BBVA Research

China

Economic Outlook

Fourth Quarter of 2010

Economic Analysis

- After a brief lull in activity, activity indicators are showing signs of renewed momentum, prompting additional tightening measures, including a recent interest rate hike. Given the authorities' determination to contain growth and inflation to prevent overheating, we continue to expect a moderation in momentum in line with an economic soft-landing.
- We have raised our 2010 full-year growth projection to 10.1%, from 9.8% previously, based on the faster-than-expected growth momentum to date. Nevertheless, GDP growth is moderating in line with potential, which we expect to continue and for inflation to ease by year-end to 3.2%. We maintain our growth projection of 9.2% for 2011.
- We expect further monetary tightening measures, including at least two more interest rate hikes in 2011 to curb lending growth and tame property price increases. We maintain our outlook for the RMB at 6.54 per USD by end-year, amounting to a 4-5% appreciation for the year, and a similar pace in 2011.
- The balance of risks has again swung toward overheating, exacerbated by strong capital inflows. Downside risks remain from an uncertain external environment and the weak US recovery. Risks of protectionism have also increased due to frustration abroad over the pace of RMB currency appreciation.

Index

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Summary

After successfully weathering the global economic crisis of 2008-09—and pulling along global and regional demand in the process—China's economic growth is gradually moderating. The slowdown should help avert economic overheating, and is being achieved through fine-tuning policy adjustments aimed at unwinding the massive stimulus measures implemented in 2008-09, placing a brake on rapid credit growth, and slowing the pace of price increases in the property sector. We have raised our 2010 full-year growth projection to 10.1% (from 9.8% previously), and we continue to expect growth of 9.2% in 2011.

GDP growth moderated in Q3 to 9.6% y/y (down from a peak of 11.9% y/y in Q1), somewhat ahead of expectations, but still in line with our soft-landing scenario. Nevertheless, growth momentum remains very strong, with inflation on the rise. This prompted the authorities to hike interest rates in mid-October, as anticipated in our previous *China Economic Outlook*, and to take further steps to curb credit growth, including a recent additional hike in required reserve ratios.

Inflation has been picking up on rising food prices. Headline inflation in September rose to 3.6% y/y, with signs of rising inflationary expectations. We expect inflation to moderate during the remainder of the year to 3.2% y/y by December, thanks to the government's recent tightening measures and favourable base effects. With GDP growth expected to stay within potential, inflation should also remain moderate in 2011, at 3.3% on average. Nevertheless, given strong demand and growth momentum, the balance of risks on the inflation front is tilted to the upside.

Aware of the rising inflationary pressures, the PBoC hiked interest rates by 25 bps in mid-October. The move followed a fourth hike in required reserve ratios for the year, and an intensification of measures to cool the property sector. We expect more monetary tightening measures ahead, with at least two more rate hikes likely in 2011.

The RMB continues to appreciate gradually against the USD within the more flexible exchange rate regime adopted last June. To date, the appreciation has amounted to only about 2½% against the USD (and has actually depreciated in nominal effective terms in recent months), but is nevertheless in line with our full-year expectation of a 4-5% appreciation to 6.54 per USD by end-year. Despite rising international pressure on the authorities to accelerate the pace of appreciation—all the more so given a further significant build-up of foreign exchange reserves in Q3—we expect the gradual approach to continue, with a further 4% appreciation anticipated in 2011.

The thrust of fiscal policy is expected to remain supportive of growth. For the remainder of the year, the authorities will continue to implement the expansionary two-year fiscal package adopted in 2009 in response to the global economic crisis, although the pace of spending is moderating. Details on next year's budget will only become available early next year, but indications are that the emphasis will continue on social spending, subsidies to support domestic consumption, and further infrastructure development. Special emphasis is likely to be given to investment in affordable housing.

The balance of risks, for the time being, has swung back toward overheating. After a brief lull, recent data point to continued strong growth momentum, rising inflation, and a pick-up in the housing sector. While downside risks to the external environment remain, the emphasis is now on measures to restrain growth in order to ensure a soft landing. Additional risks arise from protectionist sentiment in China's trading partners, due in part to frustration over the gradual pace of currency appreciation. Diplomatic strains between Japan and China could also have economic spillovers, and bear watch.

Our medium-term baseline outlook continues to incorporate a gradual rebalancing of growth toward domestic consumption. As highlighted in the outlines of the forthcoming 12th five-year plan, social wellbeing will be a key focus of policy. In line with this, the authorities have already taken steps to extend subsidies to boost domestic consumption, maintain social spending to improve livelihood in the rural areas, and enhance the social safety net (which would help reduce the need for precautionary savings, and thereby increase consumption levels). Currency appreciation is an ingredient of the package of policy reforms to encourage greater consumer spending, as is enhancing access to consumer finance.

1. Global outlook: slow north, fast south

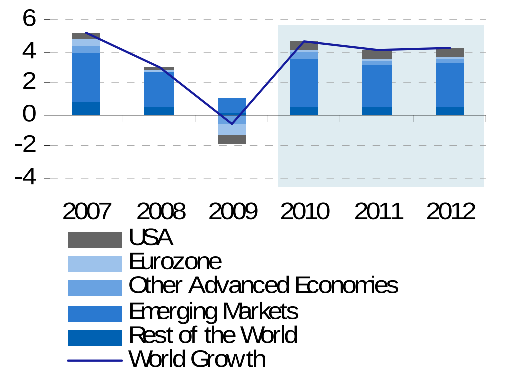
Before turning to the outlook for China, we review the Global Economic Outlook

The global economy keeps growing strongly, mostly in emerging countries, whereas cyclical and financial concerns dominate advanced economies

Global growth continues to be strong, and is expected to reach 4.7% in 2010, and 4.1% in 2011 (Chart 1), mostly unchanged with respect to our forecast three months ago. This encouraging performance is mostly due to strong outturns in emerging economies, which have been less affected by the financial crisis, as their banking sector was in very good shape, and have thus recovered rapidly. In contrast, renewed cyclical concerns in the US have joined financial concerns still dominating Europe, where macroeconomic and financial adjustments are still underway. Thus, in line with our expected scenario, the outlook for the next two years continues to highlight the growth gaps between the advanced north and the emerging south (Chart 2) even if the latter also embarks on a controlled slowdown to ameliorate the risk of overheating.

