



Weekly Notes on China's Economy

August 9, 2010. Worldwide Edition

Carl B. Weinberg, Chief Economist

Sustainable Growth

Quite a bit has been written recently about returning China's economy to a sustainable rate of growth. So the question has to be asked, what is a sustainable rate of growth for China? Waiting, as we are, for the first salvo of monthly economic data for July, we have time on our hands to ponder the longer-term picture.

The obvious answer starts with the last chart on this page. Over the 31 years for which consistent data are available, China has averaged 9.8% GDP growth per year. If you run a regression across those 31 yearly observations, you will find the trend in growth is increasing. Compared to that trendline—which we think of as China's demonstrated potential growth rate—the economy has grown faster than trend in two of the last five years, below trend in two of them and just about on trend in one of them. *To the extent that we can extrapolate from history what is possible in the future, the trend rate of China's GDP growth over the last five years is sustainable.* While the recent data put year-over-year GDP growth at 11.9% in Q1 and 10.3% in Q2, both faster than the sustainable growth rate, these two quarters follow five quarters of GDP growth below trend.

This seems to us like a normal economic cycle. The economy is now recovering from a cyclical downturn—a period of subpar GDP growth. Cyclical downturns need not mean economic contraction! Contraction only occurs when trend growth is modest, or when the downturn is severe. Neither is the case in China. In a normal economic cycle, a period of below-trend growth is followed by a few quarters of above-trend growth, in a “recovery.” *This is what China's economy is experiencing today.*

Quite a bit of China's economic growth is occurring in the cities. A few weeks ago, we analyzed how strong migration trends from the countryside into the urban centers propels China's economy. A worker in an urban center contributes about 12 times as much to

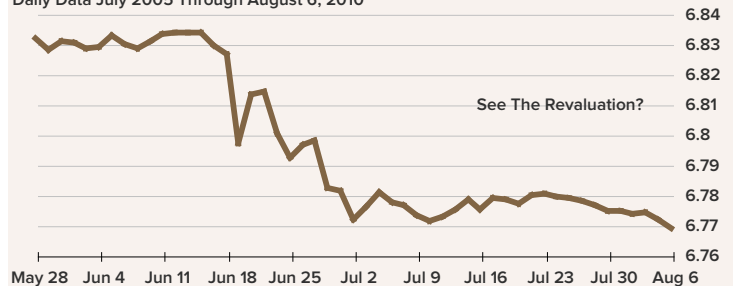
Recent & Upcoming Economic Releases

Date (Est.)	Content	Expected/Actual	Prior
July 11	Foreign Exchange Reserves (6)	\$2.454tn	\$2.447tn
July 15	GDP (Q2) %chya	10.3%	11.9%
August 1	CFLP PMI (7)	51.2	52.1
Soon	Trade Balance (7)	+\$20.83bn	+\$20.02bn
Soon	Exports (7) %chya	37.1%	43.9%
Soon	Imports (7) %chya	30.5%	34.1%
Soon	M1 (7) %chya	23.4%	24.6%
Soon	M2 (7) %chya	18.8%	18.5%
August 11	CPI (7) %chya	3.2%	2.9%
August 11	PPI (7) %chya	5.9%	6.4%
August 11	Retail Sales Value (7) %chya*	23.6%	24.0%
August 11	Industrial Production (7) %chya*	15.5%	13.7%
August 11	Fixed Asset Investment (7) %chya		25.5%
Soon	Cumulative FDI (7) %chya		39.6%

* Data derived from levels, do not match official releases.

