BBVA Research

China

Economic Outlook

Third Quarter of 2010

Economic Analysis

- Economic growth over the past quarter has been moderating as the authorities' recent measures to rein in rapid credit growth bear fruit. Loan growth has eased and the pace of housing price increases has slowed.
- We expect GDP growth of 9.8% in 2010, in line with our previous soft landing scenario. Inflation has recently moderated on a decline in food prices. We expect inflation to peak in July at just above 3%, below our previous estimates, and to subside thereafter as growth continues to moderate during the second half of the year.
- The moderation in growth has reduced the likelihood of additional monetary tightening measures in the near term. We expect up to one interest rate hike in Q4, and given strong external inflows further currency appreciation, which commenced as expected in Q2 with the implementation of a more flexible currency regime.
- Risks of overheating have diminished due to the moderation in growth and uncertainties in the global environment. As such, the balance of upside and downside risks is now more even that at the time of our previous update last May.

Index

Publication date: August 5, 2010

Summary

Economic growth in China is moderating in line with our soft landing scenario, consistent with our previous 9.8% GDP growth projection for 2010. After peaking at 11.9% (y/y) in the first quarter, growth moderated to 10.3% y/y in Q2 as tightening measures by the authorities have worked to slow credit and investment growth. The moderating trend has reduced the risks of overheating. Our projection for 2011 remains 9.2%.

While underlying inflation continues to rise, the pace has recently moderated. Headline inflation in June declined to 2.9% y/y, well below expectations due to a decline in food prices on abundant supplies. Inflation is now expected to rise to 3.3% in July, somewhat below our previous expectations, and to average around 3.0% for the year.

The authorities' recent efforts to restrain rapid lending growth and contain property price bubbles appear to be working. Loan growth has been slowing in line with the RMB 7.5 trillion target (19% in annual terms). There has been a significant decline in the volume of property transactions, and the pace of housing price increases has moderated. We expect the authorities to keep a watchful eye on property price developments.

The likelihood of further monetary tightening measures in the near term has diminished given the moderation in economic activity, slowing inflationary trends, and uncertainties to the global outlook. While the authorities have so far refrained from rate hikes—opting instead for increases in the required reserve ratio earlier this year and other quantitative measures to absorb liquidity—we expect up to one 27bp rate hike in Q4 to keep overall growth within potential. This is down from our previous expectation of two rate hikes this year.

The authorities have recently introduced a more flexible exchange rate regime, and since late June have allowed some RMB appreciation against the USD. The move was in line with our expectation that currency appreciation would commence in Q2 of this year. They have announced the move in the context of a resumption of the reform of the exchange rate framework introduced in July 2005, based on a currency basket. Details of the framework are still lacking, however, and in practice the authorities retain discretion over the day-to-day movement of the currency. We maintain our outlook for the currency at 6.54 per USD by end year, equivalent to a 4-5% appreciation for the year. In the meantime, the currency issue has political overtones given frictions in trade relations with key partners. To date, the currency this year has appreciated by less than 1% against the USD.

Fiscal policy remains supportive of growth. The two-year stimulus package continues to be implemented even as the pace of budgetary spending has slowed. The focus of public investment is now on continuation of existing infrastructure projects, subsidies to boost domestic consumption, and on social spending. If growth were to falter, there would be room to step up spending, including on public housing.

Risks are now more balanced than at the time of our previous update when we flagged the threat of overheating. The moderation in overheating risks is due to the softening growth indicators, stabilizing housing prices, and rise in uncertainties to the global outlook. While overheating risks remain, downside risks are also present in the event that the deceleration in growth were to become more rapid—a factor weighing recently on market sentiment—or if the external environment were to deteriorate rapidly. In such a case, there would be room for further stimulus measures to cushion the impact on domestic growth.

Our medium-term outlook continues to incorporate a gradual rebalancing of growth toward private consumption. The authorities have taken steps in this direction including through policies to boost domestic consumption directly, improvements in the social safety net (which would reduce the need for precautionary savings), and currency appreciation which will help to foster growth toward domestic sources.

1. Reassessing the risks for the global economy

Before turning to the outlook for China, it is useful to review the main risks facing the global economy, all the more so given heightened uncertainties and the important role of financial and trade links with the Asia region.

The effect from the fiscal adjustment on growth in Europe will be lower than commonly assumed. The positive impact on credibility will almost compensate the negative effect from reduced public demand. Conversely, medium-term risks from unsustainable fiscal positions in other developed regions are probably underestimated.

