

China: Drive to more balanced growth in 2007

Emerging Markets Research

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Overview

In 2006, the Chinese economy went from accelerating growth in Q1 and Q2, powered by rising consumption, investment and exports, to moderating growth in Q3 and stabilising growth in Q4. In our view, the slowdown is due to a series of tightening measures introduced by PBoC beginning in late April that reined in growth in M2 and FAI, while consumption and exports remained strong. In 2006 we saw unprecedented policy activism – in the space of six months, PBoC hiked lending rates twice and banks' required reserve ratio three times, in addition to conducting open market operations and issuing central bank bills. Moreover, we also witnessed a shift by the central bank towards the use of indirect market instruments for macro management, though it continues to employ window guidance.

The November data from China provide a host of reasons to believe that PBoC's earlier tightening measures are beginning to bite. Growth in the money supply (M2) and FAI continued to moderate, and industrial output growth stabilised. Although overall inflation picked up due to rising food prices, CPI ex-food remained steady. The pattern supports our long-held view that this round of tightening is largely over (see [China: Enough tightening; ready to reform CNY?](#), 6 October 2006).

Going forward, we expect China's economic growth to remain robust over the next 12 months. In 2007, our forecast calls for China's GDP to expand by 9.6%, supported by further acceleration in domestic consumption growth, stabilisation in FAI growth and some moderation in export growth.

China's trade and current account surpluses are projected to remain sizable in 2007, and its growing trade surplus may provoke an increase in protectionism. We believe the authorities are becoming more aware of this risk through multilateral and bilateral dialogues (eg, last week's inaugural Sino-US Strategic Economic Dialogue in Beijing). To deal with its external imbalances, we expect China to introduce new measures that focus on increasing imports, particularly imports of equipment, technology and financial services from industrial countries (especially the US), as well as commodities and energy.

While PBoC has become more active in using monetary policy to manage macroeconomic risks, exchange rate policy has played only a limited role. We continue to expect the pace of CNY appreciation to accelerate in next year and believe that China may be ready to take tangible measures to improve the management of its FX reserves. On monetary front, although we believe the current round of tightening is largely over, we also think PBoC will continue to actively manage liquidity through open market operations and the issuance of central bank bills, and we have not ruled out another hike in the reserve requirement ratio in the next few months, if necessary. We expect fiscal policy to remain prudent next year, but believe the government is prepared to adopt a more expansionary stance, if export growth slows too sharply (not our baseline scenario).

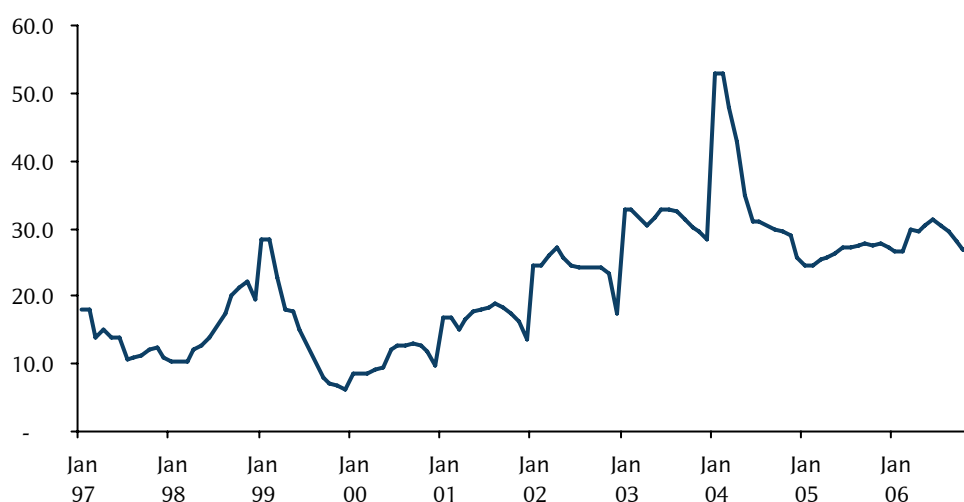
Economic growth appears to be stabilising

In 2006, the Chinese economy went from accelerating growth in Q1 and Q2, powered by rising consumption, investment and exports, to moderating growth in Q3, and finally to stabilising growth in Q4, as suggested by the data released so far that cover the first two months in the quarter.

While FAI growth continues to slow, growth of IP and M2 has started to stabilise

The November data show that the economy is moving towards a more balanced growth path. FAI growth continues to slow: the YTD pace accelerated from January (+26.6%) to June (the peak, at +31.3%), then fell from July (+30.5%) to November (+26.6%) (see Figure 1).

