

# Australian Business Economists



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***China: what kind of recovery?***

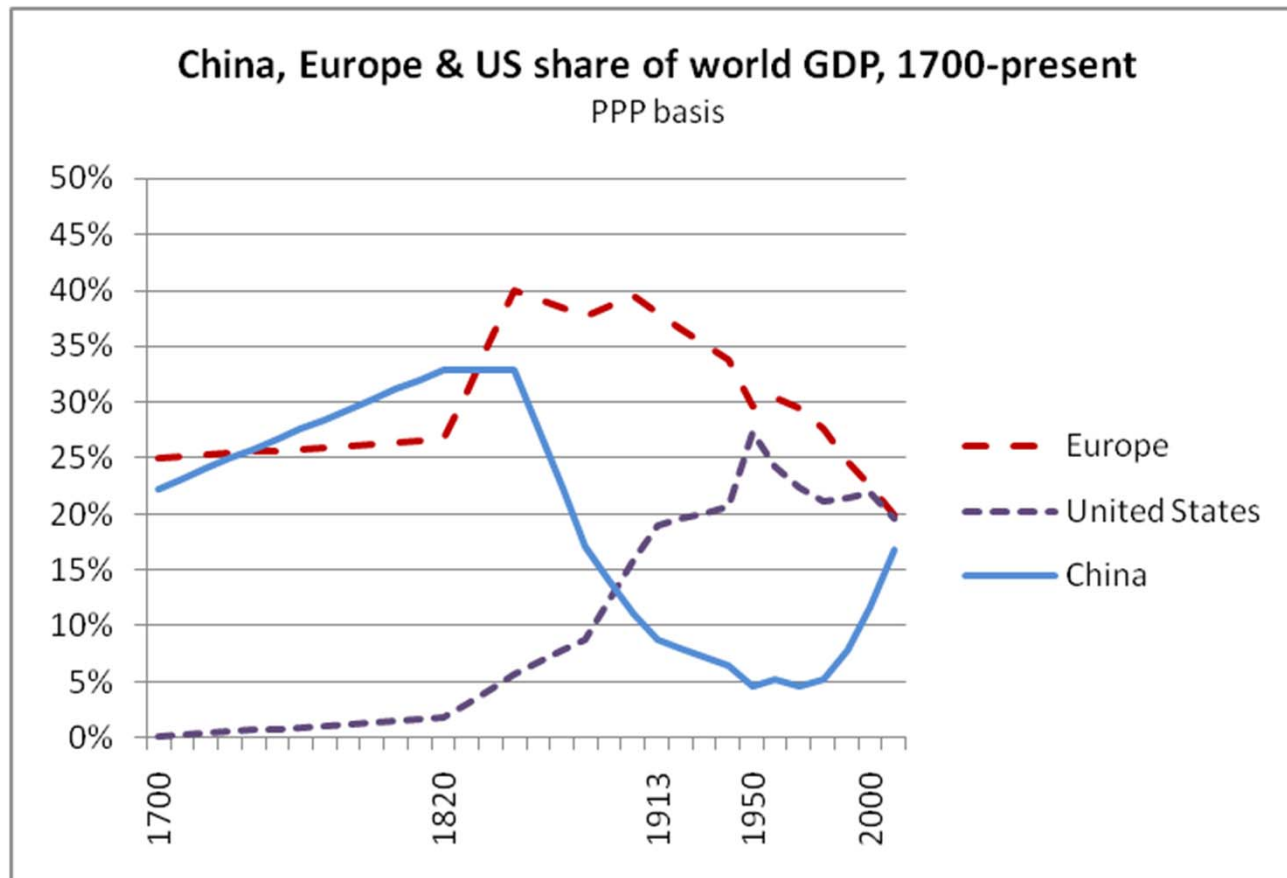
10 November 2009, Sydney

# China's growth: opportunities and challenges

Arthur Kroeber  
Managing director  
GaveKal Dragonomics Research

- Chinese economy – historic/structural view
- Immediate challenges
  - Stimulus structure and withdrawal
  - Improving efficiency of investment
    - Financial market construction
    - Domestic service/distribution market deregulation
    - Role of the state sector
  - Inflation/currency trade-off
- China's emerging global role
  - Global imbalances and economic governance
  - Outward investment
  - Energy and climate change

# China joins the Big Three

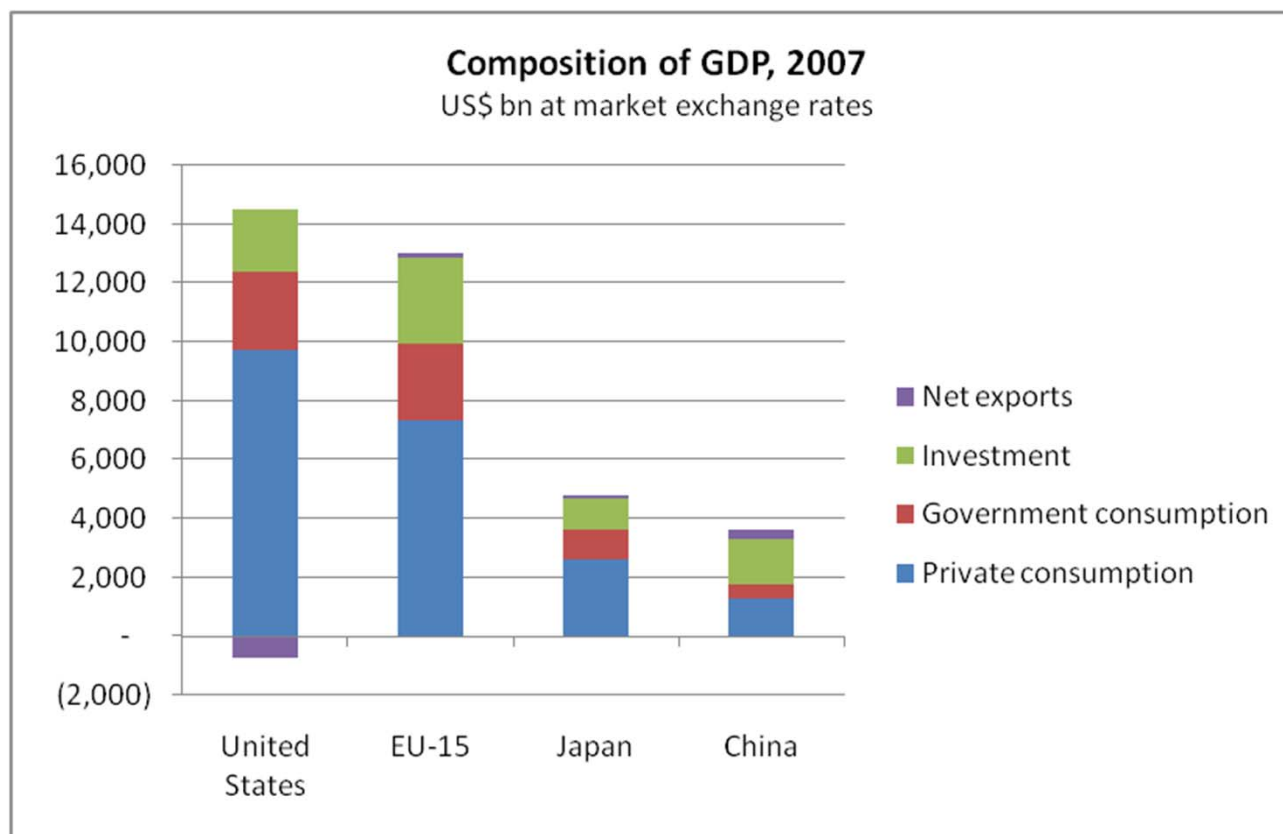


Source: Angus Maddison

**China will soon take its place as one of three major economic blocs.**

- Prior to 1840, China's share of global GDP was about equal to its share of global population: 25-30%. Its small role in the global economy 1840-2000 was an aberration.
- By 2030, the US, EU and Chinese economies will be roughly equal in size.
- Unlike Japan, China has signaled a desire to play a large governance role in the global economic order.
- But its political system remains the major obstacle to full integration.

