

Diagnosing Chinese Economy

- China that follows Japan's failure?

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My storyline

1. Current state of Chinese economy

- Two speed economy (“new economy” and “old economy”)
- Maintaining growth by old fashioned stimulus is poisonous

2. The aftermath of investment bubble

- Over debt is worrisome, but immediate hard landing is unlikely, rather, it seems to follow Japan’s previous course

3. The future prospect (short/mid/long term)

- Weak economy will last for a decade (balance sheet recession)
- Improving TFP through supply side reform is the midterm key
- Fiscal sustainability & demography are the long term concerns

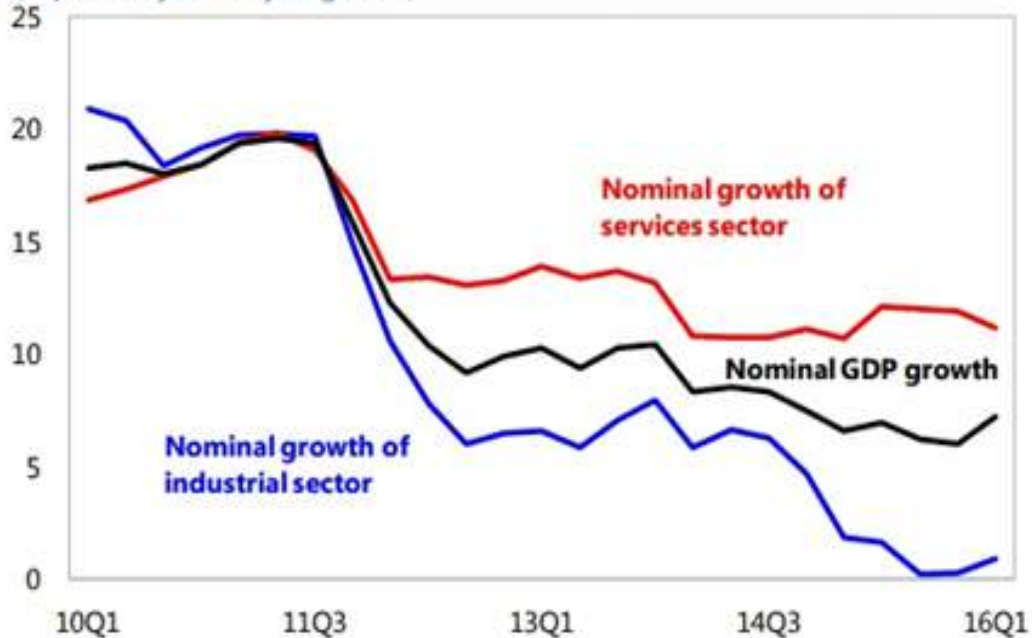
4. Other issue

- Currency: countering capital outflow, global impact worrisome
- One Belt One Road, AIIB, FTA
- MY reading of Xi Jinping’s politics

“Two speed economy”: fast growing service sector and deteriorating manufacturing sector

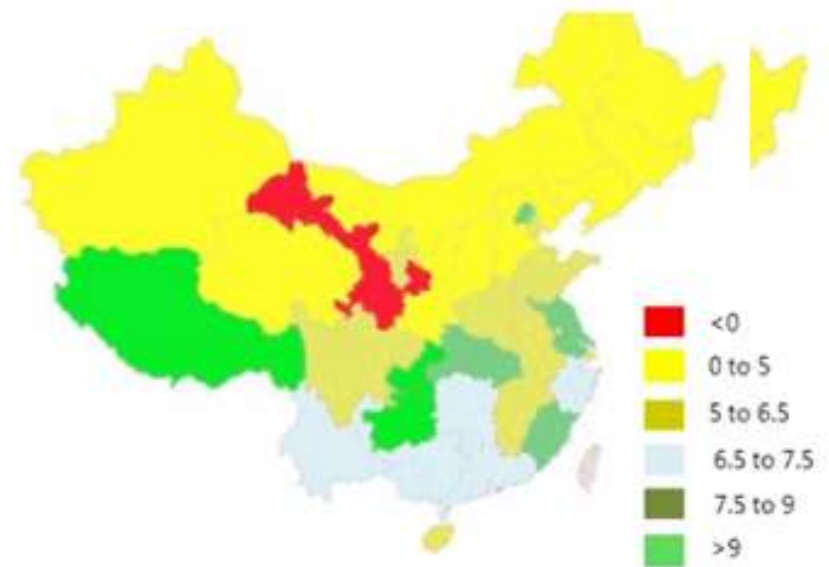
Two-speed Economy

(In percent, year-on-year growth)



Wide Regional Growth Disparity

(In percent, year-on-year growth, 2015)



Source: 2016 IMF Article IV Consultation Report on China

IMF also argues that overcapacity sectors/regions are already experiencing ‘Hard landing’.

Not all is unhopeful in Chinese economy: “New economy” is growing fast



Tmall: a subsidiary of Alibaba World's largest retailer with annualGMV \$485 billion



Alipay : a subsidiary of Alibaba One of the largest Fintec srvice provoder



DIDI (滴滴打车) a Uber like Chinese Company

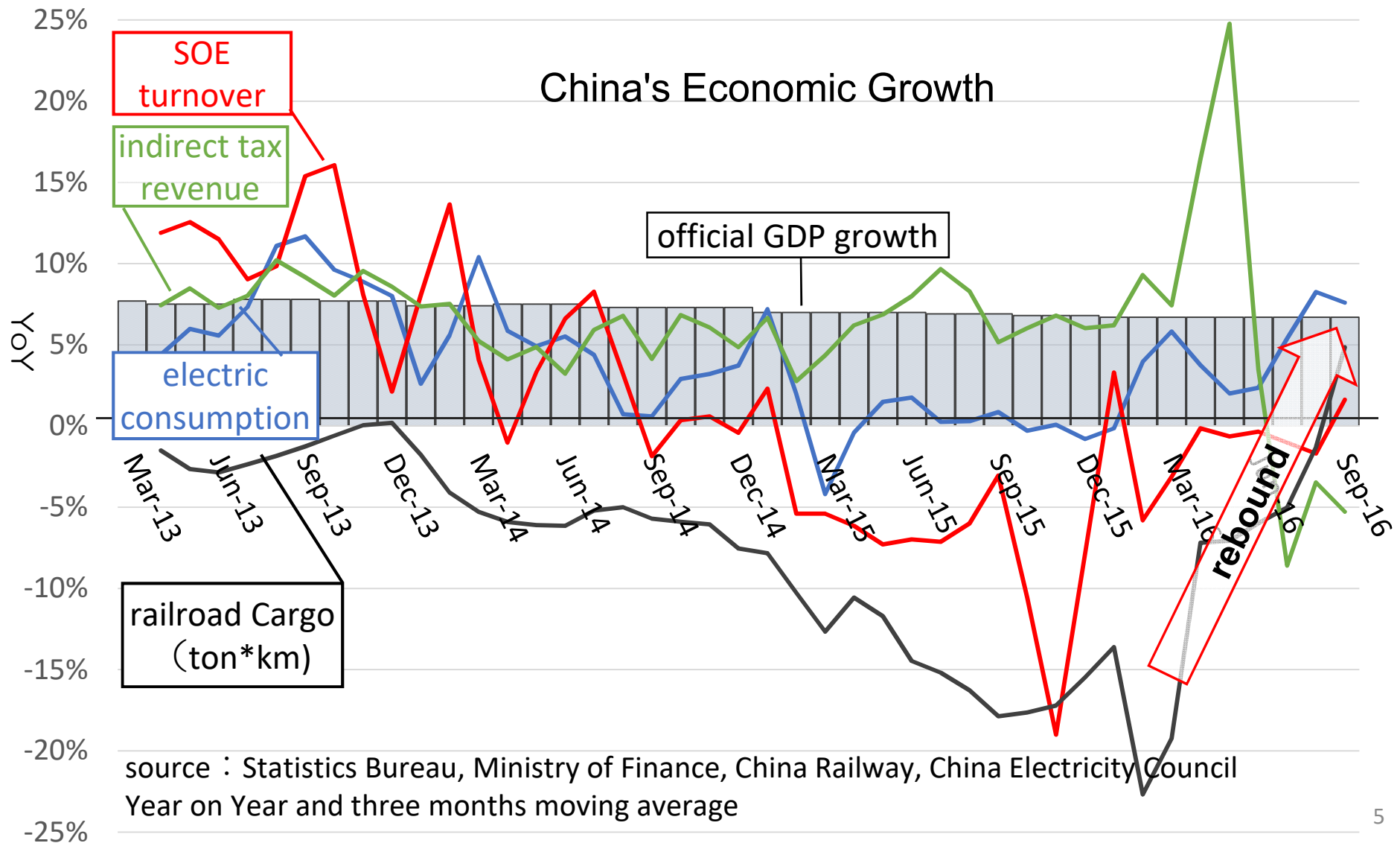


Huawei : an ICT device manufacturer, ICT service provide Solution provider with annual turnover \$ 60billion



DJI: a consumer drone manufacturer with global share of 70%

Another Stimulus made Economy rebound in 2016 1st half : Not a good news



A policy discord in the administration?

