Economic Viewpoint

Desjardins Economic Studies
www.desjardins.com/economics

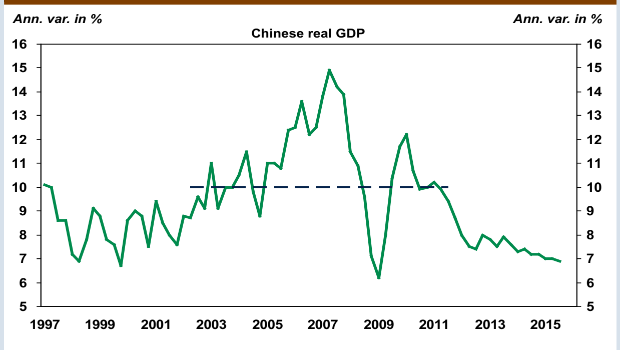
November 2, 2015

The Chinese economy's uncertain future

A development model that has reached its limits

The times in which the Chinese economy grew at a pace greater than 10% a year seem to be over. The country's economic growth has declined in the last few years and is now below 7% (graph 1). This *Economic Viewpoint* examines the deep causes behind the slowdown, causes that are essentially related to the fact that Chinese's development model is showing its age. Reforms seem needed to repair the situation over the long term, but would probably be at the cost of an adjustment period that would temporarily penalize growth. All in all, we do not anticipate any improvement in China's economic situation and uncertainty could remain palpable.

Graph 1 – China's economic growth is slowing

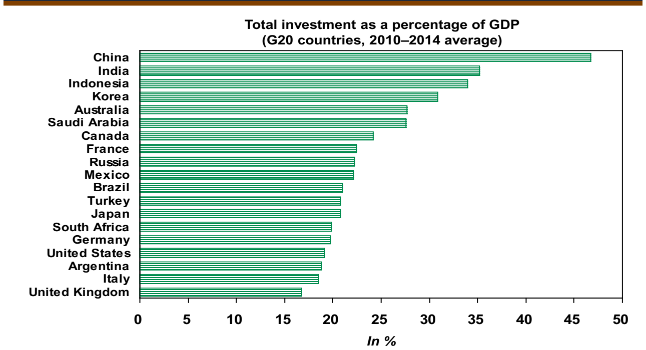


Sources: Datastream and Desjardins, Economic Studies

OVERVIEW OF CHINA'S DEVELOPMENT MODEL

The Chinese economic boom of the last two decades was based on a very particular recipe. Firstly, the economy is very investment heavy. Investment accounts for about 45% of China's GDP, putting the country in top place among the major economic powers (graph 2).

Graph 2 – The weight of investment is much higher in China



Sources: International Monetary Fund and Desjardins, Economic Studies

However, such investment requires substantial financial resources and at the lowest cost possible. China is managing to meet its needs without a net inflow of foreign capital. Instead, it depends on households' strong propensity to save; given the lack of adequate social security measures, households have to shield themselves from life's vagaries and provide income for retirement. Their savings mainly go to the banks, with other investment opportunities quite thin on the ground. China's stock and bond markets remain relatively small and the intense volatility, such as was seen in the stock market last summer, encourages savers to opt for the safety of bank deposits.

Chinese authorities' control over international capital flows makes it easy to capture national savings cheaply. Although the country frequently posted growth rates above 10% between 2002 and 2011, interest rates remained very low during this period, often below inflation (graph 3 on page 2). Control over capital flows limits savers' ability to invest in assets outside the country, where they could get better returns.

