The Prospects for the Chinese Economy

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Outline

- The Shifting Centre of Gravity of the World Economy and the “Partial De-Coupling Hypothesis”
- The Chinese Advantages and Disadvantages
- The Prospects for the Chinese Economy
  - Favourable economic fundamentals
  - Demand-constrained rather than supply-constrained output
  - Is a hard landing likely? (Problems of excess capacity, local government debt and shadow banking)

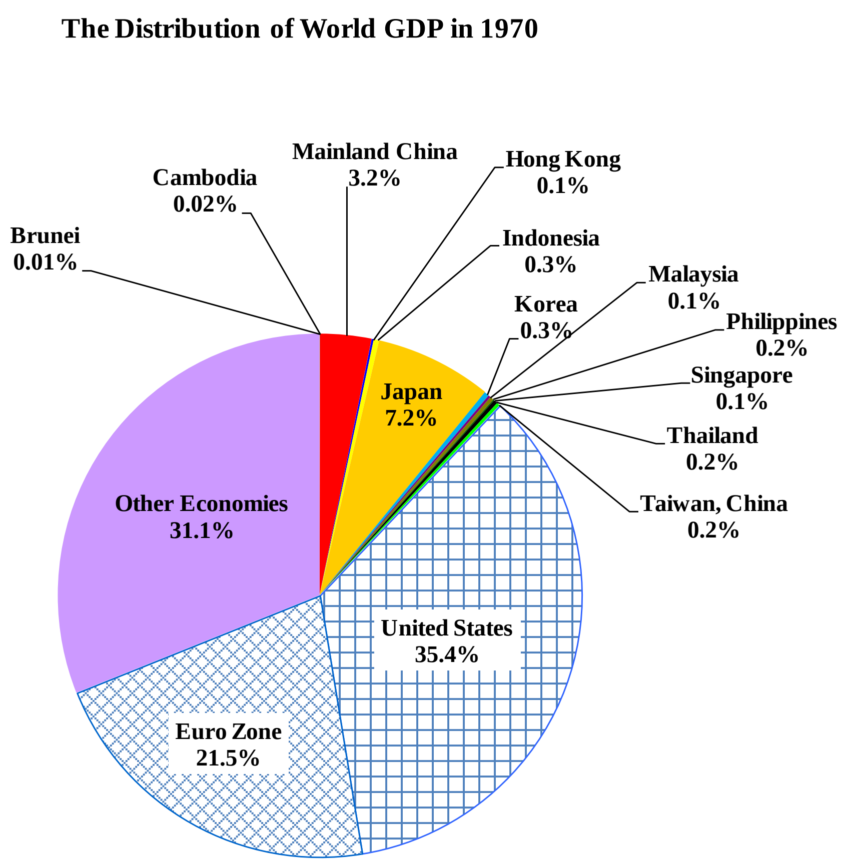
The Shifting Economic Centre of Gravity

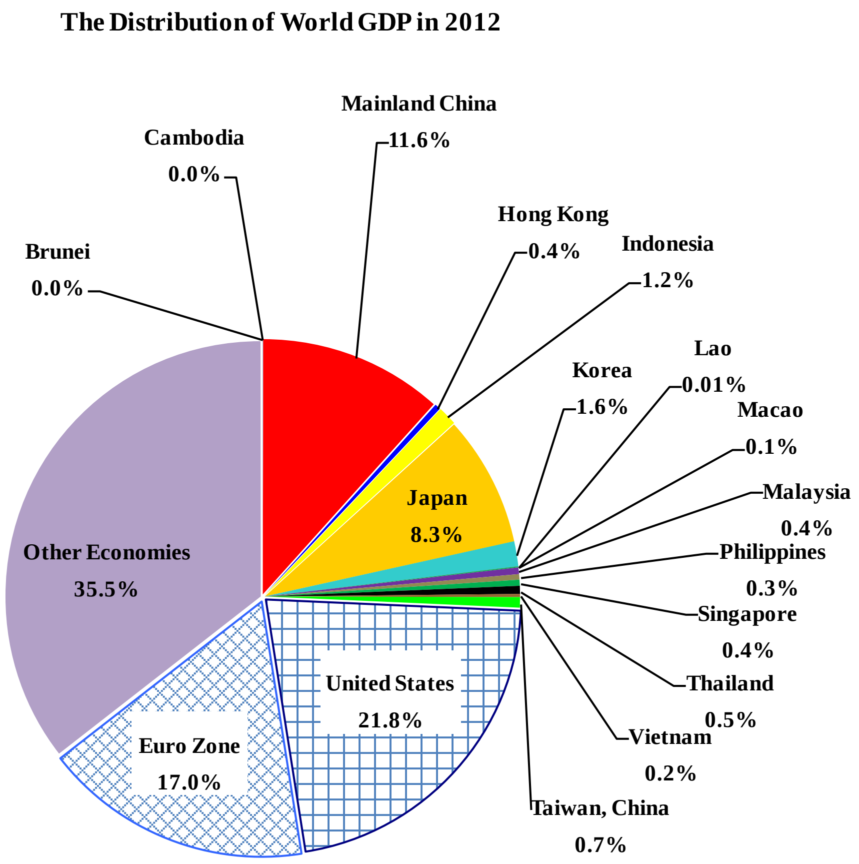
- There has been a gradual shift in the centre of gravity of the World economy from the developed economies of North America and Europe to the economies of East Asia over the past three and a half decades.
- The East Asian economies have been steadily coming into their own and becoming less dependent on the developed economies, enabling a "partial de-coupling" of the East Asian economies from the developed economies of the West.
- The fact that the Chinese economy could continue to grow, albeit at a somewhat lower rate, even as the U.S. and European economies were mired in recession, lends credence as well as empirical support to the "Partial De-Coupling Hypothesis".

The Shifting Economic Centre of Gravity: GDP

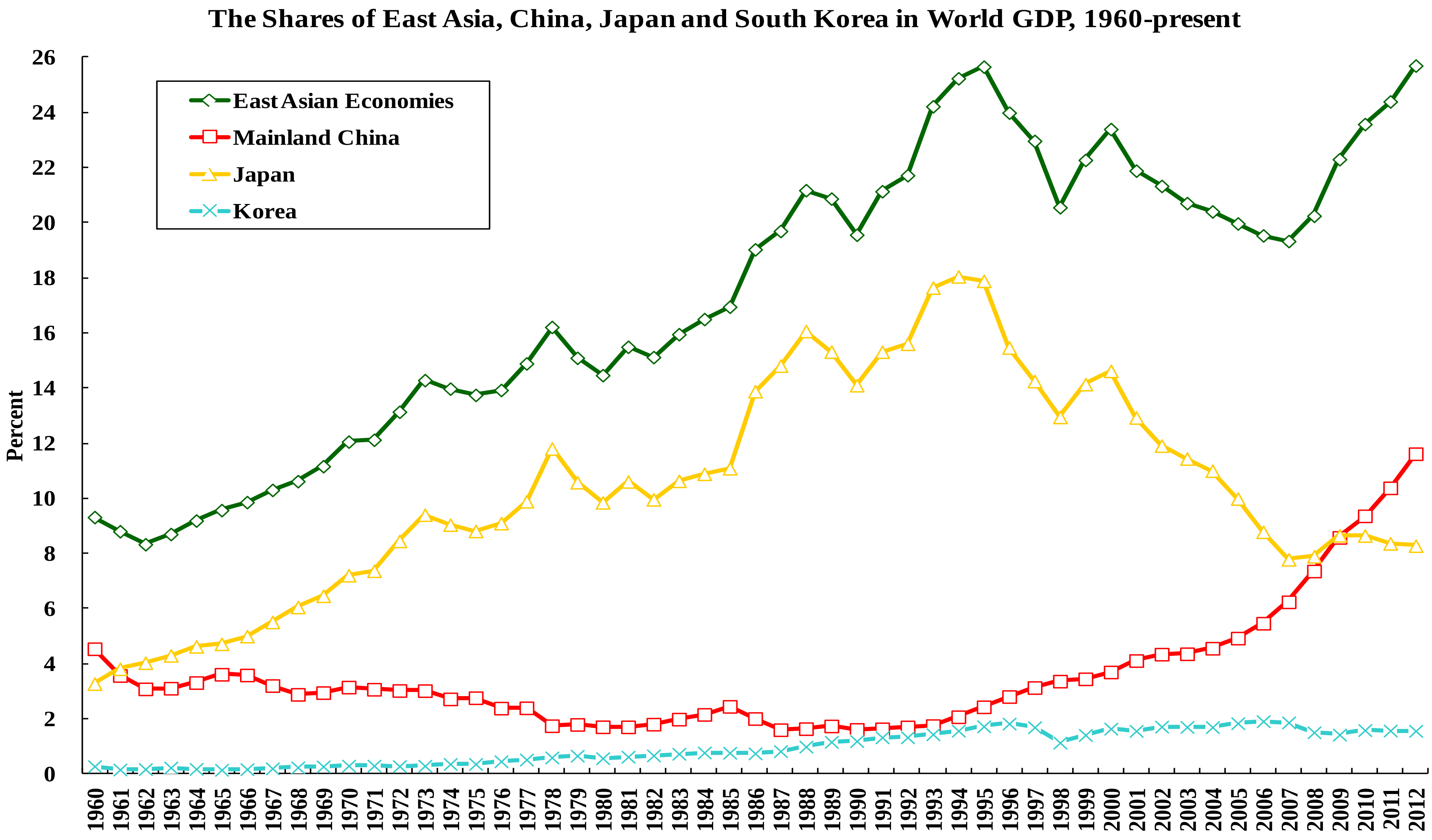
- In 1970, the United States and Western Europe together accounted for almost 60% of World GDP. By comparison, East Asia (defined as the 10 Association of Southeast Asian Nations (ASEAN)--Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam--+ 3 (China, Japan and the Republic of Korea)) accounted for approximately 10% of World GDP.
- By 2012, the share of United States and Western Europe in World GDP has declined to approximately 45% whereas the share of East Asia has risen to 25%.

The Distribution of World GDP, 1970 and 2012, US$





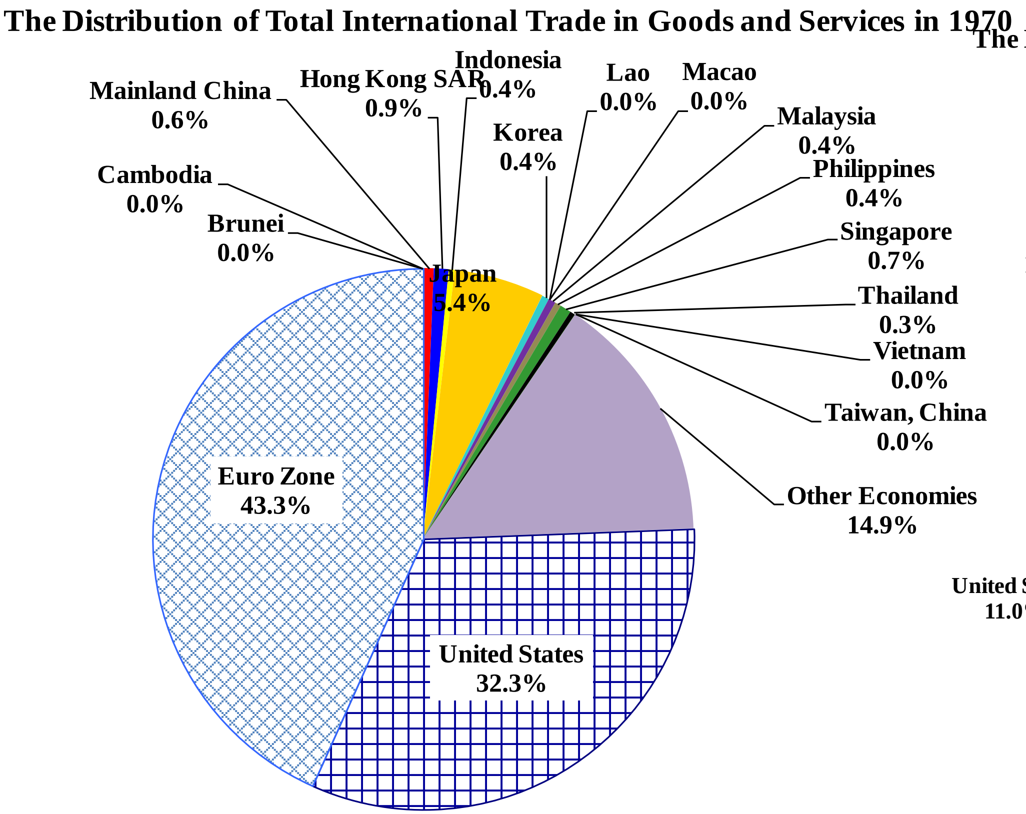
The Shares of East Asia, China, Japan and South Korea in World GDP, 1960-present

