BBVA | RESEARCH

Economic Outlook

China

First Quarter 2013
Economic Analysis

- **The global economic outlook is improving** due to reduced tail risks in Europe, the avoidance of the "fiscal cliff" in the US, and the resilience of emerging economies. We expect global growth to rise from 3.2% in 2012 to 3.6% in 2013.
- **After slowing by more than expected through Q3 2012, China's economy has gained speed.** Growth rose to 7.9% y/y in Q4, bringing the full-year outturn to 7.8%, thus avoiding a hard landing. We expect growth of 8.0% in 2013, a slight upward revision from our previous projections.
- **China's new leadership team has signalled it will maintain a supportive macro policy stance in 2013** after it takes office in March. Nevertheless, with inflation and financial fragilities rising, we expect overall macro policies to be set cautiously in the coming year, with no further interest rate cuts.
- **Modest currency appreciation is likely to continue in 2013.** Growth is on track, the balance of payments is still in surplus, and capital inflows are projected to increase. We expect the authorities to accommodate a further modest rise in the RMB against the USD to around 6.10 RMB/USD by end-2013.

Index

Publication date: Feb 20, 2013

Summary

After a slowdown in growth in 2012 that was steeper and more prolonged than expected, China's economy has turned the corner. Growth picked up to 7.9% y/y in Q4 after bottoming out at 7.4% in Q3 on the effects of policy stimulus, a recovery in the property sector, and stabilization in exports. As a result, full-year growth reached 7.8%, lower than the previous year (9.3%), but still comfortably above the government's 7.5% growth target.

Recent activity indicators suggest that the pick up in momentum is continuing in 2013. In particular, industrial production and PMI have picked up. On the demand side, the growth of retail sales has been rising steadily since July, consistent with a pickup in private consumption and a further rise in the consumption-to-GDP ratio. External demand and exports have also been stabilizing.

Accordingly, we have revised our 2013 growth projection upward to 8.0%. The revision is modest (compared to 7.9% in our previous Outlook) as we anticipate a weakening of momentum in the second half of the year as policy stimulus is gradually withdrawn. Underpinning growth will be continued consumption demand, supported by tax cuts and increases in household income. Investment growth will decline slightly, but should still support aggregate demand on continued public spending on social housing and infrastructure.

Inflation is picking up, but remains within the government's comfort level. After bottoming out at 1.7% y/y in October, inflation rose to 2.5% y/y in December on stronger demand, rising food prices, and base effects (it subsequently fell to 2.0% in January on base effects from the timing of the Chinese New Year). The end-2012 outturn was below previous expectations, and well within the government's target of 4.0%. We expect inflation to rise gradually in 2013 as growth picks up, and should reach 3.8% by end-2013.

We expect policy continuity after the transition of the new leadership team in March. The newly selected team has signalled that it will maintain a supportive policy stance in 2013, marked by "prudent monetary policy and proactive fiscal policy". Based on recent statements and press reports, we expect the 2013 official growth target to remain at 7.5%, and the inflation target to be lowered to 3.5% from 4.0% last year. For the longer term, the new leadership team is likely to stress the quality of growth, and to maintain the pace of economic reforms to boost productivity, improve social welfare, and facilitate economic rebalancing.

Nevertheless, with inflationary pressures and financial fragilities gradually rising, we expect overall macro policy settings to be applied cautiously in the coming year. In particular, we no longer expect further interest rate cuts; and further cuts in the RRR will be dependent on domestic liquidity conditions. That said, the pace of bank credit growth should remain on par with 2012. On the fiscal front, we expect the central government to announce a supportive budget stance in March, with a deficit target of around 2% of GDP.

Modest currency appreciation is likely to continue in 2013. With the balance of payments still in surplus and with external demand and capital inflows projected to increase, we expect the authorities to accommodate a further modest rise in the RMB against the USD to around 6.10 RMB/USD by end-2013, or around 2% from its present level. There are, of course, risks to this outlook, especially in light of the recent depreciation of the yen. It is also possible that currency flexibility will be further enhanced during the course of the year.

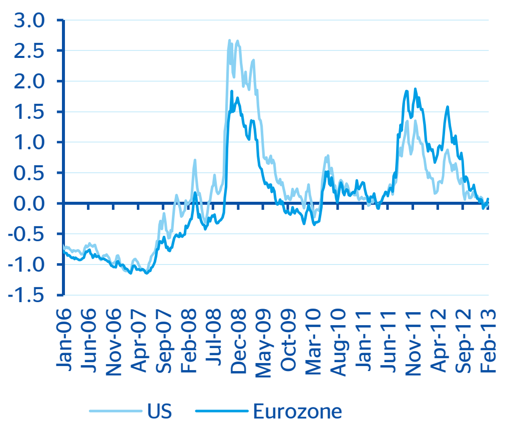
With the pickup in growth and improvement in the global environment, risks to the near-term outlook have become more balanced than in previous quarters. While downside risks remain from the uncertain global outlook and rise in domestic financial fragilities, there could also be upside surprises to the domestic and external growth outturns.

1. Improved sentiment and lower 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.

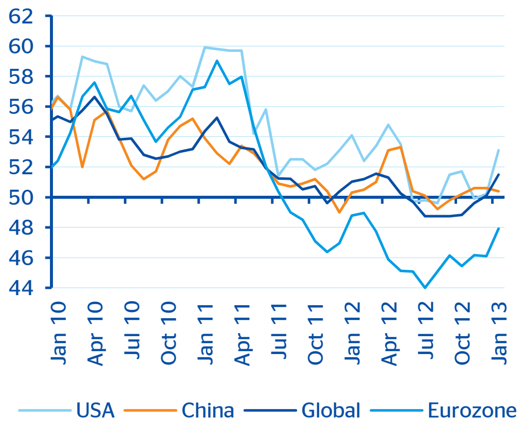
Over the past three months, a number of threats to the global economic outlook have faded, sparking a tide of renewed optimism. Financial tensions have decreased to two-year lows (Chart 1), particularly in Europe, and almost all asset classes have benefited. There has also been a boost to consumer and business confidence which has spread among regions (Chart 2). However, there has not yet been any significant change in economic activity. According to our estimates, global GDP in 2012 grew by 3.2%, down from 3.9% in 2011. Recent data suggest that global GDP may now be accelerating, albeit from low levels.

Chart 1
BBVA Financial Stress Index



Source: BBVA Research

Chart 2
Confidence Indicator (PMI)



Source: BBVA Research

Advances in policy implementation lie behind improved confidence

China has averted a hard landing. As discussed in further detail in Section 2 below, since the third quarter of 2012, GDP growth has accelerated on the back of stimulus policies, a recovery in the property sector, and tentative signs of stronger exports. The rebound of the Chinese economy has been hailed as an element in the global economy's resilience. Other export-oriented economies are benefiting, including in Latin America which is benefiting from improved commodity prices.

The US did not fall off the cliff. In spite of a decline in GDP in 4Q12 (-0.1% in annualized terms), the underlying picture is brighter. Consumption growth has remained quite stable over the past quarters, averaging only slightly below pre-crisis growth levels. At the same time, the housing sector has gained momentum.

The fiscal deal at the turn of the year was welcomed by markets. It avoids a larger drag on the economy and it helps improve US public-debt sustainability. However, the agreement did not deal with two potential sources of uncertainty. First, the expenditure sequester is still scheduled to take place at the beginning of March. If implemented, there would be an additional drag on the economy of 0.8% of GDP. Second, there was no permanent agreement on the debt ceiling, although a later deal suspended this ceiling until mid-May. Hence, in coming weeks more negotiations will take place to avoid a sharp economic contraction in 2013 and, at the same time, to contribute to fiscal sustainability. However, a grand bargain is unlikely as long as policymakers continue kicking the can and fail to reach a bipartisan compromise.

Europe has done its part. The deal on Greece has shown that Europe is committed to maintaining its eurozone membership. In addition, the banking-union process has advanced since the December EU summit. The process seems critical to breaking the vicious circle between government and banking finances, and also to stemming the tide of capital outflows besetting some countries in Europe's periphery. Agreements reached at the December EU summit were not as ambitious as had first been hinted, but are still quite positive since they include a clear calendar for implementing a single supervision mechanism and initial steps towards a single resolution mechanism.

Finally, the ECB's OMT program appears to be having long-lasting effects as a real backstop, preventing financial tensions from escalating, even if neither Spain nor Italy (the most likely candidates) have yet asked for its activation. That situation may continue because governments of core and peripheral countries lack incentives to undergo such a process. With Spain's bonds yielding 5 – 5.5% and Italy's at 4 – 4.5%, the financial situation of the sovereign can hardly be seen as unbearable, in particular considering the political costs of a bail out from the point of view of the politicians in charge.

