ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Working Paper 143

December 15, 2010

} MACROECONOMICS } FINANCIAL MARKETS } ECONOMIC POLICY } SECTORS

Gregor Eder

China in 2011 – characterized by growth and change

Allianz

AUTHOR:

Gregor Eder
Tel.: +49.69.263-53358
gregor.eder@allianz.com

China in 2011 – characterized by growth and change

China's share of the global economic cake is growing fast. Ten years ago, it accounted for no more than just short of 4% of global output, compared with an impressive 9.5% this year. In the past, it was the US that was looked upon as the engine behind global growth – a role that more and more voices are keen to ascribe to China. This is reason enough to look at the economic prospects in store for China next year. Two issues are likely to be the core of economic policy measures next year: the battle against overheating without compromising growth, and reform of the Chinese growth model.

Growth set to continue – risks still prowling

Let's start with the good news: the Chinese economy is likely to record solid growth to the tune of around 10% this year, largely due to the two-year government stimulus package that was launched back in the autumn of 2008 and to the marked recovery in global trade this year. Chinese exports in 2010 are expected to be up by around 30% year-on-year, catapulting them well above the record levels seen in 2008. Looking at the year-on-year figures, the Chinese economy would appear to have reached the peak of the current economic cycle in the first quarter of 2010, when it returned growth to the tune of 11.9%. Growth momentum has been easing gradually ever since. In the third quarter of the year real GDP was still 9.6% up on a year earlier.

Currently, a number of economic indicators suggest that growth is starting to pick up speed again. The purchasing managers' index for the manufacturing sector, released by China's National Statistics Office, was up for what was already the fourth consecutive month in November. The index currently stands at 55.2 points, well above the 50-point expansion threshold. Values above the threshold point to an expansion in economic activity, while values below the threshold signal that things are slowing down. Other indicators, such as the data on industrial production and retail sales, suggest at least that underlying economic momentum is starting to level off at a fairly high level.

All in all, we expect the Chinese economic upswing to continue next year. Given that the Chinese government is currently deploying a range of different (growth-dampening) measures to combat economic overheating and taking into account the expectation of more moderate development in world trade, we predict economic growth of 9% for the coming year.

Purchasing managers' index signaling higher growth momentum

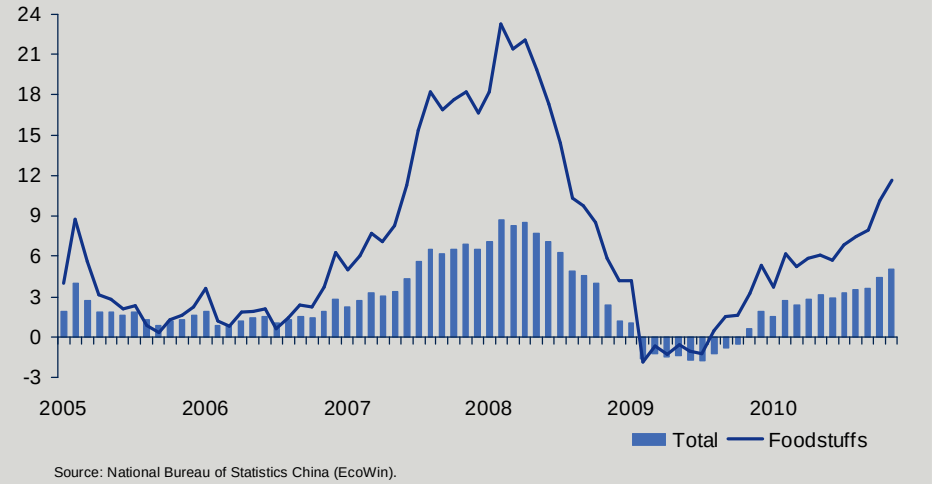
National purchasing managers' index and components, in points

Source: National Bureau of Statistics China (EcoWin).

