

China Watch

Economic Research Department

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China recovered stronger in Q2 2009 on massive fiscal and monetary stimulus. The economy expanded 7.9% compared to 6.1% in Q1. While the growth was mainly led by domestic demand with investment as a significant driving force, exports remained sluggish and are likely to stay so in the near term. Given the recovery is still fragile, the full impact of the stimulus policy should be allowed to run its full course.

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Executive Summary

- China's economy recovered steadily in Q2 2009. The Q2 GDP accelerated to 7.9% year-on-year on a sharp rebound in fixed asset investment, propelled by rapid credit growth. For the first half of the year, the economy grew 7.1%, one of the fastest growth rates registered in the world.
- The Q2 growth, which can be considered a record figure in today's depressed economic environment worldwide, was led by a strong growth in fixed asset investment, while domestic consumption remained supportive. Export growth, despite showing some signs of stabilization, continued to fall by double digits and it is likely to remain sluggish going forward due to weak external demand.
- Despite a strong domestic demand, CPI and PPI inflation continued to fall. For H1, CPI declined by 1.1%. The just-released July CPI figure continued with its falling trend, declining by 1.8%, a further drop of 0.1% compared with June. Price declines in clothing, dwelling, and transportation were the major contributors. However, we do not think these price developments will necessarily lead to protracted deflation in China, as M2 and credit growth have been growing at an unprecedented rate and the economy is expected to expand vigorously going forward. In fact, such price falls could have expansionary effect for both private consumption and production.
- Looking forward, given the implementation of the large fiscal stimulus package is gaining stronger traction, we expect the Chinese economy to recover strongly in Q3 and even reach 8.6%. We therefore continue to maintain our call that China will be able to achieve a growth rate of 8.1% in 2009 on the massive fiscal stimulus package, ample room for further monetary ease, and easy implementation of policies. We have since revised our forecast for 2010 to 8.6% from the previous 8.4%.
- While we continue to maintain China will be the first economy to recover from the severe global recession, there are a number of downside risks and uncertainties surrounding our relatively upbeat outlook going forward.
- First, the Chinese economy, though recovering at a steady pace, remains vulnerable to protracted weak growth in G-3 economies. As long as the export sector remain sluggish, industrial overcapacity is likely to persist. This will then continue to put pressures on domestic prices. Therefore, it is premature to discuss any fiscal withdrawal and monetary tightening measures at this stage of recovery. Any premature tightening may run the risk of snuffing out the burgeoning recovery.
- Second, the rapid credit growth in H1 does raise concerns over an asset boom that may quickly grow into an asset bubble. The concerns were partly reflected by a 75% rebound in stock price and a rebound in both transaction volumes and prices. We caution that the run up in asset prices should not be used as the only gauge for policy tightening decision as long as considerable slacks remain in the economy, unemployment rate high, and wage pressure nonexistent. Therefore, some monetary policy accommodation may be contemplated to adjust the structure of rapid loan extension, but drastic monetary tightening is not an option at this juncture of the recovery process.

Recent Economic Developments

1. GDP Growth and Economic Activities

China expanded the real GDP growth rate to 7.9% in Q2, up 1.8 percentage points from 6.1% in Q1, as massive pump-priming and record lending pushed for a rebound from the worst growth in a decade. The yoy growth for H1 is 7.1%, indicating the economy is approaching the target rate of 8% for 2009. The accelerated growth is mainly driven by the resurging domestic growth, especially growth in domestic consumption and a strong increase in industrial activity spurred by central government's 4 trillion yuan stimulus package. However, the real external demand shrank again in Q2. (Chart 1)

Although the weak global demand continued to drag down exports, strong growth in industrial production offset this negative impact. Exports further shrank by 23.42% in June, from 22.05% yoy decline in May, while the industrial production picked up the growth for three successive months and realized a 10.7% increase in June, which is the largest gain in nine months. (Chart 2)

Household disposable income rised in an accelerating pace in Q2, as the income transfer scheme under the fiscal stimulus package begin to take effect, resulting in a surge in real retail sales. Household income reached a 31.4% yoy increase in June from 23.5% in May. The real retail sales, the main gauge of consumer spending, grew by 17.4% in May and 17.7% in June. For the first half of this year, the real retail sales has increased by 16.6% yoy, 3.7 percentage points higher than that in the same period last year. China has been trying to boost consumer spending as a way to mitigate the impact of the global financial crisis, it looks like the policy function well. (Chart 3)

Spurred by the 908 billion RMB public spending on infrastructure and the fast booming bank credit, the nominal FAI rising 35.25% in June, slightly moderated from 38.67% in May and the real FAI realized a faster increase by 46.70% in June from 49.43% in May, thanks to the decrease in PPI. The boom in property market has accelerated investment on real estate sector to grow 21.68% in June, compared to 19.71% in May and 14.26% in April. Moreover, the post-disaster reconstruction of Sichuan Province carried out this year is another drive for FAI growth. (Chart 4)

Chart 1: Real GDP driven by domestic demand

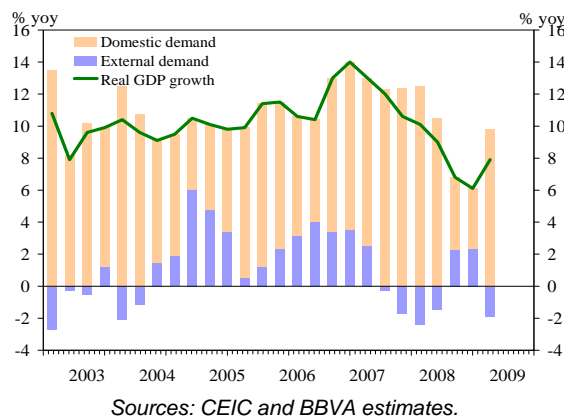


Chart 2: Industrial production and exports

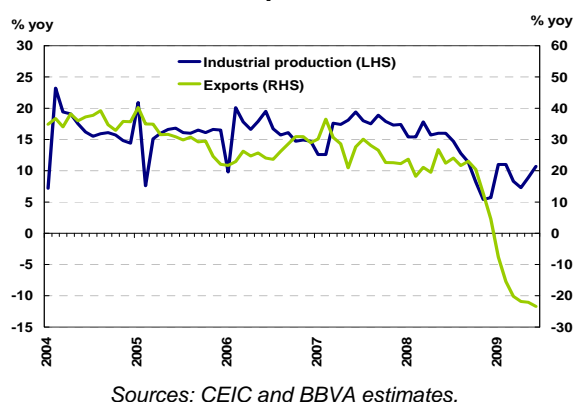


Chart 3: Real retail sales and income

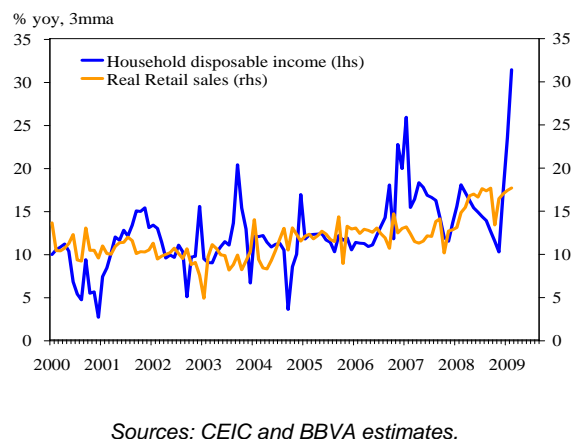
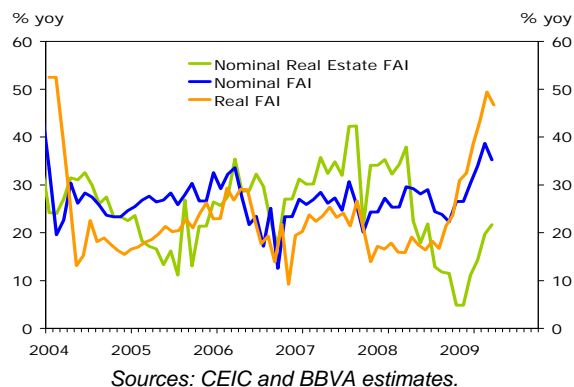


