BBVA | RESEARCH

Economic Outlook

China

Fourth Quarter 2011
Economic Analysis

- **China's GDP growth has moderated following efforts to avert overheating and steer the economy towards a soft landing.** Domestic demand and production remain strong, and the pace of the slowdown has been in line with a soft landing.
- **However, external headwinds have increased, and we have lowered our growth projections on weaker external demand.** Inflation is now easing, albeit from very high levels, and we anticipate a further decline in the months ahead.
- **With inflation easing and downside risks rising, the policy mix is being fine-tuned to support growth.** While our baseline anticipates no changes in interest rates, selective easing is underway which could include cuts in required reserve ratios. It is also possible that currency appreciation may slow.
- **Risks to the outlook are tilted to the downside**. The main risks are from uncertainties to the global environment, exacerbated by a rise in domestic financial fragilities. The odds of a hard landing have increased, but remain low.

Index

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Summary

Growth momentum has slowed following the authorities' policy efforts through much of the year to avert overheating and steer the economy towards a soft landing. Domestic demand and production remain reasonably strong, and the pace of the slowdown has been in line with a soft landing. Nevertheless, intensifying external headwinds from the European debt crisis and sluggish growth in the US, on top of domestic financial fragilities, have increased downside risks.

To reflect the impact of the weaker external environment we have lowered our full-year growth projections since our last quarterly update modestly for 2011 and 2012 to 9.1% and 8.6% (from 9.4% and 9.1 percent previously). Third quarter GDP growth slowed to 9.1% y/y from 9.5% in Q2, and other high frequency indicators are easing in line with a soft landing. With exports slowing, we project growth in the fourth quarter to moderate further, to 8.4% y/y, and to rise gradually during the course of 2012 as the external environment improves.

Encouragingly, inflation is now easing. For much of the year inflation has been a predominant policy concern, peaking at 6.5% y/y in July. Since then, year-on-year inflation has moderated due to declining food and commodity prices, as well as base effects. But at 5.5% y/y as of October, it remains above the authorities' 4% comfort level. As such, inflation is a constraint to monetary policy easing. We expect inflation to ease further during the remainder of the year, to around 4% y/y by end-December, and to remain in that range during 2012.

With inflation easing and downside risks on the rise, the policy mix is being fine-tuned to support growth. Through mid 2011, the monetary stance was tightened through hikes in interest rates and required reserve ratios in order to rein in credit, reduce inflation, and prevent risks of overheating. As growth moderated and risks to the external environment increased, policy tightening was put on hold in July. The authorities have recently signalled a fine tuning of policies to support growth, and selective forms of easing are now underway to relieve financial stresses and to ensure an adequate flow of credit to SMEs. In the property sector, macro prudential measures to contain the pace of price increases remain firmly in place.

Monetary easing may take the form of a relaxation of required reserve ratios for small banks, with broader cuts in the RRR possible in early 2012, and a slowing of currency appreciation. Barring a further deterioration in the external environment, we do not anticipate cuts in interest rates. We expect gradual appreciation against the US dollar to continue, at 3-5% in the coming year. However, the pace may slow to the bottom of this range, if not lower, due to external headwinds.

A number of domestic financial fragilities have increased, although risks remain manageable. In the property sector price increases are easing following implementation of macro prudential measures over the past year. In the meantime, local governments are continuing to cope with a build up in debt incurred during the 2008-09 fiscal stimulus package. Financial strains associated with an acceleration of shadow bank lending have also recently surfaced, with the authorities now taking steps to prevent liquidity shortages and spillovers to the broader economy.

Overheating has faded as the predominant policy concern, and the balance of risks is now tilted to the downside. The main risks to China's near term growth outlook are associated with uncertainties to the global environment due to the intensifying European debt crisis and sluggish growth in the US. Risks of a hard landing have increased, but remain low in our view given that underlying domestic demand remains strong and the room for policy stimulus, if needed, to cushion the impact on growth of a deterioration in the global environment.

1. Global outlook: slowdown with risks tilted to the downside

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.

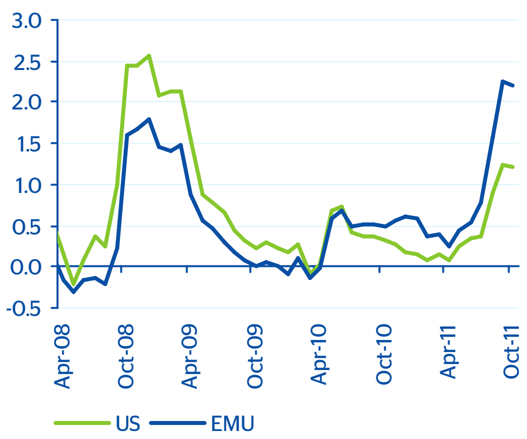
The outlook is heavily dependent on the resolution of the European debt crisis

The outlook for the global economy has worsened over the past few months, driven mainly by four factors whose influence is still being felt. First, lower than expected economic growth mainly, but not only, in developed economies. Although US growth increased in the third quarter, economic activity in Europe, which had held up in the first quarter, is now on a clear deceleration path. Second, the sovereign debt crisis in Europe has intensified and has become more systemic. While decisions announced in the October summit go in the right direction, key elements are still unresolved, especially regarding the firepower of mechanisms for providing sovereign liquidity--a leveraged European Financial Stability Fund (EFSF), the restructuring of Greek debt held by private investors, and a roadmap for advancing European governance towards a fiscal union. Third, the feedback between sovereign concerns and the health of the European financial system has intensified, with financial tensions exceeding the levels reached after the collapse of Lehman Brothers in October 2008 (Chart 1). Finally, higher global risk aversion has resulted in increased financial market volatility, spilling over to emerging market assets for the first time since 2009.

In this context, we revise downward our global growth forecasts by 0.3pp in 2011 and 2012, relative to our previous Global Economic Outlook, mostly due to lower expected growth in advanced economies (US and Europe, compensated in part by Japan), although emerging markets will also grow slightly less than previously anticipated. Thus, the global economy would grow by 3.9% in 2011 and 4.1% in 2012, supported by still-solid growth in emerging economies against lackluster performance in advanced countries (Chart 2).

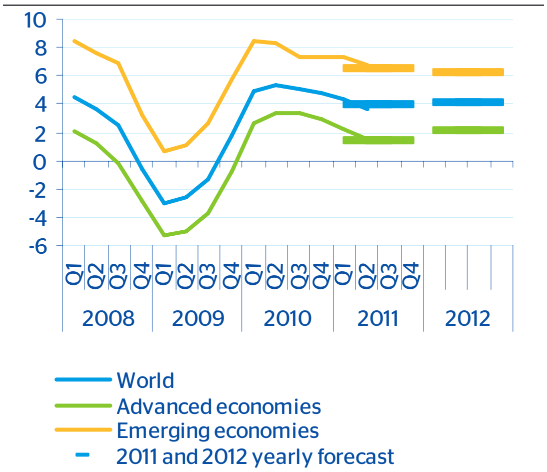
While these are still reasonably strong growth rates, risks are strongly tilted to the downside, hinging in the short term on the evolution of the sovereign-financial crisis in Europe. In particular, a quick reduction of financial stress in Europe is needed to avoid a sharp impact on growth both in Europe and in other regions through financial exposures and spillovers from global risk aversion.

