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CHINA'S ROCKY ROAD TOWARDS LONG-TERM PROSPERITY

Highlights

- China's rapid economic growth has created significant economic and financial imbalances. For example, non-financial sector debt-to-GDP has ballooned to 230% and home prices have become excessive. The economy has also been distorted by unproductive fixed investment and excess capacity.
- China acknowledges the challenges and has embarked on deep economic and financial reforms. However, the transition in the economy and financial system may not go smoothly.
- China's leaders will have to accept slower economic growth in the coming years. The government's growth target of 7.5% will be hard to hit this year and will likely have to be lowered in coming years. Financial restructuring and deleveraging will also lead to further debt defaults.
- If the economic slowdown and/or financial strains become too pronounced, policymakers have considerable capacity to stimulate the economy and recapitalize the financial system. This implies that the odds of a deep or sustained hard-landing are low. However, the scope for stimulus does not guarantee that events will proceed smoothly. A critical dimension is whether the policy response to future challenges is proactive and timely, rather than reactive and slow. The evolution of the risks in China will be a major global theme in the coming years.

Worries about China have intensified in recent months. The concerns are focused on the possibility of a further slowdown in economic growth and/or financial strains causing a wave of debt defaults. In our opinion, there are unquestionably heightened risks to China's outlook. The country has embarked on deep economic and financial reforms that may not go smoothly at a time of already more moderate economic expansion. There is a high probability that China will not be able to achieve its economic growth target of 7.5% in the coming years. Financial strains are likely to persist and policy efforts aimed at deleveraging are expected to lead to further debt defaults by firms and local governments. The key issue is how well China's central government can manage the transition in the economy and financial system. This will have global implications. The extent of China's economic slowdown and financial strains will depend greatly on whether policymakers can act in a proactive and timely manner to address emerging challenges. While the risks have increased and the path may not be smooth, the odds of a major and sustained downturn in China over the medium term remain limited due to the scope that is available for significant fiscal and monetary policy stimulus. The bottom line is that policymakers in China will likely have to accept slower economic growth; but, if conditions deteriorate too sharply or too deeply, they have the means to bolster the economy and financial system. The more stimulus is deployed, the longer it will take for China to achieve its long-term goals, however China's leaders do indeed have a long-term focus.

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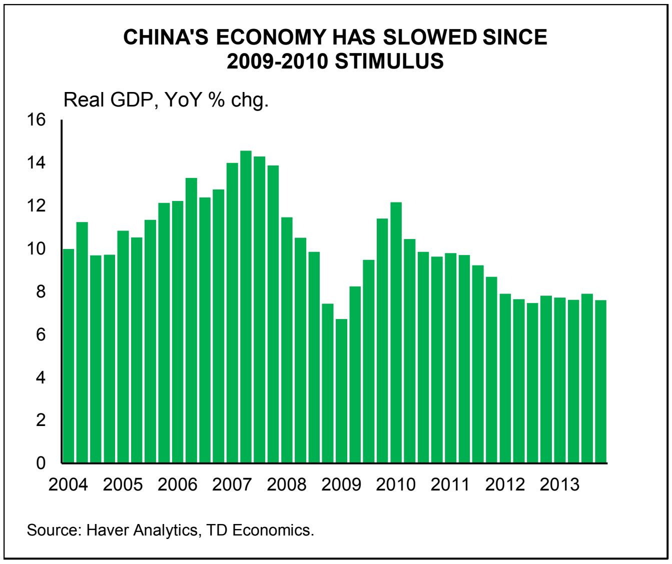


Rapid growth creates imbalances

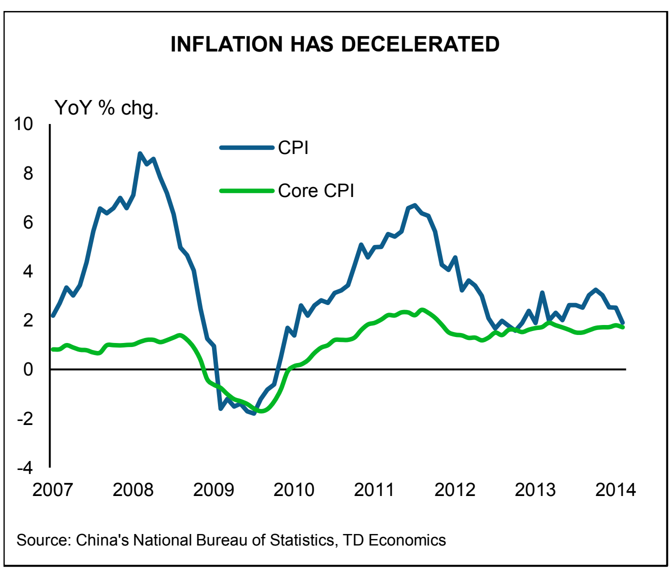
China has delivered rapid economic growth averaging almost 10% annually since 2000, dramatically lifting China's share of the global economy. However, rapid economic expansion has also fuelled imbalances. China deployed enormous stimulus in the midst of the global recession, which caused the economy to roar back to life in 2010 and 2011. The resulting pace of economic growth was excessive, causing inflation to become a problem. The government responded and was successful in bringing inflation down to around 2%.

