INSIGHTS

# China's Goldilocks Economy

## The congee may be "just right"

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The latest economic indicators support our view that China's economy is back on a strong, sustainable growth path set to extend through 2011 and beyond, with inflation trending up, but at a slow pace.

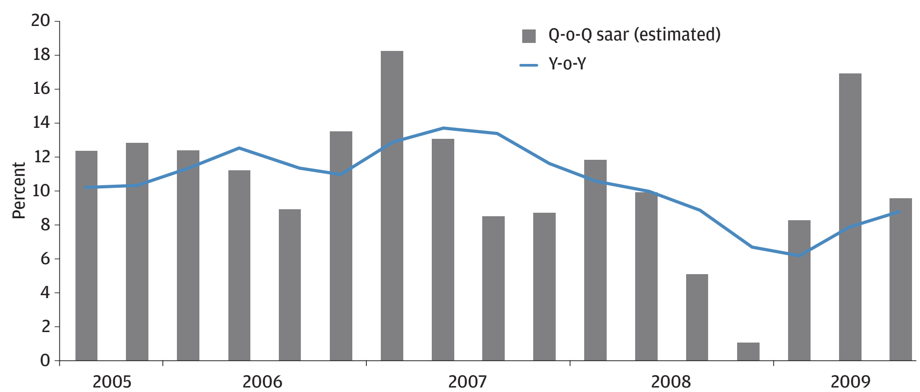
## GDP Growth: Strong But Moderating

We always thought China's recently released third quarter GDP data would pleasantly surprise. In fact, the report in our view does enough to confound both minority camps: (a) those who see China's growth as unsustainable, based on little more than policy steroids and (b) those who see it as running out of control and headed for another bout of overheating.

The main point to stress is that the third quarter 2009 figures point to an economy that remains on a sustainable GDP path and which is thus unlikely to elicit any major policy tightening response by the authorities. Indeed, commenting on the release, the National Bureau of Statistics spokesperson said Beijing would continue to "insist on the proactive fiscal policies and moderately lenient monetary policies" and that "the overall situation of the national economy was good." That remains our view as well.

On an annual basis, real GDP grew by 8.9% in 3Q:09, up from 7.9% in the second quarter. The higher annual growth rate was due to a lower base in 2008. However, in quarter-on-quarter terms (see CLSA estimates in **Exhibit 1**) growth lost some momentum, decelerating to a much more sustainable trend—one that Beijing is likely to be more than comfortable with. To overwork a phrase that one no longer hears in a U.S. context, the Chinese economy has entered a "Goldilocks" growth

**EXHIBIT 1: CHINA GDP—WATCH THE Q-o-Q, NOT THE Y-o-Y**




Source: CLSA China GDP and Quarterly Data by Charts, October 22, 2009.



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phase where the porridge/congee is neither too hot nor too cold, but at just the right temperature.

Turning to the composition of final demand, the official GDP data does not provide a quarterly expenditure breakdown. But according to the release, over the first three quarters of 2009 GDP grew by 7.7%, with investment contributing +7.7% and domestic consumption contributing +4% (implying a net trade contribution of around -4%). This is confirmation that China can achieve strong GDP growth in 2009 despite a negative contribution from net exports. There was some sign of a shift towards domestic consumption in 3Q:09, as retail sales volumes grew by 5.5% qoq, faster than the overall growth of China's economy.

Further supporting our optimistic view of China's growth outlook we note the following:

- A manufacturing Purchasing Managers Index (PMI) above 50 for seven consecutive months
- Higher-than-expected total new RMB bank loans in September (Rmb517bn, ex-discount bills totaling Rmb868bn)—and no early tightening by the People's Bank of China (PBoC)
- Above-consensus trade performance; September exports and imports up a solid 9.3% and 12.8% mom
- Electricity consumption growth nearing double digits (9.5% y-o-y), led by industrial demand
- Firm retail sales trends with volume growth above 15% y-o-y (**Exhibit 2**)
- Very strong auto sales, up 77% on September 2008 (**Exhibit 2**)
- A vigorous recovery in the property market (September real estate investment up 36% y-o-y)
- Infrastructure projects substantial enough for urban fixed asset investment (FAI) to continue driving growth in 2010