Chart 1
BBVA Financial Stress Index



Source: BBVA Research

Chart 2
Global GDP growth (%yoy)



Source: IMF and BBVA Research

Europe takes steps in the right direction, but leaves key elements unresolved

In our view, there were five main points that needed to be successfully addressed in the October EU summits: (i) tackling the sustainability of Greek debt; (ii) erecting sovereign firewalls in the EMU; (iii) pushing for further reforms in peripheral countries; (iv) strengthening the banking sector; and (v) advancing euro area governance. In this regard, the recent summits have taken important steps in the right direction, but have not yet addressed most of these points definitively. First, private bondholders of Greek debt are asked to take a voluntary haircut of 50% –much higher than agreed in July– but doubts still linger about participation in the exchange and about the solvency of Greece, even with full participation. Second, the EFSF will be leveraged as an insurance mechanism and complemented with outside investors (including possibly the IMF), but it is unlikely that the specifics of the functioning of the EFSF will be in place before December. Many weeks will pass to ascertain its effectiveness, and hence the ECB will still be needed as a buyer-of-last-resort for sovereign debt, against the reticence of core European countries. Third, while it is welcome that more economic reforms are now on the agenda (notably in Italy), the recapitalization of the banking sector is being done inefficiently, posing risks of a sudden deleveraging of European banks. Also, a long-term liquidity provision mechanism is not in place yet. Finally, while there have been some advances in European governance, there is no clear roadmap to a fiscal union or Eurobonds, which in our view a key to a more credible monetary union in the long run.

As we have emphasized in the past, partial solutions may help prevent a further escalation of financial tensions, but not to reduce them to more sustainable levels. As such, the agreements reached so far still leave doubts about whether the necessary structure to prevent contagion from a Greek debt restructuring is in place. This would require a sufficiently large EFSF with the ECB as debt-buyer-of-last-resort and recapitalized banks with access to financing. Without these elements in place, markets will continue to discount the sustainability of reforms in Greece and appetite for further bailouts in core countries, increasing the probability of a downside scenario of a credit crunch and a recession in Europe, with global spillovers.[1]

Some improvements in US growth in Q3, but structural weaknesses remain

More on the positive side, growth in the US seems to have accelerated in the third quarter, at least according to preliminary estimates. This is not saying much –growth in the first two quarters was very low and the output gap is still very high. But it appears to have reduced market expectations of a double dip. Nevertheless, structural weakness remain in the US economy, as consumer and business confidence continue to be weak along with prospects of further housing market adjustments. This would imply lower resilience in the face of a possible shock from Europe. In addition, political deadlock could impede a "grand bargain" to (i) prevent an unintended fiscal contraction in the short run and (ii) push reforms towards a credible fiscal consolidation in the long run.

Emerging economies are on track for a soft landing, but with external headwinds

Emerging economies continue growing strongly, supported by the resilience of domestic demand. Still high commodity prices for Latin America and export growth in Asia –despite strong corrections in both cases– also contribute to a strong growth outlook, which is on track for a much-awaited soft landing after concerns of overheating seen earlier in the year. Renewed turmoil in Europe and the US already represent strong headwinds from financial markets in both regions –reflected in increased market volatility, depreciated exchange rates and reduced capital inflows. However, many countries also enjoy sizable buffers –stronger public finances and better macroeconomic management than in the past– and are well positioned to introduce policy stimulus to counter weaker external demand. Overall, a more negative external environment has switched the focus in emerging countries from overheating to downside risks and, increasingly, the possible need for policy support.

[1] See "Channels of global contagion in the event of a disorderly default in Europe", Box 1 in the July 2011 Global Economic Outlook for an outline of the channels of transmission and global impact of a disorderly default in Europe.

2. Moderating to a soft landing

After the authorities' efforts through much of the year to avert overheating and steer the economy towards a soft landing, growth momentum has slowed. Domestic demand and production remain reasonably strong, and the pace of the slowdown has been in line with a soft landing. Nevertheless, intensifying external headwinds and the revelation of domestic financial fragilities have reinforced fears among some analysts of a hard landing, which we still regard as a low probability.

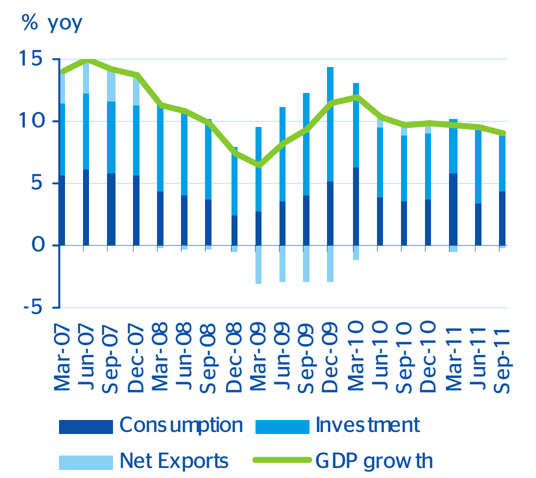
To reflect the impact of the weaker external environment we have lowered our full-year growth projections for 2011 and 2012 to 9.1% and 8.6%, respectively (from 9.4% and 9.1 percent previously). The revisions are relatively modest, given our view, as noted above, that the economy is on track for a soft landing. Encouragingly, inflation is also now easing. That said, downside risks have increased, causing the authorities to put further tightening measures on hold and, indeed, to signal their readiness now to "fine tune" policies to support growth, particularly in the event that downside risks to the global environment materialize.

Activity indicators moderating on policy tightening and external headwinds

Third quarter GDP growth slowed to 9.1% y/y from 9.5% y/y in Q2 due to weakening investment and net exports (Chart 3). On a q/q basis (seasonally adjusted, non-annualized), our estimates suggest that growth moderated to 2.0% in Q3 from 2.3% in Q2 (official figures on quarterly growth also show a slight decline in Q3 to 2.3% from 2.4% in Q2). GDP trends have been consistent with our real activity indicator (Chart 4). Weaker investment (which contributed 5.0 percentage points to GDP growth ytd in Q3) was due to policy-induced credit tightening and lower public infrastructure spending (such as on railways). Meanwhile, the contribution of consumption increased to 4.5 percentage points ytd reflecting robust domestic demand, while net exports made a small negative contribution due to weaker external demand.

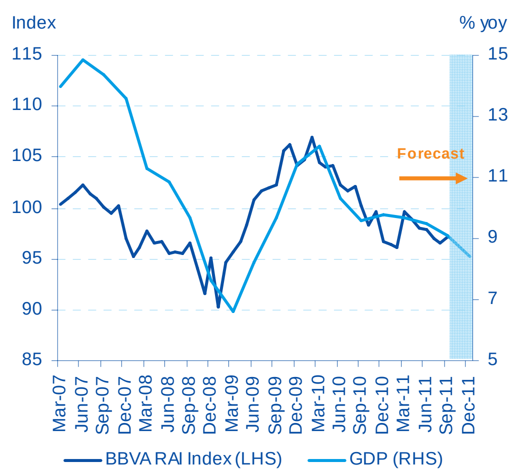
Recent high frequency indicators are broadly consistent with the GDP trends. In particular, the Purchasing Manufacturers Index (PMI) has been moderating, but has hovered above the critical 50+ expansion zone (Chart 5). Industrial output has also remained strong, broadly in line with expectations. On the demand side, retail and automobile sales growth has remained steady (Chart 6) and urban fixed asset investment (YTD) has also held up at 24.9% y/y, although it is on a declining trend. Less encouraging are recent export growth trends: after remaining strong for much of the year, exports began to show a significant weakening trend in September, due to weaker demand from Europe, the US, and Japan.