François Dupuis
Vice-President and Chief Economist

Hendrix Vachon
Senior Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

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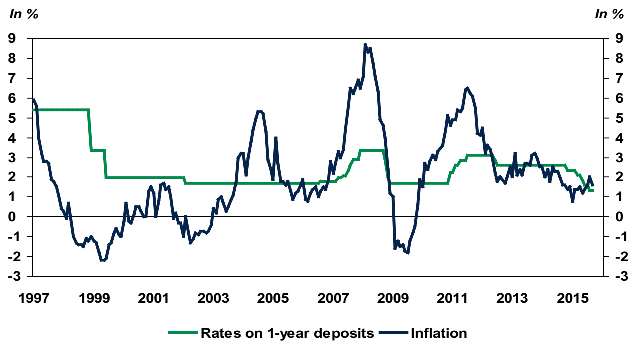
Graph 3 – China is keeping interest rates very low



Sources: Datastream and Desjardins, Economic Studies

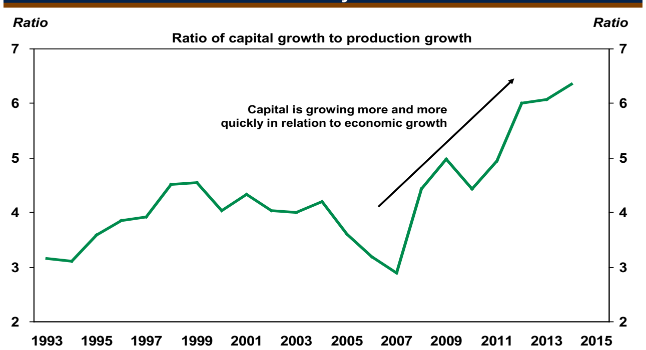
High savings also means more moderate consumption, creating an imbalance with the increase in production capacity boosted by investment. To deal with the situation, China must export some of its production; using a managed exchange rate policy helps it maintain a positive trade balance.

Beyond the mechanisms in place that define the Chinese model, the existence of a large pool of labour has also provided important support for economic growth. So have migratory movements, as the movement of the large rural population to industrialized urban areas improved productivity through a more efficient use of workers.

OVERINVESTMENT IS TESTING THE MODEL'S LIMITS

The model made rapid development possible in China for many years, but this does not mean it is infallible. The signs of that it is running out of steam are proliferating. Among them, the return on investment has declined sharply over the last few years, as can be noted by the change in the incremental capital-output ratio (graph 4). The ratio's increase means that investment is becoming less and less

Graph 4 – In China, investment has become much less efficient in recent years



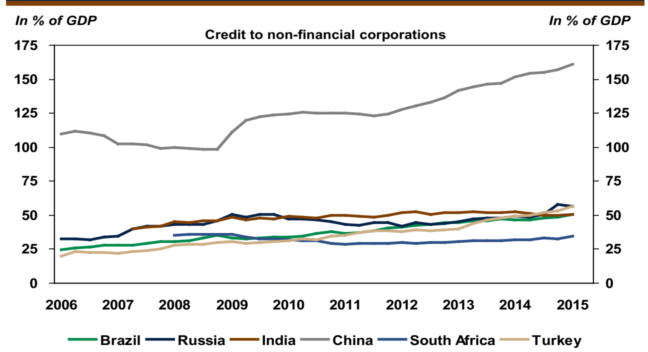
Sources: International Monetary Fund and Desjardins, Economic Studies

efficient at generating economic growth. The phenomenon may seem normal, to a point. Although, in the early stages of a country's development, the first roads, railroads and plants generally pay off handsomely, at one point, the positive impact of adding new infrastructure or production capacity dwindles. The fact that China has very intensive investment both speeds up and magnifies this result, however.

The problem is exacerbated by deficiencies in the funding conduits. Chinese banks, which reap the bulk of the savings, are often directly or indirectly controlled by the government. Political interference makes it hard to ensure that the capital goes to the most profitable projects. The underdevelopment of the bond and stock markets is also an issue.

Another consequence of overinvestment is that it accelerates debt growth. Compared with other major emerging economies, Chinese businesses carry much heavier debt loads (graph 5). This could become especially problematic in a context of declining return on investment. A vicious circle could materialize if, in response to weaker economic growth, the authorities stimulate credit to give even more support to investment; this would, in the end, further reduce the return on investment while increasing debt loads.

