IQ INSIGHTS

January 2015

The Outlook for the Chinese Economy in 2015

George R. Hoguet, CFA, FRM
Global Investment Strategist,
Investment Solutions Group

This article briefly reviews the outlook for the Chinese economy in 2015. We conclude that, while risks are to the downside, there is insufficient evidence to reject the consensus view that China will grow by 7 percent in 2015. Further, the roughly 60 percent drop in crude oil prices since June 2014 is positive for China, and should increase growth by at least 50 basis points in 2015.

In nominal GDP terms, China's output is valued at roughly $9.2 trillion, or 12 percent of total annual global output. By contrast, output for the United States is valued at approximately $17 trillion, or 22 percent of annual global output. China is now the world's second-largest economy, and is nearly twice as big as Japan, the world's next-largest. By 2030, it is estimated that the Chinese economy will surpass the US. Already, in Purchasing Power Parity terms (which adjusts for differences in domestic prices), China is the world's largest economy.

As China's economy continues to grow, developments there have a more tangible impact on the global economy, and particularly affect Asia and commodity-producing countries. For example, many Asian countries export more to China than to the US, and thus are more sensitive to economic conditions in China. And China's impact on global commodity prices is profound. For example, China represents roughly 59 percent of global demand for iron; 46 percent for nickel; 44 percent for zinc; and 45 percent for aluminum. Other channels by which China, now the world's largest exporter, impacts the global economy include:

1. trade and investment;
2. international monetary (China holds $1.2 trillion in US Treasuries, or approximately 9 percent of total debt held by the public);
3. environmental; and
4. national security.

The median estimate of 52 economists polled by Bloomberg as of December 23, 2014, for Chinese output growth in 2015 is 7 percent, with a high of 7.6 percent and a low of 6.5 percent. For 2015 Chinese inflation (CPI), the median estimate is 2 percent. And the median estimate for the Chinese current account as a percent of GDP is 2.2 percent, well below the high (10 percent) reached in 2007.

In its most recent World Economic Outlook (October 2014), the International Monetary Fund (IMF) forecasts that the Chinese economy will grow 7.1 percent in 2015. And in its most recent annual Article IV consultation, the IMF suggested that over the next five years China's sustainable trend growth rate was 6.5 percent to 7 percent per annum. This rate is roughly three times faster than current estimates of post-crisis US GDP growth, and roughly six times greater than 2014 Eurozone output growth! Even if Chinese growth were to disappoint in 2015, and reach just 6.5 percent, it is important to remember that the absolute level of growth is well above the level of growth in the developed world.

STATE STREET GLOBAL ADVISORS

Global investors, however, continue to be concerned about the pace of restructuring of the Chinese economy, weakness in the Chinese property market, and fragilities in China's shadow (non-bank) banking market. The fear is that a "hard landing" in China, where corporate indebtedness has risen sharply in recent years, could lead to a cascading series of defaults which could create financial instability and a sharp contraction in real economic activity. These risks exist (just as the risk of a debt restructuring by a major European sovereign exists in the medium term), but they are—in a probabilistic sense—small and containable, particularly in 2015. While China's medium term structural problems are large, the underlying economic dynamics are much more favorable than those of the Eurozone.

Importantly, the Chinese economy benefits from substantial monetary and fiscal policy flexibility, unlike many Western economies. And with $4 trillion in foreign exchange reserves and a central government debt to GDP ratio of 40 percent, China has more than ample borrowing capacity in the event of an external or internal shock. (Note that China's external debt rating by Standard and Poor's (S&P) is not too far removed from the US: AA+ for the US and AA- for China).

2014 in China—A Year of Intense Policy Activism

Economic developments in China in 2015 should be interpreted in the context of the far-reaching and ongoing reforms announced at the Third Party Plenum in November 2013. China is in the midst of a profound multiyear economic and political transformation. Some major goals are: to double per capita income (currently $6,560) by 2020; to avoid the so-called "middle-income" trap (where growth stalls); to liberalize the economy and let markets play a "decisive" role in the allocation of resources; to further integrate into the world economy; to reorient the economy to "consumption driven" rather than "investment driven"; and to further legitimize and enhance the role of the Communist Party.

