



British Embassy  
Beijing

## China Economic Focus – February 2010

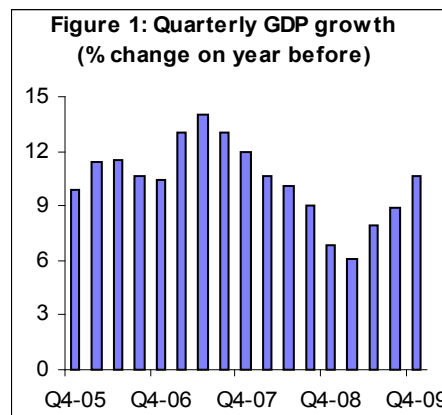
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### Summary

- The economy grew 10.7% in the year to the fourth quarter of 2009, up from 8.9% in the year to the third quarter. Growth was 8.7% for calendar year 2009, exceeding the authorities' 8% growth target. China is likely to become the world's second largest economy in 2010. The IMF predict growth will be 10% this year.
- Exports rose 21% in January on a year earlier, higher than December's 17.7% rise. China overtook Germany to become the world's largest exporter in 2009. Imports surged 86% in January on a year earlier, up from December's 56% increase. The monthly trade surplus fell to \$14.2 billion in January, down from \$18.4 billion in December.
- The authorities continue to hold the renminbi stable against the US dollar. On 25 February the Ministry of Commerce said recent declines in China's trade surplus made foreign pressure on China to resume appreciation "more and more groundless". But the resumption of gradual appreciation remains likely, perhaps in the second half of the year.
- Banks extended RMB 1.4 trillion (£127 billion) in new loans in January, lower than last January (banks usually front load their lending) but higher than the authorities would like (their target for 2010 as a whole is RMB 7.5 trillion). Additional measures have been announced to stabilise lending and limit the build up of non-performing loans.
- Consumer price rose 1.5% in January on a year earlier, lower than December's 1.9% increase and below market expectations. But producer price inflation continues to rise - to 4.3% in January, up from 1.7% in December. Inflation is still one of the key risks facing the economy - though the authorities believe they can keep inflation within their tolerance threshold (less than 5%). The central bank raised the reserve requirement ratio by 0.5 percentage points on 25 February, for the second time this year.
- At a Politburo meeting on 22 February President Hu Jintao restated that the authorities' 'moderately loose monetary policy and proactive fiscal policy' would be maintained in 2010 as the economy still faced uncertainties, in particular the risk of a 'double dip' global slowdown. Hu stressed the need to strike a balance between ensuring employment generation and avoiding high inflation. But this won't be easy. On 27 February Premier Wen said 2010 would be the most "complicated" year for the Chinese economy.
- National (based on 70 cities) property prices increased 9.5% in January on a year earlier, the fastest rate of increase since early 2008 (price rises have been much faster in some major cities). But turnover in some big cities has recently fallen, possibly as a result of measures adopted by the authorities over the last year to curb speculation and avoid overheating in the property market. The authorities are unlikely though to adopt harsher measures to cool the market, as this would result in a sharp contraction in the property market - choking the economic recovery.

**Growth back on track**

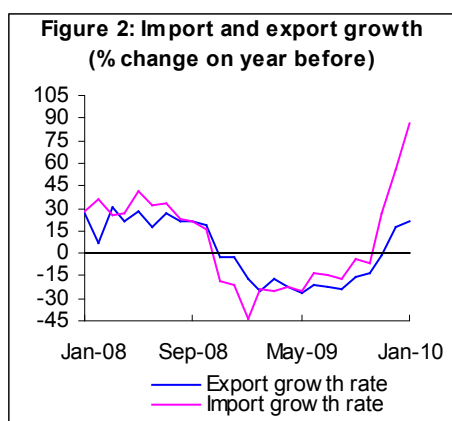
1. The economy grew 10.7% in the year to the fourth quarter of 2009, up from 8.9% in the year to the third quarter and the fastest rate of growth since 2007 (see Figure 1). But the underlying rate of growth (on an annualised quarter-on-quarter basis) was little changed from the third quarter (estimated at around 10%). Growth was 8.7% for calendar year 2009, exceeding the authorities' 8% growth target but down from 9.6% in 2008. Fixed asset investment was the main driver of growth last year, rising 30.1% in 2009.



