



## Weekly Notes on China's Economy

June 5, 2017. Worldwide Edition

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### Mining The New Axis

We have long argued in these *Notes* that China's long-term growth potential is set by the "demographic dividend" arising from the migration of workers from the farms to the cities. Each time a worker moves from a job on the farm to a job in the urban sector, his or her contribution to GDP growth goes up five-fold. A problem with that model for growth is that if it happens quickly, as China has experienced, the urban population rises so fast that migration's increment to the urban workforce diminishes each year as a percentage of the total workforce. At the same time—if we believe Adam Smith—the marginal product of urban workers declines as their numbers increase. *As of right now, the demographic dividend generates about 6-to-7% GDP growth. It used to generate 10% growth as recently as a decade ago.*

China enjoyed half a decade of hyper-strong GDP growth in the early aughts, when the demographic dividend was augmented by a special export windfall as China entered the WTO. Net export growth added a fillip to underlying growth of about three percentage points per year for five years. The problem with that windfall was that, like most windfalls, it could not last forever. China's low-cost exports quickly penetrated global markets and filled them to saturation. Once all the demand in, say, Britain for Topshop women's blouses, is entirely satisfied by goods made in China, exports of those goods by China no longer add to GDP growth. The level of China's GDP may be high because of those exports, but the rate of growth of GDP will not be affected at all.

So China can use more export growth to drive GDP growth back to its 9-to-10% potential rate. Yes, we know the official growth target for GDP is 6.5% this year. We view this as a political declaration rather than an economic forecast. It is an official statement that is meant to be exceeded at all costs. It is the minimum growth rate that the government will ever report.

### Recent & Upcoming Economic Releases

Date	Content	Expected/Actual	Prior
Apr 17	GDP (Q1) %chya	6.9%	6.9%
May 31	CFLP PMI (5)	51.2	51.2
June 9	CPI (5) %chya	1.4%	1.2%
June 9	PPI (5) %chya	5.2%	6.4%
June 14	Industrial Production (5) %chya	6.8%	6.5%
June 14	Retail Sales Value (5) %chya*	11.7%	10.7%
June 14	Fixed Investment (5) %chya ytd		8.9%
Soon	Foreign Exchange Reserves (5) trillions	\$3.032	\$3.030
Soon	Trade Balance (5) RMB billions	209.0	262.3
Soon	Exports (5) RMB %chya	11.5%	14.3%
Soon	Imports (5) RMB %chya	20.1%	18.6%
Soon	Aggregate Financing (5) RMB millions	1993.0	1390.0
Soon	M2 (5) %chya	10.6%	10.5%
Soon	M1 (5) %chya	17.3%	18.5%
Soon	Foreign Direct Investment (5) %chya		-4.3%

\*Official figure; HFE calculation of percent change differs.

### Trade-Weighted Yuan Index

Monthly Data, End Of Month Values, Last Datapoint Is June 2, 2017  
Lines Show One Standard Deviation Around Trend, Increase Signals Yuan Appreciation

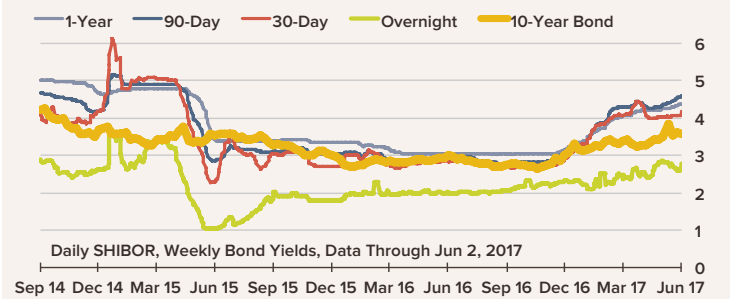


### Yuan Per U.S. Dollar

Daily Data Through June 2, 2017



### China: Daily SHIBOR Vs 10-Year Bond Yields, Percent



So can China sell more exports? The OECD export markets are not growing very fast at all, and China's export penetration there is all but surely maxed out. **China has to open up new markets for its goods and services. That would be the new EU-China trade initiative along the new Silk Routes.**

That new market includes 2.5 billion consumers in emerging economies with no way to go except to get richer. As they do, they will need a lot of the technology that Europe has to offer, and much of the consumer and capital goods that China has to sell. So Premier Li spent last week wooing Europeans away from the sphere of influence of the newly inward-looking United States, into trade deals with China

along the Silk Routes. At the same time, President Xi is working the other side, pushing trade deals with Kazakhstan, a key geographic link along the Silk Routes and also the holder of the eleventh-largest reserves of crude oil in world. Kazakhstan reserves are equal to the total proven reserves of Brazil, Algeria and Mexico combined.

