ING investmentweekly

November 30, 2009

The Chinese Economy, Policy Issues and Prospects

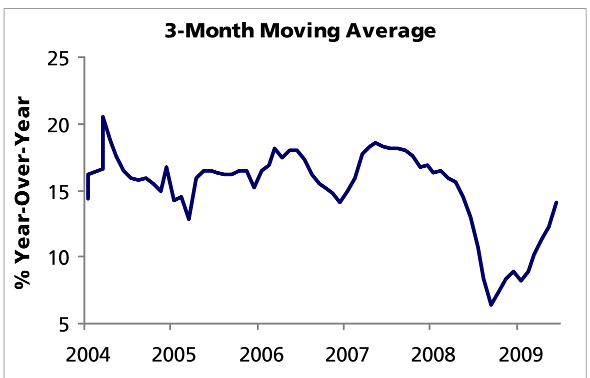
Tanweer Akram
Global Rates,
Fixed Income

The recently concluded high-level policy meetings between U.S. and Chinese leaders highlights China's crucial role in the global economy and the international financial system. In order for the global economy to continue its revival, sturdy growth in China and a decent recovery in the United States are essential.

The Chinese economy is in the midst of robust rebound. Chinese authorities acted quickly in response to the global financial crisis and economic slowdown, easing both fiscal and monetary policy substantially to support the economy. Monetary authorities cut the policy rate, lowered reserve requirements and encouraged banks to lend. The magnitude of fiscal expansion was quite impressive, as public spending was ratcheted up, mainly on various public investment projects but also by increasing public consumption and transfers. Crisis-related discretionary expenditures in China are expected to amount to over 3.0% of GDP during 2009 and 2.7% of GDP in 2010; in the U.S., Japan and Germany, this metric is expected to come in at 2.0%, 2.4% and 1.6% of GDP, respectively, for 2009 according to the International Monetary Fund.[1]

Industrial production growth in China has rebounded forcibly (see graph below). While industrial production in the major developed countries — such as the U.S., Japan and Germany — is still below year-ago levels, Chinese industrial production growth merely slowed during the height of the crisis and is again growing at a sturdy pace, around 15% on a year-ago basis.

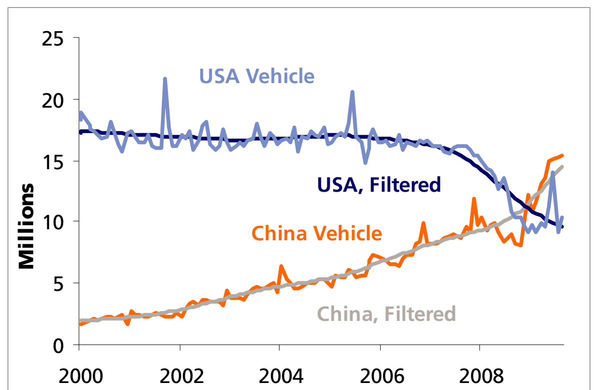
Chinese Industrial Production Has Rebounded



Source: Reuters EcoWin

A variety of other measures are also indicative of a recovering economy. Business confidence has come back since the beginning of the year. Consumer confidence has risen lately as well, although it remains markedly below 2007/early 2008 levels, and consumption has proved to be fairly resilient. Nominal retail sales have continued to rise, though its pace has slowed since around mid-2008. Vehicle sales in China have been rising steadily and year-to-date have surpassed those in the United States, as shown in the chart below. Of course the number of vehicles per 1,000 persons in China is well below that of the U.S. and other high-income countries, at about 30 vehicles per 1,000 persons compared to 700 per 1,000 persons in the U.S. (according to the World Bank's *World Development Indicators*). With rising per-capita income and modernization of its economy and infrastructure, the demand for vehicles in China shall grow.

Vehicle Sales in China Now Exceed Those in the U.S.



Source: Reuters EcoWin

The Chinese economy is poised for strong growth next year, with the leading index of economic indicators, such as new orders, jobless claims, money supply, average workweek, and building permits, rising sharply. However, consumer prices on year-ago basis in China are declining. In 2007 and early 2008 consumer prices had risen as food prices shot up; with food prices falling since late 2008, consumer prices have followed suit. There has also been a much larger decline in producer prices, probably reflecting the vast amount of excess capacity in Chinese manufacturing industries.

[1] See IMF (2009). "The State of Public Finances Cross-Country Fiscal Monitor: November 2009," *IMF Staff Position Note*.

Currency Politics

Due to excess capacity in China and its policy of keeping its currency "undervalued," the prices of Chinese imports into the U.S. remain contained. Indeed, U.S. import prices of Chinese goods on a year-ago basis have declining since March of this year (see the chart below).