One of the most important channels through which the fiscal crisis has affected the European economy has been the loss of confidence, and a prerequisite to restore confidence is fiscal prudence, given the high public deficits experienced in many of these countries. Consolidation plans in Europe are being implemented according to schedules presented to the EC at the beginning of 2010. Fiscal consolidation in Europe needs to focus on the structural side, but a positive factor is that the planned adjustment is fast and tilted towards reducing expenditure, which will boost confidence and almost compensate the negative effect on growth from reduced public demand. Thus, as long as the determination on fiscal consolidation is maintained, the impact on European economic activity will be limited and transitory. On the other hand, other advanced economies, where fiscal impulses have been substantial and debt levels have increased at a pace similar to that in Europe, are relatively slow in coming to grips with reducing deficits and –at least– stabilizing debt levels. This is a medium-term risk that is being underestimated, as experience shows that the effect of lax fiscal policy on interest rates is highly non-linear, and there is a risk –with uncertain timing– of a sudden increase in long-term rates and a displacement of private demand; exactly the opposite effect intended by the fiscal stimulus packages.

The main risk to the global outlook is still coming from financial markets. Stress tests have had positive –though asymmetric– impacts throughout Europe. Although risks have been reduced, the potential fallout from renewed tensions is still sizable.

Financial risks, which stemmed from sovereign debt concerns, formed a feedback loop that ended up increasing market risk and drying up liquidity, especially in Europe. Nonetheless the sharp increase in financial tensions in Europe in the second quarter is starting to abate (see Chart 1). The release of European stress tests results has had positive effects on lowering tensions, although there has been a clear differentiation across countries. In particular, it may act as a powerful driver for removing uncertainty surrounding the Spanish financial system, as the implementation of the exercise looks rigorous and the outcome seems credible and is very informative. Undoubtedly the risk to Europe and the global economy coming from financial markets is still the main source of concern.

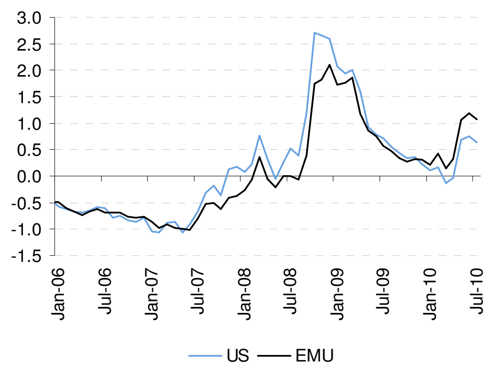
Increasing divergence in monetary policy strategies. Heightened uncertainty will prompt the Fed and ECB to postpone the exit from accommodative policies. On the contrary, tightening has resumed across much of Asia and Latin America.

Financial strains in Europe and uncertainty about the pace of recovery in the US will prompt central banks in both regions to postpone their first rate rises and keep very low policy rates for an extended period. Inflationary pressures in both areas will remain subdued, allowing them to keep lax monetary policies. Nonetheless, a faster recovery in the US will mean that the monetary exit will be earlier there than in Europe, and both factors will weigh down on the euro. Although both central banks will postpone monetary tightening, communication and the assessment of risks continue to differentiate both institutions, limiting the ECB's relative capacity to react, in particular to deflationary risks. On the other hand, in emerging economies monetary tightening is resuming, after a pause as the European debt crisis unfolded. This will help reduce inflationary pressures in Asia – where they were starting to build – and prevent potential pressures from developing later in the year in South America. An important exception is Banco de México, likely to hold rates until the second quarter of 2011. Even when inflation edges up in the last months of this year, it will remain within Banxico's forecasted range and long-term inflation expectations are still well anchored.

The global economy is on track for a mild and differentiated slowdown. In China and elsewhere in Asia, a moderating growth trend should reduce the risks of overheating. However, in the US private demand will remain weak without policy support, whereas in Europe confidence will be negatively affected by the fallout from the financial crisis.

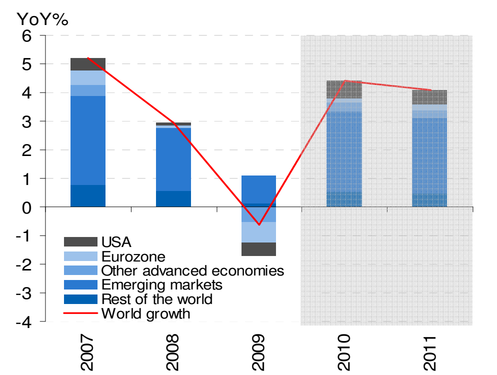
Spillovers from the European financial crisis to other geographical zones have been relatively limited. Nonetheless, the global economy will slow down going forward (see Chart 2). The severity of financial tensions in Europe will affect confidence and reduce growth in the second half of 2010 and the beginning of 2011. Moreover, external demand will not be as strong as it was in the first half of the year, although it will provide some support for economic activity. In the US, the recovery is likely to lose momentum on account of softening labor and housing markets. This shows the limits of private demand taking over as an autonomous driver of growth. In China, slowing GDP growth in the second quarter and moderating activity indicators are evidence that the authorities' tightening measures are being effective to steer the economy toward a soft landing in the second half of the year. Latin America will also slow down in 2011, but keep robust growth rates going forward. Therefore divergences will continue to widen both between advanced and emerging economies and within each of those groups.

