Economy Insight:

China's Growth Challenge

October, 2015

Background

China's unexpected move to devalue Renminbi in August 2015 took the world by surprise. Though the extent of devaluation was limited to 4.6% (vis-à-vis USD), allaying fears of a probable steeper fall; this was enough to send the stock markets across countries in a frenzy. Further, concerns were also raised about this move stirring beggar thy neighbor policies. The Chinese government has on record indicated the step as a move towards allowing markets to have a greater role in currency valuations; however, this also points towards a more deep rooted slowdown in the country than was being anticipated.

As China has emerged as a key driver of global growth over the past two decades, recent developments have raised anxiety especially when the western world is already reeling under prolonged moderation. One of the primary questions that arise is how successful will China be in its attempt to make a shift from the export/investment led model to a more consumption led and service oriented economic structure. In this note we present some of the key developments in China to be watched in coming years as these would define the growth trajectory both qualitatively and quantitatively.

China's Exchange Rate Regime: A Brief Chronology

China embarked on the economic reform process in the late 1970s. Reforming its exchange rate policy was one of the key tools used to move from an era of import substitution industrial strategy to increasing the country's participation in global trade. Prior to reforms, China's currency was kept overvalued under a tightly controlled foreign exchange regime. All export and import transactions took place under the authorization of a few trade corporations and purchase and sale of foreign exchange was strictly under the ambit of Bank of China.

It was in the year 1978 that China undertook calibrated liberalization of its foreign trade and this was accompanied by a measured flexibility lent to the foreign exchange market. In the year 1979, as a first step, exporters and the provincial governments were allowed to retain a certain proportion of their foreign exchange earnings. And this policy of permitting retention of foreign exchange earnings was also extended to non-trade transactions such as remittances and tourism.

In addition to this a dual exchange rate system was introduced on January 1, 1981; wherein addition to the official exchange rate, an internal rate for settlement of trade transactions was introduced. The internal rate for all trade transactions was set at RMB 2.8 to USD, while the official exchange rate was kept at RMB 1.5 for USD. The latter was applicable to all non-trade transactions. Following this, the official exchange rate was devalued intermittently for about three years and the two exchange rates were finally converged in the year 1984. Nonetheless, the internal swap centers which were set up around mid-1980s continued to operate.

Renminbi crossed 3.0 yuan for a dollar for the first time in October 1985. Following this a steep devaluation by about 14% was undertaken in July 1986 (to 3.7 for a dollar) and then by another 14% in December 1989 (to 4.2yuan for a dollar). The reasons cited for this sudden major devaluation was the rising trade deficit and slowing exports.

Another major reform came in the year 1994 when the government merged the official exchange rate and the swap market rate at 8.7 yuan for a dollar. For a period of ten years between 1995 and 2005, China's official exchange rate was kept at around 8.28 yuan for a dollar with a very narrow fluctuation band.

RMB Exchange Rate Regime: Summary Table

Stage	Period	Target of RMB exchange rate policy	Characteristics of RMB exchange rate
Command economy period	1953-1972	Relatively fixed exchange rate	Kept stable; ineffective as an economic tool to modulate China's economic development.
	1973-1980		Fluctuated frequently; overvalued.
Economy transition period	1981-1984	Dual RMB exchange rate regime	Two exchange rates existed simultaneously: official exchange rate and RMB Internal Settlement rate (ISR).
	1985-1993	Cancelled ISR, but actually implemented dual exchange rate regime again	Frequently adjusted; depreciated sharply; Foreign Exchange Swap Centres (FESC) established.
Market mechanism period	1994-2005	Managed floating exchange rate regime	RMB official exchange rate depreciated in one-step sharply; de facto pegged to the US dollar since 1997 Asia Financial Crisis until 2005.
	2006-2013	Managed floating exchange rate regime based on market supply and demand with reference to a currency basket	Appreciated gradually; widened daily movement band from ± 0.3% to ± 0.5%, ± 1.0%.

