CHINA’S ECONOMY
Will it become the next Japan?

The recent economic worries have prompted critics warn that China might be at the risk of slumping into a Japan-style stagflation (that ensued after bursting of the asset price bubble in 1990s and the subsequent two-decades of economic slump) if Asia’s largest economy doesn’t initiate remedial measures soon. While it is probable that China’s reform trajectory would not be plain sailing, there is absolutely no doubt that it’s well poised to surpass the US, to emerge as the largest economy in the world by 2026.

Critics are obviously overreacting. Notwithstanding the recent spate of negative news that has kept pouring in from a raft of sectors and on several other fronts, and seemingly over-enthusiastic critics, the concern that China might head Japan way does not hold ground.

Alarming August Data
The series of negative data in August raised concerns that all is not well with the world’s second and Asia’s largest economy. Indeed, a raft of ominous data on China’s economy in August has sent alarm bells ringing across the globe. The Government stimulus doesn’t seem to be working. Overcapacity remains evident. An overwrought housing market seems to persist. Shadow banking continues to loom large, an albatross round the neck of a seemingly fragile banking and financial system weighed down by rising debts. China’s power generation declined for the first time in four years, falling 2.2 percent in August from a year earlier, while growth in sales of most housing-related goods slowed. Mortgage issuance in the first eight months of 2014 fell 4.5 per cent from a year earlier, worse than a 3.7 per cent drop in January-July as banks grow more cautious in anticipation of further price declines.

Industrial output rose only 6.9 per cent in August from a year earlier – the lowest since 2008 – compared with expectations for 8.8 per cent, slowing sharply from 9.0 per cent in July. Some analysts believe annual economic growth may be sliding towards 7 per cent in the third quarter, casting doubt on the government’s full-year target of 7.5 per cent. Experts reckon output growth of around 9 per cent would be needed to attain such a goal. Meanwhile, Premier Li Keqiang points out that the economy still created 9.7 million new jobs in the first eight months of 2014, a rise of over 100,000 from the same period last year. He asserts that China cannot rely
on loose credit to lift its economy, and that Beijing would continue to roll out modest “targeted” measures to shore up growth. So, what is going on? Would China in 2014 presage a repeat of Japan’s ‘lost decades’ as claimed by some analysts?

The worries are primarily three-fold: the risks of a housing bubble, a possible shadow banking crisis and questionable ability to deliver a new model of sustainable growth.

A Housing Bubble?
The first major difference of China’s housing market is that traditionally, the gearing (on average about 50 per cent) is very low by international comparison. According to findings of the Institute of Real Estate Studies, Tsinghua University (2007-10), the ratio of housing prices to disposable income varies below 13 per cent for eight major Chinese cities except Beijing (18 per cent) and Shenzhen (22 per cent). A 30 per cent drop in price would translate into only 3 per cent negative equity. In an article “China’s property market is no bubble” in the Wall Street Journal, Yukon Huang, Senior Associate at the Carnegie Endowment for International Peace and a former country director for the World Bank in China, shows that the graph of construction and real estate value-added as a percentage of GDP (1981-2012) only rises moderately between 5 to 12 per cent with no sharp hikes and drops. No real property market existed in China until housing was privatized more than a decade ago. Since then, the market has been characterized by massive pent-up demand supported by continuing income growth, urbanization, rise of smaller families and an exploding middle class.

Shadow Banking and a Wobbling Banking Sector?
The answer lies in the following perspectives. First, China’s big four banks are amongst the world’s top ten largest by banking assets. The vast majority of China’s banking assets are state-owned, backed by a colossal foreign exchange reserve of $4 trillion. They are also by far much less leveraged than Western banks. Second, shadow banking is a universal phenomenon, the outcome of modern-day credit creation outside the formal banking system. According to data from JP Morgan, measuring financial intermediaries as a percentage of bank assets, China’s shadow banking exposure (some 30 per cent) ranks below average (50 per cent) among 20 jurisdictions at the end of 2012. The US and Netherlands had the largest shadow banking systems at 170 per cent and 150 per cent respectively while South Africa and Mexico had the largest among emerging-market countries, at 66 and 56 per cent respectively. Third, Beijing is well aware of the risks of shadow banking and is applying the brakes across the board. Last but not least, China’s shadow banking has arisen primarily because of “financial repression”. Under this current system, the state extracts surplus savings through suppressed bank deposit rates. Lending goes mostly to large state-owned enterprises. This has spawned a plethora of high-interest-bearing wealth management products outside bank balance sheets. The resultant investments give rise to dubious projects infested with corruption. These multi-faceted problems are now being vigorously tackled. There is the existential need to consolidate the Party’s legitimacy, to liberalize the financial system and hasten the full convertibility of the RMB as an international reserve currency.

Ability to deliver a New Model of Sustainable Growth
Following the 60-point decisions of the Communist Party Third Plenum in November 2013, there is little doubt that the Xi leadership really wanted fundamental reforms. But the question is to what extent
these reforms may deliver a substantially transformed China by 2020.

Much recent skepticism misses how the Communist Party collectively works. There was considerable political gestation leading up to Xi’s installation as President. Any serious differences in direction had largely been ironed out. The “Bo Xilai affair” helped further to concentrate the mind. There is now consensus in the top leadership that absent urgent systemic reform, including Party discipline, the whole Party would sink together. Hence the unprecedented resolve in the current anti-corruption campaign to bag top political tigers. The dust is expected to settle by the Fourth Plenum meeting this October, when the economic and Party reform roadmap will be unveiled in greater detail.

