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Is China's Economy In For a Hard-Landing?

An 'overheating' economy is an extremely uncommon concept spoken about these days as most of the world's economies are grappling with a fragile and precarious recovery in the midst of a European fiscal crisis. Many countries are struggling to exit their depressed economic state, which bottomed early last year, and with the troubles in Greece and the other European countries, the recovery process may be further delayed. Amid this economic dilemma and with downside risks still a key concern, the Chinese economy has provided the exception to the rule, displaying the most perfect 'V-shaped' recovery. Recently, however there has been increased pressure for the Chinese to tighten policy and allow a revaluation of the Yuan, as the Chinese economy may be 'overheating'. According to renowned economist, Nouriel Roubini*, "China should be tightening monetary policy, increasing interest rates and letting its currency appreciate over time. They are too slow; they are not doing it fast enough."*

Indeed, there are increased fears that the world's third largest economy may be at risk for a 'hard-landing'. The Chinese economy expanded at a substantial 11.9%, year-on-year rate during the first quarter of 2010, representing the biggest gain since the second quarter of 2007, just before the global financial markets were plunged into turmoil. China's burgeoning inflation rate and property market are also adding to the concern of an overheating economy. Property prices rose at a record pace in April 2010, surging 12.8%, in spite of the government crackdown on speculation which deepened last month. Producer prices soared 6.8%, the fastest pace in 19 months, while consumer prices climbed 2.8%, up from 2.4% in March. Retail sales expanded 18.5%, bolstered by government subsidies for purchases, while industrial production rose 17.8%. Foreign direct investment also climbed for a ninth consecutive month in April, as a result of the country's stimulus package and the government's decision to ease rules to entice investors. Investments expanded almost 25%, compared to a year earlier.

The government has subsequently announced measures to cool the mushrooming real-estate market, highlighting concern that asset bubbles may be forming after the record increase in values. The State Council has since raised the mandatory down payment ratio for buyers of second homes and ordered developers not to take deposits for sales of uncompleted flats. As the State Council released the credit rules, the Ministry of Land and Resources publicized its 2010 plan for nationwide land development. The ministry said the government would open up for development an additional 180,000 hectares, double the amount made available in 2009. This measure is aimed at containing speculative demand as well as to balance overall supply and demand. The China's land auction process, which had been very strong in the prior weeks immediately cooled following the announcement.

One of the more contentious issues which the Chinese authorities face is their foreign exchange policy. Analysts believe

that the Chinese currency may be undervalued by as much as 40%, giving the country an unfair advantage in world trade by effectively subsidizing exports, and putting a de facto tax on imports. On this basis, many, including the US, the International Monetary Fund (IMF), the governments in the European Union and central bankers in Brazil and India are calling for the Chinese authority to reexamine the Yuan's peg to the US dollar. On 13 May, the Central bank fixed the currency's daily mid-point little changed at CNY6.8277 against the US dollar. The Chinese currency may rise or fall 0.5% from its mid point each day, but has moved fractionally since it was revalued by 2.1% to CNY8.11 per dollar in July 2005. After scrapping the peg to the dollar in July 2005, the Chinese government allowed the Yuan to gain 21% before holding it at about CNY6.83 to the dollar since July 2008.

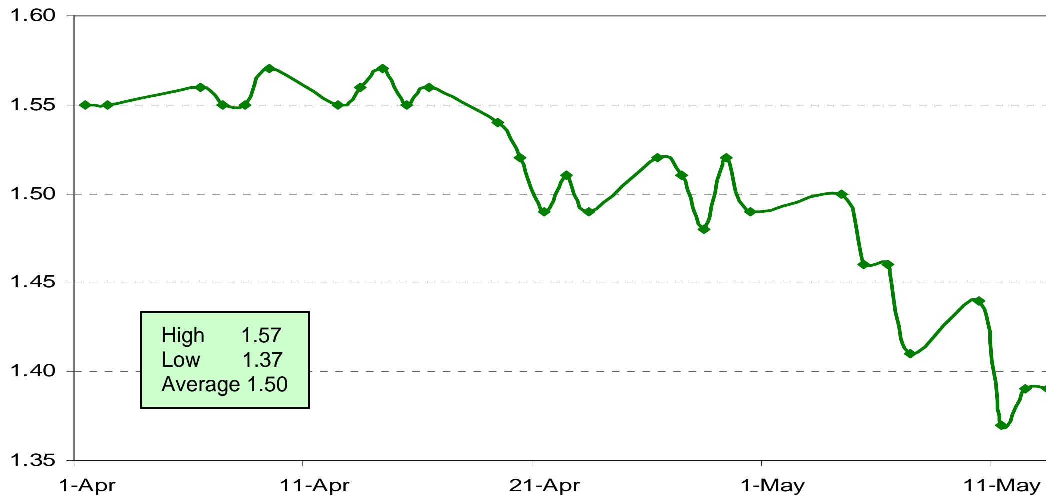
Meanwhile, China's central bank is erring on the side of caution, citing that the country faces risks to price stability and that the European debt crisis could impede the global recovery. Despite the tightening measures adopted to curb the rapidly expanding Chinese economy, particularly, the escalating property market, the central bank is yet to raise interest rates from crisis levels, or abandon the Yuan's peg to the US dollar. According to the Deputy Governor of the People's Bank of China, so far policy makers have avoided using the "heavy-duty weapon" of interest rates. Instead they have favored targeted measures to quell property speculation and drained cash from the financial system via three increases this year in the proportion of deposits banks must hold as reserves.

