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Economic Outlook

China

May 2011
Economic Analysis

- **China's GDP growth in the first quarter of 2011 was higher than expected**, but signs of welcome moderation are evident as monetary policy is tightened further to avert overheating.
- **Strong growth momentum is being facilitated by a robust global economy**, fed by demand in emerging markets.
- **Inflation has risen well above the authorities' comfort range and is the most pressing and immediate policy issue**. In addition to food and energy, demand-driven price increases of non-food items are becoming a contributor.
- **We expect further monetary tightening,** with two more 25bp hikes in interest rates in the second and third quarters, and another 100bp increase in reserve requirements.
- **Risks are still titled toward overheating**, although they are moderating. Risks of a hard landing cannot be ruled out either, but we regard such a scenario as relatively remote.

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Summary

Over the past year, the Chinese authorities have been fine-tuning their policies to achieve a soft-landing for an economy that, at times, has been teetering on the brink of overheating. Though the battle is far from over, particularly against inflation, the authorities' efforts so far appear successful. Through a mix of fiscal, monetary, and macro-prudential measures, the authorities have been able to slow GDP growth just enough, while preserving sufficient momentum to propel the economy forward even in the face of external headwinds from rising oil and commodity prices and, more recently, the impact of the earthquake in Japan.

Rising inflation and strong domestic demand have prompted the authorities to implement an increasingly aggressive approach to monetary policy. GDP growth in the first quarter exceeded expectations, at 9.7% y/y, down only slightly from the previous quarter. Meanwhile, inflation has picked up, to over 5% in March and April, above the authorities'4% comfort level. On the basis of a stronger-than-expected GDP outturn in Q1 and rising inflation, we are revising up our full-year growth and inflation projections to 9.4% (from 9.2% previously) and 4.9% (from 4.5% previously), respectively. The revisions are still within our expected soft-landing scenario.

Policy tightening has taken the form of interest rate hikes and increases in required reserve ratios (RRR). There have been two rate hikes so far in 2011, for a cumulative increase of 100bps since October of last year. Reserve requirements have been increased so far in 2011 at a monthly pace, to stand at a record-high 21%. We expect further tightening, consisting of two more 25bp rate hikes in Q2/Q3, along with a further 100bps increase in the RRR.

The pace of RMB appreciation has been broadly in line with expectations, and we anticipate further gradual appreciation during the remainder of the year. Reserve accumulation has continued at a steady pace, despite a narrowing of the trade surplus in the first quarter of the year. There is evidence that capital inflows have risen as interest differentials widen and on expectations of further appreciation.

While still growth-supportive, fiscal policy has also become somewhat more restrictive, with the 2011 deficit target some 0.5ppts lower than the 2010 outturn. The 2.0% of GDP deficit target is being implemented through a slowdown in the pace of an otherwise ambitious program of infrastructure. Nevertheless, public expenditure in 2011 is still projected to show a hefty annual increase of 11.9% (nominal terms), with a focus on social spending and affordable housing.

In the banking sector, full-year results for profitability in 2010 surprised to the upside. In addition, non-performing loans (NPL) and capital adequacy ratios (CAR) stood at healthy levels. However, the recent aggressive monetary tightening measures, especially the hikes in reserve requirement ratio (RRR), appear likely to weigh on banks' profitability in 2011.

The authorities have maintained a focus on important medium-term objectives as laid out in the 12th five-year plan (2011-2015) that was released in March. As expected, the Plan sets quantitative targets for China's economic and development indicators, with an emphasis on rebalancing the sources of growth toward domestic demand, reducing income inequality, and promoting high-value added and environmentally friendly industries.

Risks continue to fluctuate between overheating on the one hand, and the possibility of a hard landing on the other. Overheating risks stem from rapid credit growth, the potential for asset price bubbles, and strong domestic demand. On balance, we view overheating risks as somewhat lower than our update of a few months ago due the aggressive tightening stance of the authorities and the accumulation of data showing a moderation in activity. In addition, new headwinds to growth may act as a counter balance to overheating. Meanwhile, a hard landing scenario, which we view as an even more remote possibility, could materialize from excessive policy tightening, an abrupt change in market sentiment, or deterioration in the external environment.

1. Global: recovery, global shocks and vulnerabilities

Before turning to the China Outlook, we review the* Global Outlook. *Readers who wish to do so may go directly to Section 2 on China (page 6).

The global economy will continue growing strongly, but risks are tilted to the downside

The global economy continues to grow at a robust pace, and is still expected to expand 4.4% both in 2011 and 2012, supported primarily by emerging economies (Chart 1). However, the threat coming from high commodity prices (especially oil) increases the uncertainty and introduces a risk to growth and inflation in most regions, even to some of those that might benefit directly from high commodity export prices. At the same time, local risks identified in the previous issue of the Global Economic Outlook continue more or less unchanged. In particular, financial stress in Europe is likely to continue, especially for Greece, Portugal and Ireland. The political noise around proposals to finally start the process of fiscal consolidation in the US will only add to uncertainty in the markets, even as we think that some form of fiscal adjustment will take place in the end. Finally, overheating pressures in emerging markets continue, although going forward they will be more of a concern in South America, given tailwinds from commodity prices.

While high commodity prices pose risks they are unlikely to dent growth

The greatest global risk stems from the rise in oil prices since the beginning of the year, caused mainly by political instability in the Middle East and North Africa (MENA). Although uncertainty is high and protests in the region are still unfolding, in our view, contagion to the point of disrupting oil production in other important oil producers beyond Libya will not occur. Thus, the geopolitical risk premia incorporated in oil prices will gradually be reduced, given ample OPEC spare capacity and OECD inventories, both above historical means. Nonetheless, oil prices may remain high at around US$110-120 per barrel during most of 2011, before receding gradually to around US$100 in 2012.

