How China’s Economy Can Weather a ‘Long, Slow Fall’

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To implement reforms or not — that is the tough question currently facing China’s leadership

The times are changing. China’s economy grew at an annual rate of 7.3% in the third quarter of this year, its slowest pace since the global crisis five years ago, as a slump in its property sector decimated domestic demand and industrial production. Despite signs that the economy will fall short of the annual growth target of 7.5%, top leaders have refrained from unleashing the type of massive stimulus they used to fend off recession in 2009.

Some expect growth to slow more dramatically: New York-based non-profit business and research organization The Conference Board forecasts that China’s annual growth will slow to an average rate of 5.5% between 2015 and 2019, compared with 7.7% last year, and drop further to an average rate of 3.9% between 2020 and 2025.

Most economists and experts agree that China urgently needs structural reforms, but they are divided over whether Beijing should sit tight or go ahead with a major stimulus package. Regardless, China will likely muddle through implementation of reforms whether or not it endures a hard landing: Thanks to the country’s modest level of development, China has more room to expand than Japan did when it faced its own abrupt transition to a low growth era in the 1990s.

Despite similarities between Japan’s past experience and China’s current predicament of unbalanced growth, industrial overcapacity, excessively high property prices and an undercapitalized financial system, China has bigger growth potential and its authoritarian government has a stronger capacity for taking bold and quick action when necessary. The Chinese government owns almost all of the country’s banks, and President Xi Jinping appears
determined to implement reforms that should help rein in shadow banking and local government debt while shifting the world’s second-biggest economy away from investment and export-driven demand toward consumption-driven growth.

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‘There Is Plenty of Entrepreneurial Spirit’

The Conference Board forecast, issued in a report titled, “China’s Long Soft Fall,” is much lower than most other economists’ outlooks for China. But The Conference Board does not foresee a “hard landing” or financial crisis. “We think the economy will have a long, soft fall or gradual slowdown,” says Andrew Polk, Beijing-based China resident economist for the nonprofit. “The 5.5% growth rate we see for the next five years is an average. This is a natural change as the economy matures, and China goes through a demographic transition and shifts toward service industries.”

Since services involve more labor-intensive growth, overall economic expansion will slow as the service sector becomes more important, but employment will remain relatively robust, Polk adds. “China’s growth model has reached a transition point that inevitably requires significant structural adjustments,” according to The Conference Board report. “There is no debate about the desired direction — decrease the economy’s reliance on credit fueled investment, de-lever non-performing debt, consolidate massive industrial over-capacity, bolster both return on capital and productivity growth, and promote household wealth and welfare accumulation and consumption.”

Though all the above is easier said than done, other economists say The Conference Board’s forecasts are overly pessimistic. “I think it would be hard for China to accept below 4% growth, but I would say that is not a very likely scenario,” says Louis Kuijs, a China economist at the Royal Bank of Scotland Plc’s Hong Kong branch. “My own medium-term forecast is not as low as that. I do not think China can grow say, at a rate of 9% for the coming 10 years but I also do not think growth would fall to as low as 5% from now on.”

He added that the decline in investment will amplify China’s slowdown, but it also will eliminate waste and misuse of capital. “If you are able to grow the way China did without running into things like current account deficits or high inflation, that proves your supply side is pretty solid, and you can broadly sustain this kind of growth,” Kuijs notes.

He adds that some of the reforms, such as easing the environment for the private sector, have been progressing, but financial reforms such as opening the capital account and establishing deposit insurance have slowed down. “I think the feeling is the financial reforms are not going to go ahead as quickly as we thought a year ago. Probably the weakening growth is one factor behind that. Much of the attention of policymakers is on growth and how to manage the low growth. This reduces the appetite for reforms in this area,” he says.

Wharton finance professor Franklin Allen says China has the capacity to keep the economy growing at a rate of 7% to 7.5%. “In the long run, if they reform the financial system, they can grow at a similar rate for some time to come. GDP per capita is still less than quarter of that in the U.S., so there is huge scope for growth and there is plenty of entrepreneurial spirit,” he notes. “If they do the reforms quickly, they could grow much faster than now. They could grow at a rate of 7% or 8%, even 9%, in the next 10 years."