Graph 5 – China's businesses have an especially big debt load



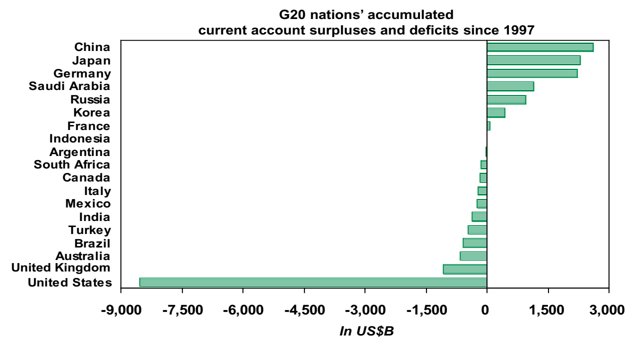
Sources: Bank for International Settlements and Desjardins, Economic Studies

AN EXCHANGE RATE POLICY WITH PERVERSE RESULTS

The exchange rate policy that allows China to maintain a trade surplus also has its limitations. The policy implies that other countries must continuously spend more than they produce; in other words, they have to go into debt. Sooner or later, these countries will have to reduce demand to pay off their loans or at least rein in their debt loads. This would force the countries that are amassing surpluses to find other outlets, particularly local outlets. Since 1997, China has amassed current account surpluses in excess of US$2,600B;

this places it in the lead among G20 nations, after Germany and Japan (graph 6). At the other end of the spectrum, the United States has accumulated total deficits of more than US$8,500B over the same period. If Americans decided to take on less debt in the future, this would necessarily limit the ability of countries like China to maintain trade surpluses.

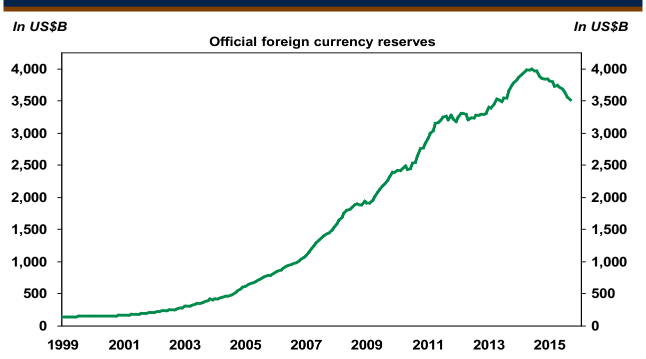
Graph 6 – China is contributing to global imbalances by artificially maintaining a trade surplus



Sources: International Monetary Fund and Desjardins, Economic Studies

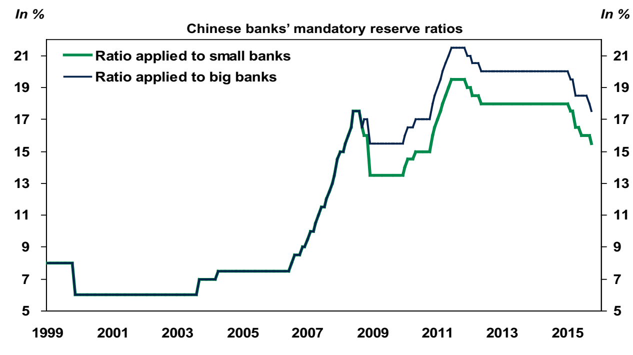
Managing the exchange rate also comes at a price for China's economy. Until 2013, China amassed substantial foreign exchange reserves to curb the yuan's appreciation (graph 7). This strategy has the drawback of increasing the monetary base, which could generate inflation and an appreciation in real terms of the exchange rate. To counter these effects, monetary authorities must sterilize the accumulation of foreign exchange reserves by taking liquidity out of the financial system. The main tool used here is the mandatory reserve ratio, which ratio hit a ceiling of 21.5% in 2011 for the country's major banks (graph 8). However, this strategy affects the banks' profitability and makes them less able to cope with bad debt. Moreover, it encourages banks to cut the interest rates offered to depositors or to increase rates for borrowers. Although the monetary authorities regulate retail rates heavily, the banks have some leeway.

