

# ***What to expect next year for China and Hong Kong?***

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# Outline

## ***1. Global Outlook:***

Recovery proceeds with downside risks gradually diminishing

## ***2. China Outlook:***

Growth momentum continues, but with rising fragilities

## ***3. Hong Kong Outlook:***

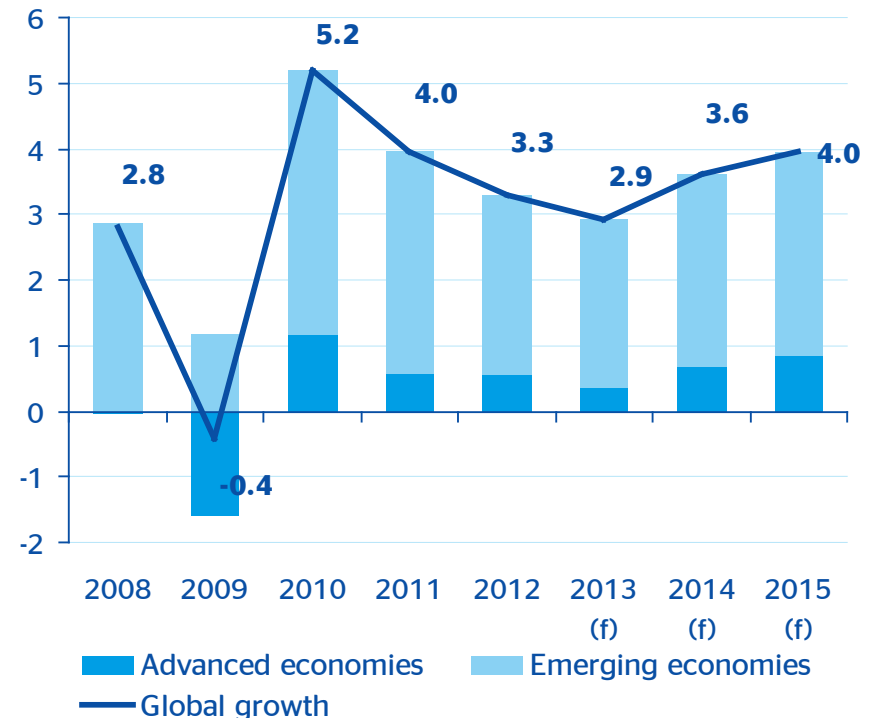
Adapting to a changing environment amidst medium-term challenges

## Global Outlook

- Our current outlook incorporates an improvement in global growth as emerging markets join the ongoing pickup in advanced economies.
- Risks are still biased to the downside but have declined in recent months:
  - the eurozone has begun to recover
  - US fiscal wrangling appears to be over
  - QE tapering has been well received by the markets, and vulnerable countries are preparing

### Global GDP growth (%)

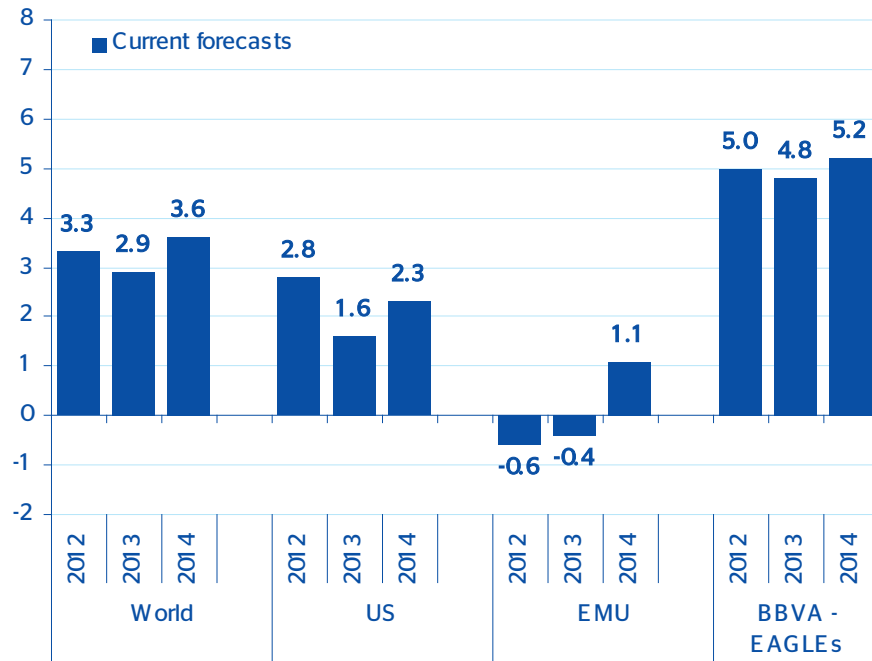
Source: BBVA Research



## A recovery with risks diminishing

### GDP growth (%)

Source: BBVA Research and IMF



Global recovery continues to on the back of advanced economies, with emerging economies now joining. Upward bias to US projections.

Nevertheless, advanced economies are vulnerable to tighter financial conditions. In the eurozone, risks remain from AQR and wrangling over banking union

In emerging markets, vulnerability to a less favorable global liquidity outlook must still be monitored

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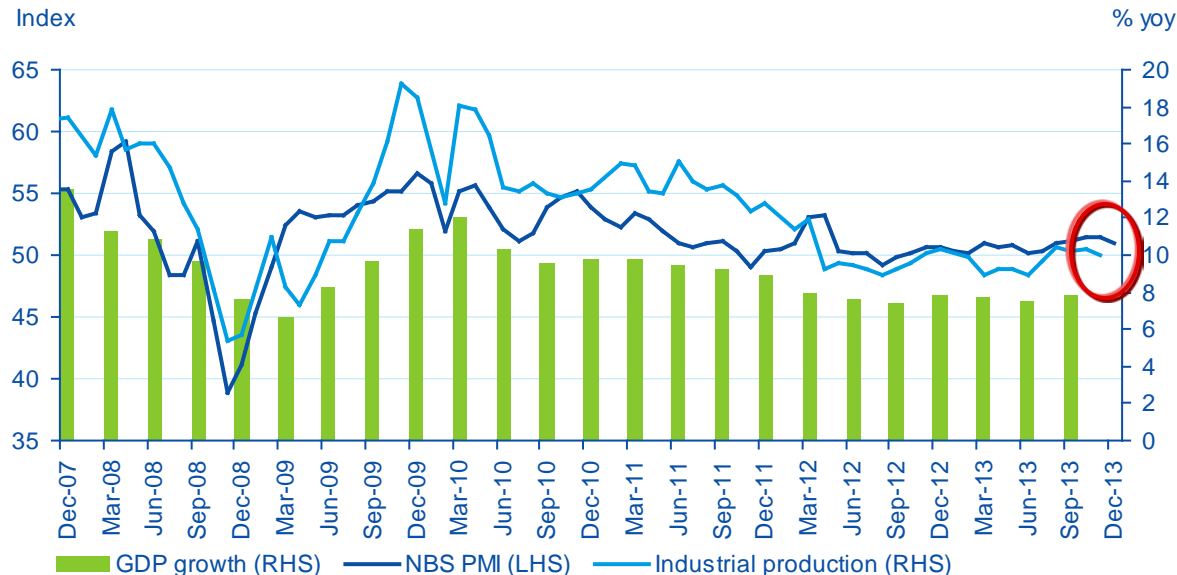
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## China's recovers slowly

