Country report **CHINA**

Summary

GDP growth has been slowing, with annual growth estimated at 7.8% in 2012. The weak external environment is one reason, but domestic factors also play a role. Unlike in 2008/09, the government's stimulus response, both fiscal and monetary, has been limited. Although growth has slowed, longer-term risks have not significantly increased. Regarding much needed economic reforms, small steps are being taken but major steps remain elusive. China's next leadership will be "elected" shortly. Although no major policy changes are expected, it remains to be seen if these new leaders will be willing and able to pass through the needed reforms.

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China

National facts	
Type of government	Communist State
Capital	Beijing
Surface area (thousand sq km)	9,597
Population (millions)	1,313
Main languages	Mandarin
	Cantonese
Main religions	Taoist
	Buddhist
	Christian
Head of State (president)	Hu Jintao
Head of Government (premier)	Wen Jiabao
Monetary unit	Renminbi yuan (RMB)

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	7212	10.43
Nominal GDP at PPP	11453	14.43
Export value of goods and services	2087	9.47
IMF quotum (in mln SDR)	9526	4.38
Economic structure	*2011*	*5-year av.*
Real GDP growth	9.3	11.2
Agriculture (% of GDP)	10	11
Industry (% of GDP)	47	47
Services (% of GDP)	43	42
Standards of living	*USD*	*% world av.*
Nominal GDP per head	5459	50
Nominal GDP per head at PPP	8670	70
Real GDP per head	3218	39

Social and governance indicators	rank / total
Human Development Index (rank)	101 / 187
Ease of doing business (rank)	91 / 185
Economic freedom index (rank)	138 / 179
Corruption perceptions index (rank)	75 / 183
Press freedom index (rank)	174 / 178
Gini index (income distribution)	42.5%
Population below $1.25 per day (PPP)	13.1%

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
US	18	Japan	13
Hong Kong	14	South Korea	10
Japan	8	Taiwan	9
South Korea	4	US	7
Main export products (%)			
Office machines			11
Telecommunications equipment			11
Electrical machinery			11
Clothing & apparel			8
Main import products (%)			
Electrical machinery			16
Petroleum & petroleum products			14
Metalliferous ores and scrap			10
Professional instruments			5
Openness of the economy			
Export value of G&S (% of GDP)			29
Import value of G&S (% of GDP)			26
Inward FDI (% of GDP)			3.1

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

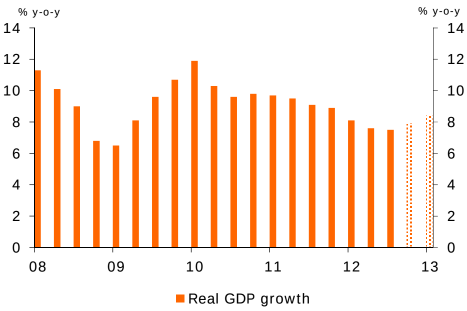
Economic structure and growth

China, the most populous country in the World with 1.3bn inhabitants, is the second-largest economy in the World - after the US - measured in both nominal GDP (USD 7.2bn) and in PPP terms (USD 11.5bn). At the heart of China's economic success has been its successful export- and investment-led growth model. On the back of this model, China's real GDP has grown by an average of slightly above 10% a year since 1978.

Even though China has become the World's second-largest economy, per capita income is still only 50% of the World average and only about one-ninth of average Dutch GDP per capita. Hence, strong economic and income growth are still badly needed. However, looking forward, many of the advantages that support China's growth model so far will start to diminish, thereby hurting China's international competitiveness. Meanwhile, adverse side effects, such as a rapidly rising income inequality and major environmental problems have become too great to ignore. China's growth model will thus have to be adjusted in a major way in the coming years. Its economy will have to become more consumption-driven, instead of investment driven as is the case today, endogenous innovation will have to be nurtured while environmental responsibility will have to gain in importance. The 12th 5-year plan that was launched in March 2011, in which China's economic policy outlines are described, stated that China will focus on generating growth that is sustainable in economic, social and environmental terms. This presents a major shift from the "strong growth at all cost" focus that China had adhered to in the past 30 years. However, implementing the plan correctly and timely will be a key challenge for Chinese authorities, with major downside risks, such as a sharp economic slowdown or public unrest present.

