BBVA | RESEARCH

# Economic Outlook

## China

First Quarter 2012
Economic Analysis

- **The global economy is slowing down, and will only rebound in the second half of 2012** as financial tensions in Europe begin to ease. Risks are titled to the downside, however, given the challenges that remain in resolving the European crisis.

- **China's economy continues to slow under the influence of weaker external demand**. However, growth is being supported by robust domestic demand and a gradual loosening of the policy stance. As such, we are lowering our growth projections only modestly, to 8.3% and 8.7% in 2012-13.

- **The shift to a looser policy stance is being facilitated by a decline in inflation.** We anticipate further reductions in the RRR, along with interest rate cuts if the external environment weakens. Fiscal support will consist of subsidies to households and construction of affordable housing.

- **Risks remain tilted to the downside**. The main risk is from the uncertain global environment. Domestic financial fragilities are being addressed, but bear watching. While a hard landing cannot be ruled out, we continue to believe the risk is low, especially given room for additional stimulus to sustain growth.

# Index



Publication date: February 14, 2012

# Summary

**China's economy continues to slow at a moderate pace.** The deceleration reflects the impact of deliberate policy actions through the middle of 2011 to prevent overheating and, more recently, the effect of slowing external demand on export growth. While downside risks remain, we believe the economy is averting a hard landing, thanks to robust domestic demand and a gradual loosening of the policy stance.

**In view of the weaker external outlook, we are revising our 2012 and 2013 GDP growth projections downward, to 8.3% and 8.7%, respectively,** from 8.6% and 8.9% previously. Fourth quarter GDP growth came out at a better-than-expected 8.9% y/y, from 9.1% y/y in Q3, bringing full-year growth to 9.2%. The strong growth momentum going into 2012 and buoyant domestic demand should help cushion the impact of the weaker external environment. We expect growth momentum to bottom out in Q1, and rise gradually during the remainder of the year as the policy mix becomes more growth-supportive, and as the global economy begins to improve in the second half of the year.

**Inflation has continued to ease due to a combination of slowing GDP growth and softer food and commodity prices.** After peaking at 6.5% y/y in July, inflation declined to around 4% by December, at the top of the authorities' comfort range, although it picked up to 4.5% y/y in January due to seasonal effects from the Chinese New Year. We expect headline inflation to decline to around 3% y/y in mid-2012 on a further easing of food and commodity prices, and end the year at 3.5% on demand-pull factors as growth picks up.

**The decline in inflation is enabling the policy mix to be adjusted to support growth**. Our baseline incorporates further easing of the monetary stance and implementation of growth-supportive fiscal initiatives. Following a cut in the required reserve ratio (RRR) last November, we expect another 150-200 bps of reductions in the RRR during the first half of the year, followed by possible interest rate cuts of around 50bps in Q2/Q3 if the external environment continues to worsen. On the fiscal side, we anticipate the extension of subsidies to boost household consumption, tax cuts, and spending on affordable housing and other high priority infrastructure projects.

**Currency appreciation is slowing, and is expected to remain limited during the first half of 2012 due to the weak external environment.** Nevertheless, we expect appreciation to pick up again in the second half of the year, and to amount to about 3% against the USD for the full-year, slower than last year's pace of around 5%.

**The main risk to the outlook is the uncertain global environment from the European sovereign debt and financial crisis.** Weaker external demand is already causing export growth to decline and, notwithstanding the boost to global markets in early 2012, financial tensions in Europe may have a chilling effect going forward on risk appetite and investment. If downside risks materialize there would be room for policy stimulus to sustain growth and help prevent a hard-landing.

**Domestic financial risks continue to pose a challenge.** These include declining property prices, the impact of rapid shadow bank lending and subsequent measures to curtail its growth, and high local government debt. The authorities are taking measures to address each of these risks, which we believe remain manageable.

# 1. Global slowdown and recession in Europe

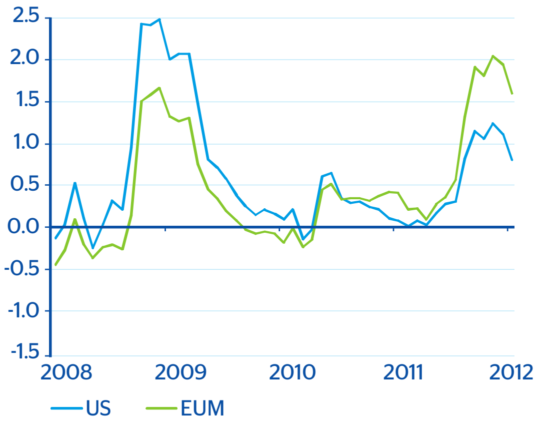
***Before turning to China, we review the Global Outlook. Readers may go directly to the sections on China, if they wish, by turning to page 6.***

## The global economy slowed down at the end of 2011, but should rebound in the second half of 2012

The global economy decelerated markedly in the last quarters of 2011. This was the result of weaker growth in Europe (already negative in Q4) and a deceleration in emerging economies, to around 1% quarter-on-quarter at the end of 2011, their lowest growth rate since the 2008 crisis. However, the drivers of this deceleration differed. Europe has been feeling the effects of persistently high financial tensions since September (see Chart 1), owing to the lack of major advances to solve the sovereign and financial crisis. On the other hand, the slowdown in emerging economies, in addition to the headwinds from developed economies, is partly the result of previous policy tightening through the first half 2011 to avoid overheating.

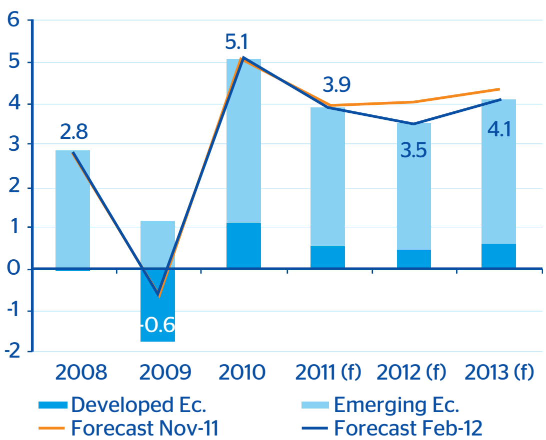
Going forward, decisive action expected by the European authorities should slowly reduce financial tensions and global risk aversion, facilitating a global rebound in the second half of 2012. The biggest contribution to that rebound will nonetheless come from emerging economies, as their policies turn more growth-supportive. At the same time, even though the US will grow more slowly than in previous recoveries, it will decouple from the recession in Europe in the first half of the year. Thus, relative to our previous Global Economic Outlook published in November, we are revising down our forecasts for global growth by 0.6pp in 2012 and 0.3pp in 2013, to 3.5% and 4.1%, respectively (Chart 2).

Chart 1
BBVA Financial Stress Index




Source: BBVA Research

Chart 2
Global GDP growth (% yoy)




Source: BBVA Research and IMF

## The euro area is still the main risk to the global outlook

Even after the downward revision of growth rates in Europe and emerging economies, risks remain titled to the downside. These risks hinge on the evolution of the sovereign-financial crisis in Europe, which continues unabated and can potentially deepen the recession there and spill to other regions through trade links, financial exposures and an increase in risk aversion.

Although there have been some advances since October –mainly the provision of long-term liquidity by the ECB and some agreement towards more fiscal discipline– there needs to be more decisive action on three main lines. First, on the sovereign debt front, concerns about the solvency of Greece need to be addressed by completing the deal with private sector bondholders. At the same time, sizable and credible sovereign firewalls should be erected to prevent contagion to less liquid countries. Second, macroeconomic reforms should be pushed forward to raise growth prospects, including those aimed at repairing financial institutions' balance sheets, while taking care to avoid a sudden a reduction in credit to the private sector. Finally, further advances in euro area governance are needed to strengthen the monetary union, including a clear roadmap to a fiscal union.

