BBVA | RESEARCH

Economic Outlook

China/Asia

Fourth Quarter 2013
Economic Analysis

- **Global growth is expected to accelerate in 2014, but with downside risks** from US fiscal wrangling and QE tapering, lingering uncertainties in the EU, and financial fragilities in China. We have lowered our global outlook to 2.9% and 3.6% in 2013-14 on weaker growth in emerging markets.
- **Economic trends across the Asia region have continued to diverge**. Growth has picked up in North Asia, especially in China and Japan, but has weakened elsewhere, most notably in India and Indonesia. Regional growth is expected to rise in 2014 on improving external demand.
- **In China, improving growth momentum** has given rise to a slightly higher full-year growth outlook of 7.7% in 2013, and 7.6% in 2014 as projected previously. However, medium term concerns persist on signs that rebalancing has been delayed and that financial fragilities have continued to grow.
- **Risks to the regional outlook** stem from prospects of renewed capital outflows from QE tapering, and uncertainty about the sustainability of China's growth momentum.

Index

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Summary

Economic performance across the Asia region has continued to diverge. Growth has picked up in North Asia, especially in China and Japan, but has weakened elsewhere, most notably in India and Indonesia. In the latter two, the divergence has been exacerbated by volatility in capital flows brought on by previous expectations of QE tapering which, in turn, revealed structural weaknesses in the form of current account deficits and fragile investment climates.

Regional market sentiment and growth outturns have improved with the delay in QE tapering, pickup in China's growth momentum, and continued recoveries in the US and EU. The delay in QE tapering and (temporary) resolution of the US debt ceiling debate have helped alleviate financial pressures in the region, and have provided breathing room for policymakers in several countries to undertake further policy adjustments and structural reforms. Nevertheless, economies with current account deficits and which are dependent on portfolio inflows, such as India and Indonesia, remain vulnerable to a renewal of external pressures once QE tapering begins, possibly in early 2014.

In Japan, economic developments remain broadly positive. Growth momentum has continued to improve under the fiscal and monetary stimulus policies of "Abenomics". Non-residential investment, which had been the missing ingredient so far, has recently accelerated, contributing to the pickup in private spending and exports. After a prolonged period of deflation, headline inflation has been positive since June, albeit still short of the Bank of Japan's 2% target by end 2014. The priority now is to implement bold structural reforms to boost longer term growth, without which fiscal and monetary policies alone will likely fail.

Consistent with our recent quarterly Outlooks, our baseline continues to build in a gradual improving trend in growth given an expected strengthening of the external environment. However, downward revisions to the growth outlooks in India (4.2% in 2013 and 4.6% in 2014) and Indonesia (5.6% in 2013 and 5.8% in 2014) more than offset small upgrades for Japan (1.9%) and China (7.7%) in 2013, resulting in a modestly lower growth outlook for the region as a whole compared to our last quarterly update. The inflation outlook remains benign, except in India and Indonesia, where their respective central banks have hiked interest rates to stem currency depreciation pressures and contain inflation expectations.

In China, a wave of earlier pessimism about near-term growth prospects has given way to optimism that the authorities' 7.5% growth target for 2013 will be easily achieved. Improved policy clarity, implementation of "mini-stimulus" measures, and stronger external demand have led to a pickup in private manufacturing investment and growth momentum. After bottoming out at 7.5% y/y in Q2, GDP growth rose to 7.8% y/y in Q3, and momentum is continuing in Q4. We now expect full-year growth of 7.7% in 2013, compared to 7.6% previously; our projection for 2014 remains unchanged at 7.6%.

We expect the broad policy mix in China to remain unchanged, albeit with a slight tightening bias to slow credit growth and curtail financial fragilities. No changes in interest rates are anticipated through 2014, and we continue to expect the RMB to be at 6.10 per USD at end-2013, and to continue appreciating thereafter by around 2-3% per year.

However, concerns about the sustainability of the pickup have arisen on signs that rebalancing has been delayed and that financial fragilities have continued to grow. Rapid credit growth from the shadow banking system has continued, leading to higher levels of corporate and local government debt. Housing price increases have also picked up at an alarming rate. These financial fragilities pose a constraint to further policy easing and place a premium on reforms to ensure a more healthy balance of growth over the medium-term.

Risks to the regional outlook stem from the possibility of renewed volatility and tighter financial conditions as investors evaluate the timing and degree of Fed tapering. Moreover, given uncertainties about the sustainability of the pickup in China, a slowdown in 2014 and beyond could weigh on the region's growth.

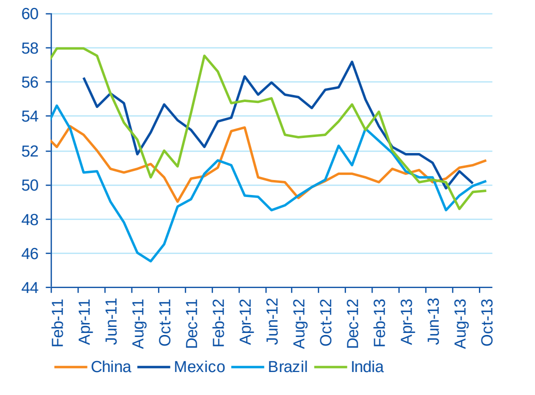
1. Global recovery underway with downside risks

Before turning to Asia and China, we briefly review the *Global Outlook*. Readers may go directly to the sections on Asia, if they wish, by turning to page 6.

A positive economic assessment on declining risk aversion

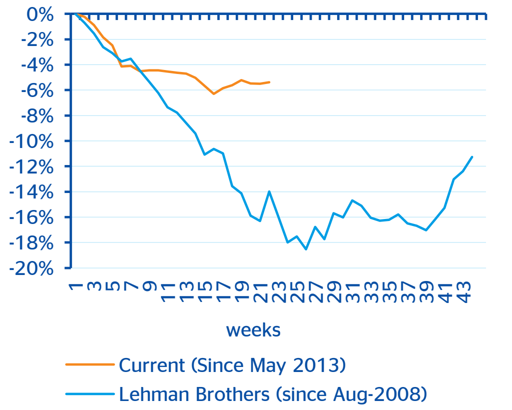
Confidence and activity indicators have continued to improve in the advanced economies, and have stopped deteriorating in major emerging economies such as China (Chart 1). There has also been a decline in financial volatility and outflows in emerging markets (Chart 2), both as a result of the delay in expected Fed tapering and improving near term prospects for growth in China. In addition, the end of recession in the euro zone and the (temporary) fiscal agreement in the U.S. have kept risk aversion in financial markets at relatively low levels.

Chart 1
Manufacturing PMIs have stopped deteriorating in emerging markets



Source: Haver and BBVA Research

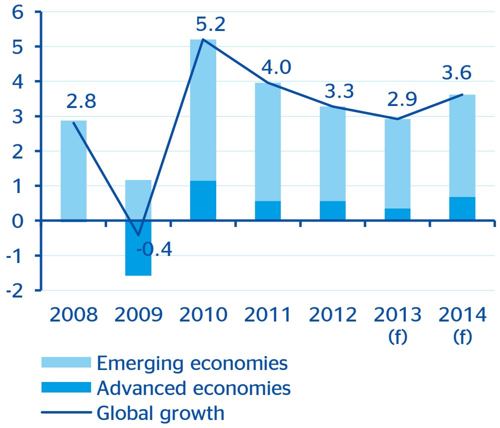
Chart 2
Bond and equity outflows from emerging markets have stabilized



Source: EPFR and BBVA Research

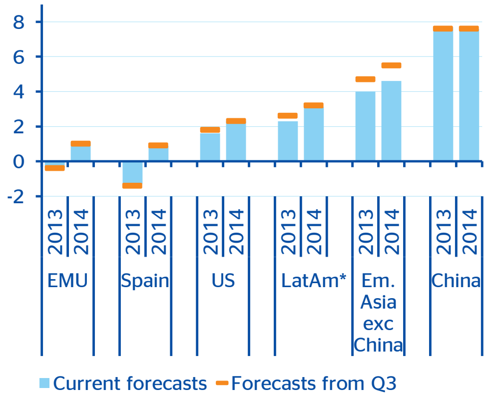
As detailed in our *Global Outlook*, the global economy will grow nearly 3% in 2013, somewhat less than we expected previously, given downward revisions to growth in the U.S. and Mexico and in some emerging economies in Asia (Charts 3 and 4). Nevertheless, we maintain our forecasts of an upturn in growth in 2014 and 2015, now to around 3.5% and 4%, respectively. This scenario is of limited recovery, supported relatively more by advanced economies which, except for Japan, should grow more strongly in 2014 and 2015 than in 2013, and with sustained contributions from emerging economies in Asia and Latin America.

Chart 3
Global growth is recovering, but remains weak…



Source: BBVA Research and IMF

Chart 4
…on downgrades to growth projections in emerging markets



* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venzuela.
Source: BBVA Research

Risks are titled to the downside, but less so than previously

Risks remain of a "disorderly exit" from the Fed's QE program, expected to begin in early 2014, entailing an "excessive" increase in long-term rates in the U.S. Such an event would slow down an already moderate global recovery, especially in the euro zone, where weaknesses persist from financial fragmentation, still pending reforms pending in the banking sector, and the length and depth of the recession that is now ending. Another risk related to the U.S. is the short-term resolution of the budget negotiation and debt ceiling, which will be taken up again in a few weeks. Weaker growth in emerging market economies, especially in China, poses another risk to the global economy. In the case of the Chinese economy, although our growth outlook has not changed, there are risks lurking for 2014 and beyond due to the buildup of financial fragilities and the need for reforms to sustain medium term growth, but which may have short-term negative effects on growth.

