

Is China's Economy Tanking? Understanding New Data

CEIP, 30 January 2009

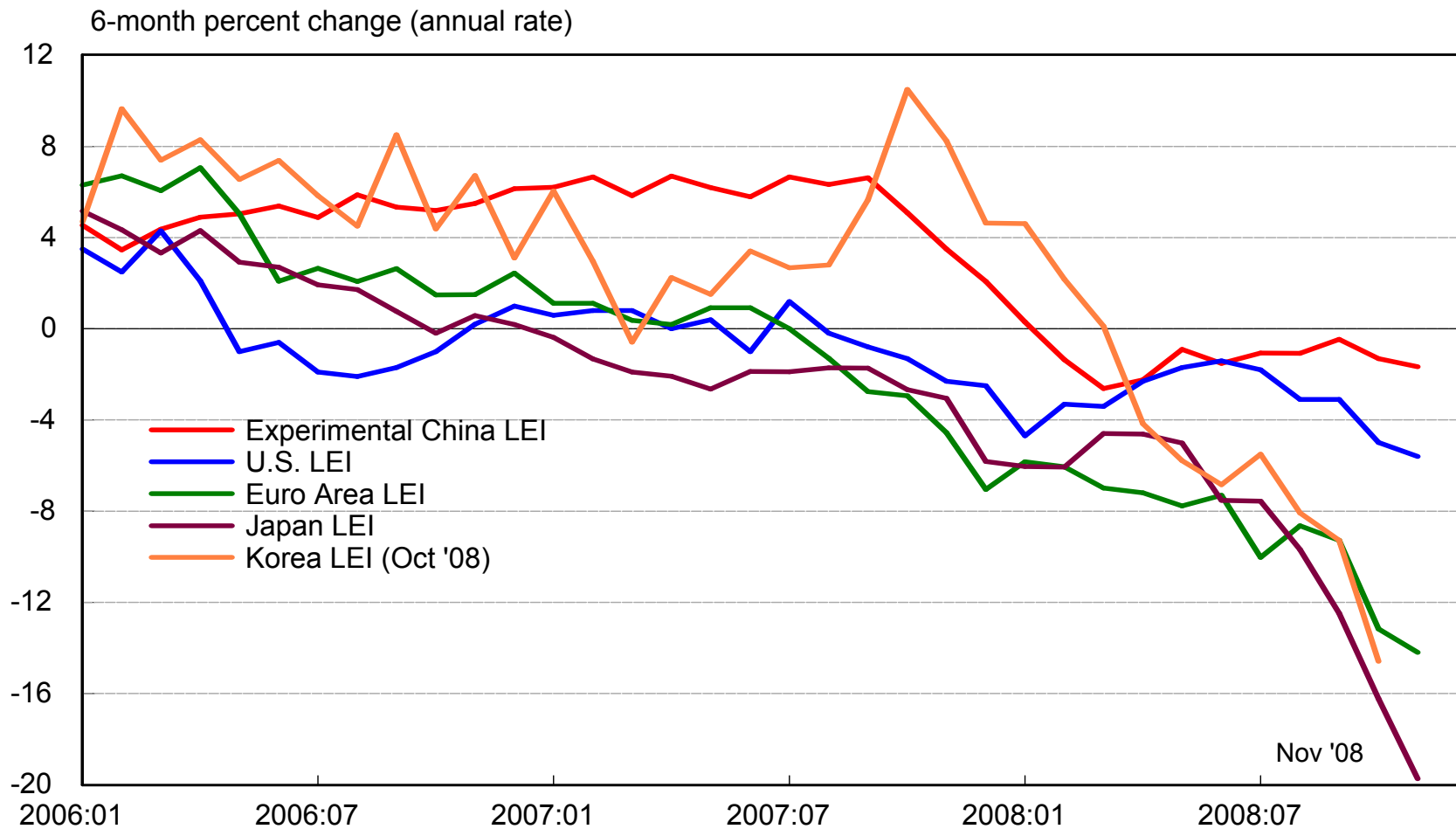
Pieter Bottelier

Overview

- Inflation worries of last year have evaporated
- The focus is now on China's sharp economic slowdown (though less sharp than rest of world) and unemployment
- The slowdown started in H2 07 as a result of government efforts to cool the overheating property sector
- The domestically engineered slowdown was compounded by the effects of the US financial crisis in H2 08
- Manufacturing adjustment to China's property slump and export slowdown was surprisingly rapid
- Government action is directed at sustaining purchasing power and preserving social stability while *rebalancing* the economy
- Property overhang and unemployment are projected to remain serious in near-term future
- Fortunately, China is well-positioned to avoid economic collapse and start recovery in 2009