- Fears of a hard landing in 2013 did not materialize: Q3 GDP rose to 7.8% y/y, and momentum continues
- Growth has picked up due to improved policy clarity, mini stimulus measures, and improving external demand.
- Still, caution is in order on the growth outlook for 2014 given headwinds from financial fragilities: growth momentum appears to have slowed somewhat in December

### GDP growth bottomed out in Q2

Source CEIC and BBVA Research

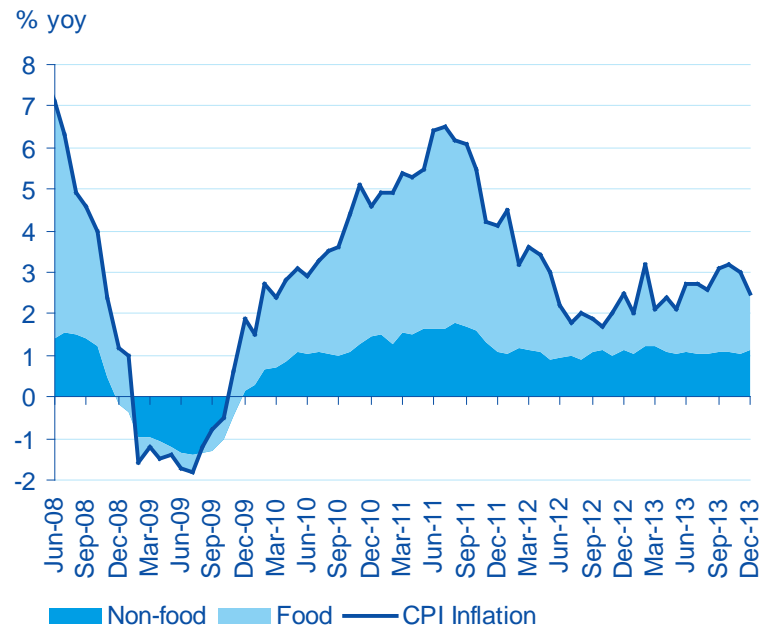


## Inflation not really a problem

- Inflation remains contained, falling to 2.5% y/y in December on easing food prices, below the 3.5% target
- PPI deflation has been eased further to -1.4% y/y
- Medium-term inflation is likely to be in the 3.5-4.0% range on higher wage growth

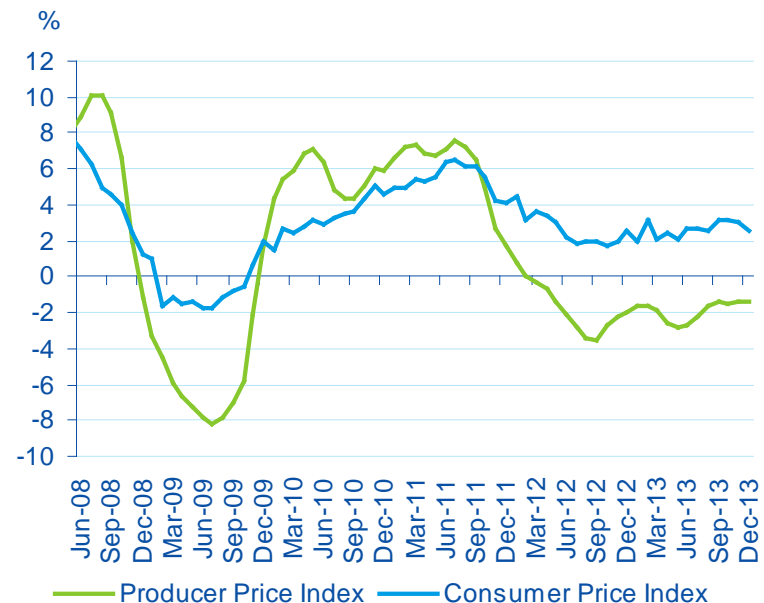
### Inflation moderated on easing food prices

Source CEIC and BBVA Research



### ... while PPI deflation remains

Source: CEIC and BBVA Research

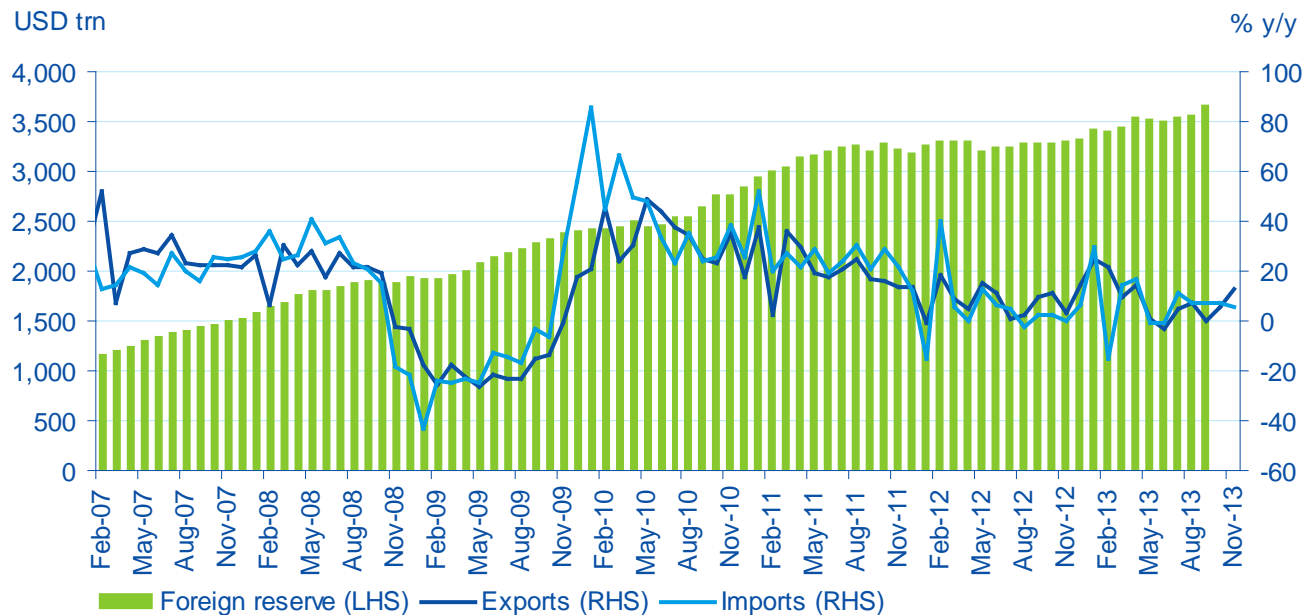


## The external environment supportive

- Exports are improving on stronger demand from the US and EU
- The trade surplus remains substantial, and reserves picked up in the third quarter