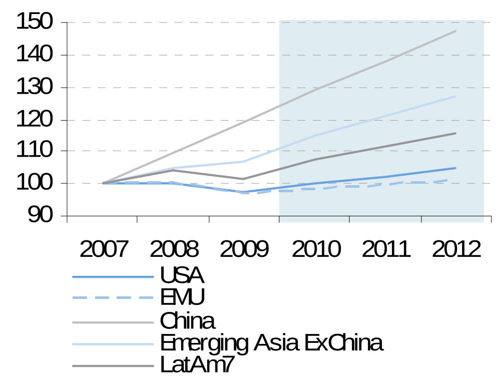
But there are also significant policy differences inside each of these groups. In the US, monetary expansion is set to intensify in relative terms with respect to Europe (and most other countries), and has thus been reflected in a depreciation of the dollar against the euro and complicating Europe's recovery. In emerging economies, there is an asymmetry in exchange rate policy between Asia and Latin America continues, forcing the latter to bear (together with the euro) a significant part of the exchange rate appreciation derived from renewed monetary easing in the US.

Chart 1
Global GDP growth and contributions



Source: BBVA Research

Chart 2
GDP level: 2007=100



Source: BBVA Research and Datastream

Growth in the US will remain low given ongoing household deleveraging, but a double dip scenario is very unlikely.

Over the last quarter, relatively weak indicators of economic activity in the US have raised the specter among market participants of a possible relapse into a recession. The weakness observed in some key sectors that had benefited directly from fiscal support through incentives for purchases (durable goods and housing) is a strong signal that the recovery in private sector demand is still not self-sustaining. This weakness is a consequence of an ongoing household deleveraging process and a weak labor market, which will continue to push households to save more than what was observed since the second half of the 1990s. Even though this is to be welcomed in the process of rebalancing growth in the US, it increases cyclical concerns since consumption (one of the pillars of recovery in past recessions) will remain muted and only partially compensated by stronger investment in equipment by firms and exports.

Recent concerns about the health of the housing sector are, in our view, excessive and the possibility of a relapse into further significant real estate price drops is very small, given that prices have declined by about 30%. There are certainly elements of concern, such as elevated house inventory levels and the potential impact of an unexpected further supply of housing from new foreclosures, which may come either from increased delinquencies or due to owners walking away from increasingly negative housing equity. But there are also elements of support, such as the huge gains in housing affordability since the crisis started and the demographic trends that should help prop up demand going forward. It is true that if house prices continue to decline, it might have a non-negligible impact on consumption, but at least the banking system seems in a relatively good shape to withstand a moderate shock to prices. All in all, the scenario of further significant price drops is highly unlikely. Instead, a period of relatively stable house prices seems more likely, while past excesses are finally reabsorbed.

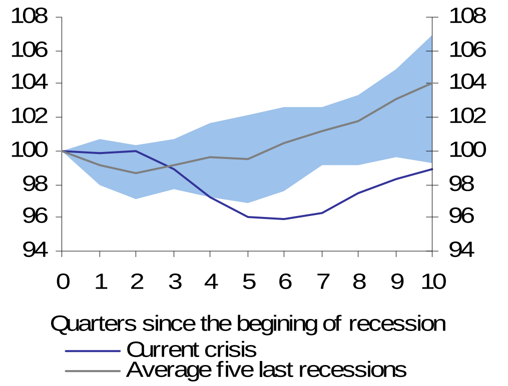
Overall, the drag on consumption and the low probability of further fiscal stimulus–out of concerns about the size of current deficits and the political arena, especially if there is a change in the balance of power after November's congressional elections–will be partially compensated by recovering private investment as sales improve and regulatory uncertainties diminish. This will imply an exit from the crisis in the US at a pace much lower than in previous cycles (Chart 3), as we have been forecasting for a long time. While the probability of a double dip in the US is low, in any case, the lack of strength of domestic demand will induce the US more and more to press the rest of the world (especially countries with a current account surplus and high domestic saving rates) to increase their demand and contribute to the necessary global rebalancing.

Financial stress in Europe is still a source of concern, though systemic risk is lower than before the summer. Fiscal consolidation remains crucial to sustain confidence, and will not have a large negative impact on growth beyond the short-term.

After decisive advances in fiscal consolidation, measures to provide support to distressed governments and especially after the financial sector stress tests, there has been a qualitative change in the dynamics of the crisis in Europe. Even if average sovereign spreads have remained relatively stable, markets have highlighted the differentiation between sovereign assets, thus reducing the risk of a systemic event. In addition, financial markets have started to open–though selectively–and renewed debt issuance is a further sign of lower tensions.

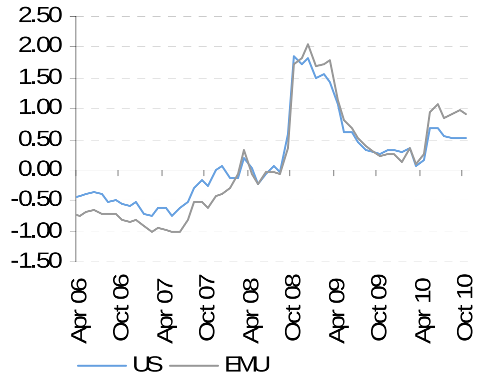
Notwithstanding this, financial market stress in Europe is still the main source of risk for the region (Chart 4) especially given the link between sovereign concerns and risks to the financial sector, given their national and cross-border exposure. In addition, the recent strengthening of the euro means an added challenge given that best performing economies had been supported by external demand. This makes it more imperative to tackle decisively in the short run the sources of macroeconomic vulnerability in the region, namely fiscal sustainability and external imbalances, as well as avoiding further delays in restructuring the weak part of banking systems. The key is to continue rebuilding confidence to reduce market tensions and rebuild the autonomous strength of private sector demand. In addition, to sustain growth in the long run, it will be crucial to undertake much needed structural and institutional reforms, the latter especially geared towards preventing and resolving future fiscal imbalances. The focus on structural reform more than sustaining demand has been precisely the differentiating factor between the ECB and other central banks, prompting a less expansive stance than the Fed.

