

Research

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China: Booming growth and big FX reforms – but challenges loom

- Last month I visited China talking to local analysts and policy makers. The general impression is that the dynamism and optimism in the Chinese economy remain intact. And as China moves further up the value chain it is difficult to see anything stopping the Chinese boom just yet.
- We forecast that the Chinese industry will gain speed during spring as the global industry bottom out. With investment growth remaining around 20% y/y and China's industry doing fine we expect the economy will grow at close to 10% y/y in 2007.
- Moving beyond the outlook for short-term growth the big issues in China are 1) the environment, 2) inequality, and 3) rebalancing the economy. We provide a brief update on the issues.
- On the fx front big changes are underway. China will create a new investment agency to manage a portion of the foreign exchange reserves. The investment agency will invest in stocks, bonds, equity stakes and probably also energy supplies. On the margin the changes to China's fx reserve policy are a) USD negative, b) positive for risky assets, e.g. equities and emerging market assets and 3) negative for developed market bonds.
- We expect the Chinese authorities will allow for more flexibility in the renminbi. A more active use of China's fx reserves and a more flexible currency will over time diminish the 'automatic stabilization' on the global financial markets coming from central bank buying.

Boom continues

Will China re-accelerate again?

A recent trip to some of the financial centres in Asia involved a series of talks with local analysts and policymakers in China. In this paper we report back on our impressions of the Chinese economy, focusing on three different themes: 1) China's short-term growth prospects, 2) long term challenges, and 3) financial and FX reforms.

Our general impression is that the Chinese economy is still growing very fast. Although the official GDP fig-

ures and other data showed that the Chinese economy decelerated slightly in 2H of 2006 (see *Flash Comment - Early signs of an industrial slowdown*), the dynamism and optimism in the Chinese economy remain intact. And as China moves further up the value chain it is difficult to see anything stopping the Chinese boom just yet.

The tightening campaign of the Chinese authorities last year and the slowdown in US industry did manage to slow China's industrial and investment growth in 2H 2006. However, going forward, the crucial question remains of whether the Chinese economy will re-

accelerate again. For now, though, our stimulus indicator for China's industry still points down.¹



Hence, our picture of Chinese industry does not send the same strong signal that the OECD leading indicator does.

OECD leading indicator sends excessively strong signals



Looking into the different subcomponents of the OECD leading indicator, it is mainly M1 and chemical fertilizer production that are rebounding. But in forecasting our industrial indicators, these series do not have much leading explanatory power, as especially chemical fertilizer production is more a lagging indicator. In forecasting our industrial indicator, M2 growth and bank loan growth are better variables.

But what to make of the stimulus to China's industry in 2007? As we argued in the report *Research Global: Business confidence to trough out, 28 February*, we expect global industry to bottom out during the spring, and the US to lead the recovery. This will, of course, be positive for China's industry. Over the last months M2 has continued to fall whereas bank loan growth has stabilized.

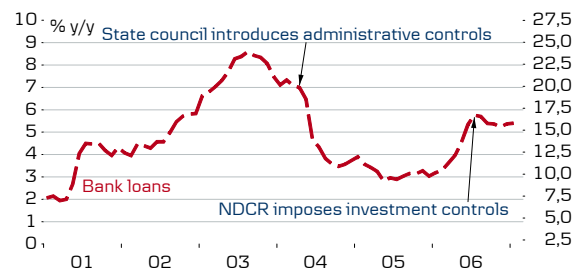
¹ Our industrial indicator includes growth in exports, imports of machinery and electronic products, industrial production and the production of non-ferrous metals.

Monetary/credit policy has tightened



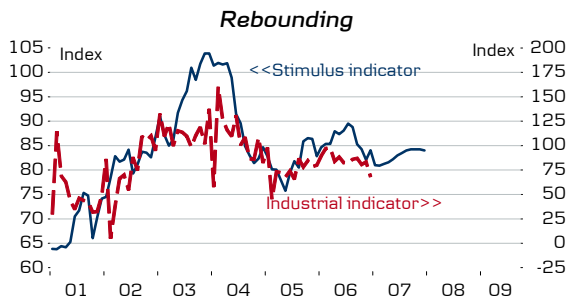
In our view, the Chinese authorities are now clearly more determined to keep a tight grip on monetary/credit policy, one example being the 4 reserve requirement ratio hikes over the past year. It would seem that the PBoC, the central bank, is enjoying increasing autonomy when it comes to deciding monetary policy. But as we have argued before, monetary/credit conditions in China tend to be driven to a much larger extent by administrative controls targeting investment, rather than by interest rate hikes or the raising of reserve requirements. This was the story in 2004 - and was it again in 2006.

