

China Outlook

Second Quarter of 2010

Economic Analysis

- Economic growth is expected to remain brisk in 2010 at 9.8%. This assumes a “soft landing” from the current rapid pace as tightening measures are implemented to prevent overheating.
- Inflation has been rising, but is not yet a serious concern. Inflation should peak around mid-year, and then recede as monetary and credit growth are reined in.
- Monetary tightening will continue with further quantitative measures and some hikes in interest rates and gradual currency appreciation.
- Risks are tilted toward overheating, with downside risks present from uncertainties in the external environment, especially in Europe.



Index

1. A Challenging Global Environment.....	4
2. China: growth momentum gathers pace, raising the risks of overheating.....	6
3. Strong growth set to continue into 2010.....	10
4. Risks are tilted toward overheating	12
5. Tables	13

Summary

Economic growth in China is expected to remain brisk in 2010 at 9.8%. This is based on our expectations of a “soft landing” from the very rapid pace of growth seen in Q1 (11.9% y/y), as further tightening measures by the authorities are implemented to head off risks of overheating. Growth in 2010 would be led by further strength in investment and a turnaround in net exports, which will contribute positively to growth, from a negative contribution last year.

Inflation has been rising, but is not yet a serious concern. We expect headline inflation to peak at around 4% in June on account of rising food prices and base effects, and to recede thereafter provided the authorities are successful in restraining rapid monetary and credit growth. The risk of rising housing prices leading to a bubble has prompted the authorities to tighten monetary conditions through hikes in reserve requirements and measures to rein in lax liquidity and rapid credit growth.

We expect rapid growth in bank lending to slow further, in line with recent trends. Although credit growth has recently exceeded expectations, we believe the authorities' loan growth target for 2010 of RMB 7.5 trillion is achievable (19% growth in annual terms). In our view, this will require further quantitative measures to restrain credit growth and liquidity, including additional hikes in required reserve ratios, “window guidance”, open market operations, and use of credit quotas. We anticipate these measures to be supported by small interest rate hikes in Q2 and Q3, although unfolding risks to the external environment could result in some delay.

Monetary tightening measures are likely to be accompanied by gradual currency appreciation beginning in Q2. As with interest rate hikes, the precise timing of such a move will depend on the authorities' assessment of risks to the external environment. Nevertheless, with reserves continuing to rise and export growth remaining strong, we expect appreciation to commence in the near term, and for the RMB to appreciate against the USD by 4-5% by end-year.

While risks are tilted toward overheating, downside risks are present due to uncertainties from the external environment. In particular, there are heightened risks of financial strains in Europe spilling over to the global economy. This poses challenges for the authorities, as they seek to restrain growth to prevent risks from overheating on the one hand, while providing support for the economy in the event of a renewed global downturn on the other.

Given the risks to the global environment, we expect the authorities to maintain an overall supportive fiscal policy stance during the remainder of the year. Though the pace of government spending is being scaled back, we expect the authorities to continue implementing the two-year fiscal stimulus package adopted in late 2008. On this basis, the overall fiscal deficit is projected to amount to 2.8% of GDP in 2010, the same outturn as last year. Spending is gradually shifting toward the social sector, with approval of new infrastructure projects now on hold and efforts being implemented to rein in spending by local governments.

Notwithstanding risks uncertainties in the global economy, there are upside risks to our projections, especially if record-high credit growth cannot be contained effectively. In a relatively benign scenario, rising inflationary pressures and asset price bubbles could necessitate further measures to cool the economy in the near term, including by scaling back some of the planned fiscal stimulus. In a more extreme, but less likely overheating scenario, where the housing bubble bursts and there is a sudden loss in confidence, NPLs could surge, leading to a “boom-bust” cycle and resulting in a more sudden decline in growth.

Our medium-term projections take into account China's efforts to rebalance its pattern of growth from one based on exports and investment toward one based more on private consumption. These include reforms to reduce precautionary savings such as a strengthening of the social safety net, especially enhancements to the pension and health care systems. Similarly, ongoing policies to promote consumer finance should help boost consumption levels. Currency appreciation should be permitted to foster the rotation of growth toward domestic demand.