Graph 7 – China has large foreign currency reserves



Sources: Datastream and Desjardins, Economic Studies

Graph 8 – The mandatory reserve ratio has been raised several times to sterilize exchange interventions



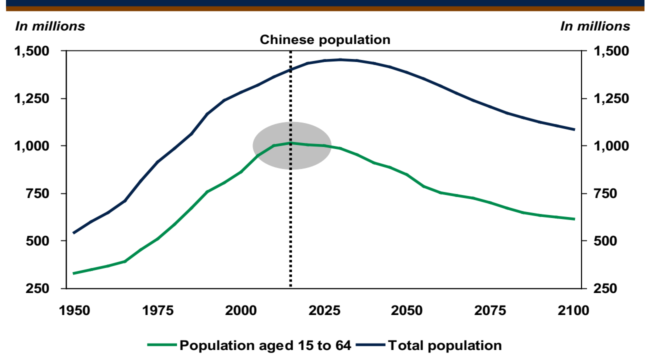
Sources: Datastream and Desjardins, Economic Studies

Given that the Chinese exchange rate is essentially pegged to the U.S. dollar, the greenback's generalized rise since last year has trimmed the yuan's undervaluation considerably. Among other things, this resulted in a reduction in foreign exchange reserves. This does not mean the problem is solved, however. China still has a substantial trade surplus, and the mandatory reserve ratio applied to the banks remains very punishing. Moreover, an eventual drop by the U.S. dollar would probably be enough to make China amass further foreign exchange reserves.

LESS FAVOURABLE DEMOGRAPHICS

The advanced nations are not the only ones undergoing structural changes due to demographics. The one-child policy enforced in China from the end of the 1970s has curbed population growth and the population aged 15 to 64 has already begun to crest (graph 9). Stabilization by this part of the population points to weak growth in the number of workers and, in turn, a drop in China's economic growth potential. The recent end of the one-child policy will not change the situation for the next 15 years.

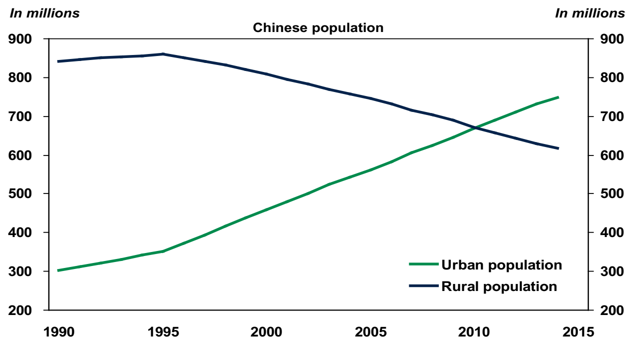
Graph 9 – The 15-to-64 population group is stagnant in China



Sources: United Nations and Desjardins, Economic Studies

Economic growth is still being buoyed by productivity gains, including the gains that stem from population migration to urban areas. Although the urban population became larger than the rural population in 2010 (graph 10), China is still nowhere near the urbanization rate of about 80% that characterizes advanced countries.

Graph 10 – Migration to urban areas continues



Sources: Datastream and Desjardins, Economic Studies

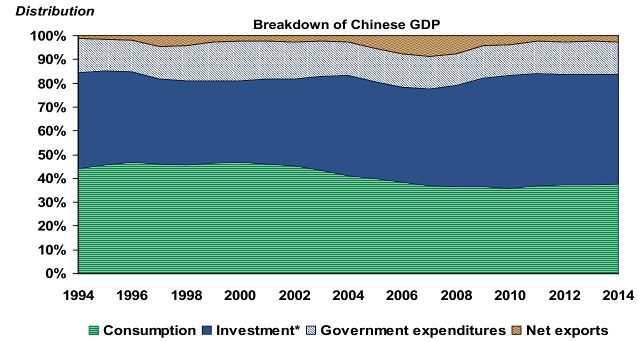
GIVEN SLOWING ECONOMIC GROWTH, REFORMS ARE NEEDED

China's development model is showing clear signs of age. If nothing is done, economic growth could keep eroding. The monetary authorities are piling on the measures, such as interest rate cuts, to stimulate credit, but such actions could be harmful over the long term if all they do is maintain an investment rate that is already too high. Devaluing the exchange rate to increase exports does not seem like a sustainable strategy, either. The solutions should instead target the Chinese economy's structural problems.

