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At a Crossroads: China Taps the Accelerator

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Introduction

Accepting slower growth has long been a challenge for Beijing. For the last few years, the task has been balancing the need to address risks in the financial system against pressure to stabilize economic growth. With the economy now facing its most vulnerable window of growth since the global financial crisis, it appears the latter is again more of a priority.

At a Crossroads: China Taps the Accelerator

BY STEVEN G. COCHRANE, KATRINA ELL, AND VEASNA KONG

Accepting slower growth has long been a challenge for Beijing. For the last few years, the task has been balancing the need to address risks in the financial system against pressure to stabilize economic growth. With the economy now facing its most vulnerable window of growth since the global financial crisis, it appears the latter is again more of a priority.

The People's Bank of China indicated it would cut the reserve requirement ratio—the amount of funds that banks must hold at the PBoC as a proportion of their total deposits—by 100 basis points from 15 October, taking the cumulative reduction in reserve requirement ratios this year to 250 basis points, and bringing them down to their lowest level since the 2008-2009 global financial crisis (see Chart 1).

That reserve requirement ratios are at multiyear lows is telling. The last time they were at this level, the Chinese economy was also in a soft patch, and the global economy was at the mercy of the worst financial crisis in decades. Beijing implemented a mammoth CNY4 trillion stimulus package (14% of 2008 GDP), and banks, many of which are state-owned, went on a lending spree, countering what would have been a significant economic downturn and propelling GDP growth to 9.2% in 2009 and 10.4% in 2010.

The remainder of this paper reviews several of the factors signaling slower growth for the Chinese economy and some of the reasons why slower growth may very well be inevitable and indeed favorable for longer-term prospects for continued growth.

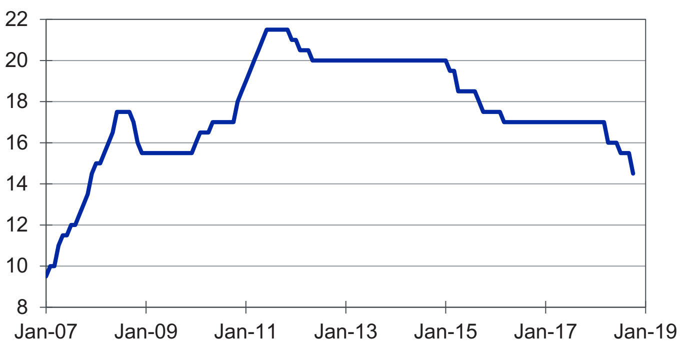
Broad-based weakening

While global economic conditions are better today, it comes as little surprise that Beijing has opted to tap on the accelerator, as a number of indicators have displayed weakness over recent months. Growth of fixed asset investment, the key driver of growth in China, has been especially weak, and sank to a record low 5.3% y/y year to date in August, the sixth consecutive month of decelerating growth. Add to that a trade war with the U.S., China's largest trading partner, and the growth outlook appears increasingly dim. Tariffs on exports to the U.S. have not yet had a material impact on China's real economy, but indicators of manufacturing sentiment along with growing anecdotes of some supply chains avoiding assembly in China, particularly at the final stage, suggest that the impact will rise heading into 2019. The Trump administration has imposed tariffs on around US$250 billion in Chinese goods imports, with a further US$267 billion proposed and no near-term resolution in sight.

Monthly trends of industrial production and credit have also disappointed. Total social financing, a broad measure of credit and liquidity, has been trending lower since its most recent peak in mid-2017 (see Chart 2). Regulatory changes are a partial driver

Chart 1: RRRs Down to Multiyear Low

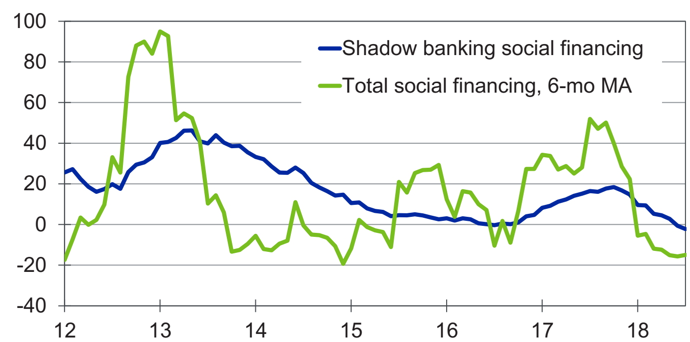
China's reserve requirement ratio for major banks, %