Source: Revisiting China's Exchange Rate Regime and RMB Basket: A Recent Empirical Study; Yuming Cui, January 2014

On July 21, 2005, China announced a new policy regime and authorities indicated that RMB would be managed against a basket of currencies rather than being pegged to USD and that the exchange rate would be given more flexibility. On that day, the exchange rate was revalued by 2.1% vis-à-vis USD. The exchange rate has by and large witnessed uniform movements since. In July 2005, the exchange rate was allowed to float within a band of 0.3% around the central parity; the band was increased to 0.5% in 2007, further to 1.0% in 2012 and to 2.0% in 2014.

August 11 2015 Mayhem

The sudden decision by China to devalue yuan by 1.87% vis-à-vis USD on August 11, 2015 took the global markets by surprise. This was followed by another round of devaluation on August 12 ad 13, 2015 by 1.67% and 1.1% vis-à-vis USD respectively, making it a steepest cut in about two decades and rattling the global stock markets. The Chinese government officials reported this as a 'one-off adjustment' and as a step towards a more market oriented approach in managing currency valuations.

While the official objective of this devaluation has been stated as above, there have been two contrary theories that have been doing rounds. While, one school of thought has been reasoning devaluation as a response to the slowing domestic economy of China; the other school conjures such a small devaluation doing little to boost growth through trade.

However, most of the economists we spoke to were of the opinion that the moderating economic growth in China is worrisome and the government is possibly using all policy levers to lend support to flagging growth. The Chinese monetary authority has cut interest rates five times since November last year and this further substantiates the growing concern about the country's moderating growth. The interest rate was cut by 25 bps on August 25, 2015 to 4.6%. The People's Bank of China also infused USD 9.4 billion in to the interbank money market on August 28, 2015. The economists opined that most of the major currencies have devalued against USD in the past one year and fall in Yuan had been the minimum thus far; so there was enough elbow space with the Chinese government to undertake this devaluation.

Immediate pain points in the Chinese Economy

China has emerged as a key growth center for the global economy. With its investment cum export led growth model, the country has witnessed unprecedented ascent over the past two decades. GDP growth peaked to 14.2% in the year 2007. Further, China was able to hold on to its position of a bright spot amidst gloomy global situation in the aftermath of the global financial crisis in 2008. The country's annual growth averaged 9.7% between the period 2008 and 2011. However, thereafter evident signs of a slowdown have been observed with GDP growth slipping to 7.7% in 2012.This growth is expected to further moderate to 7.0% in the year 2015. Given the fragile global situation, the growth of 7.0% doesn't seem bad; however what has led to some serious concern is the emergence of multiple bubbles in the economy indicating an intrinsic stress in China.

Real Estate Bubble – China has seen a significant momentum build up in the housing sector over the past one decade propelled by the government. Construction sector, with significant backward and forward linkages, has been among the primary factor allowing China to maintain its growth drive amidst the global slowdown. The real estate investments as a percent of GDP increased from about 4.0% in 1997 to 15.0% in 2013. Further, the property prices have increased 2.5 times since the reform and privatization of the real estate market in the year 1998. The rapid urbanization, rising incomes and property remaining a conventional investment choice caused prices reaching beyond the affordability levels of a common man. As a result, this was accompanied with very low occupancy rates. In fact, the housing price to average income ratio in some Chinese cities is reported to be higher than London and New York. This caused a serious glut in the real estate market; with newly developed cities often being referred to as ghost cities for being without occupants.

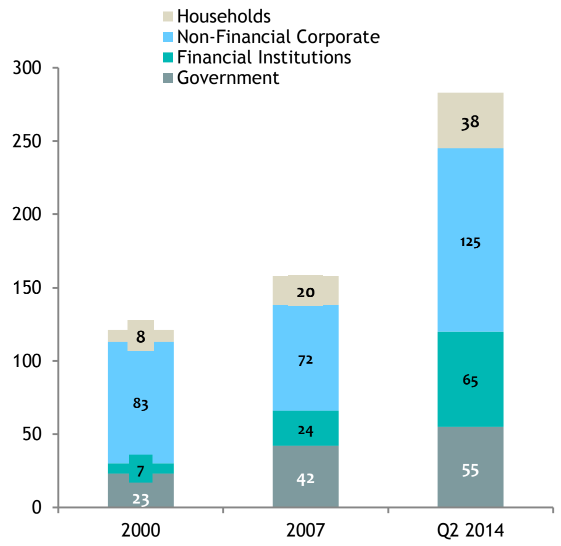
However, since 2014 there have been evident signs of moderation in the real estate activity. The housing prices have softened and the new investments in the sector also witnessed a decline in 2014. In fact new land purchases by real estate developers noted a decline of 32.0% in the first two months of this year.

