BBVA | RESEARCH

Economic Outlook

China

Second Quarter 2012
Economic Analysis

- **The outlook for the global economy is for a gradual recovery in 2012**. Risks to the outlook, however, are strongly tilted to the downside as the European crisis continues.
- **Meanwhile, despite weaker external demand, China's economy continues to avert a hard landing.** Domestic demand has held up with support from an easing policy stance. We are maintaining our growth projections of 8.3% and 8.7% in 2012-13.
- **With inflation continuing to moderate,** we anticipate a further easing of monetary policy to support growth, including further reductions in the RRR, along with interest rate cuts if the external environment fails to recover. The 2012 budget stance is mildly growth supportive, with increased spending on affordable housing and social programs.
- **Currency appreciation has slowed considerably given the weak external environment**. Based on our scenario of a somewhat improved external environment, we expect some appreciation during the rest of the year.

Index

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Summary

After a gradual deceleration in 2011, especially in the last quarter, the global economy is starting to show some signs of improved growth momentum. We estimate that global growth will continue increasing and surpass 1% quarter-on-quarter at the end of 2012 (0.6% in 2011Q4). This recovery will be heterogeneous, with widening growth differentials between key economic areas. The increase in growth will be more evident in Asia and Latin America, while the US will sustain quarterly growth rates of around 0.6% in 2012-13, compared to stagnant activity in the euro-area in 2012.

In China, growth momentum has continued to slow at a gradual pace. First quarter GDP growth slowed to 8.1% y/y, down from 8.9% in Q411, on weaker external demand. While recent indicators show some further signs of slowing, domestic demand is holding up, and forward-looking indicators suggest that growth momentum is beginning to stabilize. Together with room for further policy support, this has raised confidence that a hard landing is being averted.

We are maintaining our 2012-13 growth projections of 8.3% and 8.7%, respectively. Full year growth in 2011 came out in line with expectations (9.2%), and while first quarter GDP was somewhat weaker than expected, there are tentative signs that growth is beginning to bottom out. A supportive policy stance and pickup in the external environment, as envisaged in our global baseline, should set the stage for a gradual pickup in growth over the coming quarters, underpinned by rising private consumption spending.

Inflation has declined in line with expectations on softer food prices and weaker demand conditions. At 3.4% y/y in April, inflation remains within the authorities' 4% comfort range. We expect inflation to moderate further, to around 3% y/y by mid-year, before picking up modestly to around 3.8% by end-year. As such, average inflation for the year would amount to 3.5%, slightly higher than our previous projections due to the impact of higher oil prices under our global baseline.

Easing inflation is providing room for further policy easing to support growth. After another RRR cut announced last February, we anticipate an additional 100-150 bps of reductions in the RRR through the third quarter of the year. These may be accompanied by up to two interest rate cuts of 25bps each, especially if the external environment fails to improve. The deficit target under the 2012 budget is growth supportive, containing increased spending on affordable housing, social initiatives and other high priority infrastructure projects. Various tax cuts should help support private consumption as well.

Currency appreciation has slowed considerably given the weak external environment, narrowing current account surplus, and slower reserve accumulation. The value of the RMB has been essentially unchanged against the US dollar so far in 2012. Given our scenario of a somewhat improved external environment, we expect limited appreciation to resume during the rest of the year (2-3% against the USD). At the same time, the daily trading band for the RMB has recently been widened, which may create more two-way volatility.

The main risk to the outlook continues to be from the uncertain global environment due to the evolving sovereign debt and financial crisis in Europe. Export growth has slowed, resulting in narrowing of the trade surplus and slower growth momentum. Financial tensions in Europe may also impose a chilling effect going forward on risk appetite and investment. This said, if downside risks materialize, there would be room for policy stimulus to sustain growth and help prevent a hard-landing.

Domestic financial fragilities remain, but have eased somewhat over the past quarter. In particular, downward property price adjustments are continuing at a modest pace; a pick up in loan growth through the formal banking system is helping to ease financing constraints following the clampdown on shadow bank lending; and a further rise in local government debt has been curtailed. Nevertheless, we continue to monitor these fragilities, as containing them remains a challenge, especially over the medium term.

1. Summary: global recovery, but risks reignite

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.

Global economic activity will gradually recover, with wider regional growth differentials and risks tilted to the downside

After a gradual deceleration in 2011, especially in the last quarter, the global economy is starting to show signs of increased dynamism. Global growth in 2012Q1 is expected to have been higher than in Q4, given stronger growth in Asia ex-China (including Japan) and Latin America, and sustained –but modest– dynamism in the US. We estimate that global growth will continue increasing and surpass 1% quarter-on-quarter at the end of 2012 (0.6% in 2011Q4). This recovery will be heterogeneous, with widening growth differentials between key economic areas.

The increase in growth will be more evident in Asia, given the rebound from natural disasters in Thailand and Japan (affecting regional supply chains) and some reversal of policy tightening measures implemented through mid-2011. Also, growth in Latin America is likely to pick up, on easier monetary policy in Brazil and sustained growth in Mexico helped by US demand. The US will continue sustaining quarterly growth rates of around 0.6% in 2012 and 2013, significantly lower than in previous recoveries. This will still be a relatively strong performance compared to stagnant activity in the euro-area in 2012, dragged by aggressive fiscal consolidation and persistently high financial stress, after tensions eased temporarily in the first quarter.

Therefore, emerging economies will recover their growth differential vis-à-vis developed economies, of around 4 percentage points, for the whole of 2012 and 2013. In turn, growth gaps between Europe and the US also will continue to increase even as financial tensions slowly lower in the former from expected decisive policy actions.

All in all, our growth projections are not very different from those of our previous Global Economic Outlook (published in February). We expect global growth of 3.6% in 2012 and 4% in 2013, with emerging economies contributing around 80% of the increase in global activity (Chart 1). But this scenario is conditioned on a benign evolution of the crisis in Europe, and thus risks to our projections are still strongly tilted to the downside.

Monetary policies in advanced economies will continue to be very accommodative for an extended period. However, the effectiveness of further policy intervention (conventional or not) is decreasing, while at the same time the costs are increasing, including the risk of reduced central bank independence and the collateral damage from unconventional measures.. Policymakers in the US and Europe will need to take up part of the burden of reviving growth by implementing economic and institutional reforms and managing fiscal risks. While these measures take effect, central banks should continue providing support for an adequate functioning of the monetary transmission mechanism.

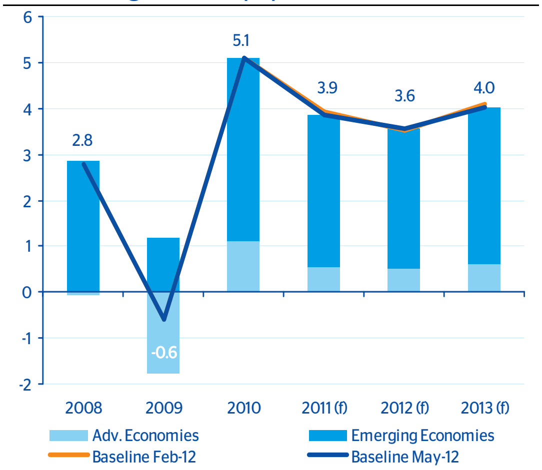
Easy monetary policies in advanced economies will mean favourable financing conditions in emerging countries. Here central banks will have to weigh the pressure from capital inflows and an uncertain external demand against inflationary risks (in part from oil prices) and strong domestic demand. The difference in inflation projections in Asia and Latin America –declining in the former but stable in the latter- will condition a different outlook for monetary policies. We expect limited further easing in emerging Asia, and a cautious tightening bias in most of Latin America, except in Brazil.