Sharp criticism against Li Keqiang and his State Council by an "authoritative insider"

1. 1st quarter's "Stable growth" was mere a result of an **old fashioned debt-fueled stimulus**
2. 'U-shaped' or 'V-shaped' recovery is unlikely, rather **we should be ready for 'L-shaped' path that last for years**
3. Main agenda must be to propel 'supply side reform', demand stimulus must not exceed requisite minimum

The "authoritative insider" is supposed to be **Liu He**, Xi's economic brain (FELSG Office)

But recently Xi himself seems to incline to maintaining growth (through investment)

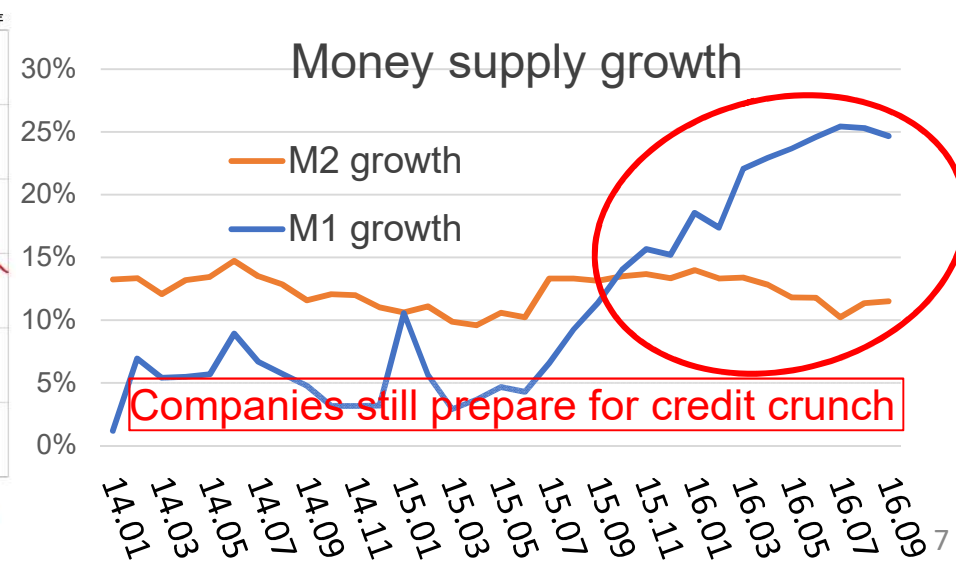
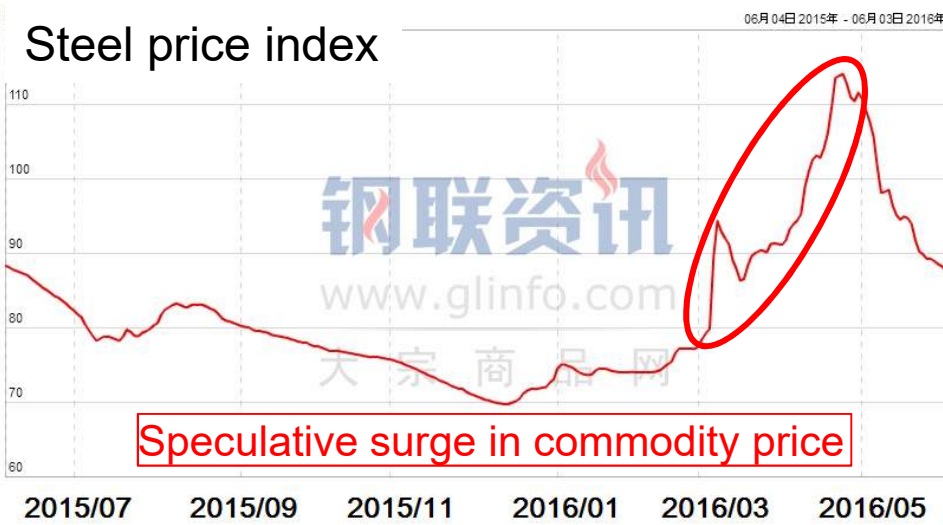
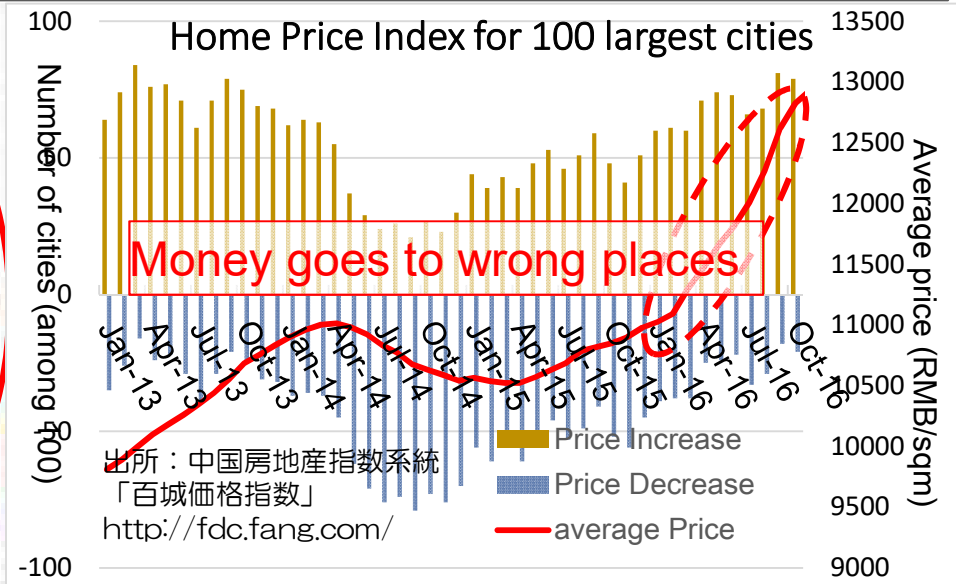
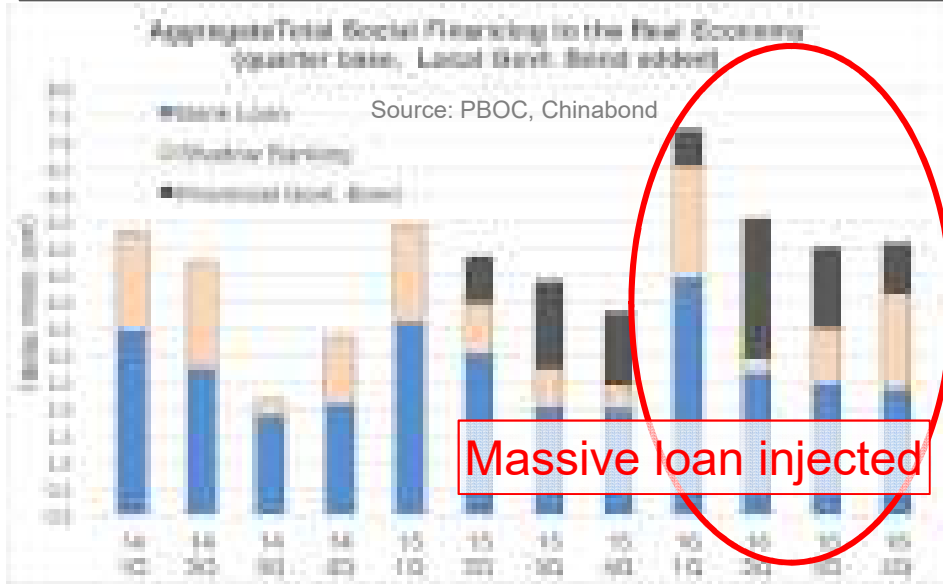
- Before: supply side reform = top priority
- After: stable growth is the key to propel supply side reform

Hint: CCP top personnel reshuffle is coming close (2017 fall)



Why the rebound was not a good news?

