

China's Outlook:  
Many strengths but also many  
challenges

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## Roadmap to presentation

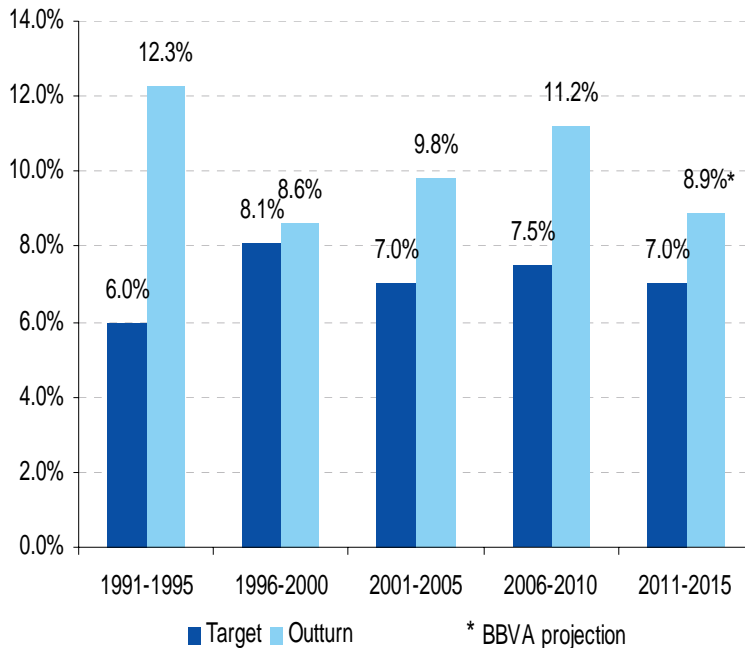
- China to be the largest economy in the world
- Growth engine to stay for quite some time
- RMB to become international
- However important challenges both
  - *Short term*
  - *And more importantly, medium term*

## China: to become largest economy in the world well before 2020

- China's GDP has grown an average of 10% per year during last 10 years
- Potential growth is slowing, but is unlikely to fall below 8% any time soon
- Our projections point to China over-taking the US before 2020