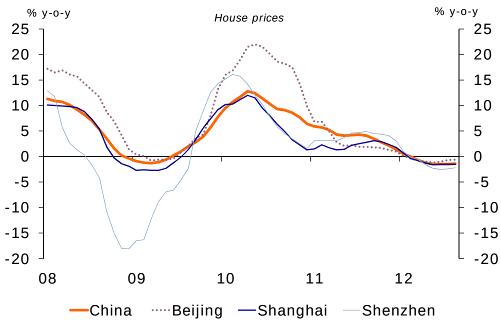
China's real GDP growth rate has been slowing since the first quarter of 2011 (see figure 1). Domestic economic policies aimed at slowing the economy in 2011 to prevent overheating were implemented and subdued growth in 2011 and 2012. In addition, the external environment has weakened on the back of a slow recovery in the US and economic stagnation due to sovereign debt related problems in the eurozone. In spite of the weakening of the global economy, the Chinese government has - fortunately - not responded with a major stimulus program to boost the economy, as it did in 2008/09. Instead, only limited monetary and fiscal policy easing has taken place and around EUR 125bn – about one-fourth of the amount extended in 2008/09 - in investment stimulus was extended. At the same time, the measures that were implemented in 2010 and 2011 to cool the overheating housing market, and which were successful (see figure 2), were maintained. As a result, a strong but unwanted growth driver – speculative investment in real estate – has been curbed.

Figure 1: Real GDP growth slows



Source: Reuters EcoWin

Figure 2: Real estate measures work

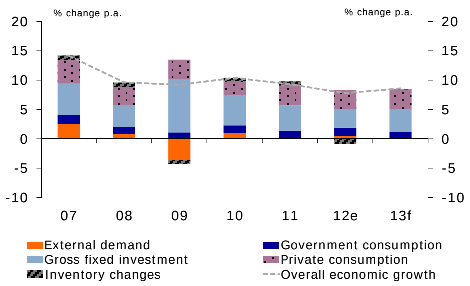


Source: Reuters EcoWin

Against this background, overall real GDP growth slowed to 7.6% year-on-year in the second quarter of this year and further to 7.4% in the third. The full year 2012 growth estimate was lowered recently, as growth didn't bottom out in the second quarter as had been expected. However, some green shoots have been emerging in the data since September. Industrial production growth accelerated slightly and purchasing managers indices improved at last. Nonetheless, both remain at a relatively low level and the uptick was only small. However, they do seem to indicate that the limited stimulus and policy easing is finally starting to work through to the real economy and we expect the economy to strengthen further in the short-term. GDP growth is therefore expected to accelerate in the fourth quarter, bringing the full year 2012 growth rate to 7.8% while between 7.5% and 8.5% growth is forecast for 2013 (see figure 3).

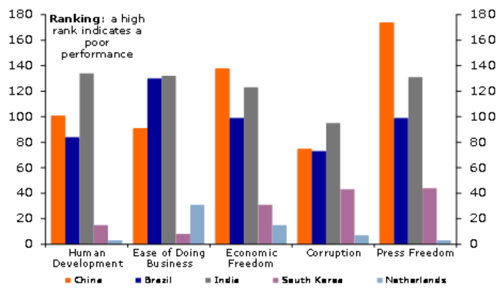
China's banking sector is dominated by five large, majority state-owned banks that hold over half of the sector's total assets. The country's financial system is closely monitored and regulated by the Chinese central bank and banking regulator. Interest rates are set by the central bank, from which banks can only deviate to a certain degree. China's financial system has expanded rapidly on the back of strong credit growth, especially due to the large, commercial bank financed government stimulus program that was rolled out in 2008/09. In 2009, domestic credit grew by 30%. In the years thereafter, credit growth slowed according to the official figures, to 15% in 2012. This has increased total domestic credit from 120% of GDP in 2008 to around 155% of GDP today. The real figure could even be higher, as informal lending and off-balance sheet lending through the use of wealth management products (WMP's) has taken a flight in recent years. The rapid emergence of informal and off-balance sheet lending makes it difficult to estimate the true strength of China's banking sector. Moreover, it is unlikely that all the loans extended in relation to the 2008/09 stimulus program will be repaid. For the time being, such loans are not recognized as non-performing, but are instead (allegedly) rolled-over in order to prevent problems in the banking sector from emerging at an economically difficult time. The NPL ratio's that are reported (1% end-2011) are therefore likely to underestimate the true problem. Banks' NPL cover ratios, which stood at 278% end-2011, are consequently overestimated. At some point in time, though, these bad debts will have to be recognized and it remains to be seen if banks will have built-up sufficient capital buffers to cover related losses. If not, government support is highly likely, as problems in the banking sector would cause great public upheaval that the authorities will want to avoid. The government is also able to do so, except perhaps in a worst-case scenario.