-- Old fashioned, debt fueled, public infrastructure dependent



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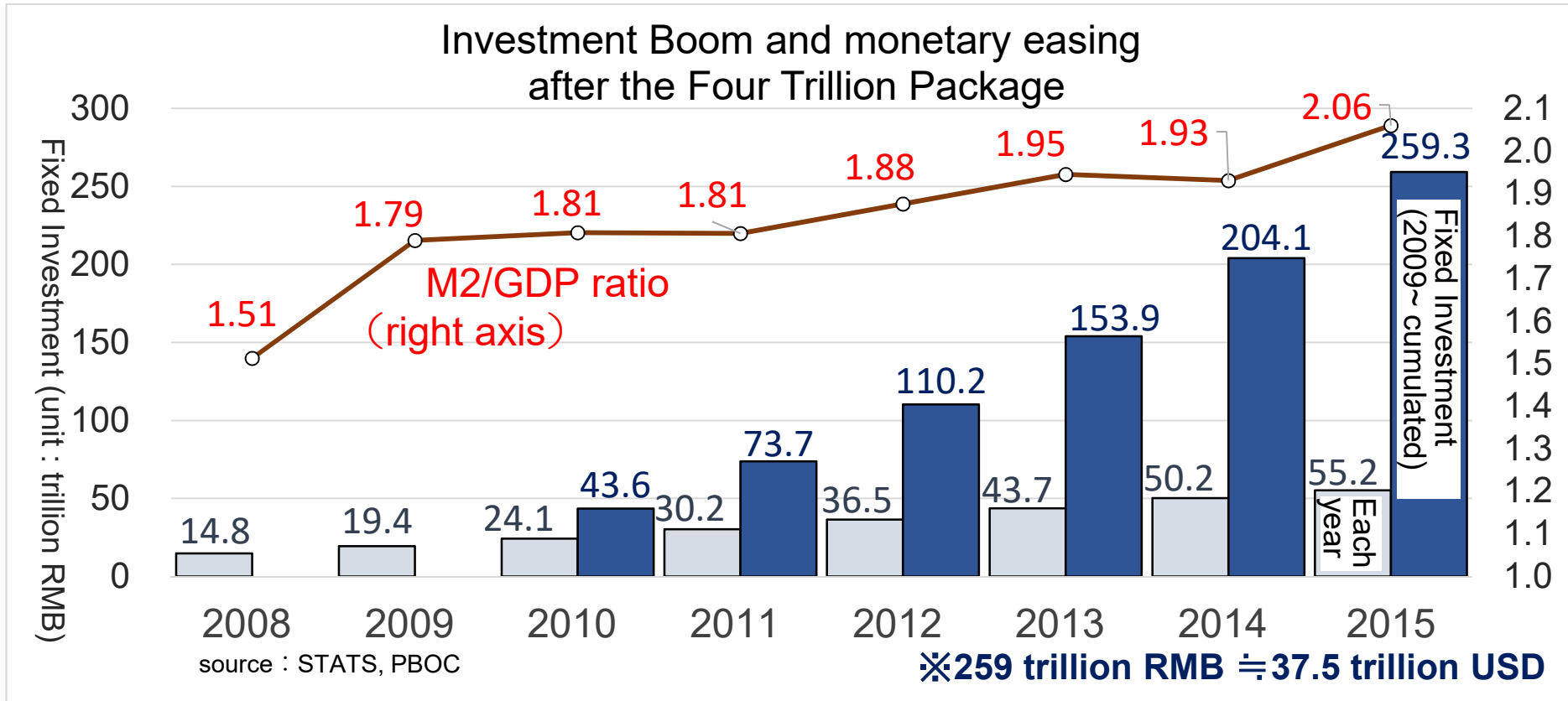
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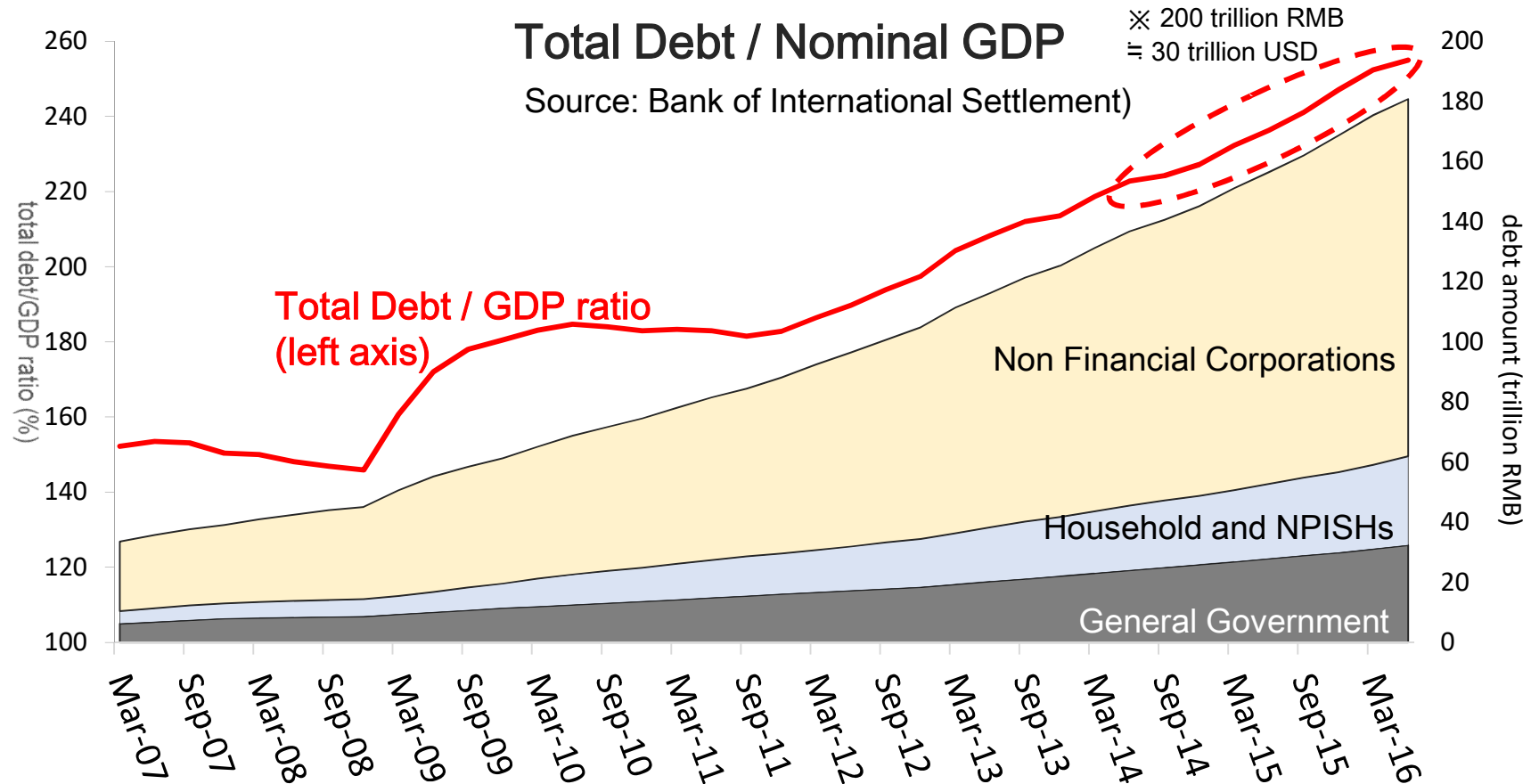
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investment bubble: too much investments have been done since 2009 (after global crisis)



Over capacities in industries, dead stocks in real estate sector, inefficient public infrastructure...Massive amount of **non-performing “assets”** were cumulated and **eroded the national Balance Sheet**. So is the case on the liability side. Massive **non-performing debts** were cumulated on the B/S

The Government aims at **deleveraging** (“New Normal”), but doesn’t do well



The Debt/GDP ratio continues to rise due to:

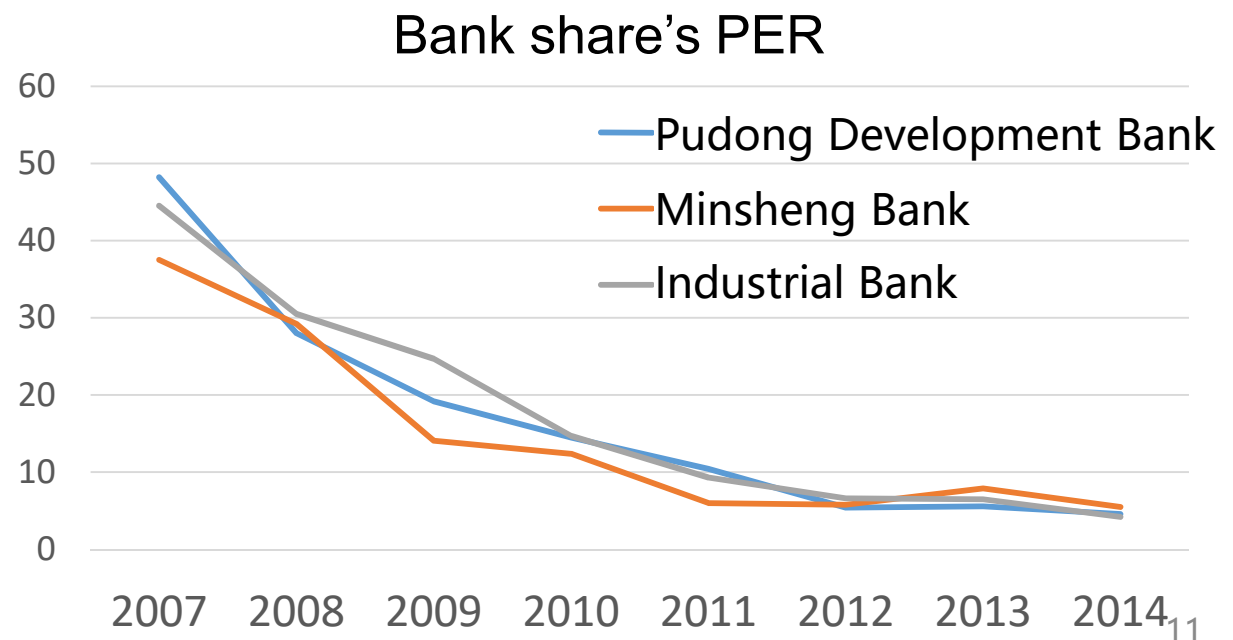
1. Slow down of GDP growth (denominator)
2. Debt redemption is slow, “zombie” can’t even pay interests (numerator)

Ballooning non-performing loan: the aftermath of the investment bubble

- Bank's NPL ratio is still 1.8%, but in wider definition comes close to 7%. Private institution's estimate is even higher
- If 5% of Banks' outstanding corporate-loan (70 trillion RMB) can't be paid back, more than half of their capital will be blown out
- Banks' share prices suggests that erosion is already happening

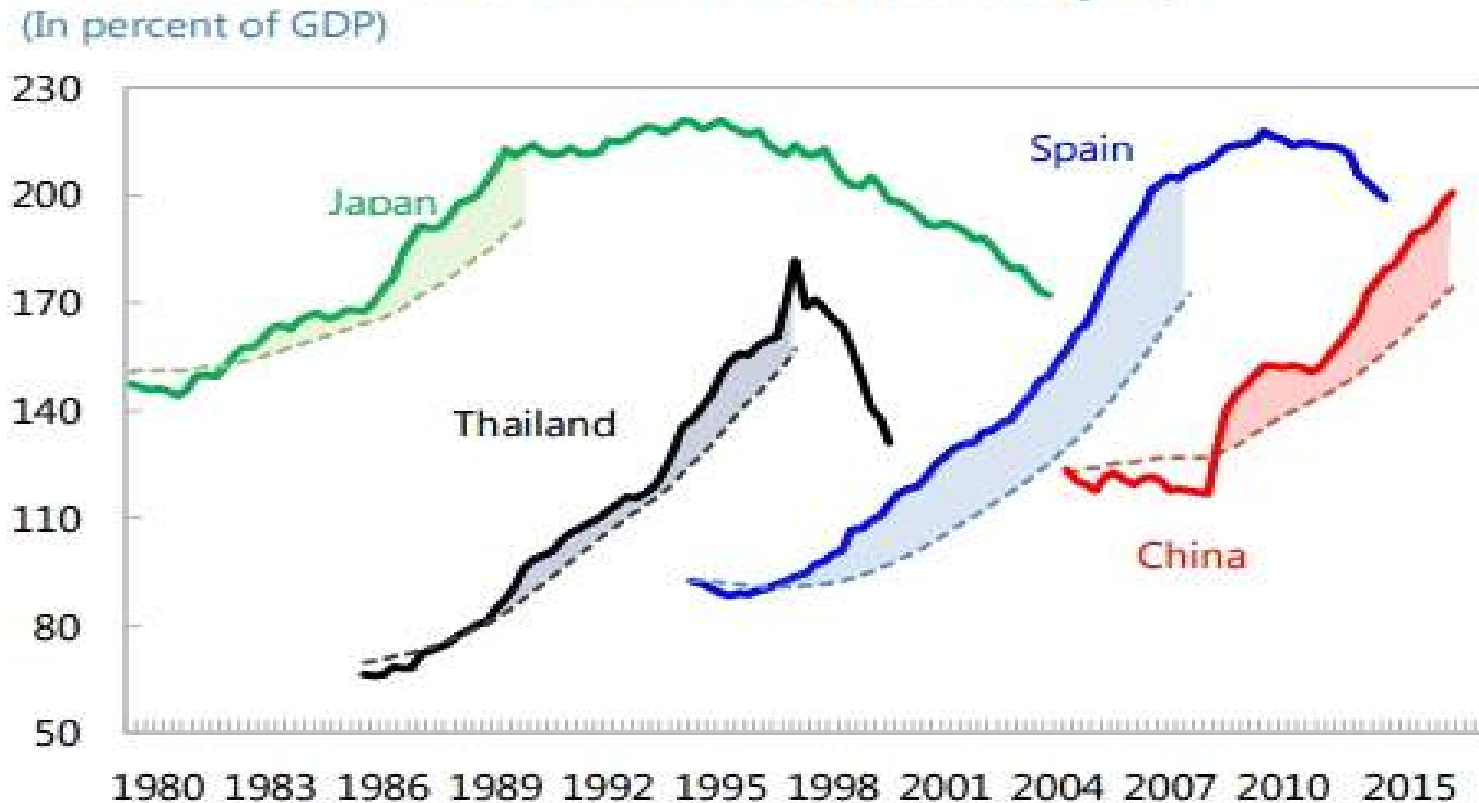
Sector	Averaged PER
IT	68
Raw Material	56
Pharmaceutical	48
Telecom	46
Consumption	33
Industry	31
Energy	30
Selective consumption	29
Public Utility Industry	15
Real Estate	21
Automobile	15
Insurance	14
Conglomerated Finance	12
Bank	6