Preventing a Hard Landing

China experts see the likelihood of a hard landing for China as low as long as its leaders implement needed reforms. So far, the process has moved slowly, however, as Xi has focused attention on an anti-corruption drive meant to consolidate the power of his administration. “My view is that the anti-corruption campaign is slowing down everything. They need to reform the financial system, but everybody is frozen with the anti-corruption campaign,” Allen says.
Any effort to counter the slowdown through extra stimulus spending — as opposed to other measures, such as tinkering with property taxes and other policies — would run contrary to the aim of pushing through the reforms, says Polk. “The reforms that the Chinese leadership promised in November 2013 seem to be slowing down because of the slower growth. We think right now the reform program is pretty slow moving. If they step in with traditional stimulus, the reforms will be totally sidelined.”

As long as the labor market is in good enough shape, most economists expect Beijing will refrain from major stimulus. “Growth is lower than the official target, but [the Chinese leadership] have been quite clear and quite public about how they want to be seen as responding to this: ‘We can deal with this and it is OK that our growth is a bit lower than our target, as long as the labor market continues to be doing [well] in terms of employment creation and as long as income continues to grow,’” Kuijs says. Still, there is a limit to China’s tolerance for slower growth, perhaps at about 6.5%. “That limit has not been reached,” Kuijs adds, noting that if it is at some point in the future, China will react more aggressively.

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Employment remains the key concern. China needs slightly below 7% annual growth to create 10 million jobs. “If growth dips below that level, I think it will give too big a shock,” says Kazuo Yukawa, a professor and contemporary China expert at the Asia University in Tokyo. “The new leadership may have to resort to a stimulus package if growth falls to 6.5% but they know that if they resort to too big a stimulus, they will have higher growth but they will be adding more new problems. They are holding back and doing their best not to resort to a full stimulus package.”

Already, pressure for job creation is easing. China has hit its demographic peak in terms of working-age population — those between the ages of 16 and 59 — which fell 2.4 million to 920 million in 2013, or 67.6% of the total population, according to the National Bureau of Statistics. The UNDP forecasts that China’s working age population will decrease by eight million in the next five years, after remaining basically flat in the past five years.

So far, the government has opted for marginal stimulus. In September, Beijing loosened mortgage restrictions to perk up demand in the ailing housing market. The People’s Bank of China said purchasers of second homes could now be considered first-time buyers and make down payments of 30% rather than the previously required 60%. The PBOC confirmed in its third-quarter monetary report that it had already conducted two rounds of liquidity injection into the country’s banking system in September and October, totaling 769.5 billion yuan, to guide interest rates lower and support growth.

Most recently, on October 28, the State Council, China’s cabinet, said China will stabilize property-related consumption, making it easier for people to access their mandatory housing savings accounts.

Kaven Tsang, a Moody’s Investor Service vice president and senior analyst, wrote in a recent report, “China Property Industry Outlook Update: Negative Outlook Reflects Protracted Decline in Nationwide Home Sales,” that he expects nationwide contracted sales, in value terms, to further shrink by 0% to 5% year-on-year in 2015, after falling more than 10% in the first nine months of 2014. “The forecasted decline will be mainly driven by a modest decline in property prices, as developers will offer discounts and increase promotions in order to boost sales and increase liquidity,” according to the report.

Such minor stimulus measures are having a modest impact, says Rajiv Biswas, a Singapore-based Asia-Pacific economist at IHS Economics. “Although domestic demand has moderated during 2014, particularly due to slowing residential construction, the upturn in exports — notably of electronics related to the Apple iPhone 6 launch — has temporarily helped to support growth and industrial production,” Biswas notes. “However, a key concern is that the export momentum could moderate after the Christmas sales surge, especially since eurozone growth is slowing
An Uncertain Outlook

But while a hard landing is seen as unlikely, uncertainties remain.

