China Economic Outlook

Third Quarter 2014
China Unit

- Global growth is recovering slowly in a complex environment, with downside risks still present from QE tapering and turmoil in emerging markets. We maintain our global growth projection to 3.8% in 2015 on account of recent outturns.
- Growth in China stabilized in Q2, due to the improving external demand and the authorities' stimulus policies. In particular, the authorities have implemented a set of unconventional monetary policies to spur bank lending and boost growth momentum.
- We maintain the growth projections of 7.2% in 2014 and 7.0% for 2015. Headline inflation is expected to rise moderately while the RMB will resume its gradual appreciation going forward. Moreover, fiscal policy will remain “pro-growth” in H2 whereas the currently loose monetary policy is likely to turn neutral.
- Risks are still to the downside. Risks concentrate on uncertainties surrounding the US monetary policy normalization, the sluggish real estate market as well as several financial fragilities, i.e. the debt overhang of local governments.

Index

Closing date: 7 August 2014

1 Summary

China's growth stabilized in the second quarter, averting a hard-landing again. GDP growth increased to 7.5% on a year-on-year term in Q2, slightly higher than the Q1 outturn of 7.4% y/y. More importantly, the sequential growth has notably accelerated to 2.0% in Q2 from 1.5% in Q1, suggesting that the economy is gaining traction.

The growth pick-up in Q2 was driven by both the government's new stimulus package and the improving external demand. The thrust of the stimulus package is the acceleration of public infrastructure investment and social housing construction. In addition, the authorities have deployed a set of unconventional monetary policy tools to spur bank lending and bolster growth, including two selective cuts in banks' required reserve ratio (RRR) and the PBoC's 1 trillion refinancing to a "policy" bank. On the external front, improving demands from the advanced economies, together with a weak currency, boosted China's shipments in Q2.

Looking ahead, we maintain our full-year growth projections of 7.2% and 7.0% for 2014 and 2015 respectively, reflecting both favorable factors (such as improving external demands as well as revived confidence of investors) and growth headwinds (for example, local governments' debt problem which has been exacerbated by the stimulus package and the ongoing correction in the property market). In the meantime, headline inflation is projected to rise moderately to 3.1% as of the end of the year, bringing the yearly-average inflation rate to 2.6% (still below the official cap of 3.5%). The prospective recovery in the external sector could give new impetus to the RMB appreciation, pushing its exchange rate against the USD up to around 6.10 at the end of the year. Additional 2-3% appreciation of the RMB is anticipated in 2015.

On the policy front, the authorities are likely to keep the overall policy stance as pro-growth. To sustain the near-term growth momentum and maintaining the financial stability, the authorities may unveil more policy initiatives to provide support for SMEs and revive the frozen property market. Monetary policy is expected to revert to its neutral stance after implementing a number of unconventional policies to spur bank lending in 1H14. That said, the authorities will flexibly fine-tune monetary policy to align the trajectory of bank loan growth with their target of 14% for 2014.

Risks still concentrate on elevated financial fragilities (such as shadow banking and trust products, local government debt), cooling of real estate market as well as any disruptive policy change by the US FED. Indeed, some recently unveiled pro-growth initiatives have aggravated financial fragilities, in particular increasing the overall debt level of the economy. Moreover, new investment projects in the stimulus package could resuscitate the shadow banking sector by buoying financing demand despite the authorities' clampdown efforts. Policy risks have also risen from the authorities' intention to stabilize growth and a keener interest in reigning in domestic financial fragilities.

2 A slower global recovery in a complex environment

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 5

The global recovery never really took off in the first half of 2014, with growth either restricted or in decline in some of the heavyweight economies such as China and the US. Thus, according to our estimates, global growth moderated by nearly one percentage point from the 3.2% registered in the second half of 2013. The surprisingly sharp drop in US GDP growth in 1Q14 was the principal cause of the slowdown which moderated but did not interrupt global growth, which we still think will reach 3.8% next year. The indicators of confidence in activity and financial volatility are consistent with a gradual improvement, although uncertainty remains biased to the downside, given the resurgence of geopolitical risks and concerns regarding the impact on global financial flows and asset prices of the upcoming higher interest rates in the US.

Our positive outlooks for the advanced economies (AEs) remain unchanged for 2015. The fall in US GDP in the first quarter of 2014 was mainly due to transitory factors (bad weather, the destocking process), as reflected in the most recent data. All in all, the severity of the adjustment has led us to reduce our growth outlook for FY14 from 2.5% to 2.0%. In the case of the eurozone, although we have left our previous growth forecasts unchanged (1.1% in 2014 and 1.9% in 2015), the risk is now moderately to the upside given the measures announced by the ECB in June. The ECB is trying to anchor interest rates, lower the cost of funding for the banks and, at the same time, ease credit availability for households and companies. In addition, we think it has reduced the risk of more intense disinflation by strengthening the banking channel for the transmission of monetary policy.

Finally, note the characteristics of the economic scenario that weigh on the recovery and on the risks it faces, namely the combination of: i) a high level of debt, which taking public-sector and private-sector liabilities together is no lower in the AEs; ii) comparatively low growth compared to other recoveries given the extent of economic policy stimulus; iii) even lower inflation in some of the most-developed economies; iv) interest rates at all-time lows, and even close to zero, which restricts the scope for central bank action, particularly those that have already expanded their balance sheets. Debt service is a heavy burden on some AEs, which is limiting expenditure decisions, particularly if the bank credit channel is still under repair. According to our base-case scenario, the pending adjustment of economic agents' balance sheets will come with a combination of stronger growth and some inflation, supported by a better functioning financial system since the reforms undertaken as a result of the 2009 financial crisis. However, the acceleration of economic activity is not the only possible outcome, notwithstanding the complicated geostrategic situation (Middle East, Ukraine, Iraq): even without reaching the point of being disruptive, this could start to affect the agents' expectations.

All in all, this could result in a scenario of prolonged global stagnation, particularly if no progress is made on the reforms that could increase productivity and encourage investment. In such a scenario, without higher interest rates either due to weak growth or to central bank action in the advanced economies, this would distort decision-making regarding debt and investment and the risk/reward ratio, which could lead to significant misalignments in financial asset prices. This hypothetical situation would pose an important challenge for economic policy management, especially in the emerging economies.

3 Growth sustained by policy stimulus

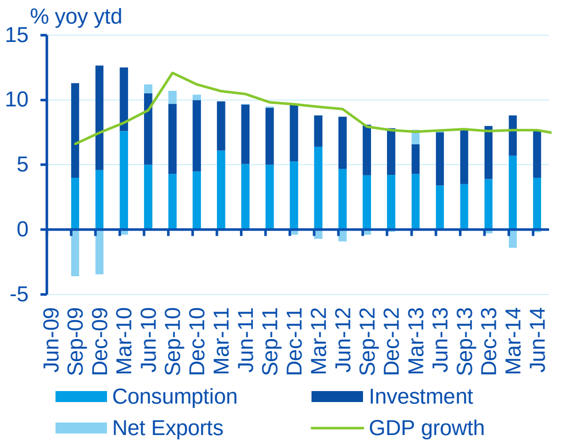
Economic activity rebounded in the second quarter thanks to the improving external demand and the expansion of the stimulus package. Indeed, the stimulus package has by now grown to a medium-sized one from the initially defined “mini-stimulus”. (We estimate that the total size of the stimulus package is larger than 1% of GDP). The main elements in the stimulus package are infrastructure construction and shantytown renovation. On the monetary front, the People’s Bank of China (PBoC) maintained an accommodative policy stance during the second quarter. Apart from keeping the interbank interest rate at a low and stable level, the PBoC deployed a set of unconventional monetary policy tools to spur bank lending to the real economy and provide direct financial aid for shantytown renovation projects. These unconventional policies include two targeted cuts in Required Reserve Ratio (RRR), the revision of calculation method for regulatory loan-to-deposit ratio (LDR) and the implementation of Pledged Supplementary Lending (PSL).

