

China Business Forecast Report Q2 2014

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Abstracts

Core Views

We continue to believe that the hangover effects of China's economic stimulus are yet to be felt, and cooling credit growth is likely to reveal these effects over the coming quarters. Newfound reform momentum has the potential to help the economy grow out from under its credit excesses. However, several obstacles stand in the way of this, including the likelihood that reform efforts could exacerbate any economic downturn. We are forecasting real GDP growth to come in at 7.1% in 2014, before slowing further to average 6.1% growth over the next five years.

Notwithstanding the surge in credit in recent years, China's consumer price inflation (CPI) rate has remained remarkably benign, while producer price inflation (PPI) has been consistently negative.

We believe that the flood of capital into the nation's property market helps to explain these trends. The outlook for real estate prices will be crucial in determining the inflation picture in 2014 and beyond, and we believe that pressures will be capped despite the current inflationary market signals.

The Chinese government is looking to control the burgeoning debt load at the local government level, while at the same time promoting regional rebalancing, improving social welfare, and reducing the reliance on unsustainable land sales. These goals seem incompatible and suggest that fiscal reforms will be difficult to achieve in practice. China's establishment of an Air Defence Identification Zone (ADIZ) overlapping the disputed Senkaku/Diaoyu Islands will increase geopolitical risks in Asia, and potentially undermine Beijing's standing in the region, as it fuels a backlash. More Asian countries will turn to the US to counterbalance China's influence.

Major Forecast Changes

Since our last Business Forecast Report we have made some slight changes to China's economic forecasts. We have upgraded our 2014 real GDP growth forecast from 6.7% to 7.1% to reflect our view that the recent pick-up in export growth will be sustained into early 2014. We remain a long way below consensus estimates, however, as we believe that reform measures are likely to be negative for headline real GDP growth.

Key Risks To Outlook

The main downside risk to our economic outlook remains another collapse in external demand, such as the one that occurred at the height of the global financial crisis. This would seriously undermine growth in trade-dependent industries and hasten a fall in the property market, potentially leading to an outright recession. There is also a risk that continued fiscal and monetary stimulus by government and the People's Bank of China could usher in stagflation.

The major political risk comes from a rise in social unrest and a surge in public demonstrations against government corruption, inflation and housing affordability, which could be triggered by overseas events or an economic slump. While we do not see the rule of the Communist Party of China (CPC) as being at risk, such events would still have a detrimental impact on the business environment and could see the CPC strengthen its grip on the economy to the detriment of growth.

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Table: Political Overview

Long-Term Political Outlook

Major Challenges Over The Coming Decades

China faces myriad economic, social and environmental challenges over the coming decades that could seriously test the Communist Party of China's ability to govern. The best-case scenario for any eventual political transition would entail an elite-led liberalisation of the authoritarian system, while the worst-case scenario would involve a violent change of regime.

CHAPTER 2: ECONOMIC OUTLOOK

SWOT Analysis

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Can Reforms Prevent The Credit Hangover?

We continue to believe that the hangover effects of China's economic stimulus are yet to be felt, and cooling credit growth is likely to reveal these effects over the coming quarters. Newfound reform momentum has the potential to help the economy grow out from under its credit excesses. However, several obstacles stand in the way of this, including the likelihood that reform efforts could exacerbate any economic downturn. We are forecasting real GDP growth to come in at 7.1% in 2014, before slowing further to average 6.1% growth over the next five years.

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Notwithstanding the surge in credit in recent years, China's consumer price inflation rate has remained remarkably benign, while producer price inflation has been consistently negative. We believe that the flood of capital into the nation's property market helps to explain these trends.

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China's exports are recovering and are likely to remain relatively strong as we enter 2014. However, beyond this cyclical upswing, the stronger yuan is likely to begin to bite, and we are forecasting exports to grow by just 8.0% in 2014 in nominal terms, from an estimated 8.3% in 2013. Some interesting export trends are developing throughout the region, though, which are likely to reduce China's exposure to external shocks, such as greater export diversification, with shipments to the US, Europe, and Japan, continuing to decline in overall share.

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