Figure 1: FAI growth (% Y/Y)



Source: CEIC, Barclays Capital.

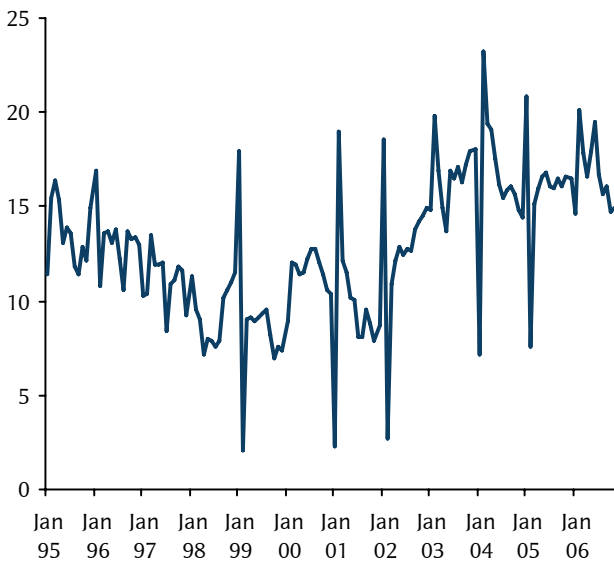
Meanwhile, growth in industrial production picked up between April (+16.6% Y/Y) and June (+19.5%), but moderated from July (+16.7%), through October (+14.7%) and appears to have stabilised in November (+14.9%). Year-to-November, industrial output expanded at an average monthly rate of 16.8% (see Figure 2).

The acceleration of IP and FAI and in Q1 and Q2 06 raised concerns over possible overheating in the world's fourth-largest economy. In response, PBoC introduced a series of tightening measures starting in late April, including hiking the 1 yr lending rate (twice for a total of 54 bp), hiking the deposit rate (once), raising banks' required reserve ratio (three times, most recently on 15 November taking the ratio to 9%), and strengthening open market operations and the issuance of central bank bills to mop up liquidity from the banking system. Indeed, the level of policy activism over the six months period since late April is unprecedented. Banks' reserve requirement and 1 yr rates are now at their highest levels since June 1999.

As a result of these measures, Y/Y growth in M2, after peaking in May (+19.1%), declined steadily to 16.8% in September, and has stabilised at around 17% (October, +17.1%; November, +16.8%) (see Figure 3).

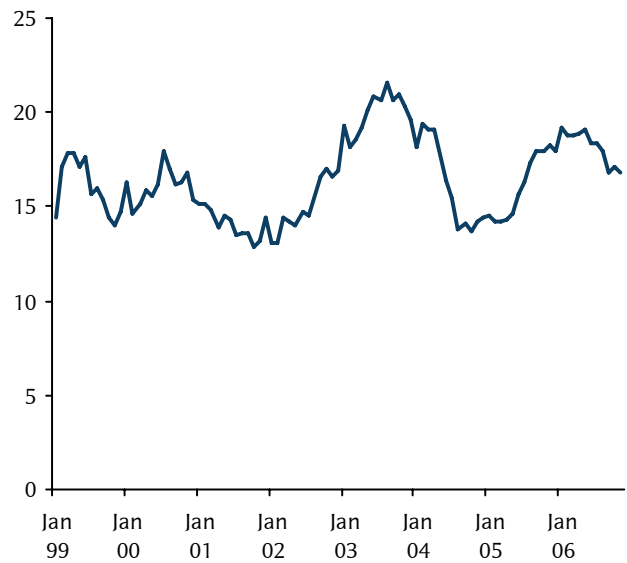
Based on slower increases in FAI and stabilising M2 and IP growth, we see overall economic growth shifting from a slowdown over the past four months towards a steadier path in the last month, suggesting that PBoC's tightening measures have taken hold.

Figure 2: IP growth (% Y/Y)



Source: CEIC, Barclays Capital.