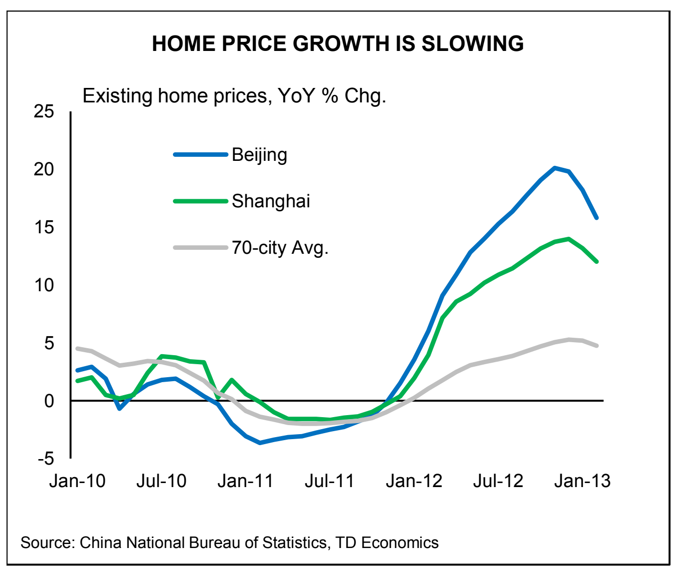
Other imbalances, however, have been much harder to address. Asset prices, particularly real estate, soared in reaction to strong income growth and easy credit. This has created concerns about a housing bubble and overdevelopment of real estate, with the latter characterized by anecdotal stories of ghost cities (i.e. urban centres with no one living in them). Real estate price growth has only recently slowed from its peak pace and the accumulated increases in prices over recent years have made the cost of property very elevated in many major urban markets, presenting a key vulnerability should an economic or financial shock occur.

China has also accumulated enormous leverage. Non-financial sector debt-to-GDP, which includes all forms of debt by governments, businesses and individuals, jumped from 135% prior to the government's large stimulus program in 2009 to around 230%. While debt service costs are manageable, the amount of leverage poses long-term economic risks and the timing of this debt accumulation has meant that a large portion of it must be rolled over in 2014 and 2015. This concern is compounded by worries that a significant portion of the debt has been accumulated for unproductive investments, such as industrial overcapacity and unneeded infrastructure, which could lead to debt defaults. It is important to note that the financial risks are tempered by the fact that China is a net creditor nation and the debt is largely owed domestically. Nevertheless, the high leverage presents a danger to the domestic financial system.

Deep reforms to address imbalances and raise efficiency

The challenges are well understood by China's leaders. They know that fundamental changes are required to China's economic model. The imbalances must be unwound in a way that does not derail job creation, particularly at a time





when large numbers of individuals are moving from rural communities to urban centres every year. There is also acknowledgement that the economy has been too dependent upon fixed investment, and prior to the recession too dependent upon exports, to drive growth. Long-term sustainable growth must come from raising the role of domestic spending. Consumer spending in China is only 39% of the economy, whereas it is 60% to 70% in advanced economies.

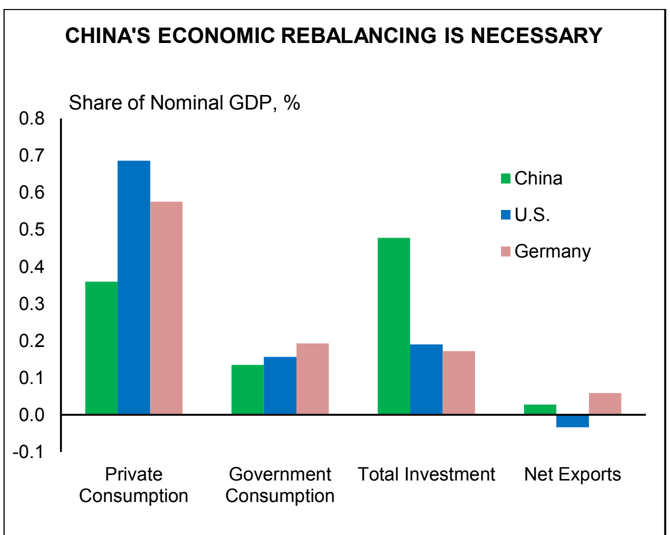
The result is an ambitious reform agenda, which was outlined at the Third Plenary session last year. China's central government outlined reforms in four core areas:

First, there is a push towards financial liberalization. The measures are too broad to list, but some of the high points include: allowing greater fluctuation in exchanges rates and policies aimed at expanding cross-border use of the renminbi, a loosening of controls on interest rates, and a gradual reduction in the threshold for foreign banks to enter the banking sector to create additional competition. The China Banking Regulatory Commission (CBRC) will pilot three to five private banks that will bear their own risk, opening up the banking sector to domestic and foreign private capital. There will also be changes to regulatory processes for securities markets, with a particular emphasis on increased oversight of shadow banking activities.

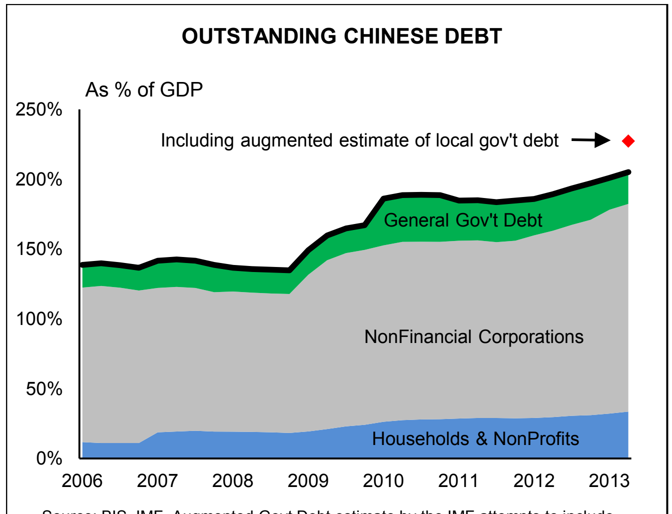
Second, there are fiscal reforms to curb wasteful investment, which include reducing government intervention and permitting markets to be a greater determinant of resource allocation.

Third, there are socioeconomic reforms, including land and pension reforms and easing the one child policy.

Fourth, there are bureaucratic and judicial reforms to reduce corruption and improve efficiency, some privatization of state enterprises and, again, efforts to allow markets (rather than bureaucrats) to have a greater influence on resource allocation.



Source: China National Bureau of Statistics, Bureau of Economic Analysis. 2012 Data.



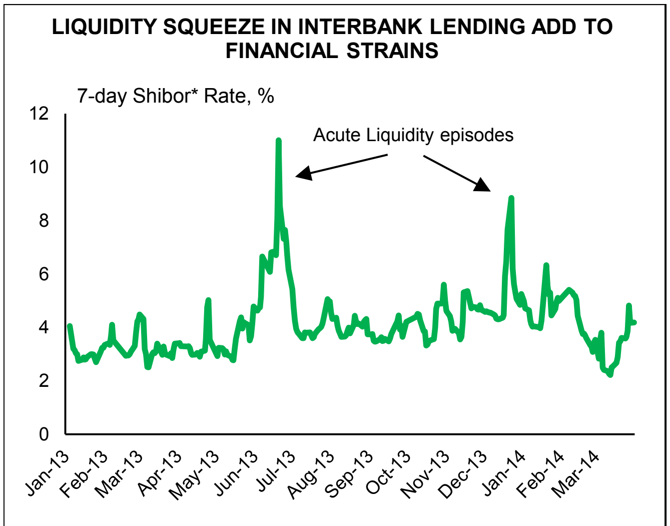
Source: BIS, IMF. Augmented Govt Debt estimate by the IMF attempts to include local govt finance vehicles.

Deleveraging efforts to add to financial strains and risks

As one might expect, the process of shifting the drivers of economic growth and the reform of the economic/political/social system will be long and may not go smoothly. A key dimension to the reform process involves deleveraging the financial system and constraining the shadow banking sector. It is the evolution of this deleveraging that has fuelled financial market anxiety.