Chart 3
US GDP: current cycle vs. previous recessions*. Beginning of each recession=100.



Source: BBVA Research and NBER
* Shaded area: range of GDP during last 5 recessions

Chart 4
Financial Stress index.



Source: BBVA Research

Monetary policy in advanced economies will be lax for a long time, adding pressure to exchange rates worldwide

Prospects of very low growth and subdued inflationary pressures in advanced economies will translate into low interest rates for a prolonged period in the three most important advanced areas (US, Europe and Japan). However, against the backdrop of renewed cyclical concerns and the much-reduced scope for further fiscal stimulus, markets were focused on the US embarking into a new bout of unconventional monetary easing (so-called Quantitative Easing 2, or QE2). The expectation of this further increase in liquidity lowered the exchange rate of the dollar across the board, including vis-à-vis the euro. Going forward, given that most of QE2 has been already priced in by markets, euro-dollar exchange rates will depend more on relative growth prospects (which favor the US vis-à-vis EMU) but also on the relative perception of monetary policy in both areas and the evolution of investment flows. At the same time, we expect appreciation pressures on emerging economies to continue due to increased global liquidity, stronger macroeconomic fundamentals and positive return differentials favoring renewed capital inflows.

Emerging markets face increasing policy dilemmas from strong growth, abundant global liquidity and neighbours' foreign exchange interventions

Emerging economies continue to grow strongly, with emerging Asia leading the world recovery, as discussed below. In both Asia and Latin America, private domestic demand is taking over policy-induced stimulus as the source of the recovery. Going forward, growth in Asia will slow down because of a reduction in momentum from the ending of the global inventory cycle, weaker external demand and a withdrawal of policy stimulus, thus reducing the risk of overheating. But the region will continue to contribute the most to global growth.

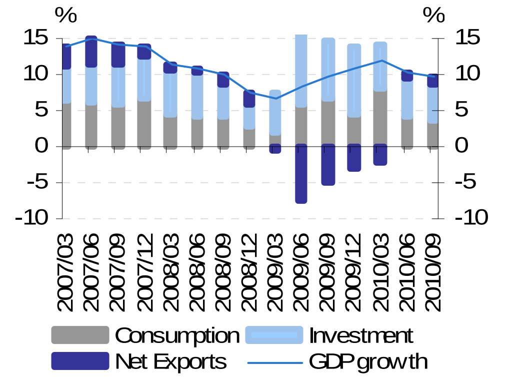
Both Asia and Latin America confront increasing monetary and exchange-rate policy dilemmas, between cooling strong domestic demand and preventing strong capital inflows and preserving competitiveness in foreign markets. Some countries have started introducing administrative measures to discourage strong capital inflows and some others have slowed their rate of monetary tightening.

Given the relative inflexibility of exchange rates in China (and, to a lesser extent, in the rest of emerging Asia), Latin America is facing a significant part of the adjustment, to the point that further exchange-rate appreciations will start to be a problem for growth. Thus, many countries in the region are weighing further exchange rate interventions although experience shows that their effectiveness if rather limited, contributing mostly to slow down the rise in exchange rates, but not prevent them. The risk is that increased intervention in foreign exchange markets ends up sliding into retaliatory trade measures. This highlights the importance of increased exchange rate flexibility in Asia (China, in particular) as a way to provide more policy space to the rest of the world.

2. China: engineering a soft landing

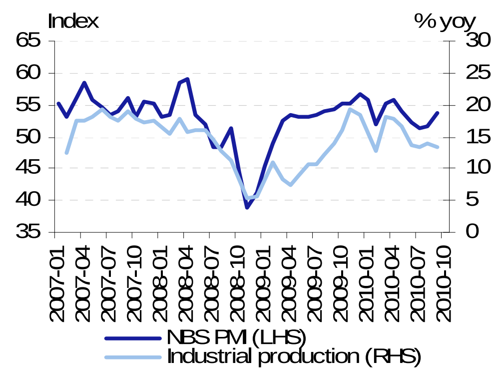
After successfully weathering the global economic crisis—and pulling along global and regional demand in the process—China's economic growth is gradually moderating. The slowdown is being achieved through fine-tuning policy adjustments aimed at placing a brake on rapid credit growth and slowing the pace of price increases in the property sector. GDP growth has moderated from a peak of 11.9% y/y in the first quarter, to 9.6% in Q3 (Chart 5). Nevertheless, growth momentum remains uncomfortably strong, with risks of overheating still present. Rising inflation and continued strong credit growth have prompted the authorities to implement further tightening measures, including a hike in interest rates in mid-October which likely marks the beginning of a new tightening cycle. Meanwhile, under intense international pressure, the currency continues to appreciate, but at a very gradual pace. Based on strong indicators through Q3, we have raised our full-year growth projection for 2010 to 10.1% (from 9.8% previously), and we are maintaining our 9.2% projection for 2011. Given signs of weakening external demand and the authorities' determination to prevent overheating, our baseline continues to center around a soft-landing for the economy.

Chart 5
China's growth is moderating… (Contribution to GDP)



Source: CEIC and BBVA Research

Chart 6
…as industrial production eases, although momentum remains strong



Source: CEIC and BBVA Research

Growth momentum remains strong, amidst signs of a healthy moderation

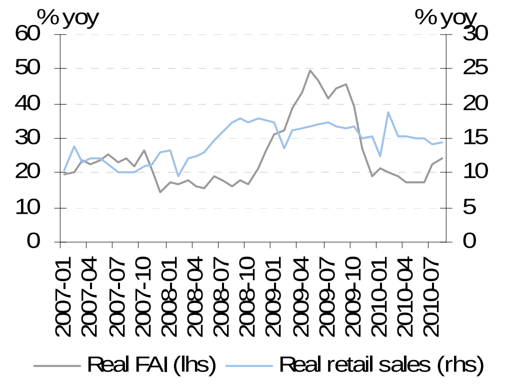
The economy is showing signs of a gradual moderation in momentum. GDP growth eased to 9.6% y/y in Q3 from 10.3% in Q2, still ahead of expectations (BBVA: 8.9%). A brief lull in economic indicators in Q2, activity gave way to renewed momentum in Q3. Indeed, our estimates of quarterly growth (seasonally adjusted) suggest that momentum actually picked up from 8.0% in Q2 to 9.6% in Q3 (given data limitations, estimates of q/q growth are subject to an unusually large margin of error). We have raised our full-year growth projection for 2010 to 10.1% (from 9.8% previously), and we are maintaining our 2011 projection at 9.2%.