Chart 4: Fixed asset investment



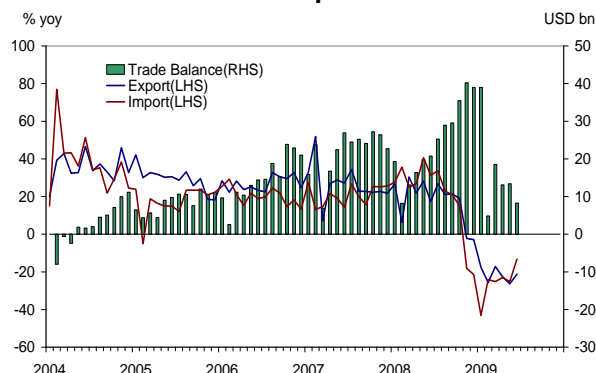
2. External Trade

The weak external demand still weighed on Chinese foreign trade. China's exports continued the eighth successive month of contraction, while at a slower rate: the June exports have fallen 21.27%, compared with May's slide of 26.39%, and also better than estimate. Imports fell by 13.2% yoy in June, the smallest decline over eight months. The trade surplus mildly shrunk in Q2, and the overall value for H1 was US\$ 96.9 billion, a decrease of US\$ 2.1 billion over the same period last year. (Chart 5)

As China's domestic demand grew more strongly and the prices of commodities gradually rebounded again, imports were boosted, driving down the trade surplus. While the demand of exports may still need time to recover, as the unemployment rates in the European Union and US, China's top two overseas markets, have been rising recently. China's exports to US slump further by 17.33% in May, and export to EU continued to decline by 24.94%. (Chart 6)

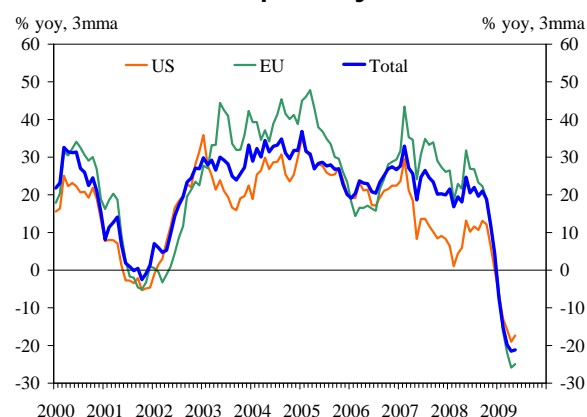
However, as imports could work as a leading indicator for exports in China, the good signals in imports might indicate the China's external trade is struggling out of its worst period. Meanwhile, despite signals of the economic recovery in US is still weak, the purchase manager's index (PMI), an indicator of the economic health of the manufacturing sector, has been picking up to 39.9 in June from its bottom of 33.6 last November (Chart 7). We think that the export sector of China might return to "normal" by the end of this year or early 2010.

Chart 5: Trade performance



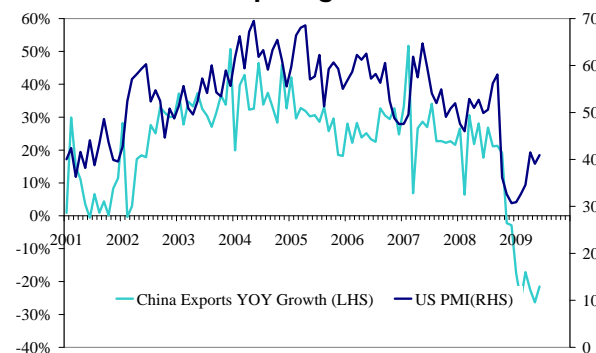
Source: CEIC and BBVA estimates

Chart 6: Exports by markets



Sources: CEIC and BBVA estimates.

Chart 7: China Export growth and US PMI



Sources: CEIC and BBVA estimates.

BOX 1: Foreign Exchange Reserve Diversification

After Premier Wen Jiabao in March expressed concerns over the safety of China's holdings of US assets, there appears to be a pattern that is gradually emerging in China's foreign exchange diversification strategy. This emerging pattern aims to gradually reduce China's heavy concentration of the US dollar assets in its portfolio by investing more in gold, commodities, non-US dollar assets, and boosting the capital base of international financial institutions. Specific actions have been taken in the following areas:

- **China has increased its Gold reserve.** According to the State Administration of Foreign Exchange, China has boosted its gold reserves to 1,054 metric tons, which is 76% more than the 600 metric tons reported at the end of March this year, a level that had been unchanged since 2003. This is the first time that China acknowledged that its gold reserves had increased in more than five years. The increase makes China the world's fifth-largest holder of gold.
- **China planed to boost its holdings of IMF bonds.** The government also considered purchasing \$50 billion of the IMF's bonds as the international lender will boost its fund by \$500 billion.
- **China has earmarked \$34.2 billion for the multi-lateralized swap arrangement under the Chang-Main Initiative.** Under the agreement reached in May 2009, the finance ministers from ASEAN+3 agreed to set up a \$120 billion fund as well as how much each economy in the region would need to contribute to the fund. China will contribute equally with Japan of \$38.4 billion (with Hong Kong contributing \$4.2 billion in China's total). The rest will be coming from Korea and ten members of the ASEAN economies.
- **China has expanded its RMB swap arrangements.** China has signed 650 billion yuan (or \$95.1 billion) of currency swaps since last December with 6 nations (Table 1). This is viewed as an initial step towards internationalization of the Chinese renminbi. These swaps permit those central banks to sell yuan to local importers in those countries who want to buy Chinese goods. This also reduces the currency fluctuation risk for Chinese exporters.

Table 1: Chinese Yuan Currency Swaps

Date	Counterparty	RMB bn
12-12-2008	Korea	180
20-01-2009	Hong Kong SAR	200
08-02-2009	Malaysia	80
11-03-2009	Belarus	20
24-03-2009	Indonesia	100
29-03-2009	Argentina	70
Total		650

- **China is encouraging its trading partners to use the yuan to settle cross-border trade.** This step promotes broader use of the Chinese yuan internationally and reducing China's dependence on the dollar over time. The policy has a practical function that lowers Chinese exporters' currency exposure and transaction costs.
- **China has started to change the structure of its US Treasury holdings.** In May, China increased its holdings of US treasury securities by USD 38 billion, the largest single month increase since 2009, and the holdings stood at \$801.5 billion, while, Japan, the second-largest holder of U.S. Treasuries, decreased its holdings to \$677.2 billion in May from April's US\$685.9 billion. Although China's US Treasury holdings increased due to the lack of good alternative reserve assets at this time, China has started to change its maturity preference

from long term to short term. As shown in Table 2, its long-term Treasury holdings declined from 90.3% to 73.4%. This allocation shift is rather consistent with China's concern of the dollar risk in the medium term given the expansive monetary policy stance, large US budget deficit, and very high level of national debt. Meanwhile, the SAFE has sold some agency bonds and stocks.

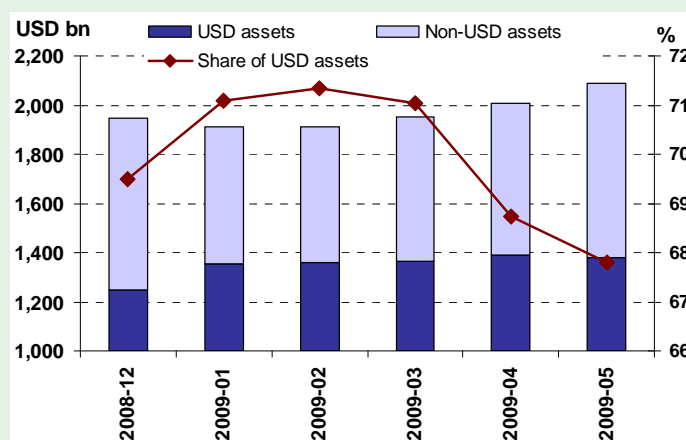
Table 2: The Composition of USD Assets (USD bn)

	Treasury Securities					Other long term investments		
	Total	Long term		Short-term		Agency Bonds	Corporate bounds	Stocks
		Amount	Share	Amount	Share			
2008-09	618	558	90.3%	60	9.7%	509	24	99
2008-12	727	562	77.3%	165	22.7%	498	28	99
2009-01	740	563	76.1%	177	23.9%	494	28	99
2009-02	744	562	75.5%	182	24.5%	493	27	99
2009-03	768	577	75.1%	191	24.9%	493	28	99
2009-04	764	584	76.5%	179	23.5%	492	26	99
2009-05	802	588	73.4%	213	26.6%	490	26	99

Source: Reuters

- China has also started to diversify away from USD asset holdings.** As shown in Chart 1 and consistent to our previous estimates, China has been shifting away from the US dollar assets at a gradual pace. Our estimates show that US dollar asset holdings declined from over 71% to 68% as of May 2009.