Although the policy easing has put growth back on an upward trajectory, it also aggravated the existing financial fragilities. Through the first half of the year, the overall debt level of the economy continued to rise at a rapid pace, in particular for local government financing vehicles (LGFVs). On the other hand, the implementation of long-term structural reforms has been muted since the PBoC widened the RMB’s daily trading band in mid-March. It seemed that structural reforms have given way to short-term stimulus as the pressure of sustaining growth surged in the second quarter.

Growth stabilized in the second quarter

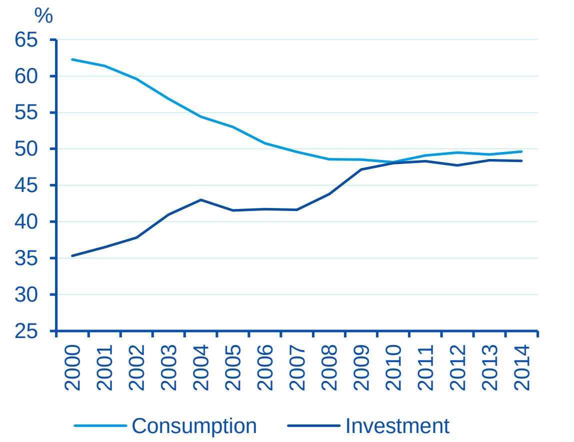
GDP rose to 7.5% y/y in Q2 from 7.4% y/y Q1 (Figure 3.1), on a par with the official growth target. In sequential terms, officially reported quarterly GDP growth is 2.0% (8.0% annualized), increasing from 1.5% in Q1 2014 (6.0% annualized). According to the National Bureau of Statistics (NBS), the consumption expansion contributed to 4.0 ppts of GDP growth, followed by investment (3.6 ppts), while the contribution of net exports stood at -0.2 ppts. Although the net export still has negative contribution to the GDP growth, it has significantly improved compared with Q1 (Figure 3.1). The trend of economic rebalancing continued in the second quarter, as the share of service sector in total GDP rose up and the current account surplus shrank (Figure 3.2 to Figure 3.4).

Figure 3.1
Growth momentum is stabilizing in Q2



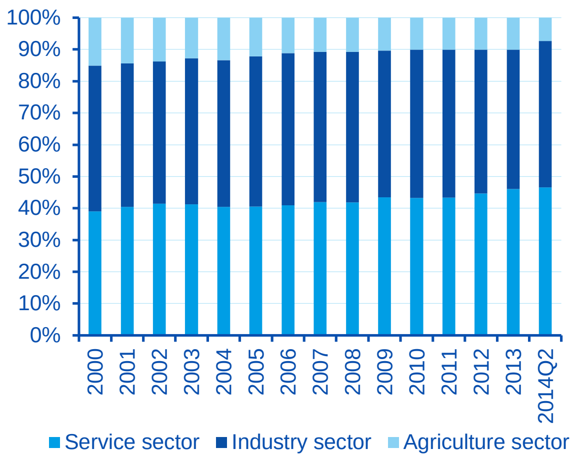
Source: NBS, CEIC and BBVA Research

Figure 3.2
Gradual Rebalance towards consumption driven



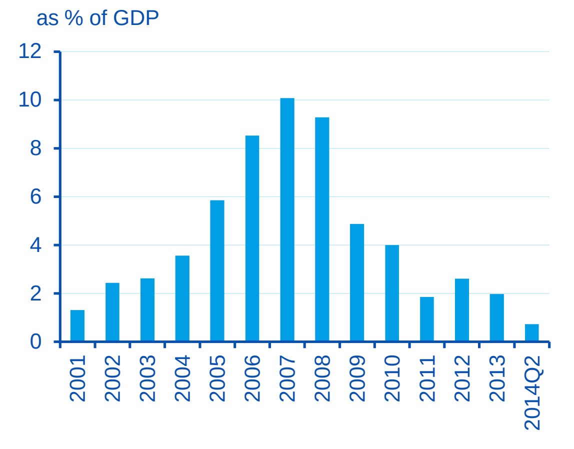
Source: NBS, Wind and BBVA Research

Figure 3.3
The share of the service sector rises further



Source: NBS, CEIC and BBVA Research

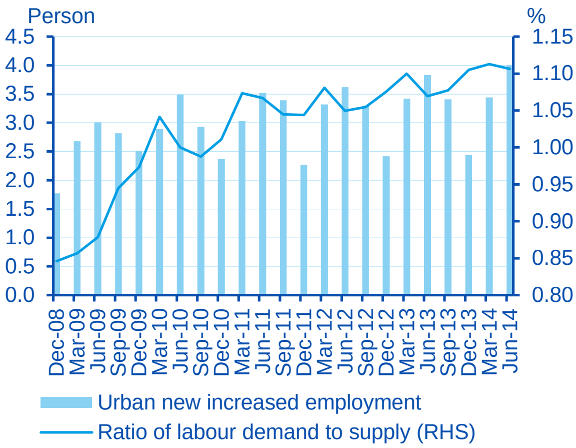
Figure 3.4
The current account surplus declines



Source: NBS, Wind and BBVA Research

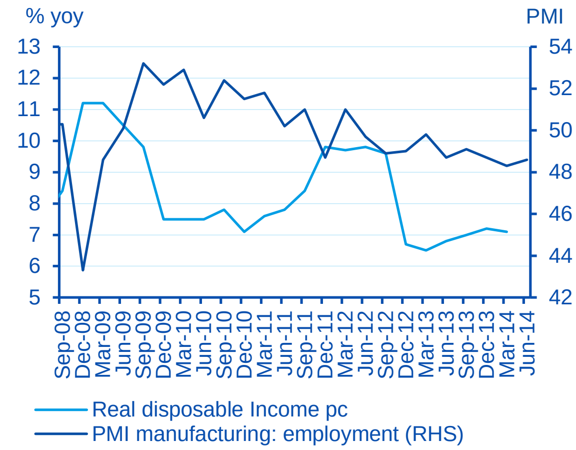
The labor market is in good shape. The urban registered unemployment rate stays low, at about 4.1% in Q2. The government recently revealed that China's survey unemployment rate, which is a more reliable indicator of unemployment but before was not open to the general public, stood at 5.1% as of end-June, suggesting a healthy trend in the labor market. In the meantime, the ratio of demand to supply in the labor market remains high (Figure 3.5) while the PMI sub-component of the manufacturing employment has slightly increased (Figure 3.6).