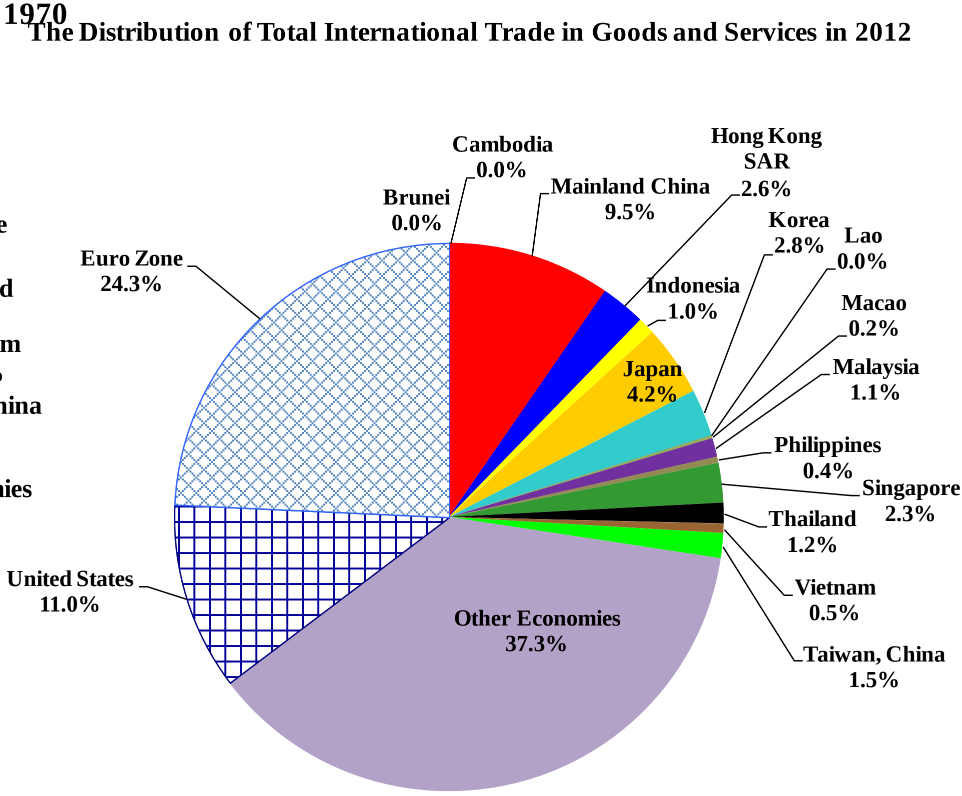


The Shifting Economic Centre of Gravity: International Trade

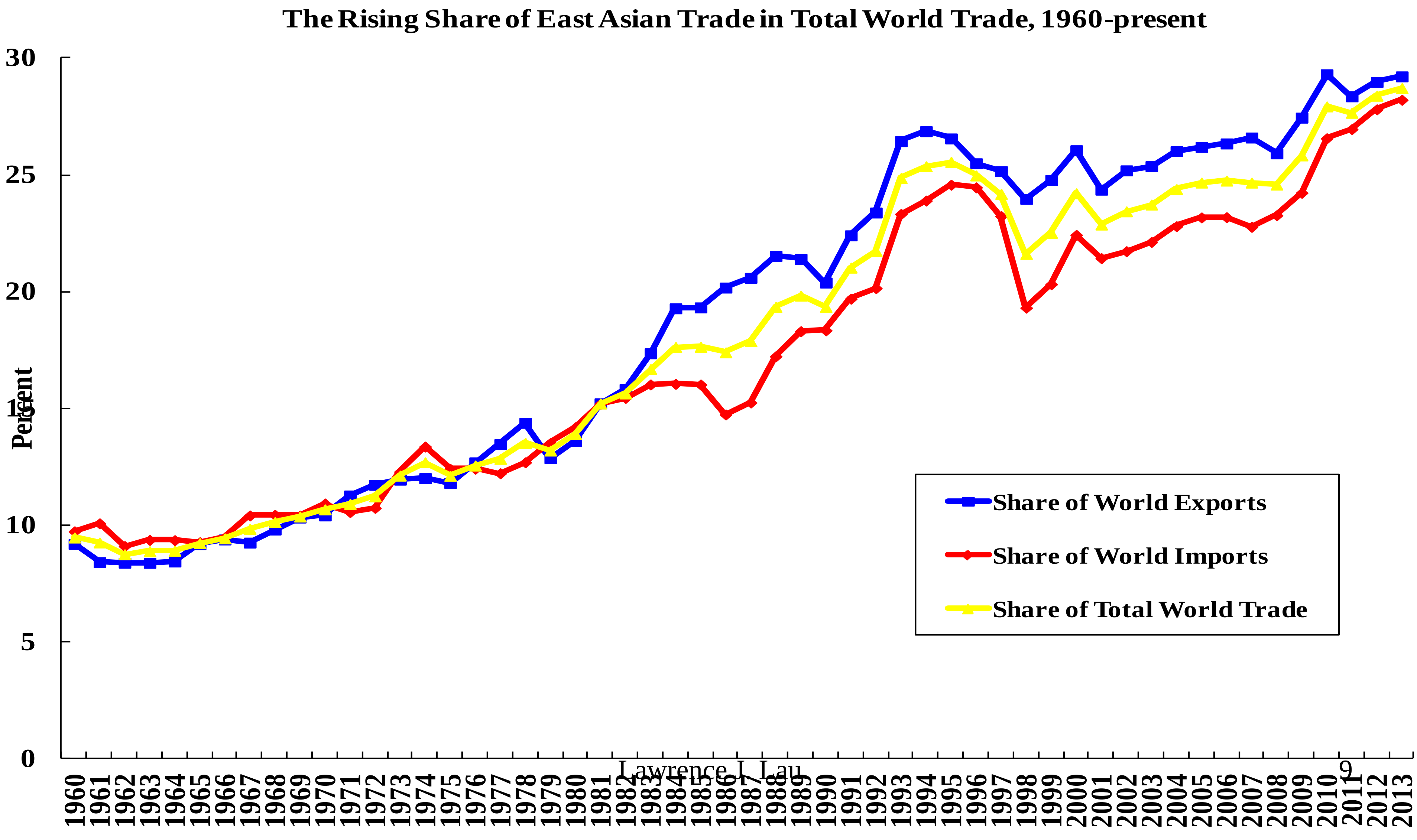
- In 1970, the United States and Western Europe together accounted for over 75% of World trade. By comparison, East Asia accounted for approximately 10% of World trade.
- By 2012, the share of United States and Western Europe in World trade has declined to below 40% whereas the share of East Asia has risen to almost 30%.

The Distribution of Total International Trade in Goods and Services, 1970 and 2012