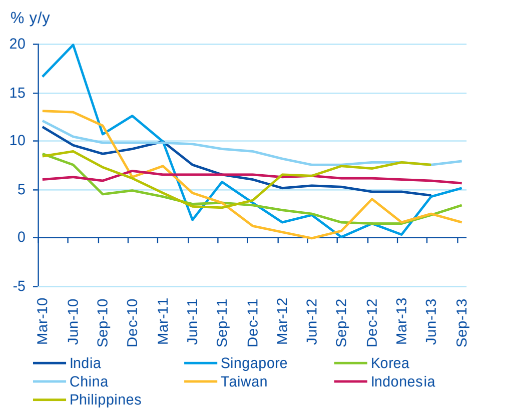
Lastly, the possibility of a resurgence of the euro crisis remains a relevant risk. That said, one of the most positive elements of the current situation is the changing perception about the European currency area, in view of the recent progress made on the road to banking union. The return to growth, the effective short-term easing of fiscal policy and the ongoing confidence in the ECB's role as a guarantor of the currency's stability have all contributed to this shift. However, to sustain the confidence of the markets, the authorities will need to make further progress in strengthening the monetary union, and in particular banking union, also with measures that reinforce the sustainability of public debt in the medium term.

In short, in our baseline global scenario, improving confidence should be reflected in stronger GDP growth from the second half of 2013. Nevertheless, the key to improving the confidence of households and businesses, reducing financial market stress, and sustaining the global recovery will depend on how economic policies are implemented and coordinated in the U.S., Europe and China.

2. Asia sees diverging trends

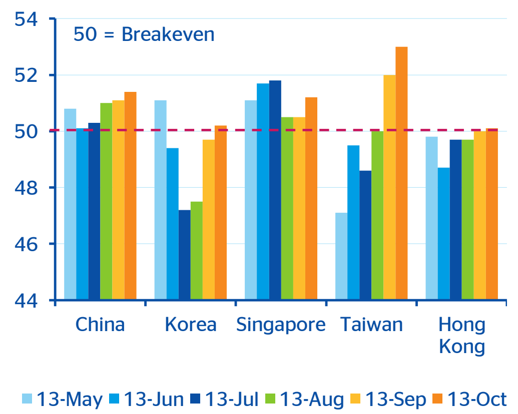
Over the past few quarters, economic performance across the Asia region has continued to diverge. This trend has been exacerbated by volatility in capital flows from previous expectations of QE tapering which, in turn, have revealed structural weaknesses, most notably in India and Indonesia, leading to weaker investment and GDP growth in those economies (Chart 5). At the other end of the spectrum, growth in Japan and the Philippines has accelerated on domestic policy stimulus and renewed market confidence in their respective near-term prospects. Meanwhile, economic conditions in North Asia, especially Korea and Taiwan, have been relatively resilient due to supportive economic policies and improving external demand for final consumer goods in advanced economies. More generally, a pickup in near-term GDP growth in China, as described in more detail in Section 3, has allayed concerns of a hard-landing and has helped support regional trade flows and growth momentum (Chart 6).

Chart 5
Q3 GDP growth has weakened in India and Indonesia, and has picked up elsewhere ...



Source: Haver and BBVA Research

Chart 6
... while manufacturing PMIs in the region show signs of improvement

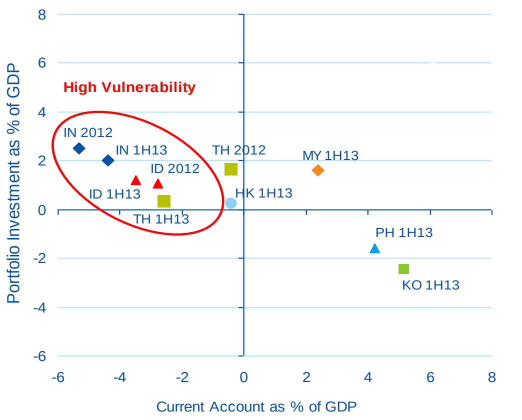


Source: Bloomberg and BBVA Research

India and Indonesia get some breathing space

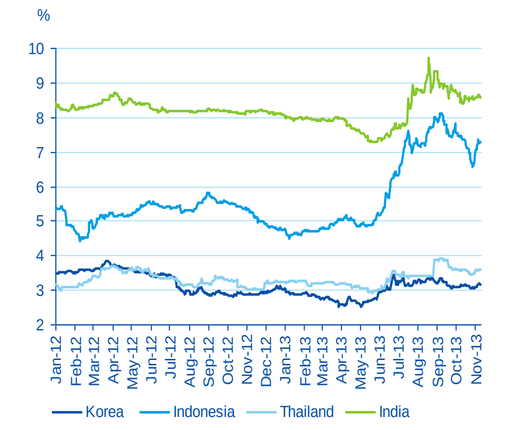
The recent delay in QE tapering and resolution of the US debt ceiling debate has helped alleviate financial pressures in the region, and has provided breathing space for policymakers to undertake further adjustments and structural reforms. Economies with current account deficits and which are dependent on portfolio inflows, such as India and Indonesia, and to a lesser extent Thailand, remain the most vulnerable to a renewal of external pressures once QE tapering begins in the US (Charts 7 and 8). In recognition of this, policymakers in India and Indonesia have been especially active in raising interest rates and adopting other policy measures to trim their current account deficits and attract foreign investment flows.

Chart 7
India and Indonesia are most exposed to sudden stops...



Source: CEIC and BBVA Research

Chart 8
...and tighter financial conditions have raised government borrowing costs



Source: Bloomberg and BBVA Research

In response to downward currency pressures (the rupee hit a record low of 68.8 per USD at the end of August), the Reserve Bank of India took a series of measures beginning in July, including tightening short-term liquidity, supplying dollars directly to public sector oil companies, restricting residents' capital outflows, opening a swap window to attract non-resident Indian dollar deposits, and easing norms for overseas borrowing. Measures also included steps to reduce the current account deficit (projected at 4.2% of GDP in 2013) through curbs on gold imports, and to attract capital inflows by raising limits on foreign investment in key sectors such as multi-brand retail. Subsequently, to address inflationary pressures the RBI, under its new Governor, Raghuram Rajan, implemented back-to-back interest rate hikes in September and October, while easing rupee liquidity by reversing some of the measures taken in August.

The RBI's policies under its new Governor have improved the central bank's credibility among market participants and, together with the respite provided by the delay in QE tapering, the rupee has stabilized at around 61-62 per USD, well off its previous lows. However, with growth slowing to a disappointing 4.4% y/y in Q2 2013, the key to achieving a more durable boost to confidence will be bolder structural reforms to reduce fuel subsidies, improve land acquisition for infrastructure development, and open additional sectors to foreign investment.

In Indonesia, to contain soaring inflation sparked by an administered fuel price increase in June, the central bank hiked interest rates by a cumulative 150bps from June-September, before pausing in October as inflation subsided and the currency stabilized at around 11,000-11,500 per USD. Meanwhile, in late August the government announced a policy package to address the current account deficit (which widened to an unexpectedly large 4.4% of GDP in Q2) and stem inflation which peaked at 8.6% y/y in July. The thrust of the package aimed to reduce the current account deficit and stem currency pressures by reducing fuel imports (through the promotion of domestically-generated biodiesel products) and the elimination of mineral export quotas. It also sought to support growth momentum through tax incentives for labor-intensive industry, to ease inflation pressures through the elimination of import quotas on beef and horticulture products, and to increase investment by streamlining approvals and revising the negative investment list.

While the package on its own seems unlikely to resolve currency pressures, some of the measures represent a welcome reversal of protectionist policies implemented over the past year. As in India, a combination of policy measures and the delay of QE tapering has reduced external pressures, and provides time for the central bank and government to undertake further measures to shore up investor confidence.

Japan continues to shine, but with challenges and risks ahead

Under the fiscal and monetary stimulus policies of "Abenomics" momentum has picked up, with GDP growth of 3.8% saar in Q2, after 4.1% in Q1, underpinned by private spending and exports. Although private consumption weakened in Q2, non-residential investment, which had been the missing ingredient so far in the economic pickup, accelerated noticeably. Recent high frequency indicators for exports, industrial production, and retail sales have also generally been moving in the right direction. At the same time, inflation expectations have picked up, and after a prolonged period of deflation, headline inflation has been positive since June, rising to 1.1% y/y in September on continued rises in energy prices. However, inflation is still far short of the Bank of Japan's 2% target by end 2014.

Financial markets have levelled off after a dramatic rise during the first six months following Abe's election victory in November 2012. After surging by 80% through May, the stock market has fallen 9% since its peak. Similarly, after depreciating by 30% against the USD through May, the yen has been range bound at around 98 per USD.

The levelling off of financial markets may reflect scepticism about the sustainability of Japan's pickup. Indeed, GDP growth has probably slowed in the second half of the current year as fiscal stimulus is wearing off and as export demand from the rest of Asia may have temporarily weakened. The market focus has shifted to the implementation of the "third arrow" under Abenomics, namely structural reforms to boost medium-term growth prospects. In that regard, it is encouraging that the government plans to proceed with a previously agreed three percentage point increase in the consumption tax to 8% in 2014. To address the near-term negative drag, the government plans to implement an offsetting stimulus package of ¥5 trillion in 2014, consisting of tax incentives for investment, tax breaks for home purchases, possible cuts in the corporate tax, and unspecified spending (details expected later this year).

