BBVA | RESEARCH

Economic Outlook

China

Fourth Quarter 2012
Economic Analysis

- **Bold policy actions by central banks have reduced uncertainties in the global outlook, but challenges remain.** We expect the world economy to continue its soft recovery, with GDP growth of 3.5% in 2013, up from 3.2% in 2012.

- **After slowing by more than expected through the third quarter, China's economy is picking up speed**. We expect momentum to rise gradually on policy support, bringing full-year growth to 7.6% and 7.9% in 2012-13, albeit slightly lower than our projections from last quarter.

- **With inflation still soft, there is scope for further policy easing as a safeguard against downside risks to the outlook.** While the likelihood of monetary easing has receded for the time being, our baseline continues to build in further reductions in the RRR of 100bps and we would not rule out another 25bp interest rate cut in the coming 1-2 quarters.

- **Currency appreciation has picked up in recent months, but may prove short-lived given weakness in external demand.** We have left our end-year forecast of 6.32 per USD unchanged, with, with appreciation expected to resume in 2013.

Index

Publication date: Nov 13, 2012

Summary

China's growth momentum continued to slow by more than expected in the third quarter, to 7.4% y/y from 7.6% in Q2 due to external headwinds and lags in the effect of policy stimulus put in place earlier in the year. Though picking up in sequential terms, on a year-over-year basis GDP growth fell to its lowest pace in almost 4 years, resulting in downgrades to the growth outlook and temporarily raising renewed concerns of a more abrupt slowdown.

While the slowdown this year has been somewhat steeper and more prolonged than previously expected, more recent activity indicators are showing signs of a pickup. In particular, activity indicators for September and October show a rebound in investment, led by a pickup in public infrastructure spending. Consumption spending and exports are also increasing, although their sustainability remains in doubt. The data suggest that growth slowdown is likely to have bottomed out in Q3, and that the official full-year 2012 growth target of 7.5% is still easily achievable.

Our updated growth projections for 2012-13 reflect modest downward revisions, to 7.6% and 7.9% (from 7.8% and 8.3% previously). The revisions are due to the weaker-than-expected Q3 outturn and expectations of continued sluggish external demand. That said, our projections incorporate a pick up in the coming quarters from the effect of policy easing, and as external conditions improve under our global baseline.

Inflation has continued to soften, reaching a new low of 1.7% y/y in October, on subdued demand pressures, moderating food prices, and favourable base effects. We expect inflation to rise gradually as growth picks up, to 2.6% y/y in December, and to 3.8% by end-2013. As such, inflation should remain within the authorities' 4% comfort level over the coming year, providing room for additional policy support as needed.

With inflation low and the recent growth pickup still at risk, we expect policy easing to continue in the coming quarters. The overall policy stance has been growth supportive, marked by interest rate and RRR cuts earlier this year, more recent PBoC liquidity injections, and stepped up infrastructure spending. As a safeguard against risks to the outlook, over the coming 1-2 quarters we expect further cuts in the RRR (up to 100 bps) and we would not rule out another 25bp cut in interest rates, accompanied by further fiscal initiatives.

Currency appreciation has picked up in recent months, but may prove short-lived, prior to an expected return of a more sustained pace of appreciation in 2013. After remaining flat against the USD for most of this year, the RMB has recently strengthened to around 6.23 per USD, reflecting a combination of renewed capital inflows and, possibly, efforts to head off criticism from trading partners, especially in the context of the recent US Presidential elections. As such, we have left our end-year projection of 6.32 per USD unchanged, with a return to a more sustained, but modest 2-3% pace of appreciation against the USD in 2013 as external conditions gradually improve.

Domestic fragilities remain manageable, but are at risk of increasing again from the authorities' efforts to stimulate the economy. On the one hand, concerns of a hard landing in the property sector have diminished given the recent stabilization in prices and sales transactions, even as tightening measures remain in place to maintain affordability. On the other hand, after stabilizing over the past year, local government debt and shadow bank lending are on the rise again as the authorities encourage credit flows to finance infrastructure spending. While these risks bear watching over the medium term, they do not pose imminent threats given their limited magnitude and the authorities' vigilance in monitoring them.

The main near-term risk to the outlook continues to be from the uncertain global environment due to the sovereign debt and financial crisis in Europe, and the US "fiscal cliff". If downside risks intensify, we would expect policy stimulus to be stepped up to sustain growth in line with the targets of the Five-year Development Plan (around 7%).

1. Central bank actions reduce tail risks

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 7.

Bold actions by central banks have reduced uncertainties in the global economic outlook, but challenges remain

The world economy is expected to continue its soft recovery, with GDP growth of 3.5% in 2013, up from 3.2% in 2012. The outlook is supported by lower risk aversion after influential decisions taken by central banks, especially the ECB. However, three factors stand out that could undermine the outlook: first is the risk of a re-emergence of euro break-up fears; second is the threat of the so-called US fiscal cliff (a spending-cut and tax-hike package worth 4% of GDP) due to take effect at the beginning of 2013 that would push the US economy back into recession; and third, is the risk of a slowdown in the emerging economies, especially in China.

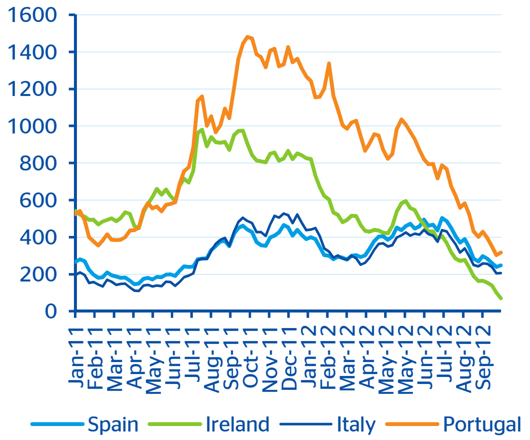
Central banks to the rescue; other policy makers should follow

Against a backdrop of uncertainty and threats to the world economy, policy makers – in particular central banks in the eurozone and the US – have taken steps to avert a systemic event that could have been comparable in scale to the financial crisis of late 2008.

"… whatever it takes…"

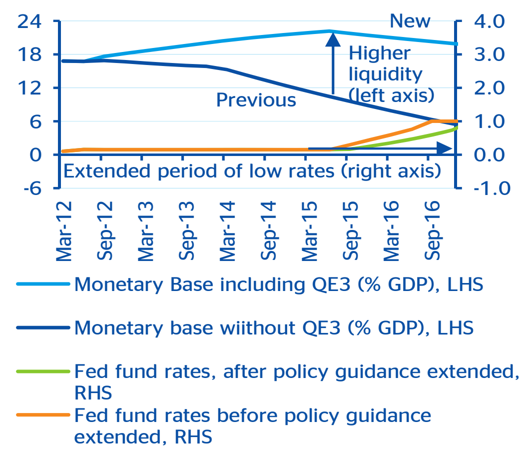
In our view, European Central Bank (ECB) President Mario Draghi's announcement of a new bond-purchase program (Outright Monetary Transactions, or OMT) in late July was a decisive step toward ending the debt crisis in Europe. Under certain conditions, the ECB could intervene in secondary sovereign-debt markets. The ECB's move came after a eurozone summit in June where leaders reached agreement on a broad roadmap towards a single banking supervisor, far-reaching plans on fiscal issues, and growth-supporting measures. The ECB has committed itself to buy unlimited quantities of sovereign bonds of those countries that seek financial aid from Europe's funds (European Financial Stability Fund & European Stability Mechanism) with "strict and effective conditionality." Tensions in financial markets have eased significantly since June (see Chart 1).