# GDP of major economies



**China has a long way to go before catching up to the US in consumption – and therefore in innovative capacity.**

• In 2007, China's investment relative to other major economies was:

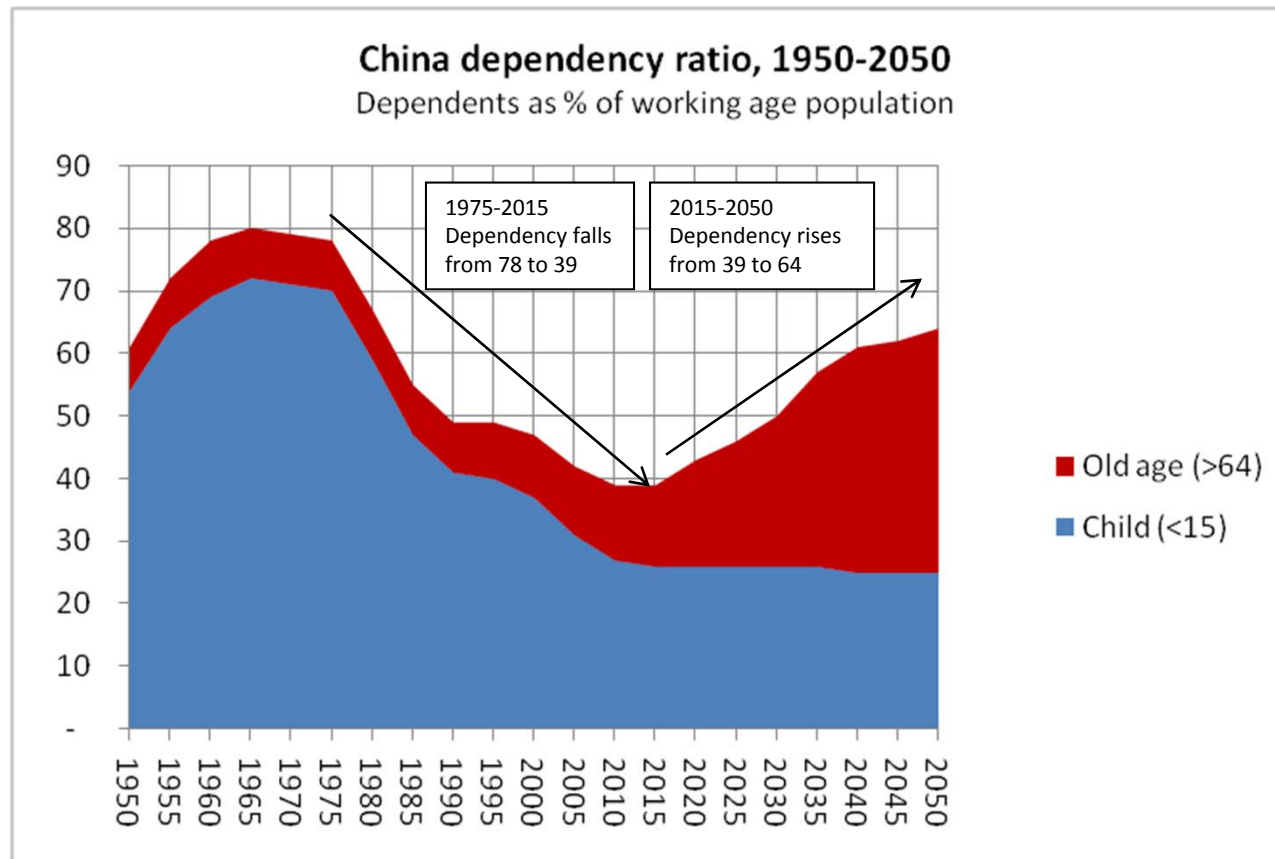
vs US	72%
vs EU	53%
vs Japan	144%

• But for consumption the ratios were:

vs US	13%
vs EU	18%
vs Japan	49%

• In the long run it is consumer markets, not investment, that drive innovation and technological change.

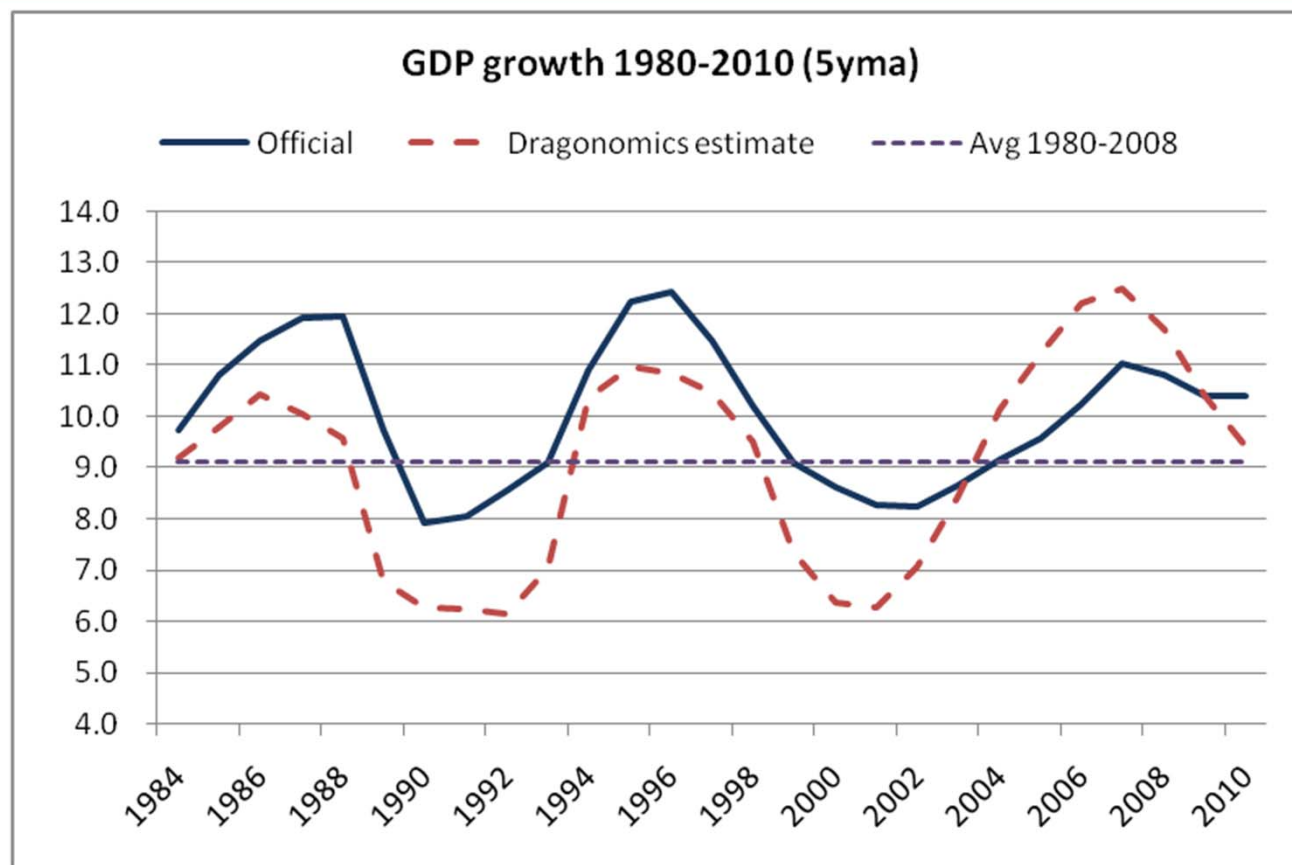
# Demographic destiny



## **China's demographic window is closing.**

- A large contributor to China's economic growth since 1980 has been a declining dependency ratio.
- Largely a function of falling birth rates – the drop started before the one-child policy.
- Beginning around 2015 the dependency ratio will rise, mostly due to an aging population.
- China's structural growth rate will almost certainly fall as a result.
- This 'demographic tax' can be partially offset by extending working lives and increasing education levels.

