China's rapid growth is not sustainable!

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INTRODUCTION

Since the reforms of Deng Xiaoping, China has been on a trajectory of rapid economic growth that is of an unprecedented scale in human history. China's emergence from extreme poverty to become the world's second largest economy was driven primarily by massive export growth, as China became the world's factory. However, since the Global Financial Crisis (GFC), China's growth has become reliant on credit stimulus and a related property bubble. This unsustainable growth model is now coming unstuck. While a "hard landing" is unlikely, China's growth is certain to slow further and the risks for the global economy and financial markets are significant.

WHY CHINA'S RAPID GROWTH IS UNSUSTAINABLE

China's economy was opened up to trade and foreign investment by Deng Xiaoping in 1978/79. An abundance of cheap labour and supportive policies enabled very rapid economic growth for several decades thereafter. The first and longest phase of this growth was underpinned by exports, which grew from just 6% of GDP in 1980 to 35% of GDP by 2007. During an extraordinary period from 2001 to 2007 following China's entry to the World Trade Organisation, China's exports surged by 15% of GDP and economic growth averaged an incredible 11% per annum, as China cemented its place in global manufacturing supply chains.

When the GFC took hold, China's exports collapsed to 24% of GDP. The response from the Communist party was the largest credit stimulus in history, fuelling an investment boom that continues today. China's state owned banks issued new credit of $10 trillion from 2008 to 2013, equivalent to the entire US banking system[1]. Although credit growth has slowed recently, it continues to accumulate at a rapid pace (15% per annum), well above China's GDP growth rate. Returns to new credit have fallen from around 75 cents in the dollar to just 20 cents, as more and more new debt is used to rollover existing loans[2]. China's credit-fuelled investment growth phase is reaching its end game and new sources of growth are needed to drive the economy.

Around half of China's credit stimulus since the GFC ended up in the property market. In 2007, China was constructing around 1.5 billion square metres of gross residential floor space per year (or approximately 15 million housing units) to support urbanisation, replace old housing stock and meet the investment needs of Chinese households. By 2012, despite there having been no change in the rate of urbanisation, the annual residential construction rate reached 2 billion square metres and has remained elevated since. This equates to millions more units of housing being constructed each year than new households being formed. To fuel its construction boom, China used more cement in 2011 and 2012 than the US did in the entire twentieth century[3].

Most of China's excess housing supply is vacant stock held by private investors, with the remainder sitting on the books of highly indebted real estate developers. According to the China Household Finance Survey, 22% of urban housing in China is vacant. Meanwhile, vacant floor space on developers' books has increased by over six times since 2007[4]. A build-up of unoccupied properties held by investors and developers will ultimately lead to a major contraction of construction activity.

Shifting demographics will also reduce China's GDP growth rate by around 3% per annum over the next fifteen years[5]. The working age population (aged 15 to 59 years) peaked in 2012 and is currently declining by several million people each year.

Although economic data out of China are problematic, there are a number of indicators that suggest a major slowdown is already underway. Cement production contracted by 2% per annum from 2013 to 2015, compared to 11% growth per annum in the decade prior. Steel production, electricity production and freight traffic have all slowed materially, growing at just 1% to 2% per annum in the past two years. Trade data shows that growth of real imports has also slowed materially[6] which may, in part, reflect domestic macro weakness.

TWO SCENARIOS FOR CHINA'S ECONOMY

China's growth is almost certain to continue slowing over the short to medium term, and the risk of a hard landing or recession cannot be ruled out. The two scenarios facing the Chinese economy are:

1. A managed slowdown (most likely) – the government slows credit growth and implements reforms to rebalance the economy towards consumption. This would result in much slower, but more sustainable, GDP growth.
2. A hard landing (tail risk) – rapid credit growth and over-investment continues risking a major crash, a recession and many years of sub-par GDP growth.

A hard landing in China is possible if key risks to China's economy materialise and policy mistakes are made.

One key risk is that authorities are either too quick or too slow to address the pervasive moral hazard in the financial system. Currently, $1.3 trillion in corporate loans are owed by Chinese companies whose profits aren't sufficient to cover interest payments, which suggests potential bank losses equivalent to 7% of GDP[7]. Greater recognition of defaults, losses and non-performing loans could lead to a tightening of credit conditions by China's banks, coupled with a pull-back in loan demand from the private sector - triggering a downturn and, possibly, a panic in the poorly regulated shadow banking system. On the other hand, if credit stimulus continues unchecked or is ramped up to maintain GDP growth rates, returns to additional credit growth may diminish rapidly, causing widespread losses and a recession.

