Schroders
Economic and Strategy Viewpoint

Craig Botham
Emerging Markets Economist

China: Problems build behind the dam of growth

- China's growth is stable but all the old problems remain, with renewed and persistent renminbi (RMB) weakness beginning to nudge complacent investors back into mild concern. More government stimulus will be needed – and delivered – in 2017, but we expect severe problems before the decade is out.

China: problems build behind the dam of growth

Growth target on track

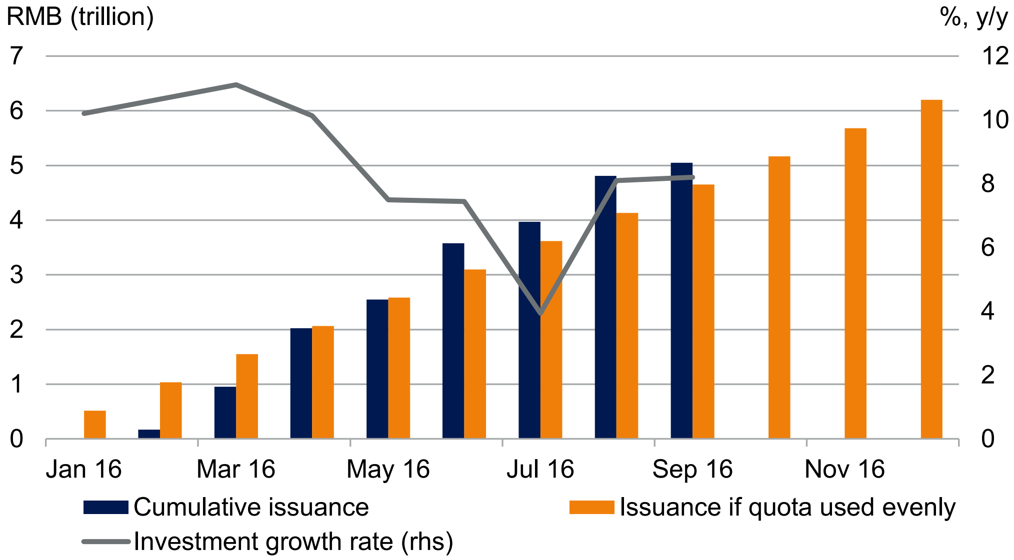
6.7% growth in Q3 means the 6.5% target is safe

Chinese third quarter GDP grew 6.7% year-on-year, in line with expectations, and unchanged from the second quarter. A breakdown of the data reveals an acceleration in primary industry and a smaller increase in the tertiary, or services, sector. Manufacturing managed stable growth. Overall, this is not a promising sign for the rebalancing story, and suggests growth is being maintained at the cost of longer term sustainability.

A look at the higher frequency data helps to illustrate this point. Over the quarter, credit growth barely slowed despite a dip in corporate lending, as mortgages and government municipal bond issuance helped to fill the void.

Yet we are now seeing a crackdown on the property market both through macroprudential tools and, reportedly, the credit channels as the central bank leans on lenders. In tandem, the ability of local governments to support credit growth through municipal bond issuance is waning. A quota ceiling of RMB 6.2 trillion for the year implies a reduction in the average issuance for the final three months of the year, from RMB 600 billion per month to RMB 400 billion.

Chart 10: Municipal bond issuance and investment growth



Source: Thomson Datastream, CFETS, Schroders Economics Group. 25 October 2016.

Government support has helped investment, but debt ceiling looms

When you consider that even with this support, governments have been unable to do more than halt the decline of investment, a softer investment outlook as 2016 closes seems certain.

Part of the problem has been, and remains, weak private sector investment. This growth has taken another step down in the third quarter. A number of challenges face the private sector: overcapacity, lower profits and a higher cost of credit.

The return of producer price inflation to positive territory may help with profitability but the other problems do not look likely to go away. The central bank seems reluctant to ease in the context of a property market bubble and building currency depreciation pressure, and state-owned enterprises (SOEs) continue to weigh on capacity.

