Economic Outlook for China

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1. Introduction

During October new economic data was in line with our expectations as mentioned in our earlier report. First, if we look to the inflation side we see a slight slow down in the CPI figure for September compared to August. In Fig.1, the trend in inflation is still considered to be down the hill in the rest of the year. It is likely that in 2012 inflation will be in a downward trend as long as the economy keeps the current pace to slow down. The CPI for September has been announced as 6.1%, which slowed down from 6.2% in August.

Food prices, which account for nearly one third of the basket of goods in the nation's CPI calculation, was up 13.4% in September from a year earlier and 1.1% month-on-month, according to the National Bureau of Statistics.

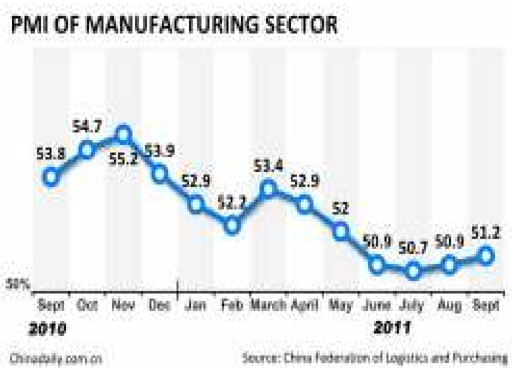
China's CPI hit a 37-month high of 6.5% in July this year, which was far above the Chinese government's full-year target of 4% for 2011. The government target will not be achieved for 2011 and for the medium term controlling inflation will still remain to be a top priority.

China's new Yuan-denominated loans in September stood at 470 billion Yuan ($73.7 billion), a drop of 131.1 billion Yuan from the same month of last year according to the Central Bank.

By the end of September, the outstanding broad money supply (M2), which covers cash in circulation and all deposits, rose 13 percent year-on-year to 78.74 trillion Yuan, the statement said.

The narrow measure of money supply (M1), which covers cash in circulation plus demand deposits, increased 8.9 percent year-on-year to 26.72 trillion Yuan by the end of last month. It also said that China's foreign exchange reserves totaled $3.2017 trillion by the end of September, compared with $3.1975 trillion by the end of June.

Some factors that drive prices upward have been contained but not eliminated, while inflation remains relatively high, the central bank said in a statement on its website. Therefore, stabilizing the overall price levels remains the top priority of macro-economic regulation. The Central Bank of China will remain on hold against possible hikes in inflation in the coming months. Although, the trend in CPI seems to be downward, a reversal in the current tight monetary policy should not be expected in the short term under current conditions.



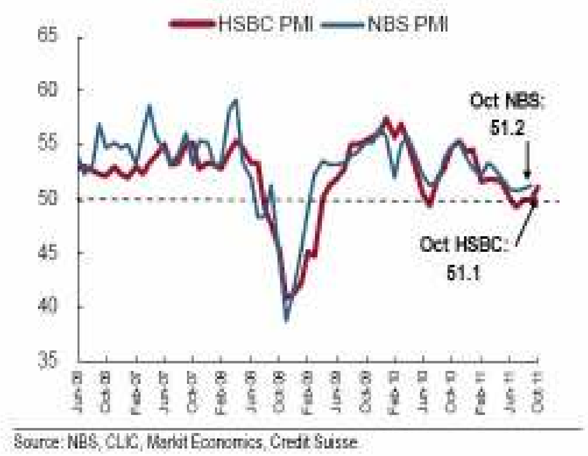
China's Purchasing Managers' Index (PMI) continued its rise in September, hitting 51.2 percent in September from 50.9 percent in August, the China Federation of Logistics and Purchasing (CFLP) said on Oct 14. China's Purchasing Managers' Index (PMI) dropped to 50.4 percent in October after rising for two consecutive months, down 0.8 percentage point from September.

The CFLP report said the drop indicated the country's economic growth might continue to slow down in the fourth quarter but the trend of a moderate economic increase would not change fundamentally. It estimated that the country's gross domestic product, or GDP, would grow around 9.2 percent in 2011.

The CFLP report said the 0.3 percentage-point rebound marks the PMI's two-consecutive-month rise, indicating that economic development is continuing to stabilize and that the worries of a hard economic landing are being eased.

PMI index reading contributed to the rise in the headline number, which climbed from 49.9 to a five-month high of 51.1 after adjusting for seasonal factors.

