

Economic Outlook

China

Third Quarter 2012
Economic Analysis

- **The outlook for global growth is highly dependent on timely policy implementation in Europe and the US.** Following a deterioration in economic conditions in the first half of 2012, our updated global scenario envisages a slight rebound in 2013.
- **After slowing more than expected so far this year, China's growth is beginning to stabilize** with fiscal and monetary policy support. We expect momentum to pick up gradually during the rest of the year, bringing full-year growth to 7.8% and 8.3% in 2012-13, around 0.5ppts lower than our previous projections.
- **With inflation remaining soft, there is room for additional policy measures to support growth.** This includes further monetary policy easing, with 150bps of reductions in the RRR and up to two more interest rate cuts in 2012. Fiscal policies are also turning more growth supportive.
- **Currency appreciation has reversed due to the weak external environment.** With exports slowing, we are scaling back our forecasts of appreciation for the rest of the year, to 6.32 per USD at end-2012, with gradual appreciation resuming in 2013.

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Summary

China's GDP growth has slowed by more than previously expected, giving rise to an increasingly forceful policy response to support domestic demand. GDP growth decelerated to 7.6% y/y in 2Q12 from 8.1% y/y in 1Q12 on slowing exports and sluggish private consumption. With monetary and fiscal policies turning more growth supportive, recent activity indicators, although still mixed, suggest the slowdown in domestic demand may be stabilizing.

We are revising down our 2012-13 growth projections to 7.8% and 8.3% (from 8.3% and 8.7% previously). The revisions are due to a combination of the slower growth outturns so far this year as well as the weaker global outlook. Our projections anticipate a gradual pickup in growth momentum during the remainder of the year as investment and consumption are supported by the easing monetary and fiscal stance.

Inflation has declined faster than expected on slowing growth and lower commodity prices, to 1.8% y/y in July. After bottoming out in July, inflation is expected to rise gradually to around 3% by the end of 2012 on base effects and as GDP growth gathers pace. Such an outturn would be well within the government's 4% tolerance level, providing room for further policy support.

The authorities are likely to implement further stimulus measures to support GDP growth. Since June, interest rates have been cut twice, on top of a series of cuts in the RRR since last November. We anticipate up to two interest rate cuts of 25bps each during the remainder of the year, accompanied by additional 150 bps of reductions in the RRR. Fiscal initiatives are also being implemented, including increased spending on infrastructure projects, construction of affordable housing, consumption subsidies, and tax cuts. The initiatives are similar in spirit to those implemented during 2008-09, but are much smaller in scale.

Currency appreciation has reversed on account of the weak external environment, narrowing current account surplus, and slower reserve accumulation. The RMB has depreciated slightly against the USD so far this year, although it has still appreciated in effective terms due to the USD's relative strength. With exports slowing, we are scaling back our forecasts for appreciation during the remainder of the year, to 6.32 per USD at end-2012, with gradual appreciation resuming in 2013, at about 3% per year.

Domestic financial fragilities still remain, but appear manageable in view of the authorities' recent efforts to contain them. Downward property price adjustments have recently stabilized, and a pick up in bank lending is helping to ease a credit crunch in the informal shadow bank market, a further buildup in local government debt has been curtailed. That said, recent stimulus measures can be expected to reverse the decline in these financial risks. As such, they should be monitored, and remain a challenge over the medium term.

The main near-term risk to the outlook is from the uncertain global environment due to the evolving sovereign debt and financial crisis in Europe. Export growth has recently slowed by more than expected, and heightened global risk aversion has had a chilling effect on domestic investment and financing conditions. If downside risks intensify further, we would expect policy stimulus to be stepped up to sustain growth in line with the targets of the Five-year Development Plan (around 7%).

Despite the current difficulties stemming from the global environment, we remain optimistic about China's ability to restore growth over the medium term. On the basis of a further gradual rebalancing of growth toward domestic consumption, overall GDP growth is expected to rise above 8% in 2013 and beyond, although a number of important challenges remain, including aging population, containing financial fragilities, and enhancing social protection.

1. Summary: a slowdown that may deepen without decisive policy action

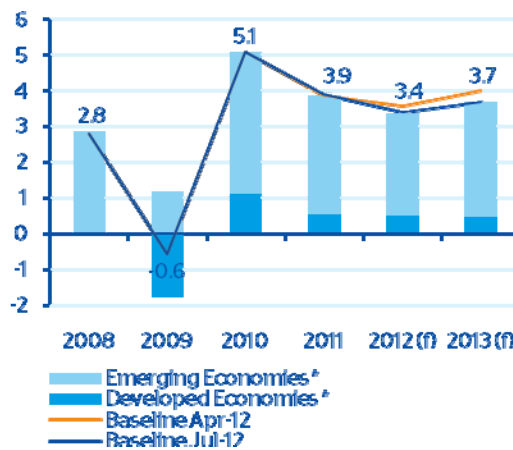
Before turning to China, we review the **Global Outlook**. Readers may go directly to the sections on China, if they wish, by turning to page 6.

Global growth will improve only with key policy implementation

After the deterioration in global economic conditions in the first part of 2012, our updated scenario envisaging a slight economic rebound in 2013 is dependent on economic policies. Our global GDP growth forecast stands at around 3.5% in 2012-13, on the assumption that several global policy measures are implemented. Some of them have already been announced or approved but await implementation; others have yet to be passed. Policy measures are needed to prevent a further financial deterioration in Europe, a steep US fiscal adjustment in 2013, and a slowdown in emerging economies.

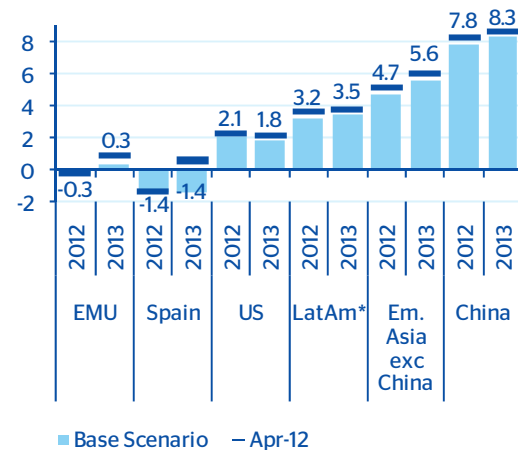
At their policy summit in June, Eurozone leaders reached significant agreements to reinforce the currency union, including unified banking supervision in the euro area, far-reaching plans for banking and fiscal issues, and growth-supporting measures. However, financial-aid mechanisms to ensure financial stability (i.e., EFSF & ESM) still must be used to their full extents to prevent a financial "accident." In the US, an agreement is needed to prevent automatic spending-cuts and the expiration of tax cuts from taking effect at the beginning of 2013. Such a "fiscal cliff" would push the US economy back into recession. The presidential campaign makes an agreement difficult before the election.

Chart 1
Global GDP growth (%) to pick up in 2013



(*) Growth contributions
Source: BBVA Research

Chart 2
GDP growth (%) is being led by emerging markets



(*) LatAm: Arg, Bra, Chi, Col, Mex, Per, Ven
Source: BBVA Research

Meanwhile, in emerging economies with room for policy stimulus, measures are needed to prop up domestic demand to mitigate the effects of the external slowdown. Additionally, volatility of capital inflows could increase due to the ebbs and flows of the eurozone crisis and prospects of a new round of quantitative easing by the US Fed.

Failure to instill market confidence could drag out the euro crisis

The main uncertainty over the current economic scenario is whether efforts to reinforce EU governance will be preceded by a further deterioration in the financial situation. The decisions already taken, if implemented forcefully and quickly, should suffice. These measures aim to eliminate emerging risks from the sovereign-banking feedback loop in Spain, and to stabilise financial markets across the eurozone with the active use of the EFSF/ESM in purchasing bonds in the primary and secondary markets. Recent policy measures in Spain to reign in the deficit and the strongly supportive stance by the President of the ECB are helping to ease tensions.

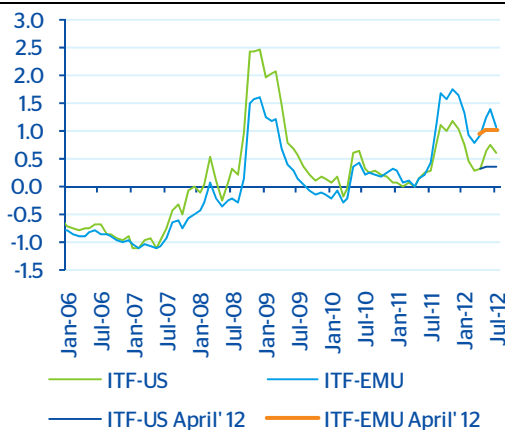
All in all we have revised downwards our previous forecasts of three months ago due to continued financial stress in the euro area and the deterioration in global economic confidence.

