**China**Intelligence
Financial and business advice on China

# themonthlydragon #6

September 1, 2015

## Many signs of weakness support our view that GDP growth in China will decline to below 5% in a few years.

**Property markets and consumer spending remain stable for now. The recent minor currency devaluation may be a precursor to further RMB weakening.**

Many recent economic data have been pointing to a slowing economy in China. The most critical one probably is contracting labor demand. Despite signals of a stable property market and consumer spending, this points to a slowdown in economic growth. We have maintained since inception of our publications that we expect a growth rate of 5.5 to 6.0% in 2016 and that «we will see annual GDP growth rates below 5% in a few years». The targeted transition of China's economy from being investment-led to being consumption-led is unlikely to happen without temporary setbacks and a slowdown in growth.

The news of a – so far minor – devaluation of the RMB vs. the USD has to be seen in this context. In the absence of a mega-stimulus package, the government has no choice but to support the economy through a combination of measures like infrastructure investments, lower interest rates, reforms and market liberalizations. After a 12% and 30% strengthening of the RMB on a trade-weighted basis over the last 2 and 4 years before its devaluation, respectively, weakening its currency may be a necessary tool to address economic weakness. This is particularly the case if one of the major risks to China's economy were to materialize: rising USD interest rates leading to a much stronger greenback.

One reason some Western media reacted to the weaker economic data and a currency devaluation of a mere 3% with misguided headlines like «The Chinese model is nearing its end», or that the Chinese government is «Strong, but incapable», or «China devaluation raises spectre of currency wars» may be that the effects of China's slowdown are beginning to be felt in the Western economies: collapsing commodity prices, continued deflationary pressures, lower profits for many multinational companies in China and questions about the sustainability of Western equity market valuations at current levels. This has got to raise fears of possibly having relied too much on China's economy for growth impulses.

### HIGHLIGHTS

- *GDP: slowing growth*
- *Labor market: worrisome decline in demand*
- *PMI: at 49.7, the weakest reading since August 2012*
- *Consumers: remaining confident*
- *Real estate: stable demand, increasing prices, lower inventories*
- *Interest rates: too high, will decline further*
- *Equity markets: volatility will continue, but valuations not stretched anymore*
- *Overall: most data point towards a continued slowdown in growth*

In order to define which economic scenarios are realistic and which are not, it is important to assess the state of the key elements of the Chinese economy, and not just focus on headline-grabbing events. **The key elements we want to highlight are the labor market, consumer spending and the state of the property market.** We will then make a few comments about the currency turbulences in August, which we see more as a result of the economic weakness than as a key event itself.

Our conclusion at this juncture is that the government will have no choice but to address slow GDP growth below its self-proclaimed objective of 7% with **further stimulating measures on all fronts. A mega-scale stimulus package is unlikely, but no measures will be off limits,** including making sure that the RMB does not strengthen further in trade-weighted terms. The interest rate cuts at the end of August are a further step in the right direction.

The equity markets will continue to be volatile because there are still some leveraged investment positions in the market. They will need to be liquidated at some time, which may not happen in an orderly fashion. **The effect of this summer's turbulences in the**

A-share market on the real economy are small – few people were engaged in equities and participated with relatively small amounts of money. And the major indices still are more than 30% above their levels 12 months ago.

In addition, the somewhat clumsy reaction of the Chinese authorities in countering the falling equity prices should not be too much of a concern. This summer was the first time the authorities faced a China-induced, severe drop of the equity market. The much larger drop in 2008 was caused more by international events. Compared to the US authorities, for example, which had experienced such equity market collapses several times (1987, 2001/02, 2007/08), the Chinese authorities have not yet had the opportunity to learn from past events and prepare an effective set of measures. They will do better next time, or better yet, make a bigger effort to be ahead of the curve and try to prevent excessive rallies in order to mitigate outsized price corrections.

## Labor demand drop: temporary or here to stay?

One of the most worrisome developments has been increased caution regarding hiring activity. The official statistics show an unemployment rate of between 4.0% and 4.1%, unchanged for the last four years. This probably is too low and does not adequately reflect underemployment in rural areas. But **the strong labor market has been a mainstay of China's relative economic stability in the last four years.** If labor demand were indeed to drop, with follow-on effects on personal income and consumption, not only would economic growth be further impaired, but the re-focusing of the economy on a more consumption-led model would be delayed.

