

China Economic Outlook

Averting a hard landing

Hong Kong General Chamber of Commerce

Hong Kong
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China Economic Outlook

- China's economy continues to slow under the influence of weaker external demand.
- The shift to a looser policy stance is being facilitated by a decline in inflation.
- Risks remain tilted to the downside.

Available at: www.bbvarsearch.com

The image shows the cover of a research report titled 'Economic Outlook China' by BBVA Research. The cover is white with a blue border. At the top left, the BBVA logo and the word 'RESEARCH' are displayed. The title 'Economic Outlook' is in a large blue font, with 'China' below it in a smaller blue font. On the left side, below the title, it says 'First Quarter 2012 Economic Analysis'. On the right side, there is a list of four bullet points summarizing the report's key findings and risks. The bottom of the cover features a decorative graphic of horizontal bars in various shades of blue.

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Economic Outlook

China

First Quarter 2012
Economic Analysis

- **The global economy is slowing down, and will only rebound in the second half of 2012** as financial tensions in Europe begin to ease. Risks are tilted to the downside, however, given the challenges that remain in resolving the European crisis.
- **China's economy continues to slow under the influence of weaker external demand.** However, growth is being supported by robust domestic demand and a gradual loosening of the policy stance. As such, we are lowering our growth projections only modestly, to 8.3% and 8.7% in 2012-13.
- **The shift to a looser policy stance is being facilitated by a decline in inflation.** We anticipate further reductions in the RRR, along with interest rate cuts if the external environment weakens. Fiscal support will consist of subsidies to households and construction of affordable housing.
- **Risks remain tilted to the downside.** The main risk is from the uncertain global environment. Domestic financial fragilities are being addressed, but bear watching. While a hard landing cannot be ruled out, we continue to believe the risk is low, especially given room for additional stimulus to sustain growth.

Overview

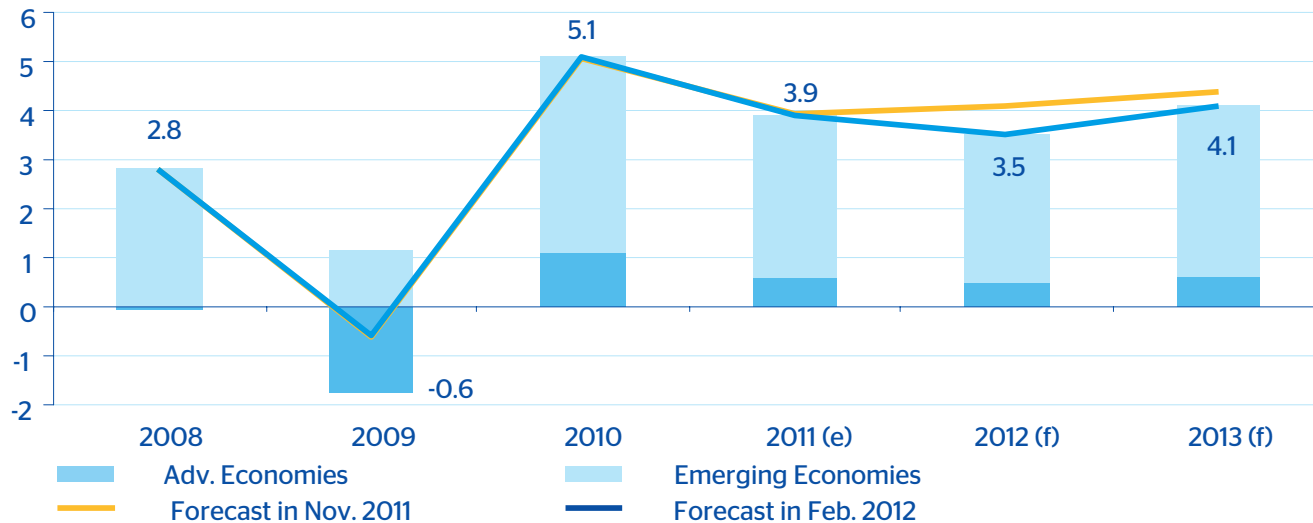
- **Despite the ongoing slowdown in China, we expect GDP growth to remain robust, at 8.3% and 8.7%, respectively, in 2012-13.**
- **In the near-term, growth will continue to decelerate before picking up in the second half of 2012 on policy support and an improving external environment.**
- **Inflation is easing.** Food prices are declining which, together with slowing growth, should result in subdued CPI inflation, of 3.3% in 2012 but oil prices are adding to inflation.
- **Monetary policy is easing.** We expect 100-150bps cuts in the required reserve ratio in the coming months, and up to two interest rate cuts.
- **The pace of currency appreciation is slowing.** We expect full-year appreciation of 2-3% in 2012, tilted toward the second half of the year.
- **Fiscal policy is growth supportive,** underpinned by spending on social housing, infrastructure, consumption subsidies, and various tax cuts.
- **Risks are to the downside** due to global uncertainties and recent domestic financial fragilities (local government debt, shadow bank lending, and falling property prices)

The global backdrop

- Global growth has been slowing, but will remain between 3.5% - 4% in 2012 and 2013.
- Downside risks to growth are diminishing as European policies boost confidence.
- Europe has entered a recession, with disparities across countries.
- Emerging economies are on track for a soft landing, buttressed by resilient domestic demand and growth-supporting policies.

Global growth (%)

Source BBVA Research



Outline

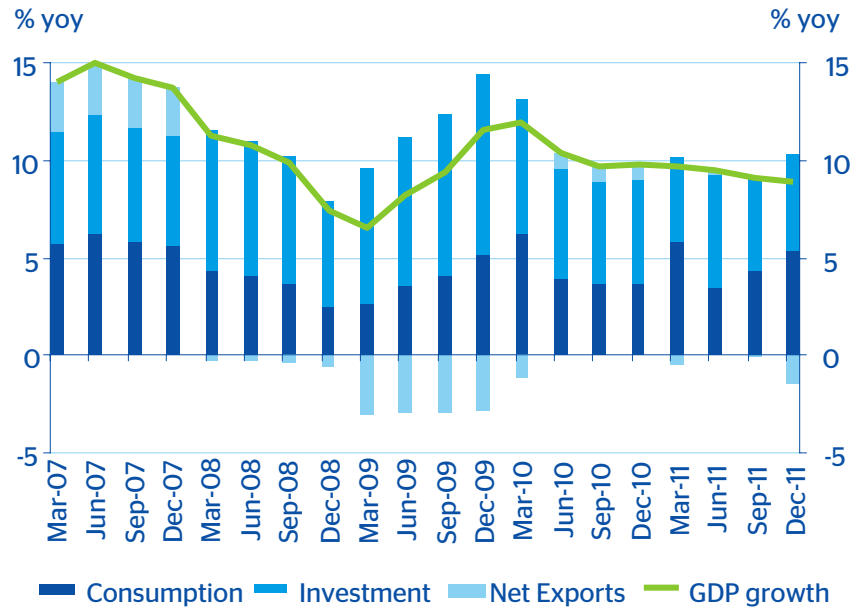
- 1 Recent Developments: Slowing growth and falling inflation
- 2 Outlook: Slowdown bottoming out on supportive policies
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Resilient GDP growth