Our new scenario implies a period of stagnation in the Eurozone in 2012-13. The balance of risks continues to be tilted to the downside, given the likelihood that approved measures are introduced too slowly due to domestic-policy considerations in some countries.

The risk of a euro break-up, while still a tail event in our view, is fuelling the fragmentation of financial flows across the eurozone and impeding funding access for economies with a net debt position with the rest of the zone. Fast implementation of financial-aid mechanisms and reinforcement in size and access to the ECB's funding are key to eliminating the risk of a eurozone break up. In the end, the necessary measures will imply a transfer of national sovereignty to the European institutions with some form of liability sharing (debt mutualisation). If the challenges are met satisfactorily, global growth could gradually gain traction during 2H12.

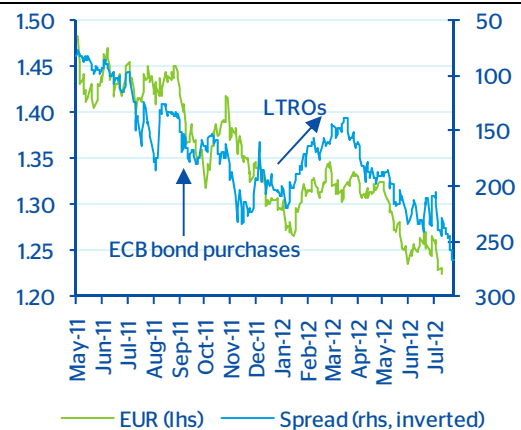
In the case of the US, the downward revision to our outlook for 2012 and beyond has been driven by a combination of disappointing growth figures in 1H12 and the impact of financial stress from the euro area. Emerging economies are likely to be the main drivers behind the slight acceleration in global GDP growth that we expect for 2013. In Latin America, despite a generalised downward revision in growth forecasts compared with three months ago, estimates for Mexico (3.7% and 3.0% for 2012 and 2013, respectively) remain unchanged thanks to upbeat activity data in 1H12, the continuation of favourable financing conditions in the domestic market, and gains in competitiveness. In Brazil, growth forecasts have been significantly revised downwards (to 2.2% from 3.3% in 2012) due to the impact of the external environment and domestic issues such as the slowdown in credit markets and loss of competitiveness.

Chart 3
Financial stress indicator, BBVA Research (*)



Source: BBVA Research and EPFR
(*) Tracks the trend of a series of financial variables, including stock market volatility, interest rates and exchange rates, sovereign and corporate credit risk and liquidity tensions.

Chart 4
USD-EUR and Spanish and Italian risk premiums, Average spread vs. 10Y Bund, bp; index Jan11=100



Source: BBVA Research and EPFR

As for Asia, growth in the first half of the year slowed in China by more than expected. In line with the weaker global outlook, we have accordingly revised down our projections for 2012-13. Nevertheless, monetary and fiscal measures to support growth should lead to a pickup in China, with growth in 2013 rising to 8.3%, a half percentage point higher than in 2012. Elsewhere in the Asia region there is also room for policy stimulus to support growth. But there are downside risks, including a more severe worsening of external demand and a continued slowdown in China, exacerbated by ongoing domestic financial fragilities.

Changing risk perceptions in developed and emerging markets

The risk scenario that dominates the forecast horizon (2012-2013) is more focused on the developed economies and in particular, on the Eurozone. Emerging economies have more room to manoeuvre with fiscal and monetary policies, and also have, overall, lower accumulated imbalances. There have been increasing capital flows from Europe into the US and the emerging markets, including those in Latin America. Since the end of May, when markets started pricing in that the US economy was running out of steam, yields on bonds that are traditionally regarded as risk-free sovereign assets (i.e., US and Germany) have fallen to historic low levels. Doubts surrounding the ability to reach a rapid solution of the euro crisis have been pressing in the same direction. But there are risks to the sustainability of this scenario.

2. Slowing growth spurs policy support

Against the backdrop of a sluggish global economy, China's growth continued to slow in the second quarter, to 7.6% y/y, prompting the authorities to step up their policy support. The slowdown has been more pronounced than previously expected, due in part to the effects of policy tightening in 2010-11 to prevent overheating, including curbs in the property market. Despite the slowdown, growth still remains above the authorities' official 7.5% target for 2012 and recent data, although mixed, suggest that growth is beginning to stabilize on the heels of monetary policy easing and stepped up fiscal spending.

Further policy stimulus measures can be expected in the coming months, albeit on a more limited scale compared to the massive stimulus program of 2008-09. While domestic financial fragilities persist in the form of inflated real estate values and a high level of local government debt, the legacy of the 2008-09 stimulus measures, they continue to be manageable in the near term. As such, while these fragilities are acting as a constraint on the size of new measures, there is still enough room for the authorities to stimulate the economy, in our view, without unduly exacerbating domestic financial risks.

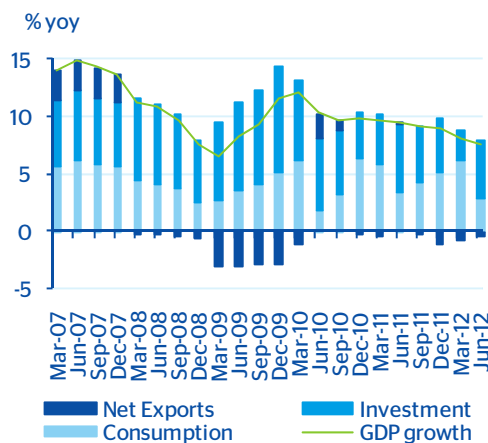
GDP growth has continued to slow, but is now bottoming out

GDP growth has now slowed for two consecutive quarters in year-on-year terms, to 7.6% y/y in the second quarter, the lowest level since Q4 2008, and down from 8.1% y/y in Q1 (Chart 5). In sequential terms, however, official data show a slight rebound, to 1.8% q/q seasonally adjusted from 1.6% in Q1 (in contrast, our own seasonal adjustment estimates are that sequential growth remained flat at 1.7% q/q in Q2 and Q1).

Weaker external demand has been a key factor for the slowdown, with net export contributing minus 0.4 ppts to GDP growth in Q2. Domestic demand has also weakened, but unlike the previous quarter, investment in Q2 picked up, contributing 5.0 ppts to GDP growth. In contrast, the contribution of consumption declined to around 3.0 ppts. With domestic demand remaining relatively resilient and exports weakening, the current account surplus has continued to narrow from its peak of 10.1% in 2007, to 2.3% of GDP in H1 2012 (in comparison to 2.8% in 2011) (Chart 6).

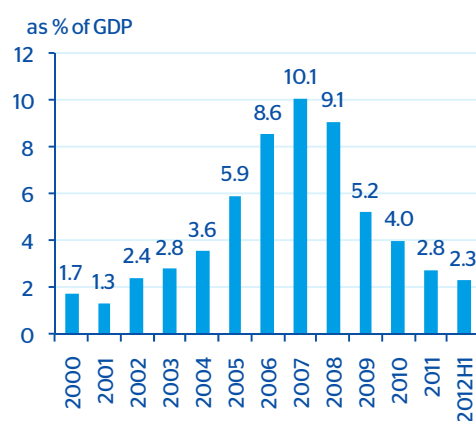
Some high frequency activity indicators have showing signs of stabilizing growth trends, especially on the demand side. In particular, growth of urban fixed asset investment has held up, at 20.2% year-over-year in Q2 (20.4% y/y in July), offsetting some moderation in retail sales growth (Chart 7). Meanwhile, the official Purchasing Manufacturers Index (PMI) has remained above the 50% expansion/contraction threshold, and the private sector PMI (Markit), whose composition is tilted toward smaller, more export-oriented firms, rebounded in July (Chart 8). On the production side, however, industrial output growth has moderated.

Chart 5
GDP growth declining on weak net exports and softer domestic demand...



