China's growth prospects and the 'two' Chinas

Dr Jim Walker and Dr Justin Pyvis, Asianomics Group Limited

Abstract

In the first three decades of the former Soviet Union its rate of urbanisation was approximately the same as it has been in China since 1978[1]. Yet despite plenty of platitudes from Western academics, politicians and members of the media, the Soviet Union eventually collapsed under the weight of its own contradictions. While it was easy to centrally plan urbanisation and the growth of its industrial sector from a low base, the Soviet Union never managed to take the requisite next step towards entrepreneurship and services-led growth. To do so would have necessitated abandoning much of what had worked for it in previous decades, allowing market forces and the incentives they create to respond to the tastes of consumers rather than that of the *nomenklatura*. This is the position that China faces today and has done since its double digit growth dipped in 2009, impacting on both its domestic economy and on global growth.

We raise this point because, while they are incredibly different economies, there are similarities between the choices the leadership of the Soviet Union faced and those that China faces today. While China already has far more 'capitalism' than the Soviets ever did – one need look no further than the likes of e-commerce giant Alibaba, which today has 423m annual active buyers and 410m monthly active mobile users – the unpredictable, chaotic nature of market-led growth is causing the Chinese leadership to increasingly veer left with regards to economic policy. In that respect, China had pre-2009 – and still has – a choice as to whether or not to take the "old road" (centralised, industrial-led growth) or the "new road" (decentralised, market-led growth). One cannot hope to understand China today unless one appreciates from whence it has come and the political forces at work in China today.

Falling back to the old ways?

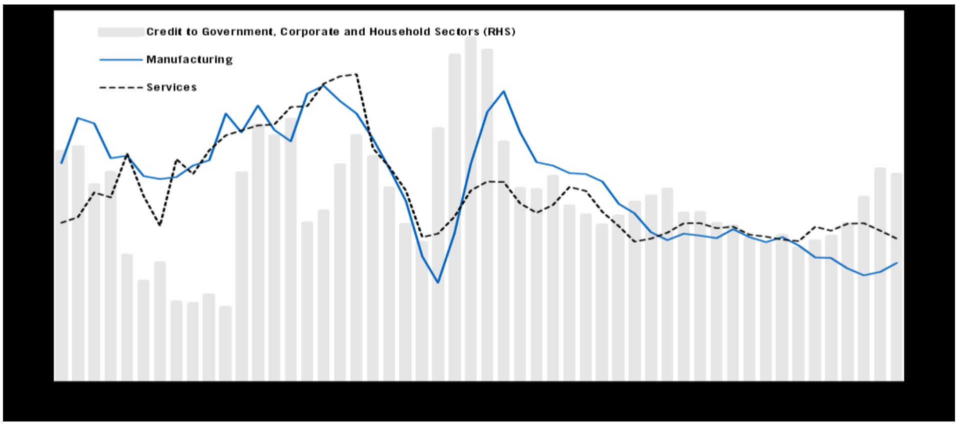
As the Soviet Union approached its end, its budget deficits ballooned and the money supply grew rapidly, leading to price inflation of above 50% a month. However, this experience was not unique: throughout history regimes have resorted to the printing press to delay the inevitable and hold on to power for just that little bit longer. And China is no different. For the past 30 years it has relied on a combination of liberalisation along with a centrally planned industrial sector, combined w with a relatively lax monetary regime.

In the context of rapid urbanisation and industrial development, central planning and ample credit were able to be tolerated. Indeed, China's entire growth model was dependent upon the rapid expansion of credit. But while that works well for an economy playing 'catch-up', eventually the easy investments dry up and the returns to that ever-expanding credit fail to materialise. Thus the problem today is that the low hanging fruits of urbanisation and industrial development have been picked, with the old model of catch-up and easy money no longer providing the same impetus to growth as it once did. Figure 1 shows the year-on-year growth in Chinese credit to the government, corporates and household sector alongside GDP

[1] *Arthur Kroeber (2016), China's Economy: What Everyone Needs to Know, p. 71*

growth for both the secondary (e.g., industrial and manufacturing) and tertiary (e.g., services) sectors from 2003 to today.

Figure 1: China credit growth by sector, % YoY, 2q 2002 – 1q 2016



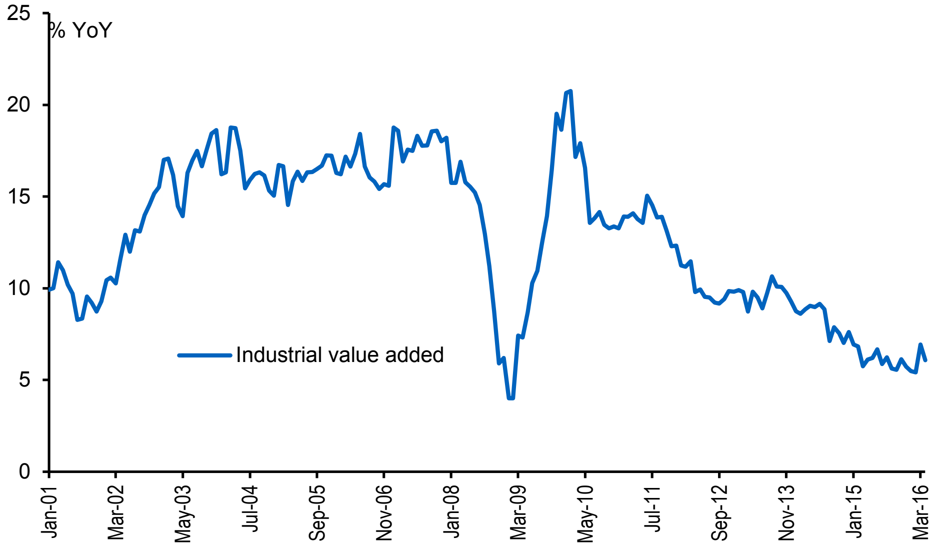
Source: NBS

While the 2009 stimulus, lauded by Keynesian and Monetarist pundits in the West as a stroke of genius, was a standout given that it restored China to pre-crisis levels of growth, it ultimately contained the seeds of its own destruction. Monetary stimuli can only ever work for a limited period of time. They work by fooling actors in an economy, both at home and abroad, into believing that there is far more available capital than actually exists. Activity booms and people invest believing that the effect is permanent when in reality there is not enough capital to go round. The party must eventually end and when it does we wind up with an excess in whatever sectors were stimulated during that particular boom - in China's case industrial productive capacity (this was as true pre-2009 as it is post-2009 – it just got far worse).