Administrative measures rule

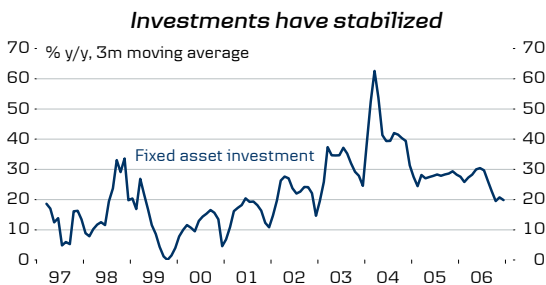


In our view, it is extremely difficult to judge how effective or serious Beijing will be in trying to control investment growth in 2007. Are the investment controls imposed on the provinces in August 2006 still effective? We would say essentially yes. When China has previously imposed investment controls they have tended to have a pronounced effect in the short term, but to fade over time, as Beijing faces an uphill struggle when it comes to enforcement. However, our feeling is that there will not be a similar spike in loan/money supply growth as was seen from mid-2005 to mid-2006. The drivers then were 1) The Chinese authorities feared that the revaluation in July 2005 would have a negative effect on the economy, which led them to ease monetary policy, and 2) The launch of the 11th five-year plan, which created a spike in loan demand. On the other hand the Chinese authorities are likely to be relatively comfortable with the current level of investment growth of around 20% y/y. Therefore, we only see limited risks of 'over tightening' by the Chinese administration.

In the figure below, we have included in the stimulus indicator our forecast for the US ISM and the PBOC's target for bank loan growth (13% y/y) and M2 (16 % y/y) for 2007. It seems that even if the Chinese authorities manage to slow credit growth, the rebound in the US ISM will put upward pressure on Chinese industry during 2007.

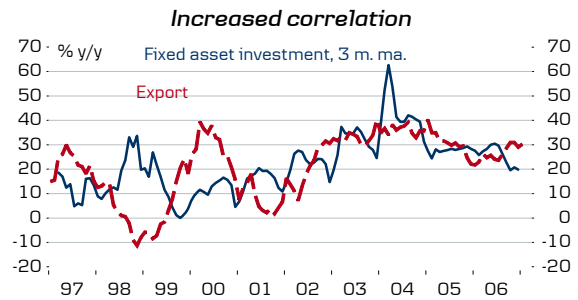


A strong growth driver in the Chinese economy has been investment growth. So, what is the outlook for investment growth going forward? Looking at investment growth over the past 10 years, three characteristics stand out: 1) investments tend to surge in the beginning of the year (although less so in 2005-2006), 2) investment growth was on a strong uptrend from the end of 2001 (when the world economy recovered and China entered the WTO) until the beginning of 2004, when China imposed its tightening controls, and 3) investment growth has been much more stable since end-2004.



The Chinese authorities have been more effective at controlling investment growth over the last 2-3 years, and as argued above we expect that the Chinese authorities will be able to better control credit growth going forward. Therefore, we don't foresee a spike in investment growth in the first half of 2007.

However, looking at the connection between investment and export growth, it is clear that a lot of the investment boom of recent years has been driven by the surge in exports. With China's industry set to rebound in 2007, we do not expect FAI to fall significantly below 20% y/y in 2007. As global industry starts to pick up during the spring, Chinese investment may reaccelerate in 2H.



Where does this leave us in terms of the growth prospects for 2007 as a whole? The Chinese economy will continue to boom in 2007, with investment growth remaining around 20% y/y and China's industry doing fine. We expect the economy will continue to grow at very close to 10% in 2007.

China's longer-term challenges

Environment becoming a domestic issue

Moving beyond the outlook for short-term growth, the big issues in China are 1) the environment, 2) inequality, and 3) rebalancing the economy. Below, we provide a brief update on the issues.