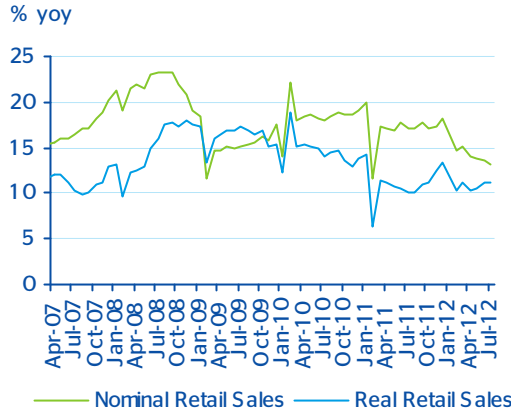
Source: CEIC and BBVA Research

Chart 6
A further narrowing of the current account surplus



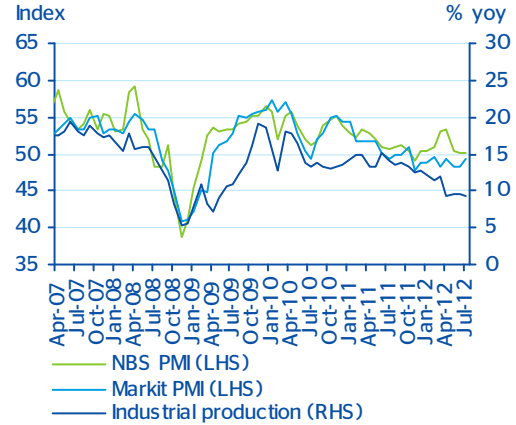
Source: CEIC and BBVA Research

Chart 7
Retail sales growth is slowing,
but remains reasonably robust



Source: CEIC and BBVA Research

Chart 8
PMI has been rising above the 50-threshold

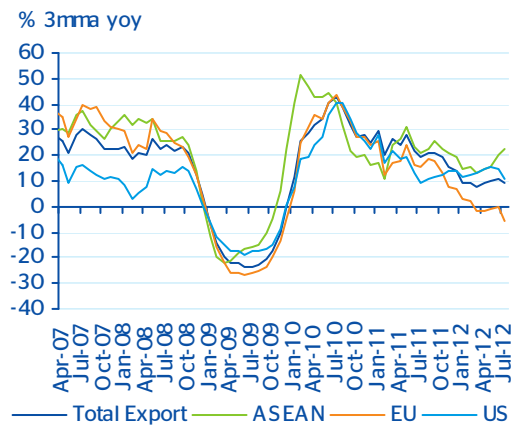


Source: CEIC and BBVA Research

The trade sector remains weak

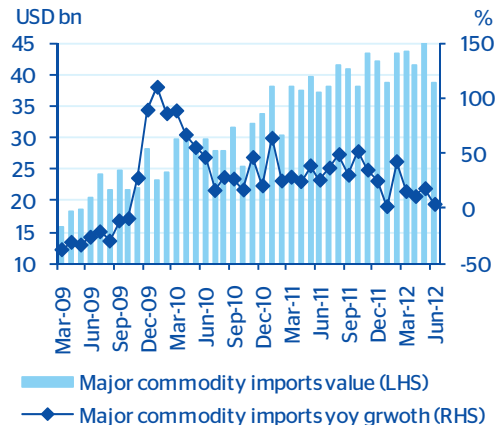
While the effects of previous policy tightening in 2010-11 are a factor, we believe that the most significant drag on growth has been the weak global environment. Although export growth rebounded slightly in Q2, to 10.6% y/y from 7.6% y/y in Q1, base effects were largely at play and more recent data has weakened further (exports grew by just 1.0% y/y in July). By destination, the EU has been consistently weak, while demand from other emerging markets has been more resilient (Chart 9). Meanwhile, import growth has slowed by somewhat more than expected reflecting a decline in commodity prices, and a levelling off of processing components related to slowing export orders (Charts 10 and 11). This combination has allowed the trade balance to remain in substantial surplus (Chart 12).

Chart 9
Export growth has declined, especially to the EU



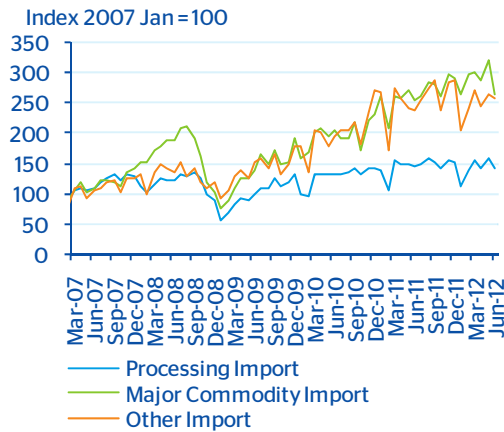
Source: CEIC and BBVA Research

Chart 10
Commodity imports
have declined with the fall in prices



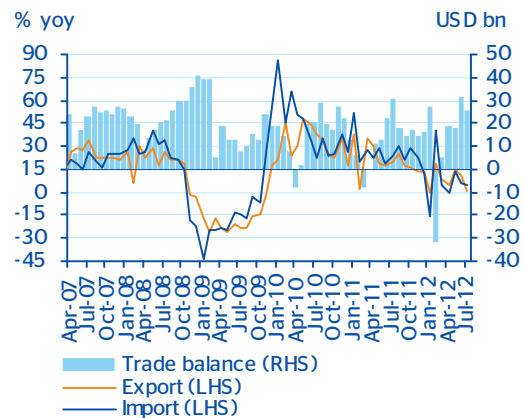
Source: CEIC and BBVA Research

Chart 11
Processing and commodity imports moderated



Source: CEIC and BBVA Research

Chart 12
Export and import growth are weakening



Source: CEIC and BBVA Research

A reversal of currency appreciation on weak external demand

With the current account surplus continuing to narrow, reserve accumulation levelling off (see below), and the external outlook remaining uncertain due to the Eurozone crisis, the authorities have slowed the pace of currency appreciation against the USD in 2012 (Chart 13). Indeed, the currency has depreciated against the USD by around 1.5% since early May, although measured against a broader basket of currencies, the RMB has remained much stronger due to the USD's relative strength during this period (Chart 14).

After continuing to set the daily exchange rate fixings on an appreciating path in early 2012, in the second quarter the PBoC began to limit the currency's rise against the USD, keeping the daily fixing stable at around 6.32 (Chart 15), with variations around this level largely explained by cross currency movements between the USD, EUR and JPY. During this time, the daily spot rate has stayed near the upper limit of the daily +/-1.0% trading band, reflecting depreciation pressures under the weight of weakness in external demand and a tendency for capital outflows. One-year forward NDFs are pricing in a nearly 0.7% depreciation (Chart 15).

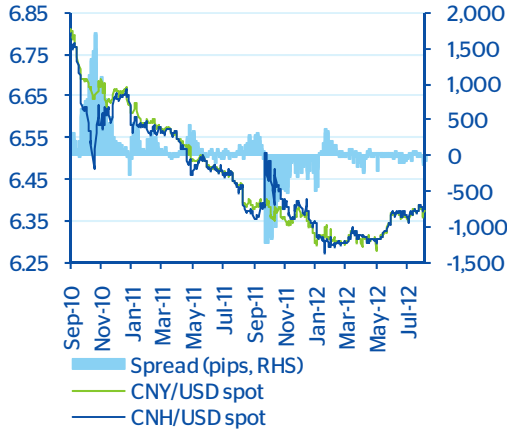
While the combination of the substantial appreciation of the real effective exchange rate since mid-2011 and narrowing of the current account surplus imply that the degree of currency undervaluation has undoubtedly declined (in its latest assessment the IMF has relabelled the currency as "moderately" undervalued from "substantially" in previous reports), we continue to see scope for modest appreciation in the coming 2-3 years, once the external environment improves.

An acceleration of policies to attract capital inflows

Weaker expectations of RMB appreciation, along with risk aversion associated with renewed financial tensions in Europe have generated some capital outflows, resulting in a levelling off of foreign reserve accumulation (Chart 16). In the first half of 2012, China recorded a deficit of USD 20.3 billion in its capital and financial account, the largest since H2 2008 (Chart 17). We estimate a total of over USD 95 billion in portfolio outflows during the second quarter, more than offsetting an estimated USD 16 billion of portfolio inflows in Q1 (Chart 18). An additional factor for the weaker capital and financial balance are trends in FDI. Specifically, inward FDI flows declined by 3% y/y in the H1 2012 to USD 59.1 billion, while outward FDI flows (non-financial sector) grew by 48% y/y during the same period to 35.4 billion, as enterprises, often under the support of the state explore offshore opportunities to take advantage of attractive asset prices.