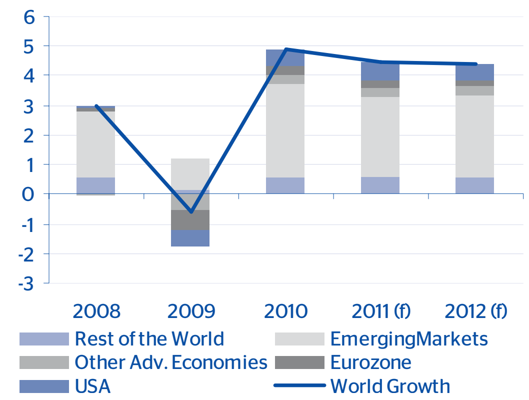
Given a rise in the price of other commodities such as food and metals as well, the main negatively affected regions will be the major developed countries and most of emerging Asia, the main importers of raw materials. On the other hand, the main beneficiaries of improved terms of trade would be the Middle East and Latin America, which will recycle part of this windfall revenue. However, a shock of this magnitude will be absorbed by the global economy without significantly affecting economic activity. This, together with relatively strong data in the first quarter of 2011, justifies relatively unchanged growth forecasts in most areas, as compared to our February Global Economic Outlook. The main exceptions are Mexico and South America, where strong data in the first quarter of 2011 and better terms of trade warrant a moderate upward revision of our growth forecasts for 2011. Core countries in Europe, as opposed to those in the periphery, will continue to grow, while risks to the U.S. forecasts shift from being biased upwards three months ago to be more balanced now because of higher oil prices.

High oil prices will push up headline inflation, necessitating earlier central bank interest rate increases in most regions

The main effect of the oil shock will be felt on prices. Higher inflation in most economies in 2011-12 will prompt monetary authorities to bring forward, and in some cases push for more aggressive, paths of interest rate increases (Chart 2). Nevertheless, there is still a wide heterogeneity in central bank approaches to the risks stemming from high oil and other commodity prices. In particular, in the US and euro zone, central banks are shifting—at different degrees—their focus from supporting growth or preventing a tail risk scenario of very low growth and deflation, toward keeping inflation expectations well-anchored, particularly considering that the monetary policy stances are very accommodative. As a consequence, the balance of risks has tilted towards a higher probability of early hikes. The timing of the first hike depends on the perceived need to react to potential risks of second-round effects. The ECB's hawkish approach is to avoid any risk by being pre-emptive (and thus its first hike in April). On the other hand, the Fed, focusing more on the lack of sustainability in the recovery, prefers to wait and act only if risks materialize. Between these two approaches, emerging economies seem open to more front-loaded hikes if needed, but with an eye also on avoiding excessive capital inflows and exchange rate appreciation.

Chart 1

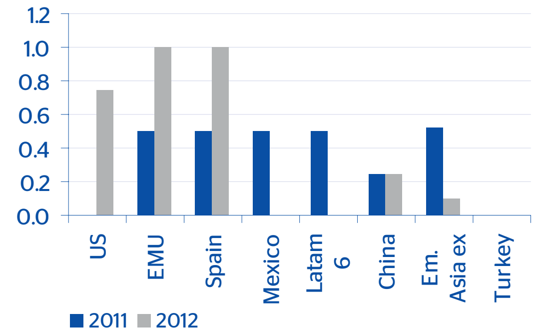
Global GDP growth and contributions



Source: BBVA Research and IMF

Chart 2

Changes in year-end expected official interest rates relative to February 2011



Source: BBVA Research

Financial tensions in the periphery of Europe will remain high

As long as doubts persist about the solvency of countries in difficulty, namely Greece, Ireland, and Portugal, and risk of debt restructurings linger, headwinds to private sector funding to these economies and high sovereign spreads and could spread to other countries. Thus, a comprehensive and carefully designed approach to debt resolution—one that does not risk contagion to the rest of Europe—is urgently needed.

In the US, fiscal consolidation will likely be achieved

In the U.S., the political process to reach a sustainable path for public debt involves difficult negotiations between two opposing approaches to deficit reduction. In the end, fiscal consolidation will have to come either from a reduction of entitlements or from higher tax revenues. In our opinion, both parties will reach an agreement that translates into lower deficits and a sustainable debt path, but the political process will be protracted.

Overheating concerns continue in emerging economies

Emerging economies continue to show risks of overheating, but with marked heterogeneity. Some countries are beginning to confront these risks through more restrictive monetary policy, for example, in the important cases of China and Brazil. We think overheating risks are manageable but, going forward, they may become more pronounced in South America, to the extent that commodity price increases are a tailwind, but act as a headwind for emerging Asia. In addition, doubts about the extent of the slowdown in Japan could weigh on economic activity in most of Asia, given extensive trade links and integrated production chains. Furthermore, current account surpluses in much of Asia provide a buffer for the region, as compared to South America.

2. China's growth: still going strong

Over the past year, the Chinese authorities have been fine-tuning their policies to achieve a soft-landing for an economy that, at times, has been teetering on the brink of overheating. Though the battle is far from over, particularly against inflation, the authorities' efforts so far have been surprisingly successful. Through a mix of fiscal, monetary, and macro-prudential measures, the authorities have been able to slow GDP growth just enough, while preserving sufficient momentum to propel the economy forward even in the face of external headwinds from rising oil and commodity prices and, more recently, the impact of the earthquake in Japan.

