



Ted Scott on the wire

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China: An emerging market or an emerging bubble?

In Summary

- **China & the US are interdependent**
- **The renminbi's tie to the dollar remains an issue but could it be about to change**
- **China is changing from an agrarian economy to an industrialised economy...**
- **...but old habits die hard**
- **China's economy remains export led**
- **Infrastructure spending is not sustainable**
- **Domestic consumption must rise**
- **Change of rural psyche required**
- **Inflationary pressure set to rise**
- **The economy is too lopsided**
- **Speculative flows means markets are vulnerable**

Introduction

The recent visit by President Obama to China has focused attention on the relationship between the two countries that are the most important in shaping the destiny of the global economy. The relationship has been a fragile and tense one for some time but the two nations have also become interdependent, and the respective authorities recognise the need to be cordial and constructive in their discussions.

At the heart of the debate is the issue of China being an export led economy with the US as its main customer. This has generated a huge trade surplus for China counterbalanced by the large deficit in the US. As a result, China accumulated vast foreign exchange reserves that it mainly invested in US Treasuries helping to keep bond yields low, which in turn aided the growth of the US economy. It was a virtuous circle in which both nations benefited until the bubble burst in 2007-8 as the US plunged into recession, quickly followed by the rest of the world.

The credit crunch has forced the US to address its burgeoning trade deficit, as well as the large shortfall in its internal budget. As internal demand collapsed, due to the recession, the US looked to the export sector to help revive the economy and it is here that it has come into conflict with China. China's exports fell sharply (see chart below) because of the downturn but in an effort to revive its flagging trade it has intervened in the foreign exchange market and not allowed its currency, the renminbi (RMB), to rise against the dollar. This has angered the US who feel that the Chinese are playing a game of 'beggar thy neighbour' whereby it is taking trade away from the US by supporting its own export market and effectively transferring its unemployment to America. The US has called for the RMB to be revalued and imposed some tariffs to protect internal jobs and industry but China has failed to respond to these overtures.



Sources – Thomson Datastream, CEIC, Capital Economics

This note explores how and whether this friction between the world's two most important industrial nations can or will be resolved.

China's industrial revolution

It is easy to forget that China has been the biggest economy in the world before. Prior to the European industrial revolution at the beginning of the 19th century, China was a more technologically advanced nation and had the largest share of global GDP. In 1820 China contributed 32.9% to world GDP compared to just 1.8% for the US. By 1950, the respective figures were 4.6% for China and 27.3% for the US. That is now swinging back in favour of China again.





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China is presently undergoing its own economic transformation. The communist regime has rightly been praised for being economically enlightened and the country is enjoying the fastest industrial revolution in history. By 2025 it is confidently predicted that the Chinese economy will be bigger than that of the US.

In achieving this transformation China is effectively changing from being an agrarian to an industrial economy. Large parts of the population are moving from the countryside to the city and many new large cities have been created in the last several years to accommodate this transformation. In this respect, the Chinese economy is very different from a mature developed economy.

China's growth has been export led and the export sector contributes about 40% to GDP. Internal consumption is much smaller at about 35% of GDP compared to around 70%-80% in a developed country. The relative importance of the export sector explains why the authorities are so intent on supporting it by intervening in the foreign exchange market to prevent the RMB from rising. However, if consumption accelerated it should be able to take up the slack and at the same time allow the trade surplus to diminish and create downward pressure on the RMB. Economists have been calling for a while for China to boost its internal consumption and it would be welcomed by all developed economies.

If it happened it would be a natural solution to the imbalances between the internal and external sectors of the domestic economy and go a long way to placating the US and other nations who feel that China is unfairly taking trade away from them by maintaining an artificially weak currency.

China's response to the credit crunch

The path to China's economic transformation has not been a smooth one and the current financial crisis is the latest challenge to confront the policy makers in its objectives of keeping the economy on a strong growth trajectory.