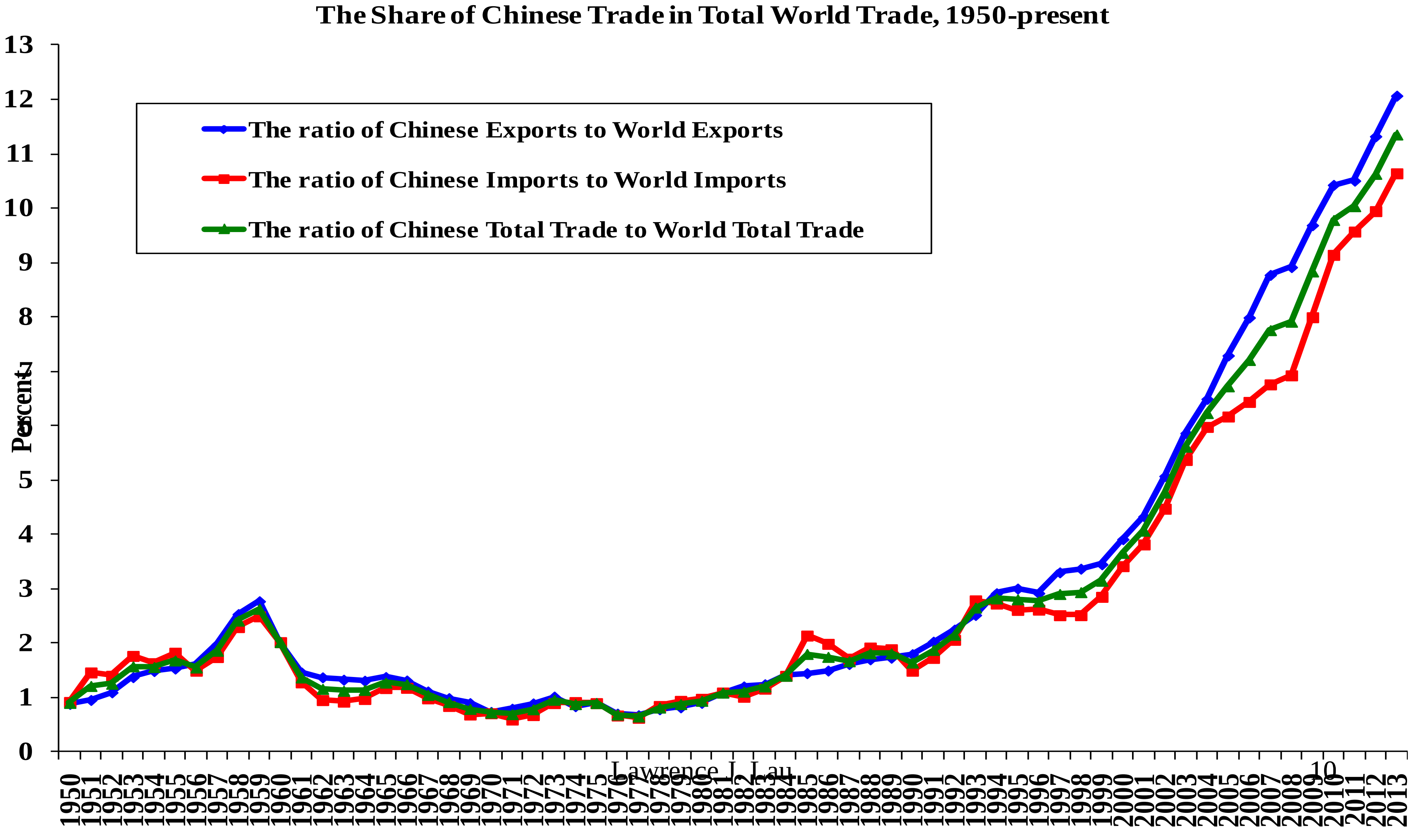




The Rising Share of East Asian Trade in Total World Trade, 1960-present



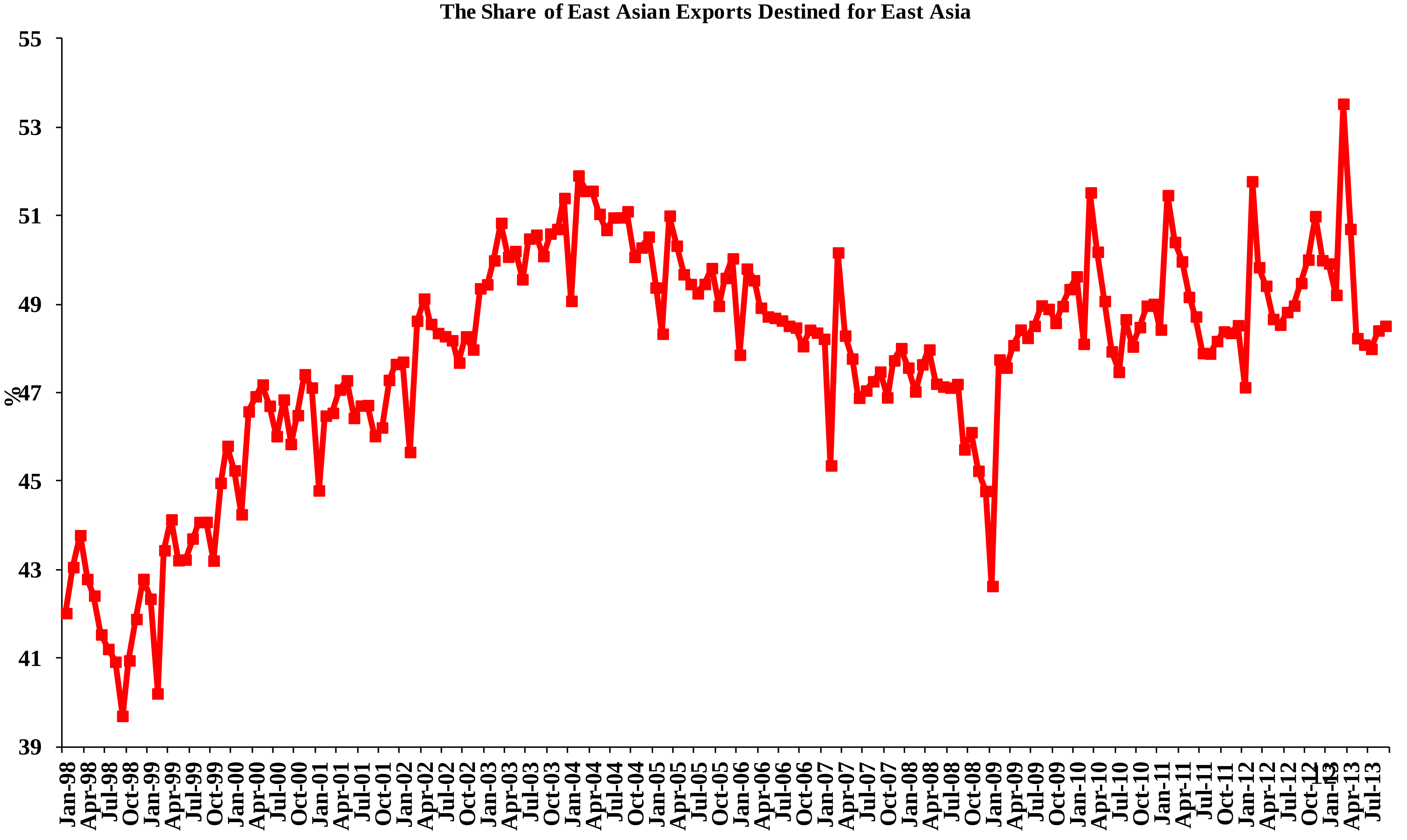
The Share of Chinese Trade in Total World Trade, 1950-present



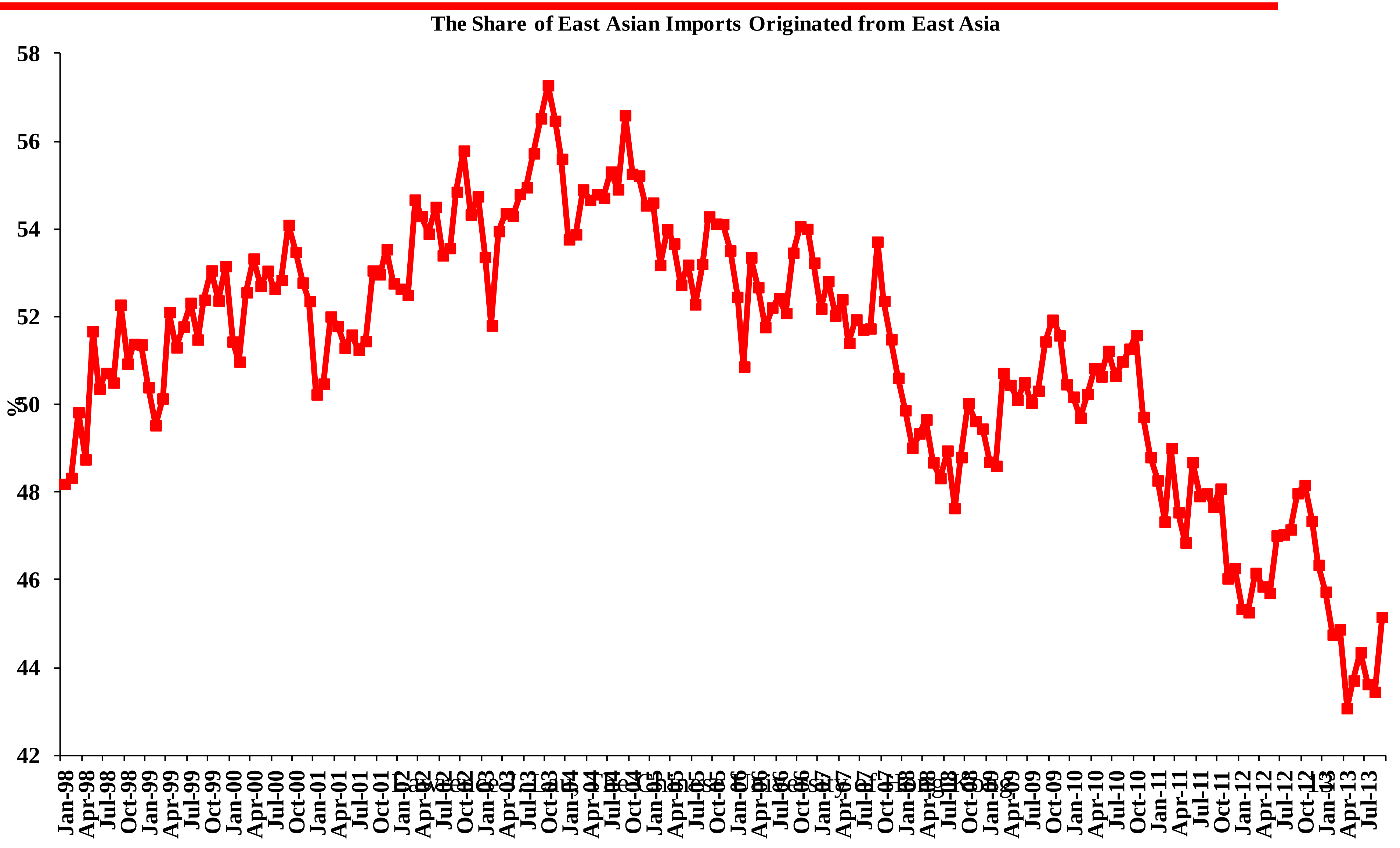
The Partial De-Coupling Hypothesis

- A particularly interesting development is the rise in intra-East Asian international trade. The share of East Asian exports destined for East Asia has risen to over 50% in the past decade. This is a sea-change compared to 30 years ago when most of the East Asian exports was destined for either the United States or Western Europe.
- Similarly, the share of East Asian imports originated from East Asia has remained around 45%.

The Share of East Asian Exports Destined for East Asia



The Share of East Asian Imports Originated from East Asia

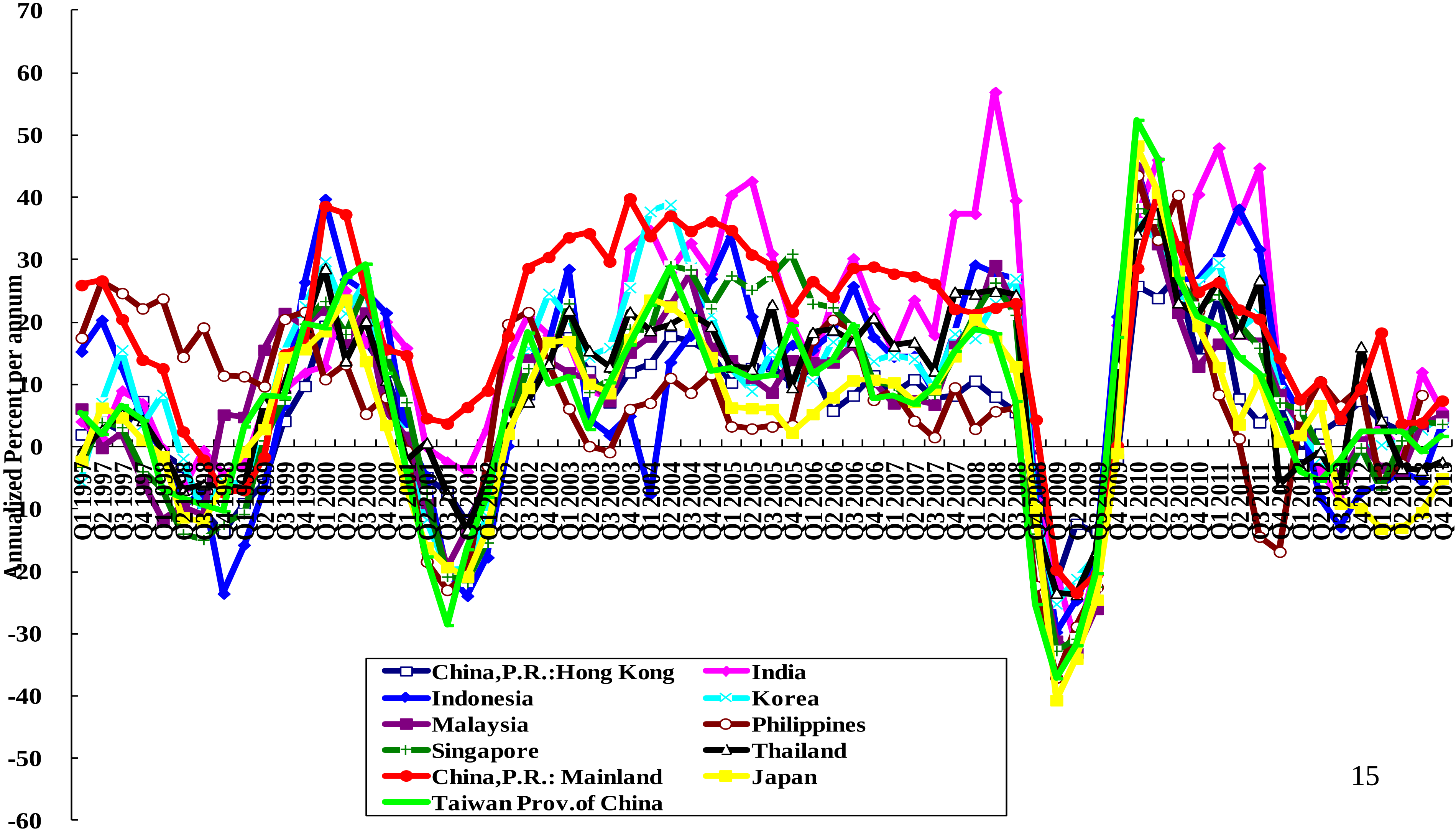


The Partial De-Coupling Hypothesis

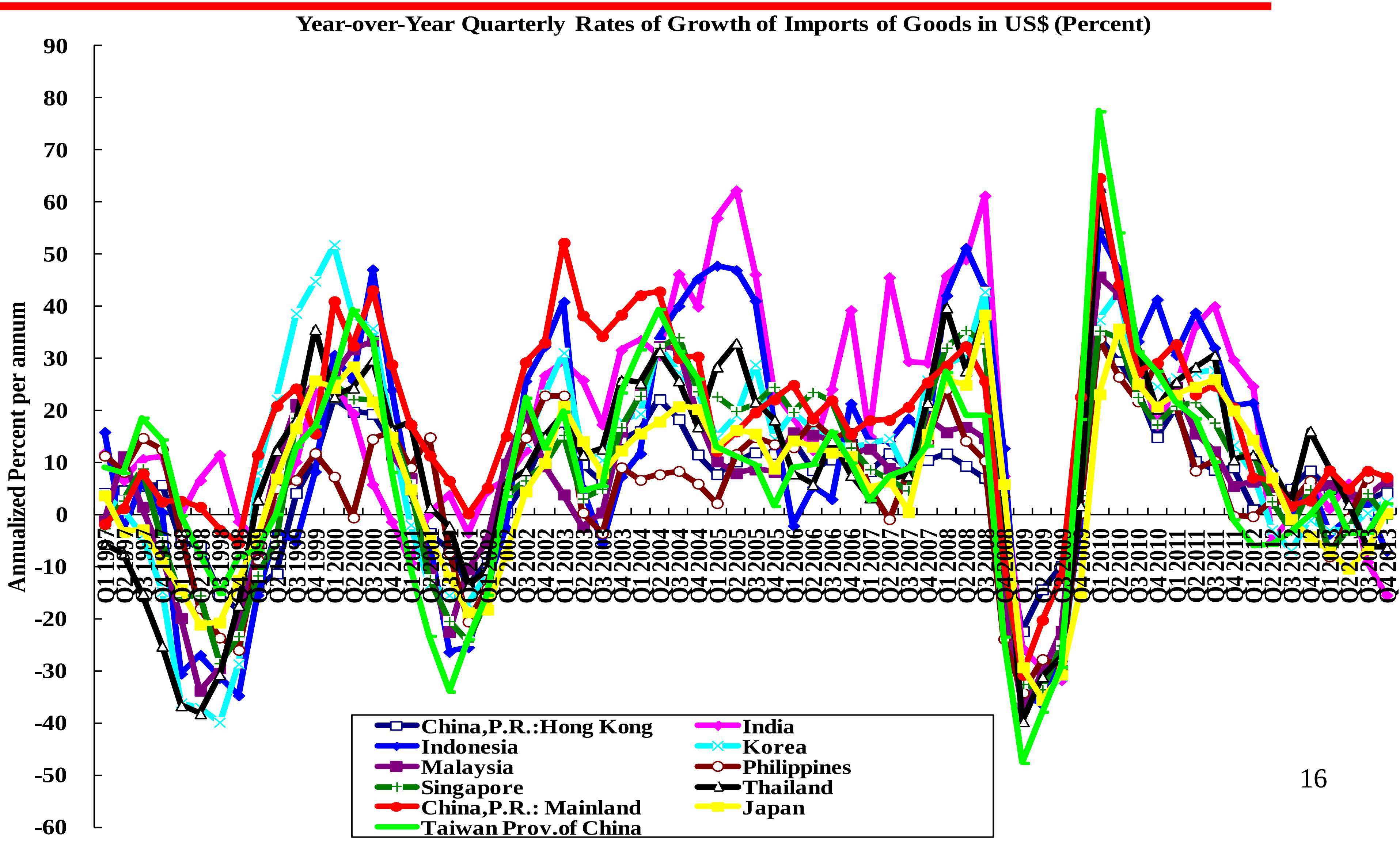
- Any doubt that the Chinese economy can be partially de-coupled from the World economy should be resolved by an examination of the following three charts on the rates of growth of exports, imports and real GDP of East Asian economies. Even though Chinese exports and imports fluctuate like those of all the other East Asian economies, the rate of growth of real GDP of the Chinese economy has been relatively stable compared to those of the other East Asian economies.

