

# Asia Economics Flash

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## China: Thoughts at the start of 2008

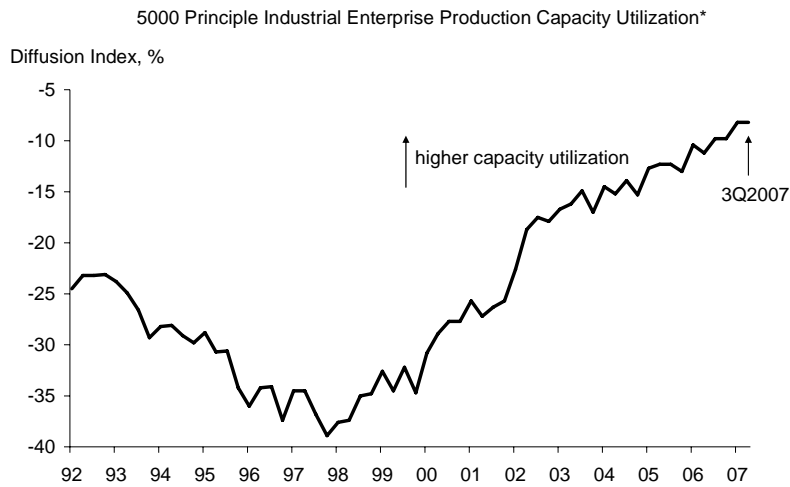
- Rising downside risks on two fronts—namely, the state of the US economy and the policy tightening in China—have already led to a marked correction in China-related asset prices since November last year. We believe these risks will likely continue to exert downward pressure in the Chinese asset space, and the overhang is unlikely to resolve until at least “one of the shoes” is fully dropped.
- In our view, the most important macro questions for China in 2008 are the behaviour of inflation and the choices of policy responses. The goldilocks phase of the business cycle with fast growth and low inflation is clearly behind us. Five-year cyclical expansion, particularly the substantially-above-potential growth in 2007, has resulted in capacity pressures, on a much broader base than in 2003-2004, as evident by the rising capacity utilization, increasing unit labor costs, and escalating inflation pressures.
- Our baseline forecast of a decelerating inflation trend in 2008 assumes a significant monetary policy tightening path. However, it remains to be seen whether the current tightening package, which involves a lot of arm twisting but little change in the underlying economic incentives, will be effective. If not, the risks of a more aggressive CNY appreciation would rise considerably.
- In the meantime, US data continues to suggest growing weaknesses in the economy. Given the significant contribution to growth from net exports, a meaningful slowdown in trade surplus growth will surely have a notable impact on China’s growth and corporate profitability in the industrial sector. The risk is that the slowdown in exports may be a gradual but prolonged process, while policy tightening also becomes an extended exercise in 2008.

Needless to say, 2008 will likely be a more challenging year for the Chinese economy and its markets compared with the past few years. Rising downside risks on two fronts—namely, the state of the US economy and the policy tightening in China—have already led to a notable correction in China-related asset prices since November last year. Both A and H shares have been down by about 20% from its peak in late October 2007. In our view, these risks will likely continue to exert downward pressure in the Chinese asset space, and the overhang is unlikely to resolve until at least “one of the shoes” is fully dropped. In this article, we offer our current thoughts on these issues.



1. **In our view, the most important macro questions for China in 2008 are the behavior of inflation and the choices of policy responses.** The goldilocks phase of the business cycle with fast growth and low inflation is clearly behind us. Five-year cyclical expansion, particularly the substantially-above-potential growth in 2007, has resulted in capacity pressures, on a much broader base than in 2003-2004. This can be seen from the Production Capacity Utilization Index compiled by the government (see Exhibit 1), and worryingly, in rising unit labor costs (see Exhibit 2).

