SPECIAL REPORT

ECONOMIC RESEARCH

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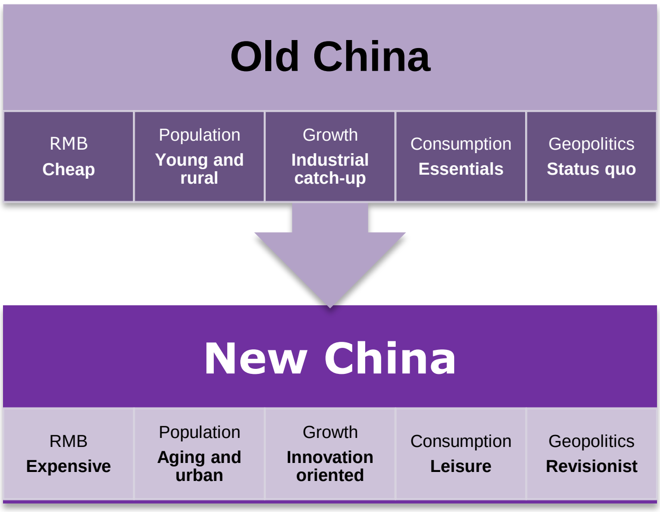
From Old to New China: Tectonic shifts for Asia in 2016?

Summary

2016 will be a crucial year for China's transformation into a consumption/service-based economy. These tectonic shifts from an Old to a New China will not only create shockwaves in China but also in the rest of Asia with key winners and losers. This report focuses on five key themes: the currency, demographic changes, the shift in growth model, changes in the consumption pattern and an increasingly assertive geopolitical agenda.

Finally, we analyze whether the transformation towards a New China will happen according to plan. Such outcome hinges on the Chinese government's ability to put up with the unavoidable costs of such shift. We argue that two interrelated issues determine whether 2016 will be a consumption story or an export motivated one, namely the path of the RMB and the "corporate disruption" that the Chinese government will be willing to accept.

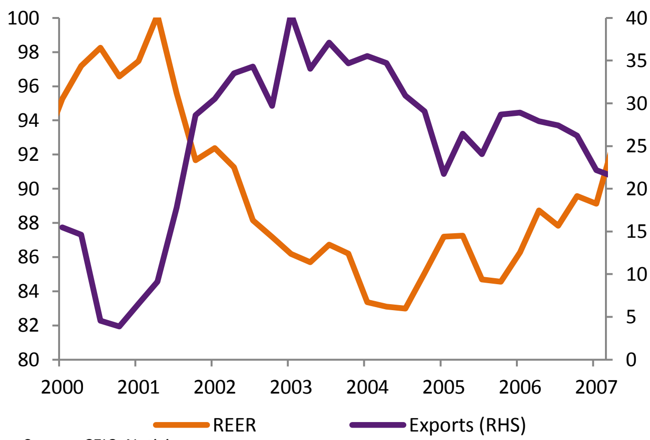


Out with the old, in with the New China

Changes happen "gradually, then suddenly." While gradual tremors have taken place for years, major tectonic shifts are coming to Asia in 2016. A central catalyst for this transformation is China, which will begin to aggressively shed its old skin and adopt new priorities to achieve targets for 2016-2020 and beyond. This will have major implications for China and the rest of Asia for years to come.

We analyze five major themes of the New China (**Figure 1**). For each of them, we explore which sectors and countries may thrive in this new landscape. Finally, we look at the risk of China not being able to transit smoothly from the Old to the New China. First, we take a look at the most important change to the region in the past three decades: the transformation of a cheap RMB into an expensive yuan (**Chart 1**).

Chart 1. The RMB was cheap, helping exports



Source: CEIC, Natixis

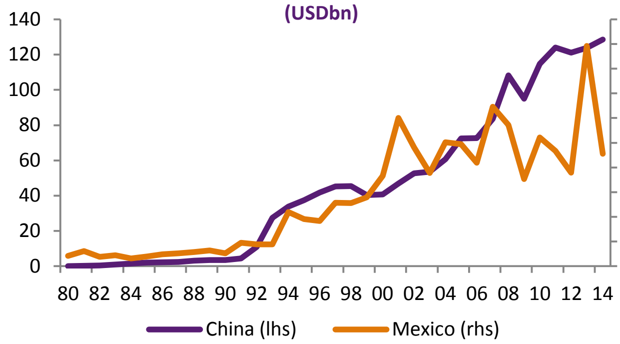
1. The RMB: Cheap to Expensive

The red back is arguably the most controversial currency in town. The price in which Chinese assets are valued influences not only the attractiveness of Chinese markets for the rest of the world but also regional (if not global) competition for capital and export market share. By opening up its flood of cheap 440 million-people labor force and keeping the yuan inexpensive through accumulation of reserves, China managed to divert direct foreign investment from places as far as Mexico and as close as ASEAN (**Chart 2**). But overtime, as the supply of cheap labor declines and wages have been rising rapidly, the yuan has become expensive. This change has and will continue to transform China and the region. We first take a look at the impact of the cheap yuan and then identify the domestic winners and losers of an expensive RMB.

Cheap yuan

China has been gaining export market share steadily for years thanks to rapid growth of exports, supported by an undervalued RMB. In fact, China exports reached 12% of global market share in 2014 from less than 1% in 1980. Not even Japan ever got there. In the same vein, China has attracted huge amounts of FDI inflows, diverting funds from Mexico when China joined the World Trade Organization in 2001. Finally, high VAT taxes, artificially low deposit interest rates capped by a ceiling, and an undervalued RMB curbed Chinese consumers purchasing power, channeling their very large savings to state-owned enterprises.

Chart 2. China's cheap yuan diverted FDI from Mexico (USDbn)



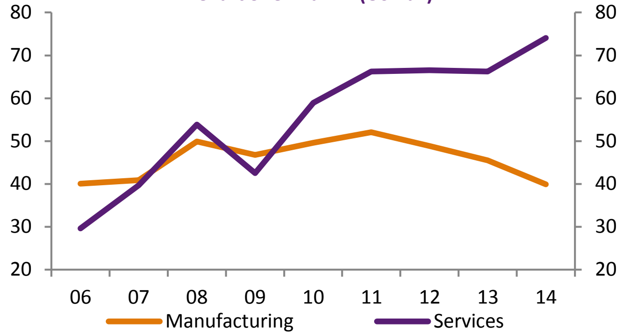
Source: UNCTAD, Natixis

While this strategy supported China's rapid industrialization in the earlier years, dependence on external demand was quickly abandoned in the aftermath of the Global Financial Crisis. China looked inward for sources of growth through investment and the RMB was allowed to appreciate as a response to US pressure but also the relatively less importance of a cheap RMB for China's growth strategy. From 2011 to 2014, the yuan rose on a real trade-weighted basis and versus the USD. More recently, the Chinese leadership took a decision to rebalance away from an investment driven growth model into a consumption one. The announcements made by the Chinese government for 13th five-year plan (2016-2020) push even harder in this direction.

