RESEARCH

# Economic Outlook

## China

August 2011
Economic Analysis

- **China's GDP growth has been moderating through 2011**, in line with the authorities' efforts to prevent overheating and achieve a soft landing.
- **Efforts to cool the economy, however, have failed to prevent inflation from rising**. In response, monetary policy has been tightened further; and with falling food and commodity prices, inflation is likely to decline during the remainder of the year.
- **The policy tightening cycle appears to be nearing an end.** While our baseline anticipates one more rate hike, heightened downside risks to the external environment could well keep the authorities on hold.
- **Risks to the outlook are now more balanced**. Overheating risks have eased, while downside risks have increased on global uncertainties. If external demand weakens, there would be policy room to cushion the effects on domestic growth.

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# Summary

**China's economic growth has been moderating through 2011, in line with the authorities' efforts to prevent overheating and achieve a soft landing.** Under a mix of monetary and macro-prudential measures, GDP growth has slowed, but with enough momentum from fiscal support to keep the economy on an even keel in the face of external headwinds. As a result, GDP growth slowed to a still-strong 9.7%y/y and 9.5% y/y in the first and second quarters, down from 10.3% for full-year 2010.

**Efforts to cool the economy, however, have failed to prevent inflation from rising.** Inflation reached 6.5% y/y in July, well above the authorities' 4% comfort level, driven by large increases in food prices. In response, the authorities have tightened monetary policy with further hikes in interest rates and required reserve ratios through June and early July. They have also implemented supply side measures to stem the rise in food prices.

**We continue to hold a positive outlook for the Chinese economy, in line with our previous soft landing scenario, and despite an increase in global fragilities.** With second quarter GDP growth coming in line with expectations and more recent high frequency indicators pointing to sustained, though moderating activity, we are maintaining our GDP projections of 9.4% for 2011 and 9.1% for 2012. At the same time, we are raising our inflation outlook for 2011 to 5.3% (average), based on our expectation that inflation has now peaked and should fall to 4.0% by end-year on easing food and commodity prices and favorable base effects.

**The policy tightening cycle appears to be nearing an end.** Our baseline anticipates one more 25bp rate hike and, possibly, another 50bp hike in the required reserve ratio during the remainder of the year. However, with inflation expected to decline, and downside risks on the rise due to the uncertain external environment, the likelihood of further policy tightening is diminishing, as recently signaled by the authorities.

**In the meantime, we expect further gradual currency appreciation, in line with our previous expectations.** The RMB's appreciation to date has been in line with our expectations of 4-5% annual appreciation. The large current account surplus and pace of recent reserve accumulation set the stage for further appreciation.

**Risks to the outlook are now more balanced than at the time of our previous quarterly update last May.** In particular, overheating risks have eased on moderating growth trends, while downside risks have increased with uncertainties in the global environment. Although markets have occasionally been on edge about the possibility of a hard landing, we regard the chances as remote. A more likely downside scenario is a weakening of external demand. If that were to occur, the authorities would have policy room to cushion the domestic effects by postponing further monetary tightening, slowing currency appreciation, and implementing fiscal stimulus if needed.

**Our medium-term outlook continues to be based on an expected rebalancing of the economy toward domestic demand, particularly private consumption.** This is in line with policy priorities in the latest five-year plan, adopted last March.

# 1. Global outlook: politics at the centre of the economic outlook

***Before turning to China, we review the Global Outlook. Readers may go directly to the sections on China, if they wish, by turning to page 6.***

## The global economy will continue growing, after a soft patch in the first half

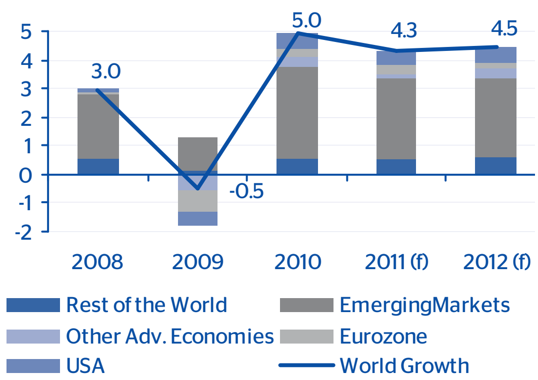
The global economy experienced a mild slowdown in the first half of the year, more pronounced in the US, but also in some emerging countries. Nevertheless, as the factors behind the slowdown are mostly temporary in nature (high oil prices, supply chain disruptions from Japan and bad weather), global growth is set to continue at a robust pace, at 4.2% in 2011 and 4.4% in 2012 (Chart 1).

However, risks to the outlook are now more tilted to the downside. Although the slowdown in activity in the US should be temporary as oil prices stop climbing and international supply chains are restored, the recovery is still weak and prone to relapses, as expected in the aftermath of a financial crisis with highly leveraged consumers. The recent soft patch in the US is a reminder of that, and may dent consumer and producer sentiment going forward.

Both in Europe and the US, fiscal concerns also pose big challenges for policymakers. As solvency concerns have not been addressed, the sovereign debt crisis in peripheral Europe has intensified (Chart 2), with the risk of becoming systemic as market pressure spreads beyond Greece, Portugal and Ireland to Spain, Italy and could eventually claim Belgium. Although its solvency is not in doubt, the US also faces the challenge of a large near-term fiscal adjustment, with the risk that political negotiations deal with short-term fixes rather than a long-term consolidation plan. This would increase the chances of a sudden spike in long-term U.S. yields.