In 2011, the big challenge facing China will be to forge ahead thoroughly with the moves initiated this year to abandon its extremely stimulating economic policy without choking off the economy in the process. There are already signs of overheating in several parts of the economy: the vigorous lending activity in the banking sector and real estate price trends have been cause for concern for some time now. What is more, yet another problem has reared its head of late: inflation. The increase in consumer prices has gathered considerable pace over the past few months. There is no doubt that all of these trends are partially interrelated and fuel each other. The property boom in many big cities, for example, would have been virtually impossible had it not been for the massive surge in lending. Last year, Chinese banks had opened their lending floodgates wide to help stimulate the domestic economy, granting new loans worth a total of around 9,600bn renminbi (CNY). By way of comparison, the average new lending volume in the period between 2000 and 2009 came in at somewhere in the region of CNY 3,000bn a year. The sort of lending expansion that we witnessed last year can only mean one thing: laxer checks on credit-standing. Consequently, non-performing loans are expected to start increasing in the foreseeable future. This is also likely to be the reason why the Chinese banking supervisory authority has several times in the course of this year urged financial institutions to reinforce their equity base. Corresponding measures have now largely been taken. Although the expansion in lending has indeed slowed this year, the volume of new loans granted is expected to once again be well above the long-term average of around CNY 8,000bn.

Consumer prices accelerating sharply

Inflation, percentage change on a year earlier

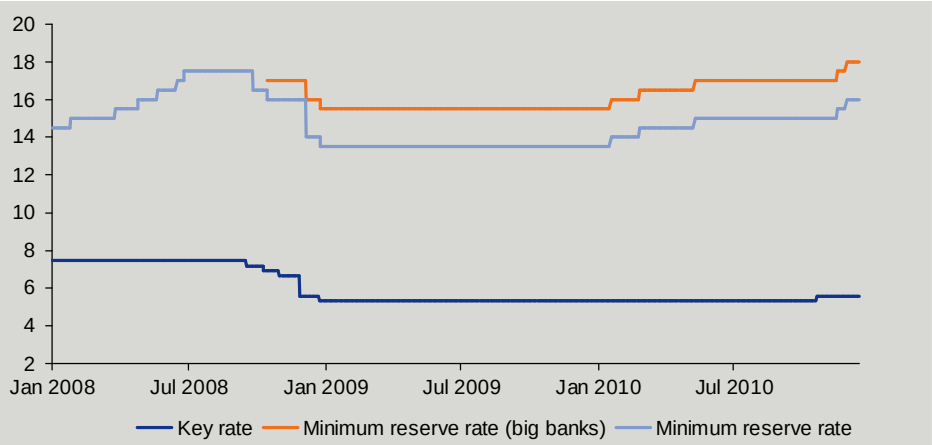


Source: National Bureau of Statistics China (EcoWin).

The latest headache for Chinese policymakers, and the one with the greatest potential for social tension, is inflation. In November, consumer prices were up by 5.1% on the previous year. The Chinese central bank's tolerance threshold stands at 3%. The development in food prices, which were recently up by as much as 11.7%, poses a particular problem. The government is trying to curb inflation by setting price caps for basic products (e.g. household energy), a very sensitive area from a social perspective. The monetary policy reins are also being increasingly tightened. This year, the Chinese central bank has already stepped up its minimum reserve requirements for banks on several occasions and also jacked up its key lending rate in October for the first time in three years. With the Communist Party's politburo recently announcing that it would be adopting a "cautious approach" to 2011, next year is very likely to see further interest rate hikes.

Monetary policy reacts to signs of overheating

Key interest rate and minimum reserve rates, in percent



Source: The People's Bank of China (EcoWin).

With domestic price pressure on the rise, a very different issue is also coming to the fore: exchange rate policy. After all, a stronger renminbi would promise two-fold benefits for China. First of all, it would boost domestic purchasing power, bolstering private consumption. Second, appreciation would make imports cheaper, alleviating some of the

inflationary pressure. Not least, given the above, we expect to see continued moderate appreciation of the renminbi against the US dollar next year to the tune of a good 4%.

We believe that the Chinese government should be able to master the balancing act inherent in a "controlled growth slowdown". China has proved capable of rising to this challenge several times in the past. Nevertheless, the risks associated with this particular balancing act are not to be taken lightly. We see possible negative (financial) repercussions above all on the state finance front and less so in the real economy. If, for example, a sharp rise in non-performing loans puts the Chinese banking system into a precarious spot, a capital injection from the government would be more than likely. It wouldn't be the first time, after all.

