

Growth in China's Year of the Ox and Beyond

By Robert Huebscher

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Of the major global economies, China stands out because of its size and rapid growth. In both the short and long term, China is likely to grow faster than any developed market, creating opportunities for investors. To better understand China's economy in 2009 – The Year of the Ox – and beyond, we spoke with Rachel Ziembra, who works with Nouriel Roubini at the RGE Montior.

Ziembra is RGE Monitor's lead analyst for oil exporting economies (Russia, GCC etc) and China. She has an AB from the University of Chicago and an M Phil in International Relations (International Political Economy) from St Antony's College, Oxford University.

We spoke with her on March 5, 2009.

Since 1998, China has grown at 10% annually, but growth dropped to 6.4% in Q4 of 2008. The Chinese government is now targeting 8% growth for 2009. You have said it will be very difficult for China to grow more than 5% this year. What is the basis for your forecast?

Very clearly there has been a sharp slowdown, but you must be careful with China's reported growth statistics. Unlike most of the rest of the world, China just reports year-over-year growth statistics, and not quarter-over-quarter data. This makes it hard to track trends and compare with other countries. It also means that, as best as we can tell, on a quarter-over-quarter basis China's GDP in Q4 of last year was probably flat or slightly positive or negative, which sounds a lot worse than the reported 6.8%. On a quarter-over-quarter basis, Q1 of 2009 may be negative. On a year-over-year basis, growth will be more in the 5% range for the whole of 2009.

In general, we build our forecast based on sources of growth. China now faces contracting exports, slowing investment, and weakening consumption. In China, a critical source of growth is the property markets – both residential and commercial – which are continuing to contract this year. This contraction weighs on investment. Investment in China is 40% of GDP. Property is 20% of this 40%, or 10% of total GDP. That



contraction creates a pretty big hole to fill up. At the same time, exports are contracting and will continue to contract. Imports are contracting at a faster rate, and this may keep going for a few months. Things can deteriorate ahead, reflecting a deterioration of external and internal demand.

Government investment is the other area adding to growth today. But, despite government investment and the rollout of China's stimulus package, growth will be slower than the optimistic projections. Government spending will not be able to boost consumption as much as hoped.

Consumption growth is slowing. Retail sales have been propped up by government discounts to rural families to help them purchase items such as appliances. China's urban population is responsible for 75% of consumption, and rural families can't make up the difference. Job losses are continuing and may be higher than previous government estimates. There is still downside risk to consumption.

China is in a volatile environment, fueled by a fear of job loss. Traditionally, it is a country of savers, and it faces the risk of increased savings at the expense of consumption. There are not many signs of shifting to consumption-fueled growth, especially since the fiscal stimulus (which will support growth) is focused on infrastructure.

You have said that a more optimistic view for Chinese growth hinges on two key assumptions. What are those assumptions?

We believe our forecasts are reasonable, but we also look at the other scenarios. One factor that could accelerate growth – and this is a big factor – is the trajectory of the US and global economies. Consensus still expects the G3 economies to bottom out by early in the second half of this year and stage a recovery by late this year, and, if so, they could boost demand for Chinese goods. Our view is that recovery will not occur before at least the first half of 2010, and there is risk that the expansion will be sluggish and well below potential growth. Most of China's exports are bound for the US, Japan, and the European Union.

The global and US outlook really determines the outlook for China. Optimism for China requires a strong global recovery.

Given that most of China's investment is financed by retrained profits (which there won't be much of this year), capital expenditure is likely to be



weaker. Furthermore, further investment could further exacerbate existing overcapacities.

The second key assumption underlying an optimistic scenario is that monetary and fiscal policy responses will be effective to support and boost growth – especially consumption-led growth. But, despite the fact that China has been successful implementing infrastructure projects (its stimulus package contains a greater share of infrastructure spending than does the US package), we do not believe these projects will employ that many people. There is an increasing risk that Chinese policy response may lead to a temporary boost in growth midway through the first half of this year, only to slow again as the external environment remains weak.