**The drop in labor demand at the end of July 2015** (see chart #1), evidenced from a monthly survey taken among recruitment managers in the construction, manufacturing and service sectors, **must be a concern.** Maybe this is a sign of caution on the part of the companies involved, which are holding back with ambitious plans for the moment to review the development of their business. Many Chinese companies are not tied to mid- or long-term development plans but decide very opportunistically how to advance their business. Therefore it is entirely possible that this caution is temporary and the labor market will not change markedly in the quarters to come. August's improved survey reading seems to support this view. But the danger of weaker labor demand is real.

One important way for the government to influence the hiring pattern is to **encourage companies to continue investing.** Recent volatility in equity and currency markets have unsettled many companies regarding implementation of mid-term investment plans. And many companies have been disappointed by the performance of their speculative investments in the equity market, learning that straying from their core business may not always provide better profitability.

## Increased real lending rates despite much slower GDP growth

One major reason investment projects, and subsequent hirings, may have been held back are lending rates which still are far too high. Although they have been declining a bit, **interest rate declines are insufficient to compensate for the much lower GDP growth rates, the low inflation rates, commodity price pressures and the very strong RMB in trade-weighted terms.**

The interest rates have declined since the People's Bank of China (PBoC) started cutting rates in Q4 2014. But the real lending rates have increased over the last four to five years – despite slowing GDP growth (see chart #2). Interest rates have always been sky-high in China, but the rationale was that, as long as GDP growth was at 10% or higher per year, the strength of the economy – and thus individual business projects – would justify paying between 7% and 9% for commercial loans. **In an environment of GDP growth below 7%** such a concept clearly does not hold anymore and **paying interest rates for commercial loans of at least 6% to 7%** (= benchmark lending rate of 4.6% plus a spread of 1.5% to 2.5%) **is suffocating many companies.**

Why have interest rates been kept at elevated levels? And why have interest rate spreads (benchmark lending rate minus benchmark deposit rate, see chart #3) stayed high, currently at 2.85%? **Maybe maintaining the high spread for the commercial banks, which helps deal with the undoubtedly high amount of troubled loans, is deemed a more important policy objective.** Although the official ratio of technically non-performing loans (NPLs) has been reported consistently at between 1.0% and 1.1% for the last five years, the amount of loans outstanding to companies which do not have the economic strength to ever repay them is several times higher.

Since most banks in China are majority-owned by the government, and most troubled loans are held by these banks, a simple way to pay for the NPL problem is by keeping

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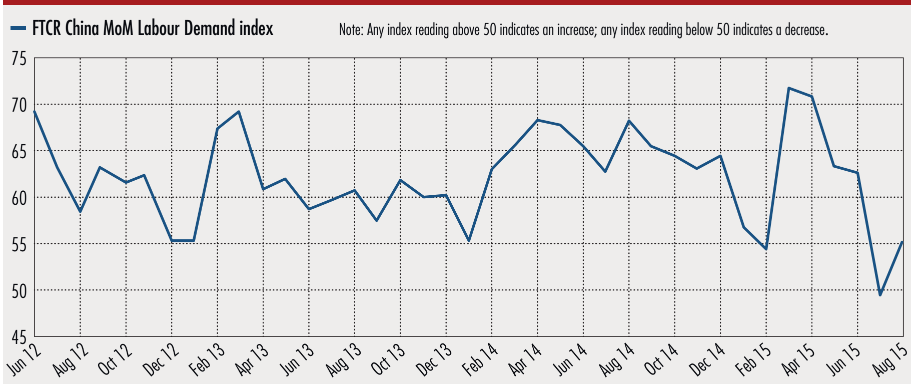
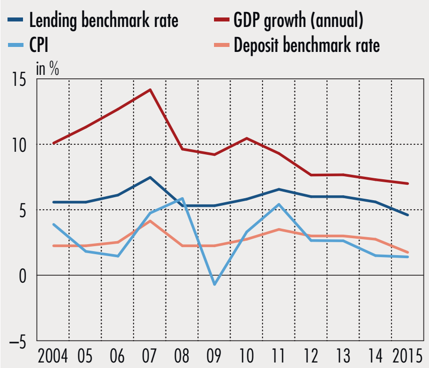
**Demand for labor is a concern** ❶



