BBVA | RESEARCH

Economic Outlook

China/Asia

First Quarter 2014
Economic Analysis

- **Global growth should accelerate in 2014, with downside risks still present** from QE tapering and turmoil in emerging markets. In line with previous forecasts, we expect global growth to rise to 3.6% in 2014 and 3.9% in 2015 on improving prospects in advanced economies.
- **Growth momentum across the Asia region has evolved as expected over the past few quarters,** with weaker domestic demand offset by gradually improving external conditions. However, there is divergence, marked by improving growth trends in North Asia, with mixed performance elsewhere.
- **Our growth projections for China remain at 7.6% in 2014 and 7.5% in 2015.** But rising financial fragilities pose downside risks. The focus now is on implementation of reforms announced at November's Third Plenum.
- **Risks to the regional outlook** stem from renewed capital outflows with QE tapering, and uncertainty about the sustainability of China's growth momentum.

Index

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Summary

Growth momentum across the Asia region has evolved as expected, with weaker domestic demand offset by gradually improving external conditions. However, divergence in performance has continued, marked by improving trends in North Asia (Korea, Taiwan, and Hong Kong) on linkages through exports to the recoveries in the US and EU. Growth in commodity export-dependent economies such as Australia continues to struggle, along with Indonesia and India under the weight of higher interest rates. Elsewhere in Southeast Asia, the Philippines' resilience continues to surprise, in the wake of recent natural disasters.

Regional market sentiment has been influenced by global trends under the weight of QE tapering that began in January. Stability in the region's most vulnerable economies, namely India and Indonesia, has held up well in comparison to the pressures witnessed in mid-2013. Policymakers in these economies took advantage of the delay in tapering to make adjustments, and those dividends are now paying off. Nevertheless, it will be important to sustain reform momentum, and further external pressures cannot be ruled out, all the more so given uncertainties surrounding national elections in these countries later in the year.

In Japan, though slowing by more than expected in Q3, growth remains intact under the influence of stimulus measures. While a consumption tax hike scheduled for April 2014 may pose a risk to near-term growth, business and consumer confidence have improved, and non-residential investment shows signs of reviving, contributing to higher private spending and exports. After a prolonged deflation, headline inflation has been positive since June, albeit still short of the Bank of Japan's 2% target. The priority now is implementation of bold structural reforms to boost long-term growth, without which recent stimulus policies alone will likely fail.

We expect growth for most Asian economies to pick up marginally in 2014 as an improvement in the external environment offsets some slowing of domestic demand. This is especially the case in export-oriented North Asia which stands to benefit from improving external demand. The picture for the ASEAN and South Asia region will be more mixed under the weight of tighter financial conditions from Fed tapering, as well as domestic political uncertainties. We have made only fine-tuning adjustments to our previous forecasts, and we expect growth in the Asia Pacific region to rise to 3.6% in 2014 and 4.0% in 2015.

Despite persistent concerns, the Chinese economy once again averted a hard landing in 2013. Full year growth came to 7.7%, as expected, thanks to a pickup in the second half of the year. That said, the pickup in growth came at the cost of a further rise in financial fragilities, and with indications late in the year that the economy may be slowing once again.

Our growth projections for China remain unchanged at 7.6% in 2014 and 7.5% in 2015. We expect the broad policy mix to remain unchanged in 2014, 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 appreciate, to around 5.90 per USD by end-year.

The focus now is on implementation of reforms as announced last November at the Third Plenum meeting. Key elements, many of which will be introduced gradually over the coming years, include policies to promote urbanization and financial sector reform, the latter entailing steps toward interest rate liberalization and exchange rate flexibility. In regards to domestic fragilities, priorities in 2014 include efforts to address local government debt, curtail shadow bank lending, slow the pace of housing price increases, and address over-capacity.

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

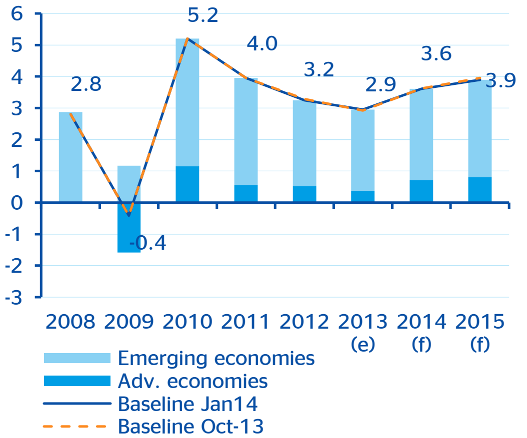
1. Global expansion to continue with more balanced risks

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

The global economic cycle is improving and we now have clarity on some economic policy uncertainties

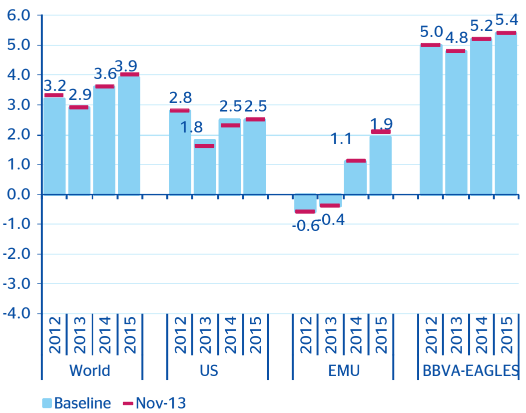
The global economic cycle strengthened during the latter months of 2013. According to our estimates, during the second half of 2013 global GDP accelerated, driven by developed economies. In the EMs, the situation is more diverse, but some of them (e.g. China) are posting relatively stable rates of growth. Our improved evaluation of the global scenario is also the result of economic policy news. The US reached a more far-reaching agreement on fiscal policy than we expected, and the Fed started to tape at the beginning of 2014. In Europe, further progress has been made towards the banking union. The global outlook would be even clearer were not for the effect that tapering is having on EM financial markets.

Chart 1.1
Global economic growth (%)



Source: BBVA Research and IMF

Chart 1.2
EM GDP growth (% QoQ, sa)



Source: BBVA Research and IMF

Altogether, our assessment of the global scenario is better than it was three months ago. Our projections now indicate that global GDP growth, which in 2013 had decelerated to 2.9%, will increase to 3.6% and 3.9% in 2014 and 2015 respectively (Chart 1.1). We still see some downside risks to our forecasts, although they are less severe than in the past.

Sufficient speed for the US to start unwinding monetary stimulus

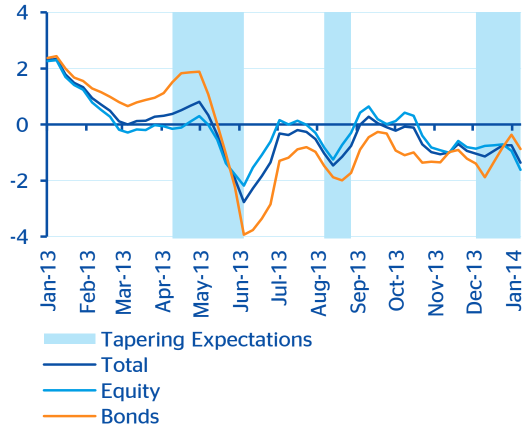
US GDP growth accelerated through 2013, and by year-end had already reached cruising speed, allowing the Fed to take the first steps towards withdrawing monetary stimulus. There is also now more certainty regarding fiscal policy. The lack of agreement between the parties on the fiscal consolidation process in the US led to a partial and temporary interruption of federal government activity. Subsequently, in December, an agreement was reached that represents an important step forwards in eliminating the uncertainty in funding the government activity in 2014-15, as well as reducing the scale fiscal adjustment initially forecast.

Altogether, we have revised upwards our forecast for US growth in 2014 to 2.5%, the same as our estimate for 2015. This adjustment reflects both the strength of the US economy in the second half of 2013 and the additional momentum contributed by the reduced fiscal drain thanks to the agreement reached at the end of last year. There are upside risks to our forecast if the improvement in confidence results in additional investment and hiring.

Tapering clouds the outlook for some emerging economies

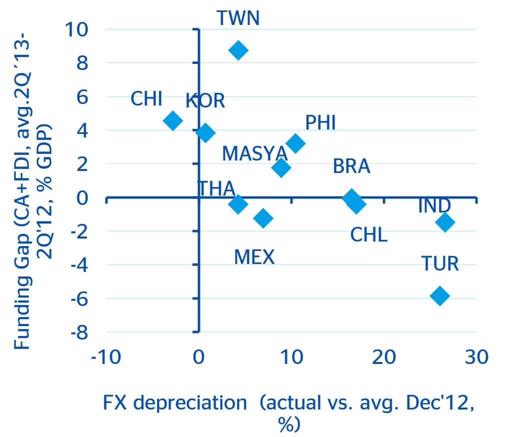
The emerging economies are being subjected to capital outflows and currency depreciation. Even so, the intensity of the non-resident capital outflows is no worse than on previous occasions when expectations have changed regarding the start of Fed tapering (Chart 1.3). In addition, there continues to be differentiation between economies: higher external deficits and more dependence on short-term and foreign-currency funding are associated with greater vulnerability to capital outflows and currency depreciation (Chart 1.4). The risk is higher in the economies that are financially more integrated in global portfolio indexes and that have the above-mentioned vulnerabilities: Turkey, Brazil, Indonesia and India in particular. The monetary tightening being introduced by some of these countries to control currency depreciation and inflation expectations will inevitably have a negative impact on growth. All in all, the diversity within the EM group means that our outlook remains favourable. In China, our 2014 and 2015 forecasts remain unchanged.

