A transition with Chinese characteristics

In brief

• The Chinese economy is slowing as it makes the transition from investment- and industry-led growth to an economy more dependent upon consumption and services. This transition is both needed and an evolving reality.

• Although China has been engineering a smooth transition, the risks of a policy mistake have increased. The Chinese government, however, has many tools to manage this transition.

• Internationalizing China’s financial system has important consequences for global financial markets.

• A slower rate of growth in China is a headwind for emerging markets, but not necessarily for developed markets.

Investors are more worried about the economy than markets

Concerns about China spooked markets in 2015 and again this year when Chinese equities fell 10% within the first week of 2016. Stock market volatility within China can spur volatility around the world, something investors were reminded of in early January. The August devaluation of the yuan, together with the January suspension of trading on stock exchanges, raised doubts about China’s commitment to reform. Despite the headline-making stock market moves, the most pervasive fear still seems to be that Chinese economic growth will plunge, knocking the world into recession—a so-called hard landing for China. In a soft landing, Chinese growth would slow at a measured pace. Underscoring investor fears are rising doubts about the ability of Chinese policymakers to engineer a transition, as highlighted in the most recent market turmoil when concerns over policy changes prompted the equity selloff. When investors do not have a particularly good understanding of China’s economy, the data are opaque, and the economy is changing dramatically, how should investors think about China?
The Chinese economy is evolving

China is in transition. This widely used phrase has profound implications. As the Chinese economy rebalances, drivers of growth are changing from the industrial sectors to services and domestic consumption. This welcome and necessary transition has been unfolding for years; 2015 marked the first time the tertiary sector (mainly services) has accounted for at least half of nominal GDP growth, according to official statistics.

The services sector has been growing in importance

EXHIBIT 1: SHARE OF NOMINAL ECONOMIC OUTPUT GENERATED BY EACH SECTOR, %

Source: National Bureau of Statistics, J.P. Morgan Asset Management. 2015 numbers are year to date through the first quarter, which are more recently available; data are as of January 12, 2016.

The risks of a hard landing have risen as the transition has progressed, partly because services-led economies typically grow more slowly than industrial-led ones. Additionally, China is grappling with some of the supply-side constraints familiar to developed markets, such as slowing growth in both population and productivity.

The Chinese economy will have to rely less on investment

China’s rapid rise as an economic power relied on substantial investment by the government and an efficient and low-cost manufacturing sector. Infrastructure spending (roads, railways, bridges and dams) and low-cost financing for targeted industries—often through state-owned firms—led to excessive and unproductive investment. Encouraged by the government, banks extended credit with little hope of recouping their investments; local governments borrowed far beyond their means to finance often wasteful projects and cheap credit enabled companies to take on large amounts of debt. Each contributed to the significant and ongoing buildup of debt in China. In the second quarter of 2015, private sector debt stood at 196% of GDP, up from 112% prior to the start of the global financial crisis. As highly indebted companies focus more on managing their debt burden, companies without such burdens, typically non-industrial firms, will have an opportunity to grow, furthering the transition to a domestic demand-led economy.

Risks during the transition

Realizing the country would need to find a new engine of growth, Chinese policymakers began to plan for an economic transition as early as 2000. Their reform agenda lays out a shift from an investment-led to a services-led economy while also allowing market forces to play a larger role; those forces which already
encouraged the transition. However, during times of economic stress, the state frequently pulled on old levers of growth, with diminishing effectiveness. This maintained social stability and kept unemployment low, but also heightened the risk of a hard landing. We think China will avoid that scenario, but acknowledge the increased risk of a policy mistake. As investors think about China in transition, several questions certainly spring to mind.

**How is the Chinese government involved in the economic transition?** Ultimately, the smoothness of China’s economic transition depends on the government’s commitment to often difficult reforms. In our view, Chinese authorities seem willing to make the necessary tough choices. To manage the transition, the government has considerable control over where capital is invested, and the ability to wind down the buildups of unproductive credit. The People’s Bank of China (PBoC) can lower policy rates and reserve requirement ratios to manage liquidity in the economy, as they have been doing. Reforms to the social safety net and public health care system could entice consumers to increase their spending. Targeted stimulus measures in the real estate and auto sectors could boost short-term growth.

**Can investors trust Chinese data?** According to official statistics, real GDP grew by 6.9% year-over-year in the third quarter of 2015. Independent estimates suggest lower growth, and official statistics have been unnaturally smooth for the past few years. However, even if growth is much lower than officially stated, China is growing much faster than most of the developed world.

