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China
THE WAY OF THE DRAGON

In the following article, Chris Kushlis, Fixed Income Sovereign Analyst at T. Rowe Price, considers the growth outlook for China, the potential impact of the renminbi, and also looks at how China is influencing the broader Asian region today.



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Slowing economic growth, currency volatility, policy errors, equity market volatility – it is fair to say that 2016 has been a difficult year for China. For many, these events serve as proof that the Chinese growth model is broken.

The slowdown in Chinese economic activity is not a new story – Chinese authorities have, for some time, drummed home the message that this is merely part of China's 'old-to-new' economic transition. However, a number of cracks have started emerge in China's economy in recent years. The credit-driven growth model has seen China's debt levels spiral, heightening the country's credit risk. At the same time, substantial capital outflows and falling capital reserves have combined to put pressure on China's currency and undermine confidence in the equity market. The question many are now asking is: are we headed for a hard landing?

HARD OR SOFT? THE OUTLOOK FOR GROWTH

While China's economy continues to grow at a relatively fast pace, it has recently started to show some vulnerability. This is largely due to the fact that, since the global financial crisis, growth in China has been driven by rising leverage. In response to the crisis, authorities were quick to provide credit stimulus. However, once the immediate threat passed, the stimulus was not withdrawn, allowing credit-to-GDP levels to rise to historically unprecedented highs. Where we have seen anything like this level of credit expansion in history, it has ended badly for the country involved. Unsurprisingly, this is heightening fears that the Chinese economy may be heading for a crash. Ultimately, the likelihood of this happening will be influenced by two main risk factors: what is the risk of a financial crisis and what is the risk of a sharp economic slowdown?

Financial crisis? Ensuring liquidity is the key

China is still a relatively closed system - as long as a degree of control over capital outflows is maintained, policymakers will have the flexibility to provide bail-out funds as needed and so prevent a run on the system. In the past, financial crises have usually been triggered by problems with liquidity. If the central bank can ensure continual liquidity, then the risk of a financial crisis is modest, in our view. However, history shows us that the cost of maintaining this kind of strategy invariably leads to a period of lower growth once the credit expansion cools off. China may not be able to avoid a similar fate, but getting to that point is likely to be a slow process, with policymakers drawing on a range of measures in order to spread the adjustment out over time.

Sharp economic slowdown? Not while cyclical forces are still working

Credit remains very important in terms of driving the cyclical outlook in China. Even though the structural outlook remains weak, credit can still work through channels like housing. Historically there has been a reasonably good correlation between the housing market and credit growth in China, but this has weakened in the latter stages of the current cycle. We saw a big acceleration in credit that started in late 2015, but only in the last few months have we seen housing construction start to pick up in China. Many questions are being asked about whether there is an over investment bubble in China. The answer is: maybe, depending upon which city you look at but, at a national level, there still appears to be clear demand for housing in China – inventory is being visibly digested in the major cities, to a point where levels are low enough for construction to commence again.

This suggests that the cyclical forces in China are still working. The issue, however, is that every time we go through a cycle, growth is ratcheting down a notch; initially from 10% to 8%, and more recently from 7% to 6%. It seems reasonable to expect that this pattern will be maintained moving forward, with growth steadily moving downwards.

A QUESTION OF CURRENCY

The small devaluation of the renminbi in August 2015, triggered by massive capital outflows, sent shockwaves through global markets, and brought into question the ongoing stability of the currency. While the pressure eased, it returned in January and early February 2016. With this in mind, it is important to understand what has driven the vast outflows we have seen over the past year. Is it due to Chinese companies paying back liabilities to foreigners and unwinding the carry trade, or is it being driven by Chinese residents collectively withdrawing their money? In truth, it is a

CHINA'S SHADOW BANKING SYSTEM – MIRACLE OR MENACE?

China's shadow banking system has been a unique feature of the country's credit boom. There has been a great deal of negativity around the development of shadow banking, but it helps to take a step back and consider what China's financial system was like prior to the global financial crisis. Essentially it was very bank-centric system, dominated by a handful of large, state-owned banks, supported by a network of provincial banks. It was also a system where deposit and lending rates were controlled. The initial function of the shadow banking sector in China was to provide investors with an alternative to the banks in order to earn extra yield. However, the shadow banking system quickly took on a life of its own, expanding exponentially and without appropriate oversight. Banks started to abuse it, using it as a means of getting around capital adequacy rules by moving loans off-balance sheet. Over time, the products and structures have become increasingly complex and opaque, with growing instances of bad loans and increasing levels of risk.

That's the dark side of the shadow banking system. The more benign side is the development of a more mature financial industry like that of the developed world, and a solid step towards financial liberalisation. China's shadow banking system is effectively providing access to money market products made up of a pool of assets with low default risk and which offer a higher yield than is available from the traditional banking sector. Some are now being offered through online platforms, making them easy to invest in.

Despite the negativity surrounding shadow banking, it is quite difficult to actually separate the good from the bad. Should it be viewed as a relatively benign form of financial market liberalisation and development, or as something opaque and largely unchecked and which is spreading throughout the economy?

combination of the two. As far as companies' paying back liabilities goes, these will eventually taper off and the situation will stabilise. However, if Chinese residents are withdrawing their money because they are worried about the outlook, then the outflows could continue for some time, putting ongoing pressure on the exchange rate. Roughly half of the total outflows are being driven by liability repayments and half by Chinese residents buying assets abroad. What is significant here is that, in the past, the outflows from Chinese residents has always been covered by China's current-account surplus and foreign direct investment (FDI) inflows. This situation has recently changed, however, with these outflows no longer fully offset by the current account and FDI inflows.

We expect the outflows from Chinese residents to stay fairly steady at the current levels and somewhat above the level of current account and FDI inflows. This means that there will likely be a moderate, but ongoing, draw on Chinese reserves (around $10-$20 billion a month) from here on. With $3.2 trillion in reserves currently, authorities don't need to panic yet. We think that reserves would need to fall to around $2 trillion before there would be any cause for concern in terms of reserve adequacy.

WHAT INFLUENCE IS CHINA ON THE ASIAN REGION TODAY?

What does all this mean for the rest of Asia? China has been hugely significant in shaping the global economy in recent decades, and more recently it is reshaping Asian trade networks and economies. The typical paradigm for Asian economies is that they are small and highly dependent on external demand and export competitiveness. The trade slump that we have seen over the past two years actually began four years ago for Asia, when export growth ground to 0% in 2012, before starting to contract aggressively in 2015. A principal driver of this has been growing competitive pressure from China, which is hurting Asian export bases. Not only is China moving up the technology value-added chain and competing in spaces that Korea, for example, was taking over 10 to 20 years ago, but China is also starting to onshore a lot of its production chain. The traditional Asia trade involves a long production chain, with components being manufactured in certain countries, before being shipped to other countries where more value is added, with the last stop usually being China, where final assembly takes place before shipping to developing countries. We are now seeing a lot of these fragmented parts of the process being integrated and brought home to China, and this is hurting the rest of Asia.

Meanwhile, China's influence is also apparent in the significant credit expansion seen in Asia since 2009. In response to the global financial crisis, all the Asian countries followed China's lead by letting domestic credit expand rapidly as a way to support domestic demand. Hong Kong, Singapore, Thailand, Malaysia and Korea – all have seen a massive credit expansion. This is significant as, from these levels, it is going to be hard to keep growing credit, leading to a modest outlook for Asian domestic demand growth going forward.

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