

China's economy emerges with credit

Our cautiously bullish view on China this year has proved far too cautious, as the economy has outperformed expectations. With the 'four trillion yuan budget' underpinning growth and a pumped-up money supply jump-starting the property market, economic growth is heading back towards the government's 8% target rate, despite the weakness of export markets. We remain optimistic on the outlook and see China as continuing to expand its role as an engine of growth for the global economy.

While China is, not unreasonably, described as an export-oriented economy, the impact of the recession has made clear that the real driver of growth is the massive investment in the industrialisation of the economy. Exports are important: they provide additional demand for the new factories; they pay for imports of raw materials; and they ensure that China's developing industries are exposed to international competition and technology. However, the 2% or 3% that exports have over recent years been adding to Chinese GDP growth is merely the icing on the cake of the Chinese economy, which has been generating over 8% of growth internally.

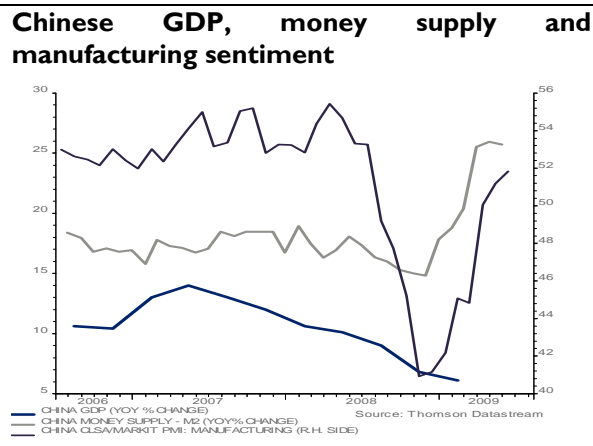
So it was domestic growth that was the target of the four trillion yuan budget announced in response to the global recession. Although the budget measures included a degree of double-counting of already planned expenditure and will be spread over two years and beyond, the direct impact is estimated to be equivalent to around 3% of GDP this year and only slightly less next year. This massive injection of new investment underpinned our initial forecast of at least 5% growth for this year. However, the question was whether the slumping Chinese property market would pick up. Here, the trigger was a massive boost to the money supply, which we believe will lift GDP growth towards the 8% target rate.

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Inevitably, there are risks. The huge rise in capital expenditure inevitably produces waste, corruption and white elephants, as with any rapid increase in government spending. Yet these inefficiencies are overwhelmed by the productive potential unlocked by this investment. We would also cite the risks that the booming money supply creates a speculative bubble, whether in the stock market, property or commodities. Yet, although China has experienced a series of property bubbles in the past, their deflations have barely registered on the surface of the economy.

We also see a continued stream of measures to address the issues that we have raised, illustrating that the Chinese authorities are well aware of the limitations of the existing economic structure and are planning for the longer term. For example, they are developing the stock market to encourage more efficient capital allocation and are expanding pensions and health care to remove the need for the current high, precautionary levels of saving by consumers.

Even if the Chinese economy does not see a return to the export-fuelled boom of 2007, the outlook is favourable, and China does not face the same headwinds as most developed economies in the aftermath of the global financial crisis.

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