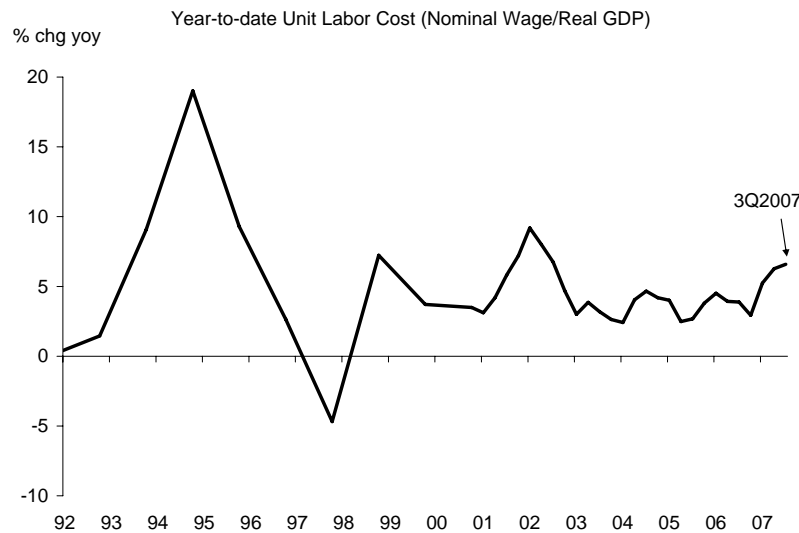
**Exhibit 1: Excess capacity is at an all-time-low**



\* The diffusion index measures the difference between the shares of firms that reported above-capacity production vs. below-capacity production. For example a -X% reading means that there are X% more firms that reported under-capacity than those that reported over-capacity production.

Source: CEIC, Goldman Sachs Economics Research.

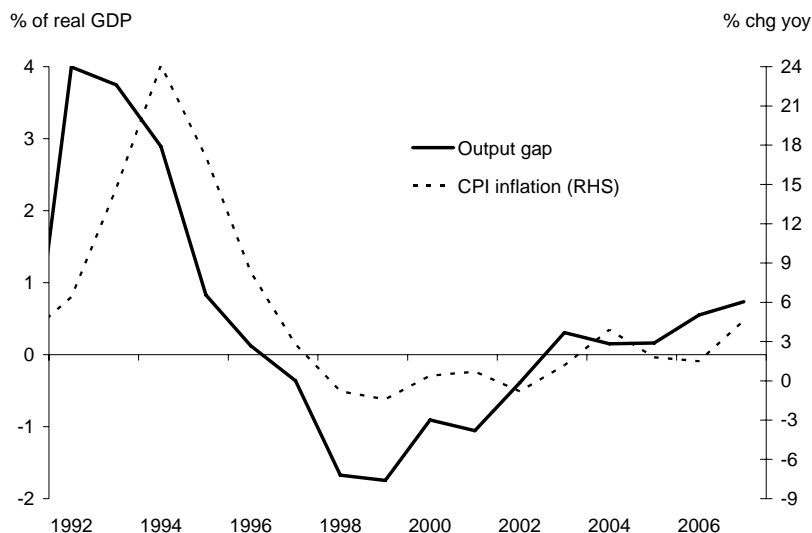
**Exhibit 2: Rising unit labor cost points to inflationary impetus**



Source: CEIC, Goldman Sachs Economics Research.

2. We believe the significantly positive output gap, that is, the excessive growth in aggregate demand relative to the economy's aggregate supply capacity, has been the main driver for CPI inflation this time around as well as in the past inflation episodes (see Exhibit 3). In other words, the 11-year-high CPI inflation of 6.9% as of November 2007 is not the result of any temporary domestic or international supply shocks. Therefore, for inflation to subside meaningfully, we need to see policy measures or other demand shocks that will bring down aggregate demand growth.

### Exhibit 3: Excessive aggregate demand expansion leads to rising inflation with a time lag



Source: CEIC, Goldman Sachs Economics Research.

