

Economic

Credit Agencies:

Moody's: A1
S&P: A
Fitch: A+

Nominal GDP (2008):

USD 4,221.535 bn

Population (2008):

1,328 million

Total Trade / GDP (2008):

59.9%

Currency:

Yuan (Renminbi)

Exchange regime:

Pegged arrangement

Merchandise imports from Canada (Jan-Sep 2009):

CAD 8,358 mn (6.6%)

Main sources of Foreign Exchange (excl. FDI):

Manufactured exports

Main Merchandise Export Destination:

United States (21%)

Main imports:

Industrial Machinery (19.1%)
Textiles (14.3%)

Risks to the Outlook


Labour productivity
Fiscal stimulus



Weak foreign demand
Fragile banking sector
Excess capacity
Unemployment

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Market Spotlight: GDP growth expanded at an impressive 8.9%/y/y in Q3-09 following a 7.9%/y/y growth rate in Q2-09. While positive sentiment is replacing earlier scepticism, major challenges lie ahead as external demand will remain subdued over the near term and the massive fiscal stimulus may have added to existing overcapacity. Chinese growth for the year is now expected by most market watchers to hit the targeted 8% deemed necessary for political and employment stability.

Recent performance: Q3-09 GDP growth accelerated to 8.9%, impressive in light of global conditions, albeit still below trend. Retail sales grew 15.8% y/y in November slowing from 16.2%/y/y in October and have remained fairly constant around 15% most of the year, and the annual average will be well below that of 2008. Investment (mostly government funded) remains the key driver; a rebalancing toward private consumption has failed to materialize thus far and is not expected to as a weak social safety net is a major hurdle. Fixed asset investment—almost entirely fueled by government investment initiative—continued to accelerate rising 32.1% y/y in the January-November. Industrial production surpassed pre-crisis rates growing at 19.2% y/y in November bolstered by a recovery in heavy industry but benefiting heavily from favourable base effects.

Fiscal policy: The massive fiscal stimulus announced in November is expected to exceed RMB 4trn (USD 586bn) or 13.4% of 2008 GDP by the end of 2011. The stimulus will be geared toward increasing investment and consumption through subsidies and tax reforms with an emphasis on housing, utilities, public transportation and disaster relief. The 2008 fiscal deficit has been revised to 1% from 0.8% of GDP. The fiscal stimulus package may bring 2009 and 2010 deficit to 3% of GDP and 2.4% of GDP, respectively. The government overall fiscal position is strong, with a low public debt (18% of GDP) and registering its first surplus in over two decades last year.

Monetary policy: In November food prices rose for the fourth consecutive month climbing 3.2% y/y turning overall CPI positive to 0.6% y/y growth. In light of easing inflation pressures and the global financial crisis, the PBC (People's Bank of China) cut both its lending and deposit rates in December by 27 bps to 5.31% and 2.25% respectively. No further easing is expected at this point. Non-food inflation pressures continue to dissipate falling 0.7% y/y in November (although the rate of decline has eased). The policy rate cuts along with the lifting of credit quotas have succeeded in increasing new loans, but there is some concern that a considerable share will be nonperforming.

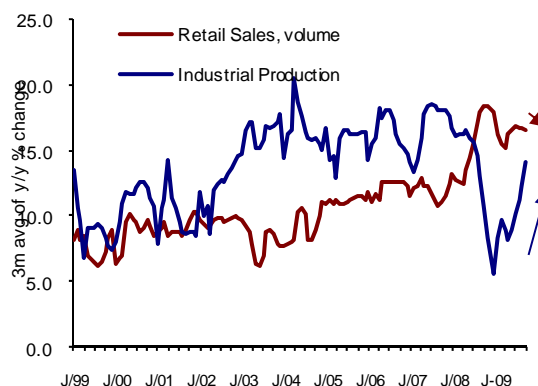
External sector: China's current account surplus weakened to 9.6% of GDP in 2008 from 10.7% in 2007 due to the export slowdown. In November, exports contracted 1.2% y/y and imports rose 26.7% y/y compared to October's 13.8% y/y and 6.4% y/y respective declines reducing the trade surplus to USD 19.1bn from USD23.9bn. China's raw material stockpiling continued longer than expected, but should begin to wane. The renminbi appreciated 6.7% and 12.1% respectively against the USD and the Euro in 2008, but has depreciated this year against the Euro as it tracks the weakening USD (boosting Chinese exports). Any appreciation against the USD going forward will likely be very gradual in nature. FX reserves in September were close to USD 2.3 trillion, representing 22 months of import cover.

Outlook: While growth has finally succumbed to global pressures expanding below recent trends at 9.0% in 2008 and 8.3% in 2009, the economy has proved fairly resilient. The fiscal stimulus in theory signals government recognition that growth needs to be rebalanced toward domestic consumption but so far it has mainly spurred government investment. The government will subsidize production to boost domestic consumption and employment, but with a strained export sector (despite the recent easing in export decline), the resulting job and income losses, and the non-existent safety net will pressure households to save rather than spend. Investment concentrated in state-owned enterprises thus crowding out private initiative. Private consumption in essence has a very long way to go and the stimulus may be only increasing excess capacity ultimately risking the formation of asset bubbles.