The now expensive yuan

Just as the industrial and exporter-oriented sectors, especially manufacturing, benefited from cheap wages and RMB, they are reeling from the lost competitiveness, both because of a much more expensive currency, especially in a real trade weighted basis, but also because of a very rapid growth in wages. Furthermore, non-wage compensations have also risen, squeezing profit margins (**Chart 4**). As a result, FDI into manufacturing declined (See [Will the geese fly to west China or to ASEAN?]) as well as exports.

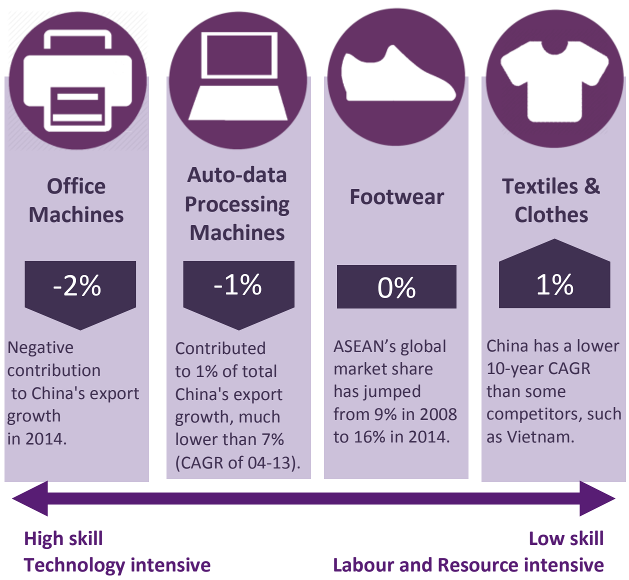
Chart 3. China FDI (USDbn)



Source: CEIC, Natixis

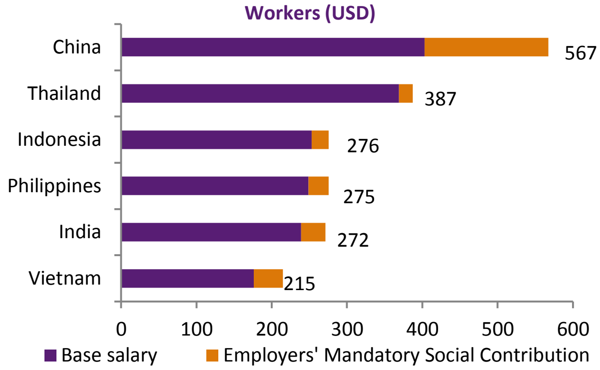
As China is turned its back to cheap labor and a cheap currency, people may be tempted to believe that only low-end products will be affected. Given wage competition elsewhere – specially in ASEAN but also Mexico – a large spectrum of Chinese exports may be affected. Below are some examples of the industries expected to decline further in 2016. **Regionally, VN, ID, IN and PH all should benefit from this.**

Figure 1.: Declining Industries and Change in Market Share



Source: UNCTAD, Natixis **Market share change since 2012.*

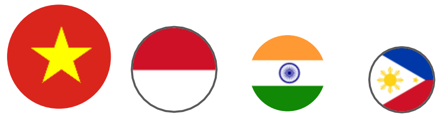
Chart 4. Average Monthly Wage of Manufacturing Workers (USD)



Source: JETRO, Natixis

Key Regional Winners

Vietnam Indonesia India Philippines

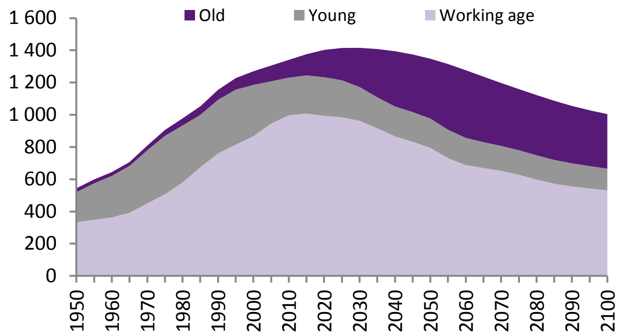


Source: Natixis

2. Demographics: rural to urban

China's working age population ballooned in the past three decades, fueling growth. But this is a thing of the past since the labor force will start to decrease rapidly in 2016. So China will be adding many more retirees than employees in the next twenty years. While China is still the most populous nation in the world and will likely add another 40 million people by 2030, adverse demographics cannot but reduce potential growth. As baby-boomers age and their children are not enough to replace them, a vicious circle of wages rising, demand declining, saving rates deteriorating will bring potential growth down. An additional consequence of this is that more (public) funds are needed to support dependents.

Chart 5. China's population (m)

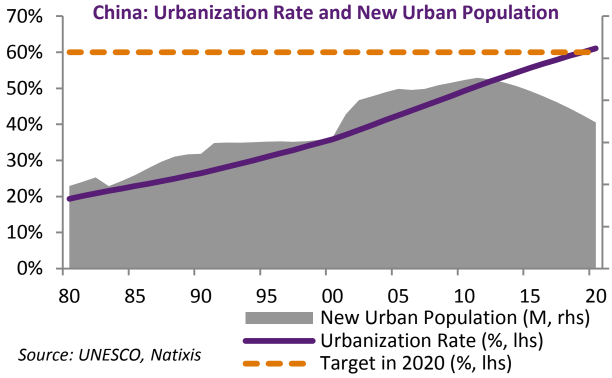


Source: UN's projections, Natixis

In 2015, after declining sharply for decades, China's ratio of the number of dependents per worker (dependency ratio) is rising sharply again. The median age will be 41 in 2025 from 37 today. But this economic time-bomb is well-known and authorities have announced two measures to cushion it. The first is scrapping the one child policy, which – even if it were to raise China's fertility rate – will only increase the labor force in 18-20 years so with no impact on potential growth for a long time (See More (adult) diapers needed: China scraps one child policy). The second is facilitating more rapid urbanization rates. The latter policy is much more relevant in the next five years to come.

