

China: The Necessary Reforms After the Crisis

The Chinese expectations of keeping elevated economic growth rates, together with their fair wishes of playing a greater international role, means to deal with a series of important macroeconomic challenges such as a prudent flexibility of their exchange rate and the threat of a real estate bubble.

At the end of 2009, China started to recover its normal economic dynamism, after a year of turbulences in the international scenario originated in the North American economy. Although the Asian giant was one of the few countries in the world which continued growing at high rates during the economic crisis of the past years, it did not end up completely undamaged. We must also recognize that its effort in public policy issues was successful and contributed to the recovery of the global economy.

The international recession strongly affected the demand for its products; therefore, the counter cyclical policies applied, both in monetary and fiscal matters, were determinant to face adversity. However, now that exports have recovered and the economy starts growing by itself, we should review some of the policies applied to prevent the economy's overheating and other unwanted effects such as the risk of a real estate bubble.

The normalization of the economic policies will also imply a complicated discussion concerning one of the tools used during the crisis: the exchange rate. Although in June of this year, China committed itself to initiate a new transition towards a more flexible exchange rate, the continuous interventions of the exchange market and the statements of this country's authorities, have demonstrated that a rapid appreciation of the Yuan is not really part of their plans. Beyond its consequences in the Chinese exportation model, this means to maintain the frictions with the Western Powers, especially the United States which have insistently demanded to transparent the real value of a currency which, in their opinion, is undervalued and would generate an unfair competition in the markets.

Table Nº 1

CHINA'S ECONOMIC INDICATORS

China	2004	2005	2006	2007	2008	2009	2010p	2011p
Actual GDP (% var)	10.1	11.3	12.7	14.2	9.6	9.1	9.8	8.6
Domestic Demand (% var)	10.1	7.1	10.6	12.1	8.8	11.8	13.1	12.0
Private Consumption (% var)	8.1	9.6	11.3	9.6	9.5	8.5	9.5	10.0
Investment (% var)	15.3	16.8	14.9	12.3	10.0	14.0	15.0	11.0
Balance of Trade (US\$ Bill.)		134. 2	217. 7	315.4	360.7	249.5	184.4	163.2
Exports (US\$ Bill.)	593. 4	762. 5	969. 7	1220. 0	1434. 6	1203. 8	1581. 0	1894. 2
Imports (US\$ Bill.)	534. 4	628. 3	751. 9	904.6	1073. 9	954.3	1396. 6	1731. 0
Current Account (GDP %)	3.5	7.0	9.1	10.7	9.4	6.3	5.9	5.1
Inflation (% Dec/Dec)	2.4	1.6	2.8	6.5	1.2	1.9	2.6	3.4
Fiscal Balance (GDP %)	-1.3	-1.2	-0.8	0.6	-0.4	-2.2	n/a	n/a

Source: IIF and JP Morgan

The Chinese expectations of keeping elevated economic growth rates, together with their wishes of playing a greater international role, means to deal with these challenges in the following years.

China Will Continue to Grow Strongly

In 2010, China is expected to grow 9.8%, more than the 9.1% registered in 2009, and for 2011 it is expected that to grow around 9%. This growth is mostly explained thanks to the increase of the Chinese domestic demand, which is expected to rise approximately 13% in 2010 and 12% in 2011 (see Chart 1).

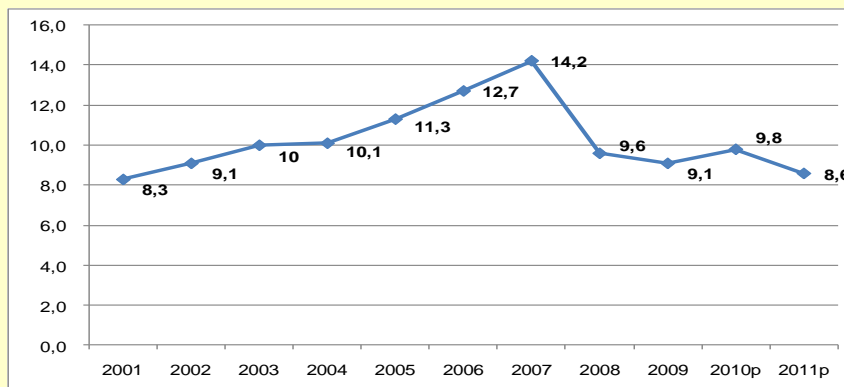
In 2009, China became the world's biggest exporter by reaching a share of around 10% of the shipments and displacing Germany, the country holding this title in the past years. Nevertheless, this achievement was clouded by the international trade's big fall. Although China reduced its exports less

than Japan and the great Western exporters, its shipments abroad were nevertheless reduced by 19% in 2009.