Quarterly Rates of Growth of Exports of Goods: Selected East Asian Economies

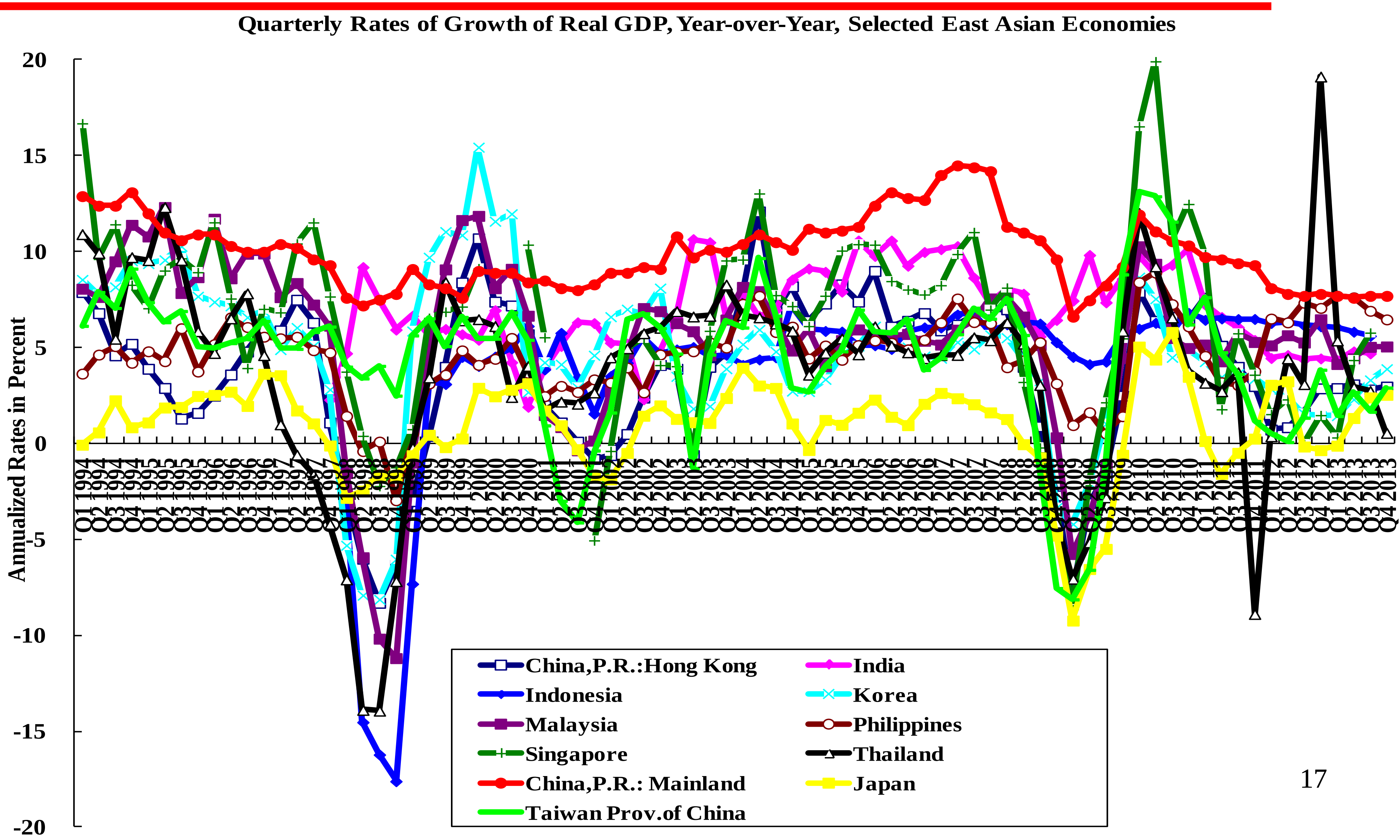
Year-over-Year Quarterly Rates of Growth of Exports of Goods in US$ (Percent)



Quarterly Rates of Growth of Imports of Goods: Selected East Asian Economies



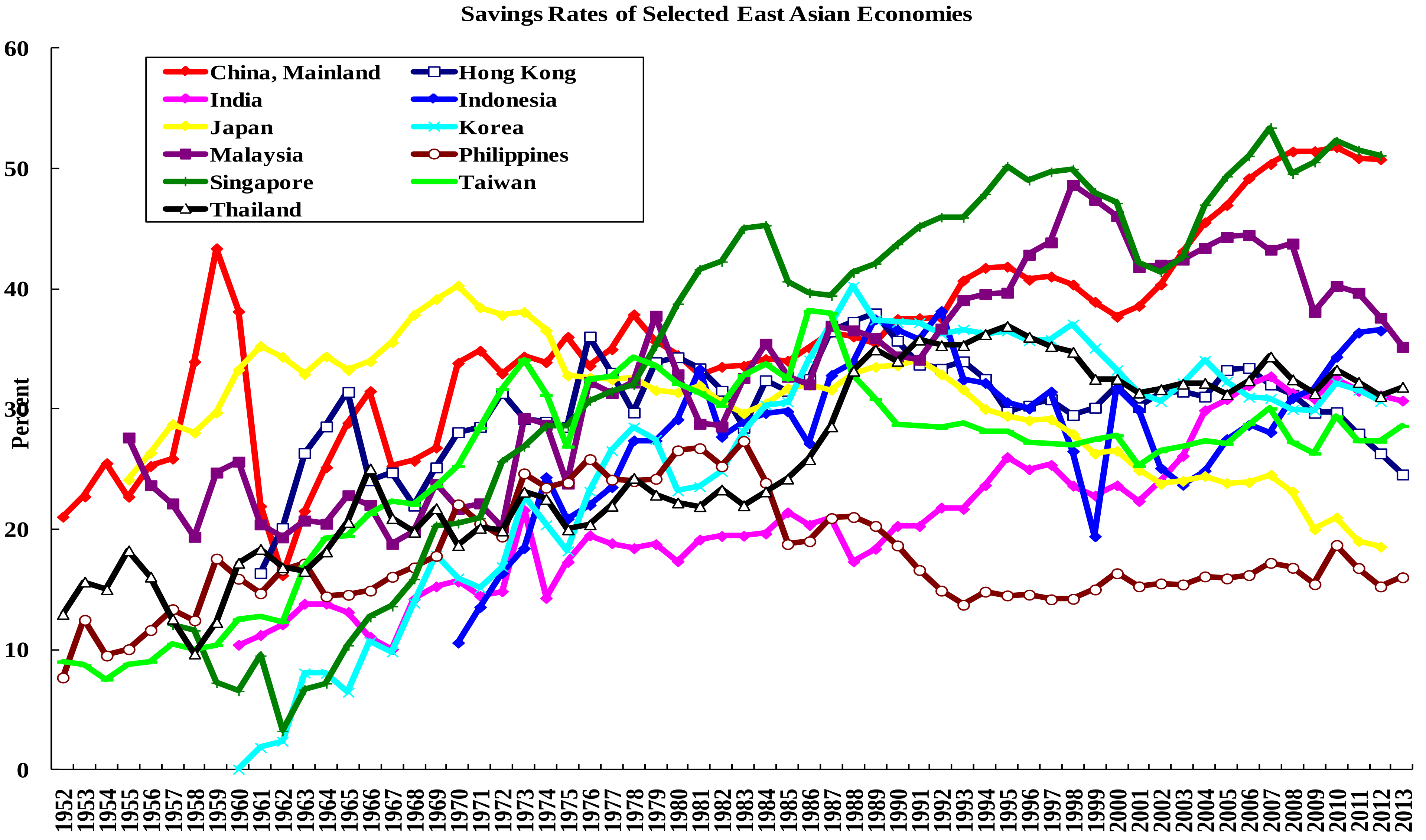
Quarterly Rates of Growth of Real GDP, Y-o-Y: Selected East Asian Economies



The Chinese Advantages and Disadvantages: High Saving Rates

- Economic growth in China and East Asia has been under-pinned by a high domestic saving rate (see the following chart), with the Philippines being a notable exception.
- A high domestic saving rate means, among other things, that China and most of the East Asian economies can finance all of their domestic investment needs from their own domestic savings alone. Thus, they can achieve a high rate of growth of their tangible capital stocks without having to depend on the more fickle foreign capital inflows (including foreign portfolio investment, foreign direct investment, foreign loans or foreign aid).

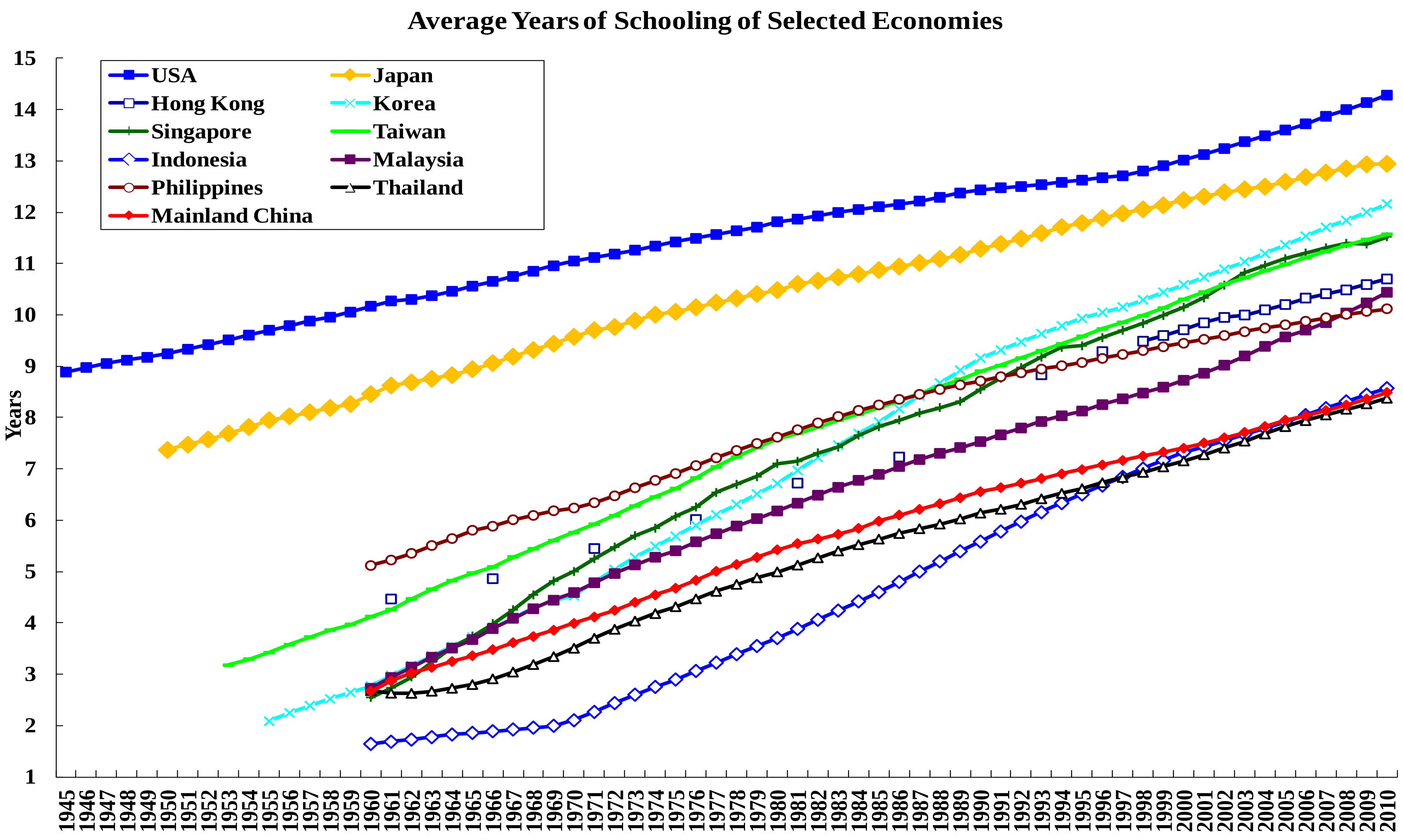
Savings Rates of Selected Asian Economies (1952-present)