Industrial production accelerated in August, before falling to 13.3% in September, perhaps reflecting government measures to reduce energy consumption and emissions (Chart 6). However, the purchasing manager's index (PMI), which is a leading indicator of trends in the manufacturing sector, is showing signs of a pick-up after a brief slowdown in June and July. The PMI index was much higher than market expectations in September and October, reflecting a pickup in activity.

On the demand side, investment indicators are showing signs of moderation, although they still remain strong (Chart 7). Retail sales are also showing resilience, in part due to ongoing government initiatives designed to boost consumption, such as subsidies for automobile purchases and incentive programs for home appliances.

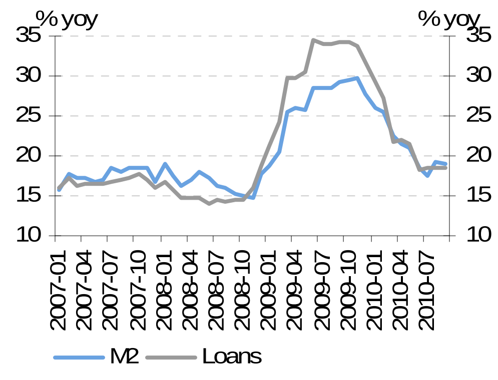
Importantly, money and credit growth remains stable, following last year's surge on government stimulus measures (Chart 8). New loans for the year through September amounted to 6.29 trillion, suggesting that the authorities' RMB 7.5 trillion target limit for new loans in 2010 remains achievable (the typical seasonal pattern of new loans is front-loaded toward the beginning of the year). However, keeping loan growth within the target will require continued efforts by the government to restrain lending (for the month of September, new loans were well ahead of expectations, at RMB 595.5 billion compared to a consensus of RMB 500 billion).

Chart 7
Investment and consumption indicators remain strong



Source: CEIC and BBVA Research

Chart 8
M2 and credit growth showed deceleration, but held up recently

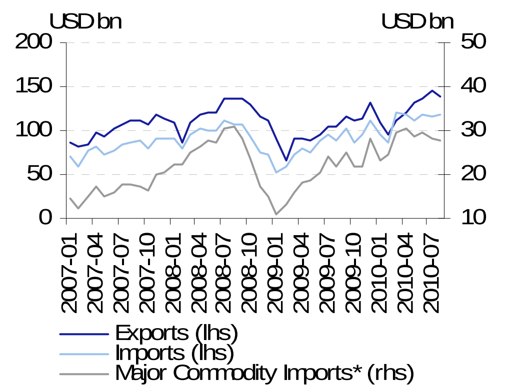


Source: CEIC and BBVA Research

On the external front, despite some slowing in year-on-year terms due to base effects (to 25.1% y/y in September from 34.4% the preceding month), exports remain strong, and have now recovered to above their pre-crisis peak in nominal USD terms (Chart 9). China's top export destinations are still the EU and US (a combined share of about 40%); however, the share of exports to other countries is rising. China's exports to Latin America now account for above 6% of total exports. Manufactured products still contribute most to China's export structure (96 percent).

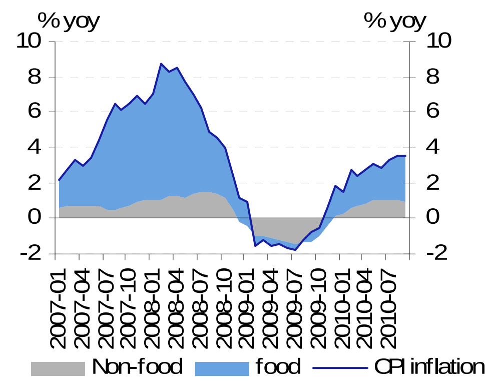
Year-on-year import growth also eased in September (24.1% y/y), but remains high in level terms reflecting robust domestic demand. Significantly, imports of commodities—which have fuelled demand from commodity-rich regions—is showing signs of tapering off due to reduced stock-piling and an easing in government-led infrastructure projects.

Chart 9
Export and import trends are robust, with signs of weakening commodity demand



Note: *includes metal ore and products, coal, and oil.
Source: CEIC and BBVA Research estimates

Chart 10
CPI inflation has been rising on food prices and global commodity prices



Source: CEIC and BBVA Research

CPI inflation has been rising on a further increase in food prices

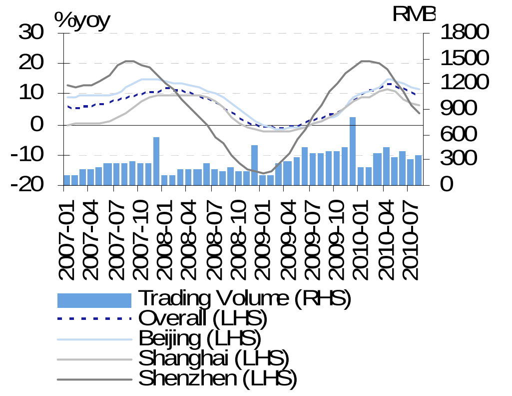
Headline CPI inflation has been rising somewhat ahead of expectations and above the government's perceived comfort level (generally thought to be around 3%), due to an ongoing increase in food prices (Chart 10). Inflation reached a two-year high of 3.6% y/y in September, up 0.6% m/m from August (non-seasonally adjusted). Nonfood inflation, on the other hand, has been relatively muted. Producer prices, on the other hand, are easing, with PPI inflation standing at 4.3% y/y in September.

