What's Ahead for the Chinese Economy

■ Charmaine N Clarke

On May 10, China's centrl bank announced its third interest rate cut in six months, the latest manoeuvre in efforts to manage the slowing of the economy. A month before, the IMF and Economist Intelligence Unit's (EIU) predictions that, for the first time in 16 years, India will grow faster than China over the next two years provided pundits a few hours of debate. So too did official reports that China's economy had grown by a "mere" 7% in the first quarter of 2015, the slowest in six years. The discussion has now become a familiar one: will China's "new normal", which includes less-than-double-digit-growth, mean a soft landing or will the country slide into much dreaded deflation? And, deflation aside, what are the big challenges that China will have to face this year?

On April 8, the EIU's Global Economist Joseph Lake presented their forecast for China and the rest of Asia during one of their popular Corporate Network breakfast gatherings in Shanghai. CEIBS Visiting Professor of Economics Wang Jianmao was invited to critique the EIU's China forecast during the event. *TheLINK* interviewed both men. They both agreed that there's no immediate risk of a hard landing for the Chinese economy, that China's growth will be in high single digits (5-9%) in the near future (though Prof Wang's expectations are a percentage point or two higher than the EIU's 5.6% prediction for 2019), that the government will rely a lot more on fiscal policy and that local government debt is a major problem. Read on for more of their thoughts on what's ahead for the Chinese economy and the implications for Asia.

TheLINK: ***What are the major challenges that the Chinese economy will face in 2015 in achieving the right pace of growth that will see sustainable development while avoiding a hard landing?***

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Wang: The Chinese government is now trying to stabilise growth and this is what is meant by "the new normal". Maybe the economy will continue to decline next year but the government will engineer some mild recovery in 2017 for political reasons. That's because 2017 will be an election year, when the current leadership will have to summarise what it has done in the past 5 years to get recognition for its accomplishments and legitimise running for its second term. So I expect the government would try to stabilise the growth rate ahead of that. There are also economic reasons to stabilise the growth rate because if growth continues to decline then many problems will be more difficult to resolve. For example if the economy continues to slow down, it will take a much longer time for China to resolve its bad loan problem. Another issue is income disparity. If the economy grows slower, there is less of a chance for poor Chinese to become rich. High single-digit growth, meaning 5% or more, should be maintained for at least two decades.

If the government is brave enough to change its population policy *together* with income tax rules, to allow dependent deductions and encourage people to have second kids, then consumption will really pick up over the coming decades. The change in the population policy *together* with this change in the tax policy, in my view, is the key to having a *real* soft landing of the Chinese economy. Unfortunately, the possibility of the above-mentioned structural change in China's population and its potential economic impact are missing in the EIU's "central forecast".

Lake: As expected, China's Premier Li Keqiang announced, when he delivered the government's annual work report

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to the National People's Congress in March, that the government was lowering its real GDP growth target to "around 7%" in 2015. This is down from "around 7.5%" in 2014. The adjustment of the growth target was necessary, given that China's economy is undergoing a structural slowdown. However, it is unclear how the target can be matched with other goals – notably, that fixed-asset investment growth will slow only marginally compared with 2014 and that retail sales growth will accelerate.

A key message from the report was that the government will lean more heavily on fiscal policy to support economic growth. Central and local government spending is forecast to increase by more than 10% in 2015, causing the budget deficit to widen to the equivalent of 2.3% of GDP. The focus on fiscal policy reflects a desire to slow growth in credit issuance, as well as a recognition that monetary loosening is now less effective than it used to be in stimulating demand.

TheLINK: ***What other types of policy moves should we expect from the government in the months ahead?***

Lake: The PBC [Peoples Bank of China] cut interest rates in February for the second time in three months and we expect another cut in policy rates soon. However, it is going to have to tread carefully because it is balancing a very delicate agenda. Monetary policy is relatively tight and the PBC wants to keep it that way, because the biggest danger to the economy at the moment is the credit bubble that has inflated since 2009. The PBC wants to engineer a slowdown in credit growth in order to deflate this. However inflation has eased substantially in recent months, largely because of the slump in oil prices, and this has increased real interest rates – that is interest rates in inflation-adjusted terms. Now it doesn't want to hinder the economy or cause a meltdown in bank asset quality, so it will have to reduce its policy rates; and we expect another reduction. The situation should normalise towards the end of the year as inflation starts to tick back up and we expect the PBC to tighten policy in 2016, reversing its recent rate cuts.

Another reduction in the required reserve ratio (RRR is also likely). The last two policy rate cuts, and the upcoming one, have led to a surge in capital outflows which has put pressure on the Renminbi to depreciate. The capital outflows will create a structural shortage of liquidity which the PBC will need to alleviate by reducing the RRR, so expect another cut to that as well. [Editor's note: the PBC did in fact lower the RRR by 1 percentage point on April 19 and cut interest rates on May 10.]

