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FALCON PERSPECTIVES

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SOFT LANDING EXPECTED IN CHINA

China's economy has cooled off more sharply than expected. The slowdown in the momentum of the world's second-largest economy has fueled fears of a new global recession (double dip). We do not anticipate a hard landing in China, however. The measures implemented by the government, primarily in the real estate sector, are set to put the economy back on a sustainable growth path.

China will remain a key source of stability for the global economy going forward. The gradual appreciation of the renminbi will have a positive impact on Chinese consumption, and the domestic stock market has corrected by more than 20 percent since the start of the year.

Although China's economy is still expanding at a rapid rate, the world's growth engine has lost some of its momentum. The rise in gross domestic product (GDP) slowed to 10.3 percent in the second quarter, following a rise of 11.9 percent in the first three months of this year. However, growth was still well above the government's target of 8 percent. The weaker growth is likely due first and foremost to the numerous government measures intended to cool the economy. The government has responded quickly to fears raised since the start of the year that the Chinese economy could overheat, implementing administrative measures to limit speculation in the real estate sector and instructing the state banks to adopt a more restrictive approach to lending. It has also had to combat the accompanying rise in inflation, which in May reached 3.1 percent, its highest level for nineteen months.

The government's policy is starting to bear fruit, and for the moment the threat of overheating has been dispelled. Inflation surprisingly fell to 2.9 percent in June. The key factor for the ongoing performance of the economy is how hard China plans to step on the brakes in the second half of the year. Many economists anticipate that growth could slow to just under 9 percent by the fourth quarter. This still leaves the Chinese as the "world champions of growth", and fears of a hard landing therefore seem exaggerated at present. The restrictions on lending could be eased or the pace of investment projects stepped up again if necessary.

The announcement by the Chinese central bank that it intends to increase the flexibility of the exchange rate is a positive sign. This step is good news both for China and for the worldwide economy. The appreciation of the renminbi will enable the People's Republic to make an important contribution to reducing global imbalances. Global economic growth is set to be more stable overall. The Chinese consumption sector will also be strengthened, as consumer purchasing power will be increased by cheaper imports coming into China. The main beneficiaries of the stronger domestic demand in China will likely be exporters from smaller Asian economies such as Taiwan and South Korea, not to mention Japan. The stronger renminbi will also increase the competitiveness of these countries.

The Chinese stock market, as measured by the Shanghai A-Share Index, has already lost more than 20 percent of its value this year. The stock market is now valued at well below the long-term average. An aggressive entry into the market does not yet appear sensible, however. Equities may continue to suffer in the short term as growth expectations have to be revised downward once again. The gloomier economic outlook is likely to already be largely reflected in the much lower prices, but there is a danger that corporate earnings are still expected to be high. With this in mind, further short-term corrections cannot be ruled out.

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