1. A Challenging Global Environment

The global economy is driven by two conflicting forces: the positive cyclical impulse from emerging countries and the US, and heightened risk premia spreading from Europe. While the EMU rescue package reduces uncertainties in the short-run, the balance of risks over the medium-term remains tilted to the downside

The cyclical situation has improved significantly over the last few quarters, driven by the recovery in emerging market economies and the US. Global trade is growing at 7% and we forecast 4.2% global growth for 2010. At the same time, there are doubts about the ability of the European Monetary Union within its current decision-making framework to deal with the high level of indebtedness of some of its countries. These doubts have given rise to widening spreads and renewed financial stress. Such developments may impinge first on the European economy with possible spillovers to the rest of the world. The timing and the extent of these adverse impacts will crucially hinge on the effectiveness and lasting effects of the announcement of the rescue package agreed by the European Council on May 9 and the exceptional measures adopted by the ECB. While the package has stabilised market conditions in the short-run, uncertainties remain in three main areas: i) the implementation of the rescue package in the months to come, ii) the credibility of further fiscal consolidation to be adopted by some EU countries and iii) EMU core countries' medium-term commitment to the package.

Following the short-term impulse from unprecedented fiscal and monetary expansion worldwide, the sustainability of the recovery is not fully guaranteed beyond 2010, mainly in developed countries

While economic recovery in early 2010 has been widespread, its intensity has varied a great deal across countries. This is the result of different degrees of laxness in their fiscal and monetary policies. These policies have been particularly instrumental in providing impulse to the cyclical upturn in China, as described below, and the US. At the same time, emerging economies are benefiting from the strength of their own domestic demand. As a result, in these economies the recovery looks more likely to be self-sustained. Conversely, in developed countries, as expansionary policies fade away, doubts about the sustainability of the recovery beyond 2010 are growing.

Growing divergence in monetary exit strategies looking ahead: a gradual approach in the US; no clear timing for the exit in EMU; and no a one-size-fits-all strategy across emerging markets

A very gradual path of interest rates hikes by the Fed is forecast. Rate hikes by the Fed are not expected until the beginning of 2011, with rates rising slightly above 1% by the end of 2011. There are major differences in the economic backgrounds in the US and Europe that will lead to different monetary developments in both areas. Although economic growth may prove sluggish in 2010 and beyond, the risk of a major reversion of current dynamics is rather limited in the US, with incipient inflationary pressures looming. Conversely, in Europe, in addition to a far more fragile financial situation, the upturn looks more uncertain and inflationary pressures are absent. In the case of emerging economies' monetary policies, there is no doubt about the need for a tightening stance. Given their cyclical divergences, exit strategies will vary across countries. In some countries, if the tightening of monetary policy and other measures are not implemented soon, macroeconomic imbalances will build up.

Markets have shown the limits of anticyclical fiscal policies. Economies with high public debt and limited private deleveraging are highly vulnerable to an upward movement in interest rates and higher risk premia

During period of heightened risk aversion, financial markets are particularly good at tracking inconsistent macroeconomic policies, which might otherwise be overlooked in normal times. Despite the huge rescue package in Europe, substantial risk premia should prevail in the market amid uncertainty on the fiscal consolidation path. Increasing contagion has been clear evidence of the fragility of the current scenario. Economic history is fraught with examples of undue contagion from some countries to others in the aftermath of a crisis. In these cases, geographical linkages or cyclical similarities often matter more than differences in fundamentals. In fact, the current episode of contagion appears not to be

fully justified either by the direct financial channel triggered by the Greek crisis or by any similarities in fundamentals. Though its justification may be open to debate, to cope with pressures from international investors, there is a compelling need for some countries to enhance credibility.

Long-run fiscal consolidation is the major challenge for developed countries

There are growing concerns about the long-term consequences of the build-up in public debt. This will unavoidably give rise to upward pressures on real interest rates and high risk premia for a protracted period. Even if recent contagion gradually fades, increasing discrimination across countries depending on the credibility of their fiscal stance will prevail.