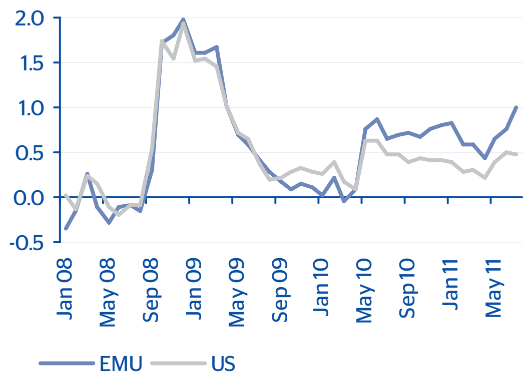
Finally, in emerging economies, overheating concerns may have eased slightly as tightening measures continue to slow growth gradually in Asia and Latin America, although fiscal policies still remain mostly accommodative, thus overburdening monetary authorities.

Chart 1
**Global GDP growth and contributions**




Source: CEIC and BBVA Research

Chart 2
**BBVA Financial Stress Index**




Source: CEIC and BBVA Research

## Its time to address European solvency concerns with bold political actions

In recent weeks a new round of financial market stress in Europe has extended to Spain and Italy, increasing the chances of the crisis becoming systemic in Europe (with spillovers beyond the EU). This was the result of the delay in providing a second package to Greece and the insistence that private bondholders should bear part of the cost of further financial aid to that country, together with the lack of a comprehensive solution to underlying solvency issues in Greece. This lack of resolve in Greece spilled over to countries without solvency problems such as Spain and Italy, and as a consequence to the European financial sector, which quickly saw their liquidity dry up.

With so much at stake, the Euro group agreed on July 21 to deal with liquidity and solvency concerns. For, the former, it decided to improve the EFSF by allowing it to lend preemptively to solvent countries in distress—much like the Flexible Credit Line from the IMF—and to buy sovereign bonds in secondary markets. Regarding solvency, it softened the conditions of official loans to Greece (also extended to other program countries) and reached an agreement with the private sector for a net present value reduction of their holdings of Greek debt by 21%, through debt swaps and buy-backs.

These have surely been big—and, in some cases, unexpected—steps in the right direction towards solving the European financial crisis. But Europe is not out of the woods, and that has been reflected in only a moderate reduction in risk premia in peripheral countries. Apart from filling in the technical details of the July 21 agreements, there remains a need for further action including an expansion of the EFSF, work towards a closer fiscal union and the introduction of Eurobonds, implementation of economic reforms, and a more definitive solution by EU authorities for Greece's debt and solvency concerns. Until these actions are taken, Europe will continue to be confronted with elevated sovereign spreads (not just for peripheral Europe).

## Fiscal consolidation in the US also focuses the attention on politics

In the US, political haggling between two opposite (and highly polarized) approaches to deficit reduction has added much noise, but so far has not increased market pressure on US rates. This reflected the belief that a solution to raising the debt ceiling would be found and default averted. . But an accord to raise the debt ceiling without a plan for long term fiscal consolidation will not address long-term sustainability concerns. Here the risk also lies—as in Europe—in the temptation to kick the can down the road, postpone a solution after the 2012 elections and increase the chances of a spike in long-term interest rates.

## Politics also holds the key to the outlook in many countries in Latin America

To a lesser extent, in Latin America, many countries also face uncertainty derived from the future course of politics. In some cases this is derived from perceived weakness by some governments as they are saddled by corruption charges or by massive protests. In other cases, it is the result of recent changes in governments or the uncertainty about the outcome of upcoming elections. Although it is true that the election cycle in the region has had less influence on the economic cycle in the last decade, it is crucial that this capital is not wasted by wide policy swings straying from continuing economic reforms.

## Overheating concerns ease in emerging economies

While overheating risks remain in emerging economies, they have receded on the whole with ongoing tightening measures and external headwinds from higher commodity prices and the earthquake in Japan. Importantly, risks of a hard landing in China have diminished with data showing that growth is slowing, but remains robust, still on track for a soft landing. However, inflation in emerging economies remains a concern, with a risk that policymakers may fall behind the curve as they exercise caution about the global environment and currency appreciation.

# 2. Moderating growth

Through the first half of 2011, the Chinese authorities continued to take steps to avert overheating and steer the economy toward a soft-landing. Under a mix of monetary and macro-prudential measures, GDP growth has slowed, but with enough momentum remaining from fiscal support to keep the economy on an even keel in the face of external headwinds from high oil and commodity prices and the impact of the earthquake in Japan. These efforts, however, have failed to prevent inflation from rising well above the authorities' comfort zone. In addition, markets remain on hedge about the risks of a more abrupt slowdown, all the more so given heightened risks to the global economy.

Notwithstanding these risks, we are maintaining our full-year GDP projection of 9.4% for 2011 and 9.1% for 2012. Growth for the second quarter came in line with our previous expectations of 9.5% y/y, and the baseline outlook remains broadly unchanged. However, we are revising up our average inflation projection for 2011 to 5.3% (from 4.9% previously) due to the higher-than-expected outturn through June and carry-forward of inflationary momentum into the third quarter.