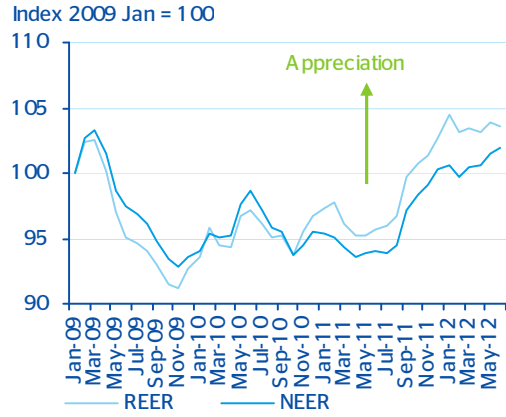
In the face of the increasing capital outflows, the authorities have accelerated their liberalization measures in the capital account. In particular, the China Security Regulation Commission (CSRC) recently relaxed rules governing its program for Qualified Foreign Institutional Investors (QFII), including by: i) lowering the entry barrier (such as minimum asset size) for QFII investors; ii) expanding investment scope by permitting QFII investors to tap into the interbank market and stock index futures; iii) enhancing the operational convenience by allowing for separate investment accounts for clients and proprietary trading; and iv) raising the limit of the total shareholding by QFII investors in a listed firm to 30% from 20%.

Chart 13
Currency appreciation against the USD has reversed in recent months



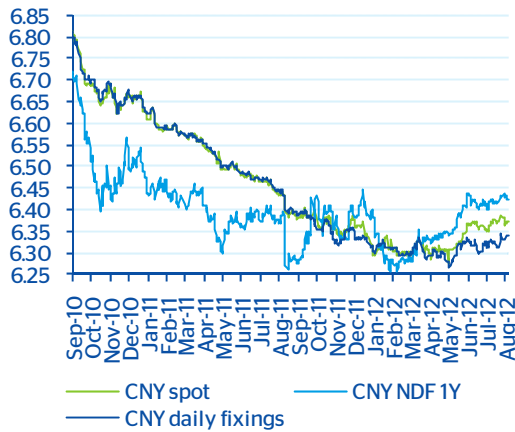
Source: Bloomberg and BBVA Research

Chart 14
The currency has appreciated in effective terms



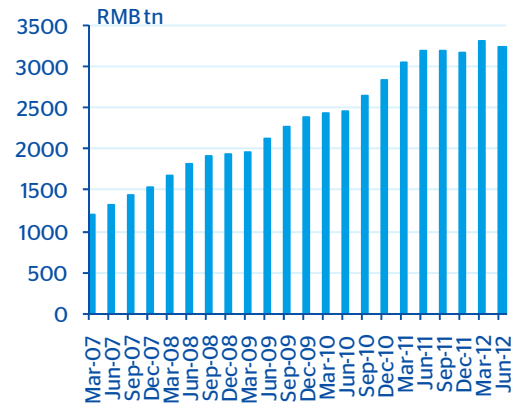
Source: BIS, CEIC and BBVA Research

Chart 15
RMB NDFs are still pricing in depreciation



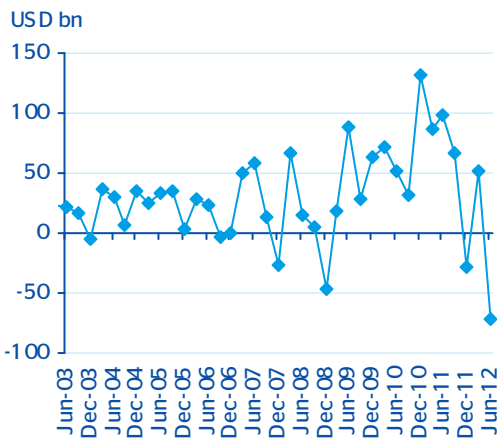
Source: Bloomberg and BBVA Research

Chart 16
Foreign reserves declined slightly in Q2



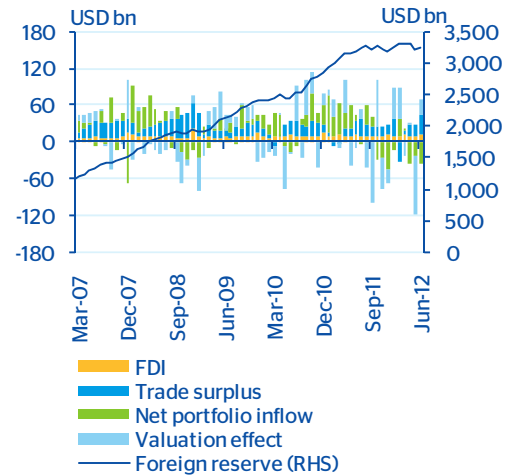
Source: CEIC and BBVA Research

Chart 17
The capital and financial account moved to deficit



Source: CEIC and BBVA Research

Chart 18
Portfolio outflows are one factor for slower reserve accumulation



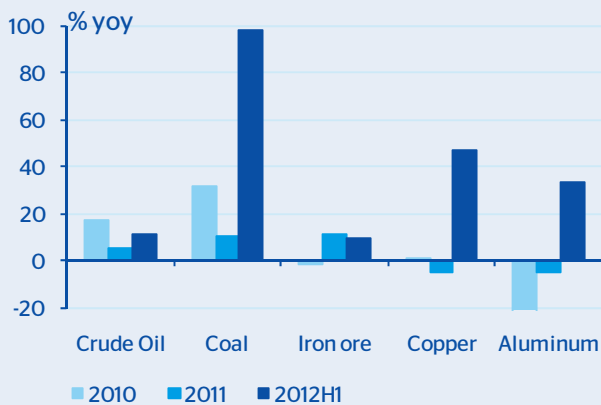
Source: CEIC and BBVA Research

Box 1: The influence of China’s fiscal stimulus policies on commodity demand

Recent policy statements suggest that China’s latest round of fiscal stimulus will be oriented toward an acceleration of investment, reflecting a short-term deviation from policies to encourage greater reliance on domestic consumption (e.g., Premier Wen Jiao-bao’s statement in the end-July meeting of the Chinese Communist Party’s Politburo). As is well known, China is a major global consumer of major commodities, and its previous stimulus package during 2009/10 led to a significant boost in investment and further accelerated demand for commodities.

China’s relatively intensive investment in new buildings, public transportation infrastructure, and manufacturing plants all involve huge amounts of commodities inputs. To the extent that new stimulus policies are focused on such investments, they are likely to boost commodity demand. This could provide support to commodity exporting countries (see the last section of the Box), amidst growing concerns about the impact of China’s slowdown (Chart 19).

Chart 19
China’s commodity import growth in volume terms



Source: CEIC and BBVA Research

China’s commodity intensity and the impact of investment

To estimate the impact of China’s investment on the use of commodities, we calculate the “commodity intensity” of production, defined as the volume of commodity consumption per unit of GDP produced¹. We apply the measure to major metals (steel, copper, and aluminum) and energy inputs (crude oil and coal) for the period between 2000 and 2011. The results are summarized in Table 1. The first row of the Table shows average changes in commodity intensity between 2003-08, which we call “*trend*”. The second row measures the impact of the 2009 government stimulus package, by calculating the

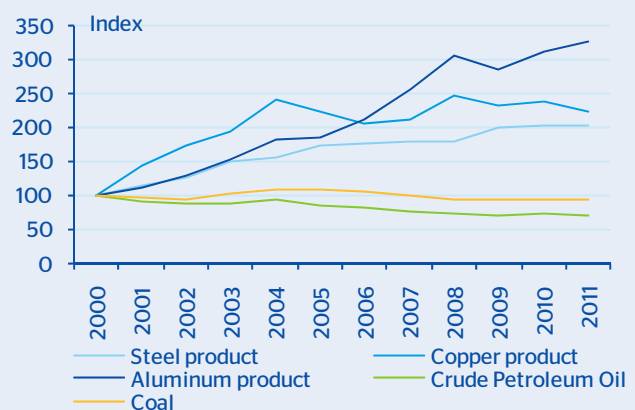
change of commodity intensities in 2009 relative to the three-year moving averages (from 2007 to 2009), which we call “*jump*”, due to policies. If commodity intensity is more positively affected by investment than consumption, as is commonly assumed, we should observe a “jump” above the trend; if it is equally affected by investment and consumption, then we would not see such a jump. It should be noted that commodity inventories could affect short-term movements in commodity intensities as calculated by our methodology, which could also lead to the fluctuating of commodity intensity indices across time as shown in Chart 20. Nonetheless, in the longer term the fluctuation caused by inventories should be largely reduced as we focus more on the trend, or the moving average as described above.

Table 1
Changes of China’s commodity intensity across time

	Steel	Copper	Aluminum	Crude oil	Coal
*Trend	4.0%	4.8%	15.2%	-1.6%	-1.6%
*Jump	6.6%	1.5%	0.7%	-1.3%	-1.3%

Note: *Trend = average change of commodity intensity from 2003 to 2008
*Jump = commodity intensity in 2009/its moving average from 2007-09
Source: CEIC and BBVA Research

Chart 20
China’s commodity intensity across time (2000 =100)



Source: CEIC and BBVA Research

Our findings are summarized as follows. Among metals, the intensities of steel and aluminum trended up across time from 2003 to 2008, while the intensity of copper remained flat. This implies that the use of steel and aluminum increases at a quicker pace than GDP growth, while the use of copper increases at the same pace as GDP growth.