- Q4 growth slowed to 8.9% y/y (8.2% q/q saar), above expectations, from 9.1% y/y in Q3
- The contribution of net exports has been negative, offset by strong domestic demand (consumption)
- PMI has rebounded back to above the +50 expansion threshold on strong domestic demand
- Other activity indicators are pointing to moderating growth

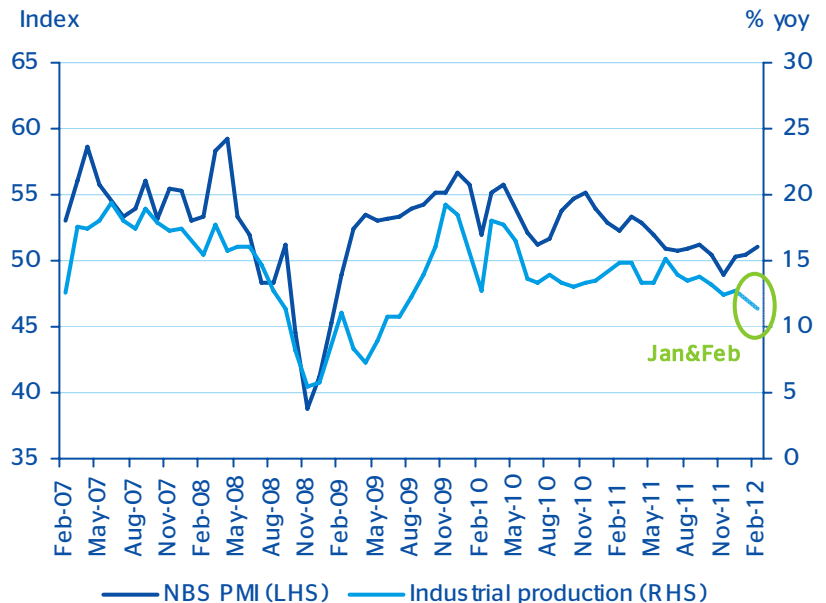
Q4 GDP growth remained resilient

Source: NBS, CEIC and BBVA Research estimates



PMI and industrial production have moderated

Source: CEIC and BBVA Research

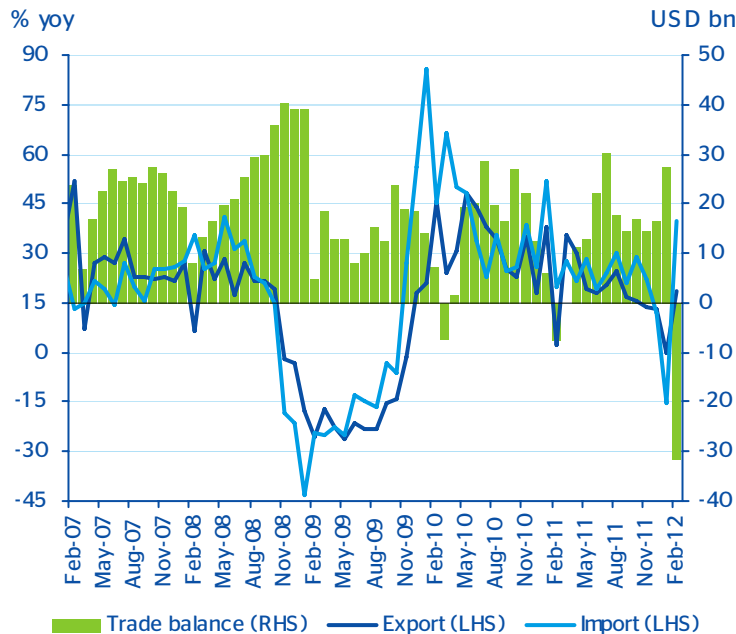


Slowing exports and reserves accumulation

- Export growth has slowed by more than expected
- Buoyant imports have led to large, but probably temporary, trade deficit in February
- Reserves accumulation has turned around, with implications for the currency outlook

