Chinese Economy at a Tipping Point:

How Will the New Leadership Address Areas of Weakness?

27 November 2012
By **Richard Cox,** Global Editor of Global Investor Spotlight

In 2002, leadership in China changed hands and the incoming President, Hu Jintao, inherited an economy primed that was for expansion and on the verge on making giant strides on the world stage. But as 2012 comes to a close, Hu's successor will face an economic environment that faces significant downside risks and will require major political overhauls in order to sustain continued growth in the medium term.

To gain a broader perspective, it should be noted that in the last 5 years, annual growth rates in China have been cut in half, falling off from the 2007 highs above 14% to a much more moderate 7.4% in Q3 2012. And while it can be said that a large portion of this weakness can be attributed to decreases in export demand from Western countries, the glaring reality is that the leadership in China has failed to adapt to a changing global environment and this political inaction and lack of foresight has put China in a vulnerable position going forward.

Given these circumstances, the most urgent task for the country's incoming president, Xi Jinping, will be to address these issues as the

new regime takes control of their Communist Party and looks to structure economic reform in ways that are sustainable and more self-reliant. Under Hu Jintao, valuations in the Chinese stock markets fell more than in any of the other four BRIC nations, and the Shanghai Composite has dropped by more 18% just in the past year. Xi Jinping (who will officially assume the Presidency in March) could face the slowest economic growth in China in 23 years, with many analysts expecting GDP to rise by a slower 7% in 2013. Longer term, markets are pricing in an increased risk of slower annual expansion, which could be as low as 3-4% in 10 to 15 years.

To avoid these declines, China will need to implement market-driven reforms that allow for greater industrial competition with state-run enterprises. For these reasons, China is now seen at a critical tipping point, and the policy direction of the new administration will be critical for determining the level of economic viability China will possess in the long term.

Gaining Historical Perspective

Given the drastic economic downturn we have seen in China over the last half-decade, it makes sense to take a step back and look at the broader forces that led to stronger expansion earlier in the decade. In the period preceding the reign of Hu Jintao, political authority under the previous President (Jiang Zemin) focused on the implementation of far-reaching economic reform, which ultimately led to China's admission into the World Trade Organization and a more prominent position on the world stage.

"Given the drastic economic downturn we have seen in China over the last half-decade, it makes sense to take a step back and look at the broader forces that led to stronger expansion earlier in the decade"

In the 1990s, these reforms changed the foundations of many of the country's institutions and are widely regarded as the main catalyst for the growth the country experienced in the following decade. Specifically, thousands of unproductive state-owned companies were closed, allowing for greater expansion in private entrepreneurship and competition within industries. These reforms were followed by a lessening of restrictions in the housing market, which led to a boom in real estate prices that has lasted for nearly 15 years.

These advances help foster a decade of growth that, on average, came in at nearly 10% each year and propelled the country past Germany and Japan into the second position in the world GDP rankings. This period saw millions of poor Chinese lifted out of poverty and the creation of a middle class that has become a key consumer base for many of the world's largest companies.

The Negative Effects of Rapid Growth

But while it might seem as though

rapid economic expansion could never result in negatives, this has not been the case in China. On the surface, it appears as though the rapid growth of the early 2000s actually blunted the ambitions of the political leadership, and much needed reforms failed to receive the attention (and action) that was required. Vested interests (which were in opposition of these reforms) were also able to make their influence felt, and when the financial crisis of 2008 came, the administration was already in a vulnerable position and unable to adequately respond to the needs of the weakened economy.

In the years between 2002 and 2007, average expansion in China's export markets approached 30% on a yearly basis, and this helped fuel a massive engine of jobs creation and tens of millions of previously unemployed Chinese were able to find new work. But as the Hu-era comes to an end this export-driven growth model is looking less and less sustainable - hurt by rising wages, increased values in the Yuan currency, and a limited number of new markets in which to sell their manufactured goods. These are some the issues which will likely present the biggest challenges for the next political regime in China.

A Look at China's Real Estate Market

But while many of these national growth numbers have started to produce some discouraging trends, a similar picture emerges on the household level. China's real estate markets have followed a trajectory that is not dissimilar with what is seen in other areas of the economy, with drastic increases in property values seen early in the decade and large drop-offs seen today.

In the early 2000s, the real estate

needs in China were substantial, with a large percentage of the urban population living in factory dormitories and decaying tenement buildings. But with the increases in household income, more and more people were able to move into the better developed city areas and this created a boom in real estate investments for these areas.

Local governments were a big part of this, as small municipalities looked to raise money by selling off large tracts of land space to city developers. But now that this boom is coming to an end, urban skylines are marked by the remnants of half-finished construction projects and oversupply from previous investments shows the harsh realities of slowing demand. One ofthe key indicators of this can be seen in the amount of new floor space that is under construction, which has fallen 12.7% year-to-date (when compared to the same period in 2011).

