

Policy Challenges Facing China

The global economy is haunted by the return of stagflation – throughout the world, inflation is rising while growth is slowing. China has scored some early successes against inflation. However, the deteriorating external environment and the austerity measures introduced earlier have posed considerable difficulties on exporters. As a result, China has adjusted its policy to ensure a well contained inflation, and on the other hand, ease pressure on the export sector and revive asset markets.

Early Signs Suggest Inflation is Subsiding

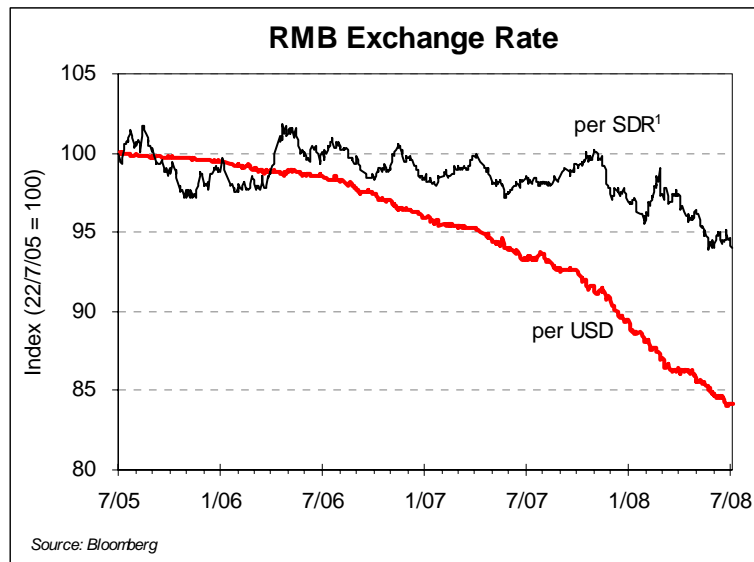
After rising steadily since early 2007, China's headline consumer price index (CPI) averaged 7.9% in the first half of this year. Food prices, which are estimated to make up one-third of the CPI, were the major driver. Importantly, however, China's food prices are not dependent on external trends. China has maintained a food self-sufficiency rate of 95% over the past decade. The factors that led to sharply higher food prices were all local in nature: a reduction in arable land, rising production costs, animal epidemics and natural disasters.

Therefore, the Chinese government tried to combat inflation through supporting higher food production and restricting food exports. It was able to lower the headline inflation rate to 7.1% in June from an 11-year high of 8.7% in February. Rising energy prices have slightly pushed up non-food price inflation, which however remained modest at 1.9% in June. This indicates that high food prices have yet to spill over to the larger economy.

To the Rescue of the Struggling Export Sector

With some breathing room on inflation, the government has turned its attention to other policy areas. Economic tightening, combined with rising production costs and Renminbi (RMB) appreciation, have brought severe hardship to export-oriented manufacturers since the beginning of this year. Compounded by the deteriorating external environment, export growth in RMB terms slowed to 6% in June from 19.8% for 2007 as a whole. The sharp slowdown has caught the government's attention, as an abrupt contraction in manufacturing could inflict a severe blow on employment and the economy at large.

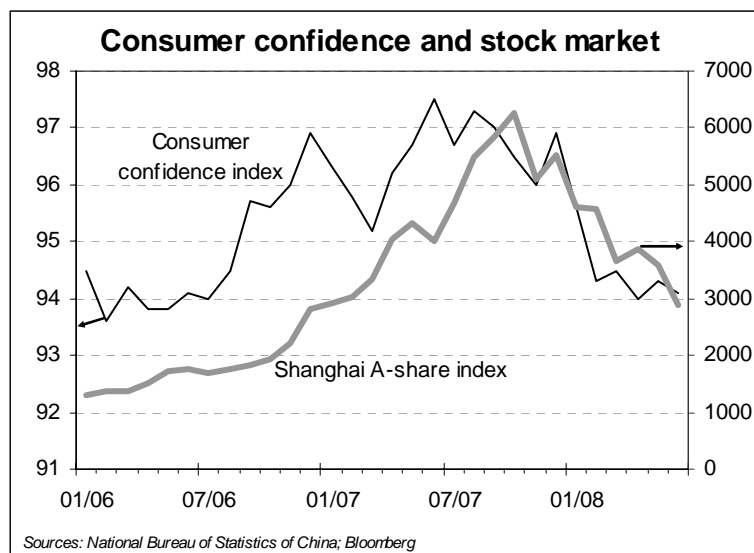
As a result, we can expect policy easing in coming months. With the waning global demand, exporters find increasing difficulties to pass on the cost of the rising Renminbi to overseas consumers. Hence, one area to watch is China's exchange rate policy: Will the government target the exchange rate to ease the burden on exporters? Since the lion's share of China's international trade and investment is conducted in USD terms, the RMB/USD exchange rate has traditionally been a focus point for media and business. Over the past twelve months, the RMB has appreciated by 11.9% against the USD; however, the RMB has increased by only 3.2% against the IMF reference currency basket¹. This indicates that the movement of RMB/USD has been affected, not only by RMB appreciation, but also by weakness in the greenback. Hence, unless the greenback reverses direction, the RMB will continue to appreciate against the USD, although we can expect the pace to be slower than in the first half.