Chart 1
Financial Stress Index for US and EMU*



* Composite indicator of financial tensions in 3 credit markets (sovereign, corporate and financial), liquidity strains and volatility in interest rate, foreign exchange and equity markets.
Source: BBVA Research

Chart 2
Contributions to Global GDP growth



Source: BBVA Research based on national accounts and IMF

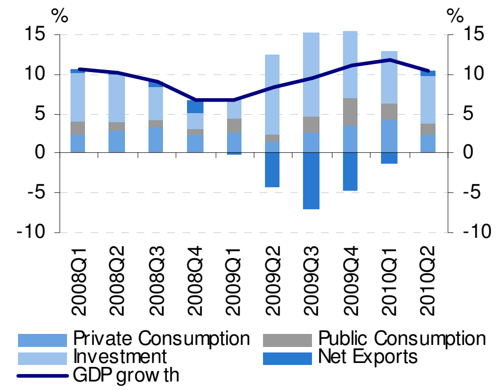
Although there were some steps in the right direction, going forward the necessary global rebalancing of demand and the narrowing of global imbalances is still pending.

As discussed further below in Section 3, the medium-term rebalancing of the Chinese economy towards more internal demand (particularly consumption) has begun, and the recent renewal of currency flexibility should help. Further reforms are being implemented to help boost consumption. Other advanced surplus countries also need to implement reforms to increase domestic demand, most notably in the service sector. On the other hand, the US and other countries with substantial external financing need to switch from a consumption-led growth model to investment, especially in tradable sectors. The recent financial crisis has shown the limits to foreign financing of growth. Economies with high external financing needs are highly vulnerable to an upsurge of international financial tensions, and the resulting sudden movements in exchange rates risk undermining global financial stability.

2. China: coming in for a soft landing

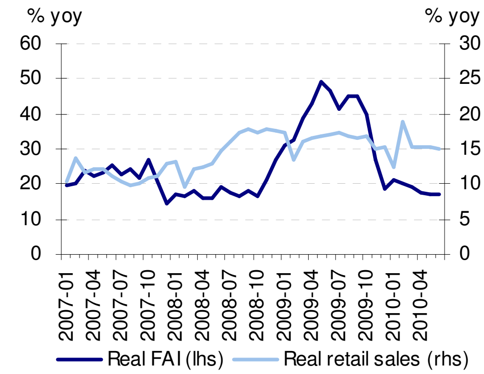
The pace of China's blistering economic growth is now easing, in line with a soft landing scenario for the economy. The moderation in growth, which nevertheless remains strong, is the result of the authorities' recent efforts to prevent overheating by reining in rapid credit growth and discouraging speculative investment in the real estate sector. After peaking at 11.9% y/y in Q1 2010, growth in the second quarter moderated to 10.3% y/y (an estimated 8.5% q/q in seasonally adjusted annualized terms) on some slowing of government-led investment and consumption which appears to have offset continued strength of retail sales and a rebound in net exports (Charts 3 and 4). With most domestic activity indicators also moderating and given the rise in uncertainties to the global outlook, risks, which were previously tilted toward overheating, have become more balanced.

Chart 3
China's growth is moderating... (Contribution to GDP)



Source: CEIC and BBVA Research

Chart 4
...as fixed asset investment eases while retail sales hold up

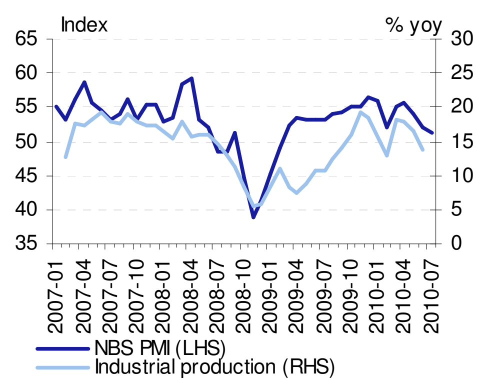


Source: CEIC and BBVA Research

Growth remains brisk, with healthy signs of moderation

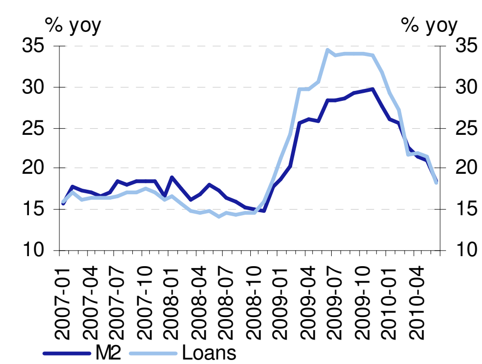
Recent data signal that the economy is slowing at a gradual pace. Expectations of a soft landing that were previously based on projections of a moderation in H2 are now being borne out by the data. The Q2 growth outturn of 10.3% y/y was slightly below expectations (BBVA: 10.8%; Consensus 10.4%). Nevertheless, quarterly growth was still strong, as the year-on-year outturn was influenced by a high base last year (full-year growth in 2009 was recently revised up to 9.1% from 8.7% previously). Growth in industrial output has continued to slow steadily, falling to 13.7% y/y in June, and the closely watched purchasing manager's index (PMI) also signals a slowing of manufacturing, although the official (NBS) index remains in expansion territory at above 50 through July (Chart 5). Importantly, money and credit growth continue to ease (Chart 6), in line with the authorities' RMB 7.5 trillion target for new loans in 2010 (through June, new loans for the year amounted to RMB 4.63 trillion).