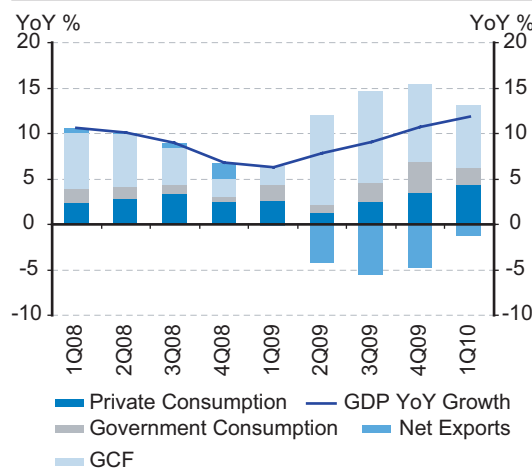
The lack of a decisive restructuring in the banking sector and the coming regulatory process poses risks to the recovery

Uncertainty stemming from the financial sector is primarily twofold. The sluggish restructuring of the financial industry, particularly in Europe, will lead to a creditless recovery. This is a growing concern since both historical episodes and empirical evidence show the importance of the credit channel in the early stages of the economic upswing. There is also uncertainty regarding the ongoing regulatory reform. The most likely outcome is one of a significant increase in capital and liquidity requirements. This could hinder the ability of the banking sector to grant credit in coming years.

2. China: growth momentum gathers pace, raising the risks of overheating

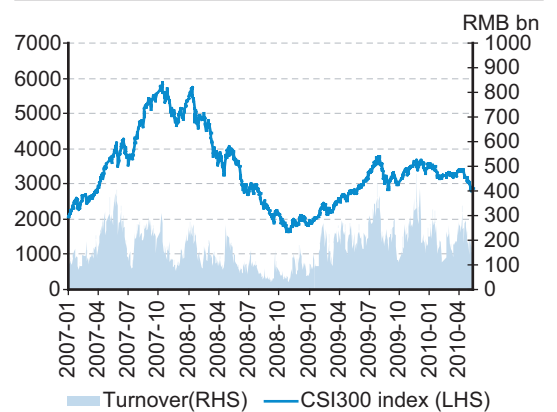
China's growth momentum has continued gathering pace on the back of fiscal and monetary stimulus policies and, increasingly, an improvement in external demand. Following last year's impressive full-year outturn of 8.7%, GDP growth accelerated further in the first quarter of 2010, to 11.9% year-on-year (y/y) led by strong investment and improving net exports (Chart 1). With the estimated output gap now closed, strong growth momentum and rapid credit growth have raised the risks of overheating. Perhaps reflecting these risks, despite strong economic growth, the stock market has declined by around 20% year-to-date (Chart 2).

Chart 1
Growth momentum has been picking up (China: Contribution to GDP)



Source: BBVA Research

Chart 2
The stock market retreats on expectations of further tightening measures

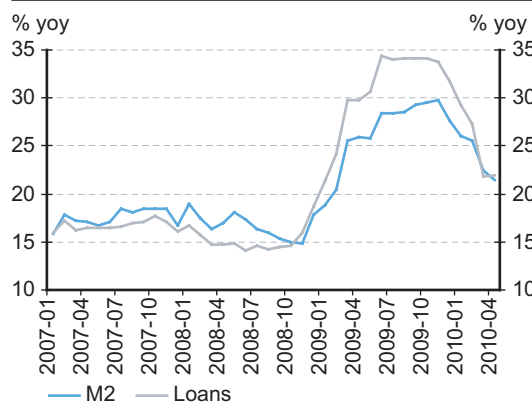


Source: CEIC and BBVA Research

Economic activity remains brisk, but signs of some slowdown are becoming evident

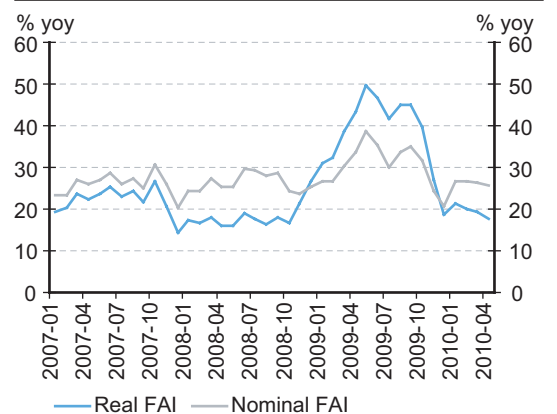
While overall activity remains brisk there are, however, some signs that recent measures by the authorities to rein in growth to more sustainable levels may be gaining traction. In particular, credit and M2 growth have fallen in recent months as new loan creation has begun to ease (Chart 3). Driven by ongoing, rather than new infrastructure projects, the growth of urban fixed asset investment (FAI) has been slowing from its peak in mid-2009 (Chart 4).