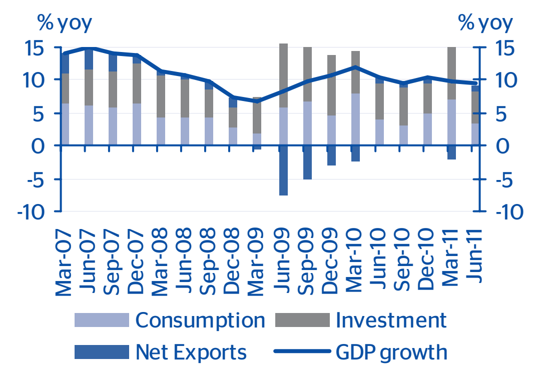
## Q2 moderation in line with a soft-landing scenario

Second quarter GDP growth slowed to 9.5% y/y from a faster-than-expected 9.7% y/y in Q1 due mainly to weakening consumption and investment (Chart 3). By our estimates, quarter-on-quarter growth slowed to 2.1%, seasonally adjusted from 2.3% in Q1 (although newly published official figures on seasonally adjusted growth show a small pickup in the second quarter to 2.2% from 2.1% in Q1). For the first half of the year, the main contributors to growth were consumption and investment (4.6 and 5.1 percentage points respectively), with net exports making a small negative contribution in contrast to a large positive contribution in 2010, and consistent with the ongoing rebalancing of the economy toward domestic demand.

The moderating trend so far is encouraging, in that it has been gradual, with underlying growth indicators remaining robust. Activity indicators through July, for example, show retail sales remaining steady and auto sales rebounding (Chart 4). Urban fixed asset investment has also held up at more than 25% y/y, driven by the activities of state owned enterprises, which have offset the slowed investment of private enterprises as some subsidy program have gradually phased out. On the supply side, industrial output has also remained strong, broadly in line with market expectations. And the Purchasing Manufacturers Index (PMI) has also been moderating, but at a gradual pace, well above the critical 50-level expansion zone (Chart 5).

Chart 3

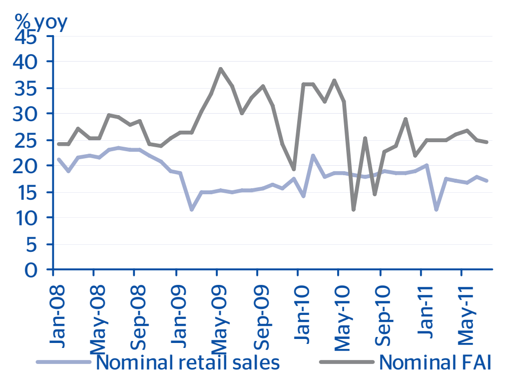
**GDP growth has been driven by robust domestic demand**




Source: CEIC and BBVA Research

Chart 4

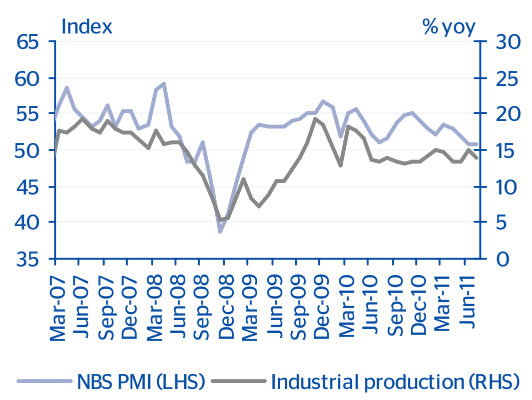
**Investment and consumption indicators are holding up**




Source: CEIC and BBVA Research

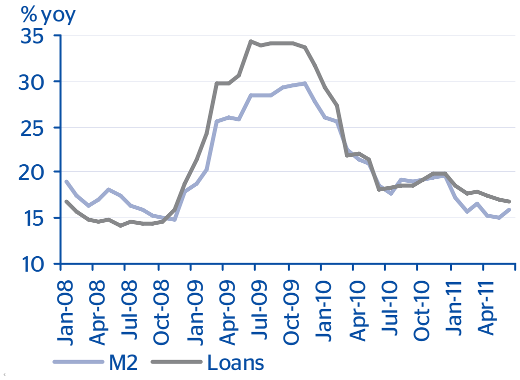
On the monetary front, credit and M2 growth are broadly in line with the authorities' targets (Chart 6). New loans in June came out at RMB 633.9 billion, up from RMB 551.6 billion in May, implying year-on-year credit growth of 16.9%. That said, new loans for the first half of the year were RMB 4.2 trillion, broadly in line with what we believe to be the authorities' (unannounced) full-year target of RMB 7.0-7.5 trillion.

Chart 5
Moderating PMI points to a healthy slowdown




Source: CEIC and BBVA Research

Chart 6
Credit and M2 growth are broadly in line with official targets



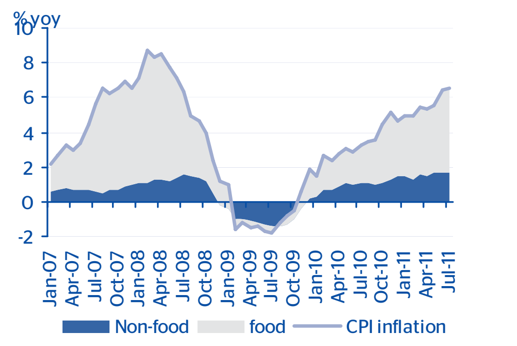

Source: CEIC and BBVA Research

## Challenge #1: Rising inflation

With growth moderating in line with a soft landing, inflation remains the predominant policy concern. Continuing a trend of rising inflation since late 2009, consumer prices accelerated in the second quarter, to 6.4% y/y in June (Chart 7), above expectations and the highest level in almost 3 years. However, much of the spike is due to base effects, as there has been some moderation in sequential (month-on-month) inflation.

