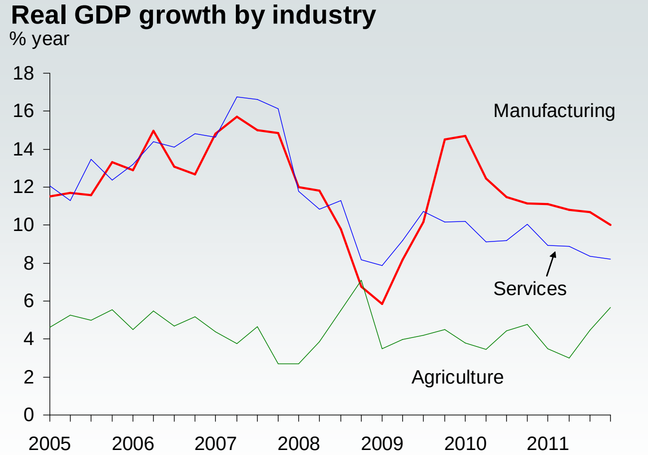
Consumption boosts China's resilience but risks of a property bust still loom

With the outlook for exports subdued and investment weak, we expect industrial output growth to slow further in 2012H1. But consumption is taking up the slack and fiscal policy is set to be supportive. As a result, we only expect a relatively modest slowing in growth in 2012 to 8.4% from 9.2% in 2011. But with house prices still falling in December, we remain concerned about the risk of a sharp slowing in the property market leading to strains on local government finances and a hard landing for growth, particularly with the external environment weak. However, central government finances are strong and fiscal transfers could provide a significant cushion in the event of a property bust.

GDP growth in China held up surprisingly well in 2011Q4, slowing only slightly to 8.9% from 9.1% in Q3 and delivering full-year 2011 growth of 9.2%. While the official seasonally adjusted figures suggest that growth decelerated to 2.0% in Q4 from 2.3% in Q3, our estimates suggest that it accelerated modestly to 2.3% (from 2.0% in Q3). In terms of output, growth in Q4 was supported by a strong showing for agriculture, which rose 5.6%, while the manufacturing and services sectors saw a modest slowing in growth.

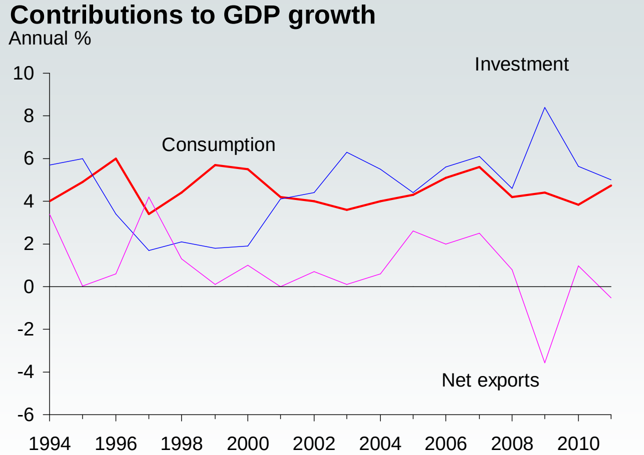
Industrial production was particularly strong, rising by 1.1% on the month in December in seasonally adjusted terms and 12.8% year-on-year. But investment was weak, falling on the month in both November and December. With the outlook for exports subdued and investment weak, we expect industrial output growth to moderate further in 2012H1. But consumption appears to be taking up the slack and fiscal policy is set to be supportive. As a result, we only expect a relatively modest slowing in GDP growth in 2012 to 8.4%.