2. The recovery in industrial activity still seems to be on track. Industrial production increased 18.5% in December, down slightly from November's 19.2% growth (no figure was released for January). The official Purchasing Managers' Index (PMI) was 55.8 in January, down from December's 56.6 but still above the 50 mark (which indicates an expansion in manufacturing output, while one below 50 indicates contraction). But a separate PMI, released by HSBC, tells a slightly different story - it rose to 57.4 in January, a record high since the series started in 2004. Retail sales - an imperfect indicator of consumer demand - grew 17.5% in December on a year earlier, up from November's 15.8% rise (no figure was released for January). 13.6 million cars were sold in China in 2009 - overtaking the US to become the world's largest car market.

3. China is highly likely to overtake Japan in 2010 to become the world's second largest economy. The IMF are forecasting 10% growth this year, the World Bank 9%. Most private sector analysts predict growth will be somewhere between the two.

**Exports continue to recover**



4. Exports rose 21% in January on a year earlier, up from December's 17.7% rise (see Figure 2) - but the shifting timing of Chinese New year makes year-on-year data comparisons difficult in January (and February). Analysts estimate the growth rate of exports in January was lower (but still positive) than in December on a seasonally adjusted month-on-month basis.

5. Imports surged 86% in January on a year earlier, up from December's 56% increase. January's higher figure was likely the result of the timing of Chinese New Year, base effects (imports in January last year were the lowest level since 2005), higher import prices (import growth figures are in value, not volume, terms), and strong domestic demand. Commodity demand remained very strong last month, though import growth rates in volume terms for most commodities were lower in January than in December.

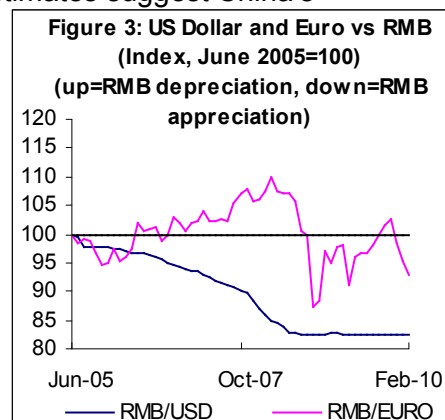
The monthly trade surplus fell to \$14.2 billion in January, down from \$18.4 billion in December.

**China-ASEAN trade growing rapidly**

6. According to official Chinese statistics exports to (emerging) Asia continue to grow at a faster rate than those to the EU and US. Exports to Taiwan increased 85.5% in January on a year earlier (compared with a 43% rise in December). Exports to ASEAN increased 52.8% in January (the month the China-ASEAN Free Trade Area went live), up from December's 50% rise. By comparison exports to the EU increased 17.7% in January, to the US 8.4%, and to Japan 4.7%. In January China's total trade (imports plus exports) with ASEAN outstripped that with Japan for the first time and was up 80% on the same month last year. In January China's total trade with the EU was \$35.2 billion, US \$26.5 billion, ASEAN \$21.5 billion, and Japan \$19.7 billion. In calendar year 2009 total trade with the EU was \$364 billion (16.5% of China's total trade), the US \$298 billion (13.5%), Japan \$229 billion (10.4%), and ASEAN \$213 billion (9.7%). China's total trade with ASEAN was twice as high last year as it was in 2004. According to Chinese statistics China runs a small trade deficit with ASEAN.

**Debate on renminbi policy intensifies**

7. To help exporters the authorities have held the renminbi stable against the dollar since the summer of 2008 (see Figure 3). Now that exports have recovered foreign pressure on China to resume appreciation has intensified (most estimates suggest China's currency is undervalued). But on 25 February the Ministry of Commerce (MofCom) said that China's shrinking trade surplus meant calls by other countries for the renminbi to be allowed to appreciate were "more and more groundless". But the decrease in the monthly trade surplus is likely to be temporary, rather than represent a structural change in China's trade patterns - and is therefore unlikely to reduce foreign pressure on China to appreciate its currency.



8. The debate over China's renminbi policy has intensified at home as well - as inflationary pressure has increased and there is a greater awareness of the need to 'rebalance' China's economy more towards consumer spending (both of which argue in favour of a stronger currency). Professor Yu Yongding, one of China's most prominent economists, argues the current policy is not in China's economic interest. His organisation, the Chinese Academy of Social Sciences (CASS, think tank closely linked to the authorities), has called for a one-off appreciation in the currency of around 10% (this has the advantage over gradual appreciation of potentially reducing, rather than increasing, 'hot money' inflows). But this looks unlikely to happen given the authorities' concerns over the detrimental impact it would have on exporters.

