International > Economics

25 October 2013

China Economic Comment

National Australia Bank

China's fragmented economic development

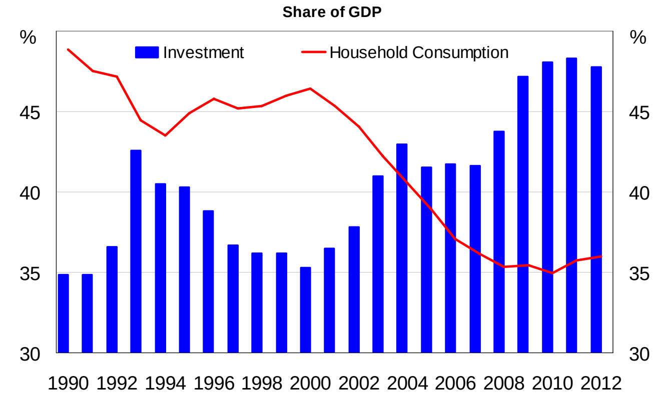
As the Chinese economy enters a transitional phase in its development, many are now questioning what this will mean for China's future economic performance. At one extreme there are those who believe that China's over reliance on credit and investment to drive growth is reaching its limits and will require a drastic adjustment to the economy that will see growth slow considerably. While this is still the minority view for China watchers, it has been gaining traction.

Nevertheless, China is no stranger to these types of adjustments. In the early to mid 1990's, China experienced an investment boom that saw the ratio of investment to GDP rise by around 7 percentage points from 35% in 1990 to around 42% by 1995. During this period, state-owned banks got themselves into trouble by lending large sums of money to state-owned enterprises, many of which turned out to be unprofitable and/or inefficient. Inevitably, non-performing loans (NPLs) began to rise (eventually hitting 50% of total credit according to the World Bank's database of banking crises) as these state owned enterprises defaulted on their loans. The Chinese government was forced to recapitalise the four major banks (injecting US$33 billion into them), which the World Bank estimates to have cost nearly 50% of GDP. Newly established asset management companies purchased US$168 billion NPLs in 1999-2000, and the big four banks were subsequently (partially) privatised. This banking crisis was associated with a GDP growth decline of around 2 percentage points below previous trend.

Turning back to the present situation, the IMF has examined a number of scenarios for how China's recent investment driven growth model could unfold over coming years. Their worst case scenario assumes that nothing is done by the Chinese authorities to address the mounting risks from overinvestment and rapid credit accumulation. Under this scenario, global demand is assumed to remain below pre-crisis levels, while a lack of reform means domestic demand in China fails to lift. Soft demand conditions results in much lower prices for manufactured goods and lower returns on investment that in turn drives profits lower and increases financial distress. In these circumstances, China's investment-to-GDP ratio is expected to correct sharply lower (around 10 percentage points), while its convergence (or income catch-up) with developed countries will stall, generating annual GDP growth of just 4% on average – well below the last decade's average of 10½% (which most would consider a 'hard landing').

The majority view, however, is that China will manage to find a way to press on with industrialisation and urbanisation that will see relatively rapid rates of economic growth for some time. There are many arguments supporting this proposition, such as the low rates of urbanisation by global standards, surplus labour and scope to remove inefficiencies stemming from the dominant role of state owned enterprises (SOE's). There is

China's growth composition



Sources: CEIC; NBS; NAB

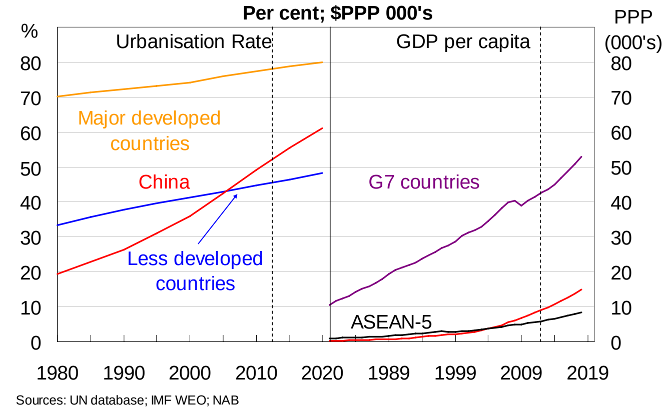
China's commercial bank restructuring

Table 1: China's Commercial Bank Restructuring

	BOC	CCB	ICBC	ABC	Total
Initial capital injection in (year):	1998	1998	1998	1998	
US$ billion	5	6	10	11	33
Initial NPL disposal in (year):[(a)]	99/00	99/00	99/00	99/00	
US$ billion	32	45	49	42	168
Subsequent capital injection in (year):	2003	2003	2005	2008	
US$ billion	23	23	17	19	81
Subsequent NPL disposal in (year):[(b)]	2004	2004	2005	2008	
US$ billion	33	15	86	117	252
IPO in:	2006	2005	2006	2010	
US$ billion	13	17	22	22	74