Longer Term Issues: China's Shrinking Workforce

While most of these issues are shorter term and more cyclical in nature, there are longer term issues that must be considered as well. One of the most well-publicized problems can be seen in the growth of the Chinese workforce, which has already reached its peak and started shrinking. United Nations estimates project that, from 2000 to 2015, China added more than 100 million people to its working-age population. Rapid increases like these helped to keep working wages at low levels and making export products out of China cheaper for international customers.

But when looking at the same projections for 2015 to 2030, a very different picture emerges. In this period, China is expected to lose nearly 70 workers, and these trends will likely create the opposite effect (pushing wages higher and productivity levels lower). In addition to this, the population of India is expected to overtake that of China in the next 10 years, further decreasing the competitiveness of the country's manufacturing prospects.

Looking Ahead: Potential Action Points for the Next Regime

All of these factors point to major areas of potential weakness in the Chinese economy, so the key question moving forward will be whether or not the next regime will be able to counter the negative momentum and enact policies that foster economic growth that is self-reliant and sustainable. One potential approach could be to reduce the reduce the level of government presence that can be seen in the economy. This can help to support growth and balance the negative economic effects of China's aging population and increases and wage gains which have already eroded the country's position as the world's primary low-cost manufacturer.

Looking at the record of the new President's stance, we can see a clear bias toward the encouragement of private private enterprise but there is some evidence of potential conflict in this area, as several of his party colleagues are more heavily directed propping the role of the state when fostering economic growth for the country.

Because of these potential disagreements, it will be very important to watch the appointments of new leaders within the central bank (PBoC) and within the country's various finance ministries that will follow the official transfer of power. These appointments will be seen in the next few months and this could be the earliest indication of the broader direction this administration plans to take in the coming year.

Assessing Recent Economic Data

So what, exactly, can investors expect from the change in China's leadership? Does this change set the stage for additional stimulus measures from the PBoC, or are we seeing too many green shoots to entertain the idea of further stimulus programs at this stage in the global recovery? Indeed, we are seeing some green shoots and recovery in the Chinese economy, after 7 consecutive quarters of deceleration.

It is important to note that the Chinese economy will grow much closer to the government target of 7.5%, rather than exceeding it by a wide margin. In recent months, the country has seen recovery in the areas of Industrial Production, the Purchasing Managers' Index (PMI)

> While there are some clear issues of concern when looking at the long term prospects of the Chinese economy, there are some reasons for optimism as well.

and even in Retail Sales. However, the recovery is not yet broad-based, as we continue to see weakness in several key areas (particularly, in housing and power generation).

But, overall, the economy is beginning to find a floor and we are starting to see some significant signs of recovery. Evidence of this recovery can be found in the latest Industrial Production figures (which rose by 9.6% on an annual basis), Retail Sales (which rose by 14.5%) and the Purchasing Managers' Index (PMI), which came in at its highest level in 13 months at 50.4.

This reading is significant for a few different reasons, as this is one of the broadest measures of

manufacturing in what is essentially "the world's factory." But the number is also significant because numbers above 50 signal expansion in this reading, and this is the first time since October 2011 that the PMI has crossed over into positive territory. Numbers like these, while still well below the highs seen earlier in the decade, are relatively encouraging and suggest that a bottom is in place. For these reasons, growth rates are likely to rebound in the coming year.

Implementation of Stimulus Programs Seems Less Likely

Many investors have looked to overlay an element of psychology in this latest change of leadership, so the next central question will be whether or not the new leadership will be more inclined to enact stimulus measures to make sure the economy is on track at the beginning of their administration period. But since the economy has started to show evidence of having a level footing, it is unlikely that we will see any major surprises in the initiation of strong stimulus programs.

Throughout the deceleration period (where national growth rates dropped toward 7%), the Chinese leadership has chosen to act in a nuanced and prudent fashion, introducing targeted measures to boost income growth and cut taxes for small and medium sized enterprises. But the PBoC has opted not to enact large scale fiscal stimulus programs, such as the ones seen in 2009.

Clearly, China has learned its lessons from the mistakes and obstacles that were generated from these programs. Specifically, when the PBoC elected to flood the country's economy with 4 trillion Yuan (nearly $650 billion) in stimulus, China experienced hyperinflation (with CPI topping out at 6.5%), issues with industrial overcapacity and significant increases in consumer debt. Because of this, the leadership is more likely to act in a much more conservative and prudent way, and this essentially means that the PBoC is unlikely to enact drastic stimulus measures when the new political administration takes the helm.

Supportive Economic Positives

So, while there are some clear issues of concern when looking at the long term prospects of the Chinese economy, there are some reasons for optimism as well. Household incomes have been one of the most impressive features, are can now be seen growing faster percentage rate than the economy as a whole. This is an essential element for true rebalancing to take shape, and gives the country's finance ministry some flexibility in terms of monetary policy.