Figure 3.5
The labor market still holds up well



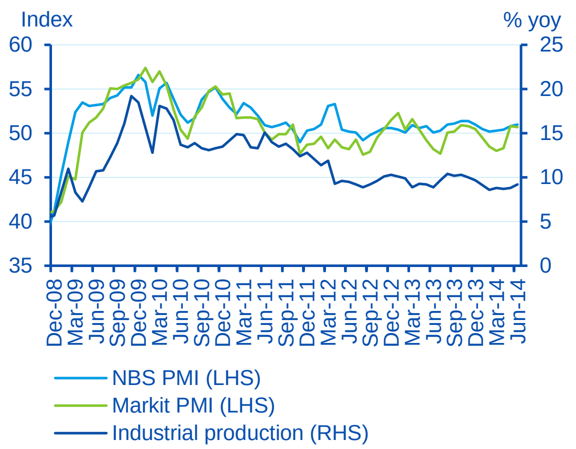
Source: CEIC and BBVA Research

Figure 3.6
The wage growth has softened



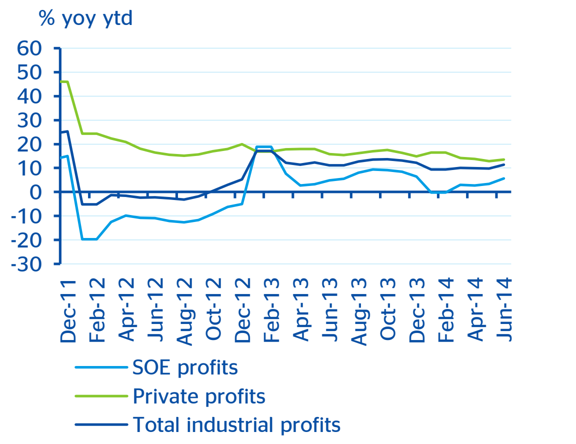
Source: CEIC and BBVA Research

Figure 3.7
China's manufacturing activities are stabilizing



Source: CEIC and BBVA Research

Figure 3.8
...so do industrial profits



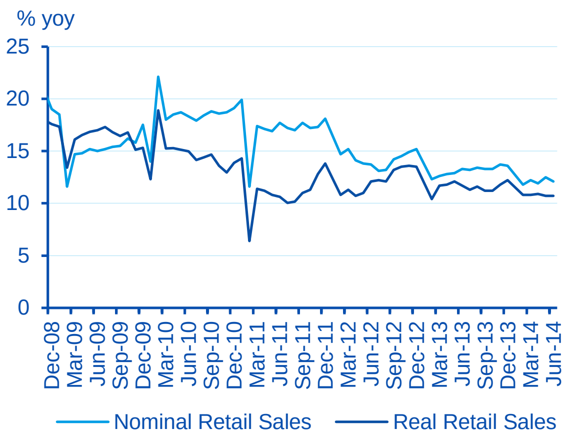
Source: CEIC and BBVA Research

Economic activity gained traction recently. Boosted by the stimulus package and the improving external demand, industrial production rose to 9.2% y/y in June from 8.8% y/y in May. (Figure 3.7) In July, both official PMI and HSBC PMI climbed to new highs of this year, indicating a continuation of recovery in the manufacture sector. Industry profits have also shown signs of pickup, in particular led by state-owned enterprises (SOEs), (Figure 3.8) proving that the SOEs are the largest beneficiaries of the government-led stimulus package.

On the demand side, retail sales softened slightly (Figure 3.9), likely driven by a combination of slower income growth (Figure 3.6) and the government's anti-corruption campaign. The anti-corruption campaign particularly slowed down the sales of luxury goods and weighed on restaurant businesses.

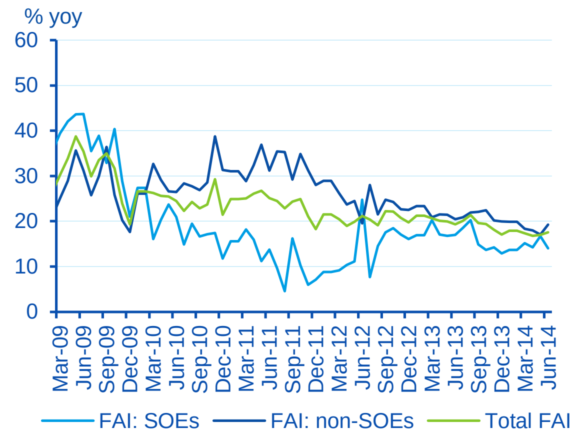
Investment however displayed an uneven pattern: the fixed asset investment (FAI) of SOEs is on the rise while the non-SOE FAI declines, reflecting the fact that the government's stimulus measures are tilting toward SOEs. In addition, the growth of infrastructure investment significantly outperforms the investment in the manufacturing and real estate sectors, suggesting that the focus of the stimulus package is still infrastructure construction.

Figure 3.9
Retail sales growth is marginally decreasing



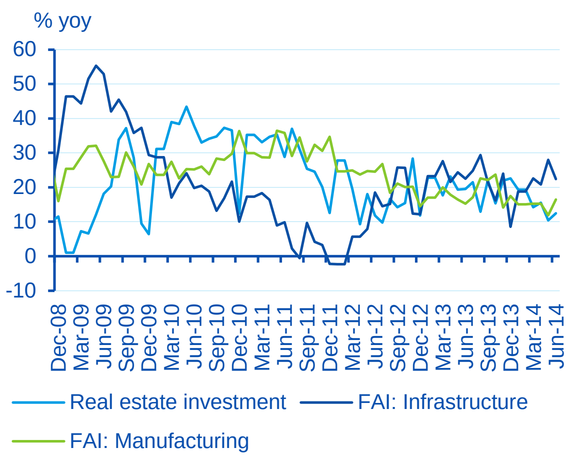
Source: CEIC and BBVA Research

Figure 3.10
Investment displays different patterns



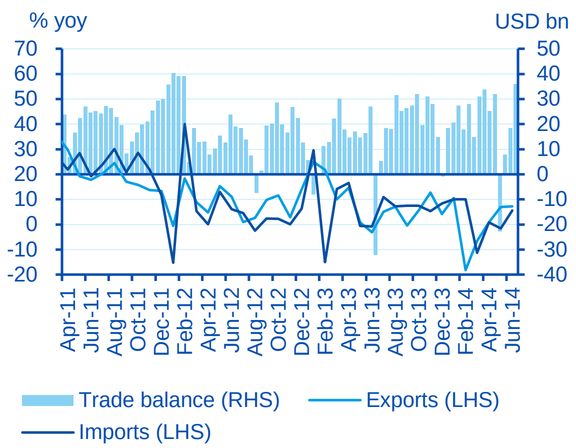
Source: CEIC and BBVA Research

Figure 3.11
Weaker real estate and infrastructure investment while increasing manufacturing FAI



Source: CEIC and BBVA Research

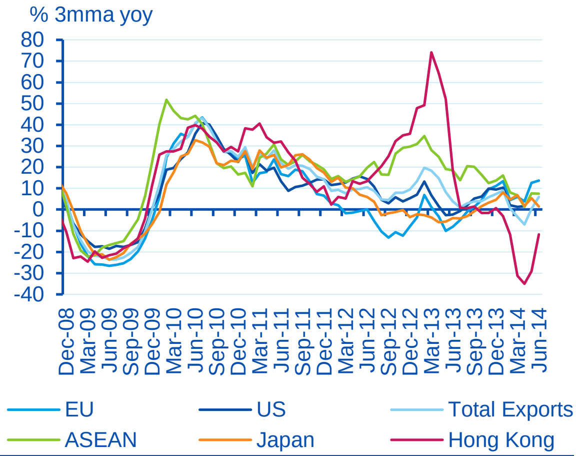
Figure 3.12
The external demand is improving gradually