There is no doubt that damage to the environment is playing an increasingly important role in the debate in China - be it air pollution, clean drinking water, etc. Importantly, environmental scandals are now the most frequent cause of protest in China. This is crucial as it highlights that environmental issues are now shifting from just being an important foreign policy issue to being a domestic issue. Preliminary reports suggest that China was only able to slow down energy consumption per GDP unit by 1% last year - much below the target of around 4% reduction per year laid out in the 11th 5-year plan. This is embarrassing for Beijing, as the plans for energy reduction were one of the few specific numbers the government laid out in the 5-year plan.

In our view there is clearly a risk that China will impose more broad-based investment controls over the year, targeted especially at preserving the environment. Again the question remains of how willing the government is to sacrifice growth on the altar of the environment - we believe not very. Employment growth is still the main priority of the Chinese leadership, as this remains the main threat to political stability. One example where China could show it really was serious about limiting energy consumption would be if it raised fuel prices, which are still significantly below market prices.

Therefore, any investment control measures will most likely be targeted at the heavily polluting sectors such as steel production, cement production, etc. But there is no doubt that China will increasingly try to attract foreign investment in less resource-intensive sectors – and Chinese policymakers are likely to become increasingly tough on foreign polluters. However, as we argued in *“Asia’s growth miracles – Is China any different?”*, 25 October, this is not in conflict with the policymakers’ ambitions of creating fast economic growth. Indeed, if it is to sustain growth performance, it is essential that China moves further up in the value chain – in part by attracting investments in higher value-added sectors.

Solving China’s inequality problems

There is no doubt that the Chinese administration is very focused on solving the huge inequality problems in China. Some of the goals the Chinese administration has been striving for in recent years are:

- 1) Abolition/reduction of agricultural taxes – implemented in 2006.
- 2) Provide free education for all rural children by 2010.
- 3) Improve the healthcare and pension systems, especially in the rural areas. It is however unclear precisely what has been achieved.

The National People’s Congress beginning next week may enlighten on the status of the initiatives regarding the healthcare and pension systems. All of these measures are designed to improve living conditions for the rural poor. But the problem is that China is now an increasingly market-driven economy – and stimulative fiscal policy measures may not do much to narrow the income gap between the rural and urban populations. In our view, the most important transformation China needs to undertake in the coming years is to facilitate a faster transfer of people from rural to urban areas. Productivity is much higher in the urban areas than in the rural areas, and therefore if China wants to narrow the income gap, more people will have to enter the urban population. To the best of my knowledge there are no official hindrances to people relocating to other provinces. But in practice newcomers don’t have access to the same social benefits as residents. As we pointed out in our report, *“Asia’s growth miracles – Is China any different?”*, 25 October, the migration of people from rural to urban areas has not been particularly fast in China relatively to what was seen in, for example, Japan or South Korea during their catching up processes. Of course, rapid

urbanisation brings its own set of social problems, but we believe China has to go down this road if it is to successfully narrow the income gaps in the society.

Rebalancing the economy is still only a long-term trend

Short term we remain sceptical about the so-called rebalancing of the Chinese economy away from export/investment-driven growth to growth driven by private consumption. The main priority of Chinese policymakers is to deal with rising inequality problems (and the environment), and therefore the focus on improving healthcare, education and pensions is targeted at the rural poor. But this is not likely to lift consumption dramatically – something that would necessitate fewer incentives for the more wealthy urban population to save.

It is likely that the industry-intensiveness of the Chinese economy will remain high for a considerable period of time (see our report *“China’s growth miracle – is it sustainable?”* 21 November, for more details). This will continue to be a strong driver for investment growth in the coming years. Moreover, in our view, China, with its hugely undervalued currency, cheap labour costs and easy financing conditions is likely to remain very competitive in many export industries for a very long time.

Paradoxically, the authorities’ attempt to slow investment may simply worsen the ‘trade surplus problem’. As we argued above and in the report, *“China’s growth miracle – is it sustainable”*, 21 November, China’s savings are likely to stay at very high levels for some years yet. Hence, a widening of the savings-investment balance will just put further upward pressure on the trade surplus.

