GavekalDragonomics

March 2016

China: Just How Worried Should We Be?

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China's economy: how worried should we be?

Worry # 1: Capital flight and a collapsing currency

- Capital flight is not a big problem (yet)
- More RMB devaluation is a real risk in late 2016/early 2017
- Key question is credibility of new exchange rate regime

Worry # 2: 'Hard landing' – short-term growth crumbles

- Risk is small: activity picked up in Q4 2015
- Government is mobilizing fiscal and monetary support
- But in USD terms China's global growth impact has already weakened dramatically

Worry # 3: 'Long landing' – economy gradually stagnates

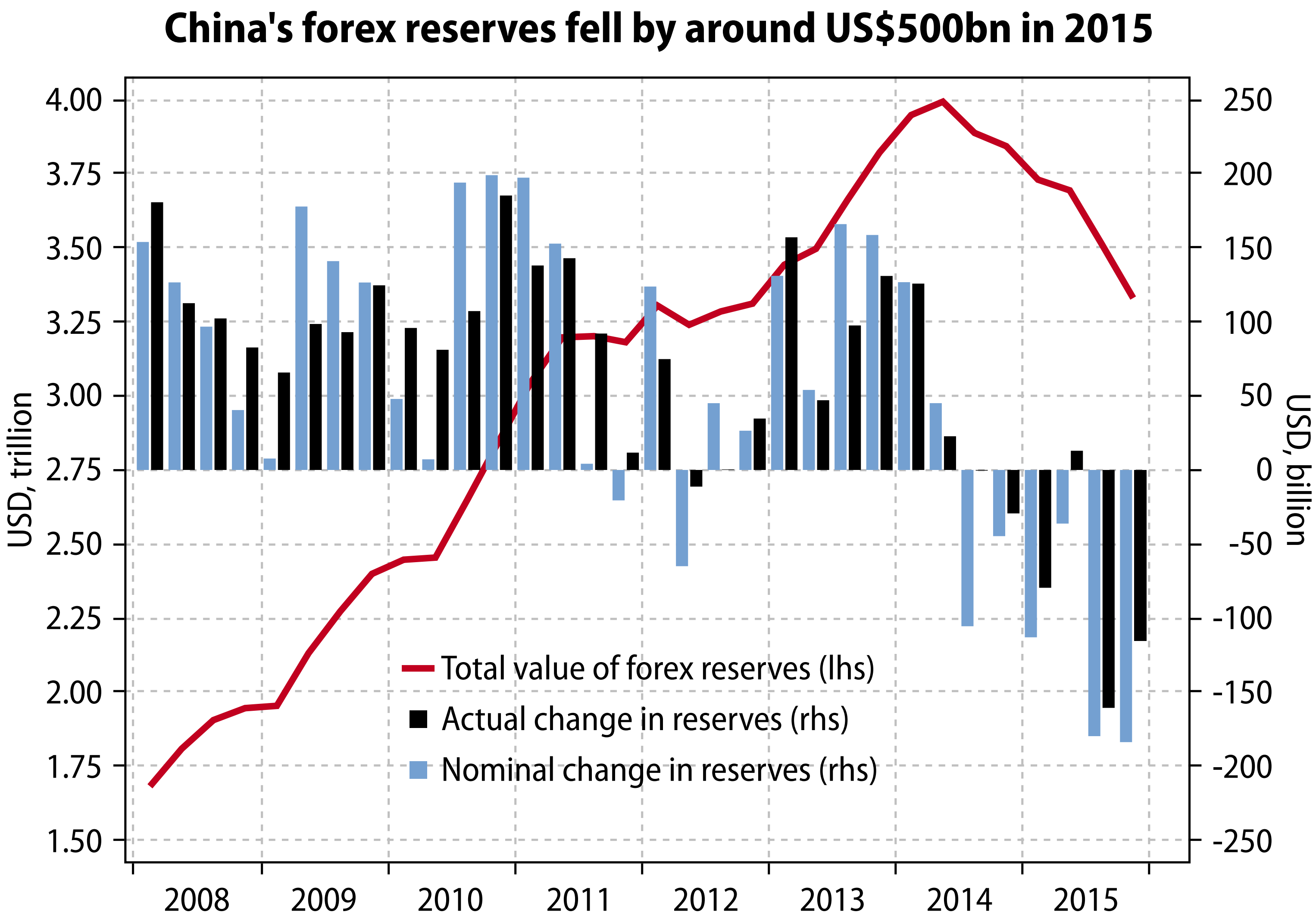
- Depends in part on success of reforms, especially to SOE sector
- The bigger question is whether a dynamic economy is compatible with Xi Jinping's agenda for ever-tighter Party control

Worry #1: Capital flight and a collapsing currency

Capital outflows do not necessarily mean 'capital flight'

- Large capital flows in both directions are to be expected in an economy of China's size and openness.
- We can distinguish between 'good' and 'bad' capital outflows:
  - **Good:** Unwinding previous speculative inflows; repairing currency mismatches on balance sheets
  - **Bad:** Money moved out of the country because of a loss of confidence (at worst, shows up as a decline in bank deposits)
- Available evidence suggests 70% of China's outflows are 'good.' Dollar liabilities are being paid down, while domestic deposits continue to rise.
- So the critical issue isn't whether China's economy is at risk from capital flight. It's not.
- The key question is the credibility of the exchange-rate regime.

Everyone's worried about the erosion of forex reserves…



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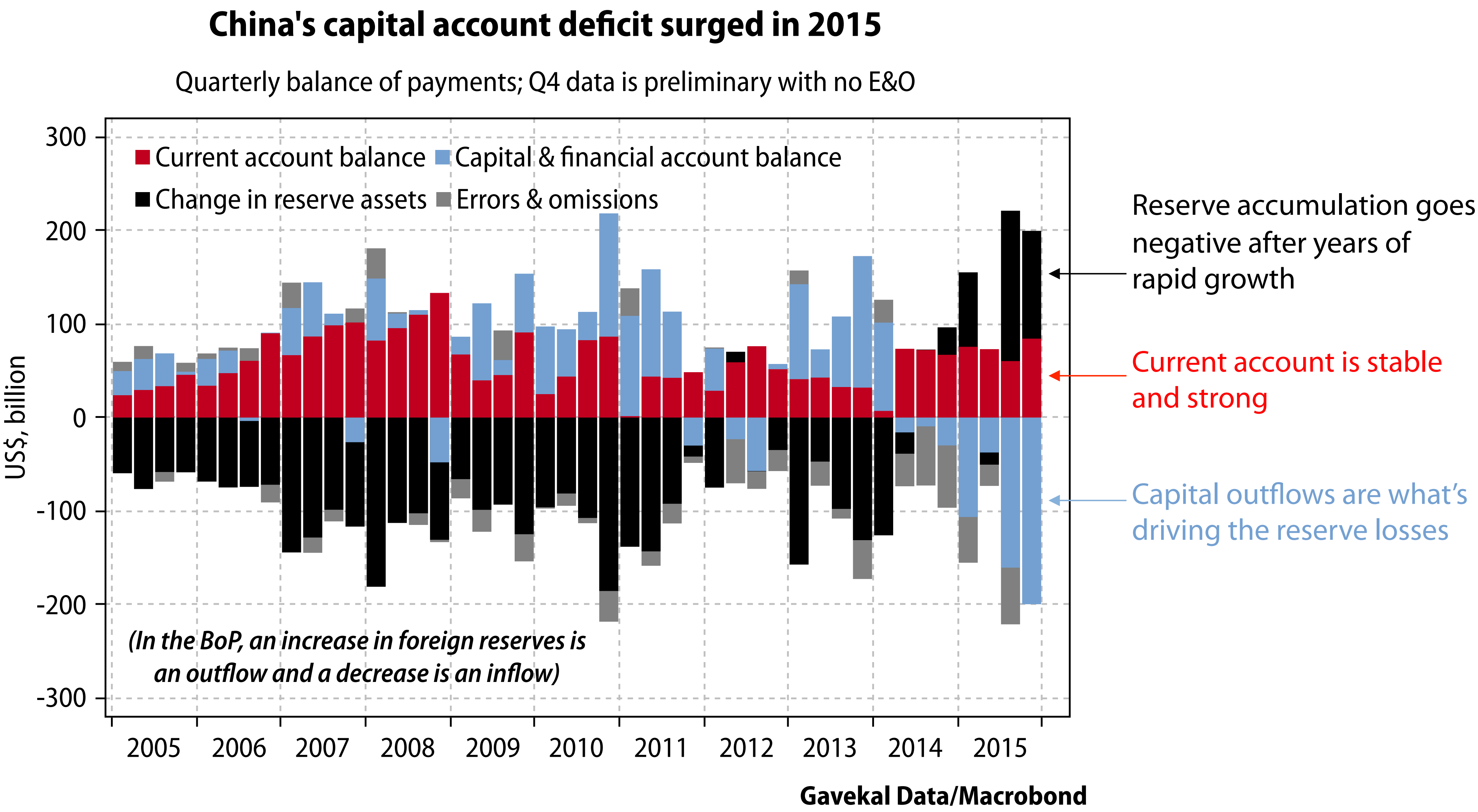
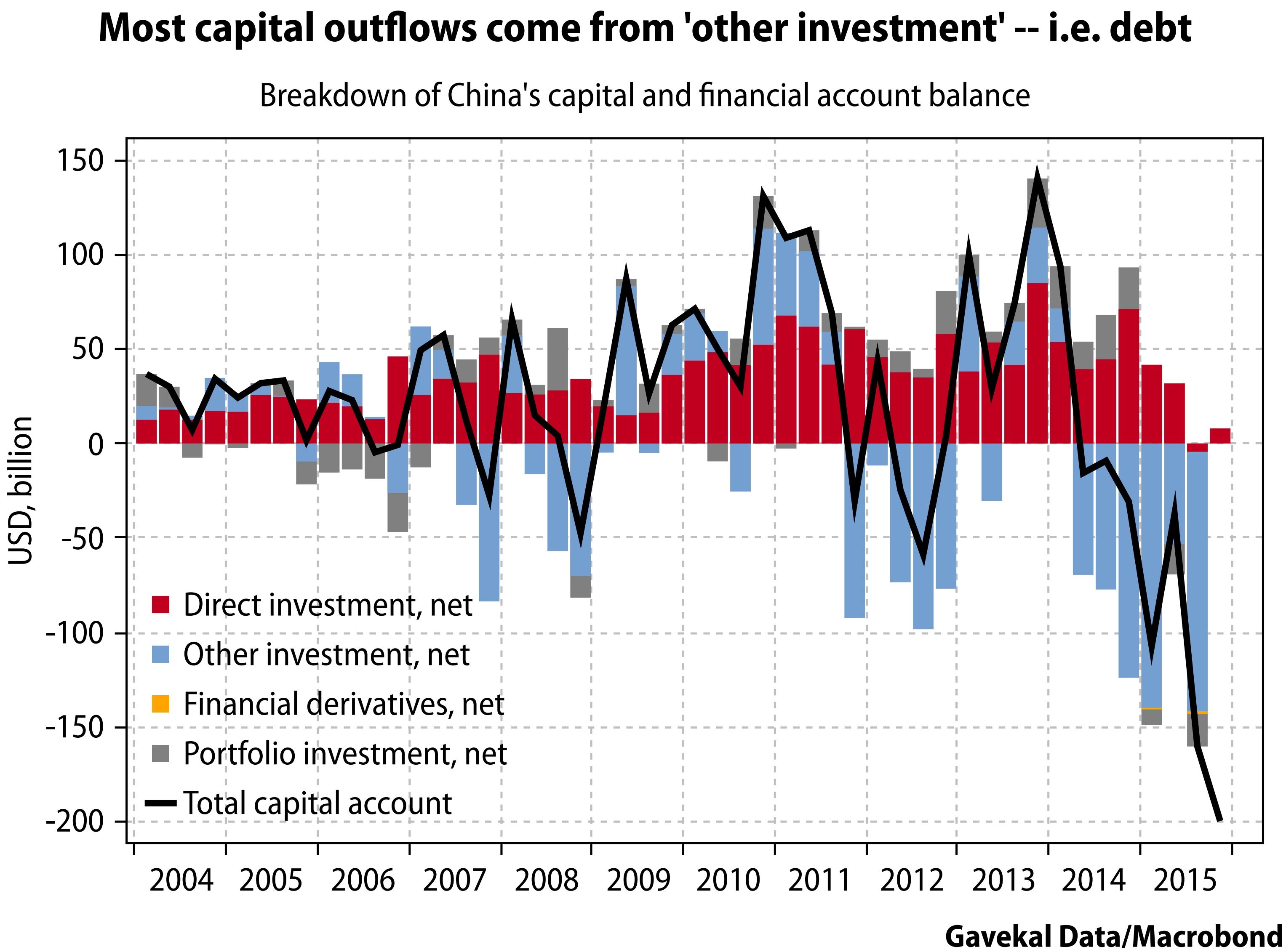
. . .which mainly reflect capital outflows



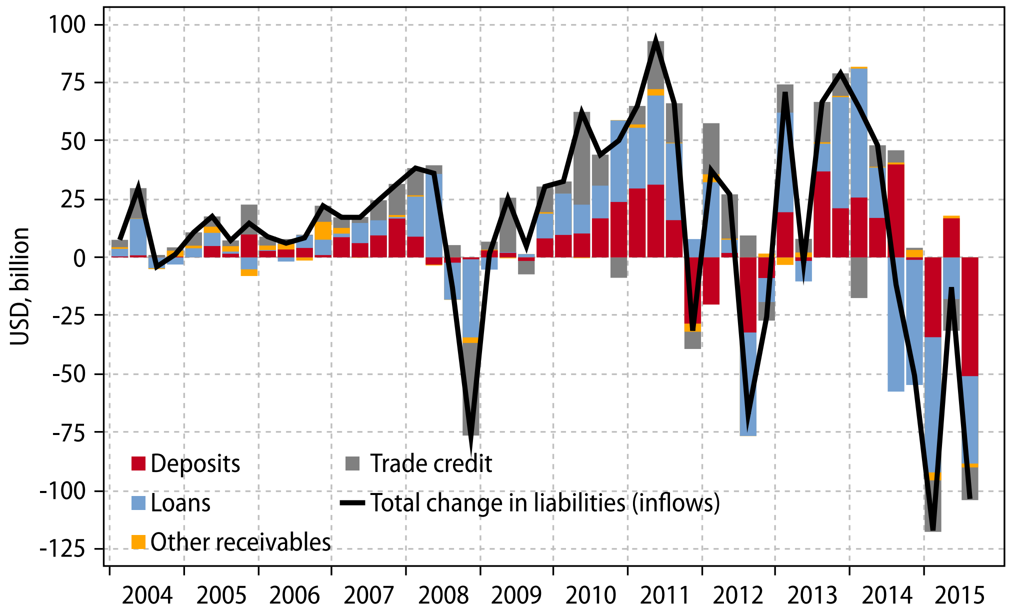
Capital outflows mainly take the form of debt



