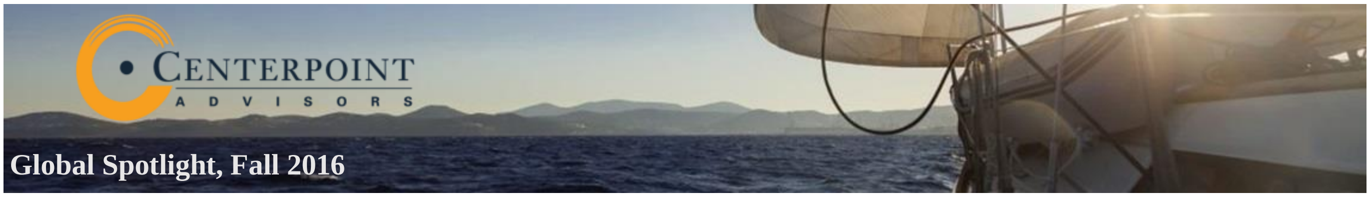

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Global Spotlight: China

The Great Rebalance

When Deng Xiaoping, the leader of China from 1978 to 1989, was questioned on his "unorthodox" economic ideas by more fervent members of the Communist Party, he often replied with "It doesn't matter if a cat is black or white, so long as it catches mice." Fast forward 35 years to today, and there is no question – Deng Xiaoping's decision to open up the economy and embark on a path of economic reform has been a resounding success. Since reforms were first implemented in 1980, the pace of China's growth has been incredible, with GDP growth averaging about 10% a year. This has transformed China into the world's second largest economy, lifting hundreds of millions of Chinese out of poverty along the way. China's economic rise also positively impacted the rest of the world, as it supplied cheap labor to produce goods for consumers in more developed economies and was a steady source of demand for commodities and other input materials.

Now, China's growth has begun to slow. Officially, China's annual GDP growth target is 6.5% for the next 5 years (their economy is currently growing around 7% per government statistics). While there is some debate over the accuracy of China's official GDP statistics, the fact remains that China has been growing much faster than more developed economies for a long time, and while this relative outperformance may continue, China's rate of economic growth is likely to decline moving forward. This decline is only natural, as a 10% growth rate in the long run is clearly unsustainable. However, China's policymakers face a number of challenges in managing this slowdown in a way that maintains domestic economic and political stability.

So how does this impact us here in the United States? For one, China now plays an integral part in the global economy, and thus a prolonged economic slowdown (which we haven't seen from China in the 35 years since it opened up) has the potential to disrupt growth in developed economies precisely at a time when they are suffering from a lack of it. Secondly, major US multinationals now derive a material proportion of revenues and profits from China, as it is after all the world's most populous country. The importance of China to both the US economy and financial markets has been apparent over the past year; indeed, Chinese economic data and/or policy was the main driver of stock market volatility in both August 2015 and January 2016, and the US Federal Reserve mentioned economic conditions in China as having been a consideration in coming to their decision to hold off on any interest rate hikes.

So, if China's economy is slowing and this slowdown will have a meaningful effect on the rest of the world, this means bad news ahead right? Not necessarily. As noted earlier, China's rate of economic growth over the past 35 years is unsustainable in the long run - growth had to decline at some point. It is the manner in which this transition to a more mature economy with lower but more sustainable growth takes place that will determine what path China takes and the ultimate impact on the rest of the world. Managing this transition is not an easy task for China's policymakers, and there are a number of necessary economic reforms that will be challenging to implement along the way. However, China's rapid economic growth has resulted in a number of positive developments that should aid in the transition, most notably a large middle class and an innovative private sector. Where China goes from here remains to be seen, as there exist both challenges and opportunities for the economy. Below you will find additional detail on some of the most pressing challenges and reforms, as well as an overview of China's "new economy" and the way forward.