In the past such monetary mistakes were not an issue because China could just grow into any investment it made and turn a profit. Yes, productivity was not as high as it *could* have been, but it was good enough given China's place on the ladder of economic development - and given from where it had come. However, by 2008 that growth model was already being tested to its limit and China's leadership, having nothing else in their play-book, could not resist falling back on the old ways. Figure 2 and Figure 3 show the after-effects of the 2009 stimulus, not just in China but in those countries whose manufacturing products are heavily exposed to Chinese demand: Australia, Germany and Brazil.

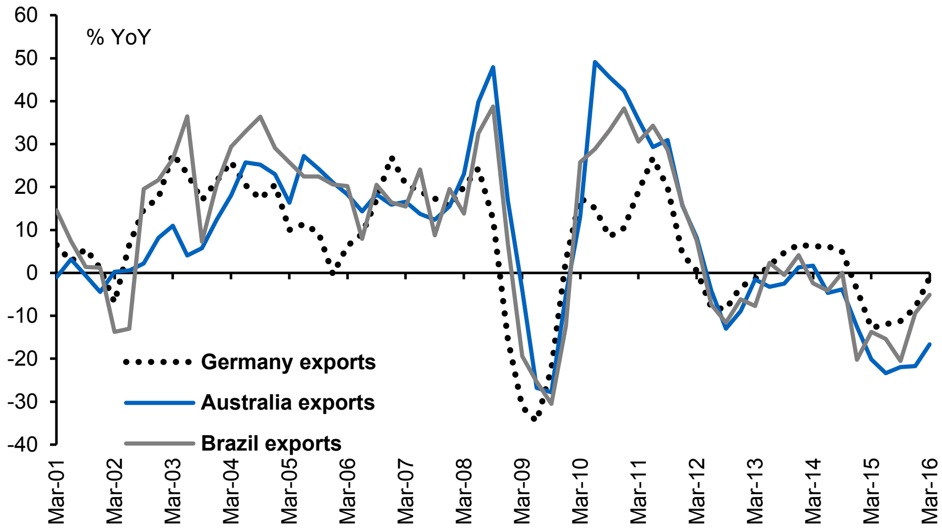
What Austrian economists call a '*malinvestment boom*' started well before 2009; indeed, the recession that China and her 'vassal' states faced at the time was not due to some random event but the revelation of prior mistakes. But 2009 is important because the actions of the Chinese government served to accentuate those mistakes – misallocations of capital, both human and physical – and worse, caused investment to flood into projects that were even less viable than those made prior to 2008.

Figure 2: China industrial value added, %YoY, Jan 2001 – Apr 2016



Source: Haver Analytics, Asianomics Group

Figure 3: Australia, Brazil, Germany merchandise exports to China, %YoY, 1q 2001 – 1q 2016



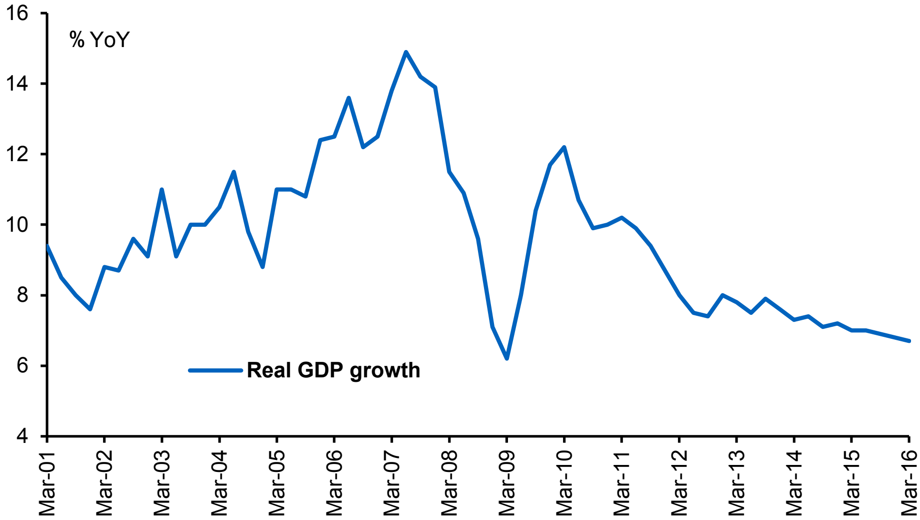
Source: Haver Analytics, Asianomics Group

Now China was not entirely at fault – the case on the Mainland is completely different to, say, the U.S. sub-prime catastrophe. Indeed, the U.S. can share some blame for the malaise in China too: the zero interest rate policy in the world's largest market for capital artificially reduced the cost of capital on global wholesale markets. It thus contributed in no small part in both growing as well as extending the duration of the boom beyond what it otherwise would have been. But the point is that the boom was always fleeting and the stimulus China enacted in 2009 was never going to provide the nation with a permanently higher growth plateau.

To the contrary, rather than restructure its economy in the face of a recession – remember, a recession is nothing more than a reflection of prior errors – the Communist Party of China (CPC) decided to fight reality so that it could continue to meet its growth targets. Much like the modern central banker faced with sub-2 to 3% consumer price inflation (or whatever arbitrary level any particular Central Bank targets), failure to achieve its growth target was deemed too great a risk. And so down the old road it marched.

The case study of 2009 is important today in that the CPC, with different leaders at the helm today, again faces a similar choice and similar political forces. Figure 4 shows that the Chinese economy is no longer growing anywhere near the rate it once was and a continuation of this trend would result in the government missing its long-term targets.

Figure 4: China real GDP, %YoY, 1q 2001 – 1q 2016



Source: Haver Analytics and Asianomics Group

What about services?