There have been some advances towards the solution to the European crisis, but crucial steps are still to be taken

Europe needs a clear roadmap to end the crisis. Despite some advances in recent months, there are still many important pending issues. First, while Greek sovereign debt held by the private sector was restructured, substantial doubts about long-run sustainability persist, due to reform fatigue and a possible deeper recession than projected. Second, the European Stabilization mechanism (ESM) has been provided with a fresh lending capacity of 500bn EUR (on top of

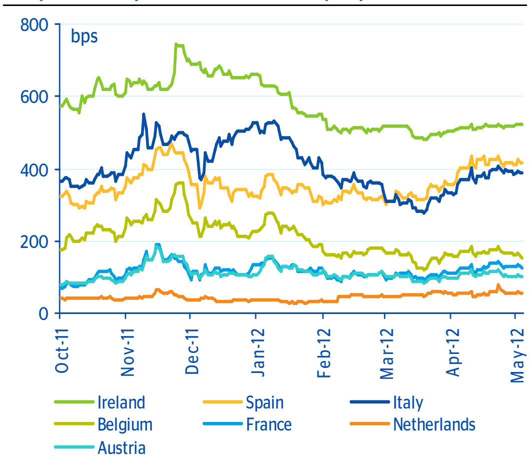
200bn already committed by the EFSF). However, that has not been enough to quell market anxiety, given Spain and Italy's financing needs for the next 3 years and the presumption that ESM loans would be senior to existing private bondholders. Further, it was not clear to what extent the increase in IMF resources of 430bn USD could be targeted to European countries. And third, there remain questions about the strength of the fiscal compact that sanctioned (pending national approval), committing governments to structural deficits not bigger than 0.5% of GDP. Although it is a significant change towards controlling member's budgets, the allowance for deviations to the rule under "exceptional circumstances" may undermine its perceived its perceived strengths among hardliners at the ECB. In addition, there have been no advances towards a fiscal union or Eurobonds.

Chart 1
Global GDP growth (%qoq)



Source: BBVA Research

Chart 2
European sovereign risk premia (10yr bond spreads to Germany, bps)



Source: Datastream and BBVA Research

A new flare-up of the European crisis is still the main global risk

Undoubtedly, one of the most important actions in the last four months was the provision of long-term liquidity by the ECB. This allowed, at least until March, a significant reduction in liquidity risk in European banks, a timid opening of wholesale funding markets and a compression of sovereign spreads in peripheral countries. But these positive effects proved temporary as risk premia have increased rapidly since March in Italy and Spain (Chart 2).

The short-lived effect of the long-term liquidity injections and the conundrum between fiscal consolidation and restoring growth highlight two conclusions. First, ECB actions can only bridge the short-run while the underlying economic and institutional problems are tackled. Economic reforms should be pushed forward, while core countries stimulate demand in the Eurozone. Second, it is imperative to reconsider near-term fiscal consolidation paths in a more gradual trajectory in exchange for comprehensive, detailed medium-term consolidation plans.

Current oil prices will have only a moderate impact on global growth, although a price spike poses a significant risk

A second threat to the global economy is a further increase in oil prices. The recent spike at the beginning of 2012 can be traced in part to tightening supply and demand fundamentals and also to an increase in the geopolitical risk premium to around 10-15 USD per barrel, due to tensions about Iran and limited market buffers (oil inventories and producer's spare capacity).

In our baseline scenario, we consider prices around 120 USD per barrel of Brent oil for much of 2012, around 15% higher than in our February forecasts. In our view, this will only have a moderate negative impact on global growth, as central banks in advanced countries view this as a temporary shock and will maintain accommodative policies. Nevertheless, should the conflict in the Gulf escalate, there could be a very large spike in oil prices, and even if central banks do not react, growth could be damaged through the associated increase in global risk aversion.

2. Moderating growth trend

As expected, China's economic growth has moderated further from the rapid pace in 2010 (10.4%) when fears were growing of overheating. The current slowdown reflects both the effect of deliberate policy actions taken in early 2011 to slow the economy as well as continued weakening external demand from the sluggish global economy. Full-year growth for 2011 slowed to 9.2%, on weaker investment and exports.

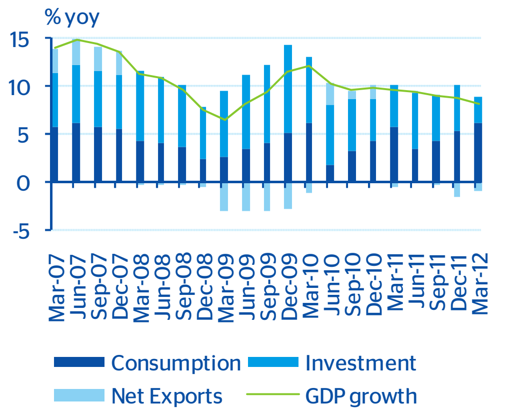
Slowing growth and a number of domestic financial fragilities have given rise to worries of a hard landing by many observers. While first quarter GDP growth (8.1% y/y) decelerated by more than expected, to its lowest level in three years, recent activity indicators suggest that a hard landing is being averted. A loosening of the policy stance is helping to support domestic demand, and some forward-looking indicators suggest that growth may pick up in the coming quarters, in line with our previous 8.3% GDP projection for 2012. While domestic financial fragilities still persist—in the form of falling real estate prices, the aftermath of rapid shadow bank lending, and high level of local government debt—they continue to appear manageable in the near term.

GDP growth decelerates at a gradual pace

First quarter GDP growth continued to decelerate, falling to a lower-than-expected 8.1% y/y, from 8.9% y/y in Q4 (Chart 3). In sequential terms quarter-on-quarter terms, the slowdown was less pronounced according to official data, to 1.8% q/q, from 1.9% in Q4, seasonally adjusted. The moderation in first quarter GDP was mostly attributable to slowing investment and exports. Private consumption has generally held up, continuing a trend in 2011, and consistent with a gradual rebalancing of the economy toward domestic demand, as emphasized in the medium-term priorities set out in the latest Five-Year Plan. Notably, the current account surplus has narrowed sharply from its peak in 2007 to 2.8% of GDP in 2011 (Chart 4).

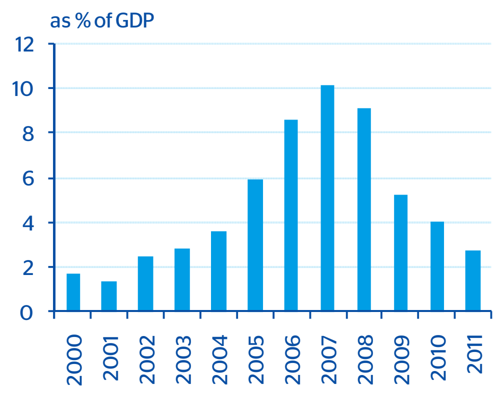
Though April outturns were weaker than expected, the overall strength of high frequency activity indicators in recent months has helped to allay concerns of a hard landing. Urban fixed asset investment growth has held up at around 20% year-over-year, while retail sales growth has moderated somewhat (Chart 5). On the production side, industrial output has also slowed. In contrast, the official Purchasing Manufacturers Index, another closely watched indicator, has remained above the 50% expansion/contraction threshold since November, and has been on a rising trend for five consecutive months; the private sector PMI (Markit) has been somewhat weaker, most likely reflecting a difference in composition oriented toward smaller and more export-oriented firms (Chart 6).

Chart 3
GDP growth driven by robust domestic demand...