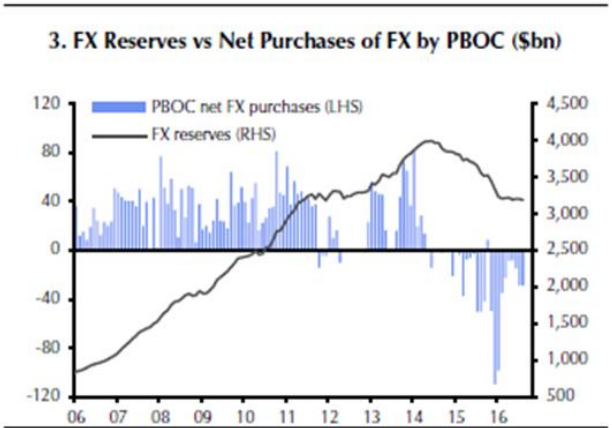
Economic Transition and Reform

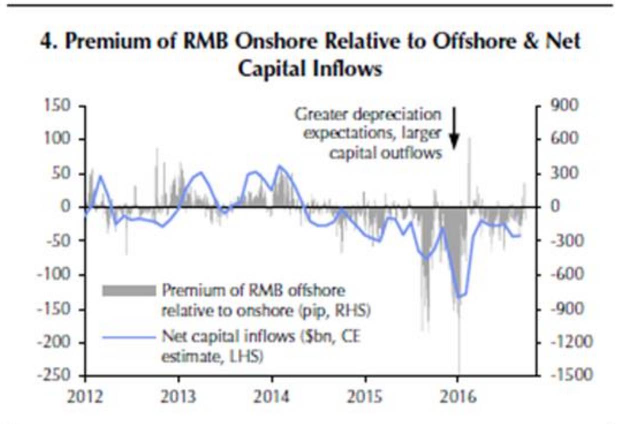
For many years, China followed an export-oriented economic model, relying heavily on manufacturing and fixed asset investment (investment in infrastructure, property, plant & machinery) for growth. Now, rising wages are causing China to lose some of its manufacturing competitiveness, with some manufacturers opting to move production to countries with lower labor costs such as Vietnam or Pakistan.[i] As a result, China must shift its economy sufficiently towards higher value-add manufacturing and services, or else it is likely to experience the "middle income trap" where growth stalls. This is well understood by Chinese policymakers, and the country has indeed started to transition from investment-led growth towards a more consumption-oriented economy with a focus on advanced manufacturing and services. This is reflected in GDP statistics, with the growth of China's "old economy" slowing significantly while its "new economy" expands, albeit at a gradual pace.

While the "Great Rebalance" within China's economy has begun, and the necessity of which is generally agreed upon by Chinese policymakers, outside economists, and other China watchers, there are still many challenges to its success. Overcapacity in the steel, coal, and other heavy industries needs to be reduced, a task that would involve shuttering or seriously reforming many of China's SOE's (state-owned enterprises) operating in these sectors. However, the government is limited by the fact that the resulting job losses would create political instability, as even minor reform has seen protests break out in China's "rust belt" industrial north. The Party will not jeopardize its primary goal of maintaining control over the country, which limits the pace of reform. The debt burden of the nonfinancial private sector (again, mostly SOEs) is also a cause for concern, having grown rapidly post-2008 crisis. While there is debate over whether this debt buildup will lead to a destabilizing crisis, a significant portion of this debt is viewed to be implicitly guaranteed by the government, as a wave of failures would threaten political stability. Nonetheless, history tells us that a buildup in debt of this magnitude, if not preceding a financial crisis, typically leads to a prolonged period of slow economic growth.

Capital account reform and exchange rate liberalization are two other steps necessary in China's transition to a consumption driven, developed economy. Higher consumption will erode China's current account surplus and thus foreign capital will be required in order to finance it. Loosening capital controls would result in greater access for foreign investors, deepening financial markets and allowing for more sustainable growth. Exchange rate liberalization plays a key part in this by increasing convertibility of China's currency, the Renminbi (RMB) and making it more likely that foreign investors are willing to hold it. All this would increase the role of the RMB in the global economy, something desired by China not only for economic reasons but geopolitical as well; the ascendance of the RMB as a global reserve currency would affirm China's importance and influence in the global economy. This desire was seen in China's push for the RMB to be included in the IMF's Special Drawing Rights (SDR) basket of major global reserve currencies, which recently succeeded. However, this move is more symbolic than anything else, as global reserve currencies are ones that foreign central banks are willing to hold in size, which is unlikely to be the RMB anytime soon given its convertibility issues.

While some progress has been made with respect to opening up the capital account and liberalizing the exchange rate, recent events have likely caused future reform to be put on hold indefinitely. Over the past year, many market participants have become concerned that China's slowing economy coupled with a Federal Reserve tightening cycle would lead to the RMB depreciating against the dollar, accelerating capital outflows. A sharp depreciation would also reduce consumer purchasing power, which would drag on the economy's transformation to a more consumer oriented economy. While the onshore RMB is not freely convertible and is only allowed to trade in a tight band around a fixed rate set by the authorities, there are no such restrictions on the offshore RMB traded in Hong Kong, which has traded at a discount to the fixed rate of its onshore peer. The PBOC has intervened heavily in the offshore Yuan market in order to minimize volatility around its fixed rate and maintain confidence in the RMB, which has used up a considerable amount of its Fx reserves.