Chart 3
Money and credit growth have eased as tightening measures gain traction



Source: CEIC and BBVA Research

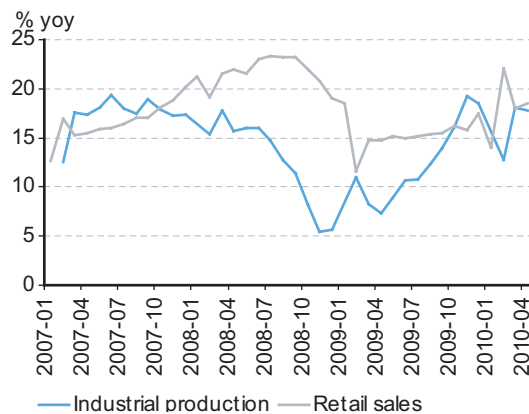
Chart 4
Fixed asset investment growth is moderating



Source: CEIC and BBVA Research

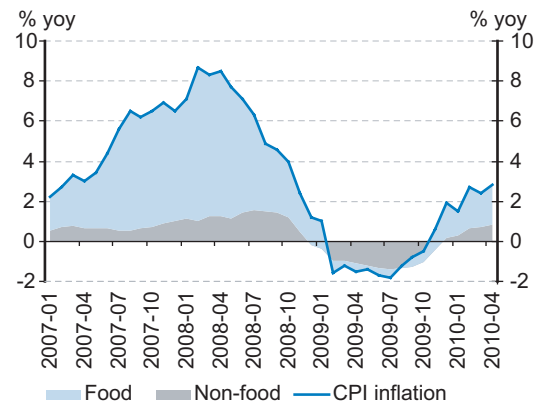
At the same time, private consumption and output indicators remain strong, consistent with the authorities' intention to provide policy support to the economy. Retail sales, for example, rose by 18.5% y/y in April driven by rising household income and continued government subsidies for auto and home appliance purchases. Meanwhile, against the backdrop of stronger external and domestic demand, industrial output has maintained its momentum, at around 18% y/y in April (Chart 5).

Chart 5
Retail sales and industrial output maintain momentum



Source: CEIC and BBVA Research

Chart 6
Inflation is rising, but not yet a problem



Source: CEIC and BBVA Research

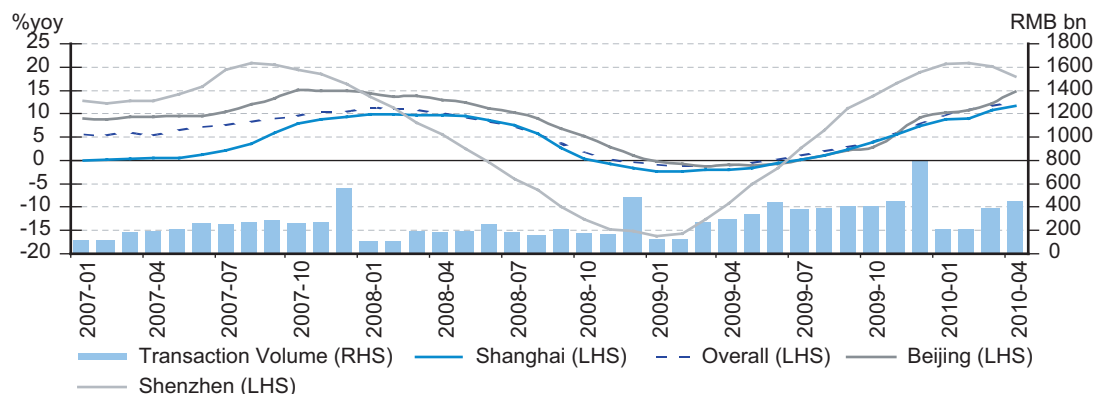
Rising inflation is a concern, but not yet a problem

Headline CPI inflation has been rising (to 2.8% y/y in April) on account of increases in food prices (Chart 6). Overall inflationary pressures remain subdued, however, with core inflation (excluding food and energy) of only 0.7% in April. That said, inflation is clearly on the rise, and with the output gap closed by our estimates, the authorities will need to continue to monitor price developments closely.