3. Our baseline forecast of a decelerating inflation trend in 2008, particularly in 2H2008, is predicated on a significant monetary policy tightening path, which we believe will involve strict quantity rationing of domestic credit by the central bank, no further rate hike, limited currency appreciation (relative to what is needed), as well as frequent hikes in the required reserve ratios for commercial banks.
4. Money and credit data in 1Q is, therefore, of crucial importance for investors to assess the effectiveness of the present tightening package, which involves a lot of arm twisting but little change in economic incentives. It is reported in the media that the total new bank lending target for 2008 is around Rmb3.3-3.6 trillion, and the first quarter's share should be around 35%. The credit quotas will be monitored on a quarterly basis and banks that breach their quotas will be subject to punitive bill issuances by the central bank.
5. Our baseline assumption is that credit rationing will still work since the government remains the dominate player in the financial markets. However, the risks have clearly risen that this old trick may not work as well as it did in the past (even compared with 2004, a very recent past) because Chinese banks/corporates have become increasingly commercial oriented, and its economy more integrated with the rest of the world. Nevertheless, the longer the needed policy tightening is delayed, the "rougher" the eventual landing of this overheating episode would be.
6. What if the banks again rush to lend at the beginning of the year? In that case, we believe the Chinese authorities would be forced to rethink their policy choices and the risks of a more meaningful upward currency (as well as some interest rate) adjustment would become significant. A significant appreciation of the CNY remains the key for putting China's macro house in order on a sustainable and efficient basis. **We believe China would make a**

**meaningful stride towards this goal in 2008, and forecast a 10% CNY/USD appreciation over the next 12 months.** More specifically, our most updated 3, 6, and 12-month USD/CNY forecasts are 7.09, 6.92, and 6.61.

7. **In the meantime, US data continues to suggest growing weaknesses in the economy.** The latest ISM and employment data have clearly raised the risk of a recession in the US economy this year. Although import demand in most emerging markets and the Middle East continue to hold up well, export data from Asia have also pointed to slowing import demand in the Euro zone. As we foresee more downside risks to growth in the developed countries, we also expect the growth momentum in China's exports to ease markedly in 2008 from 2007, and the growth rate of China's trade surplus to decline as well.
8. Given the significant contribution to growth from net exports (China's trade surplus is likely to have reached 10% of GDP in 2007), a meaningful slowdown in trade surplus growth (53% in the first 11 months of 2007) will surely have a notable impact on China's growth and corporate profitability in the industrial sector. Therefore, trade data in 1Q will be very important for investors to assess whether (as well as how much) trade may become a drag for growth this year. The risk is that the slowdown in exports may be a gradual but prolonged process, while policy tightening also becomes an extended exercise in 2008.
9. In short, despite much of the Olympic-related hype, we see more downside growth risks to the real economy in 2008, and policymakers will likely be forced to face many difficult choices. In the near term, the growth-inflation trade-off has worsened considerably, and the overheating pressures accumulated so far will require a cooling period for the economy, during which growth needs to come down to its potential level. Such a growth deceleration may be brought about by effective policy tightening, or a large external demand shock, or worse, a combination of both factors inadvertently. The uncertainties surrounding the timing, scale, and speed of these two growth headwinds will make 2008 a particularly tricky year for investors.<sup>1</sup>
10. All that said, we continue to believe in the strong fundamentals of the economy over the medium term, and see the challenges facing the market in 2008 are likely to be some sort of complex bull market correction rather than the beginning of a real bear market. With a new economic team coming to power in March 2008 after the National People's Congress meeting, we may see fresh policy initiatives or more decisive policy implementation that could help enhance both China's short-term macro stability as well as its medium-term growth potential.

It would be fascinating to watch, and so please stay tuned. But for now, we wish everyone a Happy and Prosperous 2008!

<sup>1</sup> For our views on the equity market, please see our Strategy Team's latest report: *China Portfolio Strategy: Positioning for 2008: Focus on alpha*, January 4, 2008.

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