Source: CEIC and BBVA Research

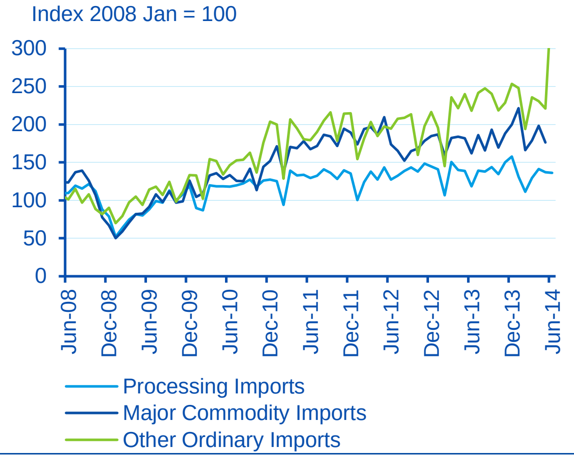
Headline figures of China's exports picked up significantly in May and June due to a confluence of factors: first, the distorted effects of exporters' over-invoicing early last year faded away; second, the ongoing recovery in advanced economies, accompanying the long-awaited improvement in their labor markets, bolstered the external demand; and last, the weakening trend of the RMB exchange rate (which is believed to be deliberately initiated by the authorities in February) and the export-boosting measures in the stimulus package also contributed to the export recovery.

Figure 3.13
The trade figure distortion was mainly with Hong Kong



Source: CEIC and BBVA Research

Figure 3.14
Domestic demand and re-exports are helping imports while commodity imports are sluggish

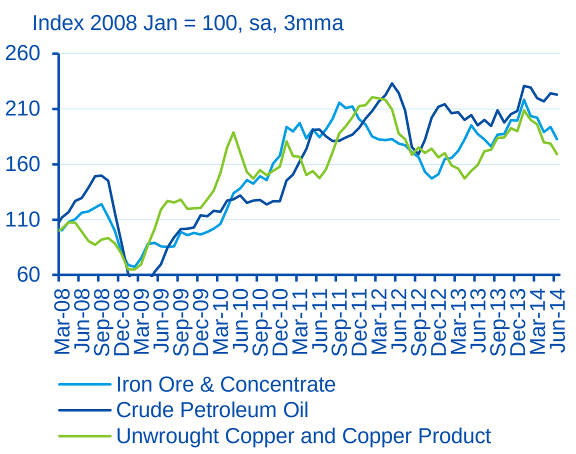


Source: CEIC and BBVA Research

Imports are broadly stable thanks to solid domestic demand. The commodity imports displays diversifying paths: Oil demand has edged up slightly in Q2 after a decline in Q1, whereas Iron Ore and Copper continue to dip in Q2 (Figure 3.15) due to the weakened demand from relevant industries that are plagued by over-capacity problems.

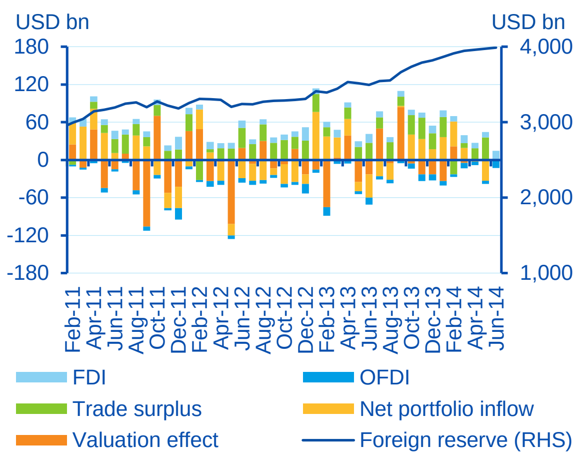
Despite that the trade surplus further shrank to 31.56 billion USD in Q2 from 35.92 billion USD in Q1 2014, foreign reserves rose to 3.99 trillion USD at end of June from 3.95 trillion USD at end of March. Moreover, capital inflow in Q2 displays a marginal decreasing pattern, due to the ongoing US QE Tapering and economic slowdown expectations in China. (Figure 3.16).

Figure 3.15
Commodity import growth displays diversifying path



Source: CEIC and BBVA Research

Figure 3.16
Capital flows become volatile

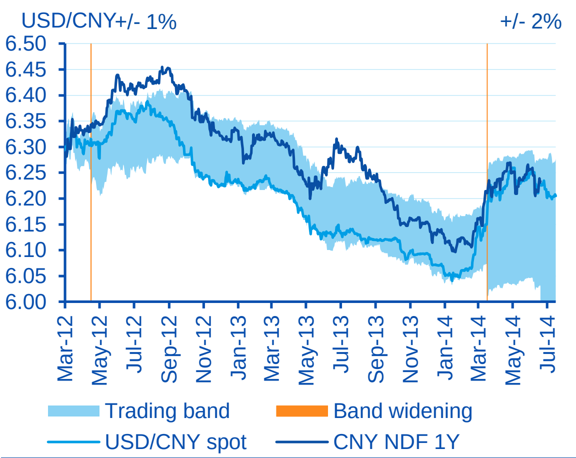


Source: CEIC and BBVA Research

The RMB rebounded recently on upbeat export outlook

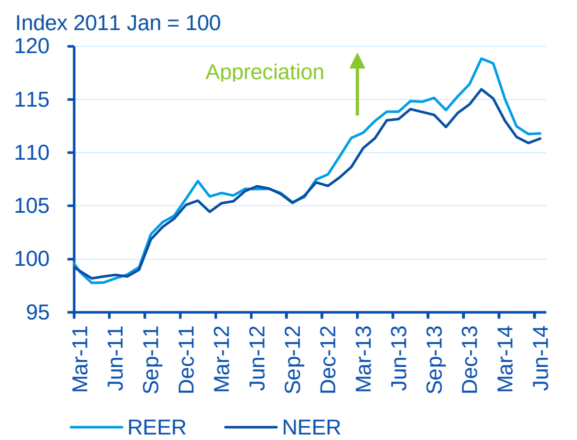
The weakening trend of the RMB continued in Q2 since the PBoC widened the currency's daily trading band to +-2% from +-1% on March 17 (Figure 3.17 and 2.18) but rebounded modestly on the improving outlook of the expert sector. To date the RMB has depreciated by 1.98% against the USD since the beginning of 2014. The NEER and REER declined around 4.33% and 5.86%, respectively, compared with the beginning of 2014; modestly strengthening the competitiveness of "made-in-China". In the meantime the exchange rate volatility has significantly risen, in line with the authorities' intention to enhance the two-way flexibility of the exchange rate to reduce speculative money inflows.

