China

Heading Towards Sunset?

The recent string of several quarters of below-par growth and gloomy forecasts by a section of critics raise an important question: Is China, the world's second largest economy, drifting towards sunset?

– **Andrew Leung**
International and Independent China Strategist, Chairman and CEO, Andrew Leung International Consultants Limited, Hong Kong

A January 2016 Goldman Sachs report, "Walled In: China's Great Dilemma", expects China to grow between 5.8% and 6.8% and avoid a hard landing in 2016; the economy grew at 6.7% in the March 2016 quarter, its slowest pace in seven years. However, its outlook for 2016-20, which spans China's 13th Five-Year Plan, is more pessimistic. It envisages a low probability of China achieving 6.5% growth rates while rebalancing the economy. Moreover, it considers that China is unlikely to escape the "middle-income trap" and will not be able to challenge US pre-eminence over the next several decades, and possibly beyond. In fact, according to the report, China is more likely to follow the path of Japan, where unfavorable demographics and excessive debt have led to slower growth and bouts of deflation.

The report's prognosis is based on the following considerations: China's growth will inevitably slow to substantially lower rates over the next decade; The path China will follow is highly uncertain as growth slows; China will incur greater risks as it attempts to implement reforms while maintaining control of the financial markets and the economy; China's debt will continue to grow, making any eventual deleveraging process as painful as it has been in the US and the peripheral countries in the Eurozone; China's financial markets will be much more volatile without any increase in expected returns; China's profile today has many parallels to Japan in 1990. The report puts forth two scenarios for the next five years (2016-20): *The Likely Path (Base Case Scenario)*: China's 6.5% minimum growth target is achieved for say, two to three years, through rapid investment and increased debt. Thereafter, GDP growth rates decline steadily; *An Alternative Path*: China's leadership forgoes the 6.5% target and, instead, focuses on implementing reforms and slowing the pace of credit growth. Both scenarios do not see that the target growth rate of 6.5% can be maintained with economic restructuring, pointing to the possibility of China being trapped in Japanese-styled 'lost decades'. "*Anyone who speaks with great certainty [about China] needs their head examined*," the report warns.

I totally agree, as China is such a vast and rapid work-in-progress. So, due account has to be taken of both sides of the picture from different perspectives if a more balanced view is to be gained. While the 74-page report has a great deal to commend itself and its prognosis may well be spot-on, the following perspectives need to be kept in mind.

Economic re-structuring towards higher consumption

China's slowdown has resulted in a great deal of doom and gloom around the world. Much blame has been attached to China's perceived economic and financial mismanagement. Pessimism about the 6.5% target is largely due to insufficient domestic consumption in relation to capital investment. Discouragingly on the surface, consumption accounted for 38.3% of China's GDP in 2006 and 38.2% of GDP at the end of 2015. However, this comparison ignores the fact that China's economy has grown from \$2.3 tn in 2005 to \$11.3 tn in 2015. So consumption at 38.2% of a much larger economy signifies tremendous growth.

Indeed, according to a report of the US Congressional Research Service of October 21, 2015, the growth of Chinese private consumption over 2005-14 was among the fastest of any major economy, averaging 8.9% annually compared with 7.3% for India and 1.8% for the US. Evidence points to continuing surges of private consumption even when the country's overall growth is slowing down. China is already the world's top market for 'e-tailing'. China's 'Singles' Day' in November 2015 splurged \$9.3 bn in 12 hours on world's biggest online shopping day. The Goldman Sachs report also quotes impressive sales figures of multinationals and local restaurants, retail outlets and cinemas.

The economy also begins to show convincing signs of shifting away from investment and industrial output. Services started to exceed the contribution from industrial production in 2012. The EIU estimated that in 2015, output of services in China as a share of GDP would total 49.2%, compared to 41.9% for industry, according to the Congressional report.

As labor and resource-intensive industries are giving way to new industrial processes and services, a massive number of jobs have been shed. Those retrenched often end up in the small or informal business sector in small towns and villages. As the service sector picks up, the labor market generally remains reasonably tight. According to the Goldman Sachs report, the unemployment rate remained flat, if not declining, in a respectable range -between 4% and 4.4%.

Market and state-owned enterprises

The Third Plenum in November 2013 affirmed a "decisive role of the market". It seems to contradict the Plenum's opening statement that 'public ownership' would remain the "main body of China's economy". While some of China's giant State-Owned Enterprises (SOEs) have risen to the world's top league by market capitalization, their productivity and global competitiveness leave a lot to be desired. As noted

in the *Financial Times* (November 19, 2013), state-owned enterprises' monopolistic privileges will be gradually "chipped away".

