

Economic Analysis

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China's Rebalancing Act

Among all major economies, China has made the most impressive recovery from the financial crisis.

In the first two months of this year, exports were 31.4% higher than a year earlier. Even more impressive, exports were 3.6% higher than the same period in 2008, just before the onset of the financial crisis. Further, retail sales growth accelerated to 22.1% in the first two months of 2010, from 16.5% in the fourth quarter of 2009.

An aggressive escalation in lending in 2009 spurred domestic demand and helped struggling enterprises weather the global financial storm. New loans expanded by Rmb9.59 trillion, almost doubled from the amount made in 2008.

With the economic situation now stabilising, the government is already taking steps to withdraw stimulus measures and address structural economic issues. However, while opening the tap was easy, stemming the flow may prove difficult.

The government hopes to limit new loan growth to Rmb7.5 trillion this year. Traditionally, some 30% of loans granted in a year are awarded in the first quarter. This would indicate that new loans should increase by Rmb2.25 trillion in the first quarter. However, total loans have already grown by Rmb2.09 trillion in the first two months of this year, making it very likely that loan growth will overshoot the government target by a wide margin.

Although the deposit reserve requirement ratio has already risen by 1% since the start of the year, we can expect additional measures aimed at further draining liquidity in the months ahead.

China's Fiscal Health

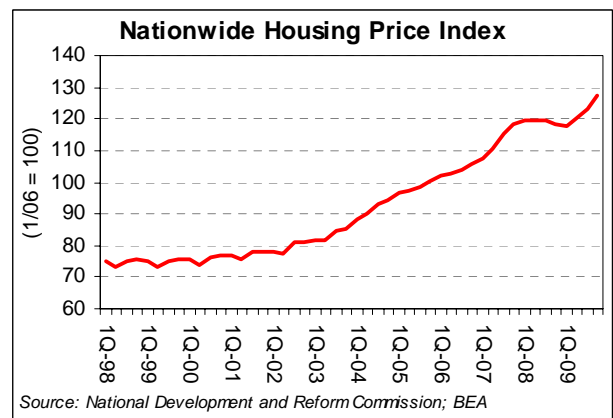
The rapid expansion in credit has not only fuelled the economy; it has also fuelled fears of a rise in bad debts. The non-performing loan ratio fell to 1.48% in January on the back of the rapid escalation in loans over the past year. However, many analysts worry that it is only a matter of time before these loans start to go bad and the ratio jumps.

A significant portion of the new loans have been awarded to local governments to support infrastructure projects. The big question is whether these projects will be able to generate sufficient economic returns to service the loans, through either direct income or higher tax revenues.

Local government debt ballooned to Rmb6 trillion this January, according to official statistics. Other estimates go as high as Rmb8 trillion. Despite these concerns, it must be pointed out that local governments sit on sizable state assets. Even if individual local governments run into financial difficulties, the Central Government alone owns assets estimated at around Rmb18 trillion, which could be used to bail out individual local governments, if necessary.

Structural Imbalance in Housing Market

Meanwhile, the loose credit policies have also had an impact on the property market. It is estimated that some 20% of new credits flowed to the property market in 2009. This helped to push average prices 10.7% higher nationwide in February compared to one year earlier, and stimulate further investment in the housing sector. The long-term health of the housing market has a critical influence on the fiscal condition of local governments, as close to one half of local government revenue comes from housing related activities.



To prevent the property market from spinning out of control, the Central Government has introduced a series of measures, including limiting the ability of some state-owned companies to participate in housing developments, penalties on hoarding land, etc. While these measures will have an important cooling effect on speculation in housing, they may not be sufficient to address the structural imbalances in the market.

From 1998 to 2009, commercial sales of residential premises jumped by almost eightfold in terms of floor space, from 108 million sq. meters to 853 million sq. meters. A number of factors have led to the surge in private housing demand. First, socialist-era policies that saw state-owned enterprises provide housing for

employees have been phased out. Second, urban per capita annual disposable income has jumped 2.5 times during this period to Rmb17,175, increasing the number of people who can afford to participate in the private housing market. Third, those who have come of age during the reform era are now starting to get married and raise children. Demographic changes have brought about a smaller average family size yet much larger number of households in urban areas. As a result, urban household size fell from 3.61 to 2.91 between 1998 and 2008.