We expect headline inflation to ease during the remainder of the year, to 3.2% y/y in December, given sufficient capacity in the economy, expected increases in agricultural output, and government measures to curb further food price hikes. Nevertheless, there are upside risks to the inflation outlook, especially as rising food prices, which were previously thought to be temporary due to weather disruptions, now appear to be more entrenched reflecting demand-side pressures. Inflationary expectations and wages are also on the rise. Minimum wage hikes this year have amounted to 20-30%. Third quarter average wage in the manufacturing sector has increased 6.4% from the second quarter.

The authorities continue to monitor trends in the property sector, on signs of a pickup

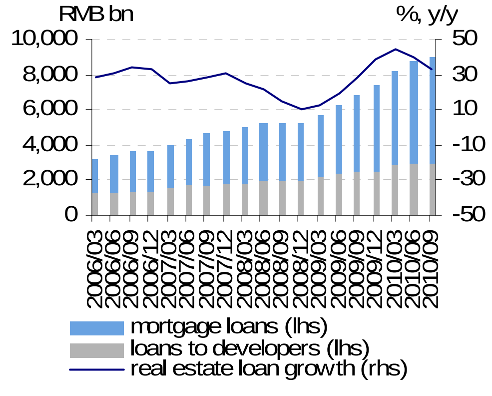
The authorities have recently intensified measures to cool the property sector on signs that transaction volumes and prices have been picking up following a recent cool-down. The authorities remain especially vigilant in monitoring trends in the property sector given their concern about destabilizing asset price bubbles and, from a social perspective, housing affordability. Following measures introduced last April, the authorities have recently clamped down on the enforcement of down payment requirements and prohibition on mortgages for third home purchases. More recently, they reduced the discount that banks are allowed to apply on mortgages for first-home purchases, to 15% from 30% previously. At the central government's urging, municipal governments have also stepped up their enforcement efforts, and discussions continue on the possible introduction of a property tax on a pilot basis, in cities such as Shanghai and Shenzhen as early as next year. On the supply side, the authorities are also stepping up efforts to promote investment in affordable housing and increase the availability of land.

Chart 11
The property sector is cooling, although signs of a pick-up remain ever-present



Source: CEIC and BBVA Research

Chart 12
Real estate credits are decelerating, but loan growth remains high



Source: CEIC and BBVA Research

Property prices (NBS data for the largest 70 cities) rose by 9.1% y/y in September, a further moderation from 9.3% y/y in August, but a month-on-month increase of 0.5 percent from August (Chart 11). Sales transactions also increased. Meanwhile, credit growth in the real estate sector continues to moderate in year-on-year terms, with loans to real estate developers decelerating more than mortgage lending (Chart 12).

Fiscal policy remains expansionary and supportive of growth

Despite efforts to rein in rapid credit growth through quantitative measures and, more recently, an interest rate hike, the thrust of fiscal policy remains broadly growth supportive. The overall 2010 budget deficit is expected to amount to 2.8% of GDP, same as the share in 2009. This stance reflects the ongoing implementation of the authorities' two-year stimulus package adopted in early 2009, including efforts to promote infrastructure development. The focus of public investment is now on the extension of existing infrastructure projects. A major source of infrastructure spending is on expanding China's vast railway network. In the third quarter, three major railway projects were undertaken, covering 567 km of the railway network in the North-eastern industrial districts and the less developed provinces of Yunnan and Tibet. In addition, local governments are also implementing their own set of development projects. For example, the government of Beijing is undertaking a public transportation network project for 12 metro lines covering 300 km. By end-2010, the highway network for the city will be completed consisting of four new expressways.

The authorities have yet to release detailed information on budget targets for 2011 (the budget will be finalized early next year). We expect the thrust of fiscal policy to remain growth-supportive in 2011, in line with newly announced medium-term policy targets which aim at supporting social well-being, investment in public housing, and a narrowing of the income gap (see discussion below on the next 5-year plan). The government has also announced an extension of subsidy programs to support consumption of durable goods and automobile purchases through 2011.

Spending initiatives remain easily financeable given the central government's substantial resources and its still-low public debt-to-GDP ratio of just below 18% of GDP (together with local governments, total public debt may be as high as 40% of GDP). Public finances at the local government level may be somewhat less healthy due to the build-up of public debt incurred through local government financing vehicles (LGFVs). According to data provided by the China Bank Regulatory Committee (CBRC), outstanding loans to such vehicles amounted to RMB 7.66 trillion as of June 2010 (19.2% of total bank loans), of which almost one-quarter were deemed to be at risk of default.

In contrast, monetary policy tightens up…

As noted above, given signs of strong growth momentum, rising inflation, and renewed speculation in the property sector, the authorities have recently intensified efforts to rein in credit growth and increase borrowing costs. In addition to stepped-up administrative measures in the real estate sector, in mid-October the People's Bank of China (PBoC) raised the required reserve ratio (RRR) for six major commercial banks by 50bp, to 17.5%. The move was the fourth hike in the RRR this year, and the first such move since last May.

Following the hike in the RRR, in mid-October the PBoC raised its benchmark interest rates for the first time since December 2007. Specifically, the one-year benchmark lending rate was raised to 5.56 percent and the one-year benchmark deposit rate was increased to 2.50 percent (in addition, 6-month deposit rates were raised by 22bps, and 5-year deposit rates were raised by 60bps; the 5-year lending rate was increased by 20bp). The rate hike took markets by surprise, as official statements had led observers to expect that additional quantitative measures, rather than rate hikes, would be forthcoming to rein in credit growth. We believe the move—which we had anticipated in Q4 in our last quarterly *China Economic Outlook*—marks the beginning of a new rate hike cycle. While it is possible that another rate hike could be forthcoming before the end of the year, in all likelihood we expect the next move to occur in Q1 of 2011.

…and banks step up effort to raise capital

Despite the authorities' efforts to restrain credit growth, profitability in the banking sector remained high during the first half of 2010 (see *China Banking Watch*). Net interest margins (NIM) improved steadily and outstanding loan volume increased in line with the fully year target of RMB 7.5 trillion. Interest income rose 27% y/y, while fee and commission income grew at an even faster pace of 35% y/y on strong demand. Meanwhile, the NPL ratio declined to a record low of 1.3% (due both to an increase in outstanding loans and a decline in the level of non-performing loans).