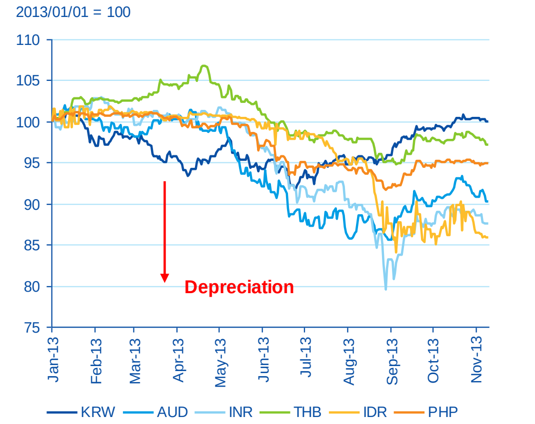
More broadly, the ruling coalition's control of both houses of Parliament following last July's Upper House elections bodes well for political stability and should, in theory, increase the likelihood of passage of additional reforms in the period ahead, including an opening up the agricultural sector, enhancing labor market flexibility, and a credible plan for medium-term fiscal consolidation. But such plans have not yet been fully articulated, and without them fiscal and monetary policies alone will likely fail. In such a scenario, investors could lose confidence in the ability of the government to service its debts, and sooner or later Japan could find itself in a debt crisis and downward economic spiral.

Elsewhere in the region growth is being supported by domestic policies and improving external demand

While recent growth outturns have disappointed in India and Indonesia, elsewhere momentum has generally improved on supportive policies and improving external demand. However, the performance is uneven. As described more fully in Section 3, China's growth picked up to 7.8% y/y in Q3 after bottoming out at 7.5% in Q2 and recent activity indicators suggest that momentum is continuing into Q4. Meanwhile, the Philippines, which has received rating agency upgrades to investment grade, remains a standout, with GDP growth of 7.5% y/y in Q2 and 7.7% y/y in Q1 on strong domestic demand fuelled by low interest rates and inflows of remittances. Damage assessments are underway after a devastating typhoon in the central area on November 8-9, and the GDP growth impact remains to be seen.

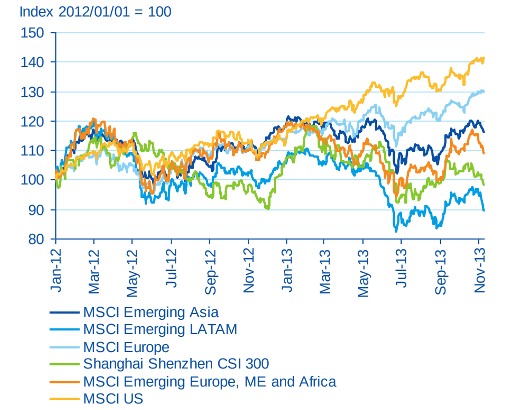
However, elsewhere in the ASEAN region momentum has been slowing, especially for commodity producers such as Indonesia and Malaysia which have seen a double whammy from softer commodity prices and tighter financial conditions from expectations of QE tapering. On the other hand, Korea's growth momentum has been sustained (3.3% y/y in Q3) thanks to the effects of fiscal stimulus earlier in the year and continued low interest rates. Korea weathered the financial volatility from QE tapering expectations exceptionally well (Charts 9 and 10), as investors came to view the economy as something of a safe haven due to strong fundamentals and success in recent years in reducing short-term external debt.

Chart 9
The Korean won has outperformed



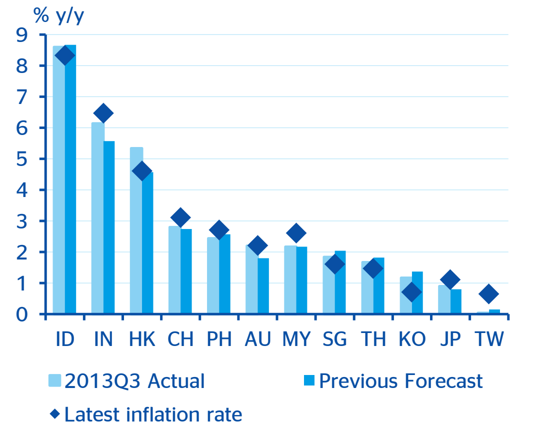
Source: Bloomberg and BBVA Research

Chart 10
Asian equity markets have largely recovered from the May-August selloff



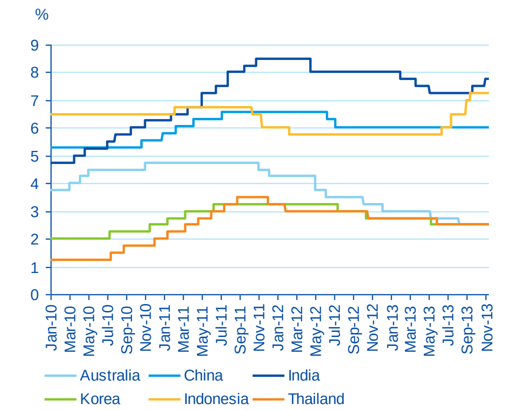
Source: Bloomberg and BBVA Research

Chart 11
Inflation remains high in India and Indonesia, and subdued elsewhere



Source: Bloomberg and BBVA Research

Chart 12
Monetary policies are on divergent paths



Source: Bloomberg and BBVA Research

Monetary policies are diverging

With the exception of India and Indonesia, which have both tightened policies in recent months, most central banks in the region have been on hold (Charts 11 and 12). As discussed above, the Reserve Bank of India hiked its benchmark repo rate by 50bps to 7.75% in back-to-back moves in September and October to stem inflationary pressures (WPI and CPI inflation stood at 6.5% y/y and 9.8% y/y respectively in September). For its part, Bank Indonesia hiked interest rates by a cumulative 150bps from June-September to 7.25%, before pausing in October, to counter downward currency pressures and rein in inflation after a 40% administered fuel price increase in June (CPI inflation eased in October to 8.3% y/y after peaking in August at 8.8%). In contrast, in the face of ongoing weakness in the non-mining sector and an uncomfortably strong currency, the Reserve Bank of Australia cut its benchmark rate to a record-low 2.50% in August, bringing the cumulative rate cuts to 225bps since November 2011.

Looking ahead, we expect monetary policies to remain on a tightening bias in Indonesia and India through early 2014 given ongoing efforts to contain inflation and rein in their current account deficits, all the more so in advance of a possible resurgence in external pressures from QE tapering. Meanwhile, we see room for further rate cuts in Korea and Australia, but we have not put them in our baseline given expectations of improving growth and the desire by policymakers to normalize interest rates.

Weaker growth in India and Indonesia weigh on outlook

Consistent with our recent quarterly Outlooks, our baseline continues to build in a gradual improving trend in growth given an expected improvement in the external environment (Table 3). However, downward revisions to the growth outlooks in India (4.2% in 2013 and 4.6% in 2014) and Indonesia (5.6% in 2013 and 5.8% in 2014) more than offset small upgrades for Japan (1.9%) and China (7.7%) in 2013, resulting in a modestly lower growth outlook for the region as a whole compared to our last quarterly update.

Risks to the outlook stem from the possibility of renewed volatility and tighter financial conditions as investors evaluate the timing and degree of Fed tapering. Moreover, with the sustainability of the pickup in China still uncertain, and given rising financial fragilities and the challenges of rebalancing, a slowdown in 2014 and beyond could weigh on the region's growth.

Beyond China, a number of country-specific risks are present. In Japan, market sentiment could turn if structural reforms are not forthcoming, or if doubts persist about the government's medium-term fiscal consolidation plans although the latter has eased with the decision to proceed with the consumption tax hike in 2014. While financial market volatility has calmed in Indonesia following the interest rate hikes and government efforts to stem the current account deficit, pressures could resurface once QE tapering gets underway. Similarly, pressures could resume in India, which still faces headwinds to growth from the lagging reform agenda, and efforts to address the "twin" current account and fiscal deficits. Finally, rising political tensions in Thailand over a proposed amnesty bill that could pave the way for the return of exiled former Prime Minister Thaksin bear watch, and pose downside risks to the growth outlook.

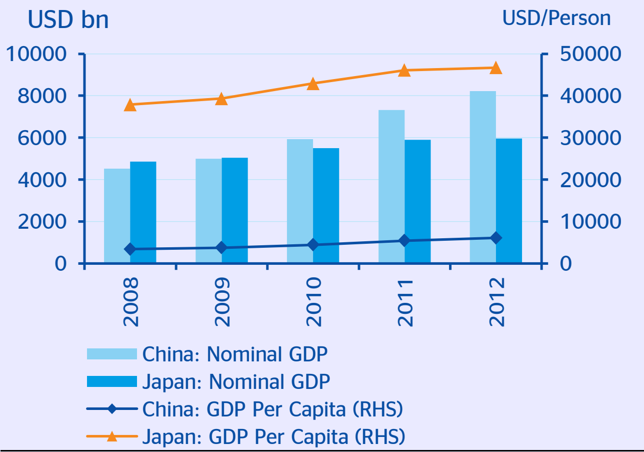
Box 1: Can a pickup in Japan offset a slowdown in China?

China's GDP growth has been decelerating since 2010, and with potential growth expected to slow further, questions have been raised about the impact on its trading partners and global growth. In contrast, there is renewed optimism about Japan's growth prospects after decades of subpar growth. As the world's second and third largest economies, respectively, it is a natural question to ask whether the slowdown in China can be offset by a pickup in Japan?

China's economic size has eclipsed Japan

China overtook Japan to become the world's second largest economy in 2010 (Chart 13), and the gap has continued to widen. Indeed, the gap can be expected to widen for the foreseeable future given that China's projected growth in the coming years is around 7% versus only 1-2% in Japan.