**Is China’s stock market turbulence a sign of a hard landing?** China’s high savings rate (estimated to be around 50% of GDP) created a large pool of capital searching for higher returns, which the stock market offered, and this encouraged risk-taking disconnected from underlying company fundamentals. The central government launched a public relations campaign over the summer to persuade citizens to move some of their savings into stocks; the government hoped the wealth effect would stimulate consumer spending. The plan fell apart as the market started to decline and investors rushed to sell their stocks. Signals that the authorities were also spooked by the equity correction further damaged investor sentiment. Ultimately, trading was suspended for several stocks. Eventually the market stabilized and began to move higher. Renewed worries about government intervention in the first weeks of 2016 again prompted a sharp sell-off in Chinese equities.

The long-term impact of the Chinese stock market downturn on consumers should be relatively muted, given that Chinese households hold only around 9% of their wealth in equities. Furthermore, companies will likely face limited troubles, as bank lending, rather than capital markets, serves as their primary source of funding.

Still, the equity rout does highlight the need for capital market reform. Freer capital flow and a market-determined value of capital would address some of the problems created by the misallocation of resources. With more accurately priced assets, global investment capital would likely move from the industry-linked sectors to the services-linked sectors that are increasingly driving China’s economic growth. In November, the government lifted the IPO suspension and reformed IPO listing rules; theoretically, these actions should make it easier for capital to find its way into companies serving the “new” China.

**Is China depreciating its currency to promote growth?** China is moving toward a more freely traded and usable currency. In August, Chinese authorities depreciated the yuan (formally known as the RMB) vs. the U.S. dollar (USD) by 3% overnight. Though the decline was small by historical standards and the yuan has depreciated further throughout the rest of the
year, the overnight decision rattled markets. The government seems to have been looking to bring the onshore (CNY) and offshore (CNH) RMB markets closer together after the gap between the two had widened considerably over the summer; a gap which again widened to record levels amidst the volatility of early 2016. More recently, the authorities are looking to bring the yuan closer to fair value, guiding the RMB to a four-year low against the dollar.

Some key takeaways about China’s currency:

• Dislocation between RMB used inside and outside the country creates confusion around the real rate of interest and transaction costs, making domestic monetary policy less effective and the RMB less usable as a global currency.

• Recently, the government has been spending some of its massive foreign exchange reserves to prop up the value of the RMB, with the overarching goal of currency stabilization—avoiding sudden steep moves in either direction. Officials seem to be pursuing a strategy of incremental devaluations to bring the yuan back down to earth, rather than an overnight adjustment. However, the gradual liberalization of the past few years has necessarily allowed more volatility in the exchange rate.

• Outright devaluation to support Chinese exporters would undermine the reform agenda, which looks for domestic, rather than foreign, demand to drive growth. At the same time, an overvalued currency is making Chinese companies less competitive. Moving to valuing the yuan against the trade-weighted basket will likely drive the yuan lower. Investors should expect further gradual moves downward in the RMB over the next few years.

• China managed its exchange rate vs. the U.S. dollar: officials set the exchange rate at the start of the trading day (increasingly closer to the prior day’s close) and allow the RMB to trade no more than 2% above or below that value over the course of the day. Though China is moving toward valuing the RMB against a trade-weighted basket of currencies (the government announced the currencies in the basket in December), the USD remains the most important. Because the yuan is forced to appreciate together with the U.S. dollar, in real effective exchange rate terms, the RMB is currently around 20% overvalued by historical standards.*

• The IMF recently included the RMB as the fifth currency in its Special Drawing Rights (SDR) basket, effective in the fall of 2016 (the others are the U.S. dollar, the euro, the yen and the British pound). The SDR is an additional unit of reserve currency issued by the IMF to member countries. Inclusion in the SDR basket marks the RMB’s arrival as a globally important currency and reflects the RMB’s importance in trade finance. But further capital account liberalization is needed in China for the RMB to become widely used in financial markets.

The yuan looks overvalued on several measures, despite devaluation

EXHIBIT 3: BROAD EFFECTIVE EXCHANGE RATE INDEXES

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<td>Real EER (PPI)</td>
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<tr>
<td>Real EER (CPI)</td>
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Source: J.P. Morgan Economics Research, J.P. Morgan Asset Management; data are as of January 12, 2016.

*Effective exchange rates compare the value of a currency to a weighted basket of several foreign currencies. Real indexes are deflated using producer or consumer price indexes.
A slower-growing China will impact other economies

Global growth matters. It matters not only because it is an important data point policymakers consider when determining their reaction functions, but also because we live in a globalized world where economies are increasingly linked. Now the world’s second-largest economy, China has accounted for around a third of global growth since the financial crisis. A slowing China will have an impact far beyond its borders. We see five main channels through which a transitioning China will impact the world: market volatility, capital flows, commodity prices, global trade volumes and prices. We would note that a slowdown in China would have a large economic impact on the emerging world, but a much more muted impact on developed markets.