(a) Value of NPLs removed from banks' balance sheets; purchased at face value
(b) Value of NPLs removed from banks' balance sheets; the purchase price was typically around 50 per cent of this
Sources: Liu (2004); Ma and Fung (2002); banks' annual reports; RBA

China's development path



Sources: UN database; IMF WEO; NAB

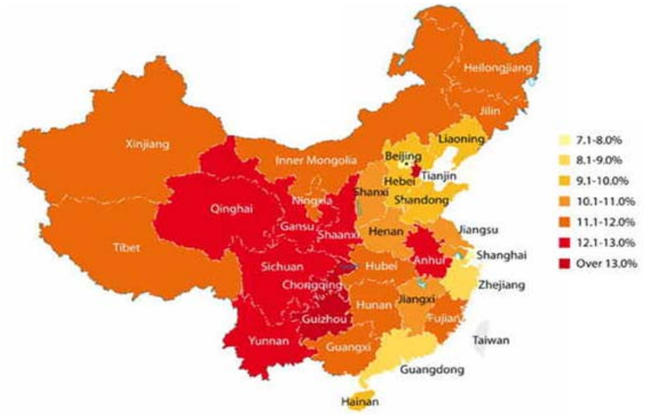
also evidence to support the argument that even though China's rate of investment has been high, the stock of capital is still well within reasonable ranges for an economy at China's stage of development.

Nevertheless, overcapacity in certain sectors of the economy highlights the need for reforms that encourage more efficient capital allocation. For example, if China were able to successfully reform the financial sector and resource pricing mechanisms, capital spending would slow and the investment-to-GDP ratio would ease gradually to 35% by 2030 (according to the IMF) – a much more stable and sustainable adjustment than the scenario discussed above. This is because these reforms will work to discourage investment in the manufacturing sector where overcapacity is most apparent, while simultaneously encouraging non-manufacturing investment that helps partially offset the slowdown. This implies a robust economic performance with real GDP growth averaging around 7% during 2013-30. However, the necessary improvement to productivity to achieve this exceeds international experience, suggesting this is more of an upper bound to expectations. While arguments for both a soft and a hard landing are compelling, the most likely outcome probably lies somewhere between these two scenarios, and will hinge upon the Chinese leadership's appetite for reform – something that appears to be gaining traction.

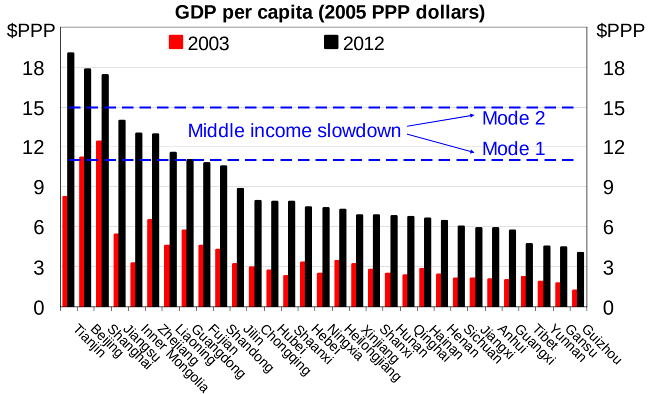
There is clearly still a significant amount of growth potential in China. This is apparent when we consider the fragmented nature of China's economic development to date. Analysis from Eichengreen, Park and Shin (2011 & 2013) demonstrates that growth rates of fast-expanding economies often decline by more than 2% per year on average once GDP per capita reaches the 15,000 (2005 PPP dollars) threshold – but many may even start to slow at 10,000. The geographical advantages enjoyed by the eastern regions (in relation to external markets), meant that economic development has been much more rapid in these areas. They have generally experienced the lion's share of China's income growth over the past couple of decades and have attracted large numbers of migrant workers from other regions in China. The hubs of Beijing, Shanghai and Tianjin have each recorded solid growth, reaching the status of 'upper-middle income' according to various benchmarks. As a result, the majority of China's provinces still have a long way to go towards convergence with the top three's income level, and may take many years to do so, driving solid (albeit moderating) rates of economic growth for the foreseeable future; provinces with GDP per capita below 15,000 account for 90% of national output, while providences below 10,000 (2005 PPP dollars) account for nearly two thirds. Another positive factor for China is that its relatively high rates of secondary education and high-tech exports place it well against the average for avoiding the middle-income trap.