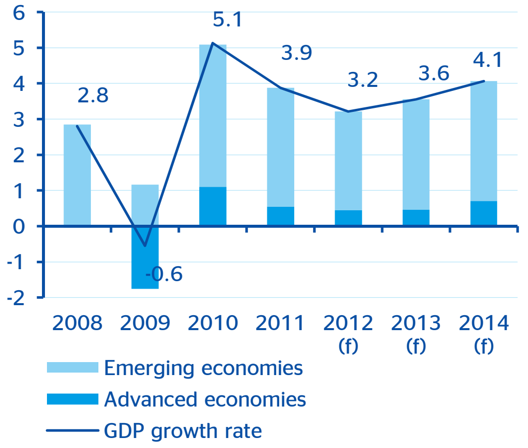
A soft recovery remains as our baseline scenario

Despite lower tail risks, improvements in economic fundamentals have been elusive. As a consequence, a soft recovery continues to be the most likely scenario for the global outlook. Even if the US has avoided falling off the fiscal cliff, US politicians still have to agree on key issues including the sequester and the debt ceiling, and fiscal policy in 2013 will turn tighter, squeezing household incomes. The real estate sector may be recovering, but the deleveraging process is still underway, and the external sector is far from buoyant. Therefore, we maintain the outlook for the US economy, although there is potential for positive surprises. In 2013 we expect the US economy to grow by 1.8% (down from 2.2% in 2012) and by 2.3% in 2014.

In the eurozone, tail risks may have disappeared, but the periphery remains mired in recession, dragged down by fiscal consolidation and funding conditions. Some economies still face deleveraging and fiscal austerity. However, leading indicators in Germany and other core countries are pointing to better prospects at the beginning of 2013. As a consequence, we roughly maintain our forecast for the eurozone of a rebound of a mere 0.3% in 2013 (after a contraction of 0.5% in 2012), and a 1.3% increase in 2014.

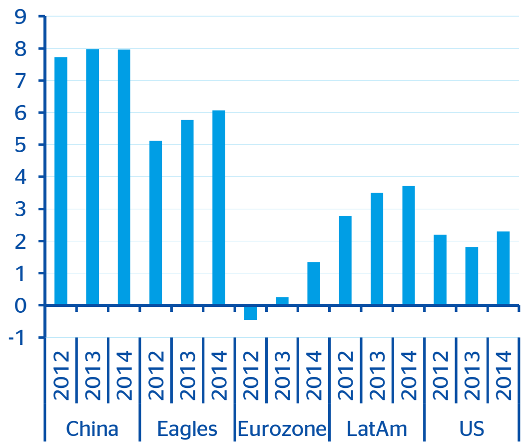
China is arguably the economy where the outlook has become clearer in the short term. As discussed below, we have revised our projections slightly upwards to 8% in 2013 and 2014. The robustness of China's economy and the resilience of the US economy will play a role in supporting demand in most emerging countries. In Latin America as a whole, we have revised our forecasts slightly downwards, due to weaker situations in Brazil and Argentina. In 2013, the Latin American economies will grow by 3.5%, whereas in 2014 they will by 3.7%, approaching to their growth potential. In turn, emerging Asia will show a more robust growth, accelerating to 6.6% in 2013, up from 6.1% in 2012 (for details, see Asia Outlook).

Chart 3
World GDP Growth Rate



Source: Haver and BBVA Research

Chart 4
GDP Growth rate (%)



Source: Haver and BBVA Research

Uncertainty surrounding the global outlook remains high and tilted to the downside but, for the first time in three years, potential upside surprises are also present. The eurozone poses the biggest risk. Financial tensions may return for different reasons. The periphery of Europe could miss its current fiscal targets. If governments react with more austerity, the downturn may intensify. However, this risk is low because the European Commission has made clear that no further adjustment will be forced on these countries if targets are not met due to cyclical factors. At the same time, such an occurrence could roil markets and trigger bailout requests. In this regard, although the ECB seems ready to intervene, any potential wrangling between core and peripheral countries on conditionality could be a possible source of instability. Other factors may also play a role, like the details of the bank bailout for Cyprus, yet to be fixed, or political events such as the Italian elections. If financial tensions increased as a consequence of one or several of those triggers, the eurozone would continue in recession in 2013 too.

The other significant source of risk stems from the US political disagreement on how to deal with the fiscal deficit. According to our estimates, if both risks materialized the world economy would grow nearly a percentage point less than in the baseline scenario, well below its historical average. Adequate implementation of eurozone-governance agreements and further pacts on fiscal issues in the US are necessary conditions for a sustained global recovery.

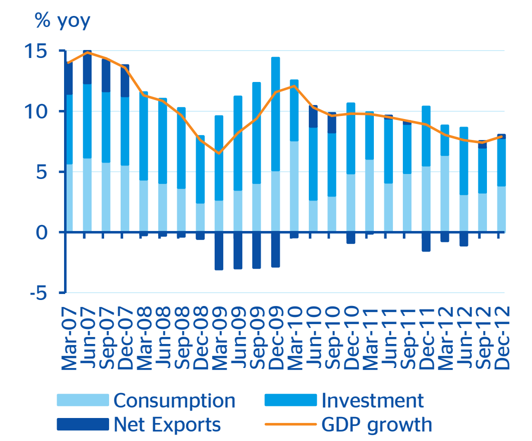
2. Hard landing averted as growth gains momentum

After persistent fears of a hard landing through much of 2012 when growth decelerated by more and for longer than previously expected, China's economy has turned the corner on the effects of policy stimulus, a recovery in the property sector, and stabilization in exports. While full-year growth of 7.8% was the weakest since 1999 (but still above the official 2012 growth target of 7.5%), momentum picked up noticeably in the fourth quarter of the year on the effects of interest rate cuts in mid-2012 and stepped up public spending. We expect GDP growth to rise to around 8.0% in 2013 as policy-induced growth in the first half of the year gradually gives way to a more self-sustaining, albeit less vigorous, trajectory in the second half on improving consumption and external demand. Importantly, the new leadership team to be installed in March has signaled it will maintain policy continuity with respect to growth supportive policies and economic reforms.

Growth picks up on supportive polices and stabilizing exports

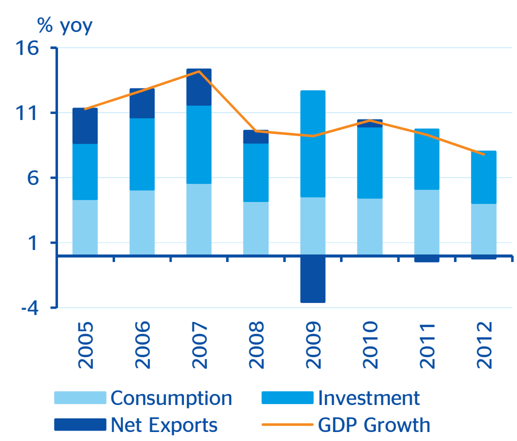
GDP growth rebounded to 7.9% y/y in Q4 after bottoming out at 7.4% in Q3, bringing full-year growth to 7.8% (Charts 5 and 6). In sequential terms, officially reported quarterly growth actually slowed, to 2.0% seasonally adjusted (8.2% annualized) from 2.1% in Q3 (8.7% annualized). However, the sequential data are less reliable given data quality and seasonal adjustment issues. For 2012 as a whole, domestic consumption (including by the government) was the main contributor to growth (4.1 ppts), followed by investment (3.9 ppts), while net exports was a drag on growth (-0.2 ppts) for the second year in a row. From the production side, growth was most rapid in the services sector, leading to an increase in its size in the overall economy to 44.6% of GDP from 43.4% in 2011(Chart 7).

Chart 5
GDP growth bottomed out in Q3…



Source: NBS, CEIC and BBVA Research

Chart 6
…resulting in 2012 full-year growth of 7.8%

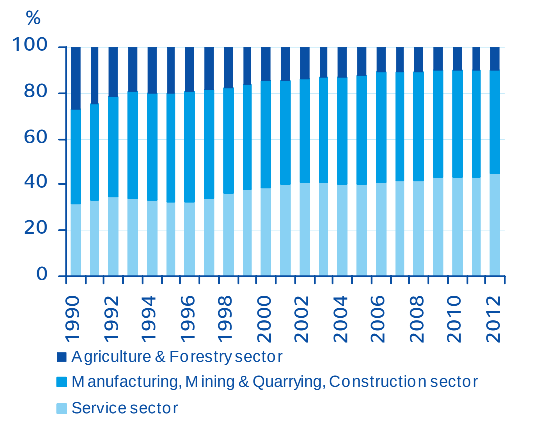


Source: NBS, CEIC and BBVA Research

The full-year growth outturn was the first time in more than a decade that growth failed to reach 8%. The slowdown reflects a combination of both cyclical and structural factors (see Box 1), the latter relating to a gradual decline in China's potential growth.

