

## **Chinese Economic Outlook in 2012**

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### **Monetary policy of Chinese central bank (PBOC) in 2012**

PBOC recently announced that during 2012 it will likely continue the prudent monetary policy and maintain the continuity of its policies. The New Year address by the PBOC governor Zhou Xiaochuan mentioned the importance of keeping a prudent approach in monetary policy during 2012. Having mentioned that, PBOC also showed signs of easing the monetary policy slightly by reducing the reserve requirement rate of local banks by 50 basis points in November- the first decrease in three years- to ease a liquidity strain as inflation softened.

The expectation in the market is towards another decrease in the reserve requirement ratio during early 2012. This is inline with the deteriorating global demand for Chinese exports. The prudent monetary policy and restrictions on credit expansion is mainly for avoiding a bigger problem in the future due to high property prices at first tier cities.

Especially, during the last quarter of 2011, prudent monetary policy and controls on real estate credits started to show their effects on property prices. A majority of cities reported moderate price falls in real estate prices during November and December. However, in first tier cities such as Beijing and Shanghai, property prices are still quite high.

It would not be surprising to claim that 2012 will be a difficult year for many countries due to high risks in Western economies. China with its lucrative market for western companies offers a lot of growth opportunities. China with decelerating export growth will put more emphasis on boosting domestic consumption.

After the first global financial crisis-that started with sub-prime mortgage crisis in the USA-Chinese central government resorted to a stimulus plan of 586 billion US dollars. This stimulus was done mostly through monetary expansion; however this created the current housing market problems with a lot of unnecessary investments in high-end housing projects, which became speculative. To avoid that problem, in line with increasing global weakness of demand, 2012 might be a year of fiscal expansion with increased government spending on social welfare and healthcare.

The good news for the Central Bank would be the slowing down inflation. In November 2011 CPI fell to 4.2% and the trend seems to be downward for 2012. Therefore, it is likely that inflation will not be a problem in 2012. With easing inflation Chinese financial market is expecting another reserve requirement cut in early 2012. However, interest rates are not likely to change in the first quarter of 2012. Monetary policy overall

will not drastically change in the first quarter, but PBOC will be trying to see the direction of economy depending on international risks.



### Property Market in 2012

The biggest risk in Chinese economy for 2012 will be the property market. The property market has been one of the biggest contributors to the fast growth in Chinese economy for over decades. The risk stems from the fact that local government revenues in China are heavily dependent on land sales, which in turn is used for real estate projects through auctions. During the last quarter some land auctions have not been successful. If there is significant drop in the demand for land and property, then inevitably local governments will start to face financial difficulties to pay back bank loans. These difficulties will force them to cut spending which will in turn reduce the GDP growth significantly.

We should note that the property market in China is quite different from other countries, thus the risk should be understood in its own context. In China there is still not officially private property, every property that people buy or sell are effectively belonging to the state. However, in practice when one buys a house that means purchasing the

right to use it. Therefore, with its current legal structure the risk concept is somewhat different than other countries. Further, the banks are not doing any securitization of property or mortgage loans. The down-payments are as high as 40%-50% and in some cases even if you want to pay at once there are other restrictions on property purchases especially for people wishing to purchase a house in first-tier cities. Thus the spillover effects of defaulting loans would be much limited and banks are state funded. This practically removes the risk of a bank failure in China. The worst that can happen is the default of some local governments, which might not be even publicized or might be public after the government injection of fund. Construction companies or real estate businesses might get hit by worsening conditions in real estate market. The indirect impact on other industries would still be limited due to the strong domestic consumption. It is true that property market in China might be gloomy in the next few years for real estate developers, but this will not slow down many flourishing sectors such as the service industries.

Furthermore, even if the local governments face financial difficulties central government is in a strong fiscal position with a large fiscal surplus. Plus considering the 3 trillion US dollar worth of FX reserves, the domestic risks are very unlikely to trigger a doomsday scenario for China. The current decline in property prices in China is at reasonable levels without any surprises and without sudden drops. If the price adjustment continues in a slow manner the risk will not materialize to threaten the whole Chinese economy.

Indeed it can be argued that the driving force of property prices in China is not the monetary policy. The main problem is the lack of enough financial instruments for people to invest. To keep the value of Yuan fixed, China kept tight controls on its capital account. If we consider a Chinese investor there are very limited number of investment tools and those two options are either depositing the money into a savings account or investing into the stock market. The banks in China often have interest rates that are even below inflation expectations; on the other hand stock market is unreliable given the absence of well established audit and accounting practices and high dependency on government policy decisions.

Given the absence of investment tools property is considered as the most lucrative investment tool in Chinese financial markets. However, the annual salary increase of average Chinese citizen could not match with the year to year increases in housing prices. This situation is hurting the lower and middle income class most. Thus, central government is trying to offer affordable houses at subsidized prices and many cities has set up limits on the houses one individual can own in the same city. These are only temporary measures and the real solution would be increasing the available investment tools to investors and channeling some of the speculative demand to other financial instruments. Recently, higher property taxes are also being implemented in first-tier cities. To solve the speculative nature of property prices, China is considering a more liberal capital account regime in the coming years and introduces new financial instruments for investment.



### Conclusions

2012 might be a difficult year for the world economy with worsening conditions in fiscal situation of European countries. The global markets are expecting China to drive the global demand more with its increasing domestic consumptions and imports. Chinese government is expected to follow a more expansionary fiscal policy during 2012. Even with it's slowing down growth rates, China will contribute significantly to the global demand and growth of the world economy in 2012. Global demand for Chinese exports might slow down which in turn will put pressure on the Central Bank to slow down the appreciation of Yuan. Overall, Chinese economy will be growing much higher than the world average and will continue to offer attractive investment opportunities for foreign firms. ***In 2012 Chinese GDP is likely to grow with rates around 8-8.5% percent with strong domestic consumption and flourishing service industry.***

### Major macroeconomic statistics for November 2011

#### Growth indexes

Industrial output: +12.4%  
 Retail Sales: +17.3%  
 Urban fixed-asset investment: +24.5%  
 Power consumption: +9.91%  
 FDI: -9.76%

#### Financial indexes

New yuan loans: 562.2 billion yuan

M2: 82.55 trillion yuan

Fiscal revenue: 645.73 billion yuan

**Price indexes**

CPI: +4.2%

PPI: +2.7%

**Foreign trade indexes**

Import: \$159.94 billion

Export: \$174.46 billion

Trade surplus: \$14.52 billion