China – Strengths and Challenges

Major Economic Challenges

1. Excessive Domestic Debt
2. Housing and Construction Slowdown
3. Rebalancing the Economy*
4. Reducing Pollution
5. Income Inequality
6. Financial Fragility

1. Excessive Domestic Debt

Over the past decade, China's credit boom has been the largest factor driving global growth. That may be about to change. President Xi Jinping's administration is encouraging banks and businesses to start deleveraging. Meanwhile, the government is committed to doubling the economy from 2010 to 2020, and getting there will almost certainly require more loans.

In 2008, China's total debt was about 141 percent of its gross domestic product. By mid-2017 that number had risen to 256 percent. Countries that take on such a large amount of debt in such a short period typically face a hard landing. That's why everyone—academics, private banks, the International Monetary Fund, the Organization of Economic Cooperation and Development, the Bank for International Settlements, and People's Bank of China Governor Zhou Xiaochuan—is sounding the alarm.

China's debt-to-GDP ratio ranks with those of developed economies such as the U.S., the U.K., and Italy. The problem is that China is still a middle-income country, with a purchasing-power-parity-adjusted GDP per capita of just $15,400—barely a quarter of the U.S. level. Maxing out on debt at such a relatively low income level will make it more difficult for China to pay for its climb toward a developed economy.

China isn't the U.S. before the housing market collapse; households are relatively lightly leveraged. Nor is it Greece going into its sovereign debt crisis; government debt is low. Borrowing is mainly on corporate balance sheets: Chinese corporate debt was 163 percent of GDP in mid-2017, according to the Bank for International Settlements. Banks are the main enablers. The PBOC, the central bank, aims to have the bond market play a larger role in financing debt, reasoning that credit is allocated more efficiently in transparent, liquid markets.

The IMF identified 43 credit booms in which the credit-to-GDP ratio increased by more than 30 percentage points in five years. All but five ended with a significant growth slowdown or financial crisis. China's debt-to-GDP ratio has risen 54 percentage points in the last five years. Moreover, it started from an elevated level, increasing the chance of a crisis, according to the IMF.

China is now the second-largest economy in the world and the biggest trading nation, and it has the third-largest bond market. A meltdown would have global repercussions. Countries with the closest trade ties are the most at risk. South Korea, Malaysia, and Vietnam each have exports to China valued at more than 10 percent of their GDP; commodity exporters South Africa and Chile are not far behind.

Too much leverage reflects an abundance of credit. The obvious solution is for the central bank to raise interest rates. With inflation under control and growth uncertain, however, the PBOC has left the benchmark loan rate on hold at 4.35 percent. Repo rates, used to guide interbank borrowing costs, have edged only slightly higher. Bloomberg Economics' China credit impulse—a gauge of new credit as a percentage of GDP—shows that new lending is no longer providing a boost, but it's not creating a drag, either.