### Export growth has stabilized and reserves are still rising

Source: CEIC and BBVA Research



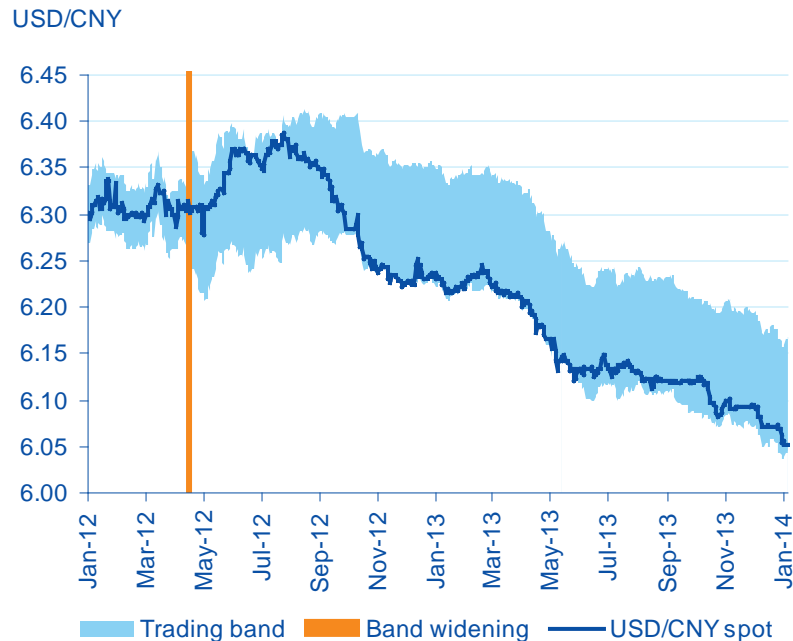


## RMB continues to strengthen

- Capital inflows and a weak US dollar have led to a faster pace of RMB appreciation of late
- Will there be another widening of the band?
- The RMB is still undervalued, and is likely to appreciate by 2-3% per year against the USD in nominal terms

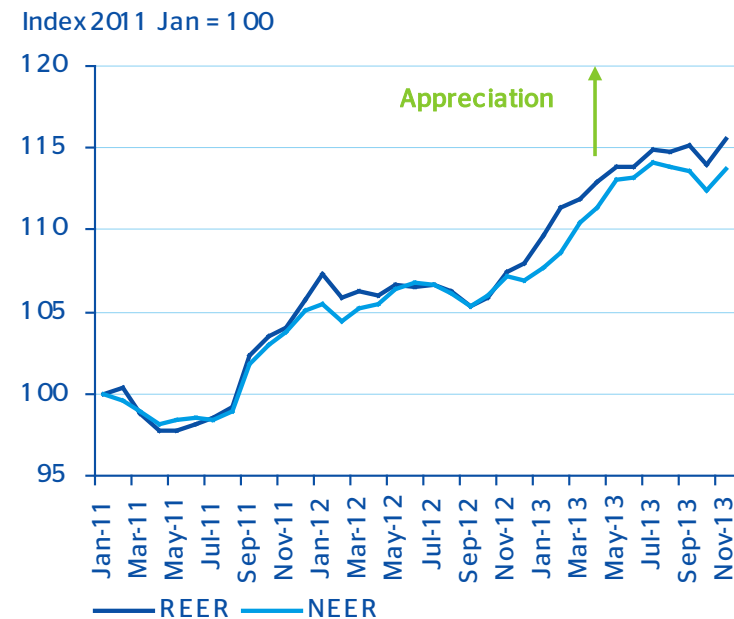
### The pace of RMB appreciation has resumed...

Source: Bloomberg and BBVA Research



### ...leading to losing external competitiveness

Source: BIS and BBVA Research

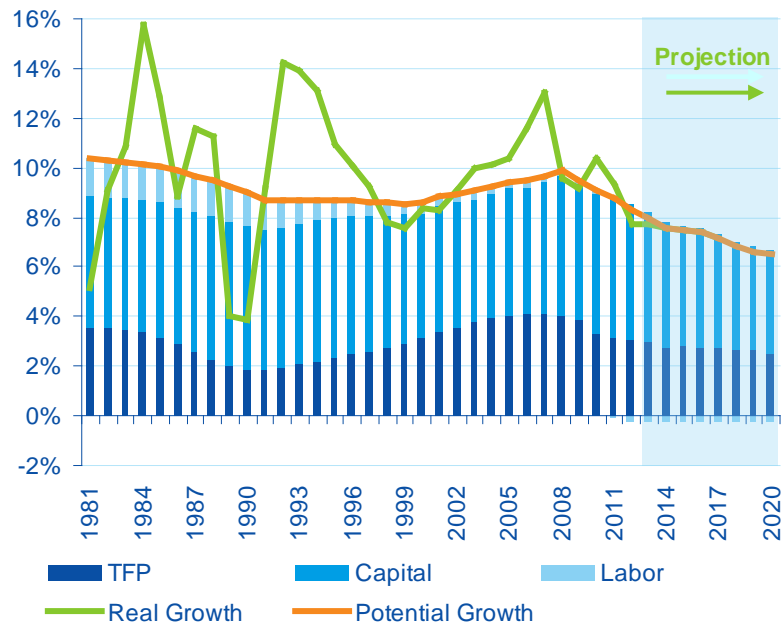


## So why worry? Decelerating potential growth

- Potential growth will decelerate in the coming decade, to 6½% by 2020, from +8% at present
- The decline is due to lower TFP, decelerating investment, and stagnant labor force growth
- These estimates are a “good” scenario, based on continued progress in economic reforms and rebalancing

### Declining potential growth ...

Source: BBVA Research



### ... as the contribution of labor and total factor productivity diminish

Source: BBVA Research

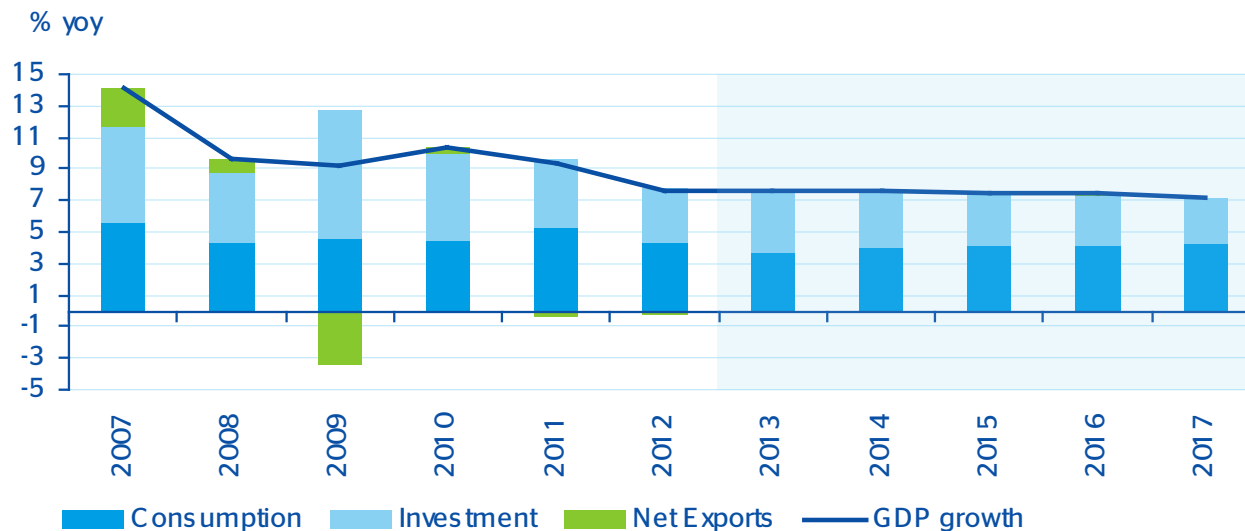
Contribution by factors	TFP	Capital	Labor	Potential growth	real growth
1981-1990	2.9%	5.5%	1.5%	9.8%	9.3%
1991-2000	2.4%	5.5%	0.7%	8.7%	10.5%
2001-2010	3.8%	5.2%	0.3%	9.3%	10.2%
2011-2020	2.8%	4.8%	-0.2%	7.5%	--

