

Sujet: Est-ce que la Chine est en train de ralentir sa croissance ? / Is China shifting course ?

Source: Capital Economics

Date: 06.05.2010



CHINA ECONOMICS FOCUS

6th May 2010

Is China shifting course?

- **Fears that China is about to slam the brakes on its economy are overdone. Overheating is a far smaller threat than is commonly supposed and policy tightening will be implemented only slowly.**
- Many months after the rest of the world proclaimed the success of China's response to the economic downturn, China's government is finally acting as if it believes the crisis has passed. Policymakers have begun to look further ahead, and are confident enough about the recovery to have launched a campaign against property market speculation.
- Many believe that this policy shift is being driven by fear of overheating and a growing property bubble as much as by confidence in the recovery. But officials on the whole still seem relaxed about these risks. The recent property measures target pockets of the market where speculative activity is strongest. They arguably make broader tightening measures less likely.
- This approach is sensible. We find little evidence that property prices across the market as a whole are at an unsustainable level – recent rapid price increases follow several years in which property prices fell relative to average incomes.
- Nor is there compelling evidence that the wider economy is overheating. GDP growth is running above potential in y/y terms, but this is simply the legacy of the collapse in growth 18 months ago, which was followed by a sharp rebound. Growth has already slowed substantially since mid-2009 in q/q terms and is back close to China's sustainable rate.
- **Meanwhile, inflation pressures seem to have eased since the start of the year and, with monetary growth in decline, the threat of an imminent spike in prices is receding.** In these circumstances, China has no need to tighten aggressively. The government also has the capacity through fiscal and credit policy to support growth at a relatively rapid rate this year and next.
- **The upshot is that many investors are braced for a sudden policy tightening that we think will not come.** On interest rates and the currency, we expect only very slow movement. However, while a return to renminbi appreciation against the dollar may buy China some time with its foreign critics, the threat of a clash over the exchange rate and China's surplus will remain.

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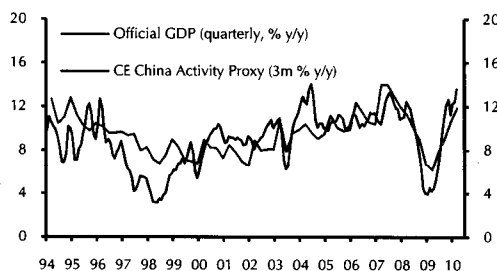
China Economics Focus 1

Is China shifting course?

This Focus is an adapted version of a presentation given at the Capital Economics International Forecast Forum held in London on 26th April.

Senior Chinese officials have been radiating a renewed sense of confidence over the last month or so. Of course, China started its recovery in the first half of 2009 and has been clocking up impressive growth for a while. Officially, the economy grew by 8.7% last year. Our own estimate of Chinese growth, which we call the China Activity Proxy, suggests that the economy was much weaker than these widely-questioned official figures showed early in 2009. But it still suggests that growth came in close to 8% over the year as a whole, something which looked extremely unlikely 12 months ago. (See Chart 1.)

CHART 1: GDP & CHINA ACTIVITY PROXY



Sources – CEIC, Thomson Datastream, Capital Economics

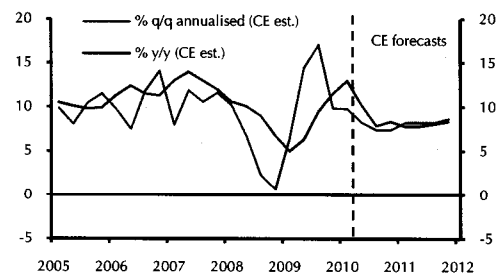
Nonetheless, it is only in the last three or four weeks that China's leaders have sounded as if they believe the crisis has passed. For the last year, official statements on the success of China's stimulus were hedged with a warning that the recovery was "not secure" or "not consolidated". China's cabinet, the State Council, dropped that line from its statement on first quarter GDP in April. In the last fortnight, the government has turned to cracking down in earnest on property market speculation. It probably would not have taken these steps if it still thought the recovery was shaky.

This is a big shift and, understandably, there is a great deal of interest in what comes next. Many think that China is already overheating, in which case we should expect significant policy tightening or inflation to follow. In the section that follows we argue that China shows little sign of overheating. As a result, pressure to tighten is low. We outline our view of the policy outlook in more detail and what all this means for China's relations with the rest of the world at the end.

Is China overheating?

China's economy is certainly growing rapidly. It expanded 11.9% y/y in the first quarter according to the official figures, and slightly more on our estimate, which is shown in Chart 2.