¹: Commodity intensity is calculated as, production + Import - export volume divided by real GDP. The analysis could be affected by inventory accumulation in the short term, but should still reflect the trend of intensity in the longer term.

On the other hand, the intensities of steel and copper jumped in 2009 (against their moving averages from 2007-09) by 6.6% and 1.5%, respectively (Table 1), which implies that the metals are used more intensively in investment compared to consumption. Aluminum (a minimal jump of 0.7%) appears to be equally affected by both investment and consumption.

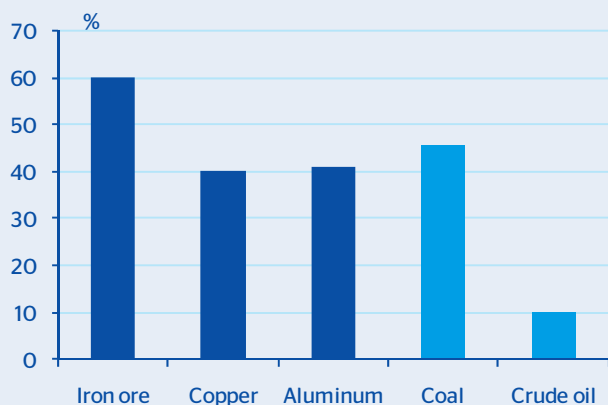
Among energy commodities, both the intensities of crude oil and coal trend down across time, consistent with China's efforts to increase energy use efficiency. In 2009 the intensities of crude oil and coal fell 3.1% and 1.3% respectively against their respective three-year moving averages, implying that the use of energy is less affected by investment compared to consumption.

Therefore, we can conclude that China's use of major commodities should increase at a quicker pace than GDP growth for steel and aluminum, at the same pace for copper, and at a slower pace for crude oil and coal; with a fiscal stimulus package oriented toward investment, more steel and copper should be used per GDP. *Therefore, the use of metals (steel, aluminum, and copper) should typically rise at a quicker pace than GDP growth if China adopts an investment-oriented stimulus, while the use of energy inputs (crude oil and coal) should rise at a slower pace.*

Price sensitivity to China's demand

With commodity supplies constrained in the short run, any sudden increase in China's commodity demand could result in global price increases (Chart 21). During China's RMB 4 trillion stimulus package of 2009-10, the contribution of investment in GDP growth rose to 6.2 ppts (2009-2011, 6.8 ppts 2009-2010) from 5.1 ppts (2001-2008). China's ongoing investment stimulus package, though likely to be much smaller than the previous one, is still expected to bolster investment.²

Chart 21
China's commodity consumption share in the world (2010)



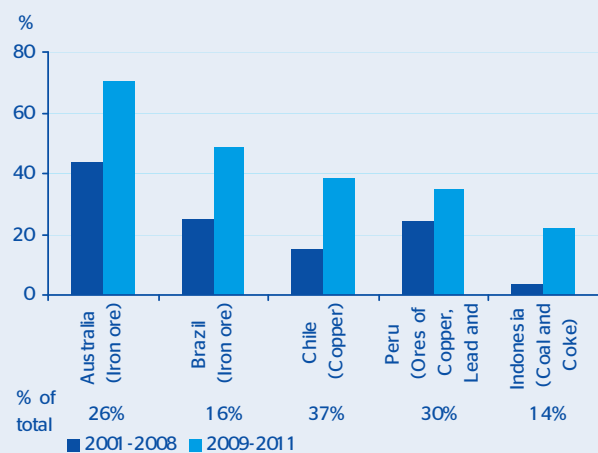
Source: IMF WP/12/115, media reports and BBVA Research

Countries which benefit the most

China's imports of certain base metals from Asian and LATAM countries have grown noticeably in the past decade. Shares of those specific commodity exports to China jumped further during the post-crisis period (Chart 22) on the effects of the stimulus package. In Australia, 70% of iron ore exports go to China in contrast to about 40% in pre-financial crisis period; In Brazil, about 50% of iron ore export is shipped to China compared to previously 25%. Other countries like Chile (40% of copper export goes to China), Peru (35% of copper, lead, and zinc export goes to China), and Indonesia (20% of coal export goes to China) share similar stories.

Thus a shock of China's demand is likely to have large impact on commodity exports of these countries. In light of the importance of commodity exports to total exports in these countries (26% of total exports in Australia, 16% in Brazil, 37% in Chile, and 30% in Peru, and 14% in Indonesia), we would expect these economies would be impacted significantly via the trade channel under a demand shock from China. Among them, Australia and Chile would be most susceptible, and Indonesia would be least affected.

Chart 22
Countries with main commodity exports to China



Note: percentages within the parenthesis represents the shares of that commodity export to total exports for that country.
Source: UN Comtrade and BBVA Research;

2: This conclusion is in line with, Roache, Shaun K. (2012); "China's Impact on World Commodity Markets", IMF Working Paper WP/12/115.

Policy easing to sustain growth momentum

The authorities' policy stance has turned increasingly growth supportive in response to disappointing activity outturns and the weakening global environment. Officially, the policy stance continues to be described as, "prudent monetary policy and proactive fiscal". Recent policy statements have emphasized a "fine tuning" to support growth. More recently, the authorities have stepped up their infrastructure spending, and in so doing appear to be reverting to a similar set of investment-led stimulus measures that so effectively sustained growth momentum during the 2008-09 global financial crisis, albeit on a much more limited scale

On the monetary side, the PBoC implemented back-to-back interest rate cuts in June and July, on top of the 150bps in RRR cuts implemented since last December (along with steps toward interest rate liberalization). On the financial side, the authorities are complementing such measures through various forms of regulatory forbearance to spur bank lending. Importantly, however, curbs on property market speculation remain in place, and the authorities have reiterated their commitment to maintain them.

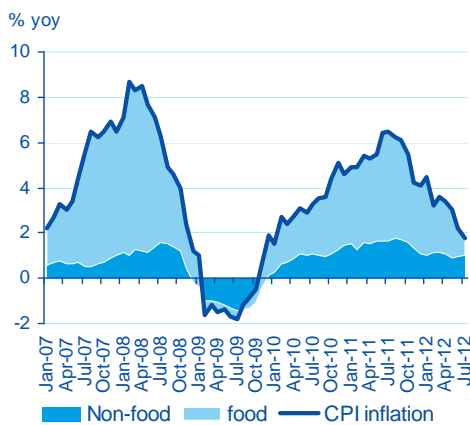
Rapid decline in inflation provides room for monetary easing

Slowing growth has resulted in reduced demand pressures which, together with easing commodity prices, has led to a steeper decline in inflation than previously expected, to just 1.8% in July, well within the authorities' 4% comfort zone. Producer price inflation has fallen even more precipitously, to -2.9% y/y in July, the fifth straight month of deflation.

A benign outlook for inflation in the coming months has provided room for further monetary easing (Chart 23). The PBoC surprised markets with back-to-back interest rate cuts on June 8 and July 6, for cumulative declines in the one-year benchmark lending rate of 56 bps and 50 bps for the deposit rate. The rate cuts, however, were tilted toward the lending rate after considering a widening of the allowable lending rate discount to 30% (from 10% prior to June) and 10% premium for the deposit rate (previously no premium was allowed on the deposit rate. In addition, the required reserve ratio (RRR) has been cut for three times since the easing cycle began last November, by 150bps accumulatively in May to 20% for large banks (Charts 24 and 25). Together with the interest rate cuts and the reverse repurchase in the open market operations, this has led to looser liquidity conditions and a moderation in interbank rates (Chart 26).

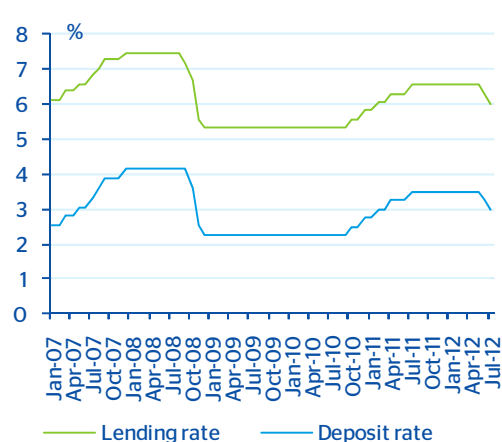
Concerns over the growth slowdown have led to a further under-performance of China's stock market (Chart 28). Expectations of further policy easing and a pickup in growth during the second half of the year could provide support and for a long-awaited turnaround later in 2012.