In property, which has driven much of the growth this year, September sales continued to surge. Yet despite the booming sales environment, new starts decelerated sharply. That this came even before the majority of restrictions were introduced suggests a further slowdown is likely, which will weigh on fixed asset investment.

Deflating China's housing "bubble"

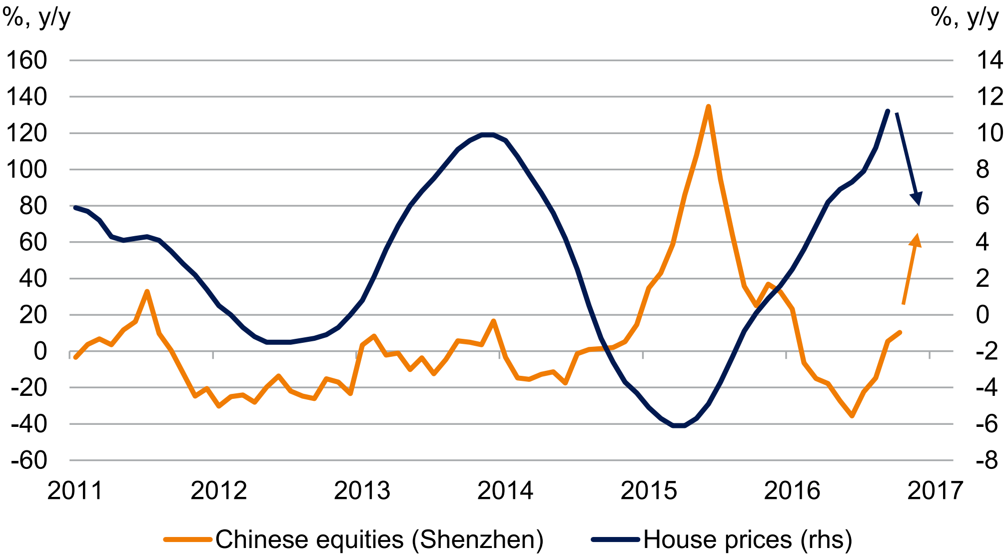
Authorities cracking down on frothy housing markets

So the party is, for now, over. Following a surge in Chinese property prices, 20 cities have now implemented tighter restrictions on house purchases, and the People's Bank of China (PBoC) has reportedly instructed a number of banks to curb their mortgage lending. While September data largely pre-dates the tightening measures, the national statistics agency has taken the unusual step of releasing "flash" mid-October house price data for 15 cities which does show a deceleration.

However, liquidity is not drying up. The central bank does not want to tighten at a macro level because some parts of China have not witnessed anything like the same market surge. Excess inventories remain a problem in lower tier cities, hand in hand with low or zero economic growth. That is, this is not a nationwide housing bubble. Tighter monetary policy would only exacerbate their problems. Consequently, the PBoC taps will remain open, generating more double digit growth in the money supply. That has to go somewhere, but where?

An interesting correlation we saw in China in 2014 and 2015 was the inverse relationship between the stockmarket and the property market. A downturn in the latter coincided with an upswing in the former as the Shanghai-Hong Kong Connect was launched, and central bank issued liquidity was plentiful. Then, as the rally faltered and collapsed in 2015, the property market regained the ascendancy.

Chart 11: The relationship between equities and housing in China



Source: Thomson Datastream, CFETS, Schroders Economics Group. 25 October 2016.

Liquidity whack-a-mole could drive money back to equities

There are reasons to think this is more than a spurious regression at work. Saving options are limited in China, and property still accounts for a large share. With capital controls hindering households' ability to take money out of the country, it is conceivable that the money generated from the equity rally (at one point the index was up 150%, in the space of less than a year) was invested into property. We may now see the opposite, with housing cooling and the returns enjoyed ploughed into an equity market which is about to undergo another liberalisation. The Shenzhen-Hong Kong Connect will provide overseas investors with an opportunity to buy "new China" stocks, very different to the SOE-dominated Shanghai index.