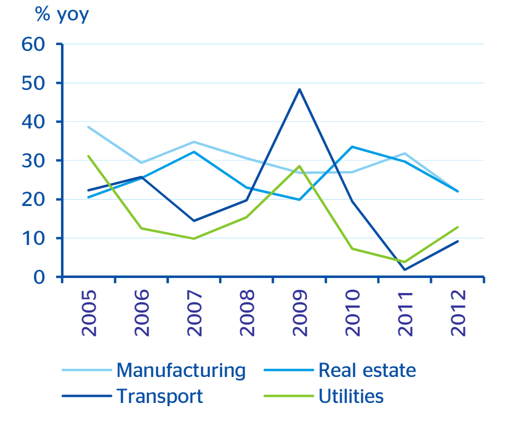
From a cyclical perspective, the pickup in growth in Q4 was mainly due to policy stimulus, especially the gearing-up of public investment in infrastructure (Chart 8). Meanwhile, polices to boost household incomes and consumption, along with a stable urban unemployment rate (4.1% in 2012) helped support consumer spending (Charts 9 and 10). A stabilization of export demand toward the end of the year helped ensure that net exports were less of a drag on growth than the previous year.

Chart 7
The share of the service sector is increasing



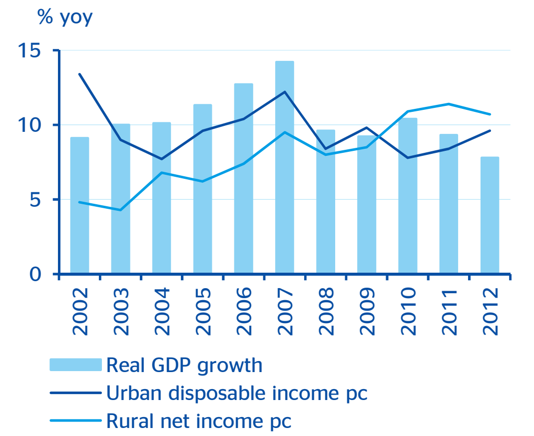
Source: CEIC and BBVA Research

Chart 8
Infrastructure investment supports growth



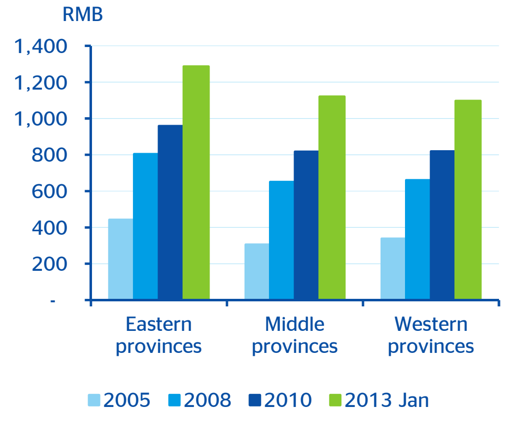
Source: CEIC and BBVA Research

Chart 9
Disposable incomes outpace GDP growth



Source: CEIC and BBVA Research

Chart 10
Minimum wages rise rapidly

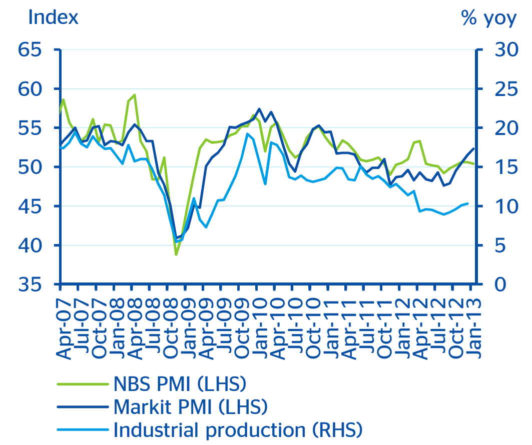


Source: CEIC and BBVA Research

Recent high frequency indicators suggest that momentum is continuing into 2013, including industrial production and PMI (Chart 11), with the latter also suggesting that the inventory destocking cycle may have bottomed out, adding to prospects of further increases in output in the months ahead, and boosting market confidence (Chart 12).

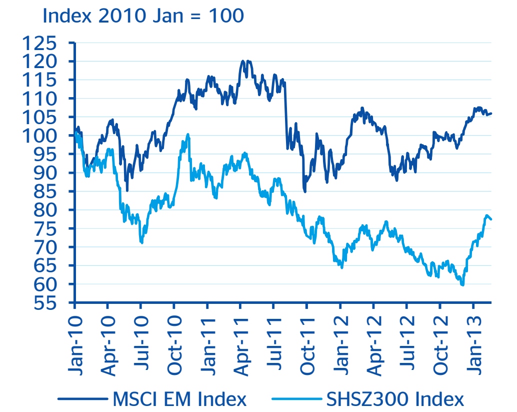
On the demand side, the growth of retail sales has been rising steadily after bottoming out in July (Chart 13). Indeed, growth of total consumption was the only demand component that accelerated in 2012, and its share in GDP has begun to rise since 2011 (Chart 14), a sign of the long-awaited rebalancing. In contrast, the performance of investment was mixed in 2012, but held up well from mid-2012 as the real estate sector recovered and as infrastructure spending (transportation and utilities) picked up.

Chart 11
PMI and industrial production improve



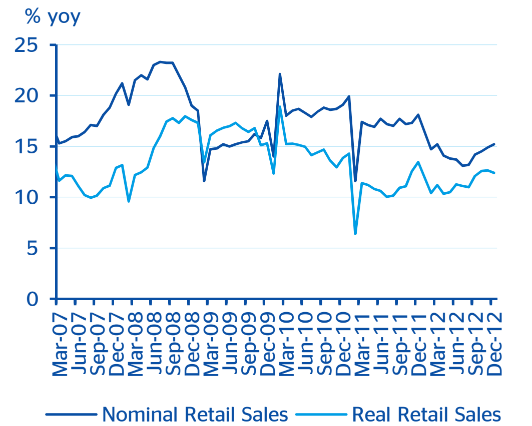
Source: CEIC and BBVA Research

Chart 12
Stock markets rebounds on confidence



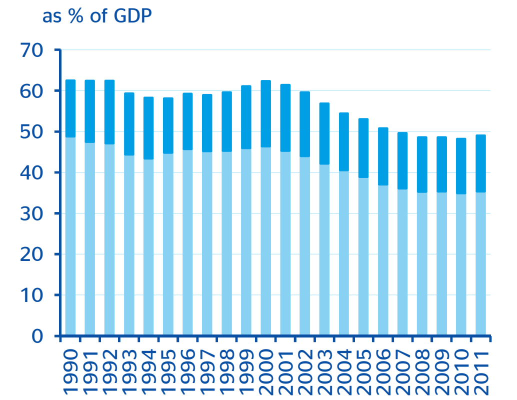
Source: Bloomberg and BBVA Research

Chart 13
Retail sales held up well



Source: CEIC and BBVA Research

Chart 14
Consumption-to-GDP appears to be rising

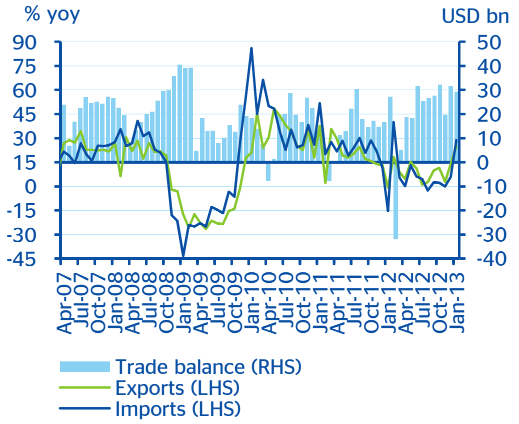


Source: CEIC and BBVA Research

Despite the weak state of the global economy, exports began to stabilize in Q4, rising by 9.4% y/y from 4.4% in Q3 (9,1% y/y in H1 2012) (Chart 15). Underpinning exports was continued strong intraregional trade, particularly due to demand from the ASEAN economies (29.7% y/y in Q4) and a modest improvement from the US (5.4% y/y in Q4). In contrast, exports to Europe and Japan remained weak, falling by -7.9% and -3.5% y/y in Q4 respectively (Chart 16). Meanwhile, imports also recovered in the fourth quarter of 2012 on improving domestic demand, rising 2.8% y/y in Q4 from 1.4% in the previous quarter. Commodity imports rebounded[1] (Chart 17), as did processing imports. For the year as a whole, exports and imports decelerated to 7.9% and 4.3% respectively from 20.3% and 24.9% respectively in 2011, underscoring the impact of the global downturn. As a result of these trends, the trade surplus expanded to 231 billion USD from 155 billion in 2011, and the current account balance continued to narrow to 2.6% of GDP, down sharply from its peak in 2010 of 10.1% (Chart 18).