# China growth: long-term view



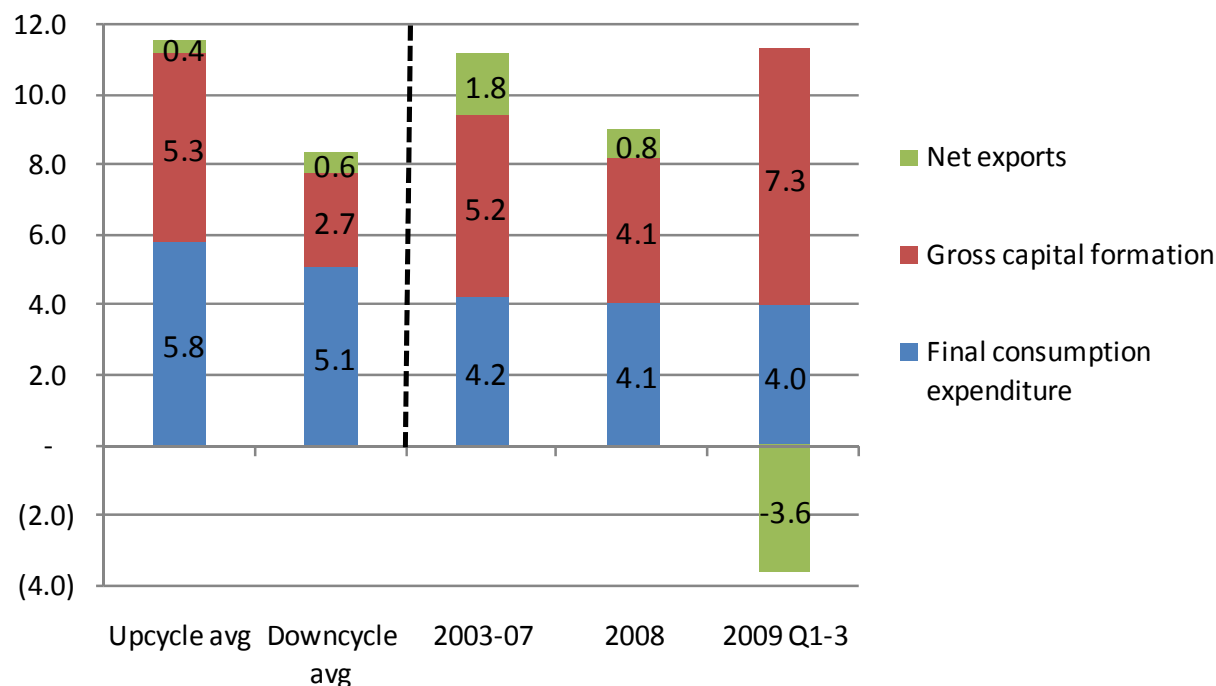
## **Needed: more investment efficiency.**

- Since 1980 China's economy has grown at about 10% year on official numbers, or 9% by our estimate.
- In the late 1980s and late 1990s cyclical slowdowns (aggravated by exogenous shocks) pushed growth down to around 6.5%.
- This time the external shock is greater, but so are government monetary/fiscal resources.
- In the short/medium term the key to sustained recovery is improved investment efficiency. This will pave the way for more consumption in the long run.
- Sustained 8% growth in 2010-20 is achievable.

# Where will growth come from?

## Contributors to GDP growth

Cycle averages vs 2003-09 actual

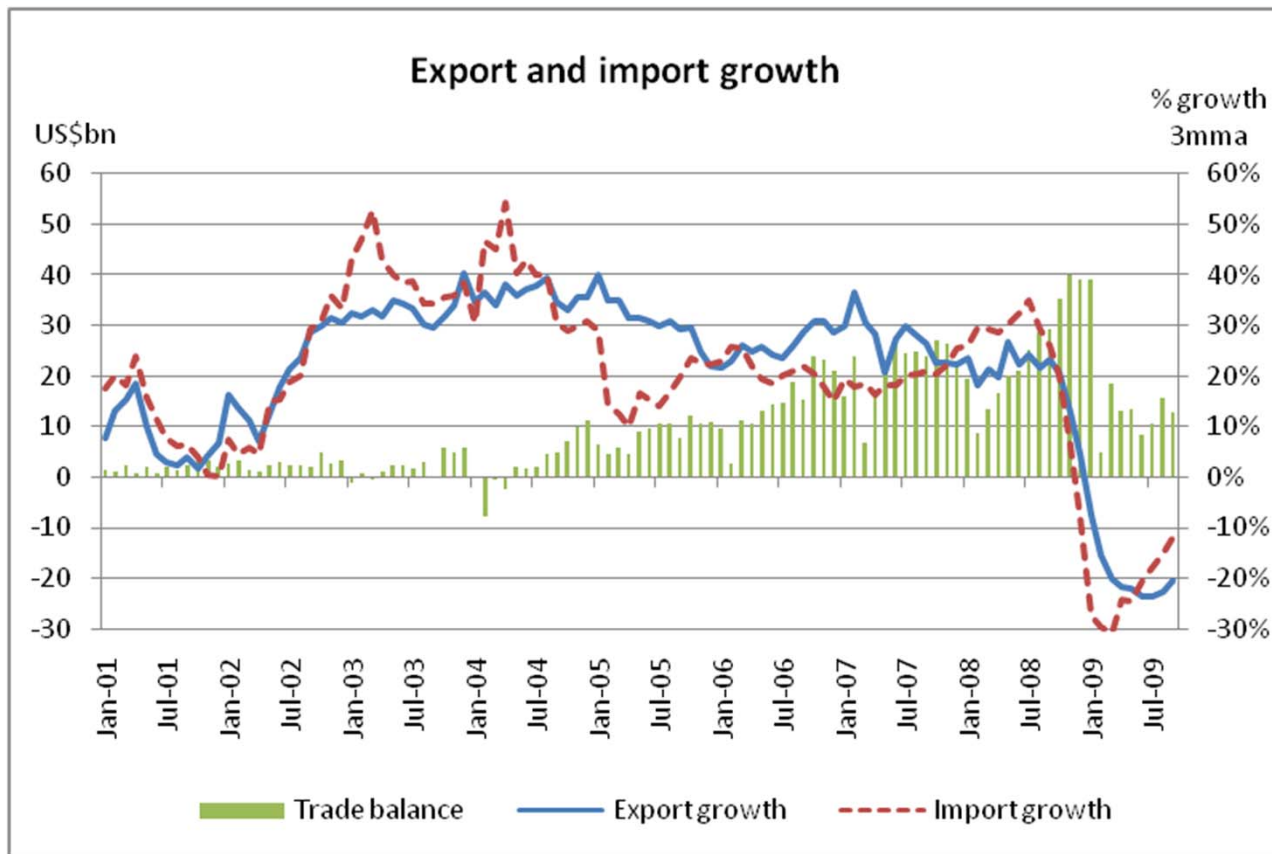


## How to get the magic 8%

- In 2009, export value will fall for the first time in 30 years (by 10%).
- Fiscal/monetary stimulus totaling 15% of 2009 GDP has created extraordinary investment-driven growth, focusing on infrastructure.
- Infrastructure investment (eg high-speed rail) is economically productive, not “bridges to nowhere.”
- Medium-term growth requires more private investment in higher-return projects.
- Long-term growth requires more consumption.
- For both, financial market construction and decreased barriers to internal trade are needed.



# Exports and imports



## **Exports and imports rebound; trade surplus narrows.**

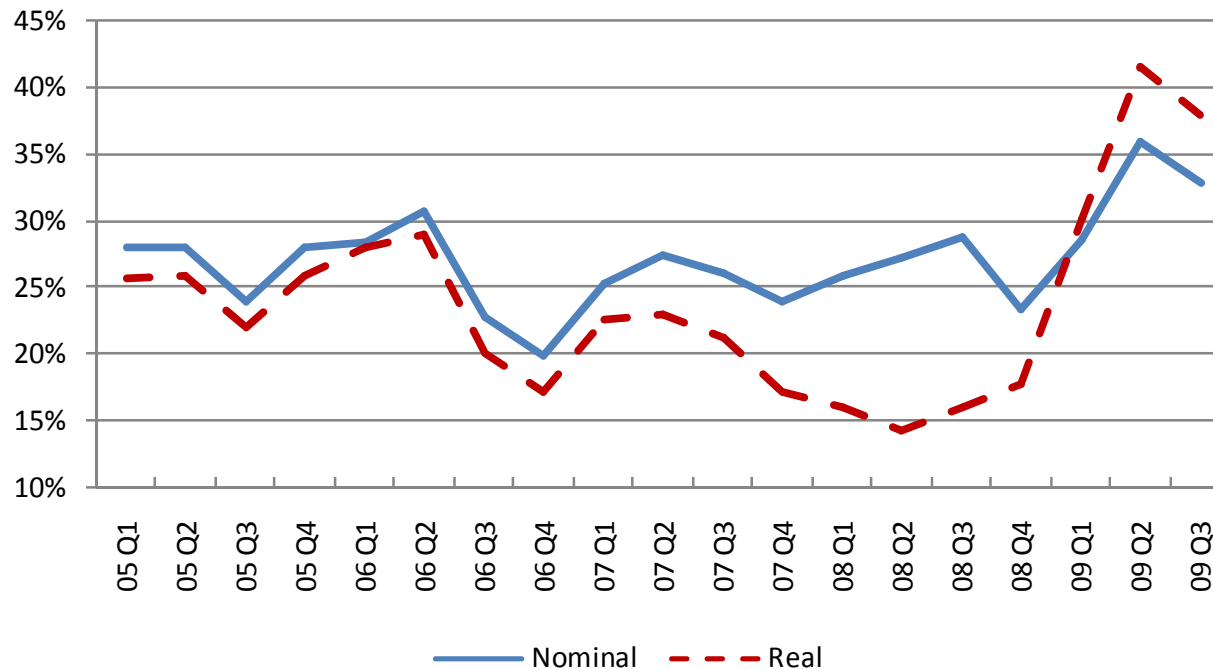
- Import growth rose sharply in Sep, to -4% yoy vs -17% in Aug. Volume demand for raw materials/equipment rose; negative commodity price impacts disappeared.
- Exports are also picking up: growth was -15% in Sep vs -23% in Aug.
- In Q4, we expect import growth of 12%; and export growth of -5%. The full-year trade surplus will be down about 31% on 08.

