

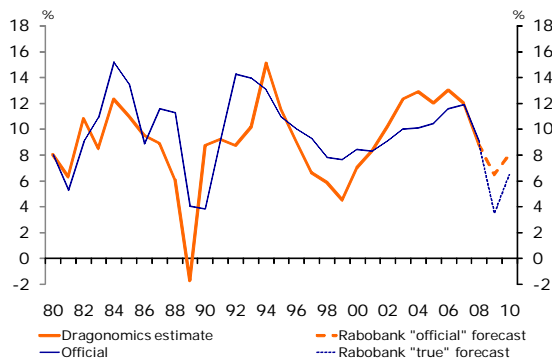


Rabobank

China: 6.5% is 3.5%, really!

A general, said Sun Tzu, "must be able to mystify his officers and men by false reports and appearances" to ensure secrecy. The Chinese authorities seem to have taken this phrase to heart. The notoriously unreliable statistics of China has allowed the government to publish consistently higher growth figures during economic downturns in the hope of maintaining social stability. Hence, we expect the current global economic meltdown to force the authorities to publish a growth figure close to 6.5% yoy for 2009, while the true figure will be closer to 3.5%. In any case, the expectation that China will tow the rest of the world out of this crisis is likely to be a tad optimistic.

Graph 1: GDP growth forecast

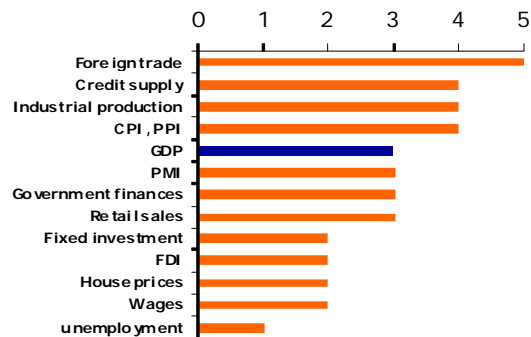


Source: Dragonomics, Rabobank

Rough landing ahead

The Chinese economy will experience its sharpest slowdown in at least the past 20 years in 2009 on the back of weaker external demand and real estate investment. The main point of interest is, therefore, how deep and protracted the slowdown will be. Given the notoriously unreliable statistics of the country's economy, accurate forecasting of GDP growth is an extremely challenging task. We have taken up the challenge to produce a reliable estimate of GDP growth given uncertainties around exports, investment and consumption.

Graph 2: China's statistics (most reliable=5)

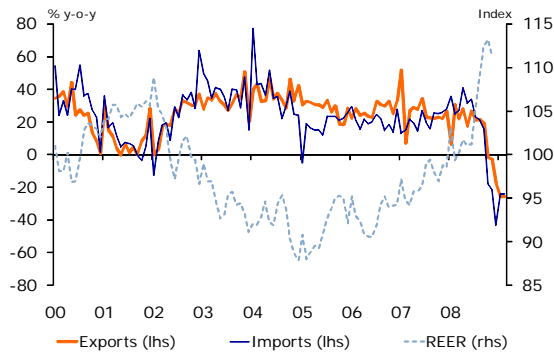


Source: Goldman Sachs

Weakening external demand...

Our expectation of agonizing growth contractions in the US and the EU in 2009 poses a significant downside risk to China's growth. Exports, accounting for 35% of GDP, plunged 25.7% yoy in February. In a recent study, Goldman Sachs calculates that the overall exposure of China to an external demand shock is even higher (48% of GDP) once the capital expenditure related to the export sector is accounted for, while deducting the import component of exports. More importantly, import growth, which serves as a leading indicator for exports given that processing trade for re-exportation accounts for nearly half of total trade in China, points to further pain ahead. Imports dropped by a whopping -24.1% yoy in February. Sadly, the increase in export VAT rebates initiated by the government cannot accomplish much. Neither will the government's stable exchange rate policy against the dollar (USD) because the renminbi (RMB) has already appreciated strongly in real effective terms. Although the financial markets expect a small depreciation of the RMB against the USD in a year (based on the non-deliverable forward rate), we deem this highly unlikely since it (i) would not be enough to bolster export growth and (ii) will raise the volume on China-bashing rhetoric in the West.