Chart 1.3
EM: flows into funds in bonds and equities (4 weeks cumulative, specialist EM funds, flows over total assets)



Source: BBVA Research based on EPFR data

Chart 1.4
Exchange-rate depreciation (%) and external funding gap (CA + FDI, % GDP)



Source: BBVA Research and Haver Analytics

Gradual recovery in the eurozone continues

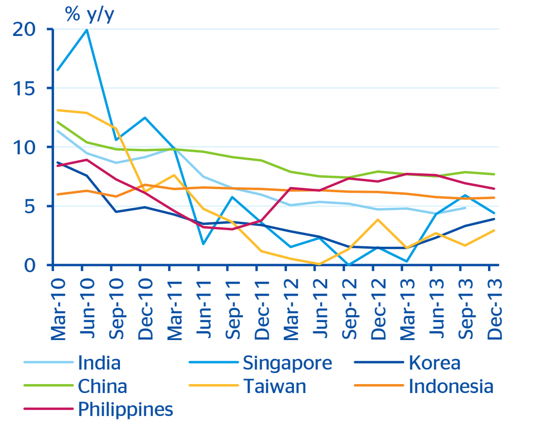
After starting the year in recession, the eurozone managed to sustain moderate expansion throughout the second half of the year, in line with our forecast. The driver of this slight improvement was the prospect of an increasing role played by domestic demand, although the engine of European growth in 2013 and 2014 was, and will continue to be, the export sector. The factors supporting the moderate recovery in the eurozone are: i) the recovery of external demand; ii) the sustained improvement in financial conditions, favoured by the ECB's determination of, and commitment to, an expansive monetary policy; and finally, iii) the steps taken towards banking union, which should reduce the financial fragmentation that is hampering the role of monetary policy in the region as a whole. We cannot rule out periods of instability as we approach events that could alter progress in banking union and of strengthening the monetary union in Europe in general. Events to watch include the European Parliamentary elections, and news flow on the conditions and results of the stress test and asset quality review of the banking sector.

All in all, we reiterate our forecast for eurozone GDP growth at 1.1% for 2014. For 2015 we estimate 1.9%. However, given our projection of continued cyclical weakness, we cannot rule out deflation as a risk factor.

2. External demand lifts Asian growth

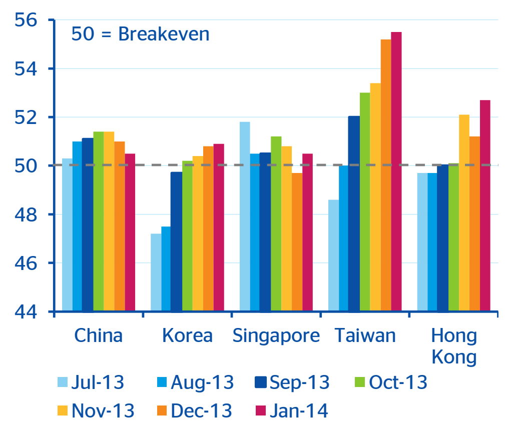
Growth momentum across the Asia region over the past few quarters has evolved as expected, with weaker domestic demand offset by gradually improving external conditions (Chart 2.1). Divergence in performance has also continued, marked by improving growth trends in economies such as Korea, Taiwan, and Hong Kong that are linked through exports to the recoveries in the US and EU (Chart 2.2). Meanwhile, growth in commodity export-dependent economies such as Australia continues to struggle, along with growth in Indonesia and India under the weight of higher interest rates, external pressures associated with current account deficits and QE tapering, and an uncertain domestic political outlook. In Japan, despite a disappointing Q3, growth remains intact for the time being under the influence of stimulus measures under Abenomics. And as described more fully in Section 3, we believe that growth in China will continue, although rising financial fragilities and recent weak PMIs have reignited perennial market concerns of a hard landing.

Chart 2.1
Q4 GDP growth beat expectations in Indonesia and the Philippines…



Source: Haver and BBVA Research

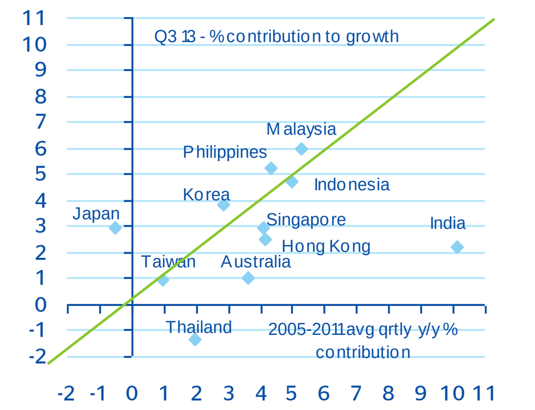
Chart 2.2
… while manufacturing PMIs in the region show signs of improvement



Source: Bloomberg and BBVA Research

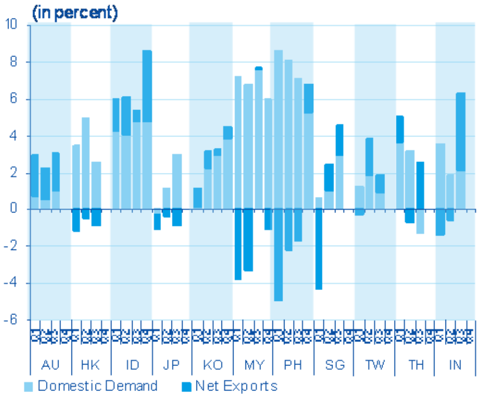
Against this background, we expect growth to pick up marginally in 2014 in most Asian economies. Around this trend, we see three themes in the coming year. First, economies dependent on demand from the US and EU are likely to do best. This is in contrast to developments over the past couple of years when economies with large domestic demand, room for policy stimulus, and with growing intraregional trade, such as in Southeast Asia, held up relatively well. Second, QE tapering will continue to exert pressure on emerging Asia, especially economies with current account deficits and which are dependent on portfolio inflows, such as Indonesia and India. And third, the growth outlook will depend on external demand improving at a sufficient pace to offset an expected weakening in domestic demand from tighter financing conditions and a withdrawal of policy stimulus (Charts 2.3 & 2.4).

Chart 2.3
Domestic demand is weakening...



*Q4 for Indonesia, Philippines, Korea and Malaysia
Source: CEIC and BBVA Research

Chart 2.4
...but remains an important growth driver (contribution to growth in ppts)



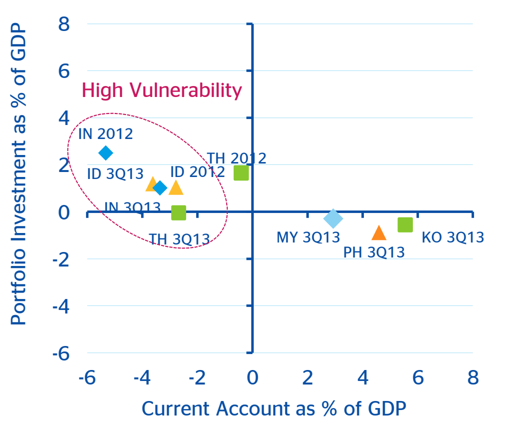
Source: CEIC and BBVA Research

India and Indonesia take steps to bolster resilience

The region's two most vulnerable economies to a tightening of external financing conditions appear to have weathered the worst of QE tapering fears. In May-August last year, financial markets in India and Indonesia were hit hard by expectations of an imminent start to tapering. With current account deficits, a dependence on external portfolio inflows, and slowing growth, these two economies stood out as being especially vulnerable (Chart 2.5 & 2.6 and Box 1).

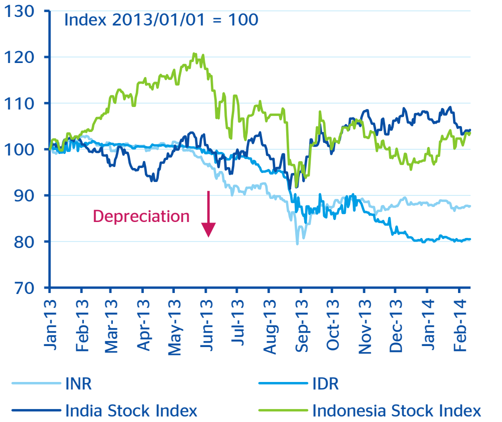
Encouragingly, policymakers in Indonesia and India have successfully taken steps to shore up their economies' resilience. Such steps include interest rate hikes (175bps cumulatively in Indonesia and 75bps in India) to stem inflationary pressures and narrow their current account deficits, along with efforts to revive structural reforms to bolster investor sentiment. As a result, financial markets have stabilized even as external pressures in other EM economies have re-intensified. That said, pressures on these two economies could return if reforms begin to slacken once again, all the more so given political uncertainty surrounding national elections scheduled this year.

Chart 2.5
India and Indonesia are most exposed to sudden stops



Source: IMF, CEIC and BBVA Research

Chart 2.6
Currency and stock markets in India and Indonesia are recovering from last year's selloff



Source: Bloomberg and BBVA Research

Japan's growth weakens temporarily as stimulus fades

In just over a year, "Abenomics" has made headway in shaking Japan out of its economic stupor. Japan is the world's third largest economy, and almost 50% larger than Germany. As China's growth slows and the Fed tapers Quantitative Easing (QE), the rest of Asia will need Japan to stay healthy. Already a huge investor in Asia and source of liquidity, a revitalized Japan could help stimulate global growth.

Abenomics is based on "three arrows," consisting of monetary easing, flexible fiscal policy, and structural reforms. After years of conservatism—which in part explains why growth and per capita incomes stagnated for two decades after the bursting of the asset bubble in the early 1990s—the Bank of Japan broke with its past and launched aggressive monetary easing in April 2013, aiming to double the monetary base (even more ambitious than the Fed in relative terms) and achieve a 2% inflation target in two years.

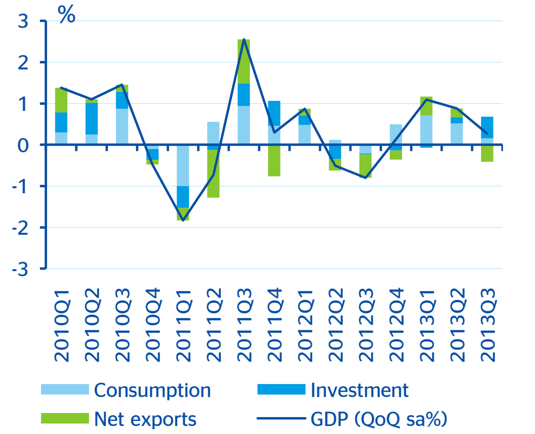
In fiscal policy, the government has implemented short-term stimulus packages to kick-start growth, most recently with a ¥5 trillion package to offset the drag on growth from a planned 3 percentage point hike in the consumption tax in April (from 5 to 8%). The latter is an important signal of the government's commitment to medium-term sustainability, which is crucial given Japan's dangerously high public debt of almost 250% of GDP.