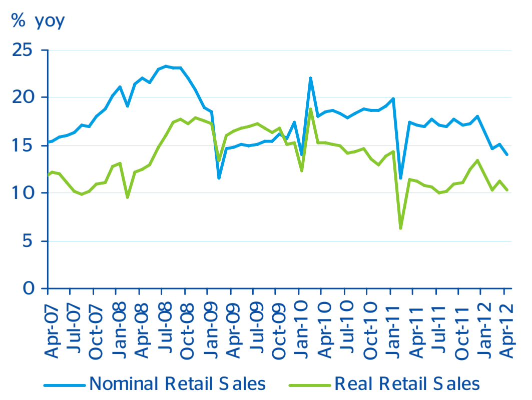
Source: CEIC and BBVA Research

Chart 4
Narrowing current account surplus



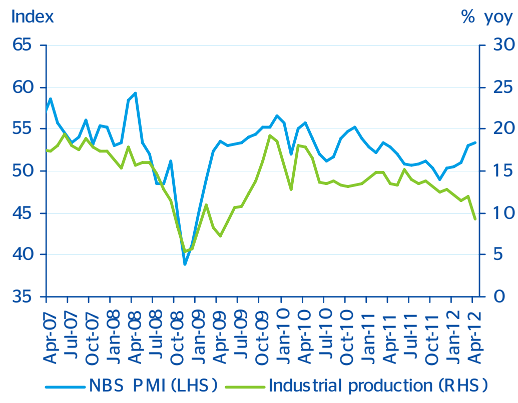
Source: CEIC and BBVA Research

Chart 5
Retail sales growth is slowing, but remains reasonably robust



Source: CEIC and BBVA Research

Chart 6
PMI has been rising above the 50-threshold

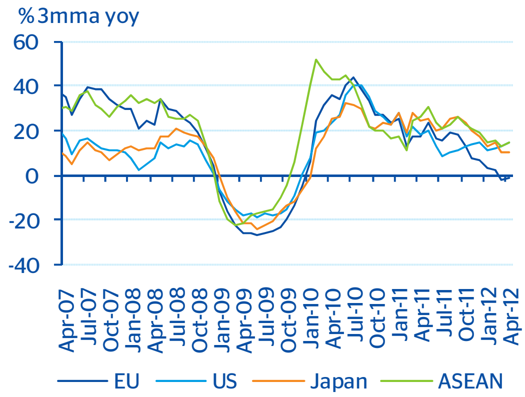


Source: CEIC and BBVA Research

The trade and current account surpluses have narrowed sharply

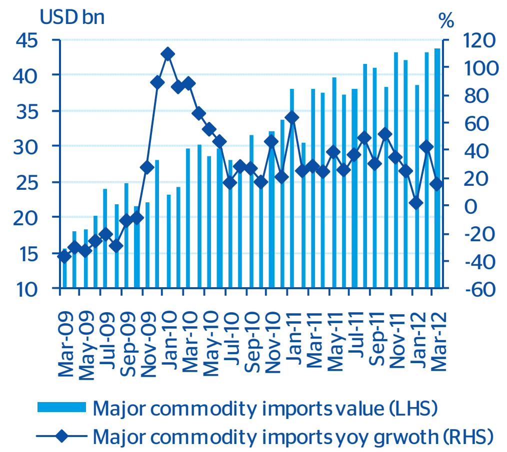
Export growth has been sliding steadily, down to an average of 7.6% y/y in Q1 from 14.3% in Q4 2011 and 20.6% in Q3. The decline has been driven by weaker external demand, especially from the EU, China's single largest export market accounting for nearly 20% of total exports (Chart 7). Import growth has also declined, reflecting the moderation in domestic demand, including for commodities and a levelling off of processing components, consistent with declining export orders (Charts 8 and 9). Overall, the trade balance remained in surplus in the first quarter, at USD 810 million, despite a temporary monthly trade deficit in February (Chart 10). The first quarter current account surplus, meanwhile, narrowed to USD 24.7 billion, down from a quarterly average of USD 50.4 billion in 2011.

Chart 7
Export growth has declined, especially to the EU



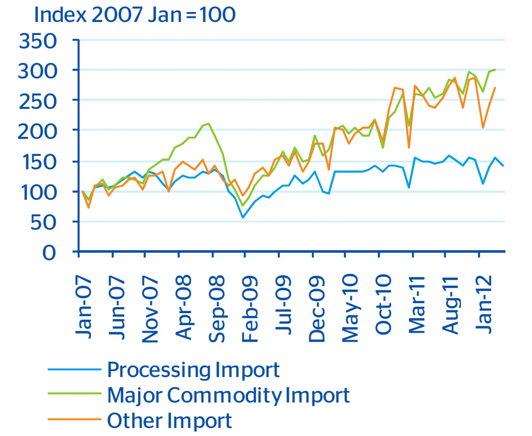
Source: CEIC and BBVA Research

Chart 8
Commodity imports remain strong, but have leveled off on falling prices



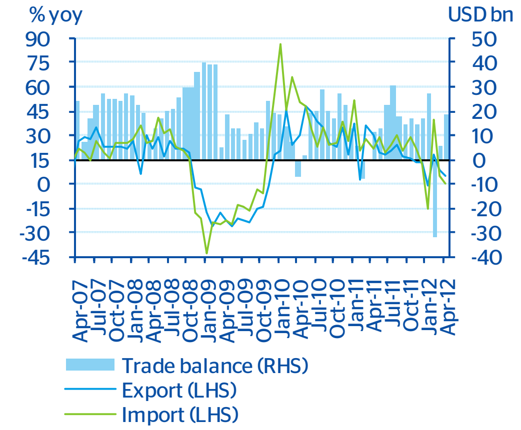
Source: CEIC and BBVA Research

Chart 9
Processing imports have levelled off



Source: CEIC and BBVA Research

Chart 10
Export and import growth are weakening



Source: CEIC and BBVA Research

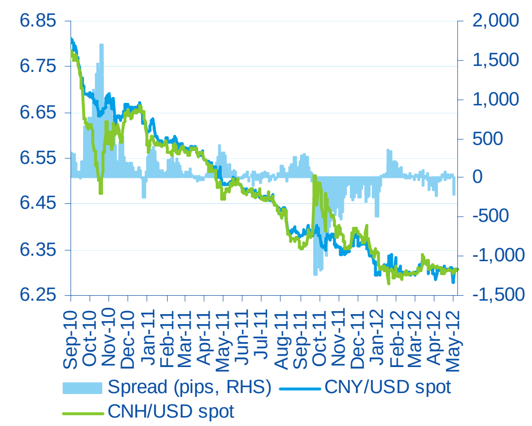
Slowing currency appreciation reflects a weaker external environment

After rising in value by around 5% against the USD last year, appreciation of the RMB against the USD has virtually stopped in recent months (Chart 11). While the currency remains heavily managed – despite a widening of the daily trading band to enhance flexibility and the role of market forces, as described below – the slowing of the appreciation trend is not surprising in light of smaller external inflows, as evidenced by a recent levelling off in the pace of reserve accumulation. Furthermore, a substantial real effective exchange rate appreciation in 2011 (the result, in part, of relatively high domestic inflation), may have led the authorities to view the current exchange rate level as closer to equilibrium (Chart 12).

Market expectations of the pace of appreciation have been further scaled back following weaker growth outturns and the sharp narrowing of the current account surplus. Indeed, one-year forward NDFs are pricing in a nearly 0.6% depreciation (Chart 13).