## The end of a growth model

- An unhealthy mix of growth at present, too heavily weighted toward investment
- Sustaining growth in the medium-term will require slower investment growth and faster private consumption
- Policies: facilitating urbanization and growth of household income, improvements in social safety net, market reforms , boost to consumer finance, currency appreciation
- Third Plenum outline for reforms encouraging but many questions on implementation and contradictions

### Rebalancing will take time

Source: CEIC and BBVA Research estimates

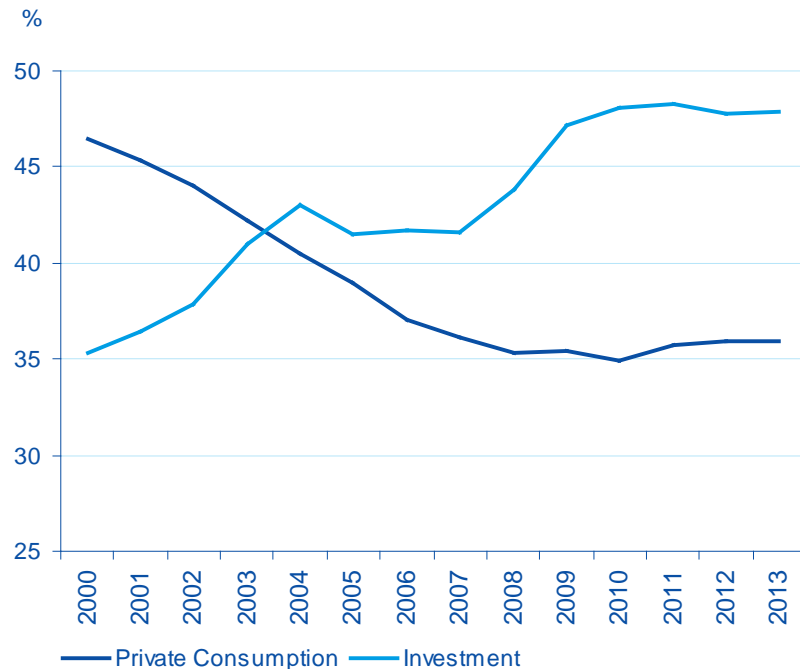


## No evidence of rebalancing so far

- Rebalancing has hardly begun, but if you look hard enough, there are some signs
- Narrowing current account balance, stabilizing consumption and investment, growing services sector

### Rebalancing toward domestic consumption remains disappointingly slow

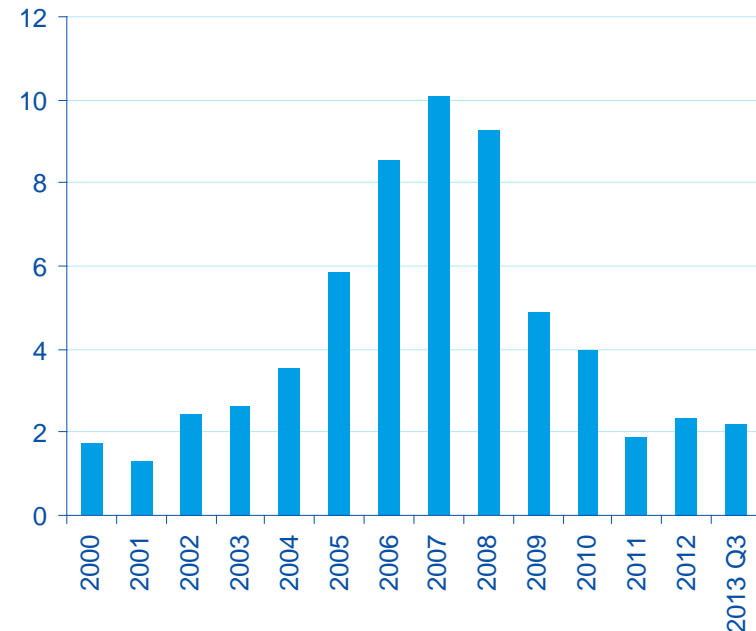
Source CEIC and BBVA Research



### ... and current account surplus has narrowed

Source: CEIC and BBVA Research

as % of GDP



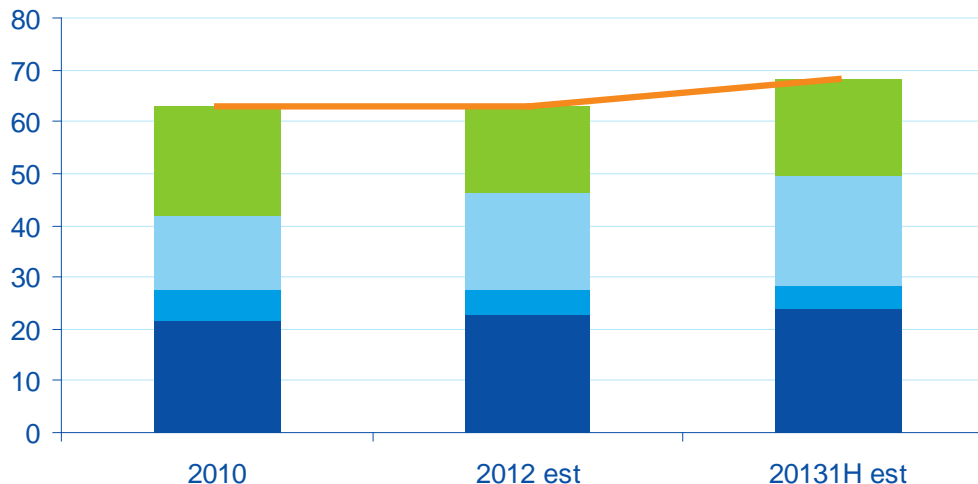
## Local government debt to weigh on bank profits