Several China economists forecast a 15% to 30% probability that a sharper-than-expected property downturn and ineffective government policies may lead to 5% growth in 2015, a pace that would be considered a hard landing. “There are significant imbalances in the Chinese economy, including the residential property sector downturn, rising non-performing loans in the formal banking sector and growing concerns about the upsurge in unregulated lending by shadow banks over the last four years,” Biswas says. “IHS estimates that there is a downside risk of around 25% probability that China will face a hard landing sometime in the next three years with growth slowing to below 5%.” His baseline forecast for the Chinese economy, however, is that GDP growth will be 7.3% in 2014 and 7.1% in 2015. “Over the next five years, Chinese economic growth is projected to be around 7% per year,” he adds.

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Hong Kong-based UBS AG China economist Tao Wang said in her most recent report, “China Economic Outlook 2015 and 2016,” that she expects growth to slow to 6.8% in 2015 and 6.5% in 2016, down from a forecast of 7.3% in 2013. “Risk to our 2015 forecast is biased on the downside. We see a 15% chance of a property-led hard landing with growth slowing down to 5% plus,” Wang writes. “However, we think a financial crisis is much less likely in the near term, given China’s high domestic savings, largely closed capital accounts, government control of the banking system and a still manageable government debt level.”

History Repeating?

Some analysts say non-performing loans (NPLs) held by China’s banks are already higher than the 8.2% peak level of total lending held by Japanese lenders during the collapse of that country’s asset bubble. In Japan’s case, a series of official discount rate hikes beginning in May 1989 caused NPL assets to accumulate, leading to a banking crisis in the early 1990s. The official NPL ratio for China’s major banks stood at 1.08% at the end of June this year, up 0.04 percentage points from the end of March, according to the China Banking Regulatory Commission.

But those numbers understate the reality. “We suspect that China’s NPL ratio could be much higher than Japan’s was at its worst, over 8% some 10 years after the property bubble burst,” David Cui, a strategist at Bank of America Merrill Lynch (Singapore) said in a recent report. “In fact, judging from past experience in China, we could argue that ultimately, the NPL ratio could be significantly into the double digits.” Cui, in his report, which is titled “Will China Repeat Japan’s Experience?," concludes that the financial system has worsened a great deal over the past year and half, especially in the shadow banking sector.

Cui noted that the new generation of Chinese leadership is still focused on consolidating its power, rather than economic matters. “We are unlikely to see a resolution to the long overdue bad debt recognition and financial system recap until the political dust settles,” Cui said.

Still, most economists are less concerned about the risks of those debts snowballing into a major financial crisis. “If you look at the high rate of investment and rapid increase in domestic debt, China shares some similarities, [with Japan], but I would say there is a big difference between China now and Japan in the late 1980s,” Kuijs points out. “There are companies and local government vehicles that have difficulty paying back loans, but these problems have not yet taken on broad-based and systemic nature.”

Apart from that, Japan was much more advanced in its development and growth trajectory and had less leeway for
rapid growth at the time its bubble burst. China’s per capita GDP is still only 14% of that of the U.S., while Japan’s was something like 70% to 80% of America’s in the late 1980s. At China’s level of development, “It is so much easier to grow out of problems such as asset bubbles or debt issue,” Kuijs notes.

Ultimately, China must pursue its reforms to ensure sustainable, long-term growth, since resorting to traditional stimulus is becoming less and less powerful and effective, says Polk. “We do think China will move on reforms eventually, but it is our expectation that they will not move until the pain of inaction becomes greater than the pain of action,” he adds.

Dawdling and muddling through could also carry risks, however, says Wei Yao, a Paris-based China economist for Societe Generale Cross Asset Research. “An abrupt correction does not have to mark the end of the China growth story like Japan in the 1990s,” she says. “It is the top leaders’ choices during the difficult time ahead that will determine the fate of the Chinese economy. The key is not to waste the crisis.”