Some of these changes are beginning to be implemented. For a start, SOE's tribute to the state will be increased from 15% to 30% by 2020. According to a report in the *South China Morning Post*, guidelines jointly issued by the Party's Central Committee and the State Council mandated that SOEs are to have mixed public and private ownership. Some will be transformed into state-owned investment companies (similar to Singapore's Temasek). Private banks are to be introduced. Concrete results are wanted by 2020.

According to a report of Voice of America (March 26, 2015), China recently launched a plan to take 112 of its massive SOEs and merge them into 40 even bigger companies in the hope that they can become more competitive internationally. The merger between stated-owned train-makers CNR and CSR Corporation is to create a new entity capable of challenging foreign players like Siemens and Bombardier. More of such mergers are expected.

However, it's true that certain proposals to enhance SOE governance have been shelved, at least for the time being. Among them are the appointment of general managers by the board instead of the party and the removal of civil service ranks and perks for state-owned enterprise executives to make corporate profits their only concern. As SOEs are by definition assets of the state, it is understandable that national interests cannot be entirely be precluded from business considerations where strategic assets are involved.

Financial reforms

China sets its sights on ensuring the RMB plays a more influential role in the world in future. A milestone, even if symbolic, was reached when it was accepted as the third weighty world currency in the IMF's elite basket of Special Drawing Rights. The Chinese currency's continuing ascendancy is predicated upon the continuing opening up of China's financial system. However, recent stock market gyrations and irregularities informed the Chinese leadership that all is not well with the state's regulatory system. Pending the build-up of a more robust financial system, certain reflex actions and market interventions were introduced, for better or worse. It is part of China's learning curve. But these ad hoc measures must not be conflated with rolling back financial reform.

Shadow banking

According to a research paper (March 16, 2015) of the Fung Global Institute, a Hong Kong-based think tank, the overall shadow banking asset size is still moderate compared with the size of the financial sector and GDP. At the end of 2014, China's total shadow banking risk assets rose to RMB 32.2 tn, or 51% of GDP, compared with a global average of 117% of GDP.

China has an exceptionally high level of corporate deposit holding equivalent to 90% of GDP, compared with only 7% of GDP in the US. As loans are often recycled back to the lending bank as deposits, this enables the banks to earn high interest spreads and acts as a cushion against any exigencies. China's household debt (and gearing) remains comparatively low and does not support the contention of a massive mortgage crisis.

Hence, despite rise in credit volumes, China's economy is not over-indebted while the government possesses adequate capacity to absorb losses. There are also massive private savings, offering scope for the corporate sector to undertake debt-equity swaps. Nevertheless, shadow banking has morphed into a roundabout-way of funding local government and private sector investments in real assets with moral hazard implications. China's slower growth and adjustments in the property sector could escalate domestic financial risks impacting foreign banks and investors. China's shadow banking sector is now closely monitored by various regulatory authorities. Nonetheless, more systemic reform and improved governance remain a critical issue.

National debt

As for debt, a look at McKinsey Global Institute's Debt-to-GDP Ratio – Country Ranking in 2Q 2014 may help to put the matter in a little perspective. At 217%, China ranks 22nd out of 47 countries, compared with the following countries in the top 10 rankings:

1. Japan (400%)
2. Ireland (390%)
3. Singapore (382%)
4. Portugal (358%)
5. Belgium (327%)
6. Netherlands (325%)
7. Greece (317%)
8. Spain (313%)
9. Denmark (302%)
10. Sweden (290%)

Moreover, a significant proportion of China's debt is going into building infrastructure for history's largest and fastest urbanization, which is not yet completed. This scale of urbanization is essential to overcoming China's 'middle-income trap' and is likely to supply the needed economic impetus.

Urbanization, *hukou* system, and the consuming middle-class

According to a report of the McKinsey Global Institute, the world's top 600 cities will account for 60% of global growth to 2025. Of 136 new cities to enter the top 600, all will be from developing countries, with 100, the lion's share, coming from China. The country is undertaking the fastest and most extensive urbanization drive in human history. By 2025, China will have 221 cities with one million-plus inhabitants—compared with 35 cities of this size in Europe today—and 23 cities with more than five million. By 2030, China's urban population is expected to hit the one billion mark. In 20 years, China's cities will have added 350 million people, more than the entire population of the US today.