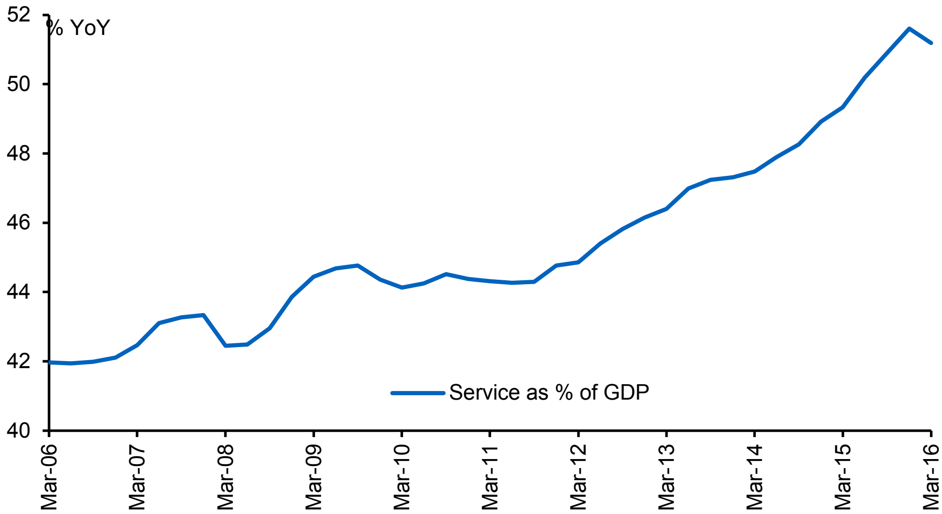
There is no denying that China has a flourishing services sector with many world-leading performers. But what really makes an economy tick as it moves towards having the tertiary sector become the largest component of growth, is competition at the margin. Free entry and exit, not dependent upon whom a business might know in the CPC or whether or not it can afford enough lawyers to navigate an industry's regulations, but rather the ability to test a new idea and have it succeed or fail on its merits.

China has improved immensely in that area over the past few decades. According to official data (so take this with a pinch of salt) there are now over 10,000 businesses created every day in China – seven every minute, with half of those listed as "internet companies"[2]. The State Administration for Industry and Commerce says that today there are some 73 million private enterprises and family businesses in China, and these without question represent the future source of growth[3]. Not all of them will succeed but that is the point: trial and error and ultimately Schumpeter's "creative destruction" are how economies transition to

[2] *China's startup boom: 7 new firms every minute, China.org.cn, 9 June 2015*
[3] *China's Business Feels the String of the Party, Bloomberg, 05 May 2016*

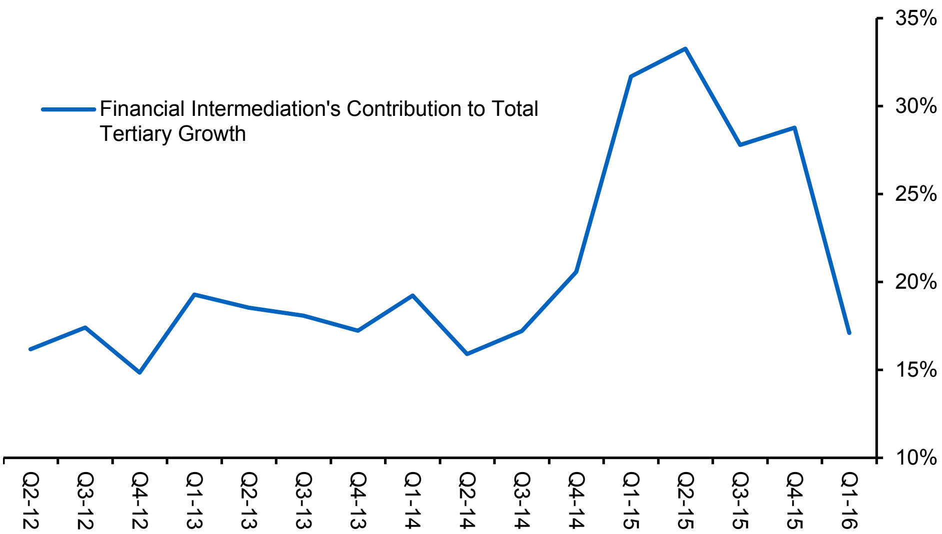
high wealth societies. Older, inefficient industries are left by the wayside – which can create immense social pressure within an economy that is used to it (e.g., look at all the pushback against Uber), let alone one that has only recently been exposed to such forces – as new sectors which more ably meet consumer demand begin to thrive.

Figure 5: China services as a % of total GDP, 1q 2006 – 1q 2016



Source: Haver Analytics and Asianomics Group

Figure 6: Financial intermediation as % of tertiary sector's GDP contribution, 2q 2012 – 1q 2016



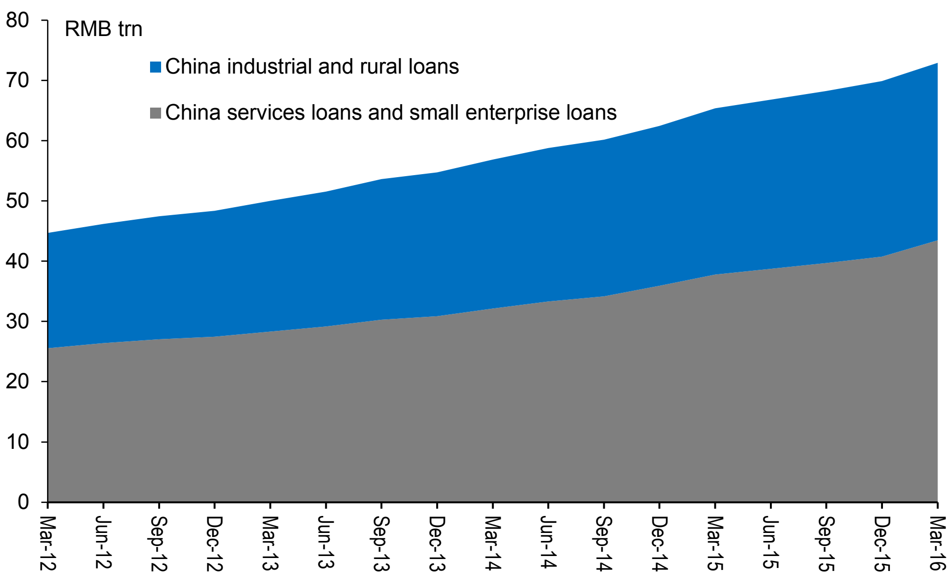
Source: Haver Analytics and Asianomics Group

But the fundamental question for China is: can its new sectors grow fast enough to offset the massive malinvestment and necessary contraction in its primary and secondary sectors? We believe that the answer to this question is a resounding NO, if the rates of growth that the government is forecasting is what it truly expects to achieve i.e., 6.5% real GDP growth over the next five years. The growth in the services sector will offset the decline in the traditional, heavy industry sectors but if industry is in contraction (which it is at the moment) then services will, at best, bring total GDP growth up to the 3-4% range in the coming years. Indeed, China's services sector is now responsible for much more growth than has ever been the case in China's past, and today it makes up more than half of total GDP (Figure 5).