Chart 6

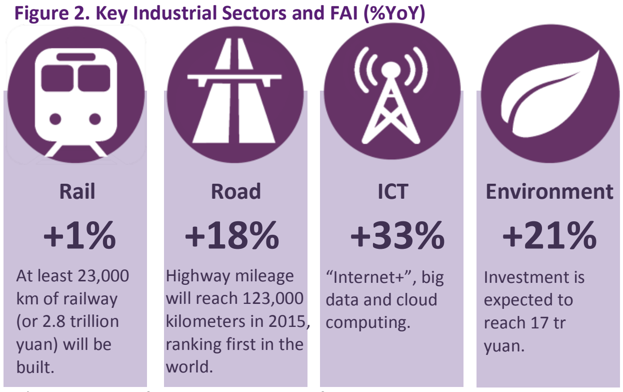
China: Urbanization Rate and New Urban Population



Source: UNESCO, Natixis

The leadership has announced that, in the 13th five-year plan, another 81 million people will be urbanized by 2020. Currently 779 million people are living in urban areas. They aim to raise this to 860 million people. This is equivalent to achieving a 60% urbanization rate by 2020 from 54.8% currently. Within this urbanization binge, the government wants to create multiple city clusters, such as the Beijing-Tianjin-Heibei, Yangtse River Economic Belt. The New Silk Road Economic Belt is another example of a huge urbanization effort. Notwithstanding the demise of the infrastructure sector lately, we believe that another boom may be in the making, especially on whatever relates to urbanization. Transportation is an obvious one but also information, communication, and technology (ICT) and pollution treatment and other environmental protection projects. Below is the growth in fixed asset investment thus far this year in some of the key sectors that will benefit.

Figure 2. Key Industrial Sectors and FAI (%YoY)



**YTD Value as of Nov 2015 while ICT is for Oct.*

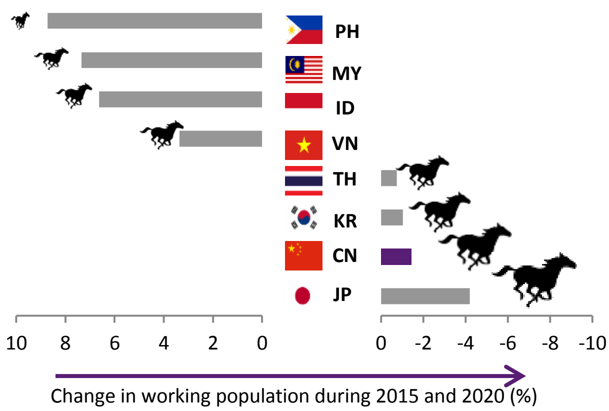
***ICT stands for information and communications technology.*

Source: Bloomberg, Natixis

Another consequence of the demographic shift is more investment in education, moving away from the supply of labor to its quality. The government is pledging better public services, including increasing senior high school enrolment rate as well as pre-school education in addition to the current nine years of compulsory education. Additionally, they want to create first-class universities.

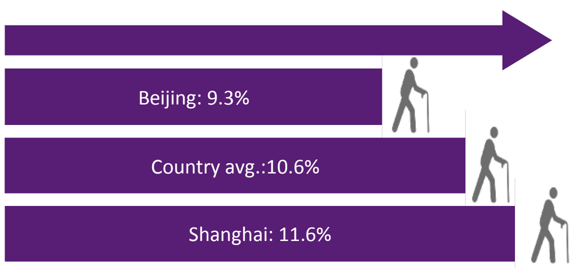
An aging population also increases the needs for health services. In that regard, China wants to liberalize investment in sectors such as medical and elderly care. **Japan** is in the best position to offer aging-related services as its aging has started much earlier than the rest so one could foresee a boom in the exports of Japanese goods and services for Chinese elderly (See Aging in Japan: A drag but also an opportunity? Japan Inc. to the rescue).

Who is winning the aging race?



Source: Datastream, Natixis

Per-capita medicine and medical care expenditure 2000-2014 (CAGR)

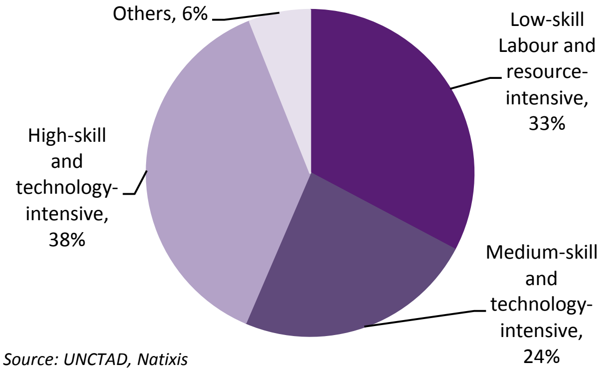


Source: NBS, Natixis

3. Growth: Catch-up to Innovation

With an expensive RMB and an aging population, will China hollow out its industrial sector? Certainly not, and especially not according to its newest 13th five-year plan. Instead of depending on cheap labor, authorities want to upgrade the industrial base to a medium-high technology level. While manufacturing employment is declining, it is still a large share of the total employment pie. As wages rise (and an expensive RMB add to that), labor and land become more expensive and scarce, the government is turning to a new industrialization strategy – innovation. Currently, despite significant progress moving up the value chain, China's exports are still quite labor intensive (**Chart 7**).

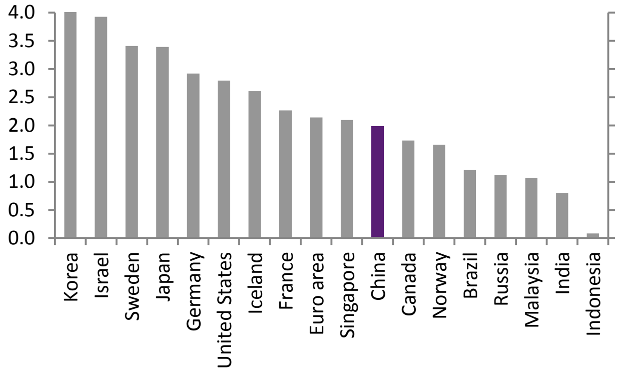
Chart 7.
Breakdown of export value in 2014



Source: UNCTAD, Natixis

But the government is determined to change this through increased funding in research and development (R&D), and investment in targeted sectors. The sectors they want to encourage to grow include information technology, robotics, marine equipment manufacturing, and medical devices. Regarding R&D, they want to create a number of national laboratories that will further research in internet and communications, semi-conductors, nuclear power stations, advanced urban rail systems and electronic equipment. In the specific case of the internet sector, the government invested RMB430 billion to have a nationwide internet system in 2015 and another RMB700 billion are planned for 2016-2017.

