China Economic Update

by NAB Group Economics

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National Australia Bank

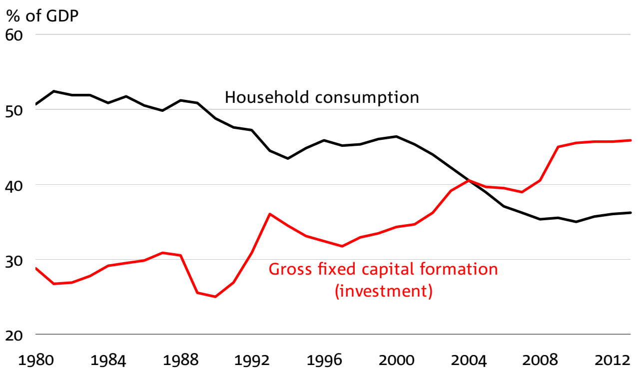
Modest progress on reform could constrain China's longer term growth

Twelve months ago, China's Government announced its reform agenda, following on from the Third Plenum. So far, progress on these reforms has been limited – primarily in social policies such as loosening the Hukou system (which we have argued could go further) and the One Child Policy, along with reforms to the budgetary relationship between Beijing and local governments (which should ease some of the concern around local government debts). In contrast, progress towards broad deregulation and liberalisation of the finance sector and expanded competition across the economy has been slow.

Last year we expressed cautious optimism towards the proposed reforms, anticipating a long and slow path. We highlighted that the Government had set an implementation target of 2020, that there were significant obstacles presented by vested interests and that there had been a history of sweeping reform proposals that fell by the wayside.

That said, the slow pace of reform is somewhat concerning, given the widespread view that China's growth model has run out of steam, and that transition towards a consumption based economy (as opposed to the investment model that has fuelled the country's growth in recent decades) is urgently required. The reform agenda has been viewed as necessary to support this transition – particularly financial market reforms (such as deposit insurance and liberalisation of interest rates) which would end the long standing policies of financial repression and boost the household sector's share of the economy.

China's investment driven growth has driven the household share of GDP to low levels



Source: CEIC, NAB Economics

China's growth prospects depend on pace of reform

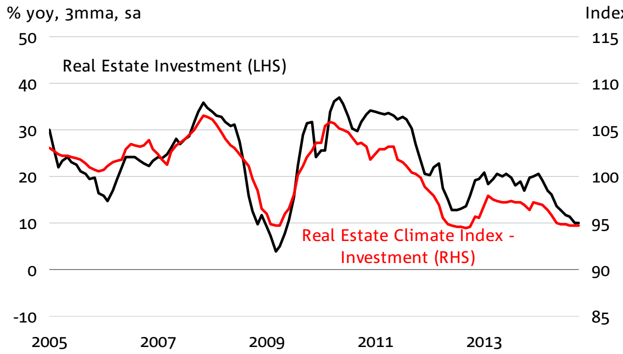
The Government also announced a broad economic target at the Third Plenum, aiming to double the size of China's economy between 2010 and 2020 – equivalent to an annual average growth rate of 7.2%. Given that China's growth rate is currently slowing – we forecast annual growth of 7.3% this year and 7.0% in 2015 – this target already appears to be challenging.

Growth projections for China's economy beyond 2015 depend in a large part on assumptions around the path of reform, but generally assume that the rate of growth is set to slow. For example, the International Monetary Fund (IMF) expect China's annual growth rate to average 6.6% between 2015 and 2019, with the main risks identified including excess capacity – a key issue in a range of sectors, including the steel industry – and the credit overhang, highlighting the ongoing importance of credit-fuelled investment to China's growth. The IMF note that failing to transition towards a consumption based economy will result in increased vulnerabilities to growth.

The projections from the World Bank are similar (albeit somewhat more optimistic) – with economic growth expected to average 7.0% a year between 2016 and 2020. The World Bank notes that the pace of deleveraging in China is a key risk to the outlook.