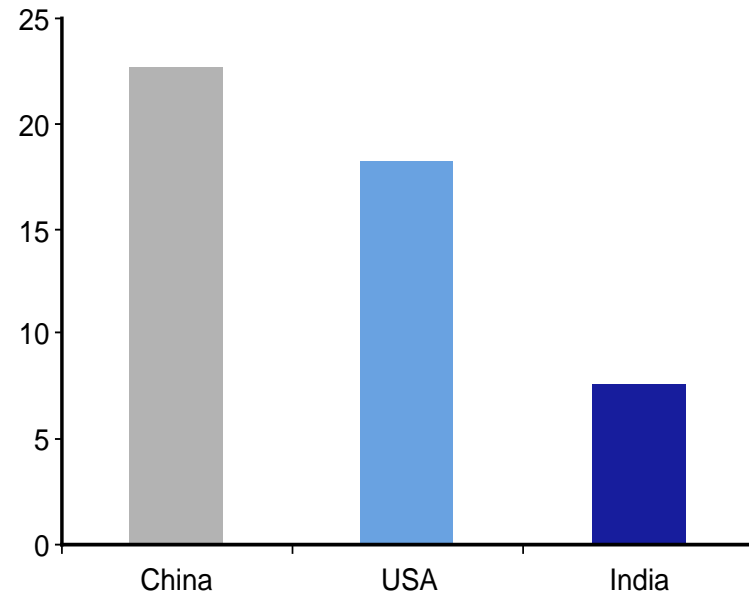
### GDP growth targets and outturns

Source: CEIC & BBVA Research



### GDP adjusted by PPP: level in 2020 (trillions)

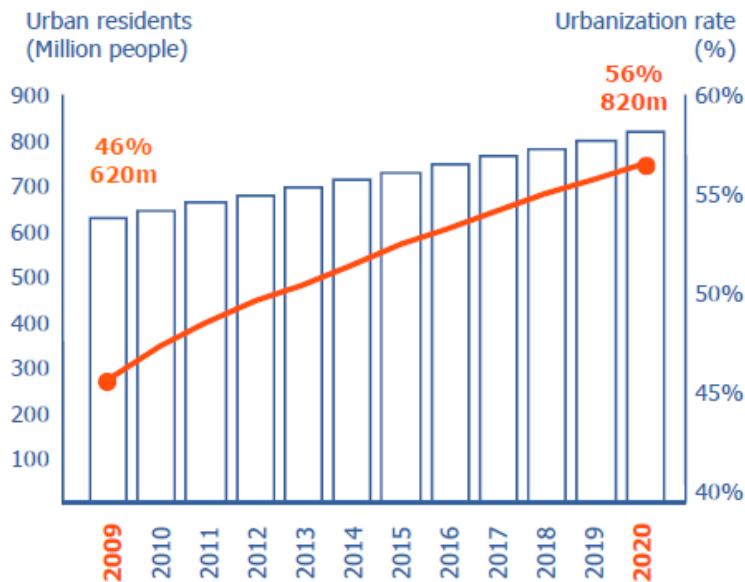
Source: BBVA Research and IMF



## China: very resilient to internal shocks

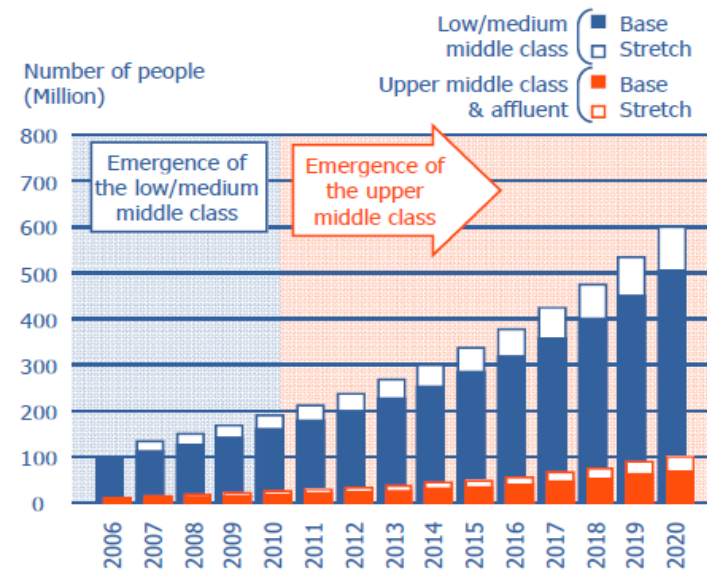
- Internal shocks (social and/or political) are possible, but unlikely
- Rapid and continuous growth of household income and wealth contribute to stability
- 12<sup>th</sup> 5-year Plan emphasizes “high-quality and equitable” growth and more private consumption

### Urbanization rate is set to grow to 51.5% by 2015



Source: China City Planning & Design Institute.

### Income gains will lead to a larger middle and upper middle class



Source: InterChina analysis.

Note: Low/medium middle class = USD 4-12,000.

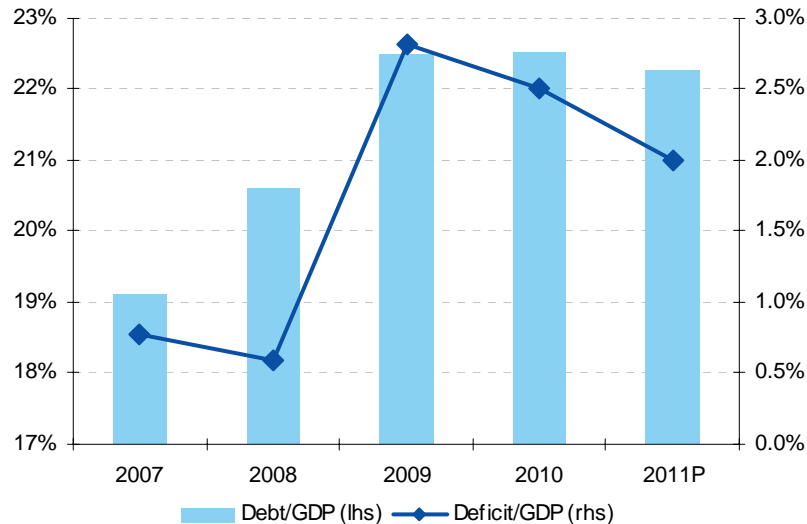
Upper middle class & affluent > USD 12,000.

