China Economic Update

by NAB Group Economics

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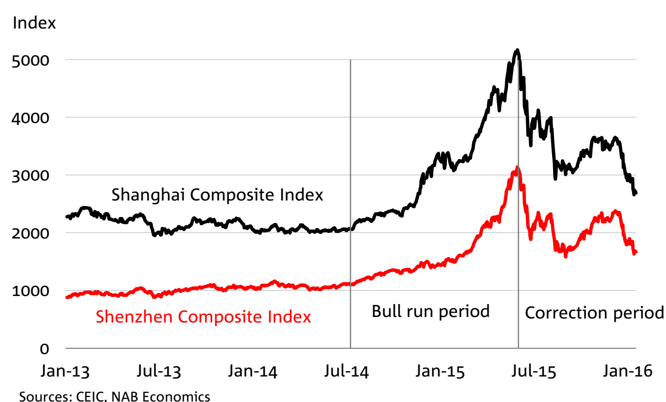
China's risk levels have risen ahead of the year of the Monkey

The early weeks of 2016 have seen more turmoil in Chinese financial markets, as volatility in share markets has persisted and concerns around capital outflows have continued to grow. Allied with a further slowing trend in China's economy at the end of 2015, it appears that the outlook for China in the year of the Monkey is riskier than has been the case in recent years.

Equity markets – erasing the 2014-15 bull run?

Across January, China's two main share markets, Shanghai and Shenzhen, recorded significant falls from their end-2015 levels – down by -23% and -27% respectively. As we have previously argued, the bull run in China's share markets that commenced in late 2014 was not supported by underlying fundamentals – fuelled instead by an inflow of new investors and margin lending that created an unsustainable bubble in these markets.

Chinese share markets have plunged since the start of the year, but still have some way to go



Sources: CEIC, NAB Economics

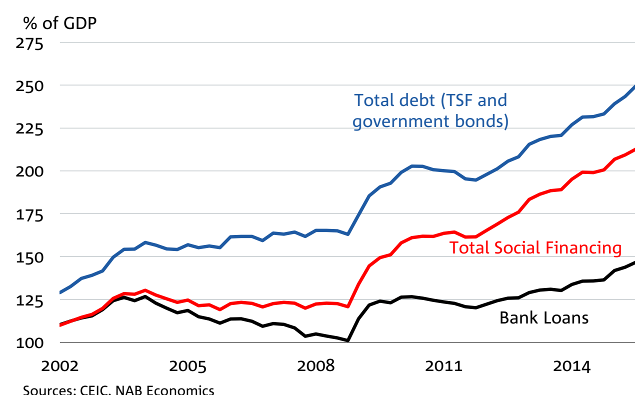
Policy measures intended to support these markets following the mid-2015 correction have proved largely ineffective – initially attempting to prop up the market at unsustainably high levels and more recently implementing a circuit breaker mechanism (that was suspended after four days of use) – as equity prices have continued to trend down. In early February, the Shanghai and Shenzhen composite indices were still around 30% and 50% respectively above their pre-bull run levels, indicating the potential for further downward pressure in the short term.

While the wealth effects of the bull run (and subsequent crash) in equity markets were too short term to impact household spending plans, there are still likely to be significant impacts from the continued volatility in these markets. Arguably the most important is the impact on equity financing for Chinese firms – which are generally highly leveraged – with Chinese investors likely to be more risk averse in the short term, limiting the potential for a much needed rebalancing in corporate financing.

The Debt Dilemma – how fast can China afford to grow?

China's debt levels have grown considerably over the past decade. Prior to the Global Financial Crisis, there were few concerns expressed around the scale of China's debts – which trended around 160% of GDP. However, total debt grew rapidly following the GFC – with an initial spike connected to the large scale stimulus introduced to ward off the crisis, followed by steady increase that commenced in 2012 – as China's credit intensity (the ratio of credit growth to nominal GDP growth) increased significantly, with debt outpacing economic growth.

Narrow estimate of China's total debt now exceeds 250% of GDP – but could be higher



Sources: CEIC, NAB Economics

According to a relatively narrow estimate, total debt (comprising bank loans, other social financing and government bonds) totalled just over 250% of GDP in December 2015. This figure excludes parts of the country's shadow banking sector – which we previously estimated at up to 100% of GDP in late 2014 – meaning that a broader estimate of China's total debt could exceed 300% of GDP.

China cannot afford to allow debt to grow unchecked – to do so would increase the likelihood of a major financial crisis and a hard landing longer term. However managing this debt burden would likely mean tolerating a lower potential rate of economic growth than seen in previous years – something that may face severe political opposition.