There are pressures on banks to raise new capital (market speculation is that the CBRC may raise capital standards by the end of 2012; currently the capital ratio is 11.5% for large banks). During the first eight months of 2010, listed banks had raised RMB 330 billion in new capital. Going forward, more capital raising plans are expected to be implemented with an amount of up to RMB 320 billion through Q4 2010 and the first half of 2011.

Modest currency depreciation, despite external inflows and international pressure

Since the re-adoption of a more flexible exchange rate framework in June this year, the RMB has appreciated by just 2½% against the USD, reflecting the authorities' gradual approach to currency realignment (Chart 13). In nominal effective terms, the currency has actually depreciated in the past few months given the decline in the value of the USD, although in real terms there has been a modest appreciation (Chart 14). The pace of appreciation is more or less in line with our existing baseline scenario, which anticipates a further gradual appreciation of the RMB, amounting to 4-5% for the year as a whole by year-end. While modest, our expected pace of appreciation exceeds the 3% currently priced in to 12-month forward NDFs.

We believe that the authorities recognize the benefits of currency appreciation for the domestic economy, as one of the ingredients of the policy package to bring about a rebalancing of growth toward domestic sources and boosting private consumption. Despite rising international pressure, we view prospects for a significant acceleration in the pace of revaluation to be low in the near term, given the authorities' preference for gradualism, concern about the strength of the global recovery, and fears of generating speculative capital inflows (see below).

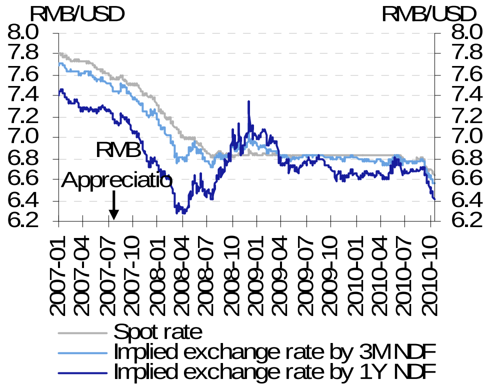
Steps are being taken toward the gradual internationalization of the RMB

Although full convertibility of the RMB still remains a long-term goal, the authorities are taking incremental steps in the mean time toward the eventual internationalization of the RMB. Such steps include the introduction of a program of cross-border RMB trade settlements and the establishment of offshore RMB investment channels. A pilot program for RMB cross-border trade settlement was expanded last June to 20 provinces and municipalities with China and to all foreign nations. The scope of the pilot program has also been expanded to include the settlement of other current accounts besides trade in goods. As an indication of potential for a full-scale RMB market, after a slow start, the volume of RMB deposits in Hong Kong has been rising sharply in recent months (Chart 15), due in part to expectations of RMB appreciation.

Hong Kong has been designated as the main offshore center for RMB business, under a supplementary Memorandum of Cooperation signed between the PBoC and the Hong Kong Monetary Authority (HKMA) last July. In August, the PBoC issued a circular allowing RMB settlement banks in Hong Kong and Macao, foreign banks participating in the RMB cross-border trade settlements, and foreign central banks or monetary authorities, to invest in China's interbank bond market (with the permission of the PBoC). This is an important step toward increasing incentives to hold RMB outside of China. Another initiative is the development of an offshore RMB denominated bond market. Following issues by Hopewell Infrastructure and the McDonalds Corporation (worth 1.4 and 0.2 billion yuan respectively), the Asian Development Bank recently issued its first international RMB-denominated bond, of 1.2 billion yuan. The authorities are gradually showing an increasing willingness to allow RMB funds raised offshore to be repatriated to the Mainland for FDI investment, although approvals are still required on a case-by-case basis.

Chart 13

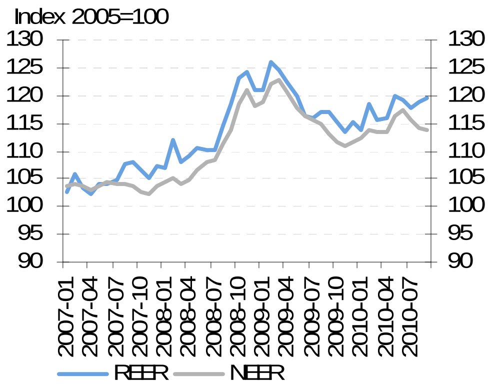
A gradual pace of appreciation so far



Source: CEIC and BBVA Research

Chart 14

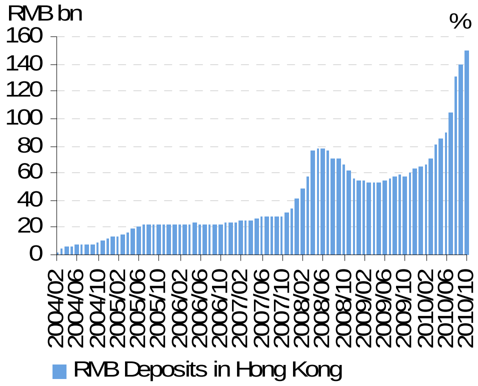
Appreciation of the nominal effective exchange rate has been limited so far



Source: NBS, CEIC and BBVA Research

Chart 15

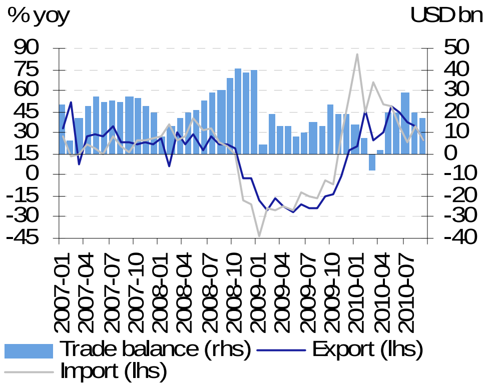
RMB deposits in Hong Kong have been rising sharply