Source : China Securities Index Co.,Ltd 2016/8/3



“China’s over debt” became a global concern

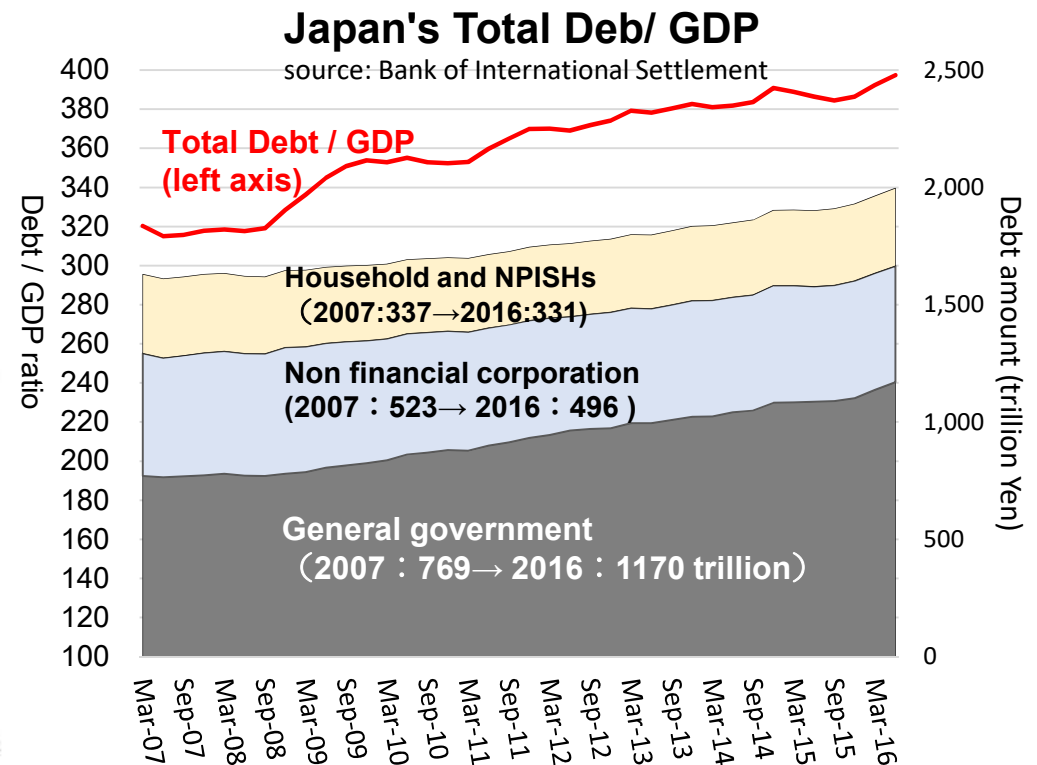
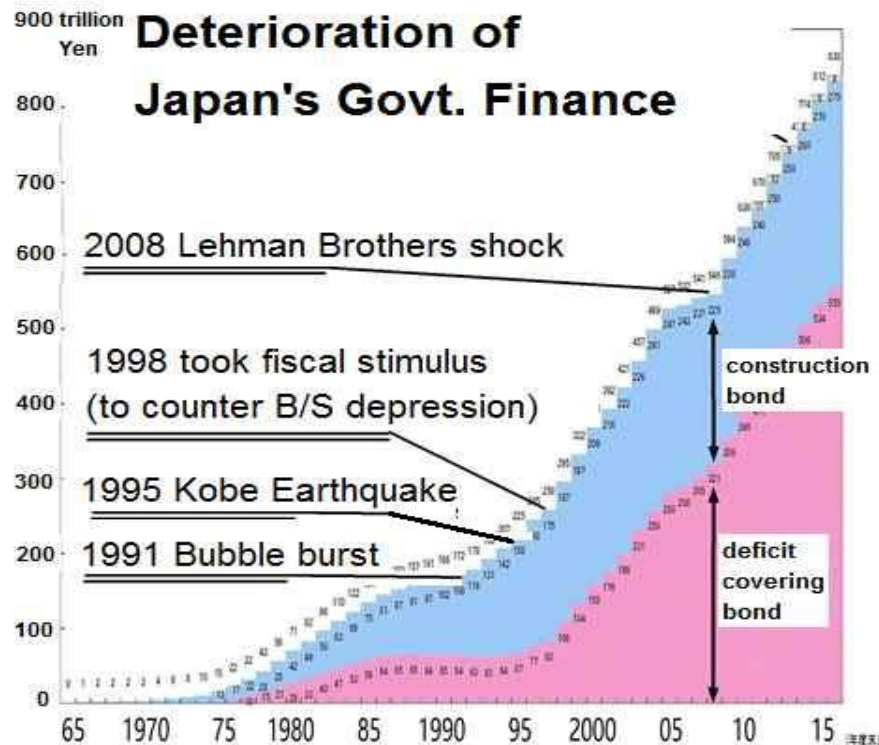
IMF: Fast credit growth may lead to a hard landing



Sources: Bank for International Settlements (BIS); and IMF staff estimates.

But there is a bit different view based on Japan’s experience:

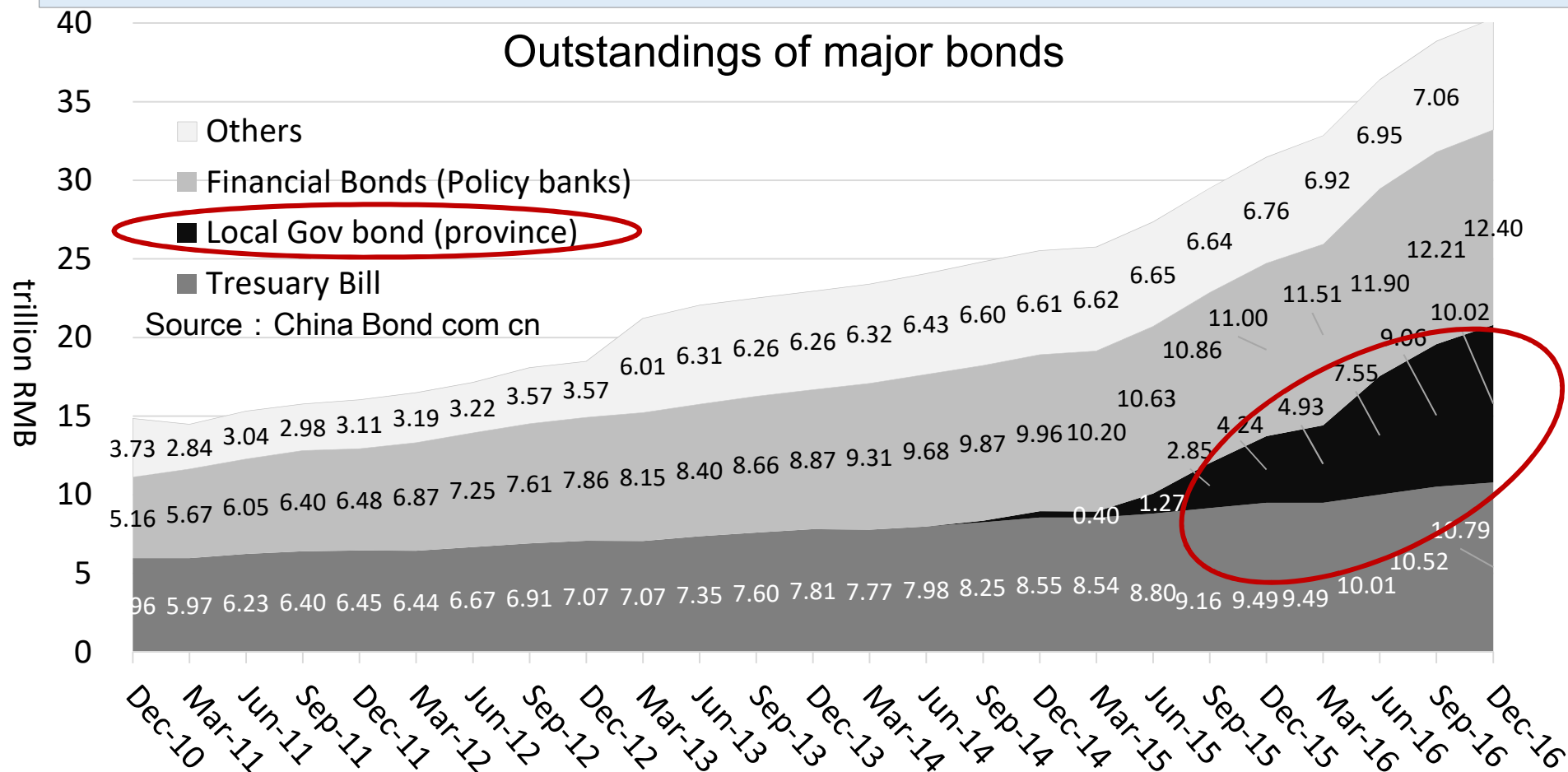
Japan's lesson : debt-driven stimulus; temporarily sustainable if borne by the Central Government; but should not exceed bounds;



The reasons why Japan has yet fallen into financial crisis;

- (1) Debts are concentrated onto the (most resilient) central Govt.
- (2) Interest rate has maintained almost 0% for two decades

Financial reform : The burden of stimulus are already going to be shifted to the upper Govts.



Funding needs of local Govts. (Prefectural level or below) are gathered and met by the upper Provincial Govts' local bond issuance
 Their outstanding amounts will soon surpass the central Govt. bond

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What's wrong with the Current policy?