Domestic Consumption and Asset Market Reform Remain at Centre Stage

Stimulating domestic demand, and making it a driver of future economic growth as envisioned in the 11th Five-Year Plan, remains an elusive goal. Since food items account for about one third of consumer expenditure, high food prices are taking a toll on family budgets. Inflation has reduced the growth of real per capita disposable income of urban households to 6.3% in the first half of this year, compared to 12.2% in 2007. Although China's deep pool of personal savings has muted the impact of inflation – retail sales volume grew by 13% in the first half – consumer confidence dropped to its lowest level in two years in June. The inflation threat has therefore contradicted the government's long-term plan to encourage the public to spend more and save less. One sign that the government is concerned is the decision to exempt households from the recent mandated rise in domestic energy prices.

The sharp drop in the local stock market, following record rises last year, is another factor eroding consumer sentiment. In the first half, inflation averaged 7.9%, while 1-year deposit rate was at 4.14%. The common wisdom is that the resulting negative real interest rates will stimulate personal investment. However, this is not the case. A gloomy earnings outlook amid a slowing global economy, together with the prospect that previously non-tradable A-shares will be dumped on the market when the lock-up period expires this year, have cast a long shadow on China's stock market. The Shanghai A-share Index has tumbled more than 50% from its peak in mid-October in 2007, the sharpest decline among major global stock markets. Bearish sentiment also clouds the real estate market. A series of tightening measures, especially a new second mortgage rule, has effectively curbed speculative activity. House prices nationwide have declined each month since October last year.



The government had hoped that rising asset prices and investment income would generate a positive wealth effect, and stimulate private consumption. At the 17th National Congress of the Communist Party of China in late 2007, President Hu Jintao made the unprecedented call for the country to create the appropriate conditions to enable citizens to generate income from their assets. Currently, asset income accounts for only 2% of per capita disposable income, on average. However, the falling asset markets are undermining that goal.

Hence, policy adjustments are expected to address these issues. Sliding property prices have not only affected investment sentiment; the impact has spilled over into other sectors such as construction, furniture, etc. For the stock market, the government is treading carefully and resisting calls to intervene. Propping up the market may produce immediate results, but these will only be short-lived unless there is an improvement in fundamentals. Instead, the government has focused on restoring confidence in the market by such measures as improving transparency. One example is recent moves to require disclosure of disposals of previously non-tradable shares. Meanwhile, the central bank has not raised interest rates since last December, despite a worsening negative interest rate. This is partially due to the concern that a rise would further dampen sentiment in an already falling equity market.

Conclusion

The twin threats of inflation and economic slowdown have put the world off balance. China is no exception. After taking vigorous measures to combat inflation, it is now rushing to cushion the fall of the export sector. At the same time, policy-makers cannot reduce their efforts to nurture consumer demand. China's sizable savings pool can still support significantly higher consumer spending, that could maintain the country's high growth rate and compensate for slowing growth elsewhere in the economy.

This latter effort has faced strong headwinds since the start of the year, as consumers are buffeted by high inflation and the slump in asset prices. While the government's effort to boost food supplies should bring inflation under control, the outlook for asset markets remains uncertain. Migration of funds from individual deposits to the stock market has reversed since October 2007, when the market began its steep fall. Since the government jumpstarted the stock market in 2006, fresh money flowing from individual deposits to the stock market is estimated to be at Rmb1.4 trillion, merely 7% of the individual's bank saving. This is far from the government's target. Reviving asset markets in order to encourage consumers to divert more of their savings into investments will remain at the top of China's policy agenda.

¹ SDR (IMF Special Drawing Right) basket weighting: 44% USD, 34% Euro, 11% Yen, 11% Pound Sterling.