In response to the slowdown, the government since end of last year has been announcing steps to revive the market. In November 2014 interest rates were brought down for the first time since 2012; this was followed by reduction in reserve requirements of banks in January this year. Then in March 2015, the required down payment for second homes was brought down and the minimum down payment for first-home buyers using public housing funds was cut from 30 to 20 per cent. The latest numbers report a pickup in housing sales and prices also seem to be stabilizing.

Rising Debt-China's debt levels have ballooned disproportionately over the last seven to eight years. Until 2007, the debt level were seen rising in line with the GDP growth levels; however between 2007 and 2014 the level of debt has gone up from about USD 7 trillion to USD 28 trillion, an increase by almost 300%. The Debt to GDP ratio increased to 282% in 2014 from 158% in 2007. The structure of China's debt levels indicate that while the Government and the Household sector have reasonable levels of debt, it is the country's corporate sector which is highly leveraged. China's corporate debt was about 72% of GDP in the year 2007 and increased to 125% by the second half of 2014. What is a key concern is the fact that most of this debt is linked to the real estate, making it vulnerable to any slowdown in the sector. According to a report by McKinsey, Debt and (Not Much) Deleveraging, it is estimated that 45% of China's debt (excluding financial sector debt) is directly or indirectly related to real estate. Also, a surge has been noted in the local government debt which according to the same McKinsey report has grown by about 27% per year since 2007. The local governments have been using off balance sheet financing vehicles to fund infrastructure and other projects with public land as collateral. Between 2007 and second quarter of 2014, loans to local government financing vehicles amounted to USD 1.7 trillion and about one third of these loans had exposure to the growing shadow banking system in the country. The shadow banking system has witnessed an exponential increase. The non- bank lending witnessed a growth of 36% per year between 2007 and second quarter of 2014; while the bank sector lending has grown by about 18.0%. About 30%of the loans to households, non-financial corporation and governments have been provided for by these non-bank financial institutions.

Of course, Chinese Government taking cognizance of the situation has announced measures to keep in check the local government debt levels and limit exposure to the shadow banking system. Further, most of the Chinese debt is internal with minimal exposure to foreign banks and in a worst case scenario would have a cushion from its ample forex reserves. Nonetheless, it remains imperative that China gets a grip on its financial system and assures improved transparency by allowing for greater role of the market forces.

Debt to GDP Ratio



Composition of Debt, Q2 2014

	Banks	Shadow bank lending	Corporate bonds and securitization	Government bonds and borrowings	Total Debt
Share of total %	53	30	4	13	100
As % of GDP	115	65	8	28	217
Credit growth 2007-2Q14 % per annum	18	36	33	12	21

Source: Debt and (Not Much) Deleveraging, Mc Kinsey, Feb 2015

Stock Market Bubble – China's stock market witnessed an unprecedented bull run over the past year. The stock market rallied between June last year and June 2015 garnering an additional market cap of USD 6.5 trillion. The primary trigger for this rally was the Chinese government announcing the China Hong Kong Stock Connect last year. Further, the government's liberal stance on monetary and fiscal policies also gave a push to the momentum. A record 30 million new accounts were added between January and May this year. Also, huge numbers of new amateur investors have put their money in to the market in order to make windfall gains. The moderation in the property market in 2014 and some restrictions imposed on shadow banking also diverted funds in to the equity market.