Chart 13
GDP and GDP per-capita

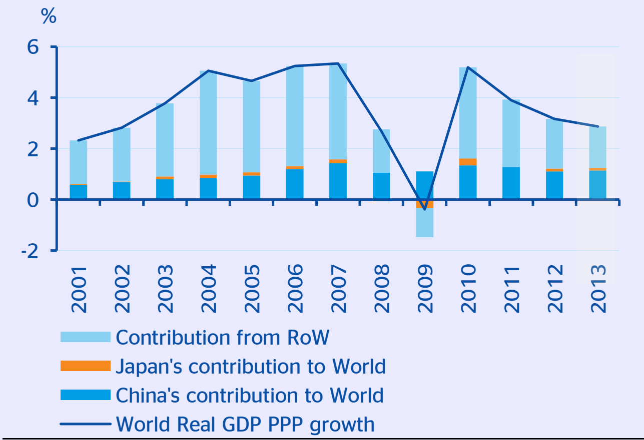


Source: IMF and BBVA Research

China contributes a much larger share to global growth

Given China's relatively large economic size and rapid growth rate, its contribution to global growth has been significantly larger than Japan's (Chart 14). Indeed, during 2001-2002 China contributed 1.0 ppts to global growth on average compared to just 0.1ppts for Japan. In 2013, with projections of 7.7% GDP growth for China and 1.9% for Japan, we estimate that China will contribute 1.1 ppts to the global growth, compared to Japan's 0.1 ppts. This means that it would take a large increase in Japan's GDP growth rate to offset a slowdown in China. For every one percentage point decline in China's growth rate, Japan's growth rate would need to increase by 1.5-2.5 percentage points.

Chart 14
China is a much larger contributor to global growth than Japan



Source: IMF and BBVA Research

The shares in the world's export market

In addition to its larger economic size, China is also a much larger importer than Japan. By market destination (Table 1), China (including Hong Kong) absorbs 23% of the region's total exports (excluding China and Japan), more than double Japan at around 10%; for the EU, China and Japan absorb 10% and 3% to total exports respectively; and for Latam, they absorb 10% and 2% respectively.

How have these shares changed in the first half of 2013, a period in which China growth slowed while Japan's accelerated? Contrary to expectations, China's share rose for Asia and Latam, and actually fell for Japan (see Table 1), quite likely due to the effect of yen depreciation. The shares from the EU fell for both economies. As Japan implements structural reforms to boost its long-term growth potential, we would expect to see a positive impact on trading partner exports. However, given the size differential between China and Japan, it is unlikely that a pickup in Japan would be enough to offset a slowdown in China.

Table 1
Exports to China/HK vs. Japan

	Exports to China/HK as % of Total Exports		Exports to Japan as % of Total Exports	
	2012	2013 1H	2012	2013 1H
Asia Pacific	23.4	↑23.6	9.6	↓9.0
Korea	30.5	30.0	7.1	6.2
Singapore*	21.0	21.9	6.2	6.1
Taiwan	39.4	39.3	6.3	6.2
India	9.1	8.4	2.3	2.1
Indonesia	12.8	13.2	15.9	15.5
Malaysia	16.9	16.3	11.8	11.6
Philippines	21.0	19.3	19.0	20.3
Vietnam	14.6	15.2	11.9	9.9
Thailand	17.4	17.1	10.2	10.0
Australia	30.6	35.5	19.3	18.1
EU 27	10.1	↓9.8	3.1	↓2.9
LATAM 7	10.2	↑10.7	2.4	2.4

*NODX (non-oil domestic exports) for Singapore
Source: IMF, UN Comtrade, CEIC and BBVA Research

3. China's growth stabilizes, but at the cost of rising financial fragilities

A wave of pessimism earlier this year about China's near-term growth prospects has given way to optimism that the authorities' 7.5% growth target for 2013 will be easily achieved. Improved policy clarity, implementation of "mini-stimulus" measures, and stronger external demand have led to a pickup in private manufacturing investment and growth momentum. After bottoming out at 7.5% y/y in Q2, GDP growth rose to 7.8% y/y in Q3 (Chart 15), and recent activity indicators suggest that momentum continues in Q4. We now expect full-year growth of 7.7% in 2013, compared to 7.6% previously. Our projection for 2014 remains unchanged at 7.6%.

While confidence in the near-term outlook has improved, however, concerns about the sustainability of the pickup have risen on signs that economic rebalancing has been delayed and that domestic financial fragilities have been allowed to grow. In particular, the pickup in growth has been investment- and credit- led. Rapid credit growth from the shadow banking system has continued, leading to higher levels of corporate and local government debt. Housing price increases have also picked up at an alarming rate. These financial fragilities pose a constraint to further policy easing and place a premium on reforms to ensure a more healthy balance of growth over the medium-term. In that regard, the Third Plenary Meeting now underway will be watched for the government's reform plans for the coming decade.

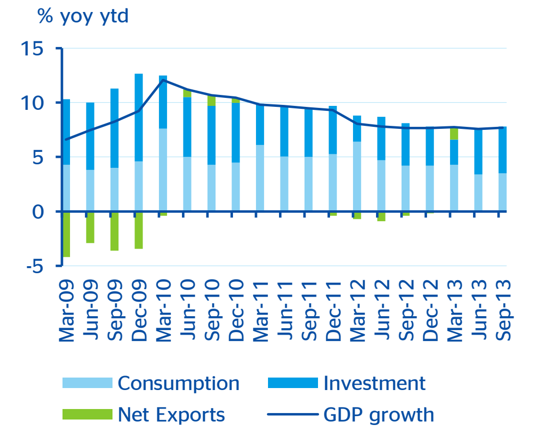
Near-term growth momentum picks up on domestic demand

In sequential terms (seasonally adjusted) officially reported quarterly GDP growth rose to 2.2% (9.1% annualized) from 1.9% in Q2 (7.8% annualized). The pickup appears to have been led by domestic demand. Using data provided by the National Bureau of Statistics (NBS), we estimate that the contribution of investment to growth amounted to 4.7 ppts in Q3, followed by consumption at 3.7 ppts, and -0.5 ppts for net exports. Strong investment was due to continued public infrastructure spending as well as a pickup in private manufacturing investment.

In addition to improving external demand (below), the economic pickup has been facilitated by supportive fiscal and monetary policies. On the fiscal front, the government implemented a series of "mini" stimulus measures during the third quarter, including the front-loading of public infrastructure spending, accelerated social housing construction, and incentives for private investment in public investment projects and services. Also included were VAT tax reform and tax cuts for SMEs, along with the streamlining of customs regulations to facilitate exports. On the monetary front, after the liquidity squeeze of last June, the central bank has been more active in injecting liquidity to maintain stability in the inter-bank market, despite occasional seasonal spikes. The central bank has also encouraged bank lending to SMEs, rural areas, and the western provinces. While these measures have been helpful in supporting growth, they fall well short of previous rounds of stimulus, especially in relation to the massive RMB 4 trillion package of 2009-10.

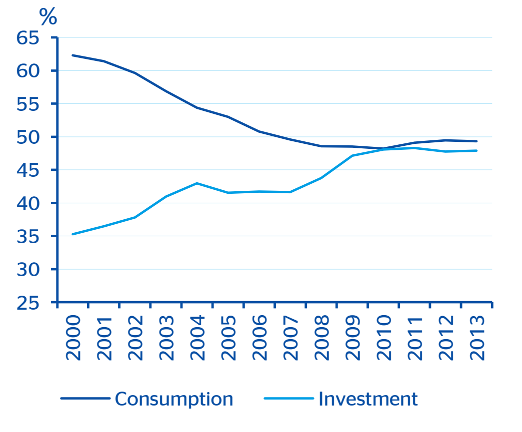
While the pickup in growth is encouraging, the mix of growth continues to be weighted toward investment, suggesting that the long-awaited rebalancing toward domestic consumption remains disappointingly slow (Chart 16). On the positive side, the share of services in the economy is rising (Chart 17), and the current account surplus has narrowed in recent years (Chart 18).

Chart 15
Growth has picked up after bottoming in Q2



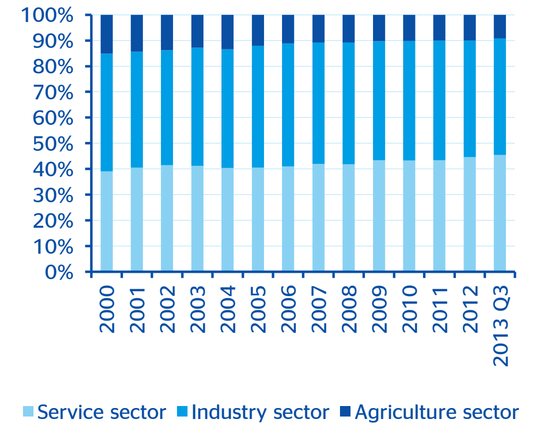
Source: NBS, CEIC and BBVA Research

Chart 16
Rebalancing toward domestic consumption remains disappointingly slow



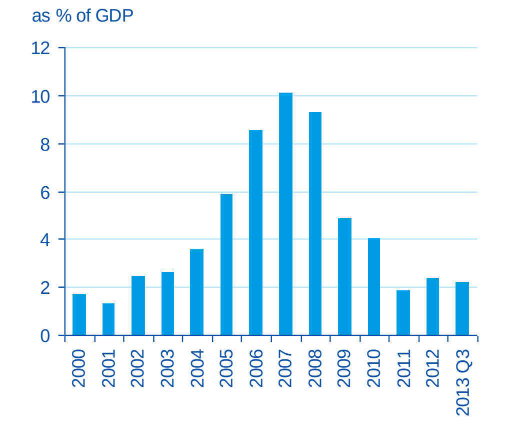
Source: NBS, Wind and BBVA Research

Chart 17
Encouragingly, the share of the service sector is rising...