The East Asian Advantages and Disadvantages: Human Capital

- The principal sources of economic growth of East Asian economies will gradually evolve from the growth of tangible inputs such as tangible capital and labour, to the growth of intangible inputs such as human capital, R&D capital, and reputational capital (branding and goodwill). This is true of the experience of developed economies such as the U.S.
- The United States and Japan are the clear leaders in human capital, measured in terms of the average number of years of schooling per person in the working-age population. South Korea has been catching up fast. Most of the other East Asian economies also have quite rapidly increasing levels of human capital.

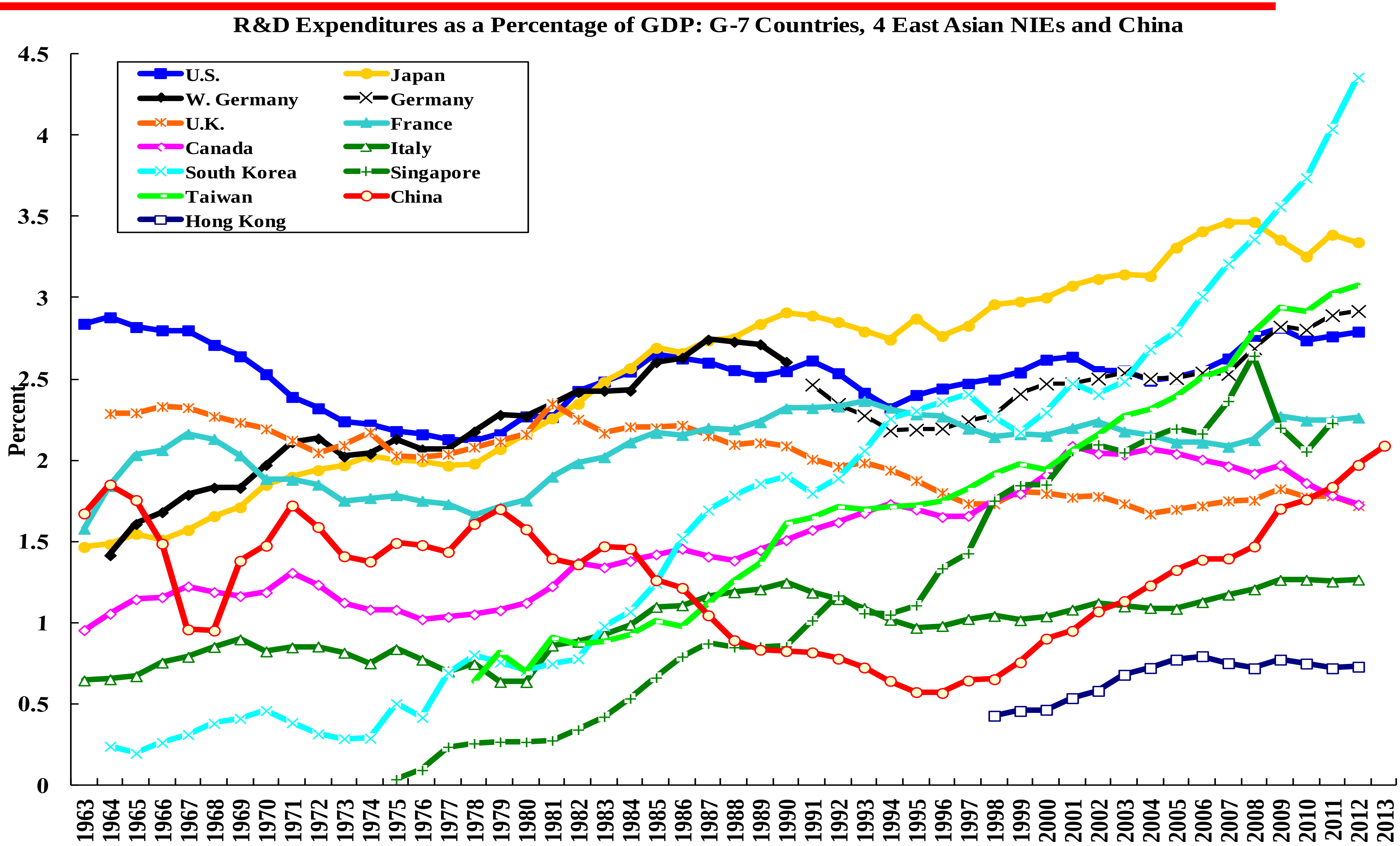
Average Years of Schooling of Selected Economies (1945-present)



The East Asian Advantages and Disadvantages: R&D Investment

- However, investment in R&D as a percent of GDP in China and other East Asian economies has generally remained relatively low except for Japan, South Korea and Taiwan which have been catching up fast.

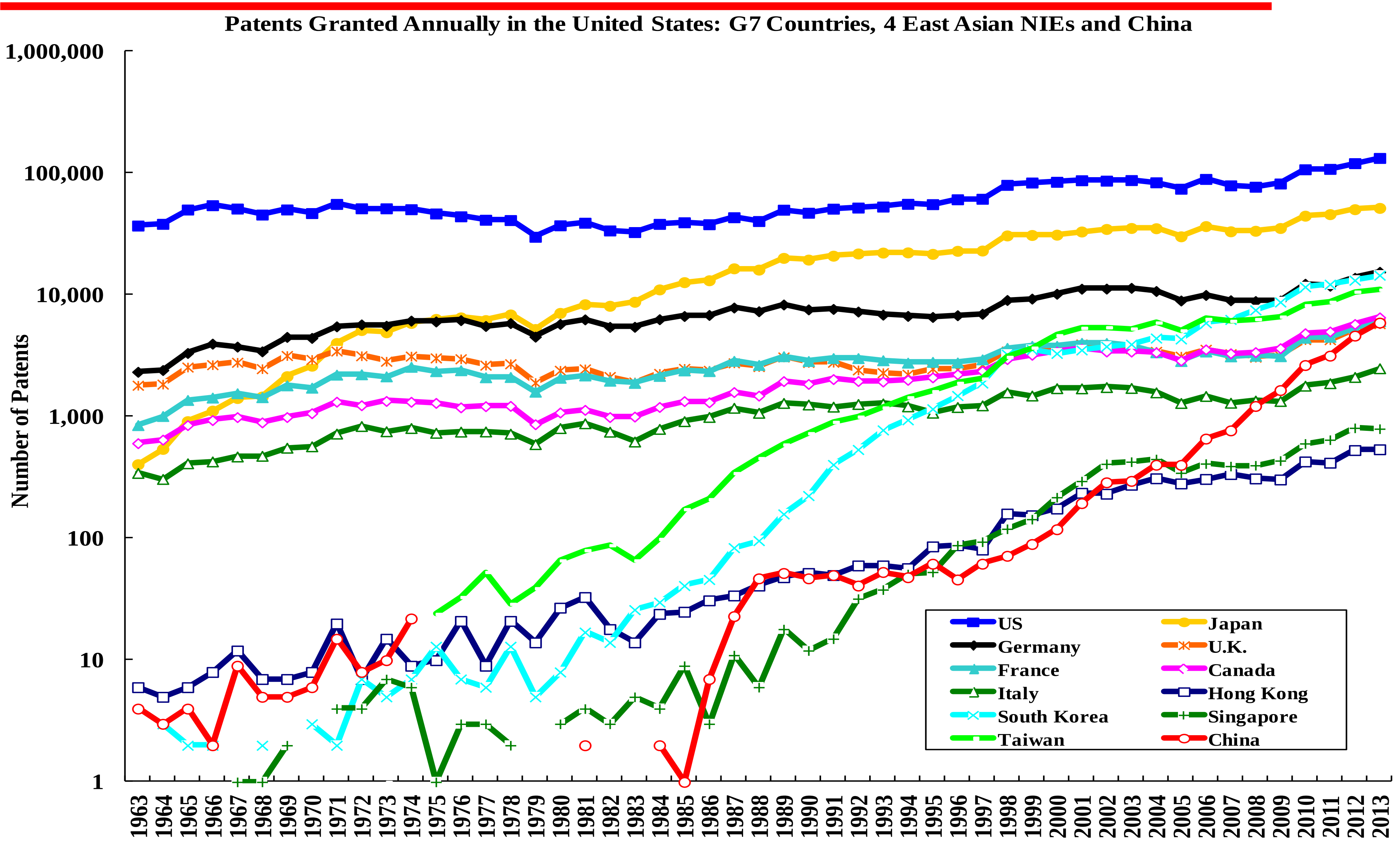
R&D Expenditures as a Ratio of GDP: G-7 Countries, 4 East Asian NIES & China



The East Asian Disadvantages: R&D Investment

- One indicator of the potential for technical progress (national innovative capacity) is the number of patents created each year. In the following chart, the number of patents granted in the United States each year to the nationals of different countries, including the U.S. itself, over time is presented.
- The U.S. is the undisputed champion over the past forty years, with 133,593 patents granted in 2013, followed by Japan, with 51,919. (Since these are patents granted in the U.S., the U.S. may have a home advantage; however, for all the other countries and regions, the comparison across them should be fair.)
- The number of patents granted to Chinese applicants each year has increased from the single-digit levels prior to the mid-1980s to 5,928 in 2013.

Patents Granted in the United States: G-7 Countries, 4 East Asian NIEs & China



The Prospects for the Chinese Economy

- Between 1978 and 2013, Chinese real GDP grew more than 26 times, from US$356.5 billion to US$9.32 trillion (in 2013 prices), to become the second largest economy in the World, after the U.S.
- By comparison, the U.S. GDP (approx. US$16.8 trillion) was less than 2 times Chinese GDP in 2013.
- China has also become the second largest trading nation by value of total trade in goods and services in the World, after the United States.
- However, the Chinese economy alone is not large enough to turn the World economy around. The idea of a G-2 group of countries consisting of China and the United States leading the World economy is premature.

The Prospects for the Chinese Economy

- Despite the rapid growth of the Chinese economy, in terms of its real GDP per capita, China is still very much a developing economy.
- Between 1978 and 2013, Chinese real GDP per capita grew 18.5 times, from US$370 to US$6,850.5 (in 2013 prices).
- By comparison, the U.S. GDP per capita of approximately US$53,086 was 7.7 times Chinese GDP per capita in 2013.