The first break in this rally was seen on June12 2015, which was followed by major aftershocks on July 27 and August 24. Between June 12, 2015 and August 25, 2015, the Shanghai Composite Index fell by 43%. China lost almost USD 5 trillion of market capitalization, which is more than the size of Germany's GDP. This sharp plunge came with investors expecting a stop on the easing by People's Bank of China. Also China's government regulator announced a ban on brokerage firms from providing unregulated margin funding to investors. Other measures by the Chinese government included a stop on all the IPOs in the pipeline and creation of a Financial Stabilization Fund to use funds for intervening in the market in case of volatility. Estimates indicate that the Chinese Government has spent USD 235 billion to stabilize the markets. A lot of stocks are still looking overvalued and what remains a grave concern is the disconnect between the real economy and the stock market.

Overcapacity– China has created an unprecedented glut of commodities like cement, steel and iron. The country has continued to produce commodities at a frenzied pace which has led to a huge overcapacity. Just to take a cue, between the period 2011 and 2013, China used 6.6 gigatons of cement, while United States used 4.5 gigatons in the entire twentieth century. The problem of overcapacity remains most acute in the heavy industry segment. High savings rate in the country, huge administrative support at local level, central government's stimulus package; subsidies to producers have been some of the key reasons for such unsustainable growth in the heavy industry segment. The Government has been working towards tackling the problem of overcapacity. Back in the year 2010, the Government drew a list of 18 industries to curb excess capacity. These included segments like thermal power, coal, steel, ferro alloys and construction material. However, even now in sectors like glass, cement, aluminum, solar panels and power generation equipment, the problem of overcapacity persists and continues to be one of the key concern areas.

Long term risks to the Chinese Economy

Demographic crisis: China is already being threatened by a looming demographic crisis. The one child policy adopted by China for over 30 years accompanied by rapid urbanization and increasing incomes has had an impact on the fertility rates. The country which is most populous in the world is already facing labor difficulties. The fertility rate in China is about 1.4 children per woman, which is below the developed world average. Also, the country has a skewed gender ratio; with approximately 115 boys for every 100 girls. Further, one child policy to some extent has aggravated the cultural bias which is in favor of a male child.

In addition, China's working age population declined for the third consecutive year in 2014 and according to analysts this trend is expected to further accelerate. This trend of a drop in working age population is also reflected in the decline noted in the movement of migrant population. According to data, the average age of migrant workers has been going up. Between the years 2008 and 2014, the proportion of Chinese migrant workers above the age of 50 has grown from about 11% to nearly 17 per cent of the country's total migrant worker force.

Increase in labor costs: As mentioned above the changing demographic profile of the country is leading to shortage of labor, which is one of the reasons behind increasing wage costs. This along with the general improvement in social awareness, the workers have become increasingly cautious of their rights and they are gradually attaining better bargaining power. According to the CBX Software's Q2 2015 Retail Sourcing Report, following 2011-15 the current Five-Year Plan in China, wages have risen in 16 of 31 provinces in the country. Further, average wages are expected to increase by around 10 percent in the year 2015. The rise in labor costs has already led to foreign companies shifting their base to other South East Asian countries. A comparison between average monthly wages in some of the Asian countries indicates China might be losing edge on this front. According to ILO data in 2013, the average monthly wage in China was USD 613; Vietnam USD 197; Indonesia USD 183; India USD 215; Philippines USD 215, Thailand USD 391.

Environmental issues: The rapid growth in China has had a negative externality of the natural environment on the country. The level of air pollution and soil contamination in the country has reached sordid levels. And the rivers in the country have become drains of industrial contaminants. The air quality of Beijing is 16 times worse than New York City. The dire state of affairs has led to growing discontent in the public and the Chinese government has 'declared a war' on pollution. The government is increasingly focusing on renewable sources of energy, has reduced coal consumption, put caps on emissions and has also started to do away with substandard industrial capacity. At present, China gets 80 percent of electricity and 70 percent its total energy from coal, and a large proportion of this coal is high polluting sulphur coal. Also, the country has promised to reach its CO2 emissions peak by around 2030, after which the CO2 emissions per unit of GDP will drop by 60 to 65 percent compared to 2005*. Also, new standards for drinking water have been set and the major waterways in the country are required to adhere to these by 2020.