Figure 3: M2 growth (% Y/Y)

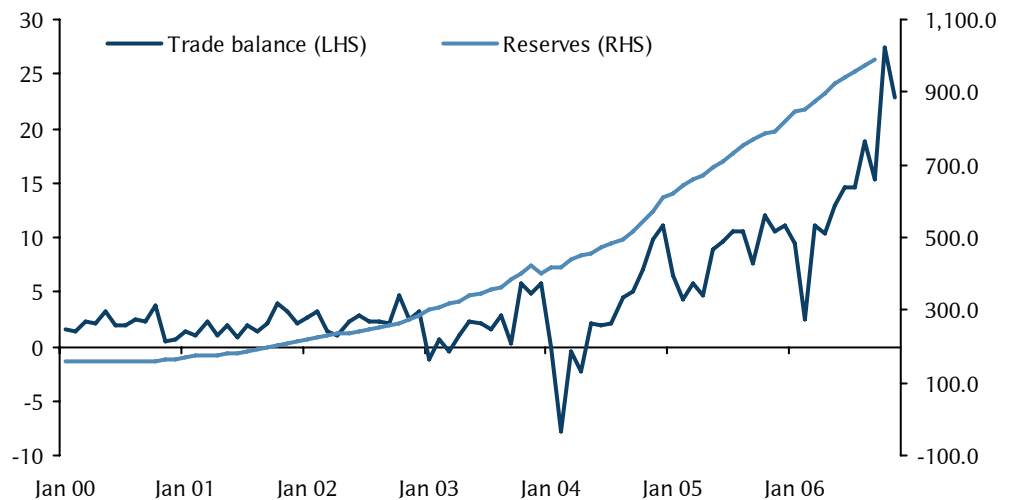


Source: CEIC, Barclays Capital.

However, the trade surplus is expected to continue to widen into Q4

However, in the past few months China's trade surplus has continued to grow very strongly. After rising to USD18.8bn in August from USD14.6bn in July (versus a Q1 06 monthly average of USD7.7bn; Q2, USD12.7bn), it reached USD23.8bn in October and USD22.9bn in November (see Figure 4). The surging trade surplus has meant rapid growth in FX reserves, which, after reaching USD988bn by end-September, have already hit the USD1trn mark (see Figure 4).

Figure 4: Monthly trade surplus and total reserves (USD bn)



Source: CEIC, Barclays Capital.

The stabilisation of M2 and IP growth in November is worth noting. We believe that it is related not only to the slowing in FAI, the continuing acceleration in retail sales and steady growth in exports, but feel that it is also an early sign of more a stable rate of growth in GDP in the next few months.

Tightening is largely over, but not active liquidity management

For some time, our view has been that the latest round of monetary tightening is now largely over and PBoC will turn its policy focus to CNY reform (see [China: Enough tightening; ready to reform CNY?](#), 6 October 2006). In our opinion, stabilising M2 and IP growth rates support this view. That is, with the domestic excesses largely contained, the central bank can be expected to tackle China's mounting external imbalances.

PBoC likely to continue to actively manage liquidity through open market operations and issuance of central bank bills

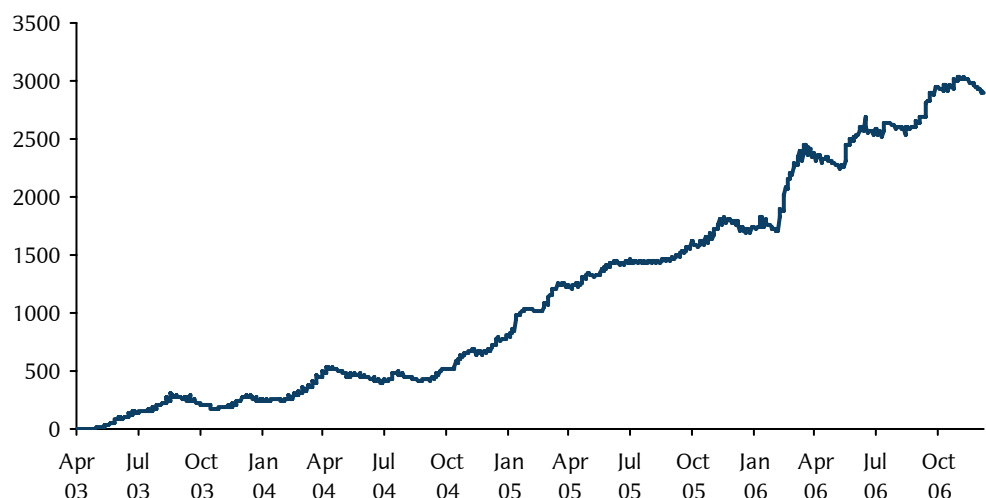
In our report [China: Monetary conditions and tightening options](#), 23 August 2006, we suggested that any further tightening by PBoC – including continued efforts to strengthen open market operations and the use window guidance – would depend on data releases. In our 6 October report, having seen more data, we adjusted our view of the PBoC's base-case scenario; we felt the central bank would avoid raising interest rates in Q4, and believed there was only a 50% probability that it would boost reserve requirements one more time before year end. Indeed, PBoC has not taken any action on interest rates and we continue to believe the chances for a rate hike before year-end remain slim. However, PBoC did raise the required reserve ratio (effective 15 November).