In line to these three points, European economic prospects would be greatly improved if the agreed fiscal compact were approved at the national level and convincingly implemented after the March EU summit, together with reforms proposed for peripheral countries to reduce their vulnerabilities and increase long-term growth prospects.

## Sustained financial tensions have pushed Europe into recession

Financial tensions in Europe continue at levels higher than after the fall of Lehman Brothers in 2008 (Chart 1). Given this, and together with the effect of fiscal adjustment in peripheral countries, we have revised down our growth projections for Europe, incorporating negative growth at least through the first half of 2012, and -0.5% for the year as a whole, with a slow rebound in 2013. Nonetheless, it is important to note that these projections depend on a fast resolution of the crisis and a notable reduction of financial stress. The divergence in performance between the core and the periphery in Europe will continue to be wide, partly because of the large fiscal adjustment in the latter.

Contrary to Europe, the US will show resilience in 2012, as in the second half of 2011. Our forecast remains unchanged from 3 months ago, at 2.3% in 2012 and 2.2% in 2013. However, the recovery is weaker than typical post-recession cycles, and is influenced by the risks from Europe as well as the domestic risk of policy uncertainty, including a possible fiscal tightening in 2013 (as tax cuts expire and automatic spending cuts are implemented). In addition, weak housing conditions, tight credit markets and ongoing deleveraging will create headwinds to consumption spending.

## Emerging economies are heading for a soft landing

In contrast to the aftermath of the fall of Lehman Brothers in 2008, confidence has remained resilient in emerging economies. This has allowed domestic demand in emerging economies, such as China as described below, to hold up well, even as some of the effects of increased global risk aversion are felt in financial markets through lower capital inflows, tighter trade finance, and reduced asset prices.

The slowdown in emerging economies during 2011 meant that their growth gap relative to advanced economies was close to 3 percentage points at the end of 2011, somewhat below the historical 4 percentage points since the beginning of the 2000's. We expect global risk aversion to remain high, but ease slowly in the second half of 2012, in line with the expected gradual reduction of tensions in Europe. In addition, economic policies will turn more growth supportive, in contrast with the tightening experienced in the first part of 2011. This will sustain domestic demand in the face of external headwinds from weakness in demand from developed countries. In this context, emerging economies are expected to recover growth rates close to 2% quarter-on-quarter at the end of 2012 (from 1% at end-2011), and grow 6.2% for the year as a whole. The main exception to this good performance will be in emerging markets in Europe, due to their closer trade and financial links to the euro area.

# 2. Averting a hard landing

China's economy continues to slow at a moderate pace. The deceleration reflects the impact of deliberate policy actions through the middle of 2011 to prevent overheating and, more recently, the effect of slowing external demand on export growth. Against the backdrop of the weak external environment and various domestic financial fragilities, fears have grown in the market about the prospects of a "hard landing" for the Chinese economy, often described as a decline in annual growth to around 5-7% percentage points for one or more quarters.

While risks remain, we believe the economy is averting a hard landing, thanks to robust domestic demand and a gradual loosening of the policy stance to counter headwinds from the weaker external environment. And while domestic financial fragilities persist—in the form of falling real estate prices, the aftermath of rapid shadow bank lending, and high level of local government debt—they are either being addressed or do not pose systemic risks to the economy in our view. In the meantime, domestic demand is holding up and recent growth outturns have been better than expected, reducing fears of a hard landing and setting the stage for robust growth in 2012-13.

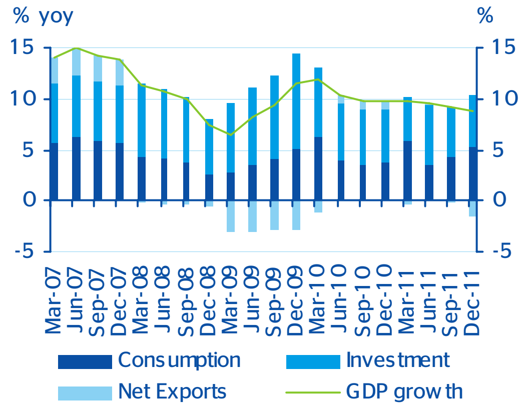
## GDP and activity indicators are still buoyant despite external headwinds

GDP growth has continued to moderate, but at a gradual pace. In particular, fourth quarter GDP growth came out at a better-than-expected 8.9% y/y, from 9.1% y/y in Q3, bringing full-year growth to 9.2% (Chart 3). On a q/q seasonally adjusted basis, Q4 growth slowed to 2.0% from 2.3% in Q3 according to official estimates. The slowdown in annual GDP growth, from 10.4% in 2010, was due to slower investment and exports, with a pickup in domestic consumption growth due, in part, to fiscal incentives designed to spur consumer spending (Table 1). The composition of growth in 2011 contributed to the rebalancing of the economy toward domestic consumption, one of the medium-term priorities set out in the latest Five-Year Plan. The contributions of investment and net exports declined (the latter turned negative), while the contribution of consumption increased from 3.8 percentage points in 2010 to 4.8 percentage points in 2011. In addition, the current account surplus has narrowed as described below.

Recent high frequency indicators point to sustained domestic demand, particularly private consumption, even in the face of external headwinds. Urban fixed asset investment growth (YTD) eased both on sequential and year-on-year terms. In contrast, retail sales growth remained resilient in the fourth quarter, perhaps due to some spending being brought forward ahead of the expiration of subsidies at the end of the year and prior to the Chinese New Year in January (Chart 4). On the supply side, industrial output has been moderating, but remains strong. Similarly, the closely watched Purchasing Manufacturers Index (PMI) has been moderating, to around the 50% expansion/contraction threshold (Chart 5).

Chart 3

**GDP growth driven by robust domestic demand...**




Source: CEIC and BBVA Research

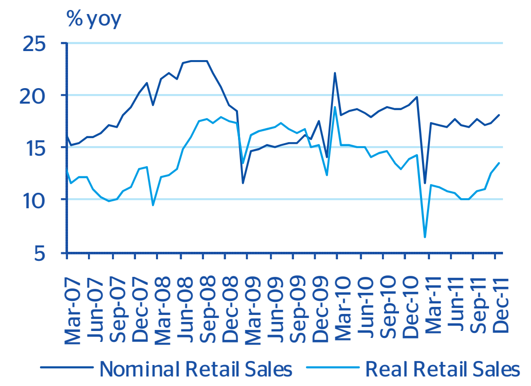
Table 1

**...especially domestic consumption**

| (%, YoY) | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|
| GDP growth | 9.6% | 9.2% | 10.4% | 9.2% |
| Consumption growth | 7.5% | 8.4% | 8.1% | 10.3% |
| Investment growth | 15.7% | 17.6% | 13.9% | 10.2% |
| Export growth (USD) | 17.2% | -16.0% | 31.3% | 20.3% |
| Import growth (USD) | 18.5% | -11.2% | 38.8% | 24.9% |

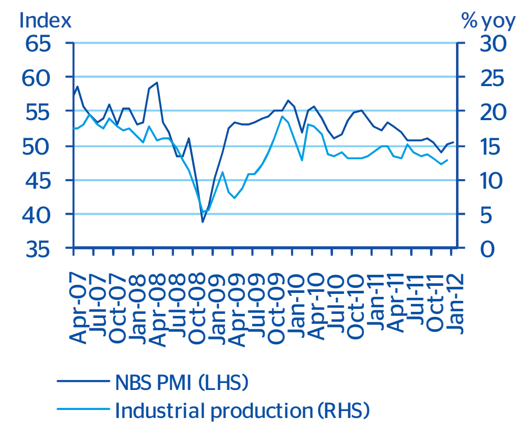
Source: Haver Analytics and BBVA Research estimates

