

Asia Economics Flash

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Raising China's growth forecasts for 2009–2010

- We have raised our real GDP growth forecasts for 2009 and 2010 given that 1) policy stimulus has been more aggressive and 2) the domestic demand response has been stronger and has occurred earlier than we originally forecasted.
- Our new forecasts predict real GDP growth of 8.3% in 2009 (versus 6.0% previously) and more importantly, to reach 10.9% in 2010 (up from 9.0%), significantly above consensus
- We expect above-trend growth in 2010 to be largely driven by stronger investment growth, especially from private investment.
- In addition, we expect policymakers to eventually normalize and shift away from aggressive policy loosening, but only when they are more assured of a stabilization in domestic unemployment and external demand. This would give additional insurance to the growth trajectory we foresee.

Aggressive policy easing and better-than-expected results from the stimulus have made a stronger case for China's growth re-rating. Since the announcement of the Rmb4 trillion fiscal stimulus package last November, policymakers in China have been pushing the envelope on policy easing in only one direction—for more and more. The pace of implementation of new infrastructure investment and the scale of domestic credit expansion have been unprecedented. However, as we have long argued, one should probably discount some of the official statistics for quality/seasonality reasons, especially in any one particular data series. We believe the message from the aggregate macro data along with other anecdotal evidence, such as domestic commodity demand, is clear: the aggressive policy stimulus has been working.

We acknowledge that policy stimulus has been more determined and persistent and the response from domestic demand has come in earlier and more strongly than we envisaged previously. The strong rebound in fixed asset investment (FAI) growth which started in January-February strengthened even further in March. This was partly as a result of rushed orders to implement investment projects and aggressive easing in financial conditions. As previously discussed, the newly released 1Q2009 GDP and March activity data surprised us on the upside both in sequential and year-on-year terms (see *Stronger-than-expected activity growth; rising upside risks to our GDP forecasts*, China Views, April 16). This is despite the fact that our previous set of GDP forecasts had already incorporated a significant growth rebound in 1Q2009 and further additional strengthening in growth momentum for the rest of the year.



Based on these factors, we have raised our real GDP growth forecasts to 8.3% for 2009, from 6.0% previously, and to 10.9% for 2010, from 9.0% previously (see Exhibit 1), which are significantly above consensus forecasts of 7.0% and 8.3% respectively. We also raised our CPI inflation forecast for both years to -0.3% yoy for 2009 and 1.5% yoy for 2010, from -0.5% yoy and 1.0% yoy respectively (consensus forecasts are -0.1% and 1.6% respectively). These forecasts are based on a data-dependent policy path, where we expect the easing bias will likely normalize and shift to a less growth-supportive stance over time once the growth recovery has established a firmer foothold. We have also baked in assumptions on further growth stabilization in the near term and sluggish growth recoveries from 2H2009 onwards in industrial economies.

Exhibit 1: Our old and new forecasts

Summary Indicators

(percentage change, unless otherwise indicated)

GDP by expenditure (at 1990 prices)	2007	2008	2009F		2010F	
			New	Old	New	Old
GDP	13.0	9.0	8.3	6.0	10.9	9.0
Domestic demand	10.6	9.0	9.8	6.5	12.6	10.1
Private consumption	10.4	9.1	7.8	7.3	10.4	9.3
Government consumption	10.6	9.5	6.5	6.5	9.6	9.5
Fixed investment	11.7	8.6	13.0	6.0	15.5	11.0
Net exports (contribution to growth)	3.3	0.9	-0.6	0.2	-0.6	-0.1
Exports (G&S)	20.1	7.0	-13.0	-13.0	7.0	5.0
Imports (G&S)	17.9	6.7	-14.0	-15.0	9.0	6.0
Memo:						
CPI inflation (period average)	4.8	5.9	-0.3	-0.5	1.5	1.0

Source: CEIC, GS Global ECS Research.

What has changed to make us think the magical growth number of 8% could be reached in 2009?