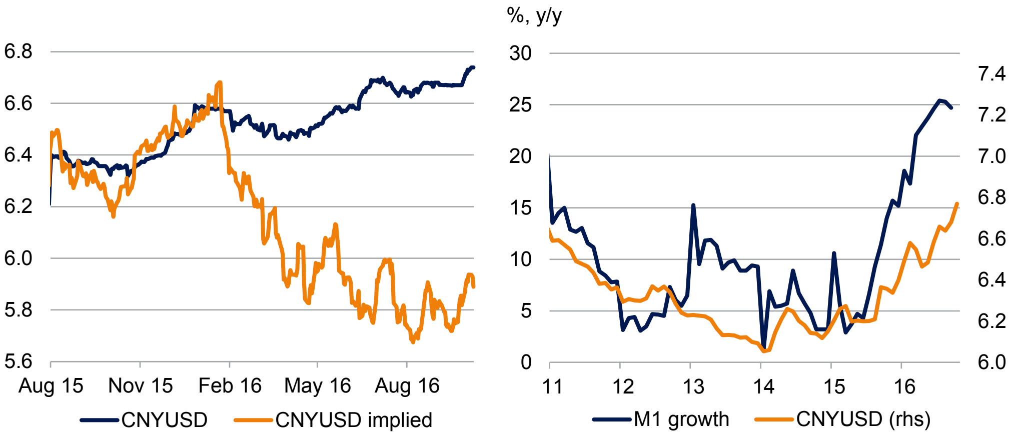
There have already been reports that property developers have begun to invest their recent windfalls into the financial markets. Elsewhere, the use of debt for equity swaps as a solution to the debt problems plaguing Chinese industry provide a strong incentive for the government to support the equity market, both through jawboning and through intervention. The confluence of factors: property money looking for a new home, the Shenzhen Connect drawing foreign money in, continued PBoC liquidity, and government desire for a successful debt swap programme, could prove very supportive for the Chinese equity market.

If not equities, then out of China?

Capital flows and dollar strength weigh on the RMB

An alternative, of course, is that the money does not stay in China at all. We have seen the RMB weaken consistently over the month, now at its weakest in six years versus the US dollar. It might be said that this reflects a stronger dollar, given that the trade weighted basket has also weakened considerably against the US currency. However, data on domestic clients' purchases of dollars from commercial banks in September were nearly three times their August level, at $28 billion, suggesting a significant increase in domestic outflows. We would also highlight a correlation we have mentioned before, which suggests a growing level of corporate deposits (reflected in ever growing M1) puts pressure on the exchange rate.

Chart 12: Is CNY behaviour driven by the dollar or domestic pressure?



Source: Thomson Datastream, CFETS, Schroders Economics Group. 25 October 2016.

FX weakness constrains monetary policy options

We have not seen big falls in the headline reserves number for a while, but that they continue to decline in the face of trade surpluses also suggests there are considerable capital outflows still occurring. If a growth slowdown occurs whilst the authorities are allowing currency depreciation, we are likely to see greater pressure on the currency and on the reserves backstop. It is possible that the authorities are taking advantage of the relative calm in markets to depreciate now, ahead of the domestic economy slowing and the Fed tightening, to avoid having its hand forced later.

In this environment, the PBoC will likely be reluctant to contemplate any significant easing, such as a reserve requirement ratio (RRR) cut, particularly with a US rate hike on the horizon. The additional pressure on the exchange rate would be unwelcome.