### **Trade surplus US\$ bn**

2007	262
2008	296
<b>2009f</b>	<b>204</b>

# Investment

**Fixed asset investment**  
quarterly yoy % growth

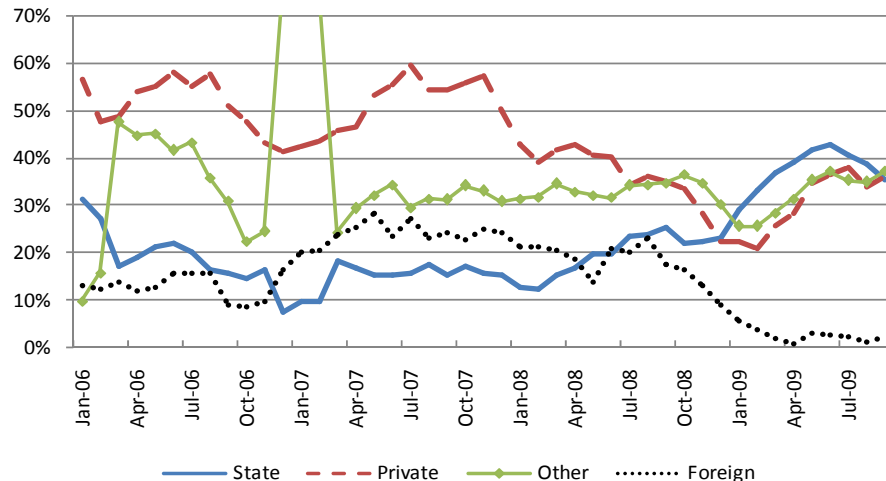


**Investment growth is very high, but slowing.**

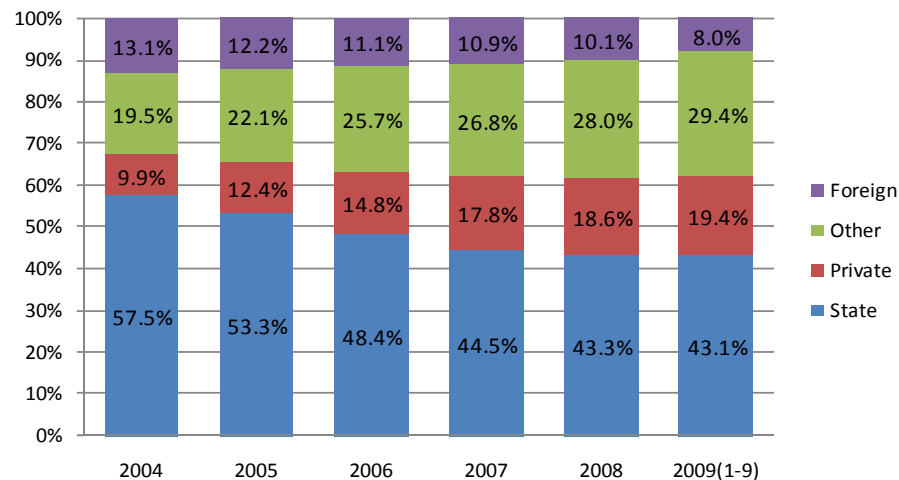
- Real FAI growth slowed to 38% yoy in Q3, from 42% yoy in Q2, but still higher than the average level of 21% during 2005-08.
- It rose 40% yoy in Sep, down from 43% in Aug.
- Infrastructure investment rose 53% yoy in Q1-3, up from 16% in 08, mainly supported by massive loan growth.
- Most FAI went into infrastructure and construction; manufacturing capex will grow more slowly.
- Gradual investment slowing is one reason why we believe GDP growth won't accelerate much in 2010.

# Investment by ownership

**FAI by enterprise type**  
monthly 3mma, yoy % change



**FAI value by enterprise type**  
% of total



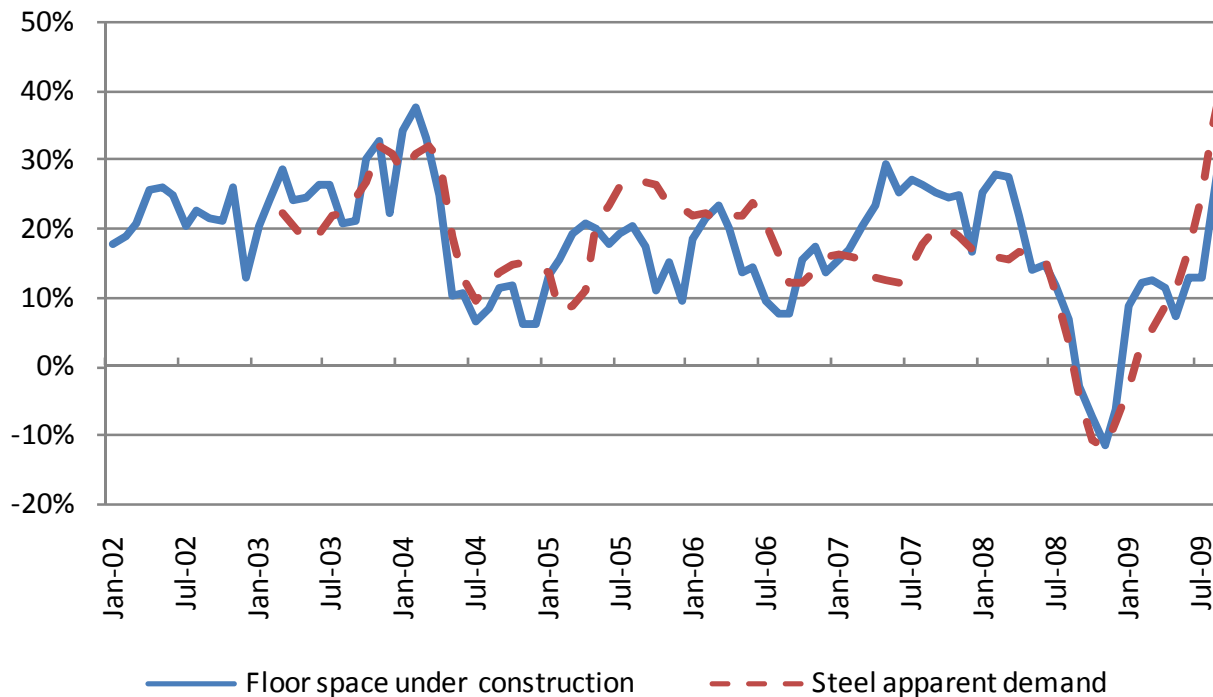
## The 'state-led investment boom' is somewhat overstated.

- In 2002-08, private enterprises were a key driver of investment growth and their share of FAI rose from 10% to 19%.
- In Q4 08 / Q1 09 state firms (blue in charts) took over as the investment growth driver.
- **But private investment bounced back into the lead in Sep**, growing 45% yoy vs 33% for state enterprises. Real estate is the main driver of stronger private investment.
- Investment by foreign firms, however, has yet to recover from its collapse.
- Ambiguous firm ownership classification means 29% of FAI is by firms not clearly state or private.
- These are mainly enterprises classified as "limited liability" or "shareholding" companies. We believe the majority of these are effectively state firms; but the private share may be rising.