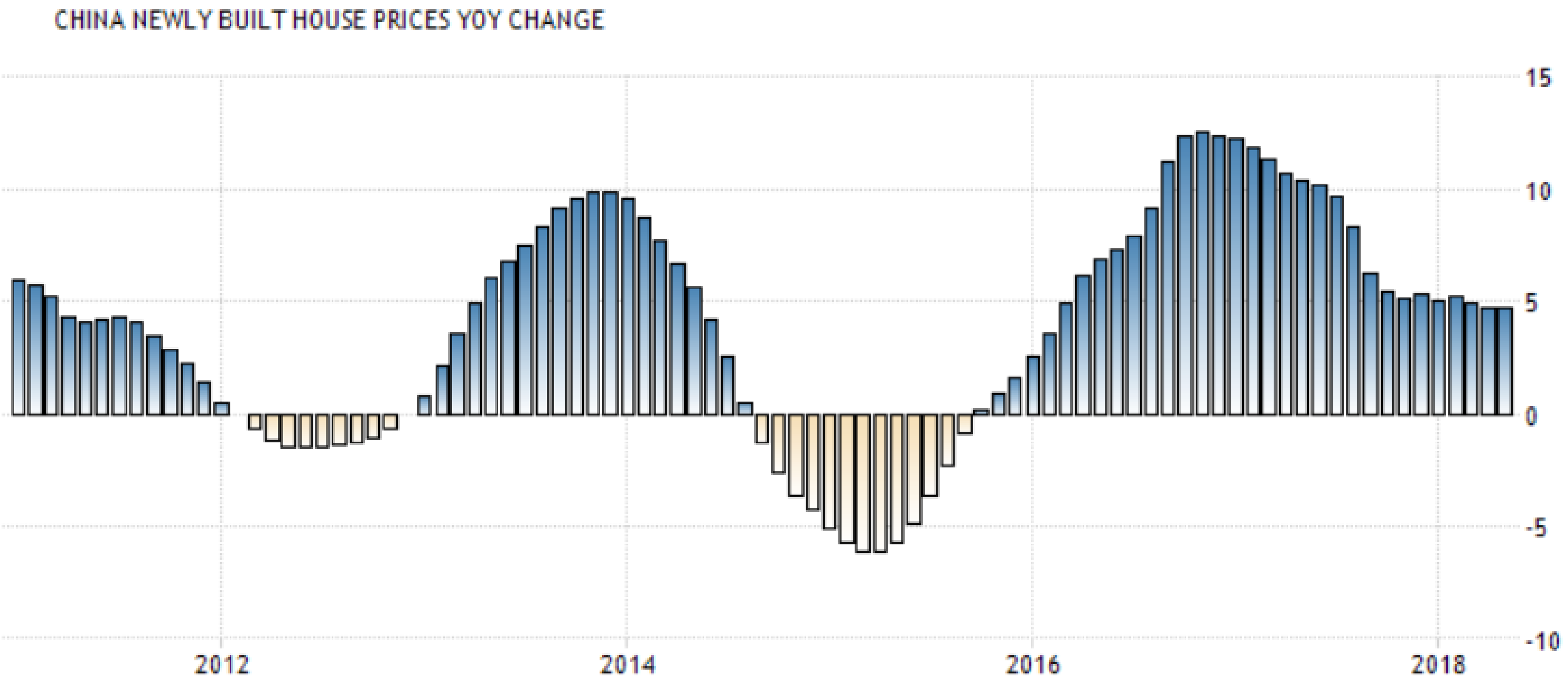
The central bank has rolled out regulations targeting bad behavior by banks. A quarterly balance sheet review punishes those that paint outside the lines on assets or liabilities. That’s proved effective, slowing banks’ investment in risky, shadow loans and reducing their reliance on expensive and unstable short-term funding.

