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Examining China's New Policy Climate



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HANDS-ON CHINA REPORT
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Examining China's New Policy Climate

This report examines recent macro developments, market conditions and challenges that China faces at a time when the government's shift toward a tightening bias has been complicated by external risks. While just a few months ago, market talk focused on the prospect of China overheating, concerns now seem to focus on the possibility of a sharper than expected slowdown in growth. In recognition of uncertainties at home and abroad, policymakers have opted for sector-specific measures and administrative controls to regulate bank lending and counter real estate speculation. A slight moderation in China's May PMI (from 55.7 to 53.9) provides some confirmation that the economy is cooling as a result. We expect the sequential pace of growth to moderate over the remainder of the year, but this largely reflects the gradual exit from ultra-expansionary policies and the recent (heavily property-focused) tightening campaign, rather than worsening economic fundamentals.

In the sections that follow, we discuss three key shifts: the shift from an ultra-expansionary policy stance toward a tightening bias, recent policy changes in the all-important property sector and the long-term shift from an investment-driven economy to one that is propelled by private consumption.

I. Shift from an ultra-expansionary stance to a tightening bias

So far this year, Chinese policymakers have raised the reserve requirement ratio three times and taken a series of measures to curb speculation and price rises in the property sector. In the context of uncertainties arising from the European debt crisis and a continuing waiting game between China's economic planners, property developers and prospective homebuyers, the government has erred on the side of caution in delaying more aggressive measures (such as interest rate hikes) that would have a broader impact across the economy.

Although there is evidence of a slight easing in the expansion of industrial activity and concerns exist about how a negative wealth effect might impact discretionary consumption, we advise against an overly cautious assessment of China's demand outlook. The government remains very committed to delivering high single-digit growth. We expect policymakers will take into account external developments and the domestic response to earlier policies before introducing further tightening measures.

In light of curbs on property investment, we believe domestic investors may gravitate towards equity investments once the primary sources of economic concern are allayed. Any easing in property tightening measures or signs of EU stability should provide a boost in sentiment and shift investor focus towards valuations that are undemanding in a historical context.

II. Property policy shifts: examining the implications

At this stage, the government's property tightening campaign appears to be achieving the aim of restraining price increases. In recent weeks, prices have softened in the secondary market and there have been several examples of price reductions for new launches, most evident outside of prime areas in first-tier cities. However, by and large, prices in the primary market have corrected only modestly.

A sharp property price correction would generate a negative wealth effect, while a prolonged downturn in transaction volumes would have repercussions for construction activity (weakness in primary sales is generally followed by a slowdown in housing starts 2-3 quarters down the road).

The initial price response to existing measures may be enough to satisfy policymakers for the time being, as their main intent is to restrain price increases rather than to engineer a sharp correction or dampen activity. Recent tightening measures emerging from the local-government level appear to have been less severe than policies announced in Beijing in mid-April. Importantly, mortgage policy remains very supportive of owner-occupied home purchases. At this juncture, we do not believe that a correction in the housing market poses substantial risk to asset quality for the banking sector.

III. New engines of growth: a shift from state-driven investment to private consumption

Having relied heavily on government-sponsored infrastructure investment to stimulate an economic recovery in 2009, Chinese policymakers are again focused on the longstanding goal of increasing the contribution of consumption to growth. Since 4Q09, China's economic data releases have shown a clear deceleration in fixed asset investment, from 31% in 2009 to 26% in April. Through a host of measures, including tax cuts, direct subsidies, minimum wage hikes, expanded social security provisions and the promotion of "new economy" industries, authorities aim to improve consumer confidence and augment disposable income.

Against this backdrop, policy support for inefficient "old economy" industries – especially midstream materials producers is waning. This can be seen in recent restrictions on bank lending and the rolling back of preferential tariff treatment for energy-intensive companies in industries plagued by overcapacity. Meanwhile, the formulation of new policy is directed at supporting service industries, boosting consumption (through wage increases and enhancements to social safety), and improving transport linkages to China's hinterland.

The investment contribution to GDP growth will likely be smaller in 2010, however we believe that in light of the recent correction in global commodity prices and the potential for a slowdown in property construction activity, the slowdown in infrastructure investment may not be as sharp as some are expecting.

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