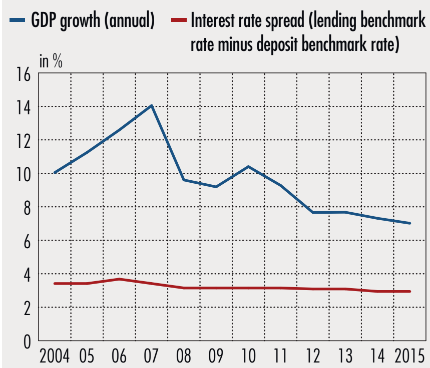

Source: FT Confidential Research / Chart: ChinaIntelligence

**Interest rates too high** ❷




Source: World Bank / Chart: ChinaIntelligence

**Interest rate spreads unchanged** ❸




Source: World Bank / Chart: ChinaIntelligence the banks' interest rate margins high. **This makes the general public pay for dealing with the problem loans,** but at the expense of healthy companies' investment activities (= financial repression). Both objectives, dealing with problem loans and stimulating investment activity, can be achieved by further, parallel reductions of lending and deposit benchmark rates. We expect two more such reductions, each by 25 bps, in the coming six months.

### Comforting news #1: consumers are not retreating

The Chinese A-share equity markets peaked on June 12, 2015. Thereafter, equities corrected by approx. 25% in a matter of weeks; today, the Shanghai Composite is 40% lower than in mid-June. This led many commentators to speculate that this would materially affect the average household's spending patterns due to some wealth effect taking place. Such speculations disregarded the fact that only a minority of households were actively invested in the stock market (no more than about 50 million brokerage accounts were open at the peak), and that they had invested small amounts of money, with the majority of individual investors holding less than USD 15,000 in their brokerage accounts.

First surveys of urban consumers are out, their results are early and a darkening of the mood in the coming six months cannot be excluded, but: **for now, consumers are more constructive towards the economy than in recent months, with consumer spending seemingly affected moderately by recent events. Retail sales in Q2 2015 continued to increase by 10.5% yoy.** Based on these surveys, consumer spending can be expected to remain broadly stable, keeping a very important engine of China's economy running (see chart #4).

### Comforting news #2: rising property prices, declining property inventories

Property prices are rising again and all property price indices have been reflecting increasing prices for a few months now (source: National Bureau of Statistics). At the same time, completed but unsold residential floor space declined further, to a level of approx. 11 months' of sales from a peak of over 14 months' of sales in the fall of 2014. These observations again support our view that the property market is anything but collapsing. **Underlying demand for additional residential living space from individuals, who actually use the space for themselves, is big enough to absorb the approx. 10 million apartment units which are being built in China every year.**

This is good news because it **stabilizes China's most important investment asset class.** The fact that inventories are declining, on the other hand, is a result of subdued construction activity. This weighs on economic growth and we expect government measures to **make more financing available to property developers in the near term.**

### The recent currency devaluation: a result of all the other economic factors

The fact that the RMB declined by 3% (yes, three percent) vs. the USD from approx. 6.21 to approx. 6.39, based on daily closing rates, between August 10 and August 18 accounted for a significant portion of the headlines in the financial press during the second half of August. We want to clearly separate what is significant, and what is insignificant about these developments.

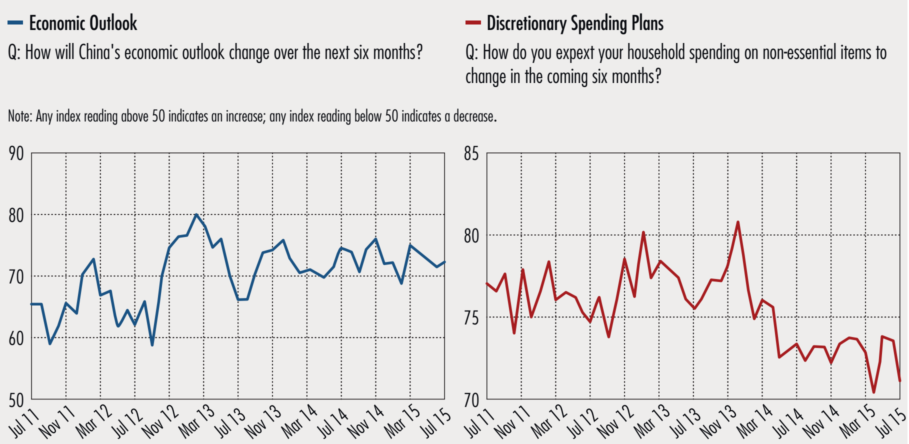
Significant are the following facts:

- The PBoC allowed a multi-percent drop of the RMB vs. the USD **overnight.** The same weakening (3.3%) had taken place before, but over the period of ten weeks from early February to the end of April 2014.
- The official exchange rate regime was loosened, leading to the PBoC's somewhat opaque wording, to **take into account FX market supply and demand and other currency movements in the future setting of the benchmark exchange rate.** This is a continuation of the developments of the past few years, during which the trading band around the official exchange rate had been broadened to +/– 1% in April 2012 and to +/– 2% in March 2014.
- After the very strong appreciation of the RMB on a trade-weighted basis (plus 12% in the past two years, plus 30% in the last four years on a trade-weighted basis, see chart #5), the move in August **may indicate that further weakening of the RMB vs. the USD should be expected in case the USD strengthens vs. the currencies of some of China's important trading partners** like Japan, South Korea and Europe (these three together account for approx. 30% of the demand for China's exports).
- **The risk of accelerated capital outflows has increased.** Capital outflows have gone up already since early 2014 and could intensify if the holders of RMB assets believe a further strong currency move against the USD is imminent.

Insignificant are the following aspects:

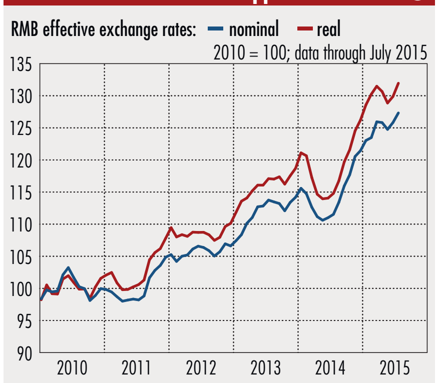
- The PBoC's devaluation of 3% can hardly be seen as the kick-off to a «currency war» in light of other currencies' massive devaluations, all against the USD, observed in recent years: the Japanese Yen's minus 55% over the last 3 years, the South Korean Won's minus 17% over the last 12 months and the Euro's minus 14% over the last 12 months.
- The economic stimulus for China's economy from this August's RMB devaluation

**Consumers remain confident** 4




Source: FT Confidential Research / Chart: ChinaIntelligence

**Substantial RMB appreciation** 5




Source: Bank for International Settlements / Chart: ChinaIntelligence alone will be insignificant; the trade-weighted appreciation of the RMB in the prior years was too large.

### *What does this mean:*

- Economic growth is slowing and it appears increasingly likely that even the officially reported GDP growth rate during H2 2015 will drop to below the government's target of 7%.
- Consumers appear to keep spending, based on their positive attitude towards the economic environment.
- Property prices remain stable and are likely to edge higher due to inventory constraints.
- The impact of the RMB devaluation in August will be small, but may pave the way to further RMB weakness vs. the USD.
- One of the major risks for China's economy are rising USD interest rates and a rising USD (as highlighted in our quarterlydragon dated July 1).
- Industrial activity is weak, the PMI reading of 49.7 (down from 50.0 the month before) leads this indicator into contraction territory for the first time since February and is the weakest number since August 2012. Industrial profits declined from January to June, in some sectors dramatically. Large SOEs suffer much more than privately owned enterprises.
- Overall, the downside risks to the economy intensified and sentiment darkened. Further selective stimulus measures by the government are needed, reforms are likely to progress.