Is there also a much more pessimistic scenario – one which, for example, says that Chinese growth was fueled by high financial and operational leverage in its manufacturing sector, and that “slow” (~5%) growth means excess capacity, unemployment, and social unrest. Without a social safety net like the one that exists in the US, could Chinese growth completely fall apart? What are the other significant downside risks?

There are downside risks to our scenario. Our scenario is more pessimistic than the consensus forecast, which is for 6.5% to 7% growth in 2009. Premier Wen today talked about 8% growth, even though within the Chinese government there is reportedly some skepticism about that figure. Like the US, China was dependent on the over-leveraging of the US consumer. China is less vulnerable to global liquidity trends than the rest of Asia, but it is increasingly reliant on exports. China and the US are among the countries with the most aggressive policy responses – most notably the Chinese fiscal policy response. Even though ultimately we believe this fiscal policy will be less effective than China’s government hopes and will take longer to be effective, it will support growth to some extent.

Given that we are halfway through the de-leveraging process, with foreign direct investment to China slowing and capital flows significantly lower, we believe global and Chinese growth will be sluggish (below potential) into 2011.

Unemployment is weighing very heavily on the minds of Chinese policy makers, and it is overshadowing this week’s meeting of the National People’s Council (China’s agenda-setting body). The combination of aggressive fiscal policy response and fairly determined responses to quell protests might limit concerns about social unrest. Chinese institutions still benefit from a fair amount of popular support, but the environment may get



worse in the next few months. Some policy measures designed to boost productivity may not boost employment. For example, sending college graduates to rural areas won't provide much income to these individuals or get many off the streets.

China is trying to build out its safety net, which is meager compared to advanced economies and does not cover rural and migrant workers. One of the best ways China can meet its policy goals is to spend more on unemployment insurance, pensions, health benefits, education, and other longer-term social programs. It is still possible that China will increase the funds allocated to such spending, perhaps extending unemployment benefits to rural workers

Longer term – say over the next decade – what growth do you expect for China?

The big question globally and for China is if and when will we go back to trend growth. We do not believe China will return to the 10% growth it experienced over the prior decade. For the long term, we forecast very solid growth for China, once it eliminates overcapacity and smooths domestic consumption. There will be slow growth in next few years – slower than 10% over last decade – but this growth will be more sustainable. And there is still a good chance it could be 7%-8%.

The overall challenge China faces is managing its transition to boosting consumption over the next five to 10 years.

How much of Chinese GDP is now domestically driven? What trends do you project for Chinese growth, in terms of the proportion that will be domestically- versus export-driven?

There are two components to Chinese GDP – corporate/domestic investment and private consumption. Consumption typically makes up 40% of Chinese GDP, which is well below most advanced economies and below many emerging market economies. Consumption as a share of GDP actually fell in the last few years (it is now about 36% of GDP), so it is not heading in the right direction. The other challenge for China, on the corporate side, is that even though net exports are only 18% of GDP, a disproportionate amount of capital expenditures are directed to that sector. In a sense, China's biggest challenge to promote domestic demand is to reorient its financing and production structure, by investing in more diverse sectors of its economy. It also needs to remove disincentives on selling domestically. China needs to reduce its overall savings rate, or at least the propensity to save externally. All parts of the Chinese economy save



(households, corporations, and the government, even though it runs a fiscal deficit). To rebalance its economy, the Chinese need to spend more rather than incurring the costs of running a large current account deficit.

You look at Purchasing Managers Indices (PMI) data to gauge the growth in China's manufacturing sector. How is the PMI data obtained, and what trends are currently taking place? How reliable is the data?

PMI data is widely used and consists of two indices: one maintained by CLSA [Ed. Note: a major Asian brokerage firm] and the other by the Chinese Federation of Labor and Purchasing. These come out at the same time but don't always agree. They are based on surveys of corporations and tend to be most effective when triangulated with other data points, such as factory closures and shipping volumes. The exact numbers can be questioned, but the PMI data seems pretty good in measuring trajectory and being a leading indicator.

