Opinion Article

THE CHINESE ECONOMY: EVALUATION OF 2009 AND PREDICTIONS FOR 2010

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Evaluation of 2009

It is now a consensus that China has achieved its target of 8% real GDP growth in 2009. In the beginning of 2009, most economists considered it too high a goal to be achieved. There was a good reason for this expert view. China's spectacular economic growth in 2002-2008 was largely driven by export growth at an average annual rate of around 30%. When the global financial crisis deepened in the fourth quarter of 2008, China's exports dropped sharply by 30%, which caused a near-zero quarter-to-quarter growth in China's real GDP in the fourth quarter of 2008 (year-to-year growth was 6.8%). The conventional wisdom is that such a strong downward trend is difficult to be reversed quickly, even if by the iron hand of the Chinese government.

The Chinese government proved that "Impossible is nothing". The government first announced a 4 trillion RMB fiscal stimulus package in November 2008. Then state-controlled banks issued new loans at an unprecedented fast pace, totaling over 9 trillion RMB in 2009. In addition, local governments were given the green light to spend money, and ten industries were selected to be boosted by a national industry revitalization program. With this wide range of actions from the government, the Chinese economy bottomed out in the first quarter of 2009 (6.1% year-to-year growth) and returned to double-digit growth by the fourth quarter of 2009 (10.5% year-to-year growth expected).

While the Chinese economy looks good in GDP growth, it has become more imbalanced and distorted. Before 2009, the Chinese economy was already overly investment-driven; now it becomes even more so. Before the crisis, the large production capacity built by investment could be absorbed by the global market. Now the external demand for Chinese goods is much less robust and it is no longer able to absorb China's excess production capacity any

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more. In the near future of one to two years, the Chinese economy can still rely on increases in government investment to maintain a high growth rate, but this is neither healthy nor sustainable.

So 2009 is both a blessing and a curse for China. On the one hand, 2009 provided China an opportunity to increase its relative power in the world economy. For example, China's banks took the top three spots in the global ranking of banks (Forbes, April 2009). China's stock prices doubled, and China surpassed Germany to become the no. 1 exporter of the world. On the other hand, China's fast recovery turned against itself in that it drove up the prices of natural resources that China imported heavily and also caused other countries to impose more trade restrictions on Chinese exports. The biggest curse is that the short-run success was achieved at the cost of intensifying the distortions in the economy. Before 2009, the Chinese economy had seen a gradual increase in the share by the private sector; this trend was reversed in 2009. Before 2009, the housing prices of Chinese cities had been gradually stabilizing; this desired situation was destroyed and housing prices saw sharp increases in 2009 again. Before 2009, China was on the track to reduce its external imbalance (too much trade surplus) by appreciating its currency and reducing tax rebates to exporting firms. Now RMB is effectively pegged to the U.S. dollar and tax rebates to Chinese exporting firms have been resumed.

In any case, the V-shaped recovery of the Chinese economy is good news for businesses in China. Although there are serious structural problems in the Chinese economy, which were further intensified by the anti-crisis policies in 2009, they do not present an immediate threat to most businesses in China. Nevertheless, for those companies that have a long-term interest in the Chinese market, it is important to develop a perspective on the Chinese economy in a longer time horizon.

Predictions for 2010

As we have learned from experiences of the past, in particular from 2009, the outlook of the Chinese economy is largely driven by government policies. What kind of policies will the Chinese government implement in 2010? Without answering this key question, one would not be able to predict the Chinese economy correctly.

The Chinese government stated that it will maintain a "proactive" fiscal policy and a "moderately loose" monetary policy in 2010. It is expected, however, that China will adjust its policies in 2010 in certain ways and at certain chosen times. Because the global recovery will be slow, China will still need fiscal expansion to maintain its economic growth and employment. The fiscal stimulus package of 4 trillion RMB is for two years and the money will continue to be spent in 2010. The Chinese government has a relatively low debt-GDP ratio of 20%, and government tax revenue increased by 30% in 2009, so there is still enough room for further government spending.

China's monetary policy is expected to be tightened. The amount of new bank loans issued in 2009 was extraordinarily high (exceeding 9 trillion RMB), which led to sharp increases in housing prices in China's cities. The real estate sector is a major source of revenue of local governments, and hence there exists great resistance against policies aiming

to cool down the real estate market. However, housing price is also a very sensitive social issue. When the increase of housing prices exceeds certain limit, the central government will act to contain the increase. Although CPI inflation is expected to be low (below 3%) in 2010, China's central bank, the People's Bank of China (PBoC), has emphasized the need to manage inflation expectations before it materializes. All these suggest that China's monetary policy will be tightened in 2010. As to the timing and the magnitude of China's policy adjustment in 2010, it will depend largely on the degree of recovery of China's exporting sector. If China's exports recover faster than expected and by a larger amount, the Chinese government is likely to carry out its monetary tightening (or so-called exit strategy) at an earlier time and by a larger magnitude.

The degree of China's export recovery will also be an important consideration in China's adjustment of its exchange rate policy. If China's exports recover strongly, the Chinese government may consider adjusting its RMB policy. However, since the global market is not likely to recover strongly in 2010, the likelihood that the Chinese government allows RMB to appreciate in 2010 is rather small. China has accumulated 2.3 trillion U.S. dollar foreign exchange reserves. To alleviate the inflationary pressure it brings, the Chinese government may speed up the process of financial opening to encourage more overseas investment by Chinese citizens and Chinese companies.

As discussed earlier, China's anti-crisis policies in 2009 intensified the structural problems underlying the Chinese economy. Although the structural problems do not present an immediate threat, they constitute risks to the medium- and long-term future of the Chinese economy. Year 2010 may be viewed as a starting point of China's transition towards a new "steady state". For the next ten years, we may envision two extreme scenarios. The best scenario is that China finds a way to moves up in the ladder of economic development with more income and a better safety net for ordinary people, more private consumption, an upgraded production and export structure, a larger service sector, a more efficient financial sector, a more balanced external account, and a more flexible exchange rate. The worst scenario is that China continues with the resource-intensive investment-driven growth model, an inefficient financial sector, a rigid exchange rate, an increasingly imbalanced external account, and with asset price bubbles building up, which will eventually lead to a hard-landing and a prolonged period of stagnation. Neither of these two extreme scenarios may actually occur, but they serve as useful references for us to formulate a long-term view about China's future.

To summarize, we expect that China will continue its fiscal stimulus policy in 2010 but will tighten its monetary policy to cool down the real estate market and reduce inflation expectations. The Chinese economy is expected to grow at around 10% in 2010. We believe that 2010 will be a critical year for the Chinese government to initiate post-crisis policies towards building a new economic model for China. Companies with a long-term interest in China should keep a watchful eye on these policies.