Chart 4
Retail sales are robust




Source: CEIC and BBVA Research

Chart 5
PMI remains just above the 50-threshold

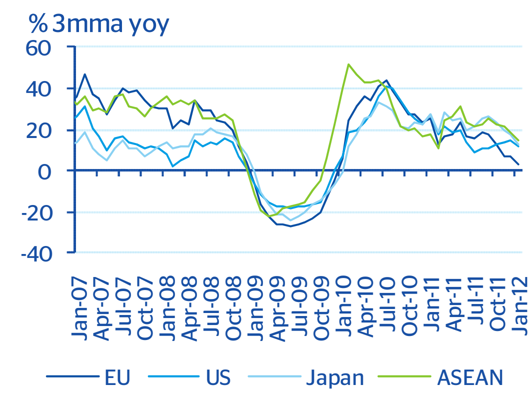



Source: CEIC and BBVA Research

## Exports are slowing on external headwinds

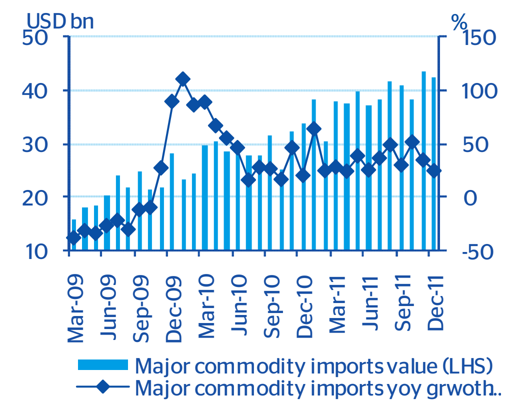
Export growth has slowed from an average of 20.6% in Q3 to 14.3% in Q4 (exports fell by 0.5% y/y in January, due to seasonal effects from the Chinese New Year). The slowdown has been driven by weaker external demand, especially from the EU, China's single largest export market accounting for nearly 20% of total exports (Chart 6). Imports have remained relatively higher, on strong domestic demand, including commodities (Chart 7). For the fourth quarter as a whole, imports grew by 20.1% y/y, down from 24.8% y/y in Q3 (the decline in January was due to the Chinese New Year; adjusting for the holiday, import growth was more robust). By component, imports of final goods and commodities have held up relatively well, while processing goods have been less buoyant due to weaker export orders (Chart 8). Given these overall developments, the trade surplus and current account have been narrowing (Chart 9).

Chart 6
Exports to the EU have dropped significantly



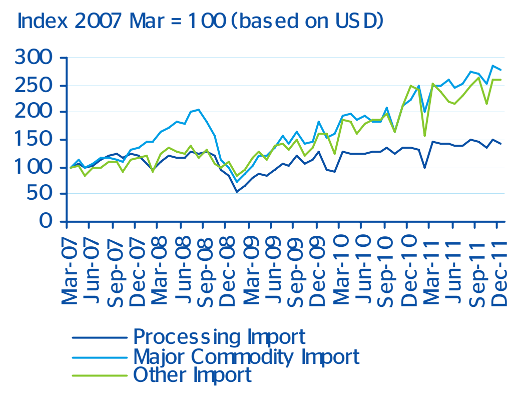

Source: CEIC and BBVA Research

Chart 7
Commodity imports remain strong, but have leveled off on falling prices



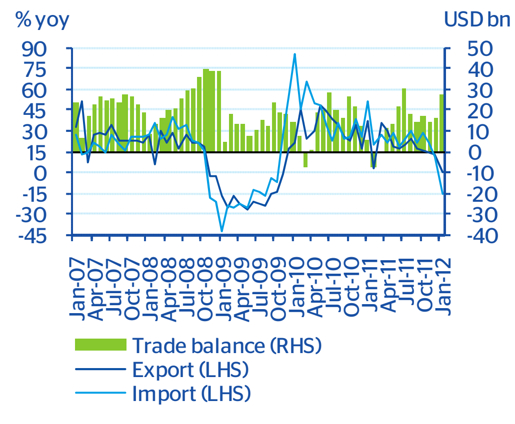

Source: CEIC and BBVA Research

Chart 8
Moderation of imports by components




Source: CEIC and BBVA Research

Chart 9
The trade balance remains in surplus

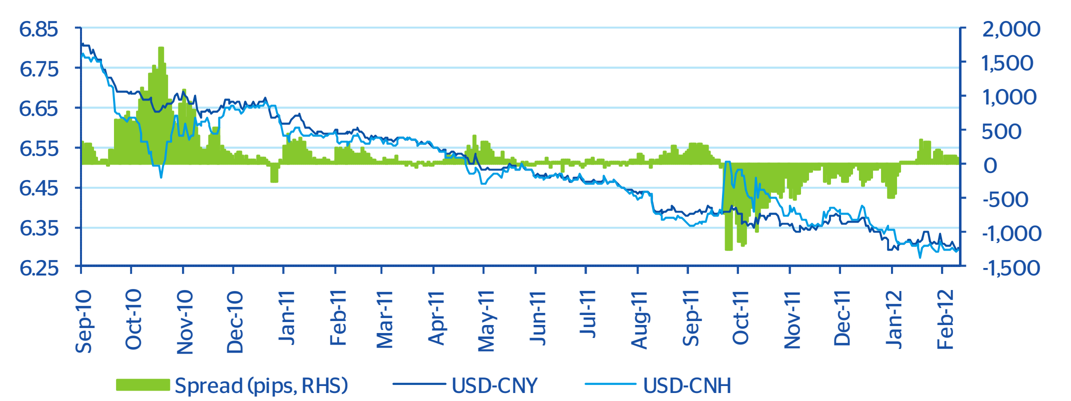



Source: CEIC and BBVA Research

## Currency appreciation is slowing due to the weaker external environment

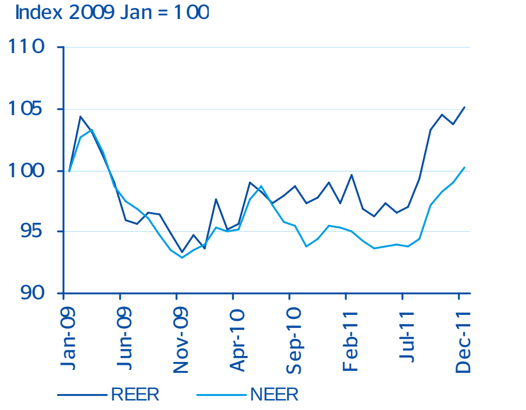
While the full-year 4.7% appreciation of the RMB against the USD in 2011 was in line with our expectations, the pace of appreciation has slowed in recent months (Chart 10). While the slowdown has attracted the attention of China's trading partners, especially the US in a politically-charged election year, the authorities have reiterated their commitment to allowing further appreciation. In addition to the more uncertain external outlook, a couple of other developments can be cited to explain the slowdown in the pace of appreciation. First, there has been a much more pronounced appreciation in nominal and especially real effective terms due to the recent rise in the value of the USD against other major currencies (Chart 11). Second, China's balance of payments position weakened considerably in the second half of 2011, with an outright decline in reserves in Q4—the first quarterly decline since 1998—due to a narrowing of the trade surplus and capital outflows (Chart 12). Market expectations of the pace of appreciation have been scaled back as measured by 12-month NDFs.