Chart 3
GDP growth driven by robust domestic demand



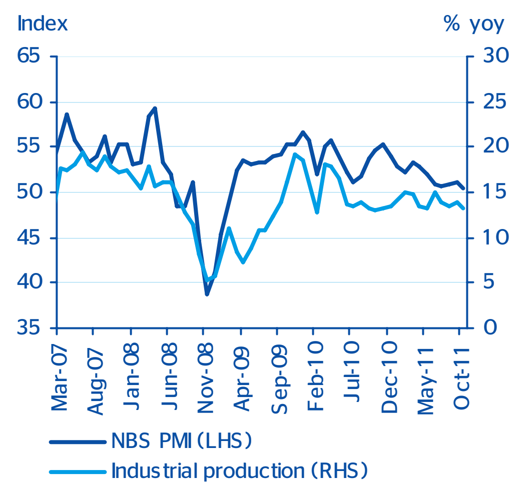
Source: CEIC and BBVA Research

Chart 4
Gradually moderating RAI



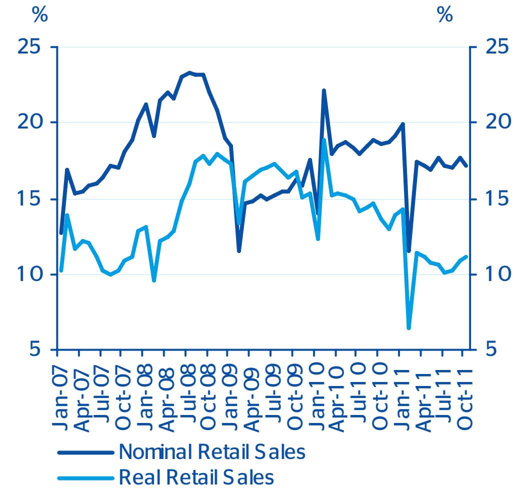
Source: CEIC and BBVA Research estimates

Chart 5
Moderating PMI points to a healthy slowdown



Source: CEIC and BBVA Research

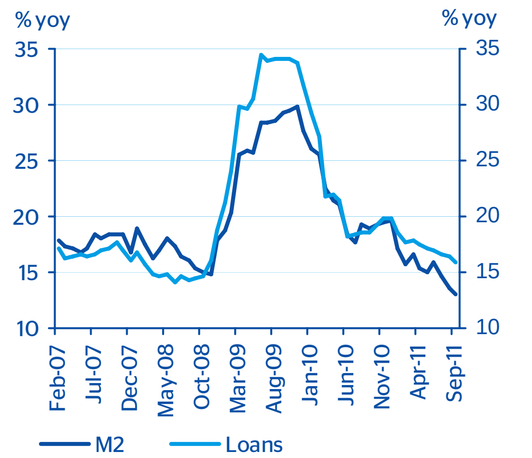
Chart 6
Retail sales remained robust



Source: CEIC and BBVA Research

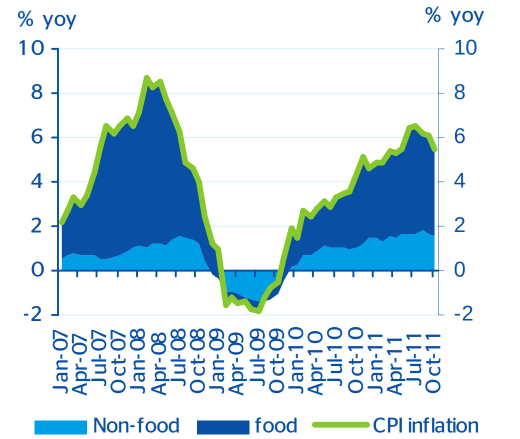
On the monetary front, credit and M2 growth have continued to slow, broadly in line with the authorities' targets (Chart 7). M2 growth unexpectedly slipped in Q3, quite likely due to a shift by depositors away from banks given prevailing negative real deposit rates, toward higher yielding "wealth management" products which are not included in M2. New loans in September decelerated, implying year-on-year credit growth of 15.9%, slightly down from 16.9% in June. On a cumulative basis, new loans for the first three quarters of the year reached RMB 5.7 trillion, broadly in line with what we believe to be the authorities' (unannounced) full-year target of RMB 7.0-7.5 trillion.

Chart 7
Credit and M2 growth have moderated



Source: CEIC and BBVA Research

Chart 8
Inflation has peaked



Source: CEIC and BBVA Research

Policy challenges

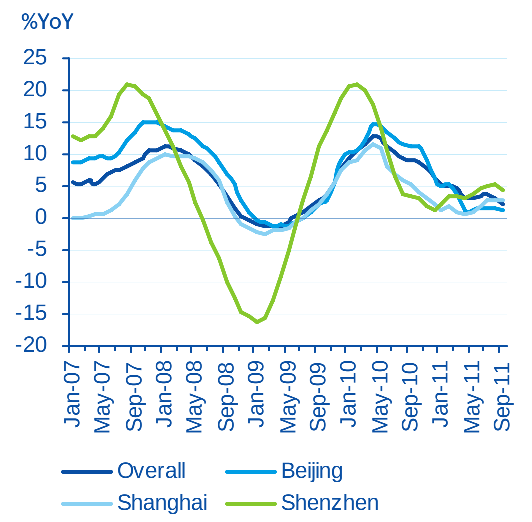
Through mid 2011, the policy stance was being tightened through hikes in interest rates and required reserve ratios in order to rein in credit, reduce inflation, and prevent risks of overheating. However, with growth slowing due to weaker external demand and downside risks to growth rising, policy tightening has been on pause since July. Indeed, selective forms of policy easing are underway to relieve financial stresses and ensure an adequate flow of credit to SMEs. In the property sector, macro prudential measures to contain the pace of price increases remain firmly in place.

Moderating but still elevated inflation

Inflation has moderated but is still elevated in year-on-year terms, and above the authorities' 4% comfort level. As such, inflation is a constraint to monetary policy easing. After peaking at 6.5% y/y in July, consumer price inflation slowed to 5.5% y/y in October (Chart 8). The moderation has mainly been driven by an easing of food prices as well as base effects. Sequentially, inflation has been moderating, to 0.2% m/m (seasonally adjusted) in October, down from 0.8% m/m in June when inflation momentum was at its peak.

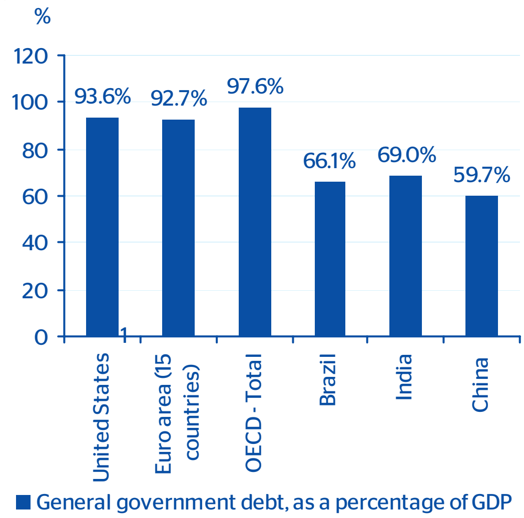
By component, food prices remain a dominant driver of inflation. After peaking at 14.8% y/y in July, food prices have moderated for three consecutive months, to 11.9% y/y in October; in large part, the decline is to supply-driven declines in pork prices. Driven by declining commodity prices, producer price inflation has also declined after peaking at 7.5% y/y in July, to just 5.0% y/y in October. On current trends, inflation appears set to decline further, to around 4% by the end-December.