Chart 1
Financial Stress Index for Eurozone countries[1]



Source: Haver and BBVA Research

Chart 2
QE3 and extended policy guidance



Source: BBVA Research

[1] The Financial Stress Index (FSI) is a synthetic indicator of: risk measures (5-year CDS, CDS of non-financial corporations and financial debt), volatility (stocks, interest rates and exchange rates) and liquidity stress (3-month spread between interbank and risk-free asset).

Other elements have recently reinforced the currency union in Europe. First, the permanent fund that will deal with any new bailout in the eurozone (the ESM) has been put in place. Second, the process for achieving a banking union in Europe continues moving forward, albeit slowly.

We expect the eurozone to come up with a full package eventually that will reinforce its governance. As we have long argued, such a package should comprise a banking union, a fiscal union, and a lender of last resort facility. Progress has been made on all of these fronts which, though not ambitious enough yet to revert the current dynamic quickly, will alleviate pressures over time. In the short term, the ECB's program and the ESM support under fiscal conditionality creates a benchmark to deal with difficult funding situations that countries such as Italy and Spain could face. At the same time, effective implementation of the banking-union plans and further definition of the fiscal-union design will be key to the long-term sustainability of the eurozone.

"... as long as needed..."

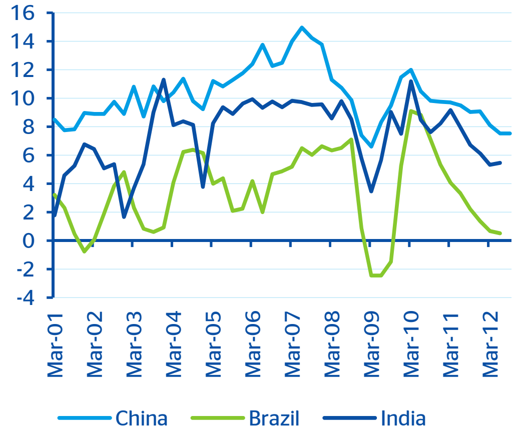
With the US economy growing slowly, unemployment remaining persistently high, and amid huge uncertainty in Europe, a pre-electoral gridlock over how to bring the US deficit down was the last thing the US economy needed. Against this backdrop, the Fed did not hesitate to act. First, and in accordance with its "forward-guidance policy," the Fed announced that it intends to keep rates at their current low levels until at least mid-2015. Second, the Fed announced a new round of quantitative easing (QE) to support growth and employment recovery. This further monetary loosening will be different from previous rounds: the Fed will purchase mortgage-backed securities (MBS) rather than Treasuries, and it will continue with this policy for a considerable period of time, even after the recovery strengthens.

In our view, by embarking on QE3 and extending policy guidance, the Fed is buying insurance against the "fiscal cliff," but it is not a silver bullet. In our baseline scenario, an agreement will be reached to avoid the complete package of automatic spending cuts and tax hikes from taking place. Yet we also expect some form of fiscal consolidation that will act as a drag on growth. The Fed has done its part to give the economy the boost it needs to avoid slipping back into recession in 2013. As previous QE programmes showed, they prompt inflows to emerging economies, decreasing risk premia, and lowering funding costs.

Central bank responses are not enough for a firm expansion

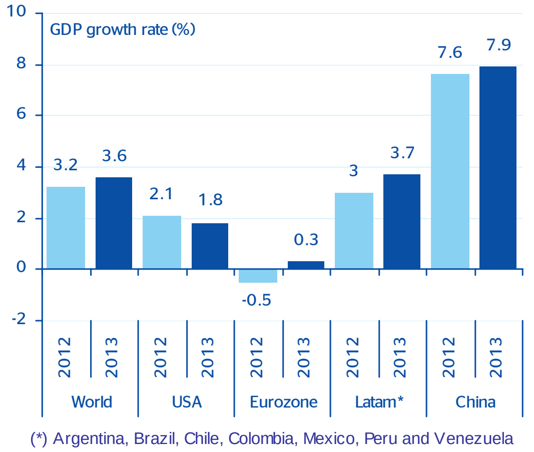
The world economy may have avoided decelerating to its slowest growth of the last 30 years (apart from the 2009 great recession) but a low growth environment continues. The advanced economies have been losing momentum since 2011. More recently the emerging economies have been hit too (see Chart 3). Brazil's economy almost stalled in the first half of the year; India's GDP grew by 5.3 and 5.5% y/y in the first and second quarter, respectively, the slowest pace since the beginning of 2009; and in the third quarter of the year the Chinese economy slowed to a rate of 7.4%, the lowest growth rate since 2009 although the more recent data points to a bottoming-out.

Chart 3
Emerging economies GDP growth rate (% y/y)



Source: Haver and BBVA Research

Chart 4
GDP Growth rate (%)



Source: Haver and BBVA Research

Under our baseline scenario, growth in the eurozone is likely to gain momentum in 2013. Although GDP will contract in 2012 (-0.5%), it should rebound slightly in 2013 (+0.3%). In the US, we have maintained our forecasts: growth will remain at around 2% in 2012 and 2013. The main downward revision in our October scenario corresponds to China (by -0.2 pp in 2012 and -0.4 pp in 2013), although its growth rate will still remain close to 8% in both years due to policy stimulus. Other emerging economies will make up for this slack: the outlook for growth in Latin America is revised slightly upwards in 2013, when the region will grow by 3.7%, up from a 3% growth rate in 2012.

All in all, the world economy is expected to continue undergoing a soft recovery with a GDP growth between 3% and 3.5%. Yet this scenario relies on several key assumptions, in particular on whether European policy makers will deliver on their commitments. In the meantime, the ESM/ECB's intervention should be enough to bring Spanish and Italian yields back to levels consistent with the mid-term sustainability of the public debt. This implies that both countries retain investment-grade ratings and deliver on their fiscal commitments (or are granted extensions to meet them, hopefully on structural balances). Finally, in this scenario, Greece should remain in the euro, which would, in turn, require further support from Europe in the form of additional funding and/or a longer period to fulfil fiscal conditionality. Based on past experience, many things can still go wrong, but policy makers have shown a tendency to find solutions when crunch time approaches.

2. The slowdown begins to bottom out

China's growth momentum continued to slow in the third quarter, to 7.4% y/y from 7.6% in Q2. While the slowdown this year has been somewhat steeper and more prolonged than previously expected, due to a combination of external headwinds and the lagged effect of policy stimulus, more recent activity indicators for September and October are showing signs of a pickup. This suggests that the growth slowdown is likely to have bottomed out in Q3, and that the official full-year 2012 growth target of 7.5% is still easily achievable. We expect growth to pick up in the coming quarters as policy easing continues, and as external conditions improve under our global baseline.

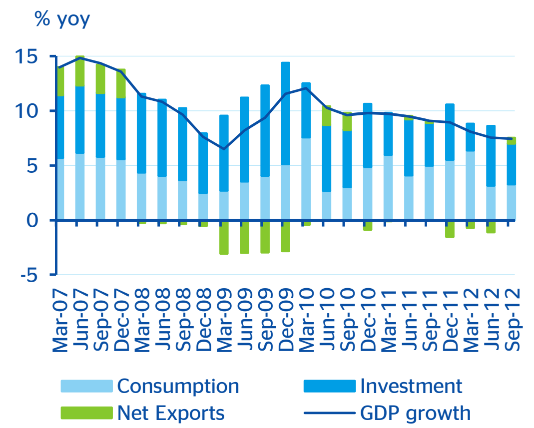
GDP growth has slowed on weak domestic and external demand

After peaking in Q4 2011, GDP growth has continued to slow, falling to 7.4% y/y in Q3, its lowest level in nearly 4 years (Chart 5). In sequential terms, however, growth actually picked up to 2.2% q/q seasonally adjusted from 2.0% in Q2, according to official data (our own seasonal adjustment estimates show a smaller pickup, from 1.7% in Q2 to 1.8% in Q3).