Figure 3.17
The RMB has strengthened modestly on upbeat export outlook



Source: Bloomberg and BBVA Research

Figure 3.18
The nominal and real effective exchange rates declined

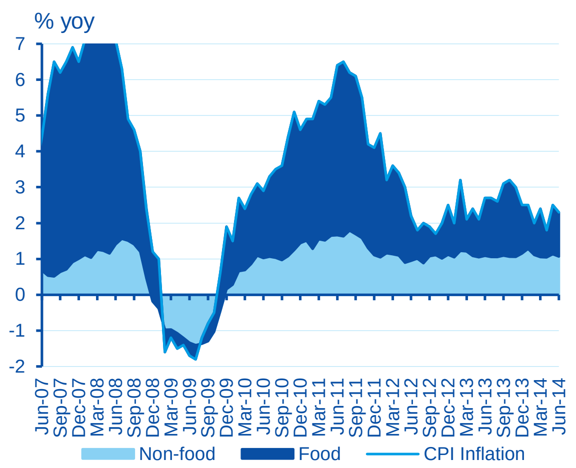


Source: BIS, CEIC and BBVA Research

Inflation remains in the acceptable region

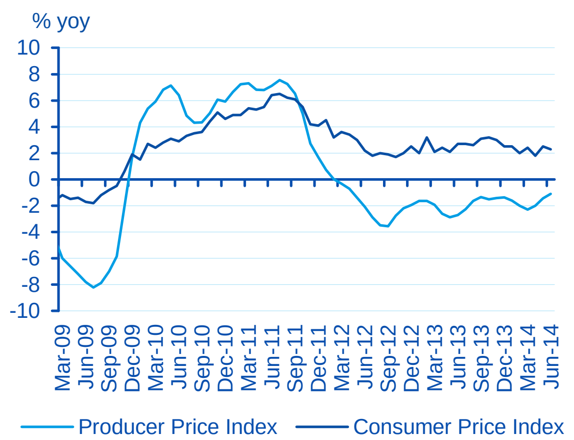
Inflation modestly decreases to 2.3% y/y in June (Figure 3.19) from 2.5% in May, well within the government's 3.5% tolerance target. Both food and non-food prices are tamed. Meanwhile, producer price inflation stayed in negative territory (-1.1% y/y in June), partly due to the overcapacity problems common in upstream industries (Figure 3.20). The benign inflation has enabled the policymakers to further loosen policies to revive the economy.

Figure 3.19
Inflation remains within 3.5% target



Source: CEIC and BBVA Research

Figure 3.20
PPI inflation is still negative



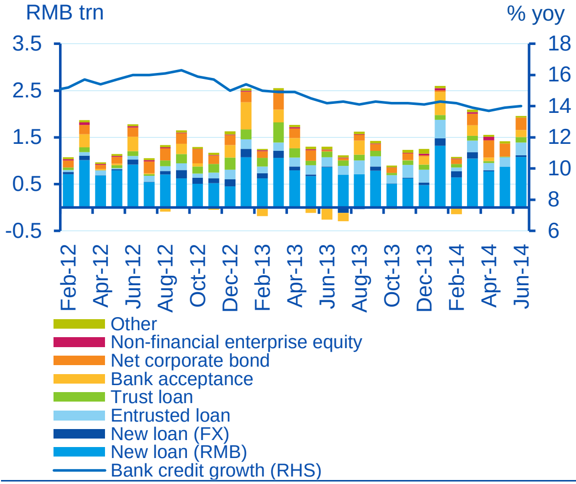
Source: CEIC and BBVA Research

Credit growth boomed in Q2

Credit growth significantly rebounded in June. Bank loans growth accelerated slightly to 14.0% y/y in June from 13.9% in May while the "total social financing", a broad gauge of credit, increased to 1970.0 billion RMB in June from 1404.5 billion RMB in May. (Figure 3.21) Meanwhile, M2 growth picked up to 14.7% y/y in June (versus 13.4% in May), due to both strong loan growth and last year's low base resulting from the liquidity squeeze (Figure 3.22). In the interbank market, interest rates at shorter tenors generally stayed at low and stable levels. Recently, the rates at the relatively longer-tenors (for example 3m Shibor) have started to decline.

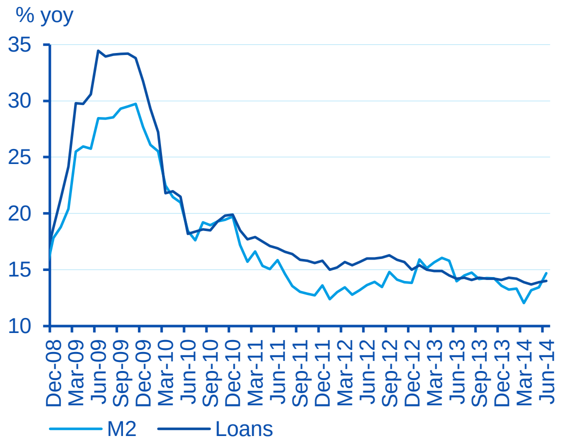
The surge of credit in June was caused by the monetary easing of the PBoC, which managed to keep ample liquidity in the inter-bank money market. (Figures 2.24) The authorities also launched a set of unconventional monetary policy tools to spur bank lending and bolster growth. (Box 1 analyzes China's unconventional monetary policies).