Chart 9
Property prices moderated gradually



Source: NBS, CEIC and BBVA Research

Chart 10
General government debt is relatively low



Source: PBoC and BBVA Research estimates

Walking a fine line: restraining property prices while avoiding a hard-landing

As noted in our annual Real Estate Outlook[2], residential property price increases have been moderating gradually under the influence of measures to tighten credit and to restrict speculative home purchases. At a national level, on the basis of official NBS data we estimate that the pace of price increases has continued to moderate, from 3.2% y/y in Q2 to 3.0% y/y in Q3, adding to a broader moderating trend since last year (Chart 9). In monthly terms, prices at a national level have been flat since August. However, 17 cities reported price declines in September, and a private sector index (the China Real Estate Index System) covering 100 cities shows an overall monthly declines for the past two months, of -0.23% in October.

With the global economic worsening, and with tighter property measures firmly in place, real estate developers have reportedly been encountering increasing financing difficulties. This has increased risks of a sharper price decline and has raised the profile of the sector as a possible contributor to an economic hard landing.[3] Nevertheless, the authorities are taking steps to contain such problems and to prevent them from spreading, including through the selective easing of restrictions on bank financing to ensure an adequate flow of credit. At the same time, however, they have repeatedly resisted pressure to loosen broader tightening measures in the property sector, consistent with their ongoing efforts to reduce the risk of asset price bubbles and ensure housing affordability. The latter is being aided by a step up in the authorities' ambitious social housing construction program.

[2] "China Real Estate Outlook" July 11, 2011.
[3] As an example, the city of Wenzhou, known for its thriving private sector and reliance on informal financing channels, has recently reported wide-spread bankruptcy cases due to tighter credit conditions. At the directive of the central government, local authorities in Wenzhou have provided policy support to ease financial difficulties to prevent the crisis from spreading.

Addressing local government debt

One of the legacies of the massive, infrastructure-led stimulus program of 2008-09 was a build-up of local government debt through borrowing from banks by local government financing vehicles (LGFVs). We estimate that such debt stands at RMB 14.4 trillion (USD 2.2 trillion) (see our report on Local Government Debt[4]). Adding these obligations (36.0% of GDP) to the stock of central government debt (23.0% of GDP) would bring total government debt to a level of 59% of GDP (Chart 10), a large figure but still manageable given projected growth and fiscal revenues.

The authorities appear well aware of the contingent liabilities posed by the buildup of local government debt and have imposed restrictions on the use of local government financing vehicles and, more recently, have allowed certain local governments to issue bonds on a pilot basis to facilitate refinancing. At the end of the day, in our view a clean-up of local government debt is likely to require some combination of a bailout by the central government and bank write-offs over the next several years. The buildup in local government debt is also likely to act as an important constraint on the size and composition of future fiscal stimulus measures, if needed, to counteract headwinds from the slowing global economy.

Limiting risks posed by shadow bank lending

The latest financial fragility to come to light regards lending through the shadow banking system. The system can be divided into two parts: off-balance-sheet lending of financial institutions (banks and trust companies) and private lending activities between non-financial enterprises or individuals. The former can take the form of trust loans (asset management products), entrusted loans (company-to-company loans) and bank acceptances (which can be used as a means of payment).

China's shadow banking system has a long history but lending recently accelerated as the authorities clamped down on lending in the formal banking system (Chart 11). In this way, the growth of lending through the shadow banking system can be viewed as a way of circumventing regulations on capital requirements and lending quotas.

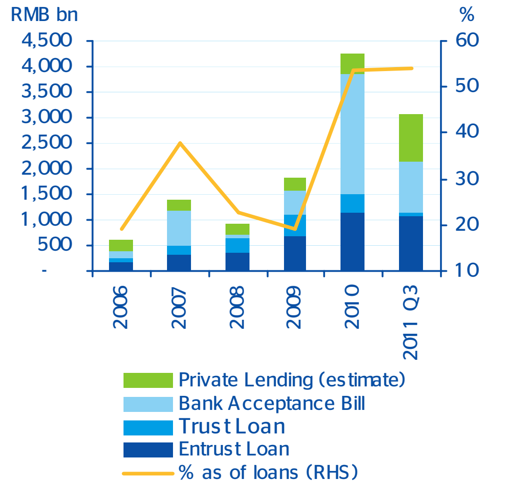
To eliminate such loopholes, the authorities have begun implementing measures including requiring banks to bring their off-balance sheet items on balance sheet, and by imposing capital requirements on trust companies. Further efforts will be needed, including enhancing enforcement of these new regulations. Given the overall magnitude of these loans, we believe that such lending does not pose systemic risks. However, to the extent that much of the shadow bank lending is to the property sector (around 20% for trust loans, based on Trust Company Association data), this concentration could lead to financial sector vulnerabilities in the event of a downward correction in property prices. The authorities will also need to monitor liquidity conditions, to ensure that firms have adequate access to refinancing, and that the siphoning of deposits from banks to higher yielding wealth management products does not lead to financial instability.

Fine-tuning the policy mix

As the balance of risks shifted in the third quarter from overheating to weakening external demand, the authorities began to signal some fine tuning of the policy stance and put further monetary tightening on hold. The pause came after a series of interest rate hikes and increases in the required reserve ratio (RRR), to a historic high of 21.5% for the large commercial banks (Charts 13 and 14). The measures resulted in tighter liquidity conditions, as reflected in more volatile inter-bank repo rates (Chart 12). Financial markets underperformed due to the tightening measures, with downtrends exacerbated by higher global risk aversion (Chart 15 and 16).

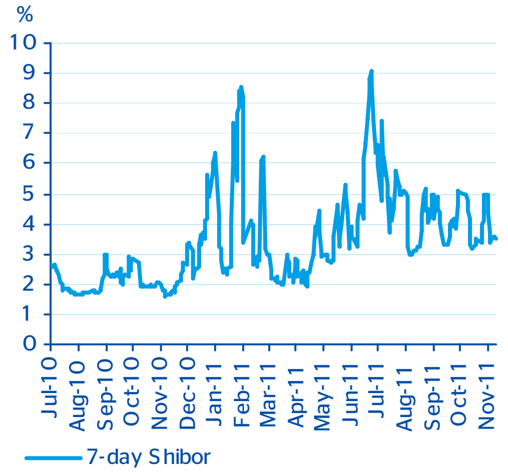
[4] "China Banking Watch: Who will pay the bill for local governments' fiscal stimulus?" July 21, 2011

Chart 11
Shadow bank lending has accelerated



Source: PBoC and BBVA Research estimates

Chart 12
Inter-bank rates have increased

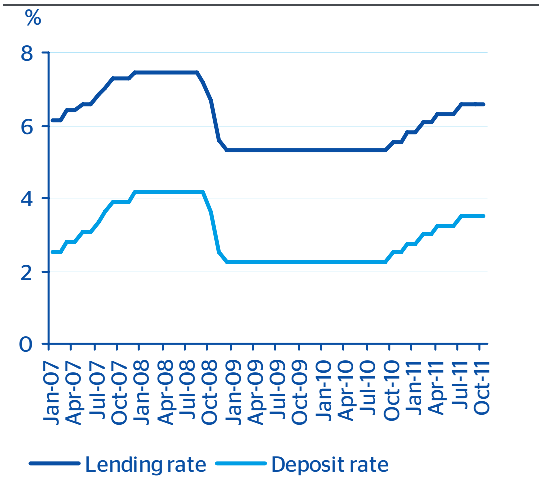


Source: Wind and BBVA Research

With inflation moderating and downside risks increasing due to the unstable external outlook, the authorities have again signalled some fine tuning of policies. In particular, Premier Wen Jiabao signalled in an October speech that the government stands ready to "fine-tune" economic policies as needed to support growth. Consistent with this, the China Banking Regulatory Commission (CBRC) has recently unveiled a set of policy initiatives to encourage commercial banks to extend credit to SMEs by relaxing capital requirements on bank loans issued to those targeted enterprises. Fiscal measures may also be forthcoming.