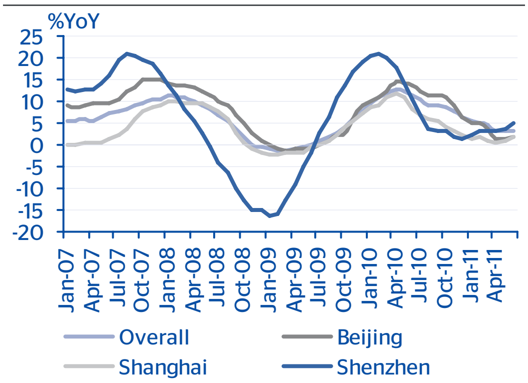
The increase in year-on-year inflation reflects a combination of rising food prices, lax liquidity conditions, and base effects. Rising food prices have been a key driver of inflation for several quarters, and was especially pronounced in June and July, when food inflation rose by more than 14 %y/y, mostly due to a supply-driven increase in pork prices. Producer price inflation also remains elevated (7.5% y/y in July) due in part to higher commodity prices. We believe that inflation has probably peaked for the near-term. Food prices should begin to ease soon as supply disruptions dissipate and as favorable base effects kick in, especially from September.

Chart 7
Inflation has reached new highs owing to an increase in food prices




Source: CEIC and BBVA Research estimates

Chart 8
Property price increases are moderating




Source: CEIC and BBVA Research.

## Challenge #2: Containing property price increases

In addition to rising inflation, containing the risks of property price bubbles is an ongoing policy concern. As discussed in our recent annual Real Estate Outlook, property price increases have moderated further, under the influence of the government's cooling measures. These include measures to reign in liquidity, tighten credit, and intensify various macro-prudential measures. A property tax has been introduced in Shanghai and Shenzhen on a pilot basis. Through the first seven months of this year, the local governments, especially for some large cites under the increasing pressure of the central government, have set their own housing price targets and implemented direct measures including imposing purchase restrictions. The authorities have also stepped up their efforts in the construction of affordable housing. At a national level, on the basis of NBS data, we estimate that price increases of residential properties have declined from 5.0% y/y in Q1 to just 3.2% y/y in Q2, continuing a broader moderating trend since last year (Chart 8).

Our estimate of the degree of overvaluation of current prices relative to fundamentals has narrowed in comparison to our previous assessment of last year, due both to improvements in our estimation methodology and to the moderation in actual price increases. Moreover, the rise in China's prices in recent years does not appear worrisome compared with international bubbles elsewhere (U.S., Spain, and Japan) and given China's strong medium-term GDP growth prospects.

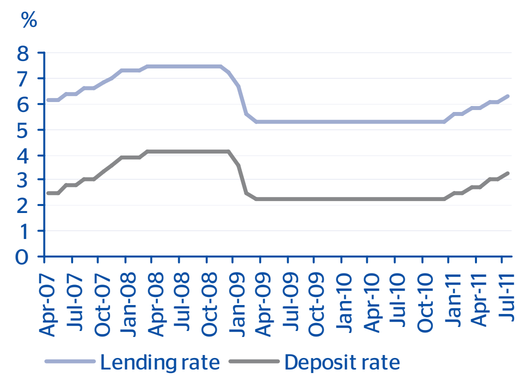
Despite the healthy moderation of the real estate market, pockets of more severe overvaluation may exist in certain sectors and cities. For some time now, prices have been rising faster in smaller cities where cooling measures are not as tight as in major cities.

## A policy mix of tighter monetary and growth-supportive fiscal

The authorities have continued to tighten monetary policy to tame inflation and prevent overheating. Interest rates were raised for a fifth time since last October in early July (Chart 9). To withdraw liquidity, the PBoC also continued hiking the required reserve ratio (RRR), effectively on a monthly basis through the first half of 2011, bringing the RRR of large commercial banks to 21.5%, a record high (Chart 10). (Moreover, the authorities tightened regulations on banks' loan-to-deposit ratios (L/D ratio) in June by requiring them to report their daily average L/D ratio on a monthly, rather than quarterly, basis. The tightening measures, together with stricter regulations, have restrained liquidity conditions, as seen in higher and more volatile inter-bank repo rates (Chart 11). With growth moderating, and with downside risks increasing due to the uncertain external outlook the authorities have recently shown signs of slowing the pace of monetary tightening.

Chart 9

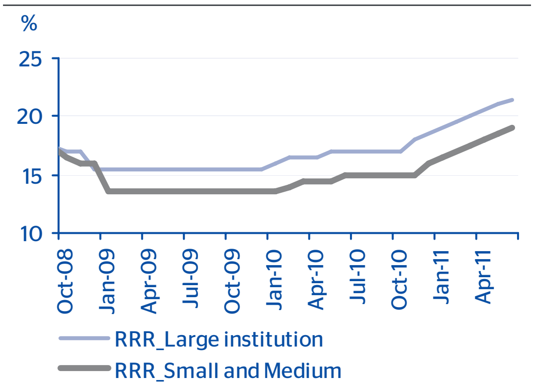
**Another interest rate hike in early July on top of previous four hikes since October...**