Sources: PBoC, Moody's Analytics

Chart 2: Tighter Liquidity Conditions

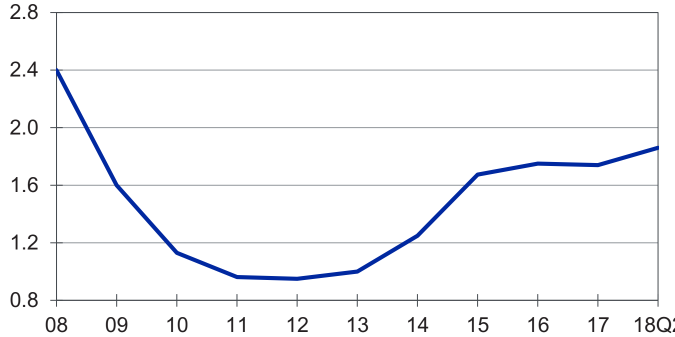
% change yr ago



Sources: National Bureau of Statistics, Bloomberg, Moody's Analytics

Chart 3: Jump After Regulatory Changes

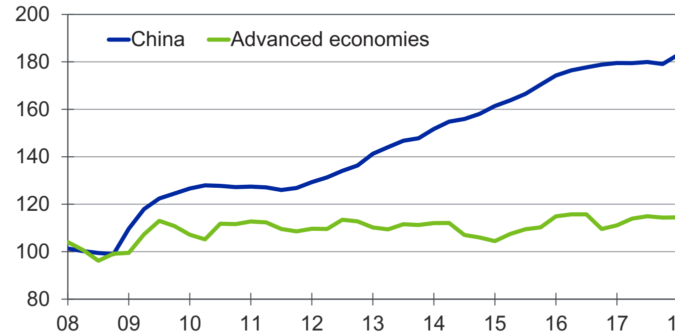
Nonperforming loans ratio, %



Sources: China Banking and Insurance Regulatory Commission, World Bank, Moody's Analytics

Chart 4: China's Rapid Debt Buildup

Total debt as % of GDP, 2008=100



Sources: Bank for Intl. Settlements, Moody's Analytics

of the deterioration. A clear example is via nonperforming loans rising to 1.86% of total loans in the June quarter, the highest ratio since early 2009, according to the Banking and Insurance Regulatory Commission (see Chart 3). This increase was partly triggered by Beijing forcing lenders to be more conservative and label loans overdue by more than 90 days as nonperforming.

The stock market slump is telling

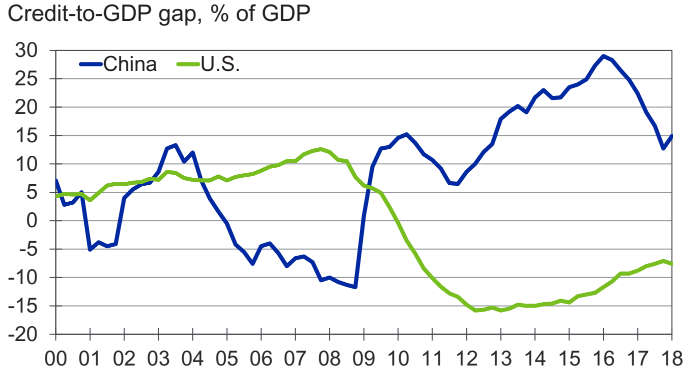
China's stock market—as measured by the Shanghai Composite Index—also reflects expectations of a weakening economy; it has resoundingly headed south this year and is hovering around a four-year low as of mid-October. While China's stock market can offer insights into local economic sentiment, it is highly volatile. This is because it has relatively high participation from speculative retail investors, so a deterioration in sentiment can snowball, creating relatively large swings to the downside and vice versa. Our prior work, however, has shown no notable correlation between China's GDP growth and the Shanghai Composite. This is not surprising given that the national accounts data are so stable, and that stocks make up a relatively small share of household assets. A combination of factors is pushing the Shanghai Composite lower, including the trade war, emerging markets' risk aversion, China's slowing growth trajectory, and signs of cooling global growth.