As on previous occasions, such as the Asian crisis of 1997 and the technology bubble of 2000, the authorities reacted in a positive and pro-active way to the threat posed by the global recession. They aggressively cut reserve requirements for banks, reduced interest rates in November 2008 and began a massive rebound in government spending and capital reinvestment. In particular, the stimulus in new bank lending was huge with RMB 7 trillion in the first half on 2009 alone.

This resulted in surging fixed asset investment such that it accounted for 88% of the growth in the first 6 months of this year compared to an average of only 43% in the previous decade. This is at a stage of the country's economic development when it should be becoming more balanced in its growth profile.

The level of growth has, without doubt, been impressive since the onset of the crisis and defied the sceptics who said that the economy would be brought to its knees by the global recession. In the second quarter of 2009 the economy grew at 7.9% and accelerated to 8.9% in the third quarter. This compares to an ambitious Government target of 8% for the year and, therefore, is likely to be achieved. However, it is the nature of the rebound that has raised much comment and concern. The growth has become increasingly lopsided and there is a risk that the capital investment driven stimulus will not be replicated by the consumer or the export sector, especially if the US consumer continues to increase his or her savings. The savings ratio in China is at an elevated 37.5% compared to around 5% in the US which itself has risen from zero!

Change of psyche required

Apart from the stimulus that is directed on the industrial sector and public works, such as building roads and bridges, the reason for the high level of savings is that China remains essentially a rural nation.

In the modern world an economy can be transformed relatively quickly from an industrial perspective but it takes much longer to change the psyche of its people, especially in a political regime where individual liberties that we take for granted are limited.

The consumption habits of the Chinese largely reflect the rural background and, therefore, given the history of job insecurity and lack of a proper welfare state to support those who are disadvantaged the savings rate is likely to remain high for the time being. This means that consumption, as a contributor to economic growth, will increasingly lag the pace of the country's rapid industrialisation despite the exhortations of the developed economies. The excess of liquidity, reflected in the high savings of the Chinese consumer, does, however, contribute to the asset bubbles that were apparent before the global credit crunch and are now, arguably, beginning to reappear.



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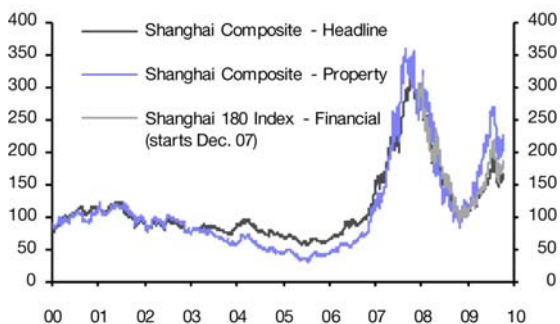
Is Chinese economic growth creating a dangerous bubble?

It is hard to deny that the sharp rise in many risk assets has much to do with the resurgence of China's economy this year. Commodities have been spectacular performers and there is a linear relationship between the performance of the Chinese economy and the leading industrial metals. Copper, sometimes going under the moniker Dr Copper because of its reputation as a harbinger of economic growth, has risen 115% for instance, and other commodities such as iron ore have also been strong. China is the main buyer of these commodities but there is no doubt that there has been enormous speculative buying of them as well. Just as commodity funds were the least popular when the markets bottomed in March they are now experiencing the biggest inflows.

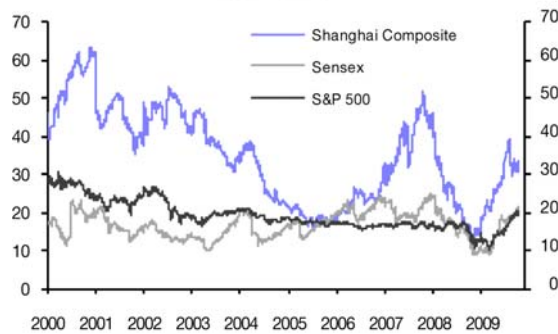
Other risk assets have also benefited from China's accelerating growth, most notably equity markets and real estate. In China and Hong Kong real estate prices have soared in popular areas and the equity markets of emerging market countries have significantly outperformed those of developed countries. This partly reflects the ability of China to recover quickly from the credit crunch but it also relates to the liquidity generated by the expansion programme; to that extent, the rise in these risk assets is symptomatic of a bubble and, therefore, vulnerable. As stated above, the Chinese consumer has a high level of savings and much of it is being diverted into the stock and real estate markets.