Chart 5
Industrial production and the purchasing managers' index point to moderation



Source: CEIC and BBVA Research

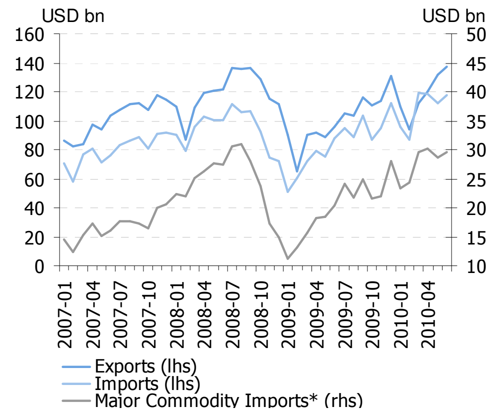
Chart 6
M2 and credit growth show further deceleration



Source: CEIC and BBVA Research

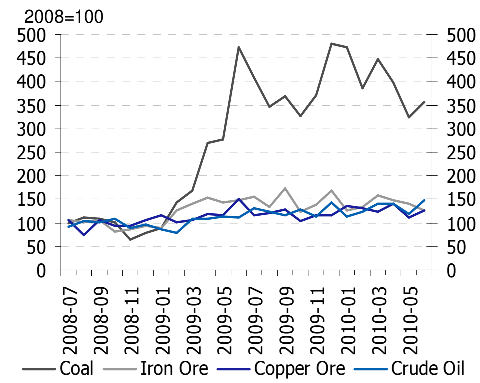
On the demand side, retail sales remain brisk, signaling that domestic consumption remains strong (Chart 4, above). Rising wages and government programs to support consumption are key factors (minimum wage increases effective from July 2010 amount to about 20%, 17% and 16% for Beijing, Shanghai and Shenzhen respectively). The external sector also continues to support growth, with exports rising to pre-Lehman levels and remaining surprisingly robust through June (Chart 7). Strong import growth is an indicator of continued robust domestic demand. The government-led surge in infrastructure spending led to a rapid increase in commodity imports (Chart 8), which recently show signs of leveling off as economic growth moderates, particularly in the commodity-intensive infrastructure investment sector.

Chart 7
Overall exports and imports have been rising, although the recent rebound in commodity imports has moderated



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

Chart 8
The infrastructure-led stimulus package led to a boom in commodity imports, which is now easing

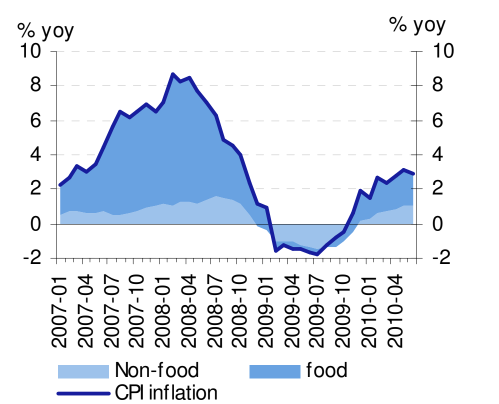


Source: CEIC and BBVA Research

CPI inflation has moderated as food prices ease

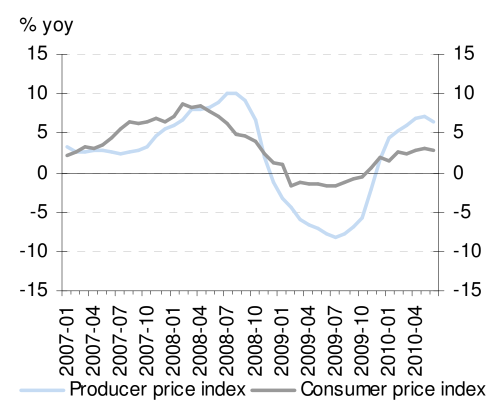
Headline CPI inflation, which had been rising steadily during much of H1, declined in June to well below expectations, at just 2.9% y/y (Chart 9). The lower outturn was due to a rise in supplies of agricultural products which helped contain the recent rise in food prices. Producer price inflation (Chart 10 with both PPI and CPI), which has been running at much higher levels, has also eased as commodity prices have leveled off.

