Asia Economics Flash

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Hong Liang
hong.liang@gs.com

+852 2978 0036

China: Re-coupling, re-balancing, and recharging—our growth and inflation outlook for 2008 and 2009

- Rising downside risk to global growth and the on-going policy tightening in China have raised the risks of re-coupling in 2008.
- Our 2008 growth forecast is below consensus for the first time in four years, while our inflation forecast is above consensus.
- However, in response to the growth challenges, we expect policymakers in China to switch to a more domestic demand friendly policy stance in mid-2008, and also allow more CNY appreciation to help rebalance the economy.
- As a result of these policy adjustments, we expect China's economy to gradually advance back to its potential growth rate in 2009 with domestic demand this time leading the charge.

In the beginning of November, we downgraded our 2008 growth forecast, as we foresee more policy tightening risks on domestic investment in China in the near term but in the meantime, the downside risks to global growth has also risen significantly.[1] This is the first time in four years that our projected growth rate for China is below the consensus level. In addition, although still strong believers in decoupling (eventually), we have highlighted the risks of re-coupling in 2008, mostly because policy choices in China have not yet allowed or prepared the economy to decouple from a significant slowdown in exports.[2]

However, not all is doom and gloom. We continue to believe in the strong fundamentals of the economy over the medium term, and foresee that the difficulties China may potentially face in 2008 would likely push policymakers to take the long-overdue strides towards rebalancing the economy, in particular in the area of currency adjustment. We expect the real economy to respond effectively and swiftly to these policy adjustments once they are implemented, and it could be recharged and get back on a more balanced and sustainable growth path in 2009.

In other words, although we foresee quite a few serious bumps in the growth path of 2008, we maintain our faith that Chinese policymakers and entrepreneurs would be able to take on these challenges (albeit with some pains) and recoup into a better and more robust shape. Specifically,

[1] See *Sticky inflation, more policy tightening, and slower (but hopefully more balanced) growth—Forecast adjustments for 2007 and 2008*, Asia Economics Analyst 07/20, November 5, 2007.

[2] See *China's renminbi: An unbearable straitjacket for the central bank*, Asia Economics Flash, November 12, 2007.

our growth and inflation outlook for 2009 projects a more balanced economy with stronger domestic demand and lower inflation than 2008 (see Exhibit 1). We believe that the more quickly China undertakes the necessary policy adjustments (including those on its currency) to rebalance the economy, the earlier it would be able to get back on a decoupling path again.

Exhibit 1: Our 2008-2009 forecasts

Summary Indicators

(percentage change, unless otherwise indicated)

	2005	2006	2007F	2008F	2009F
Real sector					
GDP by expenditure (at 1990 prices)					
GDP	10.4	11.1	11.6	**10.3**	**10.0**
Private consumption	6.7	7.8	8.5	**9.6**	**10.3**
Government consumption	9.7	8.6	9.0	**9.2**	**9.8**
Fixed investment	11.4	10.6	10.4	**10.0**	**10.3**
Net exports (contribution to growth)	2.5	2.3	3.4	**1.8**	**0.9**
Exports (G&S)	22.4	18.6	19.0	**14.0**	**15.0**
Imports (G&S)	20.3	16.6	16.5	**13.5**	**16.0**
Memo:					
CPI inflation (period average)	1.8	1.5	4.8	**4.5**	**2.5**
Current account balance (as % of GDP)	7.2	9.4	12.0	**12.2**	**10.6**

Source: CEIC, Goldman Sachs Economics Research.

Why re-coupling in 2008?

Because 1) we foresee a potential sharper slowdown in external demand, driven by the de-leveraging of financial institutions in the G-3 economies due to their sub-prime related losses. Our US Economics Team has lowered their growth forecast to 1.8% in 2008 from 1.9%, and more importantly, the risks to these forecasts seem to be still predominantly on the downside. Even such a dismal growth path projection would require the support of a 3% Fed Funds rate by mid-2008.[3] We also foresee slower growth in Europe and Japan next year compared with 2007, with risks skewed to the downside as well.

2) By keeping the renminbi (CNY) quasi-fixed at a significantly undervalued level, the policy choices made by China in 2007 (as in the past four years) have continued to repress domestic demand while preserving the strength of exports. In other words, these policy choices have made the economy more "coupled" with any significant slowdown in external demand than otherwise would have been the case.

As for the policy trajectory, we expect stringent credit control on domestic investment demand to be the main policy tool used to dis-inflate the economy in the near term (likely at least until 1Q2008). However, **we now expect only one more 27-basis-point (bp) rate hike by the end of 2007, compared with our previous call of two more rate hikes** and we expect no interest rate hikes in 2008. In the meantime, we maintain our baseline forecast that China will stay with its "gradualist" appreciation approach with annualized appreciation close to double digits for 2008, although the probability of a more substantial one-off adjustment has risen.