The results so far have been encouraging. Business and consumer confidence have increased, and GDP growth is expected to have picked up to around 2% in 2013 from the effects of fiscal and monetary stimulus. The latter has led to a depreciation of the yen and an end of deflation (Charts 2.7 & 2.8), although price increases are still short of the official 2% inflation target. But risks remain, and it is not yet clear whether the benefits are sustainable. As evidence, growth in the third quarter of 2013 was weaker than expected at just 1.1% saar after a strong H1 (around 4%).

A critical component of the future success of Abenomics hinges on implementation of the third arrow. Progress in this area has so far been relatively unimpressive, especially given the urgency of boosting labor participation to offset a projected population decline, and to raise investment and productivity in the service sector. Achievements include joining free trade agreements (such as the Transpacific Partnership), and establishing special enterprise zones to promote deregulation. More efforts are needed to increase female labor participation rates – a stated goal of the government – and promote deregulation by opening up the agricultural sector and enhancing labor market flexibility.

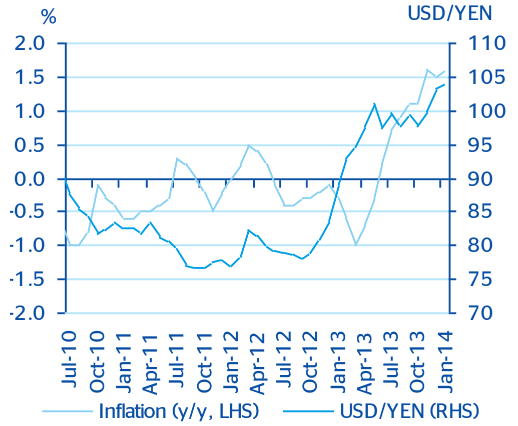
Therefore, the coming year will be decisive in Japan. A stronger breakthrough in structural reforms and progress in medium-term fiscal consolidation could sustain real growth of up to 2% in the coming years. On the other hand, if implementation lags and growth fails to materialize, investors may lose confidence in the government's ability to service its debt burden. Bond yields could soar, and Japan could find itself in a downward economic spiral.

Chart 2.7
GDP growth momentum continues in Japan...



Source: Bloomberg and BBVA Research

Chart 2.8
...as deflation ends and the yen weakens



Source: Haver and BBVA Research

Growth to pick up in 2014 on improving external demand

Recent growth outturns have evolved broadly in line with expectations. In China, as described more fully in Section 3, fourth quarter growth of 7.7% is a sign that momentum continues on sustained consumption and investment trends following the "mini-stimulus" measures earlier in the year; weakening PMIs for December and January suggest that further policy support may be needed to sustain growth in line with the expected 7.5% growth target in 2014. Elsewhere, growth momentum has been at or above expectations: in Korea, fourth quarter growth was in line with expectations at 0.9% q/q s.a. (not annualized), bringing full-year growth to 2.8% on sustained private consumption and improving exports. Even more so than many other Asian economies, Korea is well placed to benefit from the ongoing pickup in demand from the US and EU. Meanwhile in Indonesia and the Philippines, fourth quarter growth exceeded expectations on robust domestic demand, bringing full-year growth to a higher-than-expected outturns of 5.8% and 7.2% respectively. One disappointment is Thailand, where domestic political disturbances are causing tourism inflows to dry up, and investment to weaken.

Looking ahead, we expect growth for most Asian economies to pick up marginally in 2014 as an improvement in the external environment offsets some slowing of domestic demand (Table 6.1). This is the especially the case in export-oriented North Asia which stands to benefit from improving demand in the US and EU. The picture for the ASEAN and South Asia region will be more mixed, under the weight of tighter financial conditions from Fed tapering, and domestic political uncertainties, with elections due in Indonesia and India, and continuing domestic unrest in Thailand.

Monetary policies have diverged in recent months, and are expected to remain on hold for the most part during the first half of 2014 (Table 6.4). At one end of the spectrum, given still-high inflation (CPI 9.87% y/y in December 2013) the Reserve Bank of India (RBI) surprised with a 25bp rate hike at its January policy meeting, brining cumulative rate hikes since July 2013 to 75bps. The RBI maintains a tightening bias to anchor inflation expectations and given the possibility of a return of external pressures from QE tapering. For the same reasons, Indonesia also maintains a tightening bias after 175bps in rate hikes since June of last year, although it has paused for three consecutive policy meetings on signs of slowing growth and declining inflation pressures. If inflation in India and Indonesia decline in line with our baseline, we see room for possible rate cuts in the second half of the year to support economic activity. At the other end of the spectrum we expect the Bank of Japan to ease further by increasing its Qualitative and Quantitative easing if needed later in the year. Meanwhile, in Australia, after inflation picked up to a higher than expected 2.7% in Q4, due in part to currency depreciation, the Reserve Bank of Australia recently signalled it will keep rates on hold. Elsewhere, inflationary pressures remain at bay, although we would not rule out rate hikes later in the year in the Philippines, Korea, and Malaysia as growth picks up.

Box 1. India: Deciphering India's slowdown: is it structural or cyclical?

India's growth momentum slowed for a third consecutive year in 2013, halving to below 5% y/y from the near double-digit levels of 2009-11. While slowing global growth was a contributor, India's downturn was driven by rising domestic impediments to investment and policy delays, high inflation and rising interest rates (Chart B1.1).

Bulk of India's growth slowdown is cyclical

In contrast to popular perception, we find that the bulk of the recent slowdown is actually cyclical in nature. Our assessment adopts a similar methodology applied to BRICS economies in the IMF's 2013 World Economic Outlook (for details see India **Economic Watch**). In particular, we take the difference in changes to India's actual and potential GDP growth rates over the past decade to distinguish between cyclical and structural factors (Chart B1.2).

We find that the impressive growth rates of 2009-11, when GDP growth jumped from 6.7% to 9.3%, are due mainly to cyclical factors associated with lax global liquidity, subdued commodity prices, and expansionary domestic fiscal and monetary policies. In contrast, during that period India's potential growth was already beginning to worsen, from 7.6% in 2009 to 6.8% y/y in 2011, due to a lack of investment reforms, ineffective governance and public service and infrastructure bottlenecks. Since 2011, cyclical support factors have weakened as the government has cut capital spending to reduce the fiscal deficit and as the RBI has hiked interest rates to combat inflation and currency depreciation pressures.

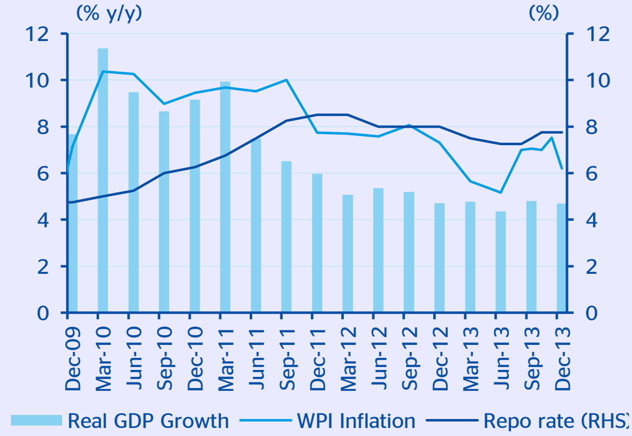
Cyclical headwinds have eased on the external front although domestic issues persist

GDP growth has recently showed signs of stabilizing, rising to 4.8% y/y in 3Q13 from a four-year low of 4.4% in Q2, led by a pick-up in exports and favourable agricultural output. Global demand is improving, commodity prices have been stable, and RBI's measures to reduce external vulnerability have been effective in encouraging capital inflows. While these measures have placed the economy in a stronger position to weather the Fed's tapering, the government's broader reform measures have yet to revive investment, and investor confidence remains fragile amidst a rising fiscal deficit and national elections scheduled in May 2014.

Expediting policy reforms across investment and fiscal space key to revive growth

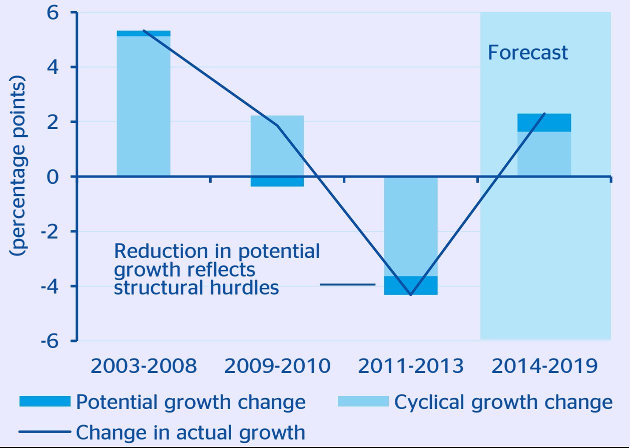
We believe the trend of slowing potential growth can be reversed with effective government reforms aimed at capacity building through infrastructure development, facilitating investment, addressing supply side bottlenecks, and resolving structural issues underlying India's twin deficits on the fiscal and current accounts. The government's policy efforts on this front so far have been a mixed bag, marked by encouraging progress in some areas, but only piecemeal or non-existent progress in others. Reassuringly, the pace of clearing stalled infrastructure projects has picked up, although faster project clearances and land acquisition is needed, particularly across power, steel and petroleum sectors. On the fiscal front, bolder measures such as deregulating of diesel prices alongside quicker implementation of taxation reforms - goods and services tax and the direct tax code – are essential to achieve long run fiscal sustainability; the chances of these being announced ahead of national elections look significantly low.