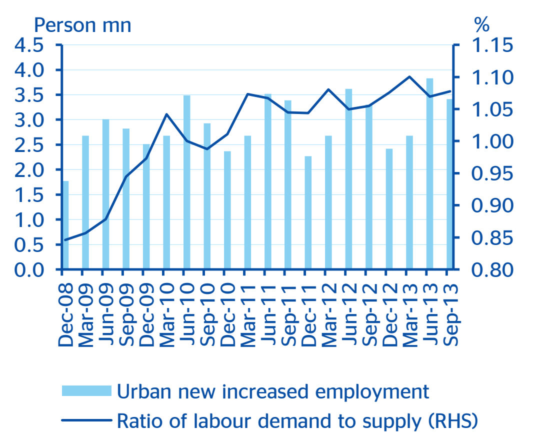
Source: NBS, CEIC and BBVA Research

Chart 18
...and the current account surplus has narrowed



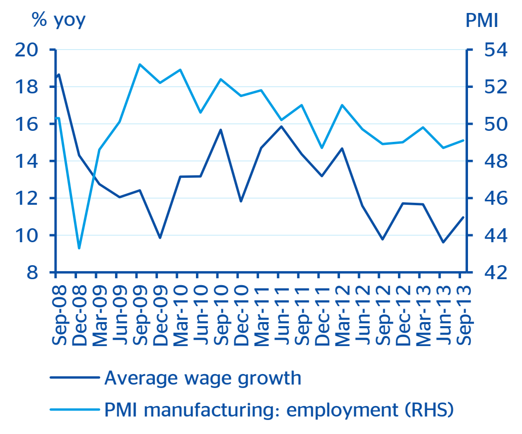
Source: NBS, Wind and BBVA Research

Chart 19
The labour market has held up relatively well



Source: CEIC and BBVA Research

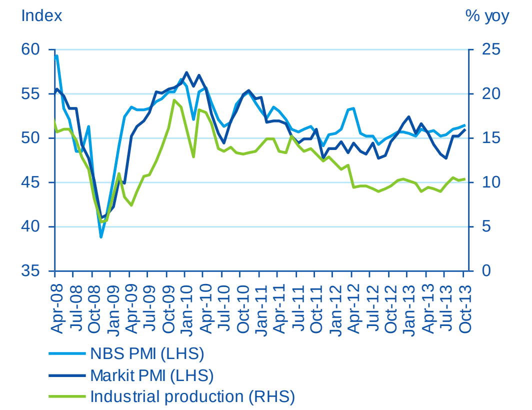
Chart 20
The deceleration in wage growth appears to have stabilized



Source: CEIC and BBVA Research

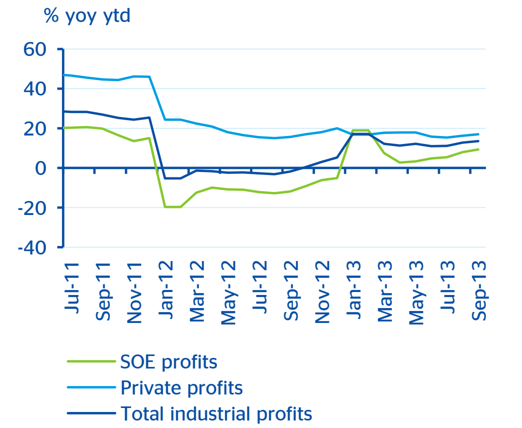
The labor market remains tight, with urban registered unemployment staying low at just 4.04% through Q3 2013. Data from the Ministry of Human Resources and Social Security, generally believed to be more reliable than NBS employment data, also suggest a stable labor market, with the labor demand-supply ratio rising to 1.08 in September (Chart 19). Recent labor market PMI subcomponents and wage growth have also edged up (Chart 20). In line with the rebound in Q3 GDP growth, monthly production and profit indictors have also been trending up since July (Charts 21 and 22).

Chart 21
China's manufacturing activities trend up in Q3



Source: CEIC and BBVA Research

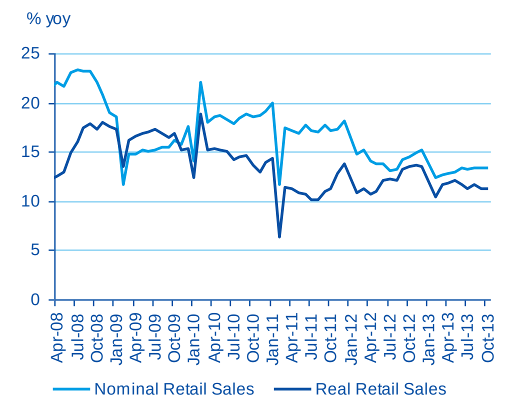
Chart 22
...while industrial profits have improved



Source: CEIC and BBVA Research

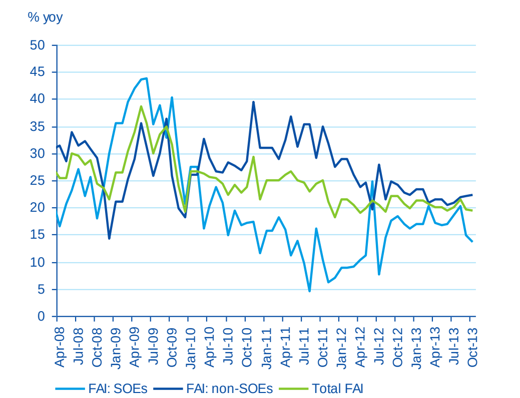
On the demand side, retail sales have been flat (Chart 23) on headwinds from slower income growth and from government efforts to discourage conspicuous consumption by public officials. Meanwhile investment indicators continue to grow more rapidly infrastructure spending and strengthening private manufacturing investment (Charts 24 and 25).

Chart 23
Retail sales growth is broadly flat ...



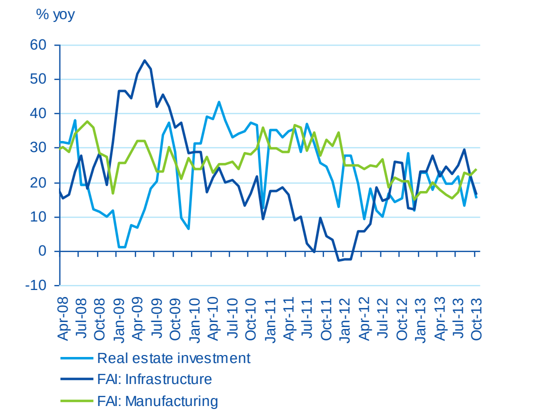
Source: CEIC and BBVA Research

Chart 24
Private investment improves ...



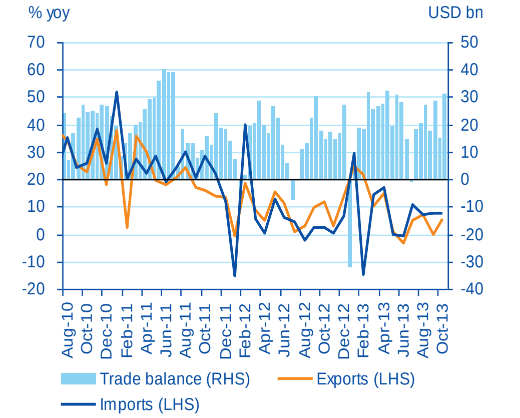
Source: CEIC and BBVA Research

Chart 25
...as manufacturing investment trends up



Source: CEIC and BBVA Research

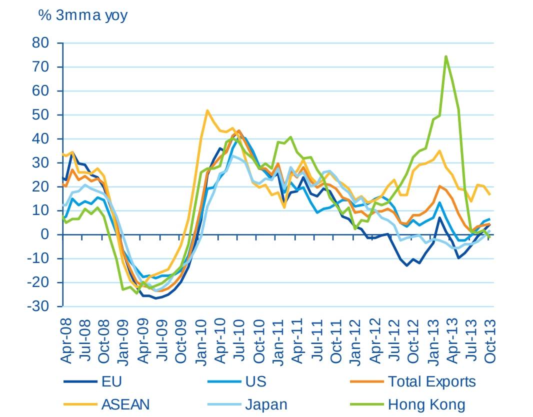
Chart 26
Exports growth dipped in September, reminding a fragile external sector



Source: CEIC and BBVA Research

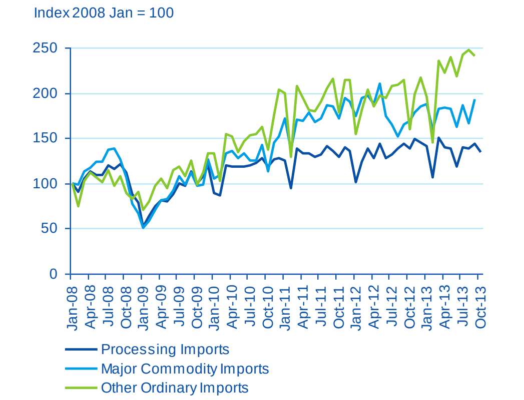
On the external front, exports have improved in the second half of the year as weakening demand from ASEAN economies has been offset by demand from the continued improvement in growth momentum in the US and EU (Charts 26 and 27). An over-invoicing problem from mid-2012 to mid-2013 has caused distortions in the year-over-year export figures. After adjusting for this, we find that underlying export growth may be a few percentage points higher than the official headline figures, at about 6.9% y/y (official: 3.9%) in Q3 from 2.5% y/y (official: 4.1%) in Q2.

Chart 27
Exports growth is improving on rising demand from the US and EU



Source: CEIC and BBVA Research

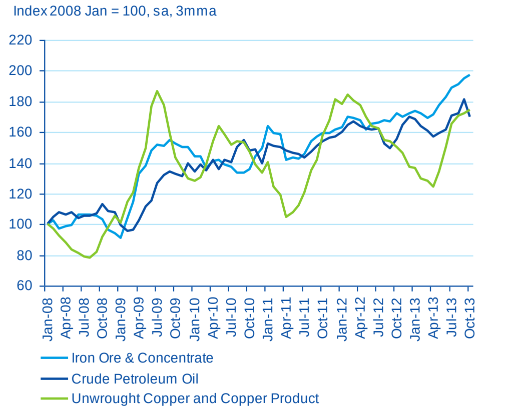
Chart 28
Imports for domestic final use are robust, a sign of stronger domestic demand



Source: CEIC and BBVA Research

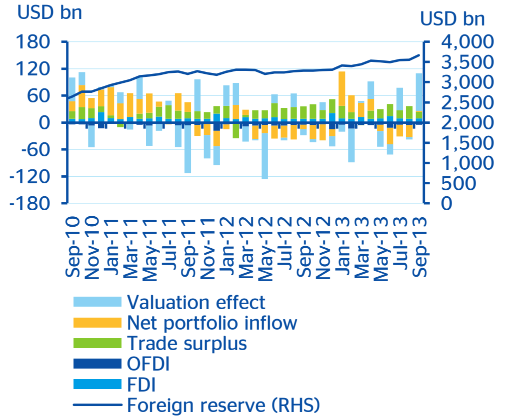
Meanwhile, imports have continued to trend up in line with strong domestic demand, especially for final goods (Chart 28). Commodity imports have also been resilient (Chart 29). As a result, the overall trade surplus narrowed to USD 61.5 billion in Q3 from 65.8 billion in Q2. Nevertheless, foreign reserves increased in Q3, to 3.66 trillion USD from 3.50 trillion at the end of Q2, on capital inflows associated with improving confidence in China's near-term growth prospects (Chart 30).