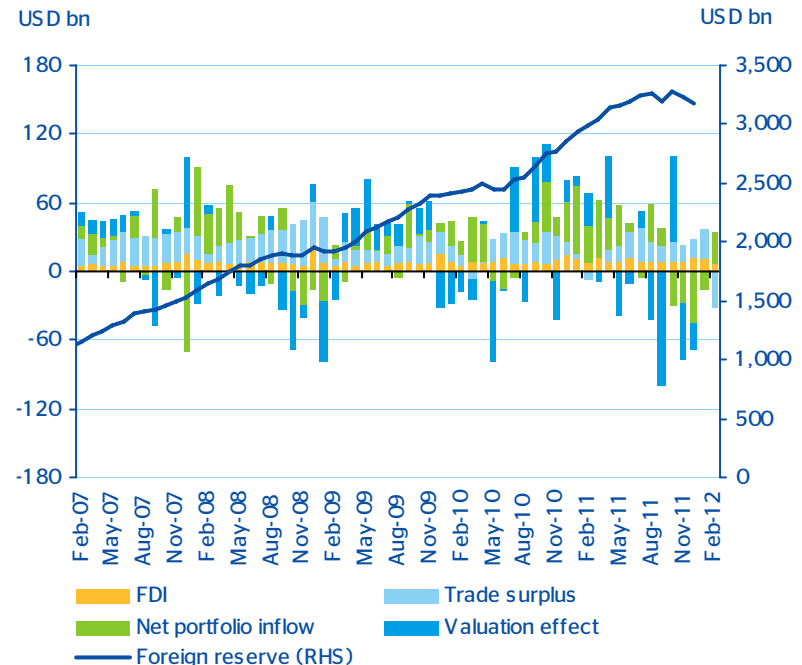
The trade surplus has turned negative

Source: CEIC and BBVA Research



Reserves declined on capital outflows

Source: CEIC and BBVA Research

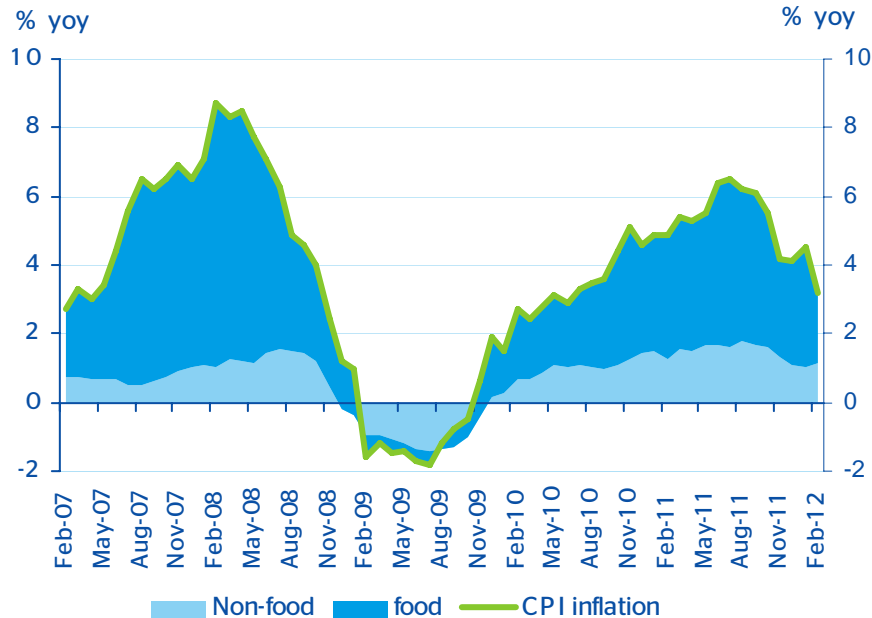


Easing inflation → monetary easing

- Inflation has been easing on favorable base effects and moderating food prices

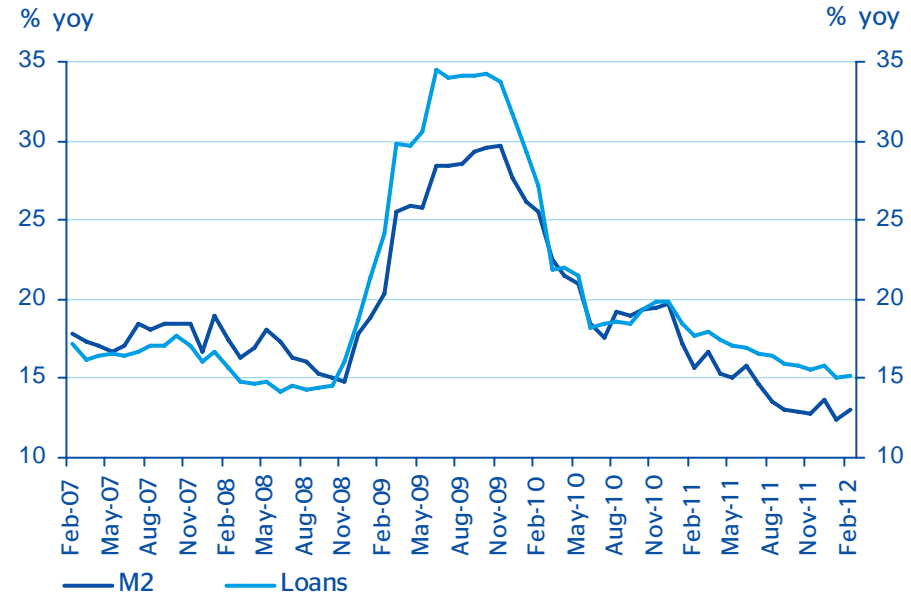
Inflation has eased...

Source: CEIC and BBVA Research



...providing room for a looser policy stance to stimulate slowing credit growth

Source: CEIC and BBVA Research

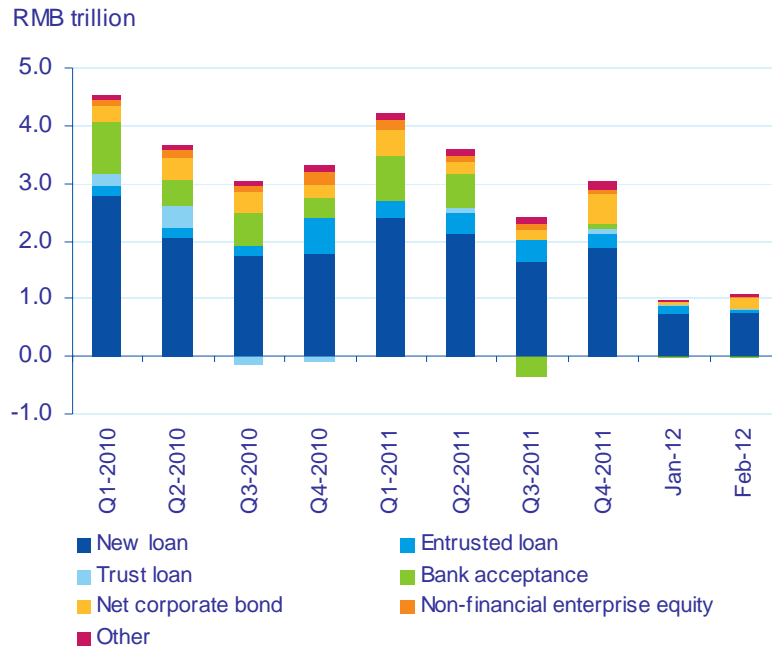


Slowing credit growth

- Credit aggregates are slowing.
- Demand vs. supply factors at work?

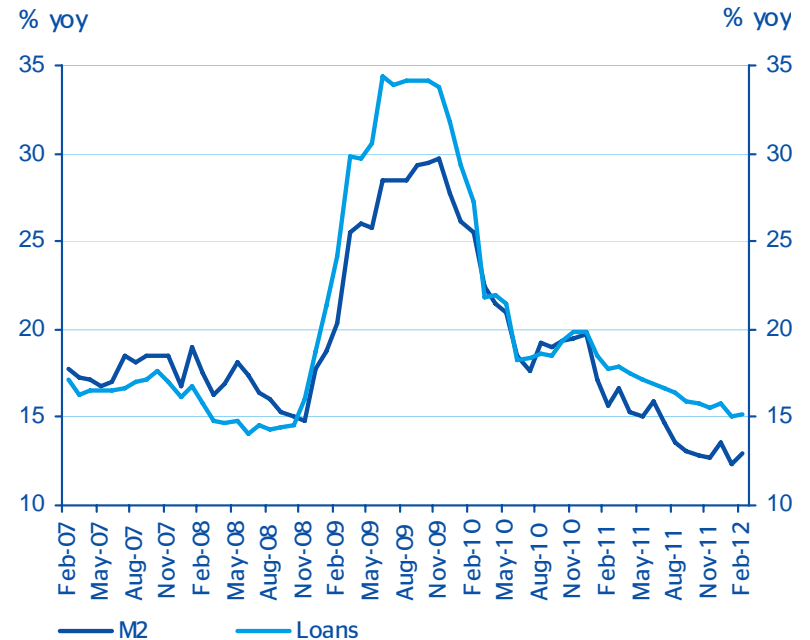
Total social financing has slowed...