Chart B1.1
India's growth has slowed to multiyear lows as high inflation prompts interest rate hikes



*BBVA GDP estimate for 4Q13 at 4.7% y/y,
Source: RBI, BBVA Research

Chart B1.2
The bulk of India's growth slowdown is cyclical



*BBVA GDP estimate for 4Q13 at 4.7% y/y,
Source: RBI, BBVA Research

3. China's growth sustained in 2013 at the cost of rising financial fragilities

After bottoming out in Q2, momentum picked up in the second half of 2013, brining full-year growth to 7.7% in 2013 for a second consecutive year. As such, the Chinese economy once again averted a hard landing as was feared earlier in the year. That said, the pickup in growth came at the cost of a further rise in financial fragilities, and with indications late in the year that the economy may be slowing once again.

GDP growth in the fourth quarter came out in line with expectations at 7.7% y/y, down slightly from 7.8% y/y in Q3 (Chart 3.1). Growth was sustained on improving exports and supportive government policies, including "mini" stimulus adopted in mid-2013 to accelerate public infrastructure spending, support SMEs, and encourage private investment. These stimulus measures are winding down as the government presses ahead with reforms and measures to curtail financial risks, some of which may be growth-negative in the near term.

Concerns continue to increase over rising domestic financial fragilities. In particular, risks associated with shadow banking lending, local government debt, and rising housing prices remain high. Signs of financial stress have become apparent in the interbank market, where interest rate volatility has increased with period spikes on tight liquidity conditions. In addition, economic rebalancing towards domestic consumption has been slow, with investment continuing to support growth (Chart 3.2). That said, the share of services in the economy continues to rise (exceeding the share of the industry sector for the first time, Chart 3.3), the economy is rebalancing towards domestic demand from external demand, and the current account surplus has narrowed in recent years (Chart 3.4).

On the other hand, recent policy developments have been encouraging, marked by the successful outcome of the Third Plenum meeting in November and its ambitious blueprint of medium-term reforms (see Table 3.1 for important reform areas). In December, the annual Central Work Economic Conference (CWEC) set key policy settings for 2014 that ensure continuity with the existing macro stance of "proactive fiscal and prudent monetary policies" to sustain near-term growth, mostly likely in a 7.0-7.5% range (the precise annual growth target will be set in March, which is now widely believed to be at the upper end of this range).

Growth momentum moderates slightly in Q4

In sequential terms officially reported quarterly GDP growth fell to a seasonally adjusted 1.8% (7.4% annualized) from 2.2% in Q3 (9.1% annualized). On a year-over-year basis, the deceleration was mainly due to slowing public investment (as the "mini-stimulus" measures of earlier in the year are withdrawn). Using data provided by the National Bureau of Statistics (NBS), we estimate the contribution of consumption to growth (y/y basis) amounted to 4.6 ppts, followed by investment (3.9 ppts), and net exports (-0.9 ppts), the latter due to strong import growth associated with robust domestic demand.

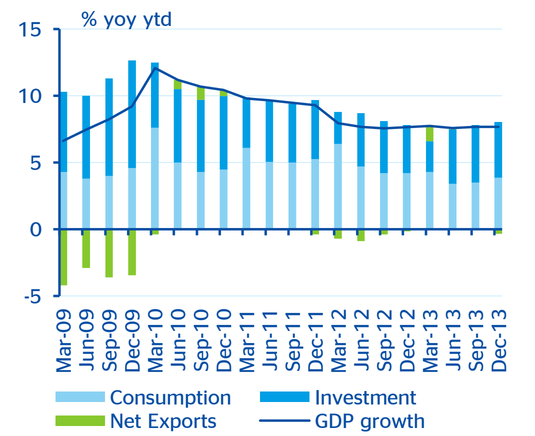
On the monetary policy front, despite no changes in benchmark interest rates or required reserve ratios, the PBoC has engineered a slightly tighter stance as evidenced by a gradual increase in interbank interest rates. This has led to an increase in borrowing costs for some firms, especially SMEs. Nevertheless, overall credit aggregates, including "total social financing", have continued to increase rapidly, underscoring the challenge facing the authorities to curtail shadow bank lending. In addition to the withdrawal of fiscal stimulus and tighter monetary conditions, the government's efforts to reduce over-capacity in some industries may also have dampened economic activity.

Table 3.1
Reform measures from the Third Plenum

Key Reform Areas	Evaluation	Elements
Economic & Financial		
Fiscal	In line with expectations. Important for enhancing effectiveness of government administration and addressing local government debt problem.	• Balance expenditures and revenues between central and local governments • Expand VAT and property tax • Income tax changes to improve distribution
Financial sector	Missing from Communiqué, but included in blueprint. Reforms are in line with expectations and ongoing initiatives. Implementation may meet resistance from state-owned banks and vested groups.	• Interest rate liberalization (remove cap on deposit rate) • Allowing private investment in the banking sector
Capital account & exchange rate	Missing from Communiqué, but included in blueprint. Sequencing and gradualism will be needed to ensure financial stability. We do not expect full liberalization before 2020.	• Capital account liberalization (gradual) • Enhance exchange rate flexibility
Urbanization	In line with expectations. Hukou reforms to be restricted to mid- and small-size cities. Awaiting details.	• Hukou system reform • Improve urban planning
SOE governance	Missing from Communiqué, but included in blueprint. Envisaged reforms do not go as far as hoped.	• SOE restructuring to reduce role in the economy and increase competition from private sector • Establish state holding companies to manage SOEs • Raise dividend transfers to central government (to 30% by 2020 from current average of10%)
Land reform	Limited in scope	• Land (ownership) rights for farmers
Market pricing	In line with expectations.	• Deregulation of controlled prices of water, gas, and electricity.
Investment access	Encouraging list of reforms, but implementation remains to be seen.	• Expand access of private investors in the service sector; shift to negative list approach • More equal treatment of domestic and foreign investors • Expand and accelerate free trade zones • Participate in regional free trade and investment agreements
Public Administration		
Streamlining and reducing intervention	In line with expectations.	• Reduce number of administrative tiers • Cut red tape
Social Sector		
Social Security	Not mentioned in communiqué, but included in blueprint. In line with expectations.	• Expand social security for rural population • Gradually raise retirement age and reduce payroll tax, improve pension system
Medical services	Not mentioned in Communiqué, but included in blueprint. As expected.	• Enhance medical insurance, hospital system reform
Population policy	Not mentioned in Communiqué, but included in blueprint. As expected.	• Further relax one-child policy
Legal & Judicial		
Rule of law	Encouraging set of reforms, but may be difficult to implement.	• Restructure the court system to enhance independence • Overhaul anti-corruption institutions • Human rights (abolish "education through labor")