Chart 10
Currency appreciation against the USD has slowed in recent months



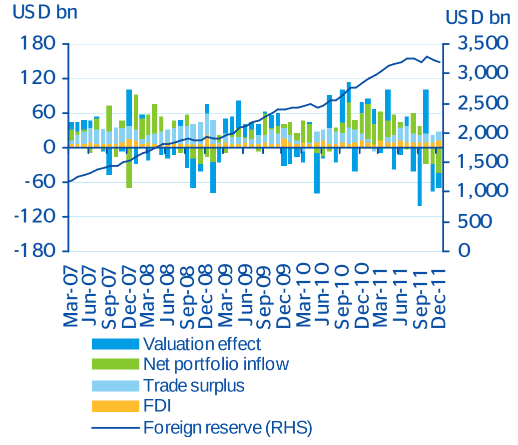

Source: Bloomberg and BBVA Research

Chart 11
Appreciation has accelerated in effective terms




Source: BIS, CEIC and BBVA Research

Chart 12
There have been some portfolio inflows outflows resulting in lower reserves



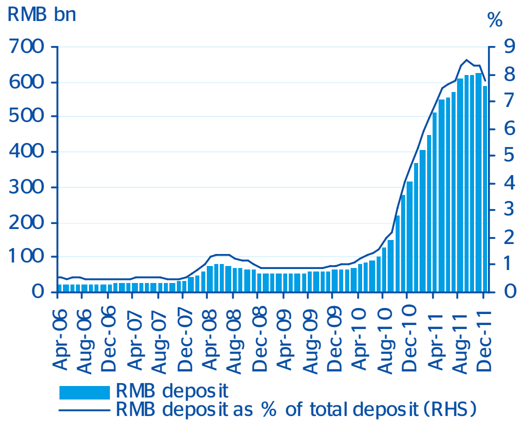

Source: CEIC and BBVA Research

## Internationalization of the RMB continues, despite headwinds

RMB internationalization is progressing, but has encountered headwinds from lower appreciation expectations. In particular, offshore RMB deposits in Hong Kong, a widely used indicator of RMB internationalization, declined sharply in December (Chart 13). In addition, in Q4 2011 the aggregate volume of RMB trade settlements (including both exports and imports) slightly declined for the second quarter in a row (Chart 14).

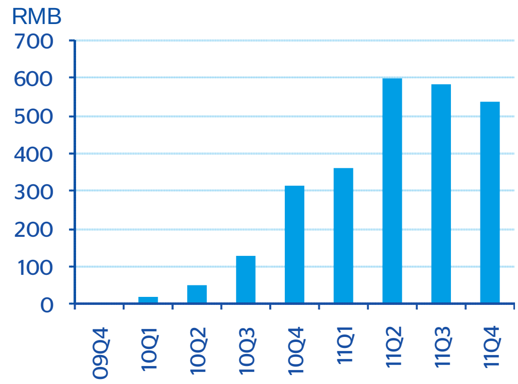
However, these trends mask other positive developments. First, the data show that use of RMB for trade settlements is becoming more balanced among offshore importers and onshore exporters. The former now appear more willing to use RMB for trade payment. Despite the decline in the total value of RMB trade settlements, around 40-50% of such settlements are now undertaken by offshore importers, up from just 20% a year ago. Second, a number of initiatives have made it easier to bring RMB raised offshore back to the Mainland. These include more regular approval of FDI inflows and the introduction of an "RQFII" scheme, permitting offshore RMB to be used to purchase domestic securities on a limited basis. These initiatives have enhanced the usefulness of offshore RMB and have stimulated the growth of offshore RMB products in Hong Kong, including a rapidly expanding "dim sum" bond market and RMB loans. There is now more competition among Hong Kong banks for RMB liquidity, resulting in higher yields on RMB deposit instruments.

Chart 13
RMB deposit accumulation in Hong Kong reversed




Source: HKMA, CEIC and BBVA Research

Chart 14
The value of RMB settlements declined on Q4




Source: Based on reported PBoC data and BBVA Research

## Policy challenges

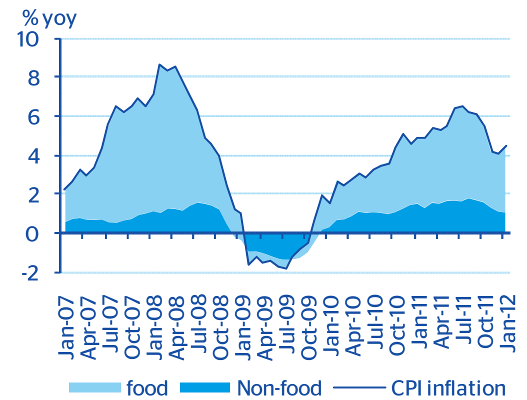
With activity slowing and the external environment weakening, policies have gradually shifted toward supporting growth. Selective forms of monetary policy easing are underway, including cuts in the required reserve ratio and efforts to step up the flow of banking credit to relieve financial stress among SMEs. Currency appreciation against the USD has slowed due to concerns about weakening export growth. Meanwhile, despite declining prices in the property sector, macro prudential measures remain in place to prevent asset bubbles and ensure housing affordability. A number of fiscal policy initiatives are likely to be continued, including spending on social housing and completion of infrastructure projects, as well as tax cuts and subsidies to support consumption (see Box 2 on page 18).

## Easing inflation is allowing monetary policy to be more growth supportive

After peaking at 6.5% y/y in July, inflation has declined gradually toward the top end of the authorities' 4% comfort level (Chart 15), enabling monetary policy to become more growth supportive. The decline in headline inflation has been broad-based, due to declines in both food and non-food components, as well as favourable base effects. As such, inflation declined to 4.1% in December, before ticking up to 4.5% y/y in January on seasonal effects from the Chinese New Year, when demand for various food items is typically high. Producer price inflation has also declined sharply, from a peak of 7.5% y/y in July, to just 0.7% in January, driven by declining commodity prices.

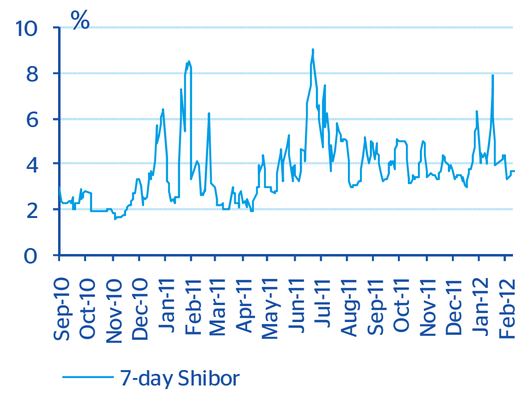
Following steps to enhance the flow of bank credit to SMEs, the authorities signalled a further easing in the monetary stance by cutting the required reserve ratio (RRR) by 50bps at end-November from a record-high 21.5% where it had been kept since July (Charts 17 and 18). In addition to falling inflation, the RRR cut was justified by tighter liquidity conditions owing to lower capital inflows. The RRR cut, together with a series of liquidity-enhancing open market operations has led to a moderation in interbank rates (Chart 16). The relaxation of the monetary stance and renewed confidence in the economy's trajectory has facilitated a rebound in China's equity markets, although they have continued to underperform relative to peers (Chart 20).

Chart 15
**Inflation has peaked**



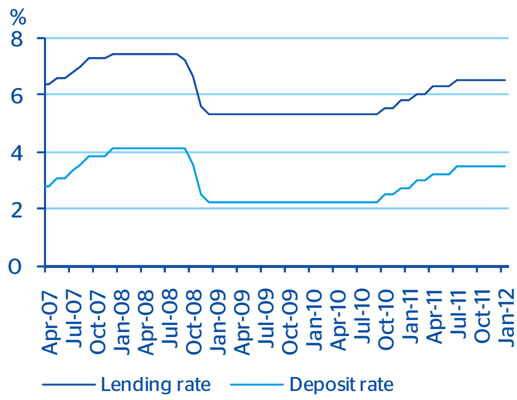

Source: CEIC and BBVA Research

Chart 16
**Inter-bank rates have increased**



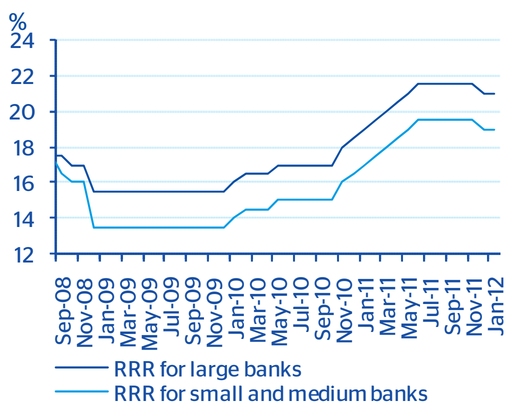

Source: CEIC and BBVA Research

Chart 17
Interest rate hikes ended in July ...