- The latest audit of local government debt shows an increase to RMB 17.9 trillion at end-June 2013
- A clean-up of local government debt may require central government funds, and bank write-offs
- Dealing with the local government debt problem is a priority for 2014

### Local government debt has risen

Source: BBVA Research

% of GDP



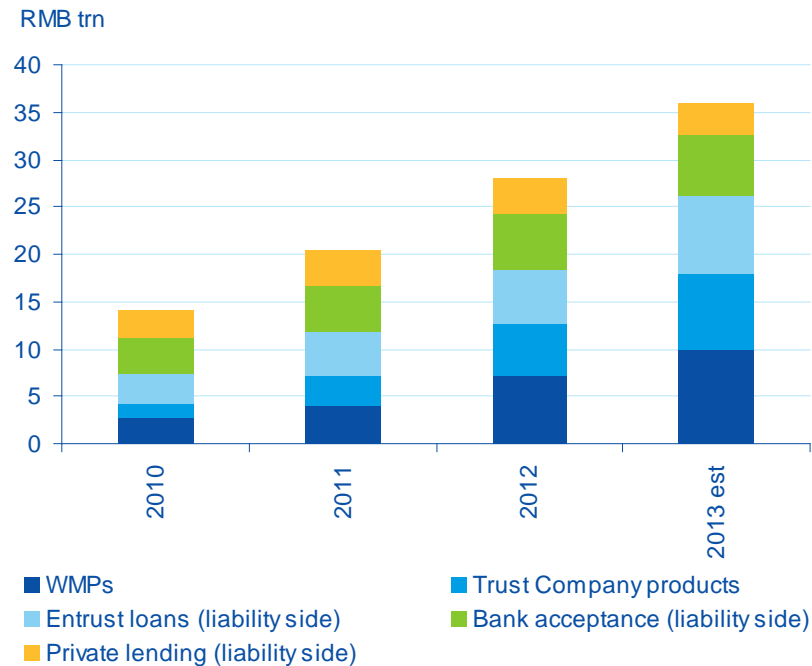
- Local Government Financing Vehicle Debt
- Local Government Agency Debt
- Bank Restructuring Cost
- Central Government Debt
- Total debt

## Shadow banking also poses risks to banks

- The size has grown rapidly in recent years as banks circumvent tightening regulations
- The involvement of banks in shadow banking activities could eventually impact their balance sheets

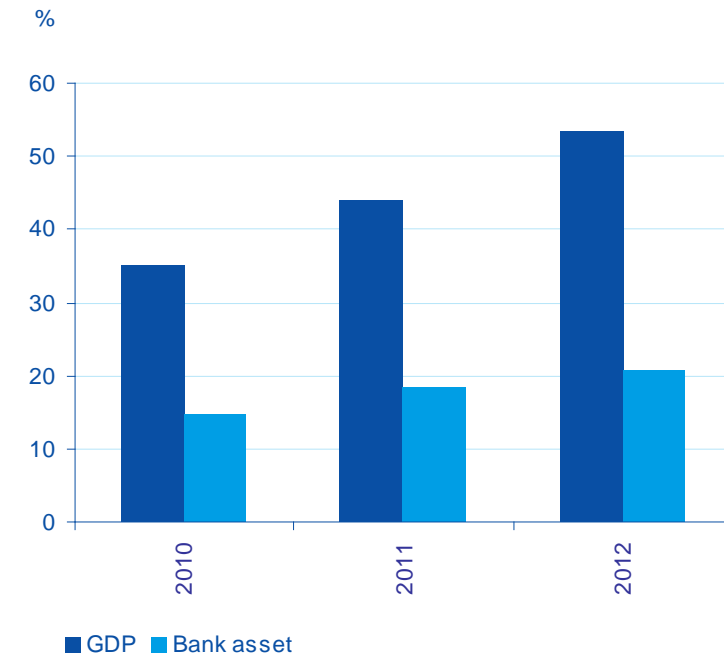
### Shadow banking activities have risen...

Source: Wind, CEIC, PBoC and BBVA Research estimates



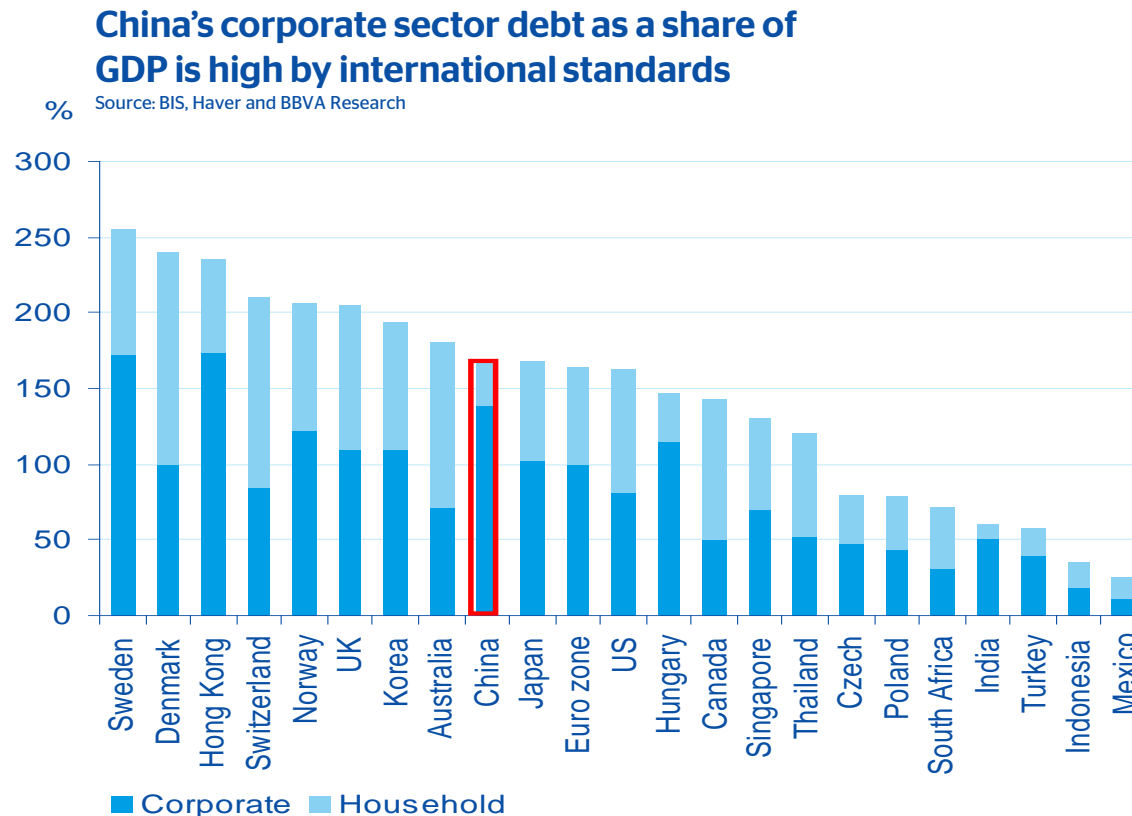
### ...leading to an increase in the size of the shadow banking sector in the economy