Chart 9
CPI inflation has recently moderated



Source: CEIC and BBVA Research

Chart 10
PPI inflation is much higher, but is also moderating

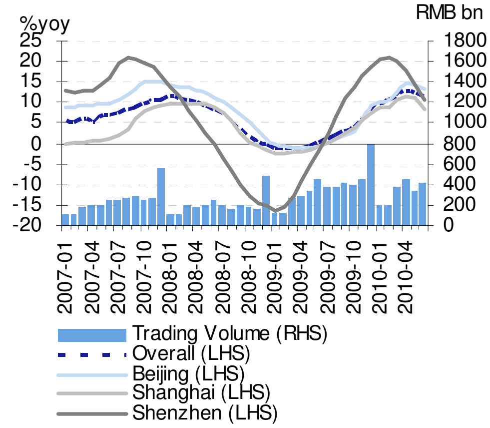


Source: CEIC and BBVA Research

The property sector begins to cool, reducing risks of asset price bubbles

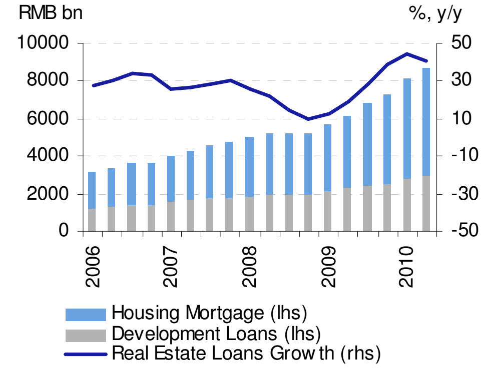
A key focus of recent tightening measures has been to prevent asset price bubbles in the property sector and to maintain housing affordability (for details, see China Real Estate Outlook). Lax liquidity conditions and rapid lending growth have led to a sharp increase in property prices over the past year (Chart 11). Measures were taken last April to contain prices by discouraging speculative home purchases. In particular, down payment requirements for second home purchases were further increased, and loans for third home purchases were forbidden. Mortgage interest rates for second home purchases were also increased relative to the benchmark interest rate.

Chart 11
Housing prices have been cooling



Source: CEIC and BBVA Research

Chart 12
Mortgage lending is still rapid, but decelerating



Source: CEIC and BBVA Research

There is evidence now that these measures are having their intended effect. The growth of property prices has continued to slow in recent months and there has been a sharp decline in sales transactions. In particular, the growth in average property prices (for 70 of China's major cities) moderated from 12.4%y/y and 0.2%m/m in May, to 11.4% y/y and -0.1% m/m in June. To date, there has been little decline in nominal prices, but it appears that price declines are likely in the near future given the sharp decline in sales transactions. The pace of lending to the real estate sector is still rapid, but shows signs of moderating, to 40.2% y/y in June from 44.3% in March (Chart 12).

The overall thrust of macro policy settings remains supportive of growth

Despite measures to prevent overheating, the authorities have signaled they intend to maintain a supportive policy stance, all the more so in light of the uncertain global environment. On the fiscal front, the two-year stimulus package continues to be implemented even as the pace of budgetary spending has slowed. The focus of public investment is now on continuation of existing infrastructure projects, rather than approval of new ones. In addition, in late May and June the State Council called upon local governments to exert stronger controls over their spending activities financed through off-balance sheet local government financing vehicles (LGFVs). The Council also called on banks to tighten their control on lending to such vehicles, following previous efforts by the banking regulator (CBRC) to strengthen the regulation and monitoring of such loans. The CBRC estimates that bank loans to LGFVs amount to RMB 7.66 trillion, of which almost a quarter (RMB 1.76 trillion) may pose repayment difficulties.

That said, the thrust of fiscal policy initiatives remains growth supportive. The government recently announced 23 new infrastructure projects in the Western region, and policies to support domestic consumption continue through the extension of subsidies for durable consumer goods and automobile subsidies. As part of their efforts to rotate spending toward the social sector, the authorities also appear intent on boosting investment in public housing, which should continue to support overall fixed asset investment. The 2010 budget aims at a broadly unchanged deficit compared to 2009 of 2.8% of GDP.

Monetary policy has been tightened, and remains now in a "wait-and-see" mode

As noted above, recent efforts to rein in rapid credit growth are bearing fruit. The decline in monetary and credit growth aggregates has been achieved through hikes earlier this year in the required reserve ratio, the withdrawal of liquidity through open market operations, and more stringent credit quotas on banks. Efforts to cool the property sector have reinforced these measures.

The authorities' RMB 7.5 trillion new lending target for the year is broadly on track (reflecting a decline in overall annual credit growth to 19% from about 32% in 2009). Through the first half of the year, the extension of new bank loans amounted to RMB 4.6 trillion, or just over 60% of the annual target (the seasonal pattern of lending is usually skewed to the first half of the year). In line with the government's policy to promote a more balanced regional pattern of development and prevent a further widening in income inequality, during the first half of the year banks extended credit to SMEs at a more rapid pace than to other sectors; geographically, loans to Western regions outpaced lending in other the regions.

Given indications of moderating economic growth and the rise in uncertainties to the global environment, the PBoC has refrained from new tightening measures over the past quarter. Rather, the authorities appear to be evaluating the impact of the measures taken to date, including the three hikes in reserve requirements implemented between January-April (of a cumulative 150bps). In this regard, they have continued to refrain from interest rate hikes, even as others in the region have resumed tightening.