## China: even more resilient to external shocks

- High FX reserves not only understood as a cushion to external shocks but also in as wealth: to restructure banks and buy companies abroad: **mercantilist approach to reserves**
- Current liabilities are low but large contingent liabilities: (local government debt and pensions).

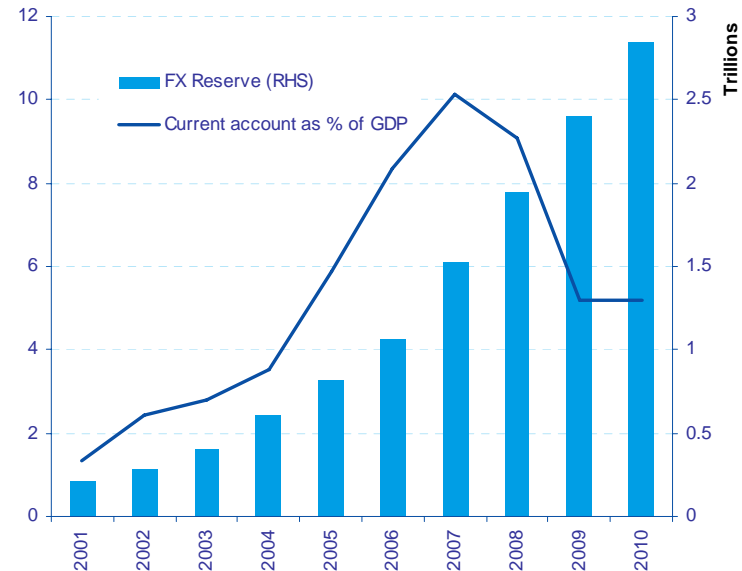
### Sustainable debt and deficit levels

Source: BBVA Research



### FX Reserve is accumulating...

Source: BBVA Research

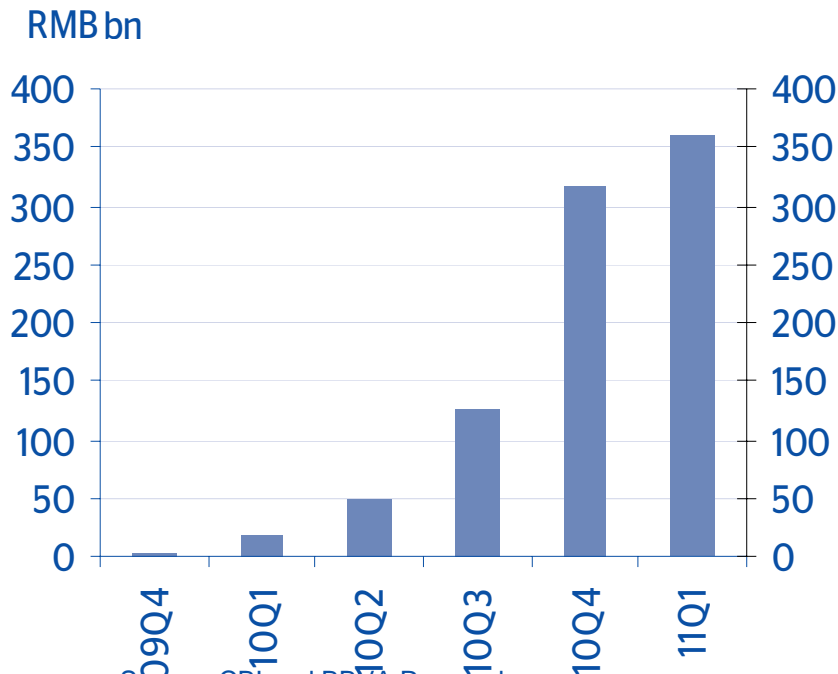


## Internationalization of RMB: invoicing function

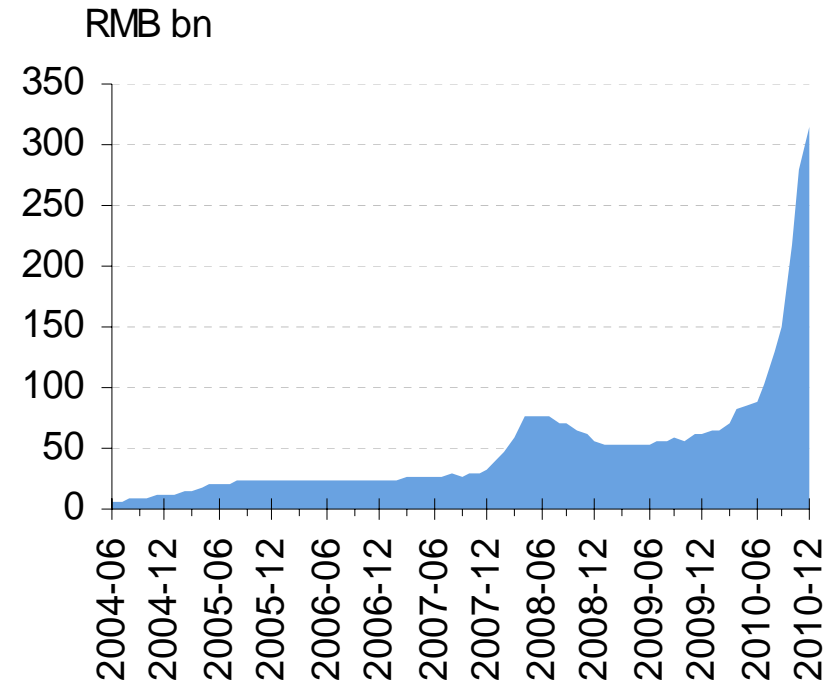
- Trade settlement program: first step, even before opening capital account