Real GDP growth by industry



Source : Oxford Economics/CEIC

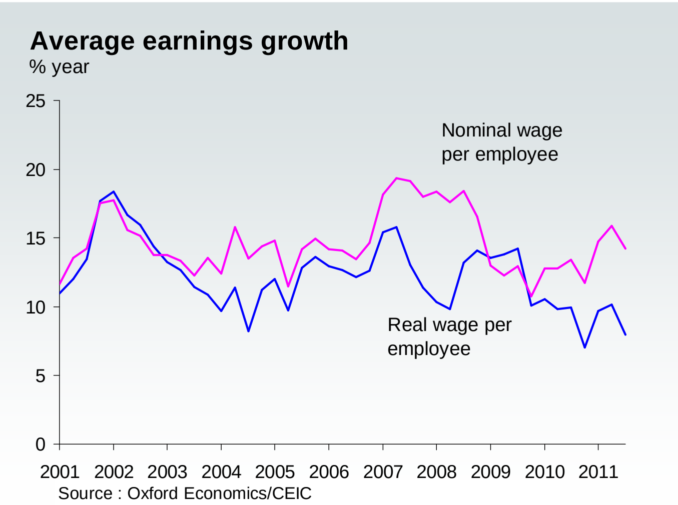
Contributions to GDP growth

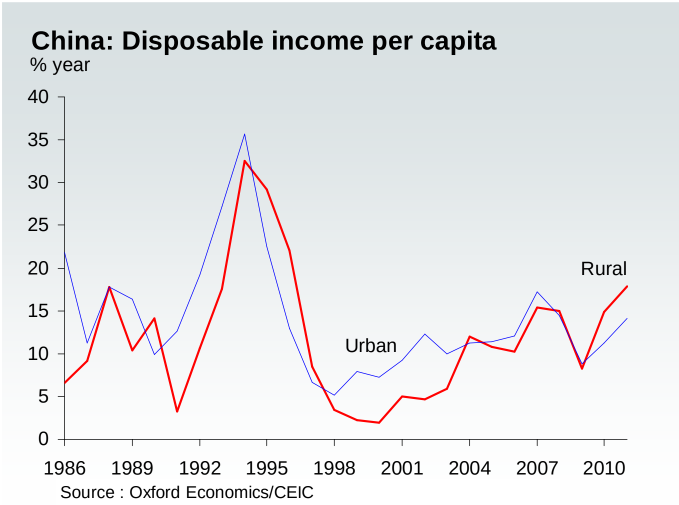


Source : CEIC/Oxford Economics

In 2011 as a whole, consumption and investment contributed roughly equal amounts to overall growth, at 4.8% points and 5.0% points respectively. Net exports actually detracted from growth marginally by 0.5% points. Retail sales were remarkably stable in 2011 and month-on-month growth even picked up in December to 1.4% from 1.3% in November. Nominal wage growth was reasonably strong throughout 2011. While high inflation dampened real wages in the second half of 2011, with inflation now lower and expected to moderate further real wage growth should start to rise again. This will help to support consumption growth of 9% this year, up from 8.5% in 2011.

For the first time, at the end of 2011, the urban population of China exceeded the rural population. But there are also important shifts in income growth, with rural incomes in 2011 supported by strong agricultural output and government transfers. While the level of urban disposable income per household remains three times the level of rural households, growth in rural incomes significantly exceeded that of urban incomes in 2011 for the first time since 1996, rising 18% compared with 14% for urban households.



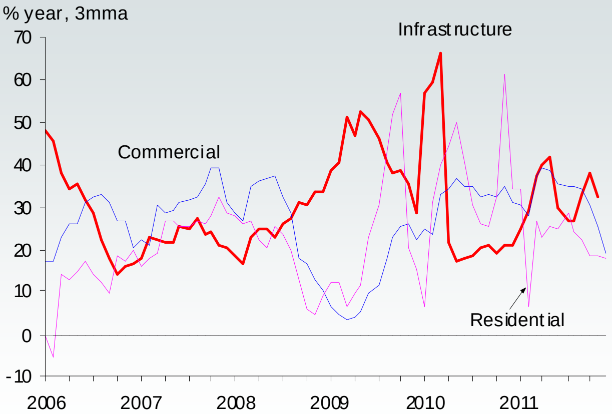


Estimated seasonally adjusted exports fell on the month in December after holding up reasonably well in November while imports dropped more significantly. As a result, the trade balance improved slightly in December to US$16.5 billion. At the same time, the overall level of foreign reserves also fell slightly, from US$3.22 trillion to US$3.18 trillion. While some of this will reflect the weakening in the euro, given the slight improvement in the trade balance it also suggests some capital outflows. The number of FDI contracts signed held up well in 2011Q4, rising slightly from Q3, but the levels remain well below those seen in 2006-07 before the global financial crisis.

Headline CPI inflation eased slightly to 4.1% in December from 4.2% in November. But non-food price inflation slowed more quickly, dropping below 2% for the first time since the end of 2010. We expect inflation to continue to moderate, increasing the scope for a further easing in monetary policy. Reserve requirements were lowered by 50 basis points in November and we expect two modest cuts in interest rates in the first half of this year.

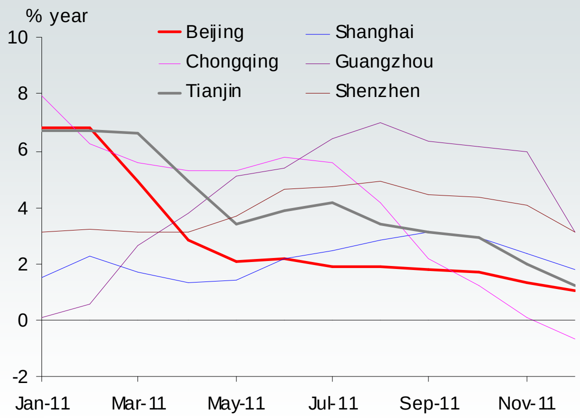
After surging in 2010 and 2011H1, residential investment is now slowing significantly. The resulting overcapacity from previous high investment rates is weighing on the housing market, with prices for newly constructed residential buildings falling in 52 cities out of 70 measured in December. We remain concerned about the risk of a sharp slowing in the housing and construction sectors leading to strains on local government finances and a hard landing for growth, particularly with the external environment weak. But still-strong foreign reserves and a government willing and able to increase fiscal transfers would provide a significant cushion in the event of a property bust.

China: Building Investment



Source: CEIC, Oxford Economics' estimates

China: Regional house prices (Residential)



Source: Oxford Economics/CEIC