There is no guarantee that the convergence will be smooth. Some of the issues facing the economy are more pronounced at the provincial level. For example, growth accounting exercises undertaken by the IMF suggest that while growth in output per worker in most provinces has managed to keep pace with more developed regions such as Shanghai, this has to a large extent been a reflection of significantly faster capital accumulation in most provinces, while human capital input has been relatively uniform across the country – a reflection of abundant cheap labour and restrictions on labour mobility

China's provincial GDP growth rates in 2012

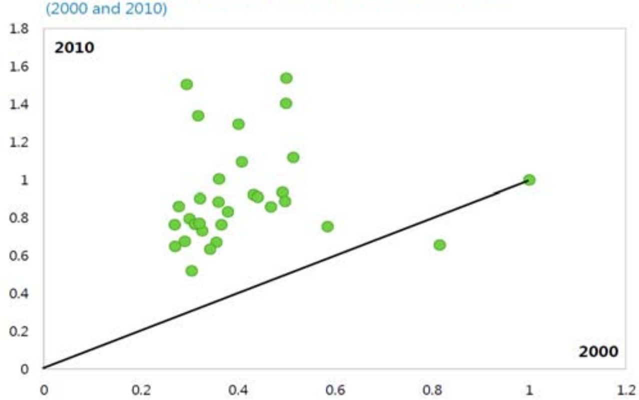


China's fragmented development

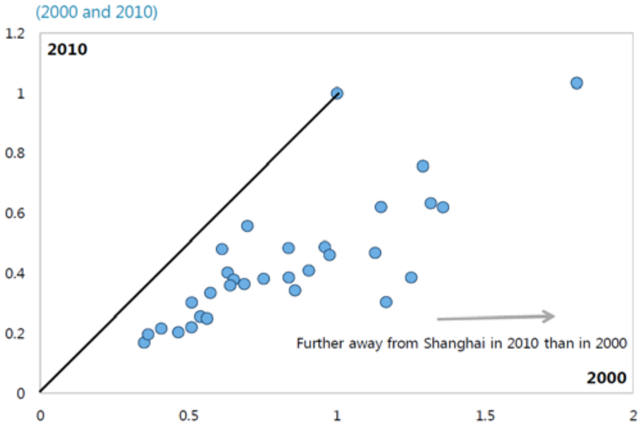


Sources: CEIC; Eichengreen, Park & Shin (2013) IMF; OECD; NAB

Physical capital input of provinces (relative to Shanghai) – IMF



Productivity of provinces (relative to Shanghai) – IMF



(namely the Hukou system). This implies that less developed provinces in China have experienced slower productivity improvements, reflecting a fall in the return on capital (a symptom of overinvestment), particularly in central and western regions; data show that Hubei, Guangdong, Shanghai, Beijing and Sichuan are the only provinces to see an improvement in capital productivity over the past decade.

Therefore, if China is to continue experiencing rapid economic growth there needs to be less reliance on capital accumulation and more emphasis on productivity improvements. There are a number of potential reforms that China could make in this respect. Reforms to open up markets (contestability) and allow for greater foreign investment, for example, have often been associated with the accumulation of expertise and technology. Deregulation of the services sector may improve the overall allocation of investment and increase the economies value-add, while simultaneously supporting household consumption via higher incomes. Greater mobility of labour is another important area for reform as policies such as the Hukou system severely limit urbanisation and the efficient matching of labour to vacancies. While there are many more potential reforms, if just these three are addressed and brought up to par with Shanghai's experience, IMF modelling suggests that China could easily achieve the ¾ percentage point acceleration in productivity improvements that are needed to match the path taken by other countries that have reached high income status.

Therefore, the good news is that China should be able to maintain a potential growth rate of 6-7% on average over the next 15 years or so. However, a combination of difficult and far reaching reforms will first be necessary to allow less developed provinces to achieve convergence. But regardless of how China's economic reforms unfold, the days of double digit growth in China appear to be behind us.

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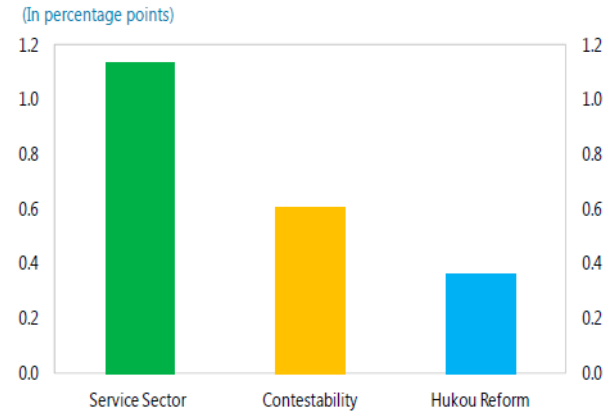
Productivity payoff from China reforms – IMF



Source: IMF staff estimates.

[1] Reforms envisage moving the national average of service sector employment share, contestability, and nonagricultural hukou share of population to the level of Shanghai in 2010.

References:

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4. Nabar and N'Diaye, *'Enhancing China's Medium-Term Growth Prospects: The Path to a High-Income Economy,'* IMF Working Paper 13/204.

