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ECONOMIC SPOTLIGHT

WEEK 31 2017

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CHINA'S ECONOMY NEEDS **TO COOL DOWN**

China's GDP-growth has surprised on the upside so far this year, however it will change, but especially one part of the economy will stay strong.

China's GDP growth is suddenly rising despite a number of Western economists and other specialists every year forecast that China's economy would stumble. I have never agreed with this prophecy and do not regard a Chinese meltdown as a particular risk during the next 10 to 15 years. Nevertheless, it is interesting, and partly surprising, that the GDP growth rose to 6.9 pct. in the first and second quarter (graphic one). Even the Chinese government's own expectation was a growth similar to last year's 6.7 pct. In addition, many, including myself, have the view that the growth rate generally will move lower and therefore 6.9 pct. suddenly seems high.

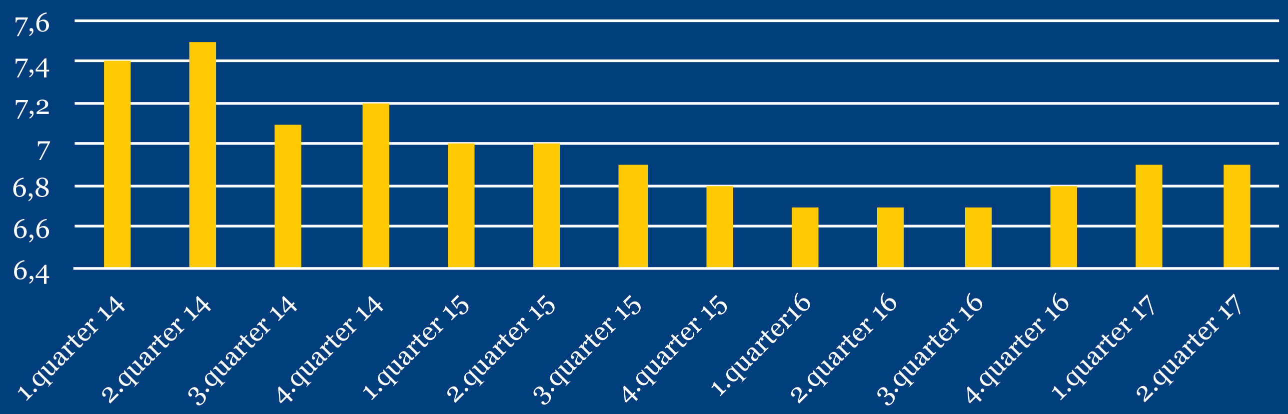
Many investors have realised that the extensive reshuffle of the Politburo Standing Committee means that China's GDP growth will not slow down in 2017. Between the lines, government sources have mentioned that an increase in infrastructure investments is possible this year. In my view, it is the way to ensure a satisfactory GDP growth in connection with the coming changes of the political leadership. I do not consider it very different from the increase in public spending which always takes place in election years in other countries. There might be differences in how governments chose to increase spending but investment in infrastructure is a classical choice in many countries. In China, such investments have an unimaginably rapid positive effect on the economy hence the GDP growth. My main scenario is that Beijing fuelled these investments already at the start of the year. Surprisingly other sectors in the economy did not contract as expected.

Since mid-2016 provinces, and later even the central government in Beijing, have fought to limit price increases for new constructed homes. Various administrative measures were introduced, ranging from limitations in the number of homes that a private individual can own, to increase the required down payment etc.
Normally, it is easy for the government to get the hot air out of the housing market. If one observes the annual price changes over time, it therefore almost looks like a sinusoidal curve swinging up and down. As graphic two indicates prices do not slow down this time, actually the reaction in the real estate market has so far been very limited. In the 70 largest cities, the monthly price increases have remained at 0.7 pct. during the past three months keeping the annual price increase at 10 pct. This robustness is interesting but in reality, it coincides with the development in a number of other countries around the world where the real estate markets also are heated.

When I slightly provoking claim that China's economy has to cool off it is related to the official efforts to slow down price increases in the housing market. My expectation is that it succeeds and therefore the construction activity and other related sectors will ease. To put

***Graphic 1*:**

GDP-GROWTH PER QUARTER ANNUALISED IN PCT.