If China's growth re-couples with a global slowdown in 2008, where would we mostly likely see pains? In our view, the pains would likely concentrate in exporters (particularly those related to the consumer and housing demand in the developed countries), industrial cyclicals, and in industries that face significant cost pressures (from wages, input costs, and interest costs) but could not pass on these costs because of falling demand.

[3] See *US Daily: Q&A on the Housing Outlook and Changes to the US Economic Forecast*, US Economics Daily, November 27, 2007.

Why do we believe re-balancing would also be the theme in 2008?

Because we believe policymakers in China are pro-growth and pragmatic.

If exports growth falls more quickly than expected, and the CNY is "forced" to appreciate more meaningfully, the downward pressures from weaker external demand on growth would likely push policymakers to re-examine their domestic demand policy stance, in particular those related to domestic investment demand.

We have long held the view that to re-balance the economy to be more domestic demand driven, China not only needs to consume more, but it also needs to invest more.[4] Fortunately, the balance sheets of both households and corporates in China continue to have plenty of room to be leveraged up for this task. The question remains to be whether policy adopted by the government would allow this to happen, or what it would take for China to switch away from the policy tightening package used in the past four years that effectively repressed the domestic demand and fueled the unsustainable strength in exports.

In this context, a sharp slowdown in exports coupled with a more substantial CNY appreciation (our forecast is a 10% CNY appreciation vs. the USD over the next year, with risks to the upside) would be a good thing, because the dampening cyclical impact on growth from these "shocks" may trigger the much needed and long-overdue policy shift.

What would it take for China to re-charge and decouple again in 2009?

Obviously, given the extent of currency adjustment needed (at least 15%-20% in TWI adjustment), China would need a comprehensive policy package to re-balance the economy away from its excessive reliance on exports (evident by this year's double digit current account surplus as a percent of GDP) towards a truly domestic demand driven economy.

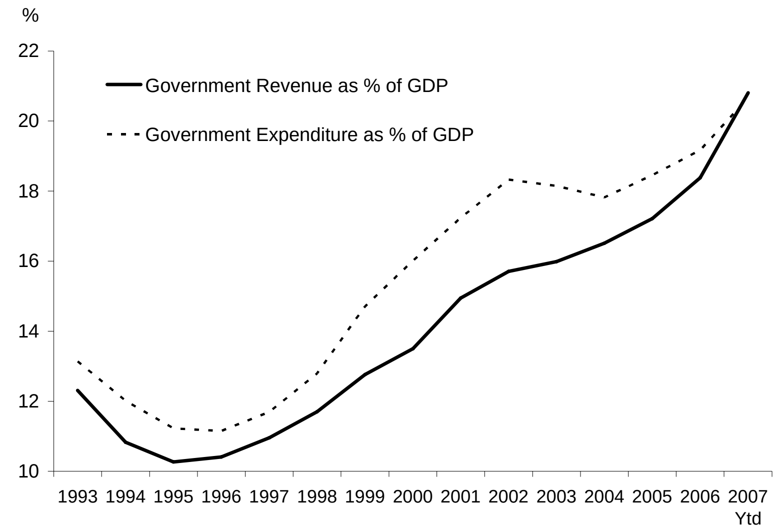
1. In our view, a substantial nominal appreciation of the CNY needs to be an integral part of this policy package, as it would help send the right price signals for the private sector to re-allocate their resources. In addition, it would help dampen the domestic inflation pressures when domestic demand is on the rise again. Otherwise, when external demand recovers at some point in the future, China may need to repress domestic demand again.

2. The administrative controls on domestic investment need to be taken off. These include the credit rationing and the lengthy (and oftentimes opaque) investment project approval procedures. In addition, the strings attached to the domestic residential investment need to be untangled. No economy is likely to succeed in boosting its domestic demand while trying to repress its housing demand. Increasing effective supply of urban housing to meet rising demand could come a long way to boost domestic demand by creating jobs (just as exporters do) and foster the rise of a middles class, as well as to dampen the upward price pressures in the sector.

3. Fiscal policy could become more of a help to the rebalancing process if needed. However, at this point, we don't foresee the need for any major fiscal stimulus program. Rather, a better expenditure rationing coupled with a full implementation of the already agreed tax reforms (VAT rebate and unification of enterprise income taxes) would help reduce the tax burden and leave more room for the non-government sector to grow. Given the government's limited capability in delivering public service, we believe tax cuts are likely to be much more effective than expenditure increases to help support domestic consumption. Again, the persistent faster-than-GDP growth of government revenue in the past twelve years should give the government plenty of room to cut taxes (personal income tax could be a starting point) and fees, as well as more fiscal transfers using the land auction fees, with little negative impact on the overall fiscal position (see Exhibit 2).

[4] See *China's investment strength is sustainable*, Global Economics Paper No. 146, October 3, 2006.

Exhibit 2: The government has enough cushions for tax cuts



Source: CEIC, Goldman Sachs Economics Research.