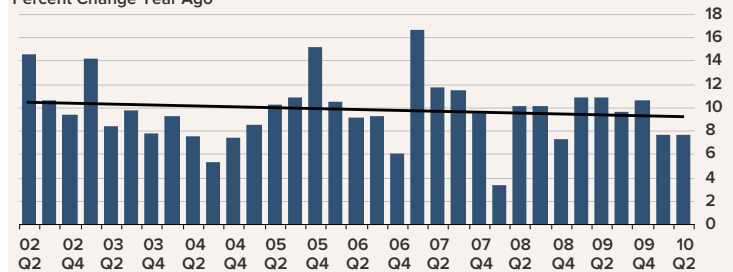
Yuan Per U.S. Dollar

Daily Data July 2005 Through August 6, 2010

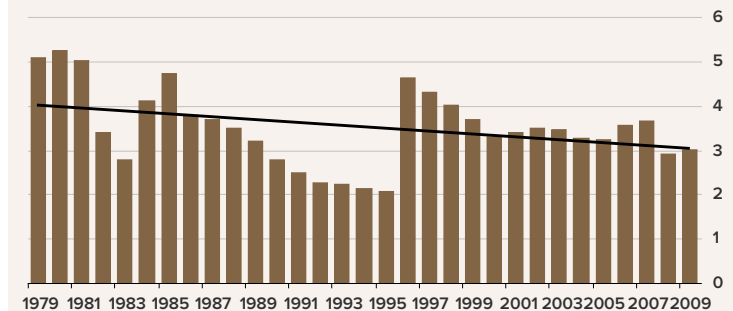


China: Per Capita Urban Household Real Income

Percent Change Year Ago

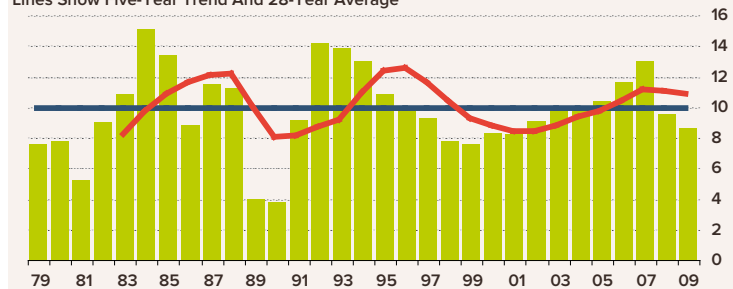


China: Urban Labor Force Growth, Percent



China: Real GDP, Yearly Percent Change

Lines Show Five-Year Trend And 28-Year Average



GDP as a worker in the countryside. Our chart on page one, updated now to include 2009 data, shows that migration from the country to the cities continues at a 3% yearly pace. At 9.1 million migrations, 2009 saw the third-greatest yearly increase in the urban population in terms of number of workers. *The primary mechanism of economic growth is still functioning, pulling people off the farms almost as briskly as ever before.*

Meanwhile, wages in the urban centers continue to rise. While we have all been impressed by the quantum increases in hourly wages recently won at a few prominent factories, the broader picture is that real disposable incomes of urban workers have been averaging just under 10% per year growth. This is astounding. This pace declined to only 8% per year in the recent downturn.

Put together 8% growth of real disposable income per worker and 3% growth in the number of urban workers to figure that aggregate real income of workers in the cities could grow by as much 11% per year. That is somewhat below the recently reported rates of growth of real retail sales and consumers' expenditures.

It is worth noting that the process of migration is not a smooth one. A recent paper analyzes the demographics and income patterns in "urban villages," based on survey data collected two years ago. These settlements of migrant workers within established urban centers generally are not covered by official statistical data because the people who live there are officially residents of rural communities, from which they journey in search of itinerant work. Looking at cross sections of survey results, the authors identify age and experience factors that suggest wages and incomes may be rising faster in these communities than in the mainstream urban centers. Even though the *levels* of income may be lower than the urban norm, their *rates of growth* contribute to GDP growth when the income is spent in shops and on services in the cities.