Source: CEIC and BBVA Research

Chart 10

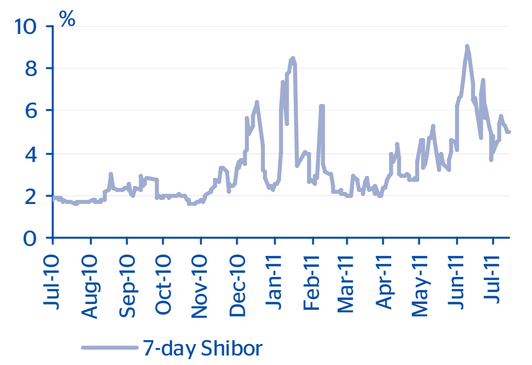
**...with monthly hikes in the required reserve ratio (RRR) through June**




Source: CEIC and BBVA Research

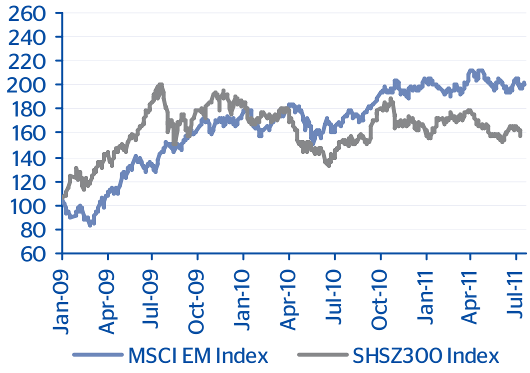
Financial markets, as expected, have reacted negatively to the tightening measures, with downtrends recently exacerbated by the global selloff. China's equity markets continued to underperform through the second quarter (Chart 12). Market sentiment has been fragile, swinging at times between worries of a hard-landing and overheating. As noted above, heightened risk aversion and unfavorable market sentiment abroad have added further downward pressures on China's equity markets.

Chart 11
**Inter-bank market interest rates have risen on tightening measures**




Source: CEIC and BBVA Research

Chart 12
**China's stock market continued its disappointing performance**

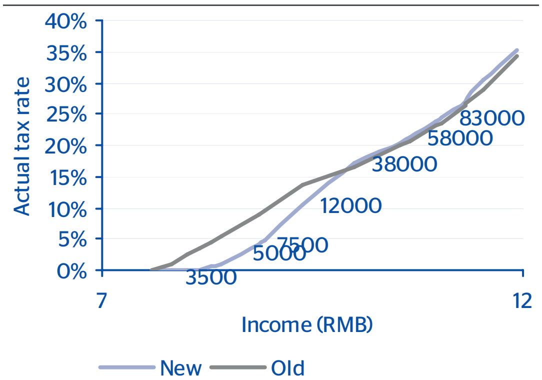



Source: CEIC and BBVA Research

Fiscal policy initiatives generally remain supportive of growth. The taxable income threshold is to be raised by more than previously expected (from RMB 2,000 per month up to RMB 3,500), along with an anticipated reduction in the number of brackets from 9 to 7, effective September 1. The changes are partly aimed at making the tax structure more progressive (Chart 13) to address income inequality. Nevertheless, the overall impact on consumption and revenues, is expected to be limited due to China's relatively low reliance on income tax for revenues (income tax revenues account for about 2½% of GDP according to the IMF) and low rates of tax compliance, especially for high-income brackets.

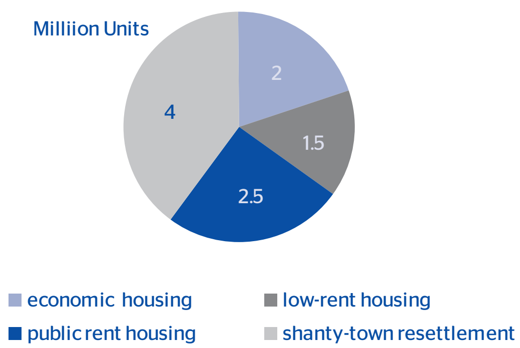
As discussed in our previous Outlooks, the thrust of public expenditure in 2011 is on the massive affordable housing program of 10 million units (Chart 14). According to official reports, about half of the affordable housing began to be constructed in the first half year.

Chart 13
**Tax reform add more progressiveness of the tax scheme**




Source: CEIC and BBVA Research

Chart 14
**Mass affordable housing program under construction**

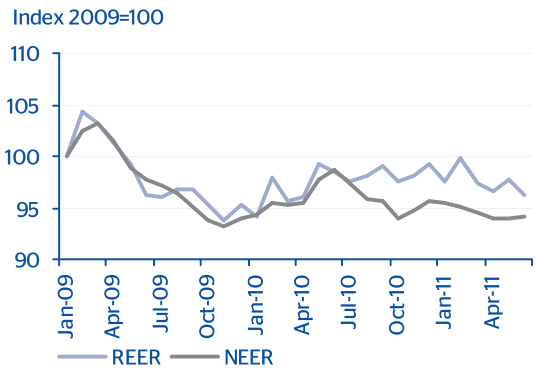



Source: CEIC and BBVA Research

## Currency appreciation continues at a gradual pace, as reserves accumulate

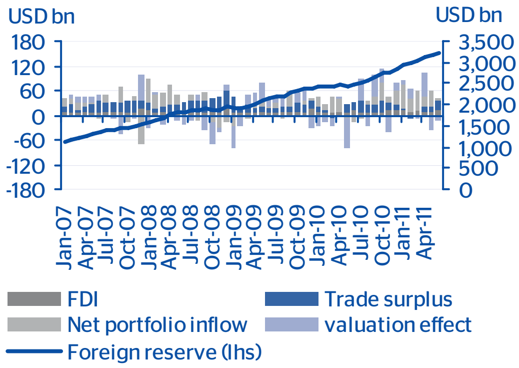
Gradual appreciation of the RMB has continued against the US dollar, at a pace of 4-5% per year, as expected. The rise in domestic inflation has meant a more rapid appreciation in real effective terms, although in nominal effective terms the currency has been broadly flat due to the decline in the value of the USD against other major currencies (Chart 15). Meanwhile, foreign exchange reserves accumulation slowed down in the second quarter to USD 153 billion from USD 197 billion in Q1, bringing total reserves to a new high of USD 3.19 trillion at end-June due in part to a slowdown in estimated "hot money" inflows on higher global risk aversion (Chart 16).