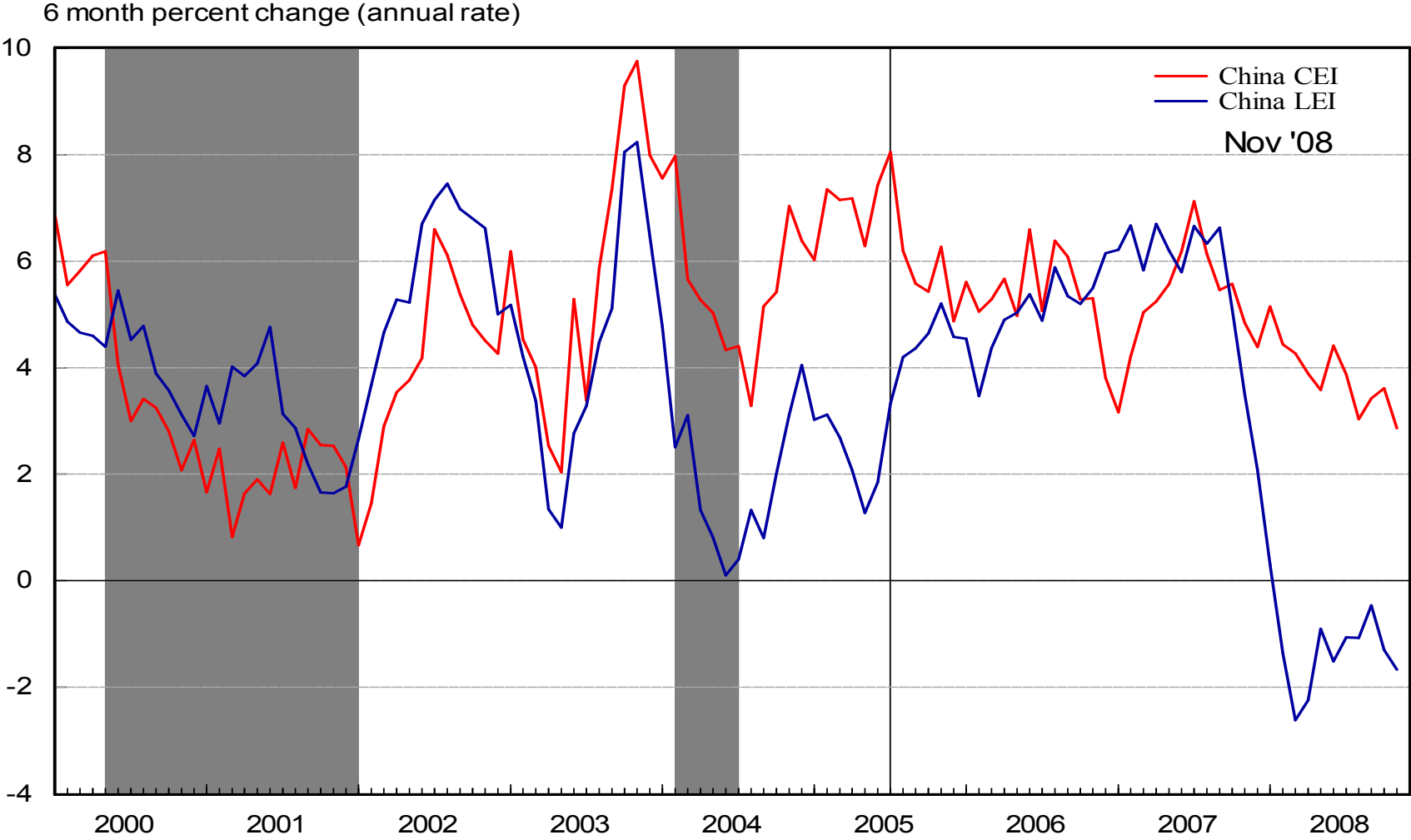
Leading economic indices decline globally, but more moderately in China