Another effect of the crisis in the Chinese foreign trade has been the ever increasing growth of imports. While exports are expected to grow around 13% in 2010 and surpass the levels before the crisis, it is expected that imports increase 46%. This impact can also be appreciated in the commercial exchange with Chile, where Chinese imports dropped 24% in 2009, while the Chilean exports to that country increased 24%.

Chart N°1

CHINA'S GDP GROWTH RATES (ANNUAL % VAR.)



Source: IIF.

This phenomenon, which began in 2008 and it is expected to continue at least until 2011, has produced a continuous drop in the current account balance of the Chinese economy. However, this fall has been offset by the strong growth of the domestic demand mentioned above.

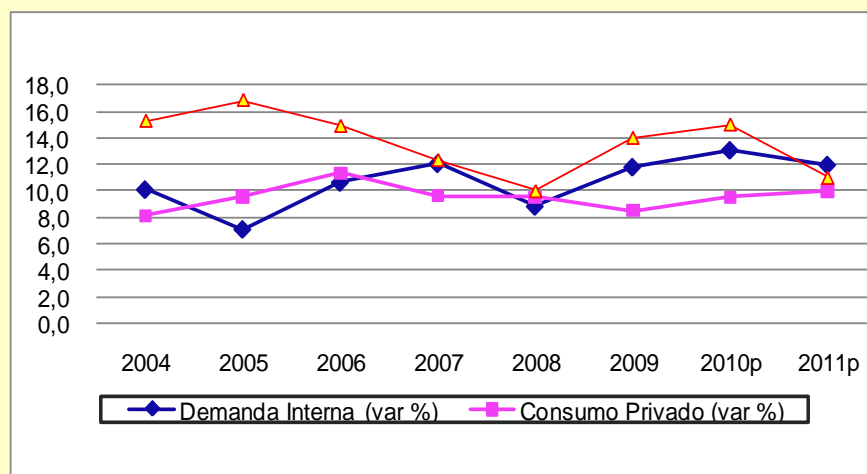
The Chinese authorities have especially emphasized this factor. During the crisis, they made substantive fiscal efforts with the aim of stimulating growth, particularly in public investments and social spending matters. Although this involved an increase of the fiscal deficit – which attained - 2.2% of the GDP - , it managed to expand the domestic demand 11.8%, in spite of the difficult international scenario and the business pessimism in the first months of the year. In fact, in 2009, half of the Chinese economy growth was a consequence of investment and government expenditure. An important aspect to be considered in the progressive increase of the Chinese social spending has to do with the concept known as “scientific development”, whose credit is given to Hu Jintao. Under this label, the present administration seeks to increase the role of the State in matters

such as social security and protection of the environmental and cultural assets. During the last congress of the Chinese Communist Party, held in October 2007, besides confirming this concept, the future leading cadres were established, where personalities such as Xi Jinping and Li Keqiang stand out, both close to the current line of President Hu Jintao; therefore, we may expect that the increasing social policies and the emphasis on consumption increase will continue to be part of the next administration's goals.

Besides the impact of the progressive public spending increase on the domestic demand growth, and the consumption of imported goods, the flexibility developed in the financial market during the crisis is also worth mentioning. The bank reserve requirements were reduced during 2008, the regulations for the mortgage indebtedness also declined, and an interest rate decrease took place. It is deemed that these policies were highly successful in fostering the credit demand which reached 31% of the GDP during 2009. Nevertheless, this flexibility in the financial market also gave birth to certain fears regarding a possible worsening in the credit quality, so therefore, once the crisis was overcome, Chinese authorities started to revert several of these measures. For example, the bank reserve requirements have risen again from 15.5% to 17%, and the interest rates for second and third property purchases have also increased. It is expected that the referential interest rate closes this year at 5.56%, and to continue with slight raises until it reaches 5.85% during the third quarter of 2011.