Chart 1: The Composition of China's Foreign Reserve



Source: CEIC, Reuters and BBVA estimates.

BOX 2: China's "Go-Out" Strategy

According to our estimate, China's reserves will increase by more than \$200 billion annually in coming years (Table 3). This will continue to put pressures on PBoC to sterilize the impact of net foreign exchange reserve accumulation going forward, especially at the time that credit growth has far exceeded the targeted one and the Chinese asset markets may run the risk of forming a bubble from the current boom.

Table 3: China Foreign Reserve Forecasts

Baseline Scenario				
	(with export growth falling 20% and imports falling 25% in 2009)			(USD billion)
	2007	2008	2009f	2010f
Foreign Exchange Reserves	1,528	1,946	2,220	2,552
Trade Balance	263	295	293	280
FDI	84	108	65	52
Portfolio Flows	116	14	-84	0

Source: BBVA estimate

Realizing the potential risk and urgency, the authorities have started actively encouraging capital outflows via the form of outward foreign direct investment (OFDI). Premier Wen Jiabao in a recent talk mentioned: "We should hasten the implementation of our 'going out' strategy and combine the utilization of foreign exchange reserves with the 'going out' of our enterprises." "Go out" means that Chinese companies should make equity-based acquisitions abroad. At present, the enterprises that can go out usually refer to large state-owned enterprises such as PetroChina, China Telecom, Chalco, etc. But this has changed. In March, the Ministry of Commerce shift more power for local governments to approve foreign direct investment by local firms whose investments fall below the amount of US\$ 100 million. In June, the SAFE issued new rules to relax foreign exchange curbs from Aug 1 on Chinese firms intending to invest abroad. The new rules will simplify the approval procedures for outbound investment and also give a free hand for Chinese companies to buy into foreign ones.

It is expected that China would roll out further policies to encourage outward investment and to leverage the opportunities generated amid the financial crisis.

Meanwhile, China could also consider the possibility to increase CIC's quota for oversea investment, as we know two thirds of the USD 200 billion were used to acquire Chinese banking assets.

Energy and Resources Are Given a Priority for Now

The chairman of the China Development Bank, Chen Yuan, suggested outbound investment should focus on resource-rich developing economies but not on US financial institutions. In the case of China Development Bank, it has secured three loan-for-oil deals with developing nations in 2009:

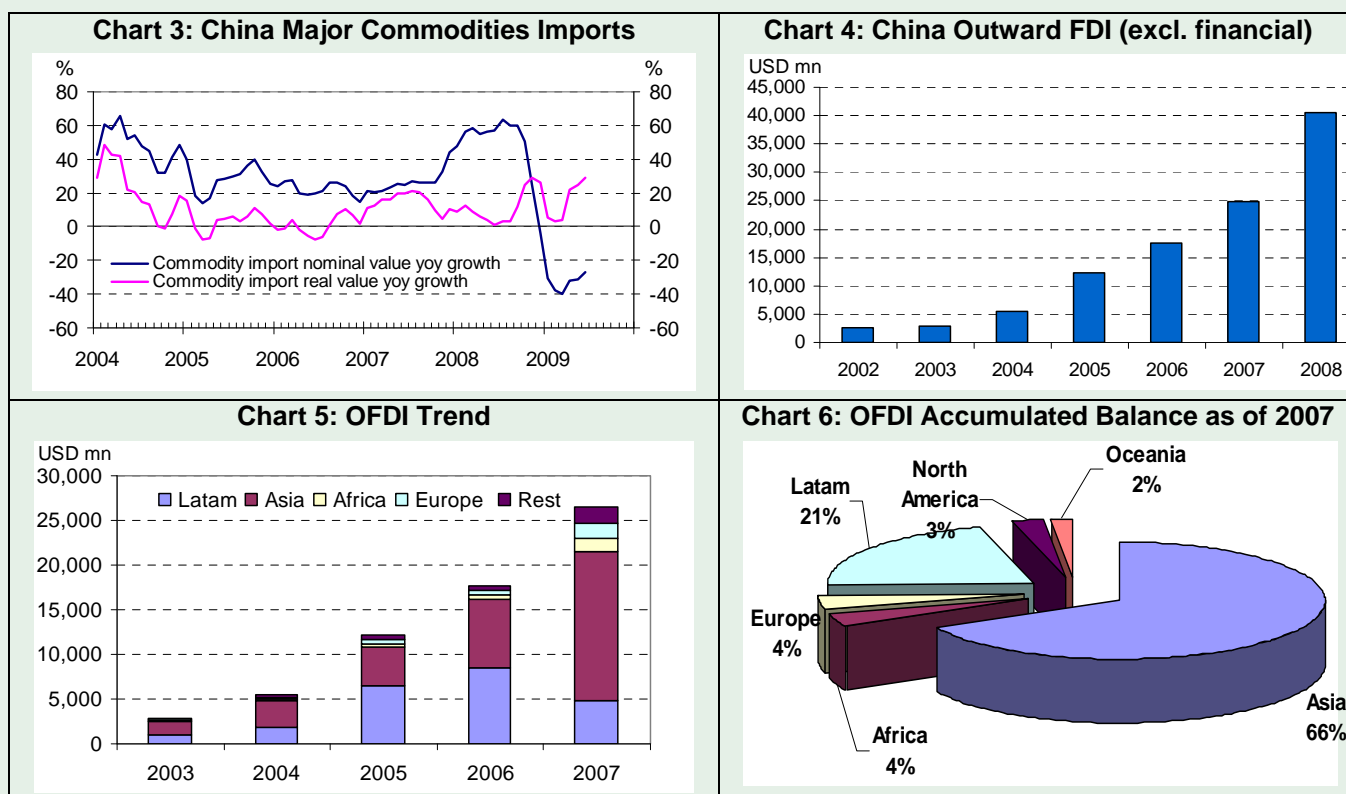
- ❖ In February 2009, China reached a long-term deal to lend \$25 billion through CDB to two Russian energy companies in exchange for supplies from huge new East Siberian oilfields for the next two decades.
- ❖ In February 2009, China gives \$4 billion in financing to Venezuelan state oil company PDVSA through CDB; in return Venezuela will increase oil shipments to China. The total lending from CDB to Venezuela reached \$12 billion since 2007.

- ❖ In May 2009, CDB signed a deal of 10-billion-dollar loan extended to Brazilian state oil company Petrobras which is linked a 10-year pact for the delivery of up to 200,000 barrels of crude daily to China.

Other than these loans for resources program conducted by SDB, other loans-for-oil pacts include:

- ❖ In March 2009, oil-rich Angola received \$1 billion loan from China.
- ❖ In April 2009, China National Petroleum Corp. agreed to lend \$5 billion to Kazakhstan's national energy companies, the fourth loan-for-oil deal in 2009.
- ❖ In July 2009, Ecuador signed a two-year oil supply contract with China National Petroleum Corp. Ecuador will also receive \$1 billion as an advance payment.

Despite these successes with developing economies, China has found it difficult to make significant deals with developed economies as illustrated by the rejection of the Chalco's increased share



holdings of the Rio Tinto in Australia.

Given China's current stage of development, it will continue to rely primarily on commodities imports (Chart 3). Following this need, China's outward FDI has also accelerated to USD 40 billion in 2008 from a negligible \$143 million in 2002, a rise of nearly 300 times. The geographic distribution has mostly concentrated in Asia, Latin America, Africa, Europe, Australia (Chart 4,5 & 6). In terms of sectors, energy and resources continue to dominate China's outward FDI in recent years.