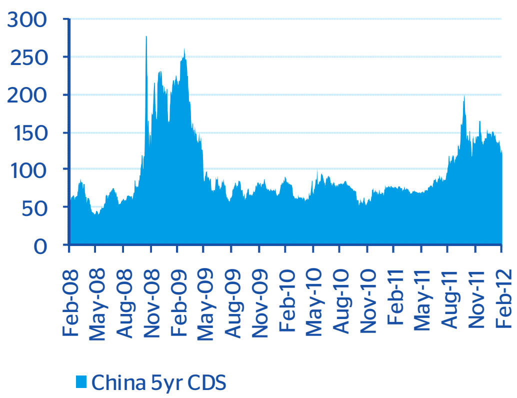

Source: CEIC and BBVA Research

Chart 18
...with a reduction in required reserve ratios in November



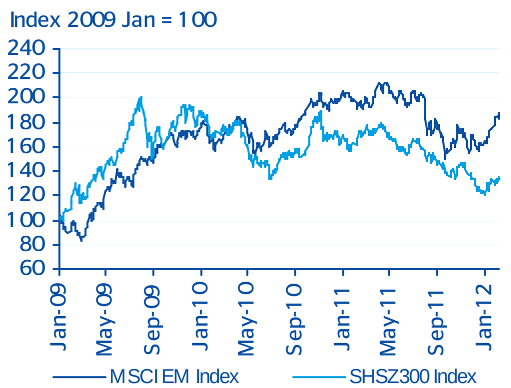

Source: CEIC and BBVA Research

Chart 19
China's CDS prices have stayed high on global risk aversion...




Source: Bloomberg and BBVA Research

Chart 20
...and the stock market has underperformed




Source: Bloomberg and BBVA Research

## Monetary and credit aggregates starting to pick up

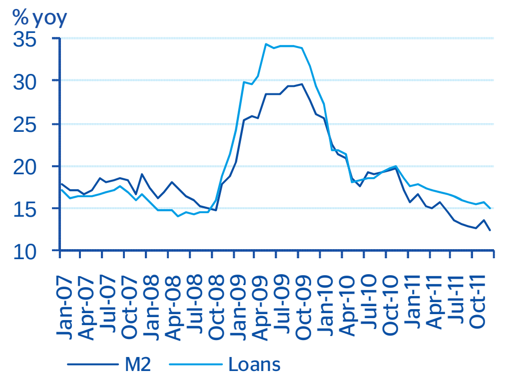
Consistent with the recent easing of the monetary stance, credit and M2 growth have shown some early signs of picking up after moderating through much of 2011 (Chart 21). New loans in December (15.8% y/y) picked up slightly from the previous month (15.6%), as did M2, although both decelerated again in January due to the Chinese New Year effect. For the full year of 2011, new loans reached RMB 7.47 trillion, at the top of the authorities' full-year target of RMB 7.0-7.5 trillion, and it appears likely that the new loan target for 2012 will be set somewhat higher, at around RMB 8.0-8.5 trillion.

## Fiscal policy oriented toward social housing and support to consumption

The overall budget deficit declined to 1.1% of GDP in 2011 based on official data, from 2.7% in 2010, on strong corporate revenue growth and a slowdown in public investment in fixed asset (Chart 22). Nevertheless, overall public spending remained high, underpinned by progress in the affordable housing program, which targeted starts of 10 million units in 2011. The target was achieved by the beginning of Q4 although actual construction may have been delayed due to the lack of financing in some cases. In contrast, infrastructure spending slowed in the second half of 2011, although the authorities continue to stress their intention to complete major infrastructure projects in the coming year.

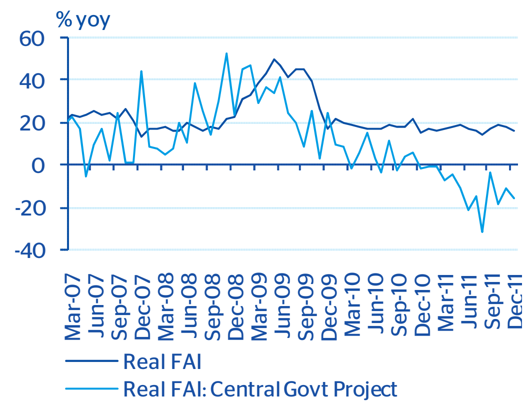
In addition, fiscal initiatives to boost private consumption have had their intended effect, including subsidies and tax cuts. With respect to the latter, the taxable income threshold was raised last September from RMB 2,000 per month to RMB 3,500, resulting in a plunge in personal income tax collections (Chart 23). The authorities also implemented a pilot VAT program in Shanghai to replace the operations tax on specified service sector industries, including transportation. The reform is expected to reduce the tax burden of industries that rely on these industries.

Chart 21
**Credit and M2 growth may start picking up**



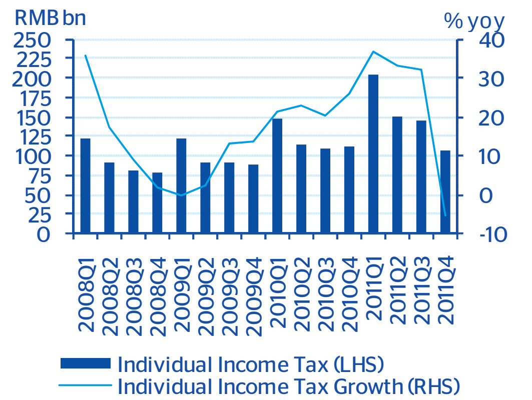

Source: CEIC and BBVA Research

Chart 22
**Real investment has slowed on public projects**



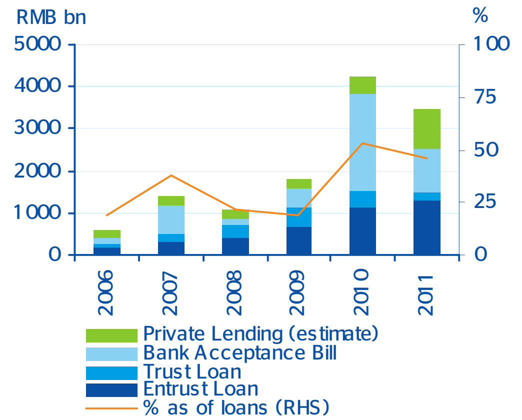

Source: CEIC and BBVA Research

Chart 23
**Tax cuts for lower income payers result in a more progressive structure**




Source: CEIC and BBVA Research

Chart 24
**Shadow bank lending has decelerated**




Source: PBoC and BBVA Research estimates

## Containing domestic financial fragilities

In addition to the challenges posed by the slowdown in external demand, the authorities have been seeking to address a number of domestic fragilities that have weighed on investor sentiment and increased the risk of a hard landing. Chief among these, as discussed in our previous Outlooks, are misalignments in the property market and recent price declines, local government debt, and rapid shadow bank lending. There has been progress in addressing these risks over the past quarter, although challenges remain.

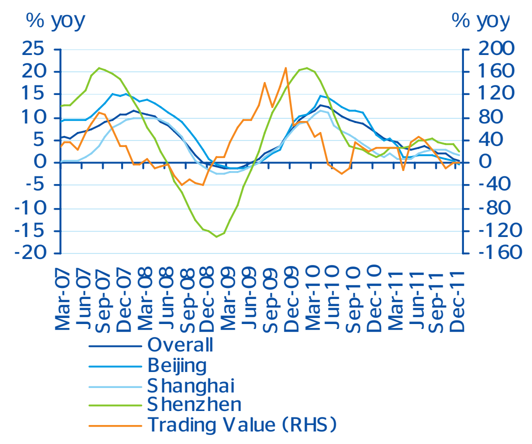
## Declining property prices reduce the risk of a housing bubble

Residential property prices have been declining on a nation-wide basis since mid-2011 (see our annual Real Estate Outlook[1] for an overview of developments and policies in the first half of 2011 and assessment of the degree of price misalignments). Based on official NBS data, we calculate the cumulative decline in average housing prices to be -0.8% between their peak in July through December, meaning that price levels were 0.4% higher in December 2011 from a year ago (Chart 25). A majority of cities (52 out of 70) were reporting price declines as of December

[1] "China Real Estate Outlook" July 11, 2011.