The elephant in the room

Beijing maintains that monetary policy remains "prudent and neutral", and that the cuts to the reserve requirement ratios partly reflect its efforts to ensure sufficient liquidity following earlier credit tightening measures and to offset maturing medium-term lending facility loans. The latest move, however, makes clear that supporting economic growth and local markets is now at the top of Beijing's policy agenda.

Chart 5: Stark Differences

Credit-to-GDP gap, % of GDP



Sources: BIS, Moody's Analytics

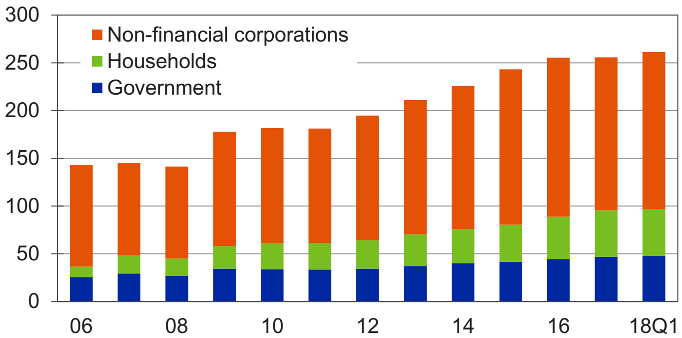
Beijing is talking down the extent of easing it is undertaking, a possible tactic to allay concerns that it is kicking the can down the road on addressing the large pile of debt it is carrying and the earlier pledge that addressing financial risk would be a top priority this year. The latest reserve requirement ratio cut follows earlier action from Beijing to step up plans to invest billions in infrastructure projects. In August, the National Development and Reform Commission, China's economic planning agency, announced the approval of a major infrastructure project—a US$16.3 billion rail project in Changchun—its first in more than a year. Several other projects have since been given the green light. On top of an increase in public works, other measures have included tax cuts, higher income-tax thresholds, and encouraging banks to increase lending.

The government has set a target of 6.5% growth for 2018, and growth still appears likely to at least match that target, particularly given the shift towards more expansionary policy that is likely to stabilize growth. Yet Beijing's resistance to slower growth carries risks, particularly given the rapid rise in debt since the global financial crisis. According to the Bank for International Settlements, total debt stands at more than 260% of nominal GDP, up from about 143% in 2008, when Beijing embarked on its credit-fueled investment binge (see Chart 4). Much of this rise is the result of a surge in corporate borrowing, with credit to nonfinancial corporations up to 164% of GDP, from 97% a decade ago (see Chart 5).

Household debt, while still low by international standards at 49% of GDP, has risen by more than twofold over the same period, the largest increase among countries for which we have data (see Chart 6).