A prime example of the financial risks is what happened last year when the actions of policymakers to constrain credit growth caused a liquidity squeeze in China's financial system. The resulting jump in the cost of funds to financial institutions caused China's central bank, the PBoC, to inject more support to the financial system through a Standing Liquidity Facility (SLF) and through Short-term Liquidity Operations (SLO). The PBoC was successful at reducing liquidity pressures, but financial markets remain wary that financial strains could aggravate the slowdown in economic growth. A litany of negative financial events added to these concerns.

In January 2014, China Credit Trust Co. (CCTC) was poised to fail due to the sale of a wealth product that had stipulated fixed returns that the firm could not fulfill. China's government ultimately bailed out CCTC, but the event drew international attention to the financial challenges of firms



Source: National Interbank Funding Center. *Shanghai Interbank Offered Rate.

in China's shadow banking system, which has expanded significantly in recent years.

In March, Shanghai Chaori Solar Energy failed to meet interest payments on its debt in what became China's first onshore corporate bond default. There were also deposit runs on several small banks, which were short-lived, as a host of China's institutions acted quickly to shore up confidence of depositors. Nevertheless, the international media coverage of the deposit runs added to financial market perceptions of risks in China.

Markets have also been increasingly concerned about local government debt. The level of local government debt as a share of the economy is low, but it has risen by a remarkable 70% over the past three years and close to 40% of the outstanding debt may need to be rolled over in 2014, with a further 20% to be rolled over in 2015.

The debt associated with real estate is also a concern, particularly if a real estate price correction occurred. In 1999, China set up four asset management companies that are strongly plugged into the banking system. The worry is that perhaps as much as 50% of their loans are now tied to real estate investments.

Given the slowdown in China's economic growth and the financial reforms being implemented, the outlook is for non-performing loans to increase, net profit margins of banks to be squeezed, and liquidity pressures could easily flare up – all of which could make rolling over debt more difficult. Given the amount of leverage in the financial system, the odds of further debt defaults by firms and/or local governments appears high.

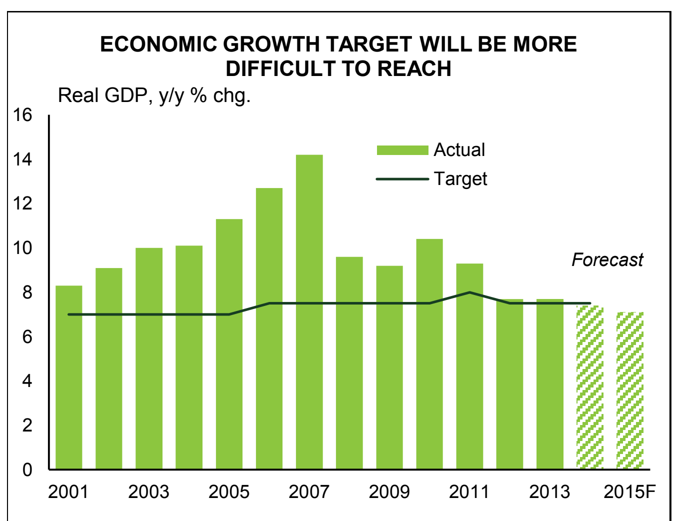
Defaults carry risk, but also a healthy development

While defaults have the potential to scare financial markets, it is critical to understand that all of this is part of the deleveraging process that is aimed at reining in unprofitable activities. Lenders are being deincentivized from extending credit to risky borrowers. Allowing firms to fail is aimed at addressing moral hazard in the financial system. For too long, financial firms and their activities have been insured by an explicit or implicit government guarantee. This has led to poor resource allocation and excessive leverage. Defaults and failures are a sign that China is addressing its existing imbalances, and so viewed in this light defaults are a positive development. The process is still only at an early stage, as illustrated by China Premier Li Keqiang's statement in March that further defaults are 'unavoidable'.

A key risk, however, is that China's policymakers have to make the right decisions on which debt defaults can be allowed to happen without triggering a systemic financial event that undermines the financial system and has significant economic consequences. Due to extensive financial linkages and the uncertainty of behavioral responses (such as investor and depositor confidence), it can often be difficult to know the full knock-on effects of a default. This means that during the financial reform process, policymakers in China have to be prepared to respond quickly to any problems. So far, they have demonstrated a capability to do so. But, the past is not always a good guide to the future.

Slower economic is a price that will have to be paid

While the risks are material, the restructuring of the economy and financial system is needed to get China on



Source: Haver, TD Economics

a long-term path to prosperity. It will, however, lead to slower economic growth in the coming years. The rotation from export and fixed investment driven growth towards consumption driven growth will take considerable time. The changes in the financial system will reduce credit growth that will, in turn, constrain the pace of economic expansion. Higher labour costs and slower labour force growth (reflecting China's demographic challenges) will also limit the pace of increase in real GDP.