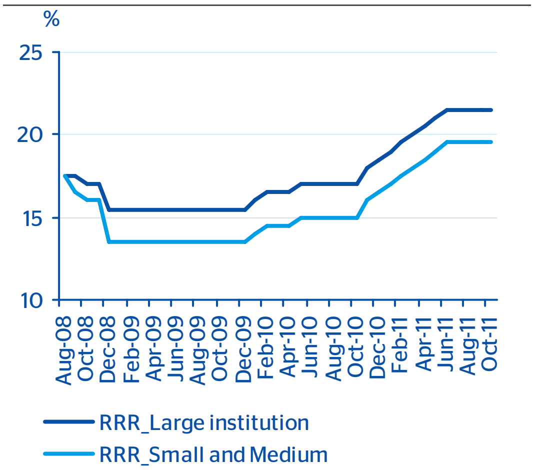
The thrust of public expenditure in 2011 has been the massive affordable housing program of 10 million units targeted for construction during the year, equivalent to RMB 1.3 trillion RMB, about 2.8% of GDP. After lagging behind schedule, the pace of construction picked up in Q3 as the central government eased financing constraints through increased transfers to local governments. By the end of September, 9.86 million units were under construction, closing in on completion of the full-year construction target. Spending on other areas of infrastructure have slowed, especially transport following a series of accidents on the newly operated high-speed railways (Chart 17). Nevertheless, further railway development remains a major component of fiscal support.

Chart 13
Interest rate hikes ended in July ...



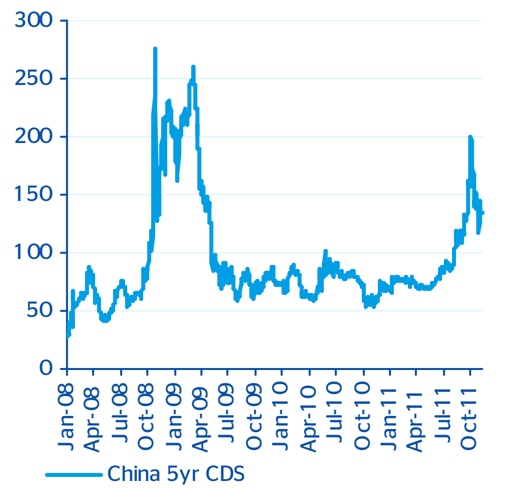
Source: CEIC and BBVA Research

Chart 14
...with no further hikes in required reserve ratios



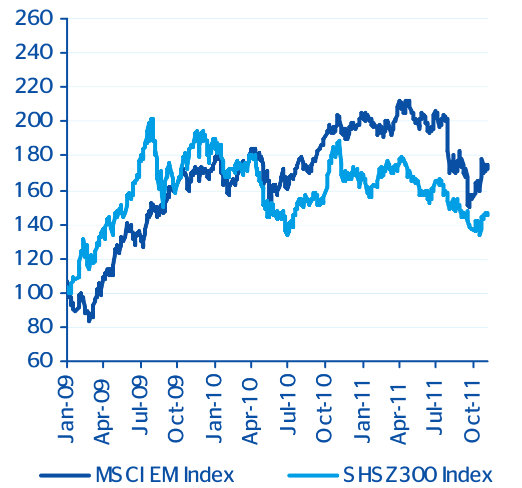
Source: CEIC and BBVA Research

Chart 15
China's CDS prices have risen on global risk aversion...



Source: Bloomberg and BBVA Research

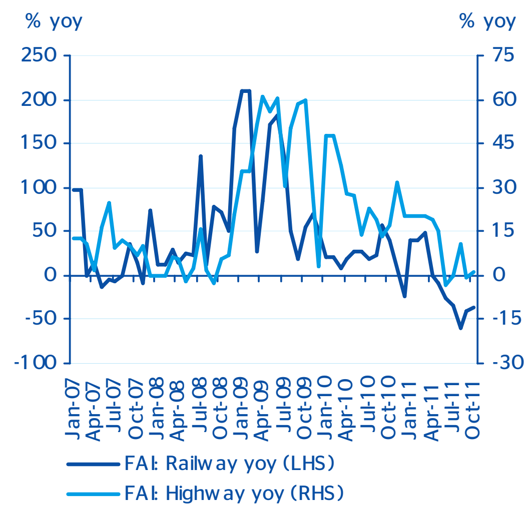
Chart 16
...and the stock market has underperformed 2009/01/05 = 100



Source: Bloomberg and BBVA Research

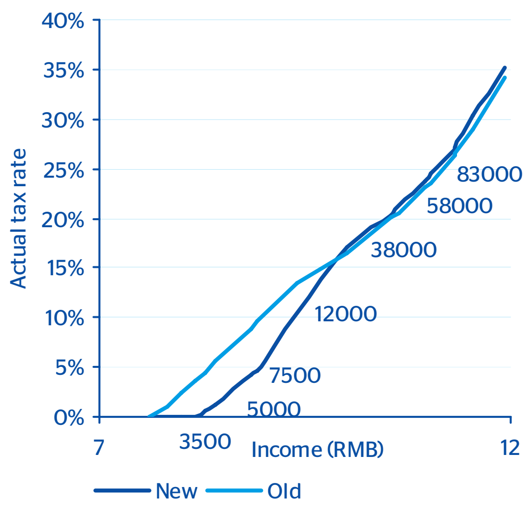
Fiscal policy initiatives are also aimed at boosting private consumption. One such policy, implemented on September 1, aims to raise the taxable income threshold from RMB 2,000 per month up to RMB 3,500, along with a reduction in the number of brackets from 9 to 7 (Chart 18). The changes result in a more progressive tax structure, intended to promote income equality and also stimulate overall consumption.

