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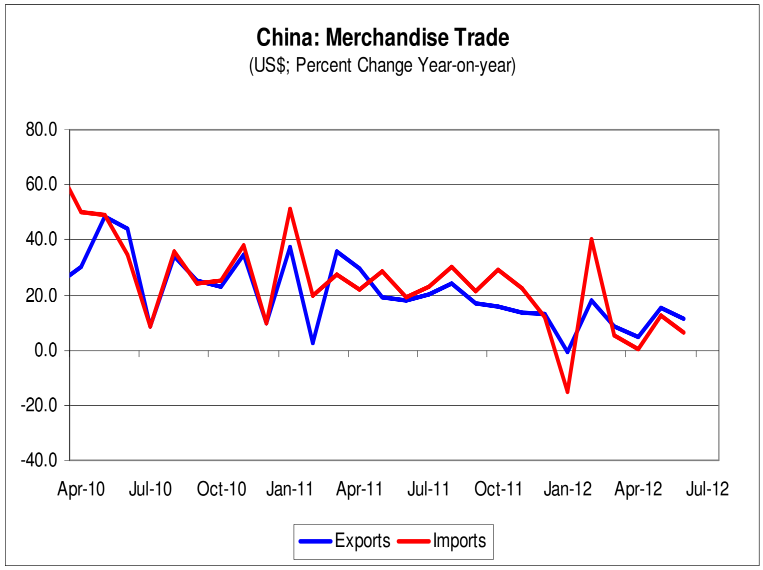
Francisco J. Larios
Chief Economist, Emerging Markets

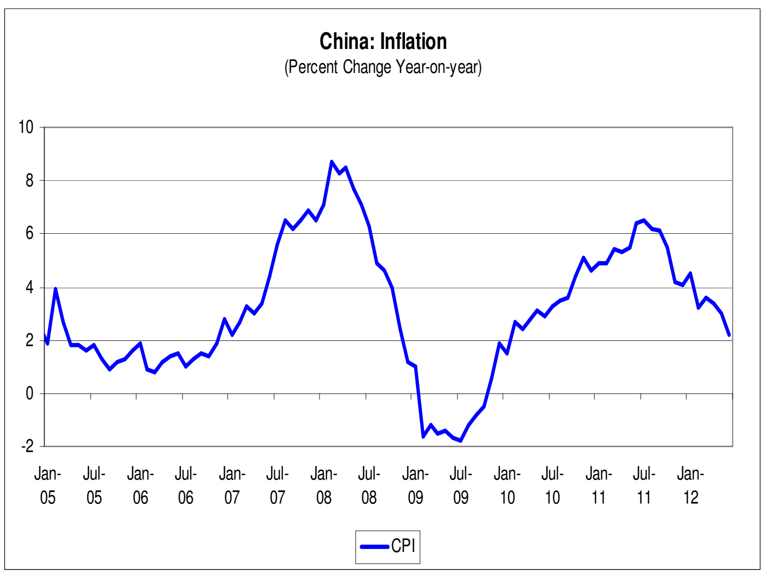
Miami
+1 305 553 2211
flarios@decisioneconomicsinc.com

China: Policy Shift Intensifying

Market views of China during the past few weeks have turned increasingly pessimistic, as economic data reveal a persistent deceleration of growth. Ironically, perhaps the focus should be elsewhere: on the appearance of a more decisive shift of the policy stance that, barring extraordinary circumstances (i.e., a global financial crisis) could prove to be a (positive) game-changer as regards the evolution of China's real GDP over the next 12-to-18 months.



The cooling trend is indeed very clear. Annual inflation in June was only 2.2% year-on-year; sequentially, the series is deflating. This week's expected releases on retail sales and investment need to be watched closely; they are likely to explain the loss of dynamism evident in China's imports, which grew only 6.3% year-on-year. Ironically, exports have continued to grow at a stable rate, slightly above 10% year-on-year: a respectable result, although far below the historical norm; also, a vulnerable status quo, given the deepening recession in Europe and the slowing US economy.



All of this, perhaps with the exception of the speed at which disinflation is occurring, helped as well by dropping commodity prices. But this is not news. What seems to have changed is the government's stance, which is shifting away from a very limited response, a policy that assigned priority to "rebalancing of growth", i.e. avoiding the traditional method of boosting the economy through credit-growth and public sector investment increases. Now, lending is growing at a faster rate, and Prime Minister Wen Jiabao has indicated that it is "important to promote reasonable growth in investment"--the strongest official acknowledgement to date that the deterioration of economic conditions has cornered them into a more decisive stimulus policy.