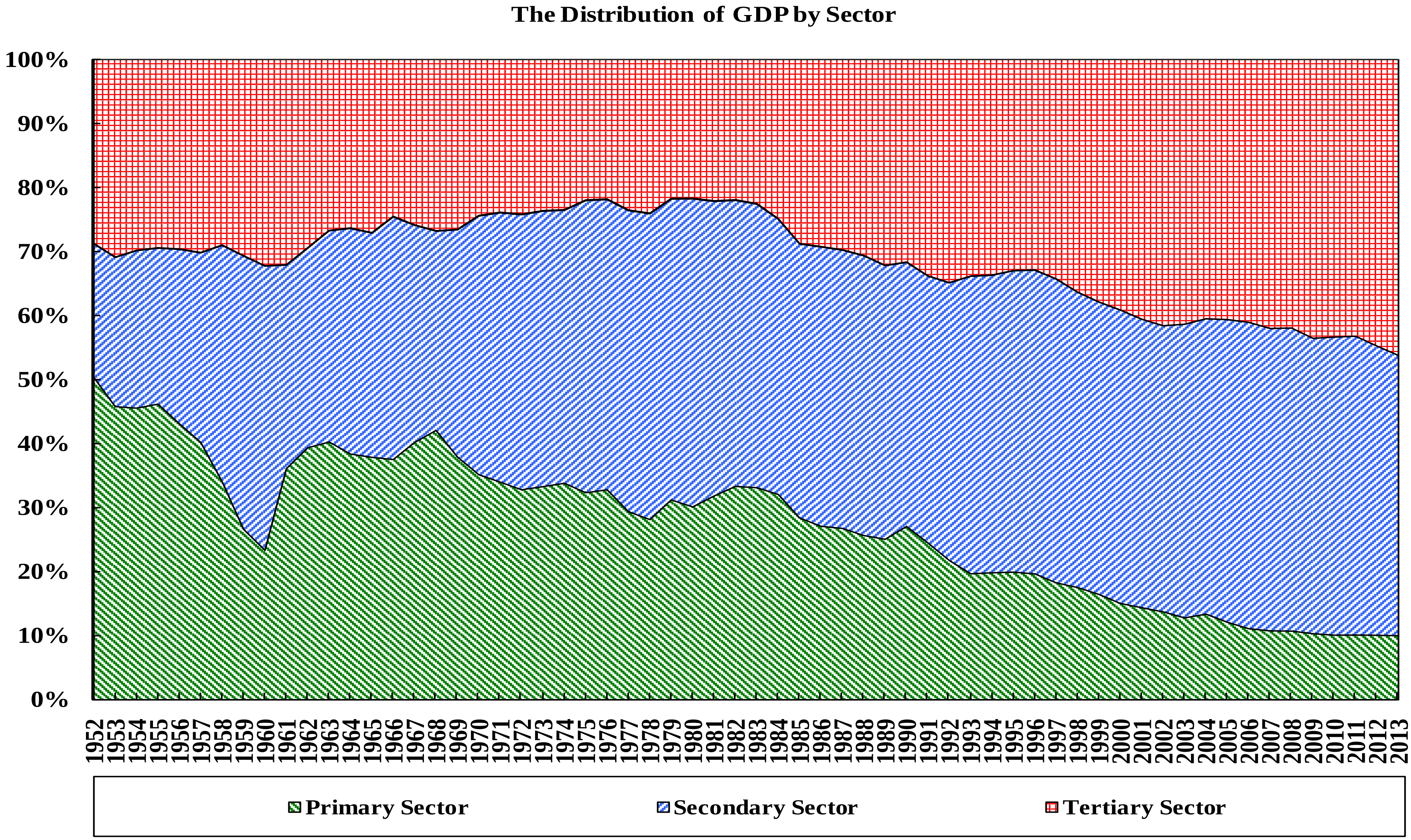
The Prospects for the Chinese Economy: The Economic Fundamentals

- Chinese economic growth since 1978 has been underpinned by three factors:
- (1) A high rate of investment, enabled by a consistently high national saving rate on the order of 30% and above except for a brief start-up period in the early 1950s. The saving rate has stayed around 40% since the early 1990s and has at times approached or even exceeded 50% in more recent years.
- This means, among other things, that the Chinese economy can finance all of its domestic investment needs from its own domestic savings alone, thus assuring a high rate of growth of the tangible capital stock without having to depend on the more fickle foreign capital inflows (including foreign portfolio investment, foreign direct investment or foreign loans). This will continue to be the case in the foreseeable future.

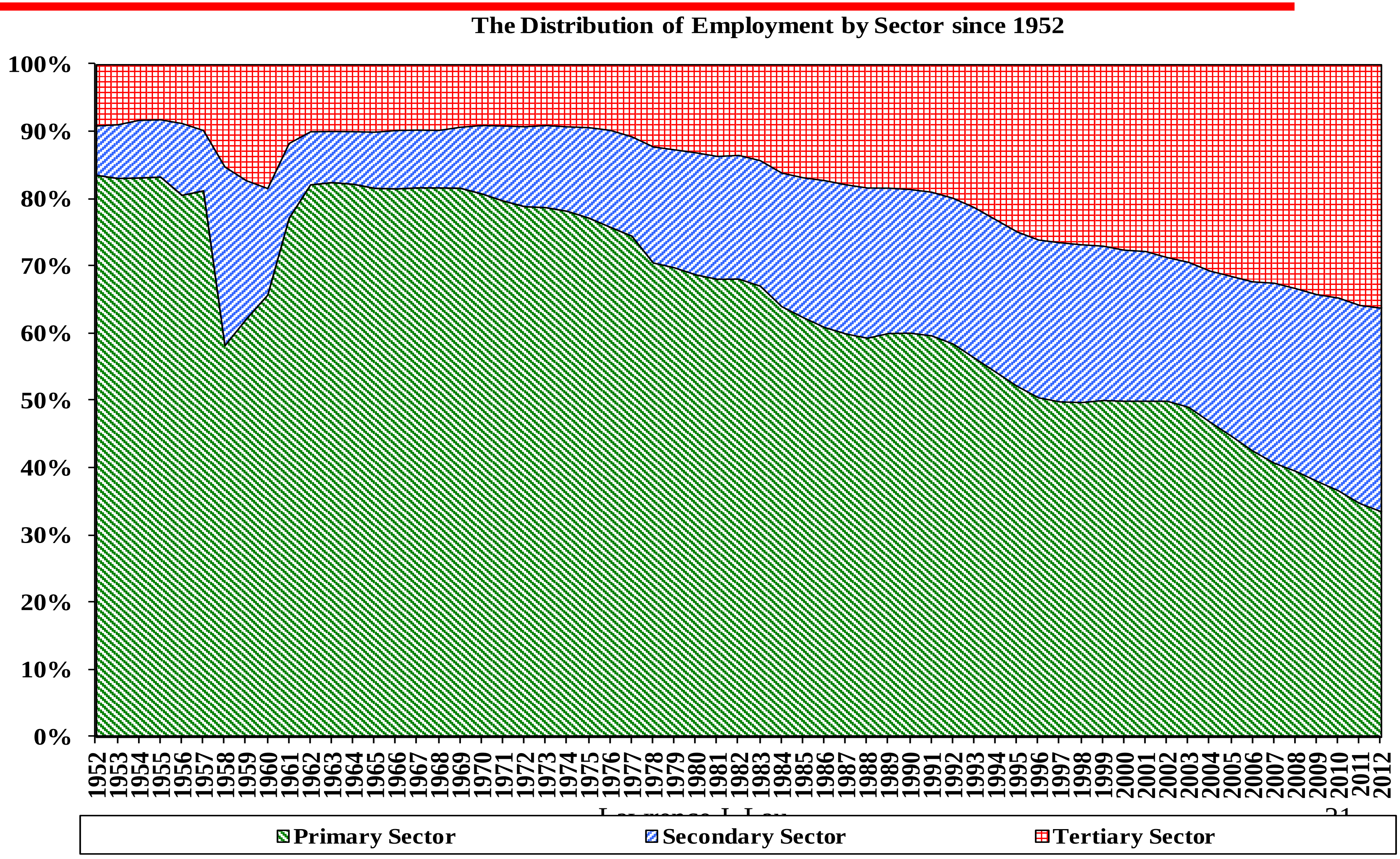
The Prospects for the Chinese Economy: The Economic Fundamentals

- (2) An unlimited supply of surplus labour—there is no shortage of and no upward pressure on the real wage rate of unskilled, entry-level labour.
- Surplus labour will continue to exist—In 2012, the agricultural sector employs over 33.6% of the Chinese labour force but produces only 10% of the Chinese GDP.
- There will not be a "real" labour shortage despite the decline of the "working-age population"—the existing retirement ages of 55 for women and 60 for men are too low given the lengthened life expectancy of the Chinese population. One ready solution is to raise the retirement age to 65.
- The "one-child policy" is already in the process of being modified.

The Distribution of Chinese GDP by Sector Since 1952



The Distribution of Chinese Employment by Sector Since 1952



The Prospects for the Chinese Economy: The Economic Fundamentals

- (3) A huge domestic market of 1.34 billion consumers with pent-up demand for housing and transportation and other consumer goods and services (e.g., education and health care), enabling the realisation of significant economies of scale in production and in investment in intangible capital, including innovation and goodwill (e.g., brand building), based entirely on the domestic market.
- Intangible capital (R&D capital, patents, other intellectual property such as brand names) is highly productive in a large economy because once the fixed cost of invention/innovation/branding is amortised, the additional revenue is almost all pure profit.

The Prospects for the Chinese Economy: Demand-Constrained Output

- The Chinese economy is not supply-constrained but demand-constrained—there is excess capacity in almost all of the manufacturing sectors—steel, cement, glass, aluminium, etc., and as long as there is adequate aggregate demand, the aggregate supply will be there to meet the demand. The Chinese GDP is primarily determined by aggregate demand.
- Continuing Chinese economic growth going forward will depend mostly on the growth of internal demand and not on exports.
- Chinese household consumption has actually been growing quite rapidly since the first quarter of 2009. The rates of growth of real retail sales have exceeded the rates of growth of real GDP and real household income significantly.

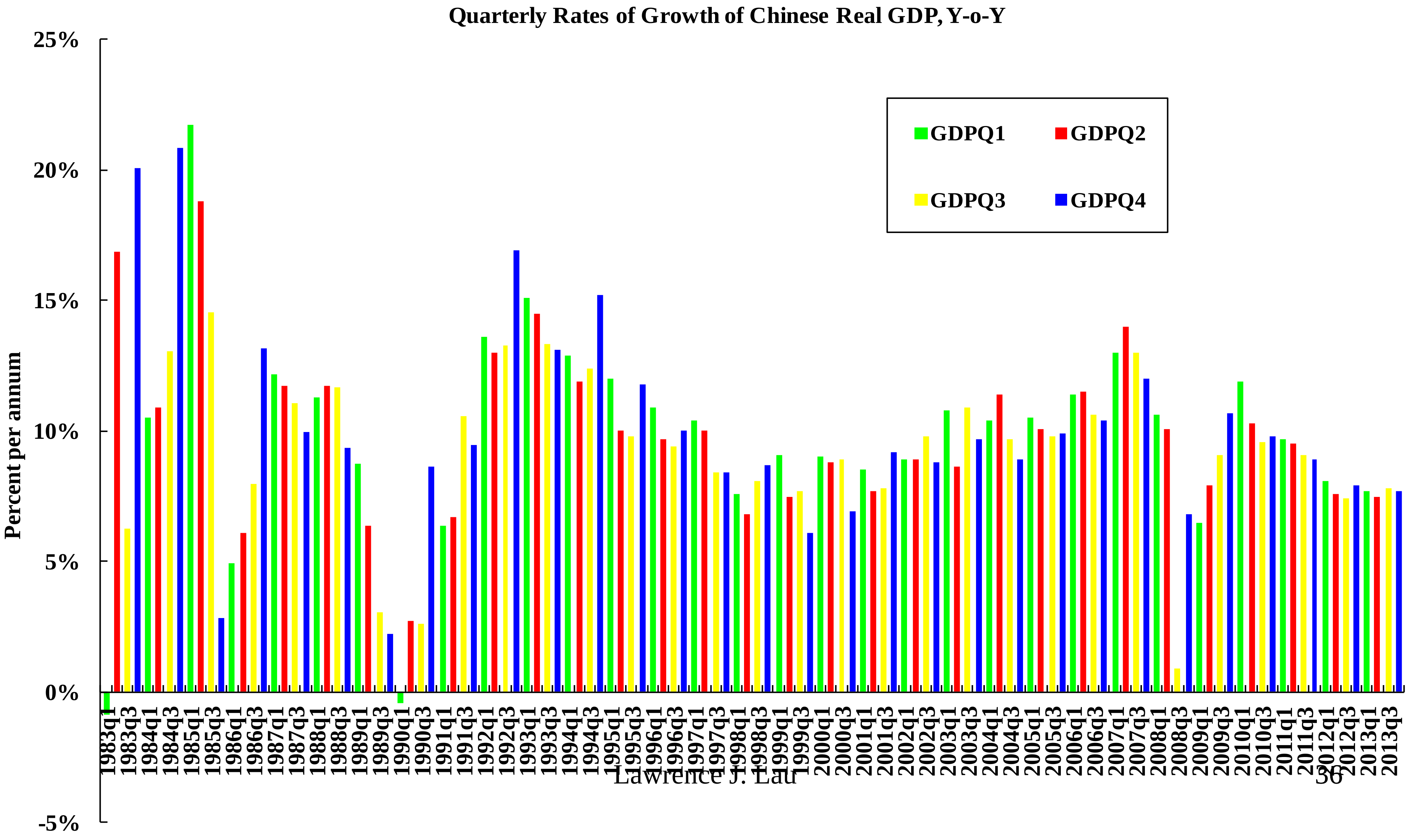
The Prospects for the Chinese Economy: Demand-Constrained Output

- However, it will be a long time before Chinese household consumption can become the major driver of Chinese economic growth. The share of household income in Chinese GDP is less than 50%. Even if the household saving rate declines to zero, household consumption will not exceed 50% of GDP, compared to between 65% and 70% for developed economies.
- Thus, the sources of growth of internal demand will have to continue to come from investment, especially public infrastructural investment, and public consumption—education, health care, and environment control, preservation, protection and restoration.