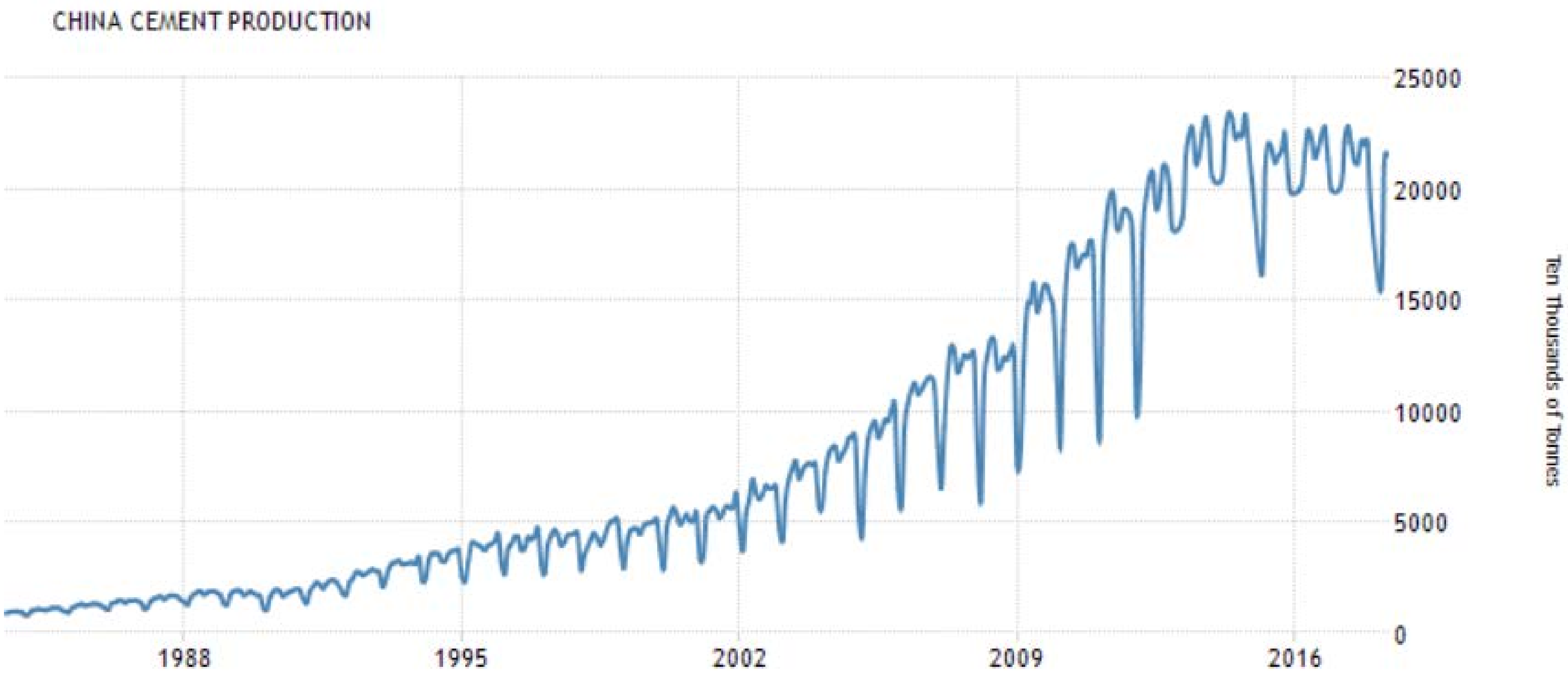
At the local level, Communist Party cadres, bankers, and businesses are working to manage down bad loans. Banks are being strong-armed into swapping loan claims for equity stakes. Small banks are being merged into bigger ones and gaining a capital infusion along the way. A review of 2016 financial statements of 41 banks found 576 billion yuan ($83 billion at the end of 2016) in bad loan write-offs, up from 117 billion yuan in 2013.

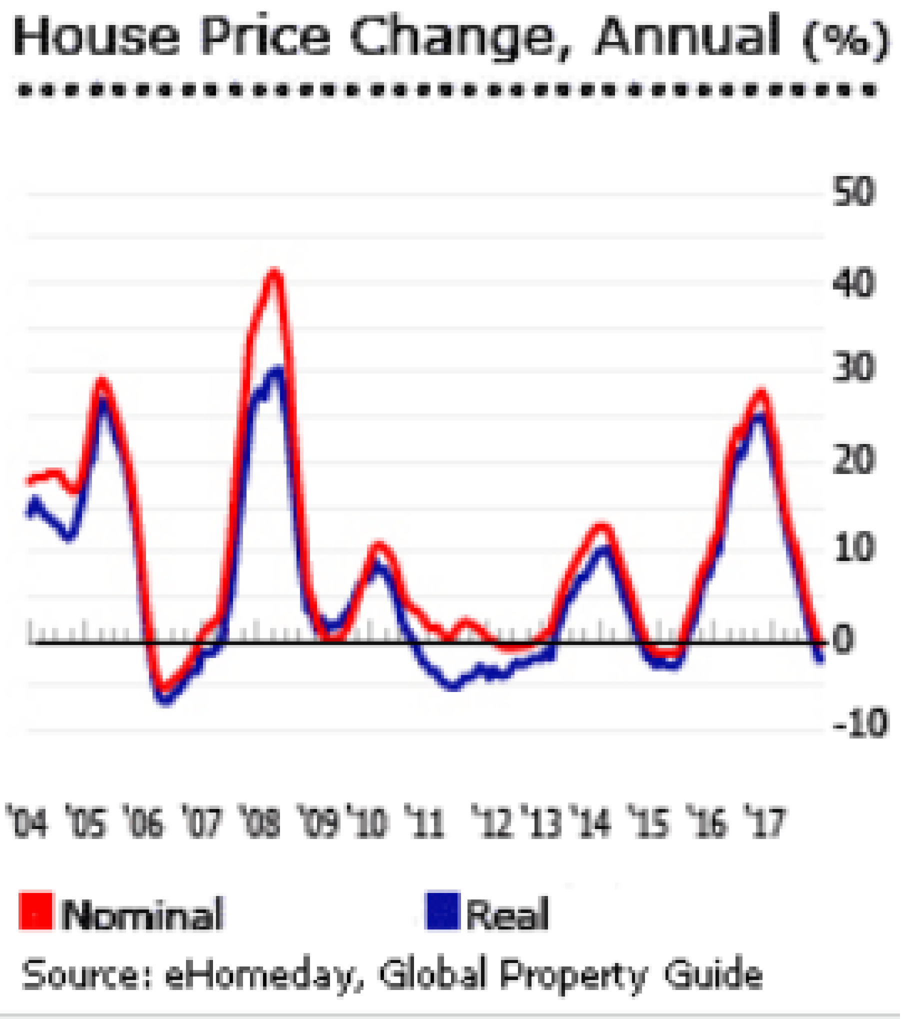
Perhaps the biggest support to the deleveraging agenda comes from what’s happening on growth. Measured in current prices, China’s GDP growth has accelerated to 11 percent year on year in the fourth quarter of 2017, up from a nadir of 6.4 percent at the end of 2015. Higher nominal growth means higher profits and more tax revenue—useful for paying down debt. Bloomberg Economics’ base case is that by 2022, China could face a debt-to-GDP ratio close to 330 percent, second only to Japan among major economies. If high nominal growth can be sustained, debt could stabilize at about 290 percent of GDP.