We have been surprised by some of the reported recovery in export orders, given that export volumes continue to be weak. February export order data seems to show a very significant jump.

In general, the quality of reported economic data is improving. A lot more people are looking at it, but you must look at a range of data to get the full picture. For example, we look at power consumption data to gauge industrial growth.

If China's industrial output levels off or starts to increase, how can you determine whether this is a sign of inventory depletion or true organic growth?

In the current cycle, PMI temporarily bottomed out in November. The sharp slowdown was likely the result of retailers cutting their Christmas orders. But since then it has been increasing but continues to be below 50, signifying contraction in the manufacturing sector. [Ed. Note: a PMI value of greater than 50 indicates expansion]. The current rise could be the end of rapid de-stocking, rather than new demand. There is also a danger that government sponsored rebates created an artificial inventory buildup. Furthermore overseas buyers are unlikely to want to pick up as much inventory as they did in the past given the weak demand outlook. Really everyone is waiting to see what happens after the Lunar new year, as the one-week holiday tends to distort data.

China is not yet near returning to trend growth, even if retailers build up inventory slightly.



The bigger issue is whether certain incentives in the manufacturing sector will remain in place. These incentives provide rebates to manufacturers for exports and inhibit internal consumption. China's structure is still pointed to exports, and it is hard to turn the ship around. The Chinese are trying to create other incentives, but that takes time.

How dependent is China's economy on the housing sector and what impacts are failing housing prices having?

Property represents 10% of China's GDP. This has a significant component of growth, but the real effects are even greater. As in the US, the contraction in housing values not only affects construction but also related services, such as electricians, housing goods, and appliances. Chinese apartments are typically shells – with no appliances, electricity, or amenities. So lack of sales also affects these related sectors.

The year-over-year contraction in housing prices and volume has had a large effect. Just like in the US, the regions with biggest booms have the farthest to fall. The biggest year-over-year decline is in the south coast, where there are export factories, a lot of job loss, and people leaving. But all major Chinese cities are affected and declines in the commercial property market are just beginning. Declining corporate profits weaken the commercial property market.

How does the size of China's fiscal stimulus compare to that of the US? How do the spending priorities differ? What will be the key factors that influence whether China's stimulus succeeds?

This is tricky. It is hard to figure out how much of the Chinese stimulus is new versus a repackaging of other things it had already planned to do. However, setting that aside, government spending will add something like 2-3% percentage points to GDP growth. The headline figure is \$600 billion, or about 15% of Chinese GDP. (The Chinese government's share of its stimulus package is no more than 2% of GDP, with the rest coming from loans.) But this needs to be divided by two, because the spending is spread out over two years, so it is really under 8% per year. There is some evidence China will front-load the government part of its investment, to jump start its multiplier effects, rolling out more spending in 2009 than first assumed.

The US package of \$800 billion is 5.5% of GDP. Less than half of this amount is to be spent in 2009. Infrastructure spending in the US may take



longer to get off the ground, but payroll tax decreases and transfers to states will kick in over the next quarter.

In China, the bulk of spending is for infrastructure, a lot of which is for reconstruction after their earthquake and China has allocated funds to extend its railway network. Approximately 20% of the world's railway cargo is goods made in China, but only 4% of the world's railways are in China. China carries a disproportionate amount of rail cargo, causing problems like coal supplies being stuck in one part of the country because of adverse weather conditions.

The Chinese are not ready to rule out additional stimulus efforts. One of their choices is to shift spending between this and next year. In US, we have a clear budget, approved by Congress, with clear allocations. The Chinese had an initial announcement but no clarification of how much spending was truly new or how spending would be distributed among some components – especially how much would be spent on social projects.

The other big issue is “who is paying for what.” Initially, the government said it would put in a quarter of the money, spread out over 22-24 months. The rest would come from bank loans. Now, the government recognizes it will spend more, one way or the other. It has agreed to backstop the bonds of local governments, who face more pressure than the national government.