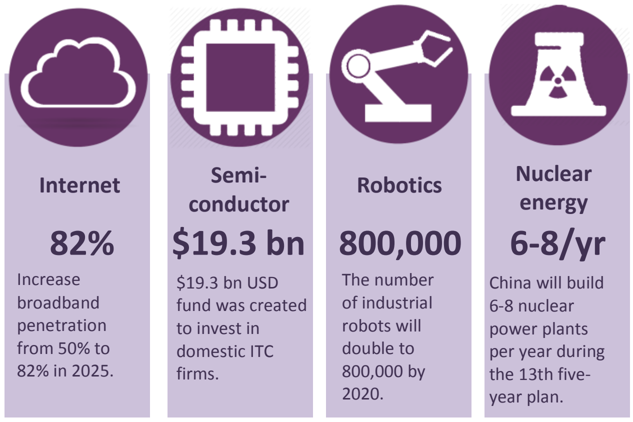
Chart 8. Spending on R&D as a share of GDP (2012)



Source: UNESCO, Natixis

Finally, as R&D is concerned, China was already spending about 2% of GDP in 2012 according to UNESCO. Although lower than Korea or Japan, it is still well above countries of similar or even higher income per capita. More importantly, China's investment in R&D has increased at a much faster pace than its competitors (more than 40% in 2014). The following industries will benefit from its innovation push.

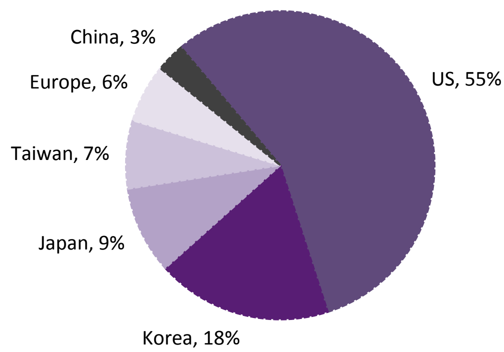
Figure 3. China: Focus in R&D and Key Metrics



Source: Natixis

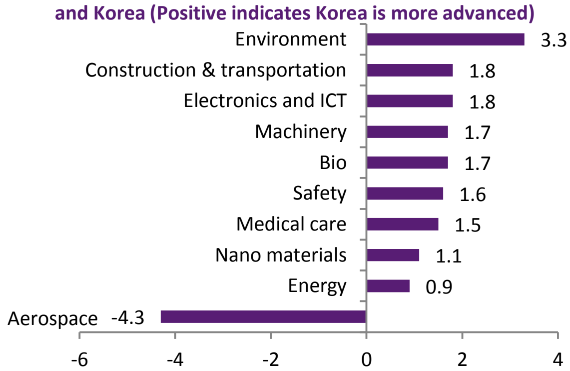
We believe **Korea** will be most negatively affected by China's emphasis on innovation. Already, growing presence of Chinese technologies groups such as Huawei Technologies, Lenovo Group, and Xiaomi have eaten into Samsung's smartphone business globally. This is forcing Samsung to provide more discounts, cutting into profit margins. While profit margins are still high, it is primarily due to Samsung's semiconductor business, which offsets the fall of mobile phones. But China's planned investment in this area will likely shatter this dominance too. **Chart 9** shows Korea having 18% of the global market share of semi-conductors while China only having 3% in 2014. But the technology gap is shrinking and will shrink even faster with the some USD20 billion fund which Chinese leaders had set up for the semi-conductor sector (**Figure 3** and **Chart 10**).

Chart 9. Global Market Share of Semi-conductors in 2014



Source: IC Insight, Forbes, Natixis

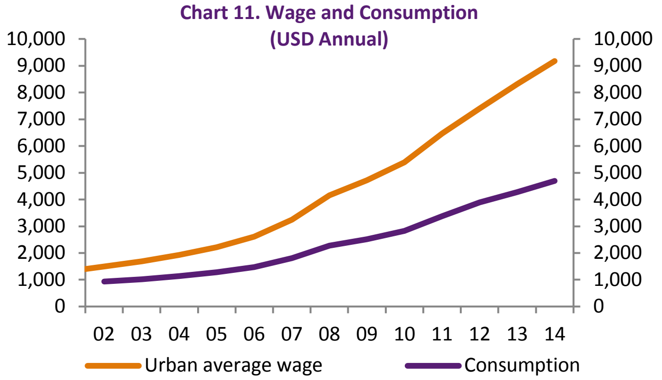
Chart 10: Survey on Technological gap between China and Korea (Positive indicates Korea is more advanced)



Source: Ministry of Science, ICT and Future Planning, Natixis

4. Consumption: Essentials to leisure

The flip side of corporations' rising labor cost is workers' higher income. While the average Chinese consumer has been repressed in terms of actual consumption, their purchasing power is rising rapidly (**Chart 11**). In 2014, GDP per capita reached USD7,600 from USD320 in 1990. Average urban households' non-private income rose to USD9,200 in 2014, of which only USD4,700 is spent per year (**Chart 11**). A declining labor force and a slowing investment cycle are giving labor a bigger share of income. Still, on average, more than 61% of this consumption expenditure is spent on basic necessities such as food, clothing and shelter.



Source: CEIC, Natixis

Who are the Chinese consumers? We categorize Chinese consumers into five distinct income groups:

Group		Annual income (USD)	People (m)
1.	Poor	0-3,000	627
2.	**Urban poor**	**3,000-5,000**	**140**
3.	Low middle class	5,000-10,000	271
4.	**Middle class**	**10,000-15,000**	**168**
5.	Elites	Above 15,000	125

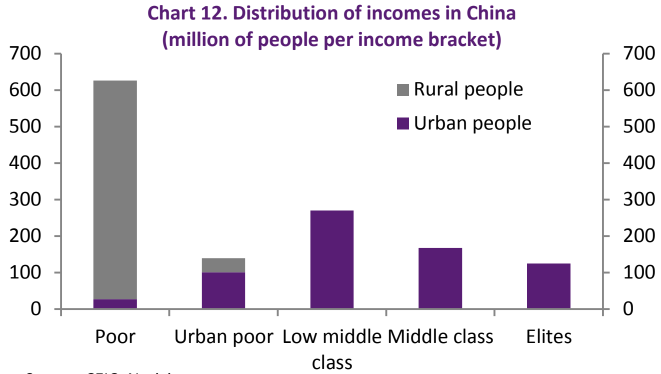
The distribution is clearly split between urban and rural where urban households enjoy a significantly higher share of income. In the future, should another 81 million people join the urban class, they will likely swell into the urban poorer category. We, thus, believe that most of the consumption growth in the future will come from Group 2 and 3, as they gain more from China's new economy. There are three fundamental reasons why this will occur: a) Chinese consumers have been repressed; b) the government prioritizes urbanization, consumption, and services for 2016-2020; and c) the labor's share of income will likely rise further as investment declines. This will benefit middle class urbanites more than the rural poor.

