

ECONOMICS: ASIAN PERSPECTIVES—JUNE 18, 2010

# China Update: Steady as She Goes, and Even Less Chance of a Sharp RMB Revaluation

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Our GDP growth forecast for 2010 remains intact, although we see some downside risk from exports; we still expect only one interest-rate rise before year-end and we don't expect an increase in minimum wages to result in exported inflation.

We have just returned from a research trip to China where we discussed various key macro issues with our contacts. Below, we update our assessment of the economic and policy outlook for the country.

## Growth Prospects

There is still tremendous optimism among business executives and local government officials about the outlook for economic growth, an effective monetary policy exit and long-term economic restructuring and rebalancing. We strongly sensed policy-makers' concern at the possibility of a spillover of risk from the European debt crisis, and this essentially reinforced our view that Beijing is ready if necessary to be relatively accommodative, despite being in the throes of a policy-exit cycle.

We are still confident about our GDP growth forecast of 10.4% in 2010, with the quarterly growth trajectory moderating from 11.9% year on year in the first quarter to around 9% year on year in the final quarter. This suggests a slowdown of the annualized rate from the exceptionally high 9.5% in the first quarter to around

8% in second half 2010. We think the latter, at this juncture, sufficiently accounts for the potential downside risk from China's residential property correction as well as any slowing of world trade caused by weaker European demand.

In our view, the biggest downside risk to our GDP forecast for 2010 comes not from private consumption growth (which is projected to remain strong) or a slowdown in the expansion of capital investment from last year's frenetic pace, but from a potentially worse-than-expected net exports position. As a result of last year's export collapse, net exports detracted from real GDP growth by one third, compared with an average 20% contribution in 2005–2007. We expect net exports to be neutral to GDP growth this year, but the reported 60% year-on-year nominal decline in China's merchandise trade surplus in the first five months of this year points to a possible downside risk to our forecast. That said, it seems that the worst of the deterioration in China's trade surplus is over, given that the surplus in May rebounded sharply and increased by

some 45% on the year. Moreover, much of the deterioration of the merchandise trade account has been caused by rising imported commodity prices. In real terms, however, the trade account should be in a much better position than the nominal trend suggests. Furthermore, China's services balance should improve along with the export recovery. Overall, we still assign a low possibility to net exports causing a big drag on GDP growth of similar magnitude to last year's.

## Policy Outlook

Despite the headline grabbing news of the May CPI figure increasing to 3.1% year on year—surpassing the central bank's line-in-the-sand 3% inflation rate—we see no evidence of the market rushing to forecast an imminent rise in interest rates. Instead, the largely tame inflation trend so far in 2010 has reinforced our long-held view that China faces little threat of an imminent inflation breakout, and we think the consensus is moving in our direction. As stated before, we have scaled back our forecast for lending rate increases from three of 27 basis points each this year to just one, in the final quarter. Some of the contacts we spoke to even suggested they would not be surprised if no rate rise took place this year. Similarly, further tightening measures directed at the property sector also look unlikely as Beijing waits to assess the impact of actions already taken.

## Wage Inflation

Last week's big story was the surprise approval of various levels of minimum wage across the country. The announcement may have been prompted by labor disputes and the doubling of long-depressed basic wages (to around US\$200 a month) at Foxconn and the Honda plants, but the move was generally perceived positively as a way of triggering China's restructuring and rebalancing over the long run, by making consumption a bigger driver of economic growth.

A proposal to increase minimum wages has been discussed for some time and the implementation, in our view, reflects Beijing's overall confidence in the growth and inflation outlook. More importantly, it also reflects a sense of the urgency needed

to deal with China's growing income disparity problem and the leadership's determination to increase labor compensation as a component of GDP. Higher wages are a key to kick-starting China's restructuring similar, in our view, to Japan sharply devaluing the yen to help solve its entrenched deflation problem. Inevitably, China's low-margin businesses will be most affected, but the move to higher wages should also mean more incentive for these operations either to leave China for even cheaper production sites elsewhere, or to relocate inland to maintain their competitive edge (Foxconn is already reported to be hiring more workers at its inland city plants). With skilled workers and a competitive infrastructure and logistics system, we think China's coastal provinces stand a good chance of moving further up

the production value-added ladder.

We need to assess China's potential for wage inflation in the near term carefully, however, and be wary of concluding that the country is about to become a big exporter of inflation to the rest of the world. Not all manufacturers pay the depressed basic wages previously paid by Foxconn and Honda, and many of them pay rates that are little different from the proposed minimum wages set by local governments. One thing is certain: a higher overall wage structure will only reduce the prospect of a sharp revaluation of the renminbi in the near term, as Beijing will almost certainly wish to avoid a double-whammy effect on manufacturing exports. ■

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