It is, thus, regrettable that China's government announced a 7.5% growth target. Achieving this goal implies that the rotation in the main drivers of economic growth will happen very slowly. And, based on recent economic data, it seems likely that China will need to deploy additional monetary and fiscal stimulus if they are to achieve their stated aims in 2014/15. It is worth highlighting that China's policymakers have already softened their language around the 7.5% target, stating that goal is 'around' 7.5%. TD Economics has interpreted this as signaling growth in the 7.0% to 7.5% range, which is broadly consistent with China's statements that 7.2% growth is needed to prevent unemployment from rising. Again, maintaining this pace of expansion could prove very challenging at a time when the global economy is delivering modest growth and during the period when China's economy is going through major reforms.

China's policymakers have powerful levers to limit economic/financial weakness

Yet, there are limits to the extent of the economic slowing and financial strains that will be deemed 'acceptable'. And, most importantly, fiscal and monetary policymakers have levers at their disposal to limit a hard-landing scenario were conditions to deteriorate sharply. Central government debt is modest at only 25% of GDP and China's foreign exchange reserves stood at US$3.8 trillion in December. In other words, the fiscal taps could be opened widely if required and there is considerable scope to recapitalize the financial system. The PBoC also has many options to inject monetary stimulus into the economy and financial system if required.

The problem with injecting stimulus is that it will likely delay, or at least extend, the economic and financial reform process. For example, fiscal stimulus often takes the form of fixed investment, which China is striving to scale back on unless targeted at productive activities. Similarly, lower interest rates and more liquidity will fuel increased credit flows, delaying or adding to the deleveraging challenge. It is worth noting that China's leaders have a strong reputation for looking far down the road when setting policy objectives. Accordingly, the pace of reform and adjustment may need to be incremental. When economic growth is adequate, they will push forward towards the long-term goals. If economic growth slows too much or financial strains intensify, they are likely to act, even if it sets them back a step on the transition to their objectives. At the end of the day, China puts paramount priority on social stability, which requires adequate job creation.

China's difficult journey

In conclusion, China's economic and financial path is unlikely to be smooth. Over the next few years, China will be faced with only moderate demand growth for its exports. Efforts to reign in unproductive fixed investment, reduce corruption, and affect some deleveraging will meaningfully constrain credit growth and temper economic growth. In this environment, the odds of economic and financial setbacks, including sporadic debt defaults, is high.

The issue is how deep and lasting the problems will be. A major policy error is required for China to realize the worst fears of financial markets. This is not to say that a policy error cannot happen – Japan's lost decades demonstrate this. However, such an outcome in China is not the most likely scenario.

The balance of risks is that China may have a very difficult time hitting their 7.5% economic growth target in 2014 and it is likely that the growth target will have to be lowered in future years. Given that China's leaders have expressed the view that growth of 7.2% is needed to absorb labour inflows to urban centres, it seems likely that additional monetary and/or fiscal policy stimulus will have to be deployed this year. And, this is likely a key theme for the future.

As China makes progress on economic and financial reforms, there could be many stumbling blocks that necessitate stimulus, even if it delays achieving the desired transitions. If any slowdown in economic growth is too pronounced and/or the financial strains become too acute, China's policymakers stand ready to open the fiscal and monetary taps – and, they have enormous capacity to stimulate the economy. Yet, this capacity does not guarantee a perfect outcome. If the policy response to negative developments is too reactive or delayed, the economy and financial system can still suffer. Ultimately, China should be able to prevent any acute tail risk outcome, like a major financial crisis or hard landing, but the path forward is likely to be a difficult one, and this has global implications.

The well entrenched linkages through globalization mean that the world's economic and financial fortunes are tied to developments in China. Accordingly, the evolution of risks in China will be a key financial theme for years to come. A weaker China will constrain global economic growth, both in the advanced economies but more importantly for other emerging market countries that are facing their own economic and financial challenges. In financial markets, the effect on world economic growth and global inflation will encourage global interest rates to remain lower than would otherwise be the case. China also has a significant impact on prices for many commodities, so weaker China demand will limit the upside, and could be a source of downside risks, for raw materials like energy and base metals. China's financial challenges could remain a source of anxiety for financial markets and might contribute to periods of financial volatility. At the end of the day, the world's fortunes are tied to how well China proceeds on the likely rocky path towards prosperity.