According to the official national accounts data, the slowdown in year-over-year growth in Q3 was attributable to weaker investment, partly offset by a swing in the contribution of net exports from negative in the previous quarter to positive, as well as a pickup in the contribution of consumption.

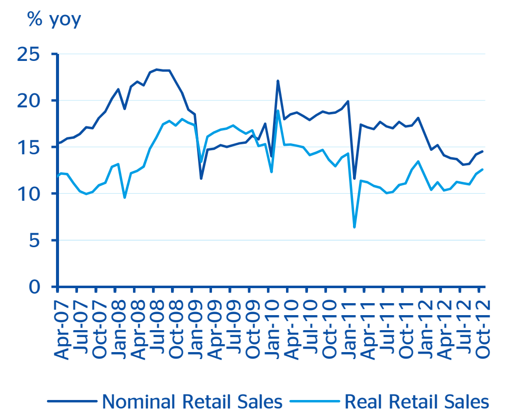
High frequency indicators for September and October provide evidence that growth bottomed out in Q3. In particular, urban fixed asset investment (22.2% y/y in October) picked up on increased public spending on railway and other infrastructure projects; retail sales have strengthened (14.5% y/y in October), industrial production has picked up for two consecutive months (9.6% y/y in October), and even exports have risen after a steady decline (Chart 7). These indicators are consistent was a rise in PMI outturns for September and October, which drifted back to above the 50% expansion/contraction zone (Chart 8).

Chart 5
GDP growth has declined on weak net exports and softer domestic demand…



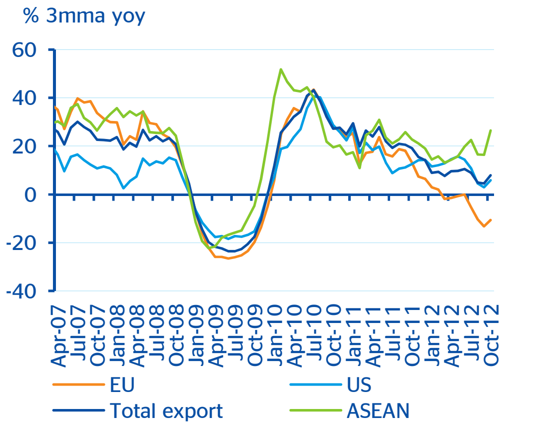
Source: CEIC and BBVA Research

Chart 6
Retail sales growth is picking up again



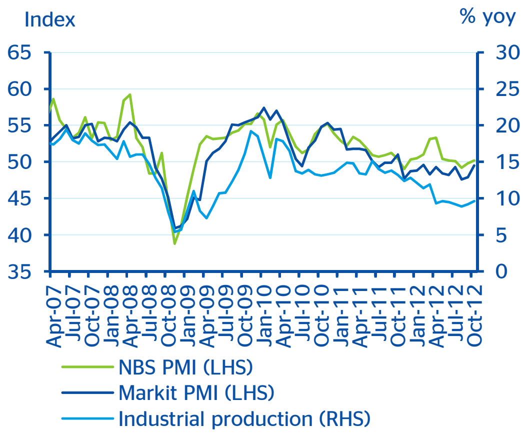
Source: CEIC and BBVA Research

Chart 7
Export growth has declined, especially to the EU



Source: CEIC and BBVA Research

Chart 8
NBS PMI has risen back above the 50-threshold

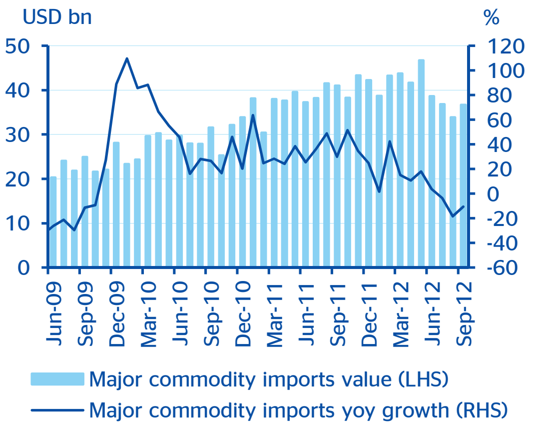


Source: CEIC and BBVA Research

The trade sector faces continued external headwinds

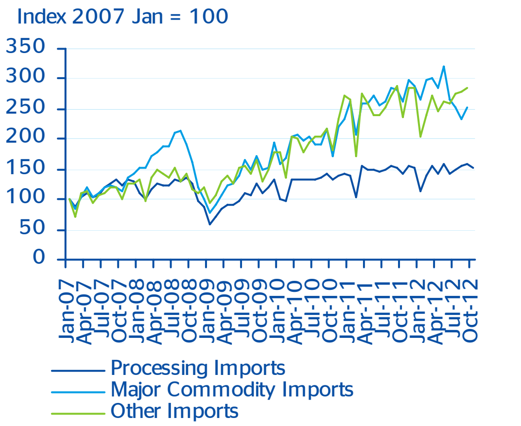
The weak global environment has continued to weigh on export growth, which slowed to 4.5% y/y in Q3 from 10.5% y/y in Q2. Export growth climbed by more than expected in September and October (11.6% y/y), contributing to the pickup in production during the period. But the upturn may prove to be temporary given weak demand in key export markets: by destination, the EU (China's largest export market), not surprisingly, has been a major drag, while demand from other emerging markets, especially in Southeast Asia, has been more resilient (Chart 8). Import growth (value) has also slowed, primarily due to lower commodity imports from a combination of weak domestic demand, a decline in commodity prices, and base effects. Imports of processing components and final goods, in contrast, held up in Q3 (Charts 9 and 10). As a result of these trends, the trade balance remained in substantial surplus through October (Chart 11). Nevertheless, as a share of GDP, the current account surplus has continued to narrow from a peak of 10.1% in 2007, to 2.6% of GDP in Q3 2012 (Chart 12).

