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Investment Publications Highlights

A Reality Check for China's Recent Growth Conundrum

Yan Wang, *China Investment Strategy*, BCA Research, www.bcaresearch.com, October 21, 2015

China's recent equity market volatility, yuan devaluation, and growth slowdown have raised questions among market observers about the state of China's economy. Although China's growth is unlikely to accelerate in the next few years, the author believes the risk to a dramatic economic crash is low.

The author's model shows China's third quarter GDP growth is about 6.7%, compared with the 6.9% growth rate officially reported. This is a marked slowdown from previous years, but is still relatively resilient. The industrial sector has been the main driver for the growth slowdown, and the financial sector is likely to decelerate further, following the bust in the domestic stock market in the summer. However, the growth headwinds are offset by a robust service sector and buoyant household consumption. The author also argues that the weak import numbers are not reflective of a sharp growth deterioration, as the import numbers may have been distorted by disguised cross border capital flows.

The author argues that while there are reasons to believe growth is moderating, it is not likely to collapse. After a brief deceleration in fiscal spending in previous months, the government boosted fiscal spending to support initiatives such as infrastructure projects in an effort to stimulate the economy. The government has also recently encouraged private-public partnerships and other funding structures that can attract private capital for new investment projects. These efforts have been supported by China's central bank, which has been easing policies to drive down interest rates and improve liquidity.

Beyond government initiatives, data suggest that the real estate sector, which has been the biggest laggard in overall capital spending, may be turning a corner. Recent increases in home sales and prices have given support to residential construction, as the annual growth rate of housing starts has returned to positive territory. With possible improvement in the real estate sector and broadly supportive government policies, the author believes China will avoid a hard landing.

China Economic Update

Karlis Smits et al., The World Bank, July 2015

Declining growth in China has challenged officials in Beijing to develop policies to stabilize the economy. The authors argue that the government's current policies—enacted to put the economy on a path to more sustainable, medium-term growth—are not only acceptable, but also desirable.

Authorities have sought to shift China's economy, currently oriented around manufacturing, investment, and exports, to one oriented around services, consumption, and imports. To achieve this, the government is providing new guidelines for local government debt—an area that has concerned Beijing for years—that set restrictions on the amount and use of borrowed funds, limiting investment. The government has also developed policies to cut excess capacity in heavy industry, in part by restricting the credit available to state-owned enterprises.

To prevent rapid growth deterioration, the authors argue, China must allow the transition to a service-oriented economy to occur incrementally. The central government is working toward this goal by balancing new policies with pointed stimulus meant to partially offset resulting short-term declines in growth. While necessary to prevent a rapid growth decline, the risk is that too much stimulus may be counter-productive. The authors acknowledge that the success of Beijing's efforts to transition its economy will hinge on how skillfully officials balance policy change with short-term stimulus.

The authors do expect economic growth to continue to decline, but they do not expect the decline to be dramatic, projecting a growth rate of 7.0% in 2016 and 6.9% in 2017. While there are many challenges facing China's economy, with measured policies the authors believe the government can complete the transition successfully.

As China Weighs on the World

Christian Keller et al., *Economic Outlook*, Barclays Economic Research, September 22, 2015

China's ability to stabilize its economy will play a pivotal role in shaping the outlook for global growth. The authors believe that while China's growth is unlikely to decline dramatically, it is likely to slow to 6.0% in 2016, down from an estimated 6.6% in 2015. They argue a slowing of this size would limit global growth in 2016 to 3.4%.

In the past several quarters, China's official GDP figures have regularly missed government projections, but they have held up relative to other emerging markets countries. Beyond China, second quarter results for almost every emerging markets country surprised to the downside. The authors continue to believe economic reforms, financial imbalances, and unfavorable demographics may impact China's future growth and the growth of connected emerging markets countries.

To review how declines in emerging markets growth could affect global markets, the authors examine the 1997–98 Asian crisis. Broadly speaking, global growth held up during this period, but the composition of growth has changed significantly in the last two decades. China, in particular, has become much more integrated in the global economy and financial system. In 1997, when the global economy grew 4.2%, China contributed 0.74 ppts, but by 2014, when the global economy grew 3.4%, China contributed 1.5 ppts. In purchasing power parity terms, China now contributes as much as the United States to the global economy. The authors note that China's dominant presence in commodity and manufacturing markets—a significant change from its position in the late 1990s—means an investment slowdown in China could have lasting effects on its trading partners in these markets.

A dramatic decline in Chinese growth could have a more significant impact on global growth than its weight in global GDP and share in trade suggest. A decline could trigger renewed capital outflow pressures and spark a currency war between China and its main emerging markets trading partners. The authors do not believe this is likely, but they note that the risk of a China-induced worst-case scenario for global growth rests on Beijing's ability to address potential headwinds in its economy. ■

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