Containing a debt bubble comes with its own risks. Meaningful steps to limit leverage necessarily involve slower loan growth. When that happens, markets fall and growth slows. In December, for example, deleveraging fears pushed the 10-year government yield above 4 percent and the benchmark CSI 300-equity index sold off 3 percent in one day. The risk is that steps to deleverage trigger the hard landing they’re meant to avoid.

2. Housing and Construction Slowdown




CHINA CEMENT PRODUCTION
25000
20000
15000
10000
5000
0
1988
1995
2002
2009
2016
Ten Thousands of Tonnes



In December 2017, the average price of new houses in China's 70 cities rose by 5.3% y-o-y.

This was a sharp slowdown from December 2016's 12.4% y-o-y price growth, based on figures from the National Bureau of Statistics of China. Clearly, tighter government measures in late 2016 have dampened the housing market.

New home prices rose in 57 out of 70 cities. House prices in cities of less-developed provinces actually had the biggest price gains, rather than 1st tier cities, suggesting that the prime cities are cooling first, followed by the provinces.

In December 2017, Beijing saw no price change in prices of first-hand properties from the previous month, while Shanghai saw a meagre 0.2% growth m-o-m. Guangzhou and Shenzhen saw price drops of 0.3% m-o-m and 0.2% m-o-m, respectively.

3. Rebalancing the Economy*

Topic to be discussed as 15 minute report by Group 4 on Second Day

4. Reducing Pollution

A new team has been created to battle pollution and will be headed by the vice-premier Han Zheng, with environment minister Li Ganjie, the mayors of Beijing and Tianjin and the governor of Hebei province serving as deputies. The State Council statement said the new group would help create a “coordination mechanism” to tackle pollution in and around the Beijing-Tianjin-Hebei region, which has been on the front line of China’s efforts to clean up its rivers, soil and skies. The establishment of the new leadership group is also a sign that China’s war on pollution, now in its fifth year, has become too important to leave solely to the Ministry of Ecology and Environment. Also on the panel will be China’s top energy official Nur Bekri, the deputy ministers of housing, finance and transportation, as well as senior regional officials from Shanxi, Shandong, Henan and Inner Mongolia. China is in the middle of a program aimed at integrating Beijing with its neighbors Tianjin and Hebei, with the goal of easing income disparities and preventing “duplicated” development throughout the region. The “coordinated development” plan was launched in 2014 and came in the wake of several politically embarrassing bouts of heavy smog in the Chinese capital, much of which was blamed on Hebei, the country’s biggest steel producing region. China’s President Xi Jinping has strongly backed the integration efforts, and he also vowed in May this year to use the full might of the Communist Party to tackle longstanding environmental problems throughout the country.