**Graph 3: External demand**



Source: Bloomberg

**...leads to slumping investment...**

The year-to-date urban fixed asset investment (FAI) growth, the most frequent data on investment in China that is monitored closely by investors, has softened only slightly to 26.5% yoy in February, from 27.6% in September 2008. However, the figure masks the underlying weakness of China's economic activity. Currently, land purchases are added to the capital stock whereas they do not constitute incremental new capacity. By not adjusting for the land purchases in investment spending data, it leads to an overstatement of capacity expansion. Our view is that fast rising land prices in recent years have exacerbated this problem.

**Graph 4: Real estate sector**

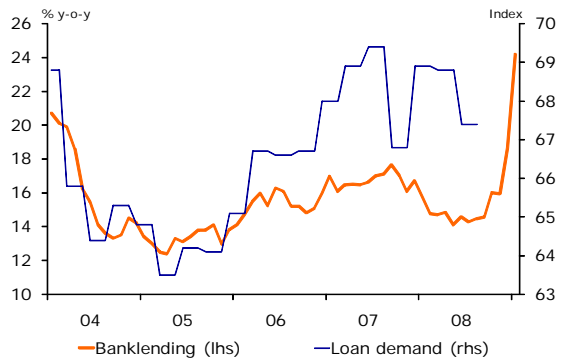


Source: Bloomberg

In particular, the massive housing correction indicates that real estate investment, which is equivalent to a quarter of total investment, will drop. A greater concern is the flagging manufacturing sector, which accounts for 30%

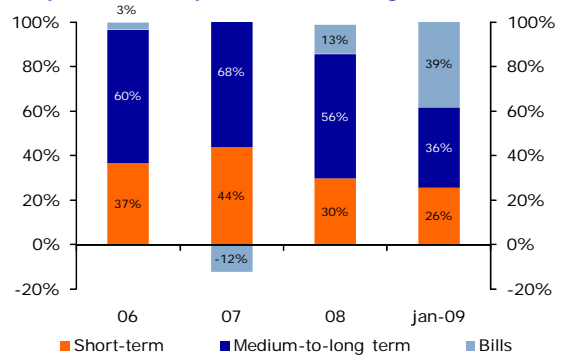
of total investment. Given that around three-quarter of China's FAI comes from retained earnings, we expect manufacturing investment to remain weak against a backdrop of falling industrial profits, which plunged 26.5% yoy in Q4 2008. As such, we do not expect the headline-grabbing RMB 1.6trn (USD 235bn) of new bank lending in January to offer much support because bank financing only provides around 20% of the funding source for China's FAI.

**Graph 5: Credit conditions**



Source: People's Bank of China

**Graph 6: Decomposition of loan growth**



Source: People's Bank of China

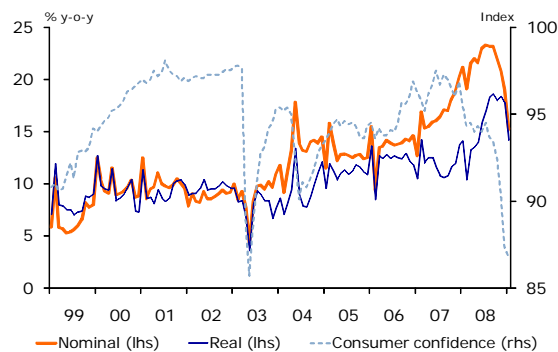
Moreover, it can be argued that the headline number is inflated because 39% of loan growth comes in the form of bill financing, which is primarily used to plug holes in balance sheets rather than increase investment. The decline in the bill discount rate to below the deposit rates has also led to arbitrage opportunities for Chinese firms. Overall, we are gravely concerned that the politicians' pressure on banks to lend more in an economic downturn will come at a cost of lower asset quality in the

medium- to long-term without having any meaningful impact on the economy.

