

ECONOMICS: ASIAN PERSPECTIVES—JANUARY 20, 2012

China: Our Policy Expectations in the Year of the Dragon ... and Change at the Top

■ **Anthony Chan**
 Asian Sovereign Strategist—Global Economic Research

We believe the Hu-Wen leadership is determined to achieve three broad objectives in its final year in office: to avoid a recession, sustain disinflation and curb the property bubble. The policy choices are not easy, and may be mutually contradictory.

China's Leadership in Transition

In March 2013, a change will occur in China's top leadership when the term of the current regime, led by President Hu Jintao and Premier Wen Jiabao, comes to an end. At this juncture, it seems highly likely that the current Politburo Standing Committee members, Xi Jinping (Vice President) and Li Keqiang (Vice Premier), will assume the presidency and premiership respectively at next year's National People's Congress.

Since the Communist Party in China is also the government, the broad lineup of the next regime's top leadership cadre should be more or less known at the Party Congress this coming October. Such orderly succession arrangements are likely, in our view, to influence economic policy this year as both the outgoing leaders and their replacements will want the transition to take place in a favorable economic environment. Accordingly, we believe the Hu-Wen leadership is determined to achieve three broad objectives in its final year in office.

Policy Objectives to Support Change

First, Beijing needs—amid lingering global uncertainty—to avoid a recession. Second, it needs to sustain the current disinflation trend throughout 2012. Third and crucially, the speculative property bubble needs to be curbed, as it is the main cause of the leveraging problem in the financial system.

These objectives may be mutually contradictory, however, if, for example, a policy relaxation to avoid a hard landing is too accommodating, and so rekindles inflation. Alternatively, a property crash could trigger an economic recession and drastic de-leveraging, while a shallow property market consolidation would not help much in scaling back some of the massive liquidity injected since 2009–2010. These are not easy choices, admittedly, but politicians need to prioritize their policy objectives.

On the basis of recent economic trends, however, we think Beijing's policy mindset is likely to run along the following lines.

Display 1
Investment Growth Remains Resilient...



As of December 2011
Source: CEIC Data and AllianceBernstein estimates

Display 2
... Thanks to Manufacturing and Social Housing Construction



As of December 2011
Source: CEIC Data and AllianceBernstein estimates

Recession Avoided

The economy has entered a cyclical slowdown at a fairly steady pace. There are no signs of a collapse, either in China or in neighboring countries. External demand has slackened significantly (export volume has grown just 3%–4% year on year in recent months) but local demand is still sufficient to offset the downturn in exports. Social housing construction remains robust, and this will counteract the downturn in private property investment. Manufacturing investment is still surprisingly firm, which may be the result of a step-up in investment in machinery and equipment as manufacturers face a growing labor shortage (**Displays 1 and 2, previous page**). Domestic consumption continues to be a bright spot and retail sales volume overall has actually been reviving, although the property sector consolidation has dragged down the purchases of white goods and home decoration materials (**Display 3**). The bottom line is that, with the increasing tightness in labor supply, China no longer needs 10% GDP growth to support full employment. It still needs to generate 7%–8% growth, however, to ensure there is no slippage in labour demand—a necessary measure to minimize the risk that, when it takes office, the new leadership will be confronted by social instability.

Disinflation Is Set

We expect the disinflation trend to be cemented this year. The normalization of food prices is certainly helping to bring about a drastic drop in headline consumer price inflation, but an even more comforting trend has been the equally dramatic decline in producer price inflation (to just 1.7% year on year in December from more than 7% year on year only a quarter earlier). This will cause cost-push inflation to fade (**Display 4**).

Property in Consolidation

Beijing's property sector measures have been blunt but effective. The December official property report showed that only

two out of 70 cities surveyed still enjoyed month-on-month price increases in residential property, while 50 cities reported a monthly price decline. Also, prices for established homes have dropped following the decline in prices for new builds, indicating consolidation in the secondary market, too. Furthermore, transaction volumes in some major cities are contracting by 20%–70% year on year, creating the conditions for a meaningful correction in prices. While it is clearly too early for Beijing to claim victory in this policy area, the measures have certainly achieved initial results, in our view. The “home purchase restriction” aimed at nonresidents has already been slightly relaxed (in late December), and we continue to expect a gradual easing of measures from the second quarter onwards, so that the new leadership will not have to contend with a downward property spiral.