Table 1. A summary of demographic transitions

	2015	2025
Working age people (m)	**1,010**	**984**
Young (m)	237	230
Old (m)	**131**	**200**
Urban (m)	758	870
Basics % of total consumption	**61**	**39**

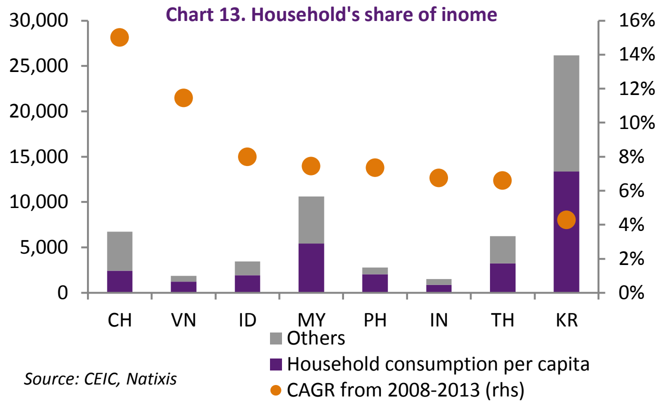
Source: Natixis, 2025 wage and consumption data are estimates while population data is from UN projections

Table 1 shows a summary of China demographic transition from 2015 to 2025. The country currently has 1 billion people in working age and this figure is peaking this year. Assuming a stringent middle class definition of having annual household income higher than USD10,000, then 293 million of Chinese urbanites fit this description (**Chart 12**). However, in the next decade, it is not the elites that will drive consumption growth but rather the low middle class and middle class that will dominate the growth – they together account for 438 million people.

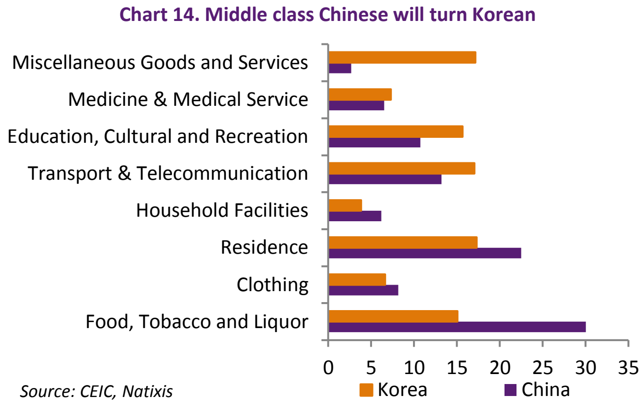


Source: CEIC, Natixis

Chart 13 shows that even with the highest annual compound growth rates (CAGR) from 2008 to 2013, average Chinese household consumption is still lower than Thais' and Malaysians' spending and much lower than Koreans'. This is due to financial repressions through a capped deposit rate, high value added tax (VAT) and import tariffs for consumer goods and a cheap RMB policy. All of these three variables have changed: the deposit rate ceiling was recently scrapped, and some import tariffs on consumer goods were reduced on 1 June 2015. More is coming in 2016 in terms of reduction of import tariffs in 2016. The RMB fast appreciation has already been described before.



Source: CEIC, Natixis



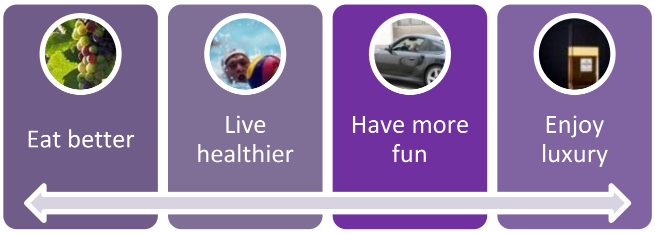
Source: CEIC, Natixis

The future of Chinese consumption

Chinese households not only consume little compared to their income but their consumption is still concentrated on essential goods. Comparing Korean household consumption with that of Chinese today, it seems obvious that, as Chinese households receive higher income to levels closer to those of Korean (they are now about half way through), they will need to reduce the share of essentials, and in particular food, tobacco and liquor, from the current 30% of the consumption basket to something closer to Korea's 15% for the same essentials (**Chart 14**).

Beyond food, as Chinese household's income rises, they will continue to move up the Maslow hierarchy of needs. Among the universe of changes in consumption that such a move will bring about, we focus on four key themes: eat better, live healthier, have more fun, and enjoy more luxury.

Figure 4. Key consumption themes



Source: Natixis, Images from Wikicommons

Eat better – Middle class households (293 million Chinese already) will continue their transition to higher protein (more beef), quality food products and become more cosmopolitan (more wine and cheese). We believe imported food will rise. **AU, NZ, TH, and TW will likely benefit from food exports.**

Live healthier – Individual spending on health products, ranging from air purifier, fitness clothing and sports equipment will increase. The government will likely spend more funds on pollution treatment and speed up environmental-protection infrastructure projects. **JP, SK and TW will benefit.**

Have more fun – Chinese consumption is going to be less basic and more fun. Urban spending on recreation and culture is bound to increase very fast. From entertainment, travel, dining, sports gaming, to using technology to be more connected, Chinese consumption will definitely be more entertaining. The Chinese film market is already expected to exceed the US in 2017, according to Motion Picture of America. If Korea is any guide, eating out and hotels will need to quadruple in China to reach that level. Spending on fun is still low, as measured by miscellaneous and recreational spending (**Chart 13**). **TW will benefit the most thanks to Chinese cultural affinity. SK will follow as key leader in Asian fashion trends.**

Enjoy luxury – Conspicuous consumption has always been fundamentally about three things: a) trading up; b) exclusivity; and c) acceptance. In the beginning, the Chinese elites have shaped the global luxury landscape to trade up, differentiate themselves from the mass peasants and gain respect. Chinese consumers globally make up 31% of the total personal luxury spending. But as the Chinese elites traded up to Hermes, became mature and gained confidence to trust their own taste, the desire for luxury has changed. Coupled with this, an anti-corruption drive is having a cascading effect to curb enthusiasm for flashy and ubiquitous brands at least domestically. As a result, sales of luxury producers in mainland have felt the pinch, as well as retailers in Hong Kong and Macau. Luxury firms will have to adapt to the more restraint but also more confident Chinese elite.