Chart 17
Spending on transport infrastructure has slowed



Source: CEIC and BBVA Research

Chart 18
Tax cuts for lower income payers result in a more progressive structure



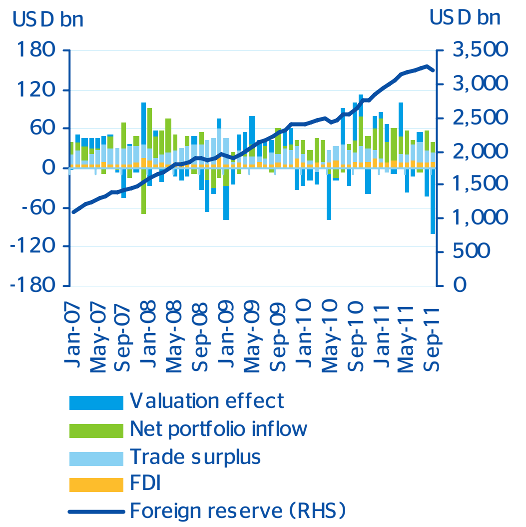
Source: CEIC and BBVA Research

Currency appreciation is continuing at a gradual pace

Currency appreciation against the US dollar has continued at the 4-5% annual pace, in line with our expectations. However, with inflows moderating in Q3, as seen in a levelling off of reserves accumulation (Chart 19) and risks to the global outlook rising, expectations of appreciation have moderated and have even turned negative, with the offshore CNH trading for the first time at a more depreciated level than onshore since September (Chart 21).

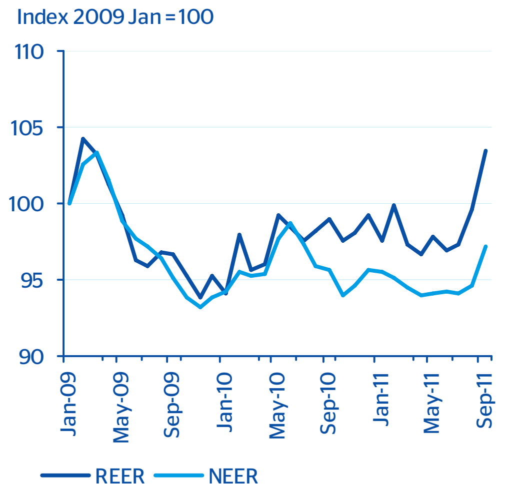
The gradual appreciation against the US dollar since mid-2010 has not been enough, however, to result in an appreciation in trade-weighted, or nominal effective terms. The real effective exchange rate, however, has seen some appreciation due to China's relatively high inflation (Chart 20).

Chart 19
Portfolio inflows softened on adverse external market conditions



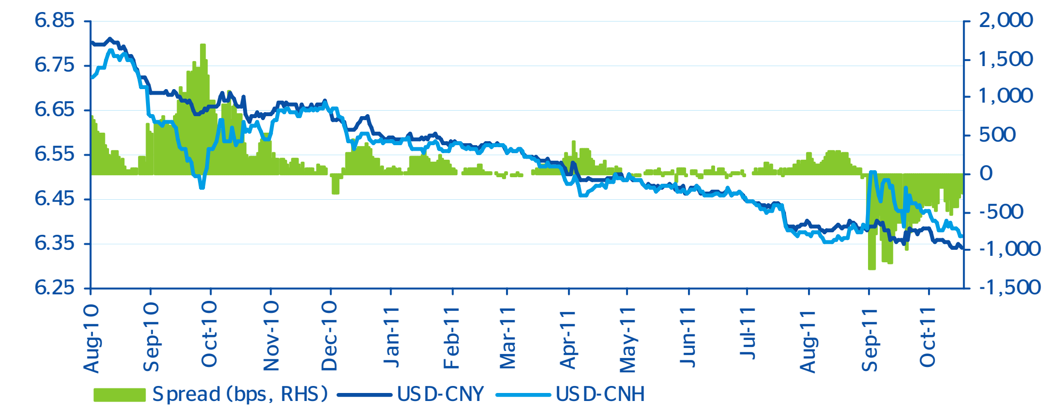
Source: CEIC and BBVA Research

Chart 20
Appreciation against the USD has translated into less movement in effective terms



Source: BIS, CEIC and BBVA Research

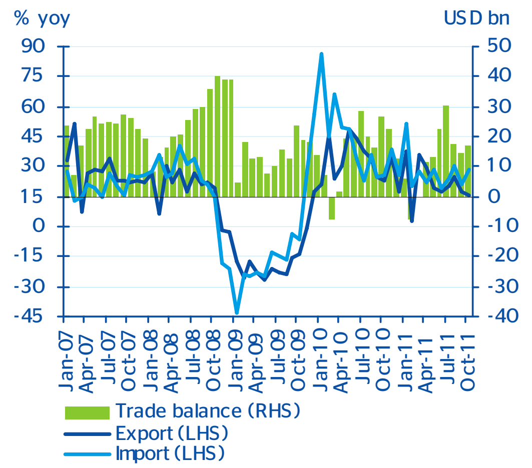
Chart 21
CNH trading at a more depreciated level than CNY



Source: Bloomberg and BBVA Research

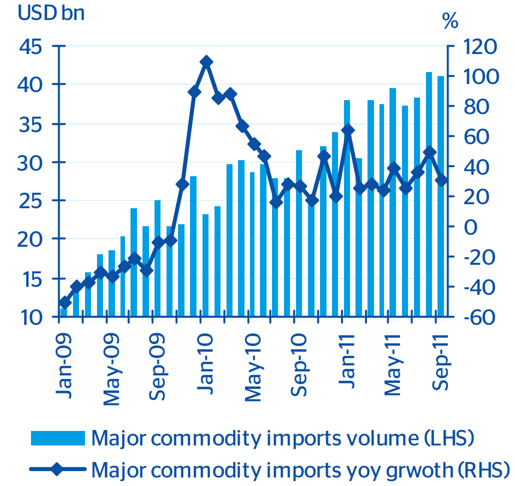
The trade balance remains in substantial surplus (Chart 22). While exports and imports remained robust through Q3, they have weakened in recent months. For example, export growth slowed to to 15.9% y/yin October from an average of 20.6% in Q3 due to weakening external demand, especially from the EU, China's largest export market (20% of total exports). On strong domestic demand, imports have been robust, rising by 28.7% y/y in October. That said, commodity imports, an increasingly important driver of global price trends, have been weaker (Chart 23), although volume demand appears robust, and should remain so with support from further infrastructure investment.

Chart 22
The trade balance remains in surplus



Source: CEIC and BBVA Research

Chart 23
Commodity imports have slowed on falling prices



Source: CEIC and BBVA Research

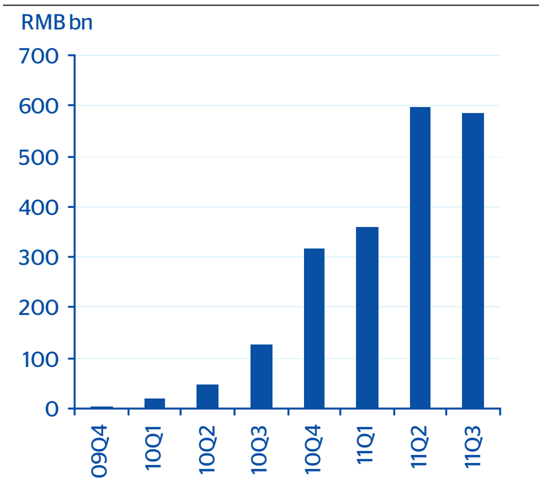
Outward FDI continues to grow

Recent data show that China's outward FDI continued to grow strongly in 2011 (see Economic Watch[5]). In the first three quarters of 2011 non-financial outward FDI, which accounted for 91.4% of total OFDI, rose by 12.5% y/y, reaching 40.8 billion USD. The rise in OFDI reflects a continuation of the "Go-out" policy, whose official motivation is to secure energy resources, and to open access for Chinese companies abroad. It may also reflect efforts to ease pressure on China's rising foreign exchange levels and to extend the country's international influence.

