China's Economy Slowing

Will Stimulus Save the Chinese Economy?

Thematic Report by
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China's Transition To A New 'Normal'

As China grapples with growth slowing toward the second half of 2015, the government has been swift in introducing monetary and fiscal measures to support economic expansion. While China's economic growth is expected to edge down to 6.5% by the end of the decade, creating a new 'normal', the government is focusing its efforts on making it a smooth transition.

Since 2014, the government has eased property restrictions, cut benchmark lending rates four times as well as reserve ratios for targeted segments, and doubled the size of its debt swap program among other measures. Despite these initiatives, the policy transmission process appears to be inefficient, considering growing concerns over the economic slowdown worldwide. Meanwhile, despite the measures taken by the government to increase liquidity in the system, the low demand and utilization scenario limits fund expansion and banks' concerns over collaterals and risks restrict credit expansion.

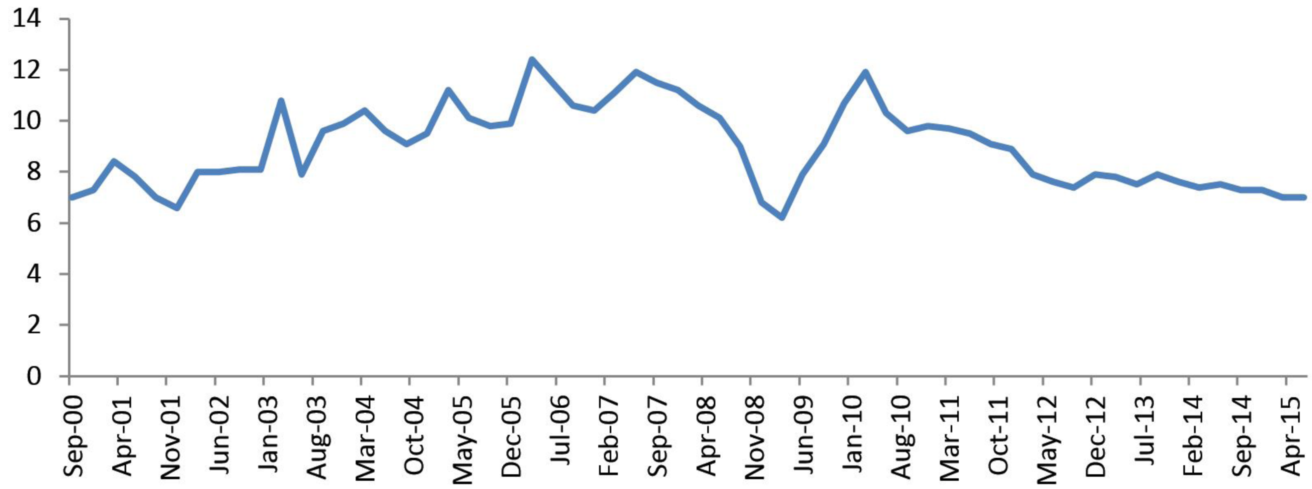
While China exits the era of high economic growth, the government will continue to navigate policies toward a new normal. However, even with accommodative policies, the transition to a slower economic growth is unlikely to be smooth.

Economic Growth Decelerating

GDP Growth Weakest Since 2009

China seems to be stepping down from the position of 'The Engine' of global economic growth. In the first two quarters of 2015, the Chinese economy expanded at its weakest pace since 2009. The GDP growth has slowed from 10.4% annually in 2011 to 7.4% in 2014 and to 7% in the quarters ended March and June 2015.

China GDP growth slowing to a new 'normal'



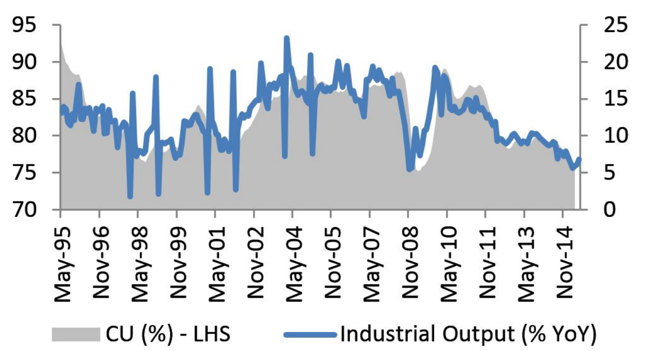
Source: Bloomberg

Key Indicators Point Toward a Slowdown

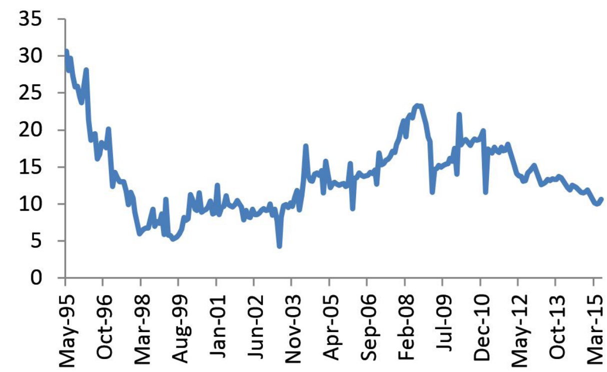
Industries face excess capacity, while consumer demand wanes

