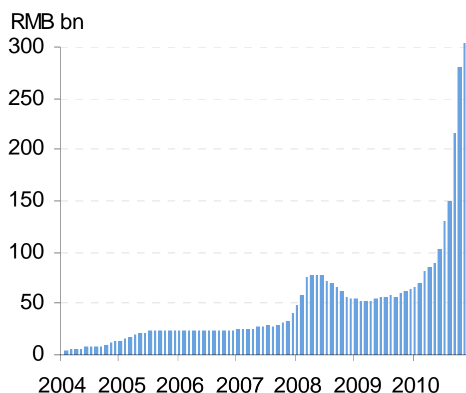
Gradual internationalization of the RMB is continuing

The pilot program for RMB cross-border trade settlement was expanded in June 2010 to cover 20 provinces and municipalities within China and all international trading partners. Along with expectations of further currency appreciation, this has fuelled rapid growth of RMB-denominated cross-border trade transactions. However, the share of RMB settlement trade volumes still accounts for a relatively small 2½% share of China's international trade. This share can be expected to rise in the coming years as the authorities continue to broaden the RMB settlement program. The latest steps in this regard were taken in January 2011, when Chinese enterprises in the 20 pilot regions were allowed to make foreign direct investments (launching new businesses, mergers and acquisitions, and strategic investment stake, but excluding financial investments) in RMB-denominated instruments.

Given its various advantages, Hong Kong has steadily advanced toward becoming the main offshore center for RMB business. Reflecting this, RMB deposits in Hong Kong have grown rapidly over the past several months (Chart 17). RMB bond issuance in Hong Kong also surged. It is expected that the authorities will further liberalize the offshore RMB market and allow Hong Kong's financial institutions to provide a breath of new RMB investment products such as the "Mini-QFII" (allowing foreigners to use off-shore RMB to invest directly into China's stock market) and RMB-denominated IPOs.

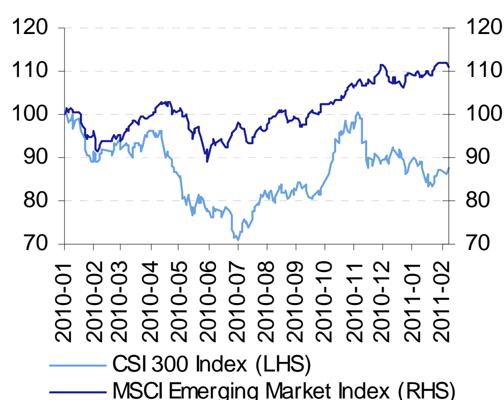
Despite recent rapid growth rates and strong prospects, China's equity markets have lagged behind those of other emerging market economies on fears of further monetary tightening. The China Security Index (the major security index of China's A-share market) declined by 12.5% in 2010, and a further 2.9% so far in 2011 (Chart 18), placing it among the poorest performing markets.

Chart 17
RMB deposits in Hong Kong have surged



Source: NBS, CEIC and BBVA Research

Chart 18
A weak stock market performance in 2010 on fears of tightening



Source: Bloomberg and BBVA Research

3. Challenges ahead in managing growth and inflation

With growth momentum and inflation higher than expected, as discussed above, the authorities are taking a more aggressive approach to monetary tightening to rein in credit growth and prevent overheating. In this regard, we expect further hikes in interest rates (another 50bps) and reserve requirements (at least 100bps) during the course of 2011, quite likely front loaded in the first half of the year. More aggressive monetary tightening may be needed if inflation fails to abate as expected. Given the authorities' determination to contain inflation and to keep growth within potential, our baseline continues to incorporate an economic soft landing.

Stronger-than-expected momentum offsets risks from aggressive policy tightening

We are maintaining our baseline 9.2% GDP growth projection in view of the authorities' determination to achieve a soft landing (Table 1). While rising inflation and a more aggressive monetary tightening response might raise the risk of a hard landing, growth momentum is stronger than previously expected and prospects for rising private consumption are good. In this scenario, growth would remain just within potential, facilitating a moderation in inflation during the second half of 2011. That said, we are raising our average inflation projection for 2011 to 4.5%, from 3.3% previously, and as compared to the authorities' announced inflation target of 4% (up from 3% in 2010). We expect inflation to remain on the high side during the first half of the year, peaking at above 5.0% in the first half of the year, before moderating in the second half of the year to 3.6% by December as monetary policy is tightened, and as food and commodity prices are expected to ease.