Chart 29
Commodity imports in volume terms trend up



Source: CEIC and BBVA Research

Chart 30
FX reserves rise on capital inflows

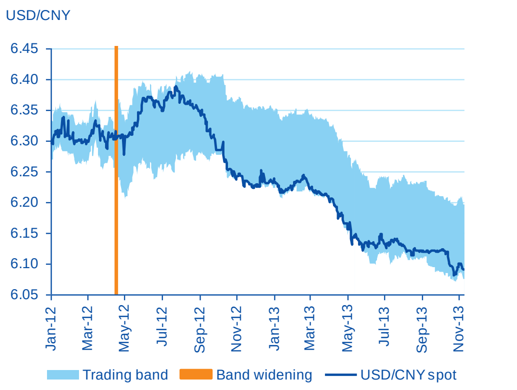


Source: CEIC and BBVA Research

RMB appreciation continues in line with expectations

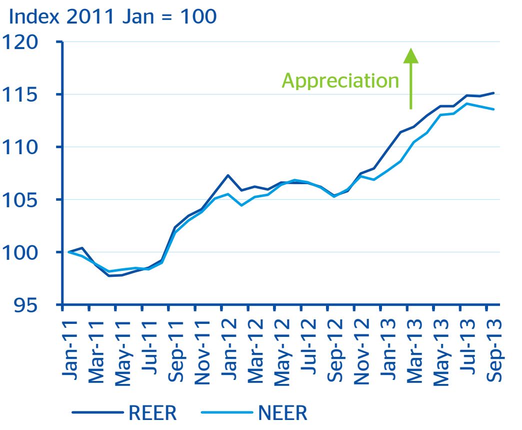
After levelling off from May to September, RMB appreciation resumed against the USD in October on account of rising confidence in domestic growth momentum, renewed capital inflows, and USD weakness (Chart 31 and 32). The spot rate has continued to trade near the strong end of the daily band, which together with a step appreciation of the one-year NDF, may be a sign of expectations of further appreciation. In effective terms, the appreciation so far this year has been substantial. Rumours continue to circulate of a possible widening of the daily trading band, to +/-1.5% from +/-1.0% at present, although the authorities appear to prefer to wait until the spot rate moves closer to the middle of the band.

Chart 31
RMB gradual appreciation continues



Source: Bloomberg and BBVA Research

Chart 32
The nominal and real effective exchange rates rise at a slower pace in Q3

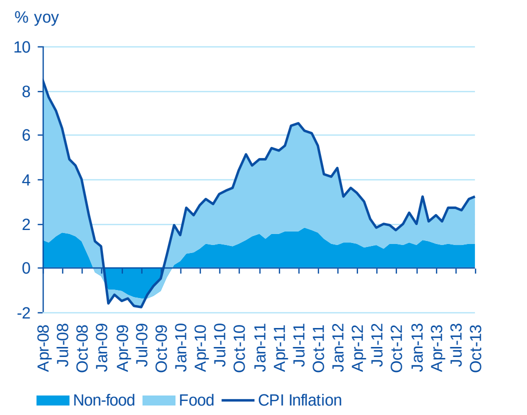


Source: BIS, CEIC and BBVA Research

Inflation is within the comfort zone

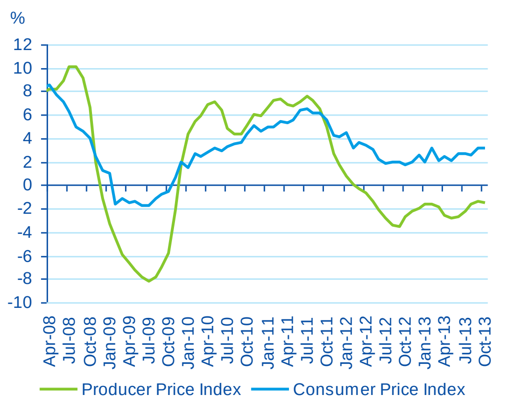
Inflation has risen gradually this year to 3.2% y/y in October (Chart 33), on rising food prices caused by disruptions from extreme weather. Non-food inflation remains low at 1.6% y/y, and producer price inflation remains negative at -1.5% y/y in October. Altogether, inflationary pressures still appear subdued, and headline inflation is still within the government's 3.5% comfort range (Chart 34).

Chart 33
Inflation remains subdued, but has risen on higher food prices



Source: CEIC and BBVA Research

Chart 34
PPI inflation is still negative, but less so than in the past

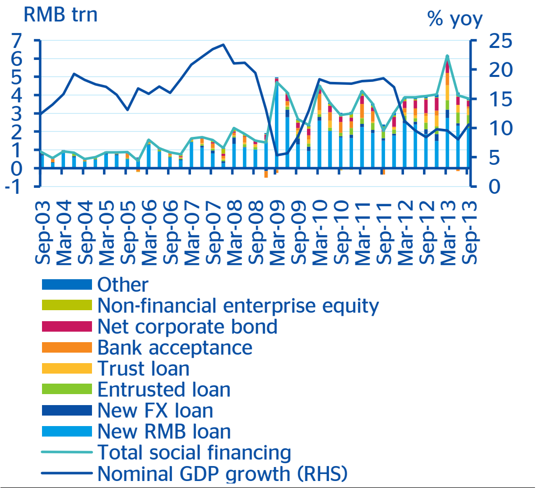


Source: CEIC and BBVA Research

Strong credit is growth supportive, but adds to financial risks

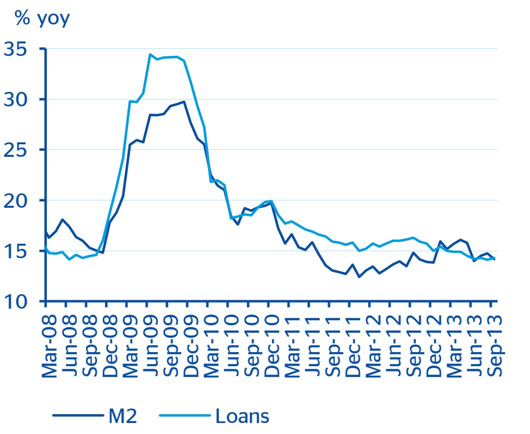
Robust credit growth continued in Q3 despite previous efforts by the government to curtail shadow banking and limit risks of high indebtedness (Chart 35 and 36). Liquidity in the interbank market has been broadly stable after the severe squeeze last June, with the PBoC remaining active with open market operations (Charts 37 and 38), although there have been occasional bouts of volatility, as recently as late October due to seasonal effects and market jitters. We expect interbank rates to ease, although they may stay above previous levels given the central bank's current tightening bias.

Chart 35
"Total Total social financing" remains robust



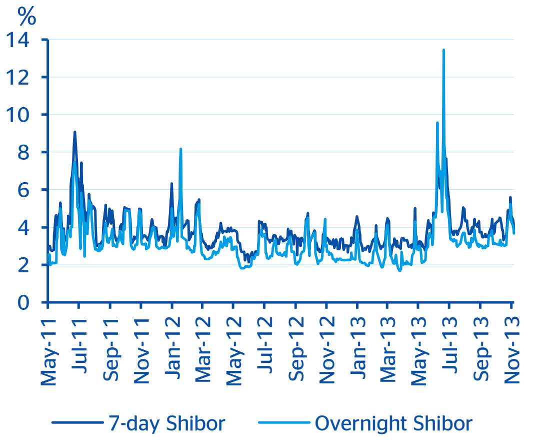
Source: CEIC and BBVA Research

Chart 36
M2 and loan growth remain on relatively high levels



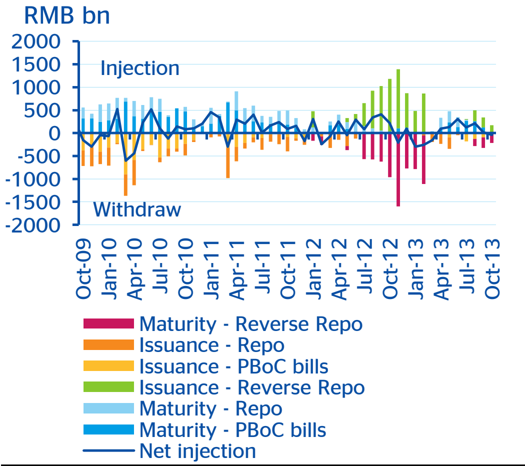
Source: Wind and BBVA Research

Chart 37
Interbank rates rose again in the end of October



Source: CEIC and BBVA Research

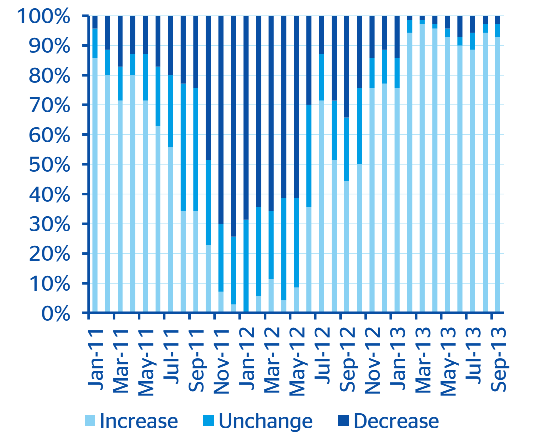
Chart 38
The PBoC is injecting liquidity through open market operations…