The U.S.'s large and persistent bilateral trade deficit with China and China's policy of keeping its currency undervalued long have been points of contention between the two countries. While it is politically convenient (in the U.S., at least) to hold the Chinese authorities *solely* (or, at best, *largely*) responsible for the significant and persistent bilateral trade deficit, it should be noted that the U.S. trade deficit can be reduced through 1) weak aggregate demand in the U.S., 2) strong aggregate demand in the rest of the world, 3) a weak dollar or 4) some combination of these factors.

For the U.S., a weaker dollar and strong demand for its exports in the rest of the world be much preferred over weak aggregate demand. Though U.S. manufacturing industries and exporters seek a weak dollar, consumers and non-manufacturing industries — including the financial services industry — are in favor of a strong dollar because it keeps inflationary pressures in check and the prices of imported goods and foreign assets low. The U.S. administration, arguing that the renminbi is undervalued, is likely to press China to allow its currency to appreciate, while at the same maintaining its rhetoric that it favors a strong-dollar policy. However, given that exports to the U.S. constitute a substantial share of China's global exports (nearly 18%), the Chinese authorities are likely to be cautious about allowing the renminbi to appreciate.

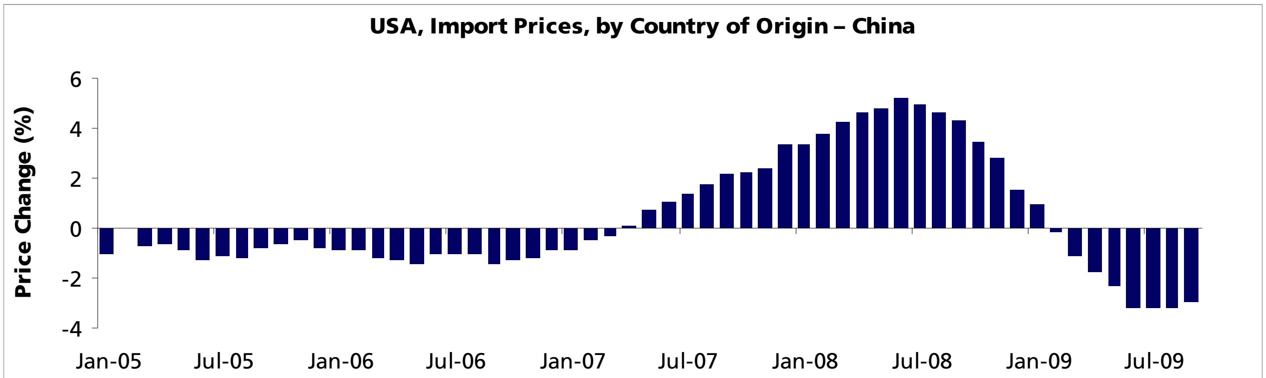
Rebalancing and Prospects

It is, however, in the long-run interest of China to gradually rebalance its economy from exports and investment to private consumption and domestic demand. An economy more focused on private consumption and domestic demand would raise the quality of life for the majority of China's population. The Chinese authorities can implement numerous measures to boost private consumption, including reducing household income tax, increasing transfers to vulnerable and low-income segments of its population, and enhancing social safety mechanisms. Increases in public sector expenditures on health and education would enable Chinese households to reduce their savings and increase their consumption. Policies to liberalize interest rates would increase deposit rates and boost the financial incomes of households. The development and the deepening of the domestic bond market would reduce the need for large corporate-sector savings and provide another alternative avenue for Chinese corporations to obtain financing.

China's economic transformation over the past few decades has been very impressive. GDP per capita has risen from less than $500 in 1990 to about $3,500 as of 2009 — a seven-fold increase within a span of two decades is indeed miraculous. But many policy challenges remain to ensure steady progress and a successful evolution to a medium-income country. Implementation of structural reforms in the financial sector, public finances and the capital markets will reduce risks and improve the standard of living and income distribution across regions in China. Better supervision of bank lending and prudential rules would curb imprudent short-term credit growth and mitigate the possibility of a large-scale outbreak of non-performing loans.

The outlook for China for the coming year is quite favorable, as are its prospects for the medium term provided structural reforms are carried out and risks are well managed. The main policy issues facing China going forward are improving its monetary policy, employing greater flexibility in its exchange rate, enacting banking and structural reforms, reducing its rural/urban income disparity and effectively managing its relationship with the U.S.

U.S. Import Prices of Chinese Goods Have Been Declining for the Last Eight Months



Source: Reuters EcoWin