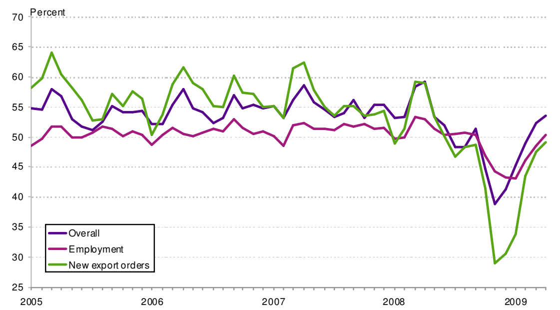
What's the outlook for the Chinese economy?

Recovery has started

The widespread fear that gripped China late last year has been replaced by relief or even subdued optimism. After stalling in the final quarter of 2008, the economy grew by 6.0% annual rate in the first three months of this year. The impressive turnaround follows a resolute and coordinated intervention by the government to boost domestic demand following the export slump caused by the global downturn.

First, monetary easing was swift and credit expansion robust. The PBoC cut the policy rate to its 2004 level in a matter of 4 months. Loan growth accelerated sharply and by March had reached 90% of last year's level. Second, a massive stimulus program worth RMB 4 trillion ($2.3trn) was also set in motion. As a result, while foreign direct investment slowed sharply due to the credit crunch, the pace of fixed asset investment growth quickened as major public infrastructure works and housing construction were front-loaded.

Chart 1: Purchasing Managers' Index



Source: National Bureau of Statistics

The current leg of this recovery still has room to run, when the secondary effects of the stimulus kick in. The lift-off in public sector investment from the government's aggressive infrastructure plans will persist as more large scale projects were reported to have been launched over the past quarter. That, and loose credit conditions will continue to drive a narrowly based recovery in construction-related industries such as steel and cement. Consequently, the drag from inventory correction will also be less pronounced. Corroborating this general improvement in industry is the ongoing uptick in the Purchasing Managers Index (Chart 1). While further interest rate cuts are unlikely, there is room for the reserve requirement ratio to be eased as the pace of credit expansion slows. The government has also promised additional supplementary stimulus should signs of a renewed slowdown emerge.

Premature to pronounce sustained upturn

Despite some healing and more positive undertones, the Chinese economy remains fractured and sizable downside risks prevail. The recovery so far is narrowly based and mainly underpinned by massive public spending and opening of the credit floodgates.

True, the global financial and economic landscape is slowly turning around but 2010 world growth is expected to stay weak, uneven and disorderly. As a result, private investment growth in China—which has continued to lag behind government spending in this cycle—will stay moribund from excess manufacturing capacity, significant pressure on corporate margins and sluggish global demand.

Against this backdrop, it looks unlikely that labor market conditions can recover well enough to drive domestic consumption, the perennial Achilles heel of the economy. So far household consumption has stayed relatively resilient from the boost to purchasing power from lower prices, wealth effect from rising equity prices and reduced deflation expectations. But urban joblessness is creeping higher and private sector jobs are still lacking. It is estimated that about 25% of fresh graduates will be unemployed this year, adding to the 15 million migrant workers who have already lost their jobs.

Finally, strong credit creation at a time of declining industrial profits raises concerns over the quality of loans and the long term risk to the banking system. Indeed, early warning signals that asset quality could be deteriorating are surfacing with the increase in loan-loss provisions and special mention loans.

All said, the immediate term outlook is positive but over the longer run, the ingredients for broad-based growth have not yet fallen into place. The economy is likely to grow at slightly below trend pace this year with risks of a renewed downturn in 2010 once the multiple effects of stimulus start to fade. Widespread pessimism at the depth of the crisis is not without cause. The reality is not as bad as feared but the Chinese economy still has some problems.

Housing market running ahead of the economy

The residential property market continues to recover alongside steadily improving economic sentiment. Sales of existing and newly constructed residential property have risen by more than 40% from a year ago in April, sustaining the renewed momentum from the January bottom. The run-up in transaction activities not only underlies the positive impact from cuts in interest rates, down payments, taxes and property prices but importantly, it reinforces the strong fundamental demand for housing outside of the high-end sector.

Prices too have bottomed and are slowly on the uptick. The rebound in prices is most visible in Shenzhen where the correction had been the steepest but in April, more than 50 cities registered prices rises. It is unclear however if the price support level can be sustained. While there is a serious medium term mismatch between high end supply and significant demand in the low-mid market segment at the national level, the unbalanced and fragile recovery and strong pace of new completed supply point to still significant downward pressure on prices.

The Chinese economy is still frayed at the edges, as is the housing market, but there is a better than evens chance of a sustained recovery in the medium term.