Chart 23
Inflation has continued to fall



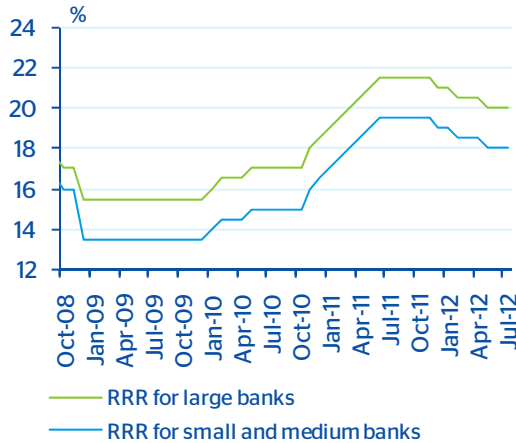
Source: CEIC and BBVA Research

Chart 24
Back-to-back interest rate cuts in June and July



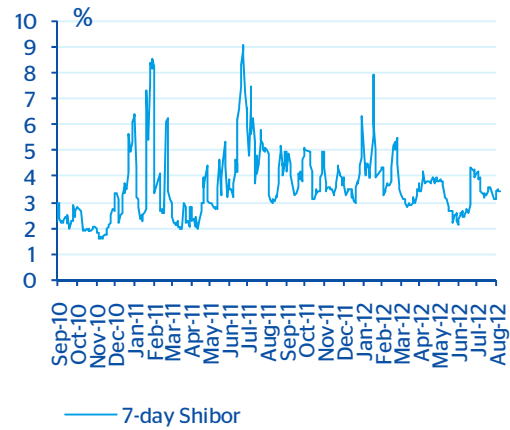
Source: CEIC and BBVA Research

Chart 25
Three reductions in required reserve ratios since November



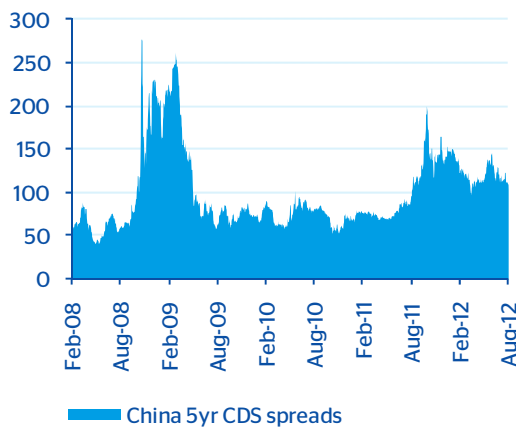
Source: CEIC and BBVA Research

Chart 26
Inter-bank rates remain reasonably low



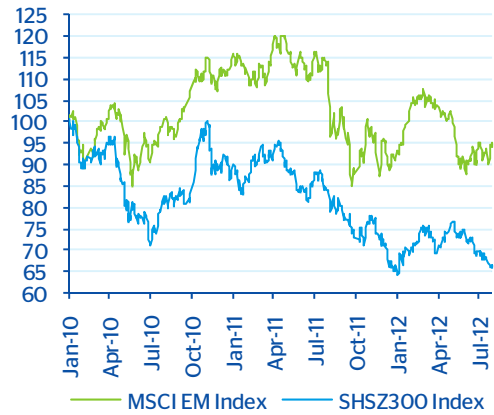
Source: CEIC and BBVA Research

Chart 27
China's CDS spreads have stayed high on global risk aversion...



Source: Bloomberg and BBVA Research

Chart 28
...and the stock market has underperformed (2010 Jan = 100)



Source: Bloomberg and BBVA Research

Monetary and credit aggregates are picking up

After disappointing to the downside in Q1, credit and M2 growth has begun to pick up (Chart 29), suggesting that the authorities' easing measures are beginning to bear fruit. Importantly, loan growth has picked up, and exceeded expectations in June, resulting in a rise in overall credit growth to 16.0% y/y, from 15.7% by the end of Q1 2012. Cumulative new loans through the first half of the year amounted to RMB 4.86 trillion, in line with the full-year informal target of around RMB 8.0-8.5 trillion. At the same time, total social financing (TSF), a more comprehensive measure of credit growth (combining bank and nonbank forms of financing), has also accelerated (Chart 30).

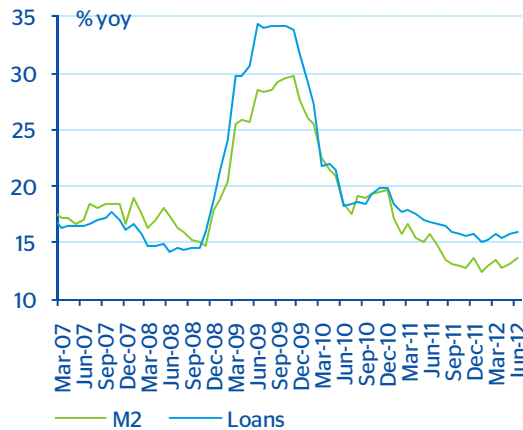
Fiscal policy support is being stepped up

The authorities' original 2012 deficit target, announced at the March NPC meeting, is effectively 2% of GDP, (after accounting for 0.5% of GDP in revenue transfers from last year), up from the outturn of 1.3% in 2011. With growth momentum slowing by more than expected, the authorities

have begun implementing a series of supportive fiscal policy measures, beyond those envisaged in the previously announced budget targets. To the extent that they rely on infrastructure spending (Chart 31), key elements of these measures bear similarities to the post-Lehman stimulus package, albeit on a much smaller scale in view of tighter financing constraints. Significantly, the State Council also recently approved a plan to promote development in six central provinces. Under this initiative, Hunan province is reported to be planning a large RMB 829 billion (US\$130 billion, or 1.7% of GDP) investment plan to be stretched out over a number of years, containing 195 projects, such as airports and subway lines. In July, the Ministry of Railway also announced plans to increase investment in 2012 by 16%, to 580 billion RMB.

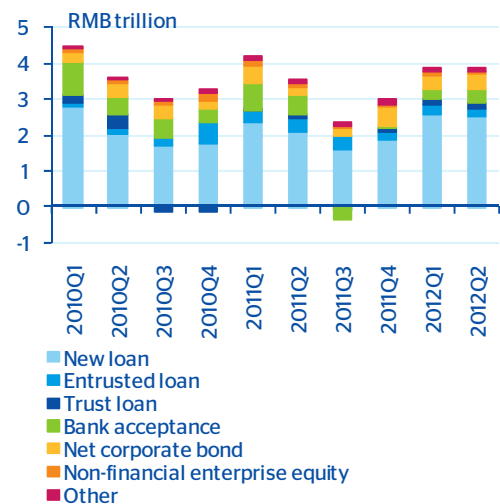
In addition to investment, current fiscal initiatives include subsidies on the purchase of durable goods, although the scale is more limited than the post-Lehman package in that they are generally smaller in size and have a shorter time span (one year). Tax cuts are also being implemented as part of a set of structural fiscal measures. In particular, effective on August 1, a reform to replace the business tax with a value-added tax in selected service industries, especially transportation, will be implemented in ten provinces and major cities. This reform will reduce the tax burden of enterprises by eliminating double taxation on the service component.

Chart 29
Credit and M2 growth are picking up



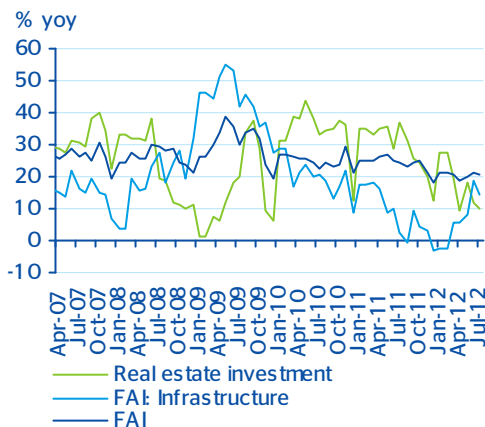
Source: CEIC and BBVA Research

Chart 30
Total social financing picked up in the first quarter



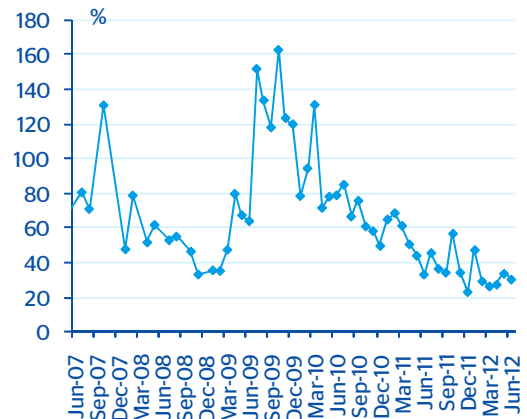
Source: CEIC and BBVA Research

Chart 31
Infrastructure investment has rebounded



Source: CEIC and BBVA Research

Chart 32
The share of med & long term loans has fallen, but may rise on a pickup in new public projects