Sources: CEIC and BBVA estimates

3. Inflation

Deflation continues in Q2, mainly dragged by fall of non-food prices. June's overall Consumption Price Index (CPI) decreased by 1.7% yoy, with food prices contributing 0.36% decrease and non-food prices 1.34% decrease (Chart 8). For H1, CPI has fallen 1.1% from the year-earlier period, This includes CPI in urban areas dropped 1.3% and 0.6% in rural area. The price of foodstuffs dropped 0.3%, and the price of clothes dropped 2.4%.

For the food part, which was the main drive for last year's inflation, the prices of both rape oil and fresh pork continue to fall in Q2. The prices of fresh pork further fell by 28.25%, while the decline of rape oil seems to be mitigated, with June's fall by 29.92% yoy from May's 32.33% decrease and April's 34.79% decrease. While on a month-to-month basis, the prices of rape oil actually have been increasing in May and June (Chart 9). However, as a good harvest is expected this summer, the chance of food price resurgence as two years ago is slim, and we expect that CPI would further decrease in July and August due to the ample supply.

Although the international energy and commodity prices experienced a slight rebound recently, the price level is still well below that of last year. In June, prices of base metals and iron & steel continued deflation compared with the same period last year, while at a slower pace. Prices of base metals declined 18.8% yoy, from May's 21.9%, and prices of iron & steel fell 21.3%, from May's 25.5%. while on a mom basis, the prices of basic metals is increasing in June (Chart 10).

China's PPI was further driven down in Q2, mainly due to the falling factory prices for industrial goods caused by excessive production capacity and last year's high base. For the first half year, PPI fell by 5.9% compared to the same period in 2008, and for June, PPI declined by 7.8% yoy. As Some industries still face the problem of overcapacity, June's PPI for industrial goods dropped further by 9.6% yoy (Chart 11).

On the other hand, the quickly expanded banking credit in H1 increase China's concern on inflation pressure again. For the first half year, total loans reached nearly 7.4 trillion yuan, an increase of 4.9 trillion yuan yoy. Also, the recently resurging commodity prices in the international market drove up imported inflation pressure (Chart 12).

Chart 8: CPI inflation

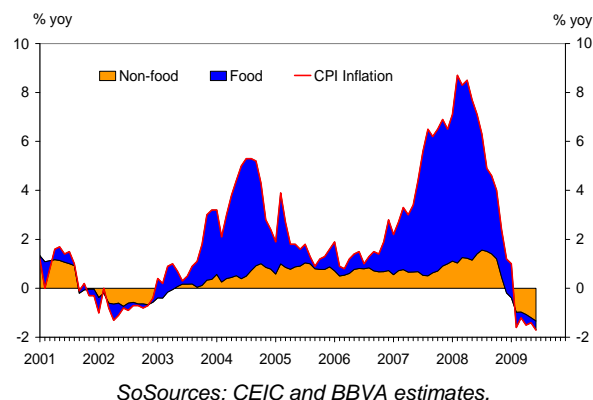


Chart 9: Retail prices of selected food

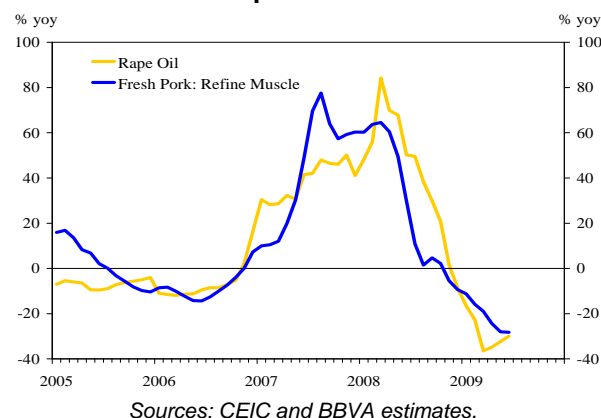


Chart 10: Prices of imported metals

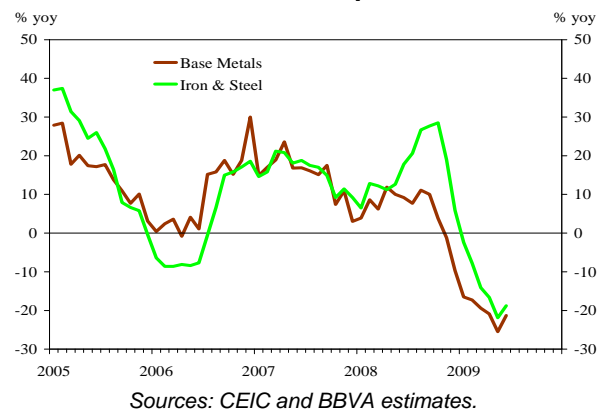


Chart 11: PPI by components

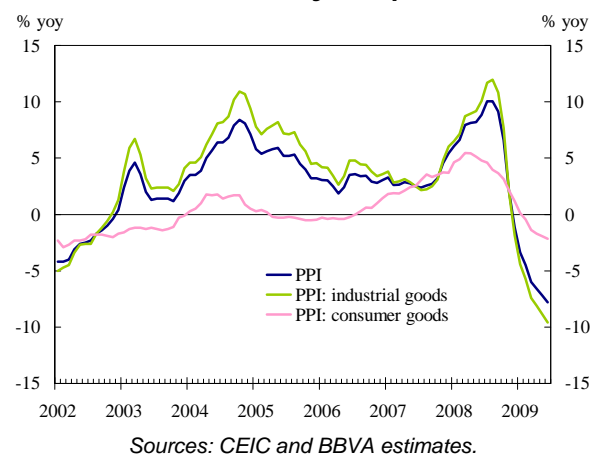
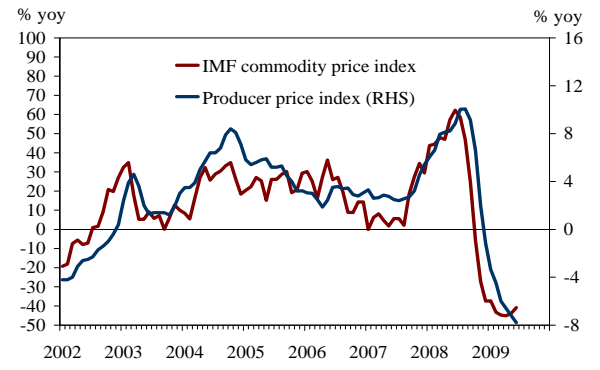


Chart 12: PPI and commodity prices



Sources: CEIC and BBVA estimates.

4. Monetary conditions

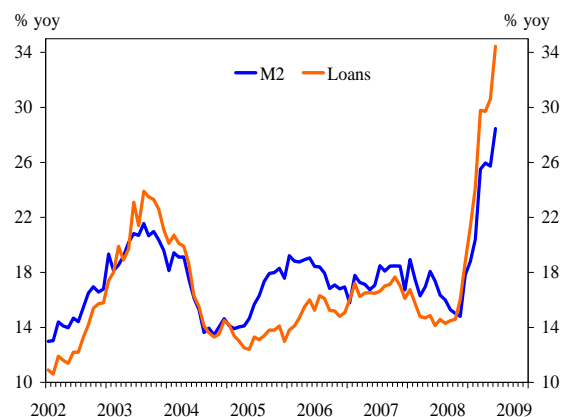
Both banking credit and broad money (M2) rose sharply in the first half of 2009 since the government refrains from tightening lending rules to protect economic growth last November. For H1, Chinese banks extended a record 7.37 trillion yuan of new loans, which is almost 25% of GDP, tripled the amount offered in the year-earlier period and 47% higher than the government's full-year target. And in June alone, the new loan volume registered at 1.53 trillion yuan, pushing up the yoy loan growth to 34.44% from May's 30.60% YoY. The YoY growth in M2 also soar up to 28.5% in June from 25.7% in May (Chart 13).