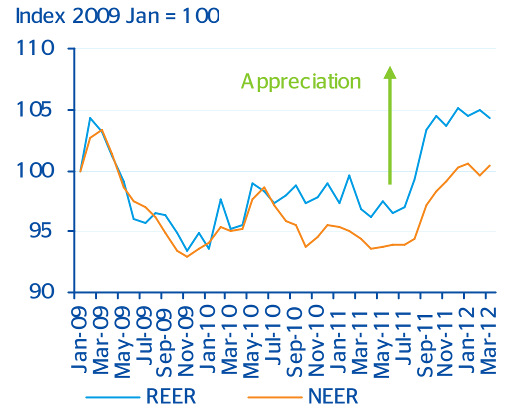
The most significant recent development on the currency front is a widening of the daily trading band effective on April 16 (to +/- 1.0% from +/- 0.5% previously). Although the timing and degree of the widening were uncertain, such a move had been anticipated by market participants given recent signals by the authorities that they planned to, "facilitate price discovery and enhance the flexibility of the RMB exchange rate." Over time, we expect the widening of the trading band to result in greater two-way flexibility. Beyond the more general objective of advancing currency reform, the move should deter "hot money" inflows by eliminating one-way bets on the direction of currency moves (see Box 1 for further discussion). So far, however, there has been little noticeable effect on the currency trading.

Chart 11
Currency appreciation against the USD has slowed in recent months



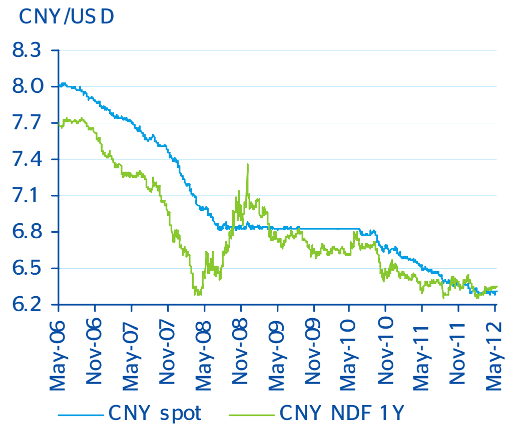
Source: Bloomberg and BBVA Research

Chart 12
Effective appreciation has levelled off



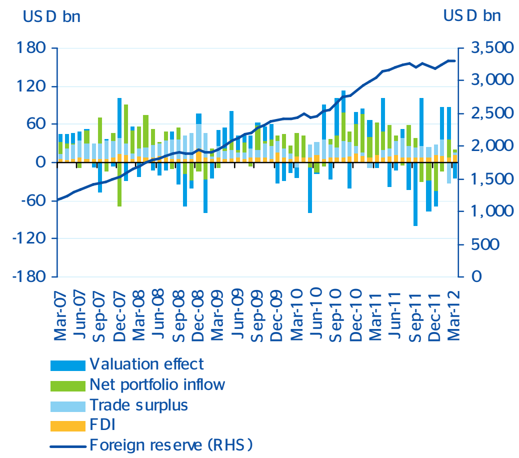
Source: BIS, CEIC and BBVA Research

Chart 13
RMB NDFs are pricing in depreciation



Source: Bloomberg and BBVA Research

Chart 14
Lower portfolio inflows are one factor for slower reserve accumulation



Source: CEIC and BBVA Research

Box 1: Recent developments in exchange rate policy

Recent reforms to China's exchange rate policy were initiated in July 2005, when the RMB's peg to the USD was suspended in favour of a flexible arrangement based on a basket of currencies of major trade partners. Thereafter, the RMB gradually appreciated against the USD, until the process was suspended from mid-2008 to mid-2010 during the global financial crisis. Since July 2005, the cumulative appreciation of the RMB against the USD has amounted to around 25%.

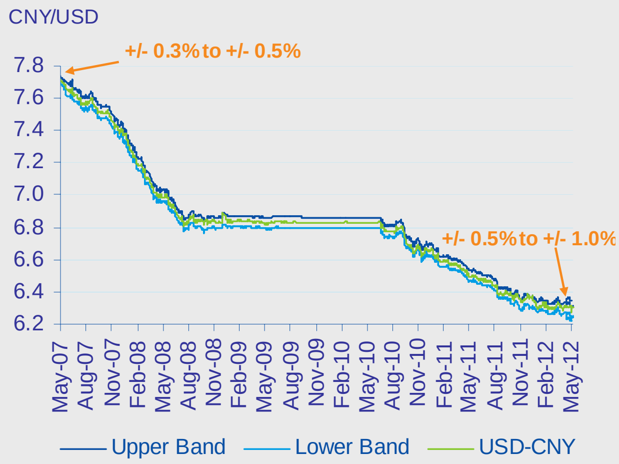
In the meantime, to increase daily volatility, the RMB has been allowed to fluctuate according to market supply and demand within a specific band. The band has been widened twice so far: on May 21, 2007 to +/-0.5% from the prevailing +/-0.3%, and on April 16, 2012 to +/-1.0%. The latest widening was also accompanied by a measure to allow domestic banks to hold short positions in foreign currencies, as a way of hedging foreign exchange risk in view of higher anticipated volatility.

The latest band-widening can be interpreted as one more step towards an eventual market-based exchange rate system. It is expected to increase the RMB's daily volatility. According to the PBoC, the widening of the daily trading band will "help price discovery and enhance the flexibility of the RMB exchange rate." Looking backward, the RMB's daily volatility jumped following the 2007 widening of the trading band (Chart 15), frequently breaking through the previous +/-0.3% limits, although the intraday high/low seldom hit the new upper/lower bounds (the upper, depreciated, bound was hit 19 times, while the lower bound was never hit). Therefore, it can be expected that the RMB's daily volatility will eventually increase by the latest move.

At the same time, however, a widening of the daily trading band does not in itself indicate anything about the level or direction of the RMB. In particular, the RMB exchange rate is still determined by the PBOC's daily fixing, based on a basket of currencies.

It is important to view reforms to the RMB exchange rate framework against the broader backdrop of China's full financial reforms, including RMB internationalization, the gradual opening-up of the capital account, and interest rate liberalization. A widening of the band will not only help the discovery of "equilibrium price", but will also facilitate the preparation for a market-based RMB exchange rate mechanism.

Chart 15
Widened daily trading band of RMB against USD



Source: Bloomberg and BBVA Research

Policy easing to support growth

As noted in our previous Outlook from last February, slowing activity and the weak external environment have resulted in a gradual easing of policies to support growth. On the monetary side, there have been further cuts in the required reserve ratio, along with steps to facilitate the flow of credit to SMEs. On the fiscal side, as expected, the 2012 budget, announced at the conclusion of the National People's Conference in March, contains growth supportive measures and an overall expansionary stance (Box 2).

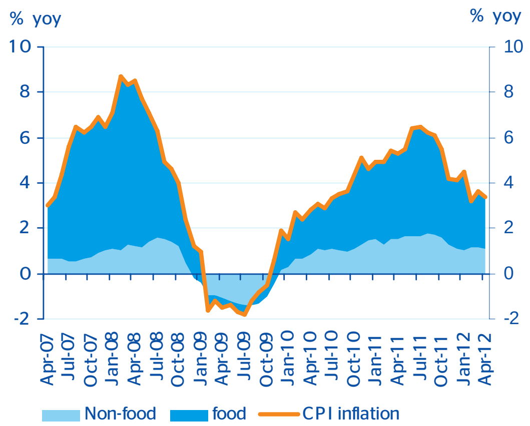
Low inflation provides room for monetary easing

After peaking at over 6 percent last July, inflation has eased to within the authorities' 4% comfort range (Chart 16), providing room for monetary easing to support growth. Inflation stood at 3.4% y/y in April on both stable food and non-food price trends. Producer price inflation has also declined sharply, from a peak of over 7% last July, to -0.7% y/y in April.