Chart 15
**Appreciation against the USD has translated into less movement in effective (trade-weighted) terms**




Source: CEIC and BBVA Research

Chart 16
**Portfolio inflows softened on adverse external market conditions**

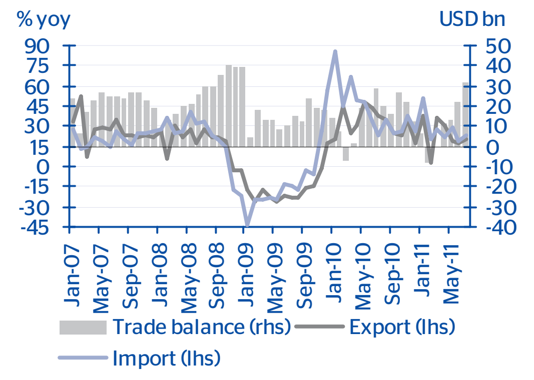



Source: NBS, BIS and BBVA Research

After registering a small deficit in the first quarter, the trade balance shifted back to a surplus in Q2 as anticipated (Chart 17). Both exports and imports were robust through July, with year-on-year increases of 23.4% and 26.9% respectively. Export growth has been broad-based, with a range of products performing well. By region, exports have increased across the board and especially to other fast-growing emerging market economies. On the other hand, exports to US and EU show some signs of slowing, possibly due to sluggish demand, although exports to the EU rose strongly in July, along with a rebound in exports to Japan. Rapid import growth has reflected high commodity prices and strong domestic demand, with July imports increasing to 22.9% y/y from 19.3% y/y.

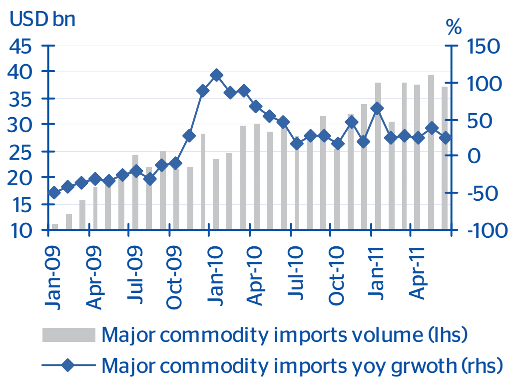
China's commodity import demand, which is of intense interest to Latin American commodity-exporting economies, slowed in June (latest available data) from 25.5% y/y from 38.5% y/y in May (Chart 18). In particular, import volumes of oil and iron both registered only modest growth through the first six months of 2011, while copper imports even declined (-23.8% y/y) during the same period. We believe the slowdown in such imports is due to strategic decisions of purchasers, who may be waiting for commodity prices to decline, rather than due to a decline in underlying demand, which remains robust. More generally, the outlook for China's commodity demand is remains strong, in our view, due to continued growth and infrastructure investment.

Chart 17
**The trade balance has shifted back to surplus**




Source: Bloomberg and BBVA Research

Chart 18
**Commodity imports have slowed**



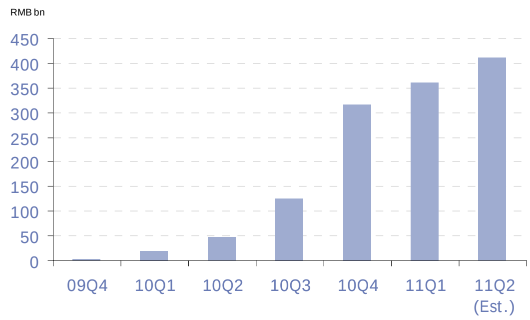

Source: Based on reported CBRC data and BBVA Research

## Internationalization of the RMB continues

The push toward internationalization of the RMB that was launched in June 2009 (see Economic Watch: RMB Cross-border Trade Settlement) has continued apace (Chart 19), with a set of new initiatives put in place in July allowing foreign enterprises to remit offshore RMB to the Mainland in the form of FDI on a more regular basis than at present. Although the policy is still in a pilot form and excludes industries "under government monitoring and control" (such as the real estate sector given the authorities' tightening efforts), it is expected to be expanded over time. The policy should help bolster the offshore RMB ("Dim Sum") bond market and accelerate the pace of RMB internationalization. In the meantime, RMB deposits in Hong Kong, one of the key measures of the pace of RMB internationalization, have risen steadily to RMB 554 billion, an increase of 22.6% over the previous quarter. (Chart 20).