Inflation has been fairly benign this year. Year to date, CPI inflation has averaged 1.35% Y/Y; it slowed to 1.4% Y/Y in October, from 1.5% in September, but rose to 1.9% in November. The November increase was driven by rapidly rising food prices, as CPI ex-food has remained at a steady 1.1% for the past three months. China plans to further liberalise prices in energy and other sectors in the new year; therefore, we expect further pass-through effects from high energy prices to the CPI, even if energy prices stabilise globally. Into 2007, we believe CPI inflation is likely to rise towards 2%. The government's inflation target for 2007 is set at 2-3%.

We have not ruled out another hike in the required reserve ratio in the next few months – if necessary

Faced with rising inflation and plenty of liquidity in the banking system, PBoC will need to continue to be watchful. Looking ahead, we believe the central bank will continue to actively manage liquidity through a combination of open market operations, further issuance of central bank bills, and, if necessary, raising the required reserve ratio in the next few months.

Figure 5: Total stock of Central Bank bills (CNY bn)



Source: CEIC, Barclays Capital.

Raising the required reserve ratio further may be necessary because PBoC faces rapidly increasing costs in sterilisation, a problem that is rooted in the country's surging trade surplus and the still very slow pace of CNY appreciation (and thus, mounting FX reserves, see Figure 4). The stock of Central Bank bills had risen in recent years – until it started to fall over the last few weeks (see Figure 5). Indeed, one could argue that the latest hike in the required reserve ratio, which took effect 15 November, may not have been necessary if one considers only the perspective of dealing with the risks of economic overheating. The growth rates of FAI, M2 and IP had already stabilised (or were close to stabilising) in October (see Figure 1 through Figure 3). However, taking into consideration of costs of sterilisation, the decision to raise the reserve ratio looks more reasonable. Not surprisingly, as a result of the hike, the total stock of Central Bank bills started to decline from its peak starting in mid-November.

Another increase in the required reserve ratio in the next few months would lower the sterilisation ratio and thus the stock of Central Bank bills. Going forward, if CNY appreciation accelerates and China's imports increase next year, we believe capital inflows may begin to moderate and the stock of central bank bills will decline further.

Drive towards more balanced growth through faster import growth and CNY appreciation, and new measures for FX reserve management

We expect China's economic growth to remain robust over the next 12 months. Our forecast calls for China's GDP to expand by 9.6% in 2007, supported by further acceleration in domestic consumption growth, stabilisation in FAI growth and some moderation in export growth (see Figure 6).

The growing trade surplus may provoke an increase in protectionist measures

Although we project a widening in China's trade and current account surpluses to remain sizeable, at USD200.8bn (6.5% of GDP) and USD 284bn (9.2% of GDP), respectively. Indeed, the growing trade surplus may provoke an increase in protectionist measures. We believe the authorities are becoming more aware of this risk, through multilateral and bilateral dialogues, and expect new measures to be introduced to deal with the country's external imbalances, with China increasing imports, particularly imports of equipment, technology and financial services from industrial countries (especially the US), as well as commodities and energy.

In this regard, the inaugural Sino-US Strategic Economic Dialogue held in Beijing during 14-15 December is worth noting. In addition to Treasury Secretary Henry Paulson, the US delegation consisted of Federal Reserve Chairman Ben Bernanke; the secretaries of Commerce, Energy, Labor, and Health and Human Services; the US Trade Representative; the Administrator of the EPA; and other senior officials. The Chinese delegation was led by Vice Premier Wu Yi, and included the ministers of Finance, Commerce, Science and Technology, Railway, Transportation, Information Technology, Labour and Social Security, and Public Health; the PBoC governor; the NDRC chairman; and the heads of State Environment Protection and State Quality Controls. The attendance of such high-ranking delegations from both sides was unprecedented. We believe that this dialogue was not just a political and diplomatic show, and we expect tangible results to emerge from the discussions.

A need to address imbalances by increasing imports next year...