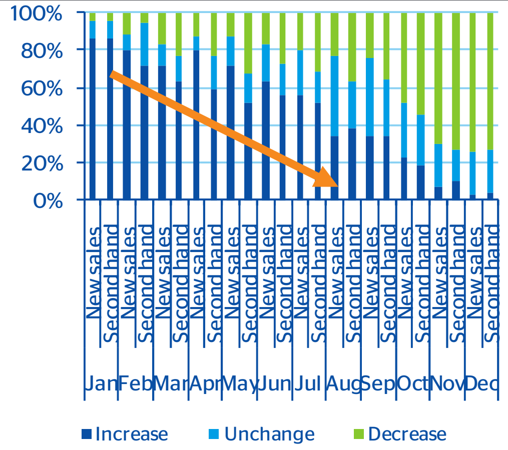
(Chart 26). Of course the degree of price declines has varied across individual markets, with greater Shanghai (lower-Yangtze river region), showing the largest price declines so far, of 1-3% since July. Along with price declines, the volume of transactions has also been declining (Chart 25).

Chart 25
**Property prices and transactions volume moderated gradually in Q4**




Source: NBS, CEIC and BBVA Research

Chart 26
**An increasing number of cities are showing housing price declines**




Source: NBS and BBVA Research

Weakness in the market reflects a combination of factors, including the impact of government cooling measures introduced since 2010 to prevent price bubbles and restrict speculative home purchases. These measures remain in place, and the authorities have signalled no intention to ease restrictions in the near future given their determination to reduce the risk of asset price bubbles and maintain housing affordability. The downward correction in prices is not surprising, in our view, given our estimates of overvaluation from the rapid, liquidity-driven rise in prices during 2009-10.

With both sales transactions and prices falling, however, financial pressures may be building on real estate developers. Such pressures could eventually trigger more abrupt price declines if liquidity-starved developers are forced to sell inventory to repay their liabilities. A rise in default rates could also undermine banks' loan quality. Although there is anecdotal evidence of a rise in financial stress among some developers, we find little evidence to date of a systemic problem.

## Local government debt remains a burden, but appears to be easing

The ratio of total government debt to GDP, including the liabilities of local governments, declined to 49% as of end-2011 from 59% a year ago. Within this, local government debt as a share of GDP declined to 18.5% from 21.7%. The declines are due to continued GDP growth and a deliberate slowdown in spending by local governments on infrastructure projects. As such, the burden of government debt appears to be easing (for additional details on the problem of local government debt, see our report *Who will pay the bill for local governments' fiscal stimulus?*.[2]

Nevertheless, the outstanding size of local government debt remains large, with almost one fifth of it maturing in the coming year. With local government finances already under pressure from shrinking land sale revenues, we expect the central government to ease restrictions on bank lending to local governments. Indeed, there are recent media reports that the authorities are planning to allow banks to engage in selective rollovers of loans to local governments to extend the maturity by up to four years.

## Shadow bank lending is being curtailed

Shadow bank lending, encompassing banks' off-balance sheet credits and non-bank loans, have been slowing following the rapid expansion in 2010 when lenders sought to circumvent credit tightening measures (Chart 24). The recent slowdown is due to the implementation of macro-prudential measures designed to curtail such lending, including requirements on banks to bring such transactions back onto their balance sheets, imposition of capital requirements on trust

[2] "China Banking Watch: Who will pay the bill for local governments' fiscal stimulus?" July 21, 2011

companies, and efforts to step up lending by the formal banking system to SMEs as a way of discouraging resort to non-bank ("private") lending.. The most significant declines appear in the off-balance sheet categories of bank acceptances and trust loans.

Despite the slowdown in shadow bank credit growth, credit quality remains a concern, as due issues of the liquidity conditions of small banks who may have trouble attracting deposits due to the low level of deposit rates and competition from higher yielding wealth management products. As such, shadow banking activities and their implication for the broader financing market still warrant close monitoring.

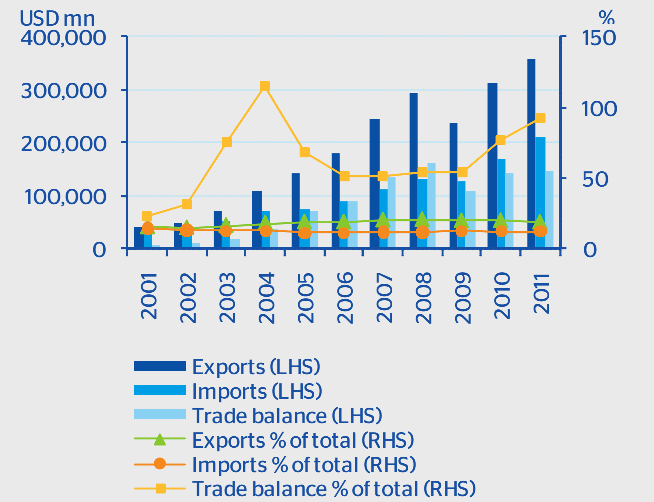
## Box 1: China's trade exposure to Europe

A further intensification of the European crisis could have an adverse impact on China's exports. In recent years, the European Union has surpassed the US (17% of total exports) as China's biggest export market, accounting for nearly 20% of total exports. Bilateral trade between China and EU reached $567.3 billion in 2011, of which China's exports accounted for $356.1 billion (according to Chinese trade figures). As a result, China ran a bilateral trade surplus with the EU of $144.9 billion. The importance of the EU market to China can also be illustrated by its share in China's total exports, total imports, and trade balance as well (Chart27).

The impact of the slowdown in Europe is already evident in China's trade flows, which began decelerating rapidly in September to 13.4% y/y from 24.4% y/y in August, The contribution of exports to Europe declined from 4.5 percentage points in August to 1.4 ppts in December. (Chart 28)

Chart 27

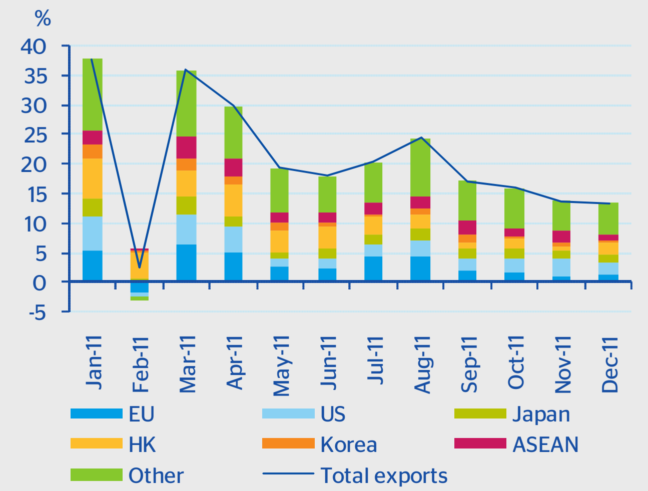
**China's trade with EU**




Source: Haver Analytics and BBVA Research

Chart 28

**Contributions to China's export growth by region**

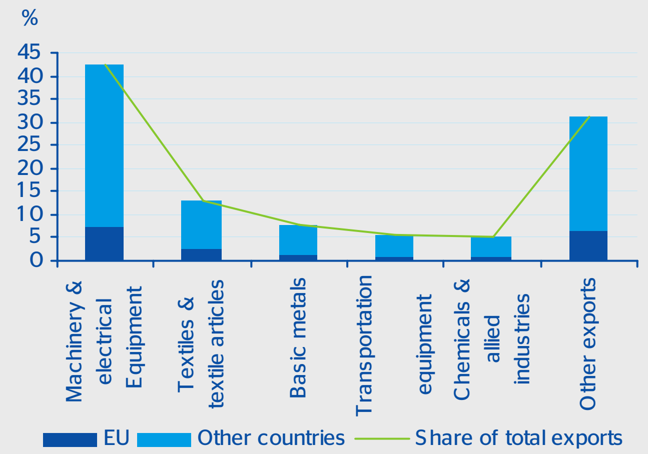



Source: Haver Analytics and BBVA Research

To what extent might a slowdown in China's exports to Europe impact the overall growth outlook? China's exports to Europe account for around 5% of GDP. Therefore, we would estimate the direct impact of a hypothetical 10% decline in exports to the EU of -0.5 percentage points on China's GDP growth. The machinery, electrical equipment, and textile sectors would be most vulnerable. (Chart 29)