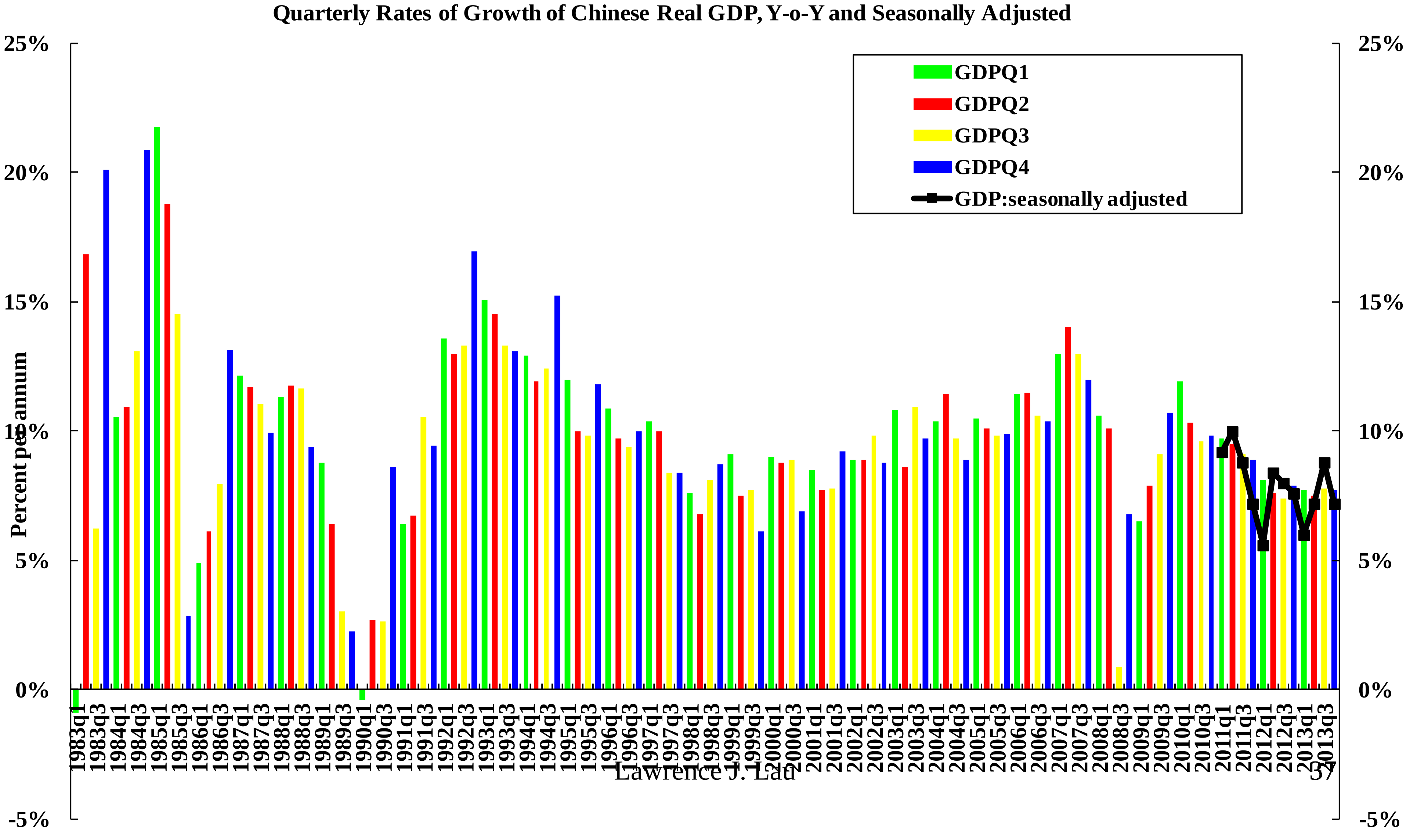
The Prospects for the Chinese Economy: Is a Hard Landing Likely?

- The Chinese economy grew 9.2% in 2009, 10.4% in 2010, 9.3 % in 2011, 7.7% in 2012 and 2013 even as the European and U.S. economies remained in recession. The slowdown is unmistakable but should be considered to be a positive development.
- In 2013Q3 and 2013Q4, the rates of growth of real GDP were 7.8% and 7.7%, Y-o-Y, respectively. In 2014 Q1, the rate of growth was 7.4%, Y-o-Y. All the economic indicators suggest that the Chinese rate of growth has begun to stabilise between 7% and 8%. The target growth rate of the Chinese economy for 2014 is around 7.5%.
- The official target average growth rate for the Twelfth Five-Year Plan (2011-2015) period is a relatively modest 7%. A real rate of growth of over 7% per annum is definitely achievable for 2014.

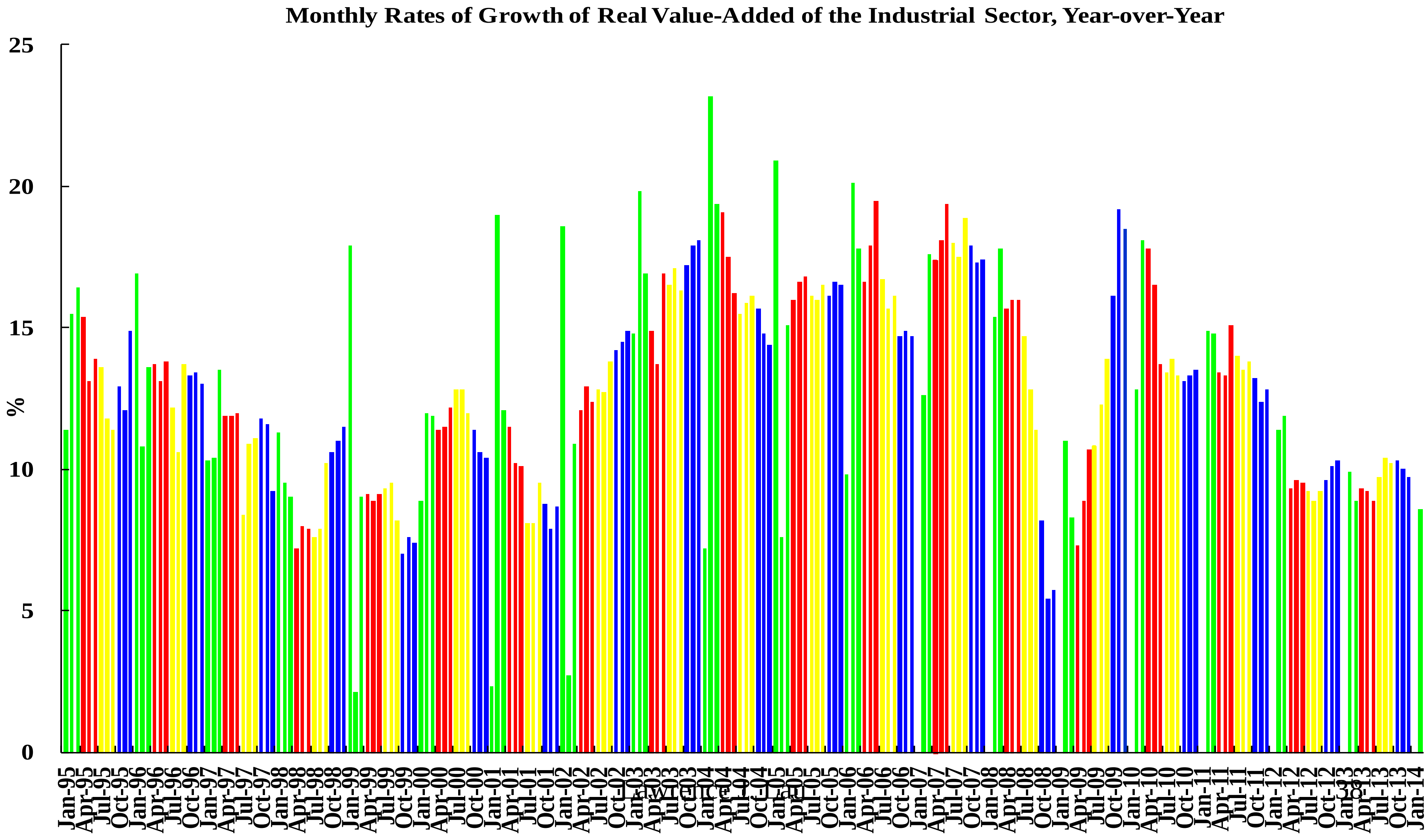
Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y



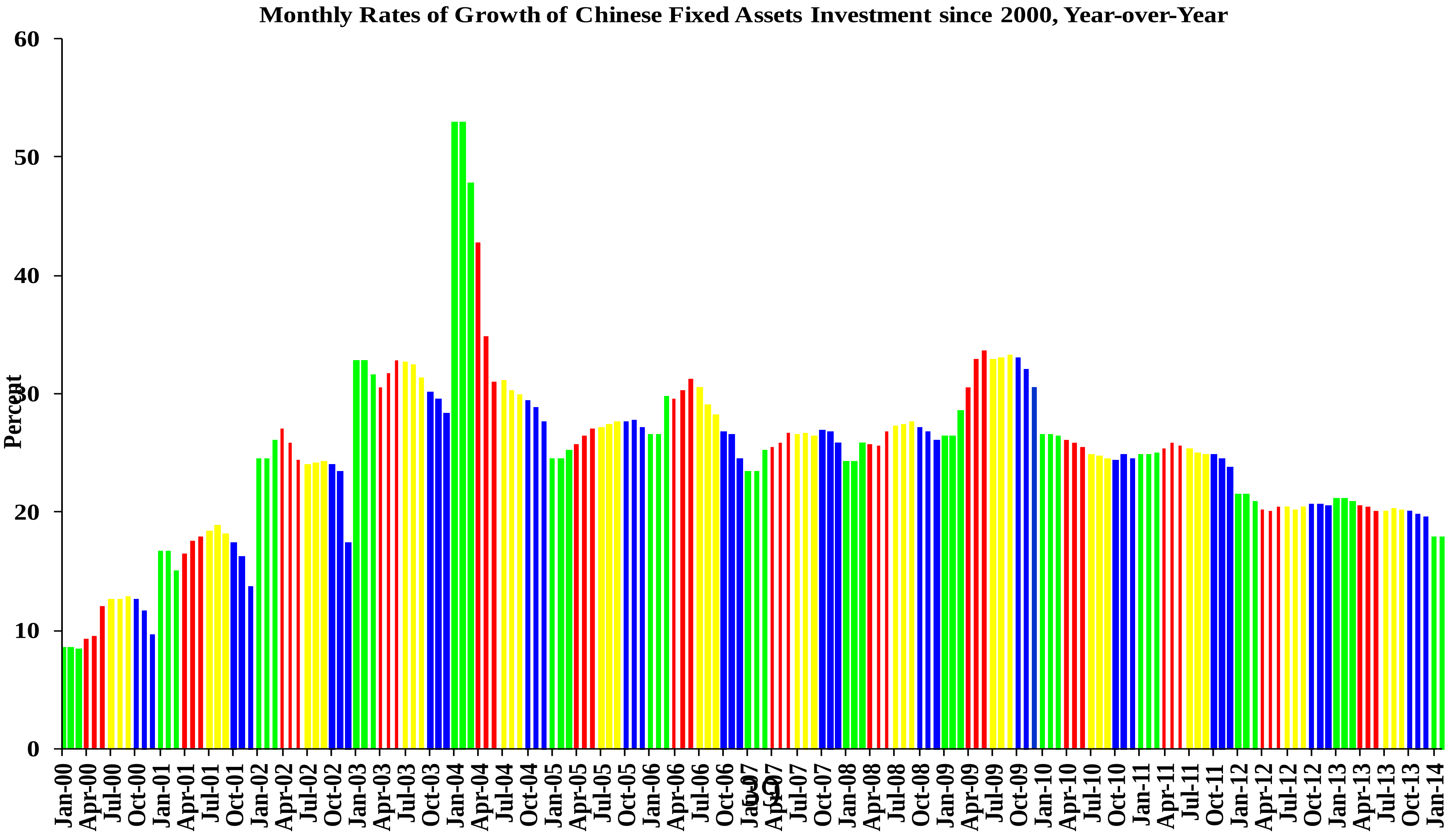
Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y and Seasonally Adjusted