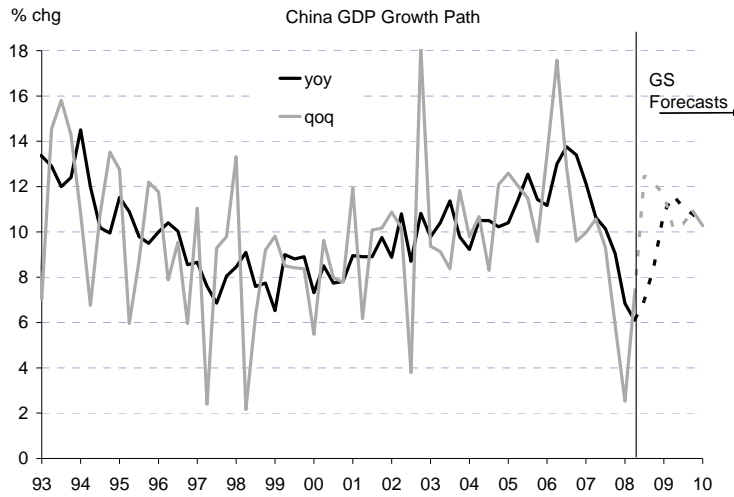
We believe the strong growth rebound in 1Q2009 reflects policy stimulus jump-starting a fast rotation of growth from export-driven to domestic-investment driven. In 2H2008, China experienced its most severe and sharpest slowdown in 30 years. However, Chinese policymakers responded almost immediately by rolling out a substantial stimulus package and aggressively easing monetary policy. This was followed by fast implementation through government agencies such as the National Development and Reform Commission (NDRC). The policy stimulus redirected a large share of economic resources to domestic fixed investment, which had been suppressed for more than four years due to the policy tightening during the period of overheating since 2004. As a result, the stimulus has released substantial “pent-up” demand in infrastructure investment, especially in terms of transportation (railways, highways, airports, and ports) and utilities. This caused strong FAI growth to come in with almost no time lag after the first two batches of central-government-led investment projects were implemented in December 2008 and before the Chinese New Year in January 2009. While many argue the effect has been boosted by the credit surge, we tend to think the commercial bank loan expansion was as much a result of government policies, including moral suasion by the central bank, as a reflection of underlying demand being relatively firm.

In the next three quarters, we expect domestic demand growth to further strengthen, bolstered by loose financial conditions and continued policy stimulus

First, we already have a boost to domestic demand growth from the substantial easing of financial conditions. Based on past statistics, we would normally expect a 6-month lag between the easing of our GS China Financial Conditions Index (GS China-FCI) and the strengthening of domestic demand. Given the large scale and rushed pace of public investment to be realized in the next few months, we think the time lag is shorter under the current circumstances. Therefore, although the impact of the 540 bp of easing in our GS China-FCI in the past five months has

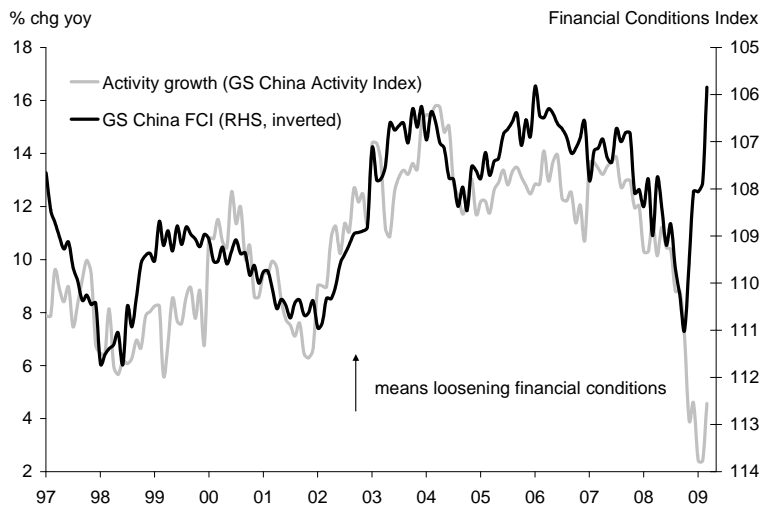
already started to show, the effect will likely become stronger in 2Q2009. We expect the easing to produce maximal effect by the end of 3Q2009 and probably moderate a notch in 4Q2009, as there is less room for further easing of the same magnitude between now and June (see Exhibit 3). Correspondingly, we expect real GDP growth in 2Q2009– 3Q2009 to be the highest in 2009 in sequential terms, when the impact from the public investment and easing of financial conditions reaches its maximum impact (see Exhibit 2).

Exhibit 2: Quarterly GDP forecast trajectory



Source: National Bureau of Statistics, CEIC, GS Global ECS Research.

Exhibit 3: Substantial loosening of financial conditions over the past four months



Source: CEIC, GS Global ECS Research.

Second, there have been no changes to the aggressive policy stimulus stance, as confirmed by Premier Wen’s remarks during the State Council meeting held last week. In particular, Wen mentioned that the third batch of central-government-led infrastructure investment will be implemented immediately. Considered together with the fact that earlier batches of investment projects are progressing into the next phase, this underpins the case for FAI growth to accelerate further this year. In addition, we also believe by leaving the loosening bias in monetary policy unchanged, the State Council has added further insurance to China’s growth recovery even beyond 2009.

But how much does growth rely on further bank loan expansion? What are the risks of creating more non-performing loans?