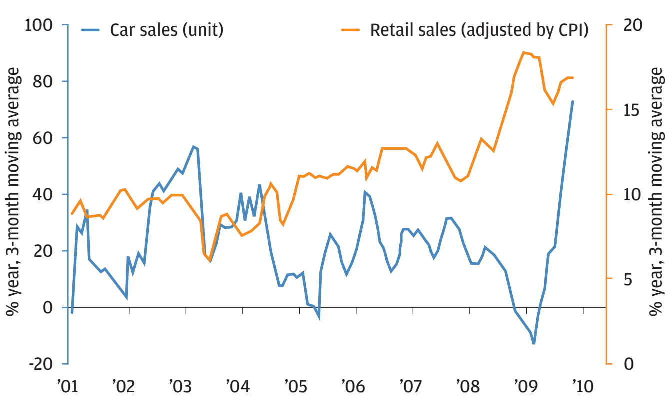
With respect to FAI, growth was 32.9% y-o-y in 3Q:09 (CLSA estimates) vs. 35.9% in 2Q:09, which is hardly a major change of pace. But on a quarter-on-quarter basis, growth may have slowed to 3.4% from 13.9% in 2Q:09. This is perhaps the one aspect of China's recent macro data where the more bearish might see weakness ahead. So far though, FAI is still quite robust at 14% annualized in 3Q:09. It is also a noisy series where higher frequency changes are best filtered to gauge the underlying trend.

## Inflation: At a Turning Point

Inflation has reached an inflection point and the trend has now turned up, but the pace of increase from here will likely be gradual. The People's Bank of China (PBoC) is unlikely to feel too much concern while annual consumer price rises remain below a 3% to 4% threshold. Negative headline inflation plus a more normal rate of domestic credit expansion together limit the risks of policy tightening near term: the first PBoC rate hike may not arrive before the second quarter of next year, though China's central bank may still find itself acting well ahead of the Fed.

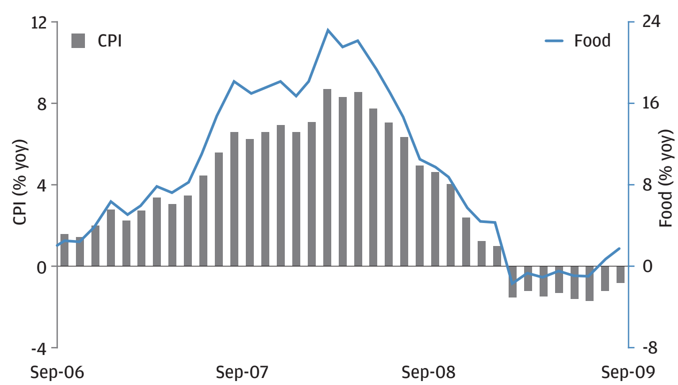
On an annual basis, deflation was still evident at the end of 3Q:09, with the headline CPI at -0.8% in September, down from -1.2% in August (**Exhibit 3**). Inflation, however, has turned

**EXHIBIT 2: RETAIL SALES SUPPORTED BY BOOM IN AUTOS**




Source: HSBC China Economic Spotlight October 22, 2009.

**EXHIBIT 3: CPI AND FOOD PRICE INFLATION BOTH BENIGN**




Source: CLSA China GDP and Quarterly Data by Charts, October 22, 2009.

positive on a monthly basis, up 0.4% m-o-m in September following a 0.5% rise in August. Food prices were the main driver in the last bout of inflation in 2004 through 2006. Currently, they are quite subdued, up 1.5% m-o-m in September from 0.5% in August. With sustained expansionary monetary policy, inflation can be expected to trend slowly higher from here.

In conclusion, with economic growth continuing at a sustainable pace and inflation trending moderately upward, we believe real policy tightening is unlikely before mid-2010 at the earliest. China has, however, begun, to implement its own quiet "exit strategy" in the form of a gradual reduction in public sector stimulus as private sector final demand takes over the running. **Market nervousness and dips on account of this should prove to be buying opportunities for those who can cope with the volatility.**


## CONTRIBUTORS

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