# Construction and steel demand

## Construction growth vs. steel demand

yoy % growth, 3mma



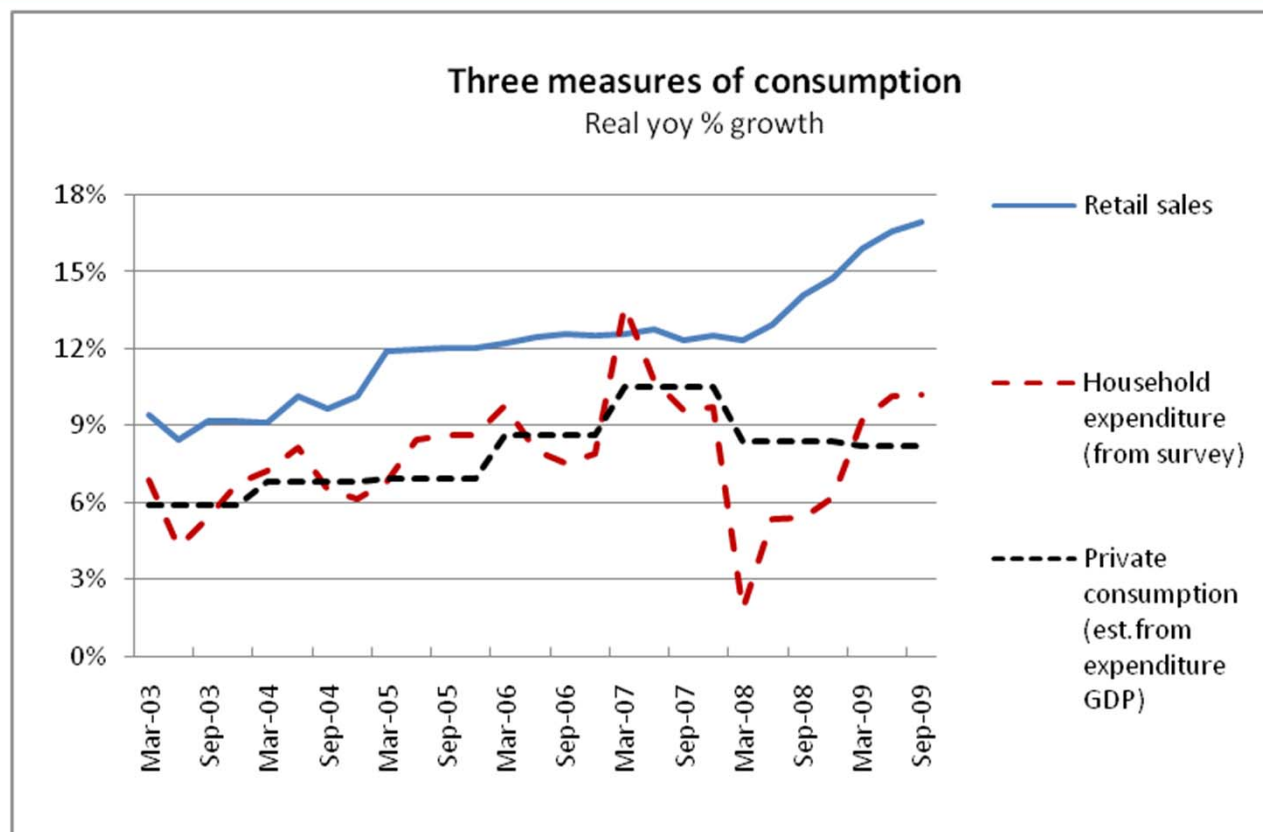
### Steel demand: picking up with construction.

- Growth in floor space under construction correlates well with apparent steel demand.
- Apparent steel demand growth surged to 50% yoy in Sep from 12% in H1. YTD steel demand growth of 22% exceeds 03-07 avg.
- We now believe stock-building plays a decreasing role.
- As with construction, we expect steel demand growth to stabilize at a level close to the 03-07 average.

### **China steel apparent demand, yoy % change**

2003-07 avg	19.4
2008	4.1
2009 Q1-3	21.6

# Consumption indicators

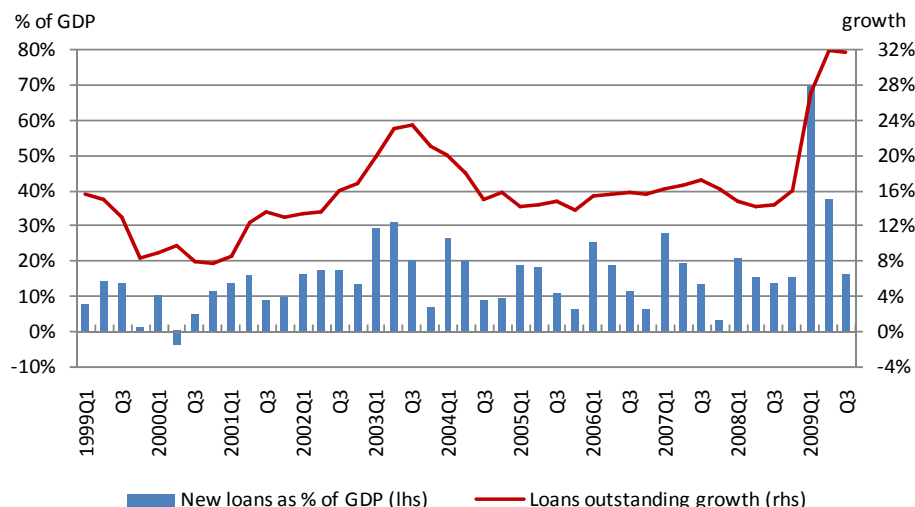


## **Private consumption is weaker than retail sales.**

- Real retail sales growth was 17% yoy in Jan-Sep. But this includes business and government purchases.
- Household survey shows 10% consumption growth.
- But expenditure GDP data imply private consumption grew at 8.2% in Q1-3, vs 8.4% in 2008.
- Both the household survey and implied private consumption in expenditure GDP show that consumption growth is far weaker than retail sales show, and may be slowing.
- Q3 PBC survey found 43% of urban residents want to increase saving; 15% want to increase consumption.

# Financing (I): loans

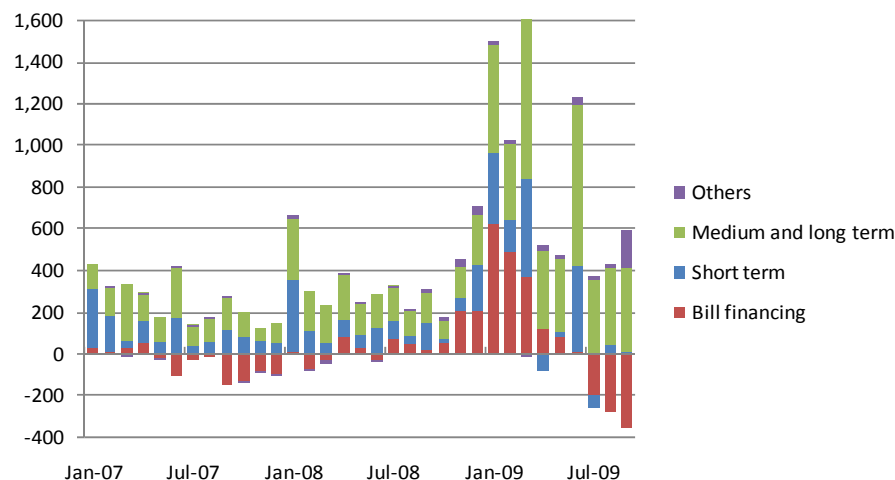
**Loan growth**



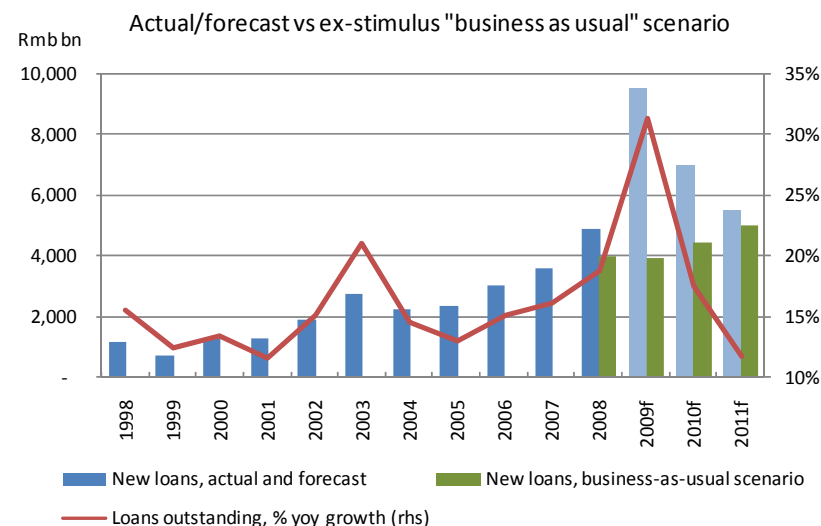
## New loans slowed.