The authorities cut the required reserve ratio (RRR) for a second time since the easing cycle began last November, by 50bps in late February to 20.5% for large banks (Charts 17 and 18). Together with a series of liquidity-enhancing open market operations, this has led to looser liquidity conditions and a moderation in interbank rates (Chart 19).

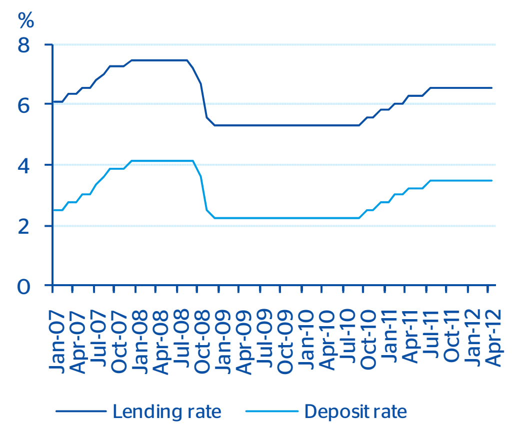
Meanwhile, China's equity market has underperformed on weak earnings and slowing growth (Chart 21). That said, an expected pickup in growth, along with newly implemented measures, including the possibility of allowing pension funds to invest in the equity market and a 25% cut in the stamp tax, may be expected to boost equity market performance later in the year.

Chart 16
Inflation has continued to fall



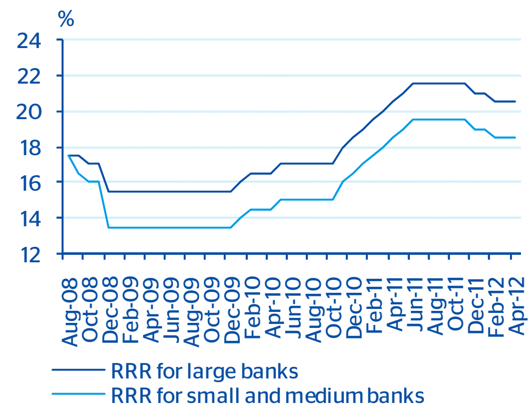
Source: CEIC and BBVA Research

Chart 17
Interest rate hikes ended in July ...



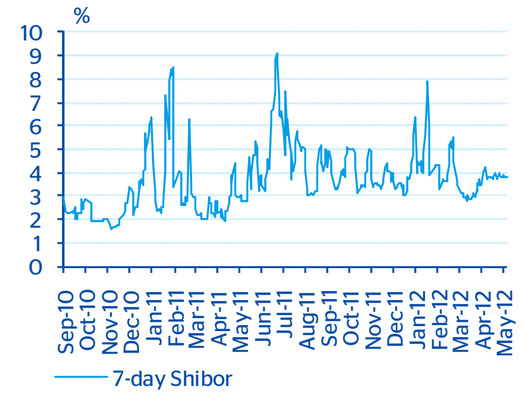
Source: CEIC and BBVA Research

Chart 18
...with two reductions in required reserve ratios since November



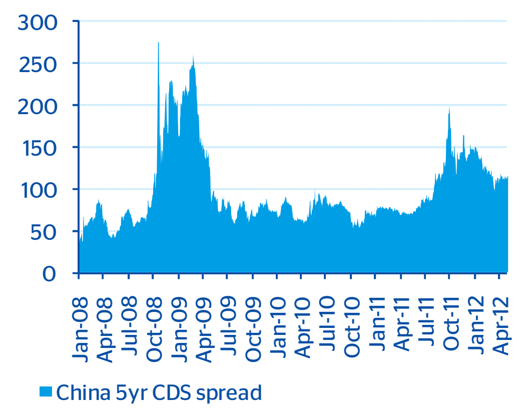
Source: CEIC and BBVA Research

Chart 19
Inter-bank rates remain reasonably low



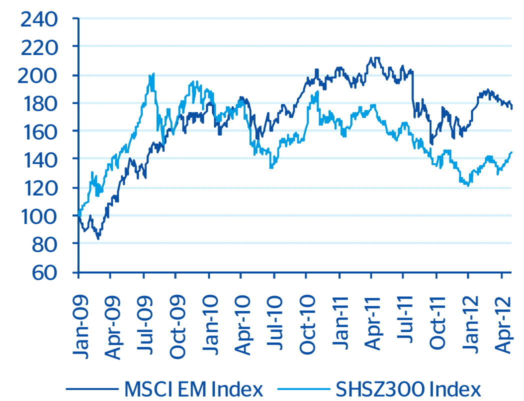
Source: CEIC and BBVA Research

Chart 20
China's CDS spreads have stayed high on global risk aversion...



Source: Bloomberg and BBVA Research

Chart 21
...and the stock market has underperformed (2009 Jan = 100)



Source: Bloomberg and BBVA Research

Monetary and credit aggregates are stabilizing

Consistent with the easing monetary stance, credit and M2 growth have shown signs of stabilizing after moderating through much of 2011 (Chart 22). New loans in March (15.7% y/y) picked up to RMB 1 trillion, helping to allay concerns of slowing credit growth; while there was some slowing in April (15.4% y/y), cumulative new loans through the first four months of the year amounted to RMB 3.14 trillion, in line with the full-year informal target of around RMB 8.0-8.5 trillion. At the same time, however, total social financing (TSF), a more comprehensive measure of credit growth (combining bank and nonbank forms of financing), rose by only 1.9% y/y in March (Chart 23). The divergence between new loans and TSF growth reflects previous efforts to clamp down on informal, or shadow banking activities.

Supportive fiscal policy targeted in 2012

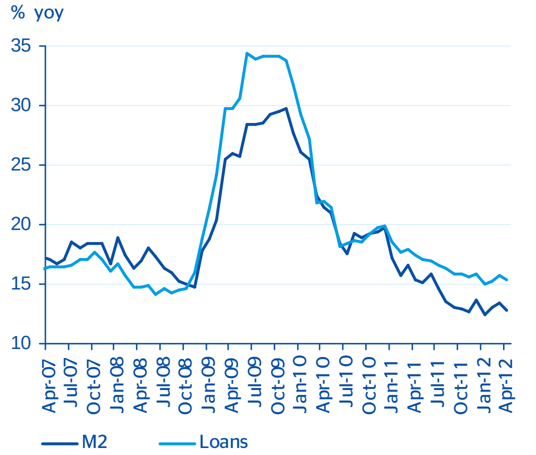
In line with the authorities' announced, "prudent monetary and pro-active fiscal policy" stance, the National People's Congress (NPC) in March released a generally growth supportive annual budget. The budget targets a larger deficit for 2012, amounting to around 2% of GDP (after accounting for 0.5% of GDP in saved revenues from last year), from an outturn of 1.3% in 2011. The budget includes stepped up spending in social areas, construction of affordable housing, and medical and health care (see Box 2 for details of the NPC policy outcomes).

It appears that public spending accelerated toward the end of Q1, according to government reports, with a notable pickup in the pace of affordable housing and infrastructure. Spending on transportation infrastructure has also seen a significant pickup after a lull in the second half of 2011 due to safety concerns in the high-speed railway network. A pickup of such spending is consistent with the emphasis in the NPC policy statement about focusing on the completion of major infrastructure projects in the coming year.

There are also a number of fiscal initiatives to boost private consumption through tax cuts. Following an increase last September in the taxable income threshold (from RMB 2,000 per month to RMB 3,500), personal income tax revenue continued to decline in Q1, by -6.24% y/y, (Chart 25). In addition, a pilot VAT program in Shanghai to replace the operations tax on specified service sector industries, resulting in a reduction in the tax burden, is likely to be extended soon to other major cities, including Beijing. However, subsidies to boost consumption, as we had previously anticipated, have not yet been announced, as they are still under discussion.

