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FOCUS NOTES

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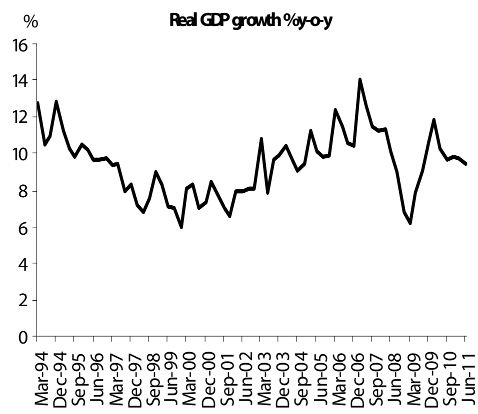
China: A soft landing amid a global slowdown

- China's economy has eased moderately in H1 2011, strongly affected by the monetary tightening, the slowdown in demand from its major export partners, and supply-side bottlenecks.
- A rebalancing of the economy towards consumption could be underway, since the contribution of consumption to real GDP growth has increased significantly from 2010.
- Easing investment activity is expected to constitute the main drag on real GDP growth in 2011 and 2012.
- Overall, real GDP growth is projected to moderate to 9.3% y-o-y in 2011 and 8.9% y-o-y in 2012. This moderation can be considered a soft landing, with the risk of a marked slowdown rather low.
- In our view, even if advanced economies deteriorate much more sharply than anticipated, the downside risks to China's growth outlook are limited by its flexible policy regime.

With uncertainties in the global economy on the rise and weaker outlook in the US and Europe, China's growth prospects have weakened, creating heightened worries about the extent to which China will slow down, given its growing global economic weight. Indeed, China's economy has eased moderately in H1 2011, strongly affected by the monetary tightening, the slowdown in demand from its major export partners, particularly US and Europe, which account for about 40% of China's total exports, and supply-side bottlenecks (domestic power shortages due to severe drought conditions and supply chain disruptions from the earthquake in Japan). According to the latest data, real GDP growth eased to an average of 9.6% y-o-y in the first half of 2011, down from 10.3% y-o-y in 2010 (Figure 1).

Domestic demand was the main driver of growth, with investment and consumption contributing 5.1% and 4.6% respectively. Indeed, the modest pick up of China's National Bureau of Statistics (NBS) PMI manufacturing index in August (to 50.9 from 50.7 in July 2011), is a reassuring sign that domestic demand remains robust. Net exports subtracted 0.1 percentage points of GDP growth, while in 2010 net exports added 1pp to real GDP growth. Survey measures of new export orders verify the weakening external demand growth; the PMI manufacturing new export orders index slumped below the 50-point-level that indicates expansion (to 48.3) in August 2011 for the first time since 2009.

Figure 1

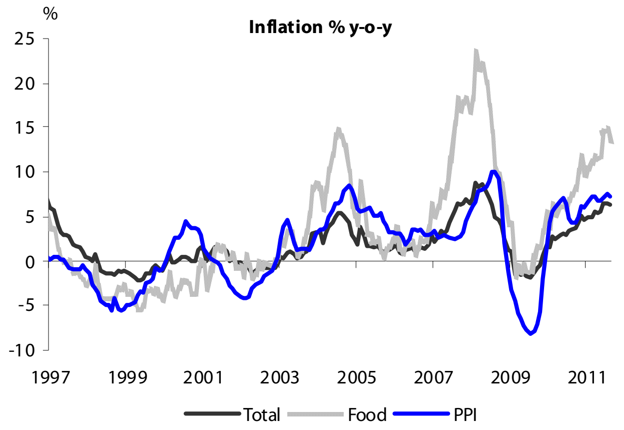


Source: Bloomberg

Looking at the components of real GDP, it seems that a rebalancing of the economy towards consumption could be underway, since the contribution of consumption to real