Related to these initiatives are the consolidation of political power in the hands of President Xi Jingpin; a far-reaching and intense anti-corruption drive, with reportedly more than 180,000 officials disciplined and some "subject to public criticism"; and a more assertive foreign economic policy, with China promoting the BRICS Development Bank and Contingent Reserve Agreement and greater use of the RMB (notably its inclusion as a component currency in the IMF's Special Drawing Right.)

Intense policy activism characterized the Chinese economy in 2014. To the surprise of many skeptics, China experienced neither a dramatic deceleration of growth nor a "shadow banking" crisis. To be sure, evidence further accumulated that the economy was slowing from its blistering pre-crisis trend growth rate of roughly 9 percent to 10 percent per annum. (Following massive fiscal and monetary stimulus in the immediate aftermath of the Global Financial Crisis, the Chinese economy grew at 9.2 percent in 2009 and 10.4 percent in 2010.) Current estimates are that the Chinese economy grew by approximately 7.3 percent in 2014.

This slowdown is a result of conscious policy and reflects as well a lower *potential* growth rate in the economy. This reduction of potential reflects several factors, including:

- Slower productivity growth as the marginal benefit of capital improvements falls
- Demographic changes
- A less robust external environment. Chinese policymakers have indicated that a 7 percent medium growth rate is acceptable and is consistent with social stability. In fact, China created 10.8 million new jobs in 2014, 800,000 more than the targeted 10 million. Official unemployment stands at 4.1 percent.

China announced, and partially implemented, a flurry of reforms in 2014. These reforms were inter-related and reflect, among other things, dissatisfaction among Chinese citizens with pollution, corruption, and food safety issues.

A *very* partial list of reforms includes:

1. Financial reform
    - A joint People's Bank of China (PBOC) and regulatory directive (Document No. 127) to regulate interbank business among financial institutions. This initiative sharply curtailed the rapid growth of the shadow banking system.
    - Partial interest rate deregulation, with banks now able to offer 1.2x the benchmark deposit rate for local currency deposits vs. 1.1x before.
    - Several measures to promote the RMB, including the Shanghai Free Trade Zone; the Hong-Kong Shanghai Connect Program (which makes it easier to trade A shares); and an additional RMB Qualified Foreign Institutional Investors quotas totaling $47 billion. China also introduced plans to launch a deposit insurance scheme.
2. Fiscal reform

    China implemented measures last year to improve its budget management and tax systems, and to harmonize spending with receipts. It also performed a national audit of Local Government Financing Vehicles and issued several important directives, including *"The Plan to Deepen Fiscal Reform,"* a Budget Law that allows provincial governments to issue local government bonds; and various decisions on local finances, revenue collection and debt management. The overall impact is to add greater transparency and rigor to budget management in China.

Chinese authorities also launched a national property register, and initiated property tax pilot programs in some cities, the impact of which could be very significant.

3. Administrative reform

   China also announced several measures aimed at making it easier to start a business. In the first nine months of 2014, 1.8 million (!) new businesses were registered, 61 percent higher compared to the same time period last year. And new environmental powers make it easier for the central government to shut down polluting factories.

4. Household registration reform and land reform

   China issued details on reform of the household registration ("hukou") reform of migrant workers in small and mid-size cities. China has roughly 100 million migrant workers, many of whom do not benefit from a social safety net. Hukou reform is designed to reduce income inequality and promote social stability. Land reform focuses on clarification of contractual and management rights and will be a multiyear process.

5. State-Owned Enterprises reform

   These reforms focus on promoting mixed ownership, executive compensation and perquisites, and governance.

6. Selective liberalization of the one-child policy

The Chinese economy continues to be characterized by an astoundingly high rate of savings (49.5 percent of GDP) and investment (47.7 percent). (By contrast, the US invests 16.8 percent of its annual output.) During the massive stimulus years of 2008-2009, Chinese entities embarked upon several large investments that resulted in excess capacity in the manufacturing sector, particularly heavy industry. As part of the restructuring process, Chinese authorities have encouraged the shutting down of excess capacity in heavy industry, namely steel, glass and cement.