Chart 19

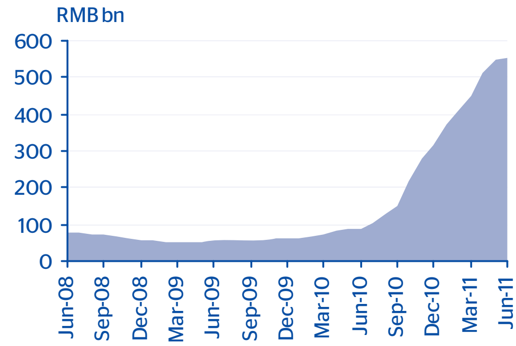
**Value of RMB settled cross-border trades have been rising steadily**




Source: Bloomberg and BBVA Research

Chart 20

**RMB deposit in Hong Kong have increased rapidly**




Source: Based on reported CBRC data and BBVA Research

# 3. A soft landing

With underlying demand remaining buoyant, we expect the moderation in growth momentum to be gradual, in line with a soft landing. Outturns through the first half of the year were broadly in line with expectations, and we are maintaining our 2011 GDP growth projections unchanged at 9.4%, and 9.1% for 2012. That said, downside risks have increased with the rise in global uncertainties.

With respect to inflation, we are raising our full-year projection to 5.3% (average) from the previous level of 4.9%. The upward revision is mainly based on the higher-than-expected outturns in recent months, and we expect inflation to ease during the remainder of the year as food and commodity prices ease, as favorable base effects kick in, and from the impact of recent tightening measures.

Our baseline incorporates the possibility of some modest further monetary tightening, including an additional 25bp interest hike and one more 50bp hikes in the RRR (Table 1), although our conviction on this call is somewhat weaker now given the uncertain external environment, and the authorities have recently signaled they may be on hold pending clearer indications of the health of the global economy..

Over the medium term, we continue to expect the main drivers of growth to rotate toward domestic demand, especially private consumption. Policies underlying the recently adopted new five-year plan are consistent with this rebalancing, with the policy focus on boosting household income and ensuring social well-being. Toward this end, we expect the thrust of fiscal policy to remain generally growth supportive.

Table 1
Baseline Scenario

| | 2008 | 2009 | 2010 | 2011 (F) | 2012 (F) |
|---|---|---|---|---|---|
| GDP (%, y/y) | 9.6 | 9.2 | 10.3 | 9.4 | 9.1 |
| Inflation (average, %) | 5.9 | -0.7 | 3.3 | 5.3 | 3.9 |
| Fiscal bal (% of GDP) | -0.4 | -2.8 | -2.5 | -2.0 | -1.8 |
| Current acct (% of GDP) | 9.9 | 6.1 | 4.6 | 4.5 | 4.5 |
| Policy rate (%, eop) | 5.31 | 5.31 | 5.81 | 6.81 | 7.31 |
| Exch rate (CNY/USD, eop) | 6.83 | 6.83 | 6.62 | 6.30 | 6.00 |

Source: BBVA Research

## Inflationary risks remain

Headline inflation probably peaked in July. Nevertheless, we expect inflation to remain elevated during the remainder of the third quarter, before declining to around 4.0% y/y by end-year on favorable base effects, moderating food and commodity prices, and the impact of recent tightening measures. For 2012, we expect to remain in the 4% range which, given base effects, would bring average full-year inflation to 3.9% y/y. Underlying our inflation projection are a continuation of efforts by the authorities to monitor and control the supply of credit and money in line with their targets.

## Gradual currency appreciation to continue on external inflows

On the external side, we project the current account surplus to remain large during the remainder of the year, although it should shrink as a share of GDP, from 5.2% in 2010 to 4.5% in 2011. A decline in external demand would create downside risks to our projection. However, even with a slowdown in developed economies, robust demand for exports should continue from other emerging markets, and a decline in commodity prices should help limit the import bill.

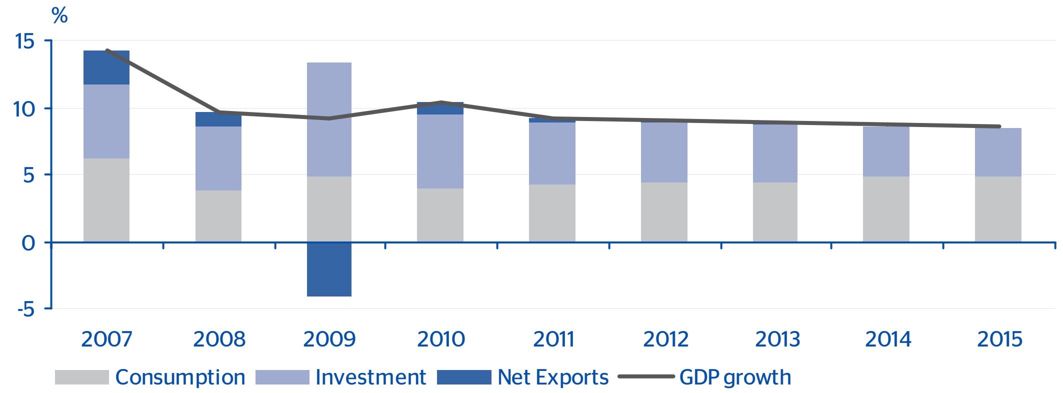
The authorities have been permitting currency appreciation in line with the annual 4-5% pace we have expected, which would bring the exchange rate to 6.30 against the USD by end-year (from about 6.42 at present). In addition to facilitating the rebalancing of the economy toward domestic demand, further appreciation should help to contain inflation through two channels: (i) directly, by lowering import prices; and (ii) indirectly, by reducing the magnitude of foreign exchange intervention, and thereby reducing domestic liquidity injections.