The Silk Route initiative may have its flaws, and trade between China and Europe may have its rough edges. However, the new trade axis that seems to have been fired up this last week will open huge opportunities for companies in Europe to expand their export businesses by several quanta. This is a boon to everyone—consumers and businesses along the Silk Routes who will benefit from access to goods, as well as the exporters of those goods. Investors, too, will now be able to invest in China's economic growth by buying shares of exporters listed on more stable and transparent EU markets. *Cool!*

**Upside Down Still**

The inversion in the money market continues, pushing funding for bond speculators way above yields on the bonds themselves. Thus speculators in the market either pay or give up 4.6% to fund a bet on bond yields, but only earn a 3.6% yield on that money while they wait for a capital gain that possibly may never come. Thus, the PBOC is hammering speculators in the bond market, and that is seen as good.

China's yuan is being supported by higher interest rates, but not as much as you might think. Interest rate-generated capital inflows to China's money markets only partially offset other capital outflows. Most of the inflows come from funds domiciled in Hong Kong, and they mostly take the form of yuan deposits. Foreigners have no easy way to put offshore money into deposits in China. *However, there is still some topspin to the yuan from this interest rate-generated inflow.*

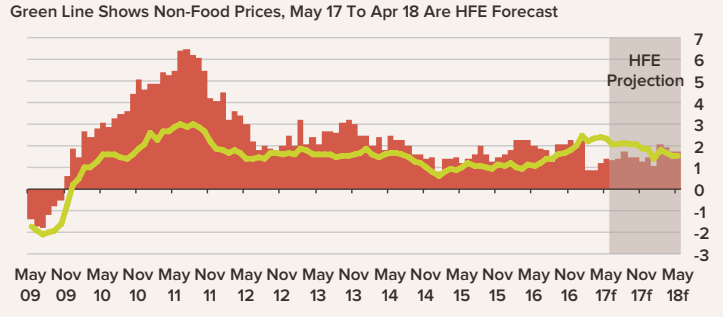
The real reason the yuan is climbing is because speculators, mostly in Hong Kong again, see topside potential for the yuan as the Silk Route initiative matures. The PBOC is also reportedly ready to jiggle the composition of the yuan basket to further reduce the weight of the U.S. dollar. That would reduce demand for dollars and boost demand for other currencies by investors who try to mimic the PBOC basket.

So we are looking for a stronger yuan, but also for continued increases in both short-term interest rates and bond yields.

**Here Come The Data**

Economic reports for May will begin to appear this week. For sure, we will see CPI and PPI reports on Friday. The basis effect from last year's oil price drop is coming out of PPI quickly: The headline index should slow to a 5.2% year-over-year rate of increase from 6.4%, with further slowing over the next few months. However, PPI has little to do with the prices consumers face. There, we predict no reversal of the drop in food prices at the start of this year. So CPI may accelerate

**China: Consumer Price Index, Percent Change Year Ago**



a tad in the May data, but to no more than 1.4% year-over-year after 1.2% in April. *There is no inflation risk here.*

At any time this week, we could see May results for foreign exchange reserves, trade and possibly money supply. The trade surplus should remain robust, although not quite as big as the record surpluses booked a year ago. By our estimate, FX reserves were trivially higher at end-May than at end-April. The implication is that strong capital outflows from China persist. As we see it, China is *using* its reserves to buy market share and access to technology, and to tilt competition to its gain in advanced economies. *We expect the yuan will continue to appreciate as long as foreign currency reserves are stable and the trade surplus is intact.*

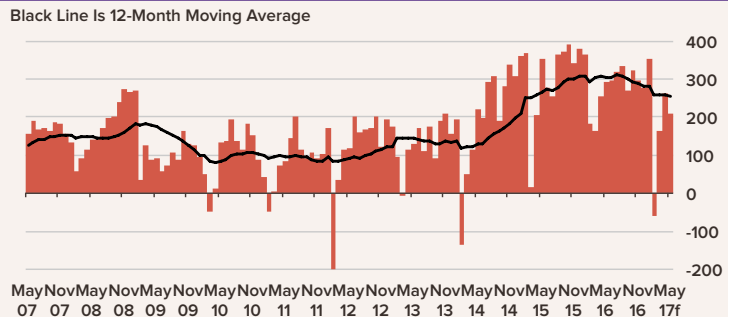
The activity side of the ledger—retail sales, industrial output and fixed investment—will not be reported until June 14. Our models predict slow but steady improvement in industrial output, and a more noticeable uptick in retail sales.

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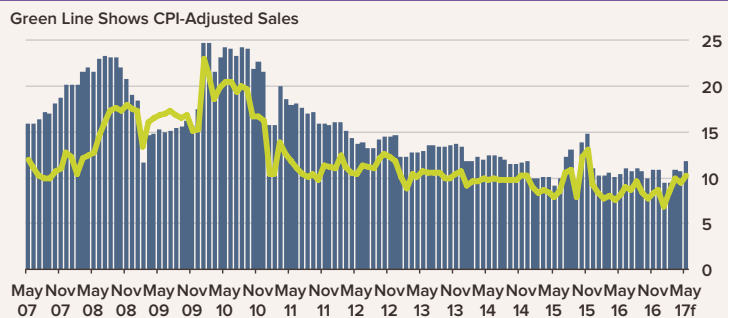
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**China: Trade Balance, Seasonally Adjusted, RMB Billions**



**China: Retail Sales, Percent Change Year Ago**



**China: Industrial Production, Percent Change Year Ago**