CHART 2: CHINA GDP



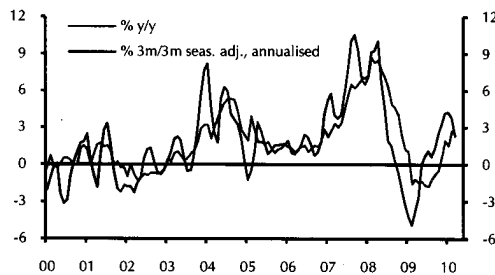
Sources – CEIC, Capital Economics

This is three or four percentage points faster than China's trend growth rate. But if you look at the quarter-on-quarter rate of growth, which is shown in annualised form in Chart 2, you can see that growth has actually already declined substantially since the middle of 2009.

Indeed, the rate of growth has almost halved since the full rush of stimulus spending hit the economy and is now down to a 10% annualised pace, which looks more sustainable than the y/y pace of growth. So the recent acceleration in y/y growth is really only telling us that the economy was weak this time last year, which we already knew. The GDP data are not evidence of overheating.

The inflation data give even less cause for concern. Those worried about inflation point to the sharp pick-up in the y/y rate in the last few months. However, as with the acceleration in y/y GDP, that is mainly telling us that prices were weak a year ago. In quarter-on-quarter terms, inflation has dropped back pretty sharply since the beginning of the year. (See Chart 3.) And with monetary growth easing, there is little reason to think that consumer price inflation is about to take off.

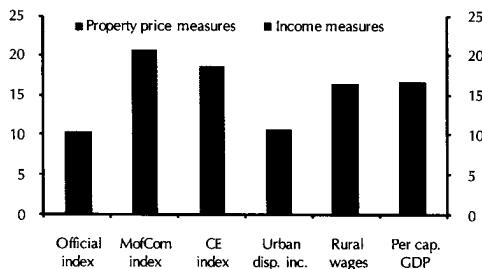
CHART 3: CONSUMER PRICES



Sources – CEIC, Capital Economics

Admittedly, property prices are rising too fast for comfort, at least in some cities and in particular for high-end properties. The government has responded with a wave of measures targeting those markets where prices have risen too fast.

CHART 4: PROPERTY PRICES & INCOME (Q1 2010, % Y/Y)

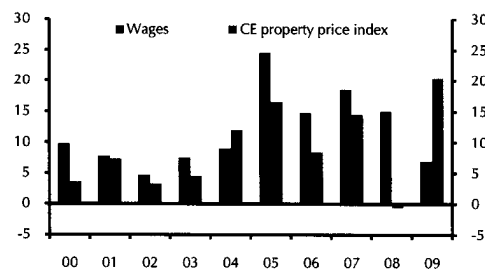


Sources – CEIC, Capital Economics

But property prices in general are still not a major concern. Property prices were roughly 10-20% higher in the first quarter than a year before, depending on the measure used. This would be a worryingly fast price increase in many countries,

but in China it means that increases in property prices were running only just ahead of those in wages. (See Chart 4.) And when we repeat these calculations using annual data, we find that 2009 was only the second year in the past ten in which property prices rose faster than average incomes. (See Chart 5.) This does not look like a bubble.

CHART 5: PROPERTY PRICES & WAGES (% Y/Y)



Sources – CEIC, Capital Economics

We round off the story with a quick look at China's equity markets. As Chart 6 shows, prices in Shanghai are still lower than they were at the start of the year and barely half of their 2007 peak.

CHART 6: EQUITY INDICES



Source – Bloomberg

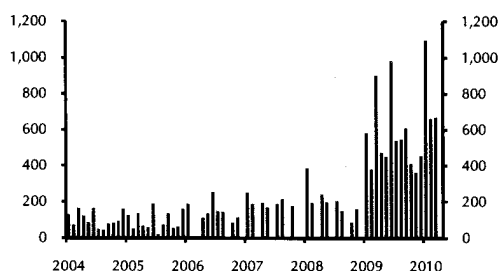
In summary then, there might be pockets of overheating in the property market, but not at the national level. And when we look at consumer prices and equity prices there is no sign of overheating at all.

Recovery still reliant on government

Instead, rather than overheating, China's rebound is built on shakier foundations than first appears. The recovery was driven last year by a massive

surge in bank lending. This continues to be the big driver of growth. New medium- and long-term lending was nearly a third larger in the first quarter than a year before. (See Chart 7.) That is unsustainable over the long-run – indeed, the government will probably end up bailing out the banks for bad loans on the lending they have already done.

