What to worry about, and what not to in China

Andrew Batson et al | Gavekal | 27 August 2015

The unexpected devaluation of the renminbi earlier this month focused international attention on the continuing slowdown in China and triggered shockwaves through global markets, as investors contemplated how the unaccustomed softness of Chinese growth could affect the world economy. Beijing's move this week to cut benchmark interest rates and inject liquidity into the domestic banking system only reinforced the message that many observers had already taken away from the slump in Chinese stock prices – that China's economy is weaker than they had believed and may now be teetering on the edge of collapse.

Such fears are exaggerated. China's economy is not collapsing. But it is slowing – indeed, three of China's provinces are already in recession. And, as it continues, the slowdown will inevitably highlight problems that until now have remained largely hidden, triggering fresh bouts of market volatility.

In the interest of clear-sightedness, therefore, we thought it would be helpful to detail four areas where fears about Chinese economic fragility have been overstated, and four areas where investor concerns are justified.

FOUR FEARS THAT ARE OVER-BLOWN

1. Devaluation will trigger a foreign debt crisis

This month's sudden change in China's foreign exchange rate policy has created heightened uncertainty over the future direction of the renminbi. Following the currency's initial 3% depreciation against the US dollar, the People's Bank of China has intervened heavily in the foreign exchange market to keep the US$-CNY exchange rate steady at around CNY6.40, while officials have declared that the immediate adjustment is complete. As a result, the probability of a significant further fall in the renminbi – say of -5% or more against the US dollar – looks slim.

Nevertheless, the market expects the Chinese currency to depreciate over the coming months, as capital outflows pick up and Chinese companies continue to unwind their short-US dollar/long-renminbi carry trades, adding to pressure on the PBOC to allow the currency to weaken.

Yet, although the fall in the renminbi has made debt servicing harder for Chinese companies which have borrowed heavily in US dollars, we see no likelihood of a foreign currency debt crisis, even if the currency does fall further. According to official statistics and to data from the Bank for International Settlements, China's foreign currency debt is around US$1 trillion. Allowing for foreign currency borrowed by the subsidiaries of Chinese companies in Hong Kong, the actual amount is higher. Even so, total foreign currency debt is highly unlikely to exceed US$1.5 trillion – which is 15% of China's gross domestic product or 40% of its foreign exchange reserves. As a result, China is well insulated from the sort of foreign currency debt crisis that has struck other emerging markets in recent decades.

2. The stock market crash will trigger a systemic crisis

The volatility of the last few days has emphasised the fragility of the Shanghai stock market and how dependent it remains on government support. With economic growth weak, earnings prospects poor, and retail sentiment crushed by the 45% decline in the Shanghai Composite since mid-June, the pressure is still downwards.

But, although a continued slump from current levels would generate plenty of hyperbolic headlines about a crashing China, even a further sell-off would have a limited spillover effect on the real economy. Equity investments are a small share of Chinese household wealth – no more than 5% – compared with property and bank deposits, so the negative wealth effect of the equity bear market on consumer demand is limited.

Moreover, the Chinese banking system has little exposure to the stock market. Although securities brokers have more than doubled their assets over the past 12 months to RMB8 trillion while trust companies have increased their equity exposure by another RMB1 trillion, the total size of this exposure accounts for no more than 6% to 7% of China's banking assets. With brokers forbidden to leverage their equity capital more than four times over, the sector is relatively well protected from bankruptcies. So, although wealth management products linked to the stock market may sustain big losses, and while it is possible some brokers could fail, it is highly unlikely that a further slump in equities will trigger a systemic crisis.

3. Property prices will collapse

According to one widely-held view, the Chinese property market is an enormous speculative bubble in which ludicrously high prices are supported only by ill-founded expectations that prices will go even higher still and, at some point soon, the whole show is destined to crash. Regular readers will know that our years of research into the Chinese property market provide little support for this view. While there has long been an element of speculation, on the whole China's property market is driven by the fundamentals of an expanding urban population and rising incomes.