Rising housing prices of particular concern as the authorities watch out for asset price bubbles

Much of the recent policy focus is on the risks of rising housing prices due to lax liquidity conditions. Housing price increases have continued to accelerate (Chart 7), prompting the authorities to take further targeted steps to cool the property market by restraining speculative home purchases. The measures have included an increase in down payment requirements for second home purchases, to 50% from 40% previously (this in turn was doubled from 20% last year), while loans for third home purchases have been forbidden. In addition, mortgage rates on second home purchases have been raised from 70%-80% of benchmark interest rate to 110%. The availability of land for affordable housing development has also been increased

Chart 7
Housing prices continue to rise



Source: CEIC and BBVA Research

While maintaining an overall supportive policy stance, fiscal and monetary settings are being tightened to avert overheating risks

The strong growth momentum and risks of asset price bubbles have prompted the authorities to begin gradually tightening policies. Mindful of risks to the global environment, however, they have expressed an intention to maintain an overall supportive policy stance during the remainder of the year.

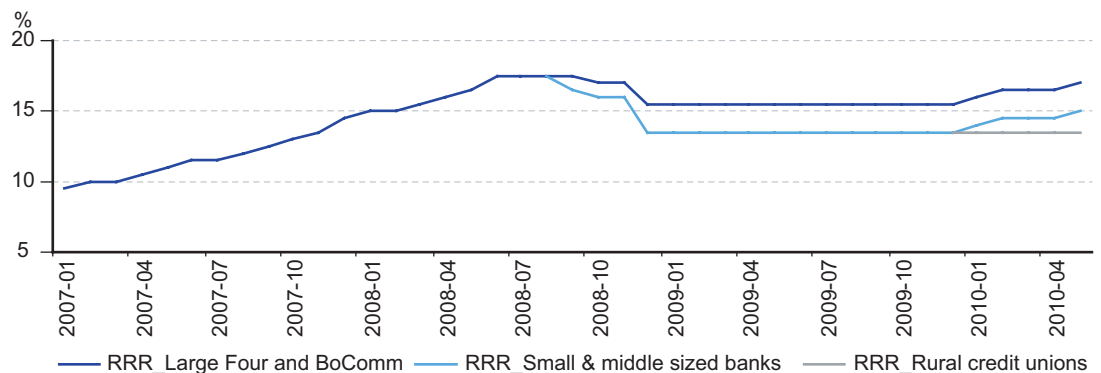
Fiscal policy stimulus is being maintained, while the growth of spending is scaled back

On the fiscal front, they are therefore continuing to implement the two-year fiscal stimulus package adopted in late 2008. However, the pace of government spending is slowing down and restrictions have been placed on the approval of new infrastructure projects. Moreover, a gradual rotation toward social spending is underway, as are efforts to rein in spending by local governments. The 2010 budget deficit is projected at 2.8% of GDP, the same level as last year's outturn. However, the growth of government spending is set to slow in 2010, at only half the rate of last year when spending grew by 22%.

Monetary policy is being tightened through quantitative measures to begin with

While monetary policy remains accommodative, steps have been taken to rein in rapid credit growth. The first of three hikes in the required reserve ratio (RRR) began in January (Chart 8); more stringent credit quotas have been placed on banks, consistent with an overall target for new loans of RMB 7.5 trillion, equivalent to 19% annual loan growth; and the withdrawal of liquidity through open market operations has been stepped up. As described above, efforts have also been taken to cool the property market. In taking these steps, the authorities have revealed a preference for quantitative measures, rather than interest rate hikes, at least for the time being.

Chart 8
Three hikes in the RRR so far



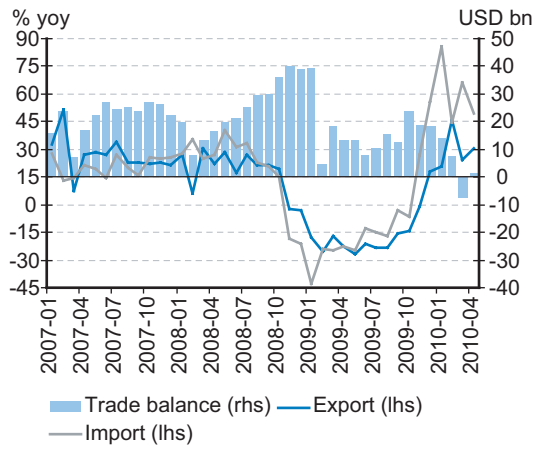
Source: CEIC and BBVA Research

Strong export growth, a large current account surplus, and capital inflows are leading to a further rise in international reserves, casting a spotlight on China's currency policy