Source: CEIC and BBVA Research



...and loans and M2 are on a declining trend

Source: CEIC and BBVA Research

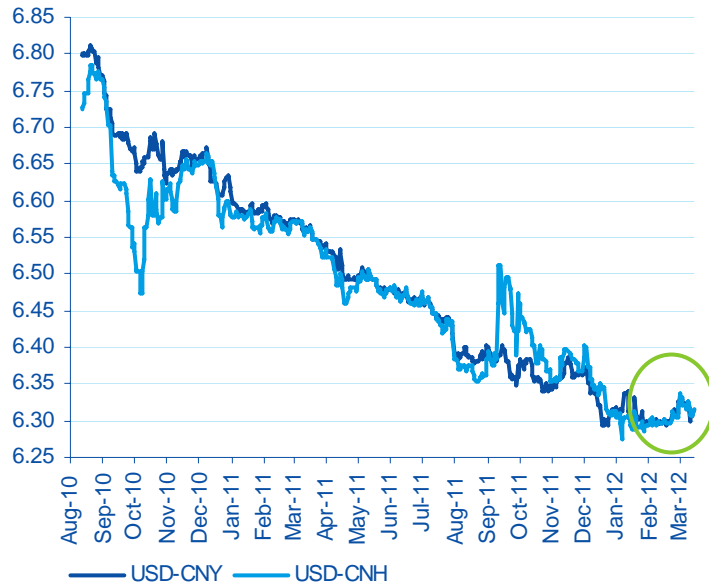


Currency appreciation has slowed

- RMB appreciation has all but stopped against the USD in 2012
- Market expectations of currency appreciation have evaporated

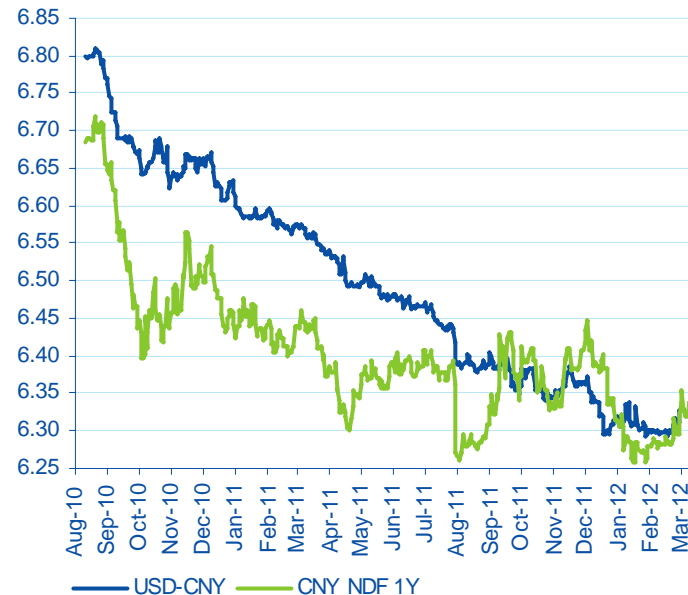
On-shore and off-shore exchange rates

Source: Bloomberg and BBVA Research



Expectations of appreciation have evaporated based on 12-month forwards

Source: Bloomberg and BBVA Research

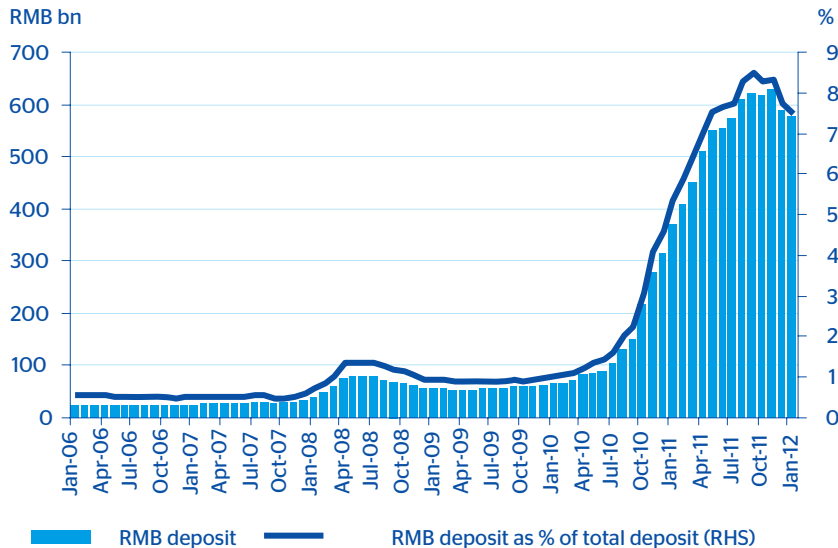


Offshore RMB market sees headwinds

- RMB internationalization is progressing, but has encountered headwinds from lower appreciation expectations
- Both the value of trade settlements and Hong Kong RMB deposits declined as of end-2011.
- However, ongoing programs (e.g. offshore RMB FDI and RQFII) should facilitate the flow of offshore RMB back to China and broaden demand for the use of offshore RMB (FDI loans)
- Offshore RMB financial products continue to develop (“Dimsum” bond issuance is strong)