Chart 6: China's Rising Debt Burden

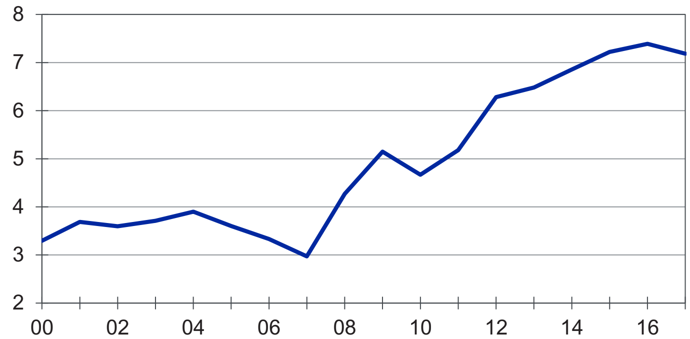
Debt by sector as % of GDP



Sources: Bank for Intl. Settlements, Moody's Analytics

Chart 7: Investment Efficiency Has Declined

China incremental capital output ratio



Sources: National Bureau of Statistics, Moody's Analytics

One measure commonly used to assess an economy's vulnerability to a financial crisis is the credit-to-GDP gap, which is the difference between the credit-to-GDP ratio and its long-run trend. Bank for International Settlements data show that China's credit-to-GDP gap surged to a record high 28.3% of GDP in mid-2016. After falling to 12.7% at the end of 2017, it ticked up to 14.9% in the first quarter of 2018, with a further rise likely given the easing in recent months. While not a complete measure by any means, the credit-to-GDP gap does highlight the credit excesses of recent years and China's vulnerability to a financial crisis. Research by the Bank for International Settlements shows that credit-to-GDP gaps of more than 10 percentage points have preceded two-thirds of banking crises.[1]

Lying in wait

Should external developments continue to threaten the economy and activity become uncomfortably slow in coming months, Beijing likely will implement additional measures to support growth. This is likely to include further measures to boost liquidity, such as more reserve requirement ratio cuts, as well as other moves such as faster issuance of local-government bonds, more tax cuts, and increased government expenditure. Housing market restrictions that have gradually been implemented since 2016 could also be eased if the property market weakens more than anticipated and threatens economic growth more broadly. Tighter housing market regulations such as higher deposit requirements, limits on home loan volumes, and homeownership limits for nonresidents have slowed property price growth considerably in parts of China, particularly in Tier 1 and Tier 2 cities.

Above all else, the variable to watch to gauge if the policy easing is having the desired impact is investment, the key driver of China's economic growth in the last few decades. Investment as a share of GDP averaged almost 40% in the decade to 2010 and reached a peak of 48% in 2011. Although it has fallen to about 44%, it remains high by international standards. A number of factors have supported this high level of investment. These include a high stock of savings, which were often channeled on favorable terms to preferred sectors of the economy; growth targets that have encouraged local governments to invest heavily; and housing reform through the 1980s and 1990s, which established a private housing market.[2]

Demographics and productivity

Clearly, capital accumulation has played a critical role in China's growth performance. However, rapid growth that is primarily driven by factor accumulation (capital and labour) is unsustainable, particularly because China's demographic profile will increasingly become a burden on the economy. As the population ages, demand for health and social welfare will rise, posing challenges to fiscal policy. Household savings will also fall, reducing the amount of domestic funds available for investment. Meanwhile, China cannot continue to keep investing at the same rate as in the past, particularly given the debt overhang from previous excesses. Investment has become increasingly inefficient, as the amount of capital investment required to increase a given level of GDP (the incremental capital output ratio) has more than doubled since 2007 (see Chart 7).

Although China's growth performance is remarkable, the factors underpinning this rise are not necessarily unique. On top of rapid physical capital accumulation, these factors include the reallocation of labour towards export manufacturing, and improvements in technology and human capital. In the 1970s, China's labour productivity—output per worker—was equivalent to about 2% of the U.S. level. That figure has now risen to around 25%. Notably, despite this rise, labour productivity remains far below that in advanced economies, indicating China still has some way to go to close the productivity gap.

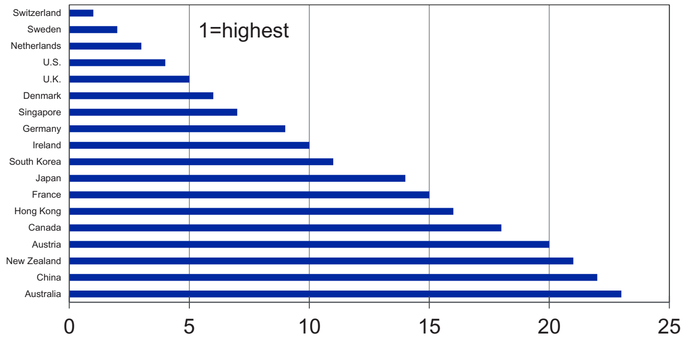
Further, China's potential rate of economic growth can no longer be supported by growth in the labor force. The size of the labor force is at its peak and will slowly decline in coming years. Slowing productivity growth combined with a declining labor force means that maintaining the rate of economic growth that is currently targeted will become increasingly difficult. A declining labor force

1 Bank for International Settlements, "International Banking and Financial Market Developments," *BIS Quarterly Review* (March 2017): 1-23.