Indeed, the fast growing credit and market liquidity have efficiently boosted domestic demand and GDP growth, however, market concerns about the incoming potential risks are also increasing. In terms of the loan structure, as banks sought for safer investment, most of this year's loans were extended to infrastructure projects, real estate development and urban construction sponsored by government, while only a small amount of this year's new loans are granted to small and medium-sized enterprises. In terms of credit quality, the lowered lending thresholds and even relaxed qualification reviews of some banks increased credit risks of banks, and the concentration of loans on government-invested projects added banks' systematic risks. As some local government projects might not be able to achieve high enough returns and would generally have longer payback period, banks might encounter liquidity problem to make the capital and interest payment. Also, should local governments faces fiscal problem or the economic slowdown worsens in the future, amount of non-performing loans (NPL) for banks may increase. In addition, the market worries that the surging money supply would over-heaten the stock markets and property markets again, increasing the inflation pressure.

The government has also begun to watch over the rapid expanding liquidity. Considering the economic recovery is not yet on a solid footing, central bank confirmed in July that a "moderately loose" monetary policy would still be maintained, but open-market operation tools would also be flexibly used as a fine-tuning policy to ensure a more sustainable money and credit growth. For example, the central bank has resumed the sales of one-year bills and nudged up money market rate to control the market liquidity, and it also encouraged banks to lend to SME, so as to further improve the credit structure.

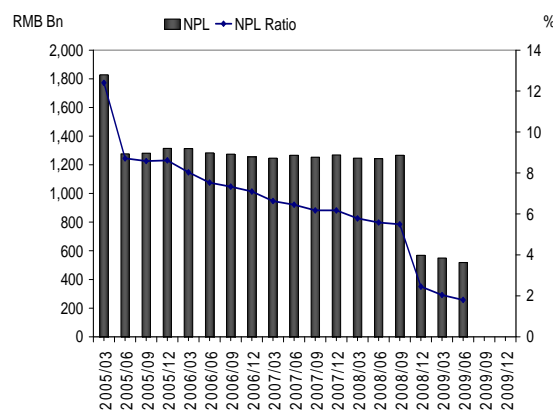
Despit the seemingly looming potential risks, the performance of banks has been improving in H1. At the end of June, NPLs by commercial banks in China, including state-owned commercial banks, share-holding commercial banks and foreign-funded banks, totaled 518.13 billion yuan, down 42.2 billion yuan from the beginning of this year. And the NPL ratio for June was 1.77%, down 0.65 percent compared with the beginning of this year (Chart 14).

Chart 13: M2 and credit growth



Sources: CEIC and BBVA estimates.

Chart 14: NPL and NPL Ratio



Source: CEIC.

Box 3: Latest Development in Banking Sector

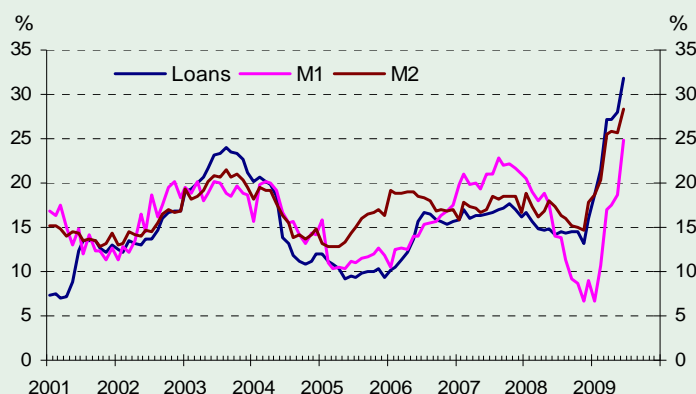
Record Credit growth heightened concerns on asset quality

China's M2, a broad measure of money supply, amounted to RMB 56.89 trillion at the end of June, up 28.4% compared to a year ago (Chart 1). On a month on month basis, the growth rate in June is 2.72 percentage points higher than the end-May figure and represented the highest level since 1999, also far beyond the target a 17% growth in M2 set in year beginning. By comparison, the growth rate of M2 is averaged at 16.7% from 2005 to 2008.

M1, including demand deposits and cash in circulation, rose 24.79% year on year to RMB 19.32 trillion at the end of June. The growth is faster than the end-May figure, which was 18.69%. The growth deviation between M1 and M2 early this year has been corrected, though M1 grows still slower than M2, but the difference is narrowed by 8.4 percentage points from January to June, implying the economy becomes more active and needs more liquidity. The deposit structure also presents a similar pattern: the share of time deposit is falling while the share of counterpart and demand deposit is trending up since 2009(Chart 2).

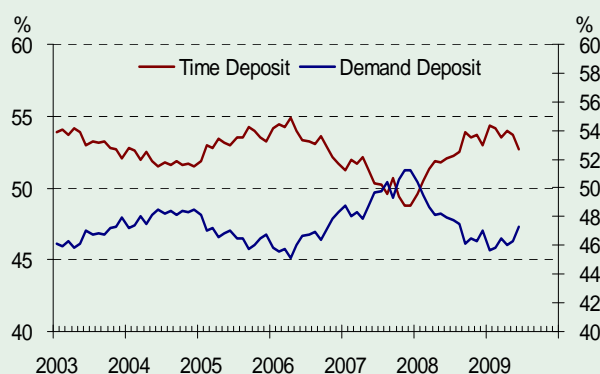
Chinese banks issued a record 7.37 trillion yuan in loans in the first six months, increased RMB 4.92 trillion from a year earlier. The outstanding loans rose 34.4% year on year to RMB 37.74 trillion at the end of June (Chart 1). Spurred by government stimulated package, banks extend more mid & long term loans to government sponsored projects. Different from the first quarter, the share of bill financing diminished. In the new loan composition, the bill financing has declined month on month because China's recovery is in sight and macro risk is lower than year beginning, and banks started to prefer profitability than liquidity (Chart 3 & 4). It is likely the rapid loan growth will slow down in the second half, due to Chinese banks lending tendency of issuing more credit in the first half year and CBRC's heightened concerns on asset quality and capital adequacy.

Chart 1: Credit Growth



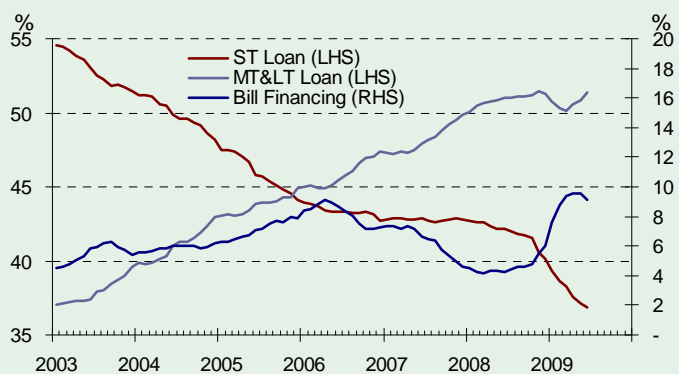
Sources: CEIC.

Chart 2: Share of Demand Deposits and Time Deposits



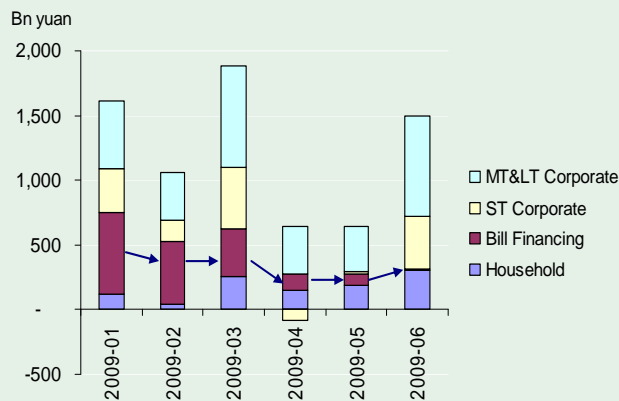
Sources: CEIC.

Chart 3: Share by Loan Category



Sources: PBOC.

Chart 4: New Loans Composition



Sources: CEIC.

