



Weekly Notes on China's Economy

November 7, 2011. Worldwide Edition

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Development-Led Growth Is Immune To EU Woes

We have been very adamant that China is broadly immune to the economic and financial woes of Euroland. Reviewing our recent *Notes on China's Economy*, we realize that we have not made it clear why we think this is so. So here comes the Big Essay on how China grows and why Euroland's woes do not matter to it. The economic analysis behind this essay was first described by Nobel Laureate Simon Kuznets in his 1966 book, *Modern Economic Growth*, which today defines our basic understanding of "modernization," a process that has been experienced in all developed industrial economies.

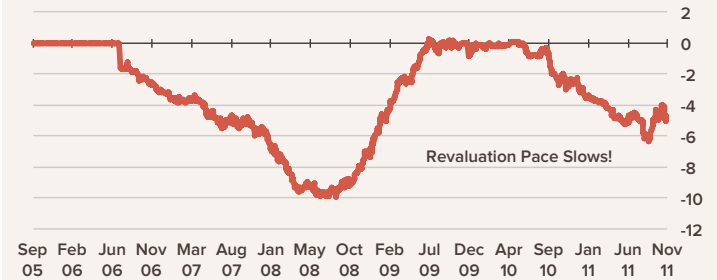
China's economy is modernizing. It is changing in structure from a rural agrarian society to an industrial one. The outstanding characteristic of this is the shift of the working population from agricultural labor to urban and industrial employment. The prerequisites of this process are numerous and complex. They include advancement in agricultural technology and medicine—lower infant mortality rates are important in creating excess labor on the farm—so workers are freed to work in the cities. Higher wages in urban employment propel the process. As our chart shows, this is what China has been experiencing. Kuznets' data suggest this process continues for half a dozen decades or more before it is over. China has been modernizing for thirty years now.

In China's case, moving a worker off the farm to the city increases his or her contribution to GDP growth by a factor of six. If you do this twenty million times a year, the pick-up in productivity in urban employment alone generates eight percentage points of GDP growth. Kuznets notes that the process of modernization is accompanied by high rates of economic growth per capita: Triple-digit increases were observed for decades in Europe, the U.S., Russia and Japan when they modernized. In China, GDP per capita is growing by about 140% per decade. GDP growth has averaged 9.8% per year for 30 years.

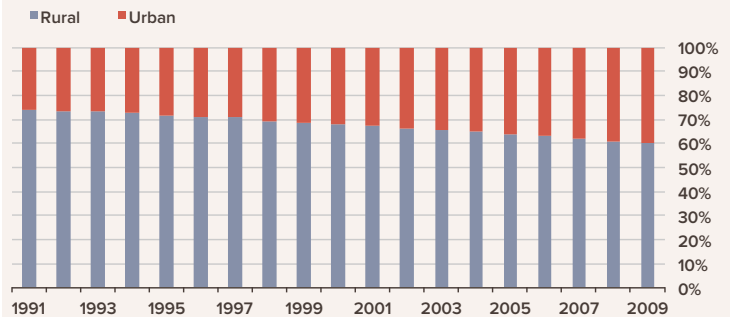
This process is entirely independent of whatever may be going on in Euroland. While credit and capital are required as part of this

Yuan Per U.S. Dollar, Percent Change Year Ago

Daily Data July 2005 Through November 4, 2011



China: Labor Migration Since 1991, Percent Distribution



process, China's huge growth rate is a magnet for foreign capital. *We can expect that a lot of internationally mobile capital will be headed out of Euroland looking for new venues, eh?* China's banks, meanwhile, may have their flaws and deficiencies, but exposure to Euroland's sovereign bond markets is not one of them.

