

**ECONOMICS:** ASIAN PERSPECTIVES—JULY 9, 2010

# China's Next Leap Forward—Economic Rebalancing and Structural Adjustment (Part 2)

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Last week we highlighted the key structural changes that China needs to pursue to fulfill its new economic strategy. This week, our analysis shifts to looking at how much of the economic rebalancing seen so far is down merely to cyclical factors and how much represents the start of genuine structural change.

### Domestic Demand Is Leading Growth

The trends presented in **Display 1** are often cited by economists and government officials as evidence of the progress of China's restructuring over the past year. On the surface, the rebalancing story looks pretty promising. China's external surplus is no longer a major driver of GDP expansion. In fact, the fall in net exports dragged down overall growth by 30% in 2009, a turnaround from the usual positive contribution of some 20% a year seen during the period 2005 to 2007. For the current year we expect that the external sector will, at best, make a flat contribution to growth.

This means that recent economic expansion has been driven entirely by domestic demand (in fact it contributed 130% of the net growth in GDP seen in 2009) and, more importantly, it seems to have come in the right mix for China's new development plans. Thus the contribution from private consumption jumped 15% to 44% in 2008 and stayed high at 40% in 2009 (and has probably remained high in 2010).

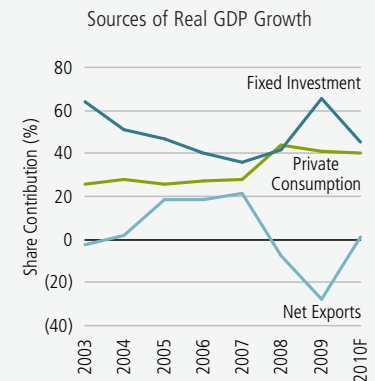
At the same time, while the share of growth coming from investment surged last year, it is now set to decline as the effect of fiscal stimulation fades and the property sector consolidates.

### Structural or Cyclical Boost?

So, is this sufficient evidence to suggest an encouraging start to China's economic rebalancing? Not really. The problem is that the sectoral shift in GDP growth has occurred against the backdrop of huge countercyclical measures implemented by policymakers in response to the global crisis in late 2008. It is therefore difficult to accurately assess the impact of some of the policies which Beijing has been pursuing over the past few years to kick-start economic restructuring.

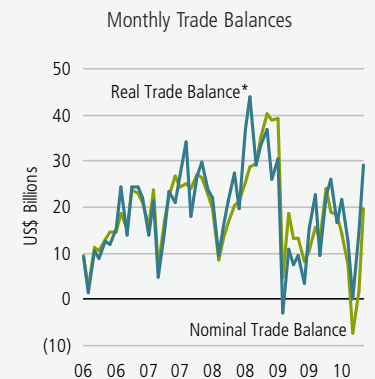
On consumption-related measures, the key policies include a toughening and broadening of social welfare insurance for workers. The government has also increased the flexibility of the household registration system (*Kouhu* system), which allows rural migrants to maintain their

Display 1  
Has Rebalancing Started?



Source: CEIC Data and AllianceBernstein estimates and forecasts

Display 2  
External Surplus Has Dropped...



\*Constant 2005 prices  
Source: CEIC Data and AllianceBernstein estimates

entitlement to social welfare and health-care benefits if they have moved within the

same province. These changes should have helped reduce the precautionary savings that a broad spectrum of households have felt necessary to maintain up to now.

On investment and exports, the government has increased its efforts to phase out some of the country's low quality and resource-intensive industries by increasing taxes and reducing export rebates. But China's competitive edge in these low-margin products has anyway been eroded by other official policies. For one thing, local production costs have been increasing as the state has started to phase out large subsidies which have protected local industries up to now. This has reduced the gap between the onshore price and the offshore price of many energy (e.g., oil and fuel) and commodity products (such as steel, coal and aluminum). Equally importantly, the Chinese renminbi appreciated by 20% cumulatively against the US dollar in the three years after changes were made to the foreign exchange regime in mid-2005, which has pushed up the price of exports.

While we would not wish to downplay the cumulative impact of some of the fundamental structural changes, we don't think that they are powerful enough yet to have produced the speedy change in China's growth engine highlighted in **Display 1**. In our view, the recent rebalancing has been as much due to cyclical factors as the countercyclical measures which have been implemented by the government over the past year.

### Rebounding External Surplus

**Display 2 (previous page)** shows that China's trade surplus has dropped markedly since the global crisis started in late 2008. In fact, the surplus in 2009 was one-third smaller than that in the previous year, and has contracted by another 60% during the first five months of 2010. However, a closer look at the recent trends seems to suggest that China's trade surplus is making a comeback, having reached a trough in the first quarter of

2010. This is more apparent if we look at the trade balance in real terms, which shows that the surplus in May (at US\$30 billion in 2005 constant prices) has already rebounded to pre-Lehman collapse levels.