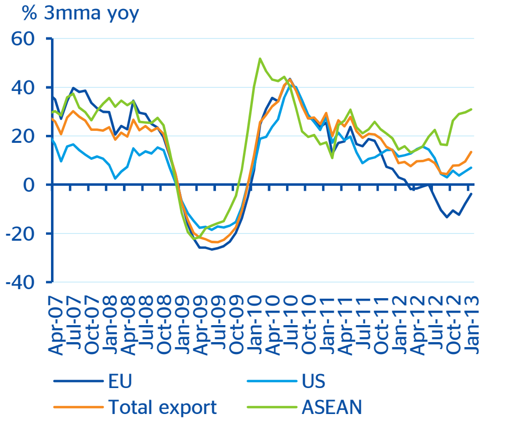
1: For further details on China's commodity demand, see Economic Watch, "What do China's growth outlook and policy outlook mean for commodity demand?" November 30, 2012.

Chart 15
Export growth appears to be stabilizing



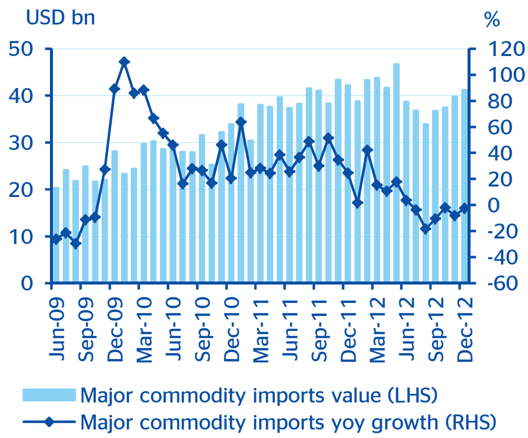
Source: CEIC and BBVA Research

Chart 16
Exports to the EU and Japan remain weak



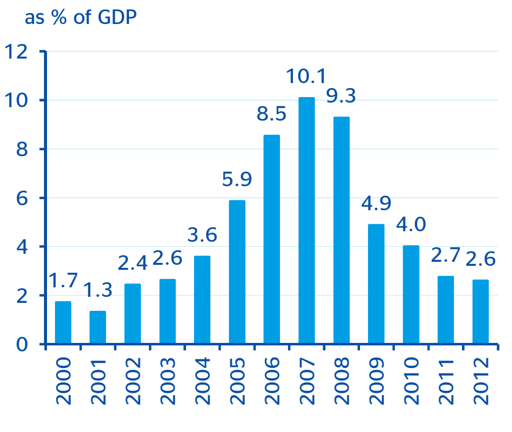
Source: CEIC and BBVA Research

Chart 17
Commodity imports are picking up on strong domestic demand



Source: CEIC and BBVA Research

Chart 18
The current account surplus has narrowed

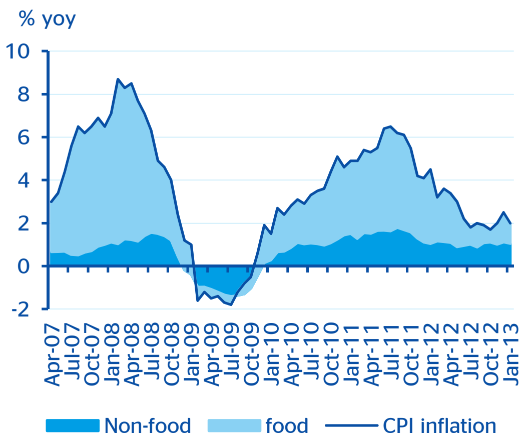


Source: CEIC and BBVA Research

Inflationary pressures are still modest, but are picking up

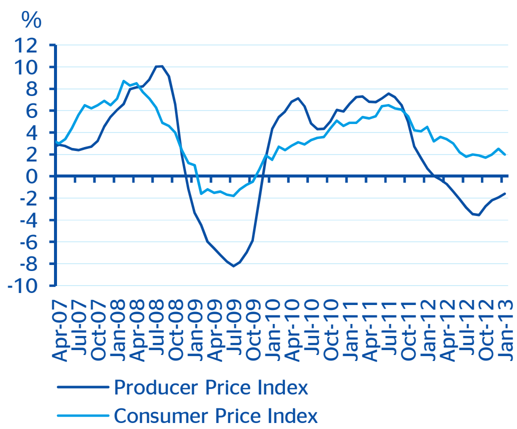
Following the deceleration in economic growth during the first three quarters of the year, headline inflation bottomed out at a lower-than-expected 1.7% y/y in October (Chart 19). Since then, inflation has increased slightly due to stronger demand, rising food prices, and base effects, although at just 2.0-2.5% in December/January, it remains well with the authorities' comfort level of 4.0%. Meanwhile, producer price inflation remains negative (minus 1.6% y/y in January), but it too has picked up as raw materials and commodity prices have increased (Chart 20).

Chart 19
Inflation bottomed out in October…



Source: CEIC and BBVA Research

Chart 20
…and producer prices are beginning to pick up as well



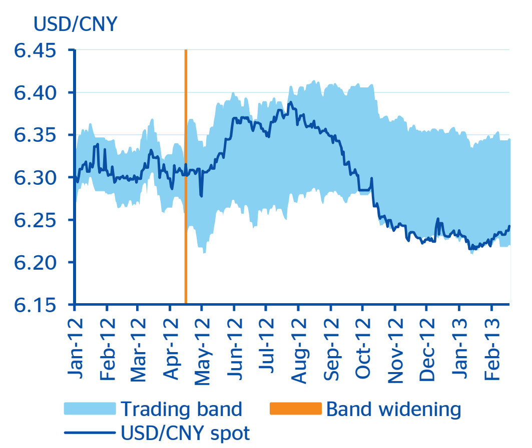
Source: CEIC and BBVA Research

Modest currency appreciation has continued

For the full year of 2012, the RMB rose by only 1% against the USD, somewhat slower than the 2-3% appreciation we had originally expected. Nevertheless, the appreciation was noteworthy in light of the continued weakness in external demand. The pace of RMB appreciation was especially rapid from July to November (Chart 21), when market forces persistently pushed the spot rate toward the strong end of the daily trading band (which was widened to +/-1% last April) and the PBoC's daily fixing were set at progressively stronger levels. As a result, and given the relatively strength of the USD in 2012, the RMB appreciated in real effective terms during the course of the year (Chart 22). Nonetheless, expectations of further appreciation are rather modest, as indicated by offshore RMB forward rates, which continue to price in depreciation (Chart 23).

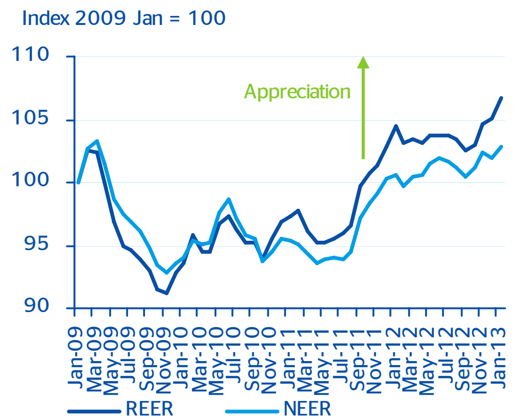
The RMB has more recently levelled off and even weakened against the USD, perhaps in response to the sharp depreciation of the yen. Consistent with the modest appreciation during the year, foreign reserves accumulation has levelled off, increasing by 100 billion USD to stand at 3.3 trillion USD at end-2012, as a trade surplus of and net FDI inflows were offset by net portfolio outflows (Chart 24).