Source: CEIC and BBVA Research

Regulatory forbearance to support economic growth

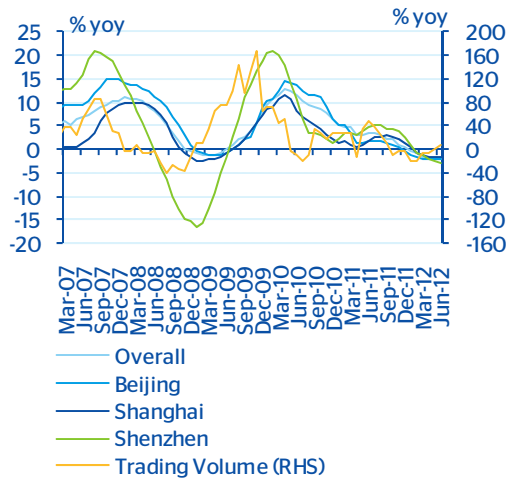
As a complement to the fiscal and monetary measures to support growth, since the beginning of the year the authorities have implemented a number of steps on the regulatory side to spur bank lending, see our report on *relaxing banking regulations*³. In addition to the announcement last February to allow banks to roll over some of their credits to local governments, the CBRC more recently relaxed further restrictions on banks to issue new loans to local government financial vehicles (LGFVs) and property developers to support investment demand. In addition, to boost credit to SMEs, in April the CBRC has urged banks to increase related tolerance limits.

Among the most significant in this regard is a one-year postponement in the original timetable of Basel III implementation to January 2013. The postponement was widely anticipated, and was formally announced by China's State Council in June. This and other regulatory forbearance measures should facilitate bank lending amidst the current headwinds to growth, and also enable banks time to strengthen their capital. However, they are being implemented at the cost of a modest increase in financial sector risk.

Property prices begin to stabilize ...

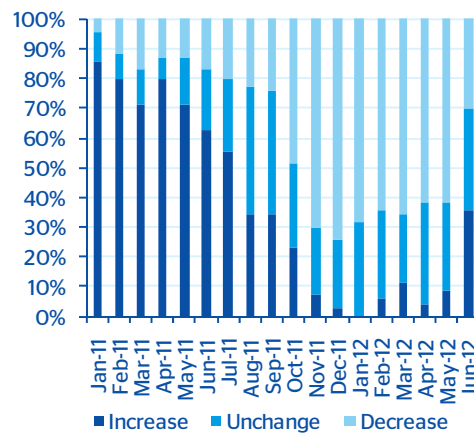
Residential property prices are showing early signs of rebounding, after a gradual fall from their peak in July 2011. Based on official NBS data covering 70 cities, we estimate that property prices declined by an average of -1.8% from July 2011 to May 2012, before rebounding slightly in June, by 0.1% (Chart 33). More cities also report sequential price increases (Chart 34). The data also show a strong pickup in sales volumes, after steady declines since last October. Nevertheless, the authorities have vowed to maintain measures to curb property prices in order to prevent asset bubbles and maintain housing affordability. On balance, a modest and sustained rise in housing prices would be positive in facilitating a pickup in overall economic growth momentum.

Chart 33
Property sales and prices are stabilizing



Source: NBS, CEIC and BBVA Research

Chart 34
Fewer cities are reporting housing price declines



Source: NBS and BBVA Research

³ "China Banking Watch: Relaxation of banking regulations in support of growth" April 10, 2012

3. Growth to pick up in H2

We expect China's growth momentum to pick up during the second half of 2012 on the effects of policy easing and an eventual stabilization in the external environment, as described in Section 1. Nevertheless, in view of the weaker-than-expected outturn during the first half of 2012 and stronger external headwinds, we are revising down our 2012-13 growth projections to 7.8% and 8.3% (Table 2), respectively, from 8.3% and 8.7% previously. In the event of deterioration in the European and/or US outlooks, China's growth prospects would be more challenging. In such a scenario, we believe there is enough policy room to sustain growth above 7% in 2012 and 2013.

Growth slowdown is bottoming out on supportive policies

The expected pickup in growth momentum during the remainder of 2012 (Chart 35) would be underpinned by a pickup in investment from accelerated infrastructure spending, and resilient domestic consumption. Our full-year 2012 growth projection of 7.8% requires growth in the second half of the year to only match the first half outturn (also 7.8%). While the investment-led policy mix to sustain growth in 2012-13 might temporarily deviate from the longer term economic rebalancing, we still expect the trend of rising consumption to resume over the medium term (Chart 36).

Inflation should remain contained on weaker growth

With commodity prices expected to remain stable, average inflation for 2012 should be contained at around 3% in 2012; however, monthly headline inflation rates are likely to pick up after bottoming out in July on strong base effects and some modest demand pressures as growth picks up. On this basis, inflation would register around 3% at end-2012, and 3.5-4.0% at end 2013.

Table 2
Baseline Scenario

	2009	2010	2011	2012 (F)	2013 (F)
GDP (% y/y)	9.2	10.4	9.2	7.8	8.3
Inflation (average, %)	-0.7	3.3	5.4	3.0	3.6
Fiscal bal (% of GDP)	-2.8	-1.7	-1.3	-2.0	-1.8
Current acct (% of GDP)	5.2	4.0	2.8	2.5	2.8
Policy rate (% eop)	5.31	5.81	6.56	5.75	6.00
Exch rate (CNY/USD, eop)	6.83	6.62	6.30	6.31	6.13

Source: BBVA Research

The policy mix is expected to turn more growth supportive

With inflation expected to remain within the authorities' 4% comfort level, our macro outlook incorporates a further easing of the monetary stance and implementation of growth supportive fiscal policies. In particular, we expect further cuts in the RRR of 150 bps during the rest of 2012. These will likely be accompanied by up to two 25 bp interest rate cuts, especially if the external environment remains weak.

The fiscal stance is also expected to be supportive, and may well exceed the budgeted 2.0% of GDP target (excluding fiscal reserves from last year's savings). The size of the deficit will ultimately depend on the split in financing between the central and local governments, as well as the extent of the shortfall in growth momentum. However, the magnitude of the fiscal package is expected to be considerably less than in 2008-09 due to constraints from the buildup of local government debt, concern about the quality of bank balance sheets, and efforts to avoid undesirable side effects, such as property bubbles.

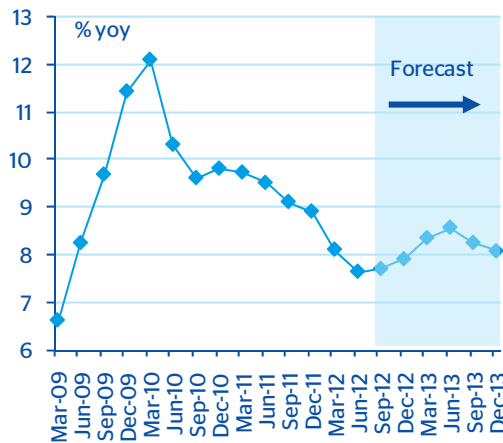
Expectations of currency appreciation are being scaled back

Given the slowdown in growth and weaker external environment, we are scaling back our projections of currency appreciation in the near term. We expect the currency to remain broadly flat against the USD through the remainder of the year, with a resumption of some small appreciation in Q4 2012 assuming a stabilization of the external environment. This would bring the currency to around 6.32 per USD by end-2012, although additional USD strength beyond that in our baseline (for example stemming from EUR weakness) could cause the currency to be a little weaker against the USD. While greater two-way volatility can be expected in line with recent widening of the daily trading band, however, the likelihood of a significant depreciation of the currency during the remainder of the year is limited in our view, especially given the political pressure from China's trading partners. We would expect a more sustained gradual appreciation to resume in 2013, of around 3%.