Property Loans Fostered Housing Market Rebound

Housing loans took off in the second quarter of this year, in view of the real estate market's rebound. In the first quarter, Chinese banks extended 187 billion yuan of personal housing loans, while in the second quarter, the amount of newly added personal housing loans surged to 408 billion yuan. The rapid growth in mortgage lending surely contributed to the property market's recovery in the first half year. The huge liquidity not only pushes up property price, but also extends banks' exposure to property market. The CBRC has alerted the lenders on the risk of housing market and banks are urged to resume stringent lending conditions for second home-buyers. Banks in several cities, Hangzhou, Shanghai, Beijing, Chengdu, Kunming, etc., have started tightening enforcement of lending conditions for second-home purchases.

It appears that property loans will not be cooled soon largely because the mortgage loans are still the preferred assets for banks to grab, and practitioners in the local sub-branches have enough incentives to bypass the stringent conditions. The October 2008 regulation did grant leeway on the implementation of mortgage lending; therefore, unless more stringent policies are rolled out, the property market will continue to remain buoyant.

The property-related loans as of March, including both development loans and mortgage loans, stood at 5.67 trillion yuan, but its share in total loans has been falling since end 2007 when the property market cooled down. The current share of property loans is 16.22% still below the peak level 18.34% in end-2007. Among 5.67 trillion yuan of property-related loans, 2.17 trillion goes to developers and 3.49 trillion were lent as mortgage loans. (Chart 5)

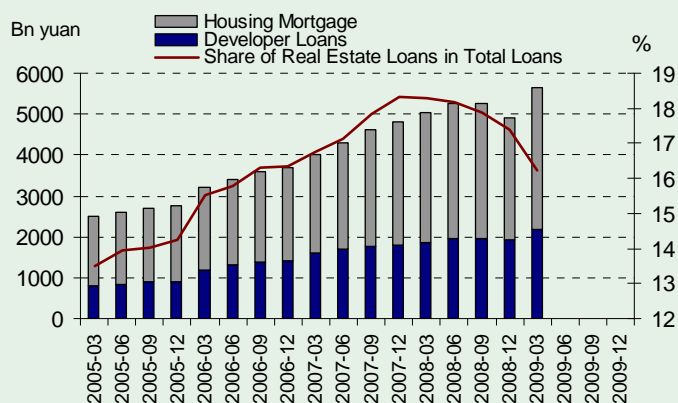
The yoy growth of mortgage loans climbed from the bottom of 11.6% in early 2009 to 21.8% in June 2009. Though still below the total loans growth rate of 34.4%, it catches up gradually as banks' willingness to lend to property sector increases. As shown in the newly-extended loans, both the new mortgage loans and its share in the new loans jumped to a higher level since March. (Chart 6&7)

Under this background, easy access to mortgage loans has prompted strong property sales, and the nationwide transaction value has surged by 75% yoy in the second quarter with price starting to rebounding nationwide (Chart 8&9). Consequently, the strong property sales boosted real estate investment significantly, which drives the auction price of land in major cities to rise. This in turn will push the property price higher.

It is true that the rising asset price, including property and stock market, will lead to consumption growth in short term via the wealth effect. However, the long-run pain will hurt more if the bubble bursts. That is why the CBRC is tightening the lending rules on concerns that relaxed lending standard to property sector will create a bubble in the country's property market. (Chart 7&8)

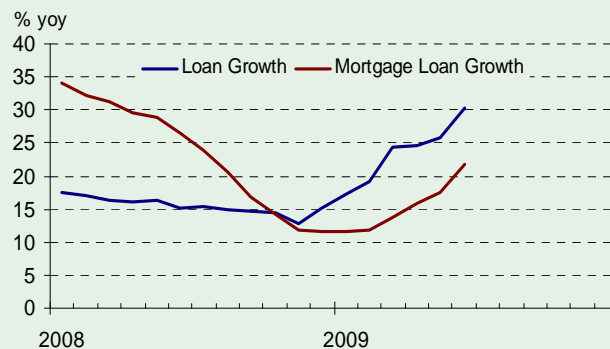
Given the recovery is still fragile and the importance of real estate sector on other sectors, we think it is unlikely that regulator will push the brake sharply by enforcing drastic tightening measures in the near term.

Chart 5: Real Estate Related Loans



Sources: CEIC.

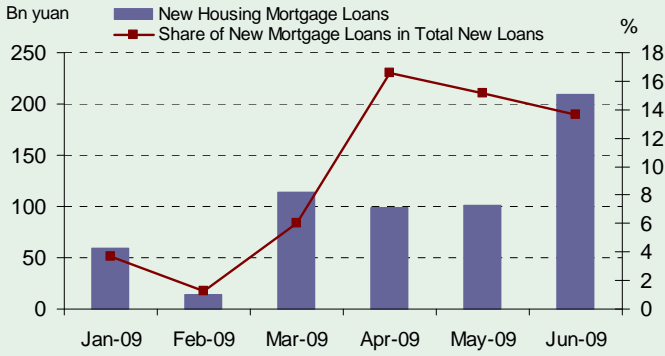
Chart 6: Mortgage Loan Growth



Note: The household mid & long term consumption loans are used as proxy for mortgage loans.

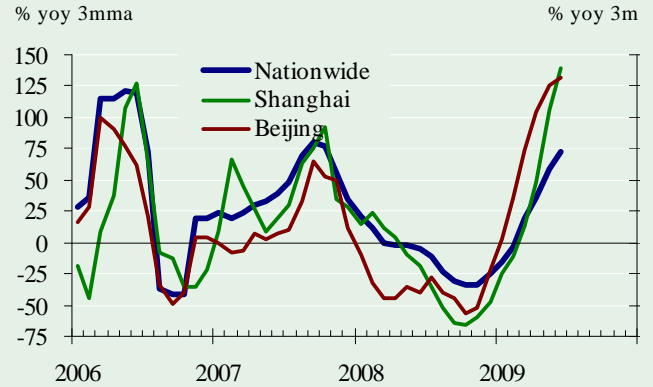
Sources: CEIC.

Chart 7: New Mortgage Loans Extended



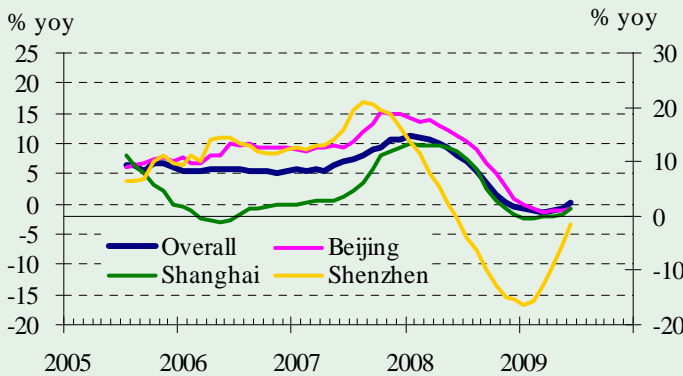
Sources: CEIC

Chart 8: Property Transaction Value



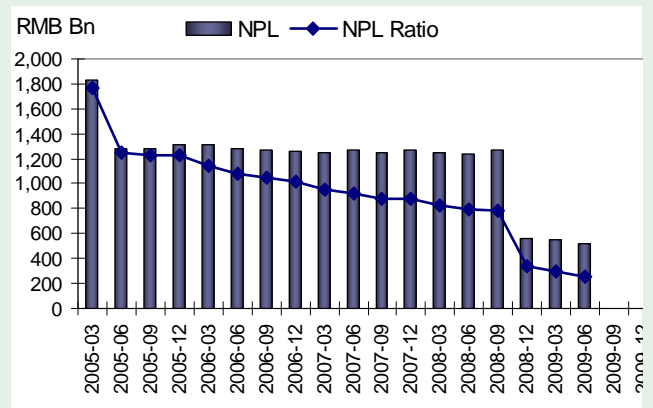
Sources: CEIC.

Chart 9: Property Price in China



Sources: CEIC.

Chart 10: NPL and NPL Ratio



Sources: CEIC

Non-Performing Loans Continued to Fall

China's low NPL ratio declines from the peak 20% in early 2000 to only 1.8 % as of June 2009 (Chart 10), representing the great success in banking reform during past years. CBRC has required banks to raise their bad-loan reserve ratio to 150 percent at the end of the year, forcing the lenders to set aside more earnings as provisions amid the concern of deteriorating asset quality, reflecting regulator to worry about a backlash from soaring credit growth.