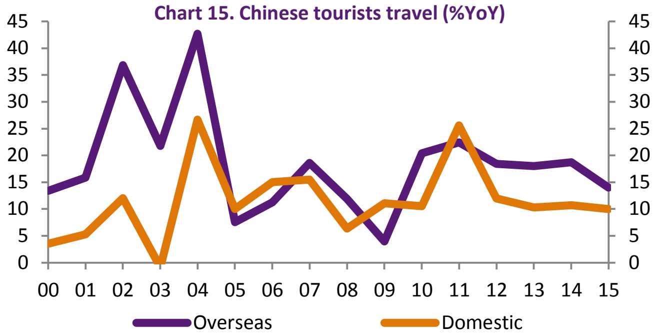
The urban middle class, too, are taking cues. Human psychology shows that the middle class imitates the elites and the urban blue-collar mass mimics the middle class. As the elites move to discriminate more on products that reflect their styles and less flashy and branded, the mass urban people are also aspiring the same. The middle market luxury will do well as the price points are more affordable.

One of the ways in which Chinese luxury consumption is changing is to become less material. The middle class are looking for a life less ordinary through increased global and domestic mobility. Travelers has ballooned in recent years.

Overseas tourism has grown even more than domestic tourism, helped by a strong RMB, longer public holidays and easing visa restrictions. Chinese outbound tourists amounted to 98 million in the first three quarter in 2015, up 14% compared with same period on 2014 (**Chart 16**). Notwithstanding the huge number, this is still very limited. The first and most simple constraint is passports. Only about 5% of China's population currently have passports while 10% of Americans do. Based on America's experience, we should expect further growth in tourism for the next few years.

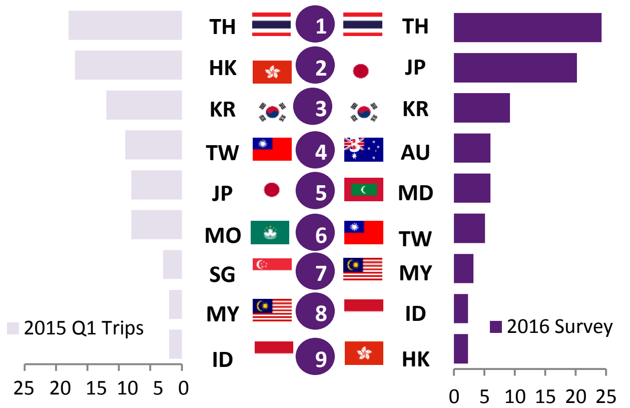
In Asia excluding Hong Kong and Macau, Mainland tourists prefer Japan, Korea, Thailand, and Taiwan. The numbers have reached 17 million in first three quarters of 2015, up by a significant 38% compared with the same period last year, contributing to those countries' current account. The Chinese urban mass particularly like Thailand and this is expected to remain the same in 2016 according to a survey that was conducted by China Internet Watch. The same survey shows the demise of Hong Kong, which is expected to move from being the largest recipient of Chinese tourists (47 million) to ninth in 2016. Instead, Japan is clearly moving up and is expected to be second only after Thailand in 2016.
HK will lose out while JP, SK and TW will gain.

Chart 15. Chinese tourists travel (%YoY)



Source: CEIC, China Outbound Tourism Research Institute, Natixis
Note: 2015 domestic figure till H1, overseas till Q3

Chart 16. Top APAC destinations among Chinese (%)



Source: China National Tourism Administration, China Internet Watch, Natixis

Domestic travel is also in vogue, helped by a push by Chinese authorities to boost the service sector. In the first half of 2015, notwithstanding the economic slowdown, domestic tourism increased by 10%, with a total expenditure of RMB1.65 trillion within this period (**Chart 16**). The government is aiming to further boost domestic spending on tourism to RMB5.5 trillion in 2020, which is equivalent to a share of 5% for the tourist sector. **Industries that cater tourism domestically will thrive thanks to growing demand but also government support.**

5. Geopolitics: status quo to revisionist

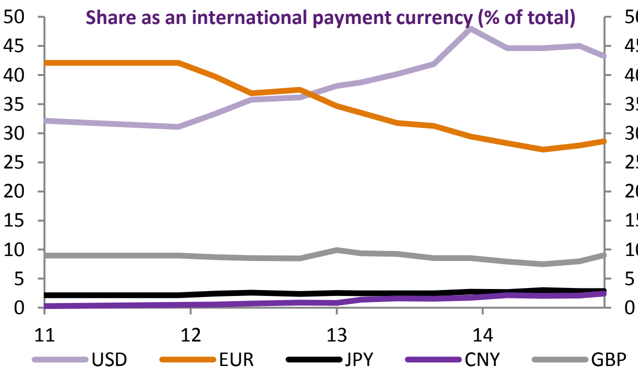
Since the President Xi Jinping came to office in 2012, his vision of China has been decisively different than his predecessors. As a realist, he aims to bring China to the top of the global powers with an emphasis on the key signals of an empire: controlling territory well beyond one's borders either through soft or hard (military) power but also by using one's currency. Such thirst for an empire can be explained, among other reasons, is the US explicit decision to "pivot" towards Asia right before Xi Jinping was nominated. In the same vein, Xi's "China Dream" to "rejuvenate the Chinese nation" symbolizes his ambition for the nation's future place in the world. The New China under Xi Jinping is, thus, no longer in full acceptance with the status quo but, rather, more of a revisionist of the existing sharing of powers.

We would like to focus on four key "revisionist" actions that China is embarking on: a) accelerate the internationalization of the RMB to reduce dependence on the USD; b) export their excess capacity to countries with infrastructure needs; c) diversify their savings from investment in US Treasury to higher yielding assets; d) expand trade routes so as to increase the number of "captive" markets.