9. The State Council, who decide currency policy, have not yet indicated they are ready to allow the currency to appreciate (Premier Wen continues to insist China will not bow to

foreign pressure on the currency). Contacts suggest the authorities are likely to wait until there have been at least six months of positive export growth before considering a policy change - suggesting the gradual appreciation of the renminbi is more likely to resume in the second half of the year (if it is to happen at all).

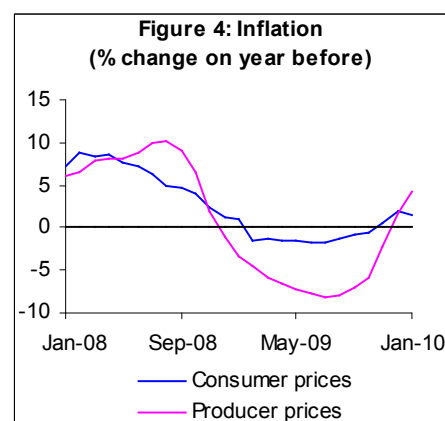
### **Bank lending remains high but further lending restrictions announced**

10. Banks extended RMB 1.4 trillion (£127 billion) in new loans in January, lower than last January (banks usually front load their lending), but higher than the authorities would like (their target for 2010 as a whole is RMB 7.5 trillion). The Chinese government has repeatedly warned banks to moderate lending this year - given concerns the recent surge in lending has fuelled inflationary pressure and asset bubbles, and will lead to a significant rise in non-performing loans (NPLs). The banking regulator, CBRC, has asked commercial banks to check their loans to special investment vehicles set up by local governments (who are not allowed to raise debt directly) to raise funds and to stop lending to projects backed only by expected fiscal revenues. The latest steps follow earlier moves to tighten restrictions on lending to real estate and infrastructure projects. The CBRC has also ordered trust companies to ensure that they are not supplying credit to developers and tightened regulations on the loan sales by banks to trust companies.

### **Risk of high inflation reduced?**

11. Consumer price rose 1.5% in January on a year earlier, lower than December's 1.9% increase (see Figure 4) and below market expectations. Food price inflation was 3.7% in January, down from 5.3% in December - the winter snowstorms appear to have had a less dramatic impact on food prices than was feared. But the timing of Chinese New Year would have had an impact on January's consumer price inflation figure (no holiday boost to sales this January). And producer price inflation continues to rise - to 4.3% in January, up from 1.7% in December. Inflation therefore remains a key risk facing the economy

– not least given continued strong growth in lending and the money supply, and stronger economic growth. But the PBoC are confident they can contain inflation within their tolerance threshold (below 5%) this year.



### **Monetary policy stance unchanged, though policy being 'fine tuned'**

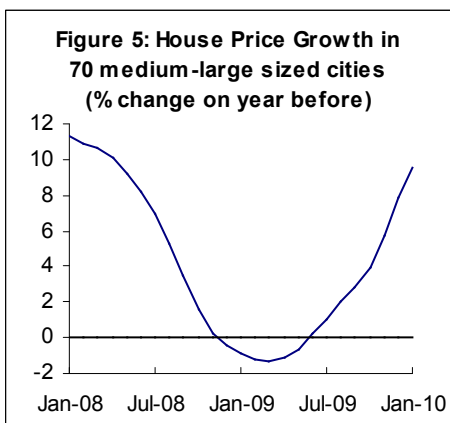
12. At a Politburo meeting on 22 February President Hu restated that the authorities' 'moderately loose monetary policy and proactive fiscal policy' would be maintained in 2010. Hu said the government would strike a balance between ensuring employment generation and avoiding high inflation (Hu's announcement came just days before the National People's Congress, which starts on March 5). But this won't be an easy balance to strike. On 27 February Premier Wen said 2010 would be "the most complicated" year for the Chinese economy.

13. But although the official monetary policy stance hasn't changed the central bank (PBoC) has been 'fine tuning' this policy. The PBoC has raised the yields on both its benchmark three-month and one-year treasury bills and increased bill sales to mop up excess liquidity. The reserve requirement ratio was raised by 0.5 percentage points on 12 January and then once again this month. But contacts tell us the PBoC's focus is on liquidity management rather than cooling the economy. Money supply growth cooled slightly in January but remains high – 26% compared with 27.7% in December – and the PBoC are seeking to bring it down further.