The Chinese stock market stands on a price to book valuation of 3.5x, expensive against developed markets. However, when one considers that the valuation peaked at over 7x before the recession it can be argued that there is still a lot of upside in the market yet (the charts below shows the rollercoaster ride of the Chinese equity market and the steep valuation compared to the US S&P Index).

Equity Indices (Jan. 2009 = 100)



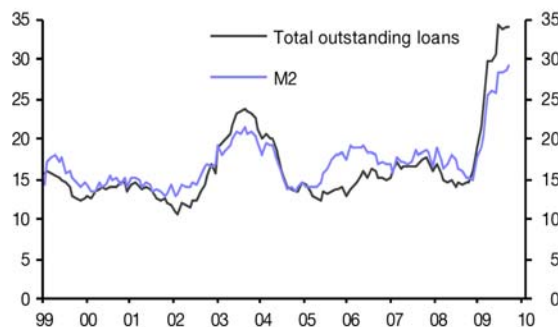
P/E Ratios



Sources – Thomson Datastream, CEIC, Capital Economics

The rise in global equities has been partly liquidity driven through the extremely loose monetary policies pursued by central banks as they seek to reflate the economies. Just as in the developed economies, the money supply has been substantially increased but the difference is that the money is getting into the real economy as the banks have stepped up lending. As we know, the banks in the US and UK are still reluctant to lend because of the weakness of their balance sheets and this is reflected in the lack of growth in the broad money supply. In contrast M2 in China (a broader measure of the money supply) has been increasing at an annualised rate of about 30% per month (see chart below that also shows the rapid growth in outstanding loans).

Outstanding Loans & Broad Money (% y/y)



Sources – Thomson Datastream, CEIC, Capital Economics

I believe that bubbles are forming again as a consequence of the Chinese growth story. The sharp rise in some risk assets has a large element of being liquidity driven and the rise in turn has attracted more hot money to these asset classes. The underlying weakness of the RMB has also attracted capital inflows to China that has further increased the money supply.





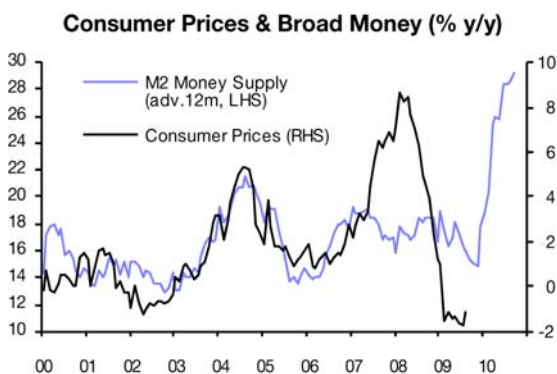
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While I believe certain risk assets are fundamentally overvalued, reflecting the liquidity driven nature of the investments I think that the Chinese economy is on a relatively sound footing. The Chinese policy makers have proved in the past that they have been adept at managing the economy through past crises and there is still little sign of the economy overheating despite the high growth rate. However, the spectacular rise in some risk asset markets as well as the fast growth in the money supply has understandably raised concerns that inflationary pressures could quickly build up. The other main concern, as we have mentioned before, is the imbalanced nature of the economy with the contribution from consumption being far too small. Both of these will be considered next.

Is inflation and overheating a threat to Chinese growth?