Economic Indicators

	02-07 avg.	2008	2009	2010
GDP (% growth, real)	11	9.0	8.3	8.8
Inflation	2.6	5.9	-0.8	1.0
Fiscal Balance (% of GDP)	-1.0	-0.4	-3.0	-2.4
Export growth (%)	30.2	17.1	-22.4	0.8
Import growth (%)	26.3	18.1	-21.6	5.0
Current Account (% of GDP)	6.6	10.4	6.3	4.8
Reserves (month of imports)	13.3	18.3	20.4	20.6
External Debt (% of GDP)	11.9	9.2	7.1	6.7
Debt Service ratio	3.6	1.8	2.4	1.9
Currency (end of period)	7.9	6.8	6.8	6.6

Sources: EIU, EDC Economics



Source: Haver

Political

Political Structure

One-party rule

The Chinese Communist Party (CCP) rules at all levels of government. All other political organizations are illegal.

General Secretary of CCP and President

Hu Jintao

Premier

Wen Jiabao

Executive/Legislative Bodies (Government and CCP)

- State Council
- Politburo Standing Committee (PSC)
- Central Committee,
- National People's Committee (NPC)

Last Elections

- Presidential: March 2008
- State Council: March 2008

Next Elections

- 18th Party Congress: 2012

Press Freedom Survey:

- 2008 Score: 84 (Not Free)
- freedomhouse.org

Control of Corruption Index:

- 2008 Score: -0.44 (-2.5: Worst; +2.5: Best)
- worldbank.org

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General Political Environment: China is a one-party state with the Chinese Communist Party (CCP) controlling the government. The nine-person Politburo Standing Committee is the top decision-making body in China. President Hu came to power in 2002 and will step down in 2012 following his second and final term. The succession plan is already being developed as the CCP plans power transfers well in advance to avoid any destabilizing surprises.

The global economic downturn has had a significant impact on China and is now the main focus of the government. Tens of thousands of export-oriented companies have gone bankrupt since late-2008, leaving millions of workers without work. During this time of rising unemployment there has been a marked increase in incidents of unrest, such as protests and riots, in regions most affected by the economic slowdown, primarily the export-focused manufacturing hubs of coastal China. These incidents are generally focused on a specific employer or local government official perceived to be corrupt and have generally been resolved without too much delay or difficulty.

Given the localized nature of the incidents, they do not yet pose a threat to the CCP's position. However, there remains a concern in Beijing that should issues such as mass unemployment not be addressed, these localized events could coalesce into a widespread anti-government movement. In the eyes of the CCP the equation is a simple one: declining economic output leads to increased political unrest, unrest that could lead to the Party's losing its hold on power.

In order to counter the effects of the economic downturn, in November 2008 the Chinese government unveiled the world's second largest stimulus package (after that of the US) valued at 4 trillion renminbi (USD 586 billion). The value of the package represents over 13% of the country's 2008 Gross Domestic Product (GDP); by comparison, the US package is roughly 6% of GDP. The stimulus package has already seemed to have had a positive impact on China's economic standing.

Investment Environment: China's complicated commercial environment poses risks for foreign investors. Frustrations tend to focus on the lack of legal protection for investor and intellectual property rights, inconsistent application of regulations, corruption and bureaucratic meddling. Growing levels of protectionism within China (i.e. the government initiated 'Buy China' policy for certain goods) during the economic downturn also have implications for foreign exporters. There are several outstanding challenges to Chinese trade policies before the World Trade Organization.

That said, China is working to encourage foreign investment by developing a more rules-based business environment. Recent changes include the passing of China's first-ever legislation protecting private property and an anti-monopoly law. While the passing of such legislation will provide further clarity to investors, implementation and enforcement of these and other changes is likely to be inconsistent across regions and industries for some time.

Public corruption remains an issue in China as it is entrenched at all levels of government. Apart from the economic impact of corruption, the issue also has wider political risk implications. Demonstrations against local-level corruption and land seizures continue to occur by then tens of thousands each year; over 87,000 in 2005 – the last year that the government released official figures. The CCP recognizes the importance of tackling corruption to ensuring its legitimacy and as a result the central government's anti-graft campaign will continue.

Political Violence: Demonstrations against local corruption and land seizures, as well as protests related to rising levels of unemployment, are becoming more numerous but they do not yet pose a major threat to the CCP owing to their localized nature. These incidents are expected to become more frequent as millions of migrant workers become out of work but are unlikely to result in widespread or sustained violence or to threaten the government's hold on power.

There have been recent incidents of unrest throughout China linked to ethnic divisions. In July 2009 almost 200 individuals were killed in clashes between ethnic Uighur and ethnic Han groups and police in Xinjiang province. Additionally, in March 2008 violent demonstrations broke out across Tibet and were met with a severe response by police with reports indicating that over 100 Tibetans were killed. The potential for future unrest exists given heightened inter-group tensions that remain.

China is deeply opposed to the pro-independence sentiments in Taiwan. Cross-strait relations have improved dramatically following 2008 Taiwanese elections and it is unlikely that tensions will escalate into military conflict in the short to medium-term.

Political Outlook

Political stability is still priority number one for the Chinese central government which views continued and regionally-balanced economic growth as they key to such stability. As such, the greatest test for the government going forward will be to ensure that the unfolding economic slowdown does not drastically impact the well-being of the general population, which has become increasingly emboldened in recent years. The recent eruption of ethnic unrest highlights the inter-group tensions that remain in certain regions of the country, namely Tibet and Xinjiang; however, such unrest is unlikely to threaten overall political stability in China.