The generally positive PMI survey findings, coupled with stronger than expected industrial production and retail sales statistics for September, add to signs that economic growth in the world's second-largest economy is not heading for a hard landing.



PMI number announced by HSBC was back above the level of 50, indicating expansion. The Flash PMI for October is announced as 51.1 up from 49.9 (actual) in September. The output index has risen to the six-month high of 51.7, versus the previous 50.3. This reading is subject to revision on November 1st.

BlackRock, one of the largest asset management companies in the world, predicts that the Chinese economy will stagnant at 7-8% annual growth in the next few years.

BlackRock recently released research claiming that the outlook of Chinese economy is negative for the next few years. The report pointed out that the outlook for the Chinese economy in the next few years in not positive. GDP growth is estimated to stagnate between 7-8% in the next few years. The underlying reasoning in their growth forecast is based on the fact that today one RMB of GDP in Chinese economy now needs about 0.30 RMB credit compared to 0.17 RMB compared to 2002. Much of the economic growth is now reliant on credit. The report also mentioned that local government debt is unlikely to create a financial crisis in China. Banks have high earnings rates with high provisions for possible bad debt.

2. Rebalancing of the Chinese economy

Income from overseas investment has been increasing rapidly in China. China is not only exporting to the world but also investing overseas. Rising labor costs is reducing the manufacturing capacity in China. Chinese companies are also increasingly investing overseas and seeking new investment and production opportunities abroad. In line with the government's efforts of rebalancing the economy, banks are lending less to manufacturing and industrials. We should also note that service industry is taking a share of 50% in the total FDI to China, which shows the changing structure of the economy and investment.

China's central banker, Zhou Xiaochuan, argued in his speech in Beijing that the Chinese economy is already rebalancing. China's Central Bank emphasized that the rebalancing process will take time and it is already happening. Current account surplus in China peaked in 2007-2008 at around 10% of GDP and post crisis period declined to 5.5% last year and to a very low point of 2.8% during the first half of this year. Central Bank predicts this ratio to be around 4% for 2011 overall. China is not only exporting to the world but also increasingly investing overseas. In China's new investment projects a lower portion is going to the manufacturing industry. There has been a decrease in the expansion of manufacturing capacity in China. Banks are lending less to the industrial enterprises, but more loans are given to infrastructure or service industry projects. China's economy is not running very huge current account surpluses as it used to have.

Final message is be prepared for potentially bad global scenario. China should be ready to provide support. Fiscal policy is likely to be used by Beijing. Last time fiscal stimulus was done through the banking system, however this method is inefficient and creates distortions to the risk evaluation system of the banks. To have a more efficient and developed financial industry the government's use of banking system as a part of fiscal stimulus is distorting the risk assessment abilities of the banks. If needed a fiscal stimulus should be done in a more traditional fashion through the increase of government spending. In China public debt is low relative to GDP, so there is a lot space for maneuver for the government in terms of increasing spending. A stimulus aiming to boost household income and consumption would be used in case of a worst case scenario. Continuing exchange rate appreciation at the same time and rebalancing the Chinese economy will be the likely choice of the central government.

3. Summary

The next ten years will be crucial for the Chinese economy in terms of transforming its economy from an export driven economy into a consumption driven one. The process will pose several challenges, however even in a worst case scenario we should note that China will only face low growth rates that might be around 7%, which is still well above the growth rates of many other countries. The most likely scenario is the continuation of the current slow down with the current pace, and probably we might see GDP growth rates around 8% during 2012. China with its transforming economy will continue to support the global growth in the next ten years. It should be noted that traditionally the saving rates in Chinese households are quite high. However, it should be noted that China was a closed economy for a long period and today this is changing slowly. Therefore, the consumption is growing at a respectable pace with growing consumer confidence even during global slowdowns.

Overall, a growth rate around 8% is not going to create any panic in Beijing since this is something expected in line with the ongoing economic transformation of the Chinese economy. Inflation on the other hand is still considered to be a priority for the Chinese economy in 2012. This is mainly due to the constraints in the monetary policy of China. Because of the exchange rate policy Central Bank is continuously buying foreign currency from the market and supplying RMB. For this purpose a more balanced current account is also one of the major goals of the Chinese government. If a more balanced current account surplus can be achieved as a result of economic transformation, then this will reduce the pressure on RMB and thus will enable Central Bank to be more flexible in terms of monetary policy and fight against inflation.