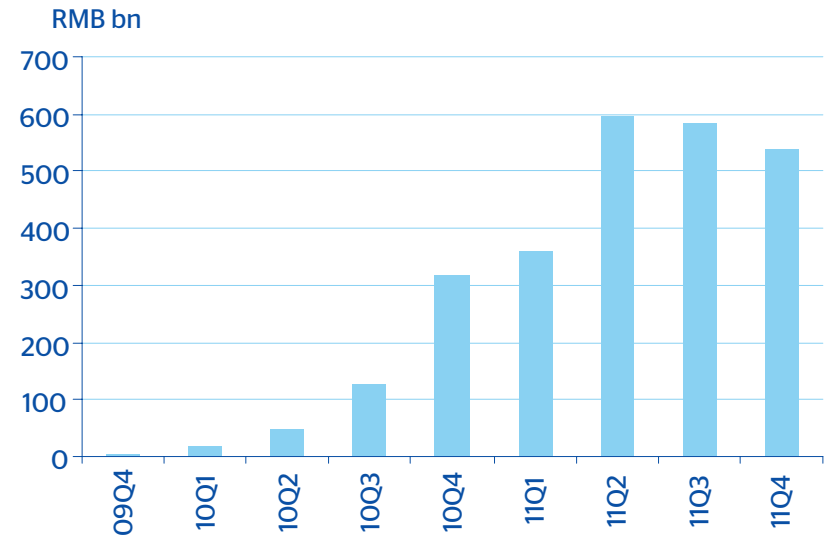
RMB deposits in Hong Kong are declining

Source: HKMA, CEIC and BBVA Research



Value of RMB settlement declined in Q4 2011

Source: PBoC and BBVA Research



Outline

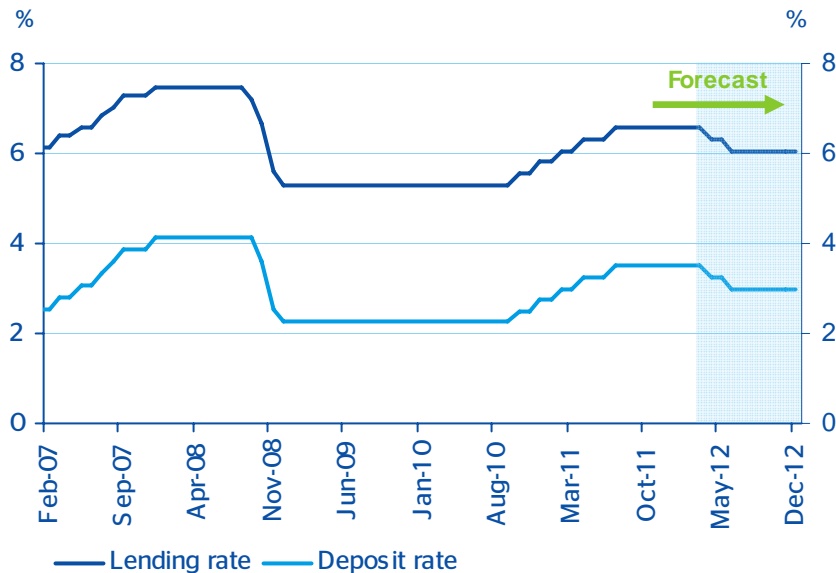
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Policies becoming more growth-supportive

- Official stance as emphasized in the NPC: “pro-active fiscal and prudent monetary”
- RRR cuts at end-November and February signal a loosening cycle
- However, new loan growth is disappointing
- Fiscal policy initiatives include investment in social housing, consumption subsidies, and tax cuts

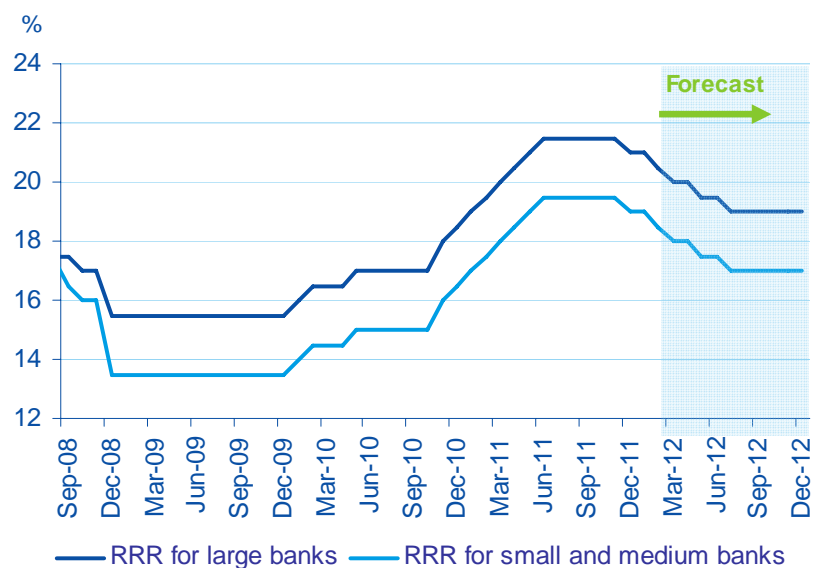
Interest rates on hold, next move down

Source: CEIC and BBVA Research



An RRR cut signals more easing ahead

Source: CEIC and BBVA Research

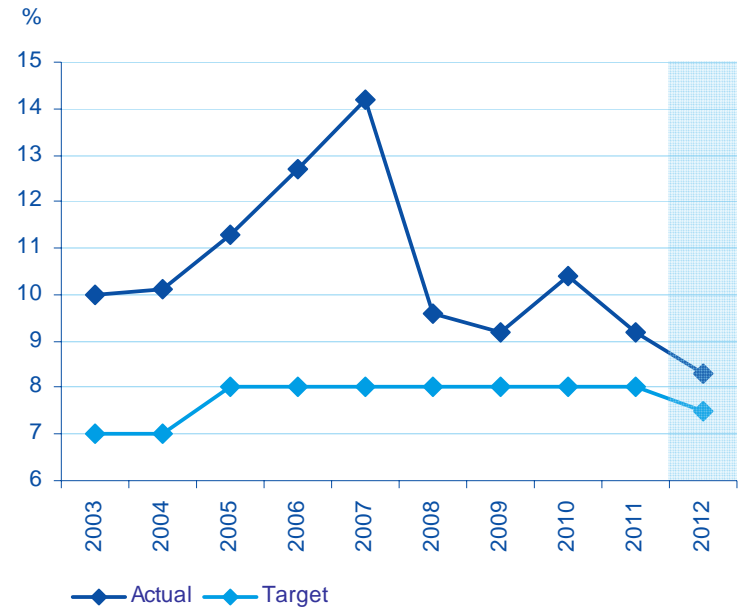


Fiscal policy outlook for 2012

- Expansionary 2012 fiscal stance
 - Deficit target is 1.5% of GDP from a 1.3% outturn in 2011, but would be higher if properly measured (2%).
- Policy initiatives:
 - Increased spending on social housing
 - Tax reforms
 - New consumption incentives?