Source: Wind and BBVA Research

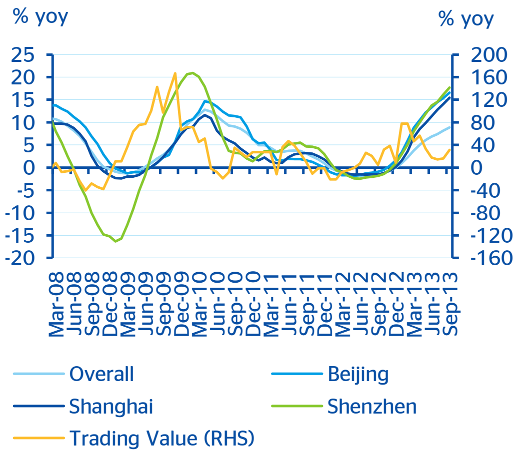
Strong credit growth and rising confidence have led to renewed rises in the property market after a cooling last year. Tier 1 cities such as Guangzhou, Shenzhen, Beijing, and Shanghai continue to lead price gains, of around 15-20% y/y (Charts 39 and 40). We estimate that on a nationwide basis that overall property prices rose by 8.2 y/y in Q3, up from 6.0% in Q2. In addition to creating social concerns about affordability, rapid increases in housing prices add to the risk of bubbles (Charts 41 and 42) and are acting as a constraint on further monetary policy easing.

Chart 39
A majority of cities report rising housing prices



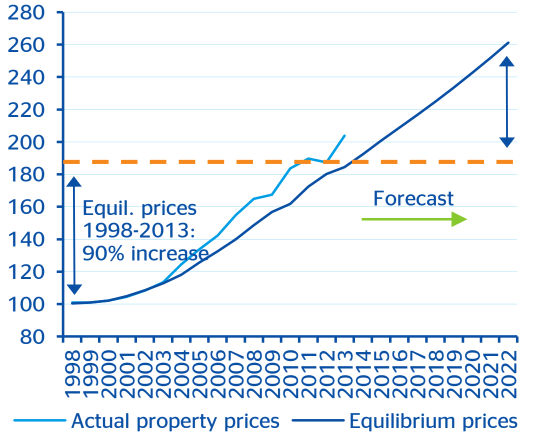
Source: NBS and BBVA Research

Chart 40
Rapid price growth is quite worrisome



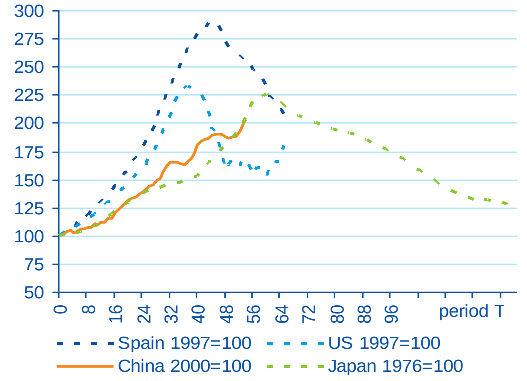
Source: NBS, CEIC and BBVA Research

Chart 41
Housing prices are currently rising faster than implied by fundamentals



Source: NBS, CEIC and BBVA Research

Chart 42
China's housing prices have not reached bubble levels of other cases, but are getting close



Source: NBS, CEIC and BBVA Research

Box 2: Taking stock of China's financial liberalization

After a few years of stagnation in the aftermath of the Global Financial Crisis (GFC), China's financial liberalization gained traction again in 2012, marked by the widening of the RMB daily trading band and expansion of the permissible range of interest rates around the benchmark. Further steps have continued this year, although there have been headwinds from vested interests and the fragile external environment. To maintain the momentum of reform, the authorities have sought to press ahead on multiple fronts, and continue to make use of pilot programs, including the recently announced Shanghai Free Trade Zone (see below).

Interest rate liberalization

The lending rate floor (70% of benchmark lending rates) was abolished last July, enabling banks freedom in pricing their loans. To date, however, the move has had a negligible impact on average lending rates, which is not surprising given that it was not binding.

More importantly, there has been less progress in removing the deposit rate cap (which is binding) perhaps due to lobbying by banks to protect their interest rate margins, as well as the authorities' desire to move gradually to ensure financial stability. We expect the cap to be removed by end-2015, after the implementation of a long-awaiting deposit insurance scheme in 2014. In the meantime, the authorities may introduce deposit rate flexibility by raising the permissible range above the cap (currently 10%) and by allowing CDs to be introduced into the interbank market, which would help to form market-based yield curve for deposit rates.

Currency flexibility

Expectations of a further widening of the daily trading band have not yet been met (the band was last widened in April 2012 to +/-1%). Such plans may have been delayed because of global financial turbulence in the wake of expected QE tapering, and more recently because of the tendency of the spot rate to trade at the strong end of the band – the authorities may prefer to wait for the spot rate to be closer to the middle of the band. Nevertheless, expectations of a further widening of the band persist perhaps during the first half of 2014.

Capital account convertibility

Relatively more progress has been made in promoting RMB convertibility as part of ongoing efforts to promote RMB internationalization. In particular, the geographic coverage of R-QFII schemes have expanded this year, to Taiwan, Singapore, and the UK, through which foreign institutional investors can repatriate offshore RMB to the Mainland for investment in bonds and equities. The size of the quotas allowed under the R-QFII scheme now amounts to RMB 264.3 bn, almost comparable to QFII scheme of RMB 289.1 bn (USD 47.5 bn).

Achieving full convertibility of the RMB will take time, and will most likely not occur until 2020. In our view, it is wise to proceed cautiously, and to complete domestic financial liberalization first, in line with commonly accepted wisdom on the sequencing of reforms. On top of expanding existing programs such as QFII, R-QFII and QDII, the authorities are planning to cut red tape in approving cross-border capital flows as well as gradually allowing institutional and private investors to undertake overseas investment.

Pilot programs in financial liberalization

In addition to the measures above, a number of pilot programs have been introduced during the past year as a way of advancing financial sector reforms. One such high profile case is the recent Shanghai Free Trade Zone (FTZ). At its inception in October, expectations were high that the zone would be used to advance interest rate capital account liberalization. While still in it's early days, the zone has not yet lived up to such expectations given the practical difficulties in carrying out such reforms within a defined geographical region. In particular, it would be difficult to prevent domestic leakages to the FTZ. The same issue has arisen in other pilot regions focusing on financial liberalization, such as Wenzhou and Shenzhen Qianhai.

Several other pilot programs, however, are proceeding at a steadier pace. One example is an expansion by the CBRC of the pilot program for consumer finance companies in September, from 4 cities previously to 16 cities. In July allowance was made private capital to be used to establish banks on a pilot basis, with a first-batch quota of 10 banks. This has prompted a large number of private enterprises to apply for bank licenses (substantially exceeding the quota), which could eventually change state-dominance of the banking sector. Another pilot program, launched in October, is to allow banks to engage in asset management activities, as a way brining shadow banking activities within the formal banking sector.

4. A strong baseline in 2014, but subject to more uncertainties

With growth momentum rebounding, we have revised our 2013 growth projection to 7.7% and maintain our projection for 2014 of 7.6%. However, the outlook for 2014 and beyond is subject to uncertainty given rising financial fragilities and the impact of reforms to rebalance growth over the medium term. The projections over the next year or two will also depend on the extent of the authorities' willingness to tolerate lower growth in favour of advancing reforms, the blueprint for which will be announced at the ongoing Third Plenary Meeting.

We expect the policy stance for 2014 to be broadly unchanged from the current stance characterized by "prudent monetary and proactive fiscal". However, it is possible that there will be fine tuning adjustments, most likely in the direction of modest tightening. The stance will be clearer after the setting of key macro targets at the December Central Economic Meeting and the annual budget meeting in March 2014. In the meantime, the setting of next year's growth target will be closely watched, with expectations of a possible cut to 7.0%, as a way of signalling the increasing weight the authorities' attach to policies to curtail risks and ensure the sustainability of growth over the medium term.

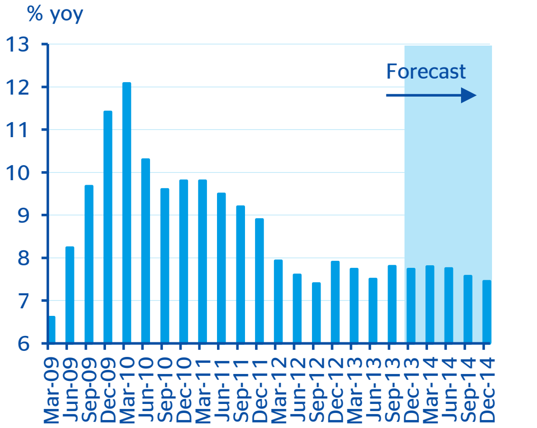
Momentum to continue in H1 2014, and trend down thereafter

Rising economic confidence, ongoing spending on public projects, and improving external demand are likely to support growth momentum through the first half year of 2014 (Chart 43). Thereafter, growth is likely to trend down as measures are implemented to curtail financial risks and as potential growth slows. Also, implementation of key reforms, such as interest rate liberalization and efforts to wean the economy from dependence on high credit growth, may weigh on near-term growth.