As regards the RMB, China is still making limited progress with international payments (**Chart 17**), while trade settlement in RMB has risen sharply in recent years (**Chart 18**). The recent inclusion in the Special Drawing Rights (SDR) will help foreign demand for the RMB as a reserve currency by only about USD29 billion.

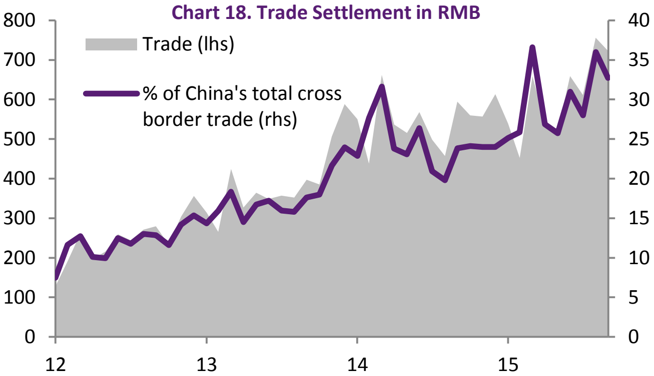
Chart 17.

Share as an international payment currency (% of total)



Source: SWIFT, Natixis

Chart 18. Trade Settlement in RMB



Source: SWIFT, Natixis

Thus, further steps are still needed to increase global demand for the yuan, and China is trying to do so through the establishment of institutions and strategic plans that will enhance appetite for the RMB. Some of the most relevant ones are the New Development Bank (NDB), the Asian Infrastructure Investment Bank (AIIB) and the Belt and Road Project (See Key Winners from the Silk Road Initiative).

Figure 5. China's challenge to the status quo

Status Quo	IMF	World Bank ADB	WTO
Revisionist	?	BRICS AIIB	One Belt One Road

Source: Natixis

Chart 19.

Capital base of world development bank (USD bn)

Source: Stratfor. Natixis

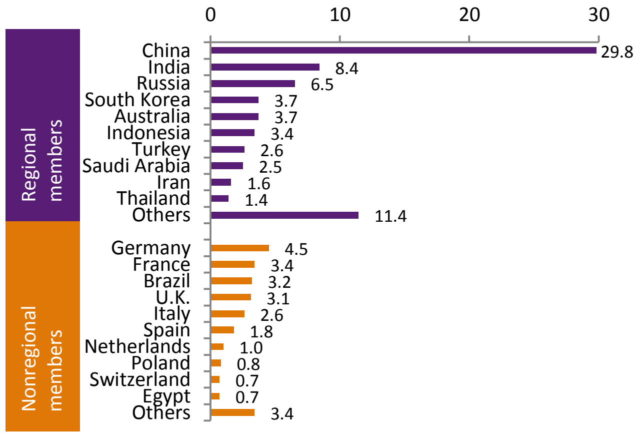
The New Development Bank (NDB) or BRICS Bank

The NDB – with a capital of USD50 billion and based in Shanghai – was created with the BRICS' axis but under Chinese leadership. The NDB can be considered an equivalent of the World Bank – a Bretton Wood institution established after WWII, with a capital four times as big. The key difference is that the NDB is controlled by Emerging Countries rather than by Developed ones. While emerging nations generally borrow from the World Bank in USD, the NDB aims to overcome this by issuing loans in the currencies of each of the BRICS member countries but with a tilt for the RMB as reserve currency of the South. The first loan that the NDB will offer in April 2016 will be denominated in RMB.

Asian Infrastructure Investment Bank (AIIB)

The AIIB is a direct challenge to the Asian Development Bank (ADB), a Japanese initiative in the region. With a working capital twice as big as NDB, USD100 billion, China is even more at the steering wheel. In fact, China's contribution is by far the largest with USD30 billion, the headquarter is located at Beijing and the President will be Chinese (**Chart 20**). This is why the RMB is expected to play an even bigger role as currency of denomination of the AIIB loans. While AIIB will only start operating in mid-January 2016, Indonesia is already seeking for the first loan from the AIIB for coal-fired power plant. Furthermore, the AIIB is expected to serve as the financing arm of the One Belt and One Road initiative.

Chart 20. Top contributors of AIIB initial capital (USDbn)



Source: AIIB, WSJ, Natixis

The Belt and Road Strategy

Figure 6. Northern and Southern route to China's Belt and Road Strategy

The Belt and Road is a flagship initiative of the Chinese government to improve regional and international commercial links by upgrading transport infrastructure. The main sources of financing are the AIIB, the Silk Road Infrastructure Fund and co-investment by private funds. While recycling Chinese corporations' overcapacity is one of the Belt and Road's key objectives, the further use of the RMB as international settlement currency is probably as important.

Beyond the internationalization of the RMB, NDB, AIIB and the Belt and Road should all be supporting Chinese corporates in infrastructure sectors, mainly transportation (railway and shipping) but also oil and gas.

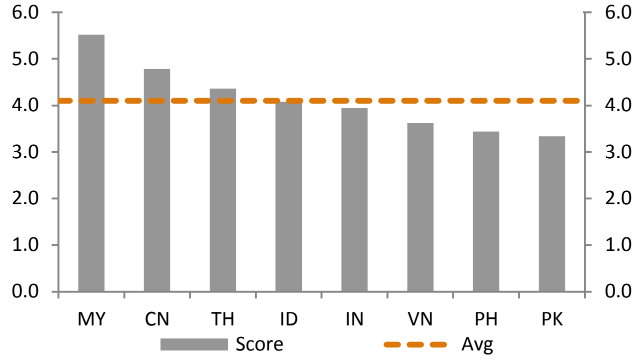
To understand the scope of the above, here are some examples of key projects: The building of a new Eurasian land bridge, the development of three economic corridors (China-Pakistan, China-Mongolia-Russia and China-Central Asia-West Asia), high-speed railway between Moscow and Beijing, the Central Asia-China Gas Pipeline and the Russia to China Eastern Pipeline.

Overall, the construction of railway, highway, aviation, power plants, telecommunication network, and electricity grids will be key in exporting China's excess capacity. Significant amounts of construction material and machinery would be in demand for large-scale infrastructure projects. It should be noted that some of these projects are already happening.

Who will benefit?