Five years ago, China declared a “war against pollution.” Since then, new coal plants have been barred from opening and existing ones have been ordered to cut emissions. Major cities restrict the number of cars allowed on the roads. This past winter, residents in Beijing were left without heat after their coal boilers were removed. As part of the campaign, officials this month expanded the powers of the country’s 10-year-old ministry of environmental protection to include water management, emissions reductions, agricultural pollution, and other duties previously managed by half a dozen other ministries. As part of its new remit, the ministry is holding a second environmental census, to be completed in 2019. It will look into industrial parks, as well as municipal and rural sources of pollution. “We will look into all kinds of pollution sources,” Hong said. China has made some important gains. Michael Greenstone, director of the Energy Policy Institute at the University of Chicago, analysed data from government air monitors collected between 2013 and 2017, and found that many of China’s densest cities have recorded major declines in air pollution. In Beijing, where several days of smog known as “the airpocalypse” of 2013 in part prompted China’s declaration of war, the concentration of fine particulates in the air fell 35%.

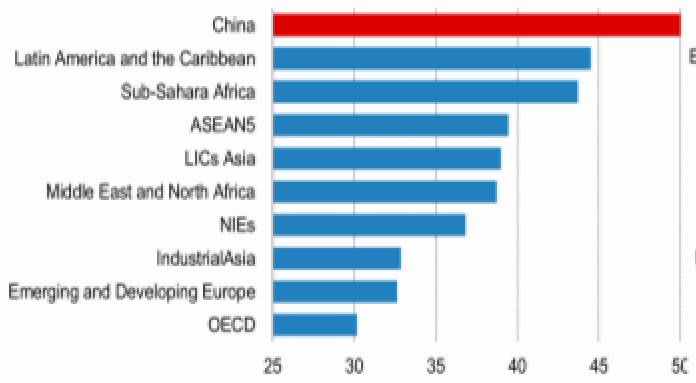
China had concentrations of PM 2.5—the smallest polluting particles, which pose the greatest health risks—were 54% lower in the Chinese capital during the fourth quarter of 2017 than during the same period of 2016. Concentrations of PM 2.5 in 26 cities across northern China, the province-sized metropoles of Beijing and Tianjin, were one third lower. China genuinely has reduced its notorious air pollution. How has it done it and at what cost? The country has had draconian anti-pollution measures since 2013, when it introduced a set of prohibitions called the national action plan on air pollution. This imposed a nationwide cap on coal use, divided up among provinces, so that Beijing (for instance) had to reduce its coal consumption by 50% between 2013 and 2018. The plan banned new coal-burning capacity (though plants already in the works were allowed) and sped up the use of filters and scrubbers. These measures cut PM-2.5 levels in Beijing by more than a quarter between 2012-13, the time of the city's notorious "airpocalypse", and 2016. The measures were notable for being outright bans on polluting activities, rather than incentives to clean up production, such as prices or taxes (though China has those, too, including what will be the world's largest carbon market, when it opens this year).

5. Income Inequality

China has moved from being a moderately unequal country in 1990 to being one of the most unequal countries. Income inequality in China today, as measured by the Gini coefficient[2], is among the highest in the world. The Standardized World Income Inequality Database (SWIID)[3] estimates the Net Gini[4] coefficient for China at 50 points as of 2013, which is above various regional averages and among the highest in Asia (see figure 1). The official estimate by the National Bureau of Statistics (NBS) assessed it slightly lower at 47.3 Gini points.[5] Furthermore, the Gini coefficient has rapidly increased over the last two decades, by a total of about 15 Gini points since 1990 (see figure 2). A combination of national sources suggests a similar increase of about 12 ½ points.[6] Given that income

Figure 1: Regional Comparison of Income Inequality Levels

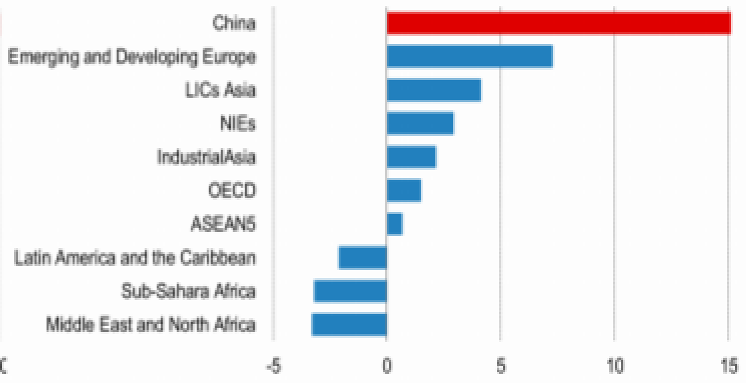
(Net Gini Index; in Gini points; year of 2015 (or latest available); average across the region)