*http://news.xinhuanet.com/english/2015-09/11/c_134611989.htm

According to estimates by China's central bank the environment ministry's targets for cleaner air and water alone require Rmb 2 trillion a year over the next five years.

Pressure on natural resources: China is rich in mineral resources and the unprecedented growth in the country has exacerbated pressure on these as well its other resources – including land and water. If not given due significance the problem is expected to intensify going ahead. From 1970 to 2008, China's per capita consumption of materials grew from one third to over one and a half times the world's average levels*. Domestic consumption of natural resources per capita increased at almost twice the rate of the whole of the Asia Pacific region due to massive investments in urban infrastructure, energy systems and manufacturing capacity*. Also, while so far China has done well to maintain food security, with increasing incomes and changing food habits this can emerge as a challenge. Water scarcity is going to be another major challenge for the country going ahead. China has only about one-third of the world's average in per-capita fresh water availability.

Need for Rebalancing Growth

The Chinese government has been reflecting on the need to rebalance the economy. The government while attempting to address the immediate concern of maintaining a stable and steady growth has also taken cognizance of the long term horizon and has indicated moves towards restructuring of Chinese growth model. After being fiercely export and investment led economy for about three decades, the country is gradually maneuvering towards greater consumption orientation. The same is reflected in the reform policies being announced by the Chinese Government as well. These include policies to promote domestic consumption through greater focus on urbanization and services sector, energy pricing reforms and shifting focus on privatization.

IMF in a Staff Report on China published in August 2015 said that China is moving to 'new normal' of slower yet safer and more sustainable recovery". According to IMF, China's growth is estimated at 6.8% in 2015, which is lower than the country's own officially projected number. IMF Staff Report suggests greater role of the market and reforms in financial sector and state owned enterprises as two key areas that would need attention.

Going ahead, China's growth trajectory is expected to remain under some strain. Nonetheless, at this juncture it would be most critical for China to stick to its reform process. How this shift pans out would depend in what direction the government tries to balance the tradeoff between maintaining steady growth and giving precedence to implementation of reforms.

China's Policy Response

China marked three decades of its comprehensive reform agenda in 2007, just a year before global financial crisis hit in 2008. While in the aftermath of the crisis China displayed significant resilience with adequate support from the government; it also embarked on the process of triggering a more fundamental change in the economy.

In fact, the need for a dire change in the structure of economy can be gauged from the famous statement made by Chinese Premier Wen Jiabao on March 16, 2007. Premier Jiabao at a press conference indicated that there is a fundamental problem in the economy and said "there are structural problems in China's economy which cause unsteady, unbalanced, uncoordinated and unsustainable development".

The twelfth five plan (2011-15) announced on March 14, 2011 emphasized on achieving a 'high quality growth' which was more sustainable. The plan focused on tackling some of the emerging issues and has been a first concerted step at attempting a restructure of the economy. The plan laid emphasis on giving a thrust to consumption demand, accelerating growth in services sector and building greater capacities in the energy sector (Annexure1).

*http://www.unep.org/Documents.Multilingual/Default.Print.asp?DocumentID=2723&ArticleID=9584&l=en

The Third Plenum of the 18th Communist party of China between November 9 and 12, 2013 was followed by announcements indicating broad reforms on anvil with market forces getting greater focus. The emphasis was laid at achieving greater efficiency and the Communique stated that decisive results would be visible by 2020. Then on November 15, 2013 a detailed blueprint of reforms was released in the paper "A Decision on Major Issues Concerning Comprehensive and Far-Reaching Reforms". The paper specified a more focused agenda on a variety of reforms spelling out greater details. These included improved land use rights for farmers, opening up space for foreign investments, environment regulation, loosening of one child policy (Annexure 2).

