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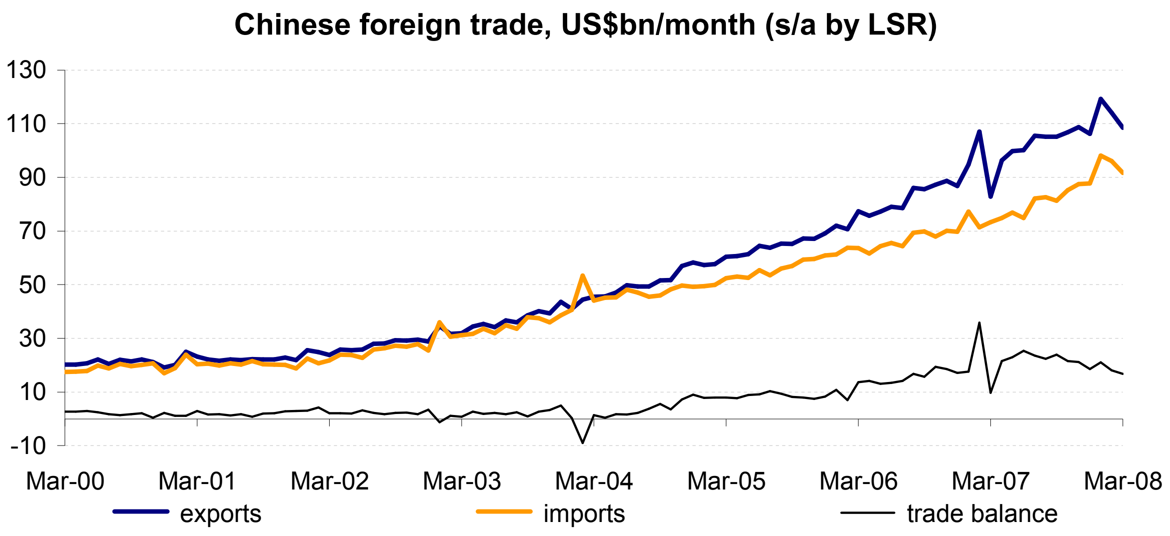
China slows – but not fast enough

WE SUGGEST: PBC unlikely to abandon tightening policy

SUMMARY: Chinese trade data can be confusing. The Q1 trade surplus narrowed. The March trade surplus widened. But the data clearly shows that the trade surplus is narrowing and that imports are growing faster than exports. Both imply weaker output growth. This is also the message from M2 and credit data. But the slowdown is not fast enough for the PBC to stop tightening policy.

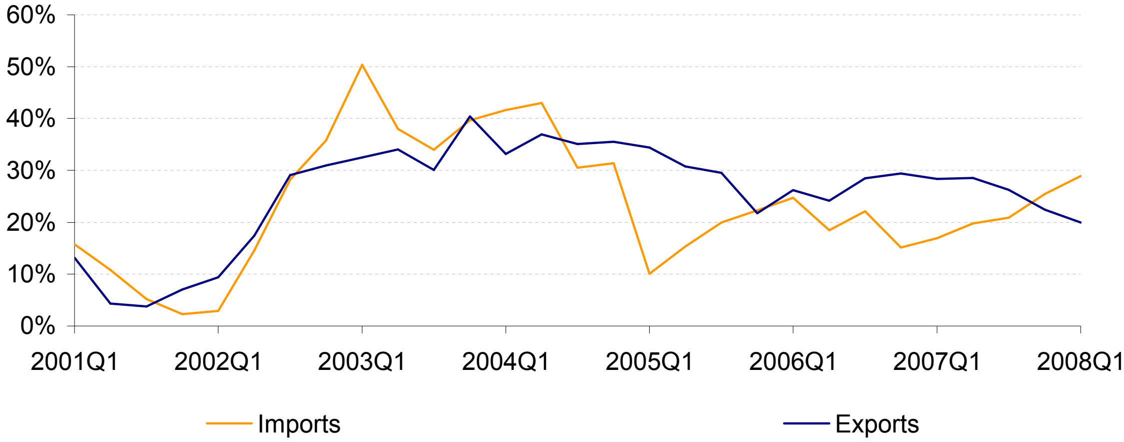
Chinese trade data is notoriously unreliable and never more so than around the Lunar New Year. For this year, the data is further distorted by the heavy snow and sleet storms in February which coincided with the New Year festivities. However, by dint of seasonal adjustment and looking at quarterly averages, it is possible to get somewhat more of a handle on what is going on.



