OBSERVATION

TD Economics

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CHINESE ECONOMY WILL PULL ITS WEIGHT AMIDST SUBPAR GLOBAL ECONOMIC GROWTH

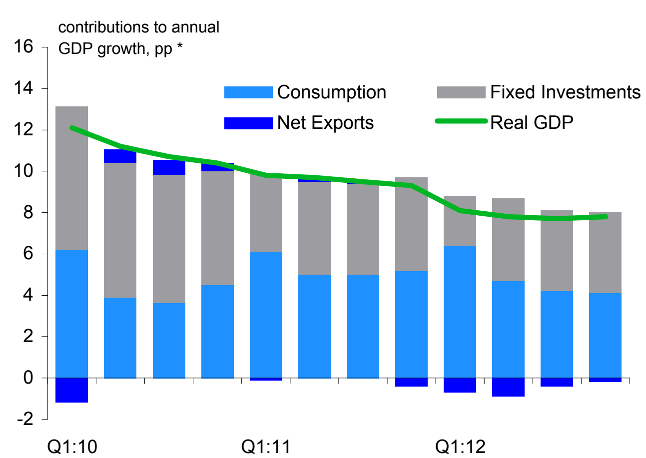
Highlights

- After a marked deceleration in the first half of last year that resulted from policy tightening and a less cooperative global environment, the Chinese economy appears to have turned a corner in recent months.
- This year, private consumption will likely keep rising at a solid pace, as real disposable income continues to outpace real GDP growth. In turn, rising credit should continue to support real estate and construction activity.
- Externally, a higher pace of growth in most of its Asian trading partners should offset the dampening effect on Chinese exports resulting from protracted weakness across advanced economies.
- Overall, the Chinese economy will expand 8.2% in 2013, a 0.4 percentage point gain over last year's tally. This will support global growth, having positive spill-over effects even in countries that export a small share of their total external sales to China, such as the U.S. and Canada.

The Chinese economy has accelerated in recent months and a number of factors suggest this pick-up in economic activity will persist throughout the year. Fourth quarter real GDP growth jumped to 8.0% y/y, ending seven consecutive quarters of decelerating expansions. The upturn reflected a sizeable rebound in net exports, a firming of fixed investments, and sustained gains in domestic consumption. This year, momentum in economic growth should modestly increase. Domestically, private consumption will likely keep growing at a solid pace, as real disposable income outpaces real GDP growth. In turn, rising credit and pent-up demand stemming from prior policy tightening should continue to support improving real estate activity. Externally, a higher pace of growth in most of China's main Asian trading partners should offset the dampening effect on Chinese exports resulting from protracted weakness across advanced economies. In all, the Chinese economy will expand 8.2% in 2013, a 0.4 percentage points gain over last year's tally.

A stronger Chinese outturn will reinforce the improving growth dynamics across Asia and other emerging markets. Ultimately, this will result in stronger global trade, having positive spill-over effects even in the U.S. and Canada.

CONSUMPTION'S SHARE OF GDP IS GROWING



Source: Haver, TD Economics. *Cumulative, seasonally unadjusted.

Chinese economy walks on a firmer footing

Economic activity has accelerated in recent months. Manufacturing, electricity production, and transport gained momentum towards year's end, as domestic production

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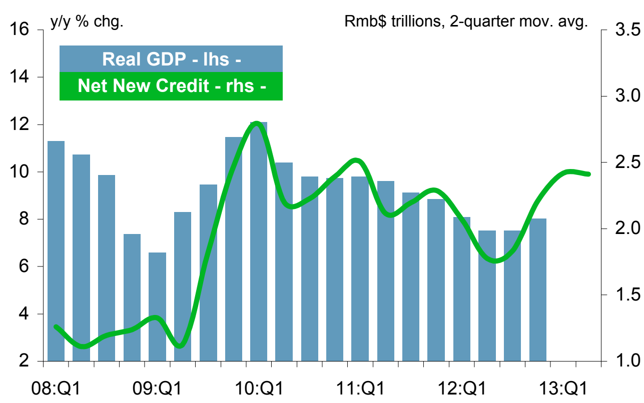
CREDIT FLOWS WILL REMAIN SUPPORTIVE OF GROWTH



Source: Haver, TD Economics. Credit data is adjusted for inflation and lagged by 2 quaters

reacted to an acceleration in public infrastructure spending and rising exports. In February, the official PMI came in above 50 for a fifth consecutive month, signaling a sustained expansion in activity.