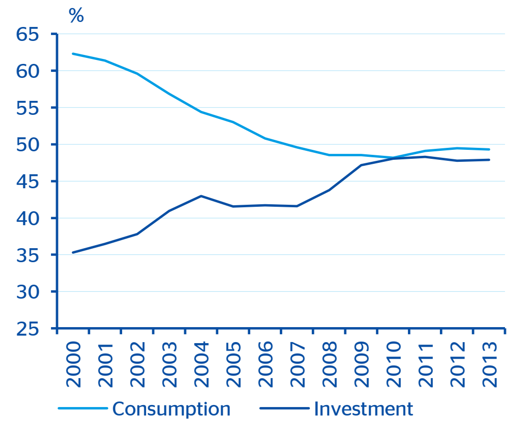
Source: BBVA Research

Chart 3.1
Growth momentum continues after bottoming in Q2



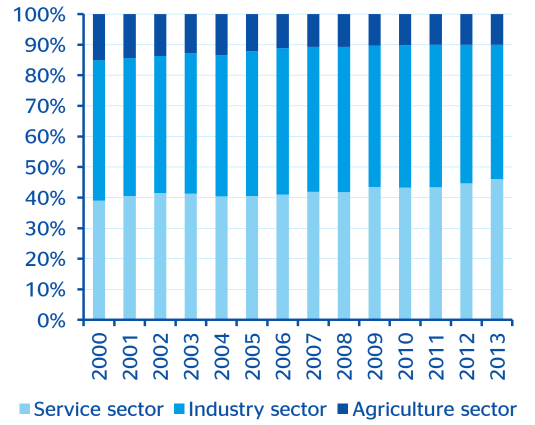
Source: NBS, CEIC and BBVA Research

Chart 3.2
Rebalancing toward consumption disappointingly slows



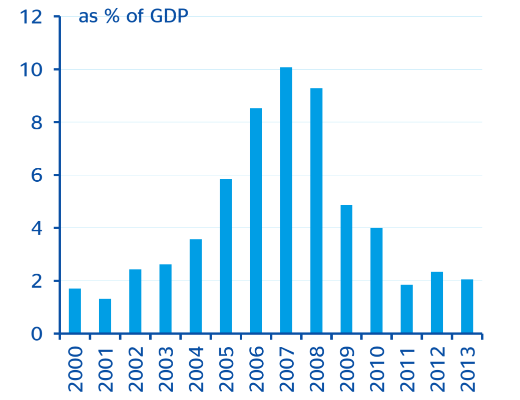
Source: NBS, Wind and BBVA Research

Chart 3.3
Encouragingly, the share of the service sector continues to rise…



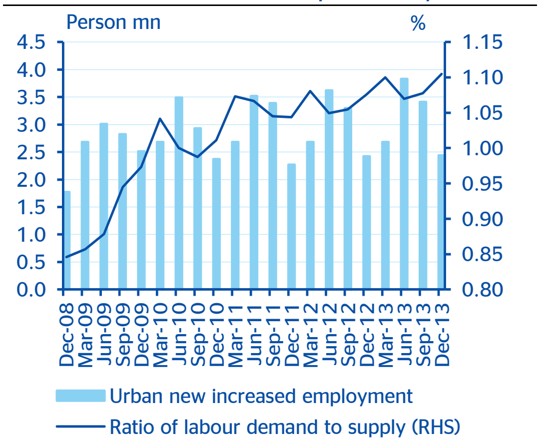
Source: NBS, CEIC and BBVA Research

Chart 3.4
…and the current account surplus declines



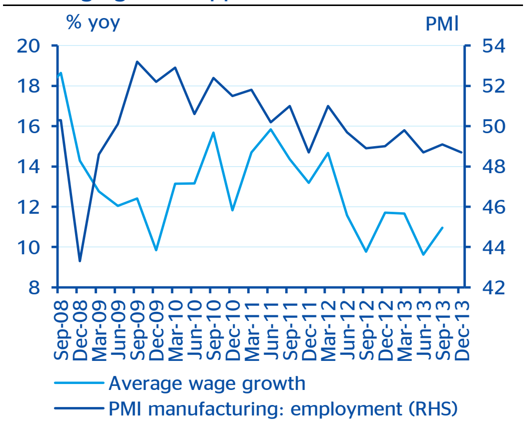
Source: NBS, Wind and BBVA Research

Chart 3.5
The labour market has held up relatively well



Source: CEIC and BBVA Research

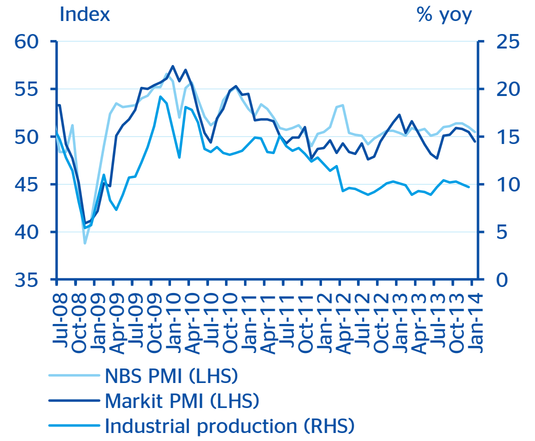
Chart 3.6
and wage growth appears to have stabilized



Source: CEIC and BBVA Research

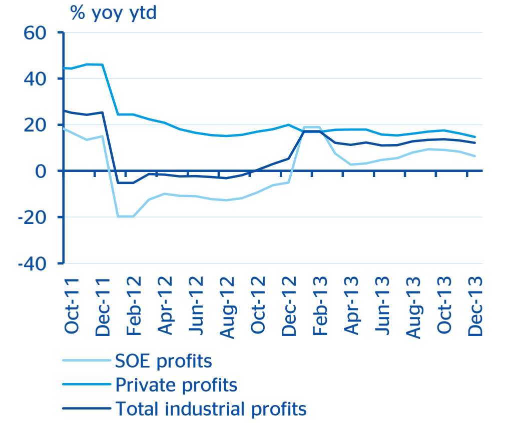
The labor market remains tight, with urban registered unemployment staying low at about 4.1%. Data from the Ministry of Human Resources and Social Security, generally believed to be more reliable than NBS employment data, also suggest a stable labor market (Chart 3.5). According to the NBS data, the economy created 13.1 million new jobs in 2013 as the working age population (16-60 ages) shrunk by 2.4 million. Nonetheless, recent labor market PMI subcomponents and wage growth have softened (Chart 3.6), likely dragged down by sluggishness in the manufacturing sector (Charts 3.7 and 3.8).

Chart 3.7
China's manufacturing activities are sluggish



Source: CEIC and BBVA Research

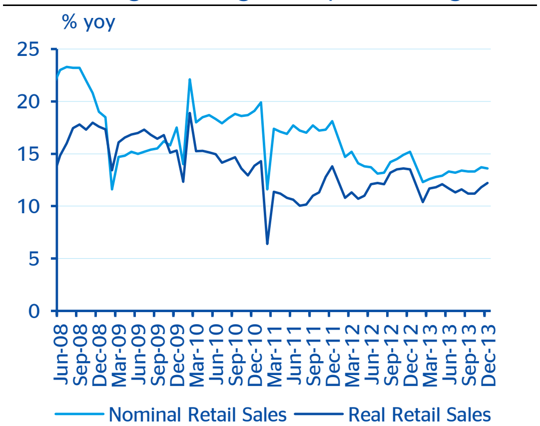
Chart 3.8
...so do industrial profits



Source: CEIC and BBVA Research

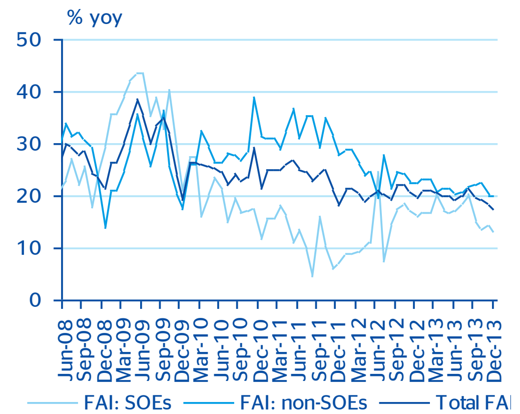
On the demand side, high frequency data in recent months confirm weakening investment (in particular public infrastructure investment, Charts 3.10 and 3.11), robust private consumption, and an improving external sector. Retail sales are recovering from the headwinds from slower income growth and from government efforts to discourage conspicuous consumption by public officials (Chart 3.9). In contrast, overall investment has fallen significantly in Q4, mainly dragged down by slowing infrastructure and manufacturing investment.

Chart 3.9
Retail sales growth is gradually recovering



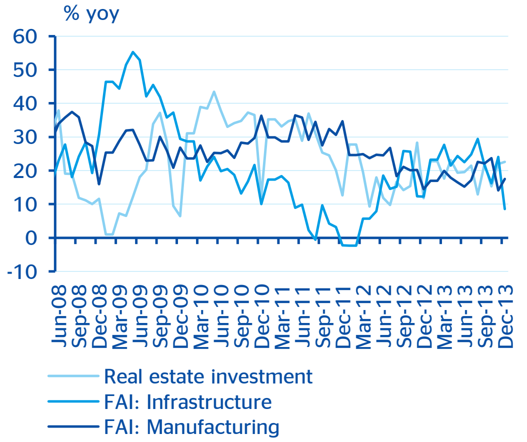
Source: CEIC and BBVA Research

Chart 3.10
... while investment decelerates significantly



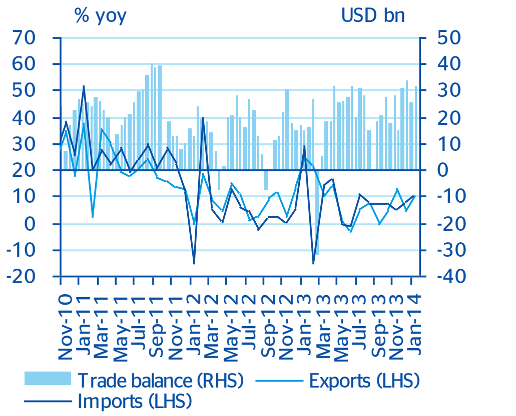
Source: CEIC and BBVA Research

Chart 3.11
...as the government winds down infrastructure investment



Source: CEIC and BBVA Research

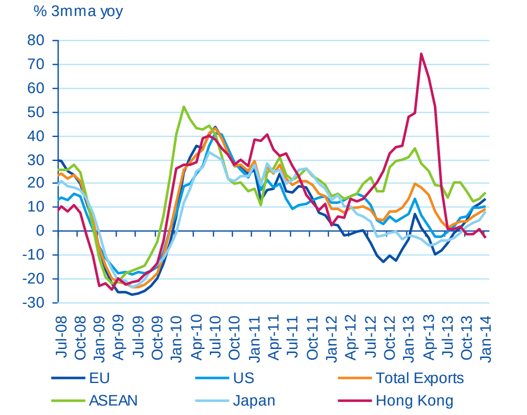
Chart 3.12
The external sector is also recovering, but remains fragile and volatile



Source: CEIC and BBVA Research

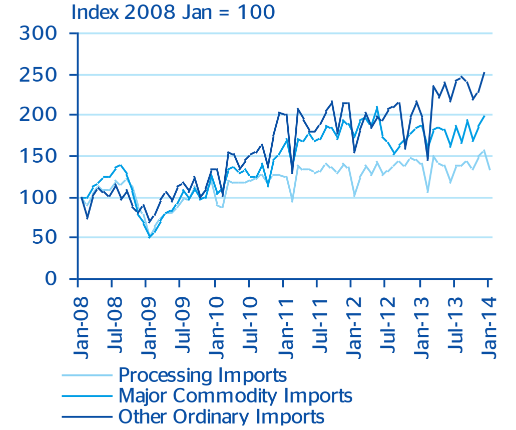
On the external front, exports have been trending up since mid-2013, as the improvement in demand from the US and EU outpaces weakening demand from the ASEAN economies (Charts 3.12 and 3.13). As in previous months, an over-invoicing problem from mid-2012 to mid-2013 has caused distortions in the year-over-year export figures (resulting in a downward bias). After adjusting for this, we estimate underlying export growth to be a few percentage points higher than the official headline figures, at about 12.3% y/y (official: 7.5%) in Q4 from 7.0% y/y (official: 4.0%) in Q3.