Sources: SWIID Version 5.1; IMF, and IMF staff calculations.
Note: ASEAN = Association of Southeast Asian nations; LIC = low-income county; NIE = newly industrialized economy; OECD = Organization for Economic Cooperation and Development

Figure 2: Regional Comparison of Income Inequality Trends

(Net Gini Index; in Gini points; change since 1990; average across the region)



Sources: SWIID Version 5.1; and IMF staff calculations.
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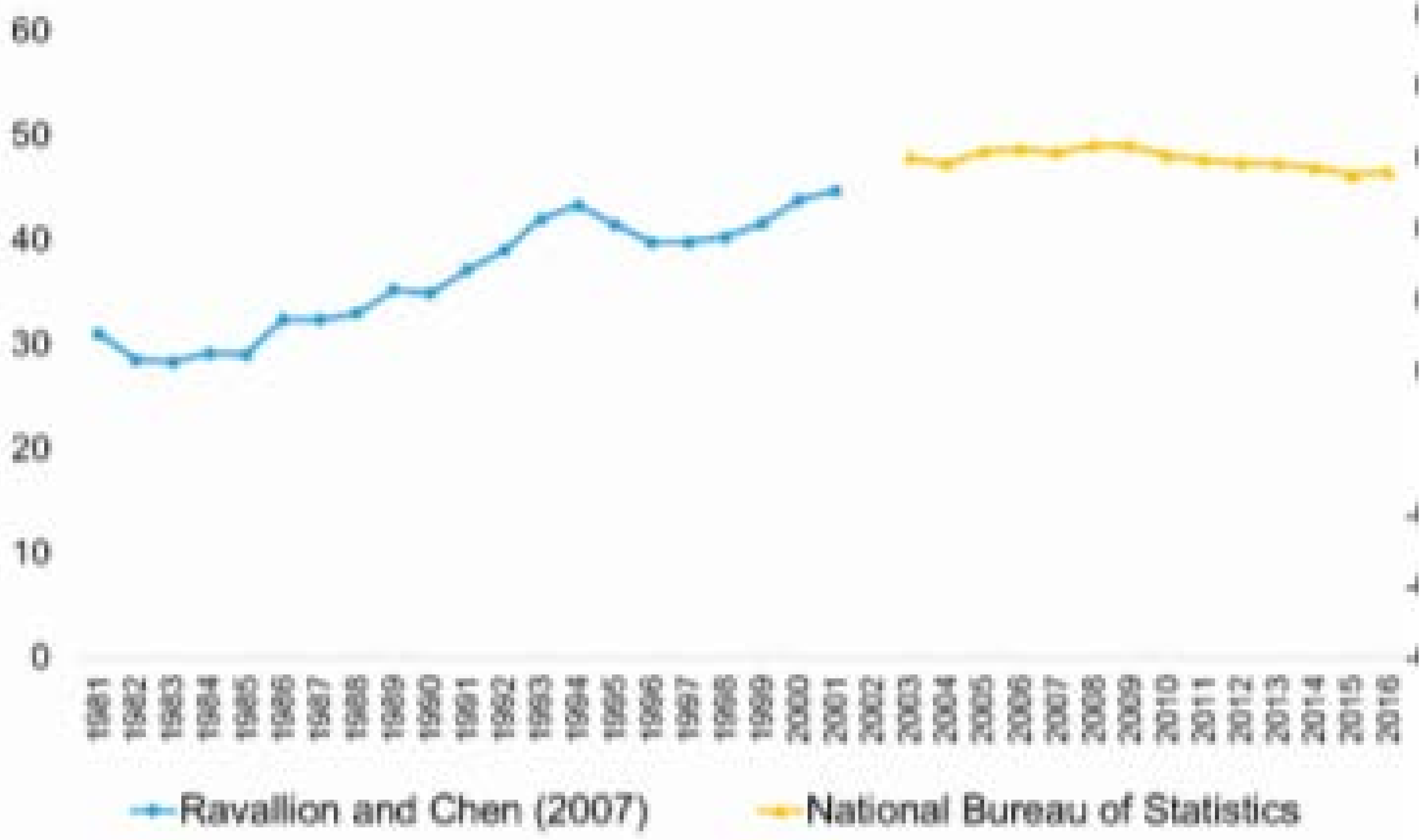
Figure 3: China's Gini Coefficient, 1981-2016