Chart 9
Commodity imports have declined with the fall in prices



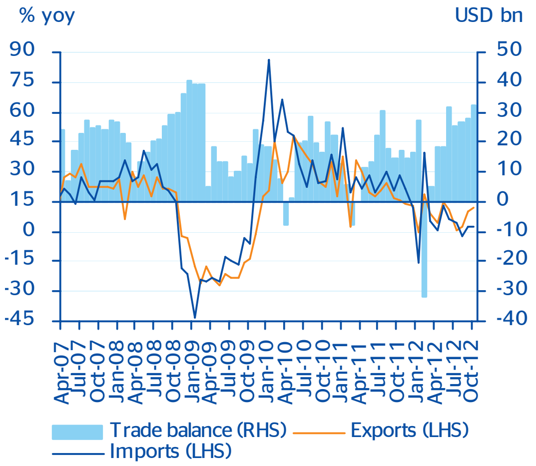
Source: CEIC and BBVA Research

Chart 10
Processing and commodity imports moderated



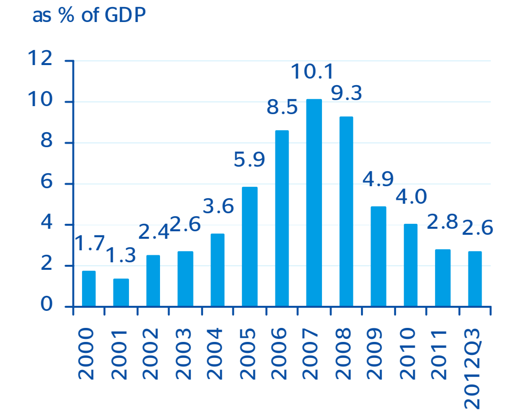
Source: CEIC and BBVA Research

Chart 11
Export and import growth are stabilizing



Source: CEIC and BBVA Research

Chart 12
A further narrowing
of the current account surplus as % of GDP



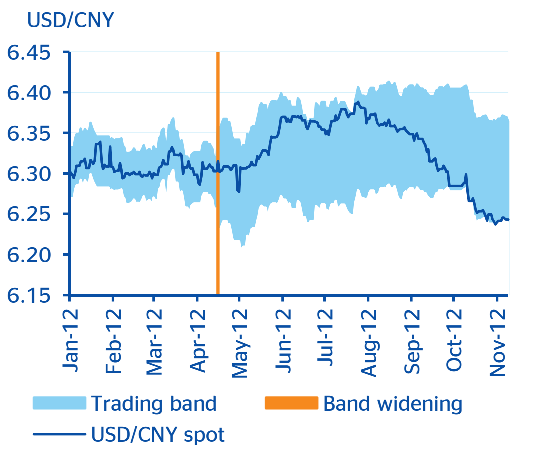
Source: CEIC and BBVA Research

A recent surge in currency appreciation

After weakening in the second quarter, the RMB has recently strengthened against the USD, reaching a maximum of 6.23 per USD—equivalent to an appreciation of 2.4% from its weak point in July--despite the continued moderation of growth momentum and uncertain external outlook. The appreciation began as the spot rate progressively moved toward the strong side of the PBoC's daily +/- 1% trading band, and then as the PBoC's daily fixings appreciated (Charts 13 and 14) (recall that the daily trading band was widened to +/- 1.0% from +/- 0.5% on April 16). The spot rate hit the strong limit for the first time on October 11 and on several occasions since then, implying a resumption of reserves accumulation. The factors for the appreciation include capital inflows spurred by the US launch of QE3, and improved confidence on firming economic data, and as the timing of the leadership transition was kept on track. The PBoC's stronger fixings in October and November might also have had political dimensions, as they occurred against the backdrop of the IMF/WB annual meetings and the US Presidential election, in which the competing campaigns focused on China's currency and trade practices (Chart 14).

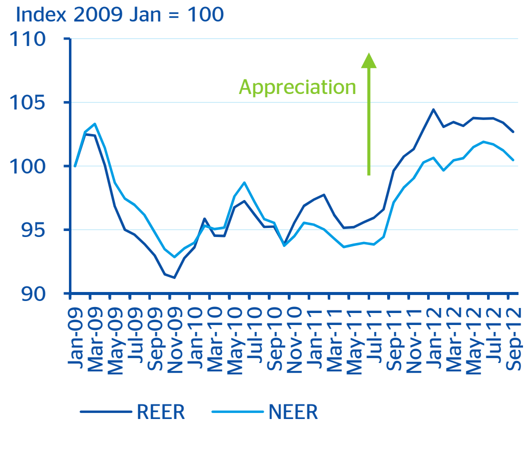
Foreign reserves through end-September were broadly flat, as the larger trade surplus was offset by portfolio outflows. As such, foreign reserves increased to USD 3.29 trillion as of end-September from USD 3.24 trillion at end-June (Chart 16).

Chart 13
Currency appreciation has resumed against USD



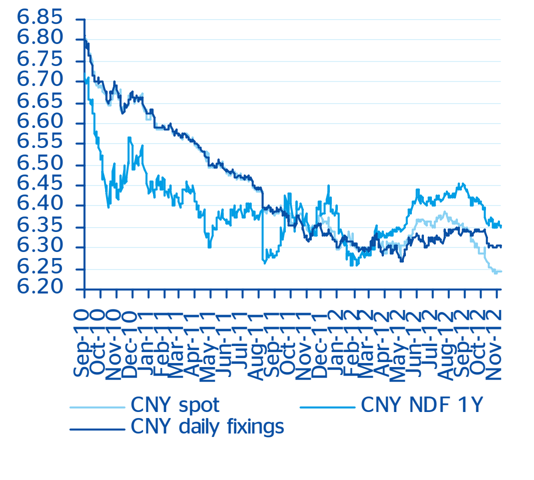
Source: Bloomberg and BBVA Research

Chart 14
The currency has appreciated in effective terms



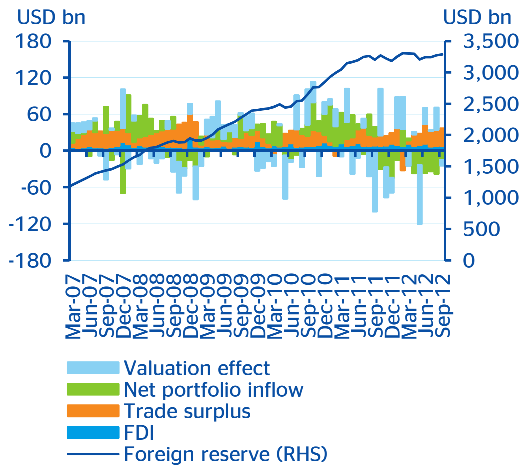
Source: BIS, CEIC and BBVA Research

Chart 15
RMB NDFs are still pricing in depreciation



Source: Bloomberg and BBVA Research

Chart 16
Portfolio outflows are one factor for slower reserve accumulation



Source: CEIC and BBVA Research

Box 1: Is China's economic rebalancing progressing?

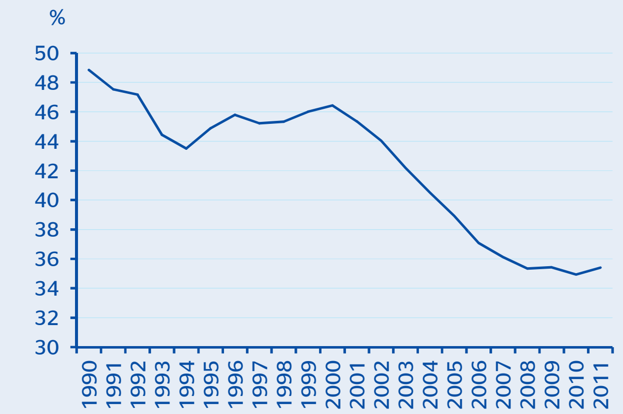
One of the top medium-term priorities set out in China's 12th Five-Year-Plan (FYP) is to rebalance the economic growth model toward domestic consumption from external demand and investment. This was one of the reasons for the lowering of the government's growth target to 7% for 2011-2015, down from 7.5% in the 11th Five-Year-Plan. To achieve the rebalancing, the 12th FYP sets the disposable income growth rate target at a faster pace than the GDP growth rate (the target for the minimum wage increases was also raised to 13% on average each year).

In opening the 18th National Party Congress, President Hu Jingtao set a goal of doubling real GDP and personal per capita income by 2020, implying at least 7.2% GDP growth for 2011-20. In the meantime, China's premier Wen Jiaobao announced the government will adopt a general guideline for reforming China's income redistribution system, aimed at addressing income inequality. Together with other initiatives including fiscal expenditure and tax reforms, the government aims to narrow the wealth gap, boost household incomes and improve the social safety net, all showing China's determination to rebalancing its economy, both externally and domestically.

Is rebalancing taking place in practice? On the external front, the current account surplus has fallen sharply in recent years -- after peaking at 10.1% in 2007, the current account narrowed to just 2.6% of GDP in the first three quarters this year, although part of this is cyclical due to sluggish external demand from the major export partners. Over the medium term, China's current account surplus is projected to level off at around 4% of GDP (as, for example, estimated by the Peterson Institute, May 2012; and IMF, July 2012).