In her keynote speech, Vice Premier Wu indicated that China will work hard to address its trade imbalances through further increases in imports. Indeed the composition of the two delegations suggests areas of possible progress, including bilateral trade (China is interested in importing more equipment from the US to upgrade its technology, in particular in energy, railways, transportation, environmental protection and public health), opening financial markets (the US is interested in exporting more financial services to China) and protection of intellectual property rights. The US is also asking for further flexibility in the CNY exchange rate regime, and on 15 December, USD/CNY reached a new low, breaking 7.82 and touching 7.811. One tangible result in terms of bilateral trade was that during the talks, China awarded Westinghouse a contract worth an estimated USD5.3bn – the biggest international nuclear reactor contract in history – to build nuclear reactors in China.

... as well as allowing faster appreciation of CNY; USD/CNY may reach 7.45 by end-2007

While the PBoC has become more active in using monetary policy to manage macro risks in the economy, the exchange rate policy has played only a limited role. Taking into account moderating FAI growth, stabilising M2 and IP growth, as well as a surging trade surplus, we expect to see further action on CNY reform. We believe there may even be new upside risks to the 4-5% appreciation range that we expect to see over the next 12 months (see [China: CNY appreciation to accelerate](#), 16 November 2006). We expect the pace of CNY appreciation to accelerate in the next few months. We note that China's ballooning current account surplus (USD91.6bn in H1 06, up 36% Y/Y), and foreign reserves have been added to Chinese policymakers' list of top concerns.

New measures to improve the management of the country's FX reserves

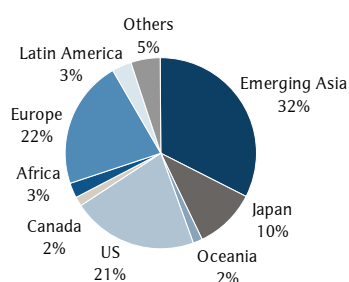
Given China's widening current account surplus and its continued rapid accumulation of FX reserves (already at USD1trn), we also expect the authorities to introduce some measures designed to improve the management of the country's FX reserves.

We expect fiscal policy to remain prudent in 2007, but we believe the government is prepared to adopt a more expansionary stance, if export growth slows too sharply (although this is not our baseline scenario).