On the basis of a stronger-than-expected GDP outturn in Q1 and rising inflation, we are revising up our full-year growth and inflation projections to 9.4% (from 9.2% previously) and 4.9% (from 4.5% previously), respectively. The revisions are still within our expected soft-landing scenario.

With one eye fixed on efforts to preventing overheating in the near term, the authorities have also maintained a focus on important medium-term objectives as laid out in the 12th five-year plan (2011-2015) that was released in March. As expected, the Plan sets quantitative targets for China's economic and development indicators, with an emphasis on rebalancing the sources of growth toward domestic demand, reducing income inequality, and promoting high-value added and environmentally friendly industries.

Strong growth momentum amidst signs of moderation

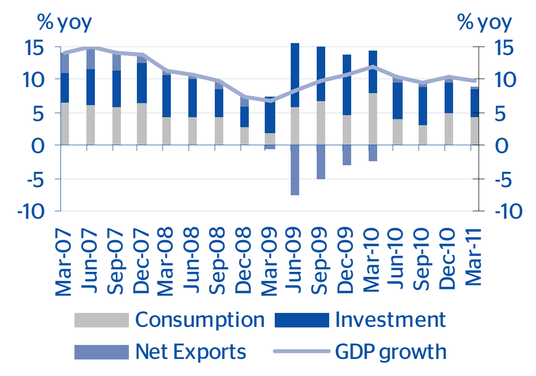
After posting GDP growth of 10.3% in 2010, the economy has continued to expand strongly in 2011, but at a moderating pace. First quarter GDP growth registered a faster-than-expected 9.7% y/y, down slightly from the previous quarter of 9.8% y/y (Chart 3). On a quarterly basis, growth momentum remained strong, at 8.6% q/q (seasonally adjusted annualized rate) according to China's first-ever official release of q/q growth statistics. Our own estimates suggest that quarterly growth was probably even stronger, at 10.9% q/q (saar), compared to 12.1% in the previous quarter.

At the same time, inflation has continued to trend up, reaching a peak so far of 5.4% y/y in March before declining to 5.3% y/y in April. As such, inflation has accelerated well ahead of the authorities' comfort level of 4%, driven by rising food prices, which now show signs of declining, and non-food items such as transportation and housing costs. Importantly, indications of demand–side pressures as a driver of inflation are becoming more pronounced.

The combination of strong growth and rising inflation has generated worries of overheating. By our estimates, GDP is now at or slightly above full potential. Encouragingly, there are signs of moderation in the data that suggest the authorities are averting overheating risks through their tightening measures. In particular, PMI readings (Chart 4) have been easing, but remain firmly in the +50 expansion zone due to declines in new orders and production. On the supply side, industrial production eased to 13.4% y/y in April from around 15% y/y in previous months. In addition, credit and M2 growth have also been easing (Chart 5). Importantly, new loans (cumulative of RMB 3.0 trillion through April) are in line with what we believe to be the authorities' full-year (unannounced) target of RMB 7.0-7.5 trillion. M2 growth has also slowed to the authorities' target range of 16.0% (Chart 5).

Chart 3

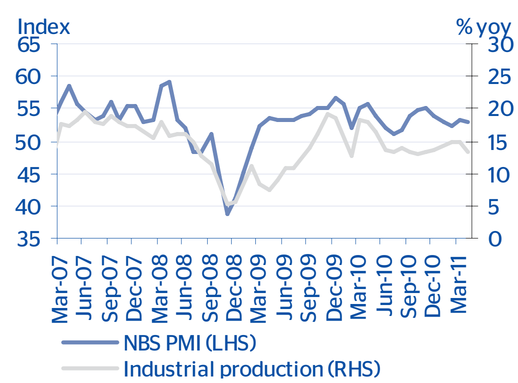
GDP growth has been driven by strong domestic demand



Source: CEIC and BBVA Research

Chart 4

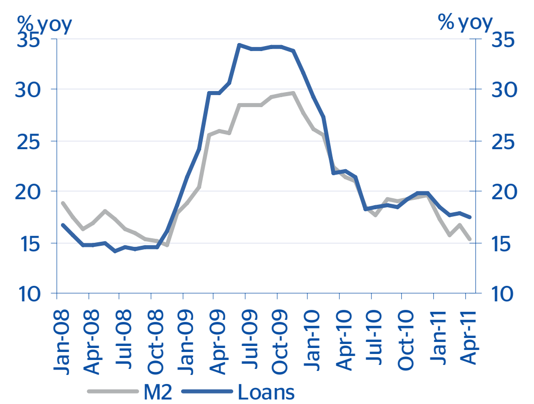
PMI and industrial production are now showing signs of moderation



Source: CEIC and BBVA Research

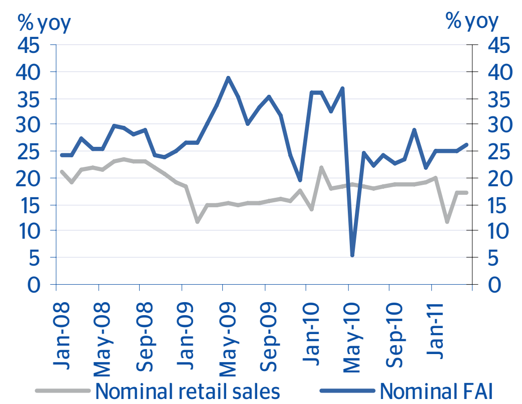
On the demand side, consumption indicators have weakened somewhat in 2011, with retail sales growth down from the levels in late 2010 (Chart 6). The apparent weakness may reflect the tailing off of consumption at end-2010, prior to the expiration of various consumption subsidies and efforts in a few large cities to limit automobile purchases due to congestion problems. We would not read too much into these trends at present, particularly given indicators of rising consumer confidence and wage growth, which bode well for consumption in the near future. Meanwhile, urban fixed asset investment has continued to rise at a fast pace (25.4% y/y in April), underpinned by spending associated with a number of investment projects set in motion at the outset of the 12th five-year plan (2011-2015).

