

# Five predictions for the Chinese economy in 2010

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As the year 2009 fades into the distance in the rear view mirror, the Chinese economy has entered into unknown territory in 2010. Investors are universally far more upbeat than one year ago. Policymakers talk busily about adjusting economic structure as the new top policy priority, seeing no risk in achieving above 8 per cent growth.

For some, China's ability to achieve strong growth amid global recession was the biggest surprise of 2009. To me, it was not. The Chinese government's abilities in mobilising resources have strengthened, not weakened, significantly during the past decade. If the government really believed that 8 per cent growth was critical, then that would happen.

But I also had my share of surprises in 2009. The first surprise was the stable job market. I predicted that labour market conditions would deteriorate sharply, as job creation from the capital-intensive infrastructure projects would not be sufficient to compensate for the job losses in the labour-intensive export sector. But job markets remained stable during the economic downturn. The country even experienced

widespread shortage of migrant workers. It turned out that construction of capital-intensive projects is actually very labour intensive.

The second surprise was the resilient private sector. As the economy became more dependent on state-dominant investment, it was natural to expect the private sector, mostly small and medium enterprises (SMEs), to decline. But, in fact, SMEs continued to grow much faster than state industry throughout the economic downturn. At least three factors contributed to SMEs' outperforming the state-owned economy: they had advantage of more flexibility in response to the crisis; they benefited indirectly from contracts associated with the stimulus measures; and there were new policy initiatives ensuring that SMEs got finance through the banking system.

And, finally, the third surprise was rapid rise of asset prices. I expected GDP growth to be strong but microeconomic conditions to deteriorate, with negative implications for the asset market. Asset prices, especially housing prices, started to surge from the second quarter. The turnaround of the asset markets was probably driven by bottoming out of the Chinese economy. But the abnormal liquidity conditions also played an indispensable role in building-up of the asset bubbles.

### **So how will the Chinese economy look in 2010?**

The truth is nobody knows. But available information does suggest that the global economy will likely do much better in 2010 than in 2009. The U.S., E.U. and Japan all climbed out of recession during the third quarter of 2009. The global economy will probably achieve 3 per cent growth in 2010. While prices may move upward, inflation is not likely to be a major macroeconomic risk any time soon. The central banks can take time before tightening the policies.

In the spirit of the upcoming 'Year of Tiger', I offer here five predictions about likely macroeconomic trends in China in 2010. I am almost certain that many of these

predictions will turn out to be false. What is important is not the conclusions, but the reasoning behind these conclusions.

**Prediction 1: The renminbi will probably begin to appreciate against the dollar.**

Some economists worry about inflation risks given extraordinary credit growth in 2009. But in the near term inflation is likely to be capped by the overcapacity problem. As the economy recovers and prices move upward, the central bank will start to tighten monetary policies, most likely around the middle of the year.

The soft peg of the renminbi against the dollar in the wake of global crisis was unfortunate. But policymakers remain committed to greater flexibility of the exchange rate and are likely to return to a managed float regime with reference to a basket of currencies during 2010. This should set a new path of steady and gradual appreciation of the renminbi in many of the years to come.

**Prediction 2: Job market pressures may rise again even as the economy recovers.**

Construction of infrastructure projects has absorbed the vast labour force released by the export sector. But these jobs are not permanent. Once construction works are completed, migrant workers will have to find new jobs again. And stable jobs can be created only when domestic demand other than state investment picks up. This could point to a brief period of recovery of economic growth and accompanied by a weakening of labour markets.

**Prediction 3: Housing prices will probably begin to weaken.**

Factors that could influence housing markets in 2010 are mixed. For instance, higher personal incomes and corporate profits could support further increases in housing prices. But overall tightening of monetary policies, particularly slower growth of bank loans and hikes in policy rates, could add to pressures on the housing market.

A prediction of weakening housing prices, however, is based on two main factors. First, the market already shows important signs of a bubble, whether judging from the income/housing price ratio or looking at the rental/price ratio. Second, policymakers already worry about consequences of asset bubbles, given the fresh lessons from the U.S. The authorities recently removed all preferential treatment for housing investment and will likely take more actions in the coming year.

#### **Prediction 4: Structural imbalances are likely to worsen.**

Almost all policymakers, from the Premier down, are talking about adjustment of economic structure in order to improve quality of growth. This is very positive. But the measures being considered, such as better credit allocation, remain administrative in nature. In fact the government has been doing the same for at least seven years. But the imbalance problems continued to worsen. I don't see any difference this time round.

So, for instance, when the global economy recovers, the government may reduce spending on infrastructure, which would eventually lower investment share of GDP. But at the same time, export growth may recover. This could mean a rebound of the current account surplus.

The root cause of the structural imbalance is distorted incentive structures, especially depressed factor costs. Until more decisive steps are taken to liberalise factor markets,

adjusting economic structure could remain on the top of policy agenda every year for a very long time.

**Prediction 5: The government will likely introduce another stimulus package**

Although most analysts expect China's GDP growth to be at 9-10 per cent in 2010, it is unclear whether strong growth can sustain itself without the helping hand of the government. The ideal scenario is that when the RMB 4 trillion spending runs out, either exports or consumption or private investment or a combination of these would be strong enough to carry forward the growth.

But it is not clear that this will happen in the near term. Exports should recover but they are unlikely to return to the levels achieved before the crisis. The growth potential of the global economy has shifted lower and rising saving ratios further limits potential for China's export growth. Consumption has been resilient, partly as a result of the stimulus measures. Without strong income growth, the consumption momentum could weaken. Private investment remains weak outside the housing sector.

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