Much of the ambitious reform agenda was mapped out well in advance in a 2012 468-page World Bank Report co-authored with the State Council’s Development Research Centre. The report, “China 2030: Building a Modern, Harmonious, and Creative High-Income Society” recognizes that the country’s 30-year-old growth model has now reached a dead-end. Drastic structural changes are imperative to transit to a higher-income economy. The report’s substance has since been embodied in the final decisions of the Third Plenum.

The epoch-making reforms include a modification to the One Child Policy to inject more young blood to enhance China’s productivity and innovative capacity. According to the 2012 Report of the World Intellectual Property Organization (WIPO), China already tops the world in filings of patents, trademarks and industrial designs. The Royal Society predicts that China is likely to overtake the United States in the number of scientific citations any time soon. Sure, China has yet to produce a single home-grown Nobel science laureate. Quantity does not translate into quality. Nor is China anywhere near the world’s commanding heights of breakthrough technologies. However, the tide is beginning to turn. At the very least, any doubt about China’s ability to produce innovative entrepreneurs ought to have been cleared somewhat by the largest Wall Street IPO in history, that of the world’s biggest e-commerce behemoth Alibaba, founded by China’s Jack Ma.

Additionally, a long-expected reform of the “hukou” (household registration) system has already been launched. This will enable peasants to mortgage, rent or transfer their land, of which they have so far enjoyed only user rights. Other reform measures are also being put in place, including universal, if basic, access to healthcare, old-age pension and education. These measures will empower the massive number of rural migrants to gradually integrate into the urban social fabric. They are set to become part of a burgeoning middle class of consumers to help balance the economy.

Some observers are confounded by Beijing’s new imperative that the market is henceforth to play a decisive role in the economy while continuing to emphasize that “public ownership” would remain the “main body of China’s economy”. This apparent paradox means that China’s largest state-owned enterprises will begin to see some of their monopolistic powers gradually chipped away by mixed ownership between public and private capital. Additionally, they have been directed to increase their state tribute from 15 to 30 percent by 2020, such extra funds to be used for improving the country’s safety net. Also on the cards are the freeing up of the pricing of water, electricity, oil, gas, transport and telecommunications, and the development of private banks.

The Third Plenum also decided to open further the finance, education, culture and medical sectors, while easing investment restrictions for nursery, pension, architecture, design, accounting, trade, logistics, and e-commerce. This is to be supported by free trade zones and investment facilitation policies. The RMB, the Chinese yuan, is to become a globally-traded currency by 2015 and to
achieve capital account convertibility by 2020, accompanied by interest rate liberalization. When these reforms are realized, the RMB is likely to become the world’s most traded currency. This should not come as a surprise as China is the world’s largest trader, trading with 127 countries worldwide compared with 76 for the United States. Six of the world’s top eight container ports are located on China’s eastern seaboard, a testimony to China’s pivotal position as a global trading and logistics hub. According to the Peterson Institute for International Economics, Washington DC, there are already more currencies moving in tandem with the RMB instead of the dollar.

It is probable that China’s reform trajectory would not be plain sailing. Treacherous rocks may pervert the torrent of productivity these reforms are expected to unleash. The test of the pudding remains in the eating. China’s Communist Party, however, is noted for executive efficiency. Many China doomsayers have remained doomsayers for decades. This time around, what concentrates the mind for ground-breaking reform is the very survival of the whole Party.

**Does China’s Economic Slow-down Herald Long-term Decline?**

China’s decades of labor-and-resource-intensive breakneck growth has accumulated a mountain of problems ranging from growing inequality, corruption, ecological degradation, lowering capital productivity, and other hurdles of the middle-income trap, which many developing countries will have to overcome to transit to a higher-income economy. China has repeatedly affirmed that she is in for a slower, more equitable, more balanced, more innovative, higher-quality, and more sustainable growth. But the question is how much slower, as a growth rate much higher than Western norms would be necessary to keep the masses reasonably employed. In a 2013 Report “Economic Outlook for SE Asia, China and India 2014 - Beyond the Middle Income Trap”, the OCED finds that China’s economy will slow from 7.7 in 2012 to 7.5 per cent by 2018. The report suggests that under a best-case scenario, China should be able to transit beyond the middle-income trap by 2026, a little later than Malaysia (2020) but ahead of Thailand (2031), Indonesia (2042), Philippines (2051), Vietnam (2058) and India (2059). Beijing has recently stated that a medium-term average growth rate of about 7 per cent is aimed for.

**An Asian Century in the Making?**

Per capita income measurements do not do justice to the economic weight of large economies with huge populations. According to the World Bank, China’s economy is likely to overtake that of the United States this year in purchasing power parity terms. The Economist estimates that with slower growth rates, China’s economy will become the world’s largest by 2021. Be that as it may, should China succeed in overcoming the middle-income trap by 2026, her economy by then will have grown much larger than the United States.

According to research by BBVA, a Spanish bank, the EAGLEs (Emerging and Growth Leading Economies, including Turkey) and NEST countries (upcoming-EAGLEs) are together expected to contribute 68 per cent to world growth between 2012 and 2022. China and India are each expected to contribute a higher share than the US. The G7 economies together will add a mere 16 per cent.

In contrast with an economically-weakened West, there are increasing signs of an Asian renaissance under new leadership. In a few more decades, the shift of gravitas to the East is likely to become even more pronounced. The world as we know it today will have totally transformed. Plus the advent of mobile and other technologies, new modes of businesses, new non-state actors across boundaries, traditional ways of looking at growth, money flows, commerce and global power will no longer be fit for the purpose.

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