Wang: I agree. The government should rely more on fiscal policy – but we need smart fiscal policy, non-conventional, sustainable or innovative fiscal policy that has a multiplier effect. For example they could offer subsidies for people to replace their old vehicles with new ones and impose penalties on those who do not. This would boost consumption and would also have a positive impact on the environment because newer vehicles tend to be much more environmentally friendly. Some adjustments in the monetary policy are also necessary, for example lower interest rates, and/or lowering the required reserve ratio; but this can only play a secondary role. We need a mutually augmenting package: monetary policy *and* fiscal policy.

Currently, the Chinese government is using monetary policy to effect a soft landing of the housing market. Fiscal policy, in the form of dependent deductions, can actually augment this policy because it will generate new demand for housing 20 years down the road, when China's rapid urbanisation reaches its end and more than half of the country's one-child couples have passed away. This will help dispel people's long-term concerns about their investment in housing. Therefore, the soft landings of China's economy, population, and housing market are mutually linked; and the soft landing of China's population is the key.

TheLINK: ***How big a problem is local government debt?***

Lake: One of the greatest challenges facing the current administration

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is the restructuring of China's local government financing system. In March the Ministry of Finance published a statement saying that local authorities would be allowed to swap as much as RMB1 trillion (US$163.2 billion) in debt for bonds with a lower financing cost. This would mark the most dramatic step forward for the reform programme so far. However, questions remain about the details of the proposal, and it does little to resolve the problem of boosting local government fiscal inflows.

To its credit the government, under President Xi Jinping, seems well aware that local government finances need to be restructured, and the issue has been prominent in its reform agenda over the last few years. Behind the rhetoric it has adopted a multi-pronged approach that involves improving transparency, adjusting incentives, restructuring existing debt, and finding new revenue streams.

Wang: Local government debt is a huge problem. But we should not forget something unique about China: under a normal economy, the government would not own huge assets; but in China even the local government sometimes owns huge assets. If you take a more comprehensive look at local government debt, you will find the situation is not so bad.

Of course there will be some mini crises or mini bankruptcies at the local government level because not every local government has adequate assets. But if the central government is willing to help, the damage can be controlled. It's a huge problem but it's manageable. Nevertheless, due to the scale of existing debt problems and the unwillingness of governments to cash out their assets, neither the central nor local authorities are in a position to use massive fiscal-policy initiatives to boost the economy as they did a few years ago.

TheLINK: ***What about deflation?***

Lake: Given the sharp drop in global oil prices in 2015, there is a small chance that China will experience consumer price deflation in 2015-16. Given the slowing economy and the lack of progress in trimming excess capacity in the economy, there has been strong downward pressure on factory gate prices, which have now been falling in year-on-year terms for around three years. This deflation in producer prices could easily be passed through into consumer prices, especially if a downturn in the real estate market also serves to depress housing costs for consumers.

Deflation could have several serious consequences. Firstly, it could encourage consumers to delay purchases in the expectation of products becoming cheaper. This would undermine household spending, which will be one of the key drivers of economic growth as investment growth slows. Secondly, it could aggravate bad debt problems for firms and banks, as it would threaten growth in corporate incomes. There is also an upside potential: if falling consumer prices were driven mostly by lower energy costs, that could boost real disposable consumer incomes and lift corporate profits by reducing their expenses.

Wang: The government is more worried about deflation than inflation so that's why you see the central bank of China cutting interest rates. Deflation would be very bad for all debtors, including local governments who are heavily over-invested.

TheLINK: *It's anticipated that the Fed will utilise monetary tightening in the third quarter of this year and that this will be a risky time for Asia. What can Asian economies do, today, to minimise their risk?*

Lake: We believe that most emerging market economies are better placed than they were in the past to withstand the capital outflows that they usually experience when the Fed tightens monetary policy. They have larger foreign exchange reserves, a greater proportion of debt denominated in local currency terms rather than in US dollars, and there are fewer pegged exchange rates so the market rebalancing will be smoother.

This is not to downplay the risks to Asian economies as the Fed tightens policy for the first time in nine years, but just to say that the risk of an emerging market crisis is lower than in past tightening cycles. That said, expect to see a lot of economies increasing interest rates next year, in stark contrast to the 20 or so economies that have already loosened policy in the first quarter of 2015.

Wang: Most Asian developing countries have already done what they should, because they learned from the Asian financial crisis. And we also happen to have very low commodity prices; that will also help. I think Asian economies are in a much better position to cope with any fallout from the Fed's monetary tightening.

But overall, rebalancing the Chinese economy won't be easy. You need a good design then good implementation of the reform. And you need time to design as well as time to implement. A change in the population policy *together* with the income tax rule change will provide the time needed. This is very important because we've already missed the opportunity six years ago when the global financial crisis started, or even a few years earlier, when the Chinese economy was overheating.