Chart 5
Credit and M2 growth are easing



Source: CEIC and BBVA Research

Chart 6
Investment indicators are still strong, with consumption weakening a bit



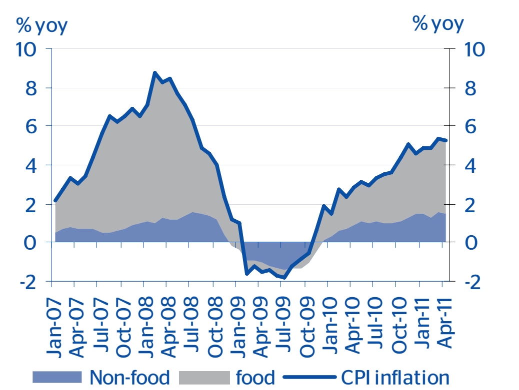
Source: CEIC and BBVA Research

Inflationary pressures on the rise

As in many emerging economies, inflation has become the predominant near-term policy concern, reaching 5.3% y/y in April (Chart 7). The main driver continues to be food prices and housing costs, which rose by 11.1% y/y and 6.4% y/y in April respectively. However, inflationary pressures have become more broad-based, with other components such as medical and health care rising as well (3.2% y/y). Producer prices remain elevated due to high raw materials costs.

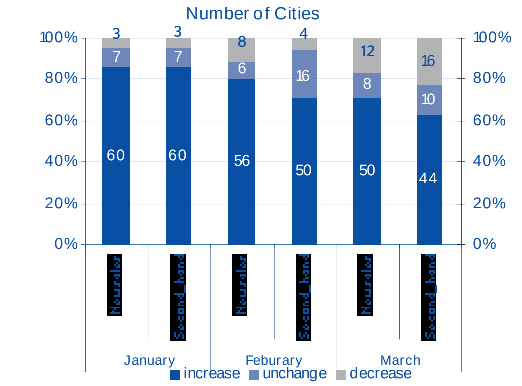
As discussed in our last issue of the China Economic Outlook, in addition to supply side factors from rising food and commodity prices, second round effect and demand pressures are also at play. Strong labor demand is pushing up wages, with 13 provinces/municipalities (out of a total of 31) so far having raised their minimum wage levels, by an average of 20.6% in first quarter.

Chart 7
Inflation is rising due to higher food prices, with pressures broadening



Source: CEIC and BBVA Research estimates

Chart 8
More cities are showing moderating property price trends



Source: CEIC and BBVA Research.

Property price increases appear to be easing

Other than inflation, risks of asset price bubbles continue to be a near-term policy concern. In that regard, the residential property is under close monitoring by the government so as to prevent price bubbles and maintain housing affordability. Following a series of actions in 2010, the authorities implemented new measures in early 2011, including a hike in down payment requirements for second home purchases and a new property tax being levied on a trial basis in Shanghai and Chongqing for newly purchased homes. A number of local governments, under rising pressure from the central government, have also announced measures to curtail speculation in the property market.

Since these measures were implemented, property price increases have decelerated. Gauging the extent of the deceleration, however, is made difficult by measurement problems and a change in the monthly price series made this past January, when the National Bureau of Statistics (NBS) abandoned its aggregate price index in favor of a city-specific prices indices (covering 70 of the largest cities) for new and existing home sales respectively.

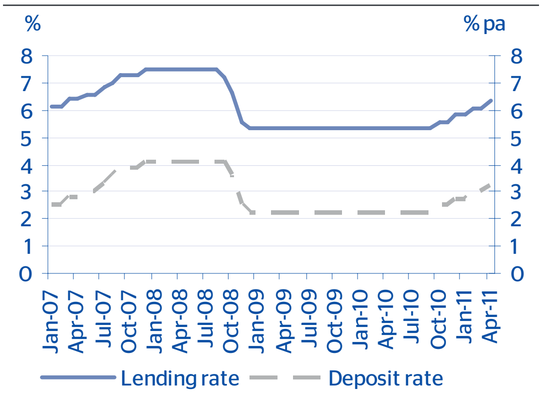
According to the new data series, during the month of March 20 cities registered flat or declining month-on-month housing prices for new home sales, and 26 cities saw flat or declining prices for existing home sales (Chart 8).

Macro policies take a more aggressive tightening stance

In view of the faster-than-expected pace of economic growth and rising inflation, the authorities have, more broadly ratcheted up their monetary tightening measures. The PBoC has raised interest rates twice already in 2011, by 25bp each in February and April (Chart 9). Interest rate hikes have been complemented by a series of increases in required reserve ratios, with 50bp hikes becoming a monthly occurrence so far in 2011 (five consecutive times through May), bringing the RRR to a record-high 21% for large banks (Chart 10). The most recent interest rate hikes have been implemented more symmetrically on the deposit and lending side, in contrast to earlier hikes which were tilted toward higher deposit rates. This may reflect the authorities' awareness of the deleterious effects of asymmetric interest rate and RRR hikes on banks' net interest margins (NIM).