In contrast, a recently released report from the Conference Board has a less positive outlook for China. Over the period from 2015 to 2019, the organisation expects China's economic growth to slow to around 5.5% a year. Central to this projection is the view that China's productivity is declining – in part due to diminishing returns on investment in infrastructure and real estate – while at the same time the pace of reform is too slow, given the continued importance of State Owned Enterprises (SOEs) and a limited role for market forces (constraining innovation in China's economy).

Real estate investment in China has slowed considerably across the past year – reflecting weak market conditions

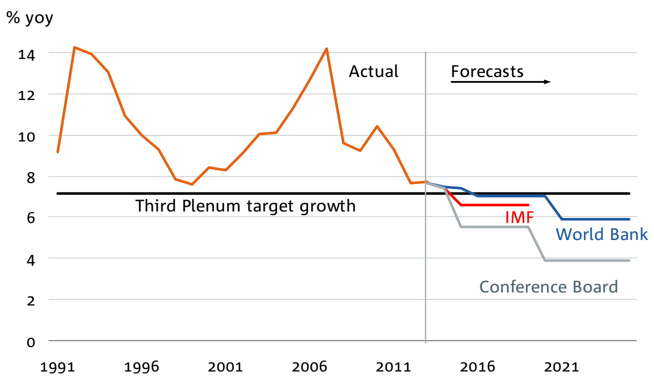


Source: CEIC, NAB Economics

According to the Conference Board, China could lift its rate of growth if competition intensifies within the economy – reducing the role of SOEs – and if financial reforms improve the efficiency of credit allocation – away from politically connected borrowers towards the most commercially viable ones (on the basis of risk and return). However, the organisation believes that this outcome to be unlikely, as the short term economic slowdown that would be associated with such reforms could be politically unacceptable.

Longer term projections of China's economic growth (out to around 2025) also point towards a slower growth trend. Over the period from 2021 to 2025, the World Bank project China to grow at an annual average rate of 5.9%, while the Conference Board anticipate 3.9% growth a year between 2020 and 2025.

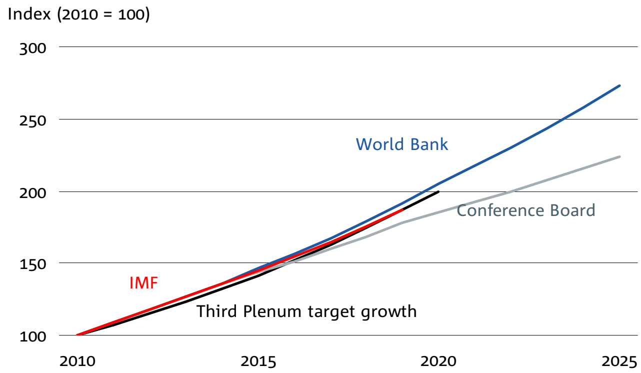
Marked divergence in longer term projections for China's growth



Source: CEIC, IMF, World Bank, Conference Board, NAB Economics

Despite having a relatively weak outlook, when compared with other forecasters, the Conference Board describe China's economic path over this period as a long soft fall, noting that China will continue to enjoy a number of advantages over economic peers. These include remaining a key growth market (due to the sheer scale of the economy), retaining a competitive position in manufacturing (even compared with other emerging markets) and providing potential benefits for multinational firms from the gradual reforms – profiting from efficiency gains within the domestic economy.

Size of China's economy would be considerably different between World Bank and Conference Board outlooks



Source: CEIC, IMF, World Bank, Conference Board, NAB Economics

Some commentators have argued that the Conference Board outlook is excessively negative – suggesting that there is considerable potential for productivity gains across the Chinese economy, particularly in sectors that are currently dominated by State Owned Enterprises. That said, periods of such sustained economic growth (as China has experienced over the past few decades) have been the exception rather than the norm, and weaker growth for China is likely over the longer term.

Conclusions

The transition away from an investment based economy is likely to coincide with a slower trend growth for China (albeit growth that is likely to be far more sustainable). The smoothness and pace of this transition will largely depend on how effectively China's Government can implement reform. Progress to date has been modest – but largely in line with our expectations – but the need to improve competition and liberalise financial markets is slowly becoming more urgent.

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