However some risks begin to appear when you start to break down the aggregate data. While services are growing, financial intermediation accounts for nearly 20% of China's total tertiary sector and has been responsible for more than 20% of its total growth since 2012, reaching heights of just under 35% in 2015 (see Figure 6).

That is an issue, for much of that growth has come from a rapid rise in debt and, more problematically, much of that was funnelled into the very sectors that are now waning (Figure 7).

Figure 7: China's credit channels, 2q 2012 – 1q 2016

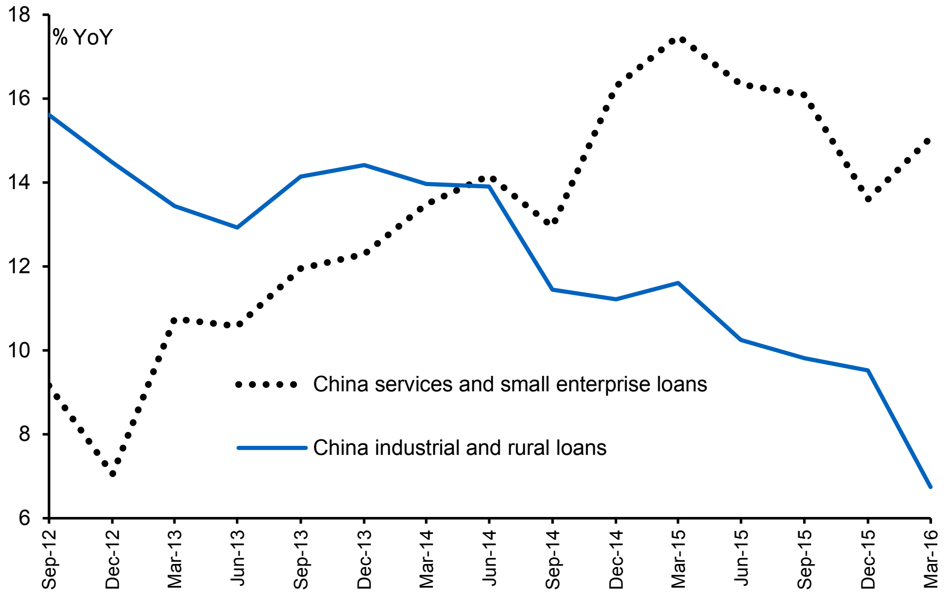


Source: Haver Analytics and Asianomics Group

While that officially changed in 2014 (Figure 8), when growth in services and small enterprise loans outstripped that of the "old" sectors, it does not change the fact that trillions of renminbi worth of loans were issued to hopelessly inefficient businesses and the ability of such borrowers to repay the principal is questionable at best.

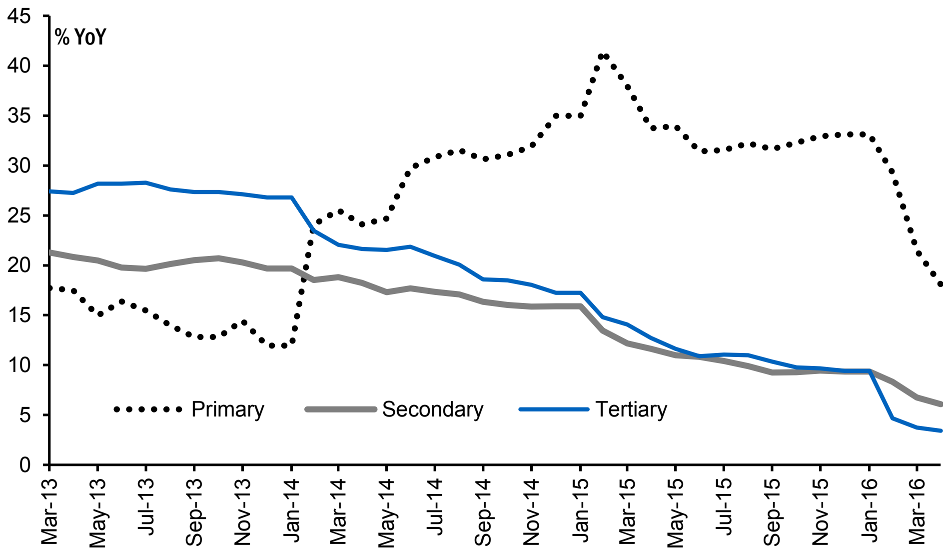
Nor does it change the fact that, in volume terms, large industrial enterprises (mostly State-Owned Enterprises or SOEs) are still absorbing much of the new credit being issued, despite being part of the "old" economy. Beijing is thus left in a bit of a tangle – it wants to liberalise further (including the renminbi) and allow its new growth sectors to thrive but in doing so it would expose the old growth sectors to, well, a far more rapid demise. That would leave its banks extremely exposed to a rush of bad debts and ultimately a crisis. So its policy is to take baby steps, weeding out corruption where it can and reforming inefficient sectors at the margin, while providing enough credit to keep the biggest problems at bay. That is quite simply not an environment in which 6%+ real growth can be expected to take place.