Figure 3: Growth performance



Source: EIU

Figure 4: Social indicators



Source: Reuters EcoWin

Political and social situation

The People's Republic of China, established in 1949, is a socialist one-party state ruled by the Chinese Communist Party (CCP) since its inception. Power is centralized in the CCP and the support of the three-million strong People's Liberation Army and a well-developed internal security system safeguards political stability. The availability of information is heavily controlled by the government. Press freedom and freedom of speech are heavily restricted, while the judiciary is not independent. As a result, developments in China, especially political ones, remain clouded and difficult to gauge due to lack of transparency.

Currently, the fourth generation of leaders is in power, led by the president and General Secretary of the CCP, Hu Jintao, and Wen Jiabao, the premier, but the transition to the fifth generation leadership is underway. Many top positions in the CCP, among which most of the members of the all-important politburo and its standing committee, will be renewed after the National Congress in November 2012. It is all-but-certain that Xi Jinping, currently the vice-president, will be appointed by the 18th CCP congress as the next General Secretary of the CCP and is highly likely to be elected as China's next president by the National People's Congress, which is scheduled for March 2013. It is widely expected that Li Keqiang, the current vice-premier, will take over the position of premier at that time. The leadership transition is unlikely to lead to drastic policy changes, as anyone with ideas that are not in line with the CCP consensus is very unlikely to be appointed to a top position. The new leadership will face the formidable challenge to oversee China's needed economic transformation, reduce income inequality and reduce corruption. At this point it is uncertain whether or not the new leadership will be able to do so.

Corruption, which has been a long-time problem in China, has come to the forefront recently as a result of the Bo Xilai scandal. Bo Xilai, the former party chief of Chongqing, was expelled from his posts and eventually from the CCP following a scandal surrounding the murder of a British businessman by Mr. Bo's wife, who has received a suspended death sentence for her part. As a result, it became public that Mr. Bo had abused his power on multiple occasions and that he was highly corrupt. More importantly, however, the scandal gave the public an insight into the lives of top CCP officials and, especially, their enormous wealth. Meanwhile, many Chinese struggle to make a decent living and are increasingly unable to fulfill their expectations of a better life. This could give rise to a potentially explosive feeling of dissatisfaction with the leadership. It is therefore of vital importance that the perception of corruption is reduced under the new leadership. Failing to do so could greatly undermine public support for the CCP and eventually lead to political instability.

Furthermore, ethnic tensions are present in the country's autonomous regions Tibet and Xinjiang, which are home to an indigenous population that claims independence. As these autonomous regions are of great strategic importance - Tibet supplies an important part of China's fresh water while Xinjiang is important with regard to the supply of energy and precious metals – the government will want to keep these regions under control at all costs.

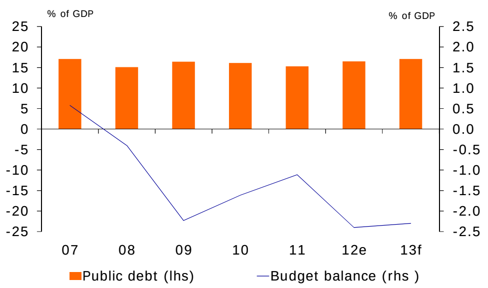
Internationally, China maintains its policies to further the country's economic integration into the international community. Seeking greater influence in multilateral organizations such as the World Bank and the IMF is part of this strategy. Furthermore, China is enhancing diplomatic bilateral ties with countries around the world on the back of strengthened commercial relationships. Within the region, tensions with neighboring countries are mostly centered on maritime territory conflicts. In these conflicts, which seem to be increasing in number and severity, China has shown it is willing to exert strong pressure on its neighbors, with economic measures complementing diplomatic pressure. Recently, tensions between China and Japan have flared up following the purchase of the Diaoyu islands (or Senkaku islands as they are called by the Japanese) by the Japanese government in September, as China also claims sovereignty over these islands. Protests broke out throughout China in response and diplomatic relations have remained tense since. As nationalist sentiments within China divert some attention away from domestic issues, the issue will likely remain in the spotlight for the time being. In the end, however, it is likely that some middle ground will be found, as the importance of economic relations between China and Japan outweighs the Diaoyu issue.