GDP growth increased to 4.6pp from 3.8pp in 2010, with private's consumption contribution increasing the most (0.6pp), from 2.8pp in 2010 to 3.4pp in H1 2011. Looking forward, we expect private consumption to display some resilience for several reasons. The government will accelerate policy reforms, which would aim at rebalancing the economy and thus support steady improvement in private consumption. Moreover, moderating inflation should underpin consumers' purchasing power. As a result of easing inflation and significant external uncertainties, we believe that monetary tightening most likely will come to a halt, easing some of the headwinds that interest rate hikes brought to real incomes and private consumption since the tightening cycle has started a year ago. However, we do not expect the People's Bank of China to shift toward an easing bias soon, either. Although the August reading of CPI inflation shows that China's inflation eased to 6.2% y-o-y from a three-year high of 6.5% y-o-y in July 2011, there are still some risks of a spill over of still high producer prices (above 7% y-o-y in August 2011) and food prices into consumer prices, suggesting that inflation will come down only gradually (Figure 2).

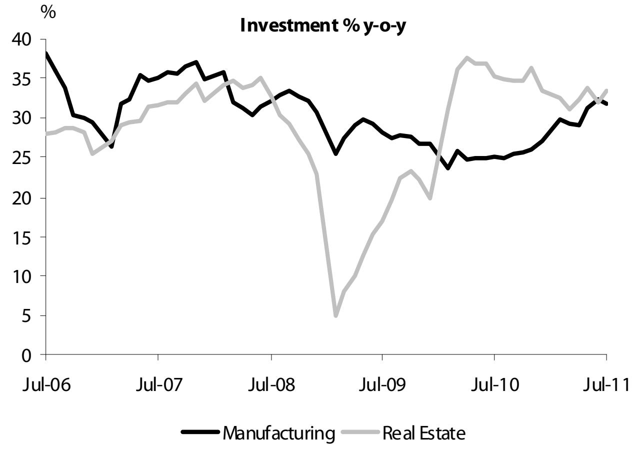
Figure 2



Source: Bloomberg

Contrary to consumption, the contribution of investment to real GDP growth decreased to 5.1pp in H1 2011 from 5.6pp in 2010 and 8.4pp in 2009, when the Chinese government introduced a CNY 4 trillion stimulus package. We expect easing investment activity to constitute the main drag on real GDP growth in 2011 and 2012. Investment growth is expected to slow further for several reasons. Taking into account that manufacturing accounts for more than 30% of total fixed asset investment, the ongoing exports slowdown is likely to affect about one third of China's investment activity. Moreover, real estate investment which accounts for about 25% of total fixed asset investment is expected to worsen due to persistent tightening measures to slow property price increases (Figure 3).

Figure 3



Source: Bloomberg

Looking forward, we expect real GDP growth to moderate to 9.3% y-o-y in 2011 and 8.9% y-o-y in 2012. This moderation can be considered a soft landing, with the risk of a marked slowdown rather low. China's economic performance will remain robust and steady growth rates should continue. Indeed, China is expected to remain the leader of global growth, growing substantially faster than advanced economies over the next few years. China's share to global GDP has increased substantially since 1980, accounting for 13.6% of GDP in 2010, significantly up from 2.2% in 1980. Indeed, according to the latest IMF forecasts[1], based on PPP data, China is expected to overtake the US and become the world's largest economy by 2016.

In our view, even if advanced economies deteriorate much more sharply than anticipated, the downside risks to China's growth outlook are limited by its flexible policy regime. Although the policy space for stimulus is more constrained than in 2008 because the economy still faces the consequences of the stimulus package, including elevated inflation, local government debt and asset bubbles, we believe that a sharp external growth slowdown would trigger a quick policy response, with the introduction of a new stimulus package, albeit significantly limited compared to the previous package. Indeed, China's fiscal situation is relatively healthy. National government debt (including local governments' debt) is about 45% of GDP, which is well below that of advanced economies. Meanwhile, fiscal revenues have been growing at an average rate of about 32% y-o-y over the first eight months of 2011, enhancing the government's capability to respond to a marked slowdown in growth.

[1] *IMF, World Economic Outlook Database, September 2011*

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