On the domestic front, private consumption in China as a share of GDP started to pick up in 2011 at 35.4% from the bottom of 34.9% in 2010, after falling continuously in 1990s and 2000s (Chart 17). The pickup in private consumption as a share of GDP is encouraging, although current investment-oriented fiscal measures to offset global downturn may cause a temporary deviation from the domestic rebalancing process. We expect private consumption as a share of GDP to rise further to 35.9% by 2015. Another sign that rebalancing may be occurring is the rise in total wage growth - a gauge of household purchasing power – which has outstripped GDP growth since 2008 (Chart 18). There has also been progress in strengthening the social safety net, such as the full coverage of New Rural Pension System and Urban Social Pension System in October 2012. While there is a long way to go, these measures help to reduce precautionary savings of household, thereby boosting consumption and contributing to domestic rebalancing.

Chart 17
Private consumption % of GDP picked up in 2011



Source: NBS, CEIC and BBVA Research;

Chart 18
Wage growth outpaced GDP growth

Source: CEIC and BBVA Research

Policy easing continues, but at a less aggressive pace

While the policy stance has turned growth supportive in response to the weakening global environment and disappointing activity indicators, the pace of easing has been less aggressive than previously expected. On the monetary side, the PBoC has been on been hold since July, following back-to-back interest rate cuts, and 150bps of reductions in the RRR between December 2011 and May 2012 (Charts 20 and 21). On the fiscal side, there has been stepped up infrastructure spending, although it has been within the context of the existing budget for the most part. There have, however, been other more subtle forms of policy easing, including liquidity injections through more active use of open market operations by the PBoC (Charts 22 and 23), and various forms of regulatory forbearance to support funding needs of state-owned enterprises and local governments. On top of allowing banks to extend new loans to credit worthy local government financing vehicles (LGFVs) in June, the authorities further relaxed restrictions to allow some local governments to issue bonds. The authorities also exercised greater leniency on local governments' to borrow from non-bank financial institutions (shadow banks) such as trust companies.

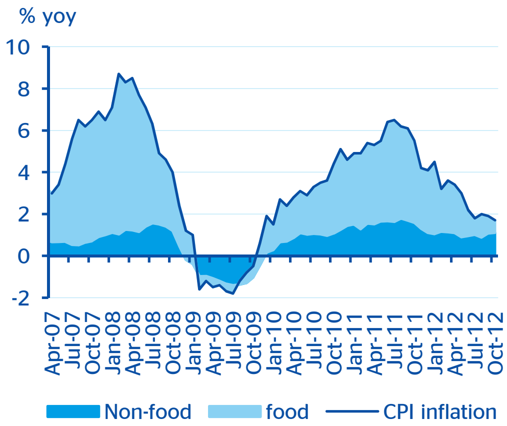
The most likely reasons for the lack of a more forceful policy response to date are: (i) concern about fuelling a property price bubble; (ii) domestic criticism that the policy reaction to the slowdown in 2008-09 resulted in over-stimulus and gave rise to domestic financial fragilities; (iii) that the slowdown to date has not been very severe, especially given a still strong labour market and signs that activity is now picking up; and (iv) tensions associated with the ongoing leadership transition. We expect policies to turn more expansionary as the leadership transition is completed, especially if external conditions remain weak and the uptick in activity proves temporary.

Inflation remains subdued, as credit and financial markets pick up

Headline CPI eased to a 33-month low of 1.7% y/y in October on moderating food prices (Chart 19). At the same time, producer price deflation has persisted (-2.8 y/y in October), but appears to be stabilizing.

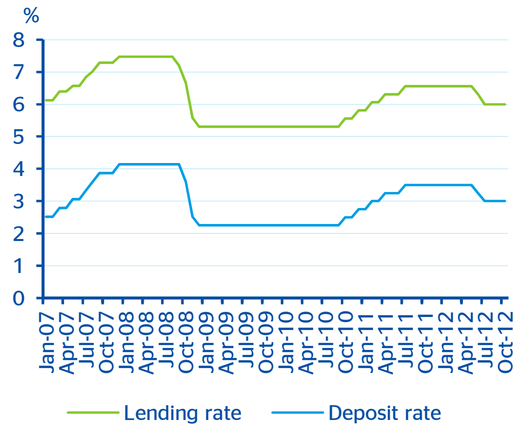
After underperforming for the past year, the stock market may be poised for an improvement as growth and profits pick up (Chart 24).

Chart 19
Inflation has continued to fall



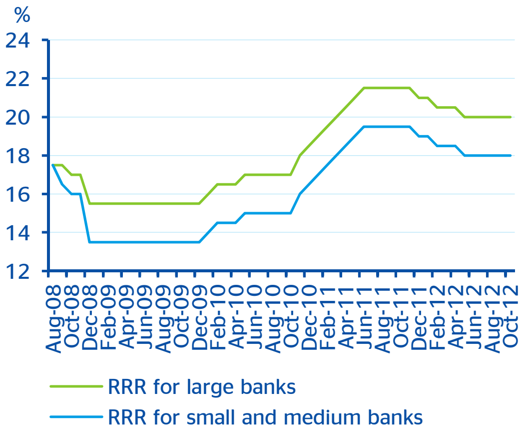
Source: CEIC and BBVA Research

Chart 20
Back-to-back interest rate cuts in June and July



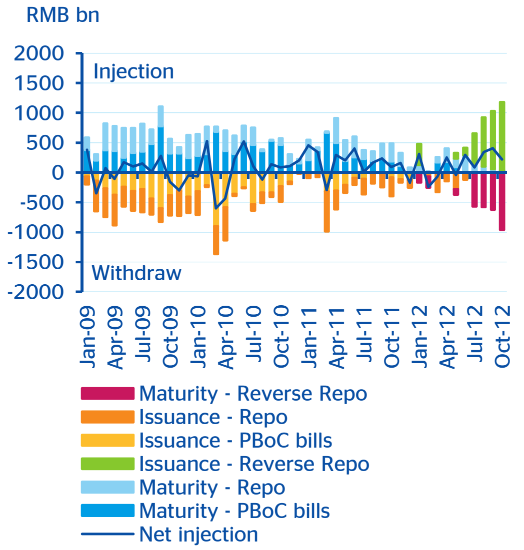
Source: Wind and BBVA Research

Chart 21
Three reductions in required reserve ratios since November



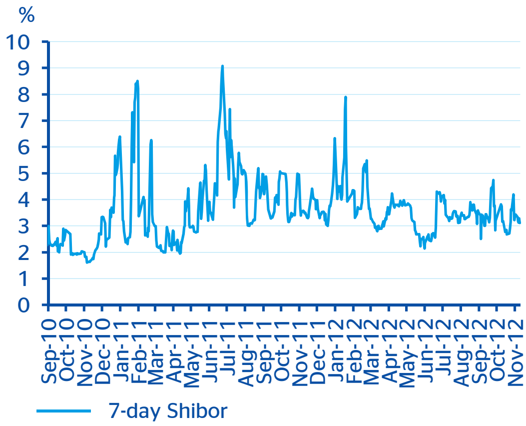
Source: Wind and BBVA Research

Chart 22
The PBoC inject liquidity via reverse repo since May



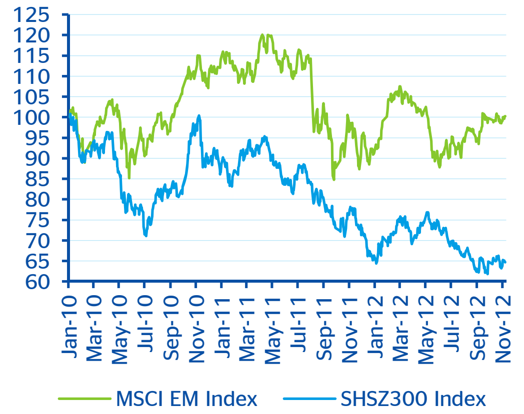
Source: CEIC and BBVA Research

Chart 23
Inter-bank rates remain reasonably low



Source: Wind and BBVA Research

Chart 24
...and the stock market has underperformed (2010 Jan = 100)