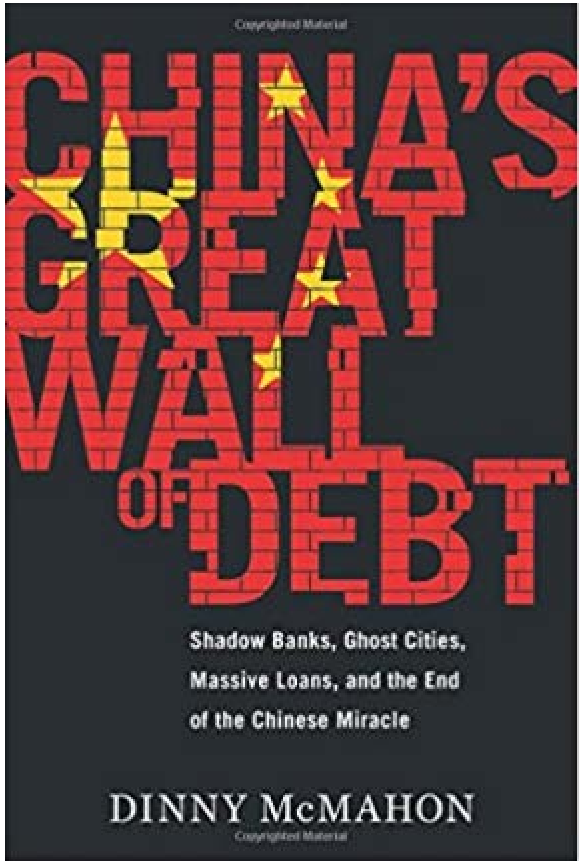


Sources: Zhuang and Shi (2016).

What policies has China implemented to address inequality?
Policy reforms have been initiated in a number of areas:

Personal Income Tax Reform.
Labor market policies.
The Dibao system.
Pro-farmer policies.
Social security.
Regional development strategy and fiscal transfer policies.
Poverty alleviation policies.

6. Financial Fragility



Through the stories of ordinary Chinese citizens, McMahon tries to make sense of the unique—and often bizarre—mechanics of the Chinese economy, whether it be the state's addiction to appropriating land from poor farmers; or why a Chinese entrepreneur decided it was cheaper to move his yarn factory to South Carolina; or why ambitious Chinese mayors build ghost cities; or why the Chinese bureaucracy was able to stare down Beijing's attempts to break up the state's pointless monopoly over the distribution of table salt.

Debt, entrenched vested interests, a frenzy of speculation, and an aging population are all pushing China toward an economic reckoning. China's Great Wall of Debt unravels an incredibly complex and opaque economy, one whose fortunes—for better or worse—will shape the globe like never before.

https://www.audible.com/pd/Nonfiction/Chinas-Great-Wall-of-Debt-Audiobook/B07BH3GJ4Z

Summary Hour 6

1. China has an enormous and exploding debt (both private and public) which has been increasing very quickly relative to other countries. This debt has financed overcapacity, malinvestment, and little used public infrastructure. The debt is concentrated in SOEs and in local government, which have little or no ability to repay. The local governments have made extensive use of LGFV to borrow money. Those who borrow use the funds to enrich themselves and then move on.
2. There has been a housing slowdown, especially in 3rd, 4th, and 5th tiered cities. Too much building in these areas has led to overcapacity and ghost cities. Some ghost cities have been populated, like the one where Foxconn created a massive factory, Zhengzhou. Reduction in construction must be part of the plan to rebalance the Chinese economy.
3. Rebalancing of China is covered by Group 4 tomorrow
4. China is involved in reducing pollution especially in some cities like Beijing. Some progress hs been made in this regard. Five years ago, China declared a “war against pollution.” Since then, new coal plants have been barred from opening and existing ones have been ordered to cut emissions
5. China is experiencing very serious income inequality. Rural and urban income gaps are worsening. Children and elderly are left in villages (since school and benefits are free there) while middle aged move to the cities. Gini coefficient for China is one of the highest in the world. Several policies have been introduced.
6. Financial fragility