China continues to run a large current account surplus. In 2009, the surplus declined by 3½ percentage points, to 6% of GDP due to high import growth from strong domestic demand, and weak export growth due to the sluggish external demand. The surplus is likely to increase modestly in the near term, due to strengthening external demand, with exports almost back now to pre-crisis levels. While recent trade data show some decline in the trade surplus (the trade balance temporarily turned to deficit in March, before reverting back to surplus in April) (Chart 9), we expect the trade balance to remain in substantial surplus as external demand continues to strengthen. Capital inflows continue to rise on FDI and portfolio investment, and foreign reserves have increased further, reaching a record USD 2.5 trillion in March.

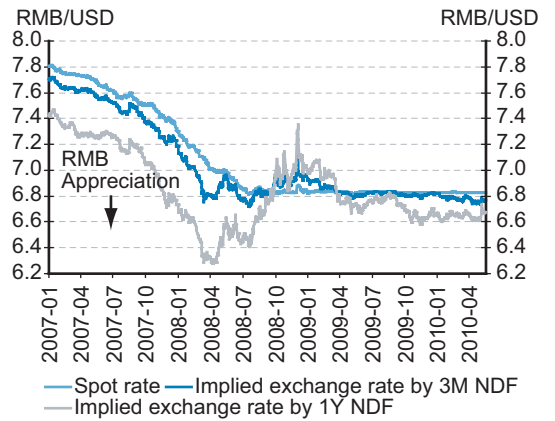
The currency, meanwhile, has remained pegged for all intents and purposes to the USD. The PBOC has recently referred to this as a "special" response to the global financial crisis, implying its willingness to allow an eventual resumption of appreciation. NDF forwards (12-month) are pricing in a small appreciation (Chart 10), and in anticipation, net portfolio inflows are increasing.

Chart 9
Further trade surpluses are expected



Source: CEIC and BBVA Research

Chart 10
NDF points to a small appreciation



Source: Datastream and BBVA Research

3. Strong growth set to continue into 2010

Looking forward, we expect strong growth momentum to continue into 2010. Our baseline is for GDP growth of 9.8%, implying that the authorities' tightening measures are successful in restraining growth in line with potential (we estimate a zero output gap as of end-2009). Barring a sharp deterioration in the external outlook, additional efforts will be needed constrain credit and monetary growth and, if necessary, some modest scaling back of fiscal measures.

A soft landing is likely, provided that further efforts are taken to restrain rapid credit growth

We expect a "soft-landing" for the remainder of the year as tighter monetary policies and dampening measures on the real estate market take effect. The pace of investment should slow as measures to cool the property sector take effect and as local government spending is reduced, but consumption spending should hold up due to rising incomes and government support measures. The export sector is expected to benefit from the recovery in external demand, although the pace may slow in H2 as global re-stocking begins to fade. Overall, we expect growth in 2011 to moderate further, to 9.2% as stimulus policies wind down (Table 1).

Table 1

Baseline Scenario

	2007	2008	2009	2010 (F)	2011 (F)
GDP (% , y-o-y)	14.2	9.6	8.7	9.8	9.2
Inflation (average, %)	4.8	5.9	-0.7	3.1	3.3
Fiscal bal (% of GDP)	0.6	-0.4	-2.8	-2.8	NA
Current acct (% of GDP)	10.2	9.3	6.1	7.0	6.5
Policy rate* (%)	7.47	5.31	5.31	5.85	6.39
Exch rate* (CNY/USD)	7.30	6.83	6.83	6.54	6.28

*Note: end-of-period

Source: CEIC, BBVA Research

Headline inflation should peak at 4.0% y/y in June driven by rising food prices and last year's low base, and recede thereafter to 3.1% by year-end. Under our baseline, growth in 2010-12 should remain at or slightly below potential, which should help keep inflationary pressures in check, assuming appropriate monetary policy action.

More quantitative tightening measures are likely, followed by modest interest rate hikes and currency appreciation

Going forward, our baseline assumes further quantitative measures to restrain credit growth and liquidity, including additional hikes in required reserve ratios, "window guidance", open market operations, and credit quotas. We anticipate these measures to be supported by a total of two 27bp interest rate hikes in Q2 and Q3. It is quite possible, however, that the timing of interest rate hikes could be delayed pending the evolution of financial market pressures arising from the debt crisis in Europe.