Chart 3.13
Exports growth is improving on rising demand from the US and EU



Source: CEIC and BBVA Research

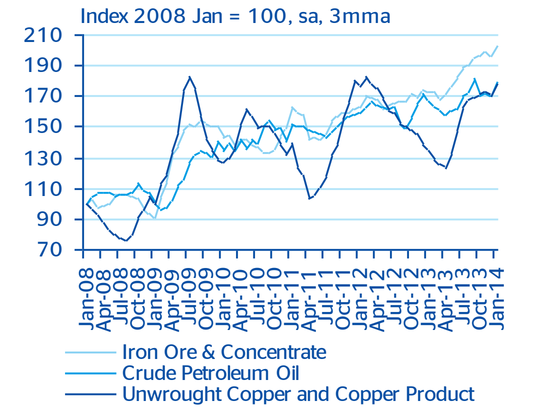
Chart 3.14
... as stronger domestic demand and exports are helping imports



Source: CEIC and BBVA Research

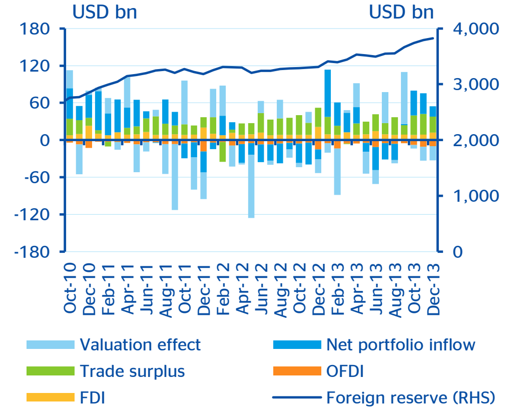
Imports have also risen in line with strong domestic demand, as well as processing imports (used in the production of export goods) (Chart 3.14). However, commodity imports have flattened in recent months (Chart 3.15). As a result of these overall trends, the trade surplus widened to USD 90.4 billion USD in Q4 from USD 61.5 billion in Q3. A bigger trade surplus, together with capital inflows associated with improving confidence in China's near-term growth prospects as well as with higher interest rate and rapid currency appreciation, has led to sharp accumulation of foreign reserves to 3.82 trillion USD from 3.66 trillion USD in Q3 (Chart 3.16).

Chart 3.15
Commodity imports remain strong



Source: CEIC and BBVA Research

Chart 3.16
FX reserves rise further on a continued trade surplus and capital inflows

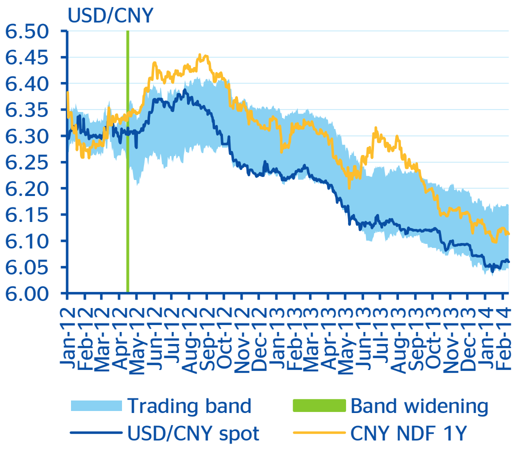


Source: CEIC and BBVA Research

RMB appreciation accelerates at a quicker pace

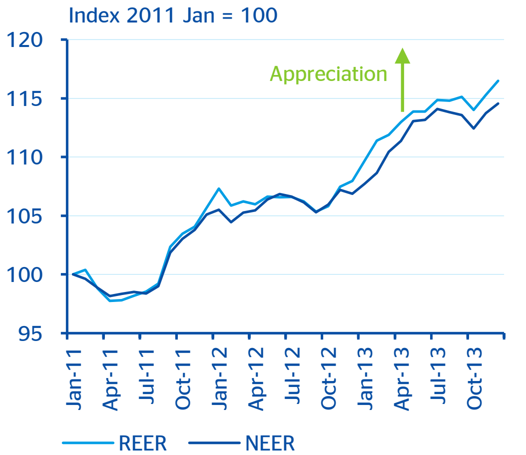
RMB appreciation accelerated in Q4, ending the year at 6.05 per USD (versus our projection of 6.10), as the authorities allowed the currency to adjust in line with the wider trade surplus and capital inflows (Charts 3.17 & 3.18). Since mid-2012, the spot rate has continued to trade near the strong end of the daily trading band, providing an indication of the degree of appreciation pressures, Meanwhile, the gap with the one-year NDF has narrowed. In 2013, the RMB appreciated by 3.0% against the USD (1.0% in 2012), and the NEER and REER rose 7.2% and 7.9% respectively.

Chart 3.17
RMB gradual appreciation continues



Source: Bloomberg and BBVA Research

Chart 3.18
The nominal and real effective exchange rates rise at a slower pace in Q3

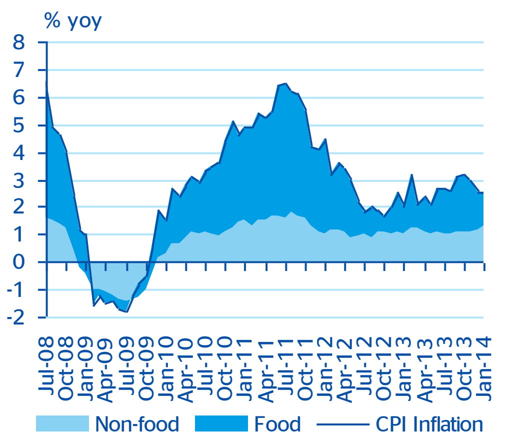


Source: BIS, CEIC and BBVA Research

Inflation moderates

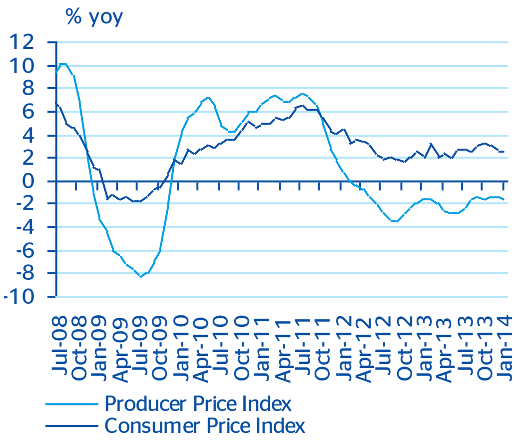
Inflation has fallen and remained at 2.5% y/y in January (Chart 3.19), on moderating food price pressures due to favourable weather conditions. While rising slightly in January, non-food inflation also remains low, at 1.9% y/y. Meanwhile, producer price inflation remains negative at -1.6% y/y. Average inflation in 2013 was 2.6%, well within the government's 3.5% comfort range (Chart 3.20).

Chart 3.19
Inflation moderates on low food prices



Source: CEIC and BBVA Research

Chart 3.20
PPI inflation is still negative

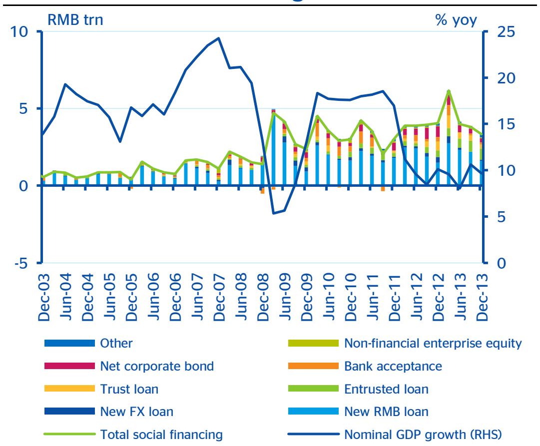


Source: CEIC and BBVA Research

Credit growth continues to be driven by shadow bank lending

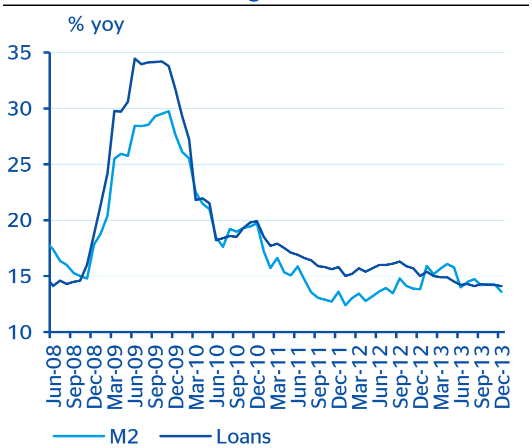
Credit growth remained strong in Q4 on robust shadow bank lending (Charts 3.21 & 3.22). Bank lending has been more constrained, at 14.1% y/y in December, probably due to the existence of unofficial lending quotas. While supportive of economic activity, the continued rapid growth of shadow bank lending is leading to higher risks and is contributing to financial stress as noted above. A recent high-profile case involving the possible default of a wealth management product is a reminder of the risks building in the system. In response, the government has been broadening regulations on shadow banking and stepping up enforcement, but the challenges in containing the growth of the shadow bank system are far from over.

Chart 3.21
“Total Total social financing” remains strong on robust shadow bank lending...



Source: CEIC and BBVA Research

Chart 3.22
...as M2 and bank loan growth moderate

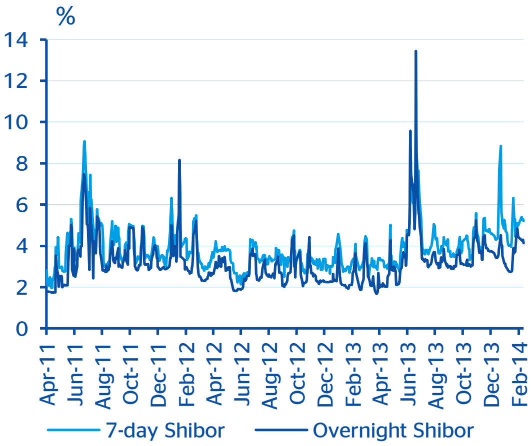


Source: Wind and BBVA Research

Interbank interest rate levels and volatility are rising

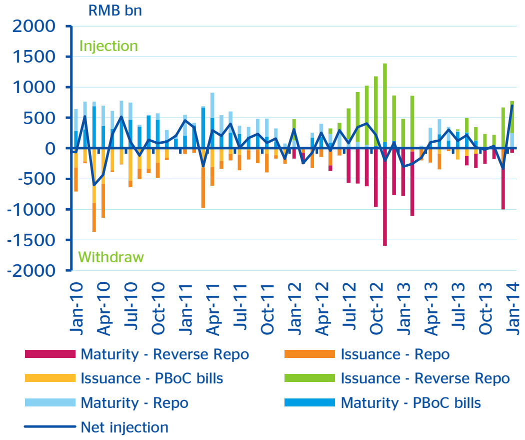
Notwithstanding stepped up efforts by the PBoC to inject liquidity, interest rates have been rising in the interbank market with periodic spikes (Charts 3.23 & 3.24). A credit squeeze in December followed a similar episode in June, although the underlying causes appear to have differed in that the June episode was policy-induced, while the December one was not. Rather, the December interest rate spike was due to seasonal cash demand which the PBoC is having difficulty in forecasting. More fundamentally, the liquidity crunch highlights the challenges of containing volatility in the interbank market as financial liberalization proceeds and the financial sector becomes more complex.