- New loans in Q3 were Rmb1.3 trn, down from Rmb4.6 trn in Q1 and Rmb2.8 trn in Q2, thanks to the collapse of bill financing and short term loans (red/blue bars in Chart 2).
- Total new loans in 09 will reach Rmb9.5 trn, double the 08 figure. Loans outstanding will rise 32% yoy.
- Monetary stimulus will be eased over two years: by 2011 loan issuance will fall to 5.5 trn and loans outstanding growth to 12% yoy.

**Net new loans to non-financial institutions**  
monthly, Rmb bn



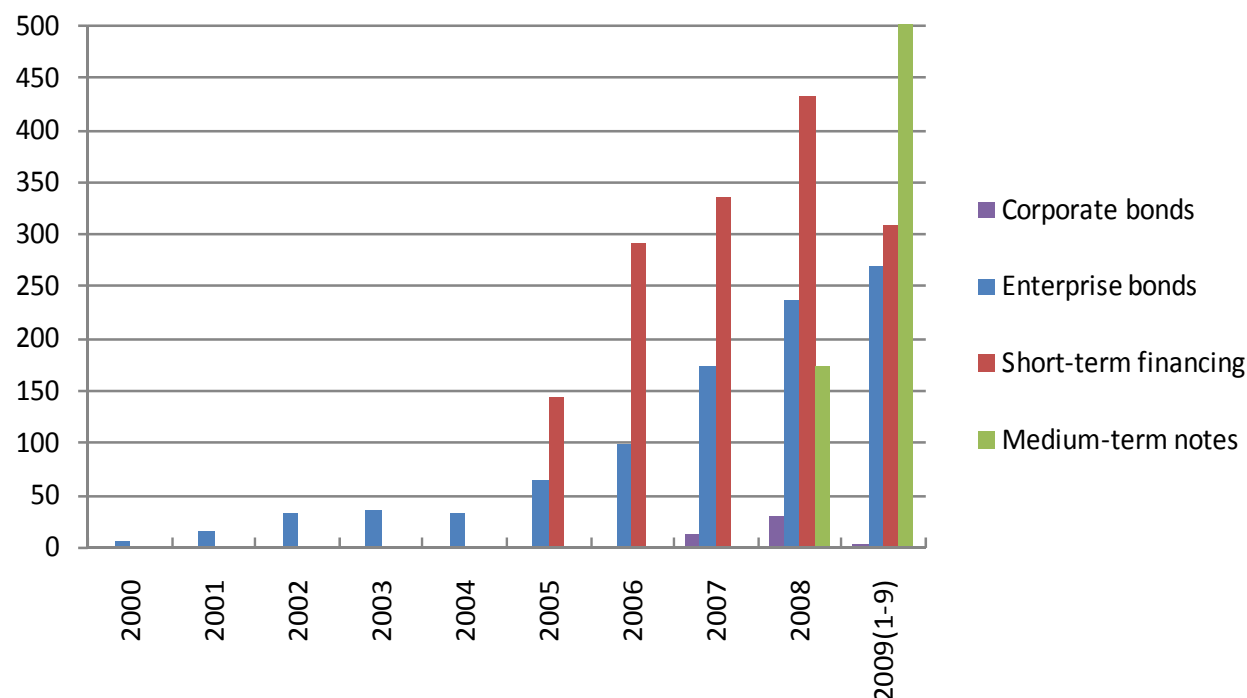
**Bank loans**



# Financing (II): bond market

**Bond issuance by companies**

Rmb bn



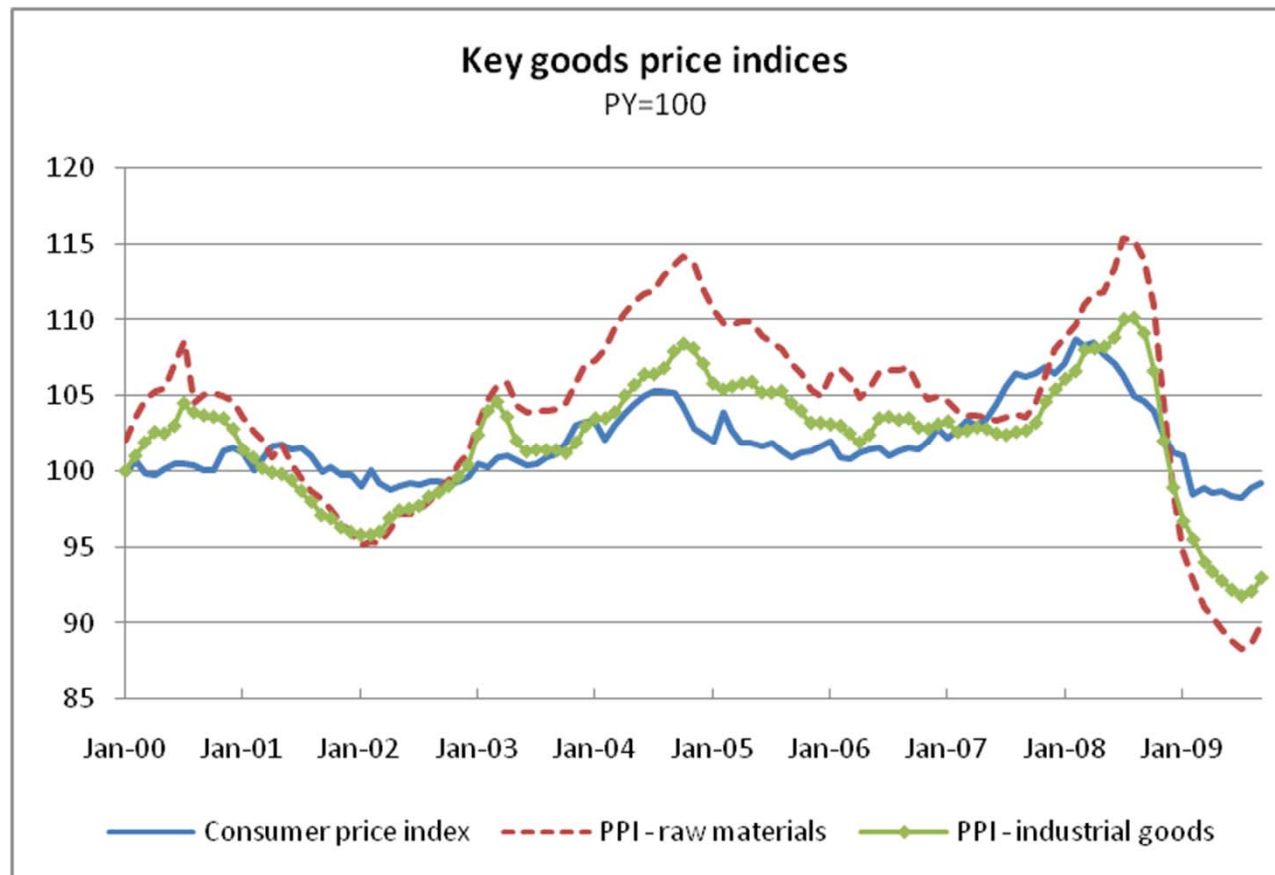
## **Bond market heats up.**

- Bond issuance in Q1-3 was Rmb1.1 trn, vs Rmb872 bn in 08. Tenors lengthened.
- 50% of issuance was 3-5 year medium-term notes, trading on the interbank market. 26% was 5-yr+ “enterprise” bonds issued by SOEs under NDRC quota. Stock-exchange traded corporate bonds re-started issuance in Jul after 10-month suspension.
- Most issuance is by local government window firms, funding stimulus projects. Loans remain the dominant form of corporate finance.