Figure 3.21
Broad-based credit growth in June



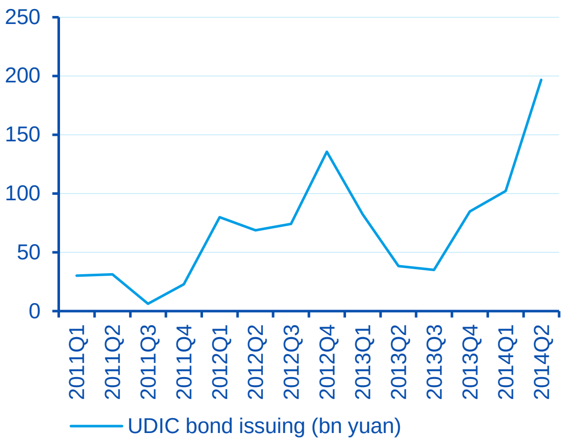
Source: CEIC and BBVA Research

Figure 3.22
M2 and bank loan growth increased in Q2



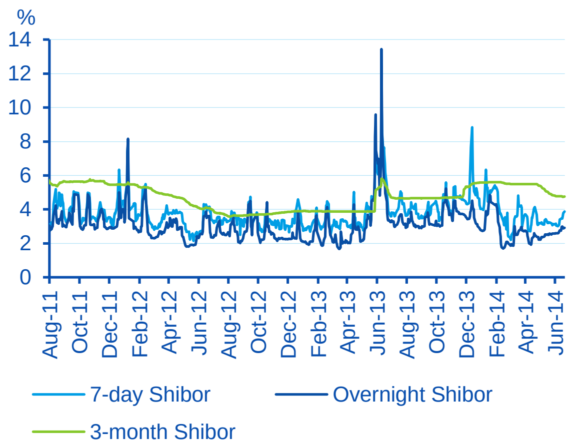
Source: CEIC and BBVA Research

Figure 3.23
LGFV bonds issuing increasing significantly in Q2



Source: Wind and BBVA Research

Figure 3.24
The interbank liquidity stabilized after the previous crunches



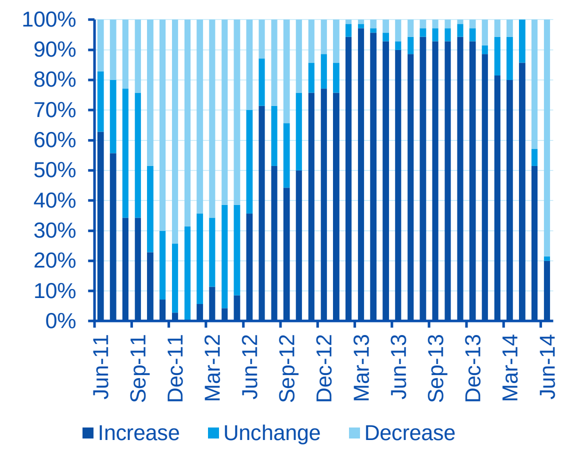
Source: CEIC and BBVA Research

The cooling real estate market

The property market showed no sign of improvement in the second quarter. Downbeat market expectations over slowing GDP growth and the oversupplied problems in many cities continued to weigh on housing prices and transactions, especially in small cities. Banks' cautious stance against mortgage loans further dampens housing demand. As revealed by the NBS, only 14 out of 70 cities reported a year-on-year price increase in June, substantially down from 56 cities three months ago. The property market transactions are sluggish as well, with its yoy growth rate stood at around -10%.

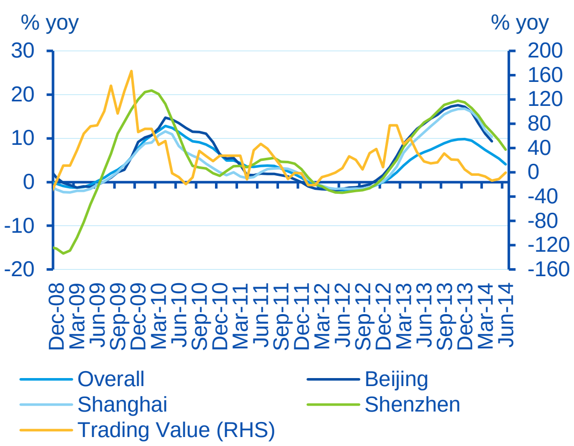
To revive the housing demand, the central government has recently acquiesced to local governments' relaxation of previously imposed tightening measures on the property market. It however remains a question whether the relaxation could take effect.

Figure 3.25
A majority of cities reported housing price decline



Source: NBS and BBVA Research

Figure 3.26
Housing prices and transactions are sluggish



Source: NBS, CEIC and BBVA Research

Financial fragilities: aggravated by the stimulus package

The stimulus package has aggravated some existing financial fragilities, in particular the indebtedness of local governments. As described in the previous section, one main element in the recent stimulus package is to accelerate infrastructure construction and shantytown renovation projects undertaken by local government financing vehicles (LGFVs), which inevitably forces them to borrow more to meet financing needs. For instance, the issuance of LGFV bond has significantly increased over the past couple of quarters (Figure 3.23). Also, the main borrowers of the PBoC's newly launched PSL program are believed to be LGFVs too. That said, China Development Bank (CDB) will receive PSL loans from the PBoC first and then relend funds to LGFVs' shantytown renovation projects in the form of normal commercial loans.

We estimate that China's total debt to GDP ratio has risen to 251% as of end-June from 236% at end-2013, mainly due to the rising debt level of local governments.

Box 1. China's unconventional monetary policies

Recently, the People's Bank of China (PBoC) has launched a set of unconventional monetary policies to boost bank lending and stimulate the economy. Compared with the conventional monetary policies, such as lowering interest rate, open market operation etc., these unconventional tools appear to be more targeted. In this Box, we analyze three new monetary tools employed by the PBoC, including pledged supplementary lending (PSL), selected RRR cut and Loan-to-Reserve ratio recalculation.

Pledged supplementary lending (PSL)

The Pledged Supplementary Lending (PSL) is a lending facility under which the central bank directly provides loans to banks for their re-lending. Unlike the existing central bank re-financing program, the PSL requires collateral assets (bank loans with different haircut ratios). Apart from channeling funds to the targeted financial institutions, the PSL is also expected to provide important guidance for the prospective trajectory of medium-term interest rates.

In April, China Development Bank (CDB) was reported to receive a three-year PSL of RMB 1 trillion from the PBoC. The funds are earmarked to provide loans in support of the shantytown renovation projects. It is reported that the PBoC will charge the CDB a favorable interest rate under the PSL, which is believed to be much lower than the current benchmark lending rate of 6%. The PSL is so narrowly based (only eligible to the CDB) and intransparent that It can't perform the role of guiding market expectations of the medium-term interest rate dynamic as the PBoC intended. In this sense, it looks more like stealth lending of the central bank rather than a monetary policy tool in common sense.

Two "targeted" RRR cuts

In April and June, the PBoC announced two "targeted" cuts in the RRR. In particular, the cuts are only eligible for banks which actively engaged in lending to the agricultural sector and SME customers. The RRR cuts were also applied to some non-banking financial institutions including finance companies, financial leasing firms, and auto finance companies. Although the RRR adjustment was a common monetary tool for China and a few other emerging markets, a "targeted" cut like above has never been seen in China before. Compared to a broad-based RRR cut, a targeted one can only unleash limited liquidity to the economy. We estimate that the cuts in April and June injected around RMB 100 billion to the banking sector.

Redefine the loan-to-deposit ratio (LDR)

In June, the China Banking Regulation Committee (CBRC) announced a revision to the calculation method for banks' loan-to-deposit ratio (LDR), which is expected to stimulate bank lending to the real economy, particularly to SMEs. Under the new calculation method, three additional items can be deducted from the LDR's numerator (total loans), including: (i) loans financed by bond issuance with a maturity beyond one year and without prepayment clause; (ii) SME loans financed by the central banks' refinancing program; and (iii) loans financed by international financial institutions and foreign governments. Additionally, two items will be added to the denominator (total deposits): (i) negotiable CDs issued by banks to corporate and individuals; and (ii) net deposits from foreign parent banks, which is only applicable to foreign banks incorporated in China. With this new LDR definition, the authorities could extend loans to specific sectors that they want to support even when the aggregate credit slows down.

In summary, China's unconventional monetary policies are intended to lead funds to some targeted areas, including shantytown renovation, infrastructure construction, the agriculture sector and SMEs. Compared with the broad-based interest rate or RRR adjustment, these unconventional measures could exceed in reducing funding costs for the targeted borrowers and preventing funds from flowing into certain high-risk industries. On the other hand, these unconventional policies, in particular the PSL, could increase the concentration risk of the banks by substantially exposing them to a few sectors. Furthermore, they will increase the overall debt level of the economy and derail the much-needed deleveraging in China.