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Recent economic data

According to National Accounts data released last week, the Chinese economy grew 2.2% in the September quarter to be 7.8% larger than the same period last year. The improvement in growth from last quarter was slightly above our expectation, but is consistent with partial indicators during the quarter. The Chinese economy has been gaining support from improvements in external demand – although export data for the month of September softened significantly – as well as stimulus measures intended to ensure that annual growth targets are achieved. Rapid credit growth earlier in the year may also be working to economic activity, but borrowing costs have now lifted noticeably.

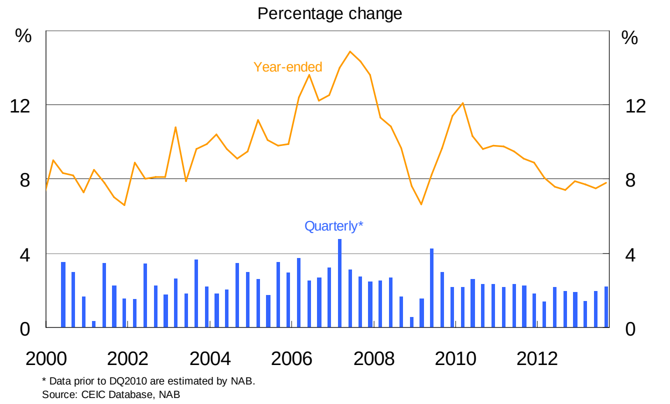
In contrast to rebalancing objectives, official data show that growth over the year-to-date in Q3 2013 was driven by investment (contributing 4.3ppts to growth), followed by consumption (3.5 ppts). This reflects the leaderships renewed emphasis on infrastructure spending to stimulate growth for this year. Net exports made a minor contraction, reflecting the smaller trade surplus. Revised q-o-q growth rates suggest the economy's growth momentum has picked up over the past two quarters, suggesting stimulus measures have been successful in helping achieve the growth target for this year (7.5%). Annualised growth for Q3 was 9.1%, well above the 7.5% rate of growth in H1 y-o-y.

The recent pick up in activity is not expected to continue much beyond the end of this year as efforts to rebalance and restructure the economy gain more traction. We have revised our forecast for 2013 slightly higher to 7.6% (from 7.5%), but we still see growth decelerating to 7¼% next year. Regarding the monetary policy outlook, we expect the central bank to continue ensuring adequate liquidity for domestic banks while maintaining tighter overall monetary conditions to discourage speculative investment and rapid credit growth. Reserve requirements and benchmark interest rates are expected to remain stable. A cut to reserve requirements can not be completely ruled out, particularly in the event of an external shock to liquidity, but this is not our expectation. We can also expect to see ongoing policy 'fine tuning' as policymakers balance inflation (and debt market) concerns against annual growth targets (ensuring growth above the implied 7% floor). In terms of the longer term policy objectives, the upcoming 3rd Plenary Session of the 18th CPC Central Committee (in November), should provide insight into the new leaderships policy objectives and their approach to achieving reform targets.

Business surveys show that conditions facing Chinese firms remain challenging, but are starting to recover. Conditions in the real estate sector continue to pick up on the back of stronger demand and expanding developer credit, but rising funding costs and concerns over affordability may soon dampen the sector. Conditions facing retail and wholesale business ticked higher, but remain at low levels, reflecting the muted growth in nominal retail sales relative to history. Consistent with this (and demonstrating the difficulties in rebalancing the economy), growth in real urban household disposable income has undershot GDP this year (6.5% ytd), although income growth for rural households was somewhat better (9.6%).

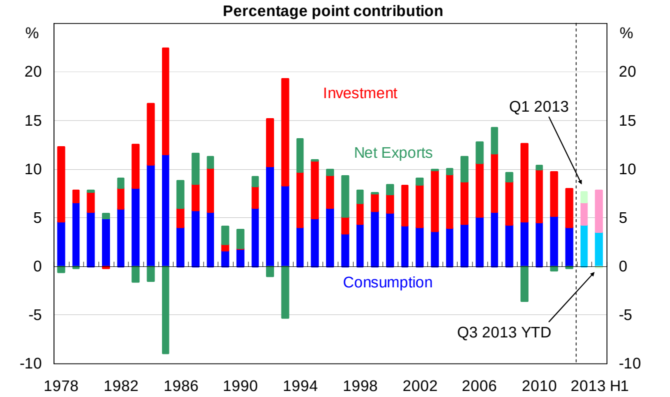
Domestic demand is tracking better. Industrial production was in line with expectations for the month, while retail sales and