Source: HKMA and BBVA Research

Chart 16

Trade surplus starting to narrow only recently



Source: NBS, CEIC and BBVA Research

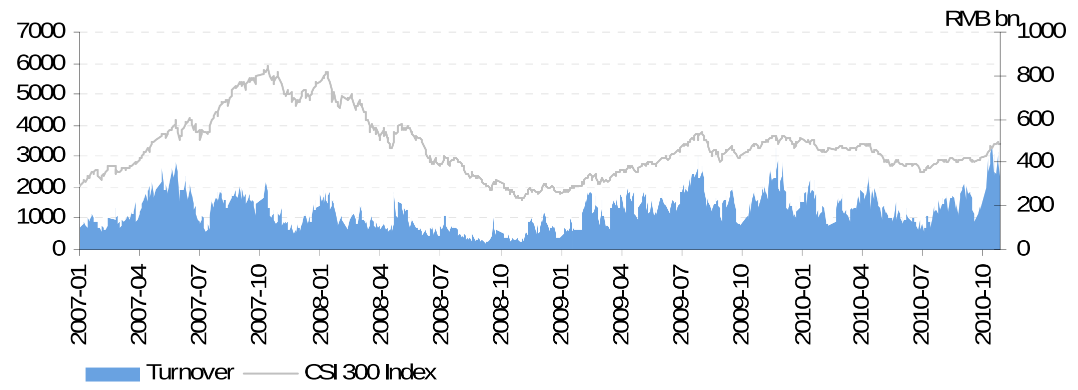
Balance of payments surpluses continue to mount, with a further build-up in reserves

Foreign-exchange reserves surged to USD 2.65 trillion at end-September, an increase of USD 194 billion for the third quarter, and a cumulative increase of USD 249.2 billion so far in 2010. Part of the increase, perhaps one-quarter, is attributable to valuation effects from the decline in the value of the USD (which increases the value of non-USD reserves). Nevertheless, the rise in reserves is one factor for renewed international pressure on the authorities to allow a faster pace of RMB appreciation.

In addition to a substantial trade surplus—USD 65.5 billion in Q3, compared to USD 41.0 billion in Q2—the rise in reserves is due to capital inflows, which accelerated following the introduction of the more flexible exchange rate framework, on expectations of further appreciation and increased global risk appetite. FDI inflows in Q3 amounted to USD 22.9 billion. After taking into account the trade surplus, and FDI inflows, we estimate hot money inflows for Q3 to be USD 20.0 billion, about double the Q2 level.

The stock market has rallied early October (Chart17) on strong macroeconomic data and the outlook for banking profitability. However, stock prices have become more volatile after the PBoC hiked interest rates, on market concerns of further tightening measures.

Chart 17
Stronger Stock Market Performance in Q3



Source: BBVA Research

3. Caution ahead: keeping growth within the speed limit

As described above, the authorities are continuing to implement fine-tuning policy adjustments in order to restrain credit growth to within their targets, and to keep a check on rising housing prices. At the same time, they are maintaining a supportive fiscal stance in order to achieve various policy objectives and as a guard against a sharp downturn in the external environment. Our outlook assumes that growth momentum will remain strong, and that the authorities will succeed in keeping growth within potential, thereby averting overheating pressures. Over the medium-term, and in line with the announced outlines of the 12th five-year development plan for 2011-2015, we expect a gradual rebalancing of growth toward domestic sources, underpinned by a gradual rise in the private consumption ratio.

Our baseline assumes growth will stay within potential, resulting in a soft landing

We now project full-year growth in 2010 to reach 10.1% (higher than our previous 9.8% projection), assuming a further moderation in growth in Q4 to 9.1% y/y (we expect growth to moderate to 9.3% y/y in H2, from 11.1% y/y in H1). For 2011, we expect growth to remain brisk, at 9.2%, as monetary policy continues to be gradually tightened alongside a supportive fiscal policy stance (Table 1). We expect growth in 2011 to be underpinned by consumption and investment growth of 9.7% and 8.6% respectively. In our baseline scenario, growth will remain just within potential, allowing inflation to moderate towards the end of the year as monetary policy is gradually tightened. We continue to expect the authorities to stay alert to risks of overheating during the rest of 2010 and 2011, and adopt further measures as necessary, including further interest rate hikes, administrative measures in the real estate sector, and additional "window guidance" to rein in credit growth in line with the annual target.

Table 1
Baseline Scenario

	2007	2008	2009	2010 (F)	2011 (F)
GDP (%, y/y)	14.2	9.6	9.1	10.1	9.2
Inflation (average, %)	4.8	5.9	-0.7	3.0	3.3
Fiscal bal (% of GDP)	0.6	-0.4	-2.8	-2.8	-2.3
Current acct (% of GDP)	10.9	9.6	6.0	5.6	5.0
Policy rate* (%)	7.47	5.31	5.31	5.56	6.06
Exch rate* (CNY/USD)	7.30	6.83	6.83	6.54	6.30

Source: BBVA Research

Our inflation projections have been revised to take into account the recent rise in the CPI. We now expect inflation to peak in October at 3.7% y/y, and to moderate in the remainder of the year, with an annual average of 3.0% (3.2% y/y by end of 2010). For 2011, we expect inflation to remain moderate, at 3.3%.

Monetary policy is expected to introduce further tightening

We believe that the recent interest rate hike marks the beginning of a new rate hike cycle. Accordingly, we expect at least two rate hikes in 2011, in Q1 and Q3 respectively, as the authorities watch for signs of further increases in inflation and property prices. Rate hikes are also likely to be accompanied by further fine-tuning adjustments to the RRR. Further administrative measures to cool down the market are also possible.

We are maintaining our expectations of further gradual currency appreciation against the USD, to 6.54 by end-year, amounting to a 4-5% appreciation for the full year (the currency has already appreciated by about 2½% in 2010), and at the same pace in 2011. The currency is likely to move in a two-way direction around this trend and at an uneven pace, as authorities continue to inject some volatility to reduce speculative hot money inflows due to anticipated appreciation.