That does not mean everything in the garden is rosy. These fundamentals indicate that housing demand is close to its peak, and that the sector has gone from being a growth driver to a drag on growth - a shift with huge knock-on effects for the rest of the economy. But the maturation and decline of housing demand is a very different thing from the unwinding of a massive speculative bubble. In particular, it means that nationwide housing prices are unlikely to undergo a deep collapse, as underlying demand is not going to evaporate abruptly, allowing supply to adjust over time to the changing conditions. Indeed, both housing sales and prices have rebounded in recent months, not just in big cities but also in smaller markets, in response to interest rate cuts and an easing of restrictions on purchasers. At least in the short run, this recovery will help to mitigate against a free fall in construction, even though investment in the sector will remain weak.

4. Unemployment will surge

While economic growth is weak, and will continue to weaken from here, China's employment market is holding up relatively well. Although deteriorating corporate profits have led to a slowdown in wage growth, the labor market in general remains tight, as the growth rate of the workforce continues to decline and service sector growth remains relatively healthy, helping to absorb the labor supply. What's more, the slowdown has been most severe in the heavy industrial and commodity sectors, which are largely state-owned - and state-owned enterprises are not free to cut worker numbers as flexibly as private sector or foreign companies. The most many SOEs have done is trim benefits. Even in the private sector, firms have balked at making mass lay-offs, with mining companies choosing instead to reduce working hours and award employees more holiday. As a result, hours worked have fallen and wage growth has declined, but unemployment has remained relatively stable and fears of a major surge in jobless numbers - with catastrophic consequences for consumer demand - appear exaggerated.

FOUR AREAS WHERE CONCERN IS FULLY MERITED

Of course, just because some fears are over-stated does not mean we can all relax.

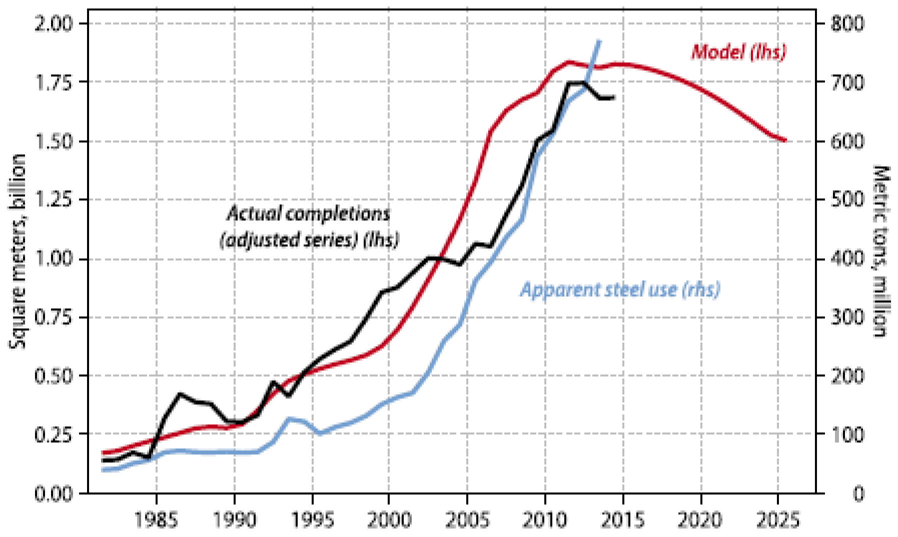
1. The investment slowdown

China is an investment-driven economy and the current slowdown is above all a slowdown in investment, which is now at its weakest in more than 10 years. We estimate that real growth in capital formation, net of depreciation, was only 2% to 4% in 2014, and it has slowed further this year.

Among the factors constraining investment are high real borrowing rates, which is why we expect further cuts in interest rates over the medium term. But, the adjustment in investment is also being driven by structural factors that Beijing is less able to control.