Real GDP growth

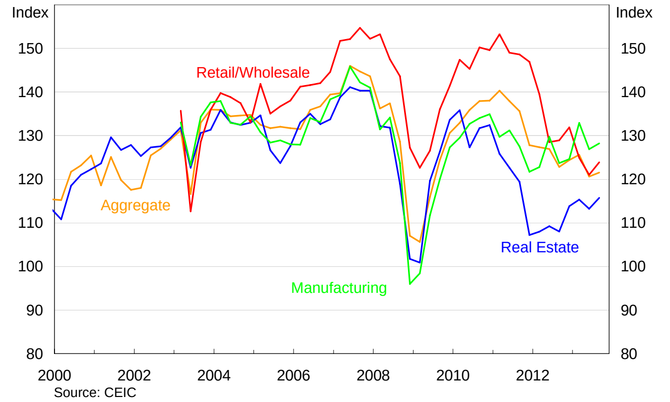


* Data prior to DQ2010 are estimated by NAB.
Source: CEIC Database, NAB

Contribution to GDP growth

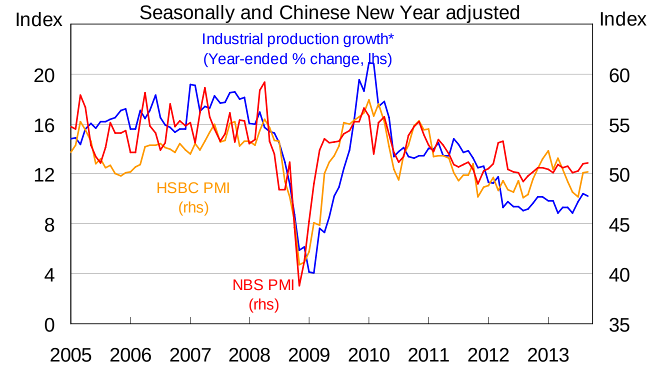


China's business climate – concerning trend for retail



Source: CEIC

Industrial Production



* Adjusted for Chinese New Year
Source: CEIC, Nab

investment were slightly below. Softer than expected exports growth may put a dampener on expectations for a recovery in manufacturing, but seasonal impacts and a reduction in ‘hot money’ inflows may help to explain some of the weakness.

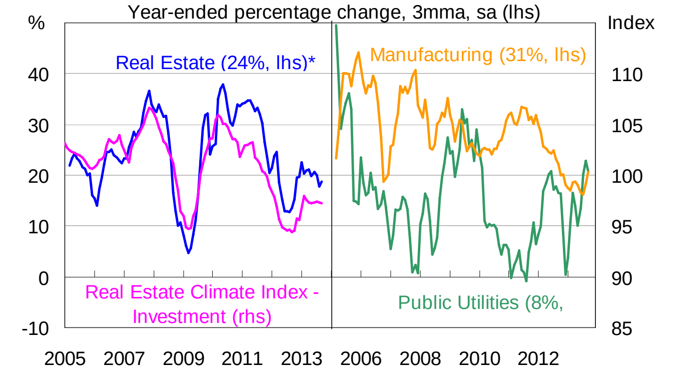
Turning to the partial indicators in more detail, industrial production growth decelerated marginally to 10.2% y-o-y in September (from 10.4%), consistent with softer merchandise exports, business investment and steady retail sales. Both major manufacturing PMI’s also rose in the month. The official NBS index increased slightly to 51.1 (from 51) indicating further expansion for large and state owned enterprises. The Markit index, more representative of small and medium sized firms, was 50.2 in September (up from 50.1) indicating a more modest expansion (the October flash lifted to 50.9). By type, production of construction related materials were mixed. Steel output rose 15.5% over the year to September, while cement production eased to 6.4%. As for other products, vehicle and textile production rose to 17.5% and 8.9% respectively, while power generation decelerated to 8.2%.

On the non-manufacturing side, the PMI jumped to 55.4 in September (up from 53.9), the highest level since March, consistent with solid GDP growth for the tertiary sector in Q3. The employment component of the index eased slightly, but still indicates robust labour demand. However, business expectations dipped to their lowest level since the global financial crisis, which may suggest flagging support from the services sector despite favourable government policies and a structural shift in the Chinese economy. This sentiment has also been echoed in private surveys and may reflect tighter monetary conditions and uncertainty over the policy and economic growth outlook.

Our estimates of fixed asset investment growth show that momentum slowed in September with growth easing to 19.4% y-o-y, down from 21.5% y-o-y in August. By sector, manufacturing investment was steady, having faced headwinds from overcapacity in some industries and weak profits growth, rising 22% y-o-y in September. Utilities investment remained soft compared to mid-year’s relatively rapid growth, which could reflect an easing in public infrastructure investment, although the series tends to be volatile and growth is still elevated in trend terms. Growth in real estate investment has been volatile over the past year, but remains above 2012 lows. Growth jumped in September to around 22% y-o-y. Looking forward, annual growth in newly started investment projects picked up in September, while the real estate climate has remained steady. However, strong increases in property prices run the risk of further actions by the government to contain the sector.