### ...and falling consumption

Evaluating the strength of private consumption in China is the most daunting task since it is measured by two flawed statistics, namely the retail sales data and the household expenditure survey. The former provides a distorted picture because it includes both government and corporate consumption. This is perhaps the reason why consumer spending appears to be robust amid waning economic growth. The latter is also unreliable because people tend to under-report their income/expenditure due to a lack of confidentiality.

Graph 7: Retail sales



Source: Bloomberg

Also, using the unemployment rate as a proxy for measuring consumption patterns in the future is not possible. The data is useless because it only covers people who have urban registration (*hukuo*) and excludes an estimated 130 million migrant workers. All in all, the slumping economy implies that people will be less willing to spend given amid insecurity concerning future job/income prospects. This is lucidly reflected in the strong drop in consumer confidence to levels not seen since the SARS episode. Thus, consumption is not going to buoy growth as much as the data suggests. And the commitment to increase the medical insurance coverage to 90% of the population nationwide by 2011 will not act as a mitigating factor because it simply comes too late. The revised spending on healthcare and education

to 4% of the total stimulus package (USD 585bn) from 1% previously is also not enough.

### Disguising the truth in the name of social stability

To sum up, China's economic slowdown will be more severe than what the authorities wish to admit. We believe that the main pillars of China's economy – exports, investment and consumption – are in a worse state than the official figures suggests. It must be mentioned that our growth forecast already assumes that fiscal and monetary easing will gain traction in H2 2009. It is wishful thinking, therefore, that an export-led economy such as China could grow around the government's target of 8% this year while the global economy enters into one of the deepest recessions in history. Judging from past experience, however, the authorities will publish a number close to 6.5% in order to overcome social unrest at all costs (see figure 1). Although this strategy might work in the short run, we are not so sure of its success in the eventual case that the world economy goes through a prolonged economic slump (i.e. an L-shaped recession).

With the current policy framework, the Chinese government seems to be taking a risky bet on the full recovery of the global economy by 2010. We are greatly concerned, however, that the ongoing deleveraging process in the Western economies will take years to complete. This begs the question, therefore, as to whether it is in the best interest of the government to continue to support an export-led economy or to opt for a 'domestic-demand-driven' growth model. The government can rebalance the economy through a variety of steps (see box).

This would enable the country to return to double-digit growth rates even if the world does not stage a robust recovery in the long-term. It must be borne in mind, however, that we would not advocate a sudden shift of macroeconomic policy towards domestic demand as it can lead to social unrest. Simply

put, economic reform must never take place in the trough of the business cycle. Having said that, the authorities must take meaningful steps towards an eventual rebalancing of the economy while they have enough ammunition at their disposal to battle the current economic downturn. In any case, shifting the growth model cannot take place this year. Against this backdrop, we expect China's economy to grow by a meager 3.5% in 2009 amid retrenching external demand.

#### **Box 1: The rebalancing act**

While China's economic growth has been seen as one of the success stories in the world, the export-led growth model that the Chinese leadership has chosen has greatly exposed the country to adverse external shocks. Therefore, to ensure that the economy will return to its trend level growth rate (9.5%-10.5%), the government must take a number of bold steps to stimulate domestic demand. We have discussed this rebalancing act in further detail in Special Report 2008/01.

In specific, the authorities can take 8 steps to rebalance the economy. It must be stressed that they must not necessarily be taken in tandem and they are not in the order of importance. The measures are:

1. Shifting government spending from investment to health, education and social security.
2. Allowing the currency to float more freely.
3. Encouraging free mobility of labor (i.e. abandoning the *hukuo* system).
4. Speeding up financial market reform (e.g. creating a mature bond market).
5. Establishing a dividend policy for the state-owned enterprises (SOEs).
6. Adjusting the price of inputs into manufacturing.
7. Removing distortions in the tax system subsidizing and stimulating manufacturing.
8. Addressing lack of competition in the service sector.

To conclude, we hope that the government will take the necessary measures in order to rid the country, once and for all, from its strong reliance on foreign consumers. In other words, the time has come for the government to deliver the 30-year old promise of 'socialism with Chinese characteristics' instead of concealing the truth via creative statistics.

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