Although the money supply is expanding fast there is still, like in developed markets, little sign of any incipient inflationary pressures. Indeed, both the consumer price index (CPI) and the producer price index (PPI) are giving negative readings. This is likely to move into positive territory soon as the effects of higher commodity and fuel prices feeds through. However, just as in the UK there is a lot of spare capacity and with the large infrastructure programme there will be more capacity available soon. The chart below shows the collapse in consumer prices in 2008 into negative territory from around 8% and the correlation with the growth in the broad money supply that has been brought forward by 12 months.

The inference is that the growth in the money supply is likely to lead to significant inflationary pressure later.

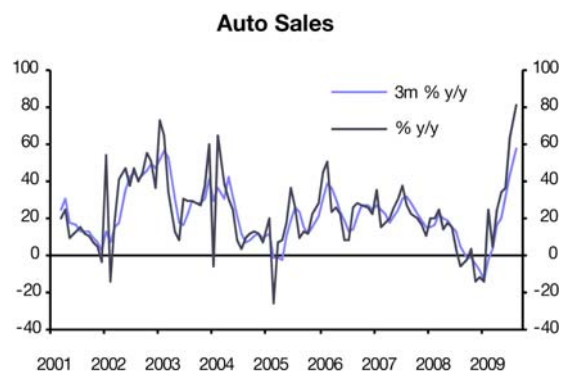


Sources – Thomson Datastream, CEIC, Capital Economics

Of greater concern in the short term is the imbalanced nature of the Chinese growth story. The Chinese growth model is export led (39% of GDP) and it is therefore dependent to a large degree on the prosperity of other countries' economies in driving its own, with the US being by far its largest customer. Since the credit crunch, China

has compensated for the collapse in its export markets, which grew 20-30% in recent years, by the huge domestic stimulus programme that has seen the surge in fixed asset investment. However, this is unsustainable without the domestic demand to satisfy the increased domestic capacity unless there is a sharp rebound in its export markets. Although the US and most other developed economies are slowly emerging from recession, growth is likely to remain subdued in 2010 and perhaps beyond. If this is the case it presents a significant challenge for Chinese policy makers to raise domestic consumption to maintain the growth momentum. If it fails the consequences could be severe not just for China but increasingly for other Far Eastern countries that are dependent on China for their own growth.

The authorities are aware of the problem of insufficient domestic consumption within GDP and the need to have more of a demand driven economy to complement the extra supply created through the infrastructure programme. For instance, consumer spending has been helped by government incentives to buy cars (see following chart) and other consumer durables but a more fundamental change is needed.



Sources – Thomson Datastream, CEIC, Capital Economics

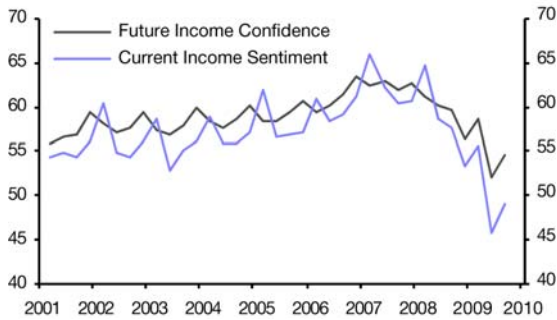
In the cities there are signs that China is becoming a more consumer orientated society but the largely rural population will take a long time to evolve more consumption driven behaviour and the savings ratio will remain relatively high for many years yet. Even the confidence of urban residents is low following the credit crunch last year (see chart below). As such, what else can be done? From a global perspective the most attractive and effective solution would be to allow the RMB to appreciate but will the authorities allow this to happen?





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Confidence of Urban Residents

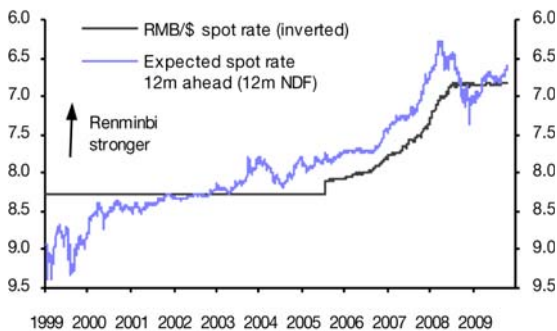


Sources – Thomson Datastream, CEIC, Capital Economics

The renminbi vs the dollar

Since July 2008 the RMB has effectively been pegged at 6.83RMB against the dollar. In the preceding 3 years, following another period of pegging the exchange rate, the RMB rose gradually by about 20% against the dollar (see chart below of how the RMB has remained pegged against the dollar for most of the last decade).