Chart 21
RMB is stable against USD after sharp rise in H2…



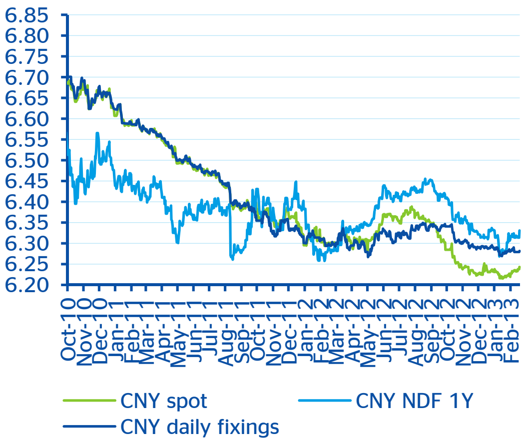
Source: Bloomberg and BBVA Research

Chart 22
… and has appreciated in effective terms



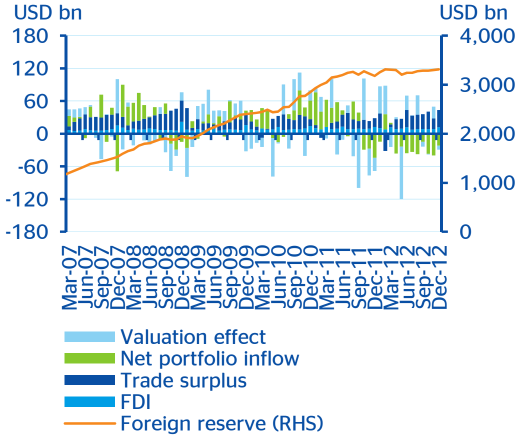
Source: BIS, CEIC and BBVA Research

Chart 23
RMB NDFs are still pricing in depreciation



Source: Bloomberg and BBVA Research

Chart 24
Slower reserve accumulation on capital outflow



Source: CEIC and BBVA Research

Box 1: Was China's slowdown in 2012 cyclical or structural?

Though still within government targets, China's 2012 GDP growth rate of 7.8% was the lowest since 1999. Moreover, the decline in growth was relatively sharp compared to an average of 9.6% during the difficult period of 2008-2011, marked by the Global Financial Crisis. While the 2012 outturn was above the government's target, and a hard landing was averted, the size of the decline after such a prolonged period of rapid growth naturally raises the question of how much of the slowdown was cyclical versus structural? The answer is important not only for making projections of the economic outlook, but also for policymakers in deciding whether to boost growth through short-term stimulus measures or allow growth to decline.

A mix of cyclical and structural factors

In our view, the reason for the recent sharp decline in growth is mainly cyclical, although structural factors are also at play. We base this conclusion on a growth accounting framework estimated from 1980 to 2020 (Table 1).

Table 1
Decomposition of the slowdown

%	2008	2009	2010	2011	2012
(1) Real growth	9.6	9.2	10.4	9.3	7.8
(2) Potential growth	9.9	9.5	9.1	9.0	8.8
(3) Change in annual growth	4.6	-0.4	1.2	-1.1	-1.5
(4) Change in potential growth	0.2	-0.4	-0.4	-0.1	-0.2
(5) Cyclical=(3)-(4)	4.4	0.0	1.6	-1.0	-1.3
(6) Output gap	1.7	0.1	1.4	1.6	0.7
(7) Inflation	6.0	-0.7	3.3	5.4	2.6
(8) Unemployment	4.2	4.3	4.1	4.1	4.1

Source: BBVA Research

Using our potential growth estimates, we find that in 2012, cyclical factors (line 5 of the table) accounted for -1.3 ppt of the slowdown, and structural factors (line 4 of the table) accounted for -0.2 ppts. Our conclusion is that the slowdown in 2012 is mainly cyclical.

Output gap and lags in employment

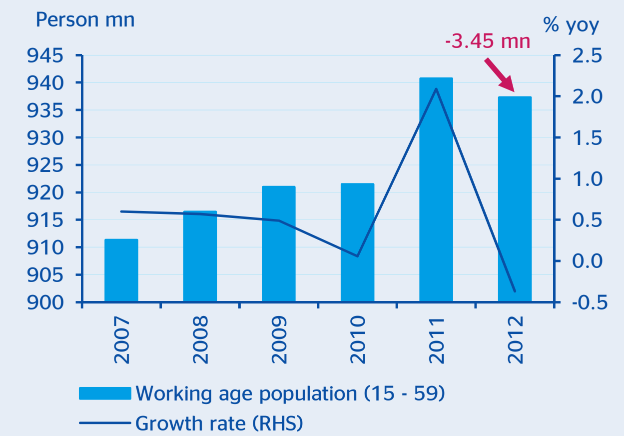
Another question is why employment has held up so well despite the cyclical slowdown in growth? While data quality and measurement issues may be an important factor, we concentrate here on the role of the output gap. As shown in the table, our estimate of the output gap was positive over the period of 2008 to 2012, meaning that output levels were actually above China's non-inflationary productive capacity. To erase the positive gap, output would need to fall below potential for a sufficient period, which is currently occurring. We expect the gap to fall to zero in 2013.

Longer-term growth: the roles of declining population and urbanization

Over a longer time horizon structural factors are behind a projected slowdown in growth. To evaluate China's longer-term growth potential, it is important to assess the outlook for labor growth, often referred to as China's "population dividend." The latest data are not encouraging on this front: China's working-age population (15-59 years) shrank for the first time in 2012 (Chart 25). In short, China can no longer rely on a growing labor force for long-term growth.

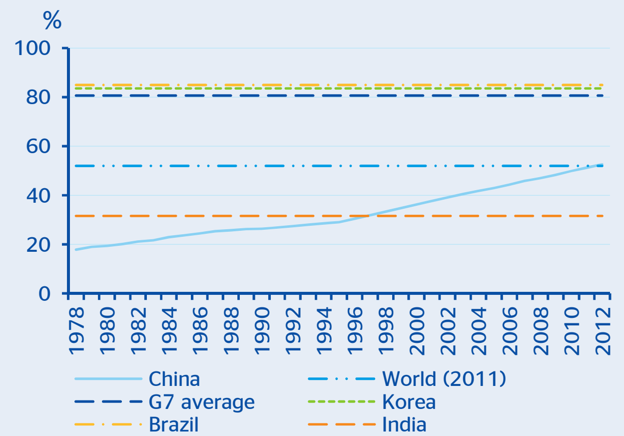
A second important factor is urbanization, which involves investments in infrastructure and housing, and higher per capita incomes and consumption. Rapid urbanization is typically associated with high GDP growth rates. China's urbanization ratio (the share of population living in cities) rose to 52.6% in 2012, after surpassing the 50% mark in 2011. Even still, the ratio has a long way to rise (Chart 26).

Chart 25
Working age population decreased in 2012



Source: NBS, CEIC and BBVA Research;

Chart 26
China urbanization is going on

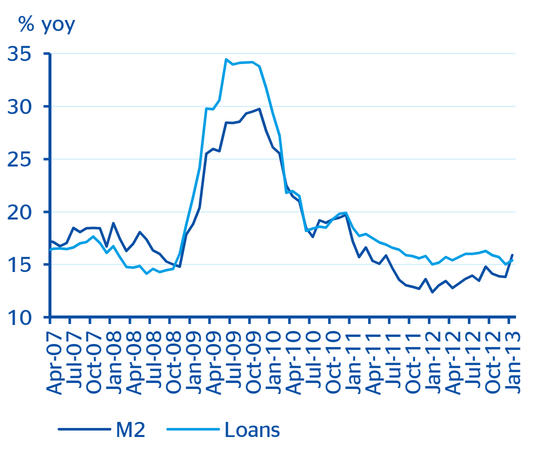


Notes: All data are 2012, except for the World level (2011)
Source: World Bank, CEIC, Haver and BBVA Research;

Lax credit policies underpin the pickup in growth momentum

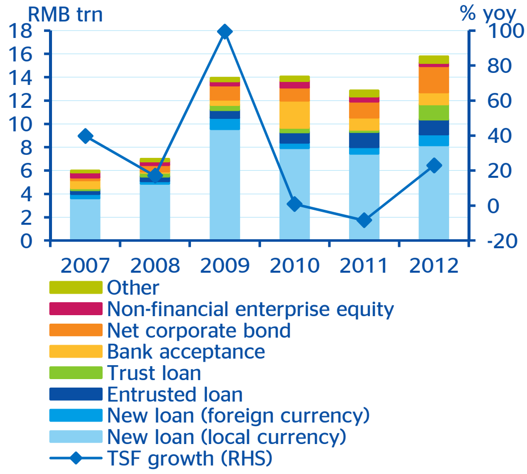
While formal bank credit and M2 growth remain relatively flat (Chart 27), the overall stance of monetary policy has been growth supportive. In particular, new RMB loans in 2012 amounted to 8.2 trillion RMB, in line with government targets and previous expectations of 8.0-8.5 trillion RMB. Most significantly, however, various forms of non-bank financing have expanded more rapidly. As a consequence, "total social financing" (TSF), a broader measure of credit that includes both bank and non-bank forms of credit, surged by 22.9% in 2012 buoyed by trust loans and corporate bond issuance (Chart 28).

