

Is the Chinese economy cooling?

Ahmet Goncu

Xi'an Jiaotong-Liverpool University

Suzhou, 215123, China

goncuahm@gmail.com

1. Introduction

China's central bank on Friday (Sep. 30th) reiterated that it will continue to pursue a prudent monetary policy and make price stability a priority. In the written statement PBOC stated that the rhythm and force of the monetary policy must be handled carefully. "China's economy is growing in a stable and rapid manner," said the statement. "Inflationary pressure has eased somewhat but still runs at a high level." It reaffirmed that the exchange rate of the Chinese currency must be kept "basically stable at a reasonable and balanced level." The current USD/RMB exchange rate as of 30th September is 6.3549.

People's Bank of China (PBOC) did not increase interest rates since the last rate hike in July. The fight against inflation is still the priority of the Central Bank. However, the central bank is holding off on further tightening as jitters about a global slowdown increase. Since last October, China has raised interest rates five times and banks' reserve requirement ratios (RRR) nine times. In August inflation declined to **6.2%** after the record high level of **6.5%** in July. September inflation rate to be announced after the national holiday during the second week of October, the expectation is slightly above the August level of 6.2%.

Did inflation rate come to a turning point?

With the food prices, which was the main drive in the recent CPI hikes, starting to stabilize, the answer would be; **Yes**. Apart from food and energy, inflation was not driven by other goods and services. The increase in CPI is slowing down mainly due to the measures taken to increase the food supply with the help of releasing some of the strategic reserves. Tightened monetary policy and lower government spending contributes to the downward trend in inflation. In September we might see another increase in CPI due to the Moon Festival and increased spending. September CPI might well be above the August level of 6.2%; however it is likely that in the coming months and during 2012 inflation will go down further.

What is the chance of further tightening by People's Bank of China (PBOC)?

Currently, chance of further tightening by the Central Bank is fairly low, given the trend in inflation and global economic outlook.

Is the Chinese economy cooling down too rapidly?

Based on the HSBC PMI report, stagnation of China's manufacturing sector continued in September. Seasonally adjusted HSBC PMI is held steady at **49.9** in September. The index averaged its lowest quarterly reading since Q1 2009.

PMI and retail sales indicate that Chinese economy is slowing down and we will be seeing growth rates falling down further. The 9.5% growth rate in the second quarter will not be achieved in the third and fourth quarters.

Overall, 2011 growth is expected to be just over 9%. However, the growth forecasts for 2012 are around 8.5%. If the economy continues to slow down with the current speed, this correction will help China to stabilize its growth at a more sustainable level, which is also the goal of the 12th five year plan announced by the central government.

Chinese monetary and fiscal authorities have enough and powerful tools to avoid a **hard landing** in the Chinese economy. Therefore, Chinese economy is slowing down but this is a necessary adjustment and should be expected to continue.

There might be two perspectives of this phenomenon. From a domestic point of view China is not worried much about a “slow down” as long as it is in the form of a soft landing, since property market is cooling down in the first place and this is a very good development if it can be done slowly.

However, from an international point of view, China is expected to do more of the heavy lifting in helping to boost world economic growth. As China's premier Wen Jiabo announced during the Summer Davos in September 14th, China will do its best to increase its investment in European bond markets in line with diversification of its investments. However, he also mentioned that China cannot be the savior of Euro zone countries. At the same time during the meetings there was

an implicit bargaining of the recognition of the Chinese economy as full market economy in WTO by EU, in return for increased Chinese investment into distressed bond markets in Europe. Following that UK made an announcement to support the recognition of full market status of China before 2016.

The general consensus in Chinese financial markets is that Chinese economy should do a soft landing to a more stable and sustainable growth path. The housing market and the high local government debt levels are sources of major risks for the Chinese economy. Slowing down of the Chinese economy is happening in a **soft way** with current indicators.

There is no evidence for hard landing; however still a hard landing might be triggered with rapidly worsening international conditions. Hence, at this point the major risk of a hard landing is more likely if the European debt crisis is not resolved through structural reforms and causes the default of large Euro zone countries.

News that led to worries in international markets is the low retail spending in China in real terms, which is weakest since 2004. We might see some loosening monetary or fiscal policies during 2012. Industrial production is slowing slightly as also indicated in PMI.

The HSBC purchasing managers' index (PMI), was at 49.9 in September, unchanged from August.

The final reading for HSBC's China PMI is stronger than the flash PMI reading of 49.4 published last week.

This implies that although the lagged effects of credit tightening will continue to cool industrial activity in the months ahead, there is little evidence in support of a sharp slowdown.

HSBC believes a PMI reading of as low as 48 in China still points to annual growth of 12-13 percent in industrial output and a 9 percent expansion in gross domestic product. Economists expect China's economic growth to hold up at around 8.5-9 percent in the coming years, despite the global slowdown.

Hongbin Qu, Chief Economist, China & Co-Head of Asian Economic Research at HSBC said: *“September final PMI still stays below 50, but shows some signs of stabilizing. This implies that although the lagged effects of credit tightening will continue to cool industrial activity in the months ahead, there is little need to worry about a sharp slowdown. Despite the global slowdown, we expect China's economic growth to hold up at around 8.5-9% in the coming years.”*

Chinese government already targeting growth rates of 7.5-8.5% levels for a more sustainable growth in the 12th five year plan announced during early 2011. Therefore, as long as there is no ‘hard landing’ in the Chinese economy, the current signs of slowing down economy is inline with the expectations of the government and is considered as a part of transforming the Chinese economy from a export driven economy into a consumption based economy.

With the possibility of double dip recession in Europe and USA, financial markets expect the Chinese government to contribute to the world growth by

stimulating its economy one more time as it did during the 2009 financial crisis. However, this time for the moment China has limited ability to promote the world growth and offer financial support to European nations due to its efforts to control inflation. Central Bank is watching the current speed of slowdown in Chinese economy. The current negative global outlook caused the Central Bank not to further tighten the monetary policy. It's likely that we will not see any interest rates or required reserve ratio hikes in the rest of the year and possibly in 2012. PBOC considers that inflation is losing its momentum and if the cooling down of the economy starts to accelerate during 2012, we will likely see a change in the fiscal policy of Beijing switching to a more expansionary state.

The tightened monetary policy is already showing strong effects on SMEs and credit crunch has been observed in several Chinese cities, such as Wenzhou, which is known for its large number of SMEs.

Conclusion

We believe that Chinese economy is slowing down and we are likely to observe growth rates around **8.0-8.5%** in 2012. However, with its good fiscal condition, record high \$3.2 trillion USD reserves and emerging middle income class with strong demand, Beijing has a lot of powerful tools to boost growth if it stalls too rapidly. Overall, the biggest risk in international markets is still originating from Euro zone countries rather than China. China's current priorities are controlling inflation while achieving a soft landing to avoid any sudden burst of the property market. In case of a hard landing local government

debt and an accompanying increase in the non-performing loans of large state owned banks will be an important problem. However, in such a situation local government debts and losses of

banks will be covered by the Central government at all costs.