- Hard to know how much is speculative (expecting RMB appreciation)
- Very rapid accumulation of HK resident deposits in RMB (10% of total)

### Value of RMB cross-border settlement

Source: CITIC and BBVA Research



### RMB deposits in Hong Kong are surging

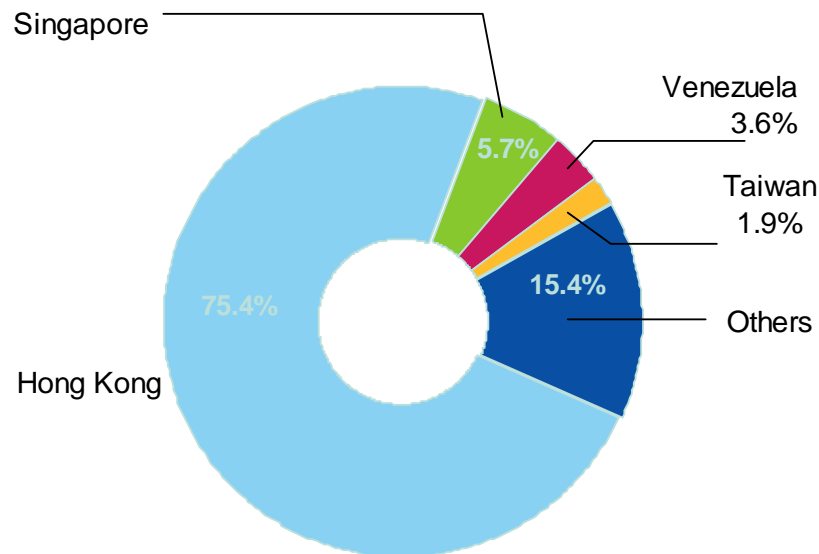


Source: CBI and BBVA Research

## Internationalization of RMB: investment/borrowing function

- HK is so far the only off-shore centre where RMB denominated bonds can be issued
- Chinese public sector first to issue, followed by HK banks incorporated in China, then foreign investment grade companies and now also foreign junk bonds