Source: Bloomberg and BBVA Research

Meanwhile, bank credit and M2 growth have been relatively flat (Chart 25). Nevertheless, the proportion of long-term loans has increased (Chart 26), a sign of credit flows for public infrastructure projects and enterprise investment. Overall, cumulative new loans through the first ten months of the year have amounted to RMB 7.2 trillion, broadly in line with the full-year informal target of around RMB 8.0-8.5 trillion. More importantly, "total social financing" (TSF), a more comprehensive measure of credit growth (combining bank and nonbank forms of financing), has accelerated during the same period (Chart 27). Trust loans (extended by non-banking institutions) and corporate bond issuance have picked up.

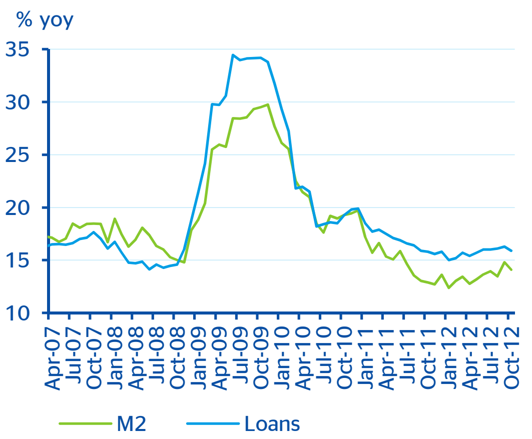
Fiscal spending is modestly stepped up

As noted our previous *Outlook*, the authorities' 2012 deficit target, announced at the March NPC meeting earlier this year, is effectively around 2% of GDP, (after accounting for 0.5% of GDP in revenue transfers from last year), up from the outturn of 1.3% in 2011. To support growth, the authorities began implementing a series of supportive fiscal policy measures, beyond those envisaged in the previously announced budget targets. To the extent that they rely on government-led infrastructure spending (Chart 28), some elements of the fiscal support bear similarities to the post-Lehman stimulus package, albeit on a much smaller scale. In the third quarter, a number of local governments announced large-scale spending plans, although details of the timing and financing have not been specified (Table 1). Investment in railroads and urban subways is an important element of the local government packages.

In addition to infrastructure investment, fiscal initiatives include subsidies on the purchase of durable goods for automobiles and consumer durables. Tax reforms are also in process, including a pilot program to replace the business tax with a VAT to reduce double taxation on enterprises (especially SMEs) in the transportation and other services sectors (the pilot has been implemented in Shanghai since the beginning of 2012 and was later expanded to eleven other provinces, municipalities and major cities). The government is also continuing to speed up spending on the ongoing social housing projects.

Chart 25

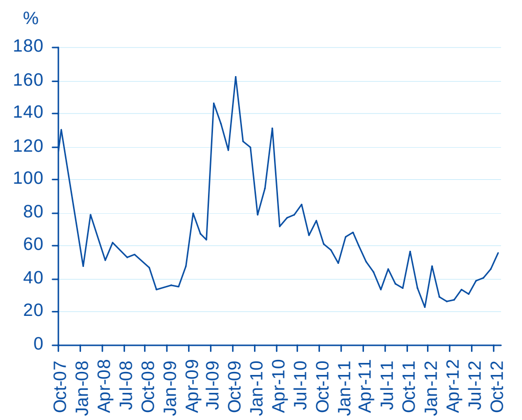
Credit and M2 growth remain flat



Source: CEIC and BBVA Research

Chart 26

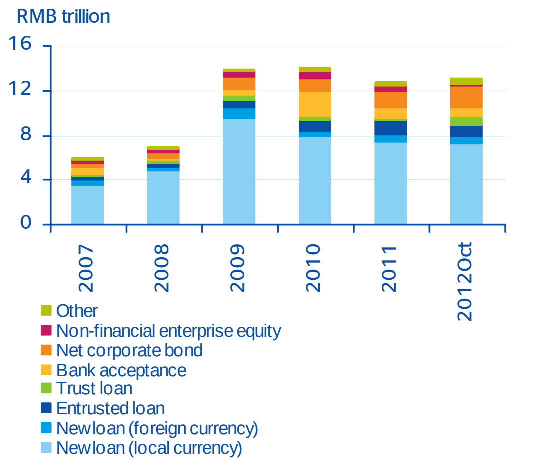
The share of medium & long-term loans may rise on a pickup in new public projects



Source: CEIC and BBVA Research

Chart 27

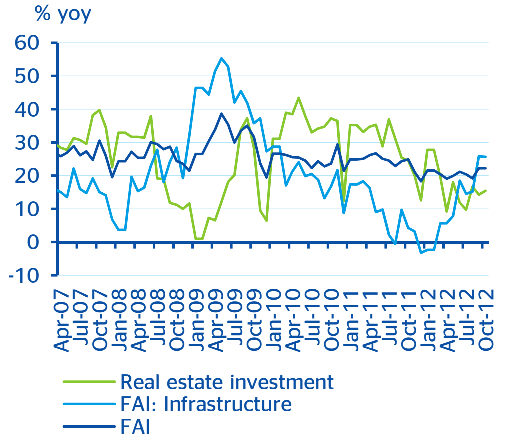
"Total social financing" picked up driven by trust loan and corporate bonds



Source: CEIC and BBVA Research

Chart 28

Infrastructure investment has rebounded



Source: CEIC and BBVA Research

Table 1

Local government stimulus proposals

Local Government		Announced Date	Value (RMB)	Period	Details
Ningbo	City	2012 July			Tax reduction and accelerate major / strategic emerging industries
Nanjing	City	2012 July			Consumption stimulus in real estate, automobile, tourism and other sectors
Changsha	City	2012 July	829 bn		Infrastructure, industrial development and other projects
Guizhou	Province	2012 July	3,000 bn	10 years	Infrastructure, ecological travelling and other industries
Guangdong	Province	2012 July	235 bn		Major infrastructure projects
Guangzhou	City	2012 Aug	1,000 bn		Major projects in marine-related secondary and tertiary industries
		2012 Aug	200 bn		Infrastructure and other industries
Fujian	Province	2012 Aug	1,400 bn	12th FYP	Investment in technological upgrading for secondary and tertiary industries
Hubei	Province	2012 Aug	300 bn	12th FYP	Major infrastructure projects
Chongqing	City	2012 Aug	1,500 bn	3 years	Major projects in 7 secondary and tertiary industries
Shanxi	Province	2012 Aug			Secondary and Tertiary industries
Tianjin	City	2012 Aug	1,500 bn	4 years	Major projects in 10 Secondary and Tertiary industries
Zhejiang	Province	2012 Aug	1,200 bn	12th FYP	Major projects in marine-related industries
Sichuan	Province	2012 Sep	3,670 bn	2 years	Major projects in transport infrastructure, energy and modern service industry