Chart 29

**EU shares in China's main commodity exports (2011)**




Source: Haver Analytics and BBVA Research

# 3. A robust outlook with increasing policy support

Despite the deteriorating external environment, growth has held up well due to strong domestic demand. We expect domestic demand to remain buoyant under increasing support from fiscal and monetary policies. As such, we have lowered our 2012-13 growth projections only modestly in response to the weaker external outlook. However, risks remain tilted to the downside due to the uncertain external environment.

## Modest further downward revision to growth outlook

In view of the weaker external outlook, we are revising our 2012 and 2013 GDP growth projections downward, to 8.3% and 8.7%, respectively, from 8.6% and 8.9% previously (Table 2). The strong growth momentum going into 2012 and buoyant domestic demand should help cushion the impact of the weaker external environment. We expect growth momentum to bottom out in Q1, and rise gradually during the remainder of the year as the policy mix becomes more growth-supportive, and as the global economy begins to improve in the second half of the year (Chart 30).

## Inflation is expected to ease further

We are lowering our inflation projections due to a combination of slowing GDP growth and a softer commodity price outlook under our baseline. We expect headline inflation to average 3.3% in 2012, down from our previous projection of 4.0%. Inflation should decline to around 3% y/y in mid-2012 on easing food and commodity prices, and end the year at 3.5% on demand-pull factors as growth picks up. Inflation is expected to remain elevated over the medium term, at around 4%, on rapid wage growth.

Table 2
Baseline Scenario

| | 2009 | 2010 | 2011 | 2012 (F) | 2013 (F) |
|---|---|---|---|---|---|
| GDP (%, y/y) | 9.2 | 10.4 | 9.2 | 8.3 | 8.7 |
| Inflation (average, %) | -0.7 | 3.3 | 5.4 | 3.3 | 3.7 |
| Fiscal bal (% of GDP) | -2.8 | -2.5 | -1.1 | -1.8 | -1.8 |
| Current acct (% of GDP) | 5.2 | 5.2 | 2.8 | 2.5 | 2.8 |
| Policy rate (%, eop) | 5.31 | 5.81 | 6.56 | 6.06 | 6.56 |
| Exch rate (CNY/USD, eop) | 6.83 | 6.62 | 6.30 | 6.11 | 5.80 |

Source: BBVA Research

## The policy mix is being adjusted to support growth

On the basis of recent policy announcements, our baseline incorporates further easing of the monetary stance and implementation of growth-supportive fiscal initiatives (see Box 2 on page 18). Officially, the authorities characterize the policy stance as, “prudent monetary and pro-active fiscal”, as set out at the annual Central Economic Work Conference (CEWC) in mid-December.

With inflation easing, we expect another 150-200 bp cuts in the RRR during the first half of the year, followed by possible interest rate cuts of around 50bps in Q2/Q3 if the external environment continues to worsen.

On the fiscal side, although details of the 2012 budget will not be available until early March, we currently anticipate the extension of subsidy programs to boost household spending on home appliances and environmentally friendly products. Budget spending will also remain focused on affordable housing, with targets of 7 million new starts and 5 million completions in 2012. Spending on existing infrastructure projects in high-speed railways and water distribution are also expected. At the same time, tax cuts may be implemented in various forms, including an increase in the tax exemption threshold for SMEs, as well as the introduction of a VAT to replace the current business tax in certain service industries. We expect the total deficit in 2012 to be 1.8% of GDP, up from a preliminary outturn of 1.1% in 2011.

## Modest currency appreciation

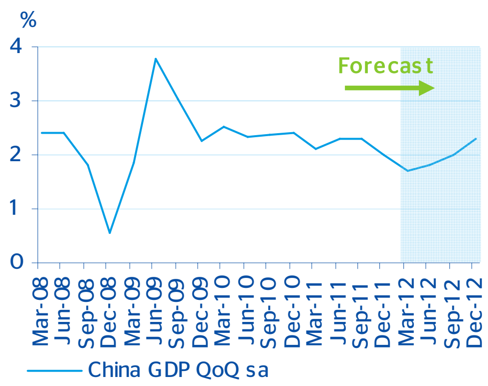
Currency appreciation is expected to remain limited during the first half of 2012 due to the weak external environment, and then pick up in the second half of the year, amounting to 3% against the USD for the full-year (slower than the pace of around 5% last year). This would bring the exchange rate to RMB 6.11 per USD by end-2012.

## Medium-term outlook: rebalancing and moderating growth

Our medium-term outlook continues to incorporate a gradual rotation of growth to domestic demand, especially private consumption, as outlined in the current Five-year Plan (Chart 31). This rebalancing, however, will take place very gradually, underpinned by a policy stance aimed at boosting household incomes and improving the social safety net.

Chart 30

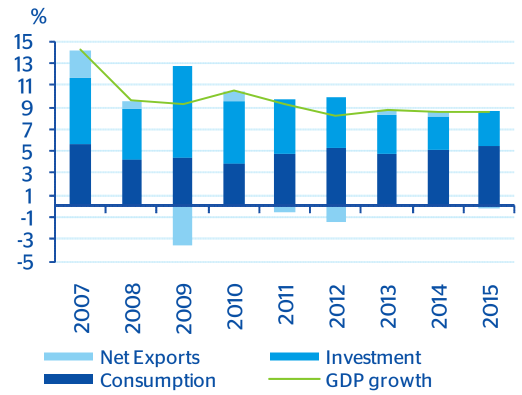
**China's GDP growth (QoQ, seasonally adjusted)**




Source: NBS, CEIC and BBVA Research estimates

Chart 31

**A rebalancing of growth over the medium term**



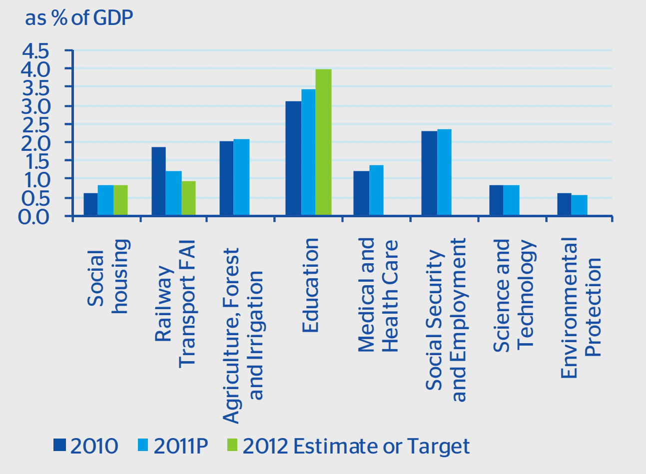

Source: NBS, CEIC and BBVA Research estimates

## Box 2: China's pro-active fiscal initiatives in 2012

Growth-supportive fiscal initiatives for 2012 are expected to include tax cuts and programs to boost household consumption, along with additional infrastructure spending, according to official policy statements. The scope for large-scale fiscal initiatives is expected to be more limited than in 2008-09 due to the high level of local government debt. Nevertheless, we believe there is sufficient scope to support growth in line with government targets during 2012.