Reduction of FX liabilities account for much of the outflows

Firms are repaying debt and increasing foreign-currency deposits

Breakdown of other investment liabilities (gross inflows) in China's BoP



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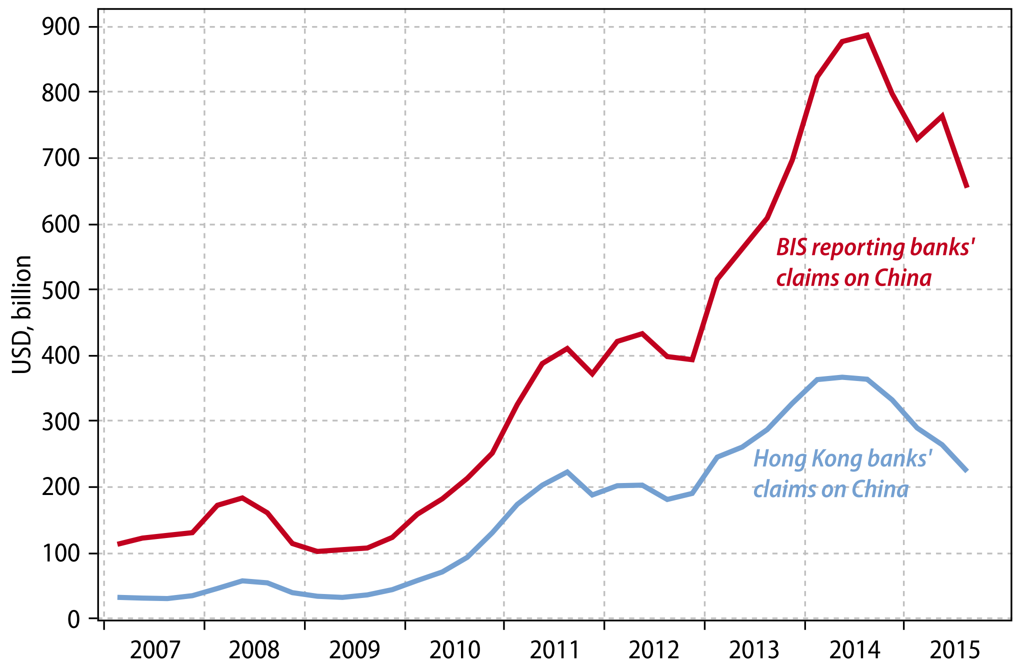
Banking data also shows Chinese firms reducing dollar liabilities



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The detailed figures on investment outflows show that Chinese firms are repaying foreign currency loans (blue). This reduction in foreign liabilities also includes importers choosing to pay in cash rather than in USD trade credits.

There is also an increase in foreign currency deposits (red). This would be a worry if this showed money flowing out of the Chinese banking system. But it doesn't: domestic bank deposits rose 12.5% in 2015, with an acceleration in H2.

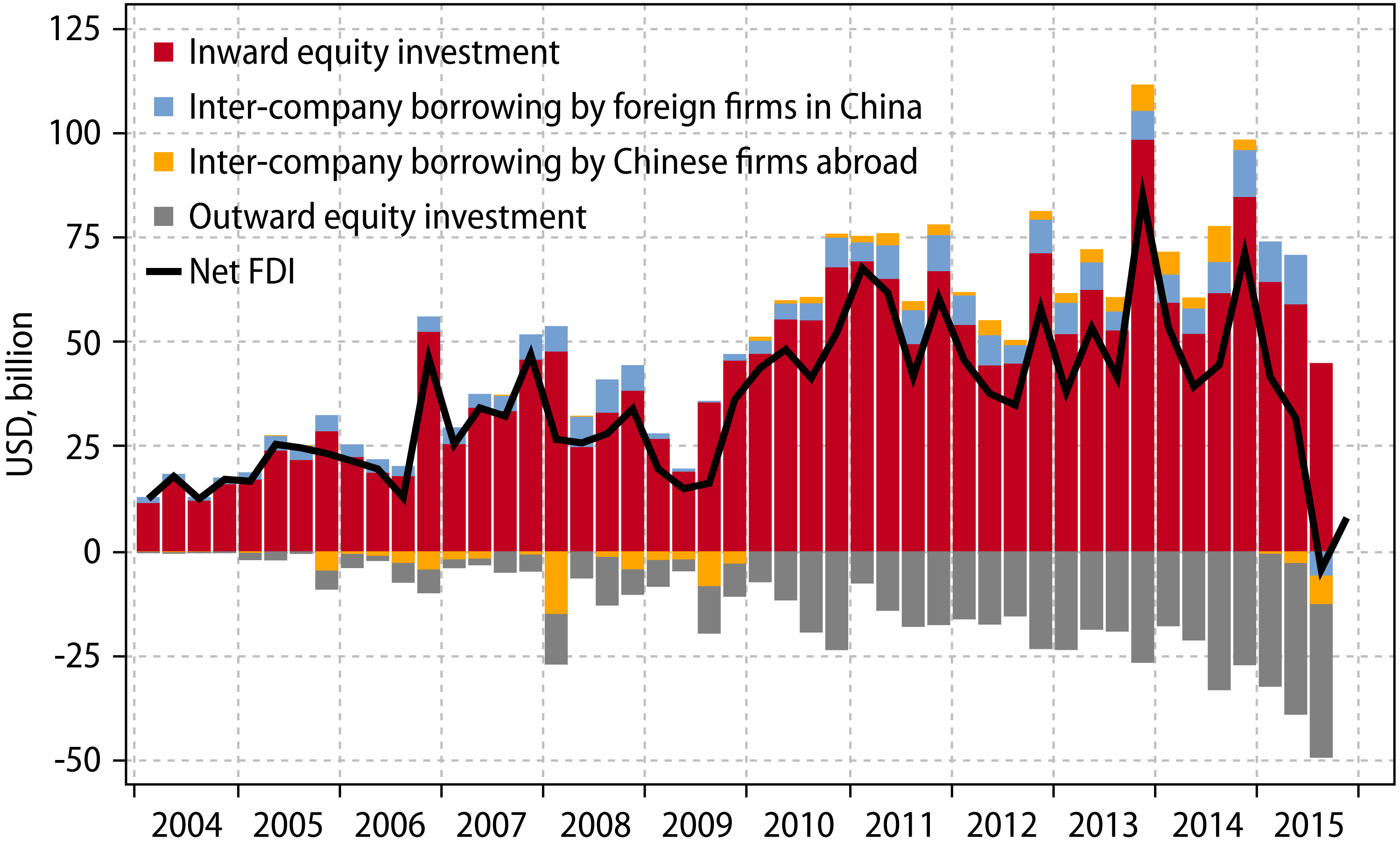
Increased FX deposits most likely reflect exporters choosing to hold more dollars, as a hedge against RMB depreciation.

The Chinese data are supported by partner-country data reported to the Bank for International Settlements, and by data from Hong Kong banks. Both show that since H2 2014 there has been a clear trend for Chinese firms to reduce their liabilities to foreign lenders.

FDI is still in good shape

Swings in offshore borrowing affect net FDI flows

Composition of foreign direct investment component of China's BoP



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The sharp decline in net foreign direct investment flows is much less scary than it seems.

FDI inflows (red) dipped a bit in H2 2015, but remain consistent with the levels since 2009.

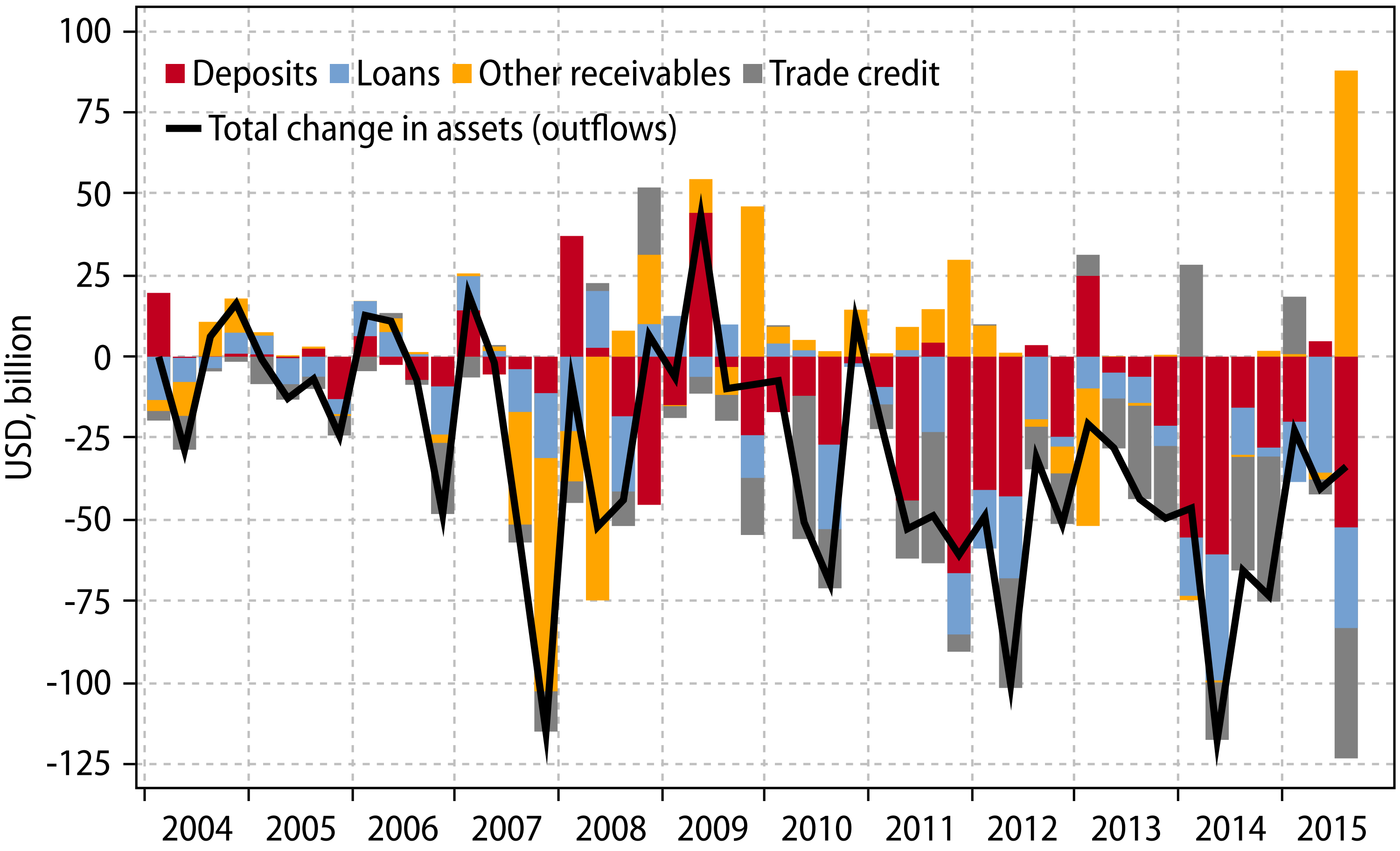
The big shifts are a steady increase in *outward* direct investment by Chinese firms (grey), and a reversal of flows from inter-company loans (blue and orange). These shifted from strongly positive in 2010-14 to negative in 2015.

Once again, this is evidence of China-based firms reducing their forex liabilities—a "good" capital outflow.

Asset outflows are generally not a huge concern

There was a mysterious surge in 'other receivables' in Q3

Breakdown of gross outflows of 'other investment assets' in China's BoP



Gavekal Data/Macrobond

Outflows of loan assets (blue) are rising. This is simply a side-effect of Chinese firms' increased global presence.

Deposit outflows (red) are also OK, reflecting exporters' wish to hold dollars to hedge against RMB appreciation. True capital flight would cause domestic bank deposits to decline—but deposits rose by 12.5% in 2015, with an acceleration in H2.

The sharp rise in "other receivables" (orange), is of concern and does bear watching. It may reflect PBOC borrowing dollars via swap lines to intervene in the FX market.