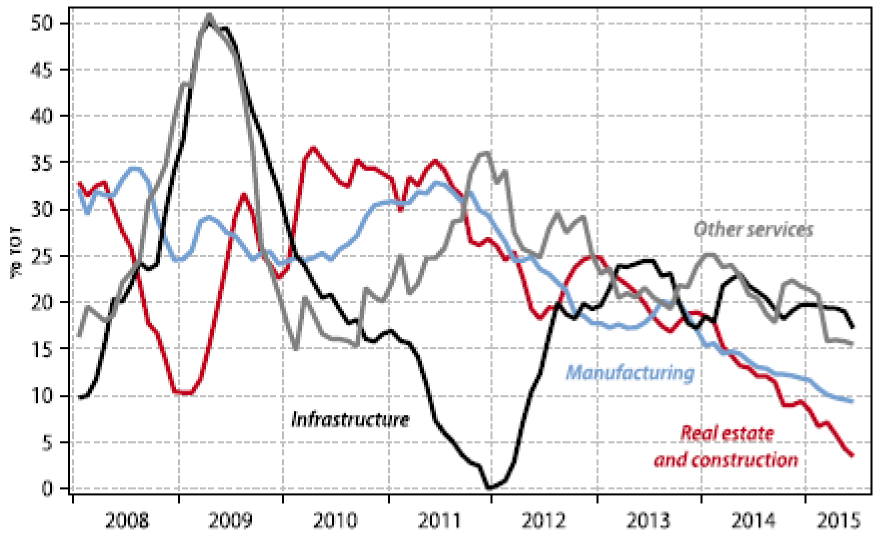
Notably, construction is stagnating as housing demand peaks with slowing income growth and as an inventory overhang weighs on investment – factors not easily addressed by policy changes. And, since final demand for the products used in residential construction is weak, manufacturers have little incentive to expand capacity.

Figure 1: Housing construction is peaking and is set to decline...
Gross residential completions, actual and projected, and steel use



Sources: CEIC, NBS, Gavekal Data/Macrobond

Figure 2: ...infrastructure and services investment cannot fill the gap
Fixed-asset investment by sector, nominal, 5mcma



Sources: CEIC, Gavekal Data/Macrobond

At the same time, Chinese companies are ratcheting back expectations for future growth from unrealistic levels.

Against these headwinds, looser monetary policy can have only a limited impact. In response, the government has ordered a fresh round of infrastructure development and is deploying quasi-fiscal stimulus via state companies in order to support investment spending. But the latest infrastructure projects - smart power grids, natural gas pipelines, urban railways - are smaller than their predecessors, more locally based and, in many cases, trickier to implement. And despite perceptions, the state sector does not wholly dominate China's economy. Private-sector investment makes up two-thirds of the total. As a result, government fiat will not be enough to maintain investment growth.

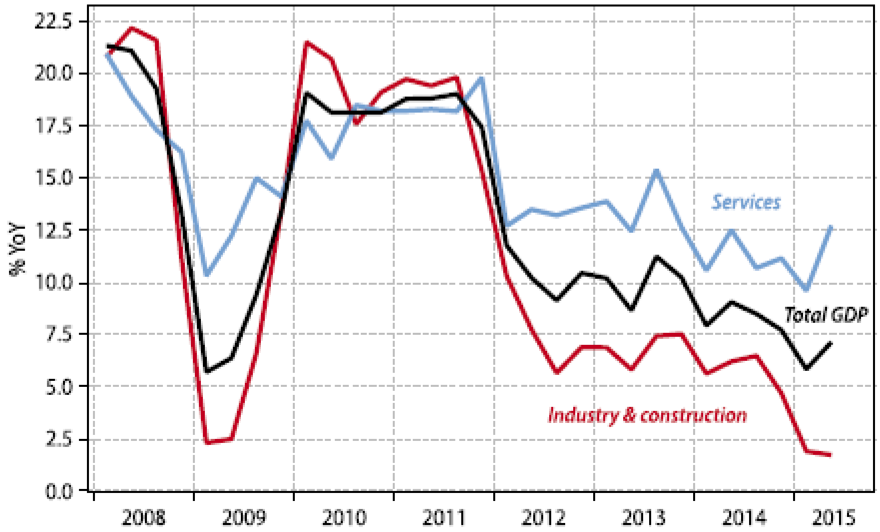
2. The recession in heavy industry and commodity sectors