A related development has been the slowdown in the housing construction sector, particularly in the Tier III and Tier IV (smaller) cities. Urbanization is a key feature of China's modernization strategy but overbuilding by developers has led to oversupply in many cities.

Property development plays a prominent (but by no means dominant role) in the Chinese economy, and its slowdown proved to be the biggest drag on growth in 2014. In 2013, property development accounted for approximately 15 percent of GDP and 20 percent of bank loans. Several contractors recently have gone bankrupt, and housing prices have fallen about 3.5 percent this year, with sharper declines in smaller cities.

JPMorgan estimates that weakness in the property market and related industries (for example, steel, cement and furniture) will shave one percentage point growth from China's GDP in 2014. At the national level, a further 5 percent to 10 percent decline in housing prices is projected, with sharper declines in some areas.

Many Chinese house purchasers, however, buy houses on an all-cash basis, or finance only a modest portion of the purchase. At the end of 2013, the Non Performing Loan (NPL) ratio for mortgage loans in China was just .26 percent; for loans to real estate developers it was just .48 percent. For the banking system as a whole it was just 1 percent. While the construction sector will contract, the secular trend of movement from the countryside to the cities, and nominal GDP growth of around 10 percent should prevent a US sub-prime-like bust in China.

The Chinese Economy in 2015

Our core forecast is for the Chinese economy to grow in real terms by 7 percent in 2015. The Consumer Price Index will rise by roughly 2.5 percent, and M2 will grow at roughly 12.8 percent. We expect further monetary easing.

China's current account as a percentage of GDP will be approximately 2.5 percent with FX reserves growing around $300 billion in 2015. The RMB is likely to weaken slightly in 2015, but we do not envisage a sharp depreciation or appreciation greater than 3 percent. Outcomes of course are dependent on developments in the global economy as a whole, particularly the US and Europe.

In 2015, a continuing challenge for policymakers will be to continue to implement the process of restructuring the economy while at the same time avoiding an excessively rapid deceleration of economic activity. Two recent convocations provide some indication of their thinking.

The Fourth Party Plenum, held in late October 2014, issued the "CCP (Chinese Communist Party) Central Committee Decision Concerning Some Major Questions in Comprehensively Moving Governing the Country According to the Law Forward." This document (well worth a read) states that "reforms have entered a place of assault and deep characteristics." It emphasizes throughout the importance of the CCP, and moving the rule of law forward in China at all levels of society, including the Army. It also emphasizes the centrality of the law in achieving the "Chinese Dream of creative rejuvenation." This initiative further prepares the public for the anticorruption campaign, and reveals the importance of institution-building that Chinese policymakers ascribe to the development process.

A second forum occurred in December, when China held its Central Economic Working Committee Conference. Participants discussed economic targets for 2015. The conference published no official targets, but President Xi repeatedly emphasized the need to "stabilize" the economy and referred to the "economic new normal," i.e., a trend growth rate in the 6.5 percent to

7.5 percent range. The “economic new normal” stresses a transition from high growth of 9 percent to 10 percent per annum to modestly high growth of 6.5 percent per annum; consumption rather than investment-led growth and reduced income inequality; and a transition to innovation-led growth.

A major focus in 2015 will be to improve the quality of growth. “Old Growth” was focused on the export and property sectors, as well as heavy industry. “New Growth” will focus on the service sector, emerging technologies and pollution and environmental industries. Environmental problems are particularly acute in China and failure to address them could lead to both public health and social problems. A recent government study found that 20 percent of farmland is tainted by lead, cadmium, pesticides and other toxins.

China passed an important milestone in 2014. The service sector now represents 47 percent of GDP, and is now larger than the industrial sector. In 2015, we expect China to continue to shut down excess capacity and to emphasize the development of rapidly growing sectors such as clean energy.

Chinese Monetary Policy in 2015

Chinese policymakers are understandably worried that the trajectory to slower growth will overshoot, leading to insufficient job creation and social unrest. In late November, the PBOC, in a surprise move, cut the official one-year lending rate by 25 bps to 5.35 percent.