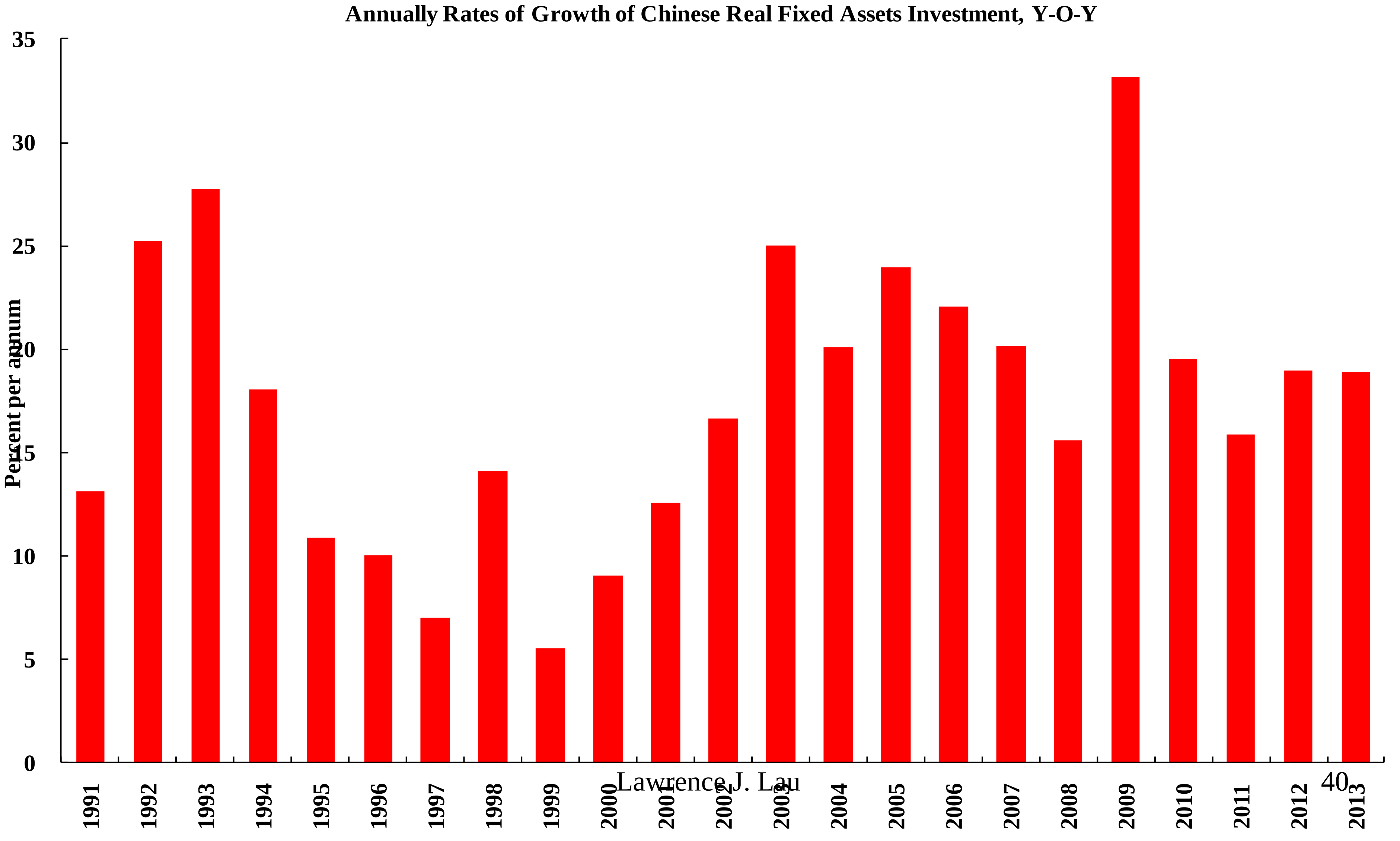
Monthly Rates of Growth of Real Value-added of the Industrial Sector, Y-o-Y



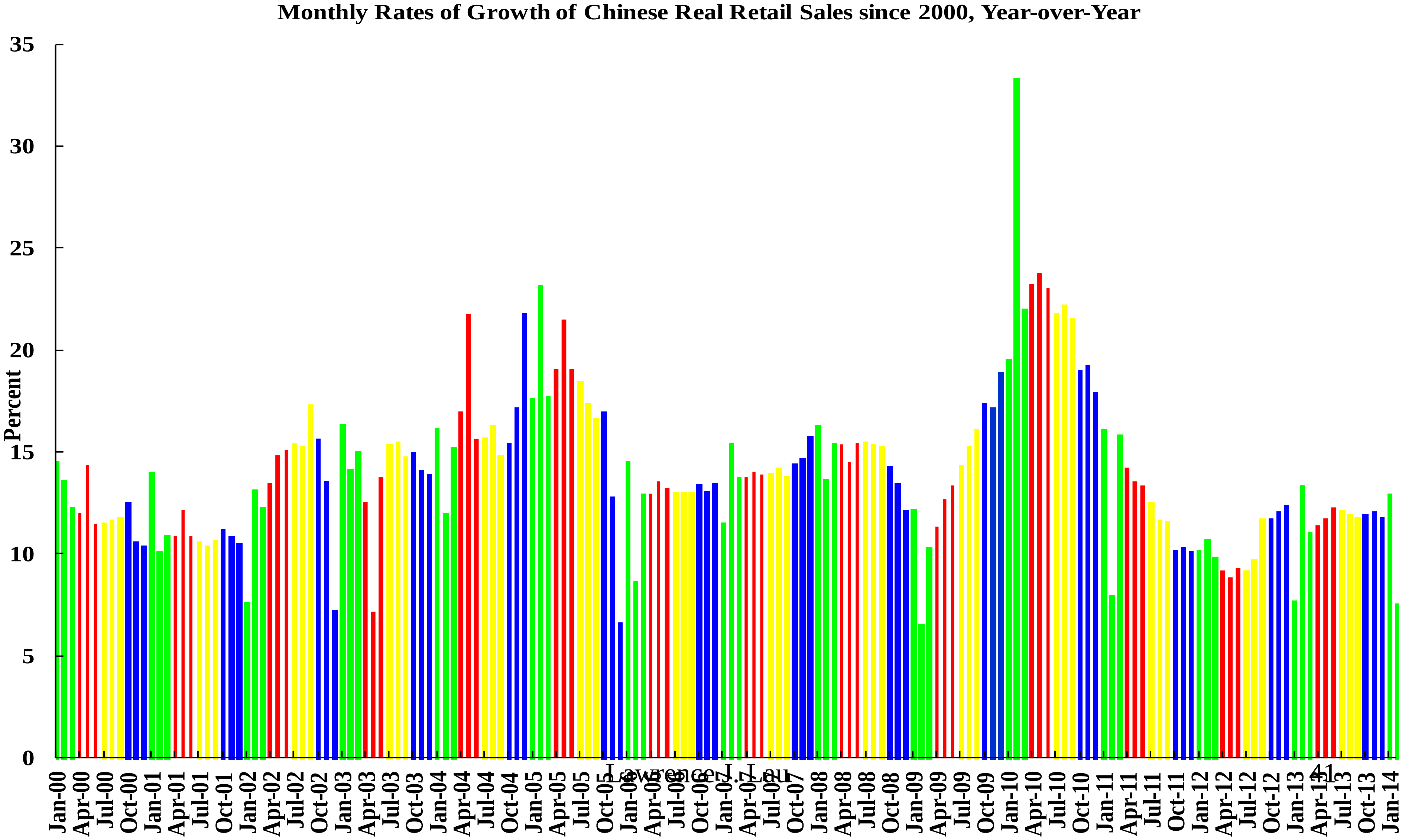
Monthly Rates of Growth of Chinese Fixed Assets Investment, Y-o-Y



Annual Rates of Growth of Chinese Real Fixed Assets Investment, Y-O-Y



Monthly Rates of Growth of Chinese Real Retail Sales, Y-o-Y



The Prospects for the Chinese Economy: Is a Hard Landing Likely?

- The principal challenge facing the Chinese economic policy planners is not so much the growth of real GDP but employment.
- In 2013, 13 million new jobs were created. In 2014, the target for new jobs is 10 million. This target is achievable as the service sector (46% by GDP and 36% by employment) is now larger and growing faster than the manufacturing sector (44% by GDP and 30% by employment). An expansion of service-sector GDP creates 30% more employment than an expansion of manufacturing-sector GDP and requires much less fixed investment.

Is a Hard Landing Likely? Local Government Debt

- Total Chinese central government public debt may be estimated at 9.8 trillion Yuan as of mid-2013, with another 2.5 trillion Yuan of contingent liabilities of various kinds, including those of the China Railway Corporation.
- Total local government debt may be estimated at 10.9 trillion Yuan as of mid-2013, with another 7 trillion Yuan of contingent liabilities of various kinds. Total local government debt has increased significantly especially since 2008Q4.
- Private household debt may be estimated at 16 trillion Yuan and enterprise debt at around 70 trillion Yuan.
- To put all of these figures into perspective, the Chinese GDP in 2013 was 57 trillion Yuan. Total central and local government debt (including contingent liabilities) as a percentage of GDP may therefore be approximately estimated as 53%.

Is a Hard Landing Likely? Local Government Debt

- However, it is unlikely that all of the local government debt would become non-performing. Even if half of the local government debt eventually becomes non-performing, in which case it is likely that part of the losses would be assumed by the central government, which will still have a relatively low public debt to GDP ratio of less than 40% compared to 150% for the U.S. and 250% for Japan.
- In addition, China has a high national saving rate in the mid forties. Its public debt is almost exclusively denominated in Renminbi and held mostly by Chinese nationals. The Government deficit is low and the rate of growth of government revenue has been higher than the rate of growth of GDP. All of this suggests that the debt problem should be manageable.

Is a Hard Landing Likely? Shadow Banking

- "Shadow banking" has become more common in Mainland China in the last few years. Shadow banking arises in response to various restrictions on bank lending and other requirements such as the total quota on the value of loans outstanding and its rate of increase, capital requirements, leverage ratios, and reserve requirements.
- The fundamental idea of "shadow banking" is to move both "deposits" and "loans" off the bank's balance sheet and hence reduce the size of its total assets and liabilities through various arrangements and devices, circumventing all kinds of requirements and restrictions.
- Shadow banking appears to have advantages for everyone except possibly for the shareholders of the bank and for the regulator. The net result, however, is a significantly lower actual capital ratio and a significantly higher actual leverage, increasing the risks to the bank and to the financial sector as a whole.

Is a Hard Landing Likely? Shadow Banking

- The proportion of financing in China accounted for by conventional bank loans was over 90 percent in 2002 but has since fallen to below 50%. Shadow banking probably accounts for 17-20 trillion Yuan worth of "loans", approximately 30% of GDP, still considerably lower than the comparable percentages in other major developed economies. But the commercial banks are involved in 60% of the shadow banking activities in China, much more than the commercial banks in other countries and regions.
- This means that the implicit hidden liabilities of the commercial banks and hence their leverage ratios are much higher than are represented on their balance sheets, posing significant risks to the financial system because of the potential of over-leveraging. Moreover, there is unlikely to be sufficient provision against non-performing "shadow loans".
- The Chinese regulators are aware of these problems and have been taking steps to control and restrict shadow banking.

Concluding Remarks

- The centre of gravity of the global economy has been gradually shifting to East Asia from North America and Europe. The centre of gravity of the East Asian economy has been gradually shifting to China from Japan.
- The Chinese and East Asian economies have been partially de-coupled from the developed economies of North America and Europe.
- On the basis of its strong economic fundamentals, China should be able to continue to grow at an average annual rate of 7% for the next decade or so, more or less independently of what happens in the rest of the World.
- The growth of intangible capital (human capital and R&D capital) will have to become a much more important source of Chinese economic growth as it has already become in the more developed East Asian economies such as Japan, South Korea, Singapore and Taiwan.