Chart 3.23
The interbank liquidity crunch in December highlights policy challenges to the PBoC



Source: CEIC and BBVA Research

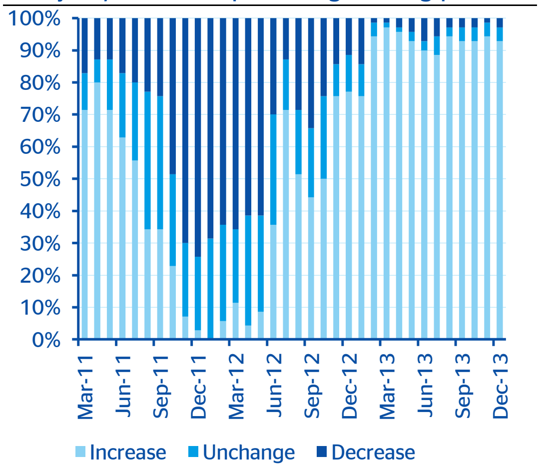
Chart 3.24
The PBoC has responded with liquidity injections



Source: Wind and BBVA Research

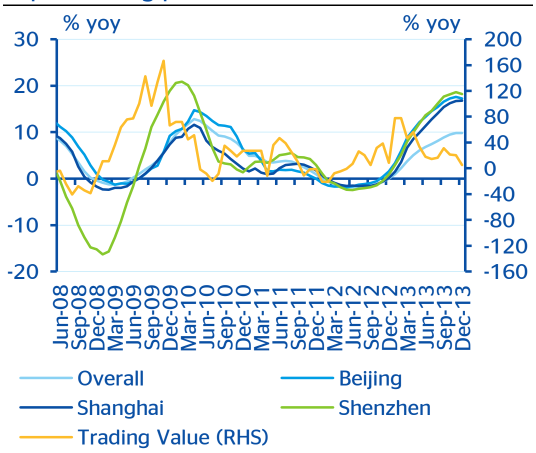
In the housing market, prices continue to rise at a rapid pace, led by Tier 1 cities such as Guangzhou, Shenzhen, Beijing, and Shanghai (about 20% y/y increases) (Charts 3.25 and 3.26). We estimate that on a nationwide basis that overall property prices rose by 9.8% y/y in December, causing the deviation between actual and equilibrium prices to diverge (according to our model of fundamentals). In addition to social concerns about affordability, rising housing prices add to the risk of bubbles (Charts 3.28).

Chart 3.25
A majority of cities report rising housing prices



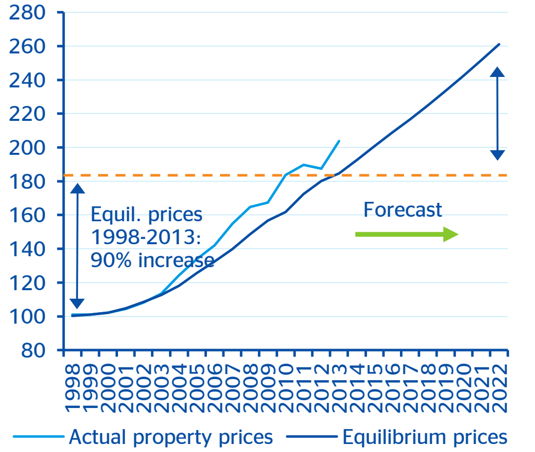
Source: NBS and BBVA Research

Chart 3.26
Rapid housing price increases are a concern



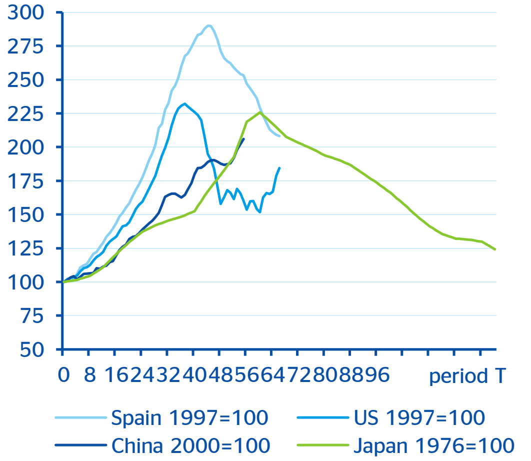
Source: NBS, CEIC and BBVA Research

Chart 3.27
Housing prices have risen faster than implied by fundamentals, adding to the risk of bubbles



Source: NBS, CEIC and BBVA Research

Chart 3.28
Are China's housing prices following Japan's bubbles?



Source: NBS, CEIC and BBVA Research

Box 2. Rising risks from local government debt

On December 30, 2013 the National Audit Office (NAO) issued a long-awaited report on China's public debt. The report found that total local government debt increased to RMB 17.9 trillion (equivalent to 34.5% of GDP) as of end-June 2013, up from 10.9 trillion at end-2010 (26.7% of GDP), the last time such an audit was carried out (see our **Banking Watch** of July 2011).

The increase implies an annual growth pace of more than 20% in local government debt over the past 36 months (although some of the increase may be due to enhanced coverage. According to the latest NAO report, the largest increase in local government debt is attributed to LGFVs: agency debt rose to RMB 7.8 trillion as of end-June 2013 from 5.7 trillion in 2010 while LGFV debt expanded to RMB 10.1 trillion by end-June 2013 from RMB 5.0 trillion in 2010. The faster growth in LGFVs mirrors previous efforts to boost infrastructure spending to support GDP growth.

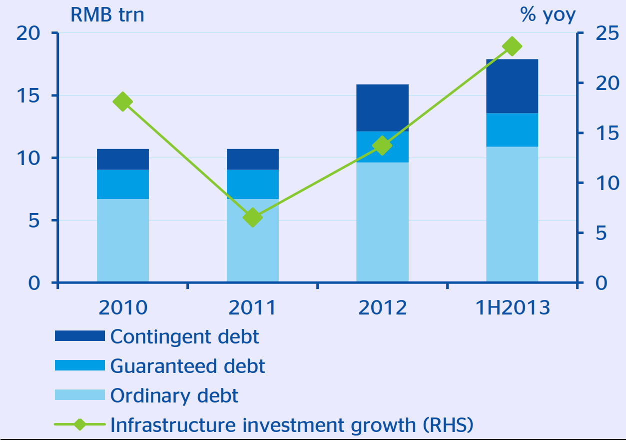
The NAO reports also provided a breakdown of local government debt by funding source: bank loans account for the bulk of local government debt, but its share dropped to 57% of total outstanding local government debt at end-June 2013 from 79% in 2010. On the other hand, bond issuance and various forms of shadow banking activities (including trust loans, borrowing from security firms, finance from insurance companies, and finance lease), have been used increasingly by local governments to meet their financing needs.

This buildup of local government debt poses a number of risks:

- Maturity mismatches, especially for LGFVs used to finance long-term infrastructure projects. According to the recent NAO report, around 60% of local government debt will come due in the next couple years, which may pose liquidity risk to some local governments if they cannot roll over existing credits.
- Interest payments are adding pressure on local government balance sheets. According to IMF estimates, the average interest rate paid by local governments on bank loans is expensive, and much higher than that of other national debt.
- Sustainability is a problem as a large portion of local government debt (37.2% by end-2012) needs to be repaid through revenues from land sales.

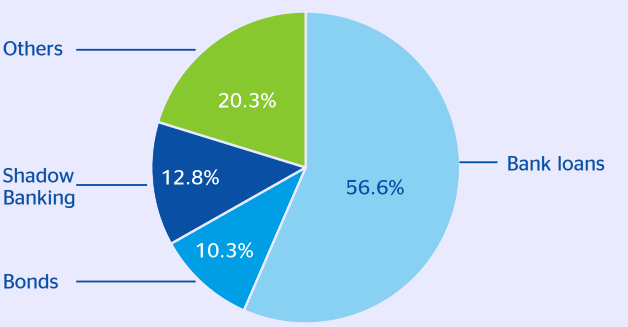
In our view there is time to defuse these risks as long as the authorities take prompt action to curtail the expansion of local government debt. In this regard, the authorities have stepped up their efforts, for example at the recently concluded Third Plenum where the fiscal relationship between the central and local governments was listed as a priority in the reform agenda. Moreover, the authorities have already started to will allow some local governments to issue long-term municipal bonds to replace their existing debts and alleviate maturity mismatches.

Chart 43
Infrastructure investment and debt accumulation of local governments



Source: NAO reports, CEIC and BBVA Research

Chart 44
Breakdown of funding sources for local government debt



Source: NAO Reports and BBVA Research

4. Reforms take center stage in China in 2014

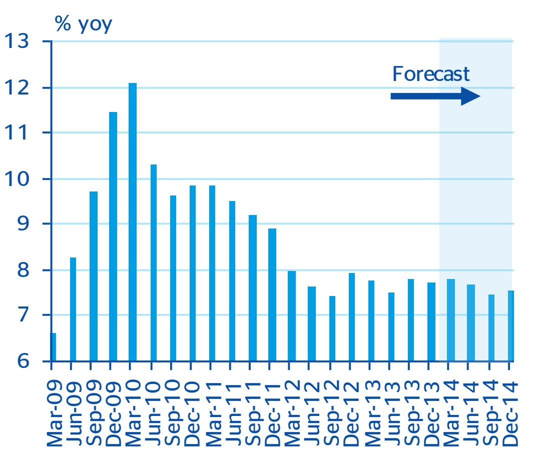
While growth has held up well so far, weakening activity indicators in December and January are a sign of headwinds that still persist. We nevertheless expect growth to remain resilient in 2014 (Chart 4.1) on an improving external environment and given room for further policy support if needed. On this basis, we are leaving our 2014-15 growth projections unchanged at 7.6% and 7.5% respectively. Risks continue to be tilted to the downside given the buildup of financial fragilities and the uncertain timing of reforms and their impact on near-term growth. Over the medium term, we expect growth to slow down gradually in line with declining potential growth (from about 8.0% currently to 6.5% by 2020).