Chart 9

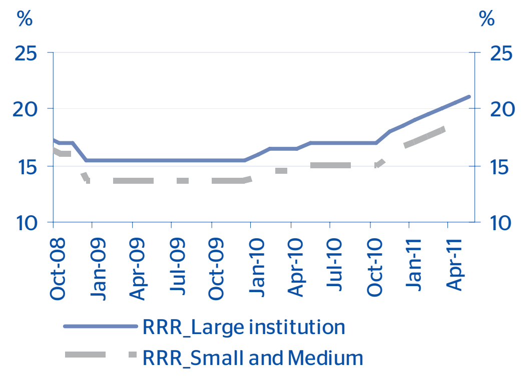
Two more interest rate hikes so far in 2011...



Source: CEIC and BBVA Research

Chart 10

...with monthly hikes in the required reserve ratio (RRR)



Source: CEIC and BBVA Research

Market sentiment has been influenced by the expected timing of interest rate hikes. The performance of China's equity market has lagged behind those of other emerging market economies (Chart 11). The primary market concern is still the further monetary tightening in the face of heighted inflation.

While still growth-supportive, fiscal policy has also become somewhat more restrictive. The 2011 deficit target is 2.0% of GDP (Chart 12), some 0.5ppts lower than the 2010 outturn. The smaller target is being implemented through a slowdown in the pace of an otherwise ambitious program of infrastructure investment (for example, spending on high-speed railway construction has been reduced to RMB 400 billion from a previously planned RMB 700 billion).

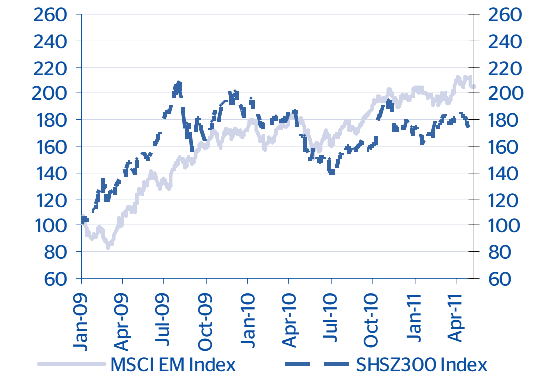
Nevertheless, public expenditure in 2011 is still projected to show a hefty annual increase of 11.9% (nominal terms), with a focus on social spending and construction of affordable housing (10 million units targeted for this year). The latter is projected to bring about an investment of RMB 1.3-

1.4 trillion in total, although only a small fraction (RMB 100 million) will be provided by the central government, with local governments and the private sector to finance the remainder.

On the revenue side, a proposal to raise the taxable income threshold is expected to be implemented during the second half of the year (from RMB2,000 per month to RMB3,000). The proposal would also increase the progressiveness of the tax schedule by reducing the number of tax brackets from 9 to 7.

Chart 11

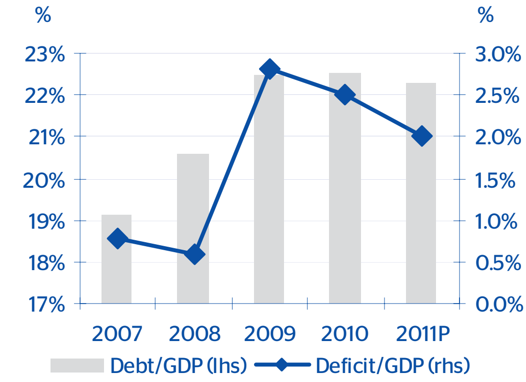
China's stock market has underperformed



Source: CEIC and BBVA Research

Chart 12

Fiscal policy is tighter, with a smaller deficit target for 2011



Source: CEIC and BBVA Research

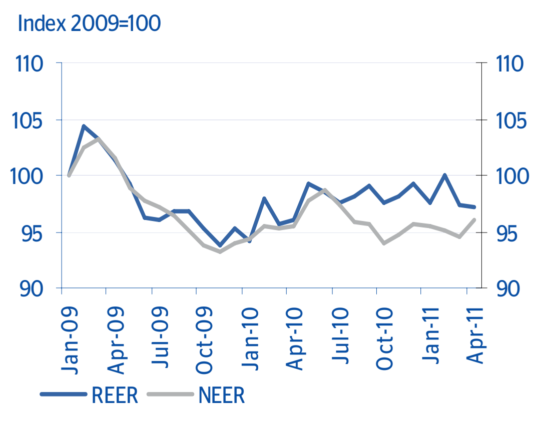
Currency appreciation continues at a gradual pace, as reserves accumulate

The pace of RMB appreciation against the US dollar has been sustained, broadly in line with our expectations of 4-5% per year. However, given the decline in the USD against other major currencies, in effective terms—both real and nominal—the currency has been broadly flat (Chart 13). Meanwhile, foreign exchange reserves have continued to rise, by USD 197 billion in the first quarter, to a record USD 3.04 trillion at end-March.

The rise in Q1 reserves was due to capital inflows, as the trade balance recorded a small deficit, for the first time since 2004. Given FDI inflows of USD 30.3 billion, we estimate portfolio (or "hot money" inflows of about USD 110 billion for the quarter (Chart 14). Such inflows are also consistent with anecdotal evidence that some enterprises have recently stepped up their offshore funding as a way of circumventing tighter domestic credit conditions.