Nominal retail sales growth was slightly below market expectations in September, easing to 13.3% y-o-y (down from 13.4% the previous month). This outcome is below the government’s target rate of 14½% for 2013, suggesting more needs to be done to promote household incomes and spending. Accounting for retail prices in the month, real growth in retail sales was 11.2%y-o-y (down from 11.6% the previous month). Consumer confidence remained around all time lows in August, consistent with slower income growth in the first three quarters of the year and may signal concern over labour market conditions. Indicators of the labour market are a little mixed. The employment component of the PMI eased in September and has remained below 50 since May 2012. In contrast, the city labour market demand-supply ratio

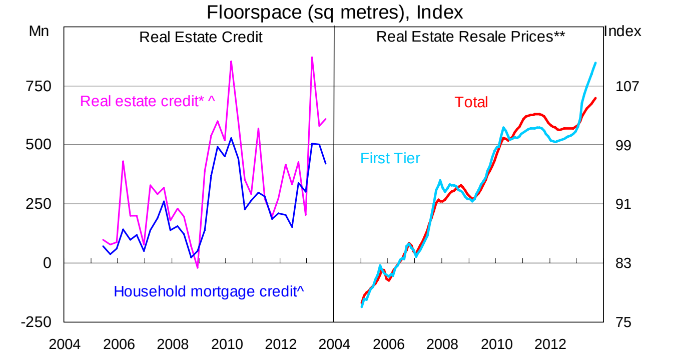
Fixed Asset Investment by Sector



Source: CEIC, NAB

* Number in brackets represents share of total FAI in 2010; Real Estate is using Real Estate Investment data

Easier finance earlier in the year driving property prices



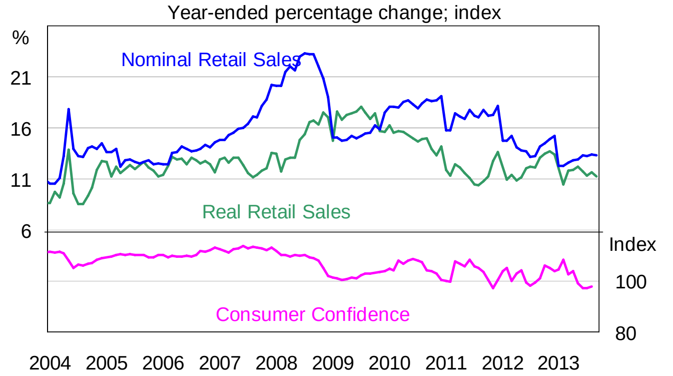
* Includes finance to real estate developers

** Weight average of cities. Calculated by NAB.

^ Non-break adjusted

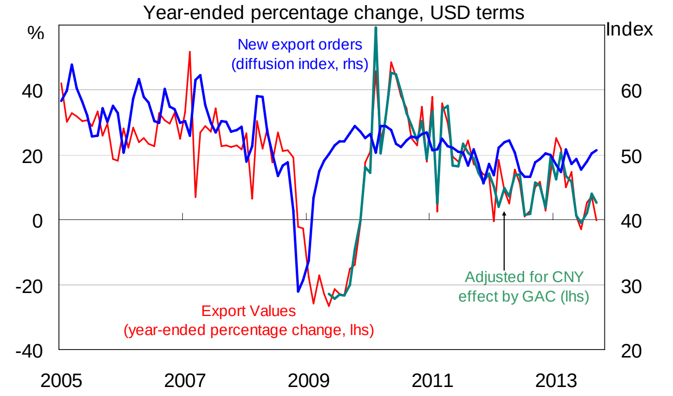
Source: CEIC, NAB

Retail Sales



* No observation is shown for January due to the effect of Chinese New Year; Feburary shows the average of January and February compared to December.

Merchandise exports and new export orders



suggests very little slack in the urban labour market – although this can be impacted by labour migration. By product, softer sales growth in food & drink, catering services and petroleum has offset stronger growth in other categories, particularly for automobiles, textiles, and household electronics.

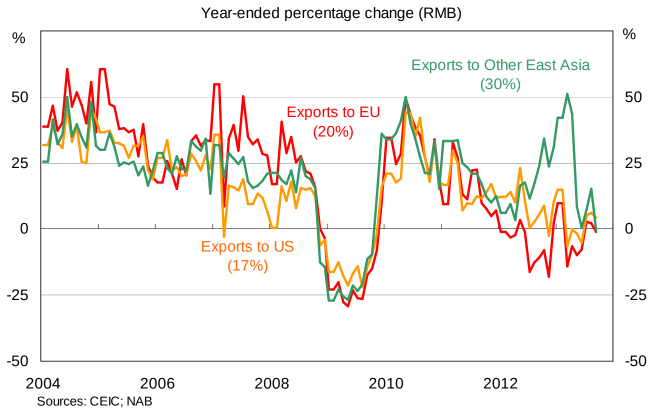
Trade data for September were mixed, although special factors may be having an impact on the headline numbers. Growth in merchandise export values was -0.3% y-o-y to September (following 7.2% y-o-y increase for August). This was well below market expectations, and might dampen hopes for further support to industrial activity from the exports sector – particularly given headwinds from political problems in the US. However, after adjusting for seasonality, exports rose by 8.3% m-o-m in September, which appears to be more consistent with recent improvements in export orders according to the PMI survey. Part of the inconsistency could stem from distortions created by the timing of the mid-Autumn holidays. Hot money inflows could also be partly to blame as these began to gather pace around this time last year.