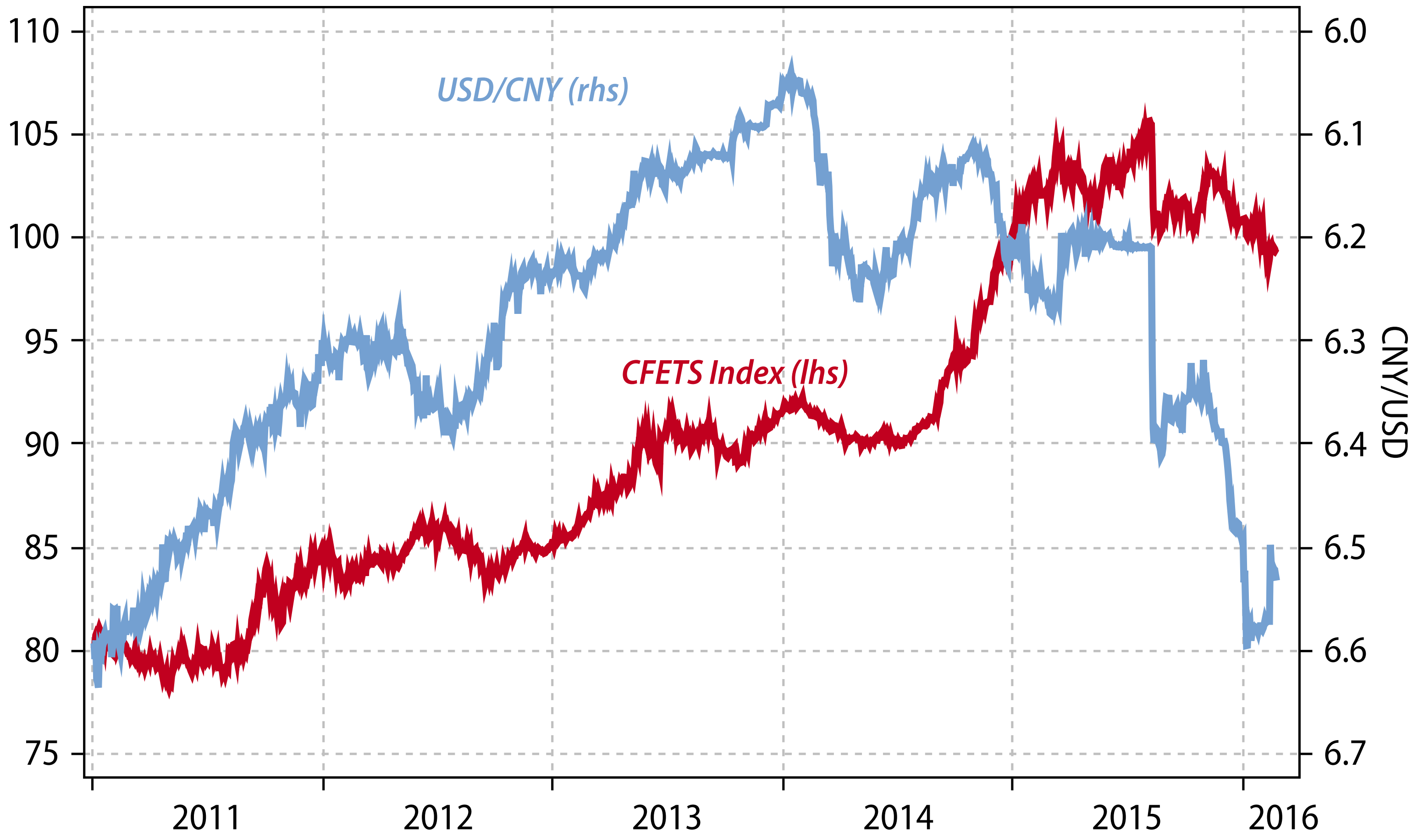
China does not want to devalue, but it may be forced to

- Capital flows do **not** tell us that something is seriously rotten in the Chinese economy.
- If they continue at their current rate, however, they will make it very difficult for PBOC to sustain its commitment to maintain the RMB exchange rate at its current trade-weighted level.
- The key variable is the US dollar. If the dollar stays strong, the incentives for capital outflows remain high and more significant RMB devaluation is likely in Q4 2016. A weaker dollar would make it possible to maintain the current trade-weighted target.
- The problem is that the ECB and BOJ are both actively weakening their currencies. This increases the risk that PBOC will be forced into a steeper devaluation by the end of 2016.

Is a devaluation the one-way bet most seem to believe?

The renminbi is stable against a basket, not the US dollar

Dec 31, 2014 = 100



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The renminbi fell by -4.7% against the dollar in 2015, but trade-weighted value still rose a bit.

PBOC now appears to target a rate of about 100 against its CFETS Index. **The direction of CNY depends mainly on the trade-weighted value of the dollar.**

Unfortunately, the BOJ and ECB are actively trying to weaken the yen and euro vs the dollar.

If the dollar strengthens or maintains its present TWI value, it is likely CNY will have to fall in H2 2016, not only against the dollar but against the basket as well (because of the USD weight in the basket.)

Is renminbi volatility permanent or temporary?

Implied volatility for the renminbi has gone up significantly

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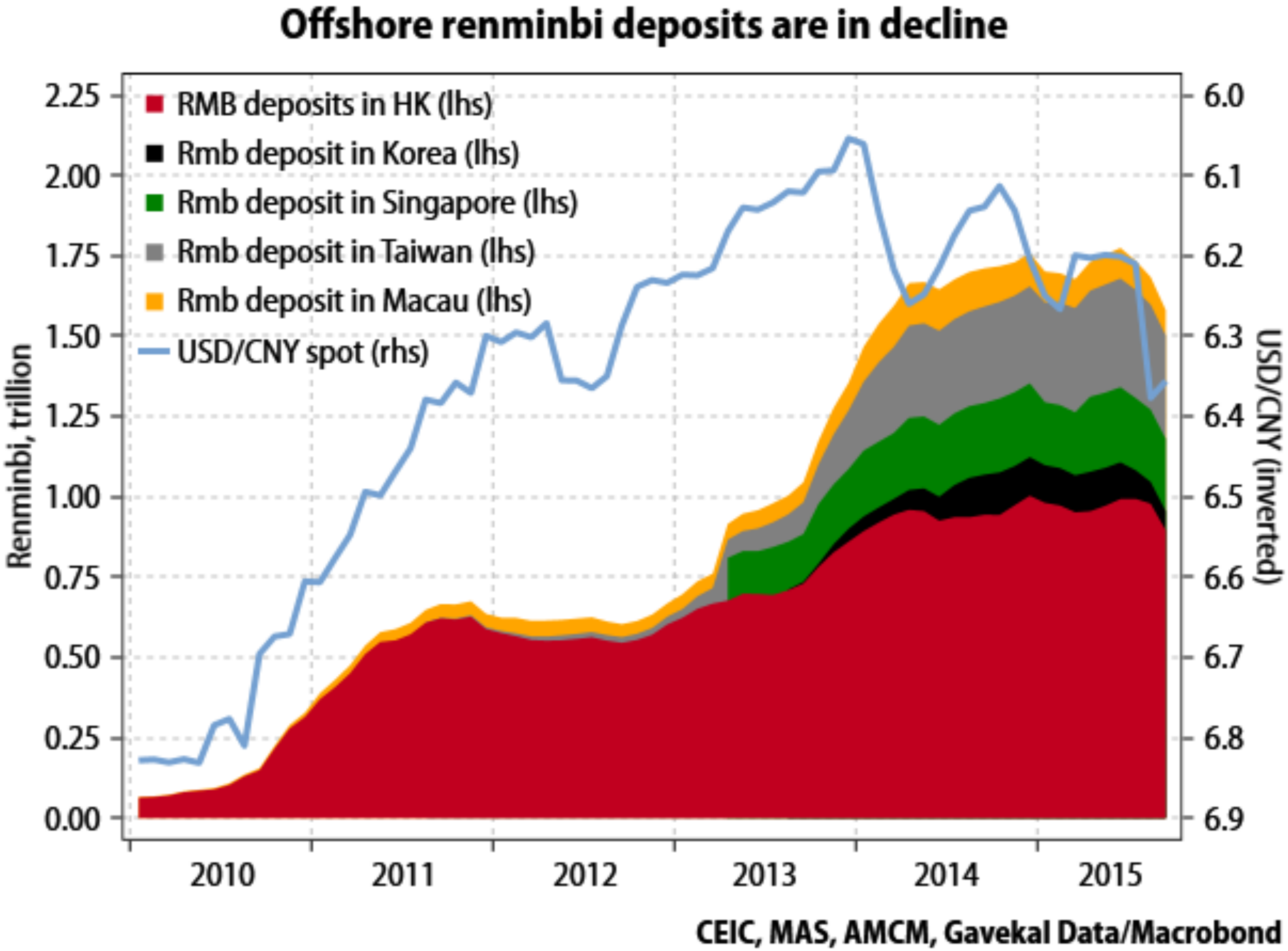
Implied volatility of the renminbi rebounded close to the August high in both the onshore and offshore markets. At 7%, implied volatility is almost as high as the yen or Singapore dollar.

In the past, the PBOC intervened to limit volatility or one-sided USD/CNY movements.

But now its task is to establish the credibility of the trade-weighted target. So it must tolerate higher volatility in USD/CNY.

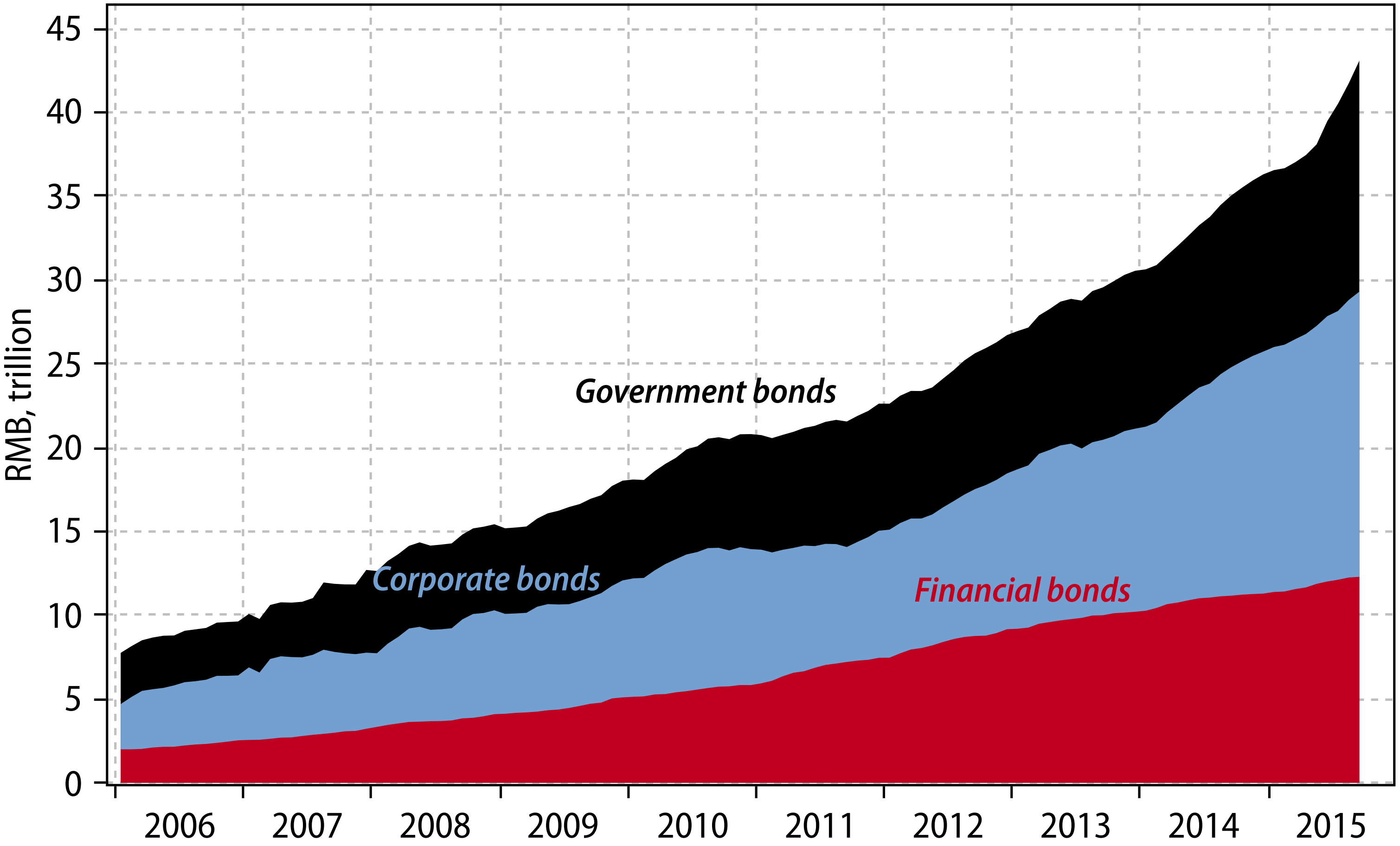
Another consequence of RMB regime change: less internationalization



Meanwhile, the domestic bond market is booming

Growth in China's bond market has accelerated in 2015

Outstanding bond issues, by type



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Credit creation is rapid, with the stock of bank loans and total social finance both rising at around 12%, or close to double the 6-7% growth in nominal GDP.

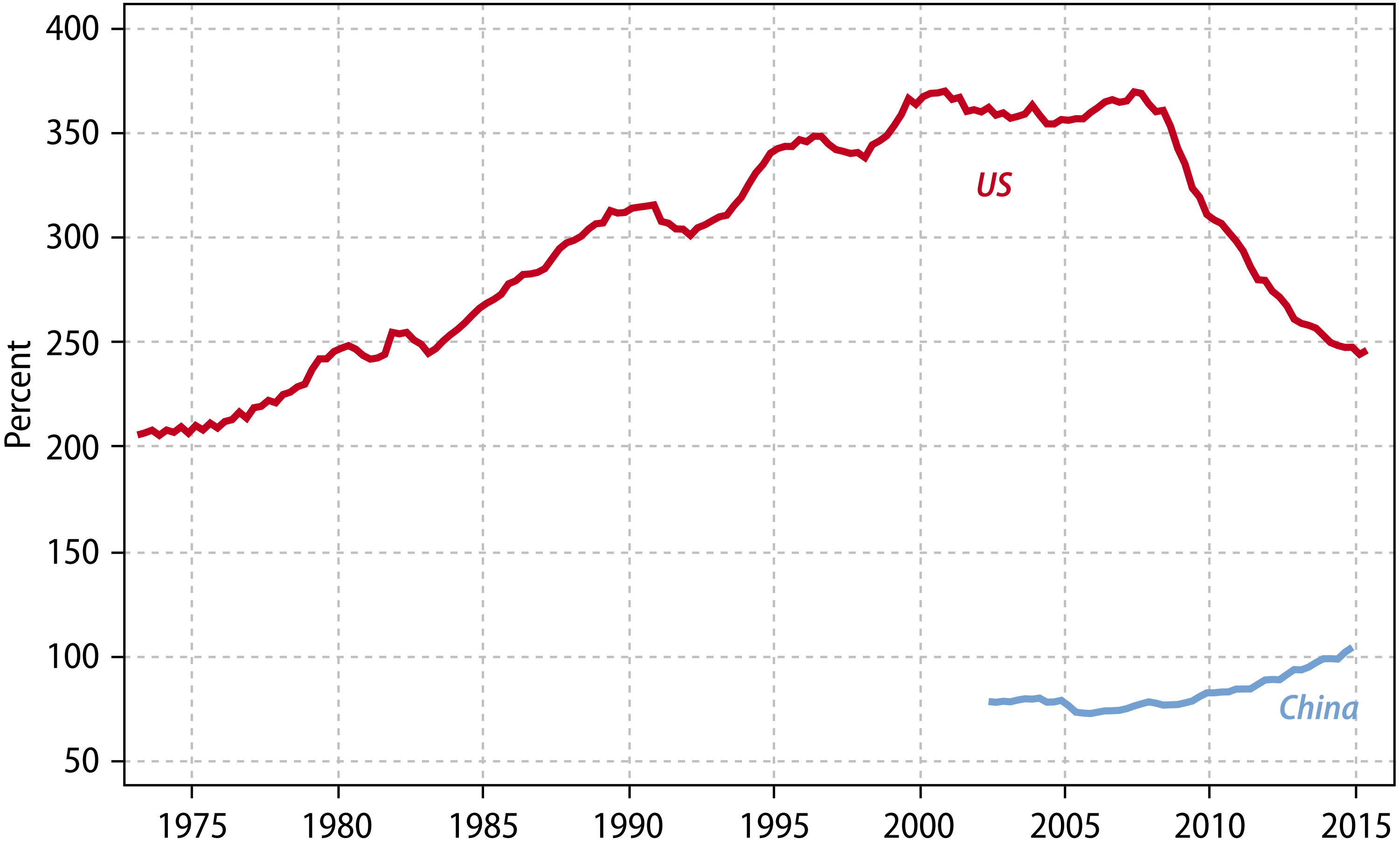
An important locus of rising leverage is the bond market: total issuance is now over Rmb40 trn, double the figure in 2010. Bonds now account for a quarter of total social finance (vs 5% for the equity market).