4 Shifting policy focus back to structural reforms

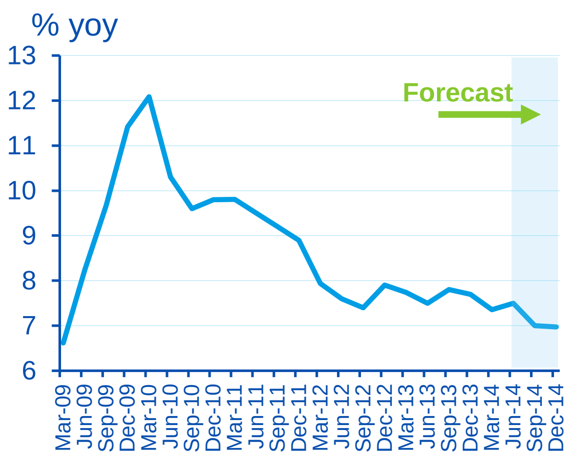
China's economic growth is expected to stabilize further in the second half of the year. Our forecast for Q3 and Q4 GDP growth are both 7.0% y/y, down from 7.5% in Q2 due to relatively higher base in 2H13. Our full-year growth projection for 2014 is unchanged at 7.2%, within the official comfort zone of 7.0%-7.5%.

We expect that the ongoing policy stimulus and the improving external demand will continue to be the main drivers of growth whereas the relative importance of the external sector could notably increase through the remainder of the year. Indeed, the room for additional policy maneuvering has narrowed after the expansion of the stimulus package in the second quarter. We estimate that it is almost impossible for the central government to maintain the current pace of fiscal spending unless this year's fiscal deficit target (2.1% of GDP) is to be revised up substantially. Encouragingly, the ongoing recovery in the US and EU seemingly gains a strong foothold and has at last started to resuscitate the ailing labor market, which is likely to bolster China's export sector in the coming months.

Inflation is expected to remain tamed during the rest of the year, thanks to weak commodities prices and the prevalent overcapacity problem in upstream industries. We therefore maintain our inflation projection of 2.6% for the full-year average and expect that inflation will go up to 3.1% at the end of 2014. Moreover, the current account is projected to maintain 2.5% of GDP, due to the improving external demand.

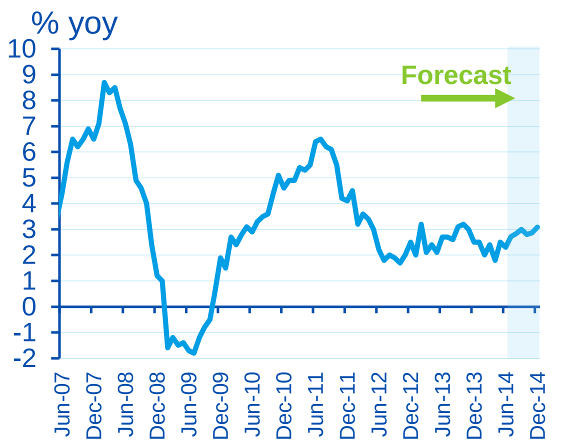
Although data shows there was net capital outflow of 36.9 Billion USD in Q2, net capital inflows are expected to be increasing at a slower rate in the second half of 2014. The reason for the capital outflow is due to the expectation of FED QE tapering, which will lead to capital outflow to almost all emerging economies; moreover, RMB depreciation and the worries of Chinese economy slow-down also contribute to the outflow in Q2. However, as China's economy will stabilize in H2, it will attract capital inflows mainly in the forms of FDI and portfolio inflow. Based on the comparative strength of the two opposite effects, we believe that there will be slower net capital inflow to China.

Figure 4.1
GDP growth will be stabilizing in 2014



Source: NBS, CEIC and BBVA Research estimates

Figure 4.2
Inflation will be maintained within the 3.5% tolerance region



Source: NBS, CEIC and BBVA Research estimates

RMB is modestly undervalued and expected to resume appreciation

Despite its persistently weak performance in the first half of the year, the RMB is expected to resume appreciation in the coming months due to the stabilized economy and upbeat export outlook. We forecast that the currency will appreciate to around 6.10 RMB/USD at the end of year from its current level. Additional 2-3% appreciation is anticipated in the next year, further aligning the exchange rate with its equilibrium level.

Nevertheless, it is noted that the RMB exchange rate is still in tight grip of the PBoC, which is reluctant to allow fast appreciation of the currency on concerns of its adverse impact on the competitiveness of China's exports. Moreover, the ongoing capital account liberalization process, the focus of which is to relax the existing restrictions of capital outflows, could temporary weigh on the demand of the currency and slow the pace of appreciation. On balance, the RMB is likely to stick to a gradual appreciation path in the next couple years with increasing two-way flexibility.

Table 4.1
Baseline Scenario: Forecasting

	2011	2012	2013	2014 (F)	2015 (F)
GDP (%, y/y)	9.3	7.7	7.7	7.2	7.0
Inflation (average, %)	5.4	2.6	2.6	2.6	3.3
Fiscal balance (% of GDP)	-1.1	-2.1	-1.9	-2.5	-2.5
Current account (% of GDP)	1.8	2.3	2.0	2.5	3.0
Policy rate (%)	6.56	6.00	6.00	6.00	6.00
Exchange rate (CNY/USD)	6.30	6.23	6.05	6.10	5.95

Source: BBVA Research

Advancing overdue structural reforms

Except for some incremental steps in the financial sector (see our *Banking Watch about China's Financial Liberalization*), the reforms in other key areas were muted during the second quarter. It seems that the implementation of long-term structural reforms gave way to short-term pro-growth initiatives amid mounting pressure of averting a hard-landing scenario.

The stabilization of growth has created necessary condition for the authorities to shift their focus back to advancing structural reforms. Given that the new leadership will hold power in a relatively longer period, they have a stronger incentive to push forward these structural reforms to reap the fruits in future. Moreover, the lackluster growth in Q1 can deepen their understanding of the weaknesses of the current government-led and credit-fueled growth model, expediting them to move quickly. In particular, we are expected to see more reforming measures in a number of key areas over the second half of the year, including financial liberalization, the overhaul of fiscal system, SOEs reform and the gradual abolition of Hukou system.

In the meantime, the authorities are likely to flexibly tailor their policies to sustain the growth momentum. Limited by the deficit target, the authorities could slow down fiscal spending in the coming months. But they will continue to cut red tape for enterprises, especially SMEs, to create a better business environment. In the face of a flagged property sector, the authorities are likely to further ease the existing macro-prudential measures on housing market, such as second-home purchase restrictions and minimum down payment requirement. In this respect, small and medium-sized cities could move more quickly than a number of super-large cities including Beijing, Shanghai, Shenzhen and Guangzhou.

On the monetary front, the PBoC has indicated to target a full-year bank loan growth of around 14%, the same as the first half of the year. That said, monetary policy will revert to its neutral stance in H2 after the implementation of a number of unconventional policies to spur bank lending in the second quarter.

5 Risks are still to the downside

Despite that the outlook of global economy has improved over the past few months, risks to China are still to the downside, concentrating on the uncertainty surrounding the normalization of US monetary policy, domestic real estate market adjustment as well as a number of financial market fragilities.

As the tapering of QE approaches its end, the timing of the Fed's interest rate hike now becomes the market's new focal point. An unanticipated interest rate hike could bring enormous shocks to global financial assets and cause disruptive capital flows across borders. Although China keeps its capital account largely closed, it is not immune to this risk. According to our estimate, China's external debt grew fast over the past few years, which has substantially increased China's vulnerability to external shocks. (see our *Economic Watch about China's External Debt*) In an extreme scenario, the Fed's rate adjustment could lead to violent price correction of asset prices in China.

