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CHINA'S ECONOMIC GROWTH – CAN TOO MUCH OF A GOOD THING BECOME A PROBLEM?

The Great Recession of 2008/09 may have ushered a lasting change to the world economic order. For decades the US was seen as the locomotive destined to pull the global economy out of recession. In the latest series of events the baton of economic leadership passed to China where centralized decision making process and unmatched financial reserves were deployed with enough speed and strength to jolt the global economy onto a renewed growth path. Investors will now focus even more on trends and changes related to Chinese policy moves as indicators of future market trends. In this edition of the Marker we review some of the issues related to the strength of economic growth and upcoming efforts destined at reigning credit growth in.

CHINA: THE AMAZING GROWTH MANUFACTURING MACHINE

CHINA	M/M % Sep	M/M % Oct	Y/Y %
Electricity Production	1.8%	2.0%	18.2%
Bank Loans	1.7%	1.6%	34.2%
M2	1.7%	1.4%	29.4%
Auto Sales	0.8%	1.4%	71.0%
Retail Sales	1.4%	1.4%	16.2%
Industrial Production	1.6%	0.9%	16.1%

Source: ISI

In 2008/09 China was spared the effects of the western world's financial crisis only to be hit very hard by secondary effects of which a massive drop in exports was the most significant. In 2007 exports represented 36% of China's GDP and grew at a 26% rate from the previous year. Contrast that with the fact that by May 2009 they were shrinking at a 4.9% rate.[1] Authorities reacted swiftly by announcing and carrying out a US$580 billion stimulus program (equivalent to 14% of 2008 GDP). While investment in export oriented production capacity has long been the driver of growth in China the package was explicitly designed to focus on investing in infrastructure. As with most Chinese endeavours the scale of the undertaking deserves pause. The program has been named the 'Iron Rooster' because of its explicit focus on rails, roads and airports. By mid year 2009 the Ministry of Transport reported work being done on 111 expressways totalling 12,000 km. At year end it was expected China could count on some 60,000 km of high speed highways versus 75,000 km for the US. The key motivation for such massive projects is the need to maintain employment growth in order to preserve social stability. Suffice it to say that 1.5 million of the 6.8 million Chinese university students having graduated in 2008 were still looking for work one year later and that, at the worst of the crisis, some 23 million migrant workers had lost their jobs due to the recession.

A STIMULUS STRATEGY THAT IMPLIES RISKS

The aforementioned focus on fixed asset investment in the form of production capacity has created millions of jobs. The short term benefits of job creation however come with their fair share of longer term economic challenges. That's because building manufacturing plants creates demand (for materials, supplies and workers) in the short term but also adds to the supply of additional goods in the long term. Excessive supply has been beneficial in muting inflation pressures in the economy so far yet fears of inflationary pressures are growing following the massive injections of liquidity capital in the economy over the last 18 months.

These capital injections have been unprecedented in scale and reached the economy with potent speed since they got administered by state controlled banks. As a result the quantity of money circulating in the economy (money supply) has been growing at a compound rate of 30% for over a year. There is no doubt a good share of this liquidity got redeployed into the equity and real estate markets feeding inflation fears. Investors reacted with concern to inflation readings for November which showed a return to price increases. Statistics for December show increases in both the Consumer and Producer price series. It therefore stands to reason that central authorities would intervene to cool down economic growth and inflationary pressures. This is precisely the intention and two sets of measures have been announced so far. They first proceeded with a symbolic interest rate hike and followed up by upping the reserves that banks must maintain at the Bank of China so as to slow down the creation of credit in the economy. ISI estimate that 2010 authorized bank loan levels will come in 22% below 2009 commitments[2].

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With economic leadership comes greater impact on market trends. Increased scrutiny of Chinese economic policies however will likely entail greater market volatility. There is no doubt the rest of the world will benefit from China's sustained growth in the coming months and few markets should do better by same than Canada's.

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FINANCIAL MARKETS

RETURNS AS AT JANUARY 29, 2010 (%)	MTD	QTD	YTD
S&P/TSX	-5.35	-5.35	-5.35
S&P 500	-1.92	-1.92	-1.92
S&P/TSX Small Cap	-2.94	-2.94	-2.94
Russell 2000	-2.00	-2.00	-2.00
MSCI EAFE	-2.84	-2.84	-2.84
MSCI World	-2.56	-2.56	-2.56
DEX Universe Bond	1.84	1.84	1.84

	RATES AS AT JANUARY 29, 2010
CAD/USD	1.07
CAD/Euro	1.48
US Treasuries yield 10-yr/30-yr	3.59/4.49
GOC bond yield 10-yr/30-yr	3.35/3.94
Fed Fund Rate (target)	0.25

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.

[1] Financial Times – China's stimulus shows the problem of success – August 25, 2009
[2] ISI Group China research – January 25, 2010

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