Chart Nº 2

EVOLUTION OF THE CHINESE DOMESTIC DEMAND, PRIVATE CONSUMPTION AND INVESTMENT (ANNUAL % VAR.)

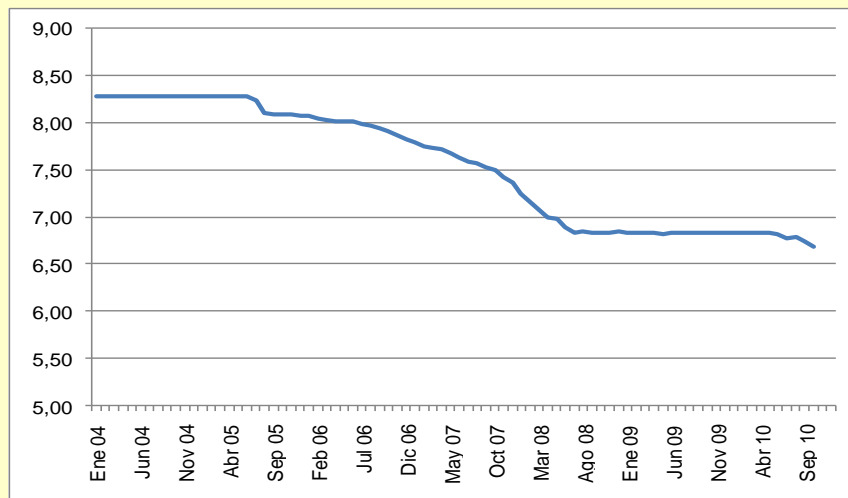


Source: IIF

A negative effect of the monetary policies applied in the last years has been the increasing property investment. This sector, which has greatly flourished in the past years, has received a large part of the investment due to the fiscal stimulus given during the crisis. Although, in average, the property prices are still growing at normal rates, certain cities have experienced higher increases, thus generating fears concerning a possible price bubble in the sector. The limited development of the financial sector, together with the high savings rate of the Chinese economy, has created an artificially favorable scenario for the real estate sector; therefore, in the following year, China shall have to make reforms to continue strengthening its financial sector. Such measures shall include a greater liberalization in the credit markets, and fostering the development of equity security markets, mutual funds and corporate bonds.

Chart Nº 3

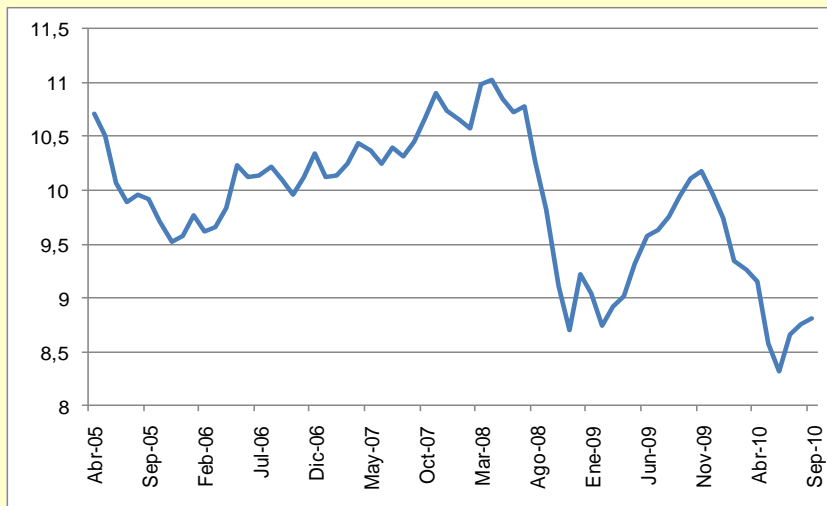
EXCHANGE RATE EVOLUTION IN CHINA YUAN/DOLLAR (MONTHLY AVERAGES)



Source: The Popular Bank of China

Chart Nº4

EXCHANGE RATE EVOLUTION IN CHINA YUAN/EURO (MONTHLY AVERAGES)



Source: The European Central Bank

The Yuan's problem

An important challenge of the Chinese economy is related to its current rate exchange system. Although in June of the present year the Chinese authorities committed themselves to ensure a Yuan's greater flexibility, the truth is that the permanent interventions in the exchange markets have demonstrated that the promised flexibility will be less than that expected the day of the announcement. From that moment until now, the Yuan has increased its value in 1.8% and the authorities have indicated that they shall prevent any accelerated increase in its value. This contrasts with the former flexibility experience undertaken between 2005 and 2008, when the Yuan increased its value around 20%.