Growth model facing radical changes

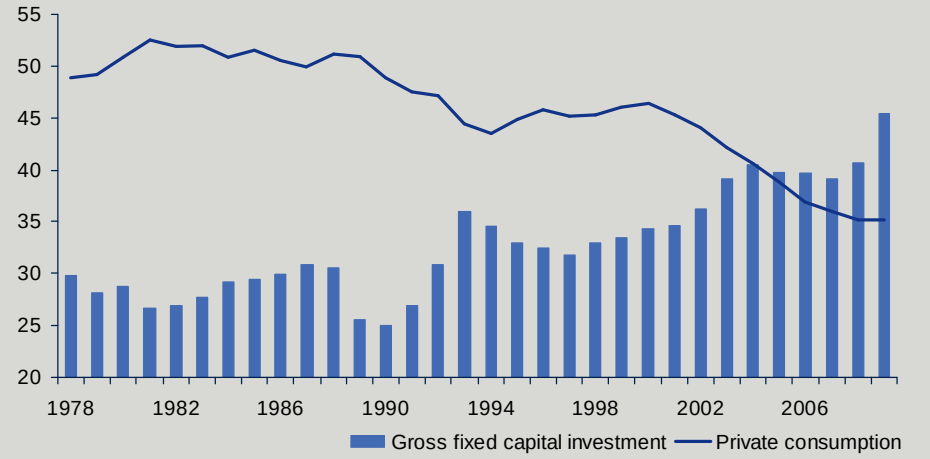
The global economic and financial crisis has made one point abundantly clear: if China wants to continue to achieve high growth in the future, the economy – now the world's second-largest – will have to focus far more on domestic demand than it has in the past and take some of the emphasis off export demand. In other words: in a world that is likely to be devoid of a "consumer of last resort", in the form of the US, for the foreseeable future, China should focus more on its domestic growth forces in the years ahead.

This is a view now evidently shared by the Chinese leadership. In October, the Central Committee of the Communist Party of China met in Beijing. The plenary meeting, which lasted several days, was used to develop proposals for the focal points of the 12th five-year plan (2011 to 2015). These proposals usually represent a condensed version of the five-year plan that is then passed in March of the following year.

The change of heart, in economic policy terms, within the Chinese leadership is evident if we compare the individual priorities and objectives of the current 11th five-year plan (2006 to 2010) with those destined for the coming 12th five-year plan: in the past, China has sworn by the mantra of "growth at all costs". This strategy is now giving way to a more development-oriented approach that puts the economic, social and ecological sustainability of economic activity at the forefront. Talk of aiming to double nominal GDP per capita within a ten-year period, which still featured in the 11th five-year plan, has been dropped. Instead, China is looking to achieve stable, but nevertheless relatively rapid economic growth. The new plan makes explicit reference to changes in the country's economic make-up, such as expanding the service sector and modernizing industry. The statements made on private consumption are of key significance: its share of GDP is to increase swiftly, household incomes are to grow in tandem with the economy, and wages and salaries in sync with productivity. China is also aiming to lift the incomes of its low-earners and boost the proportion of the population in the middle-income bracket. All of these plans are aimed at achieving an overarching objective, namely to spur domestic demand and, in doing so, reduce the reliance of the Chinese economy on foreign trade.

“Unhealthy” gross domestic product mix

Share of private consumption and gross fixed investment in GDP, in %



Source: National Bureau of Statistics China (EcoWin).

At the moment, predicting which specific measures the government wants to use to achieve the sort of change in China's growth model that has been outlined in these key objectives is like taking a stab in the dark. What is clear, for one thing, is that change has to, and indeed will, come. For another, it is evident that transforming the Chinese economy is a project that will require a considerable amount of time.

So what does all of this mean for China's medium-term growth prospects? With economic development in the world's industrialized nations leaning to the moderate side, it is presumably illusionary to expect the double-digit growth in GDP that was the order of the day prior to the crisis. Instead, we expect to see average economic growth of around 8.5% a year over the next five years (average 2003 to 2007: 11.7%).

These assessments are, as always, subject to the disclaimer provided below.

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