Public investment spending, while shrinking by 9.7% in 2011, is expected to pick up in 2012 In particular, public spending on social housing remains a priority and is expected to grow significantly in 2012. According to the Ministry of Finance, 7 million social housing units will be started in 2012, along with the construction of the majority of the 10 million units started in 2011. We expect around 18 million units of social housing under construction in 2012, relative to around 15 million units in 2011. Spending on social housing would thus increase by at least 20% in 2012. In addition, spending on infrastructure related to agriculture, education, innovation, and energy is expected to further increase, while transport infrastructure investment may continue to moderate. In particular, railroad spending is expected to decline from RMB 576 billion in 2011 to RMB 500 billion in 2012, according to reports by the Ministry of Railroad.

Chart 32
China's fiscal budget plan and targets




Source: Ministry of Finance and BBVA Research

In addition to infrastructure, fiscal initiatives are expected to support household consumption in 2012. In addition, measures will be implemented to increase the incomes of farmers and low-income groups, including implementation of a 13% target for annual minimum wage target for 2011-15 and increased subsidies for low-income groups.

Also, pro-consumption policies will include enhancements to the social safety net. Specifically, the central government will fully subsidize pension contributions in the western and central China, while subsidizing 50% of pension contribution in eastern China, based on the formal document of the Ministry of Human Resources and Social Security of China. Spending in education and health care, including health insurance, is also prioritized areas of further development. Critically, public spending in education is expected to reach 4% of GDP in 2012, up from the 3.5% target in 2011, amount to 2.1 RMB trillion, more than any other spending programs.

On the revenue side, tax cuts are expected to play more significant role in 2012 to support both business and consumption. Expected areas include higher tax exemption thresholds (VAT, business tax, and income tax) for SMEs, lower taxes and fees for distribution and logistics industries to help reduce food prices, and selective tariff cuts favoring energy and technology-intensive imports. An on-going reform is to replace the business tax with a Value-added tax in transport and other selective industries (to be expanded from Shanghai other major cities). This reform may reduce not only the tax burden of industries directly affected, but also enable other industries to deduct their expenses on these service industries in VAT.

# 4. Risks are tilted to the downside

Risks are tilted to the downside, due to the uncertain external environment and the presence of domestic financial fragilities. While the possibility of a hard landing for the Chinese economy, popularly defined as growth of around 5-7% for two or more quarters, cannot be ruled out, we believe the risk of such an event remains low. In particular, recent growth trends and the scope for policy stimulus, if needed, give us comfort that a hard landing can be averted.

The predominant risk, in or view, is from the uncertain external environment. Weaker external demand is already causing export growth to decline and, notwithstanding the boost to global markets in early 2012, financial tensions in Europe may have a chilling effect going forward on risk appetite and investment. The relatively closed nature of the capital account helps to shield China's banking system and capital markets from the direct fallout of external disturbances. Nevertheless, ripple effects through tighter financing conditions are possible, as has already been seen through the underperformance of the stock market and a decline in IPOs of Chinese companies.

The risk of a sharper decline in property prices and implications of tighter regulations on the shadow banking industry will need to be monitored. Property prices are declining at a moderate pace, and financial pressures on real estate developers do not so far appear excessive. That said, a more abrupt downward adjustment in property prices could cause financial strains to increase, with implications for bank NPLs and spillovers to other sectors of the economy.

If downside risks materialize there would be room for policy stimulus to sustain growth and help prevent a hard-landing. While the build-up of local government debt limits the room for fiscal manoeuvre in comparison to the stimulus package of 2008-09, we believe there is sufficient room, together with monetary easing, to sustain growth at or above 7% in 2012-13 in the event of domestic or external shocks. This would entail additional spending of about 1% of GDP, raising the fiscal deficit to 2.8% of GDP, a level that would be financeable through new debt issuance. The composition of such a stimulus package would likely be tilted more toward increasing household incomes and boosting private consumption, along with support measures for SMEs. Specific initiatives could take the form of selective tax cuts, additional consumption subsidies, and a speeding up of the ongoing public housing program. In addition, on the monetary side, steeper cuts in required reserve ratios and interest rates would provide further support to growth in a downside scenario.

Another source of risk is the high level of contingent liabilities to the central government, especially relating to local government debt. We continue to believe the level of such debt is manageable. Resolving potential problem loans would likely involving a combination of bank rollovers and eventual writeoffs, with implications for bank profitability, along with an injection of and central government funds.

On the political front, the coming year will see a leadership change, with new members of the Standing Committee of the Political Bureau, the key decision-making body, to be put in place in October. In March 2013, a new President and Premier will be selected, replacing the incumbent leadership of President Hu Jintao and Premier Wen Jiabao. All else equal, the forthcoming changes could make the authorities more likely to use stimulus measures to support growth and maintain stability in 2012 in advance of the leadership transition.

# 5. Tables

Table 1
## Macroeconomic Forecasts

| | 2009 | 2010 | 2011 | 2012 (F) | 2013 (F) |
|---|---|---|---|---|---|
| GDP (%, y/y) | 9.2 | 10.4 | 9.2 | 8.3 | 8.7 |
| Inflation (average, %) | -0.7 | 3.3 | 5.4 | 3.3 | 3.7 |
| Fiscal bal (% of GDP) | -2.8 | -2.5 | -1.1 (P) | -1.8 | -1.8 |
| Current acct (% of GDP) | 5.2 | 5.2 | 2.8 (P) | 2.5 | 2.8 |
| Policy rate (%, eop) | 5.31 | 5.81 | 6.56 | 6.06 | 6.56 |
| Exch rate (CNY/USD, eop) | 6.83 | 6.62 | 6.30 | 6.11 | 5.80 |

Source: BBVA Research

Table 2
## GDP

| (YoY growth rate) | 2009 | 2010 | 2011 | 2012 (F) | 2013 (F) |
|---|---|---|---|---|---|
| U.S. | -3.5 | 3.0 | 1.7 | 2.3 | 2.2 |
| EMU | -4.2 | 1.8 | 1.6 | -0.5 | 1.0 |
| Asia-Pacific | 4.2 | 8.1 | 5.8 | 5.8 | 6.1 |
| China | 9.2 | 10.4 | 9.2 | 8.3 | 8.7 |
| World | -0.6 | 5.1 | 3.9 | 3.5 | 4.1 |

Source: BBVA Research

Table 3
## CPI

| (YoY growth rate) | 2009 | 2010 | 2011 | 2012 (F) | 2013 (F) |
|---|---|---|---|---|---|
| U.S. | -0.3 | 1.6 | 3.2 | 2.3 | 2.3 |
| EMU | 0.3 | 1.6 | 2.7 | 1.8 | 1.3 |
| Asia-Pacific | 0.3 | 3.6 | 4.8 | 3.3 | 3.4 |
| China | -0.7 | 3.3 | 5.4 | 3.3 | 3.7 |
| World | 2.2 | 3.0 | 5.1 | 3.9 | 3.6 |

Source: BBVA Research

Table 4
## FX rate (End of period)

| | | 2009 | 2010 | 2011 | 2012 (F) | 2013 (F) |
|---|---|---|---|---|---|---|
| U.S. | EUR/USD | 0.72 | 0.76 | 0.72 | 0.80 | 0.79 |
| EMU | USD/EUR | 1.39 | 1.33 | 1.39 | 1.26 | 1.27 |
| China | CNY/USD | 6.83 | 6.62 | 6.30 | 6.11 | 5.80 |

Source: BBVA Research

Table 5
## Policy rate (End of period)

| | 2009 | 2010 | 2011 | 2012 (F) | 2013 (F) |
|---|---|---|---|---|---|
| U.S. | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| EMU | 1.00 | 1.00 | 1.10 | 0.75 | 0.75 |
| China | 5.31 | 5.81 | 6.56 | 6.06 | 6.56 |

Source: BBVA Research

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