The uncertainty concerning the Yuan's value does not only affect the Chinese external trade, where a possible increase could deepen the continuous decrease of its current account balance, but, in the last time, it also has become a point of disagreement with the Western authorities, especially the United States, who accuses China of keeping a low value artificially with the aim of stimulating its exportation sector. This type of conflicts affects the Chinese expectations of playing a greater role at international level where, among others, China hopes to include the Yuan in the calculation of the Special Drawing Rights (SDR), a reference currency calculated by the IMF that weights the world's key currencies, and

also to gain more rights in the governability decisions of this international organisms.

Conclusions

In the following years, it is expected that the Chinese economy grows at a sustained 9%, a number lower than the one registered in the pre-crisis years, but that is still excellent in the international context, with an increasing preponderance of investment and private consumption, which will grow 15% and 9.5% in 2010, and 11% and 10% in 2011 respectively. However, this process is conditioned to better efforts in labor flexibility matters, and also to a greater availability of urban infrastructure which is able to resist the increasing migration from the villages to the city.

It is expected that in the course of 2011 the moderation in the fiscal stimulus applied during the crisis, is maintained. In fact, figures already show a reduction in the public spending growth rates, especially in road works. Furthermore, authorities have demonstrated their interest in maintaining the social spending with the purpose of promoting private consumption in the following years. Along these lines, it is important to consider the current Chinese political situation and its projection for the years to come, where it is expected to increase the State's sphere of authority in matters regarding social security and protection of the Chinese environmental and cultural assets.

The monetary policy should keep showing slight increases during the following months. Although no important inflationary pressures are expected in the short run, the referential interest rate (rate between 6 month and 1 year) should reach 5.85% in the third quarter of 2011. Together with this rate normalization, we should see a step backward in the transitory dispositions applied during the crisis which allowed a greater expansion of credits. In this perspective, authorities have already started to increase the bank reserve requirements, and to limit the mortgage financing.

In view of the price increases in the real estate market, the authorities have proceeded to limit the number of properties bought by foreigners. Nevertheless, it is necessary to further develop the financial market, so as to diversify the investment options in China.

The export sector, after regaining the dynamism lost during the crisis, is expected to grow around 20% in 2011, focusing on the recovery of the most damaged exports during the crisis: light and electronic goods manufacture. The exports in capital goods should maintain their current growth rate in the following years, because they were not particularly weakened by the crisis.

In spite of the confidence shown by Chinese authorities, a progressive appreciation of the Yuan could have an impact on the Chinese external sector, aggravating the fall in the current account balance in the coming years. However, it has been indicated that any variation in the Yuan's value shall be gradual.

Consequently, the Popular Bank of China raised the reference rate for deposits and loans by 0.25 percentage points, after three years. The objective is to moderate the economic stimulus in the Chinese economy which is growing at 10% rates, and to contain inflation. The rate for 1 year deposits increased from 2.25% to 2.5%, and the loan rate of the Popular Bank of China (Central Bank) increased from 5.31% to 5.56%. The immediate effect has been a reduction in the commodity prices, for example, oil dropped 4.3% and, on the other side, the dollar raised 1.7%, on a trade-weighted basis. The moderate adjustment of the interest rate tends to appreciate the Yuan, due to the consequent attraction of capital flows towards China.

It is important to consider that the value of the Yuan will not only affect the Chinese balance of trade, but also its political potential at international level. The intentions of including the Yuan in the calculation of the SDR, and moreover to play a greater role in the decisions of the International Monetary Fund are being questioned by the present conflict between the Chinese authorities and the leaders of the United States. Therefore, any decision concerning the value of the Yuan in the mid-term should not be taken based on short-term economic issues only.