This rebound has come after China's external surplus suffered a double whammy last year. On the one hand, it had to cope with the recession-induced decline in world trade in 2009 at a time of an unprecedented surge in purchases of foreign commodity products by local firms as part of the government's RMB4 trillion fiscal stimulus program (**Display 3**). On the other, the terms of trade have worsened sharply. This negative price effect has exacerbated the deterioration in the trade account (**Display 4**). But real export growth has recently been resuming strongly and has started to outpace real import growth again. At the same time, export prices have been slowly reviving, while import prices seem to have peaked. So the size of China's trade surplus will probably be the focus of international attention again in the coming year.

### Drivers of Domestic Demand

In terms of domestic demand (**Display 5**), China's fixed investment growth has moderated, but only back to around trend level (15% to 20% year-on-year growth) after a phenomenal surge in 2009. This slowdown has been due to the peaking of infrastructure investment and the recent consolidation of the real estate market. Meanwhile, consumption growth—as reflected in retail sales—has remained extraordinarily robust and, in our view, there have been strong cyclical supports behind it.

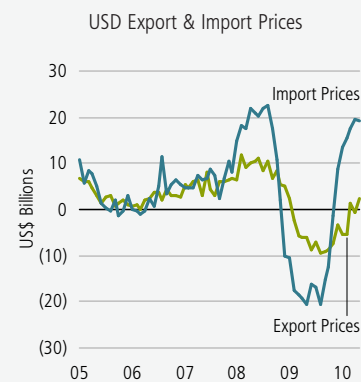
It is true that Chinese wage growth has remained at double-digit levels throughout the global crisis and any retrenchment in employment was short-lived once exports and construction activity resumed. Nonetheless, much of the strength in consumer spending has been buttressed by the government's tax incentives and income subsidies (part of last year's fiscal

Display 3  
...Due Largely to Cyclical Changes in Trade Volumes...



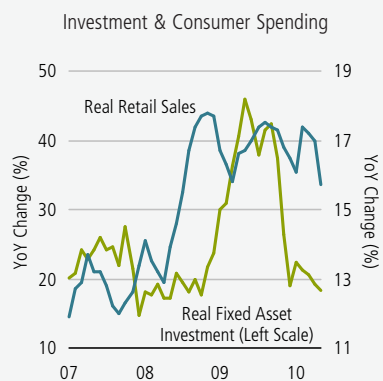
Source: CEIC Data and AllianceBernstein estimates

Display 4  
...and Prices



Source: CEIC Data and AllianceBernstein estimates

Display 5  
Consumption Is Firm but Investment Is Moderating



Source: CEIC Data and AllianceBernstein estimates

program), especially those aimed at stimulating purchases of white goods and motor vehicles by China's 700 million rural dwellers. In fact, the country's continued fiscal strength has allowed the government to extend the subsidies on home appliance purchases into this year.

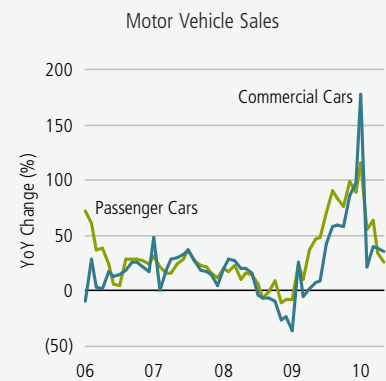
The initial boost to the sales of these goods is obvious from **Displays 6 and 7**. By the same token, the surge in property transactions before the recent dip also brought with it a significant jump in sales of furniture, household appliances and home decoration materials. We believe the cyclical peaks in most of these items should have now been reached. China therefore needs to implement more

supportive policies to sustain continued robust consumption growth.

### Restructuring: A Work in Progress

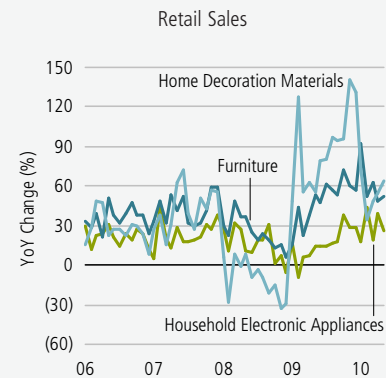
China's much-talked-about rebalancing process has yet to demonstrate that it rests on solid foundations. We suspect that the positive trends evident recently will fade once cyclical factors start to unwind. For true restructuring to take effect and for China to play its part in the rebalancing of the global economy, significant further policy changes are required. In next week's Asian economic commentary, we will turn our focus on to consumption and the structural changes that are needed to turn China into a world consumer. ■

Display 6  
Tax Effects Have Boosted Car Sales



Source: CEIC Data and AllianceBernstein estimates

Display 7  
Property-Related Sales Have Fallen



Source: CEIC Data and AllianceBernstein estimates

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