Economic policy

China's economic policies have been aimed at gradually opening up the economy and managing a step by step economic liberalization. However, the government continues to micro-manage the economy in order to ensure that its short-term policy priorities are achieved. In the coming years, economic policies will largely follow the outlines presented in the 12th 5-year plan. This will involve reducing income inequality by developing the relatively poor inland regions, especially rural areas, which have lagged severely with regard to income growth. Coastal regions, meanwhile, will have to make the next step in their development; with a focus on higher value-added production and development of the services sector. Economic policies and public investments will be geared toward reaching this goal. Maintaining short-term economic stability will remain paramount, though, and will be given priority over longer-term goals. As a result, risks on the longer-term may increase as a result of short-term policies.

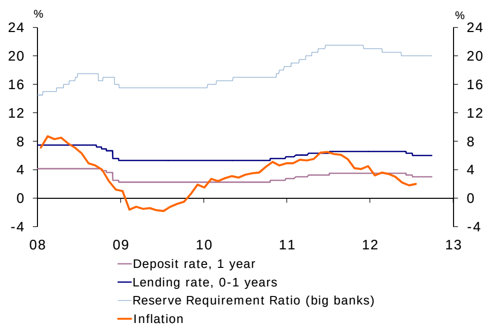
China's government finances are in good shape, even though the government is running a 2.5% of GDP budget deficit. However, the public debt level is low at only 17% of GDP (see figure 5). The large CNY 4,000bn stimulus package rolled-out in 2008/09 has not led to a strong deterioration of the government's financial position, as it was financed by commercial bank debt. However, as part of the loans is unlikely to be repaid, the government could be called upon to cover unmanageable losses. Although it is unclear just how much support would be needed, these contingent liabilities could (strongly) weaken the government's financial strength. This, in turn, would render the government less capable to manage a stable growth environment. With this in mind, the stimulus package implemented in 2012 was much smaller, but again financed with commercial bank debt.

Figure 5: Public finances



Source: EIU

Figure 6: Inflation and interest rates



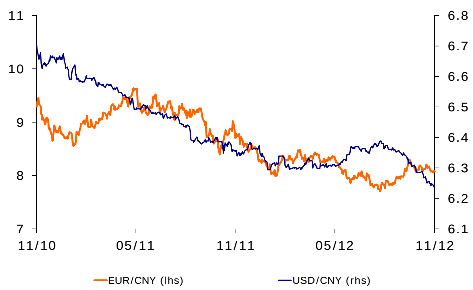
Source: Reuters EcoWin

China's central bank, the People's Bank of China (PBoC) is not independent. The government directs monetary policies that are subsequently implemented by the PBoC. Rising inflation, following the implementation of the 2008/09 stimulus program, proved a stubborn problem. As fear of rising inflation remains present, monetary policies have not been eased significantly, even as growth slowed and inflationary pressures eased to below 2% year-on year since mid-2012 (see figure 6). This prudent approach is sensible, though, as average inflation is forecast to increase 3.1% in 2012 to 5% in 2013.

Interest rates were eased, but only slightly. The 1-year deposit rate was lowered from 3.5% to 3% this year. The lending rate (0-1 years) cut was slightly larger, bringing it down from 6.56% to 6%. In addition, the room allowed to banks to deviate from the benchmark interest rate was increased. Banks can now offer up to 110% of the benchmark interest rate on deposits and charge as little as 70% of the benchmark lending rate (previously 90%). Although laudable from the perspective of financial sector liberalization and borrowers' creditworthiness, bank margins (the difference between the two rates) decreased from 2.4% to potentially 0.9% as a result, which hampers banks' ability to build up capital buffers.