The risk of property market continues to unfold as housing prices have dropped and the transaction volume has frozen. The property market has a broad impact on the economy through its close linkage to other important sectors, such as construction materials, iron and steel, chemical, transport & storage, electricity and heat, general equipment, etc. Although we believe the ongoing urbanization in China could sustain housing market from a long-term perspective, the authorities can't afford to ignore the tail risk of the property market given its importance to the whole economy.

A number of financial fragilities continue to pose risks to the financial stability and economic growth. First, the stimulus package has worsened the debt burden of local governments and could lead to severe liquidity risks. As described in the previous section, the recent stimulus package tilts toward infrastructure construction and shantytown renovation undertaken by local government financing vehicles (LGFVs), which inevitably leads to the further build-up of LGFV debt and substantially increase their debt service cost. Furthermore, the sluggish real estate market has reduced important land sales income of local governments, exacerbating their feeble balance sheets.

Second, new investment projects in the stimulus package could resuscitate the shadow banking sector by raising aggregate financing demand despite the authorities' clampdown efforts. Indeed, risks in the shadow banking sector have already started to unfold, mirrored by several high-profile possible default cases of financial products issued by trust companies in the past several months. Against such a backdrop, the rebound of shadow bank activities could quickly lead to a catastrophic implosion of the entire financial system given the complex connectedness between the shadow and formal banking sectors.

6 Tables

Table 6.1
Macroeconomic Forecasts: Gross Domestic Product

(YoY% growth rate)	2011	2012	2013	2014 (F)	2015 (F)
United States	1.8	2.8	1.9	2.5	2.5
Eurozone	1.6	-0.6	-0.4	1.1	1.9
Germany	3.4	0.9	0.5	1.8	2.0
France	2.0	0.0	0.3	0.9	1.5
Italy	0.6	-2.4	-1.8	0.7	1.4
Spain	0.1	-1.6	-1.2	1.1	1.9
UK	1.1	0.3	1.7	2.8	2.4
Latin America *	4.1	2.6	2.3	2.3	2.5
Mexico	4.0	3.7	1.1	3.4	3.0
Brazil	2.7	1.0	2.3	2.0	1.6
EAGLES **	6.7	5.0	5.3	5.3	5.6
Turkey	8.5	2.4	4.0	1.5	5.1
Asia Pacific	6.1	5.2	5.2	5.0	5.2
Japan	-0.5	1.5	1.5	1.1	1.3
China	9.3	7.7	7.7	7.2	7.0
India	7.7	4.8	4.6	5.2	5.7
Hong Kong	4.8	1.5	2.9	3.7	3.9
Asia ex China	3.8	3.5	3.3	3.5	3.9
World	4.0	3.2	3.0	3.4	3.8

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela.
** Brazil, China, India, Indonesia, Mexico, Russia, Turkey.
Forecast closing date: 1 August 2014.
Source: BBVA Research

Table 6.2
Macroeconomic Forecasts: Inflation (Avg.)

(YoY% growth rate)	2011	2012	2013	2014 (F)	2015 (F)
United States	3.1	2.1	1.5	1.8	2.2
Eurozone	2.7	2.5	1.4	0.9	1.3
Germany	2.5	2.1	1.6	1.3	1.6
France	2.3	2.2	1.0	1.1	1.2
Italy	2.9	3.3	1.3	0.7	1.2
Spain	3.2	2.4	1.4	0.3	0.9
UK	4.5	2.8	2.6	1.9	2.0
Latin America *	8.1	7.6	8.9	11.8	10.8
Mexico	3.4	4.1	3.8	4.0	3.5
Brazil	6.6	5.4	6.2	6.4	5.8
EAGLES **	6.5	4.8	5.1	4.8	4.7
Turkey	6.2	8.7	7.6	8.2	5.3
Asia Pacific	4.9	3.4	3.5	3.6	3.8
Japan	-0.3	0.0	0.4	2.2	1.5
China	5.4	2.6	2.6	2.6	3.3
India	9.6	9.7	10.1	8.5	7.9
Hong Kong	5.3	4.1	4.3	3.6	3.5
Asia ex China	4.6	4.0	4.2	4.4	4.1
World	5.1	4.2	3.8	3.9	4.0

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela.
** Brazil, China, India, Indonesia, Mexico, Russia, Turkey.
Forecast closing date: 1 August 2014.
Source: BBVA Research

Table 6.3
Macroeconomic Forecasts: Exchange Rates (End of period)

		2011	2012	2013	2014 (F)	2015 (F)
Eurozone	**USD/EUR**	1.30	1.32	1.37	1.37	1.32
Japan	**JPY/USD**	76.9	86.8	104.9	115.0	120.0
China	**CNY/USD**	6.30	6.23	6.05	6.10	5.95
Hong Kong	**HKD/USD**	7.77	7.75	7.75	7.80	7.80
India	**INR/USD**	53.1	55.0	61.8	59.5	59.0

Source: BBVA Research

Table 6.4
Macroeconomic Forecasts: Policy Rates (End of period)

(%)	Current	2012	2013	2014 (F)	2015 (F)
United States	0.25	0.25	0.25	0.25	0.50
Eurozone	0.25	0.75	0.25	0.25	0.25
Japan	0.10	0.10	0.10	0.10	0.10
China	6.00	6.00	6.00	6.00	6.00
Hong Kong	0.50	0.50	0.50	0.50	1.50
India	8.00	8.00	7.75	7.75	7.00

Source: BBVA Research

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This report has been produced by the Emerging Markets Unit:

Chief Econmist for Emerging Markets
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Asia
Le Xia
xia.le@bbva.com.hk

Jinyue Dong
jinyue.dong@bbva.com.hk

Carlos Casanova
c.casanova@bbva.com.hk

Betty Huang
betty.huang@bbva.com.hk

Sumedh Deorukhkar (India)
sumedh.deorukhkar@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Developed Economies Area
Rafael Doménech Vilariño
r.domenech@bbva.com

Spain
Miguel Cardoso Lecourtois
miguel.cardoso@bbva.com

Europe
Miguel Jimenez González-Anleo
mjimenezg@bbva.com

US
Nathaniel Karp
Nathaniel.Karp@bbva.com

Emerging Markets Area
Alicia García-Herrero
alicia.garcia-herrero@bbva.com

Cross-Country Emerging Markets Analysis
Alvaro Ortiz Vidal-Abarca
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

Mexico
Carlos Serrano Herrera
carlos.serranoh@bbva.com

LATAM Coordination
Juan Manuel Ruiz Pérez
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive Carrasco
jselaive@bbva.com

Colombia
Juana Téllez Corredor
juana.tellez@bbva.com

Peru
Hugo Perea Flores
hperea@bbva.com

Venezuela
Oswaldo López Meza
oswaldo.lopez@bbva.com

Financial Systems and Regulation Area
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Recovery and Resolution Strategy
José Carlos Pardo
josecarlos.pardo@bbva.com

Global Coordination
Matías Viola
matias.viola@bbva.com

Global Areas

Economic Scenarios
Julián Cubero Calvo
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo Delgado
s.castillo@bbva.com

Innovation & Processes
Oscar de las Peñas Sanchez-Caro
oscar.delaspenas@bbva.com

Contact details:

BBVA Research
95/F, International Commerce Centre
One Austin Road West
Kowloon, Hong Kong
Tel. + 852-2582-3111; Fax. +852-2587-9717
research.emergingmarkets@bbva.com.hk
www.bbvaresearch.com