Source: National Bureau of Statistics of China, Kina.

in another way, the GDP growth will be lower in the coming quarters. I am though not at all worried about the housing market and perceive it as robust, even in a situation with prices falling.
However, I note that the government has so far not made use of credit and monetary tightening. It is usually a part of the package and normally quite successful as changes in the money supply affects the housing market quickly. China's economy is however, becoming more internationalized or globalized if desired, which means that changes and actions will have an effect elsewhere in the financial system. A monetary tightening could easily hit China's stock market, which is an unfortunate timing right now. China is trying to attract more foreign investors so even the domestic bond market was opened lately for outside investors.
Despite the U.S. central bank (Fed) is in a sort of a monetary policy tightening cycle China has so far not hiked rates, just like a number of other emerging market countries still are on hold. I interpret the unchanged monetary policy in the way that official China would like to avoid actions that could cause volatility in the domestic financial market. The price to pay is that the rising housing prices does not cool down as quickly as desired and the CNY will decrease towards the U.S. dollar during the coming 6 months when Fed hikes again.

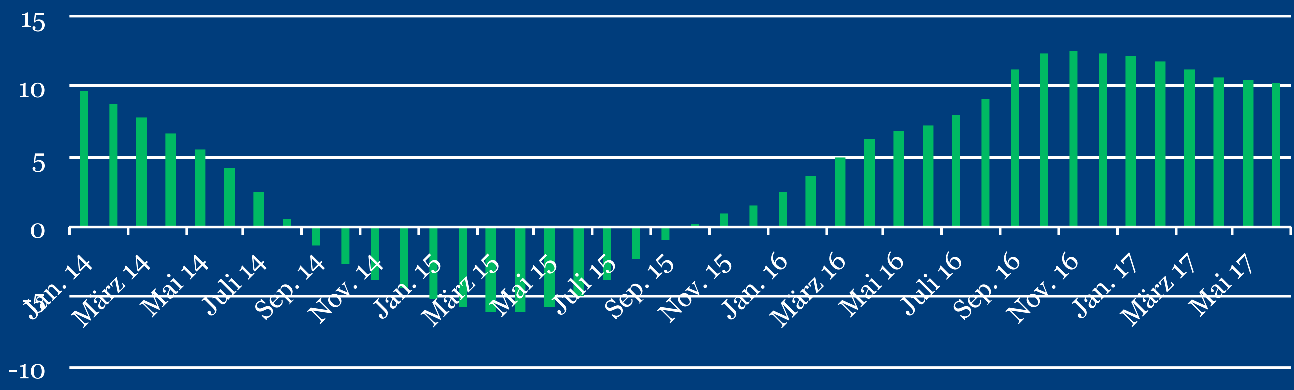
Very encouraging the GDP data confirms that private households are doing well. The disposable income among households increased by 7.3 pct. in the first half of the year, which is higher than the GDP growth. I asses it as a clear health signal when estimating the possibility for a continued positive development in domestic demand and private consumption. It is by the way one of the economic indicators that the official China pays attention to. Most likely, it positively confirms the government's own assessment of their economic policy that is conducted in China.

In my opinion, the figure truly confirms the strength and potential of private consumption in China 6 to 12 months ahead. The consumption engine however, also gets new energy elsewhere from and, as always in China, many developments are explosive. Right now, I give extra attention to the increasingly expanding internet based lending to private consumers.

Many in the financial markets might immediately think of a credit bubble and another risk to the Chinese economy. In reality, however a growing number of Chinese consumers just resemble those in the West. Some will consume too much, like in the West, but fundamentally, private consumption in China will grow even more due to loan-financed consumption. The strength in the household spending will not be affected by a slight downturn in the GDP growth. Due to a number of positive impulses, such as increased loan financed spending and rising disposable household incomes I expect that China's private consumption will be one of the positive surprises during the coming quarters.

***Graphic 2*:**

YEARLY PRICE CHANGE IN PCT. FOR NEW HOMES IN CHINA'S 70 LARGEST CITIES



Source: National Bureau of Statistics of China, Kina.