Credit growth also accelerated in the final months of 2012, due to a reduction in reserve requirements by the PBoC earlier in the year, the rollover of bank loans to local governments financing vehicles (LGFV), and higher bond issuance by the latter. As a result, for 2012, there was a 23% y/y gain in total social financing, which is a broad measure of net new credit that includes bank loans, trust loans, corporate bonds issuance, as well as undiscounted bankers acceptances. This translated into new credit rising to 30.5% of GDP last year from 27.1% the year prior. Given the lags with which credit creation affects real economic activity, we could expect this substantial money infusion to support real GDP throughout the year, especially via continued expansion in infrastructure spending.

Public projects and stabilizing real estate prices to support new construction

A decline in real estate prices, which begun in June 2011 after tighter regulations were imposed on the sector, affected construction activity during the first half of 2012. Consequently, the ratio of new construction to total construction was 31% for the year as a whole, much lower than the close to 40% ratio of the previous two years. Furthermore, land acquisitions by real estate developers were 13% lower than in 2011.

The latest data from China's Index Academy shows that real estate prices have been inching up month after month since June of last year. In January, the average price of existing real estate across 70 Chinese cities was 0.3% higher than a year ago. This broke a 12-month string of annual contractions and reaffirmed a stabilization trend in housing prices. Nevertheless, the improvement in real estate prices will be conditioned by still high inventories and by the effect of tighter rules that remain in place. Therefore, private sector construction activity will accelerate only modestly during the year. As a result, the thrust to construction will have to come from the public sector. We expect public infrastructure spending to proceed at a sustained pace, but central authorities will remain vigilant that this does not lead to excessive borrowing by local governments through LGFV.

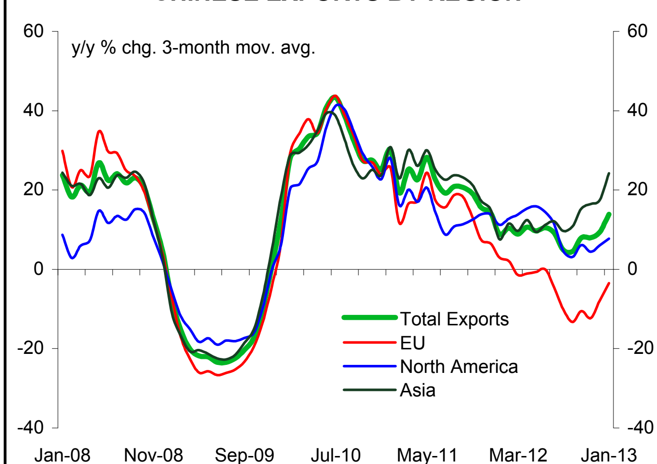
China will rely mostly on its neighbors to drive exports

On the external front, Chinese exports also sped up in recent months, on the back of improving Asian demand for Chinese products, as well as on stronger sales to North America and Africa. This year, export momentum should improve, as China's main trading partners in Asia and other emerging markets experience a further acceleration in their domestic economic activity. Nevertheless, the persistency of only a modest expansion in the U.S. and Canada and a protracted euro zone recession will limit the upside for growth of Chinese external sales.

Inflation will rise, as monetary policy remains accommodative

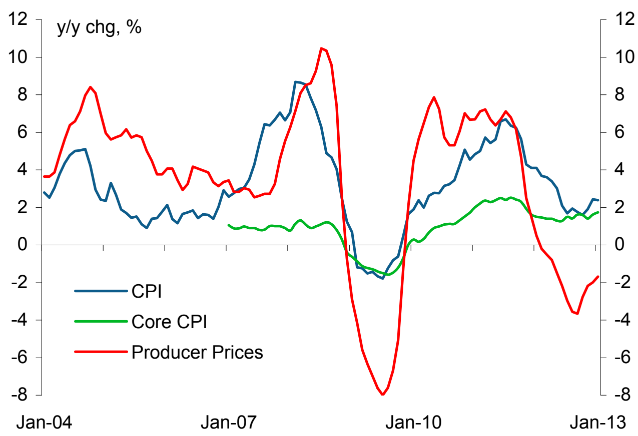
Inflation is poised to pick up in the coming months as economic activity gains more steam. Annual CPI inflation stood at 2.4% in January, unchanged from the previ-

CHINESE EXPORTS BY REGION



Source: TD Economics, Haver.

ANNUAL INFLATION IS BOTTOMING OUT



Source: China's National Bureau of Statistics, TD Economics

ous month. Due to the effect of New Year festivities on consumer prices, annual inflation will likely hover around 2.5% during the first quarter. As economic growth firms, inflation will rise closer to 3% towards the end of this year. This will reduce the odds of further relaxation in monetary policy, keeping the PBoC on the sidelines for most of 2013. If annual inflation rises above 3.5%, the PBoC will act to reduce monetary stimulus.