We expect the policy stance for 2014 to be broadly unchanged from last year, officially characterized as "prudent monetary and proactive fiscal" as announced in the annual CEWF in December. At the margin, policies may be somewhat tighter – higher interbank interest rates on the monetary side, and reduced local government spending on the fiscal side (only partially offset by higher central government spending).

Inflation to trend up gradually in 2014, still within the target

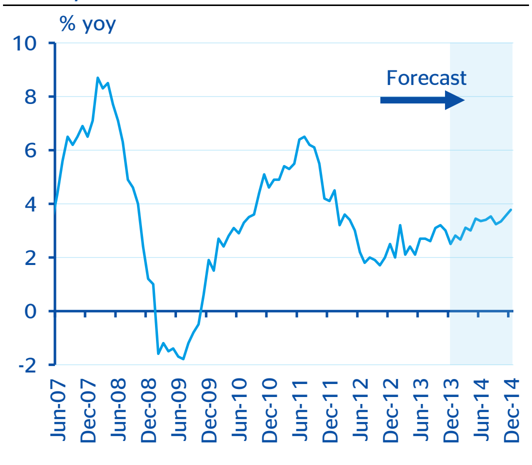
Inflation has declined by more than expected in recent months on lower-than-expected food prices. Accordingly, our inflation projection for 2014 (period average) has been lowered to 3.3% from 3.5% previously, compared with the outturn of 2.6% in 2013. Looking ahead, we higher prices of food items and utilities, along with rising wages and base effects, can be expected to push inflation modestly higher in the coming 1-2 years.

Chart 4.1
Growth momentum to continue in H1 2014, but may decelerate in H2 and going forward



Source: NBS, CEIC and BBVA Research estimates

Chart 4.2
Inflation to trend up gradually in 2014, but broadly remain within the comfort level



Source: NBS, CEIC and BBVA Research estimates

RMB to rise gradually with greater two-way flexibility

We expect the RMB to appreciate by another 2-3% in 2014 as external demand strengthens, brining the RMB to around 5.90 RMB/USD by end-2014. Meanwhile, two-way flexibility can be expected to increase through a possible widening of the daily trading band during the course of 2014 (which did not occur as previously expected in 2013). In addition, RMB internationalization is continuing as the authorities promote the use of the currency in trade settlements and investment flows, and as central banks around the world increasingly add the RMB in their reserve holdings.

Table 4.1
Baseline Scenario

	2011	2012	2013	2014 (F)	2015 (F)
GDP (%, y/y)	9.3	7.7	7.7	7.6	7.5
Inflation (average, %)	5.4	2.7	2.6	3.3	3.5
Fiscal bal (% of GDP)	-1.1	-2.1	-1.9	-2.5	-2.5
Current acct (% of GDP)	1.8	2.3	2.0	2.5	3.0
Policy rate (%, eop)	6.56	6.00	6.00	6.00	6.50
Exch rate (CNY/USD, eop)	6.30	6.23	6.05	5.90	5.80

Source: BBVA Research

Policies to focus on reforms

Growth in line with our baseline projection in 2014 should provide comfort to the authorities in implementing their reform as announced at the Third Plenum in November. The key elements where we expect some progress in 2014, many of which will be introduced gradually over the coming years, are: urbanization (especially "Hukou" system reform), financial sector (steps toward interest rate liberalization and the implementation of a deposit insurance scheme, enhancement of RMB exchange rate flexibility, and greater private entry into the banking sector), market pricing for utilities and natural resources, and the streamlining of public administration. In regards to domestic fragilities, priorities in 2014 are likely to include efforts to address local government debt, curtail shadow bank lending, slow the pace of housing price increases, and address over-capacity. In 2015, full interest rate liberalization is expected as well as fiscal reforms to reshape the central-local government relationship.

5. Regional risks are to the downside

Despite ongoing divergences across the region, we expect a modest pickup in Asia-Pacific growth in 2014 as external demand continues to improve. As noted in our Global Outlook, the assessment of the global economy has improved over the past few months and tail risks have decreased with the resolution of the US fiscal stalemate, and further progress in Europe toward banking union and measures by the ECB to maintain stability. However, rising financial fragilities in China and the uncertain impact of QE tapering on emerging market capital flows continue to exert downward risks to the outlook.

In China, although GDP growth held up well through 2013 and our outlook is still positive, recent indicators have weakened. Moreover, financial stress has become apparent, as evidenced by rising interest rates and volatility in the interbank market. Also, concerns about shadow banking have increased with questions arising about the safety of various wealth management products. While we believe these risks are still manageable, the urgency of addressing them has increased, as has the risk of policy missteps and financial instability.

Within the broader region, geopolitical risks remain from the dispute between China and Japan, and occasional tensions on the Korean peninsula. In Thailand domestic political instability has intensified. In the macro area, external pressures have eased thanks to policy measures, especially in India and Indonesia. General elections scheduled during the year in both countries, however, add an element of uncertainty.

More generally, QE tapering will continue to pose risks to financial stability in emerging markets. While emerging Asia is relatively well positioned to weather such pressures, external pressures bear watch. 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.

6. Tables

Table 6.1
Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2011	2012	2013	2014 (F)	2015 (F)
United States	1.8	2.8	1.8	2.5	2.5
Eurozone	1.6	-0.6	-0.4	1.1	1.9
Asia-Pacific	6.0	5.3	5.2	5.3	5.4
Australia	2.5	3.6	2.4	2.9	3.2
Japan	-0.6	2.1	1.7	1.5	1.3
China	9.3	7.7	7.7	7.6	7.5
Hong Kong	4.9	1.4	3.1	3.7	3.9
India	7.5	5.1	4.7	5.1	5.7
Indonesia	6.5	6.2	5.8	5.8	6.0
Korea	3.7	2.0	2.8	3.6	4.0
Malaysia	5.1	5.6	4.7	5.1	5.0
Philippines	3.9	6.6	7.2	7.0	5.8
Singapore	5.3	1.3	3.7	3.6	4.0
Taiwan	4.2	1.5	2.2	3.6	4.2
Thailand	0.1	6.5	2.8	3.4	5.5
Vietnam	6.2	5.3	5.4	5.5	5.9
Asia ex China	3.7	3.5	3.4	3.7	4.0
World	4.0	3.2	2.9	3.6	3.9

Source: BBVA Research

Table 6.2
Macroeconomic Forecasts: Inflation (Avg.)

(YoY% growth rate)	2011	2012	2013	2014 (F)	2015 (F)
United States	3.1	2.1	1.5	2.3	2.4
Eurozone	2.7	2.5	1.4	1.0	1.4
Asia-Pacific	4.9	3.1	2.9	3.5	3.5
Australia	3.3	1.8	2.5	2.5	2.5
Japan	-0.3	0.0	0.4	2.2	1.5
China	5.4	2.7	2.6	3.3	3.5
Hong Kong	5.3	4.1	4.3	3.6	3.5
India	9.2	7.7	6.1	5.8	5.8
Indonesia	5.4	4.3	7.0	5.4	4.5
Korea	4.0	2.2	1.3	2.7	3.6
Malaysia	3.2	1.7	2.1	2.9	3.0
Philippines	4.7	3.2	2.9	4.3	4.1
Singapore	5.2	4.6	2.4	3.2	3.5
Taiwan	1.4	1.9	0.8	1.5	1.8
Thailand	3.8	3.0	2.2	2.4	2.9
Vietnam	18.1	6.8	6.0	6.8	7.0
Asia ex China	4.5	3.4	3.1	3.7	3.6
World	5.1	4.1	4.1	3.8	4.0

Source: BBVA Research

Table 6.3

Macroeconomic Forecasts: Exchange Rates (End of period)

		2011	2012	2013	2014 (F)	2015 (F)
Eurozone	USD/EUR	1.30	1.32	1.37	1.30	1.35
Australia	USD/AUD	1.02	1.04	0.89	0.90	0.90
Japan	JPY/USD	76.9	86.8	104.9	115.0	120.0
China	CNY/USD	6.30	6.23	6.05	5.90	5.80
Hong Kong	HKD/USD	7.77	7.75	7.75	7.80	7.80
India	INR/USD	53.1	55.0	61.8	60.5	59.0
Indonesia	IDR/USD	9069	9793	12171	11500	10500
Korea	KRW/USD	1152	1064	1050	1050	1050
Malaysia	MYR/USD	3.17	3.06	3.28	3.18	3.13
Philippines	PHP/USD	43.8	41.0	44.4	44.0	40.0
Singapore	SGD/USD	1.30	1.22	1.26	1.25	1.24
Taiwan	NTD/USD	30.3	29.0	29.8	29.4	28.9
Thailand	THB/USD	31.6	30.6	32.7	31.4	29.7
Vietnam	VND/USD	21034	20840	21095	21600	21800

Source: BBVA Research

Table 6.4

Macroeconomic Forecasts: Policy Rates (End of period)

(%)	Current	2012	2013	2014 (F)	2015 (F)
United States	0.25	0.25	0.25	0.25	0.50
Eurozone	0.25	0.75	0.25	0.25	0.50
Australia	2.50	3.00	2.50	2.50	3.50
Japan	0.10	0.10	0.10	0.10	0.10
China	6.00	6.00	6.00	6.00	6.50
Hong Kong	0.50	0.50	0.50	0.50	1.50
India	8.00	8.00	7.75	7.25	6.75
Indonesia	7.50	5.75	7.50	6.75	6.00
Korea	2.50	2.75	2.50	2.50	3.00
Malaysia	3.00	3.00	3.00	3.25	3.50
Philippines	3.50	3.50	3.50	4.00	4.00
Singapore	0.40	0.40	0.40	0.40	0.40
Taiwan	1.88	1.88	1.88	2.13	2.38
Thailand	2.25	2.75	2.25	2.00	3.00
Vietnam	9.00	9.00	9.00	8.50	8.00

Source: BBVA Research

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