**CHART 7: NET MEDIUM- & LONG-TERM RMB LENDING
(RMB BN)**



Source – CEIC

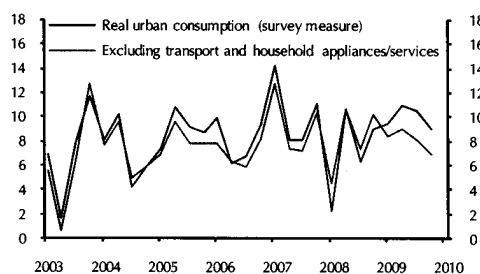
But if lending and investment slow, what will take their place? A lot of hopes have been placed on household consumption, and consumer spending did hold up remarkably well last year.

However, if consumption is to offset weaker investment growth, it will have to get even stronger. That looks unlikely. About a quarter of growth in household spending last year was due to rapid sales of vehicles and household appliances, which the government has promoted through tax breaks, subsidies and a cash-for-clunkers scheme. (See Chart 8.) Without that support from government, we could see consumption growth weaken rather than strengthen.

In other words, China current pace of growth is heavily reliant still on government support. This is another reason – alongside low inflation pressures – to think that policy support will be withdrawn slowly. Fortunately, the government can afford to keep subsidies in place for consumers for a long time – its fiscal position is very strong, and bad

loans are not an immediate threat to stability among the state-owned banks.

CHART 8: URBAN HOUSEHOLD CONSUMPTION (% Y/Y)



Sources – CEIC, Capital Economics

The policy outlook

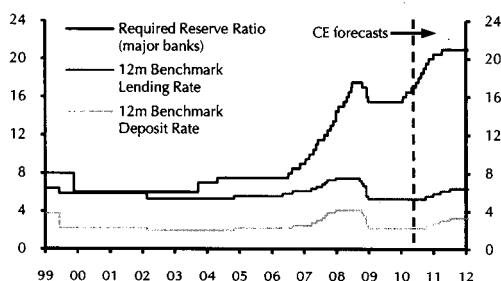
Overall, we continue to expect GDP growth of 10% this year, with 8% growth in 2011 as the impact of the stimulus fades.

The required reserve ratio for commercial banks has already been raised three times this year, most recently on Sunday. We expect several more moves, perhaps as many as one a month over the rest of the year. But this should not be interpreted as policy tightening. If reserve requirements were not increased, then every purchase of foreign exchange by the People's Bank would potentially support an ever-increasing expansion of broad money. The People's Bank has to use reserve hikes, or issue sterilisation debt which has the same effect, just to keep potential monetary growth stable. (We discussed the latest RRR hike in more detail in a rapid response note sent to clients on Sunday.)

We are forecasting only a couple of interest rate hikes over the remainder of this year. (See Chart 9 overleaf.) Of course, you might ask why China would want to raise interest rates at all given the picture we have painted. The answer, we think, is that China would be better served in the long-run by having structurally-higher interest rates – they are currently far too low for moderate rate adjustments to make any difference to loan demand. This means that the People's Bank has an

incentive to raise rates when it can, but also that rates are so low now relative to the pace of economic growth that the People's Bank has little reason to fear that hiking them a small amount would endanger the recovery.

CHART 9: POLICY RATES (%)



Sources – Bloomberg, Capital Economics

Indeed, when it comes to monetary policy, interest rates are really beside the point in China, which controls credit growth by setting quotas. The quota for this year is consistent with 19% growth in total outstanding loans, which remains pretty loose.

What next for the renminbi?

The story for the renminbi is similar. The weakness of price pressures at the moment means there is no pressing economic reason to allow the renminbi to move higher. However, economic rebalancing would in the long-run be better served by having a stronger currency. And of course, loosening of the renminbi's dollar peg would also help manage the relationship with the US.

Relaxation of the dollar peg could happen at any time. When Secretary Geithner delayed publication of the US Treasury report on currency manipulation in April, he said there was a three month window in which other means of pressing China on the issue would be explored.

That means that Geithner will be under pressure to show results by the time of the G20 summit at the end of June. This might not matter much to his counterpart in China, but we have long thought that June was in any case the mostly likely date for a resumption of renminbi appreciation. By that

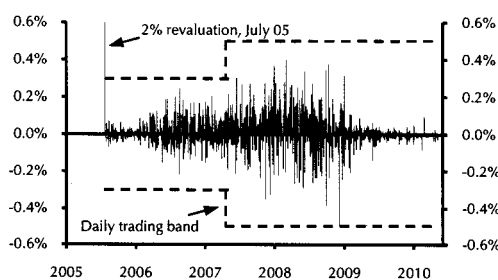
point, policymakers in China will have been able to see two months' worth of data not distorted by the Chinese New Year, and they should be increasingly confident about the outlook.