The interbank bond market was opened to international investors in February 2016. Takeup is likely to be slow because of fears over devaluation and financial stress.

Financial stress is high and rising, but crisis risk is low

The funding of China's credit is very conservative

Private sector credit (from BIS), ratio to banking system deposits



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The buildup in national leverage (with gross debt above 230% of GDP) is of serious concern on a 3-5 year horizon.

The main risk is the development of a Japan-style high debt/slow growth trap.

In the short term, the risk of a financial crisis is low, because domestic savings are very high and enable liabilities to be funded almost entirely by bank deposits, rather than by leverage within the financial system, as in the pre-crisis US.

Worry #2: A hard landing

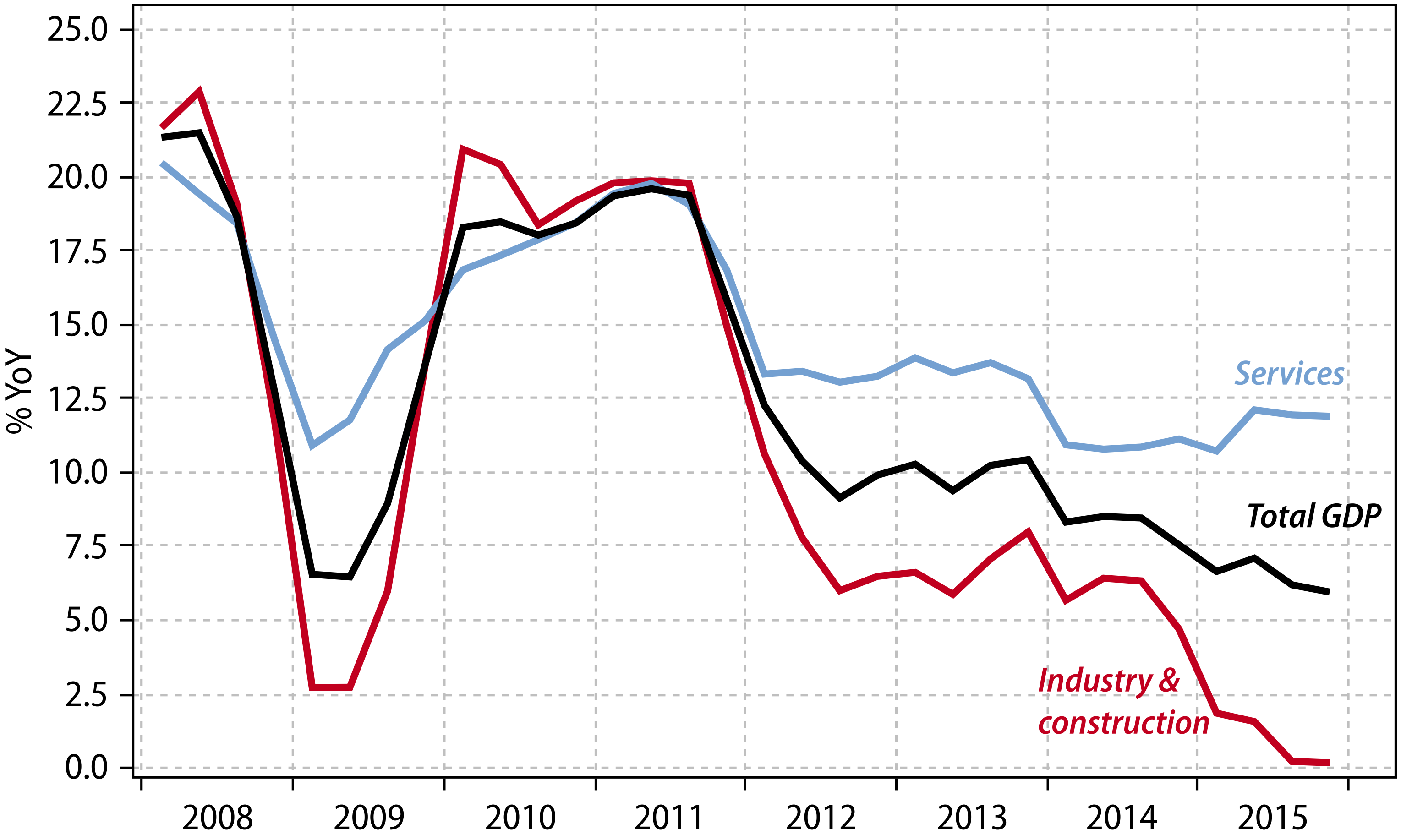
No crisis, but growth will continue to slow

- Pessimistic views of China's economy ignore the strong momentum in services and consumer spending.
- However, even without crisis, headline GDP growth is likely to slow to 5-6% in the next few years. The government target of average 6.5% growth to 2020 is unrealistically high.
- Housing construction has peaked, meaning the end of the commodity supercycle. The only hope for commodity price recovery lies in supply rationalization.
- **The global impact of China's growth has slowed far more dramatically than headline GDP.** In nominal US$ terms, China's GDP growth has slowed from 25% in 2010 to less than 3% today.

The two-track economy continues

The slowdown has been concentrated in industry & construction

Nominal change in value-added by sector



Gavekal Data/Macrobond

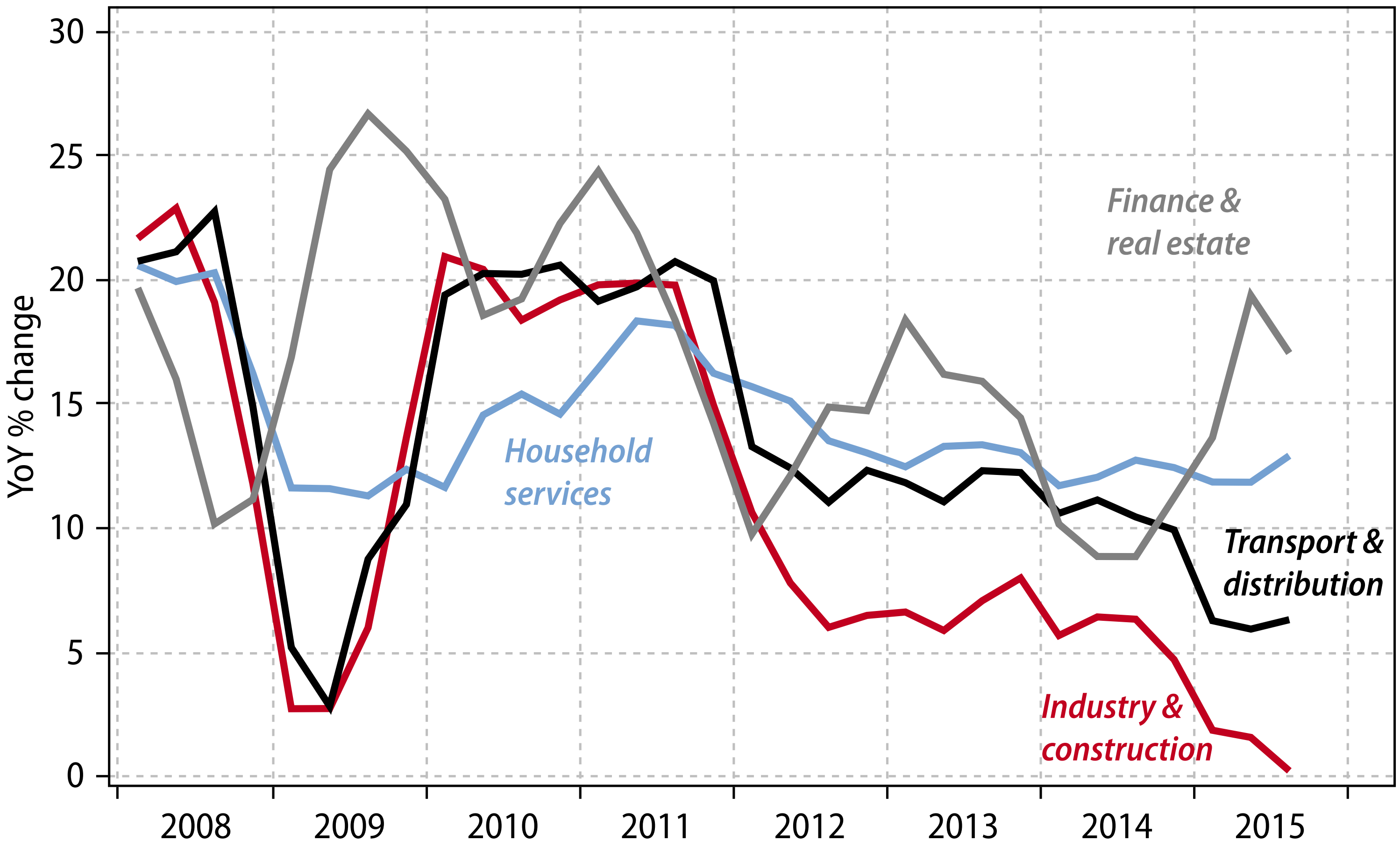
Pessimistic views of the economy focus on the downturn in industry, but ignore the solid growth in services and consumer spending.

Nominal growth in service-sector activity is still running at near 12%, even though industry and construction are nearly at recession levels.

Household services show the steadiest growth

Not all services are countercyclical

Nominal growth in value-added, by sector group



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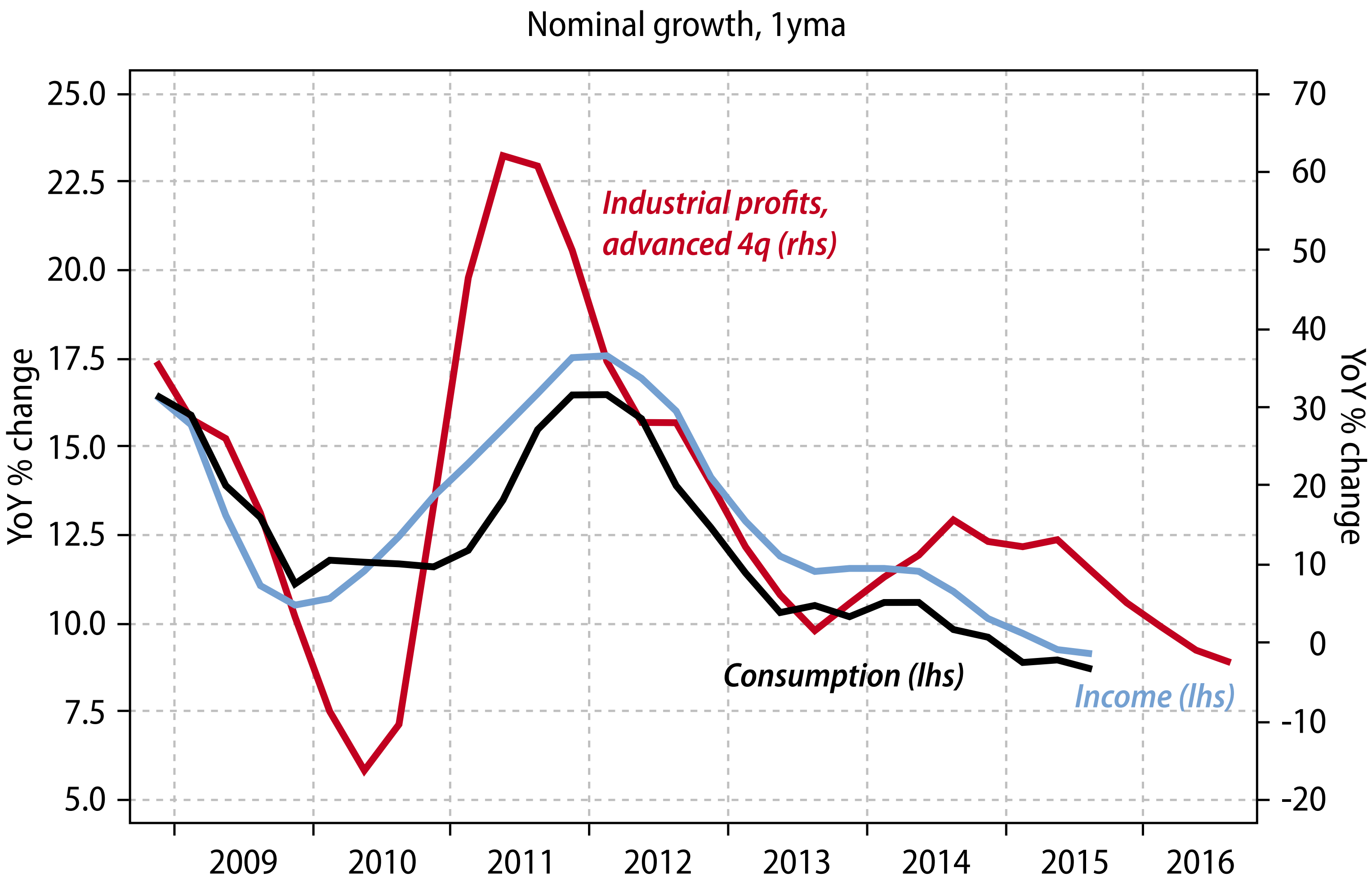
Income and consumption will slow further

The industrial cycle points to weaker household income growth



CEIC, Gavekal Data/Macrobond

Unfortunately, the consumer spending that supports services is likely to slow.