GDP outturns always exceed targets

Source: Government work report, CEIC and BBVA Research estimates



Macro outlook, 2011-15

- GDP growth projections for 2012 and 2013 of 8.3% and 8.7%, with downside risks.
- Inflation projection of 3.3% in 2012, with upside risk from oil prices.
- Exchange rate appreciation will be slower in 2012.

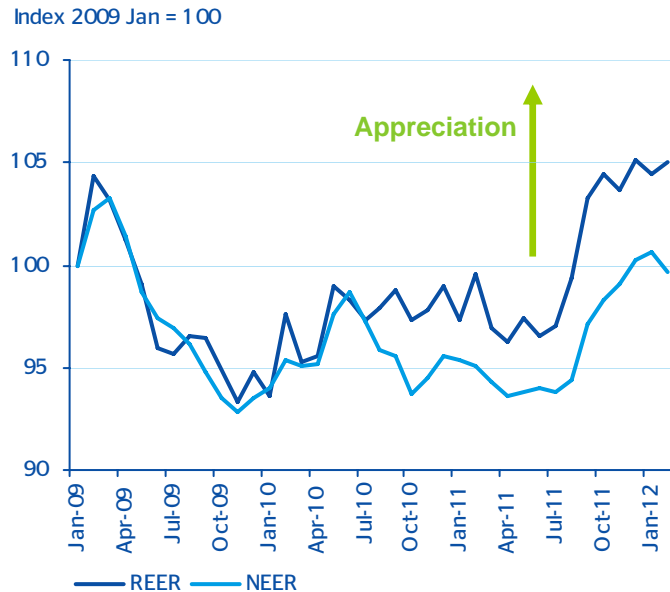
| Baseline | | | | | | | |
|----------------------|-----|-------------|-------------|-------------|-------------|-------------|-------------|
| | | 2010 | 2011 | 2012F | 2013F | 2014F | 2015F |
| | | Actual | Actual | Forecast | Forecast | Forecast | Forecast |
| GDP | | 10.4 | 9.2 | 8.3 | 8.7 | 8.7 | 8.6 |
| CPI | avg | 3.3 | 5.4 | 3.3 | 3.7 | 4.0 | 4.0 |
| | eop | 4.6 | 4.1 | 3.5 | 3.8 | 4.0 | 4.0 |
| CNY/USD | eop | 6.62 | 6.30 | 6.11 | 5.80 | 5.51 | 5.45 |
| Interest rate | eop | 5.81 | 6.56 | 6.06 | 6.56 | 7.06 | 7.06 |

RMB appreciation is slowing

- The NEER and REER have appreciated significantly recently due to USD strength.
- We expect appreciation of 2-3% in 2012.

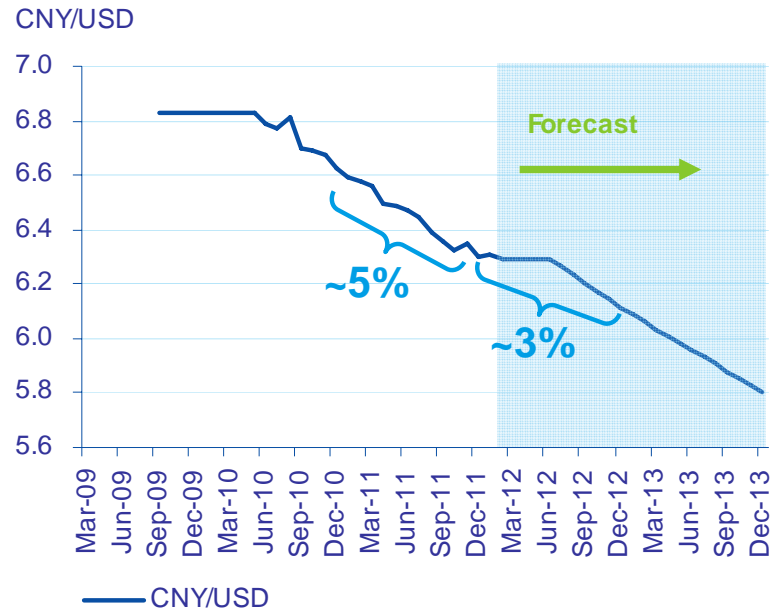
NEER and REER appreciation

Source: BIS and BBVA Research



RMB on its gradual appreciation track

Source: CEIC and BBVA Research estimates



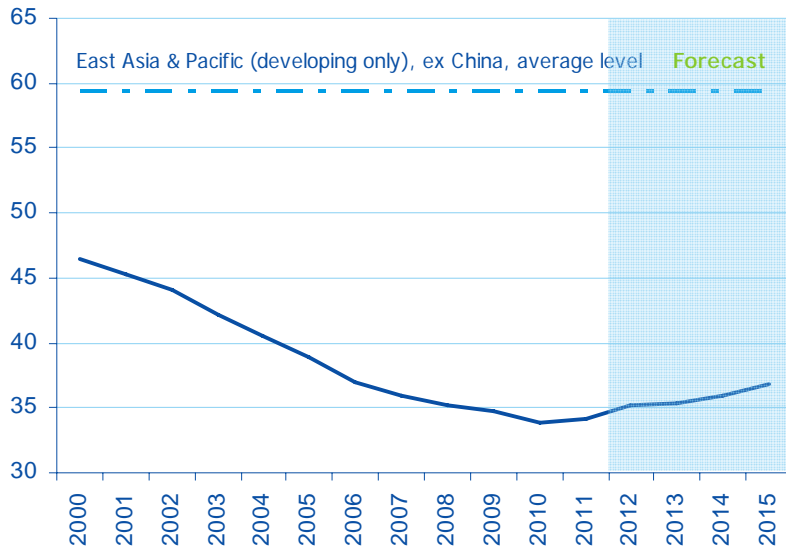
Medium-term Outlook

- Our medium-term baseline incorporates a rebalancing toward domestic demand, especially private consumption.
- The rebalancing is supported by initiatives in the 5-Year Plan.
- The current account surplus is expected to continue to decline.