What is your outlook for US Treasury borrowing by the Chinese? Will China's needs for fiscal stimulus and internal spending result in less borrowing from the US?

Two factors indicate China will buy less US debt than last year. At the moment, China has less capital inflow. Last year it was inundated by inflows, as investors were betting on a revaluation of the Chinese currency. China bought a lot of US Treasury and agency bonds, at least until June or July of last year. With the drying up of liquidity and leverage globally, inflows to emerging markets are at best half of what they were in 2008, and significantly less than in 2007. China's reserve growth is at a significantly slower pace in 2009 than in the first half of 2008.

Just because China is spending more at home, that doesn't mean it will sell its foreign holdings. But their pace of growth could be slower. The Chinese government may finance growth by issuing domestic bonds.



The bigger issue is diversification. Within the US markets, China has moved from the short end to longer maturities, after having bought \$50 billion of Treasury bills a month from September to November of last year. China has increased diversification in what they buy, investing in commodities and providing resources to cash-strapped companies around the world. These loans may still be dollar-based and thus may not effect the fx markets as much.

If Chinese growth improves, it will receive inflows. If exports remain weak (due to weaknesses in the US, Japan, and the European Union), China will be reluctant let its currency appreciate, as it would create further pressures on the export market. China may have no choice but to buy US assets.

But we are also forecasting record US debt issuance. In our view, Treasury yields will go up, but not immediately. Given vulnerability of the European Union, the US debt markets will still attract capital. US saving rates are going up. Both corporations and individuals may continue to buy US Treasury securities.

What is happening in China's capital markets? You have mentioned that, unlike the US, lending is increasing and equity markets are up this year. Where are Chinese equities relative to conventional valuation metrics, like P/E ratio?

Chinese equity markets had a big run in the last few days and weeks, and they are up over 20% this year, with the smaller exchange (Shenzhen) up even more. Chinese domestic markets are still very speculative and dominated by domestic investors. There is not a lot of information to inform value-based investment. Corporate profit estimates, even in China, are still overly optimistic and might pose downside risk to prices.

In general, P/E ratios are starting to return to attractive levels. Equities had been very overvalued at their 2007 peak. Given the low real interest rate in China, with very low returns on deposits, there were massive flows into the equity markets.

There is some evidence is that some of the massive credit expansion last December and January has been put into higher-earning demand deposits and equity markets, contributing to the current boom in the equity markets. Given the overcapacities in many sectors, companies might be reluctant to spur capital investment, despite availability of credit.

Furthermore, many of the loans extended to date are short-term loans, which means that loans may not be going to small- and medium-size



enterprises and are not going to bigger projects the banks should be funding. In December and January, the bulk of new lending was short-term bill financing and reflected a reluctance among banks to take on the risky, longer-term lending that the government wants them to make.

The government is concerned about the scale of increase in lending (which has doubled in the last few months). This is definitely an indicator to watch: How much money is being spent, and where is it going to? In China, it is harder to measure things like the velocity of money or whether inflation will become a concern.

For longer term investors (20+ year time horizons), what is your assessment of China as an investment opportunity relative to the other BRIC countries or, for that matter, the rest of the world?

We are bullish on China's long-term growth and investment outlook. China is definitely positioned to outperform some other emerging economies countries, like Russia. China has a lot of good things going for it, such as the size of its internal market and the potential for expanding its capital markets. One big question is when China will make it easier to buy shares in their domestic market. Only a few approved institutions can buy on the Chinese market. Otherwise, you must buy Chinese proxies in markets like Hong Kong. The Chinese companies trading in Hong Kong are down this year, as Hong Kong is very clearly in a recession. China faces a hard landing this year and perhaps slower-than-trend growth next year. But if it makes the right policy decisions that may put it on its way to more consumption-based growth. Given some of the strengths in China's economy, China may be well placed to take advantage of some of the next expansion. But given its reliance on exports and investment, it is unlikely to lead the world economy out of recession. .

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