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Chinese Economy: Weathering the Storm

The second quarter of 2009 brought a strong rebound on world financial markets, giving hope to Asian exporters and encouraging them to prepare for a recovery in demand for their products. In fact, signs are emerging that these exporters are already placing their bets. Rising purchases of semi-finished products by Mainland manufacturers is believed to be behind the recent pick up in Mainland imports. The year-on-year decline in imports narrowed from an average of 28.1% in the first five months of this year, to an average of only 14.1% in June and July.

This performance is echoed in Hong Kong's export numbers. The year-on-year decline in Hong Kong exports to the Mainland (which comprised a significant share of semi-finished products) narrowed markedly from 23.5% in the first quarter of this year, to just 5.4% in the second quarter. Thus, the supply chain is back in action, and we can look forward to a rising trend in overseas exports in the coming months.

This uplift is likely due to the arrival of the long-anticipated replenishment of global inventories. But demand is still not strong across the board; consumers are being picky. Sales of consumer durables have been hit hard during this recession, while demand for daily-use items have held up remarkably well. Between September 2008 and June 2009, the value of retail electronics products sold in the US fell by 7% year-on-year; meanwhile, grocery sales bucked the trend and rose by 1.5%.

China's exporters are in the best position to put products on the shelves at a price that the chastened American consumer is willing to pay. Thus, the US shopper's new-found taste for thrift should channel more orders in China's direction.

But is this a sure bet? There are lingering doubts on whether demand is sustainable once inventory replenishment runs its course. Much of the recent improvement in the US economy can be traced to President Obama's stimulus measures. The underlying fundamentals remain shaky. Unemployment may still reach double digits by the end of this year, despite the surprise improvement in July. And even if employment holds up, wages are growing at a markedly slower pace. The continued weakness in the housing market is another concern. 22% of all US homes, representing more than 20 million residences, were in "negative equity" in the first quarter. Mirroring the US consumer's new-found taste for thrift, the US personal savings rate increased to 5.2% in the second quarter. Rather than taking on debt for new purchases, US households are paying back debt and deferring purchases. Hence, there is little reason to be optimistic about consumer behaviour once the effect of the stimulus package wanes.

The Need to sustain Domestic Demand

The Sino-US Strategic and Economic Dialogue, held in July this year, concluded that China could generate more stable and balanced economic growth by reducing reliance on exports and stimulating domestic demand. This is precisely the strategy that China has pursued in the wake of the financial crisis, and the country has succeeded very well at sustaining domestic demand throughout this period.

The RMB 4 trillion yuan economic stimulus package announced in November last year focused primarily on infrastructure and construction projects. Related industrial output, such as cement and large and medium sized tractor, has registered double-digit growth since the announcement. Government measures have also supported the motor vehicle industry. Following the introduction of an incentive of up to RMB 5,000 per household to boost car ownership in rural areas, motor vehicle production rose by 12% in the first five months of this year.

However, what has really distinguished China from other economies is consumer demand. This has remained resilient. Retail sales rose by 15% in the first six months of this year. Medical products, toys, furniture and garments are among the sectors that registered double digit growth in domestic sales. This has been critical in compensating for the collapse in demand from overseas.

	Exports		Retail Sales	
YOY%	2008	2009 (Jan-May)	2008	2009 (Jan-May)
Medical products	13.3%	-10.4%	14.8%	17.6%
Toys	1.8%	-14.0%	22.6%	13.5%
Furniture	21.5%	-8.4%	22.6%	27.0%
Garment	4.1%	-8.1%	25.9%	17.3%

Source: China Monthly Statistics

Sustaining consumer spending required an extraordinary effort. China's manufacturing industry employs an estimated 28.8% of the labour force. The plunge in export orders late last year had a severe impact on manufacturing employment, as exporters shut down assembly lines. As a result, consumer confidence slid from a pre-crisis level of 93-94 to the 86-87 range in the first half of this year. This has also contributed to the return of deflation, which has hovered in the -1.5% range since the start of this year.

In order to jumpstart the domestic economy and prevent a slowdown in consumer spending, Mainland banks were encouraged to boost lending. This resulted in the extension of RMB 7.73 trillion in new loans in the first seven months of this year. Money supply (M2) growth surged to 28.4% year-on-year in July. The substantial monetary easing had the desired effect. A share of the extra liquidity found its way to the property and the equity markets, boosting prices. The resulting positive wealth effect in turn boosted private consumption.

Rising Risk of an Asset Bubble

However, just as elsewhere in the world, quantitative easing comes with a price tag. In the West, the central banks took extreme measures to meet the funding gap when it became evident that the financial system could not function properly. As the financial system resumes normal (as is gradually happening at present), central banks will need to prepare to absorb the excess liquidity. Meanwhile, it will be necessary to monitor monetary policy effectively, as ultra-low interest rates could encourage inflation if left too low for too long.

The situation in China is different. The financial system is functioning well. Bank lending is buoyant, helping to stimulate domestic economic activity and pick up the slack in the export sector. The exit strategy calls for the flow of lending to slow as exports rebound, which is likely to occur in the coming months. With the core inflation rate at -1.4% in June, the threat of a pick up in general inflation is remote. The more immediate concern is asset inflation. In the global ultra low interest rate environment, China's relatively high growth potential is becoming ever more attractive to international capital. Capital inflows surged by an estimated US$88bn in the second quarter. Combined with the money flowing from the Government's stimulus package, the new money helped push the Shanghai A-share index up almost 80% in mid-August this year since the low last November and up nearly 50% from the immediate pre-crisis level in mid-September.

However, if export growth turns out to be slower than desired going into 2010, the divergence between the performance of the real economy and that of the asset market will become severe. The necessary correction of the asset market under this scenario will inflict significant damage on the economy. Couple this to a potential jump in bad loans, following the surge in lending in the first half, and the challenge would be very serious indeed.

Conclusion

Responding to the severity of the financial tsunami, China has undertaken the unconventional measure of boosting loan growth at a time of global economic recession. While the external financial storm has subsided, storm clouds are gathering around the domestic economy. At a time when China aims to upgrade its financial market, an asset bubble is the last thing the country wants to see. Prompt action is required to relieve the pressure so that financial markets track the gradual recovery of the global economy more closely. With the improving external economic environment, in the next few months the priority must turn to credit tightening to engineer a soft landing of the asset market.