China has been on the reform track and the government has been able to maintain some continuity in this process. While decent progress has been made in areas like tackling corruption/bureaucracy, improving intra-regional connectivity; much work remains pending on reforms pertaining to state owned enterprises, distribution of spending responsibilities between central and local governments, checks on pollution etc. The forthcoming Thirteenth Five Year Plan (2016-20) provides an opportunity to carry forward the momentum and further leverage the gains made so far.

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Various Press Articles

Annexure 1

Key Highlights of China's Twelfth Five Year Plan

Key themes

- Sustainable growth
- Moving up the value chain
- Reducing disparities
- Scientific development
- Environmental protection
- Energy efficiency
- Domestic consumption

Key economic targets

- Annual GDP growth: 7%
- Increase urbanization from 47.5% to 51.5%
- Increase service sector contribution to GDP by four percentage points, from 43% to 47%
- Increase spending on R&D to 2.2% of GDP
- Hold inflation (CPI) at or below 4% per year

Key non-economic targets

- Increase non-fossil fuel use to 11.4%
- Reduction of energy use per unit of GDP: 16%
- Reduction of CO_2 emissions per unit of GDP: 17%
- Increase forest coverage by 21.66%
- Decrease pollutants COD and sulfur dioxide by 8% each

Source: 'China's 12th- Five Year Plan: Overview', KPMG, March 2011

Annexure 2

Key Highlights of the Third Plenum: Nov 9-11, 2013

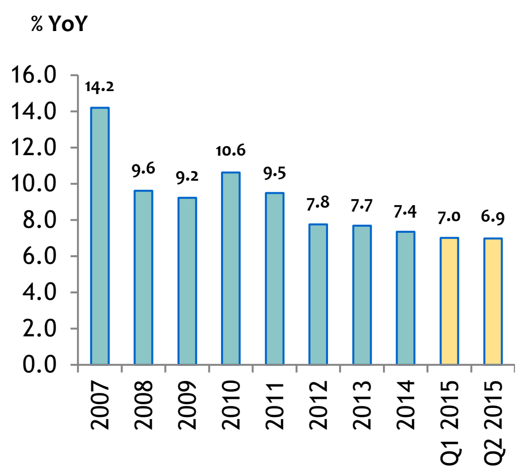
Key highlights

- The market is granted a "decisive role" in the allocation of resources, a change from its previous "fundamental role"
- The focus of the new round of reform is economic restructuring, and the key issue is to define a proper relationship between the government and market
- The private sector is granted the right to set up banks and participate in the restructuring of state-owned enterprises (SOEs)
- The "inviolability" of property rights of the private sector is emphasized
- The government is to retreat from approving corporate investment decisions on projects
- The market will be given a greater role in price determination
- A judicial court will be established to protect intellectual property rights
- The "one-child" policy will be relaxed
- Foreign companies will enjoy national treatment on market access, provided that investments are not in areas covered by the 'Negative List'
- Barriers to entry for foreign investment in finance, education, culture, healthcare, elderly care, construction design, audit and accounting, logistics, e-commerce and manufacturing will be lowered

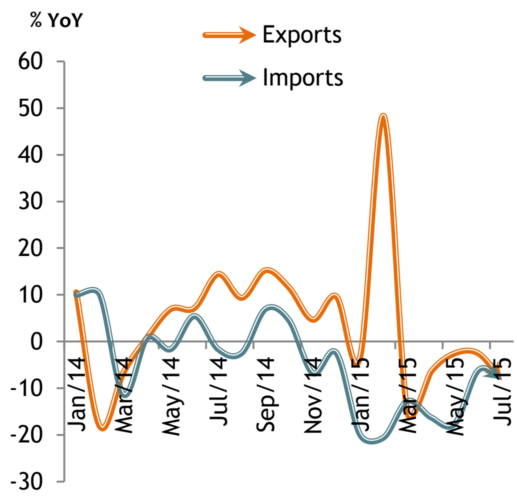
Source: 'New Roadmap for achieving the China Dream', PWC, 2013

Annexure 3

China's GDP Growth (in %)



China's Export Import Growth (in %)



Manufacturing Purchasing Manager's Index

Source: National Bureau of Statistics