Looking first at the monthly data, the problems of the Lunar New Year stand out sharply, even after the seasonal adjustment. But it is nevertheless clear that export growth has slowed down, even as import growth has continued to rise. In fact, the numbers probably overstate import growth, since the rise of the yuan would have made any given amount of dollar imports cheaper. On the other hand, we also know that the volume of commodity imports shot up (with scrap copper and aluminium playing an increasingly important role). Crucially, China's monthly trade surplus has now narrowed by some 40% from $25.3bn last June, to $16.7bn in March. This is the result of a number of factors: among them are the weaker dollar/stronger yuan, a pick-up in Chinese domestic demand as the economy overheats and a rise in commodity prices, itself the result of stronger Chinese (et al) demand.

The picture is complemented by a look at the growth rate of imports and exports. By using quarterly averages of four-quarter growth, we avoid the problems of the Lunar New Year. The important message of this chart is that import growth is now exceeding export growth. This is not unprecedented; there was a similar period 2003/2004, before weaker domestic demand caused the Chinese trade surplus to balloon. However, what is also noticeable is that export growth has slowed substantially and – on current trends – looks like dropping below 20% later in 2008.

Chinese foreign trade in goods, four-quarter change, %



Weaker exports and a narrowing trade surplus will dampen Chinese output growth in 2008. However, much will also depend on why import growth is accelerating. If it is because domestic demand is picking up, this would at least partly counteract the effect of the weaker contribution from net exports. However, if it mainly is because of the stronger yuan/weaker dollar development, then the net result will be overwhelmingly negative.

In spite of the point made above with regards to higher commodity imports, there are some other signs that the Chinese economy is slowing down. The People's Bank of China today published broad money and credit data for March. The numbers show that both M2 growth and credit growth are slowing. M2 grew by 16.3% in the year to March, down from 17.5% in February and a recent peak of 18.9% in January. Total loans rose by 16.2% in the year to March, down from 17.1% in February; while yuan loans rose by 14.8%, down from 15.7% and continuing a slowdown from 17.7% in the year to last October.

Interestingly enough, the growth of deposits (both overall and yuan deposits) is accelerating. Notably, the growth of yuan deposits has exceeded the growth of yuan loans in both February and March. This will not have much of an effect on banks' ability to extend loans; yuan deposits already vastly exceed yuan loans (YN41.6trn of deposits vs Yn27.5trn of loans in March), a point which also limits the impact on Chinese credit growth of the PBC's increases in the reserve requirement ration.

But the growth of yuan deposits is relevant from another point of view. The Q1 PBC Urban Depositors' Survey showed that households are shifting their money away from the stock market – where they have been burned – and are moving bank to bank savings, feeling that bank rates are now appropriate. But, crucially, Chinese deposit interest rates are still below the rate of inflation. Hence, those households who move back from the stock market to bank accounts are trading a possible profit (or loss) for a guaranteed real loss. In the immediate future, this need possibly not make much of an impact. But over the course of several months, it will erode the purchasing power of households and contribute to a weakening of domestic demand.

So if the Chinese economy now is slowing, will the PBC stop tightening monetary policy? Judging by what the Bank says, probably not. Because even if the economy is slowing down, it is clearly not slowing down fast enough. Earlier comments by Charles Dumas and Diana Choyleva have shown that China almost certainly now has a positive output gap. The revision of 2007 growth from 11.4% to 11.9% will have widened that output gap and increased inflationary pressures. While manipulating China's strategic pork reserve may get pork prices down, we are now seeing a surge in the global price of rice – possibly the only staple more important to Chinese food than pork. Hence Chinese inflationary pressures are likely to remain strong – and the PBC is likely to continue its attempts to dampen economic growth, at least until after the Olympics, when it may want to wait to gauge the effect of previous measures.

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