Slow-down in Chinese economy

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Slow-down in exports for the Chinese economy

For the first time in a year, China recorded a trade deficit of **$31.48 billion** in February, as import growth far outpaced exports.

Exports rose 18.4 percent from a year earlier to $114.47 billion in February, while imports were up 39.6 percent to $145.96 billion, according to the customs data.

The fast trade expansion was fueled by the lower comparative base for last February, when the Chinese Lunar New Year holiday cut working days from the month and skewed trade data. The week-long holiday fell in January this year.

After seasonal adjustments, the annual growth of exports slowed to 4 percent in February while that of imports was cut down to 9.4 percent.

Exports this January fell 0.5 percent from a year earlier, *the worst slowing in more than two years*, and imports fell even more sharply, plunging 15.3 percent.

China's trade with the European Union, its largest trade partner, grew 4.7 percent year-on-year in the January-February period to $79.8 billion. However, China's sales to the Eurozone slid 1.1 percent in the first two months year-on-year.

In February, the United States, the nation's second-largest trade partner, replaced the EU as China's largest export market, as monthly sales to the US outnumbered that to the EU.

China's trade with the US gained 9.2 percent year-on-year to $66.05 billion.

Export PMI and expectations for 2012

As export PMI data confirms there is a slow down in the export industries of China. However, at the same time manufacturing PMI in China showed signs of bottoming out.

China's factory sector expanded slightly in January, confounding expectations for a contraction and supporting hopes the world's second-biggest economy will avoid a hard landing, a government purchasing managers' index showed.

A similar HSBC survey showed the sector contracting the least in three months, further backing the view that a downturn in manufacturing may be bottoming out as the government adopts modest measures to support growth.

The official PMI rose to 50.5 in January from 50.3 in December, beating market expectations of 49.5 as new orders rose to a three-month high.

We should mention that the existing slow down is not creating a panic in Chinese financial markets due to the strong domestic demand which is currently more than enough to substitute the international demand.

The increasing domestic demand in China is not a temporary trend. On the contrary, it is quite strong and expected to last for the coming decade and so on.

Housing market in the Q1/Q2 2012

During January and February we have seen a year on year decrease in home sales in China. This decrease is mostly due to the heterodox measures of the central government to avoid a bubble in the real estate industry. Even though local governments benefit most from increasing housing prices, central government is pushing hard for increasing the low income housing available by subsidized policies and restrictions on the purchase of a second house. Credit is also squeezed against speculative transactions in the housing market. Furthermore, it can be expected that government will continue its effort to control housing prices and even let it fall for the next quarter in controlled manner.

On the other hand, even though the home sales and purchase of land parcels has dropped with respect to 2011, overall the real estate projects in second and third tier cities continue to grow.

We can expect that due to rapid urbanization in China there will be increasing pressure on commodity prices in the near future. This is due to the transition in demographics of Chinese population.

In 1990 about 20% of the Chinese population was living in urban areas. Today this ratio is slightly over 50%, but this rapid urbanization will not stop anytime soon.

Furthermore, China has started to relax the one child policy, which might slightly increase the population growth from its very low levels.

Construction industry, which is the most important industry in the development of China, will require more and more commodities to be imported. In summary, we can expect that in the long run **there will be higher pressure on commodity prices**, given the fact that China imports most of the commodities that is being used in its manufacturing and construction industries.

Increasing labor costs in China

Traditionally Chinese economy had the advantage of cheap labor and thus attracted a significant amount of foreign direct investment. Today Chinese manufacturing industry is facing a big challenge due to the increasing labor costs in the coastal regions. However, in the interior regions of China still labor cost is very low. There is increasing income gap between the rapidly developing coastal regions and the interior regions of China. Therefore, government is providing extra incentives to reduce the gap of development in different regions of the country.

Increasing costs in the coastal cities is expected to continue in the coming years. Since most of the export led manufacturing industries are located in coastal areas, companies cannot move their production to interior regions where labor costs are lower. This transition cannot happen very quickly, and even it happens still there will be important costs associated with moving the production based on the coastal regions.

China is a country that imposes restrictions on labor mobility. There are rigidities in the so called ‘houkuber’ system, which simply means that you are the resident of the place that you were born. First tier cities such as Beijing and Shanghai do not allow immigrants from other cities to become residents of Beijing or Shanghai. This also means less access to health, education and social welfare opportunities for immigrant workers. Adding the high living cost in these cities, wages are continuously increasing.