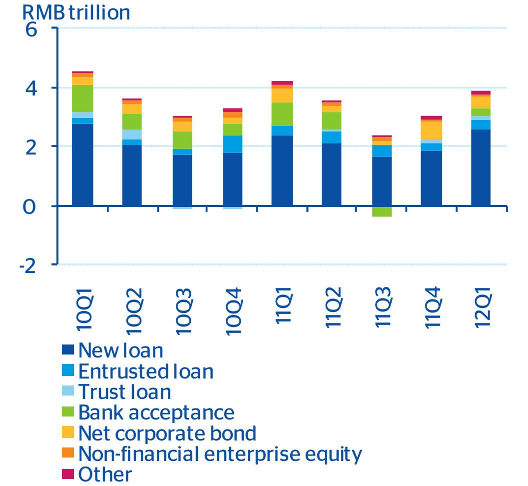
Rising wage rates and labour income are also part of the policy package to boost domestic consumption. Average monthly incomes of migrant workers, the major source of low-cost labor supply over the past decade the past decade, increased by 16.6% y/y in Q1 2012, only slightly down from 21.2% growth in the previous quarter.

Chart 22
Credit and M2 growth may start picking up



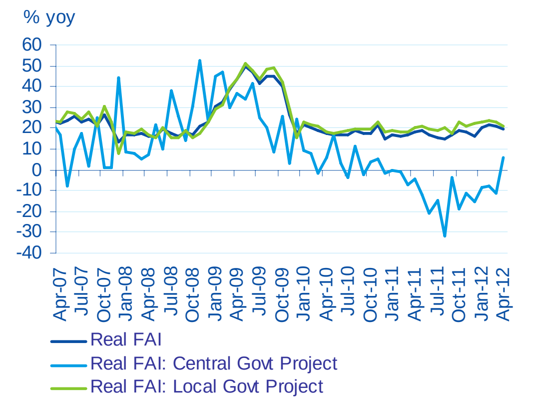
Source: CEIC and BBVA Research

Chart 23
Total social financing picked up in the first quarter



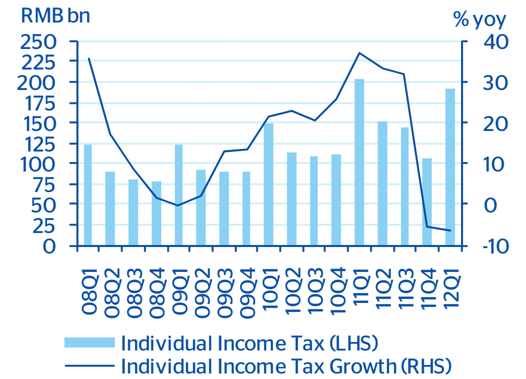
Source: CEIC and BBVA Research

Chart 24
Real investment in public projects



Source: CEIC and BBVA Research

Chart 25
Tax cuts for lower income payers result in a more progressive structure



Source: CEIC and BBVA Research

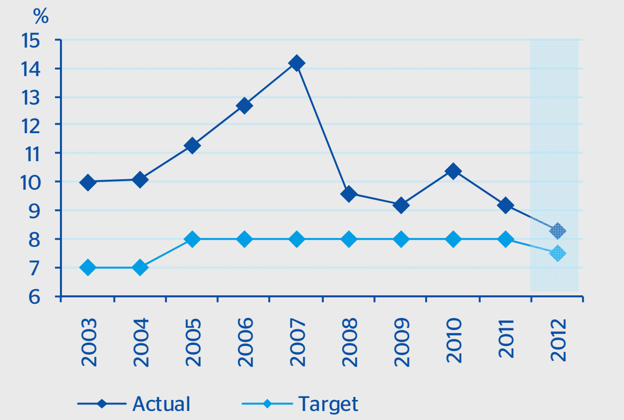
Box 2: Key policy outcomes of the 2012 National Peoples' Congress

The annual National People's Congress (NPC) for 2012 was held in March and, as scheduled, resulted in the setting of key macro targets and the central government budget. This year's NPC re-stated the government's "proactive fiscal and prudent monetary" policy mix (in force since the end of 2011), and released key annual targets including for GDP growth (7.5%), inflation (4.0%), budget deficit (1.5%), and M2 growth (14.0%). Most notably, the growth target was lowered from 8.0% in previous years.

What does the lower growth target mean?

A lowering of the official growth target to 7.5%, from 8.0% where it had been since 2005, drew a great deal of market attention. In fact, the new lower target was in line with expectations—announced last year with the release of the 12th 5-year Plan. Importantly, the official growth target should be viewed as a minimum floor, rather than a projection per se of the growth outturn. In the past, actual growth outturns have consistently exceeded targets by a considerable margin (Chart 26).

Chart 26
China's GDP outturns have typically exceeded targets



Source: Government Work Report, NBS and BBVA Research

As flagged in the 5-year Development Plan, a lower growth target reflects a renewed focus on rebalancing and the quality of growth. As such, the government's economic planners may be sending a signal that their priority is no longer on achieving high growth outturns as an end in themselves, but rather on enhancing the quality of growth, including through social protection and environmental improvements.

The lower growth target also reflects a recognition that China's medium-term growth potential is declining. We estimate potential growth will decline from around 9% at present to 8% by 2016 due to the effects of population aging, lower capital accumulation, and declining growth of total factor productivity.

2012 Budget settings are mildly growth supportive

The budget deficit target and underlying policies are generally consistent with a more growth supportive policy stance. While the officially announced budget deficit target of -1.5% of GDP does not look particularly expansionary on paper (up from an outturn of -1.3% of GDP last year), in reality it contains a significant dose of stimulus. Excluding an above-the-line transfer of 0.5% from surplus revenues from last year (deposited in a fiscal stability fund), the adjusted budget deficit would be closer to 2.0% on a comparable basis from last year.

The 2012 budget is broadly in line with our previous expectations for fiscal policy, including some acceleration in social spending, measures to boost domestic consumption through tax cuts, as well as support to SMEs through financing, favourable tax treatment and government procurement. Specifically, spending in education, the largest item in 2012 budget, is expected to grow by 17.5% in 2012, up from 14.6% in 2011. Social security and employment related spending will also grow by 16.1% according to the budget. Spending on affordable housing will continue the rapid pace of growth, with the budget expected to grow by 15.1% in 2012, much higher than the 9.6% outturn in 2011 (Table 1).

Table 1
China's 2012 budget spending targets

	Share of total budget spending 2012	% growth 2012	% growth 2011
Education	15.2	17.5	14.6
Social Security and Employment	10.4	16.1	14.2
General Public Service	9.4	5.0	4.4
Agriculture Forestry and Water Conservancy	9.0	13.7	15.9
Urban and Rural Community Affairs	6.9	12.3	10.4
Transportation	6.6	10.1	12.0
Medical and Health Care	5.9	15.4	13.0
Public Security	5.6	11.5	13.8
National Defense	5.4	11.2	12.7
Affordable housing expenditure	3.5	15.1	9.6

Source: China NPC 2012 Budget Report and BBVA Research

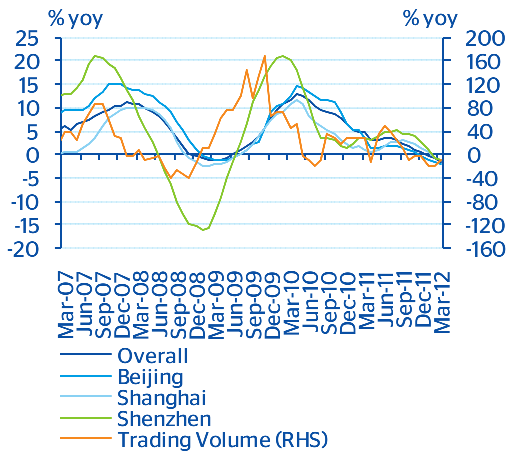
Further progress in containing domestic financial fragilities

Other than the impact of the external environment on China's economy, we continue to monitor progress in addressing a number of domestic fragilities that have come to the fore in the past couple of years. Chief among these, as discussed in our previous Outlooks, are downward price adjustments in the property market, high levels of local government debt, and the consequences of rapid shadow bank lending. There has been further progress in addressing these risks over the past quarter, although challenges remain, especially for the medium term.