Source: Media reports and BBVA Research

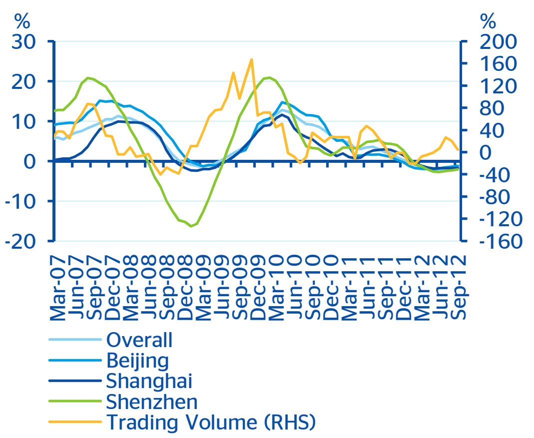
Financial liberalization proceeds gradually

Financial liberalization steps are continuing to advance. The most significant to date is the enhancement of interest rate flexibility taken last June and July, when the PBoC expanded the range of permissible lending rate discounts to 30% and introduced a 10% premium over the benchmark deposit rate -- additional measures have been implemented this year. (Banks have generally made use of the expanded flexibility to raise deposit rates, but have not used the full room to lower lending rates, as the cap on these was not binding in practice.) More recently, a financial sector plan was introduced in September as a follow-up to the 12th Five-Year (2011-2015) Plan. While vague in details and without specifying a timetable, the Plan reaffirms the intention to abolish interest rate controls, open the capital account, encourage financial innovation, and strengthen the financial regulatory framework. The Plan also establish quantitative targets for the value-added of the financial sector (to 5.0% of GDP 2015) from 4.4% in the past decade), and "direct financing", consisting of bond and equity issuance (to account for 15% of total financing by the end of 2015, from 11% at present).

Property prices are stabilizing…

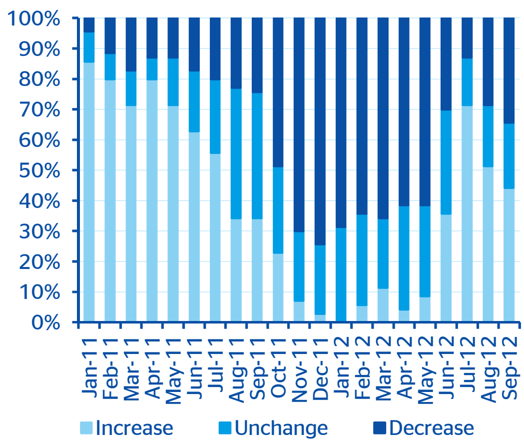
Although property tightening measures remain in place, residential property prices have been stabilizing since the second quarter. Based on official NBS data covering 70 cities, we estimate that property prices increased by an average of 0.3% from May 2012 to September 2012, following a cumulative decline of 1.8% between Jul 2011 and May 2012 (Chart 29). More cities reported sequential price increases in Q3 than in Q2 (Chart 30). The data also show a strong pickup in sales volumes in Q3, after contracting in H1. Nevertheless, the authorities have vowed to maintain measures to curb property prices in order to prevent asset bubbles and maintain housing affordability, and the pace of the recent pickup in prices has been moderating. On balance, a modest and sustained rise in housing prices would be positive in facilitating a pickup in overall economic growth momentum.

Chart 29
Property sales and prices are stabilizing



Source: NBS, CEIC and BBVA Research

Chart 30
Fewer cities are reporting housing price declines



Source: NBS and BBVA Research

3. A modest pick up in growth

After bottoming out in Q3, China's growth momentum appears set to pick up modestly during the rest of the year and into 2013. As noted above, a pickup is already evident in recent activity indicators, a trend we expect to continue on the effects of policy easing and an improvement in the external environment as envisaged in our baseline. In view of the weaker-than-expected GDP outturn in Q3 and sustained weakness in the external demand, however, we have revised our 2012-13 growth projections to 7.6% and 7.9% (Table 2), respectively, from 7.8% and 8.3% previously. Risks for 2013 are tilted to the downside given uncertainties in the global outlook, although room for additional monetary and fiscal easing would serve as a cushion. We are also revising down our medium term growth path by around 0.5 ppts on average, on the basis of lower estimates of potential GDP growth arising from reduced investment growth (see below).

Growth slowdown has bottomed out

The pickup in growth momentum we have been expecting for some time appears now to be occurring. The pickup is being spurred by the effects of previous monetary easing and an ongoing acceleration in infrastructure spending, as well as resilient consumer spending. We project full-year 2012 growth to reach 7.6%, based on an expected Q4 outturn of 7.6% y/y (Chart 31). There may be some upside potential to the 2012 outturn given the strength of just-released October activity indicators. While the current investment-led policy mix to sustain growth might temporarily deviate from the longer term economic rebalancing, we expect the trend of rising consumption to continue and to reinforce the rebalancing of the economy toward domestic sources of growth, albeit gradually (Chart 32).

Inflation should remain in check

With the recent weakening of growth momentum and falling commodity prices, inflation has been contained. Going forward, we expect inflation to reach 2.6% at end-2012, and to rise to 3.8% at end-2013 due to base effects and a modest increase in price pressures as growth resumes. As such, inflation should remain within the authorities' 4% comfort range, providing scope for additional monetary easing if needed to support growth.

Table 2
Baseline Scenario

	2009	2010	2011	2012 (F)	2013 (F)
GDP (%, y/y)	9.2	10.4	9.3	7.6	7.9
Inflation (average, %)	-0.7	3.3	5.4	2.7	3.3
Fiscal bal (% of GDP)	-2.8	-1.7	-1.3	-2.0	-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	5.75	5.75
Exch rate (CNY/USD, eop)	6.83	6.62	6.30	6.32	6.13

Source: BBVA Research

Policy support is expected to continue after political transition

While the likelihood of monetary easing has receded for the time being given the strength of recent monthly activity indicators, given risks to the outlook at the low level of inflation, our macro baseline continues to build in a modest further easing of the monetary stance and implementation of growth supportive fiscal policies. This includes further cuts in the RRR of 100 bps in the next 1-2 quarters, along with another 25 bp interest rate cut, especially if the external environment remains weak.

The fiscal stance is expected to remain supportive, with further fiscal measures possible once the leadership transition is completed in the coming weeks and months (Box 2). Indeed, the budgeted 2.0% of GDP deficit target (excluding fiscal reserves from last year's savings) may well be exceeded, depending on the eventual split in financing between the central and local governments. Still, the magnitude of any further fiscal support is likely to fall considerably short of that in 2008-09, due to constraints from the buildup of local government debt, concern about the quality of bank balance sheets, and efforts to avoid undesirable side effects, such as property bubbles.

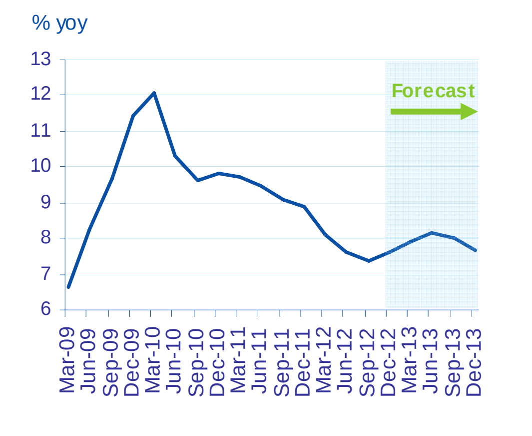
Currency appreciation to resume in 2013

Notwithstanding the recent spurt in currency appreciation against the USD, we expect some retracement during the remainder of the year given the weakening of the euro and the passing of political pressures (especially the ending of the US Presidential election cycle and publication of the US Treasury currency report). We have therefore maintained our end-year projection for the RMB of 6.32 per USD by end-2012, although there is now some upside (appreciation) potential given the recent move. Given the size of the external surplus, albeit declining, we see room for a more sustained, but still modest, currency appreciation to resume in 2013 on the order of 2-3% against the USD, which would bring the RMB to around 6.13 per USD by end-2013.