First and foremost, while bank loans are an important source of funding for FAI in China, they are certainly not the only source. In 2008, domestic loans only financed 15.7% of total urban FAI, while self-raised funds and state budget financing accounted for 62.2% and 4.7% of the total respectively. Amidst the slowdown, an unusually large share of infrastructure investment has been driven by the government. As a result, we would expect a higher share of FAI to be financed by the state budget and bank loans this year. Nonetheless, we still expect self-raised funding (such as retained earnings accumulated from previous years) to play a more important role in funding FAI growth, as business confidence improves on the back of better-than-expected domestic demand growth. Corporate balance sheets are in a much better shape now compared to in 1998 – 1999, especially considering the relatively low credit costs. We therefore expect fixed asset investment growth to remain firm even if loan growth start to slow when policy gradually normalizes.

Secondly, near-term non-performing loans (NPLs) should be manageable as rapid expansion in bank loans and aggressive fiscal stimulus help boost growth, which increases firms' profitability level and their short-term loan repayment capability. This is certainly not to deny that in the longer term, there could be asymmetric sectoral risks that investment projects will be subject to asset quality problems, especially during the next economic slowdown. However, there is heavy government involvement in many of the projects in the real economy that are receiving the credit. As such, we believe that NPLs are likely to be more of an issue for the taxpayer than for the commercial banks.

Why is 2010 growth more likely to be above-trend than below?

We believe stronger investment growth will lead growth to above-trend territory in 2010 given 1) a domestic demand rebound in 2H2009 will likely create higher returns and stronger confidence for private investment opportunities next year and 2) policymakers' tendency to err on over-stimulating instead of risking a premature growth slowdown.

Public investment for now, but private investment to catch up soon...

While we expect private consumption growth to strengthen next year as the result of increasing income transfers from government to households, we place more hope on an acceleration in investment growth in 2010. This, however, does not imply it has to be done through piling up more government-led infrastructure investment at a pace as fast as in 2009. On the contrary, we believe private investment in industrial and property areas will take the driving seat soon and lead the charge on the growth recovery path.

In our baseline scenario, we assume the growth improvement in 2009 will induce higher private investment growth in 2H2009 and 2010, as returns increase and business confidence is gradually restored. It certainly seems plausible that industrial and property investment strength next year could reach their average growth level in 2005-2006, but could still remain below the level of the 2007 rally. In this scenario, we assume public infrastructure investment growth will moderate significantly in 2010 (albeit with an increase in absolute size). We think policy makers will see less need to stimulate the economy as aggressively as in 2009, given the private investment growth recovery. That said, there could be some flexibility for public investment to adjust, in the event of any surprises in private investment growth on the downside.

Policies will be set deliberately behind the curve until all looks good

We believe Chinese policymakers are unwilling to lead policy normalization away from the current loosening stance, for fear of a premature growth slowdown. This adds more insurance to our above-trend growth forecast in 2010. We think policymakers would rather err towards over stimulation until they see minimal risks in domestic unemployment and external demand situations. However, when policy reversal does take place eventually, we believe it will almost undoubtedly lead to a policy tightening process that is more protracted than it would be if the tightening occurred earlier in the cycle, as we have seen in past cycles.

We expect policy to remain growth-supportive at least until late 2Q2009, based on our forecast for domestic demand growth to accelerate in 2Q2009-3Q2009 and the US and Europe to begin a sluggish recovery only in 3Q2009 and afterward. Despite the strong growth rebound witnessed in China's 1Q2009 GDP and March activity data, activity growth numbers have not been in the "home free" zone for long. In addition, while our Global and US Economics Research teams have recently highlighted the likelihood of a growth stabilization in the US, UK and Euroland, their views on further growth decline (albeit at a decelerating pace) in these economies in 2Q2009 have not changed. Therefore, our best estimate is that Chinese policymakers will wait for at least another month or two to see more data from both domestic and external demand before normalizing their policy to a less growth-supportive stance and even then, any tightening measures are likely to be rather modest. As a result, we do not expect the modest and incremental policy tightening to impose significant downward pressure on the growth recovery.

Will weaker exports ruin the party?

We continue to see exports growth being a drag on China's growth on the back of weaker global aggregate demand. However, the impact of the exports growth slowdown on? capex and the income effect could be masked by domestic investment strength. We have not changed our view that China's exports growth will face strong headwinds from weaker external demand in a global economic crisis. In addition, the real trade surplus could shrink faster, as imports growth could stabilize and rebound earlier than exports growth when domestic demand strengthens and the import price effect dissipates towards mid-year. However, we believe the impact on real GDP growth will be more than offset by the domestic investment growth in 2009, bolstered by the government-led infrastructure investment.