Chart 13

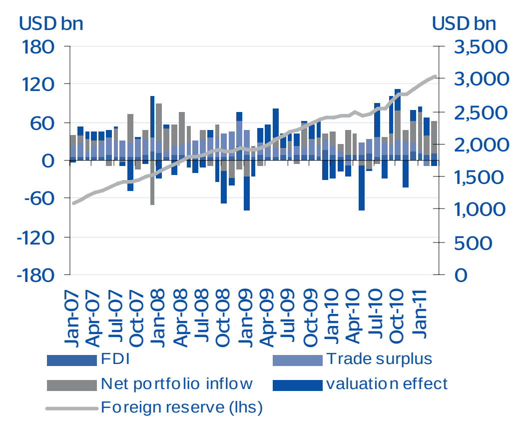
Appreciation against the USD, is much less in effective terms



Source: CEIC and BBVA Research

Chart 14

Capital inflows have increased on expectations of appreciation



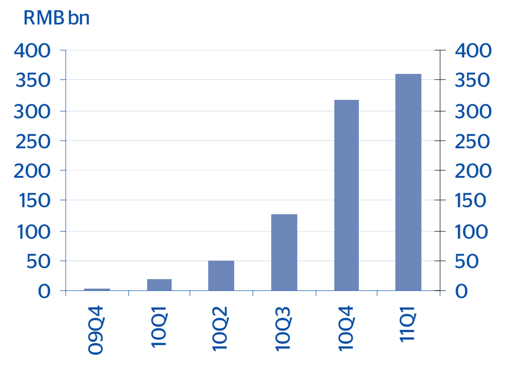
Source: NBS, BIS and BBVA Research

On trade front, exports have continued to grow strongly, up by 27.4% y/y through the first four months of 2011. Export growth has been broad-based, with a range of products performing well. By region, exports have increased across the board, and especially to other fast-growing emerging market economies. At the same time, import growth has also been strong, at 29.6% y/y through April. Rising commodity prices and strong import growth resulted in an unexpected trade deficit for the first quarter of the year of USD 1.0 billion, although the trade balance shifted back to surplus in April (USD 11.4 billion) a trend we expect to continue during the remainder of the year.

Internationalization of the RMB is advancing but has a long way to go

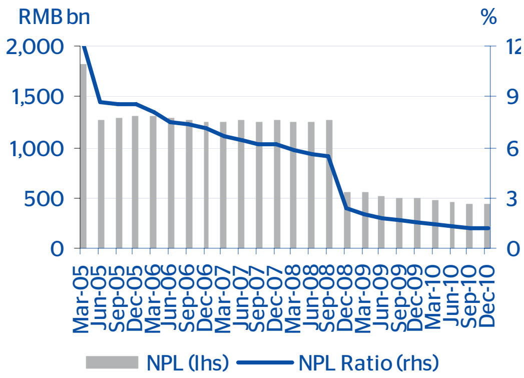
Efforts to internationalize the use of the currency are continuing (see Economic Watch: RMB Cross-border Trade Settlement). Since the launching in 2008, the value of RMB trade settlement transactions (mainly from Chinese importers) and offshore deposits have increased steadily. As of 1Q2011, the value of RMB cross-border settlement transactions amounted to RMB 360.3 billion, an increase of 13.9% over the previous quarter (Chart 15), resulting in a rise in the share of the trade settled in RMB to 7%, from only 2½% for all of 2010. Meanwhile, RMB deposits in Hong Kong, the main offshore RMB center, have increased further to above RMB400 billion in February, a doubling since the Q3 of 2010 alone (much of which, however, may reflect expectations of currency appreciation). On the policy front, the authorities are considering steps to deepen the offshore market, including: (i) expanding the existing pilot program to cover more regions within China; (ii) facilitating other offshore RMB centers, especially Singapore; (iii) developing additional RMB-denominated financial products in Hong Kong; and most importantly in our view, (iv) a possible easing of restrictions on inflows of RMB for FDI. RMB bond issuance in Hong Kong is continuing, and Hong Kong's stock exchange has seen its first RMB-denominated IPO.

Chart 15
RMB trade volumes continue to increase



Source: Bloomberg and BBVA Research

Chart 16
NPLs of China's banking sector are stable



Source: CEIC and BBVA Research

Another good year for banks in 2010

On the banking side, full-year 2010 results were released in April showing another year of strong profitability. Profits rose by 34½%, well above our expectations of 27% (see *China Banking Watch*), mainly due to higher lending volumes. The non-performing loan (NPL) ratio fell to a record-low 1.1% at end-2010, although NPLs were stable in absolute terms (Chart 16). Capital adequacy ratios (CARs) remained healthy at 11.8% in March) following banks' capital-raising efforts during 2010.

Despite the positive indicators, the outlook for profitability in the near-term is not as favorable given the recent monetary tightening measures, particularly hikes in the RRR. Moreover, slower lending growth, in line with the authorities' policy directives (around 15% y/y credit growth compared to 19.7% y/y growth in 2010) may further undermine profitability.

In the meantime, the CBRC is stepping up efforts to strengthen supervision by implementing new and stricter regulations based on Basel III principles.. In particular, the CBRC plans to impose differing criteria for systemically important banks (SIB) and non-SIBs although it has yet to specify banks' classification into the two groups.. The new rules are to include counter-cyclical capital adequacy ratios (up to 2.5% on top of the normal capital ratio requirement, 11.5% for SIBs, and 10.5% for non-SIBs), a leverage ratio (4% as minimum requirement), provision/total loans ratio (2.5% as a minimum) and liquidity ratio (liquidity coverage ratio and net stable funding ratio set at 100%). The compliance deadline is end-2013 for SIBs and end-2016 for non-SIBs.