Leveraging to the hilt

A painful resolution to the debt burden

The continued growth of credit, above and beyond growth in nominal GDP, means that the credit-to-GDP ratio continues to increase, and the economy is ever more leveraged. This is not a new story, but following recent client requests we thought an update on our views might be helpful.

looms, but not yet

We are firmly of the opinion that the debt build up is a problem. While it is true that at the moment the banks have adequate funding for the lending thanks to the high savings rate (the system's loan-to-deposit ratio is less than 100%), this is not a permanent situation. The loan-to-deposit ratio has been climbing over time and will continue to do so as long as credit growth exceeds nominal GDP growth. Some smaller banks have already seen these ratios reach 120 – 130%. A ratio of over 100% means that banks are funding loans from wholesale financing and/or overseas financing. When the banking system as a whole reaches this kind of level, the country becomes much more susceptible to a crisis of the kind seen in other emerging market economies. Extrapolation is always dangerous, but at the current rate of credit growth China will hit those levels in around three years, from today's 90% ratio.

Most recently there was a paper[1] from the IMF focusing on the debt burden in the corporate sector, which has accounted for the bulk of the credit accumulation. This noted that out of 43 economies where credit-to-GDP grew at a rate of more than 30% in five years, 38 had a financial crisis and/or a strong growth slowdown in the five years that followed. The probability of a negative outcome rose if the credit boom lasted longer than six years and started at a high level of financial depth, as in China.

So to us the question is not whether this is a problem, but rather how it will manifest. Will China blow up and suffer a hard landing, or will it experience something more akin to Japan – decades of very slow growth and an economy replete with zombie firms and banks. We think at this point it is too early to say as we don't know what the policy reaction will be when the tipping point comes, That said, it should be noted that China will still enjoy higher growth potential than Japan did at the time of its crisis, which mitigates the risk somewhat. We should get a clearer idea after the 19th Party Congress in November next year, when the policy objectives for the next five years will be set.

Slower growth ahead, more stimulus in 2017

We have listed a few reasons to think growth will decelerate for the rest of 2016: the property market policy tightening; fiscal constraints; a central bank reluctant to ease. One final reason to expect something of a slowdown in the final quarter is simply that the government can afford it. GDP growth so far this year has been comfortably above the 6.5% target, such that even 6% growth in the final quarter would see the government deliver.

Consequently, policymakers may prefer to keep their remaining powder dry in the fourth quarter, saving their firepower for 2017 to ensure strong growth ahead of the 19th Party Congress. Statements from President Xi on the importance of fiscal policy, and on the importance of state control of SOEs, suggest to us that market reforms are taking a definite back seat to growth for the time being, regardless of the long term costs. Growth should largely meet its target this year and in 2017, but the longer term picture is deteriorating.

[1] Maliszewski et al, *"Resolving China's Corporate Debt Problem"*, IMF Working Paper 16/203.