***Fiscal policy remains 'proactive' but shifting emphasis on spending***

14. The leadership has stated that they will not unwind the fiscal stimulus yet given continued uncertainties facing the economy. The fiscal deficit was 2.2% of GDP in 2009, so the authorities still have the scope to maintain relatively high levels of spending. But the authorities said there would be no new government funded infrastructure projects (though existing projects will be completed) and a greater emphasis would be placed on 'social infrastructure' spending. The health of local government finances have become an increasing concern though, given a large increase in off-budget debt (through special investment vehicles) last year to fund the stimulus package. The Ministry of Finance estimates local government debt amounts to 20% of GDP but other estimates put it higher (central government debt is around 20% of GDP). Contacts have told us the State Council is likely to announce new measures to enhance the fiscal stability of local governments. The reliance of local governments on land and property sales revenue is also a concern, and a key reason for rapidly rising land prices.

***Property prices rise faster***



15. National (based on 70 cities) property prices increased 9.5% in January on a year earlier, the fastest rate of increase since early 2008 and up from December's 7.8% increase (see Figure 5). Price rises were the fastest in Haikou (Hainan, 35.1%), Guangzhou (22.4%) and Beijing (16%). But there are signs turnover is falling in some major cities. This suggests the recent measures taken by the authorities – including adjusting property taxes and tightening restrictions on lending to second homes - to curb speculation and cool the market may be taking effect.

On 27 February Premier Wen said the authorities would be able to constrain property price increases and would focus on building more affordable housing. This has become an increasingly important political issue.

***Reports suggest growing labour shortages***

16. There is currently estimated to be a shortage of 2 million migrant workers in the Yangtze and Pearl River Deltas (though some argue this is because many migrant workers are yet to return from their home province after the Chinese New Year holiday). According to a survey conducted by the Ministry of Human Resources and Social Security just after

Chinese New Year labour demand is 15% higher than the same period last year. But this partly to be expected given the troubles faced by exporters this time last year. Reports suggest though that low salary and overtime payments, and more opportunities for migrant workers in inland provinces (due to stimulus package infrastructure spending) are also factors leading to the reported shortages in coastal areas. Migrant workers are now able to obtain similar or even higher salaries inland and be closer to their home.

17. Getting a clear picture of labour market developments in China is extremely difficult as official statistics are woefully inadequate. But the authorities have recently announced they will introduce a new survey based unemployment rate in 2011, which they will claim will provide a more complete picture of the employment situation. The registered unemployment rate (currently 4.3%), which was introduced in the late in the 1980s, has been widely criticised for understating the true extent of unemployment as it only measures unemployment amongst registered urban residents and does not cover China's more than 200 million migrant workers.

### ***Stock index futures to launch soon***

18. Recent reports in the state media suggest the long awaited stock index futures will finally go live on 22 March. On 22 February the China Financial Futures Exchange (CFFEX) started to receive applications for index futures trading accounts. CFFEX said applications had been limited so far, as the securities regulator (CSRC) has set strict eligibility criteria and investors are wary of the higher risks involved. To open an account investors must have a minimum deposit of RMB 500,000 (£46,800), pass a basic knowledge test on index futures, and have made more than 20 mock trades over a total of 10 trading days or have traded commodities at least 10 times within the last three years. The CSRC also raised the minimum trading margin from 10% to 12% and reduced the maximum holding of futures contracts on any one day from 600 to 100.
19. Reports suggest margin trading and short selling (both also recently approved by the State Council) will be launched by April. As of the end of January the Shanghai Composite Index (SCI) had fallen 14% from last August's high - given concerns that monetary tightening may slow growth and cut corporate profits, and announcements by some state banks of plans to raise additional capital after the recent surge in lending.

### ***China-UK Non-Bank Lending Forum***

20. The China-UK Non-Bank Lending Forum took place on 25 February in Beijing, jointly hosted by the People's Bank of China and the British Embassy Beijing. Officials from the Chinese and UK Governments, financial institutions, and academics discussed the policy changes needed to help increase the supply of credit from non-bank financial institutions to consumers, SMEs, and rural residents. This would not only help develop a multi-tiered credit market and contribute to the rebalancing of China's economy, but also address social/financial exclusion.

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