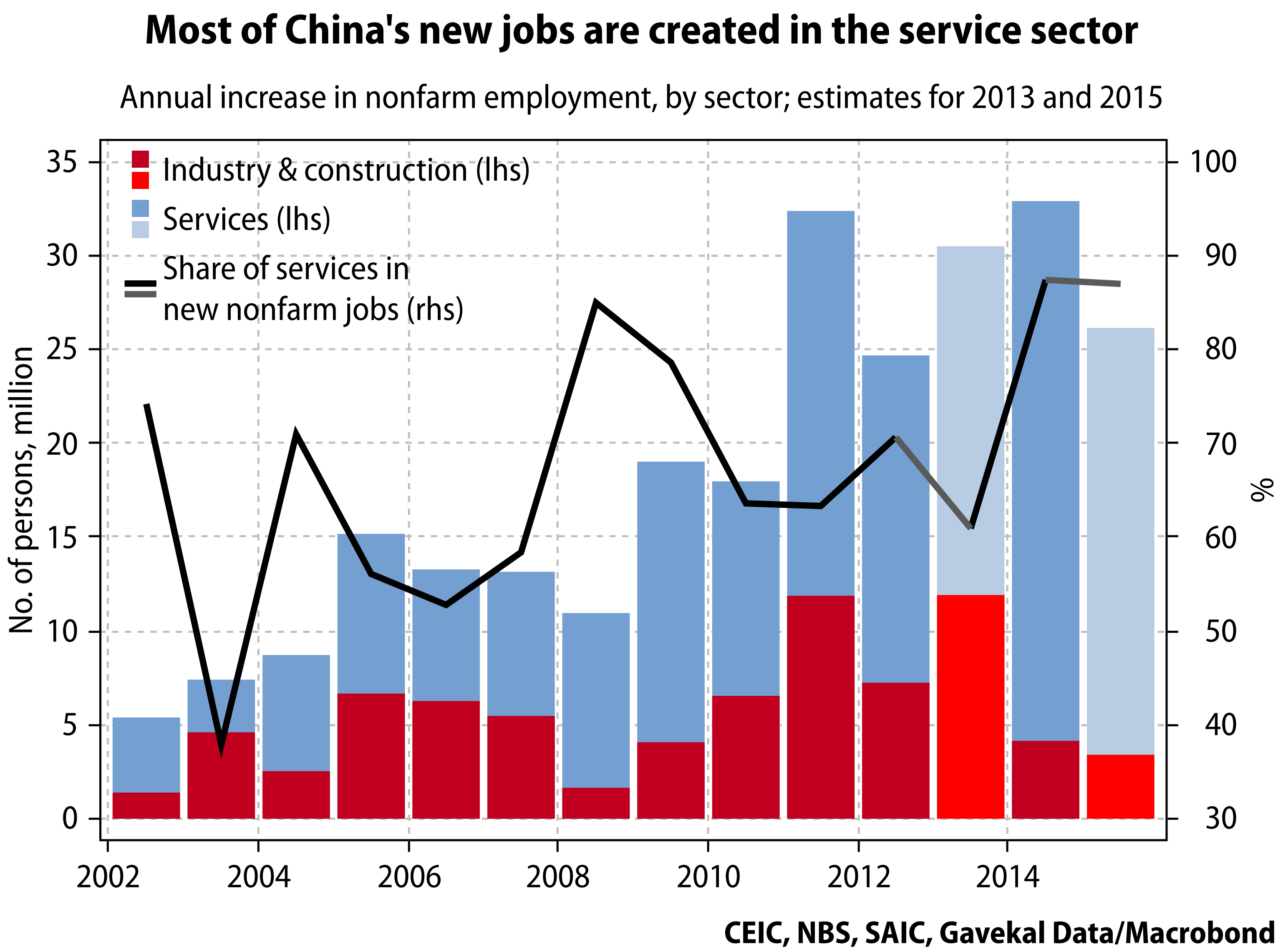
Household income and consumption growth have generally tracked industrial profits, with a lag.

This reflects the fact that industry produces the highest productivity and wage gains.

As the economy shifts towards services, where productivity and wage growth are naturally lower, the pace of household income gains will also slacken.

Moreover, it seems that wage growth *within the service sector* is slowing.

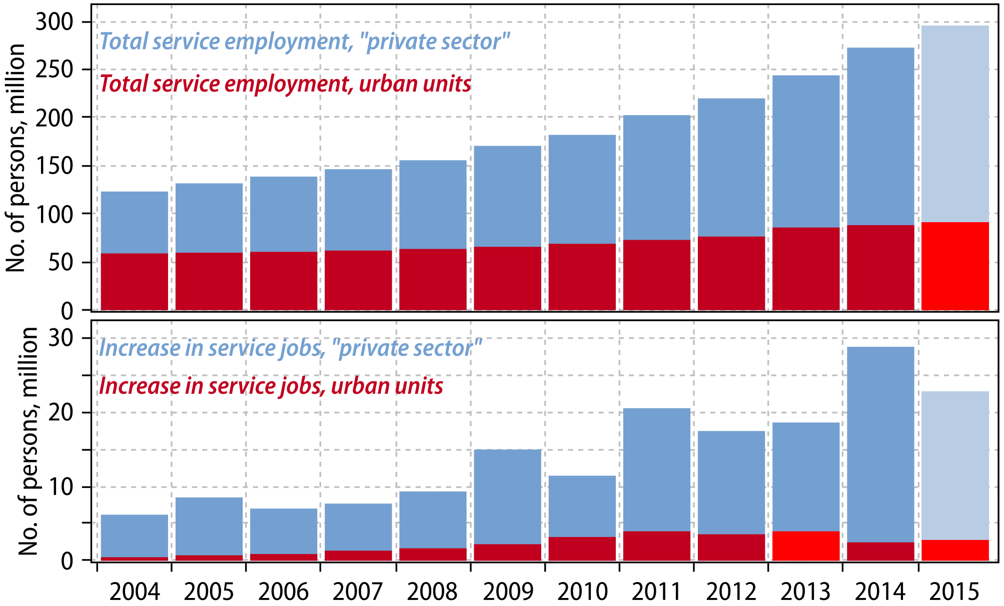
Service sector leads job creation…



…but the new jobs don't pay so much

Small private companies are the main driver of service sector jobs

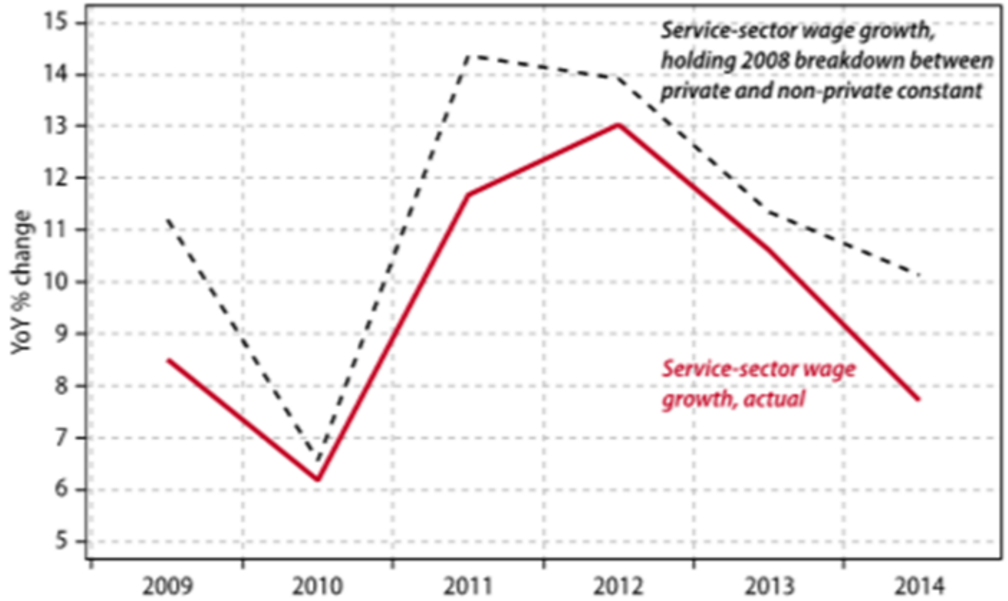
Service-sector employment, by type; estimates for 2013 and 2015



CEIC, NBS, SAIC, Gavekal Data/Macrobond

Wage growth has slowed, in part because newer jobs are lower paid

Actual and hypothetical growth of average urban service-sector wages



Wind, CEIC, Gavekal Data/Macrobond

Around 60-85% of new non-farm jobs are in services. And the main engines of service sector jobs are small-scale private firms and sole proprietorships (blue in above chart; red represents private and state-owned large-scale businesses).

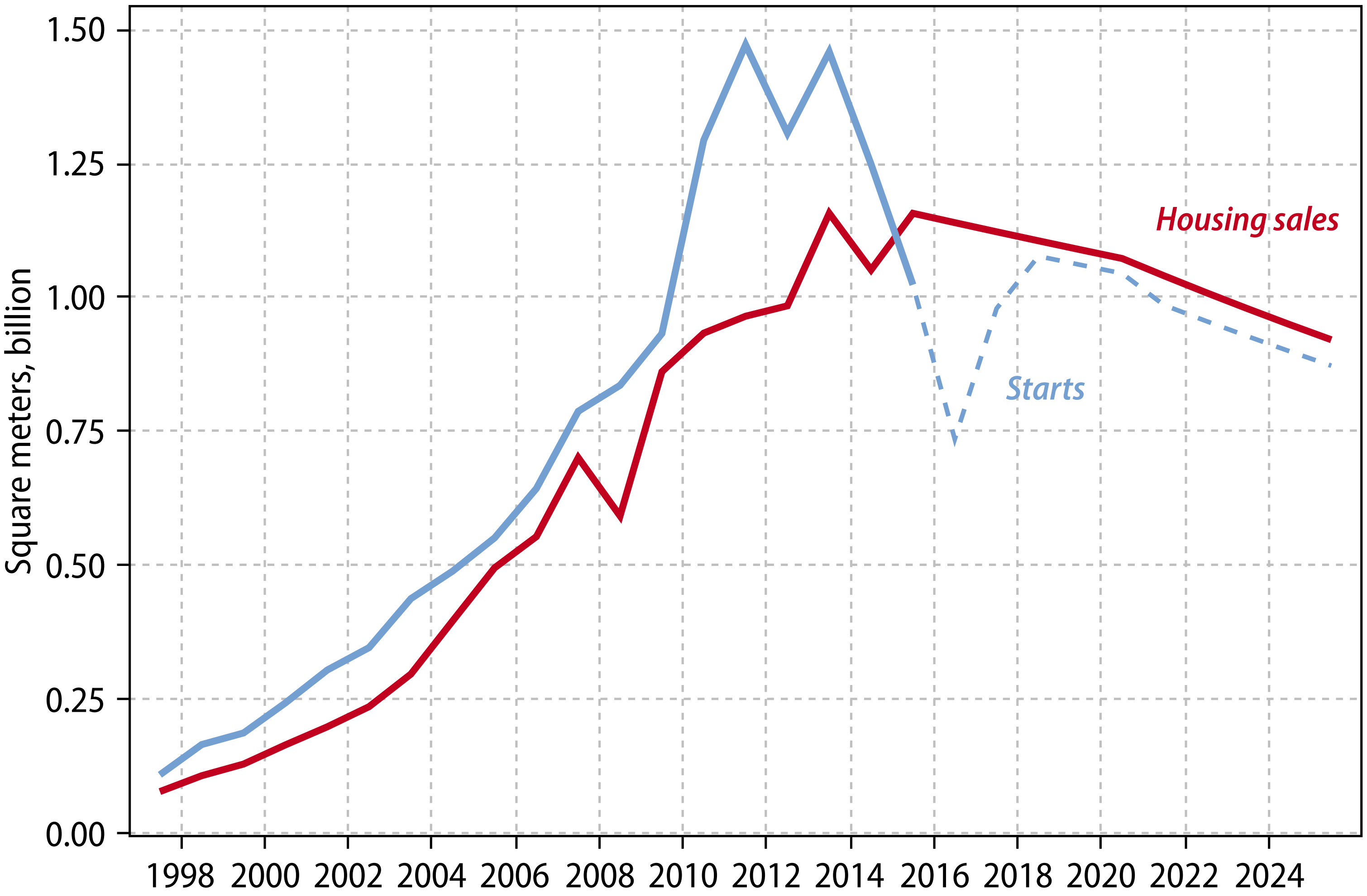
It's good that these jobs are being created, but unfortunately they tend to be fairly low-wage.

As a result, service sector wage growth has decelerated significantly since 2012.

In general, therefore, we should expect that wage growth, household income growth and consumption will continue to decelerate in the coming years.