Table 1
Baseline Scenario

	2008	2009	2010	2011 (F)	2012 (F)
GDP (%, y/y)	9.6	9.2	10.3	9.2	9.0
Inflation (average, %)	5.9	-0.7	3.3	4.5	4.0
Fiscal bal (% of GDP)	-0.4	-2.8	-2.7	-2.3	-2.1
Current acct (% of GDP)	9.9	6.1	4.6	5.1	5.0
Policy rate (%, eop)	5.31	5.31	5.81	6.56	7.06
Exch rate (CNY/USD, eop)	6.83	6.83	6.62	6.30	6.00

Source: BBVA Research

Inflationary risks are to the upside

Notwithstanding our baseline scenario of modest inflation, risks are clearly to the upside. If commodity and food price increases fail to abate as expected—and recent drought conditions in the North of China do not bode well is this regard—supply-side factors could continue to put upward pressure on the CPI. Moreover, if growth fails to moderate as expected, demand-side pressure may continue, feeding into an adverse wage-price dynamic.

A shift in monetary policy from "accommodative" to "prudent"

Going forward, we expect the authorities to maintain the recent shift to a "prudent" monetary stance, as announced following the routine end-year central economic meeting of top policymakers in Beijing. In this regard, the PBoC has signalled that it will continue to use a mix of tools, including both quantitative instruments (such as hikes in the RRR) and price-based instruments (further interest rate hikes), all with a view to containing broad money growth (M2) to around 16%, below last year's outturn of 19.7%.

In contrast to previous years, the PBoC has opted not to provide an explicit annual target ceiling on new bank loans for 2011. Nevertheless, we believe that the PBoC is likely to continue operating with internal bank-by-bank credit quotas. To restrain credit growth, the authorities have announced the intention to use a "dynamic differentiated reserve requirement ratio (RRR)". In practice this would mean that PBoC could adjust RRRs of individual banks in line with their credit growth.

The absence of an officially announced credit target for 2011 may reflect dissatisfaction with having missed the target in 2010, but more fundamentally it may signal a shift to greater use of indirect instruments of monetary control over time, in recognition of the financial deepening and growing complexities of the Chinese economy. Such an approach would also be consistent with expectations that the government will liberalize interest rates in the coming years, perhaps in the context of the forthcoming five-year plan.

Currency appreciation is expected to remain gradual

We continue to expect further gradual currency appreciation, of about 4-5% against the USD in the coming year as a complement to monetary tightening. In addition to reducing the degree of currency undervaluation and bringing the exchange rate closer to equilibrium (China's balance of payments remains in substantial surplus), appreciation would help to contain inflationary pressures, especially by reducing the imported component of food and commodity price increases. In this regard, if exports continue to perform well and if inflation does not subside as expected, we would not be surprised to see somewhat faster appreciation than in our baseline of RMB 6.30 by end-2011.

Fiscal policy to stay growth-supportive

With monetary policy geared toward containing inflation and restraining credit expansion, fiscal policy in the coming year is expected to remain supportive of growth, both as a safeguard against a deterioration in external demand, as well as to support medium-term goals of rebalancing and infrastructure development. Details of 12th five-year development plan and 2011 budget targets will be announced only in March. Some of the initiatives put into place under the two-year stimulus package have expired, such as subsidies for auto purchases (although subsidies for clean-technology vehicles remain in place), while most of the existing subsidy programs for rural areas are to continue in 2011, including for home appliances, motor and agricultural machine purchases, and energy saving products (including electric car and lighting products). The 2011 budget is also expected to include an emphasis on public housing (10 million units are slated for development in 2011 following the ambitious plans for 5.8 million units in 2010) and infrastructure investment, including the expansion of China's high-speed railway network and water distribution facilities.

On the financing side, we expect the central government to play the leading role in expenditure and investment, in order to reduce vulnerabilities being created through local government financing vehicles (LGFVs). Some initiatives may also be launched in 2011 to enhance the existing tax-revenue sharing system between central and local governments, to increase the financial strength of local governments.

Rebalancing over the medium-term will be underpinned by rising consumption

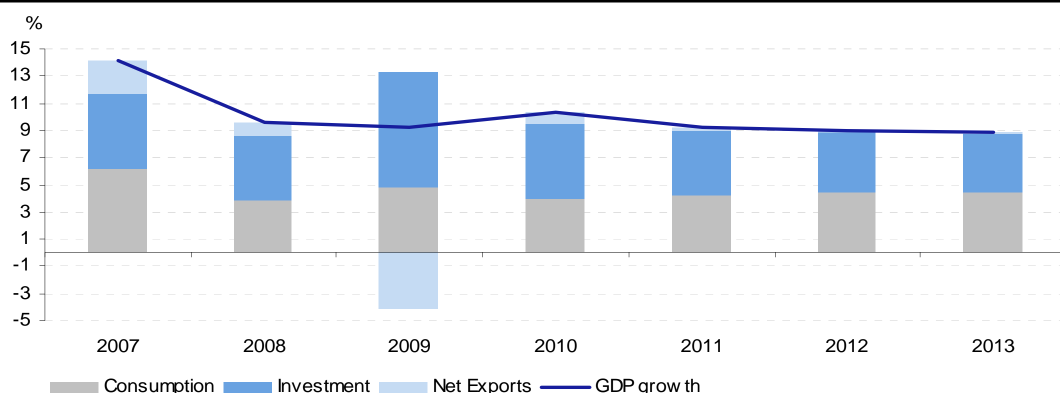
As noted previously in our research reports, while we expect China to maintain high growth rates over the medium term, the double-digit rates of the recent past are unlikely to be sustained. We estimate potential GDP growth will gradually moderate from above 9% in 2011 to just above 8% by 2015. The expected moderation is due to a combination of falling labor growth rates, and lower total factor productivity growth as the economy continues to develop.