Consistent with the timing of holidays and trends in hot money flows, exports non-Japan Asia were particularly soft in the month, driven by weaker exports to ASEAN, Korea, Taiwan and Hong Kong. Exports to the EU also softened marginally, shipments to the US were relatively steady, while exports to Japan accelerated. By product, high tech exports fell almost 2% m-o-m sa in September to be up 2.7% y-o-y, while mechanical and electrical exports were down 2.7% m-o-m sa to be 0.4% higher over the year. Exports of lower-end goods were also softer, falling 4% m-o-m sa.

Imports in September provide a more positive signal for domestic demand in China. Growth over the year was recorded at 7.4%, which was slightly above market expectations. Official estimates suggest that imports rose by 11% m-o-m (sa), although some of this comes on the back of strong commodity demand under pinned by stimulus investments. In contrast, imports of manufactured goods and machinery and transport equipment have slowed (0.7% and 2.6% y-o-y respectively), which suggests a trend that is counter to domestic rebalancing efforts. Imports of crude oil rose by 20% in the month to be 28% higher on last year, while copper imports rose by 18% to be 16% higher y-o-y. Iron ore imports rose 8.1% in September to hit a record high; 14.7% higher y-o-y. With exports growth dipping below expectations, the trade surplus narrowed in September to US$15.2 billion (down from US$28.5 billion in August).

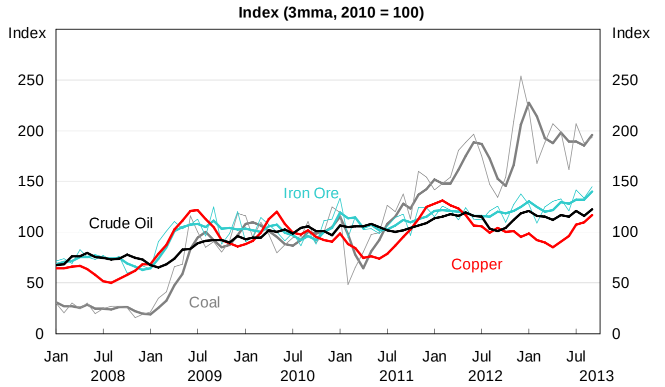
The headline CPI rose to 3.1% y-o-y in September, up from 2.6% in August. Looking through seasonal distortions, this is the closest the CPI has come to the official target of 3.5% this year. Food prices were the primary driver of the acceleration, increasing 6.1% y-o-y (up from 4.7% in August). Non-food inflation rose only slightly in the month to be 1.6% higher over the year (up from 1.5%). Deflation in factory prices moderated further in September, easing to -1.3% y-o-y (down from -3.6% in late 2012). However this was the nineteenth consecutive annual decline in producer prices.We have been flagging a potential rise in consumer inflation pressures, but September's acceleration was a little more than expected. It came on the back of poor weather conditions driving up food costs, particularly for vegetables and dairy which increased more than 17% and 6% on last year respectively. The NBS also

Merchandise exports to major trading partners



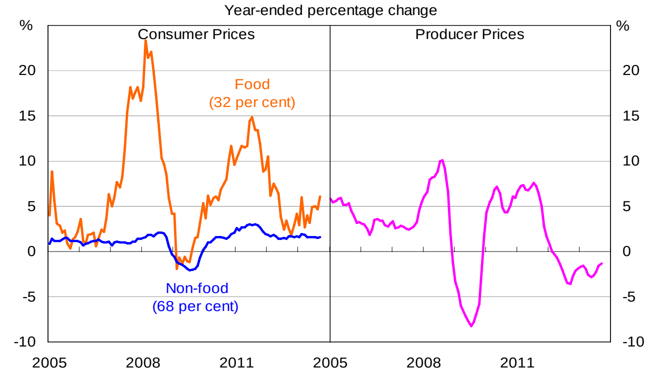
Sources: CEIC; NAB

Commodity import volumes supported by investment

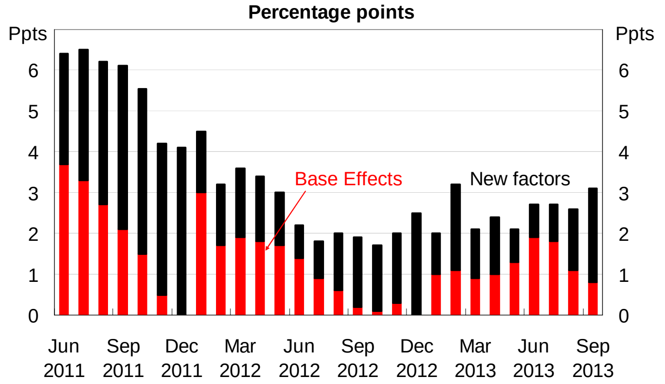


Sources: CEIC; NAB

Consumer Prices



CPI Inflation – impact from base effects



Sources: CEIC: NAB

sighted seasonal demand as a factor behind the increase. Given that most of the spike is stemming from temporary supply disruptions, policy makers are unlikely to respond in a hurry, but will be on the look out for any pass-through to other prices. We expect that solid credit growth and a global economic recovery could push CPI inflation above the government's target rate during 2014, which will present a possible constraint on further policy stimulus should it be necessary.

