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HD **China has plenty of cards to play on its economy**

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Fiscal policy China's new leaders are more likely to turn back to fiscal stimulus to fire their economy than to loosen monetary policy. Warren Hogan

The Chinese government must navigate the implementation of economic reforms while maintaining growth at a pace sufficient to keep unemployment steady. This is a difficult task for any government, and particularly so for the Chinese right now, as many critical reforms to the economy will be potentially disruptive to growth. This is all happening at a time in which most analysts and markets are worried about a significant loss of momentum in the Chinese economy.

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To delay reforms is in itself a risk to growth, albeit over the medium term. China's financial system presents a number of problems for its government. It is not allocating capital effectively, unregulated elements are growing rapidly, and the monetary policy transmission mechanism is under question.

Most of the immediate concerns around China focus on a collapse in property prices and construction activity. We do not believe China's property market is a macro-economic bubble waiting to burst. House prices have been volatile in recent years and there is nothing to say that the recent softening is any different to recent cyclical slowdowns. Furthermore, there have been major constraints on the market including tight lending conditions and a variety of curbs such as restrictive loan-to-value ratio targets for borrowers.

The major concern around the residential property market is construction activity, which looks to be more vulnerable to a slowdown than at any time since the global financial crisis. Developers are pulling back on land purchases and building commencements are slowing. As a result, construction is expected to slow down and help the market rebalance as demand softens. With this slowing comes the risk of a significant retrenchment which requires monitoring.

Despite these challenges, it should be clear that there is no disaster scenario on the horizon for China, no matter how dysfunctional the financial system appears to be. There is no "Lehman moment" just around the corner. China is, if anything, over-insured. It runs a savings rate of almost 50 per cent of GDP and presently has approximately $US4 trillion ($4.28 trillion) in FX reserves.

China can bail itself out of any financial mess that comes its way, and has been doing so for decades. That doesn't mean there won't be hiccups and volatility – because there will. Indeed, the noise around the Chinese financial system is likely to pick up as reform efforts continue.Growth targets the main priority

What we do know is from a policy perspective, reform momentum has taken a back seat to growth momentum in recent months. Premier Li Keqiang has targeted growth of 7.5 per cent. He sees it as critical to "hit the target" early in his term of government for his own credibility with the Chinese people. One could argue he needs this credibility to push forward with key reforms. In this sense the current hiatus in reforms is no big deal. The problem is if they run the macro-economy too hard, it could exacerbate any imbalances that are building in the finance and property sectors.

For **China** and Li, a desired slowing in **property** activity risks not achieving the growth target this year. Ideally, this would be offset by stronger activity from private sector SMEs and households. Easier monetary conditions, which have been kept quite tight in recent years, would help. The problem is the complexity of monetary policy operations at this point. It's not as simple as just reducing the required rate of return. The bulk of bank funding costs are determined by the deposit rate; this must also be cut.

Finally, the authorities want to make sure any new credit goes to the right sectors. This would require some diligent administrative guidelines for the banks as well. All of this makes one wonder how effective domestic monetary easing would ultimately be. It also does not factor in the possibility that lower interest rates in the core banking system might add to growth in the shadow system.

For **China**, a weaker currency would be very helpful at present. It would build on the momentum appearing in the export sector – the result of both a weaker currency and a stronger regional economy. However, a weaker currency will be hard to achieve in a world of quantitative easing. Although the Fed continues to taper, the European Central Bank is upping the production of liquidity while flagging the possibility of a full-scale QE at some stage. Meanwhile, the Japanese may need to up their QE efforts if they are to meet their inflation targets. The People's Bank of **China** may end up intervening in the FX markets just to keep the yuan from appreciating.

The latest numbers suggest that **China**'s economy is moving along at above a 7 per cent pace. If it does show signs of faltering, the government may need to refocus on fiscal policy, as manipulating monetary conditions appears particularly fraught at present. We have no reason to believe renewed fiscal stimulus will not be infrastructure-intensive and therefore good for commodities. The **Chinese** government has announced plans to build metro transport systems and redevelop shanty towns in the central and western provinces.

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