Is China going to have a hard or soft landing or merely switching to a slower and more sustainable speed?

China is slowing in the midst of a wobbling world economy. A chorus of China bears, doubters and shorters is now back in full force. This time around, the bet is that there is going to be a hard landing, if not an implosion. Their prognosis is based on a likely default of massive non-performing local government loans, the bursting of a gigantic property bubble, run-away food inflation, mounting export-tied job losses, inadequate domestic consumption , a looming water and ecological crisis, and rising social unrests, against the backdrop of an increasing demographic deficit, a continuing " US dollar trap" and an unbreakable "middle-income trap" .

It is worthwhile to examine each of these threats and challenges more closely.

Non-performing local government loans

GaveKal-Dragonomics, a China consultancy, estimates that China's real debt-to-GDP ratio could be as high as 90 %. At a recent hearing of the US-China Economic and Security Review Commission, Gordon Chang, author of "*The Coming Collapse of China*", came up with a ratio of 81%, based on his "conservative" calculations. Fitch Ratings arrives at a conservative estimate of about 48 %. Regardless of the percentage, part of the overall debt are the loans considered to be most at risk – those by off-budget local government financing vehicles (LGFVs).

The official China Securities Journal reported on 15 August that about 26% of LGFV loans, some RMB 2.8 trillion, are considered fully backed with cash flows from projects. Overall loan levels are expected to peak in 2011 and 2012, during which period about 43% or RMB 4.6 trillion of these loans is expected to fall due.

In a recent article dated 1 September on *Qiushi*, the Communist Party of China (CPC) official website, Premier Wen Jiabao revealed that according to State Council investigations (March- May 2011) , the extent of LGFV loans amounted to 10.72 trillion yuan ($1.68 trillion) or 28% of GDP. Of these loans, 51.15% were for pre-2008 commitments, mostly infrastructural and economic projects. The extent is large but is still considered manageable.

Since then, the Chinese government has applied stringent controls in regulating the use of LGFVs. As a result, credit growth has been reducing towards normalcy. M2 in July grew 14.7%, which is within the 16% target range. Nevertheless, the speed of credit growth is still high while the State intends to provide more and better credit for agriculture and Small and Medium-sized Enterprises (SMEs). So the situation is being watched vigilantly.

In the final analysis, China is deepening monetary and financial reform, including interest rate liberalization and risk control; management of foreign exchange reserve; prevention of “hot money” inflows; and improving stability of the banking system. The country has a powerful armoury for these tasks, including a flexible arsenal of fiscal and administrative levers and a powerful insurance policy in the form of a gigantic foreign exchange reserve of $3.2 trillion, which China, if she so wishes, can deploy against any default.

Housing bubble

China’s property market is beginning to show some signs of cooling across the country as a result of a series of tightening measures, including interest rate hikes, increased bank reserve requirements, purchase quotas, cramp-down on speculation, and a commitment to build 36 million low-income and low-rent housing units during the current Five Year Plan (2011-15).

On 18 September 2011, the National Bureau of Statistics (NBS) released data showing that more cities registered lower or unchanged real estate prices in August than in July. In August, property prices in 46 out of 70 monitored major cities declined or stayed flat, compared with 31 cities reporting similar market conditions in July. Prices for new homes dropped in 16 cities in August, up from 14 in July. Meanwhile, there is considerable pent-up demand for new homes as more of the relatively affluent middle class are reaching marriageable age.

So no doubt there will continue to be price corrections in the property market. Indeed, that is very much the government’s aim. Some local bubbles may well burst, but it seems over-hyped to expect a national implosion.

Inflation

The National Bureau of Statistics shows that headline consumer price index (CPI) inflation eased from 6.5% year-on-year in July to 6.2% in August. On a month-on-month basis, the August headline number increased 0.3% compared to a 0.5% rise in July,

As expected, food inflation, while coming down, still tops the overall price increases with a rise of 13.4% year-on-year, compared with 14.8% in July. In particular, meat prices increased by 29.3% year-on-year in August, slowing down from a spike of 33.6% year-on-year increase in July. On a month-on-month basis, overall food prices rose by only 0.6% in August, dropping from a 1.2% gain in July.