### Hong Kong is now a major off-shore RMB centre



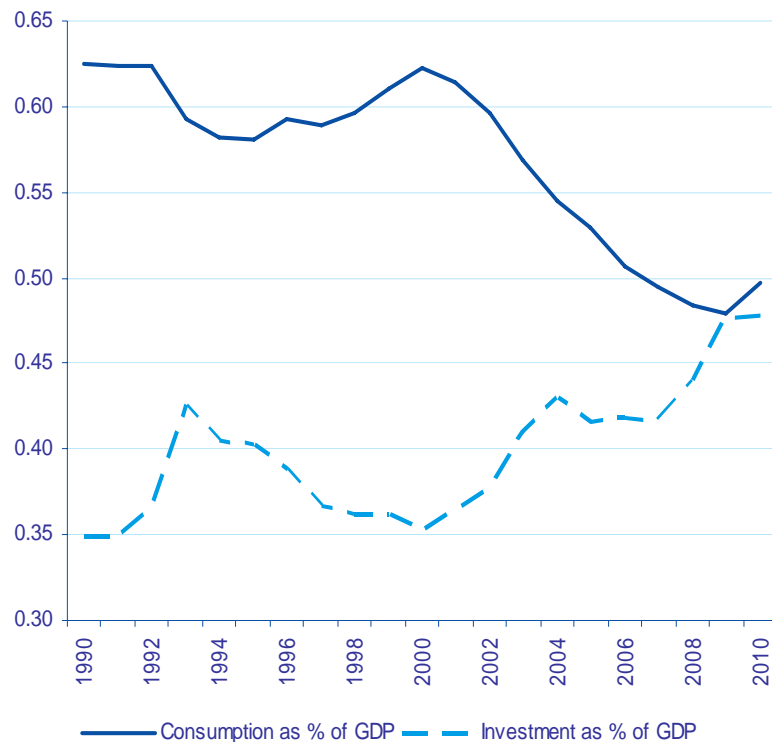
\* As of November 2010

Source: CITIC and BBVA Research

## China's more immediate challenges

### 1. Rebalancing growth towards private consumption

Composition of China's growth



Reasons to rebalance:

- External demand from the West will not recover any time soon (maybe never since potential growth will be lower)
- Investment can no longer play the growth engine (especially once urbanization reaches its limit)



## China's more immediate challenges

### 2. Inflation has become the predominant near-term policy concern

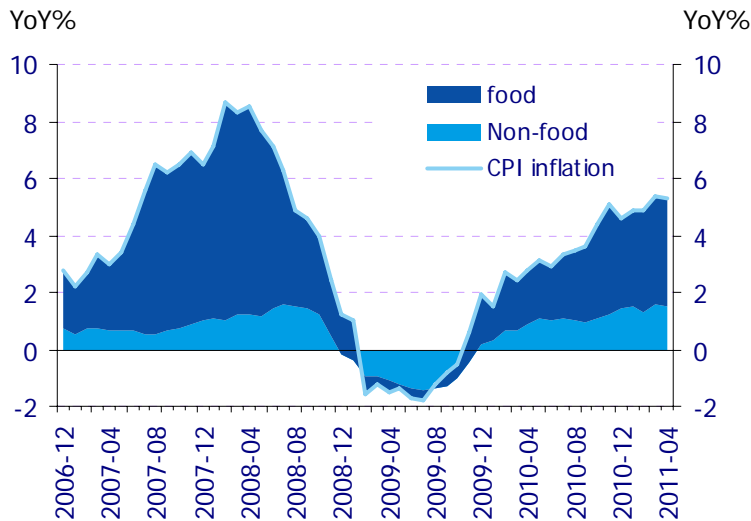
- Reaching 5.3% y/y in April, driven by rising food and housing costs.
- Strong labor demand pushing up wages, adding demand pressures to inflation

Inflation is above the authorities' comfort range and is the most pressing policy issue...

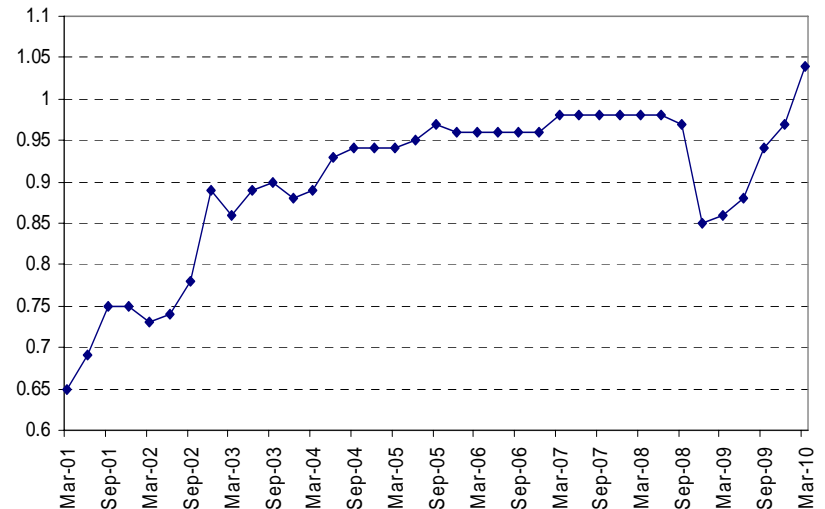
Source: BBVA Research

Demand for labor temporarily dropped due to the global economic downturn, but has been increasing rapidly...