**Important Indicators**

| | Aug 2015 | July 2015 | June 2015 | May 2015 | Dec 2014 | Sep 2014 |
|---|---|---|---|---|---|---|
| Quarterly GDP, growth yoy (%) | – | – | 7.0 | 7.0 | 7.3 | 7.3 |
| Retail sales of consumer goods, growth yoy, real (%) | – | 10.4 | 10.6 | 10.2 | 11.5 | 10.8 |
| Official Consumer Confidence Index | – | 104.5 | 105.5 | 107.1 | 105.8 | 105.4 |
| FTCR Labor Demand yoy Index | – | 58.6 | 63.2 | 76.0 | 72.6 | 68.1 |
| Real estate floor space newly started, growth yoy (%) | – | –16.8 | –15.8 | –18.4 | –10.7 | –9.3 |
| FTCR mom Home Price Index | – | 60.3 | 61.0 | 55.0 | 51.5 | 50.0 |
| CPI, growth yoy (%) | – | 1.6 | 1.4 | 1.4 | 1.5 | 1.6 |
| PPI, growth yoy (%) | – | –5.4 | –4.8 | –4.6 | –3.3 | –1.8 |
| PMI manufacturing | **49.7** | 50.0 | 50.2 | 50.1 | 50.1 | 51.1 |
| Caixin/Markit PMI | **47.1** | 47.8 | 49.4 | 49.6 | 49.6 | 50.2 |
| Fixed-asset investments, growth yoy (%) | – | 11.2 | 11.4 | 13.5 | 15.7 | 16.1 |
| Required ReserveRatio (large banks) (%) | **18.0** | 18.5 | 18.5 | 19.5 | 19.5 | 19.5 |
| Benchmark rate for 1-year loans (%) | **4.60** | 4.85 | 4.85 | 5.35 | 5.60 | 6.00 |
| Benchmark rate for 1-year deposits (%) | **1.75** | 2.00 | 2.00 | 2.50 | 2.75 | 3.00 |
| New total social financing, growth yoy (%) | – | 162.6 | –5.5 | –44.0 | 35.0 | –26.0 |
| New bank loans, growth yoy (%) | – | 52.9 | 23.0 | –5.1 | 44.0 | 9.0 |
| Exports, growth yoy (%) | – | –8.3 | 2.8 | –15.0 | 9.7 | 15.3 |
| Imports, growth yoy (%) | – | –8.1 | –6.1 | –12.7 | –2.4 | 7.0 |
| Trade balance (USD billion) | – | 43.0 | 46.5 | 30.8 | 49.6 | 30.9 |
| Electricity consumption, growth yoy (%) | – | 0.8 | 1.3 | 0.8 | 3.8 | 3.9 |
| Freight Traffic, growth yoy (%) | – | 4.2 | 4.2 | 4.5 | 7.1 | 7.7 |
| Iron ore imprts (million tons) | – | 86.1 | 75.0 | 80.5 | 86.9 | 84.7 |
| Coal imports (millions tons) | – | 21.3 | 16.6 | 17.0 | 27.2 | 21.2 |
| Crude oil imports (million tons) | | 30.7 | 29.5 | 26.8 | 30.4 | 27.6 |
| Bloomberg Commodities Index (BCOM) | **90.93** | 91.78 | 102.69 | 98.12 | 104.33 | 118.69 |
| CSI 300 (China Equity Index) | **3'366** | 3'817 | 4'473 | 4'051 | 3'534 | 2'451 |
| RMB trade-weighted, indexed (2010=100) | – | 127.5 | 126.0 | 126.1 | 121.5 | 116.0 |
| RMB / USD spot | **6.37** | 6.21 | 6.20 | 6.21 | 6.20 | 6.15 |

Source: ChinaIntelligence

### *Key developments we expect for the coming 12–24 months*

*We expect political, economic and financial stability despite all the looming challenges. Regarding some key topics our expectations are:*

- *GDP growth: 2015 year-end run rate of around 6.5%, 2016: 5.5% to 6%, below 5% for 2018-2020.*
- *Labor market: stable to slightly weaker, but with continued wage growth of between 4-7% p.a., at the lower end for high-wage earners, at the higher end for low-wage earners.*
- *Interest rates: 2 additional cuts in the benchmark rates by the Chinese New Year 2016, each by 25 bps.*
- *No big stimulus program, but a multitude of smaller and targeted measures and reforms to support the economy.*
- *Real estate prices: a stabilization of prices and demand throughout 2016.*
- *RMB: further weakness of approx. 5% during the coming 12 months from the current rate of 6.37 RMB per USD.*
- *Retail sales growth: approx. 10% p.a.*
- *Continued high volatility in the equity markets.*



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