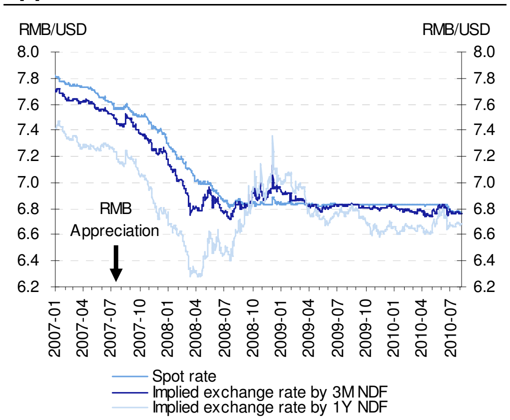
A move toward greater exchange rate flexibility on continued external inflows

The most significant move by the PBoC in the past quarter has been the announcement in mid-June of a return to greater exchange rate flexibility. Such a move toward gradual currency appreciation had been long anticipated and was in line with our expectations that it would begin in Q2, although for a time the rise in uncertainties in the global environment appeared to increase the likelihood of a delay. As such, the timing of the announcement came as a welcome surprise to the markets. There were also strong political undertones to the announcement given China's ongoing external surpluses and pressure from trading partners.

The announcement came after two years of a de facto peg of the RMB to the USD. The PBoC cast the move as continuation of the reform of its currency framework adopted in July 2005, in which reference was made to a basket of currencies. In principle the move should allow greater two-way flexibility of the exchange rate, although it is widely expected to result in appreciation over time given the strength of China's BOP surplus.

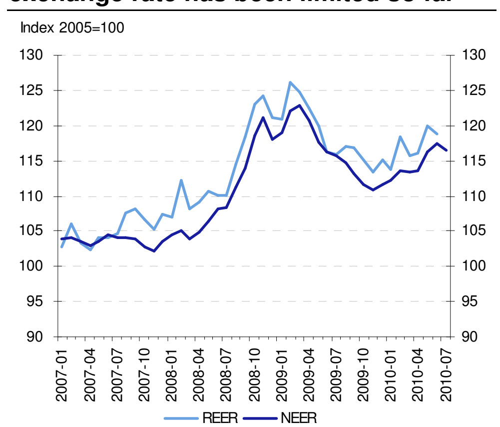
Since the announcement, the currency has appreciated by 0.7% against the USD (Chart 13). Nearly all of the appreciation, however, came within the first two weeks of the announcement, and since the beginning of July the RMB has been basically flat against the USD. After having appreciated in late June in nominal effective terms, the RMB has again depreciated due to the fall in the value of the USD against other key currencies such as the EUR and JPY (Chart 14). With continued strength in the external sector, political pressures on the authorities to allow faster appreciation are likely to build. In the meantime, the PBoC has also announced that it may soon start to publish a series for the exchange rate against a basket of currencies, which might help to clarify the composition of the basket and its use in exchange rate policy. Pending such clarification, however, the new framework lacks clarity, and leaves the authorities with discretion to move the exchange rate at a pace they deem appropriate.

Chart 13
NDFs are pricing in only a modest further appreciation of the RMB



Source: Bloomberg and BBVA Research

Chart 14
Appreciation of the nominal effective exchange rate has been limited so far



Note: NEER of Jul-10 is estimated by BBVA Research
Source: NBS, CEIC and BBVA Research

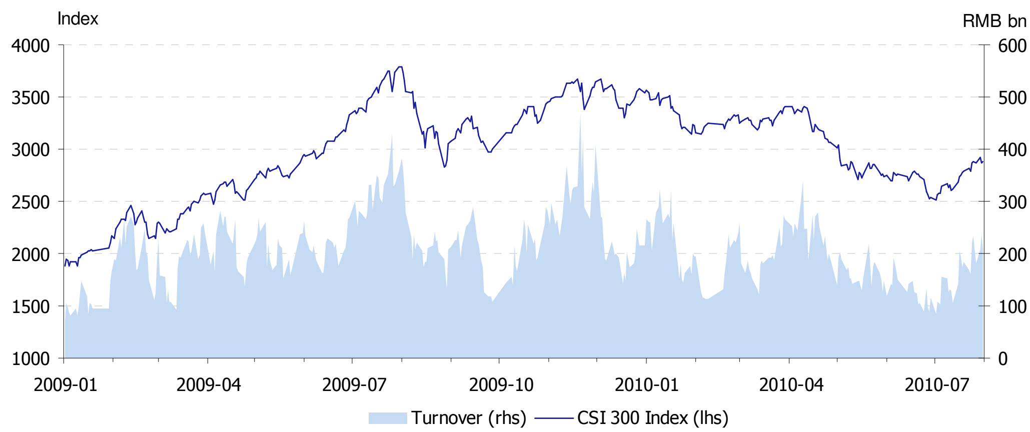
Gradual steps toward internationalization of the RMB are also continuing. Most recently, the PBoC and HKMA signed an agreement in July to remove restrictions on the transfer of RMB funds between banks and companies. The agreement reflects a further gradual step toward creating an offshore RMB market with Hong Kong playing a central role, including in the creation of RMB-denominated investment vehicles.