Source: BBVA Research



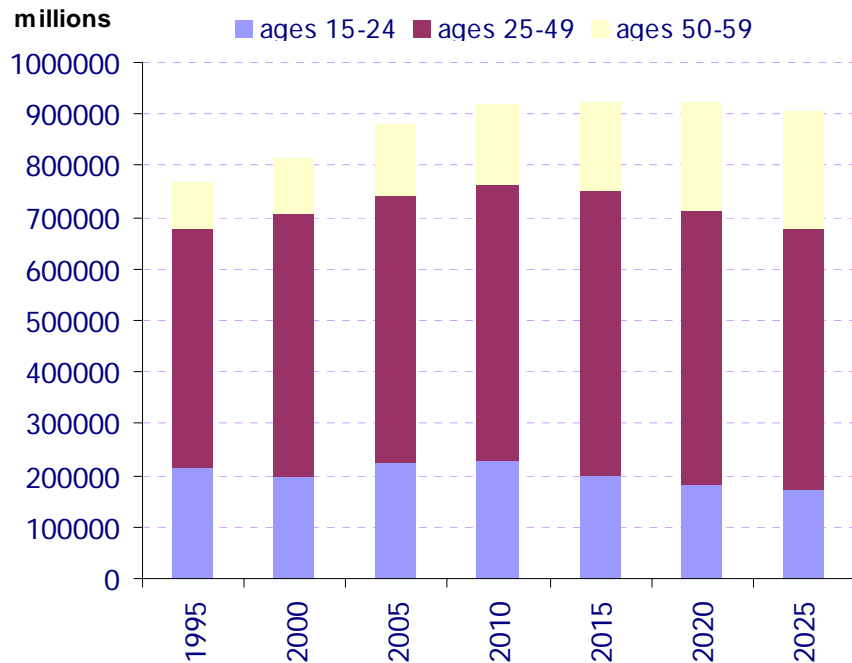
Urban Labor Demand-Supply Ratio in China



## China: Medium-term challenges

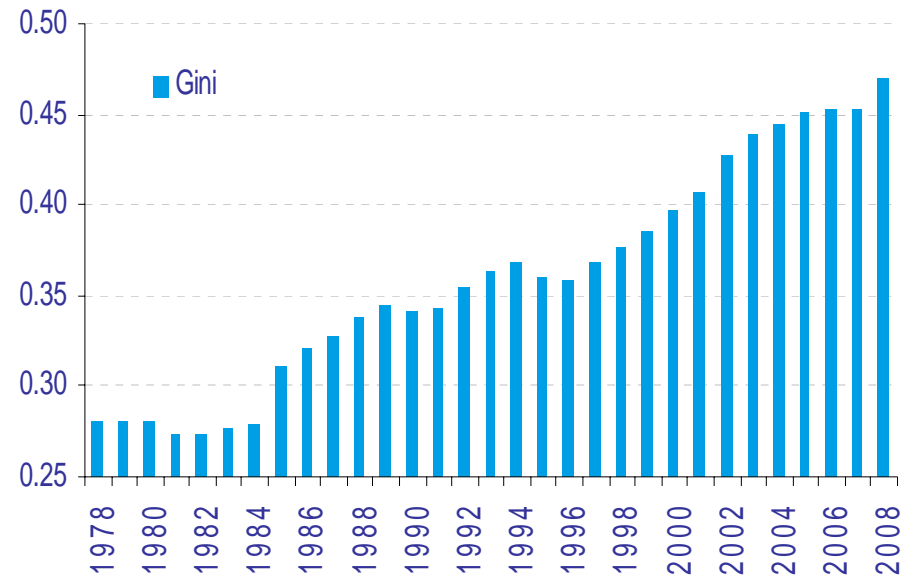
1. **Aging:** still distant but most important since it will bring lower productivity and growth as well as huge liabilities (pensions, health, etc)
2. **Growing income inequality:** currently high growth may allow China to avoid the social problems related to it but consequences bound to increase when growth slows downs and population ages