The structural oversupply in property and related industrial sectors is another key risk. To work off China's excess supply of property, residential construction activity could fall by as much as 50%. This would be devastating for the economy considering that real estate and linked industries account for 20% to 25% of GDP. Fiscal balances would deteriorate, especially for local governments which rely on land sales for around 35% of revenues, blunting the effectiveness of fiscal policy. A property fire sale by investors or highly leveraged property developers could lead to large falls in prices and capital losses, rendering many developers insolvent and having a deleterious impact on household wealth. Interest rate liberalisation, capital account opening, and the availability of alternative investments (e.g. wealth management products) could also undermine property market fundamentals.

These issues will be difficult to manage, and the mishandling of the stock market boom in mid-2015 shows that the Communist Party leadership is not immune to policy mistakes.

WHAT DOES THIS MEAN FOR MARKETS?

China is a key driver of global growth and its importance to the global economy is only increasing with time. Since 2010, China is estimated to have directly contributed around a quarter of total global economic growth, despite only representing around 12% of global GDP. China is by far the largest consumer of commodities and accounts for around half of the world's consumption of iron ore, cement, coal and steel. Should China's economy continue to slow or face a hard landing, the global repercussions are likely to be significant. Domestic weakness in China is already flowing through to asset markets around the world, particularly commodity and currency markets. Now is a time to be cautious about exposures to China.

A number of commodity exporters such as Brazil, Russia, Australia and Canada have experienced material depreciations in their currencies against the US dollar as commodity prices have fallen. If Chinese demand was to fall as the property market adjusts, these economies may become vulnerable to the unwinding of commodities-linked domestic credit booms. The same can be said for a range of other commodity exporting emerging market economies, including Chile and others in Latin America. While many emerging markets are net importers of commodities, these countries' currencies may also be vulnerable to further commodity price falls in the short term, due to highly-correlated exposures among global asset managers and recent, broad-based emerging market credit booms. Other economies with major trade linkages to China – such as the emerging markets in Asia, Japan and, possibly, Germany – could also be affected by a major slowdown or recession in China.

Further RMB depreciation is possible, although a large devaluation may be counterproductive for China because of the cascading impact on other emerging market currencies and economies and the potential feedback effects on Chinese growth. However, interest rate normalisation by the US Federal Reserve combined with shifting economic fortunes in China could accelerate capital outflows, putting pressure on the State Administration of Foreign Exchange and the People's Bank of China to further sell down its $3.2 trillion pool of foreign exchange reserves, or allow the RMB to depreciate. To reduce the likelihood of this, China has recently taken steps to stem outflows through new and tighter capital controls. The sale of foreign reserve assets such as US Treasury bonds could also put upward pressure on bond yields globally.

Although China's international financial linkages are relatively nascent, links between Chinese banks and Hong Kong or Singapore could provide channels for the international transmission of a Chinese financial shock. Foreign lending to Chinese corporates has grown at a rapid pace and much of this lending is focused on the property sector. Total claims by foreign banks on China are $1 trillion, an increase of four times since 2008[8]. Chinese companies, particularly property developers, are a major component of Asian high yield corporate bond markets and could trigger a reassessment of risk premia in the event of large scale defaults. If China experiences a recession and defaults spread across borders, an emerging markets contagion is not out of the question. Meanwhile, capital repatriation by Chinese investors could hit property markets and associated financial systems in Canada, Australia, Hong Kong, California and the UK.

Finally, the global trend towards increasing trade protection and associated rhetoric in the 2016 US election campaign could translate into protectionist policy actions that hurt China's economy, given its major dependence on international trade activity. The US alone accounts for 18% of China's exports, or 4% of China's GDP.

CONCLUSION

There are few signs that the Communist party leadership are ready to shift away from the credit-fuelled investment growth model, however authorities are aware of the problems and appear to be taking some tentative steps to slow credit growth. Fortunately, all of China's debt is held domestically and the country's capital account remains relatively closed, which makes it easier for the government to manage large-scale defaults and nationalise debt, as it did in the late 1990s.

Additional fiscal stimulus is possible but may be limited as China's general government deficit is already around 10% of GDP when adjusted for off-budget local government financing vehicles and land sales[9]. On the other hand, further monetary stimulus will almost certainly be deployed to reduce interest burdens and ease banks' reserve requirements. China's huge foreign exchange reserves and current account surplus also make it highly resilient to external financial shocks.

The Chinese government has substantial resources at its disposal, however it still may not be able to prevent a sharp slowdown in growth (or a recession) if the returns on incremental spending and investment are sufficiently low, or if private sector consumption is unable to fill the void. While there are a number of reasons to be optimistic about China's long-term economic future, the short- to medium-term challenges are considerable. China's rapid economic growth is ending and the global economic ramifications will be widespread, warranting a cautious approach by investors.

DISCLAIMER

ENDNOTES

1. Financial Times
2. Autonomous
3. Wall Street Journal
4. National Bureau of Statistics
5. Citi
6. National Bureau of Statistics
7. International Monetary Fund
8. Bank of International Settlements
9. International Monetary Fund

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