2 Reserve Bank of Australia, "China's Property Sector," Bulletin (March Quarter 2015): 45-54.

Chart 8: China Not Known as an Innovator

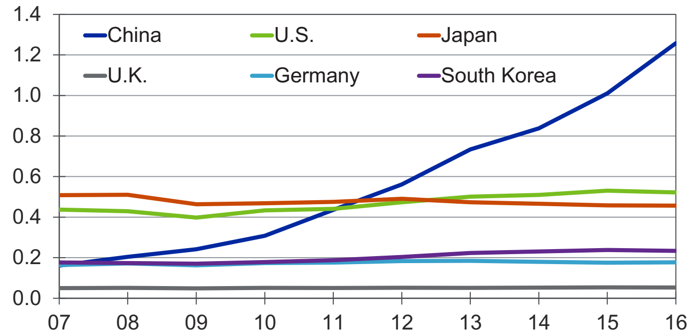
Global innovation index, selected countries ranked 1 to 25, 2017



Sources: World Intellectual Property Organization, Moody's Analytics

Chart 9: China's Rising Patent Requests

Patent applications, mil



Sources: World Intellectual Property Organization, Moody's Analytics

is not unique to China. Japan's labor force is shrinking even more quickly, and much of Europe faces a similar problem in coming years as its population ages.

China has not been known as an innovator

Thus, productivity growth is critical and the next step is for China to move up the value chain. China has laid out its strategy to achieve this via the "Made in China 2025" development strategy. This blueprint for continued economic success is a big undertaking, and success may not come easily if homegrown innovation does not improve. Being at the forefront of innovation is key, but China is not known as an innovator; the country is often more successful at replicating or finessing technology and techniques from abroad (see Chart 8).

To China's advantage, however, this appears to be quickly changing. Applications for new patents from China more than doubled in the four years to 2016 and were much higher than in advanced economies (see Chart 9).

With the labour supply shrinking and investment growth cooling to a more sustainable pace, China needs to tackle the more difficult task of increasing the productivity of capital and labour to lift growth. Yet Beijing's recent policy moves leave little doubt that weaning the economy off its credit-fueled, investment-led growth model remains one of its greatest challenges.

Although Moody's Analytics believes that managing financial risk remains high on Beijing's policy agenda, and the shift towards more expansionary policy is subtler than previous efforts, especially during the global financial crisis, it highlights the ongoing friction between the need to maintain GDP growth and stability, deleverage, and implement broader reform. Should Beijing continue to resist slower growth by reverting to its old debt-fueled growth model, risks will continue to build, leaving China more vulnerable to unforeseen shocks.

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Steven G. Cochrane, PhD, is Chief APAC Economist with Moody's Analytics. He leads the Asia economic analysis and forecasting activities of the Moody's Analytics research team, as well as the continual expansion of the company's international, national and subnational forecast models. In addition, Steve directs consulting projects for clients to help them understand the effect of regional economic developments on their business under baseline forecasts and alternative scenarios. Steve's expertise lies in providing clear insights into an area's or region's strengths, weaknesses and comparative advantages, relative to macro or global economic trends. A highly regarded speaker, Dr. Cochrane has provided economic insights at hundreds of engagements over the past 20 years and has been featured on Wall Street Radio, the PBS News Hour, C-SPAN and CNBC. Through his research and presentations, Steve dissects how various components of the macro and regional economies shape patterns of growth. Steve holds a PhD from the University of Pennsylvania and is a Penn Institute for Urban Research Scholar. He also holds master's degree from the University of Colorado at Denver and a bachelor's degree from the University of California at Davis. Dr. Cochrane is based out of the Moody's Analytics Singapore office.

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