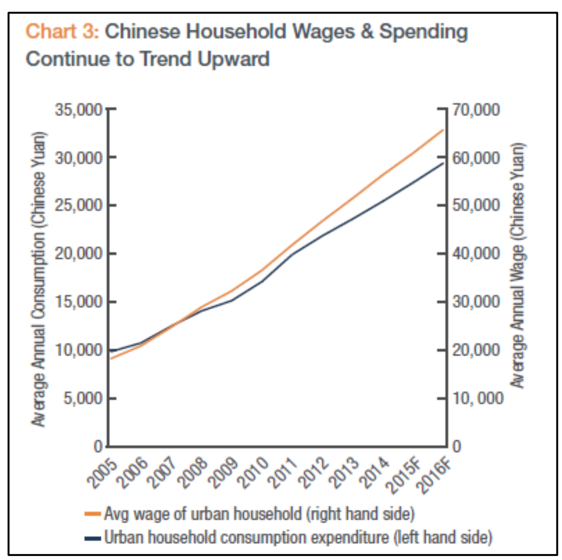
Source: Capital Economics, Thomson Datastream, Bloomberg, CEIC

However, while the PBOC has and likely will continue to intervene in order to maintain a relatively stable exchange rate, it has over the past year allowed the RMB to depreciate against the dollar, albeit in a slow and steady manner. Investors rightly fear an unorderly RMB depreciation, which would roil financial markets, but should this managed depreciation continue, both China and the rest of the global economy should be able to cope.

These are just a few of many reforms necessary for the success of China's Great Rebalance, with numerous books devoted to the topic. The transformation of the Chinese economy is a huge task, and the path it takes along this transformation will impact both global economic growth and financial markets. Ultimately, China must strike the right balance, not rebalancing too quickly which would result in a hard landing, nor delaying reforms that if not undertaken would stunt future growth.

Rise of the Consumer

Understanding that China faces a difficult path moving forward, let's take a look at some positive developments within the economy and opportunities for investors. China's economic growth has created a large and expanding middle class, which currently makes up about 40% of the population. As the economy adds more jobs in higher value-added manufacturing and services, incomes will rise and household wealth will increase. This increase in household wealth combined with an extremely high household savings rate of around 30% of disposable income leave plenty of capital to fuel consumption



Source: Mirae Asset , National Bureau of Statistics, Korn Ferry Hay Group growth.[ii] Many attribute the high savings rate at least in part to memories of tough times during the pre-1980 command economy era, which is understandable. However, the new generation of Chinese consumers, having grown up with better living standards in an increasingly wealthy country, has exhibited a greater propensity to spend, particularly on discretionary items such as technology, entertainment, and travel.

This change in consumption patterns is already well underway, and has encouraged innovation and growth in the private sector to meet consumer demands. This is particularly evident within the information technology industry, which has seen companies such as Alibaba and JD.com in e-commerce, Tencent in social media, and search giant Baidu all become leading global businesses. China's e-commerce sector is now the largest in the world, having been helped by the population's high rate of technology adoption and rapidly expanding use of mobile devices. To put the size and scale of some of these companies in to perspective, consider this statistic from 2014: on "Cyber Monday" Amazon had 36.8 million orders totaling $2.7 billion in sales, on "Singles Day," the Chinese equivalent, Alibaba has 278 million orders totaling $9.3 billion in sales![iii]

In addition to these e-commerce and internet firms, several other sectors in China's "new economy" have enjoyed rapid growth and show promise for the future. As higher labor costs have raised competitive pressures, robotic automation is being increasingly adopted by manufacturers. The government has enacted policies to encourage entrepreneurial activity, especially in advanced science and technology fields. For example, the development of the domestic electric vehicle industry has become a major priority. Demand for healthcare and financial services have grown steadily, as an aging and wealthier population are both in need of and able to afford them. This increase in wealth has also created more leisure time, and thus demand for tourism and related services.

While the growth rate of China's "old economy" will continue to decline, this decline should be at least partially offset by growth in China's "new economy" which makes up an increasing proportion of overall economic growth. Driving this "new economy" will be an innovative private sector, a focus on home grown R&D, and increased productivity, among others. Coupled with an expanding middle class which has both the ability and propensity to consume, these factors all help to increase the likelihood that China will be successful in its economic transition, and present opportunities for the future.

Sources:

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