### China's Aging Population



Source: United Nations Populations Division

### Gini Coefficient of China



Source: BBVA Research

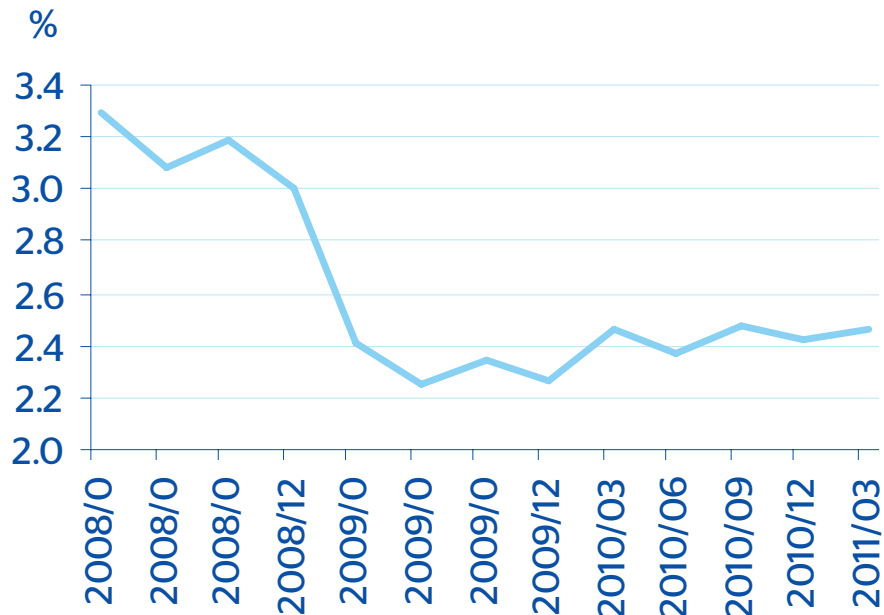
## China's medium term challenges

### 3. Financial & capital account liberalization to take place: what about financial stability?

- First mentioned in 5 Year Plan and second needed to support RMB internationalization
- Interest rate liberalization will intensify competition squeezing bank margins
- Capital account liberalization will open up invest options/diversification

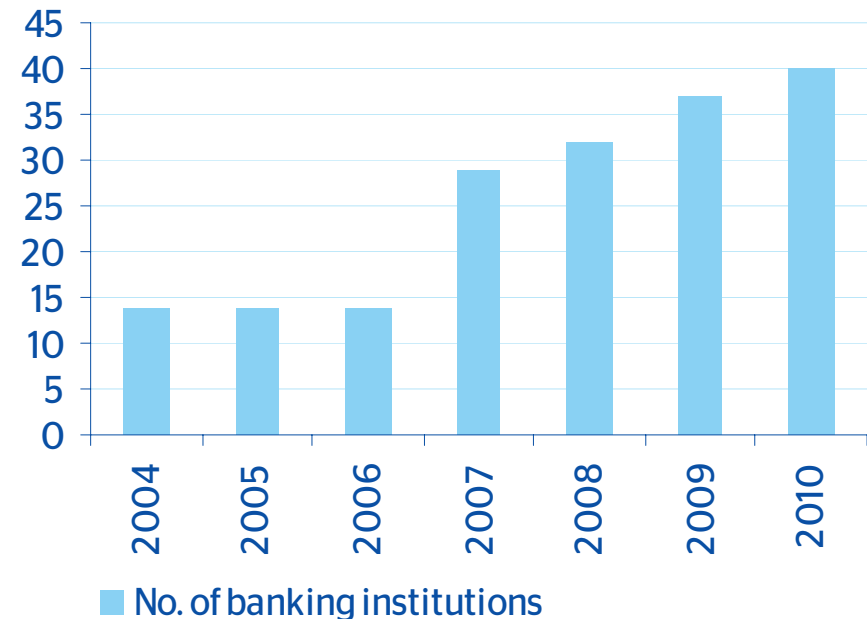
#### Net interest margins till high, but likely to fall further

Source: BBVA Research



#### The market is luring more foreign banks

Source: BBVA Research



## Conclusions

- China's outlook is very promising, but there are challenges
- Short-term challenges are important, but manageable.
- The longer term challenges of ageing population and income inequality may be more difficult to manage.