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Improved Fundamentals Support China's First-Quarter GDP Growth

Strong momentum seen in China's first quarter real GDP growth won't help to quell market fears of renewed growth and inflation risk. But those fears ignore ongoing trends in trade, investment and demand that suggest the economy is heathier, and actually making a turn for the better.

First-quarter real GDP growth came in at 9.5% year-over-year, matching the fourth quarter gain and above the consensus forecast of around 9.0% (**Display 1**).

But we don't see the significance of these numbers. In our view, China's quarterly GDP statistics are hardly a reliable gauge of the direction of the economy. For the past five years, year-over-year growth in first-quarter real GDP has been higher than the prior fourth quarter, regardless of the stage of the economic cycle. The only exception was in 2004, when the year-over-year growth rate at 9.8% was basically flat from 9.9% in the fourth quarter. Government officials have not been able to explain this pattern.

Besides, firm first-quarter GDP growth should have been well anticipated, given recent trade trends. A massive swing in net exports was reported in the first quarter, as the trade surplus reached US$16.6 billion against a deficit of US$8.4 billion in the first quarter of 2004. This represents a turnaround in the trade account of some US$25 billion, about 1.6% of annual GDP and a massive 6.6% of first quarter GDP. Even if we take into consideration the negative terms of trade in the quarter, the contribution of net exports to real GDP should remain significant.

More important than net export figures to us is the investment-induced import slowdown that has occurred since mid-2004. This slowdown has led to a dramatic turnaround in the trade balance of base metals, which, together with the expansion in textiles and apparel and motor vehicles exports, has helped China's trade surplus to surge over the past two quarters.

Demand dynamics also have changed. Retail sales data suggest domestic demand stayed firm in the first quarter, largely the result of robust consumer spending and less so by runaway local investment activities. Indeed, real retail sales growth was 11% year-over-year in the first quarter, basically maintaining the growth of the prior quarter. Underpinning this was a strong 11% year-over-year rise in per capita household income of urban residents and a staggering 16% increase in rural income during the first three months. Empirical evidence of the sharp rise in employee compensation also supports the strong consumption story in 2005.

Another reason we remain sanguine about China's economic stability is that the structure of the country's investment environment has changed. Nominal fixed asset investment growth eased marginally in the first quarter to 22.8% year-over-year from 23.7% in the fourth quarter, although admittedly, it was stronger than both market expectations and the official annual growth target of 16%. (We estimate that real growth rebounded somewhat to 17% in the first quarter from 16% in the fourth quarter.) While at first sight this might appear worrisome, inspection of January and February data reveals that investment flows have shifted from overheated to bottlenecked sectors. A full breakdown of investment is not yet available for March, but reports so far show that investment has expanded greatly in bottlenecked sectors. Indeed, investment in railways increased by a staggering 430% year-over-year; in coal surged 86%; in electricity/utilities was up 44%; and in agriculture jumped 40%, in the first quarter.

Finally, high-profile central government measures to curb property prices in Shanghai seem to have produced results. To be sure, high-end property prices have softened over the past few weeks and secondary market transactions have decreased noticeably after the tightening of bridge loans for property transactions. Importantly, we see this as an attempt by Beijing to prove that the influence of the so-called ‘Shanghai Gang’ over central government policies has faded.

Overall, we expect that a slowdown in property investment will lead to a further unwinding of China’s investment bubble, on top of the restructuring that is evident in some upstream sectors.

Policy Implications

We don’t think that the first-quarter economic releases have immediate policy implications. The overall mix of growth is within the range of expectations of policymakers, and consequently, we do not expect the central bank will rush to hike rates, nor renew credit tightening via stricter loan allocation, in the near term.

Our main concern is that the worsening external environment may prompt Beijing to hold off on a currency adjustment. At this writing, chances of a RMB revaluation occuring in 2005 look increasingly grim. Key factors affecting the decision include potential trade sanctions on Chinese exports by the US, a deteriorating Sino-Japanese relationship, and uncertainty with regards to China-Taiwan relations following next week's historical mainland visit by Mr. Lien Chan, the head of Taiwan’s main opposition party, Kuomintang.

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Display 1: Underlying Strength of China's Economy Remains Strong

Key Economic Trends in China

	1Q05	4Q04	3Q04	2Q04	March 2005	February 2005	January 2005	December 2004
Real GDP (YoY %)	9.5%	9.5%	9.1%	9.6%	-	-	-	-
Fixed asset investment (YoY %)								
Nominal	22.8%	23.7%	28.5%	24.6%	N/A	24.5%	24.5%	21.3%
Real	17.2%	15.8%	21.5%	19.5%	N/A	19.1%	18.7%	14.2%
Retail sales (YoY %)								
Nominal	13.7%	14.2%	13.5%	15.0%	13.9%	15.8%	11.5%	14.5%
Real	11.2%	11.9%	9.6%	12.1%	10.9%	11.0%	8.2%	10.6%
Industrial Production (YoY %)	16.2%	14.9%	15.8%	17.6%	15.1%	12.3%	20.9%	14.4%
Consumer Price Index (YoY %)	2.8%	3.2%	5.3%	4.4%	2.7%	3.9%	1.9%	2.4%
Producer Price Index (YoY %)	5.6%	7.9%	7.0%	5.7%	5.6%	5.4%	5.8%	7.1%
Exports (YoY %)	34.7%	35.6%	34.7%	37.1%	32.8%	29.6%	42.1%	32.7%
Imports (YoY %)	12.2%	30.4%	30.1%	42.9%	18.9%	-5.0%	23.9%	24.6%
Trade balance (US$ Billions)	$16.6	$28.1	$11.5	$1.7	$5.7	$4.4	$6.5	$11.1

Source: State Statistical Bureau, CEIC Data and Alliance Capital Fixed Income estimates, April 21, 2005