RMB trade settlement and internationalization continue despite headwinds

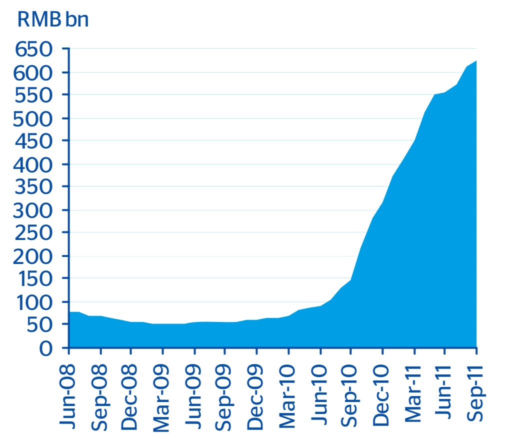
Progress in RMB internationalization is continuing, with preliminary estimates from the PBoC showing that cross border trade settlement in the first three quarters reached 1540.98 billion yuan, or 8.9% of total trade (Chart 24). In July 2011 steps were taken to allow foreign enterprises to remit offshore RMB to the Mainland in the form of FDI on a more regular basis, which is key to enhancing the attractiveness of offshore RMB. In the meantime, RMB deposits in Hong Kong, one measure of the pace of RMB internationalization, have risen to RMB 622 billion, an increase of 12.4% over the previous quarter (Chart 25). Despite this progress, RMB internationalization faces headwinds. The trade volume settled in RMB in Q3 flattened compared with Q2, as expectations of currency appreciation weakened amidst the increasingly uncertain global outlook. This reveals the speculative nature of much of the RMB-denominated deposits.

Chart 24
Value of RMB settlements flatted in Q3



Source: Based on reported PBoC data and BBVA Research

Chart 25
RMB deposit in Hong Kong have increased



Source: HKMA, CEIC and BBVA Research

[5] "China Economic Watch: "China's outward FDI expands" October 12, 2011

3. A soft landing with supportive policy

Although downside risks have risen due to the deterioration in the global outlook, we continue to believe the economy is on track for a soft landing. Importantly, domestic demand remains buoyant, and there is enough room for policy stimulus if needed to cushion the effect of weaker external demand.

Modest downward revision to growth outlook

In view of the weaker external outlook, we are revising our 2011 and 2012 projections downward, to 9.1% and 8.6%, respectively in 2011 and 2012 (from 9.4% and 9.1% previously). Our 2011 full-year projection is based on a further moderation in GDP growth to 8.4% y/y, from the outturn of 9.1% y/y in Q3. Under our baseline, we anticipate a gradual upward trend through 2012 as the policy mix becomes more growth supportive and as the global economy improves.

Inflation expected to ease

We expect inflation to ease to 4% y/y by the end of the year, on easing food and commodity prices, as well as favourable base effects. While the end-year projection is broadly unchanged from our previous Outlook, we are raising our full-year (average) inflation projection to 5.3% (from 4.9% previously) due to the higher-than-expected outturns in recent months. We expect inflation to remain broadly flat in 2012, resulting in an outturn of 3.9% (average), in line with our previous forecasts.

Table 1
Baseline Scenario

	2008	2009	2010	2011 (F)	2012 (F)
GDP (%, y/y)	9.6	9.2	10.4	9.1	8.6
Inflation (average, %)	5.9	-0.7	3.3	5.3	3.9
Fiscal bal (% of GDP)	-0.4	-2.8	-2.5	-1.5	-1.8
Current acct (% of GDP)	9.1	5.2	5.2	4.4	4.5
Policy rate (%, eop)	5.31	5.31	5.81	6.56	6.81
Exch rate (CNY/USD, eop)	6.84	6.83	6.61	6.30	6.00

Source: BBVA Research

Policies to be fine-tuned to support growth

Our baseline incorporates no significant changes to monetary policy during the remainder of the year, beyond selective measures to ensure adequate credit flow to SMEs, which could include a reduction in required reserve ratios of small banks. As inflation eases, we would expect lower reserve requirements to be applied to larger banks as well, with 100 bps cuts in the RRR in early 2012 to expand liquidity to support domestic demand in the face of external headwinds. Thereafter, assuming an improvement in the external environment and that domestic growth picks up during the year as in our baseline, we would anticipate the cycle of interest rate increases to resume in the fourth quarter of 2012, with a 25bp hike, to prevent a resumption of inflation.

Gradual currency appreciation may slow

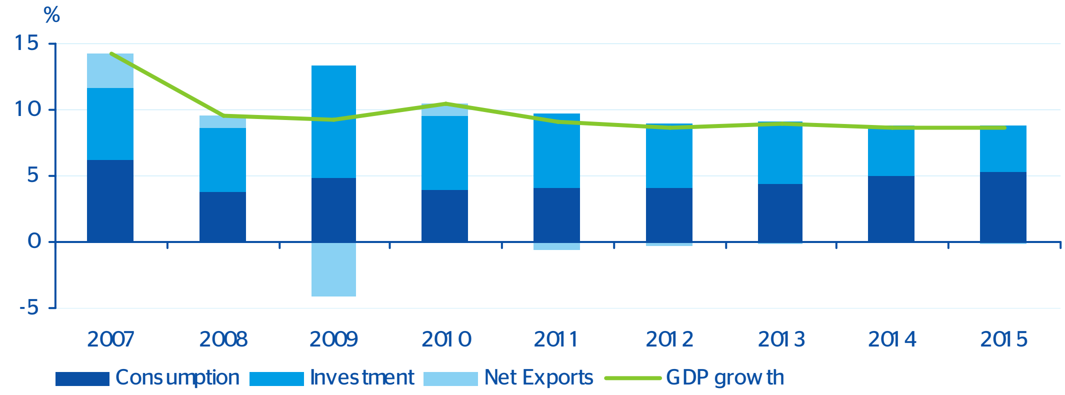
On the external side, we project the current account surplus to narrow to around 4.5% of GDP in 2011 and 2012 as strong domestic demand results in robust import growth. Though external demand is expected to be weak in developed economies, further strong growth from emerging market trading partners is expected to sustain export growth at reasonable levels.

The pace of currency appreciation so far in 2011 has been consistent with our RMB projection of 6.30 against the USD by end-year (from about 6.35 at present). At this pace (4-5%), the currency would appreciation to around 6.00 against the USD by the end of 2012. However, downside risks to the global outlook mean that currency appreciation may slow to around 3%, or even come to a halt in the event of a sharp deterioration in the global environment, as was the case post-Lehman.

Medium term outlook based on domestic demand and moderating growth

Over the medium term, we continue to expect the main drivers of growth to rotate gradually toward domestic demand, especially private consumption (Chart 26). This rebalancing, however, will be very gradual and will need support from the policies underlying China's twelfth five-year plan, whose focus is on boosting household income and ensuring social well-being (see Economic Watch[6]). Key elements of the medium term outlook include an increase in household incomes from rising wage rates, and large public investment in affordable housing.

Chart 26
A rebalancing of growth over the medium term



Source: NBS, CEIC and BBVA Research

[6] "China Economic Watch: New 5-year plan and budget set to support China's growth" March 25, 2011

4. Risks are tilted to the downside

Overheating risks, which were the predominant concern earlier this year, have faded on moderating growth trends and uncertainties to the global outlook. The balance of risks is now tilted to the downside. As such, the possibility of a hard landing, popularly defined as growth below 6% for two or more quarters, has increased, although we continue to believe that such risks remain manageable.