Despite the explosion in demand, housing supply has managed to keep pace. The prevailing per capita gross floor area rose from 17.8 sq. meters in 1998 to 28.0 sq. meters in 2007.

However, these figures do not tell the whole story. Nationwide, city dwellers complain that housing prices have risen to levels beyond the reach of the general public. According to the "2009-2010 Green Book of Housing Report", average housing prices have reached 8.3 times average annual household income, above the healthy range of 3-6 times.

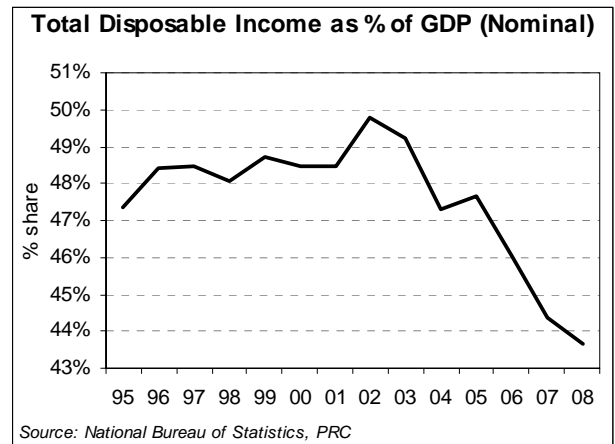
Investment demand is believed to be the major factor contributing to the imbalance. A 2007 survey¹ suggests that 65% of affluent Mainland citizens own investment properties, making property by far the most popular form of investment. The strong preference to hold properties for investment has resulted in high vacancy rates, and has skewed the market in favour of luxury apartments. End user demand for housing for the general public has been crowded out as a result.

In an effort to tackle this issue, the government has introduced measures to cool demand for second properties, including higher down payment requirements and higher mortgage rates. In the latest government work report delivered by Premier Wen Jiabao, the government announced plans to build three million housing units to meet the housing needs of lower income groups. It will also allocate more land to build small and medium size units to provide more affordable housing for the general public.

However, the government must also address two root causes of the housing problem. To make housing more affordable, either housing prices have to go down or wages have to go up. And in order to prevent housing prices from rising too fast, appetite for property investments must be curtailed.

As described above, the government has introduced measures to keep speculation in check. However, this needs to be complemented by efforts to develop alternative investment channels. This could be achieved by introducing a wider variety of financial products to the Mainland market, and relaxing restrictions on the ability of companies and individuals to invest overseas.

Meanwhile, better distribution of income in the economy will help to push wages higher. From 1996 to 2003, nominal GDP and total disposable income grew at roughly the same pace. However, during 2004-08, growth of nominal GDP averaged 18.3%, substantially higher than the 15.5% increase in total disposable income. As a result, household's share of the economic pie has shrunk. Total disposable income as percentage share of nominal GDP has fallen to 43.5% in 2008 from 49.8% in 2002.



To achieve high income growth, efforts must be made to divert resources from government and enterprises to households through job creation. This could be achieved by increasing government spending on social infrastructure, such as education and health. Also, inducing keener competition in different industry sectors will help to lower prices and increase demand, thereby creating more job opportunities. Education levels are rising quickly throughout the country, and the workforce is ready to take on more sophisticated demands. The number of university graduates entering the job market surged from 1.07 million in 2000 to 6.3 million in 2010.

One of the main themes of the 11th 5-year Plan is the promotion of private consumption. Yet, the government has allowed household income to lag behind GDP growth throughout the period of the 11th 5-year Plan, confounding the stated policy. The sharp increase in loan growth last year, which was largely channelled into investment projects, also contradicted the aim of stimulating private consumption.

There is no better illustration of the keen competition for resources in the economy between investment and consumption than the crowding out of end-user demand in the housing market by investment demand. The property sector is of special importance, as it also affects the government's long term financial health. Managing the competing interests that make up the demand for property will be one of the most difficult challenges facing China in the next few years.

¹ "Understanding the Affluent Consumers of China 2007", by the HSBC and the MasterCard Worldwide