As a direct result of the investment slowdown, the industries most exposed to the investment cycle are suffering, particularly steel, building materials and mining. Falling prices have also severely hurt China's commodity producers. In the past, domestic commodity producers accounted for a large share of China's corporate profits - a share that has now shifted into the red.

The implications for regions of China that rely disproportionately on heavy industry and resource extraction have been especially severe. In the first half of 2015, nominal GDP shrank outright in three provinces and slowed to a crawl in a number of others. The worst hit areas are clustered in northern and northeastern China, a regional concentration that compounds the impact.

The point here is that the risk of corporate bankruptcies, rising unemployment and general financial distress is not determined by the average growth rate across the country, but by the worst cases - and, in China, the worst cases are already suffering grievously. Granted, it would be a mistake to extrapolate from the fortunes of the hardest-hit sectors and provinces to the economy as a whole. But, equally, it would be a mistake to gloss over the sharp economic adjustment now taking place in those industries and regions.

Figure 3: As construction and heavy industry have slumped...
Nominal change in value-added by sector



Sources: Gavekal Data/Macrobond

Figure 4: ...growth in resource-dependent provinces has stalled
Nominal quarterly GDP growth, by groups of provinces

Sources: CEIC, Gavekal Data/Macrobond

3. Domestic debt

While we are sanguine about foreign debt sustainability, China's domestic debt is a major concern.

The high level of domestic debt is a constraint on the government's ability to run a loose monetary policy, as the growth benefits of an acceleration in credit must be weighed against the additional strain on the financial system. With total debt at 250% of GDP, China today is far more leveraged than in 2009 when Beijing last launched a major monetary expansion. Today, such a debt-fueled stimulus program is out of the question, given the high starting point.

As things stand, the combination of very high total debt plus deteriorating economic growth will push up the level of bad debt. Banks will discover more *de facto* nonperforming loans on their balance sheets, weakening the financial system and making banks more reluctant to lend, especially to riskier sectors of the economy. As a result, while the easing policies Beijing has implemented so far will make it easier for existing debts to be repaid or rolled over, they will not lead to another credit boom, reducing the government's ability to support growth.

4. Government policy

Global investors' confidence in the Chinese government's ability to steer the economy has been badly shaken in the last few months.

Firstly, the collapse of the A-share market since June has undermined the credibility of the government after state media acted as the principal cheer-leaders for the earlier bull market, linking a buoyant stock market to reform prospects. Then, Beijing's unprecedented intervention in July to prop up the Shanghai stock market led many people to abandon any hopes that the government is really interested in letting market forces play a bigger role in the economy. Worse, the failure of Beijing's efforts to lift the market only compounded the general disillusion.

Secondly, the decision to devalue the renminbi and loosen control over its exchange rate, however justifiable from a domestic perspective, came as a shock to already wobbly financial markets and further dented confidence. The currency move was seen as both confirming fears that the Chinese economy is in bad shape and as introducing new risks of devaluation and capital flight. To make matters worse, the PBOC's communication was inept, failing utterly to signal its real intentions to the market.

Seeing this, we cannot rule out further policy mistakes. In recent weeks, it has become abundantly clear that the Chinese government is not proceeding with the implementation of a carefully thought-out plan of market-oriented reform, but is pursuing an opportunistic agenda driven largely by nationalist political considerations. This means that Chinese policy decisions are becoming less predictable - and that the potential for conflict between political goals and economic fundamentals is increasing.

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