Source: PBoC and BBVA Research



## Corporate sector debt also a concern

- As a share of GDP, China's corporate debt is high by international standards
- High corporate debt may constrain growth and weigh on bank asset quality

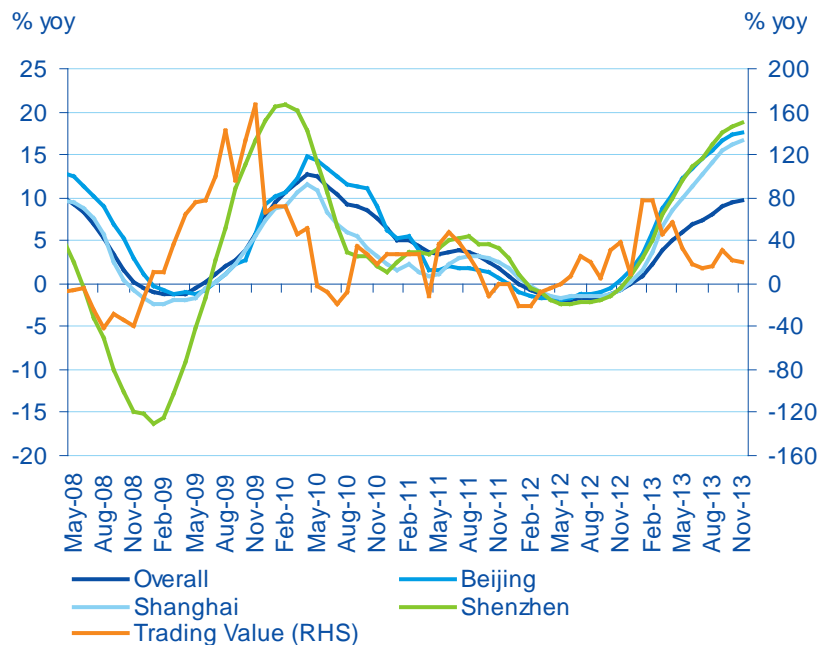


## Home prices still raising

- Accelerating housing prices have kept the focus on housing bubbles and affordability
- The government's tightening measures and home purchasing restriction are expected to remain in place
- Rising housing prices are a key factor for the authorities' reluctance to ease monetary policy

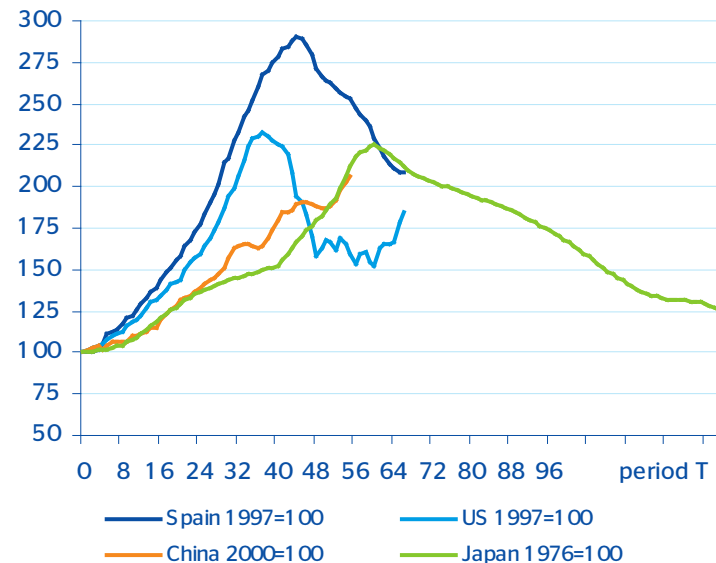
### Housing prices and transaction volumes rise sharply, led by tier 1 cities

Source: CEIC and BBVA Research



### Is the recent rise in China's housing prices reminiscent of international bubbles?

Source: NBS and BBVA Research





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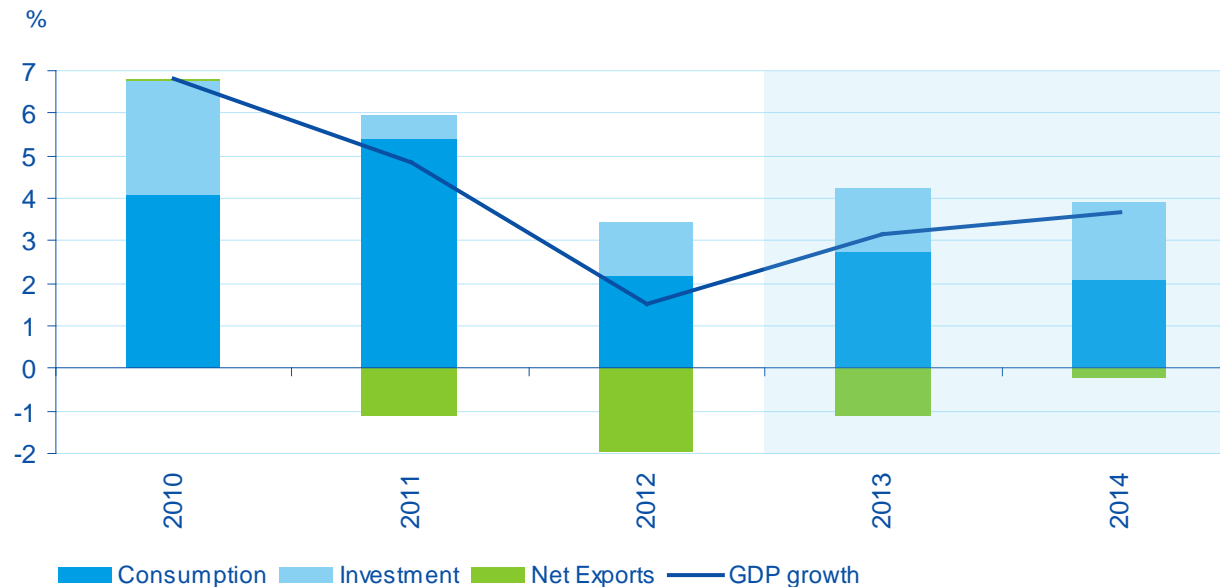
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## Hong Kong's GDP growth slowly picking up

- After a disappointing 2012, Hong Kong's growth picked up to 3.1% (est.) in 2013
- Exports and robust private consumption have been the growth leaders
- We expect growth to rise further in 2014 and 2015 (3.7% and 4.0% respectively) on sustained growth in China and an improving external environment