Construction faces cyclical and structural downdrafts

Starts need to correct further to track sales again



CEIC, Gavekal Data/Macrobond

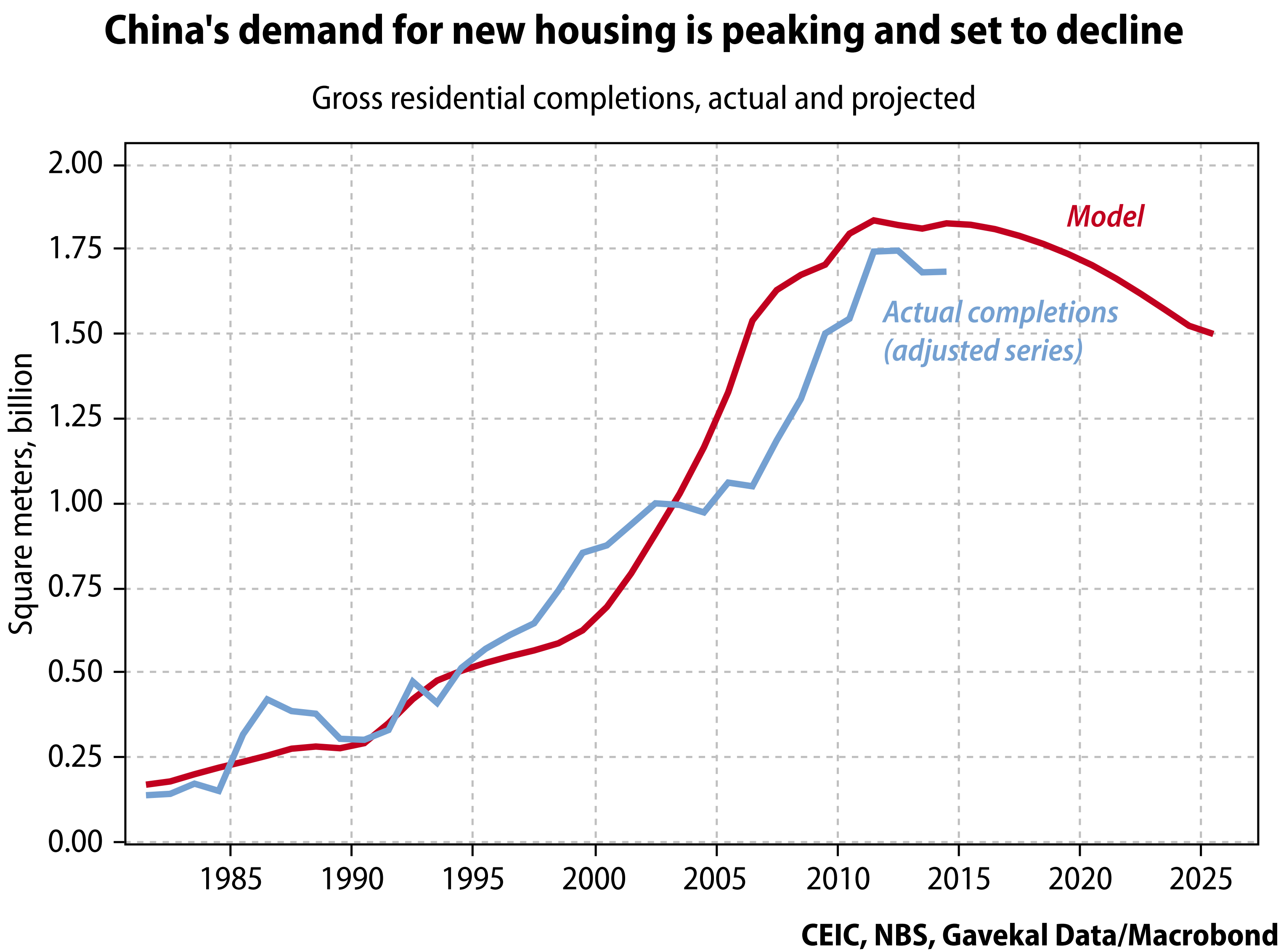
Housing starts in 2010-2014 greatly exceeded sales volume.

The starts data are probably exaggerated, but even so it is clear the housing market faces a large inventory overhang.

Our housing model suggests that about half the necessary inventory correction occurred in 2015, and the other half will occur in 2016 and early 2017.

Therefore the earliest date for a cyclical rebound in construction is H1 2017.

Don’t expect materials demand to recover

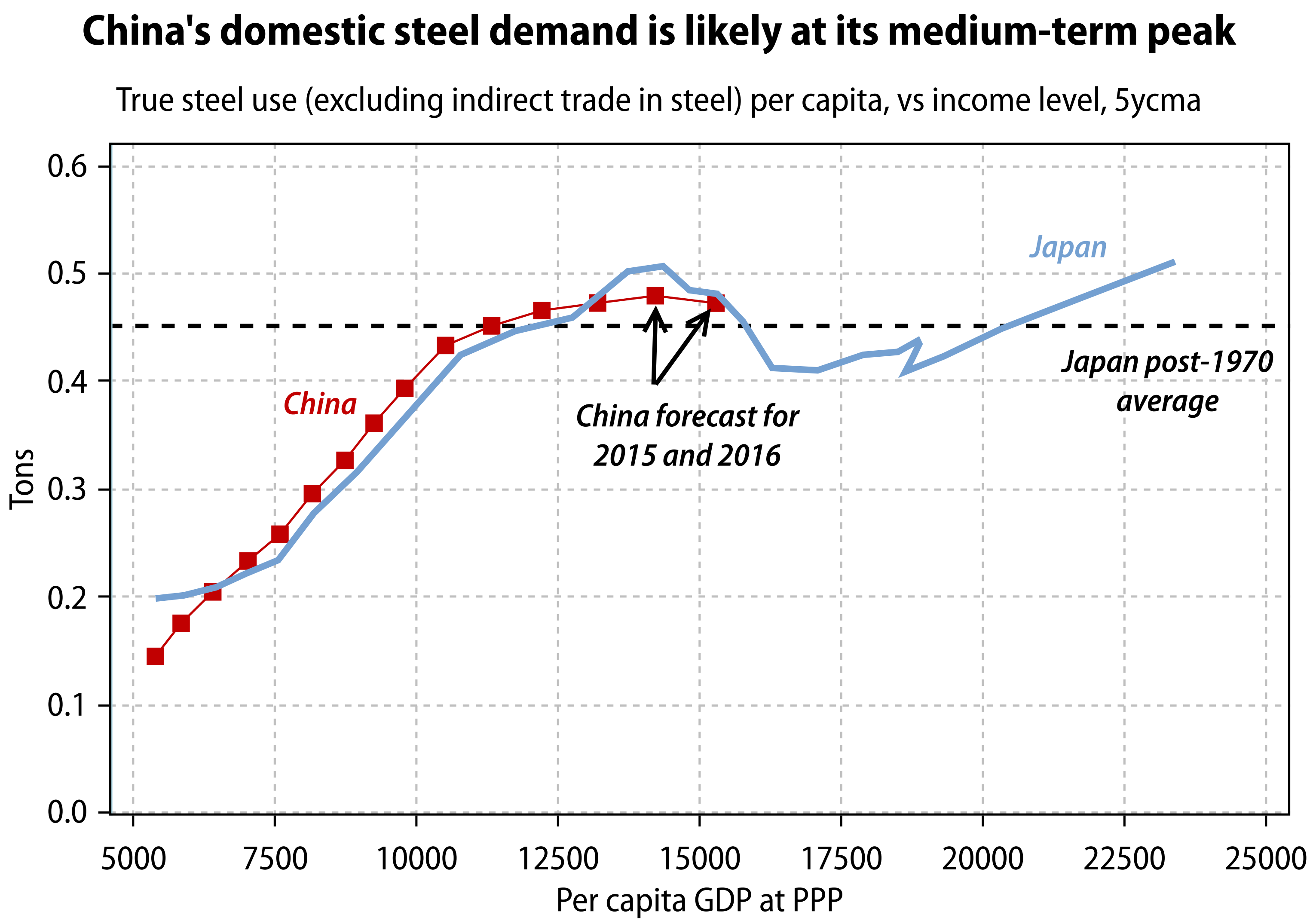


Our housing model indicates that structurally, housing demand has peaked and is likely to decline by -10% to -15% in the coming decade.

This means hard commodity demand has also peaked, since housing was the key driver of the boom.

Infrastructure cannot compensate for this loss in demand, since its growth will need to slow as well. And “Belt-and-Road” projects in the rest of Asia —even if they materialize —can absorb at best 10% of China’s enormous building materials production capacity.

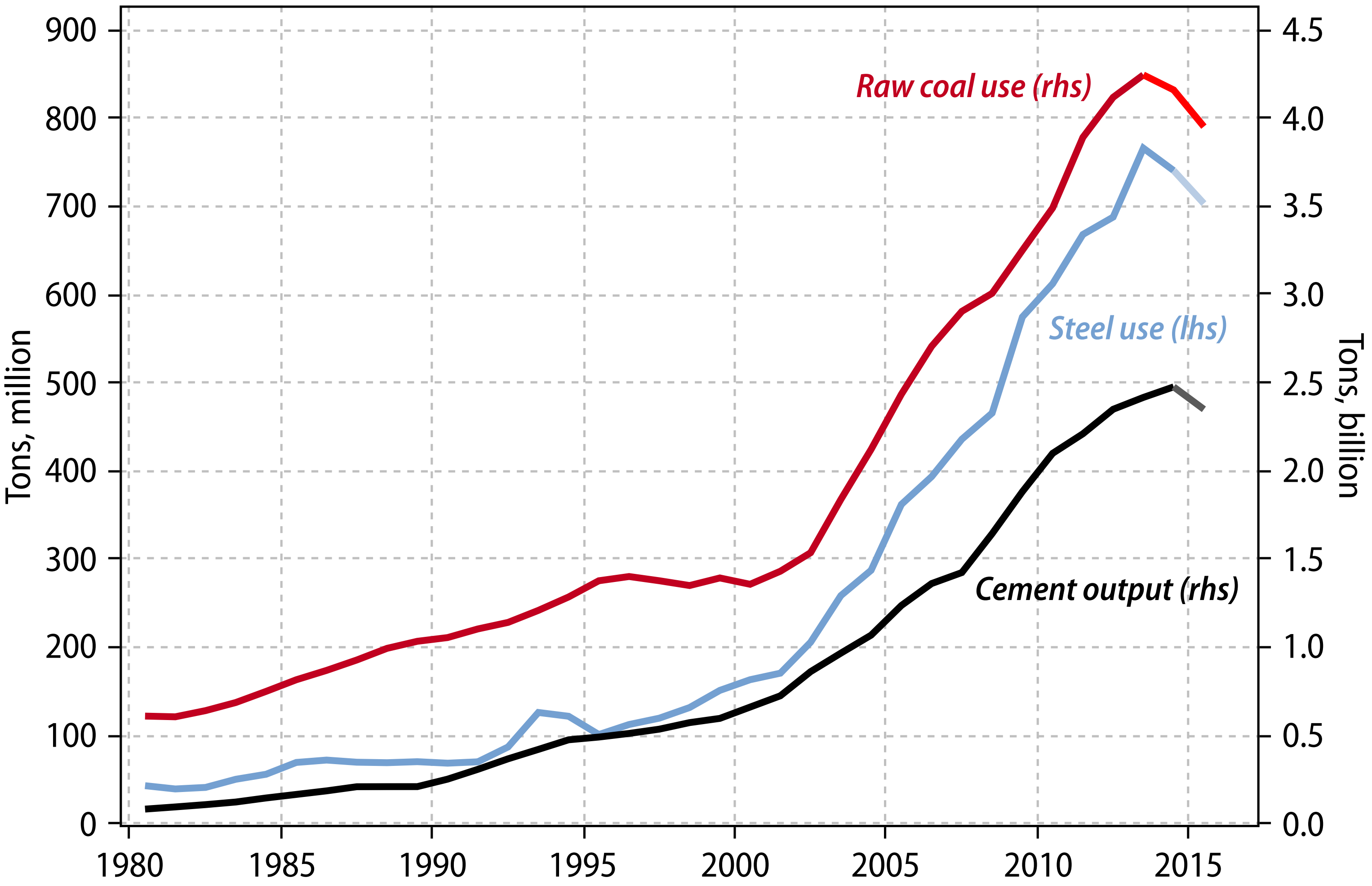
Most likely we have hit peak steel…



World Steel Association, Gavekal Data/Macrobond

…and peak commodity demand

China's demand for materials has fallen for the first time in decades



CEIC, Gavekal Data/Macrobond

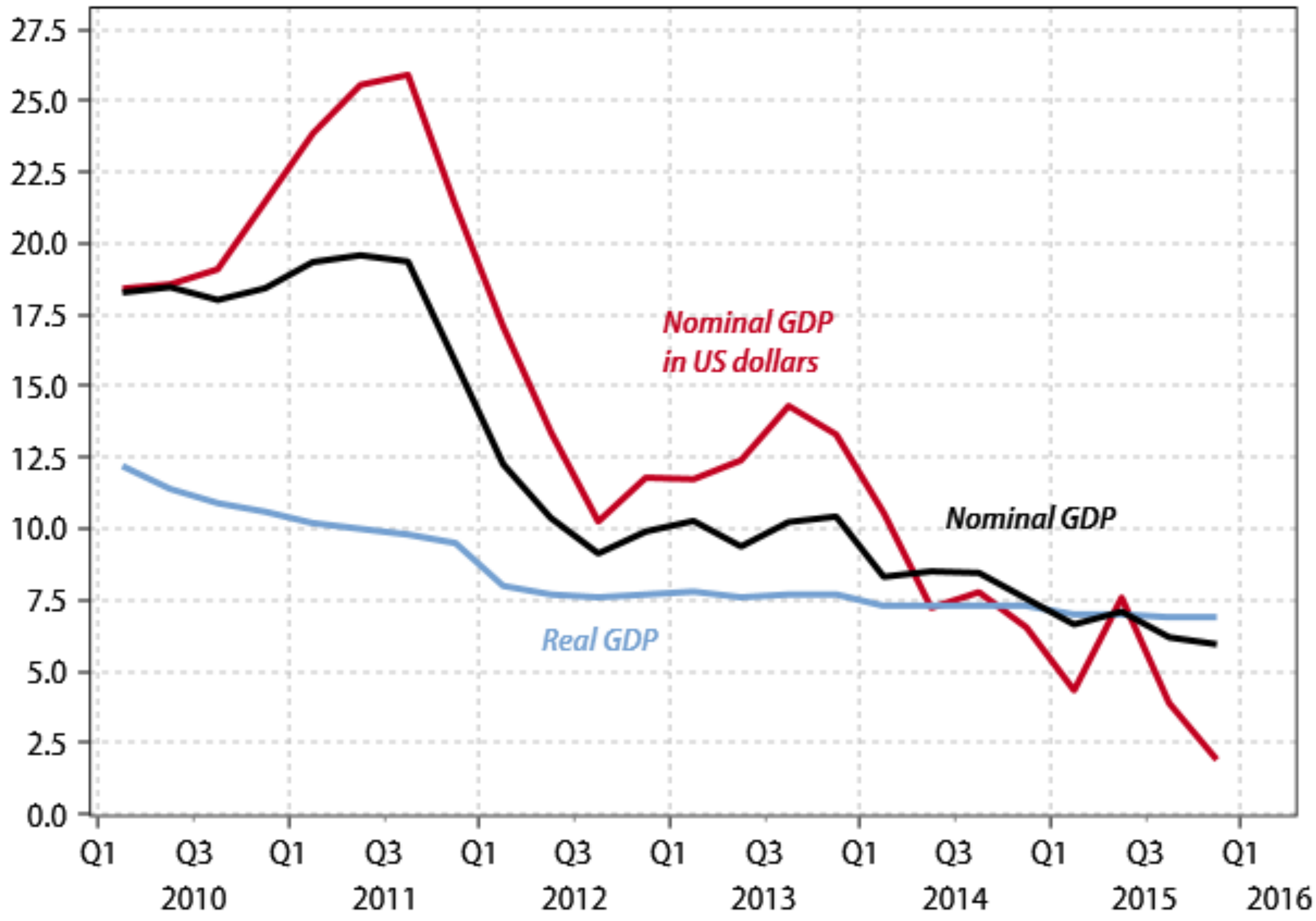
Demand for coal, steel and cement is already falling, and growth in oil demand could well slow as well (see **The Year Of Peak Everything**).