Labor wages are expected to continue to increase during 2012, especially in the coastal regions.

China will remain number one in manufacturing, but it is transferring higher costs to consumers.

China needs to focus on expanding the private sector and the services sector to avoid failing into the so-called middle-income-trap.

China’s interior provinces will likely stagnate in economic growth if major reforms do not take place.

Easing inflation in 2012

China's inflation rose in February at its lowest pace in 20 months, providing more room for the government to stimulate growth in the world's second-largest economy.

The consumer price index (CPI), a main gauge of inflation, increased 3.2 percent year-on-year last month. It eased from a 4.5-percent rise registered in January, during which shopping spree in the Chinese Lunar New Year holiday boosted retail prices.

With inflation pressures fading, it leaves Chinese policymakers with more room to further loosen the monetary policy so to shore up growth.

The pullback in February's CPI rise, along with continuous food price declines, indicates the government's inflation control target could be reachable this year.

The Chinese government has cut the projected economic growth to 7.5 percent for this year and aims to keep the CPI increase to around 4 percent.

In the first two months, the country's CPI climbed 3.9 percent compared with the previous year. On a monthly basis, CPI dipped 0.1 percent in February.

On the other hand, China's national fiscal revenue rose 13.1 percent year-on-year to 2.09 trillion Yuan ($330.27 billion) in the first two months, according to the Ministry of Finance.

The annual growth rate decelerated from 24.8 percent recorded last year, but higher than 10 percent recorded in the fourth quarter of last year.

In summary

Inflation seems to be in control and during 2012 can be expected to be around 4-4.5% level. This enables the Central Bank to be more flexible in stimulating growth if necessary. However, monetary policy and credit expansion will be used if the growth rate falls below 7.5% level. This level is already the expectation of the central government and considered consistent with the transition of the Chinese economy.

During the transition from an export led to consumption led growth model, growth rates are expected to slow down, combined with the weak international demand manufacturers will have to target the domestic market more heavily in order to substitute international demand.

In summary
During the first two quarters of 2012 increase in the labor costs might slightly slow down, but the long term trend is definitely upward.

Domestic demand seems to be strong for the first quarter of 2012, assuming international conditions remain as it is, domestic demand will play an important role as the driver of growth during 2012.

Inflation is expected to remain under control during 2012 overall. The government announced a target level of 4%. The target level might be exceeded slightly and we expect it to be somewhere around 4-4.5%.