Non-food prices rose 3.0% year-on-year, compared with a rise of 2.9% in July, while the headline producer price index (PPI) rose 7.3% year-on-year, easing from 7.5% in July.

Thus, while fighting inflation remains on top of the government's agenda, it is evident that the problem, albeit still serious, is at least not uncontrollable.

Apart from food price inflation, food security remains a sensitive national priority. It is noteworthy that Premier Wen is holding governors and mayors of national 'rice bag' provinces and 'vegetable basket' municipalities politically accountable for their agricultural output.

Unemployment

Many labour-and-energy-intensive factories in China's booming eastern seaboard are closing and some small-and-medium-sized enterprises have gone bankrupt, due to a depressed export market overseas, unsustainably diminishing profit margins, more stringent environment regulations, and shift of government support towards industrial upgrading.

Meanwhile, to attract labour for relocated industries and to grow domestic consumption, 30 provinces adjusted the minimum monthly wage in 2010 with an average wage increase of 22.8%, according to the People's Bank of China's "*2010 China's regional financial operation report*".

Wage rises are also fuelled by inflation and demand for better remuneration through government-tolerated, if not supported, collective bargaining.

A fair percentage of the vast pool of migrant workers is also returning to their home regions where new job opportunities are springing up as economic development is rapidly moving further inland.

Indeed, in various industrial sectors in the eastern seaboard, the labour market is becoming quite tight as factories and enterprises vie with one another to get workers, offering above-average wage increases and upgraded working conditions.

China's unemployment rate is showing signs of a small decline in the wake of the nation's economic rebound from the global financial crisis. At the end of 2009, China's unemployment rate was 4.3 percent. The government sought to keep the urban unemployment rate below 4.6 percent in 2010.

China had created 11.68 million jobs in 2010, exceeding the government goal of 9 million. Up to 90.7 % of the 6.3 million college graduates who entered the job market the previous year had found jobs in 2010. The fourth quarter unemployment rate remained unchanged from the third quarter, which dropped 0.1 % from 4.2 % at the end of the second quarter (China Daily, 25 January, 2011).

While these figures may hide a great deal of partial employment or under-employment, the employment situation does not seem to be getting out of hand. Indeed, as China's growth rate is expected to exceed 9% this year, anecdotal evidence of a tight labour market appears indicative at least of the blue-collar sector.

Consumption

According to the China's Statistics Bureau, the nation's retail sales climbed 17% in August from a year earlier. It further increased 17.2% in September. This appears to support a picture of rising consumption driven by a burgeoning middle class spawned by rapid urbanization.

The so-called Chinese middle class consists of different strata, from the lower middle class (annual household income bracket RMB 25,001 to 40,000), the upper middle class (RMB 40,001 to 100,000), the mass affluent (RMB 100,001 to 200,000), to the global affluent (above RMB 200,000 or $80,000 adjusted for purchasing power parity).

According to McKinsey Global Institute, China is the midst of the fastest and most extensive urbanization in human history. 221 new cities each with a population above 1 million are being created, compared with only 35 such cities in the whole of Europe. By 2025, 350 million more will be living in cities. By 2030, there will be one billion Chinese urbanites. (*Preparing for China's Urban Billion*, February, 2009).

The speed of construction often far exceeds the speed of urban population build-up, providing ample photo opportunities of apparent "ghost towns", "empty shopping malls" and "highways to nowhere", a phenomenon not entirely dissimilar to Shenzhen or Pudong in the early days.

According to the McKinsey Quarterly, in 2006, 77.3 % households were below the lower middle class income bracket. By 2015, this poor group will drastically shrink to only 9.7% while 79.2% of households will be in the lower and upper middle classes. The "mass affluent" class will jump from 9.8% of total in 2005 to 36.4% by 2025.