Chart 27
While bank credit and M2 growth remain flat ...



Source: CEIC and BBVA Research

Chart 28
... broader "total social financing" has accelerated

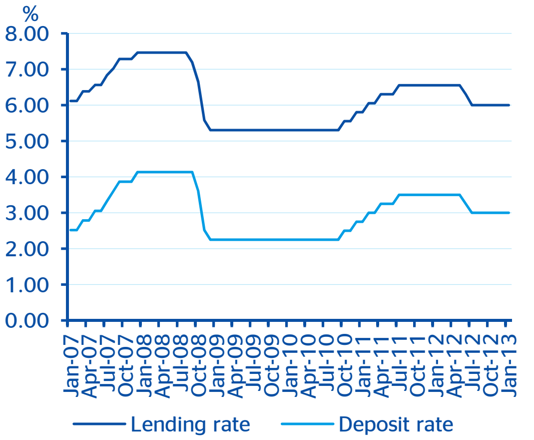


Source: CEIC and BBVA Research

The increase in non-bank financing comes after a period when the authorities sought to clamp down on the pace of shadow bank lending activities in 2010-11 to contain associated risks. The more recent pickup is most likely associated with some forbearance as the authorities seek to accelerate GDP growth, as well as their longer term efforts to develop the domestic capital markets.

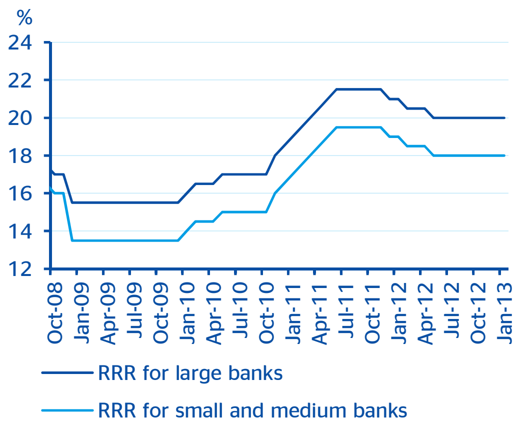
Interest rates have been on hold since the back-to-back cuts in June and July 2012, as have reserve requirements. The reluctance to cut interest rates further during the second half of 2012 appears to have been due to the concern about preventing asset price bubbles, especially in the property sector (see below). At the same time, the PBoC has been managing liquidity more actively through open market operations, including through the recent introduction of a new short-term liquidity facility, which has succeeded in stabilizing interbank interest rates (Chart 31 and 32).

Chart 29
Interest rates have been on hold since July…



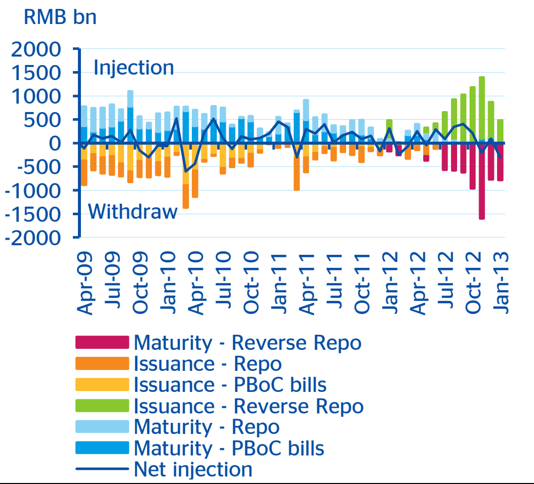
Source: Wind and BBVA Research

Chart 30
… as have reserve requirements



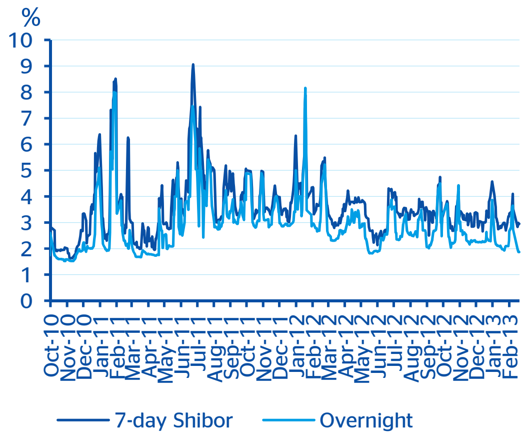
Source: Wind and BBVA Research

Chart 31
The PBoC has become more active in managing liquidity through open market operations…



Source: CEIC and BBVA Research

Chart 32
…which have succeeded in stabilizing interbank rates

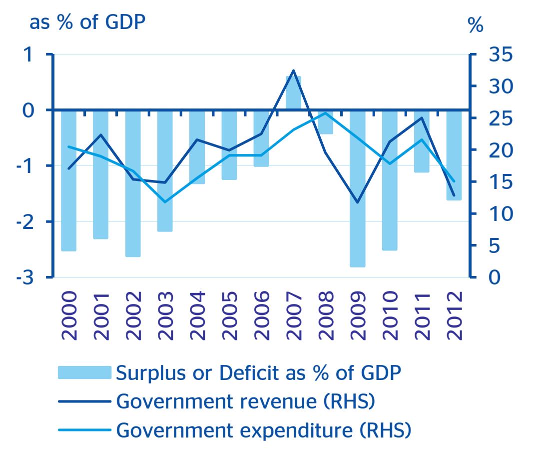


Source: Wind and BBVA Research

Fiscal spending bolsters activity through infrastructure spending

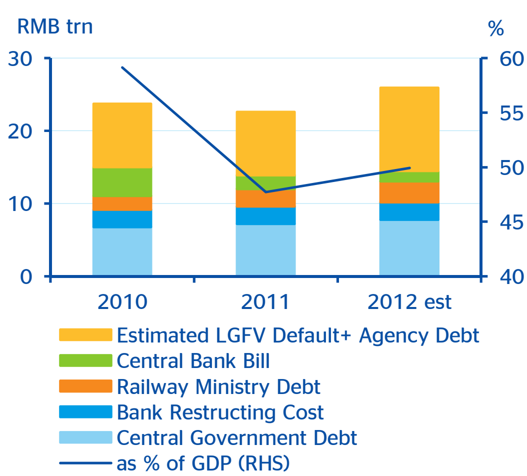
The supportive monetary stance has been accompanied by a proactive fiscal policy consisting of selected tax cuts and a step up of infrastructure spending (Chart 33). According to our estimates (after accounting for 0.5% of GDP in revenue transfers from 2011), the preliminary fiscal deficit rose to 1.6% of GDP, well below the budget target of 2.1% due to higher-than-expected revenues, from 1.1% of GDP in 2011. On the other hand, as in 2009-10, much of the fiscal support has come through local government spending on infrastructure, financed through bond issuance by local government financing vehicles (LGFVs). The resort to local government borrowing has been effective in promoting infrastructure spending, but has come at the cost of increasing local government debt in 2012, which had declined the previous year (Chart 34).

Chart 33
The central government deficit increased in 2012 on supportive fiscal policy



Source: CEIC and BBVA Research

Chart 34
Gross public debt increased in 2012



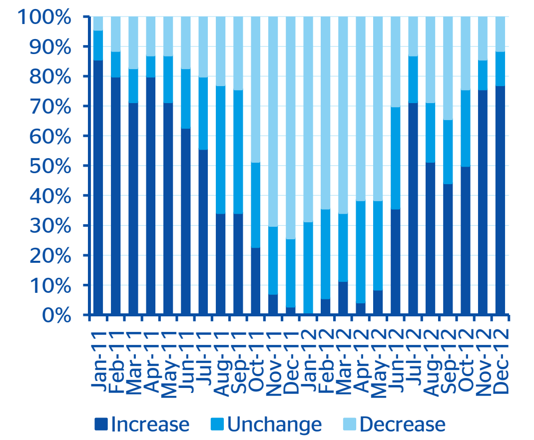
Source: CEIC and BBVA Research

The real estate sector recovers

A gradual recovery in the real estate sector has been an important contributor to the overall pickup in economic activity. Although the government has been steadfast in maintaining existing purchase restrictions to curb speculation and maintain housing affordability, looser credit conditions and an upturn in investor sentiment have led to a gradual rebound in housing prices (Charts 35 and 36). Based on official NBS data, we estimate that property prices have increased by an average of 1.0% from their lows in May 2012. The data also show a pickup in sales volumes. For further details, see our 2012 China Real Estate Outlook.