Further gradual declines in property prices reduce the risk of a bubble...

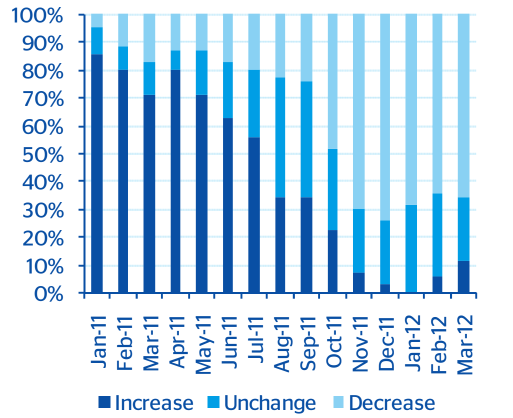
Residential property prices have continued to decline at a modest pace. (see our annual Real Estate Outlook[1] for a broad overview of developments and policies and an assessment of the degree of price misalignments). Property prices peaked in July of last year. Based on official NBS data, we calculate the cumulative decline in average nationwide price since then to be a modest -1.5%, with price declines in the first quarter alone amounting to -0.7% (Chart 27). Well over half of the 70 cities monitored by the NBS were reporting price declines on a sequential basis in March (Chart 28). The extent of price declines, however, varies widely across individual markets. For example, the lower-Yangtze river region, including Shanghai, Hangzhou and Nanjing, show the largest price declines so far, ranging from cumulative declines of -1.8 to -6.5% since July. Along with price declines, transactions volumes have fallen, although they turned up in March, perhaps as developers cut prices to clear accumulating inventories (Chart 27).

Chart 27
Property prices and transactions volume moderated gradually in Q4



Source: NBS, CEIC and BBVA Research

Chart 28
The majority of cities are still reporting housing price declines



Source: NBS and BBVA Research

As noted in our previous Outlooks, price declines in the real estate market are in part the result of deliberate policy actions to maintain housing affordability and reduce the risk of destabilizing housing bubbles. With both sales transactions and prices falling, financial pressures may be building on real estate developers. Such pressures could eventually trigger more abrupt price declines if liquidity-starved developers are forced to sell inventory to meet payments on their liabilities.

While there is some anecdotal evidence of financial stress among some developers, we find little evidence to date of a systemic problem. Moreover, the central government authorities have repeatedly stated they do not intend to ease purchase restrictions in the near future, despite efforts by some local governments in this direction. However, attempts to ease restrictions for first time home purchasers are appearing. These include, for example, discounted interest rates and lower down payment requirements in certain cities. Whether these attempts are successful remained to be watched.

[1] "China Real Estate Outlook" July 11, 2011.

Risks of local government debt and shadow banking easing, at least for now...

While the high level of local government debt remains a challenge, near-term risks have eased thanks to rapid GDP growth and efforts to prevent further net borrowing by local governments. In particular, local government debt as a share of GDP declined to 18.5% as of end-2011 from 21.7% a year ago. According to central government data, total outstanding local government debt remained about flat in nominal terms in 2011. A CBRC policy announced last February to allow banks to rollover some of the debts of local governments has also helped to extend the maturity of these loans, although a more permanent solution still needs to be found.

In the meantime, shadow bank lending continued to trend downward through the first quarter of this year as the authorities continue to implement policies to curtail such lending.

Financial reforms continue to advance, albeit gradually

Financial sector reforms remain a priority for the medium term, including gradually liberalizing the domestic financial system and opening the capital account. Over the past quarter, a few additional steps have been taken in this regard. In addition to the widening of the daily trading band of the RMB, they include:

- Implementation of a pilot program in Wenzhou to: (i) reduce entry thresholds for new private banks in order to enhance banking competition (the measure effectively brings private lending activities within the formal banking system); and (ii) to allow individuals to engage in outward portfolio investment. The program is still awaiting details and implementation. If successful, the authorities plan to broaden the program to other cities over time.
- Plans for a possible pilot program in Shenzhen to allow enterprises to borrow RMB more freely in the offshore market in Hong Kong.
- An increase in the aggregate quota under the QFII program, from USD 30 billion to USD 80 billion; and an increase in the RQFII program from RMB 20 billion to RMB 70 billion.

The policies above have also been accompanied by official statements about plans to deepen capital market liberalization, open the range of permissible lending activities, and liberalize interest rates. The latter has been cast as an effort to “break the monopoly” enjoyed by state-owned banks, whose profits have been protected by the existing system of interest rate controls covering deposit rate caps and lending rate floors. We expect such policies to be carried out very gradually timetable, however, over the coming years.

3. Growth may be bottoming out

As noted above, growth has continued to moderate at a gradual pace, helping to alleviate previous concerns about overheating while sustaining enough speed to avert a hard landing. Although first quarter growth slowed by more than expected due to the weak external environment, we anticipate a pickup in momentum on resilient domestic demand and increasing policy support. Moreover, a gradual improvement in the external environment as envisaged in our baseline should provide further support from external demand as the year progresses. We are therefore maintaining our 2012-13 growth projections unchanged at 8.3% and 8.7% respectively (Table 2). That said, the balance of risks remains tilted to the downside due to the uncertain outlook for the global economy.

Maintaining relatively high growth on resilience of private consumption

Our 2012-13 growth projections are underpinned by a further pickup in domestic consumption, which should offset slowing investment and export growth. We expect growth momentum to rise gradually during the year as the fiscal and monetary policy mix becomes more growth-supportive, and as the global economy improves in the second half (Chart 29). Over the medium term we continue to expect a gradual rotation of growth to domestic demand, especially private consumption (Chart 30).

Inflation is expected to remain moderate despite rising oil prices

We expect inflation to remain contained in 2012, at an average of 3.5% for the year. This reflects a slight increase from our previous projections (3.3%) due to the impact of rising oil prices under our baseline assumptions. We expect year-on-year inflation to decelerate to about 3.0% by mid-year, and end the year at 3.8% on base effects and as demand picks up. Over the medium-term, inflation is expected to average around 4%, boosted in part by rapid wage growth.