The next five-year plan: future fiscal policies will support more balanced growth

Outlines of the next five-year economic development plan (2011-2015) have recently been disclosed, and will be finalized in March 2011. As expected, the emphasis is on rebalancing growth towards domestic demand, especially private consumption. As such, the authorities hope to achieve a more balanced growth pattern driven by a combination of consumption, investment and exports. The plan also emphasizes social wellbeing, with policies to address income inequality and regional development disparities. Fiscal policies are to be used to narrow rural-urban disparities and raise farmers' incomes.

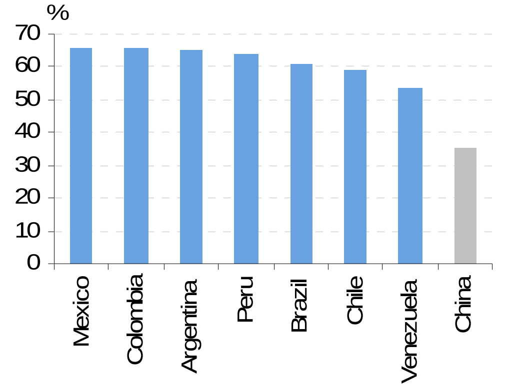
Another emphasis of the five-year plan is on strategic emerging industries including information technology, energy conservation and environmental protection, new energy, high-end equipment, new materials and new energy automobiles. The new energy-efficient automobile industry will also be supported by the government. In the meantime, policies are also to continue fostering the transformation and upgrading of the manufacturing sector and an acceleration of growth in the service sector.

The medium-term rebalancing of growth will be underpinned by rising consumption

While we expect China to maintain high growth rates over the medium term, the double-digit rates of the recent past are unlikely to be sustained. We estimate potential GDP growth will gradually moderate from above 9% in 2011 to just above 8% by 2015. The expected moderation is due to a combination of falling labor growth rates, and lower total factor productivity growth as the economy continues to develop.

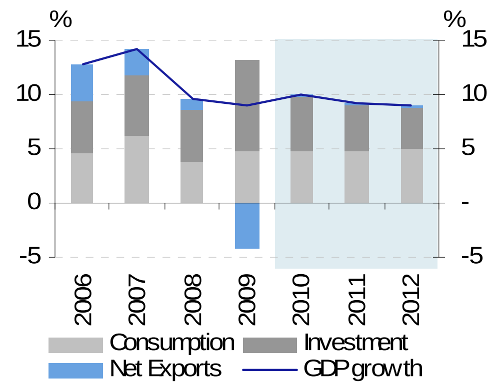
We see significant scope for a rise in the ratio of consumption-to-GDP, which is very low in relative terms (Chart 18). Policy initiatives have been supporting a gradual rise in consumption, including fiscal incentives, enhancements to the social safety net that should reduce the need for precautionary savings over time, and the move toward currency appreciation. Urbanization and rising wages should also support this trend. Accordingly, our medium-term projections incorporate a gradual rotation of growth toward private consumption, rather than reliance on exports and investment (Chart 19).

Chart 18
China's consumption rates are low by international comparison



Source: CEIC and BBVA Research

Chart 19
A rebalancing of growth over the medium term



Source: NBS, CEIC and BBVA Research

4. The risk pendulum swings back toward overheating

Risks are broadly balanced between overheating on the one hand, and a deceleration in growth from a weaker external environment on the other hand. That said, the recent strength of data and rising inflation suggest that the risk pendulum has, at least for the time being, swung back toward overheating. Mitigating these risks are the authorities' progressive and timely tightening measures. Moreover, if external demand were to weaken by more than expected, the authorities continue to have room to cushion the impact through fiscal stimulus.

Risks of asset price bubbles, especially in the property sector, remain present and are being exacerbated by capital inflows. That said, and as documented in our 2010 *Real Estate Outlook*, price increases have not been especially large in comparison to international experience, and the authorities' timely efforts to cool the sector should help to prevent a boom-bust cycle from materializing.

Another risk, albeit one for the medium term, is the possibility of rising non-performing loans in the banking system following the rapid credit growth over the past year. Banks' exposure to local government financing vehicles (LGFVs) continues to bear special watch. It is encouraging that the authorities have taken steps to discourage the build-up of further exposure both on behalf of borrowing local governments and on the banks. Real estate developers' recourse to finance from trust companies is another risk to the financial system that bears watch.

Rising global currency tensions have put China's RMB appreciation in the spotlight. Given the divergence in growth performance between China and its industrialized trading-partner countries, tensions over currency policy are likely to persist, although progress in the G-20 dialogue and the passing of mid-term elections in the US may help to tone down some of the rising political rhetoric. Nevertheless, protectionism will remain an ongoing threat in the current environment. Recent diplomatic disputes between China and Japan could have economic spillovers on trade and economic relations between the two nations.

5. Tables

Table 2

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2007	2008	2009	2010 (F)	2011 (F)
U.S.	2.1	0.4	-2.6	2.7	2.3
EMU	2.9	0.3	-4.0	1.6	1.2
Asia-Pacific	7.6	4.2	2.0	6.8	5.5
China	14.2	9.6	9.1	10.1	9.2
World	5.3	3.0	-0.6	4.7	4.1

Source: BBVA Research

Table 3

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2007	2008	2009	2010 (F)	2011 (F)
U.S.	2.9	3.8	-0.3	1.6	1.2
EMU	2.1	3.3	0.3	1.6	1.7
Asia-Pacific	2.8	4.9	0.3	2.8	2.7
China	4.8	5.9	-0.7	3.0	3.3
World	4.1	6.1	2.2	3.6	3.5

Source: BBVA Research

Table 4

Macroeconomic Forecasts: Exchange Rates (End of period)

		2007	2008	2009	2010 (F)	2011 (F)
U.S.	EUR/USD	0.70	0.70	0.70	0.80	0.80
EMU	USD/EUR	1.40	1.50	1.40	1.30	1.30
China	CNY/USD	7.30	6.83	6.83	6.54	6.30

Source: BBVA Research

Table 5

Macroeconomic Forecasts: Policy Rates (End of period)

	2007	2008	2009	2010 (F)	2011 (F)
U.S.	4.3	0.6	0.3	0.3	0.3
EMU	4.0	2.5	1.0	1.0	1.0
China	7.47	5.31	5.31	5.56	6.06

Source: BBVA Research

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