PERSPECTIVE

Craig Alexander
Senior Vice President & Chief Economist
TD Bank Group

CHINA'S PROSPECTS IN THE YEAR OF THE DRAGON

China's economic prospects will be a key factor shaping how the global economy will fare in 2012. As China enters the year of the dragon, it does so with an economy that is clearly losing altitude. The trillion yuan issue is whether China can engineer a soft landing in 2012 or whether a more disruptive outcome is in store. TD Economics is anticipating the former, but is vigilantly watching out for the latter.

In the fourth quarter of 2011, the year-over-year growth rate for the economy was 8.9%, down from 9.1% in the third quarter. As a result, China posted annual growth of 9.2% for 2011 as a whole. This is a solid performance and financial markets were cheered by the outcome in the last three months of the year, as there had been expectations for a more pronounced slow-down. However, the focus on the officially reported headline year-over-year rate of growth masks the true extent of the deceleration in the economy. The implied quarter-over-quarter annualized rate of economic growth in the fourth quarter is a far more subdued 8.2%. And, for China, a soft-landing is an outcome where growth remains close to 8% in the coming year.

Some of the moderation in the economy reflects the prior tightening of monetary and fiscal policies aimed at tempering inflation and dampening a real estate boom. Although weaker commodity prices have curtailed inflation as well, the prior restrictive policies seem to be paying dividends. Consumer inflation has eased over the past five months, falling to a 15-month low of 4.1% in December. Producer inflation is even more benign at 1.7%. Real estate is still red hot, but it is showing signs of cooling. Property sales have been declining over the past three months and prices have dipped slightly from their peak in August of last year. Most encouragingly, the 3.5% decline in apartment prices looks more like a cooling than a bubble bursting.

The good news is that domestic demand remains robust. Investment – by far the biggest catalyst to expansion in recent years – has been restrained by the tighter policies but retains considerable strength. Real investment growth fell from around 20% in early 2011 to slightly below 15% in December. And, the deceleration of inflation has helped to boost consumer spending. Real retail sales were up close to 14% year-over-year in December compared to 10% in the middle of the year. In other words, the assessment is so far so good in bringing down inflation without creating a hard landing in the domestic economy.

The story on the international trade front is far less encouraging. Weaker export growth is weighing down the economy. In the fourth quarter, year-over-year export growth fell to 14%, from 21% in the third quarter. The economic troubles in Europe took a major toll, with export growth to the European Union falling from 18% to a mere 7%. The weaker export demand at a time of strong domestic growth over the past couple of years has had a dramatic impact on China's trade surplus, which has gone from roughly 7% of GDP in 2008 to approximately

3.5% in 2011. While at face value this is a positive outcome in the sense of unwinding one of the major global economic imbalances, it has not happened in the ideal way of rising Chinese consumption, but rather has reflected weakness abroad.

In terms of the outlook, TD Economics published revised global economic projections in December; and, the forecast was for China's economy to slow from slightly above 9% in 2011 to an average of 7.8% in 2012. The recent economic numbers are a bit stronger than anticipated and they do pose a modest upside risk to our forecast, but they don't change the underlying story. China's economy will likely continue to slow over the next few quarters. A significant recession in Europe will weigh down China's export growth, and improved demand in the United States will not provide a full offset. The result is that net exports will be a material drag on economic growth and China's trade surplus will narrow further. The bottom line is that China will be more reliant on domestic demand for growth in 2012 – something global leaders have been calling for a long time. A key financial question is whether China's leaders will allow the renminbi/yuan to further appreciate in this environment.

The expectation of slower economic growth and cooling domestic inflation has created room for China to reverse some of the prior tightening of credit conditions. Indeed, China has already taken its first step in reversing policy and it appears that credit growth was already starting to accelerate late last year. However, the degree of policy loosening will likely be gradual, as a further moderation in real estate is desirable. While the near-term slowing in the economy is negative for commodity prices, the downside in a soft-landing scenario is limited. And, we have been surprised that financial markets have so far greeted the news of slowing growth in a relatively positive way, as they see it as clearing the way for a reversal of past tightening in policies.

While a soft-landing seems to be playing out, one should not be complacent. It is still early days to assess the impact of the weakness in Europe and it is hard to say when the deceleration in China's economy will abate. In other words, one still cannot rule out a hard landing and this will be a key risk to keep on the radar screen this year. Moreover, financial markets may not remain so at ease about China's slowdown in the coming quarters as economic growth drops below a quarter-over-quarter annualized pace of 8% in at least the first half of 2012.

Looking beyond the year of the dragon and the managing of the near-term cyclical moderation, the long-term challenge to rebalance China's growth model remains very much in place. In 2000, investment in fixed assets accounted for 34% of China's economy, while private consumption represented 46%. In 2010, those shares had reversed: investments accounted for 46% , while private consumption fell to 34%. For most economies, the ratio is around 20% / 65%. Devoting such a large share of GDP to fixed investments for so many years is bound to generate misallocation of resources, which at some point will have to be addressed. The single most important task for China's new generation of leaders will be to manage this transformation towards a more consumption based economy.

Craig Alexander
416-982-8064
craig.alexander@td.com

This report is provided by TD Economics. It is for information purposes only and may not be appropriate for other purposes. The report does not provide material information about the business and affairs of TD Bank Group and the members of TD Economics are not spokespersons for TD Bank Group with respect to its business and affairs. The information contained in this report has been drawn from sources believed to be reliable, but is not guaranteed to be accurate or complete. The report contains economic analysis and views, including about future economic and financial markets performance. These are based on certain assumptions and other factors, and are subject to inherent risks and uncertainties. The actual outcome may be materially different. The Toronto-Dominion Bank and its affiliates and related entities that comprise TD Bank Group are not liable for any errors or omissions in the information, analysis or views contained in this report, or for any loss or damage suffered.