We believe the trade growth outlook will be more sanguine in 2010. While our official forecast on domestic demand growth in G-7 countries is merely 0.8% yoy for 2010, we expect emerging market economies ex China to accelerate from 0.2% yoy this year to 3.7% yoy next year. We believe the higher market share that Chinese exports enjoy so far in these economies, especially in investment goods, could help restore China's exports growth in 2010. In addition, consumer stabilization as well as more value/bargain seeking spending behaviors in industrialized countries in 2010 could also help China's consumer good exports improve more quickly than exports from elsewhere given that China's consumer exports are on the low-end of the price spectrum.

Yet we do not think a change in currency policy away from the de-facto peg to the US dollar is in sight. As determined as policymakers are to "make all efforts" to stabilize exports and imports growth, we still maintain our view that China is unlikely to deviate from the current exchange rate policy for economic and political concerns (see *What to watch for in the near term*, China Views, January 12). Although the non-deliverable forward (NDF) market trading still suggests the market is expecting a small CNY appreciation, we believe it is difficult to justify currency appreciation when exports growth is facing stronger headwinds. At the same time, it is debatable whether depreciation would meaningfully boost export growth; however, it could certainly invite criticism as well as trade protectionism in retaliation. Admittedly, it is perhaps more effective to boost exports by providing bilateral trade credit, as China has done through its policy banks in the past few months.

Any fears of inflation or deflation?

Given our growth forecast for the next two years, we believe China should be able to exit deflation towards the end of 2009 and come out of 2010 without significant inflationary pressures. Although we expect policies to fall behind the curve and some further continuation of easing of liquidity conditions in the near term, we still think it will take some time for the output gap to narrow before China is lifted out of the current deflationary period and for inflation to return.

At this point, we think further interest rate cuts are unlikely, given the very strong credit growth and clear upward trend in growth momentum. However, if growth or/and deflation surprises on the downside, senior policymakers could lean towards using rate cuts to alleviate financial burdens of borrowers as well as signal further policy loosening.

Risks to our forecast

We see risks on both sides to our growth forecasts, and slightly more on the upside than the downside.

Upside risks include slower-than-expected/inefficient policy normalization, an earlier turnaround in real estate investment and a rebound in foreign direct investment

1. Policy normalization. If policymakers observe even a temporary reversal in domestic demand growth recovery and/or more weakness from the external demand, it may take them longer to switch away from the growth-supportive policy stance. In addition, even after that, we think policy adjustments will likely take place only incrementally, which is unlikely to be adequate to quickly dampen the strength in domestic demand to below-trend levels.
2. Early turnaround in real estate investment. Meanwhile, if housing sales growth continues this will put pressure on developers in areas with low inventory. We will likely then see an earlier and stronger recovery in real estate FAI growth than we expected in our baseline scenario. If real estate investment growth turns out to be 20% for 2009 and 30% for 2010 respectively, compared with our baseline forecasts of 10% in 2008 and 20% in 2009, our fixed investment growth forecasts will be around 2 percentage points (ppt) higher. With all else being equal, that could translate into around 0.8 ppt in GDP growth terms in 2009 and 2010.
3. Rebound in FDI. Lastly, foreign direct investment, which has seen a slowdown in realized value recently, has now started to show signs of stabilization.

On the downside, risks include inadvertently premature/excessive tightening in policy, further weaker-than-expected external demand growth and a slower-than-expected pick up in property investment growth

Policy tightening and external demand. If the growth recovery surprises policymakers on the upside in the near term, policy normalization to a less growth-supportive stance is likely, even with some risk of inadvertently tightening too far. In the case of a more protracted slump in the G-3 than we currently forecast, for each ppt drop in global domestic demand, our estimate is that China's real exports growth will decline by 6.2 ppt (and roughly 2 ppt in real GDP terms using the historical correlation between exports and imports growth) (see *Assessing the impact of a potential US slowdown on China*, Asia Economic Flash, August 22, 2007). Note this assumes everything else is equal; however, policy is likely to respond aggressively which will mitigate some of the downward pressures. 2. Property investment growth. The recovery of the property

market is still at a very early stage and sales may soften again in the coming months which will impact property investment growth. If real estate investment growth is 0% yoy and 10% yoy in 2009 and 2010 respectively, as supposed to 10% and 20% in our baseline forecasts, it implies our real GDP growth estimate will be approximately 0.8 ppt lower than our current forecasts.

What to watch for on policy and growth

This is probably the best time to put your ear to the ground for any indication of change in policy direction. We would attach more weight to rhetoric from the top of the political hierarchy (i.e., members of the State Council and above), if there were any suggestion of a change in policy stance.

In addition, we will continue to closely monitor any updates on domestic demand growth strength, especially private investment and housing sales, from official macro data as well as anecdotal evidence. In addition, as we mentioned, growth in bank loans could be an indicator of the pace of new investment as well as policy stance.

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