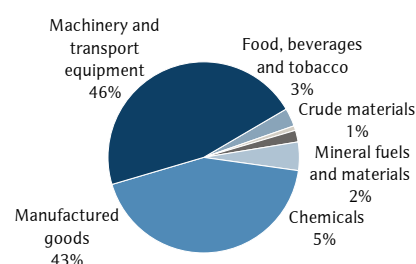
Figure 6: China – Key Indicators

	2001	2002	2003	2004	2005	2006E	2007F	2008F
National accounts								
Real GDP growth (%)	8.3	9.1	10.0	10.1	10.2	10.3	9.6	9.6
Private consumption growth (%)	4.9	6.2	5.0	6.9	5.2	8.5	8.3	8.2
Government consumption growth (%)	9.3	6.5	3.6	3.0	5.7	8.7	8.6	8.6
Fixed capital formation growth (%)	13.2	12.6	19.0	14.1	10.5	12.8	11.8	11.9
Private consumption contribution (pp)	2.4	2.9	2.3	3.4	2.1	3.2	3.1	3.1
Government consumption contribution (pp)	1.2	0.9	0.5	0.3	0.8	1.2	1.2	1.2
Fixed capital formation contribution (pp)	4.8	4.8	7.5	5.6	4.5	5.6	5.2	5.4
Domestic demand contribution (pp)	8.4	8.5	10.2	9.3	7.4	10.0	9.6	9.6
Net export contribution (pp)	-0.1	0.6	-0.2	0.8	2.5	0.0	0.0	0.0
Nominal GDP (USD bn)	1,354.0	1,486.0	1,677.0	1,974.0	2,331.0	2,648.0	3,072.0	3,563.0
Real economy								
Industrial production (%)	9.7	12.7	16.7	16.3	15.9	17.2	16.3	16.0
Unemployment (%)	3.6	4.0	4.3	4.2	4.2	4.2	4.2	4.2
Inflation								
CPI (% Y/Y average)	0.7	-0.8	1.2	3.9	1.8	1.3	2.0	2.0
CPI non-food (% Y/Y average)	1.2	-0.9	-0.2	0.7	1.2	1.2	1.5	1.5
RPI (% Y/Y average)	-0.8	-1.3	-0.1	2.8	0.8	0.8	1.0	1.0
RPI non-food (% Y/Y average)	-1.6	-1.8	-1.8	-0.8	-0.4	0.2	0.2	0.2
PPI (% Y/Y average)	-1.3	-2.3	2.3	6.1	4.9	3.0	4.5	4.5
Monetary								
M2 (%) (year-end)	14.4	16.9	19.6	14.5	18.0	18.6	17.0	16.3
Bank credit (%)	13.0	16.9	21.1	11.6	9.8	12.5	12.0	12.0
Bank credit/GDP (%)	102.4	109.1	117.1	110.9	106.8	104.0	112.9	109.1
Domestic credit (%)	13.4	29.8	19.5	8.8	10.7	12.0	11.0	10.0
Domestic credit/GDP (%)	121.3	143.5	151.9	140.4	136.2	131.2	125.6	119.1
External sector								
Exports (%)	7.6	21.8	34.4	35.4	29.3	28.0	18.0	16.0
Imports (%)	9.1	20.9	40.9	37.2	17.6	22.0	18.0	19.0
Trade balance (USD bn)	22.5	30.4	25.5	32.1	102.1	170.2	200.8	204.4
Trade balance (% of GDP)	1.7	2.0	1.5	1.6	4.4	6.4	6.5	5.7
Current account (USD bn)	17.4	35.4	45.9	68.7	160.8	247.0	284.0	287.0
Current account (% of GDP)	1.3	2.4	2.7	3.5	6.9	9.3	9.2	8.1
Capital and financial account (USD bn)	34.8	32.3	52.7	110.7	63.0	70.0	70.0	70.0
Capital and financial account (% of GDP)	2.6	2.2	3.1	5.6	2.7	2.6	2.3	2.0
Net portfolio inflows (USD bn)	-19.4	-10.3	11.4	19.7	12.0	15.0	18.0	20.0
Net FDI inflows (USD bn)	37.4	46.8	47.2	53.1	53.4	52.0	52.0	52.0
Fiscal position								
Primary budget balance (% of GDP)	-2.6	-3.0	-2.5	-1.5	-1.5	-1.0	-1.0	-1.0
Fiscal balance (% of GDP)	-4.6	-5.4	-5.0	-4.2	-4.1	-3.7	-3.4	-3.3
Public sector debt (% of GDP)	14.2	16.1	16.6	16.1	16.3	16.5	16.5	16.5
Public sector revenues (% of GDP)	14.9	15.7	16.0	16.5	16.3	16.3	16.5	16.6
External liquidity								
FX reserves (USD bn)	212.2	286.4	403.3	609.9	818.9	1,018.9	1,150.0	1,200.0
Import coverage (months)	10.5	11.6	11.7	13.0	10.0	15.0	13.5	11.5
Foreign debt (USD bn)	170.1	168.5	193.6	228.6	268.8	319.4	390.0	390.0
Foreign debt/GDP (%)	12.6	11.3	11.5	11.6	11.5	12.1	12.7	10.9
Short-term foreign debt (USD bn)	50.6	52.9	77.1	104.3	144.0	190.8	257.6	257.6
Long-term foreign debt (USD bn)	119.5	115.6	116.6	124.3	124.8	128.6	132.4	132.4
Amortisation payments (USD bn)	24.2	31.0	35.7	44.3	31.7	40.0	48.7	48.7
FX reserves/Short-term debt (x)	4.2	5.4	5.2	5.8	5.7	5.3	4.5	4.5
Policy rates								
Base 1 yr working capital lending rate (% year-end)	5.85	5.31	5.31	5.58	5.58	6.12	6.12	6.12
1 yr time deposit rate (% year-end)	2.25	1.98	1.98	2.25	2.25	2.52	2.79	2.52
FX								
USD/CNY (year average)	8.28	8.28	8.28	8.28	8.18	7.95	7.61	7.26
USD/CNY (year-end)	8.28	8.28	8.28	8.28	8.07	7.80	7.45	7.00

Export breakdown by country, Jan 05-Sep 06



Export breakdown by commodity, Jan 05-Sep 06



Source: CEIC, Barclays Capital.

Fundamental credit view on issuers covered in this report

Issuer	Current credit view	Previous credit view
China, People's Republic of	Positive	Positive

Note: Positive = We expect issuer fundamentals to improve over the next 6-12 months; Stable = We expect issuer fundamentals to remain stable over the next 6-12 months; Negative = We expect issuer fundamentals to deteriorate over the next 6-12 months.

NA = We do not currently have a fundamental credit view on this issuer.

Source: Barclays Capital.

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