Consumption should rise as a share of GDP

Source: CEIC and BBVA Research estimates

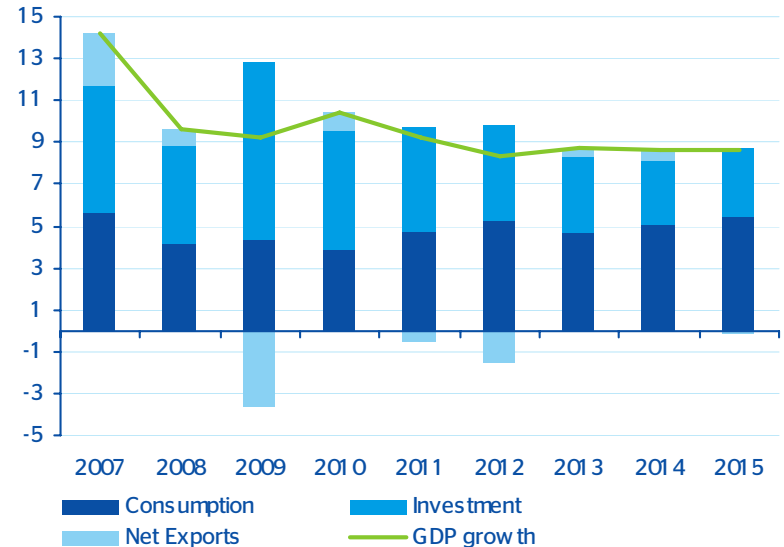
as % of GDP



A rebalancing of growth

Source: CEIC and BBVA Research estimates

%



12th Five-Year Plan highlights medium-term challenges

- Social housing
 - “Started” social housing has met the 10 million unit target for end-November 2011, “completed” 3 million units.
 - For 2012, target for “started” and “completed” are 7 million units and 4 million units.
 - Although there are delays and financing challenges, it appears that overall progress is still consistent with the original 36 million target for 2011-2015;
- Urbanization: target rate of 51.5% by 2015; already close (51.3% in 2011)
- Income growth: real growth of household income to exceed GDP growth during 2011-2015.
- R&D expenditure: target of 2.2% of GDP (1.83% outturn in 2011)
- Education expenditure: target of 4.0% of GDP, already adopted in the 2012 budget
- Decrease in energy intensity per unit GDP: Target -16% by 2015, in progress (-2% in 2011)

Outline

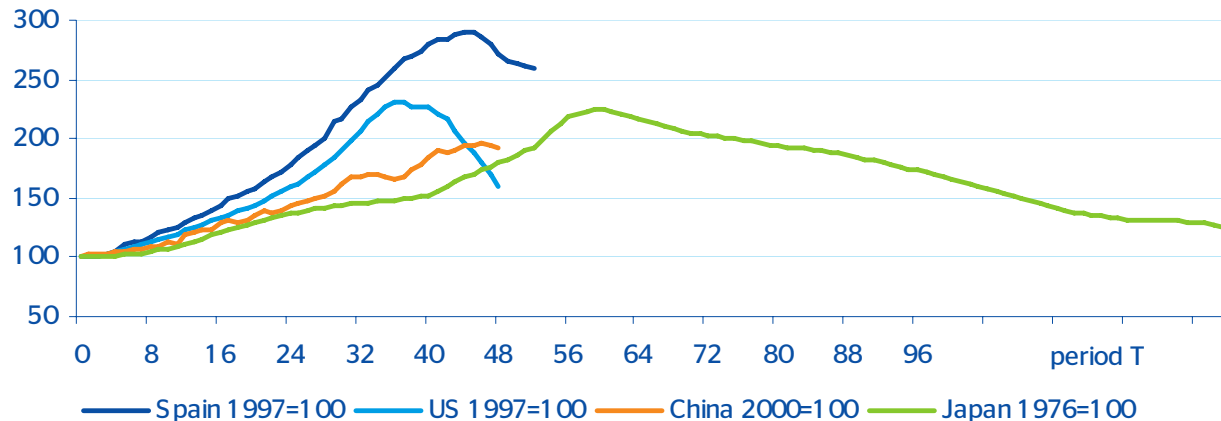
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Housing prices – not (yet) a bubble

- The rise in prices still does not look so large in comparison with international case studies of classic real estate bubbles
- Our 2011 Real Estate Outlook estimates only minor overvaluation at a national level

International comparison of price bubbles

Source: BBVA Research

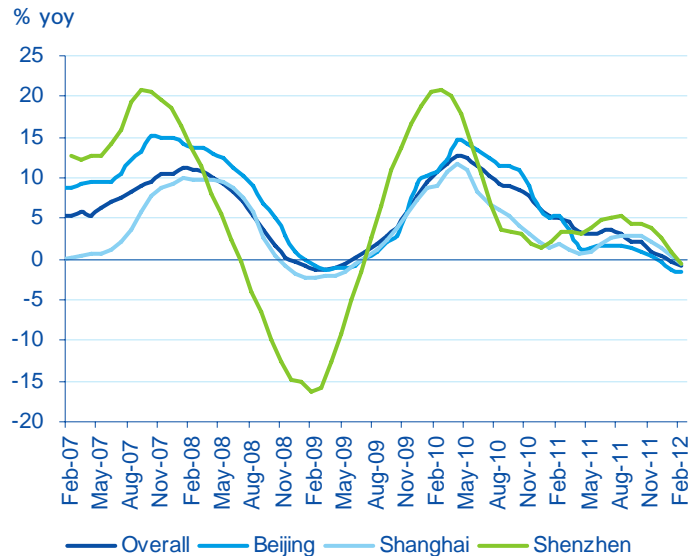


Declining property prices

- Property prices have declined by a cumulative -1.2% nation-wide, since July 2011.
- Market cooling measures remain in place.

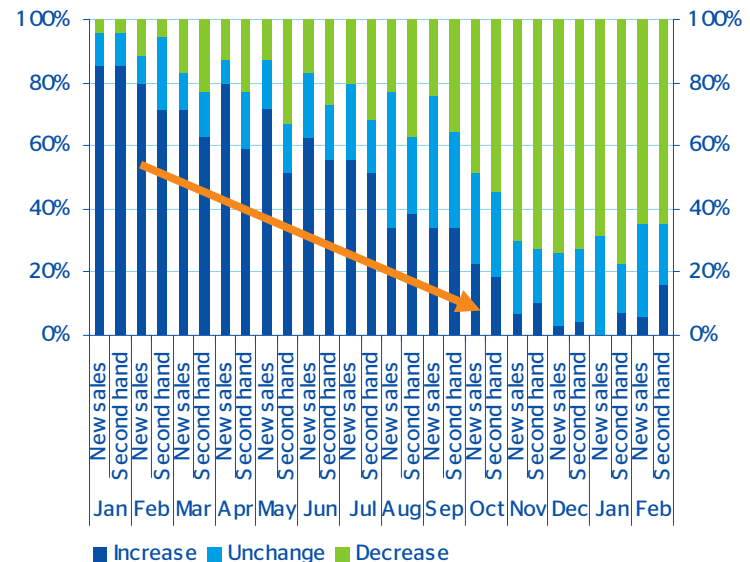
Declining sales transactions and moderating price momentum