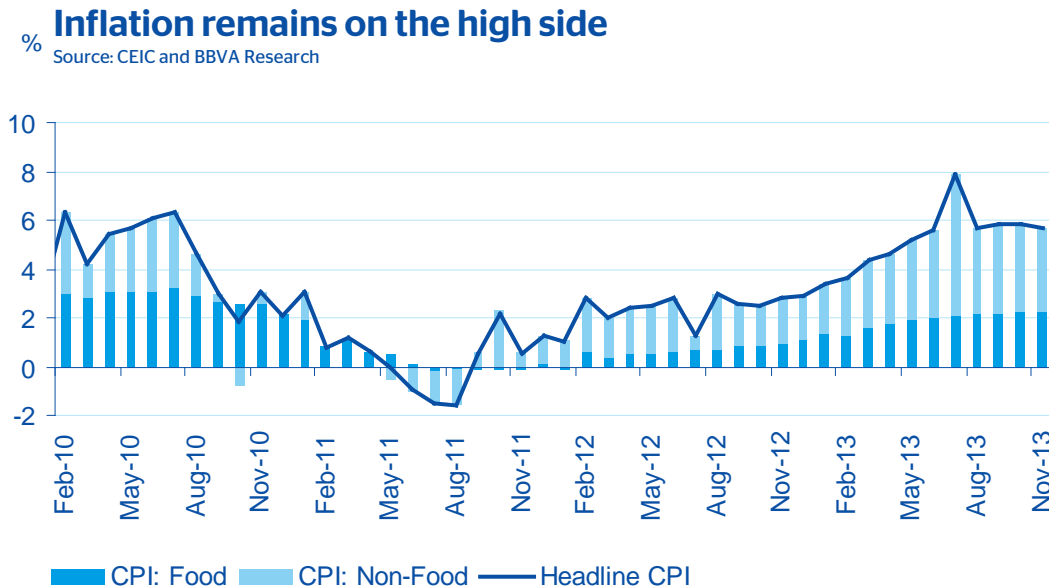
### Growth momentum picked up modestly

Source: CEIC and BBVA Research



## Inflation remains high<sup>38</sup>

- The linked exchange rate regime limits Hong Kong's scope for an independent monetary policy, and currency appreciation pressures show up as domestic inflation
- Headline inflation has remained high (4.3% in 2013), driven by food prices and housing costs
- We expect inflation to moderate somewhat in 2014 and 2015 (3.7% and 3.5% respectively) as housing prices cool



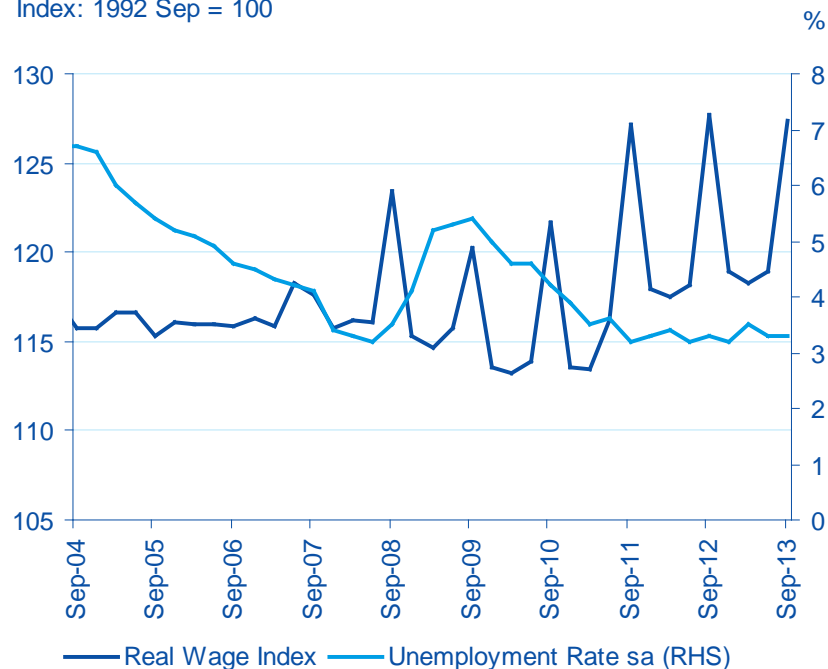
## Labor market remains tight

- As in other Asian economies, Hong Kong's labor market has been tight on strong demand and limited labor supply
- The strong labor market has helped to increase wage income and boost private consumption
- However, it has also increased inflationary pressure and resulted in labor shortage in certain sectors
- Minimum wage has risen to 30HKD/hour from 28HKD/hour as introduced in 2011, still below the market level

### The unemployment rate remains low and stable

Source: CEIC and BBVA Research

Index: 1992 Sep = 100



### Distribution of job vacancies by sector (2013 Q3)

Source: Census & Statistic Department and BBVA Research

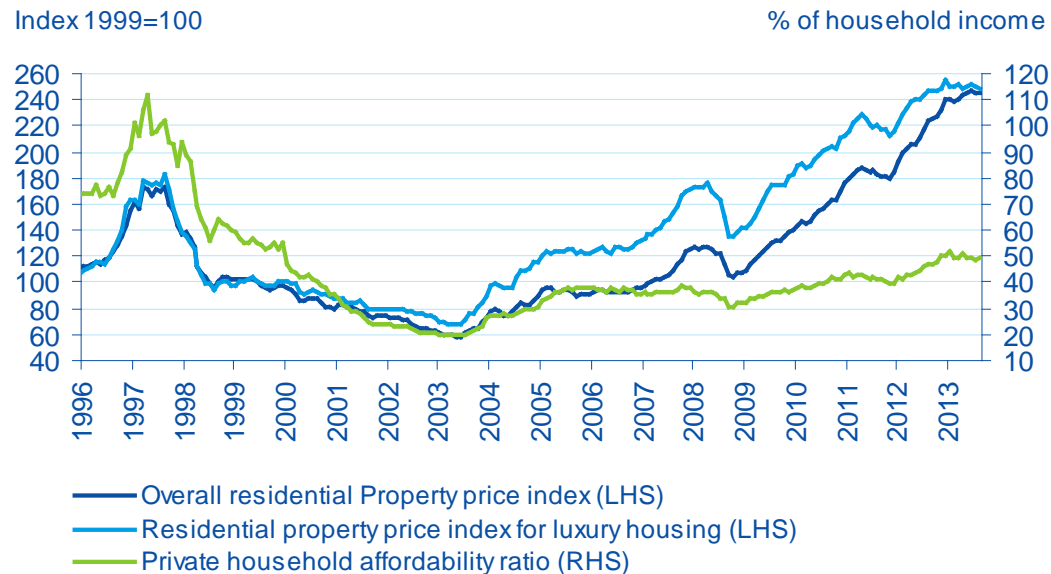


## Property market has been the focus of policy

- Property market has cooled over the past year due to macro-prudential measures and expectations of US Fed QE tapering
- The housing market is a source of vulnerability, and is susceptible to an increase in international interest rates