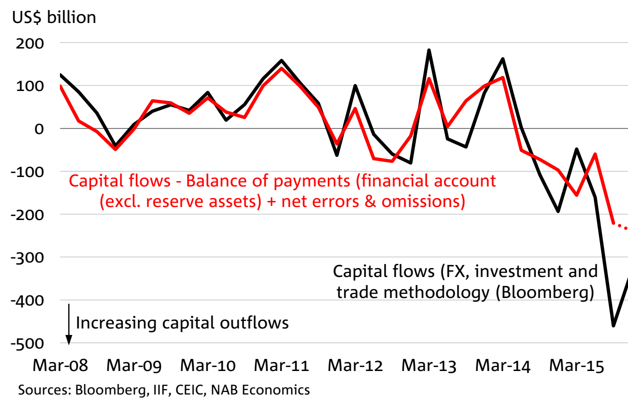
Will capital outflow continue unchecked or are tighter controls inevitable?

An acceleration in capital outflows was a key theme for China in 2015, with a range of factors contributing to this trend. Negative trends in shadow banking and exchange rate movements reversed a previously profitable carry trade, leading to hot money flows exiting the country. The Institute of International Finance (IIF) highlight deleveraging of dollar denominated debt by Chinese firms (as the Yuan ended its appreciation cycle) as a more positive factor. In addition, changes to portfolio and

foreign direct investment flows have also contributed to this trend – with inbound investment in China slowing as its investment abroad stepped up.

Estimates of the capital outflow vary considerably – for example the IIF put the figure at around US$676 billion in 2015 (using a balance of payments methodology), while Bloomberg Intelligence estimated outflows of around US$1 trillion (compared with just US$134 billion in 2014) – using a methodology based on foreign exchange, investment and trade flows.

Estimates of China's capital outflows differ, but widened considerably across 2015



Sources: Bloomberg, IIF, CEIC, NAB Economics

Accelerating capital outflows are problematic for Chinese and global policy makers – especially if they lead to more pressure for currency depreciation that could add to global deflationary pressure and some fears of 'beggar-thy-neighbour' competitive devaluations. The People's Bank of China has implemented a range of measures over the past eighteen months, including reductions to the Required Reserve Ratio and injections via open market operations in order to maintain domestic financial market liquidity, however these measures are reactive, rather than addressing the cause of capital outflows.

There have been increasing calls globally for China to implement short term capital controls – most notably from the Bank of Japan's Governor Kuroda – in stark contrast to the opening up of the capital account encouraged by the IMF ahead of the Yuan's inclusion in the Special Drawing Rights basket. While short term controls may help stabilise the financial sector, it would not be encouraging to see China lose momentum in its broad reform agenda.

Conclusions

There is little to suggest that the volatility in Chinese markets in the early weeks of 2016 is set to lessen quickly. Aside from the inherent risks associated with volatility in equity and financial markets, the policy response from China's government adds an extra element of uncertainty – as rumours around short term capital controls persist. We forecast China's economic growth to ease to 6.7% in 2016 (from 6.9% last year) – however risks to this forecast are clearly weighted to the downside.

For more information, please contact

Gerard Burg +613 8634 2788

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Riki Polygenis
Head of Australia Economics
+(61 3) 8697 9534

James Glenn
Senior Economist – Australia
+(61 3) 9208 8129

Vyanne Lai
Economist – Australia
+(61 3) 8634 0198

Phin Ziebell
Economist – Australia
+61 (0) 475 940 662

Amy Li
Economist – Australia
+(61 3) 8634 1563

Industry Analysis

Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Industry Analysis
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Industry Analysis
+(61 3) 8634 3837

Karla Bulauan
Economist – Industry Analysis
+(61 3) 86414028

International Economics

Tom Taylor
Head of Economics, International
+(61 3) 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics
Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

David de Garis
Senior Economist
+61 3 8641 3045

Tapas Strickland
Economist
+61 2 9237 1980

FX Strategy
Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Rodrigo Catril
Currency Strategist
+61 2 9293 7109

Interest Rate Strategy
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Andrew Jones
Credit Analyst
+61 3 8641 0978

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Kymberly Martin
Senior Market Strategist
+64 4 924 7654

Raiko Shareef
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web Administrator
+64 4 474 9771

UK/Europe

Nick Parsons
Head of Research, UK/Europe, and Global Co-Head of FX Strategy
+44207710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Derek Allassani
Research Production Manager
+44 207 710 1532

Asia

Christy Tan
Head of Markets Strategy/Research, Asia
+852 2822 5350

Julian Wee
Senior Markets Strategist, Asia
+65 6632 8055

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