We also have to consider that three quarters of China's population lives on the farm, where incomes are also rising. Real incomes per worker on the farms rose at a 9.5% pace in the second quarter, according to NBS's July 15 statement on the national economy. The farm population is decreasing by about 1% per year. *Taken together, the growth of real disposable incomes on the farms and in the cities adds up to real GDP growth just around 10%... exactly where the trendline says it ought to be.*

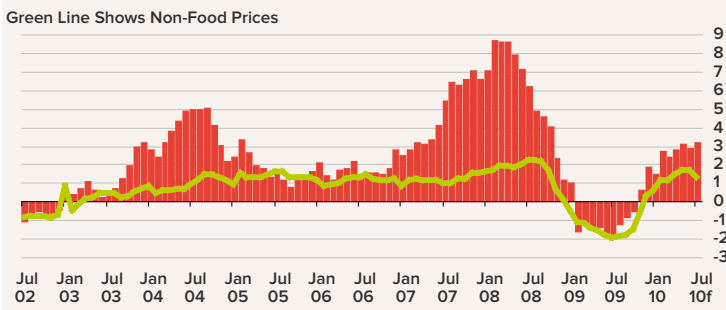
So yes, GDP growth probably will slow from the kinds of figures we have seen in the last two quarters... but not by much. With 900 million people still living in the countryside, there is a vast reservoir of people to move from the farms to the cities. We therefore see the potential for China's GDP growth to continue at its trend rate for decades to come, until some other resource gets in the way... like food supply, energy supply or land for urban and industrial development. *We see no sign of that yet.*

Carl B. Weinberg

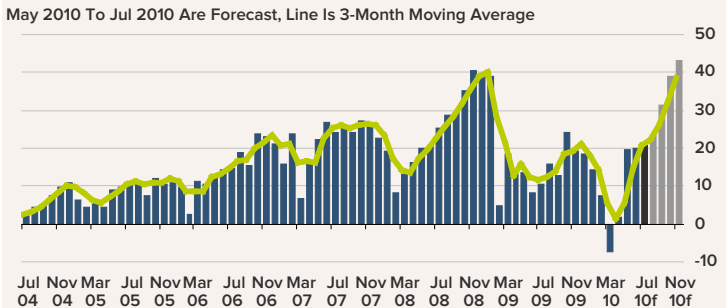
+1-914-773-2121

cweinberg@hifreqecon.com

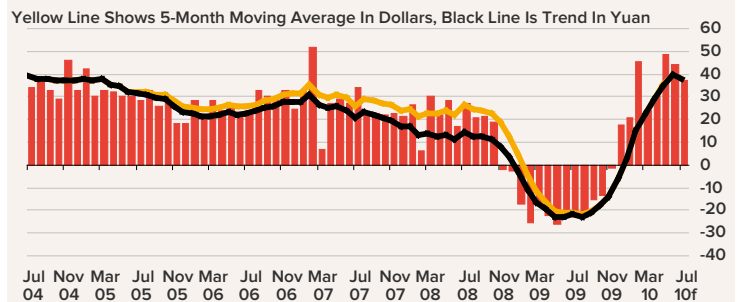
China: Consumer Price Index, Percent Change Year Ago



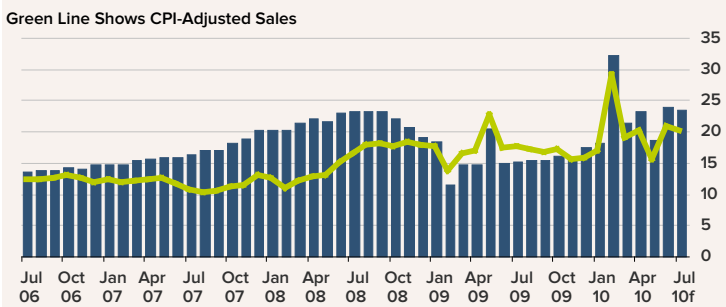
China: Trade Balance, Seasonally Adjusted, U.S. Dollars Billions



China: Exports, Percent Change Year Ago



China: Retail Sales, Percent Change Year Ago



China: Value Added In Industry, Percent Change Year Ago