Figure 8: China loan growth by sector, 3q 2012 – 1q 2016



Source: Haver Analytics and Asianomics Group

Figure 9: China investment by sector, %YoY, 1q 2013 – 1q 2016

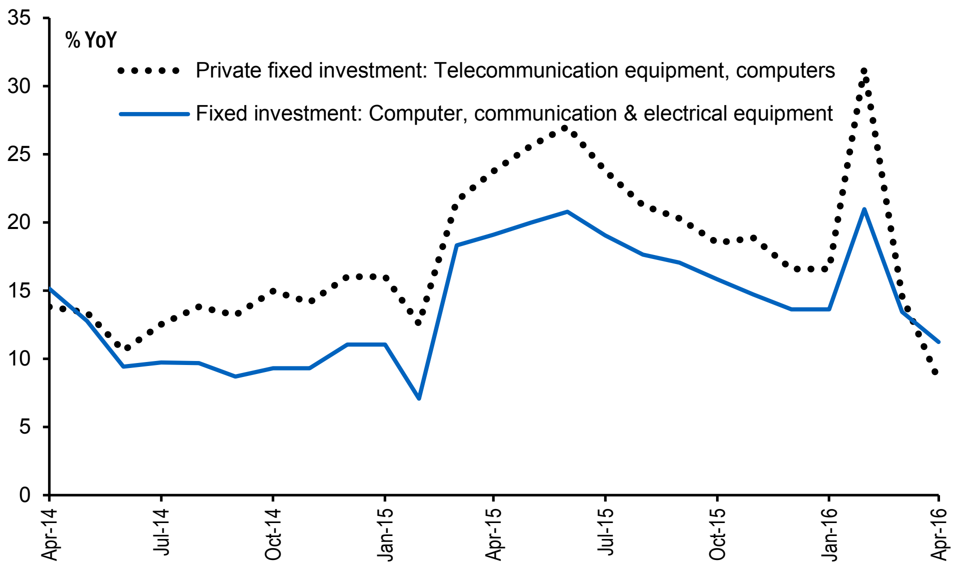


Source: Haver Analytics and Asianomics Group

But even without the problems in the financial sector there is still one other rather significant issue with the whole rebalancing story and that is that investment growth in the services sector is *slowing* along with the "old" primary and secondary sectors. Figure 9 shows fixed asset investment growth in the Primary, Secondary and Tertiary sectors side by side and of the three it is actually services which is showing the weakest growth.

When we disaggregate the services sector we find other potential concerns, too. Investment in electronic and computer equipment – an essential ingredient for the supposed 5,000 new "internet companies" registered each day – is beginning to slow both in the country as a whole but also in urban areas where, if the rebalancing story was true, you might expect investment growth to be accelerating (Figure 10).

Figure 10: China private investment in computer equipment, %YoY, April 2014 – April 2016



Source: Haver Analytics and Asianomics Group

'The hills are high and the emperor is far away' [4]

Where does all of that leave the services sector and growth in China? Other than the data and the sheer volume of "old" activity that the services sector would need to replace, we have one other major issue with the 'rebalancing' narrative: that the government is pushing back on what it does not fully understand, potentially stifling future growth. On April 8, 2016, the party's periodical, **Red Flag Manuscript**, wrote the following:

"Some businesspeople in the nonstate economy, especially some entrepreneurs, are having errors in their thinking... [They] lack faith in Marxism, socialism, and communism [and think] China under capitalism would be better".

That passage came after a number of senior leaders had expressed similar concerns and were joined by government newspapers such as the **China Daily**, which ran stories about its "concerns" over the growing role of the private sector in China's economy. Some of it is valid: there is a very good reason why

[4] *This traditional Chinese saying alludes to local officials' tendency to disregard the wishes of central authorities in distant Beijing*

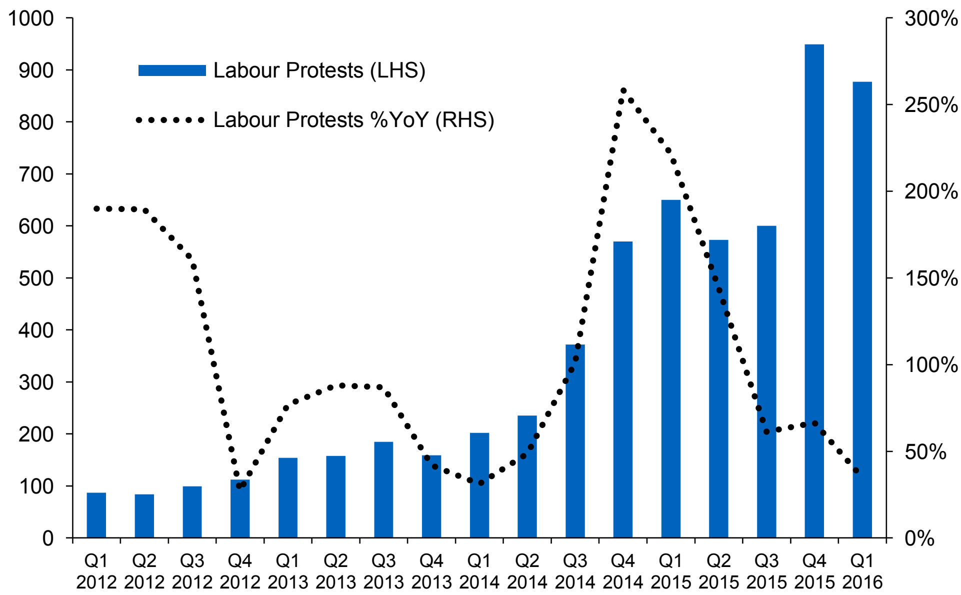
President Xi has, for the past few years, embarked on a general crackdown on corruption, in particular corrupt officials. When China allowed bits and pieces of capitalism through the gates it also invited its many bureaucrats across many levels of government to turn it into crony-capitalism.

In just one example of officials dragging their feet, in April 2016 reports circulated that the State Administration for Industry and Commerce – the bureaucracy that oversees businesses, including those in the services sector – had "failed to issue any certificates since August [2015] because it had run out of paper"[5]. Why, exactly, we do not know but the cynic might surmise that members of that bureaucracy were holding out for a bigger cut of the pie. Examples such as these are littered across China and the CPC has had a difficult time controlling its public "servants".

But corruption aside, the fact that the leadership is openly expressing doubts about the pace of liberalisation and the eagerness with which the Chinese people are embracing it, is a cause for concern. It would not take much for Beijing to deter investment in the more "capitalist" sectors such as information technology by making examples out of a few of the more enterprising businesses in its economy. While we do not expect the CPC to go down that road given that the general liberalisation regime has served to enrich its members as much as anyone else, it will continue to make examples of those individuals which bring it unwanted attention.

Two Chinas

Figure 11: The incidence of strikes in China, 1q 2012 – 1q 2016



Source: China Labour Bulletin

It is true that the services transition is alive in China, in particular in the large, wealthy cities along the Yangtze River Delta, the Pearl River Delta and Beijing itself. In Shanghai alone, one in six residents is

[5] *Pen-pushers and paper tigers: China's bureaucrats are still good at getting their way, South China Morning Post, 17 April 2015*

supposedly an owner of a start-up, having embraced the new economy with open arms[6]. But China's problems have never been located in these areas. No, the real problem confronting China today lies in its regional, industrialised cities. Jobs in those areas are not based on entrepreneurs but on SOEs and are concentrated in "old" businesses such as steel milling and manufacturing. While the official unemployment data show that nothing is wrong, Figure 11 tells a different story. The number of strikes from disgruntled or unemployed workers continues to rise, with the vast majority occurring in regions with large concentrations of the “old” growth.