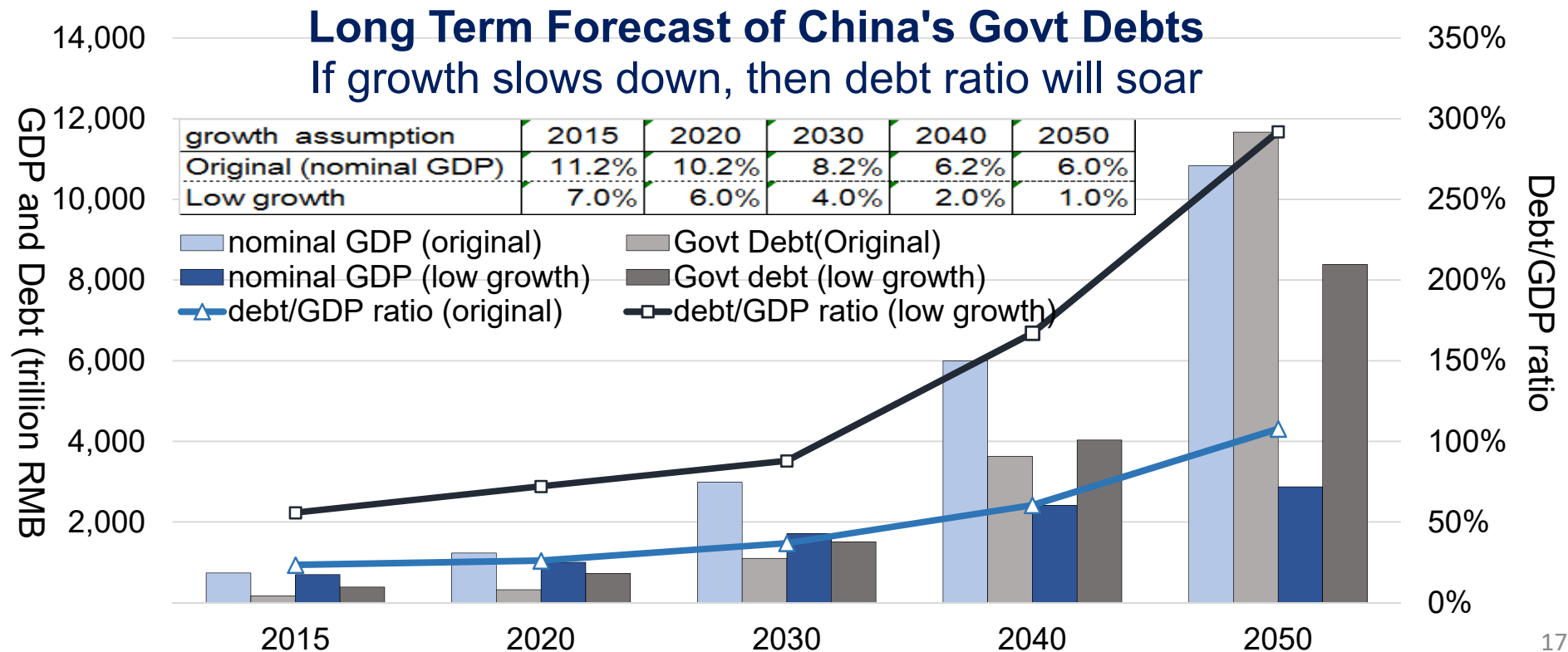
The bubble aftermath is not taken into account

- Fast growing **new economy** may grow by **3~5%**, Deteriorated **old economy** may face **minus growth**, => Without policy stimulus, the aggregated growth rate would be 0~3%
- Suffering minus/zero growth in the post bubble decade is quite natural, thanks to the new economy's growth, China can expect a bit higher growth is her fortune
- The “**New Normal**” trajectory (7.5%=>7.0%=>6.5%) is OK if it talks about the **potential growth**, but China actually means to realize 6.5% growth by way of stimulus, it is too high as IMF warns.
- So the question is the extent of allowable policy stimulus by the Govt.

Fiscal Deficit : level is already very high the ultimate risk of Chinese economy

- IMF says Consolidated fiscal deficit may reach 8~10% of GDP in 2016

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
IMF's forecast of GDP growth	9.5	7.9	7.8	7.3	6.9	6.6	6.2	6.0	6.0	5.9	5.8
Central Govt. deficit (Official Statistics)	-0.1	-0.7	-0.8	-0.9	-2.7	-3.0	-3.1	-2.9	-2.9	-2.8	-2.7
IMF's (narrow) Estimate of consolidated Government Deficit	-6.0	-5.1	-7.6	-7.2	-7.8	-8.4	-8.2	-7.8	-7.8	-7.0	-6.6
IMF's (broadest) Estimate of consolidated Government Deficit	-8.2	-7.8	-10.3	-9.8	-9.5	-10.1	-9.8	-9.3	-9.3	-8.4	-8.0



The midterm prospect depends on how the reform can improve TFP

【Macro economy】

- Need to “deleverage” and cure the wounded national balance sheet
- “New normal” is right in direction, but “6.5% growth” is too high
- Current debt-driven stimulus: don’t follow Japan’s failure

【Micro economy (≡ supply side reform)】

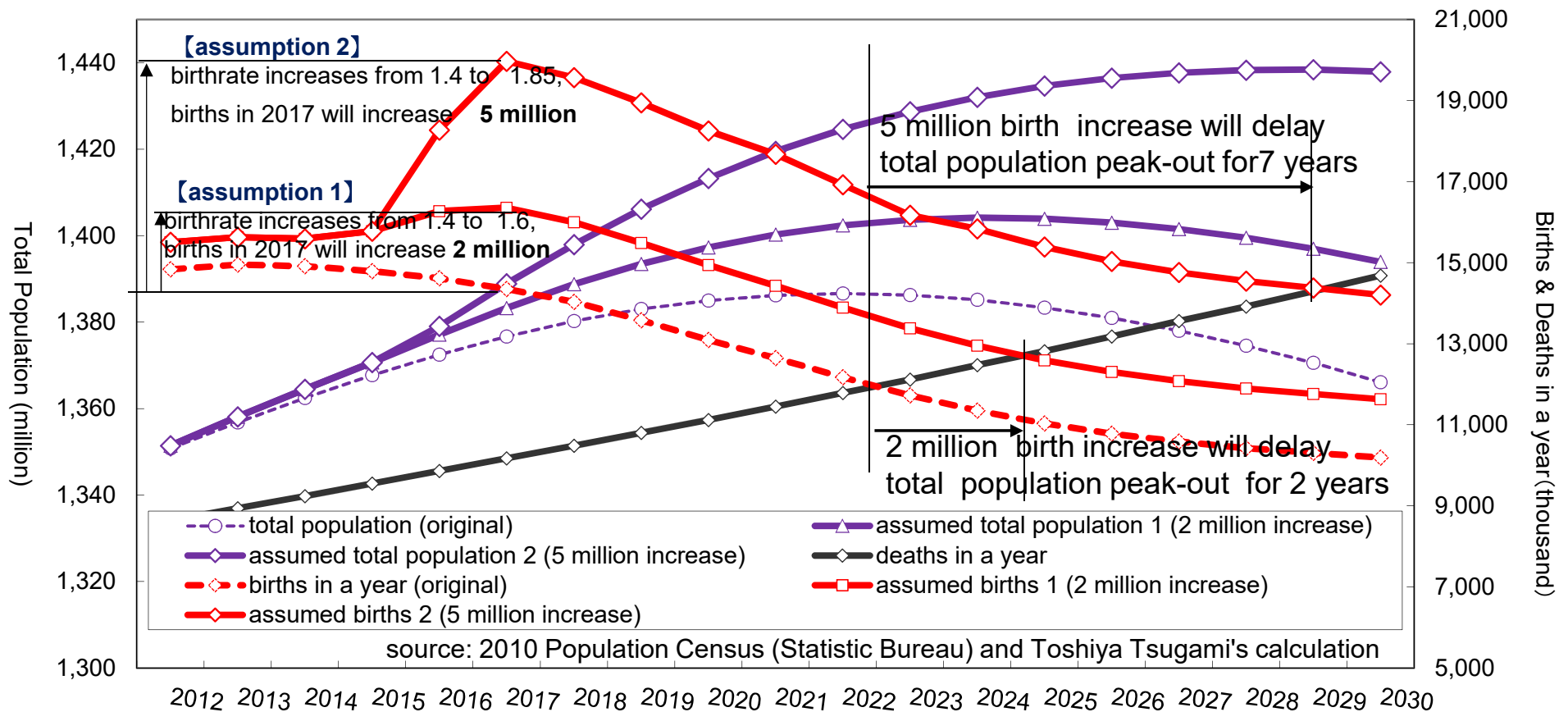
- Grow **New Economy ABAP**
- Restructure **Old and wounded Economy AFAP**
- The above two should go in tandem, but the latter one is difficult

【Up date】

- The reform is lagging, as CCP personnel reshuffle coming close
- Then the question is whether it can be resumed in 2018?