Schroder Economics Group: Views at a glance

Macro summary – November 2016

Key points

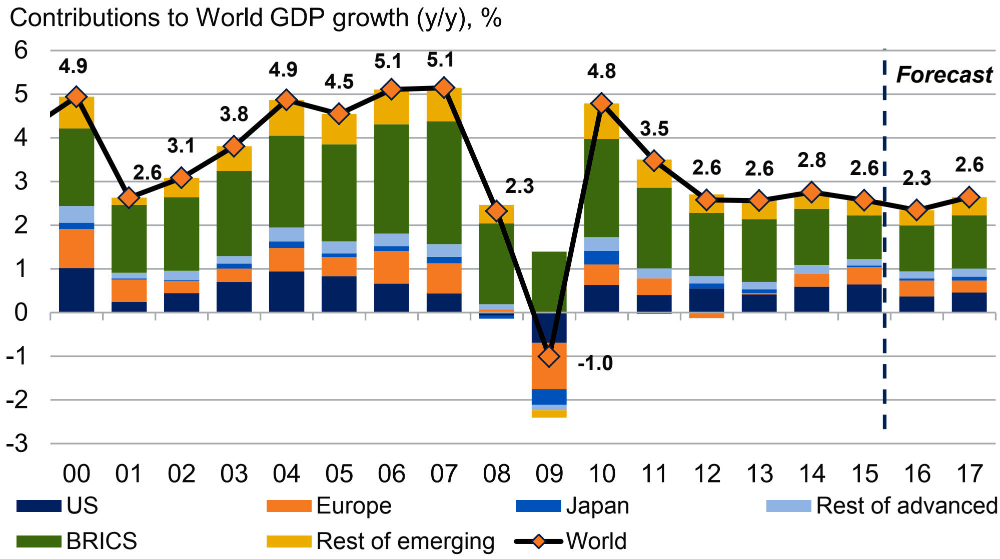
Baseline

- We have trimmed our global growth forecast at 2.3% for 2016 as a result of downgrades to the US and Europe. For 2017, our forecasts are little changed, with growth strengthening modestly as a result of more stable emerging market activity. Global inflation rises modestly as a result of the recovery in oil prices.
- The US Fed is expected to raise rates in December by 25 bps, so taking fed funds to 0.75% by end year. With inflation rising, further rate increases are expected in 2017 to 1.25% by end year, with the Fed moving cautiously on concerns about its impact on the rest of the world and the strength of domestic recovery.
- UK to slow following Brexit vote. The initial shock will cause business investment to fall, eventually leading to lower employment and wage growth. By 2017, the household sector will also feel the impact, but the economy narrowly avoids recession. The pound has fallen sharply which will result in higher inflation, but there are further downside risks to the currency. The BoE cut rates in August, and is likely to cut again to 0.1% in November. QE has also been expanded, but the BoE may need to extend purchases until the end of 2017 despite pressure from the government.
- Eurozone recovery continues in 2016, but at a marginally slower pace owing to the Brexit shock. It is likely to slow further in 2017 as inflation starts to rise, eating into the real disposable income of households. Inflation is still too low, and so the ECB is to cut rates further with the deposit rate falling to -0.5% by the end of the year where it stays through 2017. QE is likely to be extended to the end of 2017.
- Japanese growth now forecast at 0.7% this year and inflation at -0.1%. Following the strengthening of the yen, the BoJ cuts rates, but is unlikely to add more QE over the forecast period. Easier fiscal policy provides a temporary boost to growth in 2016and early 2017. Emerging economies benefit from modest advanced economy demand growth and firmer commodity prices, but tighter US monetary policy weighs on activity. Concerns over China's growth to persist, further fiscal support and easing from the PBoC is expected.

Risks

- Risks skewed towards weaker growth on fears of secular stagnation, Brexit impact on Europe and a US recession. Inflationary risks stem from an increase in tariffs on trade, a significant wage acceleration in the US, or a global push toward reflation by policymakers.

Chart: World GDP forecast



Source: Thomson Datastream, Schroders Economics Group, August 2016 forecast. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2015	2016	Prev.	Consensus	2017	Prev.	Consensus
World	100	2.6	2.3 ↓	(2.5)	2.4	2.6	(2.6)	2.7
Advanced*	62.9	1.9	1.5 ↓	(1.7)	1.5	1.6 ↑	(1.5)	1.7
US	24.9	2.6	1.5 ↓	(2.0)	1.5	1.8 ↑	(1.7)	2.2
Eurozone	19.2	1.6	1.5 ↓	(1.6)	1.6	1.3	(1.3)	1.3
Germany	5.5	1.4	1.7 ↓	(1.8)	1.8	1.7	(1.7)	1.3
UK	4.2	2.2	1.7 ↑	(1.6)	1.9	0.6 ↓	(0.8)	0.9
Japan	6.6	0.6	0.7 ↑	(0.6)	0.6	1.4 ↑	(0.9)	0.9
Total Emerging**	37.1	3.6	3.8	(3.8)	3.8	4.4	(4.4)	4.4
BRICs	23.8	4.2	4.4	(4.4)	4.5	5.1	(5.1)	5.2
China	14.8	6.9	6.4	(6.4)	6.6	6.2	(6.2)	6.3