## **Sources of external corporate finance, % of total**

	2008 H1	2009 H1
Loans	88.0	86.9
<b>Bonds</b>	<b>3.5</b>	<b>6.6</b>
Stock	7.7	1.0

# Inflation: goods prices



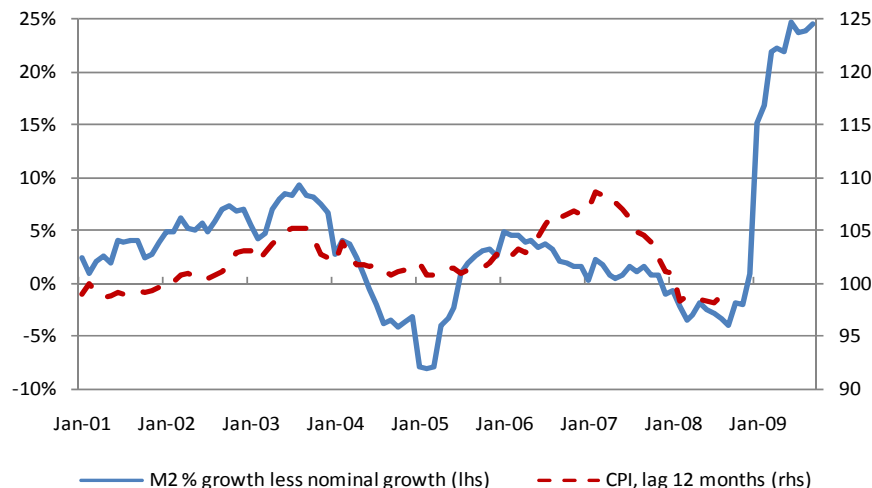
## **Deflation trend reverses.**

- PPI fell -7% yoy Sep and raw materials price index fell -10.1%. But on a month-on-month basis the indices have risen since Apr.
- Raw materials price index will probably shift sharply positive yoy in Q4. But remember that pass-through of raw material inflation into CPI is weak.
- CPI has run negative since Feb but has clearly turned up: it fell -0.8% yoy in Sep, up from -1.2% in Aug.
- Inflationary pressure is clearly building but in the absence of strong wage growth we are skeptical of how strong it can be. CPI will probably rise 2-4% in 2010.



# Inflation: monetary factors

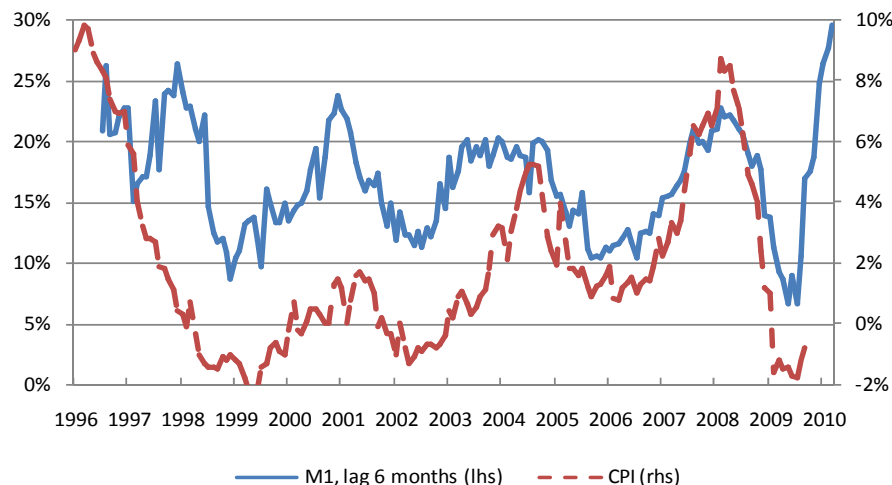
**Money growth and inflation**



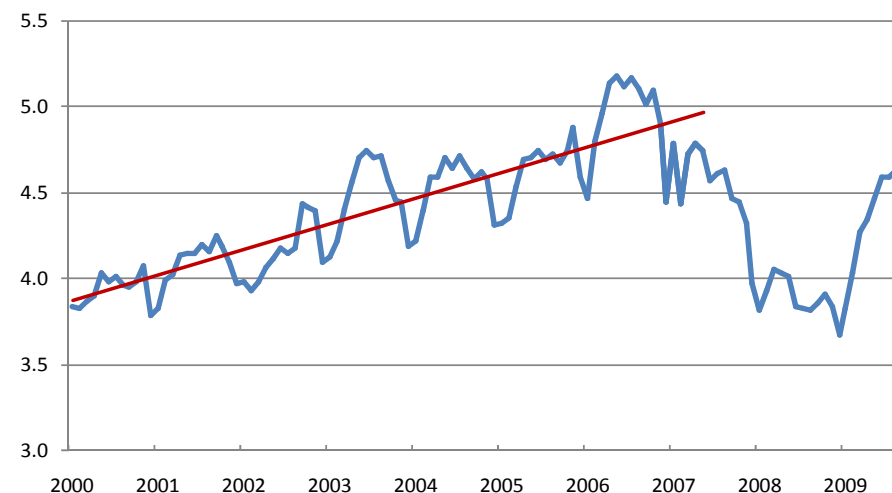
## **Inflation risk: more in assets than CPI.**

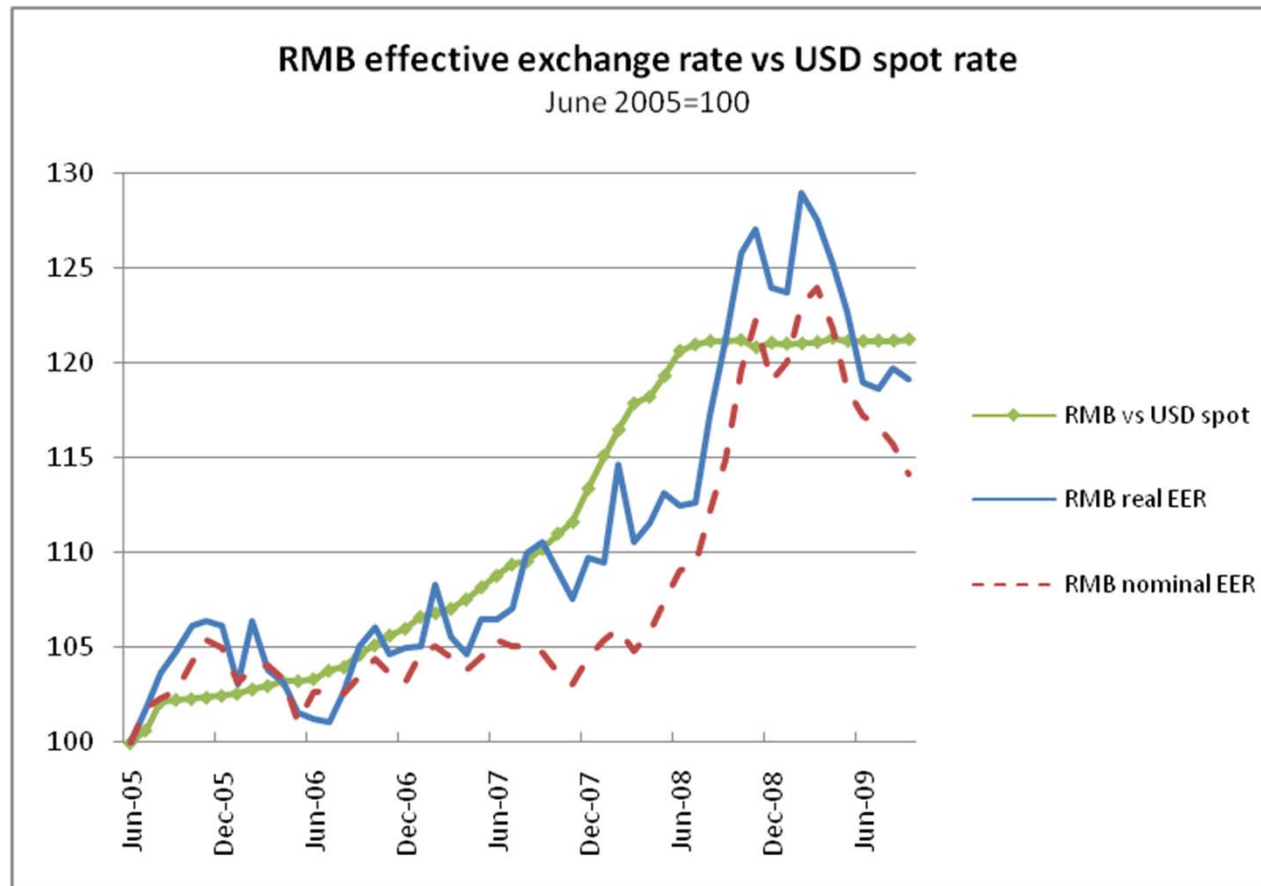
- CPI tends to follow M1 (6-mo lag) and the M2/nominal GDP differential (12 mos). Both indicators suggest strong inflation in 2010.
- But increased money supply mainly offsets a big fall in money velocity, as represented by the money multiplier which has yet to return to its 2000-07 trend line.
- CPI will rise, but not as high as M1 implies; the bigger inflation risk is asset prices.