3. More policy tightening ahead

On the basis of a stronger-than-expected GDP outturn in Q1 and rising inflation, we are revising up our full-year growth and inflation projections to 9.4% (from 9.2% previously) and 4.9% (from 4.5% previously), respectively. The revised projections are still in line with a soft-landing scenario in which growth is expected to moderate in line with potential, and inflation, after peaking in June, would decline in the second half of the year. We have made minor upward adjustments to our 2012 forecasts in line with these trends.

Our projections incorporate further monetary policy tightening by somewhat more than envisaged in our last quarterly update, as the authorities continue to adjust their policies to counter the stronger-than-expected growth and inflation momentum. In this regard, we anticipate two more 25bp interest rate hikes in Q2/Q3, and an additional 100bp of hikes in the RRR. These measures would come on top of the series of aggressive tightening steps so far which, as discussed above, include a total of 100bp increase in interest rates since last October and a series of hikes in the RRR.

Our revised growth projection for 2011 is based largely on the faster than expected outturn of the first quarter. For the remainder of the year, we expect GDP growth to moderate on the authorities' tightening measures. Both consumption and investment are expected to grow steadily, the former due to strong wage growth and continued fiscal measures (subsidies), and the latter facilitated by the government's infrastructure program. The contribution of net imports is expected to decrease as the trade surplus narrows (Table 1).

Table 1

Baseline Scenario

	2008	2009	2010	2011 (F)	2012 (F)
GDP (%, y/y)	9.6	9.2	10.3	9.4	9.1
Inflation (average, %)	5.9	-0.7	3.3	4.9	4.2
Fiscal bal (% of GDP)	-0.4	-2.8	-2.5	-2.0	-1.8
Current acct (% of GDP)	9.9	6.1	4.6	4.5	4.5
Policy rate (%, eop)	5.31	5.31	5.81	6.81	7.31
Exch rate (CNY/USD, eop)	6.83	6.83	6.62	6.30	6.00

Source: BBVA Research

Inflationary risks are still to the upside

Our revised projections are based on inflation peaking in June at 5.6% y/y, and receding thereafter to 4.0% at end-year, due to base effects, a decline in commodity prices in line with our global baseline projections, and as the monetary tightening measures work to withdraw liquidity and contain inflation expectations. The food inflation could ease gradually during the course of the year but non-food components may face relatively larger upward pressure given the increasingly tight labor market and inflation expectation. That said, inflation risks are still to the upside.

The authorities will be monitoring credit and money growth carefully

Monetary tightening measures are being calibrated to slow credit and money growth in line with annual targets. The PBoC has announced an M2 growth target of 16%, down from 17% in 2010. Earlier this year, the PBoC began publishing a new and broader quarterly credit series on "Total Social Financing," (TSF) consisting of local and foreign currency loans, loans of trust companies, bill financing, corporate bond issuance. and non-financial institutions' IPOs. It is possible over time that such an aggregate may become one of the intermediate targets in the authorities' policy arsenal.

Gradual currency appreciation expected to continue

We continue to expect gradual currency appreciation of 4%-5% against the USD in 2011, in line with our previous projections. The authorities have reiterated their intention to permit currency appreciation, at a gradual pace. Further appreciation can help to contain inflation through two channels: (i) lowering import prices; and (ii) reducing the need for foreign intervention and reserve accumulation, which exacerbate inflation by injecting domestic liquidity.

Eye on the medium term: new five-year plan aims to sustain growth through economic rebalancing

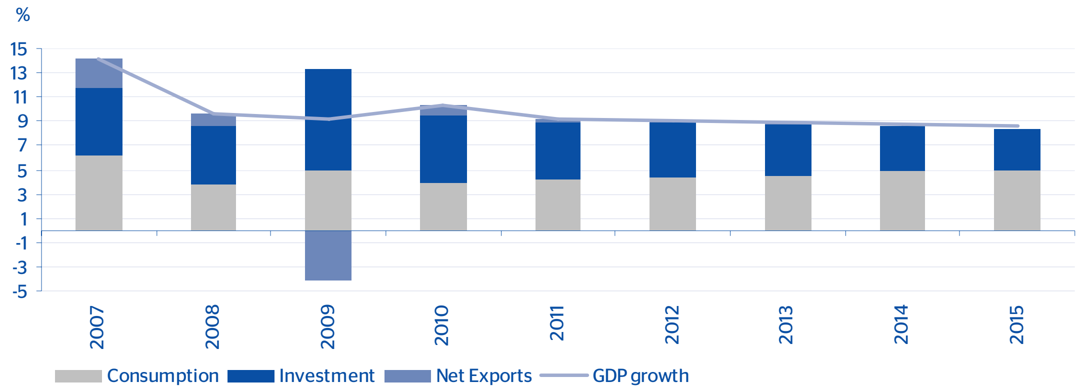
Our projections incorporate a gradual rebalancing of the sources of growth over the medium term toward domestic demand, particularly private consumption. While not new, this rebalancing has been reinforced as a central policy objective in the newly released 12th Five-Year Development Plan (2011-2015, see *Economic Watch: New 5-year plan and budget set to support China's growth*).