## Medium term outlook based on domestic demand and moderating growth

Our medium-term outlook continues to incorporate a rebalancing of growth toward domestic demand, especially private consumption. As noted previously, the rebalancing is reinforced by objectives and policy priorities adopted last March in the 12th Five-Year Development Plan (2011-2015 (see Economic Watch: New 5-year plan and budget set to support China's growth).

Key elements of the medium term outlook include an increase in household incomes from rising wage rates, and large public investment in affordable housing. In addition, we estimate that potential output will gradually decline to around 8½% by 2015 due to a gradual decline in capital accumulation from lower investment rates and a natural decline in total factor productivity.

Chart 21
A rebalancing of growth over the medium term




Source: NBS, CEIC and BBVA Research

# 4. Risks have become more balanced

While overheating risks remain, they have eased with the policy-driven moderation in growth. At the same time, downside risks have increased due to renewed uncertainties in the global environment. Given these developments, risks, which were previously tilted to overheating, have become more balanced in recent months.

To avert lingering overheating and inflationary risks, the authorities are continuing to monitor property price developments and to keep a tight rein on liquidity and stem rapid credit growth. Given risks to the external environment, we expect the authorities to take a cautious approach to further monetary tightening, and to stand ready to adopt fiscal measures if needed to bolster growth. The latter could include a step-up in the pace of construction of affordable housing and infrastructure development.

We continue to see diminishing risks of asset price bubbles given the recent steep declines in the stock market and the authorities' timely actions to discourage speculative activity in the property market. While upward price pressures remain, and are spreading now to the smaller cities, property price increases and sales transaction volumes have eased in the larger cities.

An ongoing concern for the market is the potential of a hard landing from an abrupt decline in investment. Such a development could occur if the authorities err in over-tightening through monetary policy and macro prudential measures. We view such risks as small given the gradual and well calibrated approach the authorities have been taking to policy tightening, and the strong underlying growth momentum. If the external environment were to weaken further, the authorities have ample room for fiscal policy stimulus, and could also slow the pace of monetary tightening and exchange rate appreciation.

An important source of ongoing risk for the medium-term is the high level of local government debt. As discussed in our recent Banking Watch, we the level of debt remains manageable, although resolving potential problem loans will likely require a combination of eventual bank writeoffs and central government funds. As with so many of the other important sources of risk facing the economy, the authorities appear aware of them, and are taking early action to contain the magnitude by clamping down on borrowing through LGFVs and evaluating options for addressing problem loans.

# 5. Tables

Table 1
## Macroeconomic Forecasts

| | 2008 | 2009 | 2010 | 2011 (F) | 2012 (F) |
|---|---|---|---|---|---|
| GDP (%, y/y) | 9.6 | 9.2 | 10.3 | 9.4 | 9.1 |
| Inflation (average, %) | 5.9 | -0.7 | 3.3 | 5.3 | 3.9 |
| Fiscal bal (% of GDP) | -0.4 | -2.8 | -2.5 | -2.0 | -1.8 |
| Current acct (% of GDP) | 9.9 | 6.1 | 5.2 | 4.5 | 4.5 |
| Policy rate* (%) | 5.31 | 5.31 | 5.81 | 6.81 | 7.31 |
| Exch rate* (CNY/USD) | 6.83 | 6.83 | 6.62 | 6.30 | 6.00 |

Source: BBVA Research

Table 2
## GDP

| (YoY growth rate) | 2008 | 2009 | 2010 | 2011 (F) | 2012 (F) |
|---|---|---|---|---|---|
| U.S. | 0.4 | -2.6 | 2.9 | 2.1 | 2.6 |
| EMU | 0.3 | -4.0 | 1.7 | 2.0 | 1.3 |
| Asia-Pacific | 5.6 | 3.7 | 8.0 | 6.2 | 6.7 |
| China | 9.6 | 9.2 | 10.3 | 9.4 | 9.1 |
| World | 3.0 | -0.6 | 4.9 | 4.2 | 4.4 |

Source: BBVA Research

Table 3
## CPI

| (YoY growth rate) | 2008 | 2009 | 2010 | 2011 (F) | 2012 (F) |
|---|---|---|---|---|---|
| U.S. | 3.8 | -0.3 | 1.6 | 2.8 | 2.2 |
| EMU | 3.3 | 0.3 | 1.6 | 2.7 | 1.8 |
| Asia-Pacific | 5.7 | 0.3 | 3.6 | 4.8 | 3.6 |
| China | 5.9 | -0.7 | 3.3 | 5.3 | 3.9 |
| World | 6.1 | 2.2 | 3.7 | 4.8 | 4.1 |

Source: BBVA Research

Table 4
## FX rate

| | | 2008 | 2009 | 2010 | 2011 (F) | 2012 (F) |
|---|---|---|---|---|---|---|
| U.S. | EUR/USD | 0.70 | 0.70 | 0.75 | 0.74 | 0.75 |
| EMU | USD/EUR | 1.50 | 1.40 | 1.34 | 1.36 | 1.33 |
| China | CNY/USD | 6.83 | 6.83 | 6.62 | 6.30 | 6.00 |

Source: BBVA Research

Table 5
## Policy rate

| | 2008 | 2009 | 2010 | 2011 (F) | 2012 (F) |
|---|---|---|---|---|---|
| U.S. | 0.61 | 0.25 | 0.25 | 0.25 | 1.25 |
| EMU | 2.73 | 1.00 | 1.00 | 1.75 | 2.00 |
| China | 5.31 | 5.31 | 5.81 | 6.81 | 7.31 |

Source: BBVA Research

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