Source: CEIC and BBVA Research



70 cities property price change (month-on-month)

Source: NBS and BBVA Research

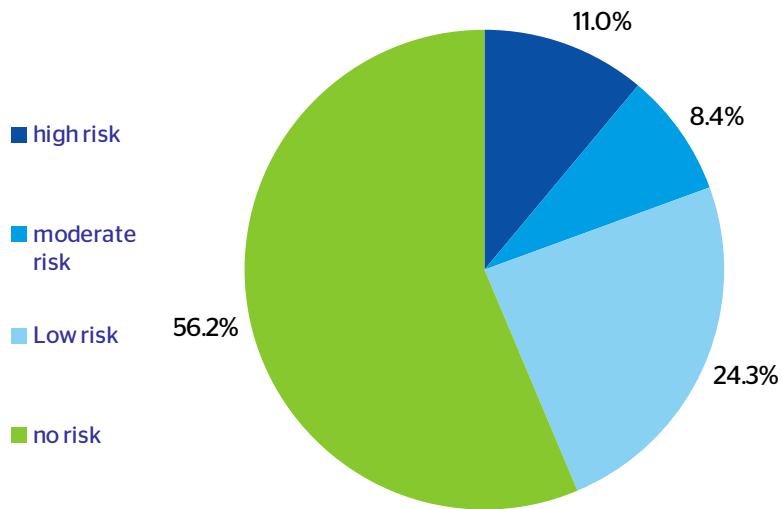


Local government debt – manageable?

- A build-up of local government debt under the massive stimulus package of 2008-09
- A clean-up of local government debt will probably need a combination of a bailout by the central government and bank write-offs over the next several years

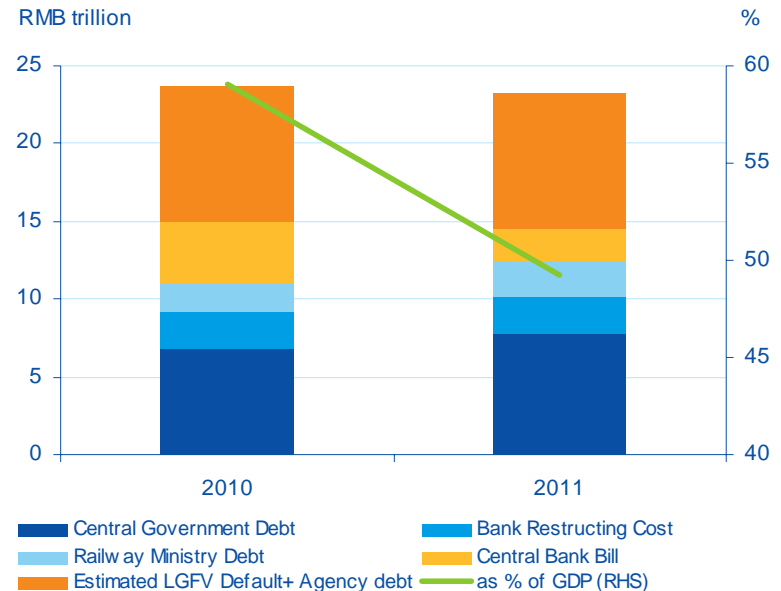
The majority of LGFV loans are safe

Source: PBoC and BBVA Research estimates



Public debt has been flat in nominal terms, and has declined as a % of GDP

Source: BBVA Research



Shadow banking risks improving

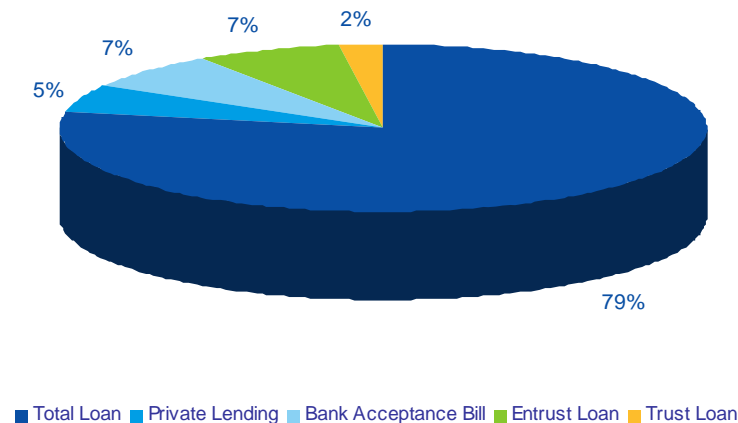
- High concentration of loans to the real estate sector combined with weak risk management practices
- Possible maturity mismatches
- Liquidity risks to the formal sector as deposits are siphoned

➔ Overall, we believe that risks are still manageable as the authorities have taken measures to contain the rapid growth of the shadow banking system.

Shadow banking accounts for a fifth of the financial system...

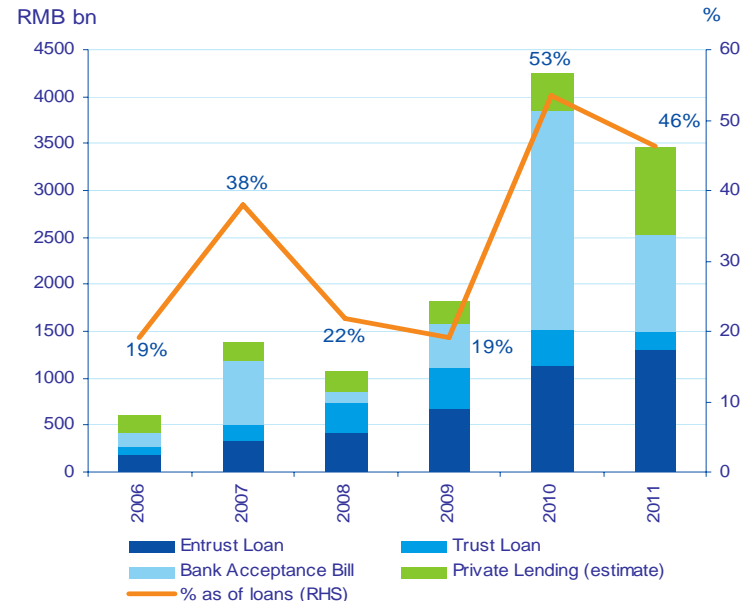
Source: PBoC and BBVA Research estimates

as % of total credit (2011)



...but accounts for a much larger share of new credits over the past year

Source: PBoC and BBVA Research estimates



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