Source: The Conference Board

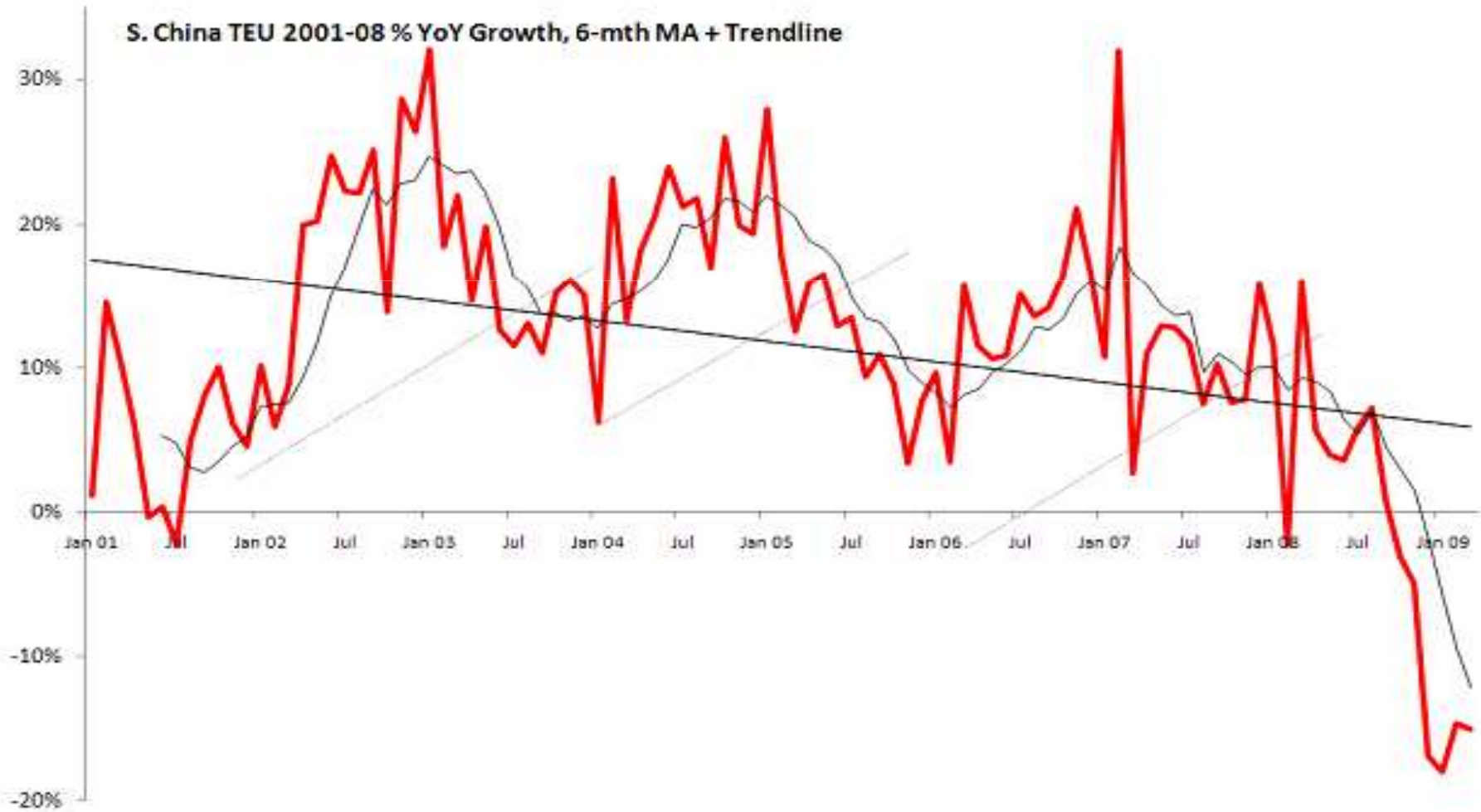


China's slowdown began before the global financial crisis

Source: The Conference Board

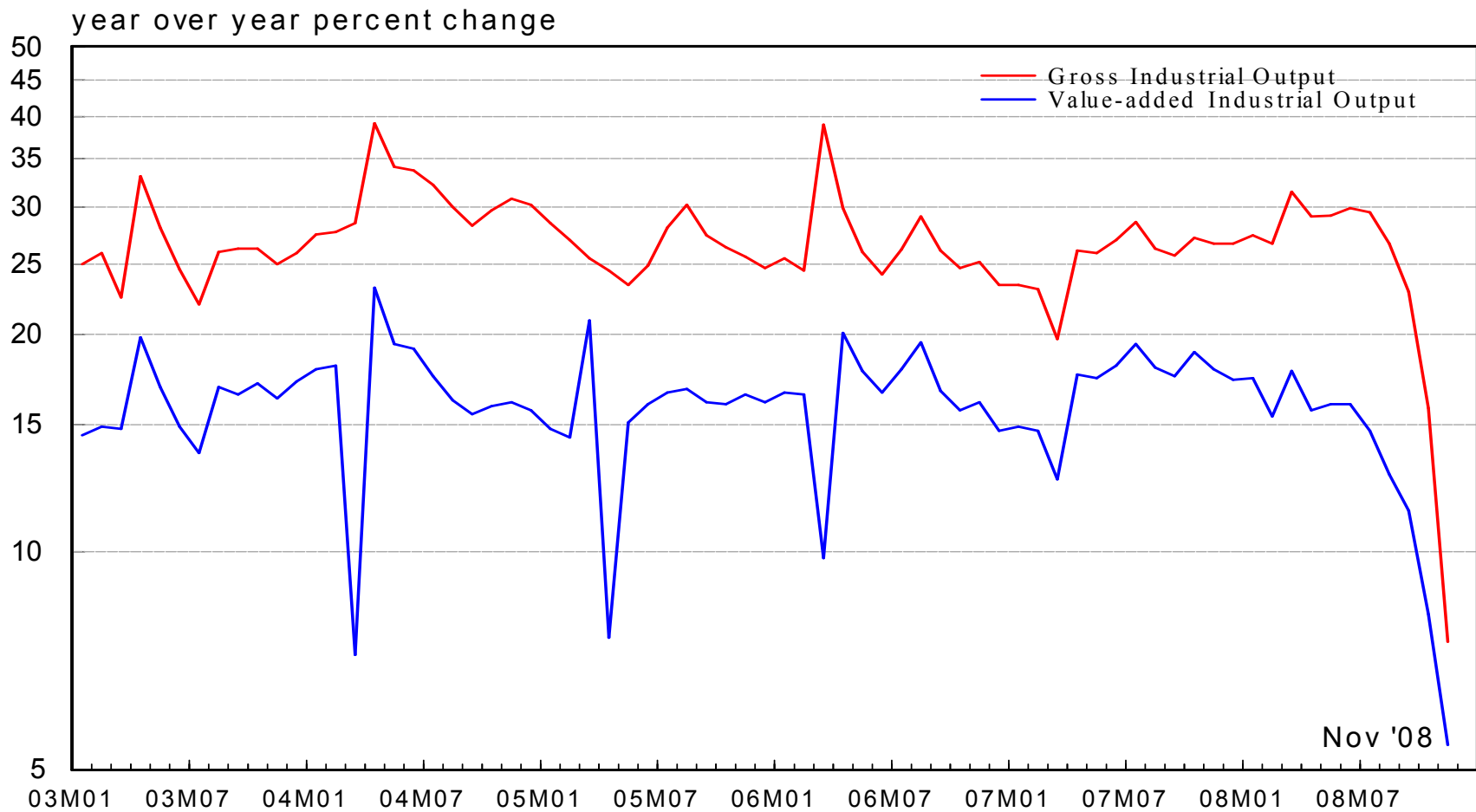


Export slowdown illustrated by TEU container shipments from Southern China



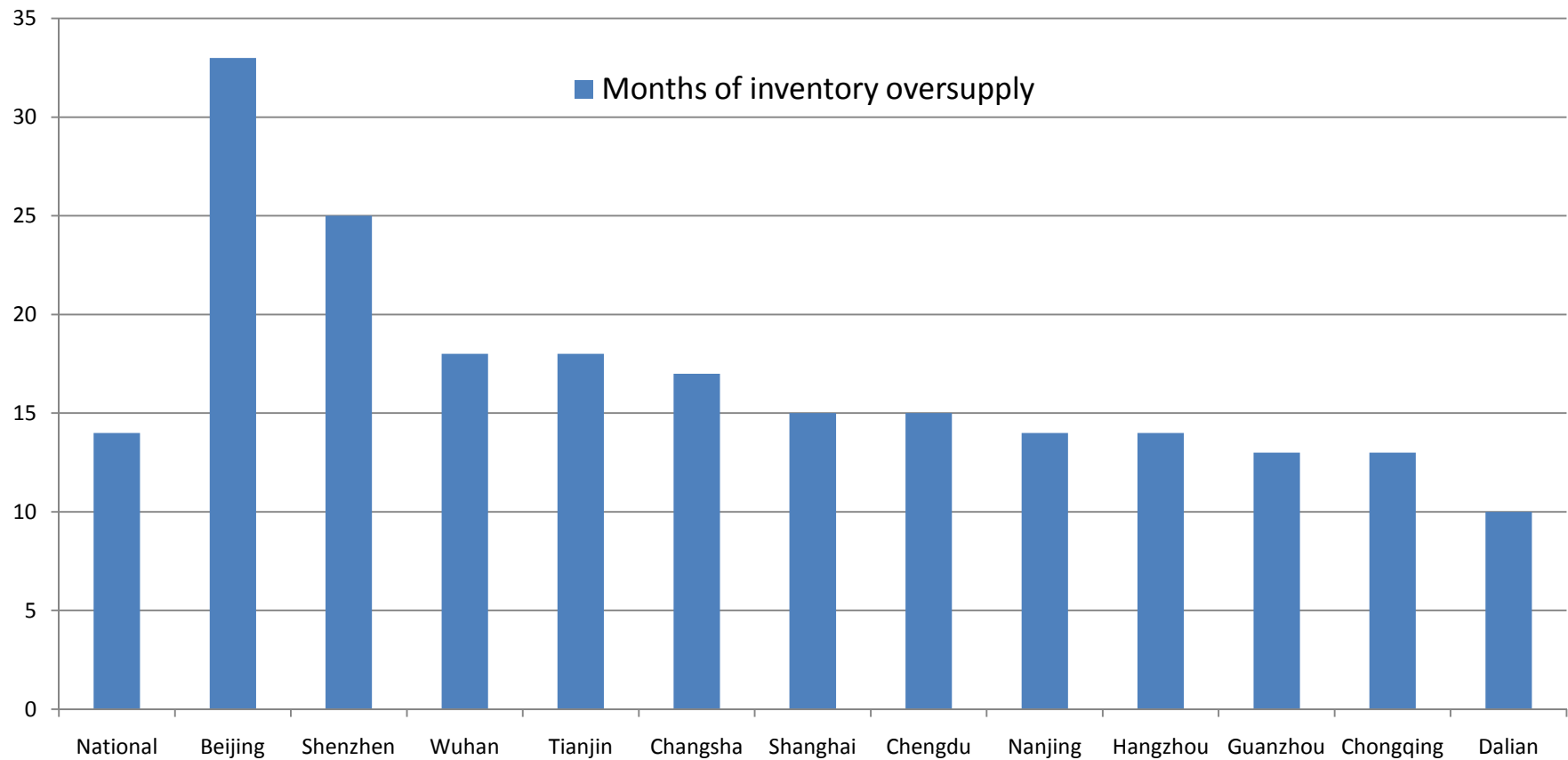
China's industrial sector adjusted quickly to fall-off in domestic and external demand

Sources: CEIC, The Conference Board



Property overhang by end 2009 will slow recovery

Source: CREIS, Macquarie Research, January '09



China's (un)employment picture became scary in 2008

- **Although hard data is scarce, it is evident that lay-offs in 2008 were numerous, perhaps 17-30 million. Main categories:**
 1. export-oriented coastal industries, 6.5-9.1 million (mostly migrants – official estimate)
 2. private SMEs supplying large-scale SOEs in construction materials, perhaps 5-10 million (mostly migrants - no official estimate available)
 3. construction workers, perhaps 5.5-11 million - out of an estimated total of 55 million at the end of 2007 (mostly migrants - no official estimate available)
- **Add to this officially reported pre-existing urban unemployment of about 12 million at end 2007**
- **This yields total non-agricultural unemployment at the end of 2008 of roughly 29-42 million, or 7-9% of the non-agricultural work force of almost 500 million**

The (un)employment situation in 2009 will be very difficult, even with 7.5% GDP growth