We continue to see significant scope for a rise in the ratio of consumption-to-GDP, which is very low in relative terms. Policy initiatives have been supporting a gradual rise in consumption, including fiscal incentives, enhancements to the social safety net that should reduce the need for precautionary savings over time, and the move toward currency appreciation. Urbanization and rising wages should also support this trend. Accordingly, our medium-term projections incorporate a gradual rotation of growth toward private consumption, rather than reliance on exports and investment (Chart 19).

Over the medium-term inflation may stay elevated, not only because of increasing demand pressures, but because of indications of tighter labor markets. China is experiencing a "Lewisian" turning point (named after the late Nobel Prize economist, Sir Arthur Lewis for his work on explaining industrial wage growth in developing countries when surplus labor diminishes), which is likely to increase labor costs over the medium term. Rising land and housing prices are also likely to be a consequence of further rapid urbanization. As a result, inflation may well hover around 4½ percent over the medium term.

Chart 19

A rebalancing of growth over the medium term



Source: NBS, CEIC and BBVA Research

4. Risks are tilted to overheating

Much of the past year has been influenced by competing risks in China between weaker growth from fragilities in the global economy and overheating from rapid credit growth, asset price bubbles, and strong domestic demand. While we would not dismiss risks to the global economy, it is clear now that overheating risks have won out. In our view the authorities recognize the risks of overheating, as seen in their aggressive approach to monetary tightening and measures to curb price increases in the property sector.

Relative to our assessment of three months ago, risks of asset price bubbles, especially in the property sector, have not vanished, but have receded somewhat on further tightening measures. That said, liquidity is still high, and speculative behaviour in the sector may continue. More broadly, risks of price bubbles in other asset markets, such as the equity market have receded on price declines.

The main risk in the near term, as noted in previous sections, is to the inflation outlook. In particular, if commodity and food prices stay high, inflation outturns may well exceed the authorities' newly raised target of 4%, perhaps by a considerable margin. Strong growth momentum may add to this risk from the demand side.

Downside risks to the outlook stem from the possibility of a weaker external environment, although that has now receded given the improved outlook in the US and Europe. While we do not anticipate a hard landing, such risks have increased due to overheating pressures and the threat of more aggressive monetary tightening if inflation does not abate as expected.

In the financial sector, the risks of rising NPLs and vulnerabilities from local government financing vehicles (LGFVs) remain, all the more so on indications of further rapid lending growth in recent months. That said, the authorities appear well aware of these risks, and their ongoing efforts—monetary tightening, macro-prudential measures, and stricter guidelines on use of LGFVs—should help to keep risks manageable in the coming years. Moreover, the successful capital raising efforts of banks in the past year have helped to shore up the banking system.

5. Tables

Table 2
Macroeconomic Forecasts: Gross Domestic Product

	2008	2009	2010	2011 (F)	2012 (F)
GDP (%, y/y)	9.6	9.2	10.3	9.2	9.0
Inflation (average, %)	5.9	-0.7	3.3	4.5	4.0
Fiscal bal (% of GDP)	-0.4	-2.8	-2.7	-2.3	-2.1
Current acct (% of GDP)	9.9	6.1	4.6	5.1	5.0
Policy rate (%, eop)	5.31	5.31	5.81	6.56	7.06
Exch rate (CNY/USD, eop)	6.83	6.83	6.62	6.30	6.00

Source: BBVA Research

Table 3
Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2008	2009	2010 (E)	2011 (F)	2012 (F)
U.S.	0.4	-2.6	2.8	3.0	2.7
EMU	0.3	-4.0	1.7	1.7	1.8
Asia-Pacific	5.6	3.7	8.1	6.5	6.4
China	9.6	9.2	10.3	9.2	9.0
World	3.0	-0.6	4.8	4.4	4.4

Source: BBVA Research

Table 4
Macroeconomic Forecasts: Exchange Rates (End of period)

		2008	2009	2010	2011 (F)	2012 (F)
U.S.	EUR/USD	0.70	0.70	0.75	0.78	0.77
EMU	USD/EUR	1.50	1.40	1.34	1.29	1.30
China	CNY/USD	6.83	6.83	6.62	6.30	6.00

Source: BBVA Research

Table 5
Macroeconomic Forecasts: Policy Rates (End of period)

	2008	2009	2010	2011 (F)	2012 (F)
U.S.	0.61	0.25	0.25	0.25	0.50
EMU	2.73	1.00	1.00	1.00	1.00
China	5.31	5.31	5.81	6.56	7.06

Source: BBVA Research

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