**Money supply and CPI**  
monthly, yoy % change



**Money multiplier: M2/base money**





Source: Bank for International Settlements

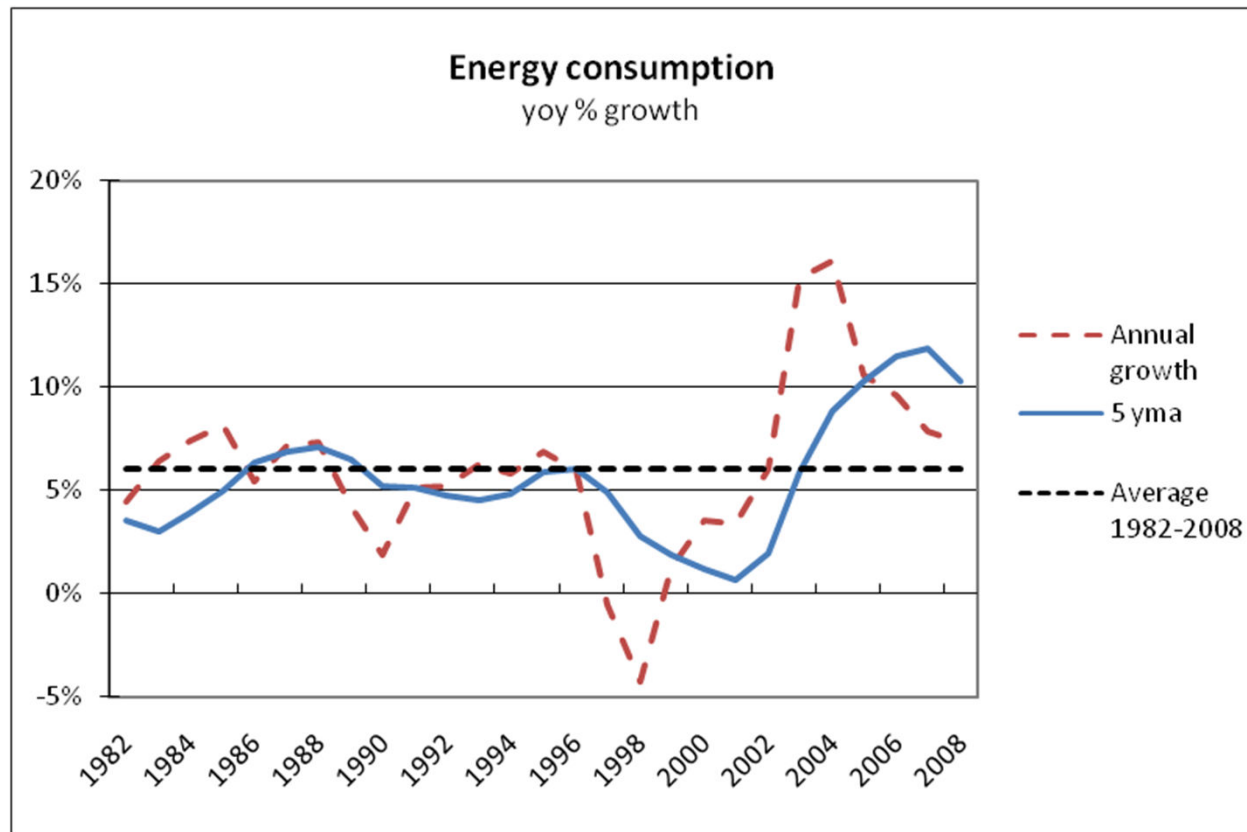
## **RMB/ USD: stable.**

- The RMB/USD rate has been stable at around 6.8 since July 08 and will remain so through 2010.
- On a real effective (trade-weighted) basis the RMB fell -8% from Feb peak to Jul, after rising 12% between Mar and Dec 08.
- But after that, real EER rose 0.4% between Jul and Sep, on dollar strength.
- In the past two years the real EER is up 9%.
- China's higher CPI/wage growth (vs trade partners) means real appreciation can continue, even without change to RMB/USD rate.

## **RMB/ USD forecast**

End 2010    6.8

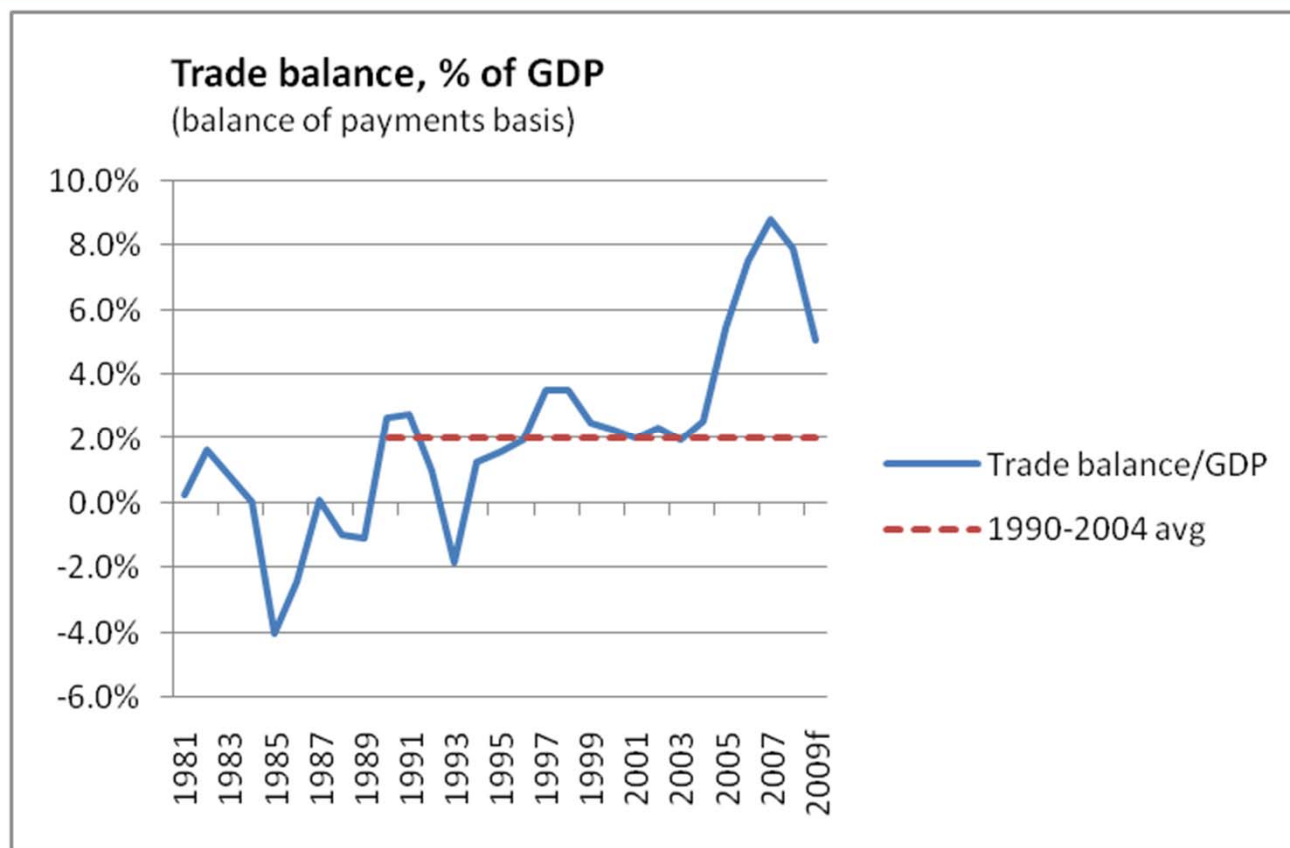
# Energy demand and growth



## **Beware the 'double deceleration.'**

- Since 02 China's resource demand has surprised on the upside. For the next few years it will surprise on the downside. We illustrate this with energy demand.
- In 02-07 primary energy demand averaged 12%, double the long-term mean.
- This resulted from a "double acceleration" of both GDP growth (from 8-12%) and the energy intensity of growth.
- Now we face a "double deceleration" as GDP growth falls from 12-8% and energy demand falls due to efficiency gains.
- Energy demand growth will be at or below the long-term mean in 09-11.

# Rebalancing: half done



## **Trade surplus falls from 8% to 5% of GDP.**

- Under our base case, China's trade surplus will be 5.3% in 09, sharply down from 7.9% in 08 and 8.8% in 07.
- The external balance is about half-way to returning to its sustainable long-run average of 2% of GDP.
- This is being achieved by a state investment push, which boosts import demand for raw materials and investment goods.
- But without strong organic growth in private investment / consumption, this risks creating a future trade surplus boom, as excess capacity finds an outlet in foreign markets.

- Infrastructure
- Urban development
- Financial services
- Logistics
- Automotive
- Energy – traditional and new
- Agriculture
- Resources

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