Room for more policy stimulus if downside global risks materialize

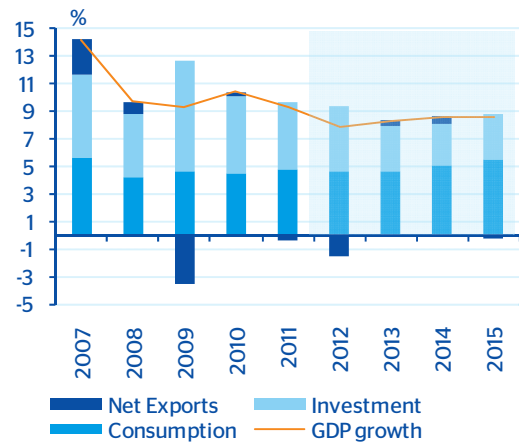
If the global environment deteriorates, China's growth momentum would be affected primarily through weaker demand through the trade channel, as well as residual effects from finance channels from heightened risk aversion (the relatively closed nature of China's capital account limits the impact of external shocks through financial flows). As noted above, we believe there would be sufficient policy room to sustain growth at around 7% in 2013, as targeted in the Five-year Plan.

Chart 35
China's GDP growth forecast



Source: NBS, CEIC and BBVA Research estimates

Chart 36
A rebalancing of growth over the medium term



Source: NBS, CEIC and BBVA Research estimates

4. Risks to the downside

Risks remain firmly to the downside in view of the uncertain external environment and the ongoing domestic slowdown that, while beginning to stabilize, has been more pronounced than previously expected. Domestic financial fragilities continue to linger, but for the most part pose medium-term, rather than immediate, challenges. In this regard, the risk of an abrupt downward adjustment in property prices appears less likely now, given the recent stabilization in housing prices. Moreover, while high levels of local government debt and financial effects of shadow bank lending are acting as constraints on the size of any new stimulus package, the authorities' efforts to contain them have been successful over the past year.

The predominant risk to China's near-term growth outlook continues to be from weak external demand, a factor that has intensified with ongoing financial tensions in the EU. While the recent easing of oil prices has provided some relief from stiff external headwinds, exports have continued to weaken, and heightened risk aversion may have a chilling effect on risk appetite and investment, even as the authorities seek to counter these effects through policy stimulus. Ripple effects through tighter financing conditions are visible through the underperformance of the stock market and a sharp decline in IPOs of Chinese companies.

In contrast, domestic financial fragilities remain under control, although they pose a challenge for the medium term and could well be exacerbated by the new round of stimulus measures, resulting in higher local government debt levels and more rapid bank lending. Property prices and sales transactions now shows signs of stabilizing, which should help ease concerns of a further decline in property investment and financial pressures on real estate developers. In any event, the overall decline in prices since their peak in July 2011 has been rather modest.

The level of contingent liabilities to the central government, especially relating to local government debt, is acting as a partial constraint on the magnitude of a new stimulus package. That said, there is sufficient room, in our view, for the government to carry out infrastructure spending and other stimulus policies to sustain growth in line with the targets of the Five Year Development Plan. There is a risk that recent policies to relax bank lending to local governments could exacerbate financial fragilities down the line, and these will need to be monitored in due course. For the time being, the authorities appear appropriately cautious in their approach, and sustained GDP growth should, over time, keep such risks manageable.

On the political front, progress continues toward the leadership transition, scheduled to take place later this year. New members of the Standing Committee of the Political Bureau, the key decision-making body, will be put in place around October. In March 2013, a new President and Premier will be selected, replacing the incumbent leadership of President Hu Jintao and Premier Wen Jiabao. Following the ouster earlier this year of the former Chongqing party chief and Politburo member on corruption charges, and more recent criminal charges against his family members, rumours of factional infighting among the top leaders continue, raising concerns about the stability of the transition process. While risks linger, it appears highly unlikely that political instability will unfold especially as most provinces and municipalities have already held their relevant selection meetings in the run-up to the Communist Party's national congress in October. In any event, it is highly unlikely that the leadership change will result in significant changes in the near-term policy direction.

Finally, rising geopolitical tensions pose a risk. China's disputes with its regional neighbors over territorial claims in the East China and South China Seas bear watch. In addition to undermining regional investor sentiment, these conflicts are giving rise to further military buildups that could divert fiscal spending from more productive investments.

5. Tables

Table 3
Macroeconomic Forecasts

	2009	2010	2011	2012 (F)	2013 (F)
GDP (% y/y)	9.2	10.4	9.2	7.8	8.3
Inflation (average, %)	-0.7	3.3	5.4	3.0	3.6
Fiscal bal (% of GDP)	-2.8	-1.7	-1.3	-2.0	-1.8
Current acct (% of GDP)	5.2	4.0	2.8	2.5	2.8
Policy rate (% eop)	5.31	5.81	6.56	5.75	6.00
Exch rate (CNY/USD, eop)	6.83	6.62	6.30	6.31	6.13

Source: BBVA Research

Table 4
Gross Domestic Product

(YoY growth rate)	2009	2010	2011	2012 (F)	2013 (F)
U.S.	-3.5	3.0	1.7	2.1	1.8
EMU	-4.2	1.8	1.6	-0.3	0.3
Asia-Pacific	4.2	8.1	5.8	5.4	5.8
China	9.2	10.4	9.2	7.8	8.3
World	-0.6	5.1	3.9	3.4	3.7

Source: BBVA Research

Table 5
Inflation (Avg.)

(YoY growth rate)	2009	2010	2011	2012 (F)	2013 (F)
U.S.	-0.3	1.6	3.2	2.0	1.9
EMU	0.3	1.6	2.7	2.3	1.4
Asia-Pacific	0.3	3.6	4.8	3.3	3.4
China	-0.7	3.3	5.4	3.0	3.6
World	2.2	3.0	5.1	4.2	3.9

Source: BBVA Research

Table 6
FX rate (End of period)

	2009	2010	2011	2012 (F)	2013 (F)
EMU USD/EUR	1.43	1.34	1.30	1.23	1.31
China CNY/USD	6.83	6.61	6.30	6.31	6.13

Source: BBVA Research

Table 7
Policy rate (End of period)

	2009	2010	2011	2012 (F)	2013 (F)
U.S.	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	1.00	0.75	0.75
China	5.31	5.81	6.56	5.75	6.00

Source: BBVA Research

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This report has been produced by the Asia Unit of the Emerging Markets team*Chief Economist for Asia***Stephen Schwartz**

stephen.schwartz@bbva.com.hk

Zhigang Li

zhigang.li@bbva.com.hk

Le Xia

xia.le@bbva.com.hk

Fielding Chen

fielding.chen@bbva.com.hk

George Xu

George.xu@bbva.com.hk

With the contribution of:*Markets Analysis***Richard Li**

richard.li@bbva.com.hk

BBVA Research*Group Chief Economist***Jorge Sicilia***Emerging Markets:***Alicia García-Herrero**

alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis

Álvaro Ortiz Vidal-Abarca

alvaro.ortiz@bbva.com

Asia

Stephen Schwartz

stephen.schwartz@bbva.com.hk

Latam Coordination

Juan Ruiz

juan.ruiz@bbva.com

Argentina

Gloria Sorensen

gsorensen@bbva.com

Chile

Alejandro Puente

apuente@bbva.com

Colombia

Juana Téllez

juana.tellez@bbva.com.

Peru

Hugo Perea

hperea@bbva.com

Venezuela

Oswaldo López

Oswaldo.lopez@bbva.com

Mexico

Adolfo Albo

a.albo@bbva.bancomer.com

Macroeconomic Analysis Mexico

Julián Cubero (i)

juan.cubero@bbva.bancomer.com

*Developed Economies:***Rafael Doménech**

r.domenech@bbva.com

Spain

Miguel Cardoso

miguel.cardoso@bbva.com

Europe

Miguel Jiménez

mjimenezg@bbva.com

United States

Nathaniel Karp

nathaniel.karp@bbvacompass.com

*Financial Systems & Regulation:***Santiago Fernández de Lis**

sfernandezdelis@grupobbva.com

Financial Systems

Ana Rubio

arubiog@bbva.com

Pensions

David Tuesta

david.tuesta@bbva.com

Regulation and Public Policy

María Abascal

maria.abascal@bbva.com

Global Areas:

Financial Scenarios

Sonsoles Castillo

s.castillo@bbva.com

Economic Scenarios

Julián Cubero

juan.cubero@bbva.com

Innovation & Processes

Clara Barrabés

clara.barrabes@bbva.com

*Market & Client Strategy:***Antonio Pulido**

ant.pulido@grupobbva.com

Equity Global

Ana Munera

ana.munera@grupobbva.com

Global Credit

Javier Serna

Javier.Serna@bbvauk.com

Global Interest Rates, FX

and Commodities

Luis Enrique Rodríguez

luisen.rodriguez@grupobbva.com

Contact details**BBVA Research**

43/F, Two International Finance Centre

8 Finance Street

Central, Hong Kong

Tel. + 2582 3111

Fax. +852-2587-9717

research.emergingmarkets@bbva.com.hk

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