There is no denying that China has, at the margin, made efforts to reform its SOE sector. For example, on 18 May 2016, the CPC released a statement following a State Council executive meeting claiming that[7]:

“The core business of centrally-owned SOEs is not good enough. Low efficiency and excessive human resources, especially in management teams, still plague those companies.”

Apparently the CPC has asked SOEs to “cut redundant management by around 20 percent within three years” and to begin using a more “market-based approach” for hiring and firing decisions. The fact that SOEs are still *not* using a “market-based approach” for such decisions says it all – and labour management is surely not the exception here. These businesses are a drag on growth of which the CPC is well aware. But for all of its talk, how much it can actually accomplish when there are a myriad of vested interests blocking the way of reform? Thus there still remains two Chinas, with the old China absorbing the majority of new credit, using it to roll over bad debts, pay its workforce and meet operational costs. The principal will likely never be repaid in full as China has reached full capacity and neither the new China nor the rest of the world has a need for the entirety of old China’s produce.

So, what lies ahead?

China is not going to re-assume the baton of global growth anytime soon. It will continue to grow but it has a long, long way to go if it is to catch up to the living standards that even less fortunate Western economies enjoy. Per capita GDP is only just above 20% of the U.S. and real GDP per hour worked is about 11%, no doubt dragged down by the hugely inefficient SOE sector. Double-digit GDP growth as a result of catch-up in its industrial sector has worked well over the past 30 years but only services sector growth and the boost in efficiency gains from a move away from large-scale, centrally-planned activity, will see it continue to move up the global wealth ladder. The CPC is talking the talk – albeit with some more disturbing exceptions – but to all intents and purposes it has yet to fully walk the walk.

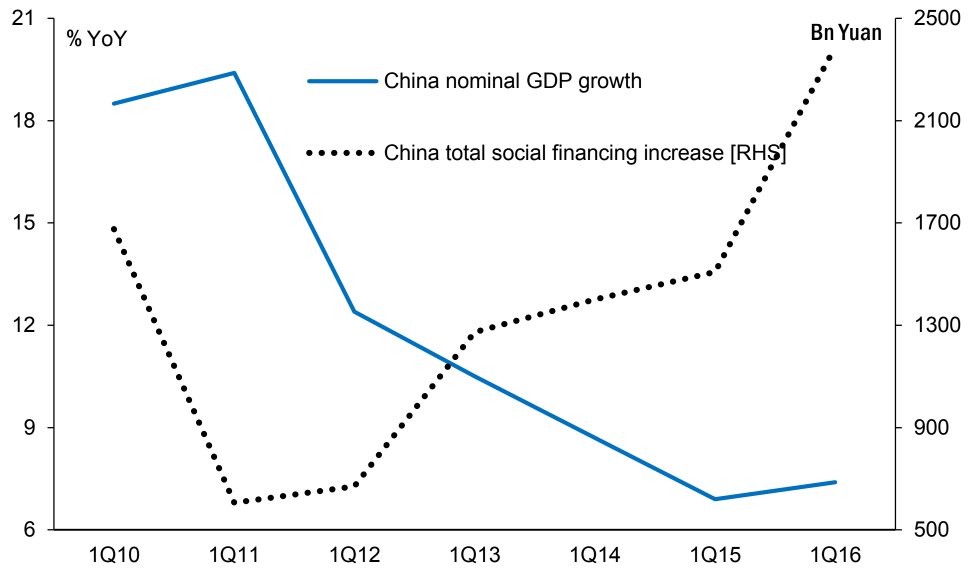
In the short term, the government is faced with the issue of labour unrest as a huge number of workers continues to migrate away from the old parts of the economy. Those 20% of redundant SOE management (the real figure is far, far larger) will not transition seamlessly into the “new” economy. Their primary skillset of making friends, obeying rules and siphoning off just enough from the kitty to go unnoticed is not needed in a small enterprise, service based economy.

Indeed, the misallocations today are so severe and have gone on for so long that many will be unable to transition at all and so the government will have to keep otherwise insolvent businesses afloat to prevent large-scale labour unrest. But the trade-off is a continuing low productivity drag on a services sector that

[6] *China's startup boom: 7 new firms every minute, China.org.cn, 9 June 2015*
[7] *China vows to make major state-owned enterprises more competitive, Xinhua, 18 May 2016*

not only has to grow but grow sufficiently strongly to offset the deadening effect of the multitude of inefficient, loss-making businesses in China's old economy.

Figure 12: Total social financing and RGDP, annual RMB change, q1 2010 – 2016



Source: Haver Analytics and Asianomics Group

To achieve this end the government needs to keep the credit spigots on the loose side, even if it serves no other purpose than to keep bad debts rolling over. It is therefore very unlikely that any expansion of credit will have a meaningful, stimulatory impact on the Chinese economy given the lack of investment opportunities for the vehicles that are still doing the bulk of the borrowing (SOEs). As Figure 12 shows, credit's influence on real GDP growth has been in decline for some time and it will not improve until the inefficient SOE sector shrinks significantly.

The fact that credit is not translating into GDP growth anymore is not due to a want of it or "tight money" but due to poor allocative efficiency. That is, China is creating plenty of debt but it is not going to entrepreneurs with good ideas but to managers of SOEs who use it to stay in business and meet their payroll. President Xi's crackdown on corruption is a move in the right direction, along with the CPC's desire to improve the efficiency of SOEs. But the only way to truly improve the efficiency of SOEs is for them to drop the "S" and not only privatise but - and this is even more important - open up the sectors in which they operate to private sector competition. Until that happens the "old" sectors, no matter how efficient the government tries to make them become, will still serve as a net drag on Chinese growth.

Where stands china in the business cycle?