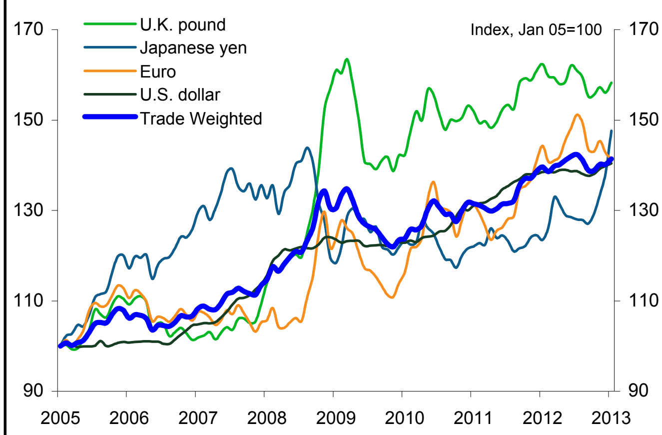
Renminbi appreciation conditional on foreign central bank actions

Since June 2010, the renminbi has appreciated roughly 13% in real terms against the U.S. dollar. This year, Chinese authorities will continue to allow for a gradual appreciation of the currency, as long as the euro and the yen do not depreciate sharply against the greenback. If that were to be the case, and other countries adopted policies to buffer the impact on their own currencies, the pace of renminbi appreciation will likely relent. Nevertheless, in light of the continuation of policy measures to support the internationalization of the currency, the renminbi should continue its gradual appreciation over the medium term.

How does stronger growth in China impact Canada and the U.S.?

The direct impact of stronger Chinese economic activity on both Canada and the U.S. is relatively small, because their exports to China represent a low share of their total shipments. Last year, Canada's exports to the Asian country amounted to 4.2% of total external sales, or 1.1% of Canadian GDP. The equivalent figures for the U.S. are 7.1% and 0.7%, respectively. However, the spill-over effects from stronger Chinese economic growth on Asia and other emerging markets will result in stronger global trade, which is unambiguously positive for the U.S. and Canada.

RENMINBI REAL EXCHANGE RATE

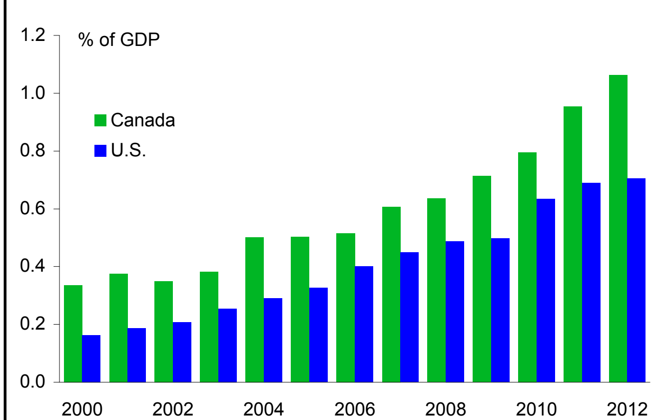


Source: TD Economics - Values above 100 represent renminbi appreciation relative to January 2005

Final remarks

After a marked deceleration in the first half of last year that resulted from policy tightening and a less cooperative global environment, the Chinese economy appears to have turned a corner in recent months. In all, we foresee China expanding around 8.2% this year. Growth could surprise on the upside if the U.S. economy improves beyond our current forecast. Furthermore, the gradual correction in real estate prices has reduced the likelihood of a more abrupt adjustment, limiting the downside risks stemming from real estate bubbles.

EXPORTS TO CHINA INCREASINGLY MEANINGFUL FOR CANADA AND U.S.



Source: Haver, TD Economics

In the medium term, the process of rebalancing the sources of growth away from fixed investments and into consumption also raises risks. This will require household income to outpace GDP growth for a number of years. Consequently, corporate profits will be under pressure, undermining the stability of highly leveraged firms, particularly in those sectors burdened with overcapacity. Negotiating this rebalancing without hindering economic growth will prove a challenging undertaking for President Xi Jinping and Premier Li Keqiang.

In any case, we still expect the new administration to resort once again to credit-led infrastructure spending if it became evident that economic momentum was faltering. Therefore, in 2013, we foresee the Chinese economy chugging along at a solid pace and supporting a global economy that longs for growth engines.

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