This puts sustained downward pressure on commodity prices and emerging markets generally.

Chinese demand will remain high but it will not increase materially. Thus the only hope for prices lies in the closure of excess supply capacity.

Oil is an important exception: Chinese demand is likely to rise at 3-5% a year on the back of increased transport demand.

Nominal US$ GDP growth has collapsed dramatically



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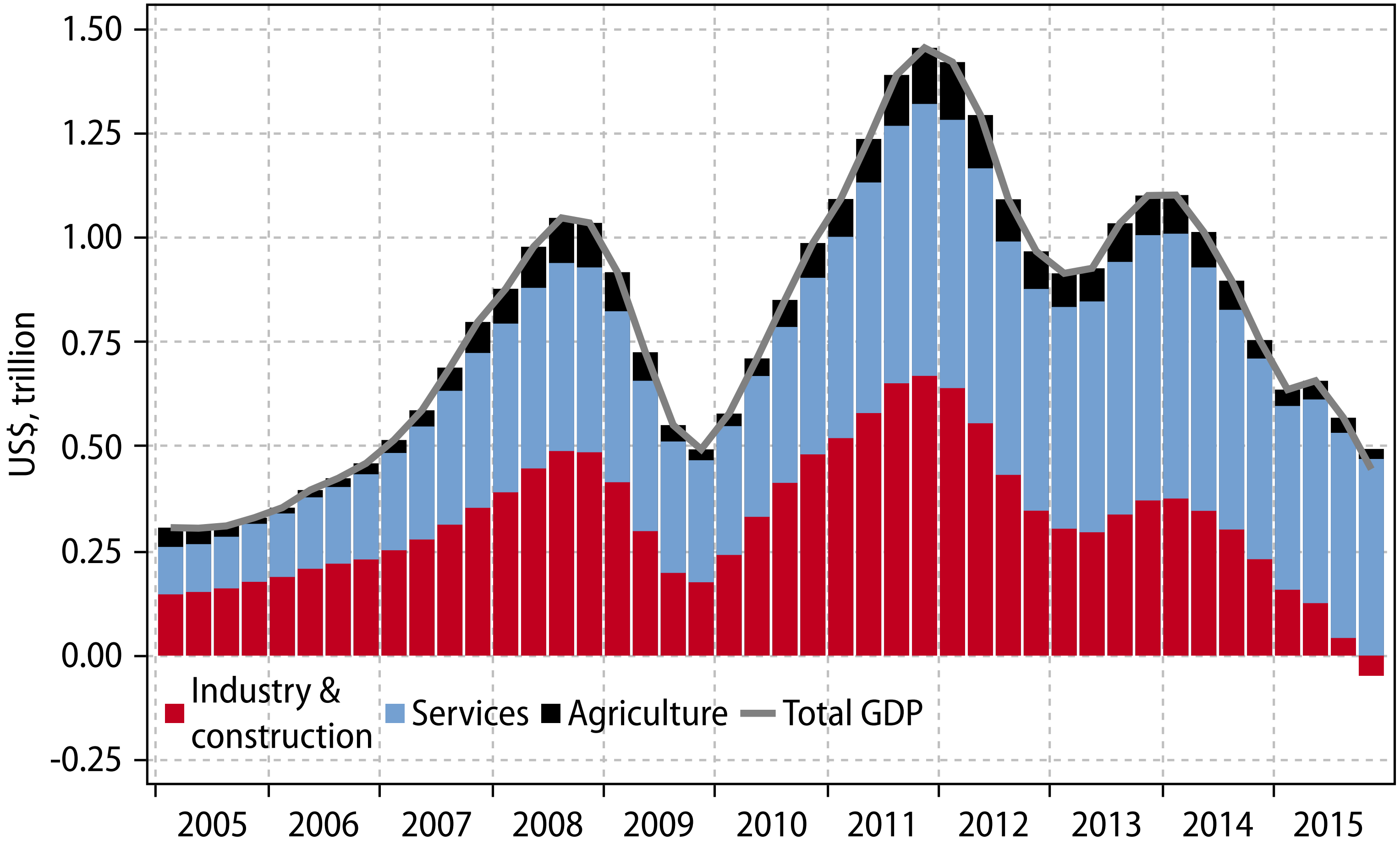
China contribution to global growth is lowest since 2006

Incremental gains in US$ GDP are back to rates of a decade ago

Nominal increment of China's GDP in US$ terms, 4q rolling, by sector



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Although real GDP growth slowed from over 10% to below 8% from 2010 to 2013, China was still adding over US$1trn of nominal GDP on an annualized basis.

While real GDP growth has slowed by less than 1pp since 2013, the nominal US $ slowdown has been much more severe. Incremental new GDP in US$ terms has collapsed to about US$450bn. This metric is on its way back to the pace of 2005-06, when China was a much smaller economy.

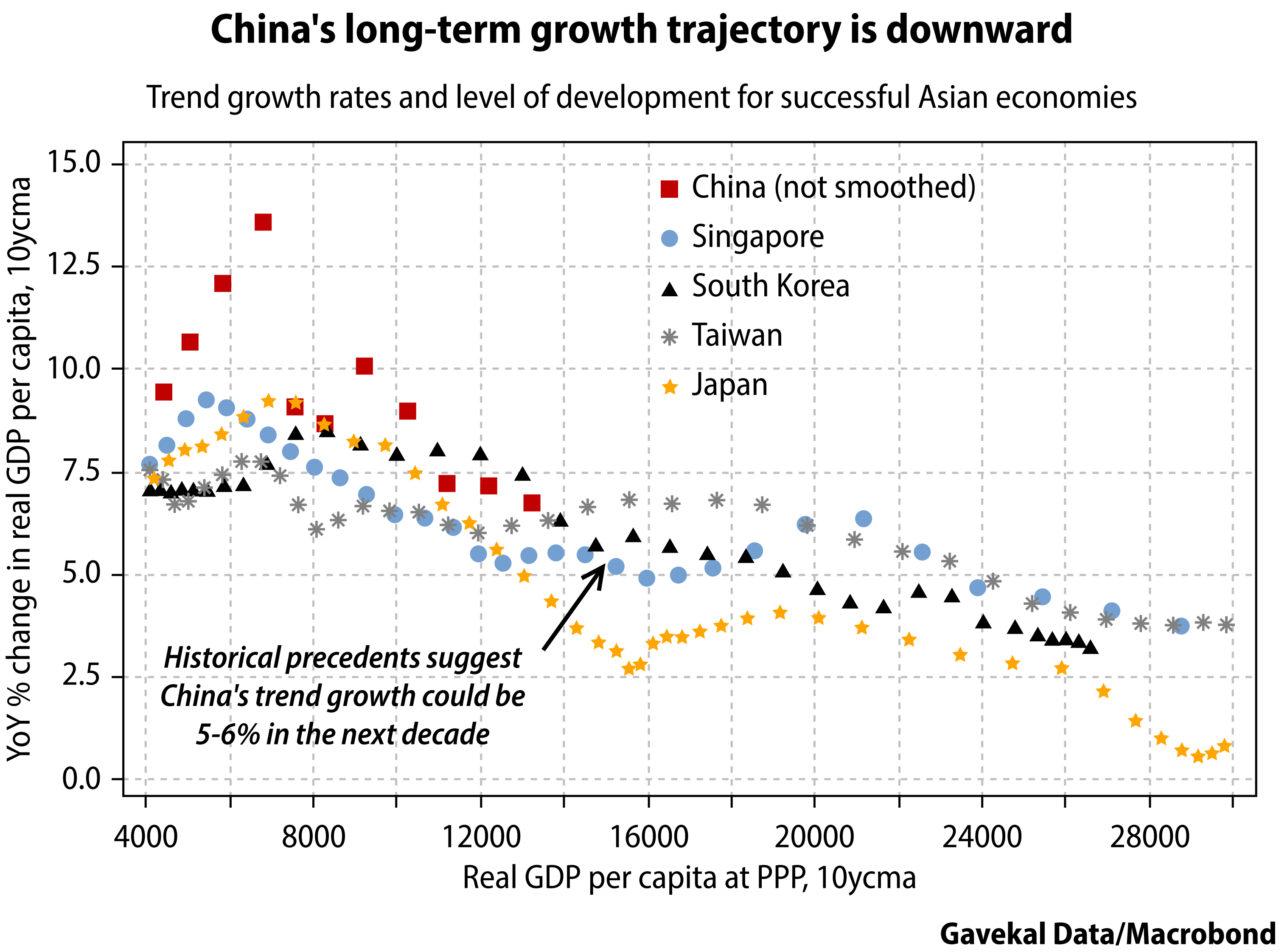
Looked at in this way, financial markets' reaction to deteriorating China data is more understandable.

Worry #3: A long landing

Reform and its discontents

- Slower growth is partly an outcome of structural transition:
  - ➢ Shift from investment- to consumption-focused growth
  - ➢ Demographic transition to an aging society
- Policy aims to guide China into a new era of:
  - ➢ Financial liberalization
  - ➢ Industrial upgrading (Made in China 2025)
  - ➢ Restructured (but not privatized) state sector
- Can policy achieve a stable (~5-6%) growth path while controlling leverage? There are doubts:
  - ➢ Financial and fiscal reforms are progressing, but raise cyclical risk
  - ➢ State-sector reform is too timid; more privatization required
  - ➢ Hostility to free expression undermines innovation push
  - ➢ Freer markets may not be compatible with Xi's political agenda

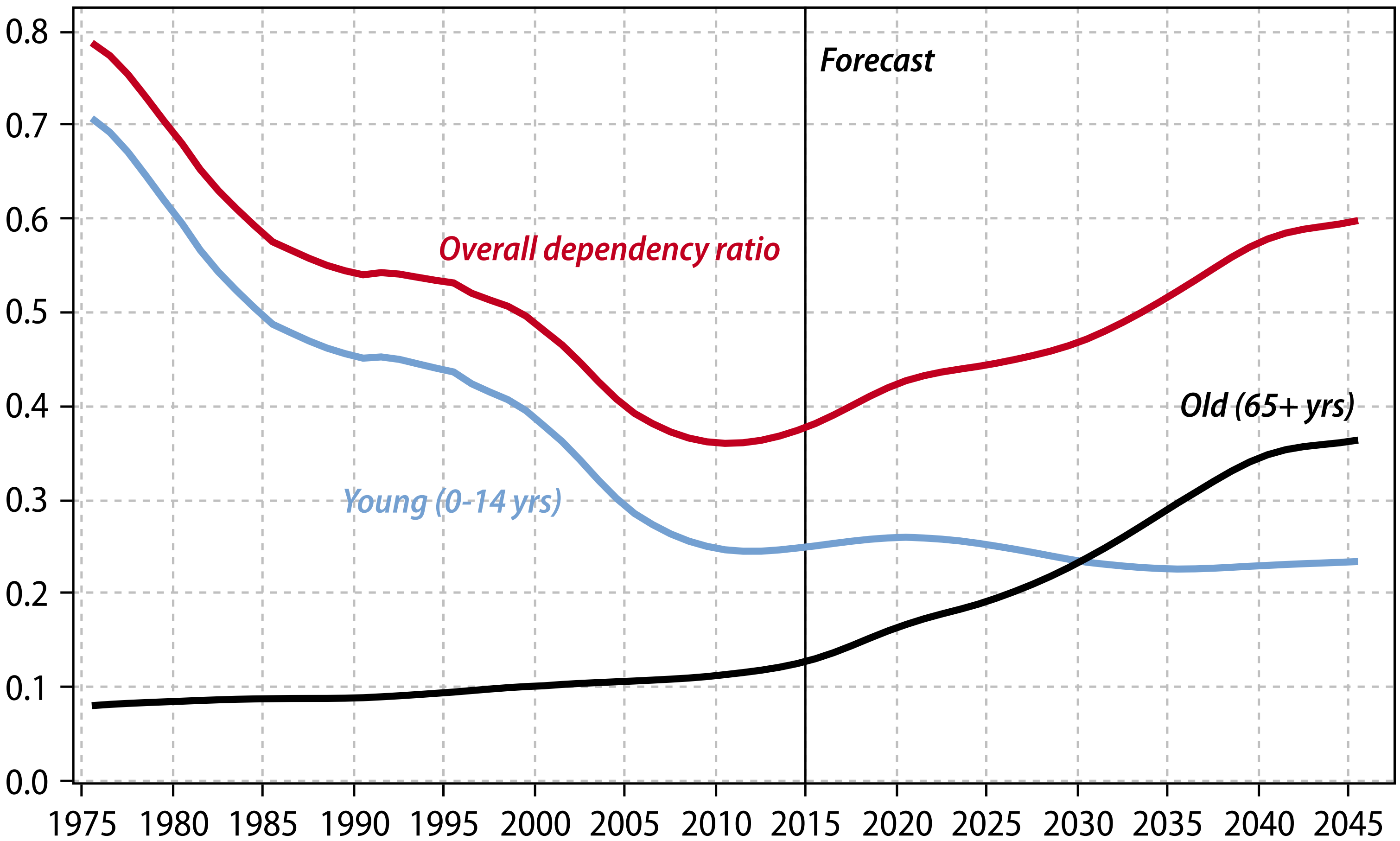
China is certainly slowing, but where's the bottom?