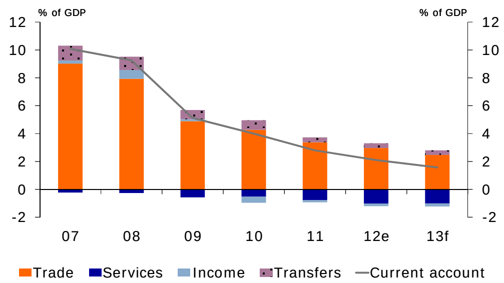
The reserve requirement ratio (RRR) for banks was lowered by 150bps, but remains high nonetheless at 20% for big banks. Open market operations have been the favored liquidity management tool for the PBoC in 2012, while before the RRR was preferred before. In recent months, the PBoC has injected large amount of liquidity in the market through open market operations in order to keep monetary conditions loose and to ensure that sufficient cash is available for banks to keep extending credit. This may also have a relationship with the alleged rolling-over of bad debt by banks.

Figure 7: Exchange rate



Source: Reuters EcoWin

Figure 8: Current account



Source: EIU

China's exchange rate is heavily managed by the PBoC. The trend of gradual appreciation was broken in 2012, as the currency depreciated slightly against the USD on the back of lower money inflows due to investors' concerns about China's weakening growth outlook. Recently, quantitative easing abroad and the presidential elections in the US, ahead of which China's alleged currency manipulation is pushed to the forefront, have led to the currency appreciating again (see figure 7).

Balance of Payments

Export growth has slowed markedly this year due to weakened external demand. In all, exports growth slowed to an estimated 6% in 2012, down from 31% in 2010 and 20% last year. Import growth, meanwhile, has also slowed to 7% on the back of slower domestic economic growth and lower export growth. The trade balance narrowed as a result, to 3% of GDP, down from 3.4% of GDP in 2011. Next year, we expect both export and import growth to pick up again. However, as import growth will expectedly outpace export growth, the trade balance will narrow further to 2.5% of GDP. China's current account is expected to register a comfortable surplus 2.1% of GDP in 2013 and 1.6% of GDP in 2013. On the longer-term, the current account surplus will continue to narrow and an all-but-balanced current account is forecast for 2016, as China gradually adjusts its growth model.

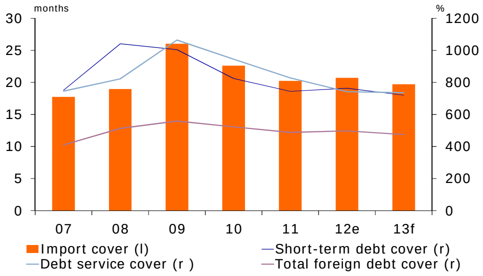
Weakening growth in China and difficult financial circumstances in many advanced economies have had an adverse effect on foreign direct investment (FDI) inflows. Compared to last year, FDI inflows contracted by slightly over 10% in 2012, to nearly USD 200bn (equal to 2.4% of GDP). Outward investment inflows have nearly doubled in 2012 compared to 2011. Net FDI flows have therefore decreased strongly in 2012 to USD 99bn. Portfolio inflows are forecast to increase to USD

11.6bn this year before growing to around USD 17.5bn in 2013. As portfolio outflows are estimated to amount to a far greater USD 41bn in 2012 and USD 72bn in 2013, net portfolio flows are estimated to be negative in 2012 and 2013, at around USD 29bn and USD 54bn respectively.

External position

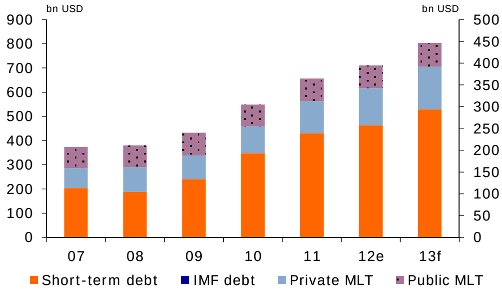
By end-2012, China will have amassed more than USD 3,500bn in FX reserves, which is at the heart to the countries exceptionally sound external position. Total foreign debt is expected to continue to increase from USD 549bn in 2010 to USD 711bn this year. For 2013, total foreign debt is forecast at USD 803bn. The share of short-term debt in the country's total foreign debt is high at 65%, which is related to the country's large trade flows. Although very high figures in nominal terms, foreign debt as a percentage of GDP is very low, at only 9%. Likewise, total foreign debt equals only 29% of total current account receipts and is dwarfed by China's FX reserves, which cover the country's total external debt nearly 5 times. Moreover, FX reserves will cover around 750% of debt service in 2012 and 2013 and around 20 months' worth of imports. Given its surpluses on the current account and its FX reserves, China's liquidity ratio is very good at around 230% in 2012 and 2013. External liquidity is therefore not a concern.