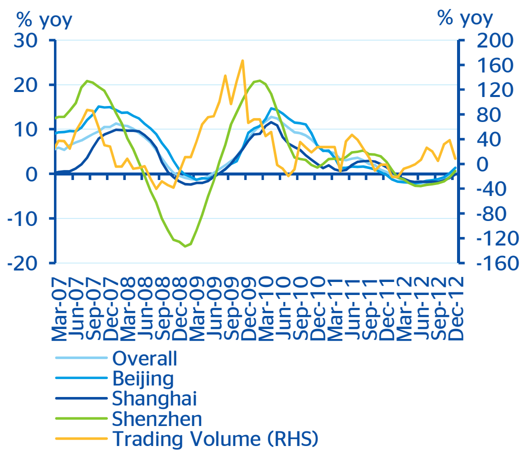
The ongoing program of public housing construction continues to be an important pillar of overall infrastructure spending and efforts to maintain housing affordability. In line with government targets, 7.81 million units were started in 2012 (against a target of 7.0 million), with completion of 6.01 million (against a target of 5 million). In 2013, the government plans to start 6.0 million units with completion of 4.6 million units.

Chart 35
More cities report rising housing prices...



Source: NBS and BBVA Research

Chart 36
... as property sales and prices recover



Source: NBS, CEIC and BBVA Research

3. A brighter economic outlook

The authorities have successfully steered the economy toward a soft landing. In so doing, they have walked a fine line between providing support to the economy through looser credit policies and stepped up infrastructure spending, while taking care not to exacerbate domestic financial fragilities in the form of shadow bank lending and local government debt.

Against this backdrop and the weak, albeit improving global economic environment, the key question in the near term is to what extent the economic pickup has become self-sustaining? While we see some signs that it has – confidence indicators are up, investment in the property sector is rising, and the inventory destocking process is coming to an end – we believe that further policy support will be needed to sustain growth to within government targets (see below). In view of the constraints on further stimulus posed by domestic financial fragilities and continued sluggish external demand, we have raised our 2013 growth projection only modestly, to 8.0% from 7.9% previously on the expectation that growth momentum will weaken slightly in the second half of the year as policy support is gradually withdrawn.

Policy continuity in the transition to the new leadership team

As the formal transition process nears completion in March, the newly selected leadership team has signalled that it will maintain policy continuity in 2013, marked by "prudent monetary policy and proactive fiscal policy". Based on recent statements and press reports, we expect the 2013 official growth target to remain at 7.5%, and the inflation target to be lowered to 3.5% from 4.0% last year. For the longer term, the new leadership team is likely to stress the quality of growth, and to maintain the pace of economic reforms to achieve rebalancing, boost productivity, and improve social welfare. Notably, policies to facilitate urbanization and address income inequality have taken on renewed prominence. The latter has been described in a new framework released in January for income redistribution via increasing minimum wages, strengthening the social safety net, increasing returns to savings through interest rate liberalization, and requiring higher dividend payouts by state-owned enterprises to finance social programs. Further details of the policy agenda are likely to emerge in March at the annual national parliament and government budget meetings.

Growth is expected to stabilize in 2013-14

With the policy stance expected to stay supportive, especially in the first half of 2013, we expect GDP growth to rise to 8.2%y/y in H1, followed by a modest slowdown to 7.8% y/y in H2 as policy support is gradually withdrawn. As the external environment improves and export demand gradually rises, this would bring full-year growth to 8.0% in 2013 and 2014 (Chart 37). Domestic consumption and investment would be the key contributors to growth, with the former benefitting from tax cuts and measures to boost household incomes, and the latter from a rise in private investment in manufacturing and the real estate sector, offsetting a small decline in the pace of public infrastructure spending. Net exports would continue to be a drag on growth, but less so than in recent years as the external environment improves.

Inflation has bottomed out, but should remain in check

We expect inflation to rise from its recent lows, to 3.3% (period average) from 2.6% in 2012, on stronger demand, rising food prices, and firming global commodity prices. Due to base effects, year-on-year inflation may well rise to above 3% in coming months, and to 3.8% by end-2013. Thereafter, we expect inflation to level off at around 4% in 2014, its expected long-term average. With inflation near or slightly above the government's 2013 comfort level, the room for further policy stimulus would be quite limited.

Table 2
Baseline Scenario

	2010	2011	2012	2013 (F)	2014 (F)
GDP (%, y/y)	10.4	9.3	7.8	8.0	8.0
Inflation (average, %)	3.3	5.4	2.6	3.3	4.0
Fiscal bal (% of GDP)	-2.5	-1.1	-1.6*	-2.0	-1.8
Current acct (% of GDP)	4.0	2.7	2.6	2.8	3.5
Policy rate (%, eop)	5.81	6.56	6.00	6.00	6.50
Exch rate (CNY/USD, eop)	6.61	6.30	6.23	6.10	5.95

* preliminary outturn.
Source: BBVA Research

Policies to remain growth-supportive, but cautious

With inflationary pressures and financial fragilities gradually rising, we expect macro policy settings to be applied cautiously in the coming year. In particular, we no longer anticipate further interest rate cuts; and further cuts in the RRR will depend on domestic liquidity conditions. That said, we expect the pace of bank credit growth to be on par with 2012 at around 10%, equivalent to an increase in new loans of RMB 9.0 trillion (from RMB 8.2 trillion in 2012); we expect the broader credit aggregate, "total social financing (including bank loans, corporate bonds, bank acceptance, and trust/trusted loans) to rise more rapidly, at around 20% in 2013, after rising 22.9% in 2012.

On the fiscal front, the government will reportedly announce a 2013 fiscal deficit of 2% of GDP. This compares to a preliminary outturn of 1.6% of GDP in 2012 and the fiscal deficit target in 2012 is 2.1% of GDP (after accounting for 0.5% of GDP in revenue transfers from 2011). Key features are likely to include a continued near-term emphasis on infrastructure and public housing construction, along with structural tax reform to boost household incomes and consumption, in order to facilitate the longer-term economic rebalancing.

Currency to rise further in 2013

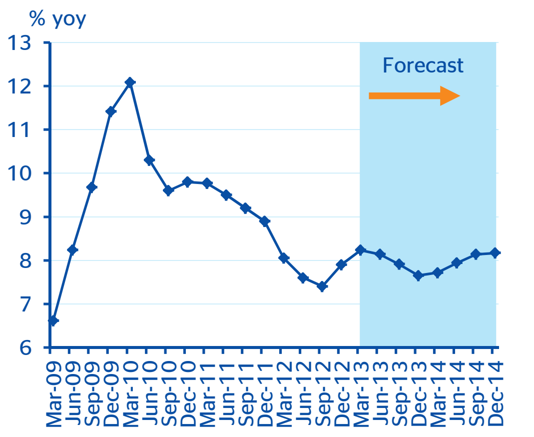
With the balance of payments still in surplus and with external demand and capital inflows projected to increase, we expect the authorities to accommodate a further modest rise in the RMB against the USD to around 6.10 RMB/USD by end-2013, or around 2% from its present level. There are, of course, risks to this outlook, especially in light of the recent depreciation of the yen, which could cause concerns domestic concerns about competitiveness in some of the sectors where China competes directly with Japan, such as consumer electronics.

It is also possible that currency flexibility will be further enhanced during the course of the year, beyond the current +/-1% band, which itself was widened last year from +/-0.5%. In addition, the ongoing internationalization of the RMB is likely to progress in 2013 as the authorities continue to promote the use of the currency in trade settlement and, increasingly, investment flows. The latter would include the introduction of more RMB products in offshore markets as vehicles to channel RMB flows back to the Mainland. For more on the liberalization of the capital account, see Box 2.

China's long term potential growth is gradually declining

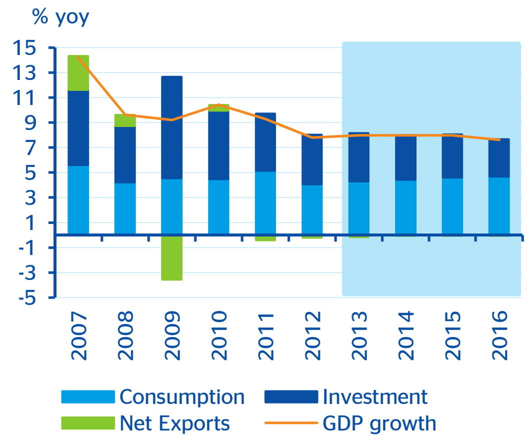
As noted in our previous quarterly Outlook, we expect potential growth to decline over time, to around 7.0% by 2020 from 9.0% in 2011. The decline is due to slowing total factor productivity growth, lower labor growth, and lower investment rates (and correspondingly lower capital stock) as the rebalancing of China's economy toward higher consumption rates takes place (Chart 38).