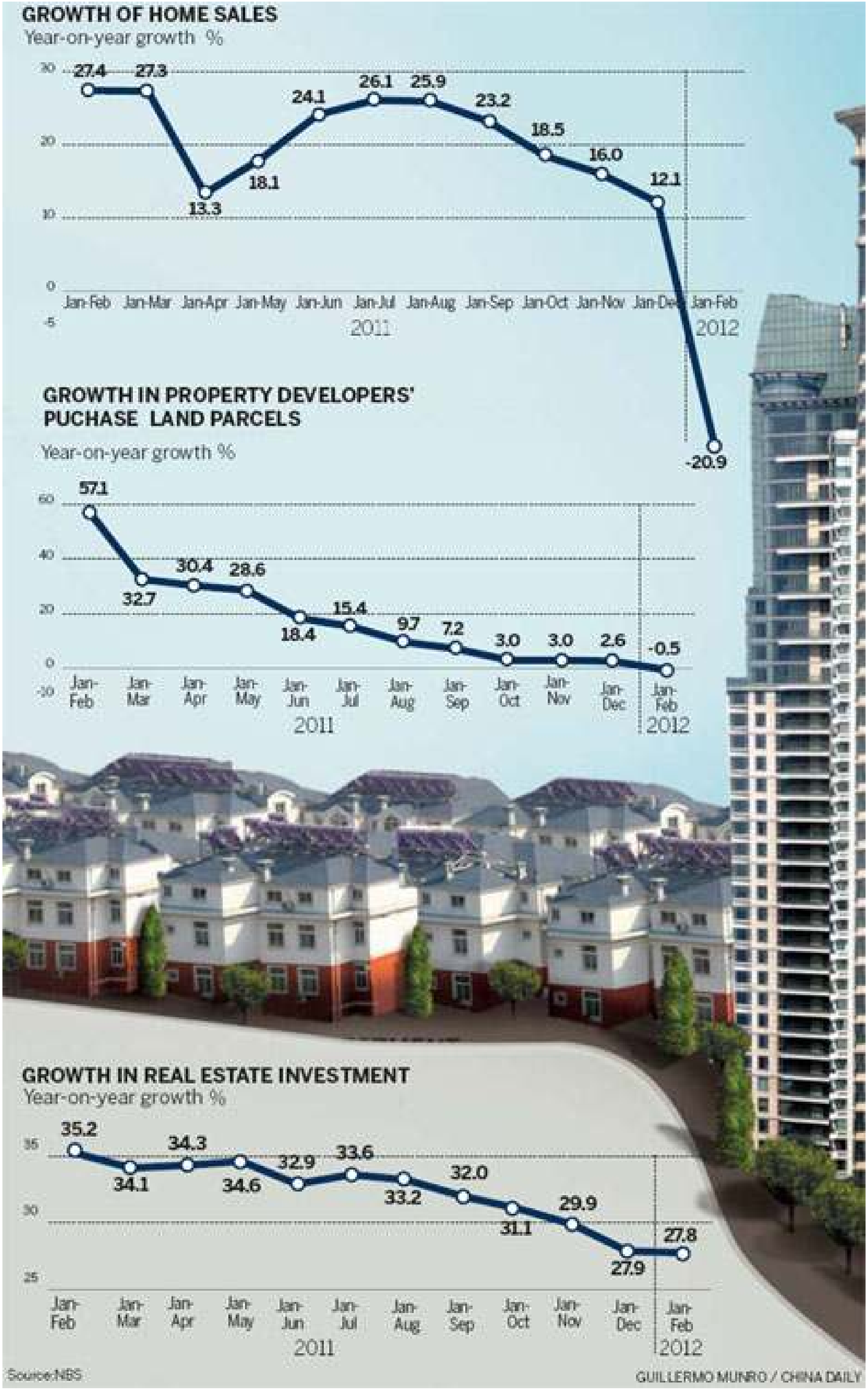
Central Bank of China (PBOC) is expected to remain prudent and cautious in terms of resorting to expansionary monetary policies.

Fiscal side is stronger and central government has a lot of options to stimulate the economy using fiscal policy tools. Depending on the international conditions Central Bank might start to cut the reserve requirement ratio in Q2 or Q3.

However, **fiscal policies will be the first choice to stimulate growth** and we do not expect large stimulus plans for 2012. The government is aware that the existing growth model is not sustainable in the long-run, therefore currently slower growth rates are somewhat desired to allow for restructuring of the economy, increasing energy efficiency, lower energy demand growth, and better utilize resources with lower costs to environment.

On the exchange rate side, Central Bank already started to stimulate the economy by allowing Yuan to devalue slightly against dollar and other main currencies. With the easing of inflation, **we expect Yuan to preserve the current level or slightly depreciate against USD** during 2012.

Yuan is expected to preserve its current hard-peg with a basket of currencies.


GROWTH OF HOME SALES
Year-on-year growth %
27.4 27.3 13.3 18.1 24.1 26.1 25.9 23.2 18.5 16.0 12.1 -20.9
Jan-Feb Jan-Mar Jan-Apr Jan-May Jan-Jun Jan-Jul Jan-Aug Jan-Sep Jan-Oct Jan-Nov Jan-Dec Jan-Feb
2011 2012
GROWTH IN PROPERTY DEVELOPERS' PUCHASE LAND PARCELS
Year-on-year growth %
57.1 32.7 30.4 28.6 18.4 15.4 9.7 7.2 3.0 3.0 2.6 -0.5
Jan-Feb Jan-Mar Jan-Apr Jan-May Jan-Jun Jan-Jul Jan-Aug Jan-Sep Jan-Oct Jan-Nov Jan-Dec Jan-Feb
2011 2012
GROWTH IN REAL ESTATE INVESTMENT
Year-on-year growth %
35.2 34.1 34.3 34.6 32.9 33.6 33.2 32.0 31.1 29.9 27.9 27.8
Jan-Feb Jan-Mar Jan-Apr Jan-May Jan-Jun Jan-Jul Jan-Aug Jan-Sep Jan-Oct Jan-Nov Jan-Dec Jan-Feb
2011 2012
Source:NBS
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