It's no surprise that China recently decided to revamp the *hukou* (household registration) system, granting millions of rural migrants their urban citizenship with social entitlements. On the cards are measures to provide them with financial support by allowing them to lease their rural land and to assist their accommodation in empty urban housing. Many of these migrants are still trapped in poverty. But by dint of hard work, many are eking out a livelihood for themselves and their dependents back home. Some have made good and become successful entrepreneurs. Given time, many will fill the lower ranks of China's exploding consuming middle-class. According to a report in *The Telegraph* (January 28, 2016), using a floor as having wealth double the annual medium income for their country, it estimates that China's middle-class has now grown to 109 million, larger than the US.

Moderately high growth compatible with reform?

There is little doubt that the Chinese leadership is determined to push ahead with economic restructuring towards a higher value-added, if slower, growth. The coming 13th Five Year Plan is likely to incorporate the Made in China 2025 strategy released by the State Council on May 19, 2015. The strategy focuses on 10 key sectors: New Information Technology; Numerically-Controlled Equipment; Aerospace Systems; High-Tech Vessels; High-Speed Rail; Energy Conservation; New Materials; Medical Devices; Agricultural Machinery; and Power Generation.

On the one hand, these strategic goals signify a technological catching-up process. On the other hand, they are preparations for a new industrial era as highlighted in The Fourth Industrial Revolution, a report commissioned by Indian business and software services giant Infosys and launched at the January 2016 World Economic Forum in Davos. The investment opportunities as well as risks of epoch defining disruptive innovations and technologies (estimated to affect five million jobs across the globe) are likely to be huge.

China is also embarking on massive state and private outward investments across the globe. These investments are not confined to resources, technologies and markets for China's goods, but extend to real estate, brands, telecoms, and a host of other businesses. A report in *The Economist* (January 16 , 2016) on how Western enterprises are warming to Chinese acquisitions in such sectors as chemical businesses and the world's largest cinema chains, speaks volumes.

This outbound trend is set to accelerate in the context of China's game-changing, trans-continental One Belt, One Road (OBOR) initiative, linking China even more closely to Asia, the Middle East, Eurasia and Europe through infrastructure, trade and investments. This initiative is backed by the China-led Asian Infrastructure Investment Bank (AIIB) and a $40-bn Silk Road Fund.

While it is early days yet, China is already winning contracts in building high-speed rail in a number of countries along the Silk Road both in Asia and in Eurasia. President Xi's first state visit to post-sanction Iran also signals that this global strategic initiative is for real.

As the world's largest trading nation and the major trading partner of many countries along the OBOR, China remains central to the global supply and production chain. This, together with surging outward investments, is well positioned to yield economic dividends all around, including infrastructural building, corporate investments, expanded markets and trade links. All these will benefit China's economic growth.

Indeed, according to the latest statistics, China's economic performance is not as dire as it is portrayed to be. In 2015, total import at $1.68 tn remained the second highest in the world, including increases in soybeans by 14.4% and crude oil by 8.8%, a historic milestone. Outbound direct investment surged to $127.6 bn, an increase of 10%. Outbound tourism registered 120 million visitor-trips, an increase of 12%, with spending overseas reaching 1 tn RMB, a 20% increase.

Demographics

China's demographic dividend is exhausted as the country starts to age. As highlighted in the Goldman Sachs report, the Two-Child Policy recently launched cannot arrest the aging trend until a couple of decades later. But China's development is changing course towards a less labor-intensive and more innovation driven economy. Less rather than more labor, and quality rather than quantity, now fit the bill. A great deal, of course, depends on education and the prospects for innovation.

Education

China's spending on education has grown by 20% per year since 1999. Some 7 million university graduates are produced every year. By 2030, China is poised to have some 200 mn graduates, more than the entire US current workforce, although most may not be able to measure up to best international standards. Additionally, China is putting more and more resources on R & D. The country is on track to become the world's top R&D spender by around 2019, according to an OECD report in late 2014.

Moreover, according to a March 2015 report by *ICEF Monitor*, a market intelligence resource for the international education industry, 459,800 Chinese students went abroad in 2014, 11.1% increase over the year before. 92% were self-funded. Chinese students are also returning to China to pursue their careers in greater numbers. 364,800 students returned to China in 2014, an increase of 3.2% over 2013. Since 1978, a total of 3.5 million Chinese have studied abroad. The total return rate for the period from 1978 to 2014 stands at 74.5%, thanks in part to an "overseas professional returnees program" with attractive terms. These highly educated returnees are enriching China's human capital.