Although the per capita expenditure of the Chinese middle class, even when converted into purchasing power parity (PPP), is only a fraction of the West, China's over-size numbers will translate into a huge impact on the global total.

For example, according to the World Luxury Association's 2010-2011 annual report, though still a relatively poor country in per capita GDP, China already accounts for 27 % of the global luxury market, ahead of US at 14 % and right behind Japan at 29 %. The report expects that China will be the world's largest luxury market in 2012.

At the mass consumption end, more anecdotal evidence is coming to the fore. Yum! Brands opened 500 new restaurants in China in 2010 including one new KFC every single day. According to a latest Boston Consultancy Group Report (January, 2011), China is on the way to becoming the world's second largest consumer market after the United States by 2015.

Ecological crisis

With decades of breakneck growth averaging 10% a year, China has been compressing perhaps one or two centuries' industrial revolution into a few decades along with much of the pollution. Premier Wen Jiabao famously called this development "*Unstable, Unbalanced, Uncoordinated, and Unstainable"* (19 March 2007).

Not only has China become the world's largest emitter of greenhouse gases, her energy efficiency per unit GDP output is the world's lowest. Moreover, the country's seven main rivers and 25 out of 27 largest lakes have been polluted. A water crisis is looming: 300 million people are threatened with unsafe drinking water; the desertification rate has reached 25% while the Yellow River is running dry.

As Standard and Poor's June 2010 report points out, China's current energy-intensive development, including urbanization, transportation, and burgeoning middle-class lifestyles, is using up a lion's share of the global demand for resources - copper (39%), aluminium (43%), steel (42%), iron ore (60%), and coking coal (52%). Clearly, such development is hitting the globe's ecological limits. Hence, it is no surprise that China is changing course towards a slower, more sustainable, and more balanced development model, as stated in the latest Five Year Plan (2011-15).

Indeed, for the past ten years, China has been quietly embarking on a "Green Revolution". China is now leading the world in solar, wind and hydro-energy. According to the Worldwatch Institute, Washington DC, China has 30 million solar households, accounting for 60% of world's installed capacity. In 2010, China overtook America as the world leader in wind energy, as confirmed by the Global Wind Energy Council. China's installed wind capacity increased exponentially from 0.3GW in 2000 to 42.3GW in 2009, now representing 22%

of the world's total. As for hydropower, in 2010, its generating capacity reached 200GW, more than 20% of the country's total power-generation capacity.

Social unrest

In 2010, the number of mass protests, riots and other incidents rocketed to 180,000, more than a fourfold increase from a decade earlier. Most of these relate to land grabs, abuse of power, corruption, pollution and issues of public health or safety.

However, according to successive PEW public opinion surveys, the satisfaction rating amongst the Chinese people of how China is run has been steadily rising during the past few decades of dramatic economic growth. In the past few years, China's rating is amongst the highest in the world.

Nevertheless, it is increasingly evident that the social divide is widening. Social discontent is spreading as the middle class and the rich are getting much better off while the poor and the underprivileged feel increasingly short-changed.

Nor is the more educated middle class, who are the beneficiaries of pro-growth economic policies, remain entirely docile as their aspirations for more freedom of expression and more government accountability are not well met.

Some of the steam is let off in China's vibrant micro-blogging community, which now numbers some 120 million members and is rapidly growing in what is the world's largest internet population of over 500 million users. More of the educated middle class are now more inclined to take to the streets in protest against what they regard as unacceptable environmental violations or serious breach of social justice.

Unlike the Jasmine Revolution in the Arab world, however, there is no general demand for regime change. Nevertheless, how successful the Chinese leadership will be in narrowing the social divide and how it will address the liberal aspirations of a rising middle class will determine the degree of stability of the country as she continues with a trajectory increasingly fraught with economic, social, ecological and political challenges.