Our medium-term baseline foresees growth of 8%-9%, in line with our estimates of gradually declining potential growth. In particular, we expect growth to moderate gradually from above 9% in 2012 to just above 8% by 2015 in view of falling labor growth rates, lower total factor productivity as the economy continues to develop (Chart 17). This is well above the Plan's "target" growth rate of 7%, which we view as a floor given that actual growth rates have consistently outpaced the targets of previous 5-year plans.

To achieve the expected rebalancing, the Plan seeks an increase in household income to outpace GDP growth. In addition, the Plan seeks to increase the share of the service sector in total GDP by 4 percentage points, which the authorities view as a complement to increasing consumption rates. The Plan also sets a target on the urbanization rate to 51.5% by 2015 from the current level of 47.5%. Importantly, it focuses on narrowing income inequality and the promotion of a sustainable, "high quality" growth path, rather than one based on quantitative targets alone.

On the production side, the Plan emphasizes a shift away from a resource-intensive growth model toward higher value added and environmentally friendly industries. In particular, seven strategic are designated: non-fossil energy, environmental technology, new materials, high-end manufacturing, bio-tech pharmaceuticals, IT (including internet-based services) and new-fuel powered vehicles. To promote the technology progress and strengthen the capability of innovation, the Plan also targets an increase in the ratio of R&D expenditure to total GDP (2.2% of GDP compared to the actual expenditure during the last 5 years of 1.8%).

Chart 17
A rebalancing of growth over the medium term



Source: NBS, CEIC and BBVA Research

4. Risks still tilted to overheating

The outlook is influenced by competing risks of overheating on the one hand, and the possibility of a hard landing on the other. Overheating risks stem from rapid credit growth, the potential for asset price bubbles, and strong domestic demand. Meanwhile, a hard landing scenario, which we view as a remote possibility, could materialize from excessive policy tightening, an abrupt change in market sentiment, or a deterioration in the external environment. We view overheating risks as somewhat lower than our update of a few months ago due the aggressive tightening stance of the authorities and the accumulation of data showing a moderation in activity.

In addition, the presence of new headwinds to growth may act as a counter-balance to overheating. In particular, rising oil and commodity prices could impact growth prospects, along with disruptions to supply chains from Japan's earthquake. In the event of a more serious downturn, the authorities have ample room on the fiscal side to support growth, for example through higher fuel subsidies.

We continue to see diminishing risks of asset price bubbles given the authorities' timely actions to prevent speculative behavior, especially in the property sector. While the battle is far from over, property price increases in some of the large cities such as Beijing, Shanghai, Shenzhen and Guangzhou, are showing signs of slowing following the imposition of purchase restrictions and tighter financing requirements. More broadly, risks of price bubbles in other asset markets, such as the equity market have receded with a pullback on expectations of further monetary tightening measures.

A key medium-term risk in the financial sector continues to stem from vulnerabilities associated with local government financing vehicles (LGFVs). While it is possible that difficulties could emerge in the next couple of years, we believe such risks are unlikely to materialize over such a short time horizon given the maturity structure of LGFV obligations, with most obligations coming due after 2013. Moreover, the authorities have continued to monitor such risks, and have issued guidelines to local governments to refrain from using such vehicles as a source of financing, except in support of public housing initiatives.

Another risk to be monitored in the financial sector is whether the banking sector can withstand a possible slump in property prices caused by aggressive tightening measures. In this respect, the authorities are implementing more stringent stress tests, with early indications suggesting that most of the larger banks should be able to withstand even a sharp correction in prices.

5. Tables

Table 1

Macroeconomic Forecasts

	2008	2009	2010	2011 (F)	2012 (F)
GDP (%, y/y)	9.6	9.2	10.3	9.4	9.1
Inflation (average, %)	5.9	-0.7	3.3	4.9	4.2
Fiscal bal (% of GDP)	-0.4	-2.8	-2.5	-2.0	-1.8
Current acct (% of GDP)	9.9	6.1	5.2	4.5	4.5
Policy rate* (%)	5.31	5.31	5.81	6.81	7.31
Exch rate* (CNY/USD)	6.83	6.83	6.62	6.30	6.00

Source: BBVA Research

Table 2

GDP

(YoY growth rate)	2008	2009	2010	2011 (F)	2012 (F)
U.S.	0.4	-2.6	2.9	3.0	2.7
EMU	0.3	-4.0	1.7	1.7	1.5
Asia-Pacific	5.6	3.7	8.0	6.4	6.7
China	9.6	9.2	10.3	9.4	9.1
World	3.0	-0.6	4.9	4.4	4.4

Source: BBVA Research

Table 3

CPI

(YoY growth rate)	2008	2009	2010	2011 (F)	2012 (F)
U.S.	3.8	-0.3	1.6	2.8	2.2
EMU	3.3	0.3	1.6	2.4	1.6
Asia-Pacific	5.7	0.3	3.6	4.4	3.7
China	5.9	-0.7	3.3	4.9	4.2
World	6.1	2.2	3.7	4.7	4.0

Source: BBVA Research

Table 4

FX rate

		2008	2009	2010	2011 (F)	2012 (F)
U.S.	EUR/USD	0.70	0.70	0.75	0.75	0.75
EMU	USD/EUR	1.50	1.40	1.34	1.34	1.29
China	CNY/USD	6.83	6.83	6.62	6.30	6.00

Source: BBVA Research

Table 5

Policy rate

	2008	2009	2010	2011 (F)	2012 (F)
U.S.	0.61	0.25	0.25	0.25	1.25
EMU	2.73	1.00	1.00	1.50	2.00
China	5.31	5.31	5.81	6.81	7.31

Source: BBVA Research

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