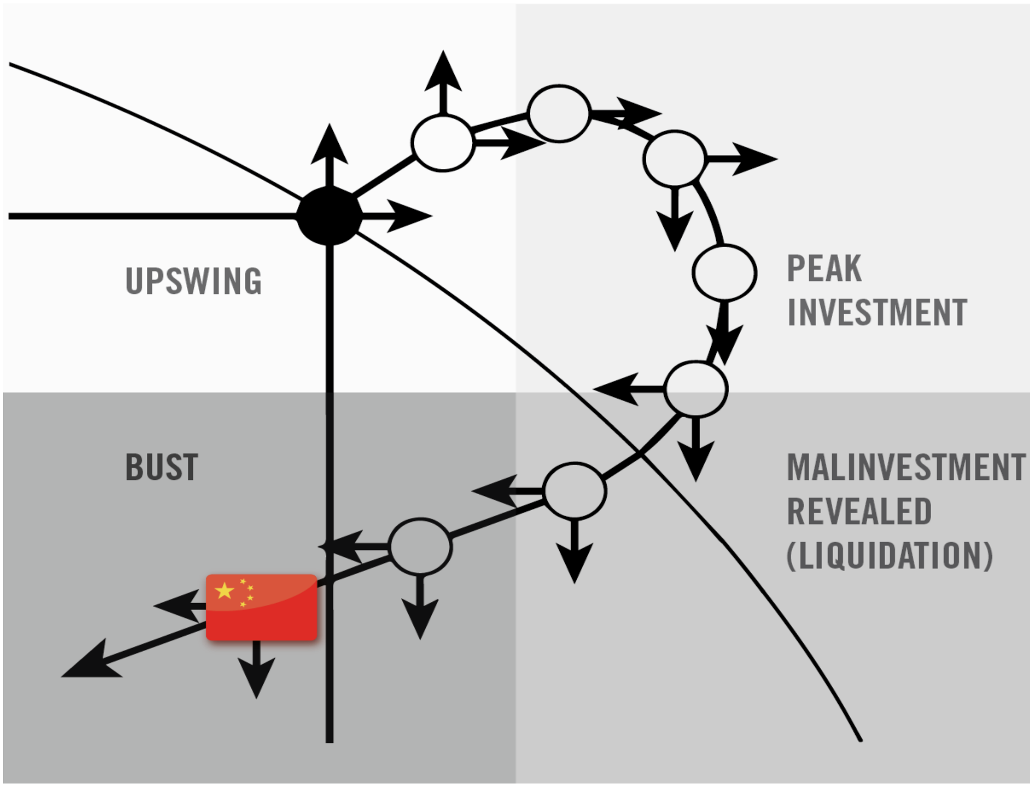
At Asianomics we assess the business cycle position of countries in Asia according to a series of what we Call "Austrian Stress Indicators". These indicators are split into two – five domestic economy indicators and two external signals. The scores – which are assessed as positive, negative or neutral – on the domestic indicators in particular form the basis for placing each country in our business cycle assessment. From a macro perspective China scores a -4 (the possible range is +5 to -5) on our domestic business cycle indicators. It is positioned firmly in the "bust" phase of the cycle and that is where we expect it to remain for the next few years (Figure 13 and Figure 14).

Figure 13: Austrian stress assessment for Asian economies (May 2016)

	Bank Credit Relative	Investment Relative	Real Lending Rate	Return On Equity	Broad Money	Money Reserves Multiple	Adjusted Resource Gap	Domestic Score	External Score	Total Score
Australia	-	-	-	-	N	N	+	-4	1	-3
China	**-**	**-**	**-**	**-**	**N**	**-**	**+**	**-4**	**0**	**-4**
Hong Kong	-	N	N	+	N	n.a.	-	0	-1	-1
India	N	N	+	N	N	+	N	1	1	2
Indonesia	+	N	N	N	+	-	N	2	-1	1
Japan	N	N	N	+	N	-	+	1	0	1
Korea	N	N	N	-	+	-	+	0	0	0
Malaysia	N	-	N	N	-	-	+	-2	0	-2
Philippines	N	+	N	N	N	+	+	1	2	3
Singapore	-	N	N	N	N	+	+	-1	2	1
Taiwan	N	N	N	+	+	+	+	2	2	4
Thailand	N	N	-	+	-	-	+	-1	0	-1
EU	-	-	+	N	+	N	+	0	1	1
US	+	+	N	N	N	N	-	2	-1	1

Source: Asianomics Group

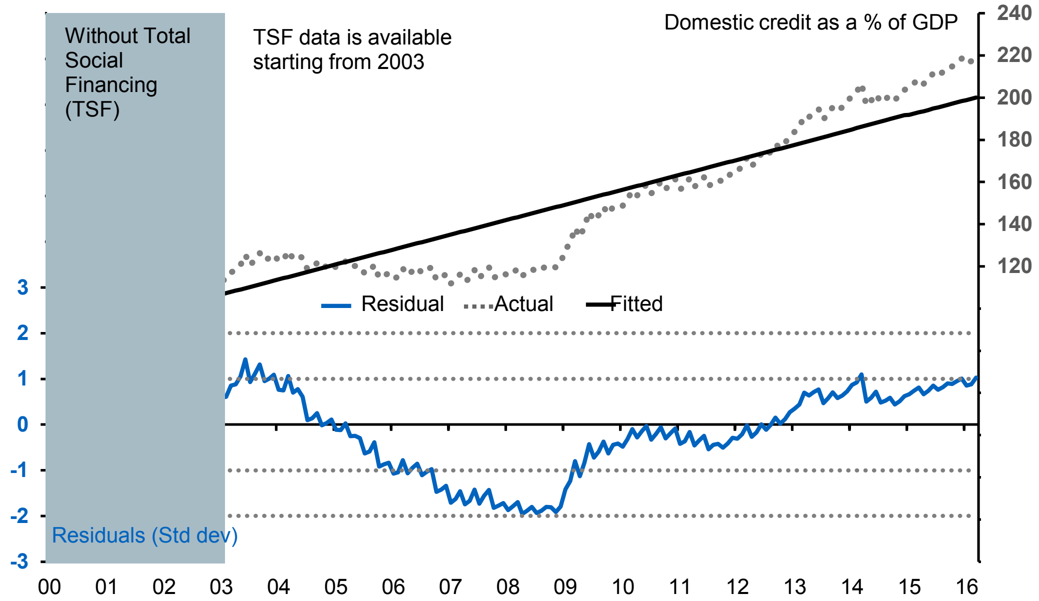
Figure 14: China in the business cycle, may 2016