While overheating risks have diminished, the authorities are continuing to deal with the lingering effects of the rapid growth of 2010 and 2011, namely high inflation and property price increases. Inflation is now easing, although it is still above comfort levels, and as such continues to be a constraint to monetary policy easing. We expect the authorities to move cautiously on that front. Property price increases have also diminished but, appropriately, the authorities continue to monitor developments and are showing no signs of relaxing their tightening measures.

The risks of a sharper decline in the property market and closely related shadow banking industry have increased. An abrupt downward adjustment in property prices could cause financial strains on developers, resulting in rising bank NPLs and spillovers to other sectors of the economy. However, we view such risks as low, given our assessment of only modest overvaluation in prices. Moreover, the slowdown in price increases has been policy-induced, meaning that the authorities can fine tune their tightening measures if downside risks in the property market begin to materialize.

Another source of risk is the high level of contingent liabilities to the central government, especially relating to local government debt. We continue to believe the level of such debt is manageable, although resolving potential problem loans will likely require a combination of eventual bank writeoffs and central government funds.

The predominant risk to the growth outlook comes from the external environment. Weaker external demand is already causing export growth to decline, and rising financial tensions in Europe are having a chilling effect on risk appetite and investment. Although the relatively closed nature of the capital account means that China's banking system and domestic capital markets are shielded from the direct fallout of such developments, ripple effects through tighter financing conditions are likely, as has already been seen through the falling stock market and a decline in IPOs of Chinese companies.

If downside risks materialize, however, there would be room for policy stimulus to sustain growth and prevent a hard-landing. While the recent buildup of local government debt limits the room for fiscal manoeuvre somewhat, and we would not expect a fiscal package of the magnitude unleashed post-Lehman, by our calculations there would still be sufficient room, together with support from monetary easing, to maintain growth at above the 7% target set out in the 5-year development plan. This would entail additional spending of RMB 1 trillion spread over 2012-13. In such a case, the 2012 fiscal deficit would rise by 1% of GDP, to 2.8% of GDP, a level that would be financeable through new debt issuance.

The composition of a stimulus package would likely be tilted more toward increasing household incomes and boosting private consumption, along with support measures for SMEs. Specific initiatives could take the form of selective tax cuts for SMEs, additional consumption subsidies, and a speeding up of the ongoing public housing program. In addition, on the monetary side, steeper cuts in required reserve ratios and interest rates would provide further support to growth in a downside scenario.

On the political front, the coming year will see a leadership change, with new members of the Standing Committee of the Political Bureau, the key decision-making body, put in place in October. In March 2013, a new President and Premier will be selected, replacing the incumbent leadership of President Hu Jintao and Premier Wen Jiabao. All else equal, the forthcoming changes could make the authorities more likely to use stimulus measures to support growth and maintain stability in 2012 in advance of the leadership transition.

5. Tables

Table 1

Macroeconomic Forecasts

	2008	2009	2010	2011 (F)	2012 (F)
GDP (%, y/y)	9.6	9.2	10.4	9.1	8.6
Inflation (average, %)	5.9	-0.7	3.3	5.3	3.9
Fiscal bal (% of GDP)	-0.4	-2.8	-2.5	-1.5	-1.8
Current acct (% of GDP)	9.1	5.2	5.2	4.4	4.5
Policy rate (%, eop)	5.31	5.31	5.81	6.56	6.81
Exch rate (CNY/USD, eop)	6.84	6.83	6.61	6.30	6.00

Source: BBVA Research

Table 2

GDP

(YoY growth rate)	2008	2009	2010	2011 (F)	2012 (F)
U.S.	-0.3	-3.5	3.0	1.6	2.3
EMU	0.3	-4.2	1.7	1.7	1.0
Asia-Pacific	5.2	4.1	8.0	5.9	6.4
China	9.6	9.2	10.4	9.1	8.6
World	2.8	-0.6	5.1	3.9	4.1

Source: BBVA Research

Table 3

CPI

(YoY growth rate)	2008	2009	2010	2011 (F)	2012 (F)
U.S.	3.8	-0.3	1.6	2.9	2.2
EMU	3.3	0.3	1.6	2.6	1.6
Asia-Pacific	5.7	0.3	2.7	4.8	3.7
China	5.9	-0.7	3.3	5.3	3.9
World	6.1	2.2	3.5	5.0	4.0

Source: BBVA Research

Table 4

FX rate (End of period)

		2008	2009	2010	2011 (F)	2012 (F)
U.S.	EUR/USD	0.70	0.70	0.75	0.71	0.74
EMU	USD/EUR	1.50	1.40	1.34	1.40	1.35
China	CNY/USD	6.84	6.83	6.61	6.30	6.00

Source: BBVA Research

Table 5

Policy rate (End of period)

	2008	2009	2010	2011 (F)	2012 (F)
U.S.	0.61	0.25	0.25	0.25	0.25
EMU	2.73	1.00	1.00	1.50	1.50
China	5.31	5.31	5.81	6.56	6.81

Source: BBVA Research

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This report has been produced by the Asia Unit of the Emerging Markets team

Chief Economist for Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

Zhigang Li
zhigang.li@bbva.com.hk

Le Xia
xia.le@bbva.com.hk

Fielding Chen
fielding.chen@bbva.com.hk

George Xu
George.xu@bbva.com.hk

With the contribution of:
Markets Analysis
Richard Li
richard.li@bbva.com.hk

BBVA Research

Group Chief Economist
Jorge Sicilia

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis
Álvaro Ortiz Vidal-Abarca
alvaro.ortiz@bbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

India
Sumedh Deorukhkar
deorukhkar@grupobbva.com

Latam Coordination
Joaquín Vial
jvial@bbvaprovida.cl

Argentina
Gloria Sorensen
gsorensen@bancofrances.com.ar

Chile
Alejandro Puente
apuente@grupobbva.cl

Colombia
Juana Téllez
juana.tellez@bbva.com.

Peru
Hugo Perea
hperea@grupobbva.com.pe

Venezuela
Oswaldo López
oswaldo_lopez@provincial.com

Mexico
Adolfo Albo
a.albo@bbva.bancomer.com

Macroeconomic Analysis Mexico
Julián Cubero
juan.cubero@bbva.bancomer.com

Developed Economies:
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Financial Systems & Regulation:
Santiago Fernández de Lis
sfernandezdelis@grupobbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Pensions
David Tuesta
david.tuesta@bbva.com

Regulatin and Public Policy
María Abascal
maria.abascal@bbva.com

Global Areas:

Fianacial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Economic Scenarios
Juan Ruiz
juan.ruiz@bbva.com

Innovation & Processes
Clara Barrabés
clara.barrabes@bbva.com

Market & Client Strategy:
Antonio Pulido
ant.pulido@grupobbva.com

Equity Global
Ana Munera
ana.munera@grupobbva.com

Global Credit
Javier Serna
Javier.Serna@bbvauk.com

Global Interest Rates, FX and Commodities
Luis Enrique Rodríguez
luisen.rodriguez@grupobbva.com

Contact details

BBVA Research
43/F, Two International Finance Centre
8 Finance Street
Central, Hong Kong
Tel. + 2582 3111
Fax. +852-2587-9717
research.emergingmarkets@bbva.com.hk

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