Many people we meet fear that China will lose export sales to Euroland, and that will cause GDP growth to falter. *We disagree!* Total net export sales have contributed 0.5 percentage points per year, on average, to China's overall rate of GDP growth over the last 30 years. That is to say, 95% of China's GDP growth does *not* depend upon increasing exports. In recent years, the contribution of net export growth has been greater: In 2007, net exports added three percentage points to GDP growth. However, the economy grew by 14.2% that year, so it would have grown by 11% even without the windfall from sales abroad.

So where does demand come from in China? When people move from the farms into the city, they need consumer goods. They need an apartment, and they need tables and chairs and rugs and cookware and cups and saucers. As they get richer, they need flat screen TVs and iPhones and laptops. About 40% of the growth of China's economy comes from growth of consumer spending, and another 40% of its growth comes from investment spending on plant and equipment to make that stuff. Remember that people already in the

Recent & Upcoming Economic Releases

Date (Est.)	Content	Expected/Actual	Prior
Oct 14	Foreign Exchange Reserves (9) trillions	\$3.202	\$3.198
Oct 18	GDP (Q3) %chya	9.1%	9.5%
Nov 2	CFLP PMI (10)	50.4	51.2
Nov 7 - 10	Trade Balance (10) billions	+\$27.5	+\$14.5
Nov 7 - 10	Exports (10) %chya	19.8%	17.0%
Nov 7 - 10	Imports (10) %chya	24.4%	21.1%
Soon	M1 (10) %chya	7.6%	9.6%
Soon	M2 (10) %chya	12.7%	13.1%
Soon	Bank Lending (10) RMB billions	256.1	470.0
Nov 9	CPI (10) %chya	5.5%	6.1%
Nov 9	PPI (10) %chya	6.1%	6.5%
Nov 9	Retail Sales Value (10) %chya	20.7%	17.2%
Nov 9	Industrial Production (10) %chya	14.2%	13.8%
Soon	Fixed Asset Investment (10) %chya		24.9%
Soon	Foreign Direct Investment (10) %chya		7.9%

cities are also experiencing income gains. They buy new stuff, too. About 10% of China's GDP growth comes from public spending.

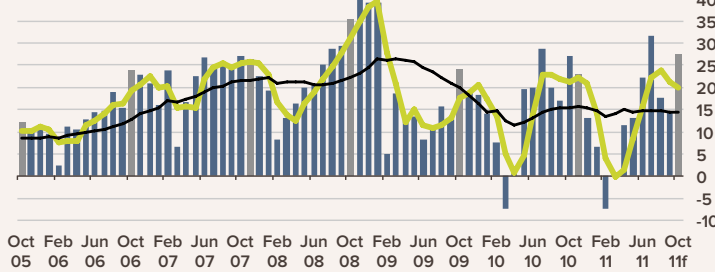
By the way, if this list of goods purchased by China's domestic households sounds to you like the inventory of your local WalMart, you are correct. China's factories produce the same goods for Chinese consumers as they make for export. They just make and sell more of these goods at home, where demand growth by new urban households is a lot bigger and will last a lot longer than the market for replacement items abroad.

So demand growth in China is driven by the demographic shift caused by modernization. With 465 million people still working on farms—and with 750 million people living in the rural economy—there is an ample supply of rural labor to fuel the growth of China's modernization process for a long time. Other constraints may come to bear on the process—energy supply, materials supply, pollution and other environmental limitations—but the big process of modernization is set to punch ahead for decades to come.

Euroland's financial system can blow up, but China's economy will continue to grow... vigorously.

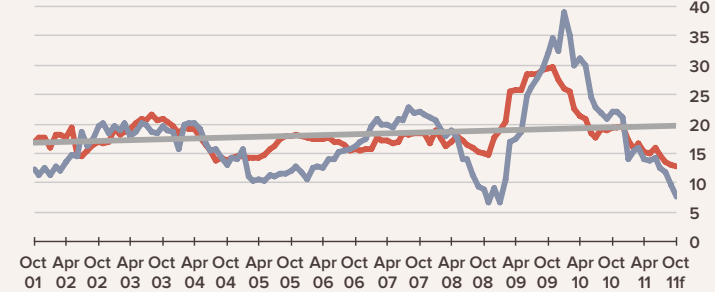
China: Trade Balance, Seasonally Adjusted, U.S. Dollars Billions