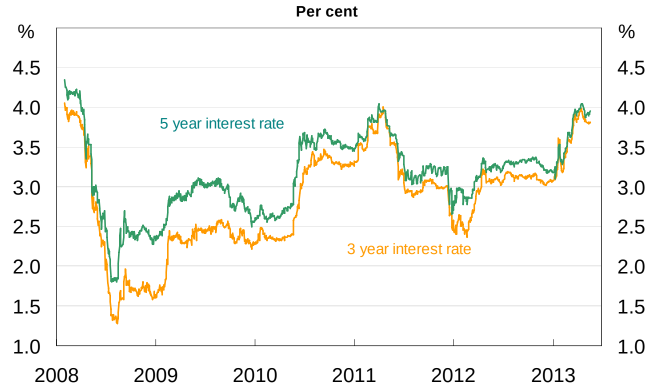
Policy expectation:

China's policy makers have recently affirmed their position on policy, indicating that they will be keeping monetary policy 'prudent' and largely stable, with some fine-tuning while maintaining appropriate levels of bank liquidity. But while inflation pressures appear to be broadly under control for now, credit expansion has been robust, which could warrant a tightening response, particularly if capital inflows resume – foreign reserves rose by more than US$163 billion in the September quarter, one of the largest ever increases. Given these conditions, chances of a cut to major policy instruments (benchmark interest rates and/or reserve requirements) are slimming, and it will likely require a significant shock to growth and the labour market to alter this position.

Consistent with this, monetary conditions in longer dated debt markets have remained very tight in an apparent attempt to rein in speculative investments. Bond rates (3 and 5 year) have held up around the highs seen at the peak of the 2010/11 policy tightening cycle. Despite this, total social financing was stronger than expected in September at RMB 1,420 billion (down from RMB 1,568 billion), as were new yuan loans (RMB 787 billion). The smaller increase in non-bank lending is a good sign for those concerned about the burgeoning shadow banking sector, although non-bank finance has been volatile recently and has been trending up from this years low in recent months (non-bank finance accounted for around 40% of total finance).

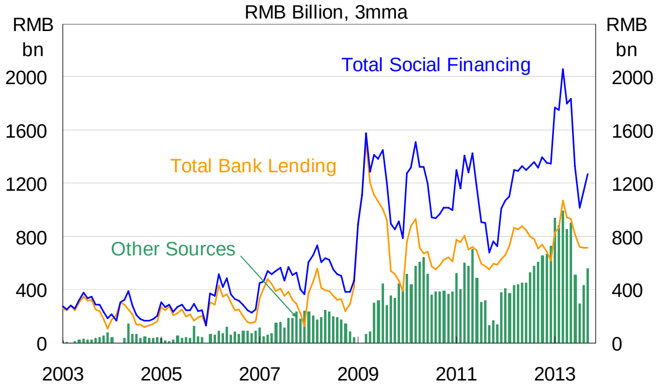
Liquidity conditions have remained significantly better than mid-years 'credit crunch', although interest rates remain elevated from earlier in the year. While the central banks liquidity injections were smaller in September, trade surpluses and concerns over the US government shutdown have kept liquidity at adequate levels. Nevertheless, the PBoC has now halted its liquidity-injecting market operations, which is pushing up interbank rates.

Longer maturity interest rates

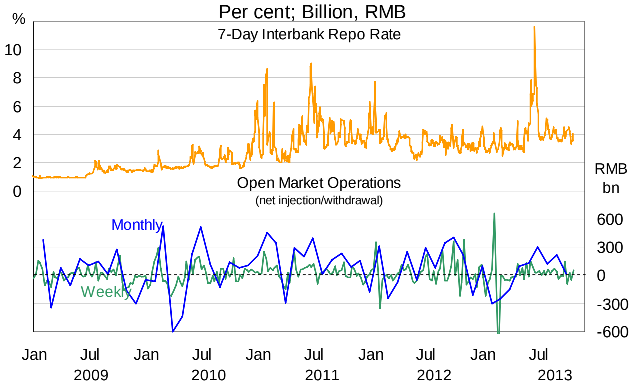


Sources: CEIC Database

Total social financing rising again



Liquidity conditions



Source: CEIC

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