Still, the conflicting messages Chinese officials have been giving on the need for renminbi appreciation underline that policymakers are still divided in Beijing. This is a further reason to think that when currency reform begins again, it will happen slowly. We expect just 3% appreciation against the dollar this year (taking the renminbi to 6.60/\$ from 6.83 today), which is only a little stronger than the non-deliverable forwards market has priced in, with a 6% gain (to 6.20/\$) in 2011.

The government is going to want to make a bit of a splash with the policy change, not least to distract attention from the fact that the renminbi is probably going to move at a rather anaemic pace. Most likely it will announce a widening of the renminbi's trading band against the dollar.

In practice, this would be nothing to get excited about. Since 2005, the renminbi has only used the full trading band on one occasion. (See Chart 10.) The band has clearly not been a constraint on the pace of appreciation. But widening it would allow China to make a bigger show of currency reform, while remaining cautious in the pace of change.

CHART 10: DAILY MOVE IN RMB/\$ SPOT RATE



Source – Bloomberg

As for the form that the renminbi's appreciation is likely to take, a wider trading band with the dollar would in principle allow China to start tracking a basket of currencies, rather than just the dollar, as

it did between 2005 and 2008. In the long-run, we expect China to move in this direction so that the value of its currency is not tied so closely to that of the dollar.

However there are immediate challenges with moving to a crawling peg against a basket, namely that if the dollar continues to strengthen against other majors, a currency regime that required the renminbi to track a basket may also require it to weaken against the dollar. In the current climate, this might be taken as a provocation.

To summarise our view on the renminbi, we expect a widening of the band against the dollar, probably in June, followed by a slow crawl higher against the dollar.

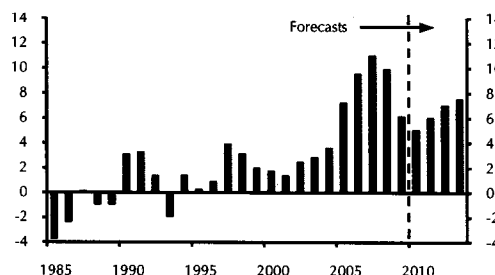
China and the world

In the short term, this is likely to buy China some time with its critics in the US and elsewhere. From that point of view, the March trade deficit – the first in six years – was nicely timed too. But it is far from certain that such a slow pace of renminbi appreciation against the dollar will do much to reduce China’s surplus, in particular the surplus with the US.

After all, the exchange rate is only one factor affecting China’s surplus. As stimulus spending slowly eases, and as China’s stockpiling of commodities slows, import growth is likely to taper off. Meanwhile, for the next few months at least, export growth should still be fairly strong, even if the renminbi is a touch higher against the dollar.

Looking further ahead, we mentioned above the extent to which Chinese consumption has been supported by government policies. There is certainly no sign of a sustained pick-up in underlying household demand. Meanwhile, the investment surge we have seen means that China’s manufacturing output growth will not slow much. That suggests that the imbalance between China’s consumption and its output, in other words its trade surplus, will reappear and could soon be very large again. (See Chart 11.)

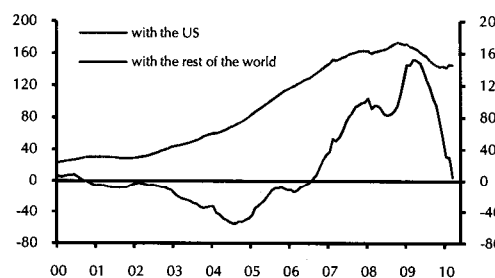
CHART 11: CHINA CURRENT ACCOUNT SURPLUS (% GDP)



Sources – CEIC, SAFE, Capital Economics

So trade tensions will soon return. Indeed, anyone hoping that a return to renminbi appreciation spelled the end to concern over these tensions, should take a look at Chart 12. It shows that while China’s surplus with the world outside the US has shrivelled to next to nothing over the last year, the surplus with the US has barely budged. Faced with this evidence, China’s critics in Congress will not be satisfied. The threat of protectionism and indeed, trade war, in the future remains real.

CHART 12: CHINA GOODS TRADE SURPLUS (\$BN, 12M SUM)



Source – Thomson Datastream

Conclusion

In summary, there is little sign that China is overheating. GDP growth is already slowing to a sustainable pace and the government has the capacity to stop it falling much further. Many investors are braced for a sudden policy tightening that we think will not come. On interest rates and the currency, we expect only very slow movement. The latter may buy China some time, but the threat of a clash over the exchange rate and China’s surplus will remain.