The trade surplus continues to widen, although reserves have stabilized

Pressure for currency appreciation is likely to continue as trade surpluses mount. After turning to a deficit briefly last March, the trade surplus has again recently widened (USD 41.2 billion in Q2 from USD 14.5 billion in Q1) due to unexpectedly strong export performance, which reached 43.9% y/y in June. Foreign exchange reserves rose by a relatively small amount of USD 7 billion in Q2, to reach USD 2.45 trillion. In addition to valuation effects (the depreciation of the EUR in Q2 depressed the value of reserves in USD terms by an estimated USD 49 billion), capital outflows may have occurred due to the weak performance of the stock market (Chart 15), property sector, and impact of global risk aversion. We estimate such net outflows at around USD 38 billion in Q2.

Chart 15

A 20% decline in the stock market since the beginning of the year reflects investor concern about the pace of the growth slowdown in H2



Source: BBVA Research

3. Moderating growth in H2

With growth slowing more or less in line with expectations, we are maintaining our full-year growth projection of 9.8% for 2010 and 9.2% in 2011. Our baseline scenario continues to assume that growth remains (just) within potential, which would help contain inflationary pressures. We do not expect any significant changes in the authorities' policy stance during the remainder of the year, other than fine tuning adjustments to ensure a soft landing for the economy. This will likely imply further gradual measures to restrain credit growth in line with the annual target, including the possibility of one rate hike later in the year, and continued efforts to cool the property sector. In the event that downside risks to the outlook materialize (see Section 4), there would be room for policy stimulus to cushion the impact on growth.

Our baseline scenario centers on a soft landing

We expect economic growth in H2 to moderate to 8.7%y/y from 11.1% in H1 as the impact of recent tightening measures continues to slow credit growth. The pace of investment would continue to slow, while consumption spending should remain robust on rising wage growth and support from government fiscal measures. Recent strength in the export sector is expected to moderate as the global policy stimulus wears off and as the inventory cycle winds down. Growth in 2011 is expected to moderate to 9.2%, in line with our previous projections, as stimulus policies continue to wind down (Table 1).

Table 1
Baseline Scenario

	2007	2008	2009	2010 (F)	2011 (F)
GDP (%, y/y)	14.2	9.6	9.1	9.8	9.2
Inflation (average, %)	4.8	5.9	-0.7	2.9	3.3
Fiscal bal (% of GDP)	0.6	-0.4	-2.2	-2.8	n/a
Current acct (% of GDP)	10.9	9.6	6.0	5.6	5.0
Policy rate* (%)	7.47	5.31	5.31	5.58	6.12
Exch rate* (CNY/USD)	7.30	6.83	6.83	6.54	6.28

Source: BBVA Research

We have adjusted our inflation forecast to take into account the recent moderation in the headline CPI. We now expect inflation to peak in July at 3.3% (well below the 4% we previously anticipated), and to moderate thereafter in line with an annual average of 2.9% (3.1% by end year). Our inflation outlook is based on an expected further moderation in credit and M2 growth, as well as indications that food prices will remain stable during the remainder of the year on ample supply conditions. Further currency appreciation, as expected, should also reduce the impact of imported inflation

Monetary policy is expected to remain accommodative, with some gradual further tightening accompanied by currency appreciation

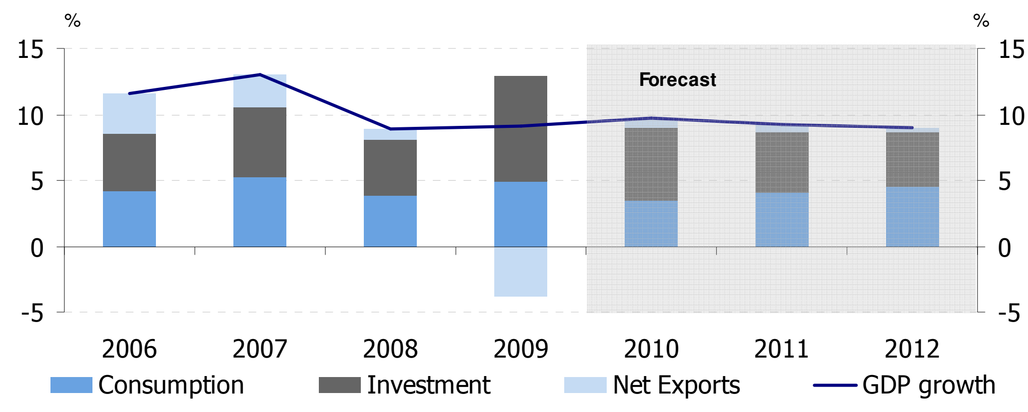
With signs that growth is moderating and given risks to the global environment, any additional monetary tightening measures during the remainder of the year are likely to be data-dependent. Our baseline incorporates the possibility of one 27bp rate hike during the fourth quarter of the year; although we concede that the likelihood of such a move has diminished given June's benign inflation outturn. We expect the authorities to remain watchful of property sector developments, and recent official statements reinforce our expectations that the authorities will not backtrack on recent measures to cool the sector or ease up on credit policies. That said, all in all, the likelihood of near-term monetary tightening measures has been reduced relative to our previous expectations.