Green Line Is 3-Month Moving Average, Black Line Is 12-Month Moving Average
Gray Columns Mark September Figures



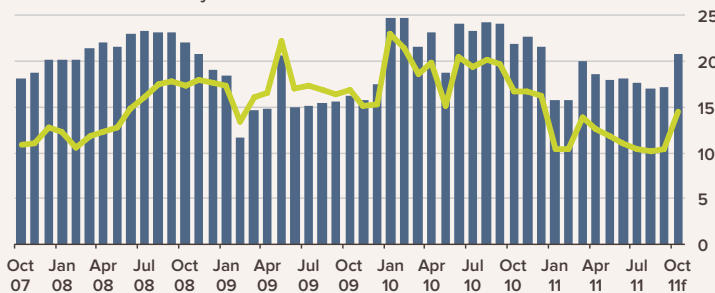
China: Money Supply, Percent Change Year Ago

M2 M1 M2 Trend



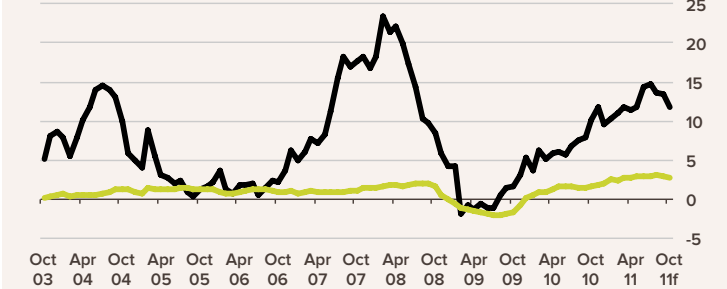
China: Retail Sales, Percent Change Year Ago

Green Line Shows CPI-Adjusted Sales



China: Consumer Price Index, Food Vs Non-Food Elements

Percent Change Year Ago, Green Line Shows Non-Food Prices, Black Line Is Food



Economic Data For October

The round of economic reports for October will be published this week. We will be looking for evidence of renewed consumer demand as consumer prices—specifically food prices—slow. The anecdotal evidence is that the flat agricultural output of the last year will be at least partly reversed by big crops in this autumn harvest. We also understand that short-term cash crops—fruits and vegetables—have seen record plantings in response to the shortages and price spikes of last year. *The only thing that was wrong with consumer prices was the rise in food prices. Non-food price increases remain below 3% year-over-year, near or below historically normal rates.* As we have noted before, lower food prices will free up discretionary income to be spent on other goods and services. The jump in retail sales is the companion to the drop in the CPI's rate of increase.

Other reports will show money supply under control, and industrial output rising slightly. The overall tone of the data should be positive.

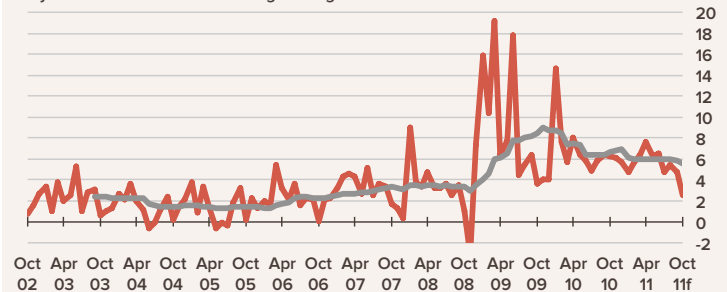
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China: Bank Lending, RMB Billions

Gray Line Shows 12-Month Moving Average



China: Value Added In Industry, Percent Change Year Ago

Yellow Line Is 12-Month Production Trend
Blue Line Is PMI Divergence From 50 To Oct 11f (Left Axis)