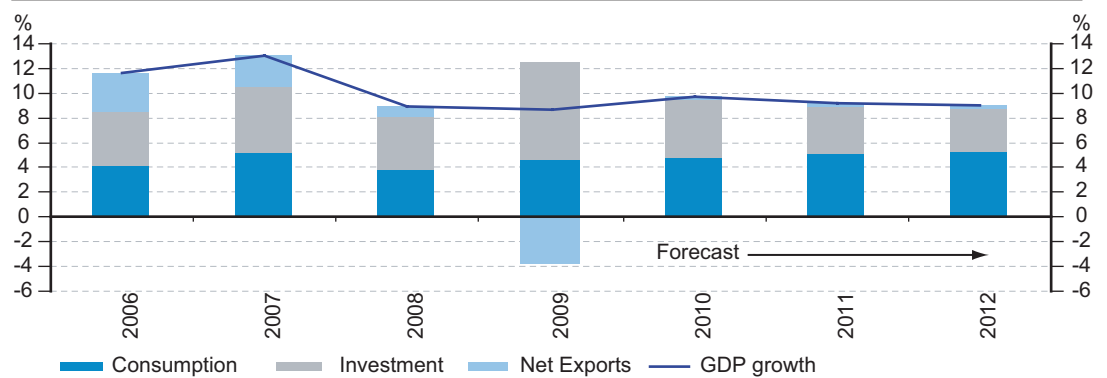
On the currency, despite recent political rhetoric, our baseline is that the authorities will allow gradual appreciation starting in the current quarter (Q2). Similar to the case of interest rate hikes, developments in Europe could lead the authorities to delay the timing of currency appreciation. That said, our baseline anticipates a 4-5% appreciation of the RMB against the USD by end-2010, which would bring the currency to 6.54 per USD.

A rebalancing of growth over the medium term

Our medium-term projections take into account China's efforts to implement reforms to rebalance its pattern of growth from one based on exports and investment toward one based more on private consumption (Chart 11). These include efforts to reduce precautionary savings by strengthening the social safety net, especially enhancements to the pension and health care systems. Similarly, ongoing policies to promote consumer finance should help boost consumption levels. There is also ample scope to improve productivity by easing investment policies and lowering market entrance thresholds in various sectors. Currency appreciation should be permitted to foster the rotation of growth toward domestic demand.

Chart 11

GDP Growth by Components



Source: BBVA Research estimates

4. Risks are tilted toward overheating

Given strong growth momentum, risks, though still manageable, are now tilted toward overheating. We see two overheating scenarios if rapid credit growth cannot be contained effectively. A relatively benign “Type I” form of overheating could develop whereby rising inflationary pressures and asset price bubbles develop over the next few years, necessitating further tightening measures beyond those contemplated in our baseline. In a less likely, but more severe “Type II” overheating scenario, where the housing bubble bursts and there is a sudden loss in confidence, non-performing loans (NPLs) could surge leading to a “boom-bust” cycle. This could increase banks’ capital needs and require government assistance.

NPLs remain low for the time being, but given recent rates of loan growth and excess supply in some sectors, such as steel, glass, and cement among others, a deterioration in credit quality could occur over the medium term. Loans to local government financing vehicles (LGFVs) in particular are a concern as banks poured a huge amount of credit into these vehicles last year 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.

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	2.7	0.5	-4.0	0.7	1.3
Asia-Pacific	7.3	4.0	1.8	5.8	5.3
China	14.2	9.6	8.7	9.8	9.2
World	5.3	3.0	-0.7	4.2	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	2.0	1.8
EMU	2.1	3.3	0.3	1.0	1.2
Asia-Pacific	2.8	4.9	0.2	2.9	2.6
China	4.8	5.9	-0.7	3.1	3.3
World	4.1	6.1	2.2	3.7	3.4

Source: BBVA Research

Table 4

Macroeconomic Forecasts: Exchange Rates (End 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 period)

	2007	2008	2009	2010 (F)	2011 (F)
U.S.	4.3	0.6	0.3	0.1	1.3
EMU	4.0	2.5	1.0	1.0	1.5
China	7.5	5.3	5.3	5.9	6.4

Source: BBVA Research

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