To start with, reforming the banking system to make it more competitive and independent from public decision makers would be welcome to improve capital allocation and investment profitability. However, it would still be better to make investment less intensive; this could be done by fostering a greater contribution from consumption. The weight of consumer spending in China's GDP is currently stable at around 40%, but has previously been around 50% (graph 11). Growth that is more dependent on consumption would also lessen the need to maintain a trade surplus, as the increase in domestic demand could replace some of the foreign demand.

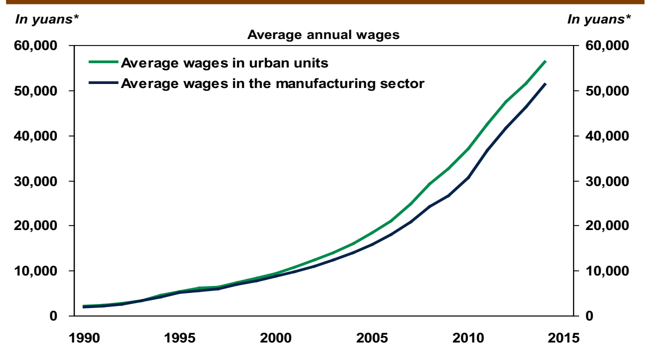
The potential provided by consumption is even greater as Chinese consumers do not generally carry much debt and have seen average wages go up substantially over the last decade (graph 12). Reforms would be needed to capitalize on this potential, however. In particular, developing social

Graph 11 – Consumption's share remains below investment's share, and is not growing much



* Including inventory change.
Sources: Datastream and Desjardins, Economic Studies

Graph 12 – Wages have grown substantially in the last two decades



* 1,000 yuans equals about US$155.
Sources: Datastream and Desjardins, Economic Studies

programs and introducing social security measures could lessen consumers' propensity to save and, in turn, would stimulate consumption. Government spending would also go up.

It would likely take even deeper reforms to maximize the chances for a successful shift to consumption. Developing the bond and stock markets to make them less volatile and more accessible to consumers would help to increase the return on their savings. The resulting wealth effect would stimulate consumption; what's more, these financing channels could improve the allocation of financial resources. Greater liberalization of capital flows would also provide other investment opportunities and contribute to the wealth effect. Lastly, abandoning the managed exchange rate regime would increase consumers' buying power when the yuan appreciates.

There is another side to this coin, however. Many of these reforms create substantial risks to the country's short-term economic and financial stability. In particularly, it would no longer be possible to keep interest rates artificially low for savers who have more investment opportunities. The banking system would have to adjust, becoming more competitive and profitable. Also, higher interest rates and tighter credit for risk loans could be hard for businesses to handle when they are already carrying a lot of debt. Some businesses would probably close, especially in sectors that are being supported by investment, low interest rates, or the managed exchange rate policy. Workers would have to turn to more consumption-oriented industries, where the growth outlook would be better. These adjustments would take time and, in the near term, would result in a higher unemployment rate and a heavier curb on the economy than if few reforms were instituted.

NO PERFECT SCENARIO

Faced with these risks, the decision to reform China's economy is not an easy one, even though it is necessary, in our view, given the long-term gains that would result from it. Moreover, the fact that China has extensive foreign exchange reserves could help it stabilize the capital flow and limit interest rate movements for several quarters or even years. On the other hand, it means that the rest of the world economy would have to absorb a lot of government bonds, which make up the bulk of China's reserves. Successfully transforming China's economy could come hand in hand with a successful effort by advanced nations to reduce their debt loads, failing which the global balance between savings and credit would tip in the direction of higher interest rates.

Given that there is no perfect scenario, Chinese authorities will likely opt to tackle the issue very slowly, to try to mitigate the risks. Banking system reforms and the introduction of social security measures could be the easiest to implement initially. However, dropping controls over capital flows, particularly for Chinese households, and liberalizing the exchange rate could be much harder to put into effect. Clearly, going slowly or even taking only partial action means that it would take longer for the benefits to materialize and, therefore, China's economic growth could continue to decline and approach 6%. As a result, it will be hard for China's authorities to completely rein in uncertainty.

Hendrix Vachon
Senior Economist