There was some notable change in language used in a report issued by the People's Bank of China on 10 May and it seems as though they may give into the pressures to adjust their exchange rate. Indeed, it was indicated that the Bank will 'likely allow the Yuan to appreciate against the dollar'. Also mentioned was the possibility of managing the Yuan 'with a reference to a currency basket'. Yuan forwards strengthened consequently, on increased speculation that China will sooner, rather than later relax its peg to the US dollar. At the time of writing, the Yuan's 12-month non-deliverable forwards appreciated to CNY6.6675 to the US dollar, up 0.2%. According to a Bloomberg survey, the currency will advance 2.4% from the current spot rate of CNY6.8276. One risk to the Chinese making these adjustments is the possibility that the Europe predicament will affect the Chinese economy, since Europe is one of China's biggest export markets.

Chinese bond yields are starting to indicate that the economy may be heading for a 'hard-landing' scenario. Figure 1 shows the spread between the two-year benchmark bond and the 10 year bond.

FIGURE 1: SPREAD BETWEEN THE 2-YEAR AND 10-YEAR CHINA BENCHMARK BONDS

Source: Bloomberg, CMMB Research Center



The significant decline in the spread between the short and long end of the Chinese yield curve since April 2010 points to an inversion of the curve. Yield curves theoretically are an accurate forecast of the turning points in the business cycle and an inverted yield curve is usually a predictor of a looming economic downturn. The declining spread between the short and long term yields for Chinese bonds indicate that investors are demanding more long term securities relative to short term, in anticipation of deteriorating economic prospects or the more dismal scenario of a hard landing. Additionally, the Shanghai Composite Index entered its second bear market in nine months during the second week of May and has recorded a decline of 19% so far this year.

Despite what the Chinese yield curve and the stock market are indicating, this does not seem to be the likely outcome. While GDP growth will revert to more sustainable levels, the likelihood of a 'hard landing' situation is diminished significantly, given that policy makers will be wary of this outcome and will be proactive in ensuring that the 'stimulus-fuelled' asset bubble is not prolonged. The tightening measures adopted by the government will help to squeeze the rapidly expanding economy and a Bloomberg survey indicates that the central bank will raise the policy interest rate by September this year. The US$1 trillion Euro-zone rescue package for its troubled members may instill some confidence in the global recovery, and to a large extent, dictate how soon Chinese policy makers will make their move.

FINANCIAL & ECONOMIC INDICATORS

As at 13 May 2010

Exchange Rate/US$	Closing Value	Previous Week
Yen	92.75	90.58
Euro	1.25	1.26
Jamaica	89.18	89.33

Commodity Prices	Closing Value	Previous Week
Crude oil (US$/bbl)	74.40	77.11
Natural Gas (US$/mmbtu)	4.26	3.97
Gold (US$/Troy Ounce)	1,232.70	1,208.57

Eurobond Indices (As at 06-05-10)

JP Morgan EMBI+ (Basis points)	280
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	ND

Policy Interest Rates (%)	Closing Value	Previous Week
United States	0.25	0.25
Euro Zone	1.00	1.00
Japan	0.10	0.10
Brazil	9.40	9.50
Trinidad	5.00	5.00
Jamaica	10.50	10.50
Barbados	2.50	2.50

Market Interest Rates (%)	Closing Value	Previous Week
US 90-day T-Bill	0.16	0.11
US 10-Yr Treasury	3.53	3.40
3-month UK Libor	0.70	0.68
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	10.05	9.95
TT 90-day T-Bill	1.16	1.15
Jamaica 90-day T-Bill	9.73	9.73
Barbados 90-day T-Bill	3.26	3.26

Sources: Bloomberg, J.P. Morgan, CMMB Research Center, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados

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