However, the 150 percent reserves might not be enough to cover potential credit losses if the economy slows substantially and NPLs surge, as Chinese banks' provision is built on the low NPL base. Nevertheless, the dynamic provisioning is a welcome step and it shows that the regulator is seriously concerned about future bad loans and financial risks.

5. Asset prices

China's stock markets kept on the rise in Q2. The Shanghai and Shen zhen 300 index climbed by 26.27% from 2507.79 points to 3166.47 points over the period, and the average daily turnover amount has increased to 211.47 billion RMB in Q2 from 162.92 billion RMB in Q1, or by 29.80% (Chart 15), suggesting that the previously depressed investment demand is now finding way out. The big first-half rebound in Chinese stocks was closely in line with improving economic fundamentals, reflecting the market confidence was reinforced as the the government's fiscal stimulus package has begun to take effect. Also, with the entrance of more "hot money" from abroad betting China's quick recovery and the greatly increased market liquidity, more capital is available to enter the stock markets.

As shown in Chart 16, the expected circulation of previously locked shares (or non-traded shares) is on the progress. The number of unlocked shares in Q2 has increased by 51.56% to 54.40 billion, from Q1's 35.89 billion, and the total market capitalization for unlocked shared in Q2 has also enlarged to 5.75 trillion RMB from Q1's 3.44 trillion RMB, or by 67.46%. However, the negative effect of unlocked shares to China's stock markets is mitigated, as the proportion of small shareholders in Q2 is much less than that in Q1. But the peak of share unlocking in October might bring up the downward pressures to stock market again by then.

China's property market has rebounded quicker than expected, mainly driven by the loose monetary and credit policy and inadequate investment vehicles available for investors to fight looming inflation. Besides the eased bank lending, listed developers have embraced chances in the resurging A-stock market to raise capital through additional share offerings, which has further eased their pressure on capital. The overall property prices have marginally come out of contraction. In June, the total property price index increased by 0.2% yoy, from the contraction of 0.6% yoy in May. And in several major cities, such as Beijing, Shanghai and Shenzhen, the contraction of housing prices has also slowed down in Q2 (Chart 17).

Chart 15: Stock market slumps and trading shrinks

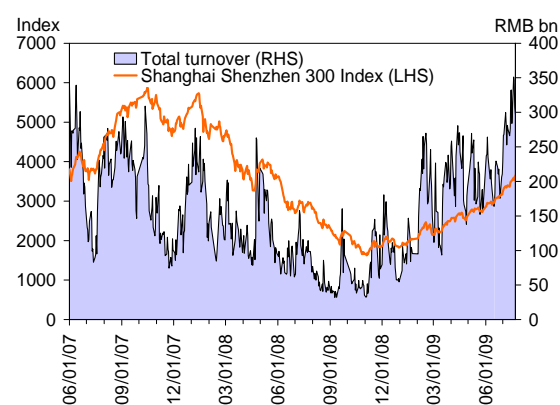


Chart 16: Circulation of unlocked shares

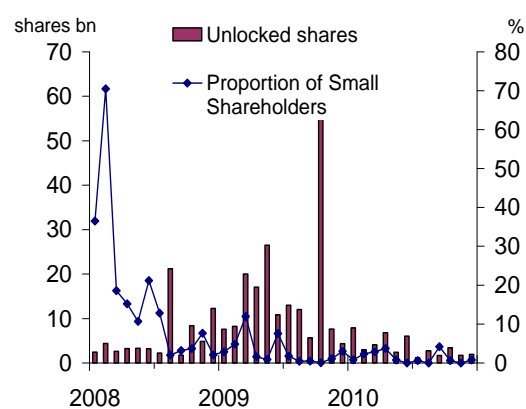
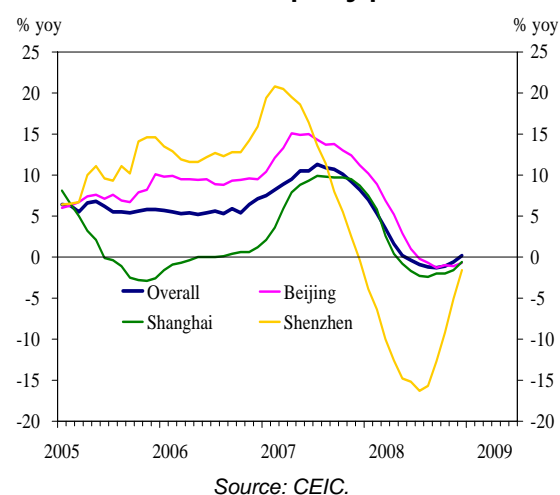


Chart 17: Property prices



6. Exchange rate and capital flows

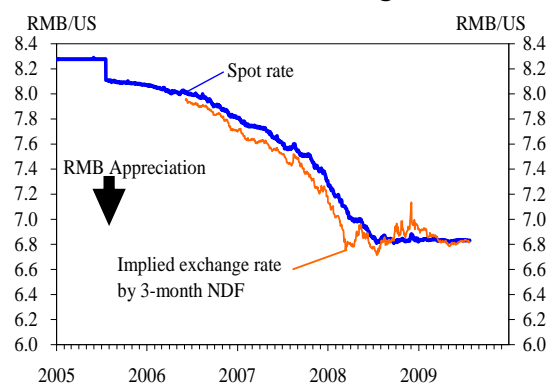
From July 2005 on, renminbi (RMB) has appreciated 21% against US dollar. However, most of the appreciation occurred in the first three years. Since July 2008, when the global financial crisis broke out, the RMB has slowed its pace of appreciation and maintained within a narrow band of CNY 6.83 to the dollar. The market expected that RMB would remain unchanged in the near future, which could be shown in the 3-month non-deliverable futures rate of CNY/USD (Chart 18). Across east Asia, the year-to-date performance of currencies differentiated by macro fundamentals, while Renminbi, Taiwan dollar and Hong Kong dollar were relatively stable against US dollar compared with currencies of other countries (Chart 19).

The appreciation pressure of RMB has been gaining place recently. First, the rapid growth of foreign exchange reserve might increase the appreciation pressure. China's foreign exchange reserves have gained momentum since this March. In Q2 the foreign exchange reserves increased by 177.87 billion USD, and by the end of June, the balance has topped 2.13 trillion USD (Chart 20). Second, the internationalization process of RMB, which started early this July, could help to mitigate effect of exchange rates on exports and pave the road for RMB's further appreciation. On July 6th, Cross-border Trade Renminbi Settlement was formally launched, and China allows Shanghai and four cities in the southern Guangdong province - Shenzhen, Guangzhou, Zhuhai and Dongguan - to settle international trade using RMB on a pilot basis. This pilot program makes RMB's path of becoming a global currency clearer, which would go from regional to international step by step.

However, although appreciation of RMB against US dollar is a clear trend in the long run, it is still not the right time for now. As the current 7.9% yoy GDP growth is still fragile, which is mainly spurred by the huge fiscal stimulus package, the government is busy with fighting for a sustainable economic growth and lower unemployment, and it would just simply not bother to reevaluate RMB to hamper the already weakened exports and occur more job losses. Further appreciation of the RMB would return to agenda, only after the economic growth rate stabilizes at 8%. We expect the exchange rate would reach 6.5 by the end of 2010.

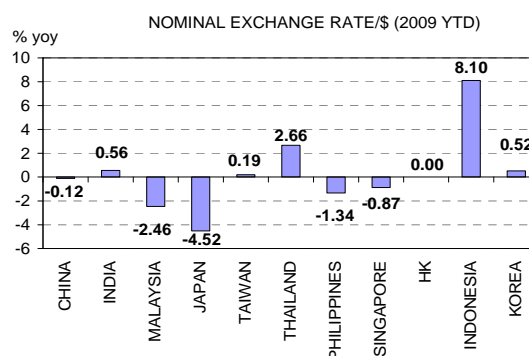
On the other side, the recent surging foreign exchange reserves ring a bell for massive inflow of international capital. Chart 20 shows that the increase of foreign exchange reserves from March to June was mainly driven by international capital inflow, while the combination of FDI and trade surplus is relatively stable. The notable capital inflow was mainly attracted by the optimistic outlook of China, which is likely to be the first of major countries to recovery of the recession. It is necessary for the government to keep a close watch over the purpose of capital inflow, and take right measure to prevent the liquidity bubble and maintain a stable economic growth.