Given recent strength in the external sector and our baseline projections for growth, we are maintaining our expectations of further modest currency appreciation, of a total of 4-5% against the USD, to 6.54 per USD by end-year (keeping in mind that the currency has already appreciated by almost 1%). This is somewhat larger than market expectations of appreciation as measured by forward NDFs, which imply an appreciation of 1-2% by end year and of 2-3% in 12 months. Within these broad currency trends, we anticipate some two-way variability, especially as the authorities seek to limit speculative hot money inflows on expected currency gains.

The medium-term rebalancing of growth toward domestic demand has begun

The authorities have continued to emphasize policies designed to rotate the sources of growth toward private consumption, rather than reliance on exports and investment as in the past. Consequently, our medium-term projections continue to incorporate an expected, albeit very gradual, rebalancing of growth in the coming years. Indeed, recent policies initiatives are consistent with this trend, including fiscal incentives to boost domestic consumption, enhancements to the social safety net that should reduce the need for precautionary savings over time, and the recent move toward currency appreciation. Further increases in wage rates and incomes should also support domestic consumption.

Chart 16
A rebalancing of growth over the medium term



Source: BBVA Research

4. Risks are more balanced

Given the recent moderation in growth indicators, stabilizing housing prices, and rise in uncertainties to the global outlook, risks that were previously tilted toward overheating have become more balanced. While overheating risks remain, especially in view of our estimate that the economy is operating at full potential, downside risks are also present in the event that the deceleration in growth were to become more rapid, or if the external outlook were to deteriorate sharply. In such a case, while still unlikely in our view, a hard landing for the economy cannot be ruled out entirely. However, given China's low public debt ratios, there would be room for further stimulus measures, if required, to soften the overall impact on growth.

The authorities have taken early action to cool the property sector and forestall the risks of destabilizing price bubbles. As documented in our recent Real Estate Outlook, the run-up in China's property prices is not very large in comparison to international experience with housing bubbles. Signs that prices are now moderating suggests that the authorities' early efforts have so far been successful in preventing a bubble from forming, all the while without inflicting damage on the broader economy. If, however, such policies are not successful down the line, a more abrupt bursting of the housing bubble and resultant loss in consumer confidence could result in a rise in non-performing loans (NPLs), leading to a "boom-bust" cycle. This could increase banks' capital needs and require government assistance.

While NPLs remain low for the time being, over the medium term they bear watch given the rapid lending growth that has taken place over the past year. Despite recent efforts to limit their growth, local government financing vehicles (LGFVs) remain a concern given the large amount of loans that banks are believed to have engaged in under the government's stimulus package. System risk is high since financials of these LGFVs are shaky and balance sheet relies heavily on land value. A sudden collapse of land prices could increase such risks significantly. Adding to these risks are recent reports that transparency may have been compromised as some banks may have shifted as much as RMB 2.3 trillion in loans to off-balance sheet investment products, effectively understating their exposure to local governments and the real estate sector.

5. Tables

Table 2

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2007	2008	2009	2010 (F)	2011 (F)
U.S.	2.1	0.4	-2.4	3.0	2.5
EMU	2.8	0.4	-4.1	0.7	1.3
Asia-Pacific	7.6	4.2	2.0	6.4	5.5
China	14.2	9.6	9.1	9.8	9.2
World	5.3	3.0	-0.6	4.4	4.1

Source: BBVA Research

Table 3

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2007	2008	2009	2010 (F)	2011 (F)
U.S.	2.9	3.8	-0.4	1.6	1.8
EMU	2.1	3.3	0.3	1.3	1.2
Asia-Pacific	2.8	4.9	0.3	2.9	2.8
China	4.8	5.9	-0.7	2.9	3.3
World	4.1	6.1	2.0	3.5	3.3

Source: BBVA Research

Table 4

Macroeconomic Forecasts: Exchange Rates (End of period)

		2007	2008	2009	2010 (F)	2011 (F)
U.S.	EUR/USD	0.70	0.70	0.70	0.80	0.80
EMU	USD/EUR	1.40	1.50	1.40	1.30	1.20
China	CNY/USD	7.30	6.83	6.83	6.54	6.28

Source: BBVA Research

Table 5

Macroeconomic Forecasts: Policy Rates (End of period)

	2007	2008	2009	2010 (F)	2011 (F)
U.S.	4.3	0.6	0.3	0.1	0.8
EMU	4.0	2.5	1.0	1.0	1.0
China	7.5	5.3	5.3	5.6	6.1

Source: BBVA Research

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