Demographic deficit

Decades of the One Child Policy has now resulted in an unbalanced population profile not only with more boys than girls but one that is aging fast. More married single-child couples are finding that they have to support four parents, themselves and their only child. In the next couple of decades, costs of pension and healthcare are bound to escalate while the working population shrinks as a proportion. The One Child Policy has long been modified in the sense that couples who are both single children are allowed to have a second child. Those who can afford to pay a fine may also gain this privilege. Moreover, all of Chinese minority peoples are totally exempt. But these minor concessions will not change the overall picture. Even if the One Child Policy is switched off, as expected by 2015, because of the long breaking distance of demographics, China is likely to grow old before she gets rich.

The "dollar trap"

As China's financial system is less developed, she has to sterilize a fair proportion of currency surpluses by investing them abroad. One third of China's massive $3.2 trillion foreign currency reserve is in US treasury bills. This has suppresses US interest rates, a welcome boon to businesses and consumers, who are thus in a position to buy more Chinese goods. So, depending on your point of view, the 'virtuous' or 'vicious' circle goes on. But if China should pull out of the dollar in any significant way so that the value of the dollar plummets, China would be the first to get hurt financially. This is what Paul Krugman calls China's 'dollar trap'.

China is now quietly trying to get out of the trap through gradually diversifying her foreign currency reserve, promoting outward direct investment, and internationalizing the RMB. The RMB has now become more accepted in international trade settlements. More bonds and financial instruments denominated in the RMB are being issued in offshore markets, especially Hong Kong. But as non-convertibility on the capital account has served China well in successive global financial crises, China is unlikely to rush towards full convertibility anytime soon. Meanwhile, despite the Great American Downgrade by Stand and Poor's, there is no credible substitute to the dollar as the premier global reserve currency. The dollar trap appears to remain intact.

The "middle income trap"

The "Middle Income Trap" is that stage of development when countries reaching about $3000 to $6000 per capita income seem to stall in productivity and income growth.

China's per capita GDP in 2000 of $949 has now grown to $4260 (September 2011), which well exceeds the original target by 2020. In July this year, the World Bank Group reclassified China as an upper middle income economy.

In the next 15 to 20 years, China is well-positioned to join the ranks of the world's high-income countries, according to Robert B. Zoellick, World Bank Group President. But he cautioned that such a transition is by no means the norm. Only a handful of countries or economies have made it. The best success examples in Asia are South Korea and to a lesser extent, Taiwan. Many countries in South East Asia and Latin America, however, are still struggling within the Middle Income Trap (between a GDP per capita of $3000 to $8000).

Some of the gripping issues China has to contend with in overcoming the Middle Income Trap include -

- Widening economic and social inequalities
- Balancing growth with ecological and resource constraints, including the economic pricing of energy and water resources
- Social, economic, and political adjustments in keeping with China's massive and rapidly-growing urban citizenry
- State cronyism and the rule of law
- Fiscal and financial reform including regulating the credit risks of numerous off-budget "local government financing vehicles (LGFVs)"
- A society that nurtures creativity and innovation by promoting rather than restricting freedom of ideas and expression
- The need for greater protection of intellectual property rights
- Growth of talent in face of a looming aging population profile
- Readiness in shouldering greater international responsibilities commensurate with the size of the economy

To emerge from the Middle Income Trap by 2020, China will need to maintain an annual growth rate of 7% whereby per capita income will grow to $8380 by 2021. The 7% growth target is stipulated in the latest Five Year Plan (2011-2015), but with a slowing domestic economy and an uncertain global economic outlook, this trajectory is by no means assured.

Conclusion

Looking at the above threats and challenges, it appears that any prediction of imminent collapse is exaggerated. As for landing, a balance of probabilities seems to support a soft landing rather than a hard one. Indeed, rhetoric aside, it is likely that under the new Five Year Plan (2011-15), there may not be any landing but a definite switch to a slower, more sustainable, and more equitable development model.

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