Chart 18: RMB exchange rate



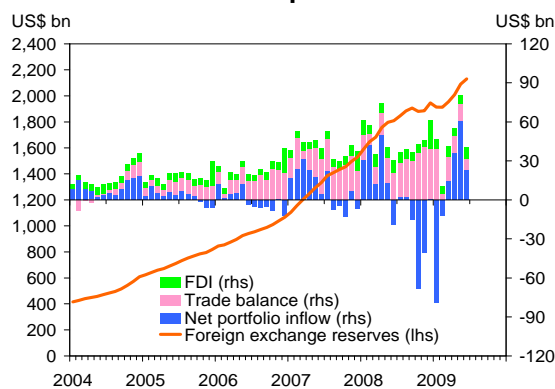
Sources: Datastream, CEIC and BBVA estimates

Chart 19: Nominal exchange rate of Asian currencies



Source: Datastream and BBVA estimates

Chart 20: Capital flows



Sources: CEIC and BBVA estimates.

Economic Outlook and Prospects

The better than expected second quarter GDP figure suggests that China's economy is on a way to a robust recovery. While fixed asset investment was the main driver for growth in H1, the export sector is expected to recover further H2 2009 on steady recovery of the G-3 economies. Therefore, the pattern of growth in the second half will become more balanced going forward.

While we are optimistic a growth rate close to China's economic potentials can be achieved, deflation in Q2 continued. Indeed, the CPI inflation has registered 6 consecutive monthly falls since February. We continue to maintain our view that deflation will not be a serious problem. In fact, it is expansionary under the current circumstances as wages have little room to move up on rising unemployment pressure. Looking forward, as the effect of rapid credit growth, rising farm subsidies, and energy price reforms start to work through the economy, upward price pressures will resume again. We continue to maintain our view that CPI inflation for 2009 will stay at around 0.5% (Table 1).

Risks and Uncertainties

While we continue to maintain China will be the first economy to recover from the severe global recession, there are a number of downside risks and uncertainties surrounding our relatively upbeat outlook going forward.

First, the Chinese economy, though recovering at a steady pace, remains vulnerable to a protracted weak growth in G-3 economies. As long as the export sector remain sluggish, industrial overcapacity is likely to persist. This will then continue to put pressures on domestic prices and increase the risk of protracted deflation. Therefore, it is premature to discuss any fiscal withdrawal and monetary tightening measures at this stage of recovery. Any premature tightening may run the risk of snuffing out the burgeoning recovery.

Second, the rapid credit growth in H1 does raise concerns over an asset boom that may quickly grow into an asset bubble. The concerns were partly reflected by a 75% rebound in stock price and a rebound in both transaction volumes and prices. We caution that the run up in asset prices should not be used as the only gauge for policy tightening decision as long as considerable slacks remain in the economy, unemployment rate high, and wage pressure nonexistent. Therefore, some monetary policy accommodation may be contemplated to adjust the structure of rapid loan extension, but drastic monetary tightening is not an option at this juncture of the recovery process.

Table 1: Forecasts

	2008	2009				2010	
	Actual	Actual		Forecast		Year	Year
	Year	Q1	Q2	Q3	Q4		
GDP	9.0	6.1	7.9	8.6	9.8	8.1	8.6
CPI Inflation	5.9	-0.6	-1.5	0.9	1.8	0.5	2.0

Sources: Wind and BBVA estimates.

Appendix: China Statistical Table

	Unit	2004	2005	2006	2007	2008	2008				2009	
							Q1	Q2	Q3	Q4	Q1	Q2
Domestic economy												
Nominal GDP	RMB billion	15988	18322	21192	25731	30067	6149	6913	7101	9904	6574	13986
	USD billion	1932	2239	2662	3391	4326	858	994	1038	1448	962	2048
Real GDP growth	% yoy	10.1	10.4	11.6	13.0	9.0	10.6	10.1	9.0	6.8	6.1	7.9
CPI	% yoy	3.9	1.8	1.5	4.8	5.9	8.0	7.8	5.3	2.5	-0.6	-1.5
External economy												
Exports	% yoy	35.4	28.4	27.2	25.8	17.2	21.2	22.2	23.0	4.3	-19.7	-23.5
Imports	% yoy	36.0	17.6	19.9	20.8	18.5	28.9	32.7	25.8	-8.9	-31.0	-20.5
Trade balance	USD billion	32	102	178	263	295	41	57	83	114	63	35
Current account balance	USD billion	69	161	250	372	426	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	% of GDP	3.6	7.2	9.4	11.0	9.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Balance of payment	USD billion	206	207	247	462	419	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	% of GDP	10.7	9.2	9.3	13.6	9.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign exchange reserves1/	USD billion	610	819	1066	1528	1946	1682	1809	1906	1946	1954	2132
	% of GDP	31.6	36.1	39.3	43.4	44.2	44.1	44.4	45.0	44.2	44.0	38.8
External Debt	USD billion	247	281	323	374	375	393	427	442	375	n.a.	n.a.
	% of GDP	12.8	12.4	11.9	10.6	8.7	10.9	10.6	10.4	8.7	n.a.	n.a.
Fiscal												
Fiscal balance	% of GDP	-1.3	-1.2	-1.0	0.6	0.0	10.5	7.9	0.8	0.0	2.8	2.3
Monetary												
M2 growth	% yoy	14.6	17.6	16.9	16.7	17.8	16.3	17.4	15.3	17.8	25.5	28.5
Loans growth	% yoy	14.5	13.0	15.1	16.1	18.8	14.8	14.1	14.5	18.8	29.8	34.4
Benchmark lending rate	% pa	5.6	5.6	6.1	7.5	5.3	7.5	7.5	7.2	5.3	5.3	5.3
Benchmark deposit rate	% pa	2.3	2.3	2.5	4.1	2.3	4.1	4.1	4.1	2.3	2.3	2.3
Required reserve ratio2/	%	7.5	7.5	9.0	14.5	15.0	15.5	17.5	16.5	13.5	13.5	13.5
RMB/USD exchange rate	(period-end)	8.3	8.1	7.8	7.3	6.8	7.0	6.9	6.8	6.8	6.8	6.8
	(period-average)	8.3	8.2	8.0	7.6	6.9	7.2	7.0	6.8	6.8	6.8	6.8
Socio-economic indicators												
Population	Person (million)	1300	1308	1314	1321	1328	1323	1325	1326	1328	n.a.	n.a.
Urban	% of total	41.8	43.0	43.9	44.9	45.7	n.a.	n.a.	n.a.	45.7	n.a.	n.a.
Rural	% of total	58.2	57.0	56.1	55.1	54.3	n.a.	n.a.	n.a.	54.3	n.a.	n.a.
Life Expectancy	Years	71.4	72.0	72.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Infant Mortality	per 1,000	n.a.	25	24	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
GDP per capita	RMB	12299	14012	16122	19474	22639	4648	5218	5354	7457	n.a.	n.a.
	USD	1486	1712	2025	2567	3258	649	750	783	1090	n.a.	n.a.
Energy												
Energy Production	SCE Ton mn	1873	2059	2211	2354	2460	539	642	651	628	n.a.	n.a.
Energy Consumption	SCE Ton mn	2032	2247	2463	2656	2850	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Per Capita Energy Consumption	SCE Kg	164	180	195	203	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Per Capita Electricity Consumption	KWH	190	217	249	275	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: National Bureau of Statistics, World Bank and staff calculations.

Note: 1) The quarterly figures for "% of GDP" are using the annualized GDP figures.

2) In December 2008, the RRR for small and medium sized banks was cut to 13.5% while the RRR for the big six was cut to 15.5%.

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