Market volatility: As investors have become more aware of China, China has had a greater potential to impact financial markets. After seeing the panicked official reaction to the stock market downturn, investors felt that their understanding of Chinese policy-making was cloudy at best, leading to greater volatility in markets worldwide. We see the potential for greater global market volatility as China pursues its reform agenda and becomes more integrated into global financial systems.

Capital flows*: China has a huge pool of savings—an estimated U.S. $5 trillion—sitting in deposits across the country. As China further liberalizes its capital account, a large portion of these savings will likely leave the country, seeking the stability and defined property rights of investments abroad. Given Chinese investors’ demonstrated preference for real assets over riskier stocks, this capital will likely flow toward developed market real estate investments, especially in major cities in North America and Europe.

Commodity prices: China’s rapid industrialization turned China into a dominant consumer of raw materials; China now consumes around 50% of the world’s industrial metals. As China rebalances away from its industrial base, its demand for raw materials has correspondingly decreased, depressing commodity prices. This trend will continue, we believe, further harming emerging market (EM) economies with significant commodity export sectors (Brazil, Chile and Australia for example).

Global trade: Slower global growth will drag on export growth for countries with close ties to China (such as Japan and the majority of EM Asia). However, most developed countries export little to China, insulating them from the slowdown. Additionally, developed world banks have modest loan exposure to China (though indirect exposure through Hong Kong and Singaporean financial institutions may be higher than some investors realize).

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* "Lombard Street Research View," September 2015. Estimated value of savings deposits in China is as of August 2015.
Exports to China are more important for EM Asia than for developed countries

**EXHIBIT 5: GOODS EXPORTS TO CHINA, % OF NOMINAL GDP, 2014**

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<tr>
<th>Region</th>
<th>% of Nominal GDP</th>
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<tr>
<td>U.S.</td>
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<tr>
<td>Euro-Area</td>
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<tr>
<td>EM EMEA</td>
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<td>EM LatAM</td>
<td>1.74</td>
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<td>Japan</td>
<td>2.74</td>
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<tr>
<td>EM Asia</td>
<td>4.44</td>
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**Source:** IMF, IMF Direction of Trade Statistics, FactSet, J.P. Morgan Asset Management; data are as of January 12, 2016.

**Prices:** Most developed countries import a significant amount of Chinese goods, giving China an important role in determining prices in these countries. Production costs in China have remained low even as the country is moving to the mid-stage of the global production cycle—reflecting both low commodity prices and some re-outsourcing of production from China to even lower cost countries. Chinese producer price growth has been negative YoY for the past 48 months, a trend reflected in developed market consumer prices. These dynamics will likely remain in play in China in the near and medium term, keeping prices low for consumers and corporations in the developed world.

When production in China is cheaper, so are prices

**EXHIBIT 6: CHINA PPI, DM AGGREGATE CPI, YOY % CHANGE**


**Investment implications**

China’s economy is slowing and official statistics likely understate the extent of the slowdown. However, we do not see a hard landing on the horizon for China. We think the authorities can likely manage the economy’s transition, given the reforms that are already in place, the tools policymakers can deploy and China’s continued internationalization. China has low external vulnerabilities, limiting the potential knock-on effects of trouble in the Chinese economy, especially since a gradual slowdown in China is our base case. Still, a slowing China does mean a slower global growth environment. Investors should be aware that China’s importance to the global investing world will only increase after its currency is included in the IMF’s SDR basket and if China opens it capital account further.

The winners and losers from China’s transition are likely to be, respectively, developed and developing economies. Developed markets are likely to see lower prices and higher volatility. In the long run, relatively weak export links and developments favoring their own domestic demand should limit any negative impact on developed markets from China’s transition.

It is a far more differentiated story for emerging markets. Commodity exporters will continue to face headwinds as the industrial sector in China slows and commodity prices remain depressed. However, some manufacturing-oriented emerging markets could benefit in the long-term as a rising middle class and increased consumer spending in China raises domestic consumption and global manufacturers move their factories to countries with lower labor costs in the coming decades. Overall, investors should expect China to continue to make headlines, but remain focused on the long-term growth prospects of China and Chinese companies. Finally, investors should not overlook the investment opportunities in Chinese markets themselves. Here we would focus on China’s new economy and utilize a high degree of selectivity.
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