- **New non-agriculture job seekers in 2009: 45-51 million, calculated as follows:**
 1. 22-28 mn unemployed migrants , assuming that 50% of those who were laid off in 2008 will not be farming and that officially reported urban unemployment at the end of 2008 (about 12.5 mn) is incremental to laid-off migrants
 2. no net new migrants in 2009 (a rather wild assumption)
 3. 6.1 mn new university graduates (official estimate)
 4. 1.7 mn 2008 university graduates who were unable to find jobs (official estimate)
 5. 16 mn elementary & high school graduates not seeking further education (unofficial estimate)
- **New non-agriculture job supply, assuming 7.5% GDP growth and 0.11 (historical) labor/GDP elasticity: about 6-7 million**
- **Consequently, non-agriculture unemployment may increase to 39-45 million, or 8-9% of the non-agricultural labor force**
- **Social/political pressures will be greatest with respect to: (1) migrants, and (2) university graduates**

Selected measures taken by government to revive economy and reduce unemployment (1)

- Reduced lending rates and eliminated lending quotas
- Softer terms for mortgage loans
- Easier access to finance for SMEs
- Programs to help university graduates to start their own business
- Restored export tax rebates to pre-crisis levels
- Stopped further nominal RMB/US\$ appreciation
- Announced a RMB4 trillion (\$586 billion) fiscal stimulus investment program for 2009 and 2010
- Increased recurrent budget expenditures for a wide range of social programs, including education, rural health insurance, income support for rural and urban poor, and pensions

Selected measures taken by government to revive economy and reduce unemployment (2)

- Temporary reductions in employer contributions to medical insurance, unemployment insurance and other pay-roll deductions for urban workers
- Allow unemployment insurance funds to be used for job-retraining and subsidies to employers for up to 70% of local minimum wage
- Delay upward adjustments of minimum wage standards
- SOEs are encouraged to avoid lay-offs as much as possible by accepting reduced earning
- Better protection and indefinite extension of agricultural land use rights

In addition: government is considering tax reductions and VAT shift from production-based to consumption-based

Unemployment is government's key concern

- The two most important groups are: (1) unemployed migrant workers who have become “urbanized” or have no land to return to, and (2) unemployed university graduates
- Of 5.6 million university graduates in 2008, 1.7 million were unable to find a job.
- University graduates projected to rise to 6.1 million in 2009
- Because lay-offs are concentrated in labor-intensive industries, total non-agricultural employment in '09 may contract by 1-1.5%, even with 7.5% GDP growth
- Job seekers may exceed available jobs by more than 40 million 2009
- By end 2009, 39-45 million workers could be unemployed out of a total non-agricultural work force of about 500 million
- *All this points to the critical importance of stimulus programs to create additional jobs, which the government is good at doing*

While fighting growth recession, China's government also aims at economic *rebalancing*

- China's growth trajectory had become very unbalanced and unsustainable since 2004
- Growth had become overly dependent on capital formation and net-exports
- The property bubble in some major cities contributed to "hot" money inflows and turbo growth
- Capacity in basic industries over-expanded, which contributed to growing trade surplus, while property sector became overheated
- RMB/US\$ exchange rate remained undervalued in spite of gradual appreciation since July 2005 – this also contributed to "hot" money inflows
- *Rebalancing* requires slimming current account surplus, consumption growth in excess of GDP growth, increased labor/GDP elasticity, better environmental protection and reduced social inequality

The good news is that...

- **Measures to fight the recession in China are in principle consistent with medium-term growth and rebalancing objectives**
- **Most in government realize that depreciating the currency will do little to stimulate exports and conflicts with rebalancing needs**
- **China has low debt and considerable fiscal and monetary room for maneuver**
- **Official data indicate that corporations and households are lowly leveraged - leveraging could stimulate growth in China**
- **The government has experience with fiscal stimulus through infrastructure investment (since Asian financial crisis of 1997/98)**
- **Since 2003 the government has built institutions for increased social spending, which are now being rolled out to sustain consumer spending and promote economic rebalancing**

On balance, I expect that...

- China's economy will not collapse
- The current recession will bottom out in the 2nd or 3rd quarter of 2009
- Social stability will be maintained
- There will be no banking crisis, although NPL ratios are rising while bank profits are shrinking
- Serious deflation will be avoided
- Some progress towards *rebalancing* the economy will be made, but the process will take many years
- GDP growth in 2009 will not be less than 7%
- Growth will remain moderate (by Chinese standards) for some years
- If the US and Europe don't set the wrong example, China will remain committed to WTO principles