Inflation CPI

y/y%	Wt (%)	2015	2016	Prev.	Consensus	2017	Prev.	Consensus
World	100	1.8	2.2	(2.2)	1.9	2.5	(2.5)	2.4
Advanced*	62.9	0.2	0.9 ↓	(1.0)	0.7	1.7 ↓	(1.8)	1.7
US	24.9	0.1	1.5 ↓	(1.7)	1.3	2.3 ↑	(2.1)	2.3
Eurozone	19.2	0.0	0.3 ↓	(0.6)	0.2	1.0 ↓	(1.4)	1.3
Germany	5.5	0.1	0.5	(0.5)	0.4	1.7	(1.7)	1.5
UK	4.2	0.0	1.0 ↓	(1.2)	0.7	2.6 ↑	(2.5)	2.3
Japan	6.6	0.8	-0.1	(-0.1)	-0.2	1.2 ↑	(0.8)	0.4
Total Emerging**	37.1	4.4	4.4 ↑	(4.3)	4.1	3.8 ↑	(3.7)	3.5
BRICs	23.8	4.5	4.0 ↑	(3.9)	3.6	3.5 ↑	(3.4)	3.1
China	14.8	1.4	2.0 ↓	(2.2)	1.9	2.0	(2.0)	1.9

Interest rates

% (Month of Dec)	Current	2015	2016	Prev.	Market	2017	Prev.	Market
US	0.50	0.50	0.75	(0.75)	0.96	1.25	(1.25)	1.16
UK	0.25	0.50	0.10 ↓	(0.25)	0.41	0.10 ↓	(0.25)	0.50
Eurozone (Refi)	0.00	0.05	0.00	(0.00)	-0.31	0.00	(0.00)	0.50
Eurozone (Depo)	-0.40	-0.30	-0.50	-		-0.50		
Japan	-0.10	0.10	-0.30 ↓	(-0.10)	0.05	-0.40 ↓	(-0.10)	0.00
China	4.35	4.35	3.50	(3.50)	-	3.00	(3.00)	-

Other monetary policy

(Over year or by Dec)	Current	2015	2016	Prev.		2017	Prev.
US QE ($Bn)	4466	4487	4475 ↓	(4496)		4493 ↓	(4514)
EZ QE (€Bn)	203	652	1552 ↑	(1548)		2512 ↑	(1788)
UK QE (£Bn)	375	375	438 ↑	(375)		565 ↑	(375)
JP QE (¥Tn)	433	383	453 ↑	(438)		493 ↑	(478)
China RRR (%)	17.00	17.50	15.00	15.00		13.00	13.00

Key variables

FX (Month of Dec)	Current	2015	2016	Prev.	Y/Y(%)	2017	Prev.	Y/Y(%)
USD/GBP	1.22	1.47	1.25	(1.25)	-15.2	1.20 ↓	(1.25)	-4.0
USD/EUR	1.09	1.09	1.06	(1.06)	-2.4	1.04 ↓	(1.06)	-1.9
JPY/USD	104.4	120.3	100	(100)	-16.9	105 ↓	(110)	5.0
GBP/EUR	0.89	0.74	0.85	(0.85)	15.1	0.87 ↑	(0.85)	2.2
RMB/USD	6.77	6.49	6.85	(6.85)	5.5	7.15	(7.15)	4.4
Commodities (over year)								
Brent Crude	50.4	52.7	43.4 ↓	(46.1)	-17.7	47.5 ↓	(51.5)	9.5

Source: Schroders, Thomson Datastream, Consensus Economics, October 2016

Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable

Market data as at 26/10/2016

Previous forecast refers to June 2016

* **Advanced markets**: Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.

** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

2016	2017

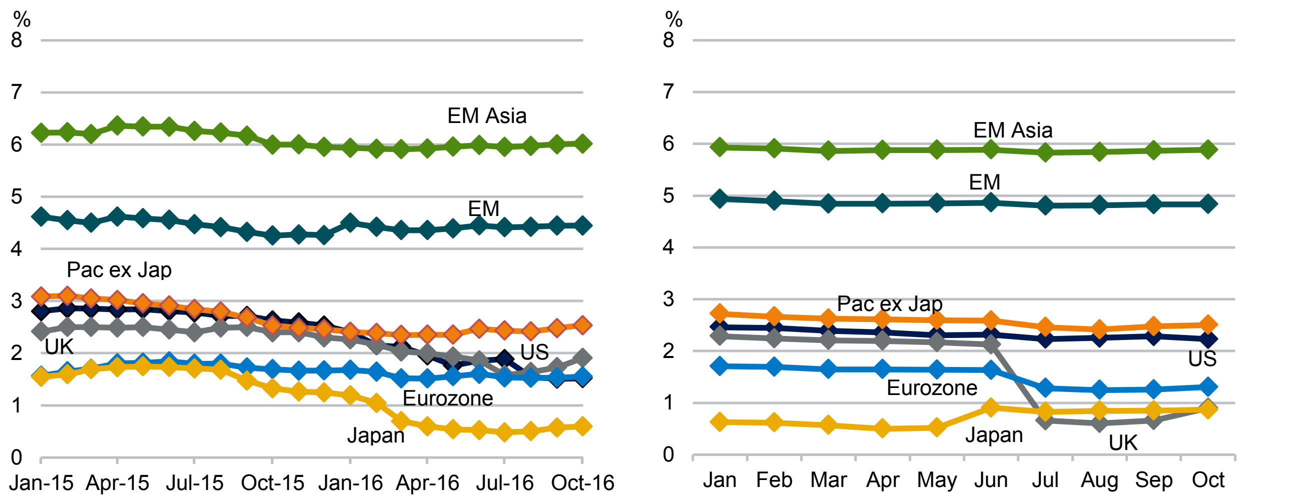
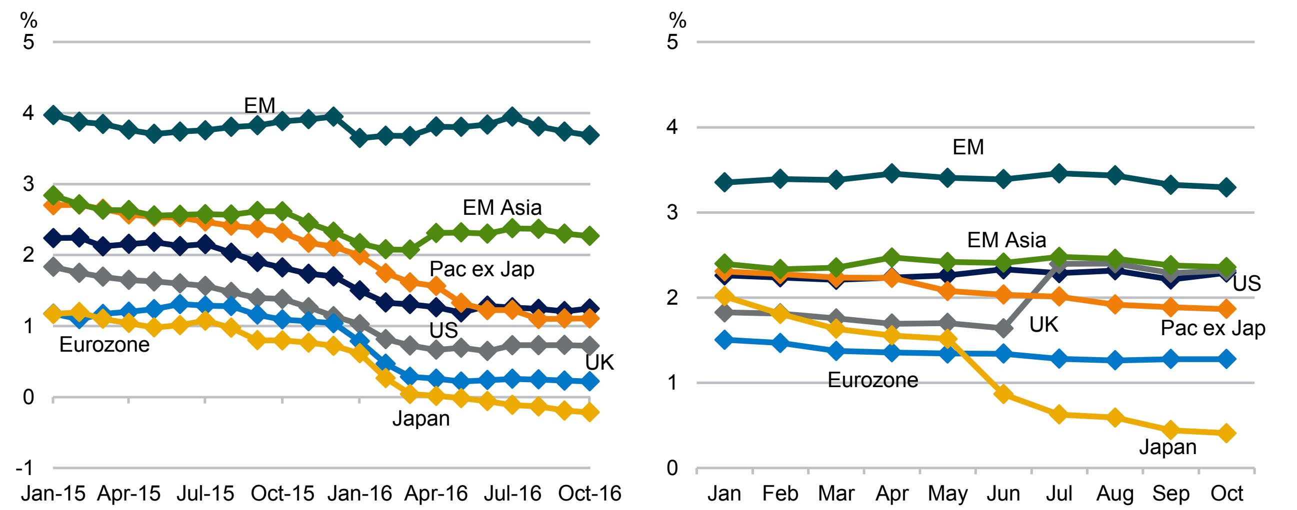


Chart B: Inflation consensus forecasts

2016	2017



Source: Consensus Economics (October 2016), Schroders.

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.

Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.