In 2011, the proportion of household consumption relative to wider GDP levels moved up to 35.4% (up from the 2010 figure of 34.9%). To be sure, this remains an extremely low proportion, relative to both historical rates and international comparisons but this is still a positive move in the right direction. These figures, along with the latest Industrial Production, PMI and Retail Sales reports, give markets a reason to believe the worst is over and that a foundation is set for the Xi administration to start making real progress.

> "These rebalancing efforts will likely direct the economy to rely more heavily on domestic household consumption and the demographic shifts in China could actually contribute positives"

Watching the Direction of the New Leadership

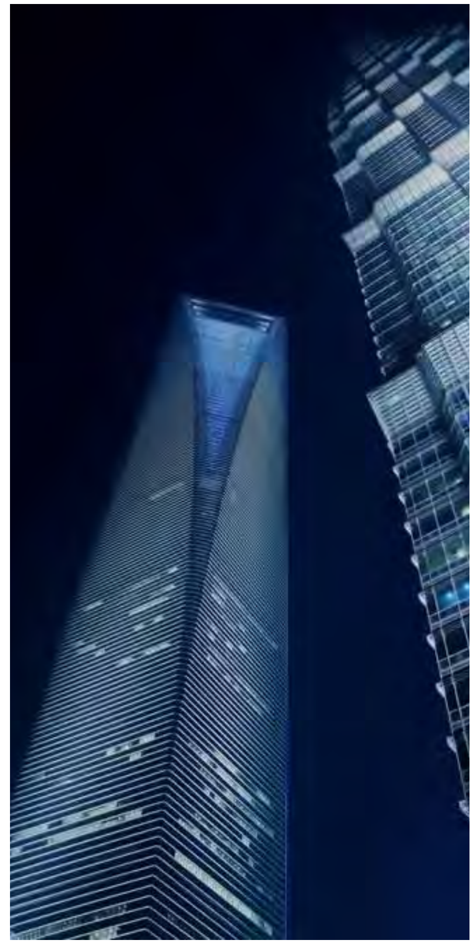
With all of these factors in mind, it is undeniable that the Xi administration will face some heavy tasks in the coming years. We are likely at a major tipping point in the future direction of the Chinese economy, and there is a distinct possibility that the foundational structure of the country's financial models will see some significant changes in the coming years.

Given that the Yuan currency has risen by more than 30% relative to the US Dollar since the Chinese government loosened appreciation restrictions in 2005, the impetus on growth could very well turn to move away from the export driven model (as manufactured items become more expensive for foreign consumers), and show a reduction of the imbalances that are seen in China's wider trade flows.

These rebalancing efforts will likely direct the economy to rely more heavily on domestic household consumption and the demographic shifts in China could actually contribute positives as the decreasing labor pool pushes up wages internally. Many familiar with the workings in the region, however, suggest that political reforms are necessary before any major economics programs can be enacted to confront China's slowing economy.

What is Required for the Xi Administration to Revive Economic Growth in China?

The pro-market reforms that will be required in order to revive economic growth in China must come in areas



like a liberalized financial sector, deregulation, and in the privatization of state-owned enterprises. On the whole, China must shift course from its investment-driven growth to a financial model that is based more heavily on domestic consumption. But it is unlikely that these reforms can take a firm hold without efforts to limit the state's control over businesses and reduce the level of political corruption that prevents otherwise stable enterprises from flourishing.

So, the main question going forward will be whether or not the Xi administration will show a willingness to pass initiatives that limit the traditional authority of the entrenched interest groups of the Communist Party (local governments and state-owned enterprises). Of course, there will be some difficulty here, as this will mean that the

Communist Party itself will be the main target of these proposed reforms. Any major changes will remove privileges and authority from the ruling elites that have established control over the country's economy, so, naturally, there will be resistance before any sweeping changes can be seen.

In the early stages of the Xi Presidency, markets will receive some clues relative to the political direction we are likely to see going forward. Initially, these clues can be seen in the appointments that are made within the PBoC, and market analysts will look at the record of these officials in terms of their potential willingness in loosening free market restrictions for private enterprise.

Early on, potential courses of action might include efforts to liberalize interest rates and currency values in the Yuan. The Xi administration could also enact reforms in the country's household registration system (the "hukou"), which currently places restrictions on migrant laborers looking to rent or purchase property. Additional areas that might be discussed could be seen in possible reforms for China's one-child policy, as this could have dramatic effects on the long term prospects for the country's aging workforce.

To be sure, the next Chinese President will face some difficult decisions, as the rapid growth seen the previous decade has clearly shown signs of significant slowdown. Some of the most critical reforms that will be needed will unavoidably threaten the authority and privilege of the long established ruling elites. And while these measures will likely encounter strong resistance, it remains clear that China will need to show resolve and adapt to a changing global economy if there is any real chance of maintaining the country's current position on the world stage. The Chinese economy is now at a critical tipping point, and the early direction of the Xi administration will provide some key clues with respect to how the country's economy will likely perform in the next 5 to 10 years. ■