China’s method of solving at least part of the ‘Balance of payments surplus problem’ is to allow more capital outflow. Just looking at our simple measure of capital outflow – *build-up in foreign exchange reserves minus trade surplus minus FDI* – it seems that China has managed to stimulate some capital outflow. But, as some observers have pointed out, part of this may be due to a transfer of money from foreign exchange reserves to the state’s own banks. With the ballooning trade surplus here to stay, it is difficult to see China being successful in reaching their objective of obtaining equilibrium in the balance of payments. China simply does not have the means to recycle the amount of funds needed to counteract the huge current account surplus.

FX reforms take shape

Big changes underway

There are big changes underway at the moment on the fx front. Most importantly, China may soon launch a big change in its management of foreign exchange reserves. Based on media reports and our meetings with government officials in China, we expect that the following will be the most likely changes:

1. China will create a new investment agency to manage a portion of the foreign exchange reserves. The agency will be named "The State Foreign Exchange Investment Corporation".

2. The investment agency is likely to be designed along the lines of the Singapore government's investment corporation, investing in stocks, bonds, equity stakes and probably also energy supplies.

3. The investment agency may control up to about one fifth of China's total foreign exchange reserves. This amounts to around 200-300 billion dollars.

4. There is some conflicting news about whether China will also create a second investment agency to manage the remaining foreign exchange reserves. This agency may be come to resemble Singapore's Temasek, focusing on investments in state-owned corporations. If such an agency is created, it may merge with Huijin, which is currently responsible for investments in state-owned banks. If this happens, it would eventually diminish the role of the State Administration of Foreign Exchange. Our feeling is, though, that SAFE is likely to retain a crucial role in the management of foreign exchange reserves.

5. There are still no details about the timing of the announcement of the new investment agency/agencies. But given the news flows on the subject, we suspect that an announcement may be made during the coming months. There is a chance that additional information may be forthcoming at the National People's Congress that begins next week.

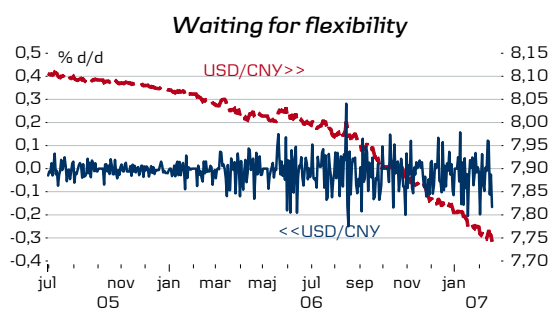
What will be the financial implications of China's reform of the management of its foreign exchange reserves? Here are our thoughts:

- a) It is difficult to reject the claim that, on the margin, the changes to China's foreign exchange reserve policy will be dollar-negative, as China will reduce the dollar-share of its FX reserves from 60-70% to around 50% over

the coming years. But as we argued in "FX Crossroads: The outlook for reserve diversification and SEK", 12 December 2006, due to its enormous reserve accumulation, China will continue to be a large net buyer of US assets. Moreover, we believe that China has invested a falling proportion of its FX reserves in dollar assets over the last 2-3 years. Therefore, one should not overestimate the impact, and we maintain our positive view on the dollar despite the upcoming changes in China.

- b) The moves of China and other large reserve holders towards a more active management of FX reserves is positive for risky assets – be they emerging market bonds or equities. In contrast, the changes are negative for developed market bonds.

What about the Chinese currency itself? The Chinese authorities have clearly speeded up the appreciation of the renminbi. Since last summer, the CNY has appreciated by 5% annualised. This has clearly satisfied US and European policymakers. But what surprised us over the last year has been that the Chinese authorities have not move further in terms of allowing more flexibility. Since flexibility in USD/CNY increased last spring, nothing has happened since. China's ultimate goal is to move towards an independent monetary policy. Hence, it should speed up the process of moving away from a crawling dollar peg and towards a crawling currency basket. If one looks at the days with the largest dollar sell-offs, none of these occurred on the days when the largest changes in USD/CNY happened. Hence, China does not by any means operate a currency basket.



We expect that the Chinese authorities will, this year, move further down the road towards allowing more flexibility. A more active use of its FX reserves and a more flexible currency will diminish the 'automatic stabilisation' on the global financial markets coming from central bank buying. As we have argued before, the world's largest central banks tend to be 'residual buyers' i.e. they buy foreign currencies when they

weaken. This may slowly change over time, with China leading the way.

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