The objective of monetary policy in the PBOC is “to maintain the stability of the value of the currency and thereby promote economic growth.” China’s Producer Price Index has been negative for roughly 32 months. As in other parts of the world, policymakers in China may be worried about the emergence of deflationary forces in the economy. Decisions about monetary policy are ultimately made by the State Council, the supreme political entity.

The PBOC benefits from several policy instruments, including the Required Reserve Ratio (RRR), the central bank base interest rate, rediscounting, central bank lending and open market operations. The RRR is the most important instrument.

In November/December 2014 the PBOC injected funds into the banking system, including the China Development Bank, by various liquidity provision methods. The goal is to stimulate bank lending in China in the face of slowing growth and to cushion China’s economic deceleration. Central Bank easing has been good for the Chinese A share market. In 2014, the CSI 300 A share index rallied by 51 percent.

Consensus holds that Chinese administered rates will fall more in 2015, with the RRR falling by about 1 percent.

Chinese Fiscal Policy in 2015

China’s corporate debt has soared from approximately 90 percent of GDP in 2007 to roughly 137 percent at the end of Q3 2014. But Central Government debt as a percent of GDP has been quite stable, and stands at about 41 percent. In the unlikely event of the need to recapitalize Chinese banks, or to stimulate aggregate demand, China benefits from substantial policy flexibility. Its debt-to-GDP ratio is low in comparison with many emerging and developed countries; its capital account is closed; and foreigners hold a very modest portion of Chinese debt. (S&P rates Chinese local currency debt as AA-).

We expect that China will run a budget deficit in the order of 2.5 percent of GDP in 2015. Because nominal GDP growth is greater than real interest rates, China’s debt dynamics are not expected to deteriorate in the next few years.

The Shadow Banking System

A key objective of Chinese policy in 2015 will be to further restrain the growth of the Shadow Banking System. Alternatives to bank loans include trust company loans, wealth management products (promissory notes), guarantees, unofficial lenders and other lenders. The appeal of the Shadow Banking System to depositors/lenders is higher rates than can be obtained at commercial banks. For borrowers, it may provide access to credit that is not otherwise available.

The Financial Stability Board estimates that the shadow banking system in China represented about 32 percent of GDP in 2013. By contrast, the shadow banking sector in the United Kingdom stood at 337 percent of GDP, and in the Eurozone 194 percent. Many loans in the shadow banking system in China are secured by collateral or otherwise guaranteed.

Further financial sector reform, such as the freeing of loan and deposit rates, and loosening of quantitative limits, should help to restrain the growth of the shadow banking system. As suggested above, China has the resources to deal with a shadow banking crisis, although of course it would require highly proactive policy.

Conclusion

Coming into 2015, there is no doubt that China’s construction and heavy industry sectors are slowing. However, the export and service sectors continue to be robust. The Chinese economy has embarked upon an ambitious, multiyear restructuring. In its annual Article IV consultation (July 2014) with China, the IMF suggests that the challenge of demand management in China is to allow the adjustment process to proceed, while at the same time avoiding a sharp slowdown. China’s opaque financial system, and particularly the use of guarantees, poses challenges for regulatory policy. But in 2014, despite widespread fears of defaults in the shadow banking system (including wealth management products, trust company loans, and local government financing vehicles), very few entities defaulted. In the event of such defaults, China also has the fiscal flexibility to assume bad debts and engage in fiscal stimulus. The consensus estimate for Chinese growth of 7 percent in 2015 is reasonable.

Of course, surprises will develop. (And the anti-corruption drive could lead to a political backlash.) But Chinese policymakers are acutely aware of the imbalances in the economy and are addressing them. Given the proactive policy stance and substantial policy flexibility, there is insufficient evidence to expect a sharp slowdown in growth in China in 2015.

Sources: Bloomberg, Brookings, IMF, JP Morgan Chase, People's Bank of China, Standard & Poors
www.https:// chinacopyrightandmedia world.com/2014