Room for policy support as a safeguard against global risks

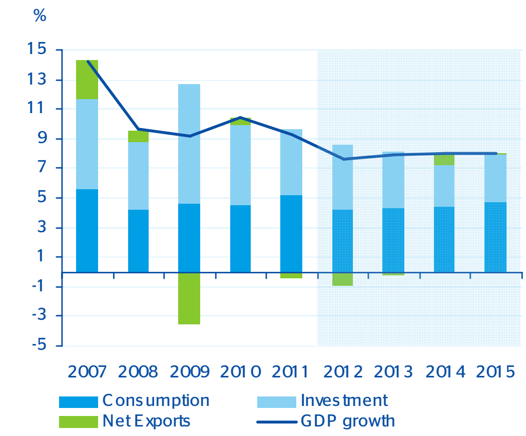
If downside risks to the global environment materialize, China's growth momentum would be affected primarily through weaker demand through the trade channel, as well as residual effects from finance channels from heightened risk aversion (the relatively closed nature of China's capital account limits the impact of external shocks through financial flows). As noted above, we believe there would be sufficient policy room to sustain growth at or above 7% in 2013, as targeted in the Five-year Plan.

Chart 31
China's GDP growth forecast



Source: NBS, CEIC and BBVA Research estimates

Chart 32
A rebalancing of growth over the medium term



Source: NBS, CEIC and BBVA Research estimates

China's long term potential growth revised down

Our updated estimates of potential growth are modestly lower than previously projected (8.3% in 2011-2020): in addition to the direct effect of weaker external demand – the legacy of the 2008-09 global financial crisis and sovereign debt crisis in Europe – the anticipated rebalancing of China's economy toward higher consumption implies lower investment rates than previously projected. This would have consequences for the overall capital stock, resulting in lower potential growth during 2011-2020 by 0.5 ppts, to 7.8% on average, and to 7.0% by 2020. As previously, the downshift in potential growth compared to the previous decade (9.2% on average) is due to slowing total factor productivity and labor growth.

Box 2: China's once-in-a decade political transition

The 18th National Party Congress commenced on November 8. The Congress is scheduled to conclude on November 14, at which time new Politburo members, the power base for the Party, will be selected. At the time of this writing, analysts were evaluating prospects for the Poliburo's Standing Committee to be reduced to 7 members from 9 previously, which would result in a consolidation of power for those in charge. In addition to top positions within the Party, the members of the Standing Committee will also assume other key roles including as the country's President, Premier and Chairman of the National People's Congress. The official appointments of these outside-party positions will be completed in March.

As to the composition of the new Standing Committee, at the time of writing, two incumbents, Messrs. Xi Jinping and Li Keqian, were expected to remain in power, while the remainder were expected to step down, including President Hu Jintao and Premier Wen Jiabao. Xi and Li, respectively, are favored to take over these positions in March.

In the past months, the run-up to the leadership transition has been more turbulent than expected due to a series of scandals. Infighting among the party leaders culminated in the widely reported fall of Bo Xilai, who was the former party leader in Chong Qing. Bo was once widely considered to have a good chance to accede to the Standing Committee.

At the time of writing, a number of issues were being monitored by investors, including whether President Hu would retire from his post as Chairman of the military. If he retained the post, the speculation was that new leaders might be blocked from making reform breakthroughs in key political and economic areas.

In the opening speech of the Congress, President Hu, provided ambitious, but achievable, goals for economic growth and incomes. He also hinted at political reforms, including to enhance the independence of legal system, expand individual liberties, and reduce corruption. Implementation of such reforms may depend on the degree of the new leaders' power concentration and to the extent that "policy reformers" are able to wield influence over "conservatives". in the Standing Committee. Although Xi and Li are widely considered to have reformist thinking, the system determined that they are not able to select other members in the Standing Committee.

China's new leaders will need to address challenges on both the economic and political fronts. They will need to continue facilitating the rebalancing of the economy toward domestic demand, in particular private consumption, so as to maintain sustainable economic growth. They will also need to respond to a growing chorus of demands to narrow the widening wealth gap and reduce corruption. Finally, they will need to play an increasing integral role in the international world order, commensurate with China's fast growth and rising economic power.

4. Risks to the downside

With the policy actions of central banks as described in Section 1, and the recent pickup in domestic growth, risks have diminished, but remain titled to the downside. The external environment remains uncertain, and the apparent policy-induced pickup in growth has yet to become self-sustaining.

A number of domestic financial fragilities have been reduced from a year ago, but could increase again as stimulus measures are implemented. On one hand, the risk of a collapse of the residential property market has subsided further with the ongoing stabilization of sales transactions and prices. On the other hand, the level of local government debt, after being contained over the past year is rising again as the authorities seek to bolster growth through infrastructure investment. Moreover, local governments appeared to be much more reliant on the shadow bank system to meet their funding needs given many restrictions of banking lending to LGFVs are still in place. Nevertheless, these fragilities are manageable for the time being given their overall magnitude.

On the political front, risks from the leadership transition are moderating as the process unfolds, with new members of the Standing Committee of the Politburo, the key decision-making body, to be selected shortly. In March 2013, a new President and Premier will be put in place, replacing the incumbent leadership of President Hu Jintao and Premier Wen Jiabao. It appears highly unlikely that political instability will unfold or that the leadership change will result in significant changes in the near-term policy direction. However, it remains to be seen whether the pace of economic and political reforms will be accelerated or held back.

Finally, rising geopolitical tensions pose an increasing risk. China's disputes with its regional neighbors, especially Japan, over territorial claims in the East China and South China Sea have escalated and are having a noticeable effect on trade and investment flows between the two economies. In addition to undermining regional investor sentiment, these conflicts are giving rise to a further military buildup that could divert fiscal spending from more productive investments.

5. Tables

Table 3
Macroeconomic Forecasts

	2009	2010	2011	2012 (F)	2013 (F)
GDP (%, y/y)	9.2	10.4	9.3	7.6	7.9
Inflation (average, %)	-0.7	3.3	5.4	2.7	3.3
Fiscal bal (% of GDP)	-2.8	-1.7	-1.3	-2.0	-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	5.75	5.75
Exch rate (CNY/USD, eop)	6.83	6.62	6.30	6.32	6.13

Source: BBVA Research

Table 4
Gross Domestic Product

(YoY growth rate)	2009	2010	2011	2012 (F)	2013 (F)
U.S.	-3.1	2.4	1.8	2.1	1.8
EMU	-4.4	1.9	1.5	-0.5	0.3
Asia-Pacific	4.2	8.1	5.8	5.2	5.5
China	9.2	10.4	9.3	7.6	7.9
World	-0.6	5.1	3.9	3.2	3.5

Source: BBVA Research

Table 5
Inflation (Avg.)

(YoY growth rate)	2009	2010	2011	2012 (F)	2013 (F)
U.S.	-0.4	1.6	3.1	2.0	2.1
EMU	0.3	1.6	2.7	2.5	1.8
Asia-Pacific	0.3	3.6	4.8	3.3	3.4
China	-0.7	3.3	5.4	2.7	3.3
World	2.2	3.0	5.1	4.2	4.0

Source: BBVA Research

Table 6
FX rate (End of period)

		2009	2010	2011	2012 (F)	2013 (F)
EMU	USD/EUR	1.43	1.34	1.30	1.28	1.30
China	CNY/USD	6.83	6.62	6.30	6.32	6.13

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	0.75	0.75
China	5.31	5.81	6.56	5.75	5.75

Source: BBVA Research

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