Table 2
Baseline Scenario

	2009	2010	2011	2012 (F)	2013 (F)
GDP (%, y/y)	9.2	10.4	9.2	8.3	8.7
Inflation (average, %)	-0.7	3.3	5.4	3.5	3.8
Fiscal bal (% of GDP)	-2.8	-1.7	-1.1	-1.8	-1.8
Current acct (% of GDP)	5.2	4.0	2.8	2.5	2.8
Policy rate (%, eop)	5.31	5.81	6.56	6.06	6.56
Exch rate (CNY/USD, eop)	6.83	6.62	6.30	6.12	5.88

Source: BBVA Research

The policy mix is becoming more growth supportive

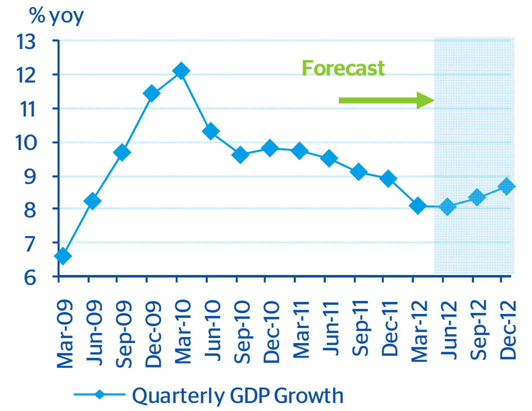
Our baseline continues to incorporate a further easing of the monetary stance and implementation of growth supportive 2012 budget policies. With inflation expected to remain within the authorities' 4% comfort zone, we see scope for some additional cuts in the RRR, amounting to a total of 100-150 bps in the second and third quarters. These could also be accompanied by up to two interest rate cuts in the third quarter, of 25bps each, especially if the external environment fails to improve as envisaged in our baseline.

As noted above, the overall 2012 fiscal stance is growth supportive, albeit mildly so given constraints from the high level of local government debt and perceptions of some "overstimulus" in 2008-09. Specific policies include various tax cuts to boost consumption, a pickup in social spending, and support to SMEs through financing, favorable tax treatment and government procurement. Spending on affordable housing construction is a key element of the 2012 spending plans.

Currency appreciation to be limited due to the weak external environment

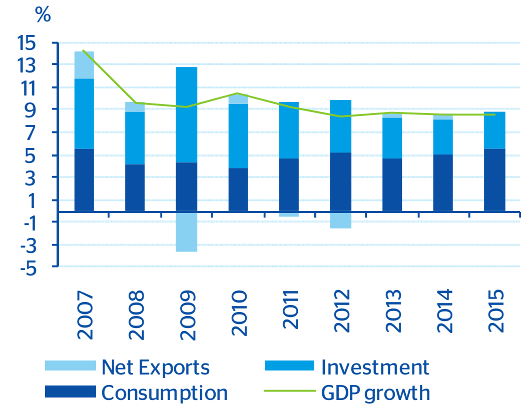
Currency appreciation is expected to remain relatively limited during 2012. After remaining essentially unchanged against the USD during the first half of the year, we expect some gradual appreciation to resume in the second half of the year, on the basis of a somewhat improved external environment. Such appreciation would amount to no more than 2-3% against the USD for the full-year (slower than the pace of around 5% last year), bringing the exchange rate to around RMB 6.12 per USD by end-2012.

Chart 29
China's GDP growth



Source: NBS, CEIC and BBVA Research estimates

Chart 30
A rebalancing of growth over the medium term



Source: NBS, CEIC and BBVA Research estimates

4. Risks remain to the downside

Risks remain tilted to the downside given the uncertain external environment and lingering domestic fragilities. While a further moderation in growth cannot be ruled out, it appears for now that the possibility of a hard landing, which we have always regarded a low risk, has diminished. Recent activity indicators, the shift to more growth supportive policies, and the room for additional stimulus if needed, provide comfort that a hard landing can continue to be avoided.

The predominant risk to the outlook in our view continues to be from the uncertain external environment. Exports have been weakening on sluggish external demand and a further deterioration of the external environment could weigh further on growth momentum. Moreover, financial tensions in Europe, should they continue, could have a chilling effect on risk appetite and investment. The relatively closed nature of the capital account should continue to shield China's banking system and capital markets from the direct fallout of external disturbances. Nevertheless, ripple effects through tighter financing conditions are possible, as continues to be been seen through the underperformance of the stock market and a decline in IPOs of Chinese companies.

Higher oil prices from possible tensions in the Middle East also remain a risk to growth and inflation. However, in the event of a large spike, the pass through to domestic prices would likely be limited through subsidies, and China's reliance on other energy sources, such as coal, would diminish the impact.

In contrast, domestic financial fragilities appear to have eased somewhat as a near-term risk, although they remain a challenge over the medium-term. We continue to monitor the risk of abrupt property prices declines and fallout of measures to slow lending in the shadow banking industry. Encouragingly, property prices have continued to decline at a moderate pace, with financial pressures on real estate developers still appearing to be manageable. Also, the gradual relaxation of monetary policy is facilitating a pick up in credit growth from the formal banking system, which is helping to ease financing constraints.

The level of contingent liabilities to the central government, especially relating to local government debt, is also a risk. In addition to acting as a constraint on the space for additional fiscal stimulus, the high level of local government debt could eventually hit bank balance sheets. In particular, resolving potential problem loans would likely involve a combination of bank rollovers and eventual writeoffs, along with an injection of and central government funds. It is encouraging that the authorities appear to have succeeded in limiting the growth of further local government debt. Together with continued strong GDP growth, the scale of the problem relative to the economies size has continued to diminish, although it remains substantial.

We continue to see scope for further policy easing if downside risks materialize. In particular, monetary policy could be eased more aggressively if necessary, and there is room for additional modest fiscal measures, including subsidies for consumption.

On the political front, the coming year will be marked by a leadership change, with new members of the Standing Committee of the Political Bureau, the key decision-making body, to be put in place around October. In March 2013, a new President and Premier will be selected, replacing the incumbent leadership of President Hu Jintao and Premier Wen Jiabao. We expect the leadership change to proceed smoothly, with few if any changes in the near-term policy direction. Nevertheless, a series of recent unexpected events involving the ouster of the former Chongqing party chief and Politburo member on corruption charges is a reminder that such transitions always entail a degree of uncertainty and risk.

5. Tables

Table 3
Macroeconomic Forecasts

	2009	2010	2011	2012 (F)	2013 (F)
GDP (%, y/y)	9.2	10.4	9.2	8.3	8.7
Inflation (average, %)	-0.7	3.3	5.4	3.5	3.8
Fiscal bal (% of GDP)	-2.8	-1.7	-1.1	-1.8	-1.8
Current acct (% of GDP)	5.2	4.0	2.8	2.5	2.8
Policy rate (%, eop)	5.31	5.81	6.56	6.06	6.56
Exch rate (CNY/USD, eop)	6.83	6.62	6.30	6.12	5.88

Source: BBVA Research

Table 4
Gross Domestic Product

(YoY growth rate)	2009	2010	2011	2012 (F)	2013 (F)
U.S.	-3.5	3.0	1.7	2.3	2.2
EMU	-4.2	1.8	1.6	-0.2	0.9
Asia-Pacific	4.2	8.1	5.7	5.7	6.1
China	9.2	10.4	9.2	8.3	8.7
World	-0.6	5.1	3.9	3.6	4.0

Source: BBVA Research

Table 5
Inflation (Avg.)

(YoY growth rate)	2009	2010	2011	2012 (F)	2013 (F)
U.S.	-0.3	1.6	3.2	2.5	2.3
EMU	0.3	1.6	2.7	2.4	1.5
Asia-Pacific	0.3	3.6	4.8	3.5	3.5
China	-0.7	3.3	5.4	3.5	3.8
World	2.2	3.0	5.1	4.4	4.0

Source: BBVA Research

Table 6
FX rate (End of period)

		2009	2010	2011	2012 (F)	2013 (F)
U.S.	EUR/USD	0.72	0.76	0.72	0.78	0.77
EMU	USD/EUR	1.39	1.33	1.39	1.28	1.30
China	CNY/USD	6.83	6.62	6.30	6.12	5.88

Source: BBVA Research

Table 7
Policy rate (End of period)

	2009	2010	2011	2012 (F)	2013 (F)
U.S.	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	1.00	1.00	1.00
China	5.31	5.81	6.56	6.06	6.56

Source: BBVA Research

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