### The property market has begun to cool

Source: CEIC and BBVA Research

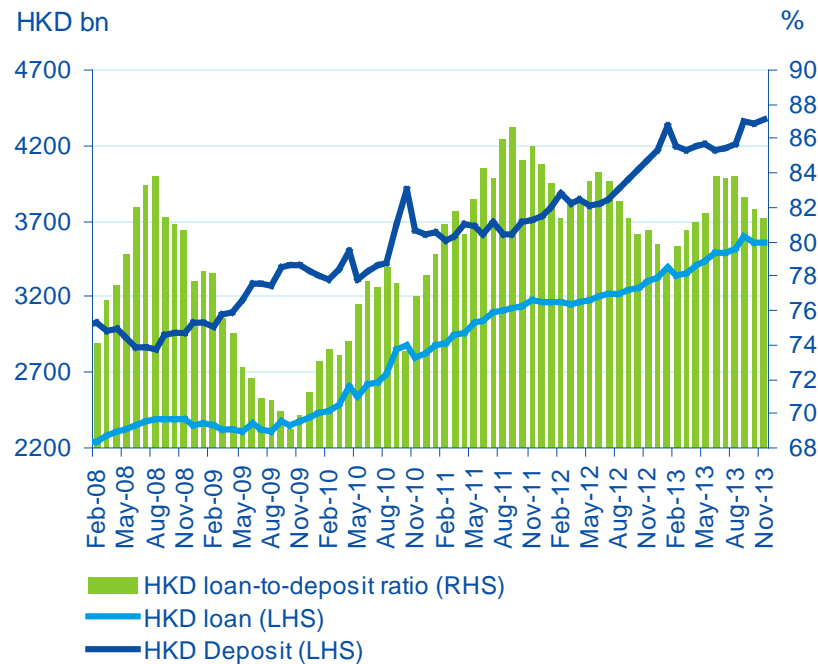


## Lending boom has moderated

- Over the past few years lending growth has been fueled by housing mortgage demand and loans to mainland companies
- More recently, mortgage lending has slowed, while offshore lending remains strong

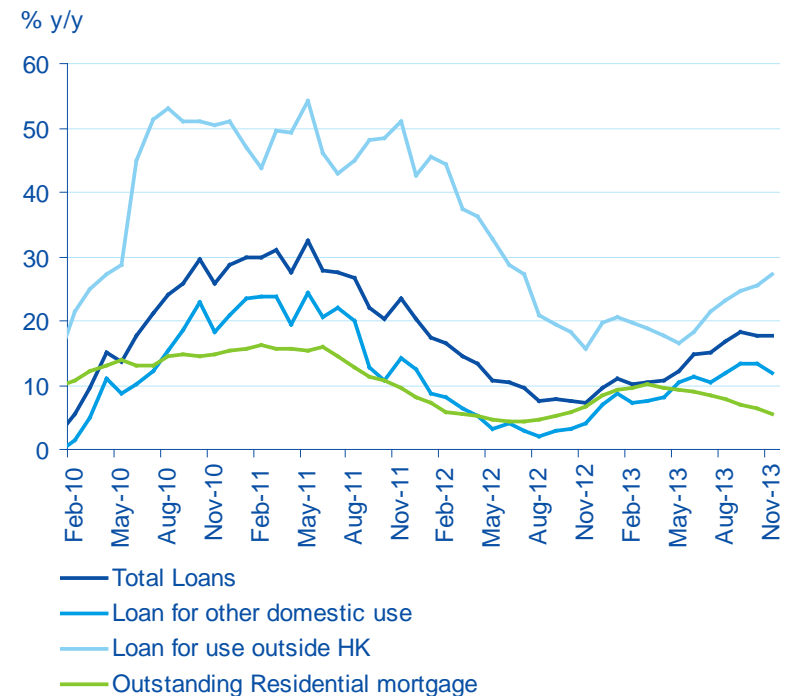
### Credit growth remains fast

Source: CEIC and BBVA Research



### Mortgage lending has eased

Source: CEIC and BBVA Research

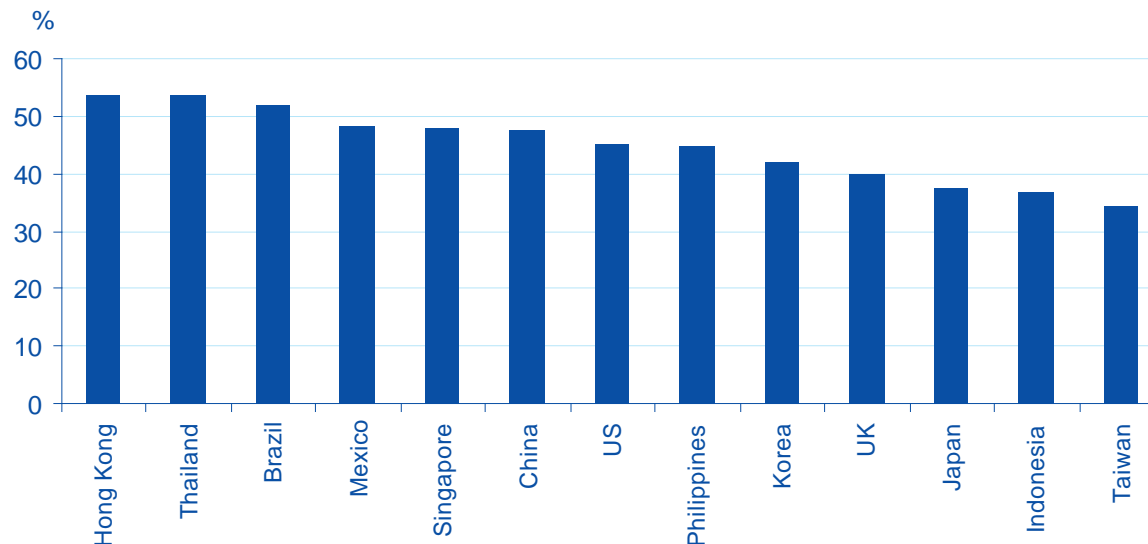


## Medium-term challenges in Hong Kong

- Vulnerability to external shocks
- Increasing economic reliance on China
- Income inequality: Gini Coefficient 53.7% in 2012
- Rising competition from Shanghai's as a financial center (e.g., Shanghai Free Trade Zone)
- Ageing population and labor shortages
- Political unrest regarding autonomy and 2017 universal suffrage

### High Gini Coefficient in Hong Kong

Source: CIA and BBVA Research



Thank you for your attention!  
Questions welcome

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# China: Near-term growth outlook

- Growth will slow in 2013-14 as the government tackles financial fragilities posed by shadow banking, local government debt, and rising housing prices
- Downside risks include: sluggish external demand, policy uncertainty, and slowing potential growth

Baseline					
	2010	2011	2012	2013F	2014F
GDP growth	10.4	9.3	7.8	7.7	7.6
CPI (avg)	3.3	5.4	2.6	2.6	3.3
CNY per USD (eop)	6.62	6.30	6.23	6.05	5.90
Benchmark interest rate (eop)	5.81	6.56	6.00	6.00	6.00

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## Appendix

# Hong Kong: Near-term growth outlook

- Growth will pick up in 2013-14 as 3.1% and 3.7%
- Downside risks include: sluggish external demand and housing bubbles

Baseline					
	2010	2011	2012	2013F	2014F
GDP growth	6.8	4.9	1.5	3.1	3.7
CPI (avg)	2.4	5.3	4.1	4.3	3.8
HKD per USD (eop)	7.77	7.77	7.75	7.75	7.75
Benchmark interest rate (eop)	0.50	0.50	0.50	0.50	0.50