Renminbi/Dollar Exchange Rate



Sources – Thomson Datastream, CEIC, Capital Economics

The reversion to a fixed exchange rate policy against the dollar has created increasing tension between the US and China; the US feels by keeping the RMB weak it is providing an unfair advantage to Chinese producers and contributing to US unemployment that has just risen to over 10% of the workforce. China, on its part, has accumulated vast foreign exchange reserves that have largely been invested in the US Treasury market. It is concerned that the loose fiscal and monetary policy of the US Federal Reserve and Government is inherently unstable and liable to generate high inflation that could undermine the value of its US bonds as interest rates would need to rise and the dollar would fall.

These opposing views appear irreconcilable and China has raised the stakes by calling for an alternative reserve currency to the dollar or even replace it, so concerned is it about the value of its dollar denominated holdings.

The subtext is that it would like the RMB to become a reserve currency but while that may remain a long-term ambition it is unlikely to happen any time soon. However, it has not stopped China and other emerging economies, most recently India last week, diversifying their reserves by buying gold and this is one of the main reasons the yellow metal has been strong of late.

With Obama's visit, the Chinese central banks did omit the key phrase about keeping the RMB 'basically stable' in its most recent monetary report so hinting at a possible revaluation of its currency. If China does respond to external pressure it is likely to be a token appreciation of the RMB rather than a significant increase of, say 25-30%, needed to reflect the fair value of the RMB and reduce speculative inflows into China. Such a large increase would have a big negative effect on export growth and the authorities would not allow this at a time when domestic demand is still growing slowly and is only a relatively small part of GDP.

There are fears that the tensions could erupt into an all out tariff war; the last time this happened was in the 1930s and it was a major contributor to the Great Depression. Policy makers, while tempted by protectionism due to high unemployment and industries in decline, are likely to resist having learned from history it is a zero sum game. The most likely outcome of the current dispute is that the countries will muddle along with the current policies because both China and the US are dependent on each other. China may allow a slight appreciation of the RMB if growth targets are exceeded although it is not a policy priority. However, at the same time, it does not want to contribute to the US relapsing into recession because it is its main export market and China holds so much of its reserves in dollar denominated assets. The US realises that China is an essential engine of global growth and as the emerging superpower, both economically and politically, needs to maintain friendly relations.

Conclusion

The Chinese growth story has been subject to much debate with many sceptics doubting its quality and longevity. Comparisons to Japan at the end of the 1990s have been made when the domestic banks also went on a lending spree and as financial markets were liberalised it all culminated in a massive asset boom and subsequent crash. China's growth story has greater substance and is more far reaching. It is the industrial revolution of the world's next superpower no less, and the authorities have generally handled the economic transformation very deftly over the last 10 years.





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The main problem is that the economy has become very lopsided and far too dependent on public infrastructure spending and exports. This reflects the fast pace of the growth story in which the largely rural population cannot keep up with the rapid industrialisation. The resulting imbalances, especially with respect to the US, in the foreign exchange markets were a major contributor to the asset bubbles that led to the current credit crunch. There is no immediate panacea to this disequilibrium but following the recession the US is gradually reducing its trade deficit and China is slowly raising internal consumption.

Of greater concern is that the resurgence of Chinese growth is leading to the renaissance of bubbles in risk assets that were evident before the credit crunch. The strong momentum and weight of money means markets such as metals and emerging market equities may continue to rise on optimism on the prospects for China, but the amount of speculative and hot money that has flowed into these markets means they are vulnerable to a significant correction.

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