Innovation

According to the World Intellectual Property Organization (WIPO), China has been topping the world in the filing of patents and trademarks every year since 2012, responsible for a third of all patents filed. While quantity does not equal quality, these statistics show that China's education is not all rote learning. Although China still lacks Nobel Laureates, world-class Chinese entrepreneurs are beginning to emerge who are defining the rules of business — Alibaba, Tencent, Xiami, to name just a few.

The environment

China has compressed centuries of industrialization into several decades, together with accompanying unbridled pollution. Now the nation has woken up

to this existential threat. Hence, China was taking a leading role at the recent Climate Change Paris Summit. In her *Intended Nationally Determined Contribution (INDC)* under the COP21 Paris Climate Agreement, China committed, by 2030, – (a) to achieve the peaking of carbon dioxide emissions around 2030 and making best efforts to peak early; (b) to lower CO_2 emissions per unit of GDP (emissions intensity) by 60-65% from the 2005 level; (c) to increase the share of non-fossil fuels in primary energy consumption to around 20%; and (d) to increase forest stock volume by around 4.5 billion cubic meters over the 2005 level. A 20-billion-yuan China South-South Climate Cooperation Fund will be set up to support other developing countries in combatting climate change.

The share of non-fossil fuels in primary energy consumption is mandated to expand to 15% by 2020 and 20% by 2030. To achieve these targets, a green dispatch system is to be implemented in favor of renewable sources in electricity distribution. China's rapidly growing solar and wind capacities will support this system. Clean coal measures, coal caps and coal-free zones are to be introduced while vehicle fuel quality standards are to be enhanced.

According to a Brookings Institution paper of November 2015, China aims to double wind capacity to 200 gigawatts and to more than triple solar capacity to 100 gigawatts by 2020 from 2014 levels. This expansion is supported by the dramatic momentum of growth of non-fossil generation capacity over 2010-2014. Solar capacity has jumped by 3,161.6% to 28.05 gigawatts, wind capacity by 225.8% to 96.37 gigawatts, nuclear by 83.7% to 19.88 gigawatts, biomass by 72.4% to 9.48 gigawatts, hydro by 39.7% to 301.83 gigawatts, and geothermal by 7.1% to 0.03 gigawatts. Overall, the increase has been 73.3% to 455.64 gigawatts in just four years. Half of China's energy use today is subject to mandatory efficiency standards. With a 'national emissions trading' scheme expected in 2017, the Chinese economy is on the way towards becoming 85% less energy-intensive, compared to the past 25 years. With large-scale deployment of wind, solar, hydro and nuclear power, China's CO_2 emission growth is expected to flatten and then peak around 2030.

'Walled in'? Not just yet

Arguing that China would inevitably follow the path of Japan's 'lost decades', the Goldman Sachs report concedes that China has three advantages compared to Japan in the 1990s. First, while China's debt-to-GDP is very high, it is still lower than Japan's in 1990. Second, while China's Total Factor Productivity (TFP) growth rate has dropped from its recent peak of 4%, it remains more than double that of Japan in 1990. Finally, China has a record of implementing significant reforms in the face of almost impossible odds.

China's reform efforts since the country opened up in 1978 have never been smooth. Few would doubt the scale of challenges in lifting over 600 mn people out of abject poverty in 37 years in a country not noted for abundance of natural resources. Dilemmas are plenty to be found. Take, for example, Deng Xiaoping's decision "*to let the few get rich first*". Or, a strategy to favor cities in preference to the countryside, or going for labor-and-energy-intensive including polluting industries outsourced from the West, or opening up the country's economy to gain entry into the World Trade Organization (WTO). A similar dilemma now applies to switching to slower but more innovative and sustainable growth. Regardless of what seemed impossible odds, successive Five-Year Plans were formulated and delivered, not without difficulties and twists and turns. But warts and all, the results are there for all to see.

As the country of over 1.377 bn people is undergoing seismic changes, there is a great deal of pain and trial and error. These have global repercussions as China is firmly embedded in the world economy. But this doesn't mean that China is necessarily more 'walled in' compared with what she has experienced before. What is more, this doesn't mean that China's leadership will roll back reform. Indeed, as evident above, the pangs of a 'New Normal' of slower growth belie a new China struggling to be born. China's new reform agenda will become clear in the soon-to-be-unveiled 13th Five Year Plan (2016-20).

Do I want to bet against China's chances of fulfilling the targets in the coming Five Year Plan? Because this time is different as China is between a rock and a hard place? While I would not vouchsafe for the certainty of success, looking at broken crystal balls betting on "*China's coming collapse*" during the past 15 years, I am hesitant to say that for now, the only path for China is walking hamstrung towards sunset. ■

Reference # 20M-2016-04-18-01