The long term prospect : demography

“One child policy” deregulation will not have a major impact
If there is a major impact, it will bring about another problem



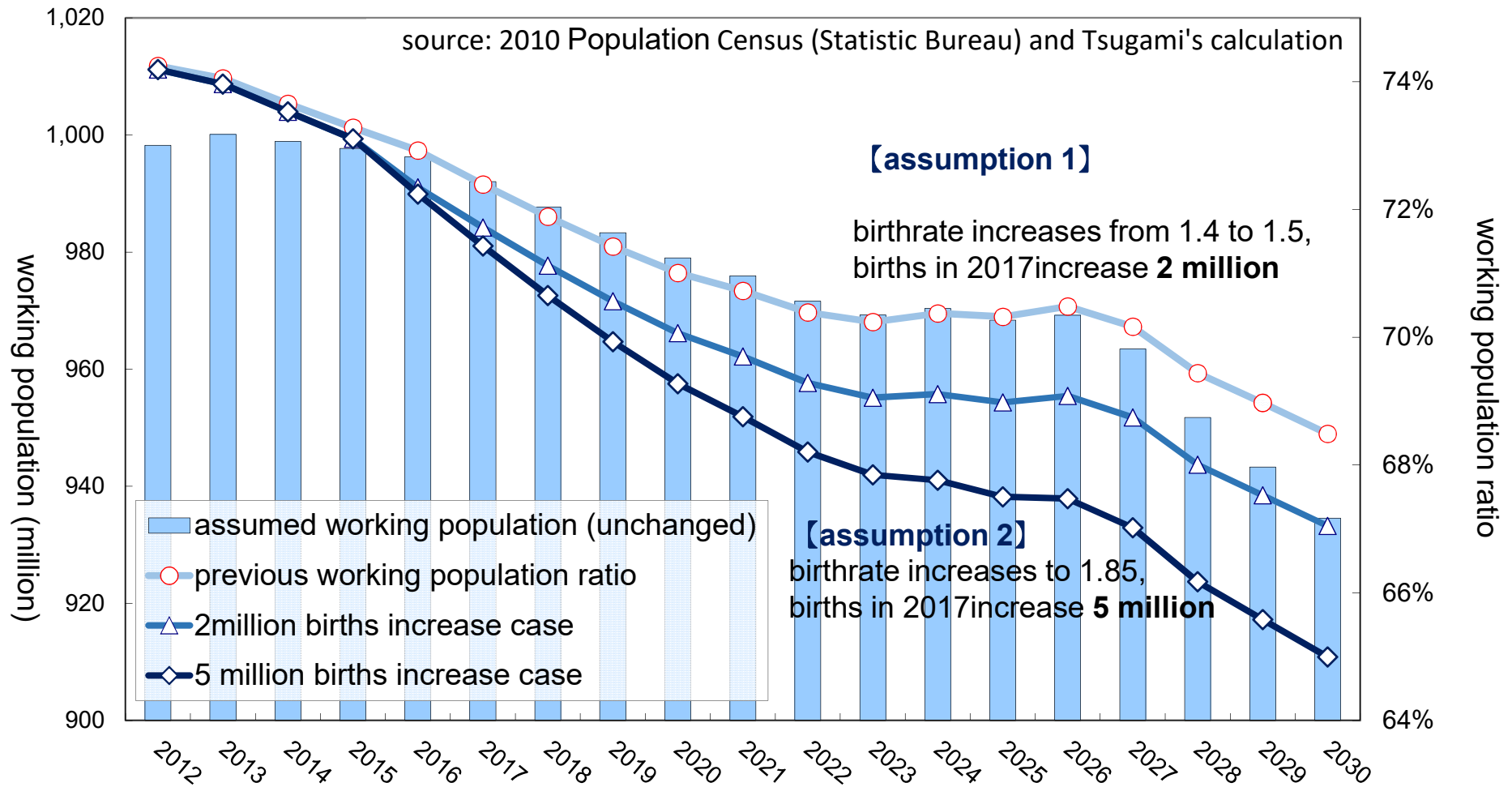
Assume that previous birth rate (TFP) as 1.4 and;

[assumption 1] birthrate increases from 1.4 to 1.6 and births in 2017 increases **2 million**, then it will delay total population peak out for 2 years at 1.404 billion

[assumption 2] birthrate increases from 1.4 to 1.85 and births in 2017 increase **5 million**, then it will delay total population peak out for 7 years at 1.438 billion

Prospect of Future Working Population

Rapid birth increase will toll future economic growth



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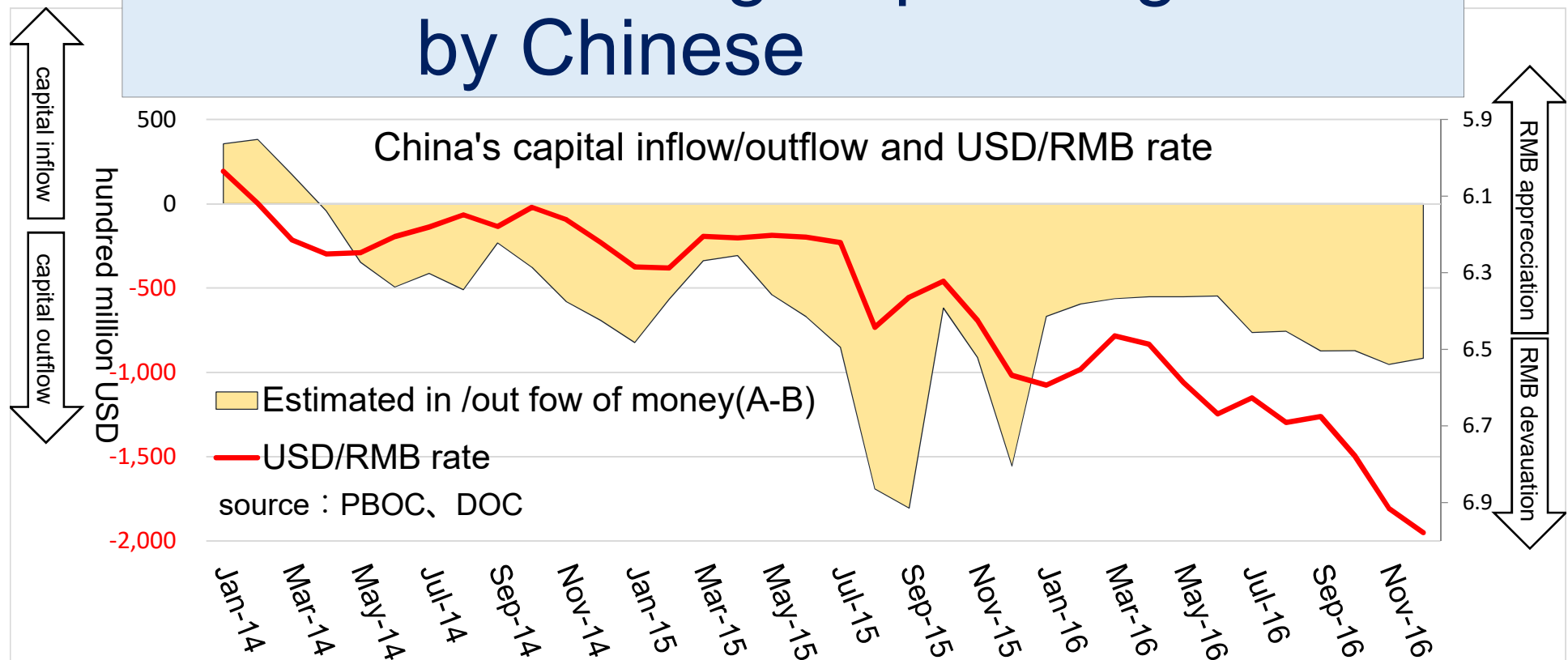
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RMB : combating capital flight done by Chinese