The demographics are starting to get ugly…

China's future: fewer workers, more dependents

Ratio of non-working ages to total population

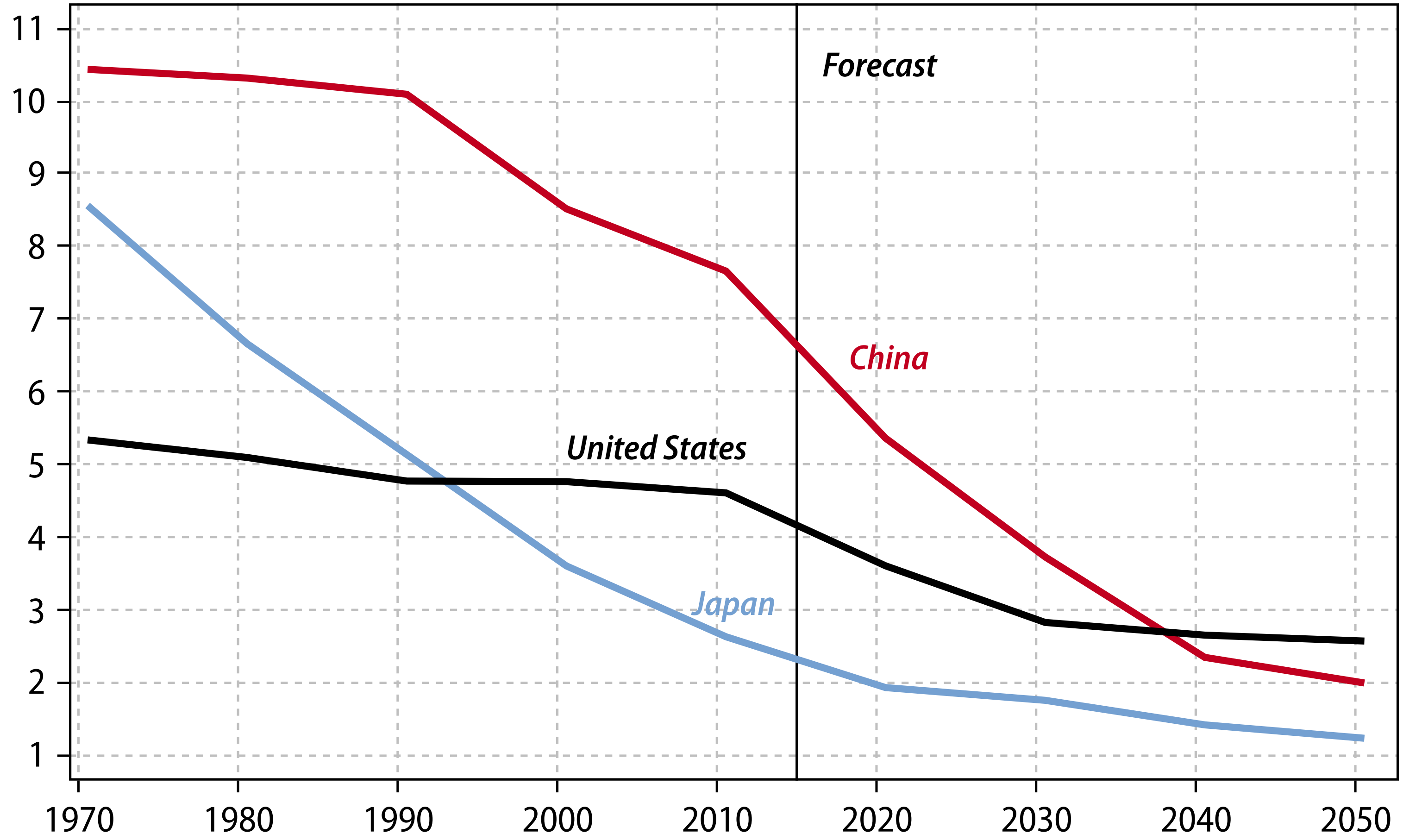


UN World Population Prospects

…and a Japan-like future is possible

China's worker-retiree ratio is heading towards Japan's

Ratio of working age population (15-64) to retirees (65+)

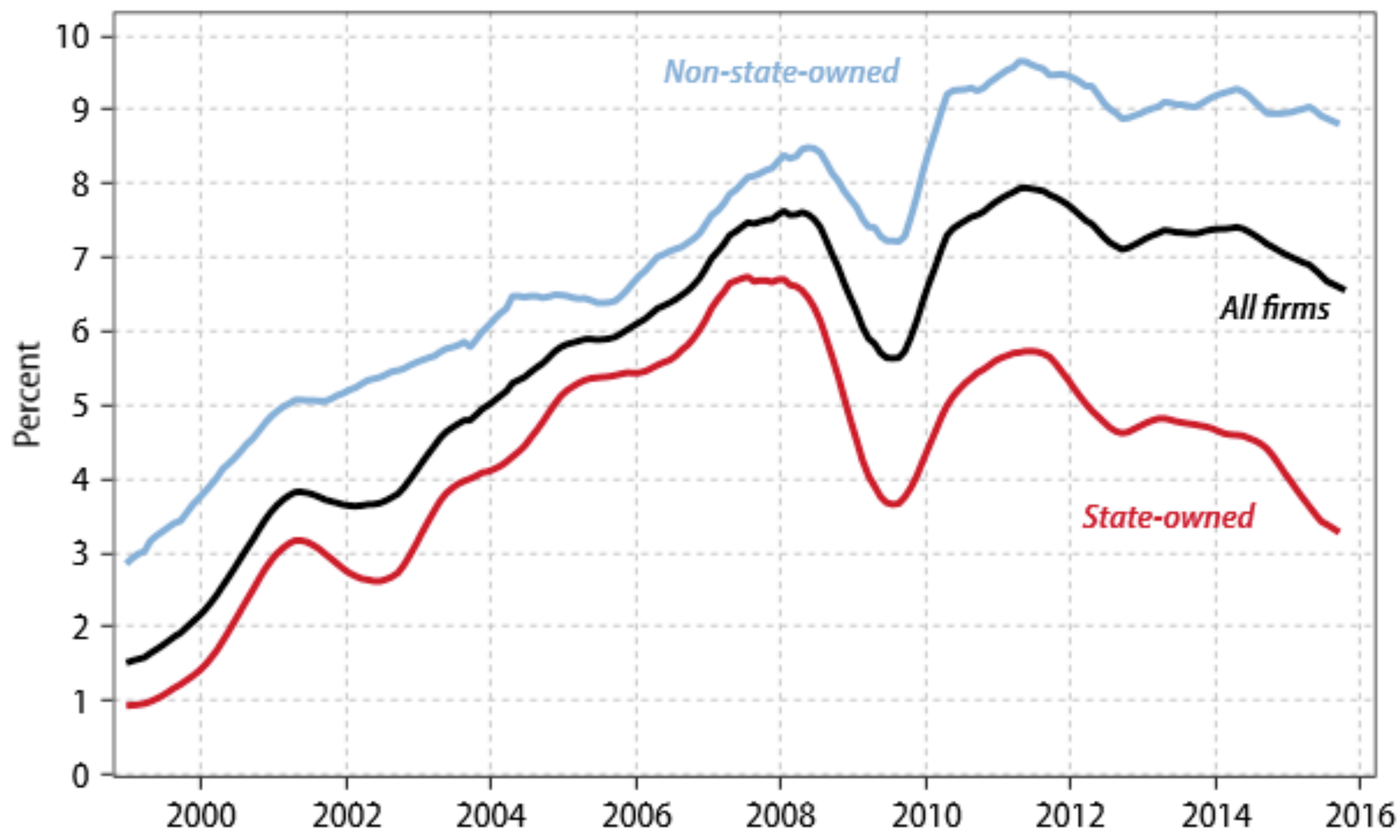


UN Population Prospects

The imperative to restructure the state sector is clear

SOE productivity has stagnated, widening the gap with private firms

Return on assets of Chinese industrial enterprises, by ownership type, 7mcma



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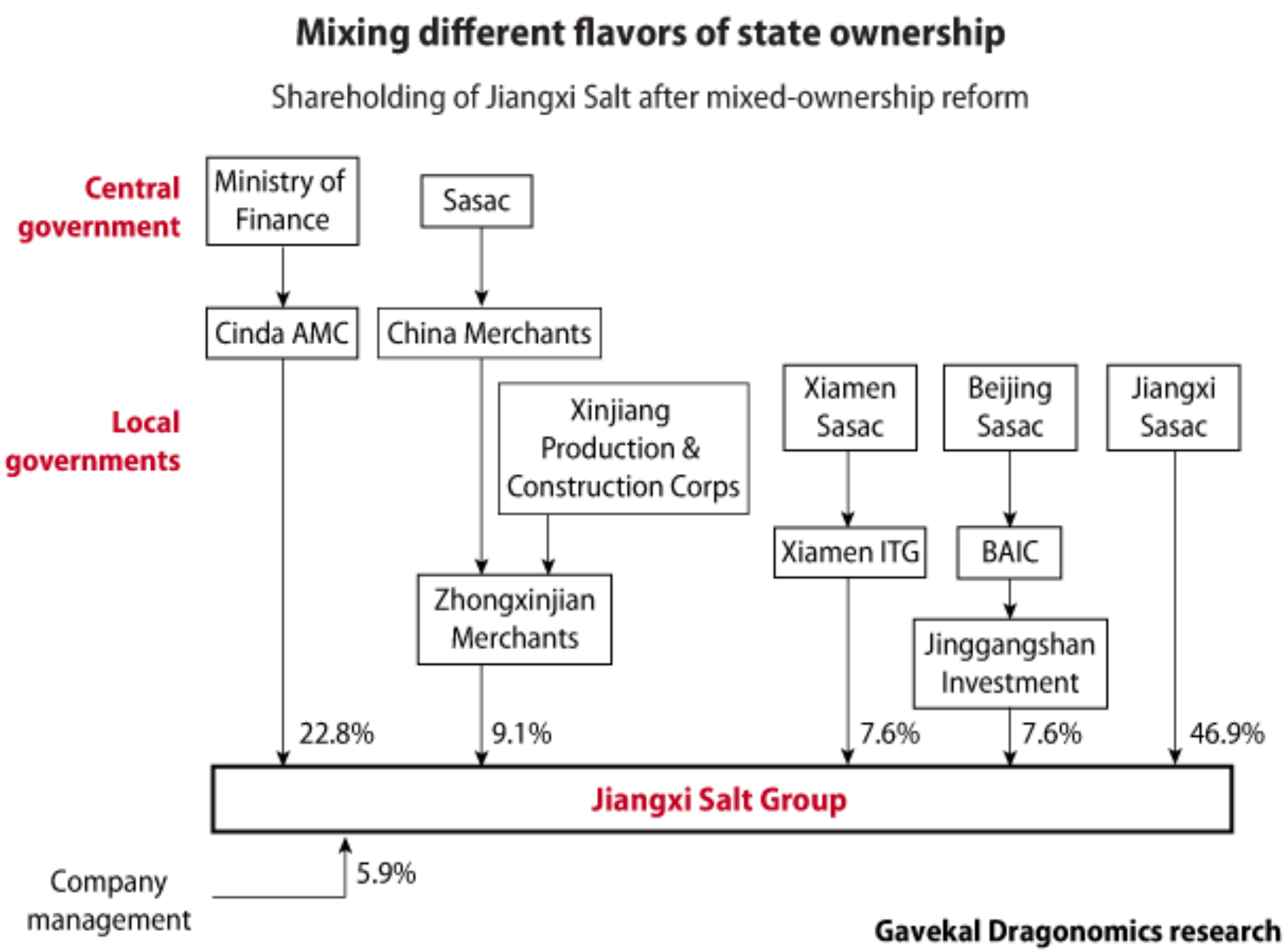
SOE reforms seem far too tepid



In September the Jiangxi provincial government announced a "mixed-ownership" deal that reduced its holding of local SOE Jiangxi Salt from 100% to 47%.

Virtually all of the new shareholders, though, are other SOEs, with company management taking a 6% stake.

This deal and others make clear that the main aim of "mixed ownership" is to rearrange state ownership, not privatize.

The question then becomes whether giving local SOEs more commercially-oriented SOE shareholders will really improve efficiency.

Concluding observations

- For Xi Jinping, economic reform is secondary to the political projects of national revival and firmer CCP control.
- A major shift from the prior 30 years: Xi seems to reject the tradeoffs that the CCP has traditionally made to balance the imperatives of regime stability and economic growth.
- Xi may accept markets as a *price-setting mechanism* but rejects them as a means of *reassigning control of assets*.
- Moreover the government reserves the right to intervene in markets if prices are 'wrong.' This can work all right in physical markets (grain, coal, houses) but is much more damaging in financial markets.

Concluding observations

- Consequences of the prioritization of political control over economic growth:
  - Risk that growth is supported not by innovation and higher productivity but by rising leverage, increasing financial stress
  - Global confidence in China's economic management will suffer: more frequent "China scares" in global markets
  - Political uncertainty will rise ahead of the October 2017 Party Congress at which 70% of the Central Committee, and 5 of 7 Politburo members, will turn over. Will Xi reveal a credible succession plan, or move to Putinesque permanent rule?

Contact and disclaimer

Thank you!

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