Chart 37
Growth in 2013 is set to slowdown after peaking in Q1



Source: NBS, CEIC and BBVA Research estimates

Chart 38
Over the medium term, consumption is to lead the growth in a rebalancing economy



Source: NBS, CEIC and BBVA Research estimates

Box 2: Latest steps in capital account liberalization

After a period of stagnation in financial sector reforms during and in the immediate aftermath of the 2008-09 global financial crisis, the liberalization process appears to be regaining momentum (see our Banking Watch, *Taking Stock of Financial Liberalization*). In particular, the authorities launched a batch of reform measures beginning in early 2012 including steps toward interest rate liberalization and greater flexibility in the exchange rate. As always, the steps are incremental and gradual in nature. The authorities also rolled out two pilot programs last year in Wenzhou (Zhejiang Province) and Qianhai (Guangdong Province), the former to allow private capital into the banking market and limited outward portfolio investment by individuals, and the latter to facilitate cross-border capital flows between Hong Kong and Guangdong province.

Following the release of a five-year plan for the financial sector last September, the new leadership team has signalled that it will press ahead with liberalization measures. In the meantime, there have been two important advances at the beginning of this year in capital account and RMB, as described below.

Portfolio flows: from institutional to individual investors

In mid-January, the Chairman of the China Securities Regulation Commission (CSRC), Mr. Guo Shuqing, spoke publicly of plans to expand the Qualified Foreign Institutional Investor Scheme (QFII) and Qualified Domestic Institutional Investor Scheme (QDII) by up to ten times their current size (Table 3). This comes on top of plans scheduled for this year to expand the QFII, QDII, and RQDII (RMB Qualified Foreign Institutional Investor) programs to individual investors on a pilot basis this year. These programs constitute the main channels for cross-border portfolio flows under China's highly restricted capital account.

The launch of new schemes catering to individual investors (QFII-2, RQFII-2 and QDII-2) is expected to be gradual, but should bring more business opportunities for both domestic and overseas financial institutions who are in a position to provide cross-border financial services to individual investors. In particular, the RQFII-2 is likely to open to the offshore RMB holders in both Hong Kong and Taiwan in a bid to push forward the internationalization of RMB.

Table 3
Quotas for QFII, RQFII and QDII programs (end-2012)

		No. of institutions	Quota approved	Quota used
QFII	USD bn	169	80	37.4
RQFII	RMB bn	24	270	67.0
QDII	USD bn	107	--	85.6

Source: Media reports, Wind and BBVA Research;

The first cross-border RMB loan in Qianhai

Separately, in late January a group of 15 Hong Kong banks issued, for the first time, an RMB-denominated loan of RMB 2 billion to a domestic Mainland company, located in the Qianhai pilot region. For the time being, this type of cross-border RMB loan is only permissible in the Qianhai pilot region and it is subject to various limitations. For example, the PBoC prohibits the use of proceeds from cross-border loans for investment in securities, financial derivatives, entrusted loans, wealth-management products, and properties. Nevertheless, given the negative interest rate differential between the offshore and onshore market, the cross-board RMB loans have a great potential for growth, which should in turn fuel the development of offshore RMB markets in Hong Kong and other financial centers. For further details, see our annual report on RMB Internationalization, *As RMB internationalization advances, new headwinds call for policy steps.*

4. Risks are more balanced

With the pickup in growth and improvement in the global environment, risks to the near-term outlook have become more balanced than in previous quarters. Downside risks remain from the uncertain global outlook; that said, our 2013 growth projection is conservative given the strength of recent data, and there could well be upside surprises to the outturn.

Domestic financial fragilities remain a source of concern. After declining in 2011 and early 2012 they have increased again with the government's stimulus measures. While the residential property market is on a sounder footing given the pickup in sales and investment, the level of local government debt has increased due to stepped up infrastructure spending financed by the shadow banking system, itself an increasing source of risk. Given their overall magnitude, these fragilities are still manageable. However, they are a potential source of instability, even in the near term, given that a large share of recent loans to local governments comes due this year, and any repayment problems could undermine confidence in the broader financial system.

On the political front, risks from the leadership transition have abated now that the new members of the Standing Committee of the Politburo, as well as the new President and Premier have been selected. After a period of instability last year due to corruption charges, the transition process has been proceeding smoothly, along with credible signals of continuity in the policy outlook. While it remains to be seen whether the pace of economic and political reforms will be maintained, the outlook so far is promising.

Finally, geopolitical tensions remain a source of risk. China's disputes with its regional neighbors have intensified further, especially with Japan over territorial claims in the East China and South China Seas, along with noticeable effects on trade and investment flows between the two economies. These conflicts have increasingly given rise to further military buildups and political tensions which, if left unchecked, could not only divert resources from more productive uses, but could have broader detrimental effects throughout the region.

5. Tables

Table 4
Macroeconomic Forecasts

	2010	2011	2012	2013 (F)	2014 (F)
GDP (%, y/y)	10.4	9.3	7.8	8.0	8.0
Inflation (average, %)	3.3	5.4	2.6	3.3	4.0
Fiscal bal (% of GDP)	-2.5	-1.1	-1.6*	-2.0	-1.8
Current acct (% of GDP)	4.0	2.7	2.6	2.8	3.5
Policy rate (%, eop)	5.81	6.56	6.00	6.00	6.50
Exch rate (CNY/USD, eop)	6.61	6.30	6.23	6.10	5.95

*preliminary outturn.
Source: BBVA Research

Table 5
Gross Domestic Product

(YoY growth rate)	2010	2011	2012	2013 (F)	2014 (F)
U.S.	2.4	1.8	2.2	1.8	2.3
EMU	1.9	1.5	-0.5	0.3	1.3
Asia-Pacific	8.2	5.7	5.2	5.6	5.8
China	10.4	9.3	7.8	8.0	8.0
World	5.1	3.9	3.2	3.6	4.1

Source: BBVA Research

Table 6
Inflation (Avg.)

(YoY growth rate)	2010	2011	2012	2013 (F)	2014 (F)
U.S.	1.6	3.1	2.0	2.1	2.2
EMU	1.6	2.7	2.5	1.6	1.5
Asia-Pacific	3.6	4.8	3.0	3.3	3.5
China	3.3	5.4	2.6	3.3	4.0
World	3.8	5.2	4.1	3.9	3.9

Source: BBVA Research

Table 7
FX rate (End of period)

		2010	2011	2012	2013 (F)	2014 (F)
EMU	USD/EUR	1.34	1.30	1.32	1.32	1.33
China	CNY/USD	6.61	6.30	6.23	6.10	5.95

Source: BBVA Research

Table 8
Policy rate (End of period)

	2010	2011	2012	2013 (F)	2014 (F)
U.S.	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	1.00	0.75	1.25
China	5.81	6.56	6.00	6.00	6.50

Source: BBVA Research

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") Of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the financial services and markets act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons. The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA is not a member of the FINRA and is not subject to the rules of disclosure affecting such members.

"BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance".

BBVA is a bank supervised by the Bank of Spain and by Spain's Stock Exchange Commission (CNMV), registered with the Bank of Spain with number 0182.

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

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

Fielding Chen
fielding.chen@bbva.com.hk

Le Xia
xia.le@bbva.com.hk

George Xu
George.xu@bbva.com.hk

BBVA Research

Group Chief Economist
Jorge Sicilia

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

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

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

Latam Coordination
Juan Ruiz
Juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Alejandro Puente
apuente@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Oswaldo López
oswaldo_lopez@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Macroeconomic Analysis Mexico
Carlos Serrano
carlos.serranoh@bbva.com

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

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Global Areas:

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

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

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

Financial Systems
Ana Rubio
arubiog@bbva.com

Pensions
David Tuesta
david.tuesta@bbva.com

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

Contact details

BBVA Research
43/F, Two International Finance Centre
8 Finance Street
Central, Hong Kong
Tel. + 852-2582-3111; Fax. +852-2587-9717
research.emergingmarkets@bbva.com.hk
BBVA Research reports are available in English, Spanish and Chinese