Source: Asianomics Group

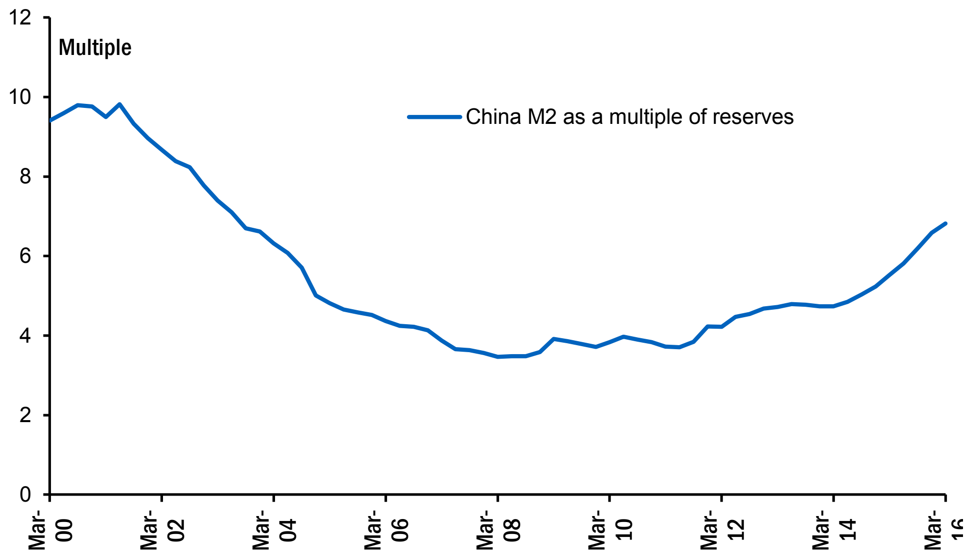
One of the key reasons why China will remain in the 'bust' phase, other than the malinvestment created during the "boom" years, is that debt to GDP is on the high side and is still running above the long-term trend (Figure 15) yet this is not translating into new growth given its non-market allocation.

Figure 15: China bank credit relative to GDP growth, 1Q 2000 – 1Q 2016



Source: Asianomics Group

Figure 16: Total M2 to reserves (1q 2000 – 1q 2016)

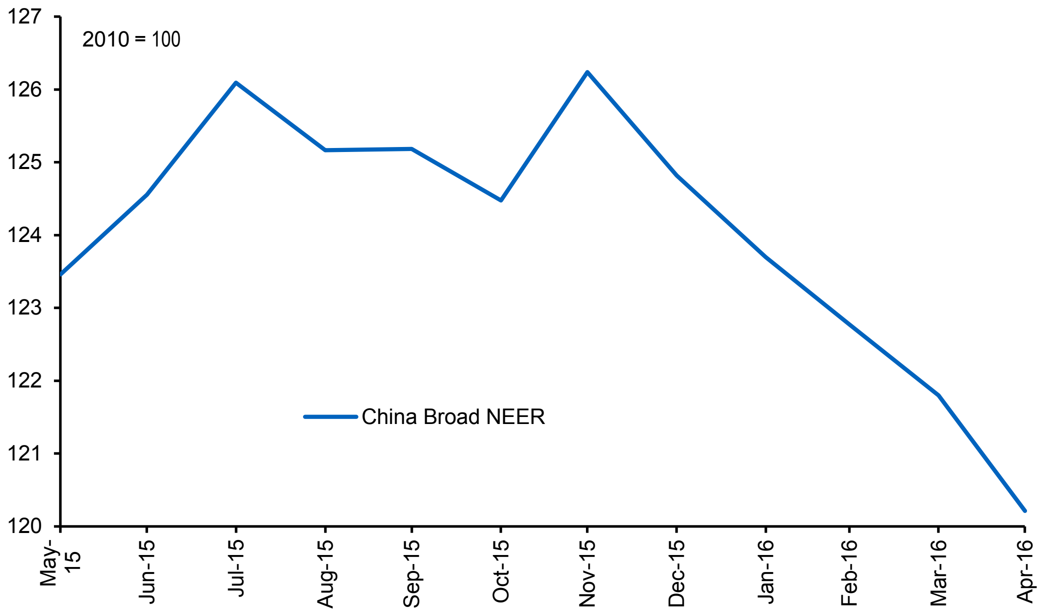


Source: Haver Analytics and Asianomics Group

The credit allocation problem is one of the reasons for the conundrum that China faces in its desire to have a fully convertible renminbi. Moves to liberalise the currency will result in liquidity being drained from the financial services sector as the Chinese move their capital offshore, reducing the credit available to SOEs and slowing services sector growth (of which financial services is a major component). As Figure 16 makes clear, its M2 to reserves ratio, our preferred proxy for the risks of capital flight and a currency crisis, continues to rise every month.

China is generally considered to have large amounts of international reserves and, in absolute terms, this is true. However, relative to the size of China's money supply, its reserve assets are quite small. If 10% of the money supply were to exit in a capital flight frenzy (not at all unusual in emerging markets), China's reserves would drop dramatically – by about two-thirds – in short order. That is why capital controls will not be relaxed any time soon.

Figure 17: China broad nominal effective exchange rate (May 15 – April 16)



Source: Haver Analytics and Asianomics Group

Currency crises in emerging markets are only caused when domestic actors lose faith in the domestic economy and the way it is being managed. Moreover, policy decisions that are poorly understood, a very real risk in China IF it floats the renminbi, can add to the tensions. But even without floating the currency, China is limited by how much it can devalue without imposing new capital controls on a regular basis as the Chinese people figure out new ways to get around them. While a one-off devaluation the renminbi of up to 10% followed by a commitment to maintain a Singapore-style managed exchange rate might have taken the heat out of things earlier this year, the People's Bank of China appears content with its current, somewhat uncertain policy. While that has worked out so far in 2016 thanks to a weaker US dollar – and Figure 17 shows that the renminbi has softened against a trade-weighted basket of currencies – if that trend reverses then it will be forced to act to strengthen capital controls.

Conclusions

While recent data have shown a slight revival in the “old” China – industrial profits, for instance, rose 7.4% YoY in 1Q2016 – this will only be fleeting. The malinvestment in the economy, which existed prior to 2009, was only accentuated in the worst possible way following a mammoth monetary and fiscal stimulus. Today there are two Chinas with two very different forces at work: one a drag on growth as the other seeks to boost it. While the “old” China will continue to absorb most of the new credit and linger in the economy like a bad smell, existing only so as to prevent civil disruption that would derail the entire economy, the “new” economy and its entrepreneurs will carry the baton of progress in the coming years. We expect 3–4% real growth, at most, for the next several years as the “old” slowly falls into insignificance, with its debts eventually washed away by growth in the “new” China.

Author Details

Dr. Jim Walker
Chief Economist, Asianomics Group Ltd.
Hong Kong
jim.walker@asianomicsgroup.com

Dr. Justin Pyvis
Economist, Asianomics Group Ltd.
Hong Kong
justin.pyvis@asianomicsgroup.com