Clearly, sectors with excess capacity in China and relevant state-owned enterprises will benefit. But emerging Asian countries with real infrastructure needs will also benefit from additional funding and increased competition in the region among creditors. On the former, the needs are massive without doubts (of the order of USD8 trillion according to the ADB) and the quality of infrastructure is still poor (**Chart 21**). On the latter, the competition is needed. The ADB, itself, stated that it will ease the time it takes to get a loan from 3 years to 18 months – 2 years. It will also end its practice of requiring government guarantees for each loan. Furthermore, Japan is also willing to step up its funding efforts as a way to counteract China's increasing dominance in the region. One of the key darlings will probably be Indonesia, given its economic and population size, as it has become clear from the Chinese government's announcement of an AIIB secondary site and the Indonesian government's parallel concession of the construction of a fast speed train to the Chinese, notwithstanding the Japanese efforts to get the deal.

Chart 21. Quality of Infrastructure (1=lowest, 7=highest)

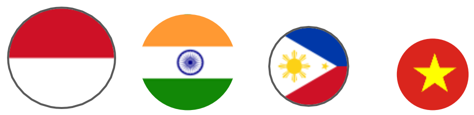


Source: WEF, Natixis

The winners are ID, IN, PH, and VN.

Key Regional Winners

Indonesia **India** **Philippines** **Vietnam**



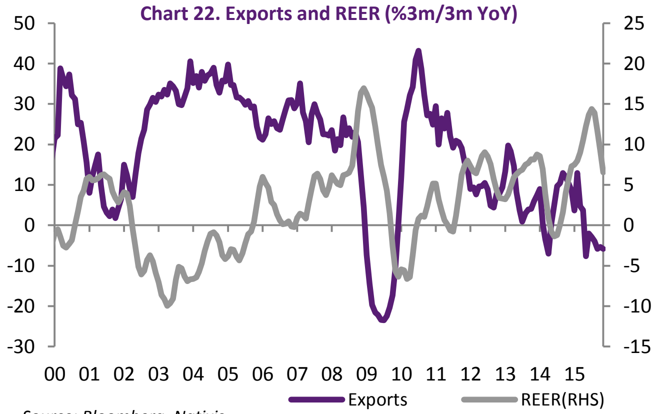
Source: Natixis

Finally: Will it work?

Of course, whether the five themes highlighted above will happen in 2016 as described in this note very much depends on whether the Chinese authorities will be willing to pull the strings of necessary transformation.

Any restructuring or reform process produces winners and losers as well as painful short-term consequences. The discomfort threshold as well as the ability to maneuver the political fallout will determine the likelihood of the outcome. In the short-term, two interrelated issues will shape whether 2016 will be a consumption story or an export motivated one. The first is the exchange rate and the other is the "corporate disruption" that the Chinese government will be willing to accept.

Chart 22. Exports and REER (%3m/3m YoY)

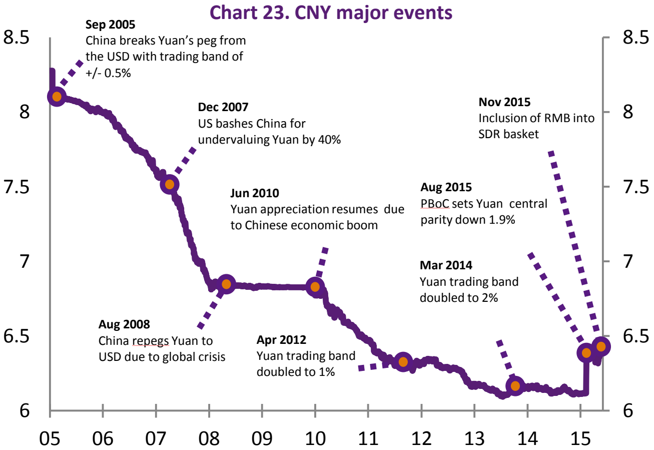


Source: Bloomberg, Natixis

The currently very expensive RMB – when compared with its trading partners – is partly behind China's languishing exports (**Chart 22**). While this is in line with the New China – a strong currency is needed to move up the ladder by keeping the low-end sectors out of business – the question really is how comfortable is the Chinese government with such "corporate disruption".

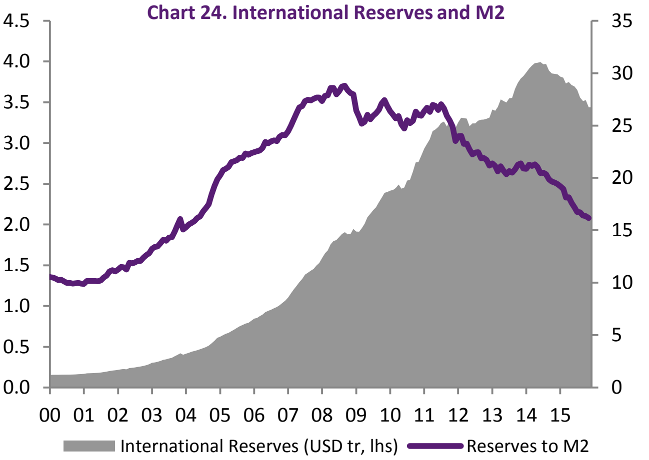
While pushing the internationalization of the RMB seems to have been a very important objective in China's recent exchange rate policy, namely stability against the USD after the mini-devaluation in August (**Chart 23**), the accumulated loss of competitiveness, as well as the rapid loss of reserves to keep the RMB stable (**Chart 24**) may be weighing more as the economy fails to recover through monetary electroshocks. More specifically, the recent announcement of the weights of the RMB basket could be a sign of a regime change towards a more accommodative RMB (See China: A currency basket to the rescue of a too expensive RMB).

Chart 23. CNY major events



Source: Datastream, Natixis

Chart 24. International Reserves and M2



Source: Bloomberg, Natixis

Should the exchange rate policy revert to that of the Old China – through a sizable depreciation of the RMB – the old dinosaurs would find it easier to avoid the "corporate disruption" needed to move up the ladder.

We believe authorities have not found the conclusive answer in its quest for a New China yet. The Old China is clearly not working anymore, but the road to the New China is full of uncertainties. Yes, authorities have a vision of what an idealized New China would look like – one in which China can shed their excess capacity, improve standards of living of households, reach its global prominence aspiration, and seamlessly escape the middle income trap into developed country status. But before it can get there, it has a Herculean task ahead, one that would begin with cleaning up its overburdened corporate and banking sectors by dealing with the excesses that it allowed to build up over the years.

In sum, while China's tectonic shift is indeed happening with shockwaves on the rest of Asia, whether they go smoothly or more awkwardly very much hinge on the exchange rate policy and the corporate restructuring efforts that the Chinese government may conduct in the next few months. Watch out for them!

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