4. Structural policies that continue to deregulate and open up the economy for more private sector participation (both domestic and foreign) in the remaining SOE dominant sectors, such as financials, heavy industries, and utilities, would also be important for domestic job creation and productivity growth over the medium term. In addition, land reform efforts in the rural areas, which would allow farmers to enjoy a larger share of the increased land value from the industrialization and urbanization processes, could transform millions of farmers into consumers of China's mighty manufacturing capacity with fast speed and vast scale.

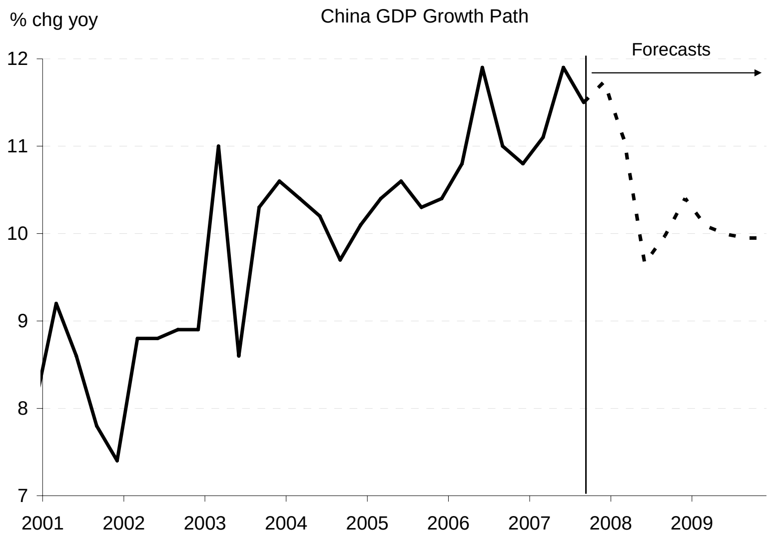
In 2008, we expect to see meaningful progresses made in areas 1, 2 and 3 that would allow the economy to recoup from the slowdown in 1H2008 and recharge again in 2009. We will watch for progresses made in area 4 to assess how China's potential growth rate will likely trend over the medium to long term.

What to watch?

Relative to market expectations, we are more concerned about downside risks to growth, and unfortunately upside risks to inflation in the short term. Therefore, in our view, before the China-related assets are to outperform again, investors would need to see 1) reduced uncertainties about the speed and extent of the global slowdown (i.e., some sense of where the bottom might be); and 2) inflation risks in China being brought under control.

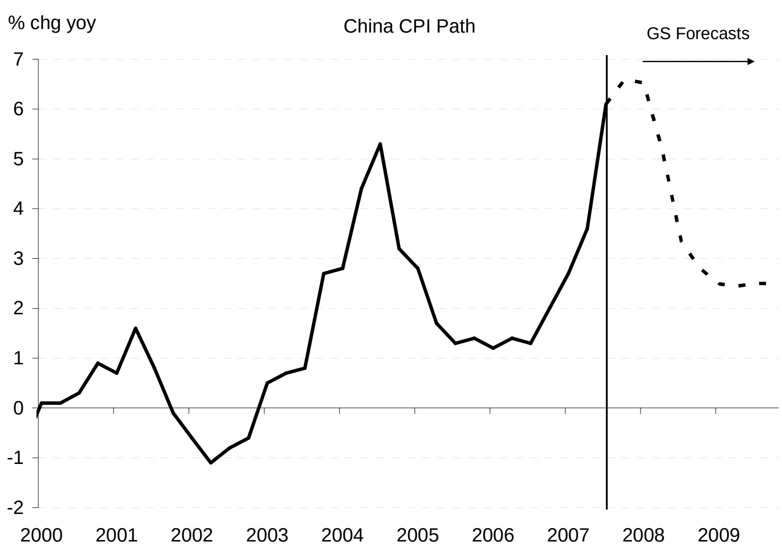
2Q2008 might be the earliest we could see such an inflection point, as we expect growth to be slightly below 10% (after three quarters of below-trend sequential growth) (see Exhibit 3) and CPI inflation to trend down to below 6% (see Exhibit 4). In response, we expect policy to begin reflating the economy again, and China would gradually advance back to its potential growth rate with domestic demand leading the charge this time.

Exhibit 3: We expect headline growth to trough in 2Q2007 in the baseline scenario...



Source: CEIC, Goldman Sachs Economics Research.

Exhibit 4: …and we also expect inflationary pressure to start receding in 2Q2008



Source: CEIC, Goldman Sachs Economics Research.

We see the risks to our forecasts as balanced at this point. The downside risks include 1) a sharper and more prolonged slowdown in global demand than we projected in our baseline, and 2) a more delayed policy reaction to the negative external demand shocks. Under these circumstances, the slowdown in China could be sharper and the recovery of the domestic economy may take longer than we envisaged here. On the upside, there could be more demand boosting effect from the Olympic Games, or from the tendency for every new government to undertake large fixed asset investment at the beginning of their new term (although we believe the central government would begin 2008 with a much more hawkish policy stance than usual because of the perceived heightened inflation risks).

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