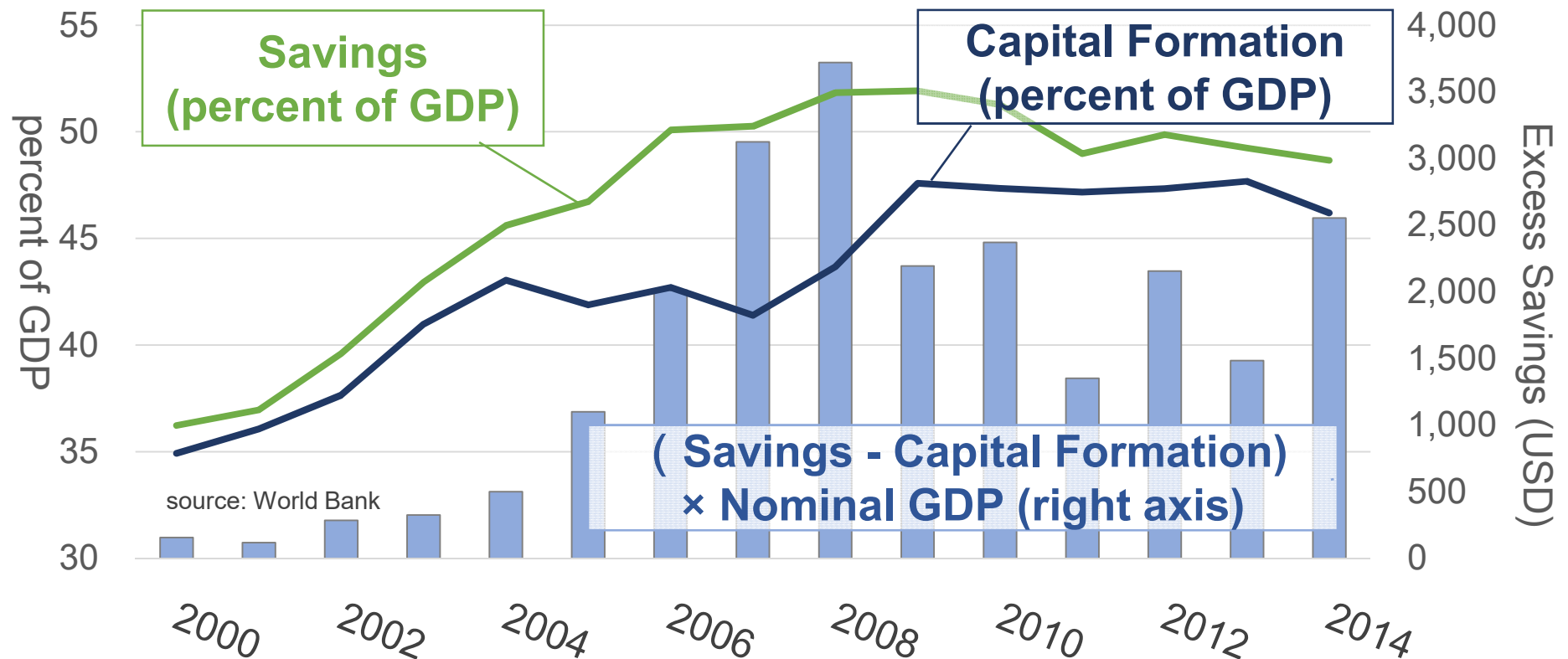


- Chinese have lost confidence for their economy, try to convert RMB assets into USD's, also various forms of speculation have been tried
- The government faces an uphill battle in combating "Capital flight", although it strengthened restriction on capital transaction, it still continues market intervention to prevent RMB from fast devaluation
- **Once China fails to keep currency rate stability, its shock wave may hit global economy**

What is the problem?

“excess debt” or “excess savings”?

Savings, Capital Formation and Excess Savings



- **Sudden and large export of excess savings from China would jeopardize world economy** (through sudden fall of RMB and/or China’s foreign reserve): Brad Sater (US CFR)

One Belt One Road: becomes much more “prudent” than two years ago

- The projects that the **Silk Road Fund** has invested so far;
 - ① Pakistan BOT hydro power plant (co-investment with IFC)
 - ② Acquisition of Italian  (co-investment with ChemChina)
 - ③ Joint establishment of industry fund with Kazakhstan Govt. (investment for cooperation on “production capacity”)
 - ④ Acquisition of 10% share of Russian LNG company (NOVATEK’s Yamal project)
- Current position seems “**cautiously choose bankable projects**” much “**prudent**” than two years ago when we first heard => **Why?**
- **strong antipathy and resentment in the public sentiment** has been growing against Xi’s massive foreign aid commitments
- Most of **the stuff came from the central bank**, who are sensitive about non performing projects

Asian Infrastructure Investment Bank (AIIB): A good partner of the WB/ ADB?

- With European participation, **AIIB was substantially upgraded**
With Canadian participation, **member countries will reach 90**
- **Collaboration with World Bank and Asian Development Bank**
 - The two banks seem actively offer AIIB chances of collaboration
 - For the time being, **more than 2/3 of AIIB's lending will be joint lending with WB or ADB**, through which AIIB can cumulate experience and track records
 - The two banks can also be benefited from the collaborations with AIIB by **mitigating their undercapitalization** (kind of “resuming leverage”),
This might be a way of **peaceful co-existence**
- Can AIIB really become an “international development Bank”?
It is still **unknown**, but so long as China go along with **internationally recognized order and customary**, there is a good chance for that

Politics: my reading of Xi Jinping Administration

1. Xi administration can be compared with a **broad coalition among CCP's various factions**, whose only common agenda is "**Save the Party in a serious pinch**",
2. Thanks to the coalition, Xi could expeditiously establish a **strong leadership**, on the other hand, he always needs to **keep balance** between various demands among the Party
 - ✓ take reformer's side on the **third Plenum reform**
 - ✓ compromise with the vested interests on **SOE reform** or stimulus
 - ✓ compromise with hardliners (public sentiment?) on **territorial issues**
3. As the **2017 personnel reshuffle** coming close, **Xi Jinping needs to compromise more** with vested interests.
If we witness the resumption of reform under Xi administration, it can only occur after 2017 (another Third Plenum in 2018?)

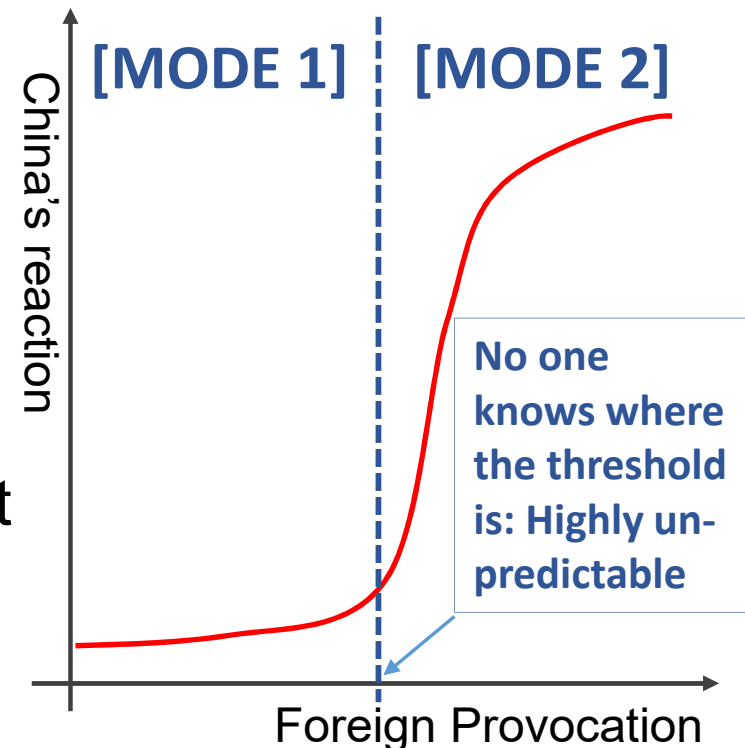
2017: a special year for CPC

somehow like “Election Year” in western countries

- Now it's all about **the personnel reshuffle (PR)** made in autumn
- Xi judges everything based on good/bad for gaining the control of **PR**
- When facing foreign provocation, its reaction function is two folded;

MODE1: Though there arise protests from hardliners, over reaction is viewed as waste of time and resources that are to be devoted to **PR**, so low key response is required and granted

MODE2: As provocation intensifies and the party opinion shifts toward hardliner, elder statesmen collectively warn Xi that not fighting back may risk losing control of **PR**, then the reaction suddenly escalates to the maximum



Xi Jinping @ Davos WEF

a new type of “United Front” tactics?

- Xi Jinping extraordinarily attended WEF in Davos, and advocated the globalization, free trade, environment protection and nuclear abolishment
- A move to fill global leadership role? Rather, it should be viewed as CCP’s traditional **“United Front” tactics** (i.e. In order to counter a strong enemy, **seek common ground** on major issues with other groups while leaving **“minor differences”** aside)
- At the same time, the **“New Type of Great Power Relations” tactics** might have been shelved ?

