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China: Rising Risks

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Ongoing monitoring of China suggests that a hard-landing, while still not the most likely scenario for the next twelve months, should be viewed now as a higher probability event. To be sure, most of the data on activity, even on export activity, have the appearance of an evolution towards a soft-landing.

Annual inflation has stabilized (it actually fell marginally in August, to 6.2%), while industrial production has come down to a lower but still strong-growth path. No evidence of stress is visible in retail sales figures, either. However, there are some related and important questions for which there is yet no firm answer:

- Have authorities taken monetary tightening too far? Possibly--but not clearly. Monetary growth has slowed sharply, and there are numerous anecdotal reports (as well as some local data) pointing towards a weak real estate sector, with prices falling. Still, nationwide house-price indices do not yet provide evidence of that phenomenon. Nonetheless, the central bank's recent statements on the need to ease credit conditions for small firms reveal that monetary tightening is perceived to be reaching a worrisome point.

- Could authorities tighten even further, increasing the risk of policy overkill? Possibly—but not likely. Still, even as the PBOC and the government shift their attention to the threats to growth originating abroad, and even as they highlight the expected lagged effects of past tightening, their rhetoric continues to emphasize inflation as the major risk.

The bottom line: calibration of monetary policy is at a critical phase in China, given the drastic curtailment of credit in the past year and the deterioration of the global outlook. Policymakers' margin to maneuver is shrinking and the potential impact of a policy error rising.