Policy Expectation

Fiscal policy should be relatively straightforward, no longer directly boosting investment outlays but, instead, using tax incentives to stimulate local consumption. This will also assist in the policy of rebalancing towards a more consumption-driven economy.

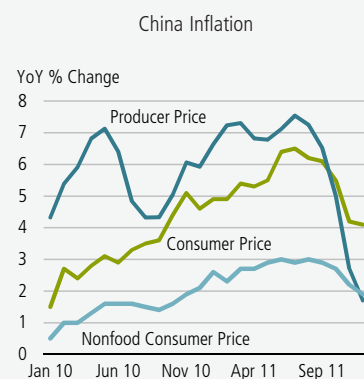
Monetary policy has already been relaxed and will only be loosened further in the coming year. The jump in new loans in December to RMB650 billion and the corresponding bounce in M2 growth to 13.6% year on year, from 12.7% year on year in November, were the first evidence of the effects of monetary easing. Before that, China's monetary policy had been too tight even though a gradual relaxation had been initiated early in the fourth quarter. In November (latest available data), the monetary base (defined as reserve money adjusted for changes in the reserve requirement ratio) shrank by around 11% year on year. This was a reflection of the depletion of foreign assets (foreign exchange reserves) from the balance sheet of the People's Bank of China (PBOC),

Display 3
Consumption Stays Robust



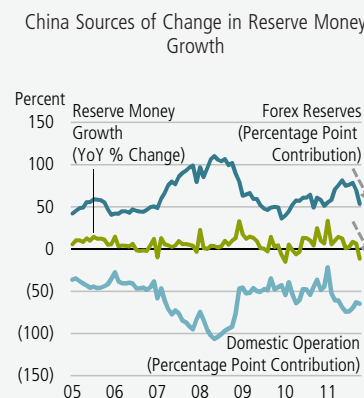
As of December 2011
Source: CEIC Data and AllianceBernstein estimates

Display 4
Disinflation Continues



As of December 2011
Source: CEIC Data and AllianceBernstein estimates

Display 5
Monetary Base Contracts...



As of November 2011
Source: CEIC Data and AllianceBernstein estimates

together with the fact that the central bank did not scale back its domestic sterilization operations sufficiently to compensate for the (admittedly marginal) impact of the foreign-asset drawdown. Broad money growth remained sluggish as there was no apparent boost to the money multiplier that would have caused an expansion in system-wide liquidity **(Displays 5, previous page, and 6).**

While the market is worried about hot money outflows from China (we estimated a total of around US\$180 billion in second half 2011), the trend is actually not bad news from the PBOC's perspective, as it means the central bank can be more confident in its domestic policy easing. Realistically, it is difficult for China to de-leverage—that is, reduce its credit/GDP ratio, which is 125%. We expect the PBOC will implicitly set a new loan target of around RMB8.0–8.5 trillion in 2012 (compared with RMB7.5 trillion in 2011) which should translate into annual loan growth of about 15%. This will mean a

credit growth rate more in tune with nominal GDP growth and, consequently, a leveling out of the credit/GDP ratio at the current level. This would be prudent enough, in our view, as a financial backdrop for the new leaders to begin their administration in 2013.

While policy measures regarding formal bank lending have begun to ease, informal lending—equivalent to about 35% of banks' formal or on-balance-sheet assets—presents a policy complication. Since mid-2011, the government has increased the direct controls on off-balance-sheet lending, causing a drastic decline in the volume of informal loans in the system. Recently, Beijing disallowed the use of trust loans to fund property activity, a move that helped reinforce the downturn in the sector. We expect controls on informal lending to stay tight this year but, if history is a guide, greater credit availability in the formal channel should reduce demand for informal credit. ■

Display 6
...and Financial Intermediation Remains Weak



As of December 2011
Source: CEIC Data and AllianceBernstein estimates

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