Figure 9: External liquidity



Source: EIU, Rabobank

Figure 10: Foreign debt



Source: EIU

Rabobank

China

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	14.2	9.6	9.2	10.4	9.3	7.8	8.0
Consumer prices (average % change pa)	4.8	5.9	-0.7	3.2	5.5	3.1	5.0
Current account balance (% of GDP)	10.1	9.2	5.1	4.0	2.8	2.1	1.6
Total foreign exchange reserves (m USD)	1530283	1949261	2416041	2866079	3202789	3538750	3809540
Economic growth							
GDP (% real change pa)	14.2	9.6	9.2	10.4	9.3	7.8	8.6
Gross fixed investment (% real change pa)	13.7	9.8	23.5	11.6	9.6	7.2	8.9
Private consumption (real % change pa)	10.9	8.5	9.4	7.1	10.0	9.2	9.5
Government consumption (% real change pa)	11.7	8.8	8.1	9.8	10.4	11.0	8.9
Exports of G&S (% real change pa)	16.6	4.8	-4.2	20.3	8.1	6.2	8.8
Imports of G&S (% real change pa)	13.8	3.9	4.5	20.7	9.4	5.9	10.0
Economic policy							
Budget balance (% of GDP)	0.6	-0.4	-2.2	-1.6	-1.1	-2.4	-2.3
Public debt (% of GDP)	17	15	16	16	15	17	17
Money market interest rate (%)	3.4	4.3	1.7	2.7	5.3	4.9	5.0
M2 growth (% change pa)	17	18	28	19	17	18	16
Consumer prices (average % change pa)	4.8	5.9	-0.7	3.2	5.5	3.1	5.0
Exchange rate LCU to USD (average)	7.6	6.9	6.8	6.8	6.5	6.3	6.3
Recorded unemployment (%)	5.7	5.9	6.3	6.1	6.5	6.4	6.6
Balance of payments (m USD)							
Current account balance	353183	420569	261120	237810	201714	170830	144840
Trade balance	315946	360646	249509	254180	243549	240930	227450
Export value of goods	1220061	1434701	1203801	1581421	1903821	2020960	2237810
Import value of goods	904116	1074051	954287	1327241	1660271	1780040	2010360
Services balance	-7910	-11814	-29398	-31156	-55229	-83030	-93030
Income balance	8044	28580	7261	-25900	-11868	-14700	-21000
Transfer balance	37103	43156	33748	40686	25261	27640	31420
Net direct investment flows	139094	114793	70317	185749	170448	99000	105000
Net portfolio investment flows	14247	35945	38731	12926	9892	-29390	-54480
Net debt flows	46824	-2280	43521	120899	103900	57240	93830
Other capital flows (negative is flight)	-91553	-150049	58833	-107345	-149244	38280	-23210
Change in international reserves	461794	418977	472522	450038	336710	335960	265980
External position (m USD)							
Total foreign debt	373083	379800	432198	548551	656330	710710	802950
Short-term debt	203698	187188	240509	347524	430057	463570	528890
Total debt service due, incl. short-term debt	205188	236954	226967	303120	386803	476700	517790
Total foreign exchange reserves	1530283	1949261	2416041	2866079	3202789	3538750	3809540
International investment position	1188110	1493820	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	2416200	2956690	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	1228090	1462870	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	9.0	7.9	4.9	4.3	3.4	3.0	2.5
Current account balance (% of GDP)	10.1	9.2	5.1	4.0	2.8	2.1	1.6
Inward FDI (% of GDP)	4.5	3.8	2.2	4.1	3.1	2.4	2.3
Foreign debt (% of GDP)	11	8	8	9	9	9	9
Foreign debt (% of XGSIT)	25	22	29	28	29	29	30
International investment position (% of GDP)	33.9	32.9	n.a.	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	14	14	15	16	17	20	19
Interest service ratio incl. arrears (% of XGSIT)	1	1	0	2	0	1	1
FX-reserves import cover (months)	17.8	19.0	26.0	22.6	20.2	20.7	19.7
FX-reserves debt service cover (%)	746	823	1064	946	828	742	736
Liquidity ratio	250	259	288	258	239	237	230

Source: EIU, Rabobank