Gradual rise in inflation, contained by moderating GDP growth

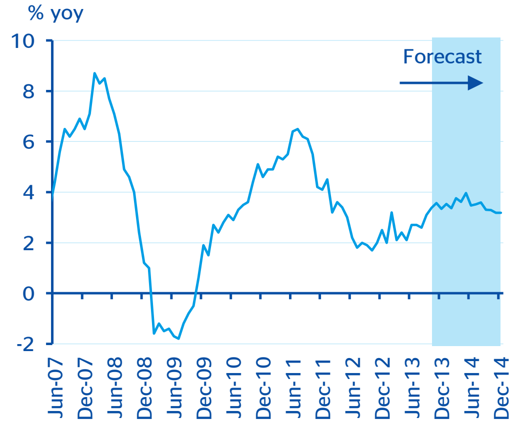
Our 2014 inflation projection remains at 3.5% (period average), up from an expected outturn of 2.8% in 2013. At the projected GDP growth rate, inflationary pressures are expected to be contained in the near term. As such, we expect inflation to peak in mid 2014 in the 3.5-4.0% range, before easing to 3.0-3.5% by end-2014 (Chart 44). We expect medium-term inflation to trend up to around 4.0% in view of rising wages and the removal of price subsidies in energy, transportation, and utilities.

Chart 43
Growth momentum to continue until H1 2014



Source: NBS, CEIC and BBVA Research estimates

Chart 44
Inflation to peak in mid 2014



Source: NBS, CEIC and BBVA Research estimates

RMB appreciation to continue with greater two-way flexibility

The RMB has appreciated in line with our previous expectations, at an annual pace of 2-3%, and is currently close to our end-year projection of 6.10 per USD. We expect this pace of appreciation to continue in 2014 as external demand strengthens, brining the RMB to around 5.95 RMB/USD by end-2014. We continue to expect two-way flexibility to increase through a possible widening of the daily trading band during the course of 2014. In addition, RMB internationalization will continue as the authorities promote the use of the currency in trade settlements and, increasingly, investment flows. The latter will include the introduction of more RMB products in offshore markets as vehicles to channel RMB flows back to the Mainland.

Table 2
Baseline Scenario

	2010	2011	2012	2013 (F)	2014 (F)
GDP (%, y/y)	10.4	9.3	7.7	7.7	7.6
Inflation (average, %)	3.3	5.4	2.6	2.8	3.5
Fiscal bal (% of GDP)	-2.5	-1.1	-2.1*	-2.0	-1.8
Current acct (% of GDP)	4.0	1.9	2.3	2.4	2.8
Policy rate (%, eop)	5.81	6.56	6.00	6.00	6.00
Exch rate (CNY/USD, eop)	6.61	6.30	6.23	6.10	5.95

*preliminary outturn; includes adjust of 0.5% of GDP in revenues carried over from 2011.
Source: BBVA Research

Policy emphasis shifting to medium-term reforms

China's new leadership has signalled a tolerance for lower growth in favour of curbing financial fragilities and ensuring sustainability and a higher "quality of growth". At the time of writing, the focus was on the Third Plenary Meeting, with expectations of the reform roadmap for the coming decade. The reform agenda is likely to include efforts to move toward a more market-based system of factor pricing (in energy, utilities, and transportation); steps to facilitate urbanization, especially liberalization of the "Hukou" system that denies social benefits to non-registered city residents; changes in center-local government financial relations in order to improve the capacity of the latter; and last, but not the least, financial sector reform including the liberalization of interest rates.

5. Risks remains to the downside

Despite divergences across the region, we expect a modest pickup in Asia-Pacific growth in 2014 as external demand continues to improve. However, as noted in the *Global Outlook*, even though tail risks have receded, risks to the outlook for the global economy are still tilted to the downside due to ongoing fiscal uncertainties in the US, questions about the robustness of the recovery in the EU, and the need for rebalancing in China.

Within the region, geopolitical risks remain, but are at bay for the time being as the dispute between China and Japan, and tensions on the Korean peninsula have all subsided. In Thailand, however, domestic political stability remains fragile. In the macro area, external pressures have eased thanks to a delay in QE tapering and, in some cases, measures taken by the authorities, such as interest rate hikes and efforts to trim current account deficits in India and Indonesia. General elections scheduled in 2014 in both countries, however, add an element of uncertainty and may exacerbate pressures if capital outflows resume once QE tapering begins.

More generally, prospects of QE tapering in 2014 pose a risk to financial stability, as was evident during the May-August period earlier this year. External pressures bear watch in India and Indonesia, both of which have seen growth momentum slow in recent months. In Japan, macro developments have been favourable, but market sentiment could still turn if there is disappointment in the structural reform program, or lack of progress in implementing a program of medium-term fiscal consolidation. With respect to the latter, the decision to proceed with the consumption tax hike in 2014 is encouraging, although the fiscal drag from the measure itself could pose a risk to near term growth.

Moreover, with the sustainability of the pickup in China still uncertain, and given rising financial fragilities and the challenges of rebalancing, a slowdown in 2014 and beyond could weigh on the region's growth. The authorities' efforts to curtail financial risks from shadow banking, corporate and local government debt, and rapidly rising housing prices pose risks to near-term growth outlook, while failure to address them pose even greater risks to the medium-term outlook.

6. Tables

Table 3
Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2010	2011	2012	2013 (F)	2014 (F)
United States	2.5	1.8	2.8	1.6	2.3
Eurozone	1.9	1.5	-0.5	-0.4	1.1
Asia-Pacific	8.2	5.8	5.3	5.2	5.3
Australia	2.6	2.5	3.6	2.6	3.0
Japan	4.7	-0.6	2.1	1.9	1.5
China	10.4	9.3	7.8	7.7	7.6
Hong Kong	6.8	4.9	1.4	3.3	3.7
India	8.9	7.5	5.1	4.2	4.6
Indonesia	6.2	6.5	6.2	5.6	5.8
Korea	6.3	3.7	2.0	2.7	3.7
Malaysia	7.2	5.1	5.6	4.6	5.2
Philippines	7.6	3.9	6.6	7.0	5.7
Singapore	14.8	5.3	1.3	2.8	3.6
Taiwan	10.8	4.1	1.3	2.3	3.7
Thailand	7.8	0.1	6.4	4.2	5.0
Vietnam	6.8	5.9	5.0	5.2	5.5
Asia ex China	6.8	3.5	3.6	3.4	3.6
World	5.1	3.9	3.2	2.9	3.6

Source: BBVA Research

Table 4
Macroeconomic Forecasts: Inflation (Avg.)

(YoY% growth rate)	2010	2011	2012	2013 (F)	2014 (F)
United States	1.6	3.1	2.1	1.7	2.2
Eurozone	1.6	2.7	2.5	1.5	1.4
Asia-Pacific	3.6	4.7	3.0	2.9	3.6
Australia	2.8	3.3	1.8	2.2	3.0
Japan	-0.7	-0.3	0.0	0.1	2.0
China	3.3	5.4	2.6	2.8	3.5
Hong Kong	2.3	5.3	4.1	4.2	3.6
India	9.6	9.2	7.7	5.8	5.6
Indonesia	5.1	5.4	4.3	7.0	5.6
Korea	3.0	4.0	2.2	1.6	2.7
Malaysia	1.7	3.2	1.7	2.1	2.7
Philippines	3.8	4.7	3.0	3.0	4.0
Singapore	2.8	5.2	4.6	2.5	3.5
Taiwan	1.0	1.4	1.9	1.0	1.8
Thailand	3.3	3.8	3.0	2.5	2.8
Vietnam	10.0	18.1	6.8	6.5	7.5
Asia ex China	3.7	4.3	3.3	3.0	3.6
World	3.7	5.1	4.1	3.8	4.0

Source: BBVA Research

Table 5
Macroeconomic Forecasts: Exchange Rates (End of period)

		2010	2011	2012	2013 (F)	2014 (F)
Eurozone	USD/EUR	1.34	1.30	1.32	1.37	1.30
Australia	USD/AUD	1.02	1.02	1.04	0.99	0.945
Japan	JPY/USD	81.1	76.9	86.8	100.0	117.0
China	CNY/USD	6.61	6.30	6.23	6.10	5.95
Hong Kong	HKD/USD	7.77	7.77	7.75	7.80	7.80
India	INR/USD	44.7	53.1	55.0	63.0	60.5
Indonesia	IDR/USD	8996	9069	9793	11200	10800
Korea	KRW/USD	1126	1152	1064	1090	1050
Malaysia	MYR/USD	3.06	3.17	3.06	3.20	3.15
Philippines	PHP/USD	43.8	43.8	41.0	43.0	44.0
Singapore	SGD/USD	1.28	1.30	1.22	1.25	1.24
Taiwan	NTD/USD	29.3	30.3	29.0	29.6	29.2
Thailand	THB/USD	30.1	31.6	30.6	31.5	30.5
Vietnam	VND/USD	19498	21034	20840	21250	21600

Source: BBVA Research

Table 6
Macroeconomic Forecasts: Policy Rates (End of period)

(%)	Current	2011	2012	2013 (F)	2014 (F)
United States	0.25	0.25	0.25	0.25	0.25
Eurozone	0.25	1.00	0.75	0.25	0.25
Australia	2.50	4.25	3.00	2.50	3.00
Japan	0.10	0.08	0.10	0.10	0.10
China	6.00	6.56	6.00	6.00	6.00
Hong Kong	0.50	0.50	0.50	0.50	0.50
India	7.75	8.50	8.00	7.75	7.00
Indonesia	7.25	6.00	5.75	7.25	6.75
Korea	2.50	3.25	2.75	2.50	2.50
Malaysia	3.00	3.00	3.00	3.00	3.50
Philippines	3.50	4.50	3.50	3.50	4.00
Singapore	0.40	0.45	0.40	0.40	0.40
Taiwan	1.88	1.88	1.88	1.88	2.13
Thailand	2.50	3.25	2.75	2.50	3.00
Vietnam	9.00	9.00	9.00	9.00	8.50

Source: BBVA Research

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