Weakening in key economic indicators point toward a deepening slowdown. Capacity utilization of the industrial sector and growth rate of industrial output are close to the lows last seen during the financial crisis. With most of the idle capacity being in high-pollution, low-efficiency industries, there is limited scope for accelerating growth by increasing utilization. Chinese manufacturers are showing increasing signs of distress as they face weak demand from both domestic and overseas markets. The retail sales growth continues to slump and is currently at more than eight-year low.

China Capacity utilization and Industrial output growth



China retail sales growth slumps (% YOY)

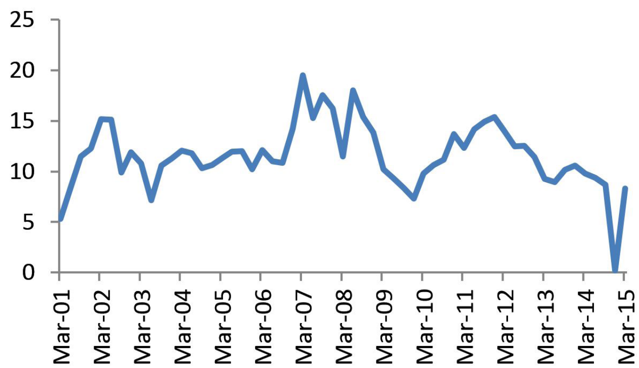


Source: Bloomberg

Consumers Ill-Positioned to Boost Demand

Slowing income growth and a drag on household wealth on account of falling house prices reflect that the consumers are ill-positioned to boost demand. The growth in per capita disposable income of urban households has substantially slowed to 8.3% YOY in the first quarter of 2015 from a peak of 19.5% in 2007.

China urban household income growth slowing

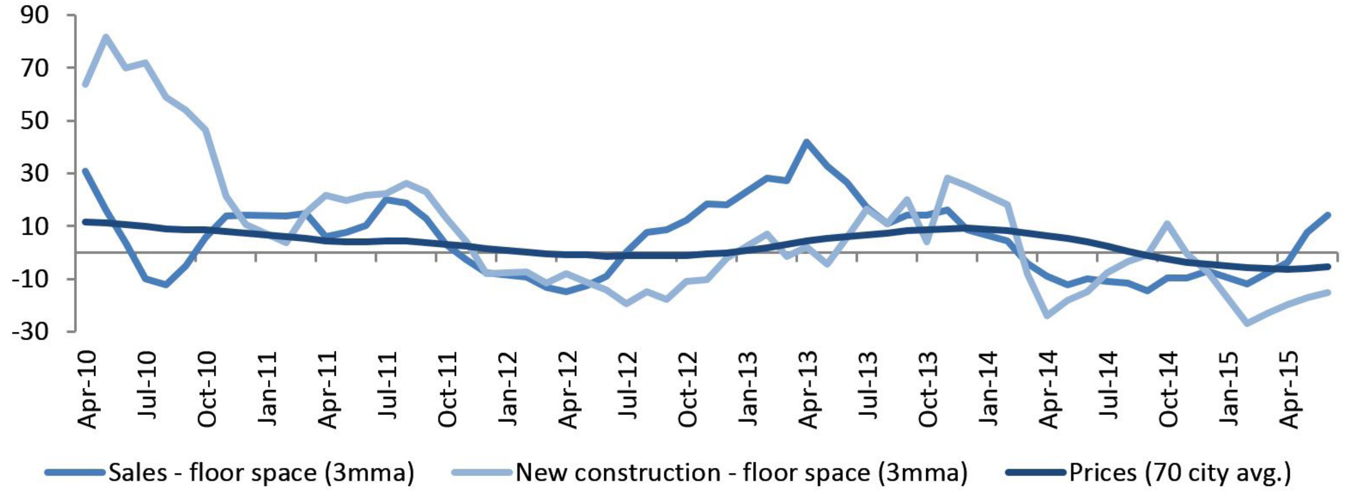


Oversupplied Chinese property markets

Source: Bloomberg

China's property market is facing the dual challenge of declining property sales and falling prices, making it difficult for Chinese cities to offload excess stock onto the market. Chinese property prices have been declining since the last eight months. Furthermore, with new construction at about 10.5 million units per year against an estimated fundamental demand of less than eight million units per year hints at an impending contraction in the construction sector.

China property market remains under pressure

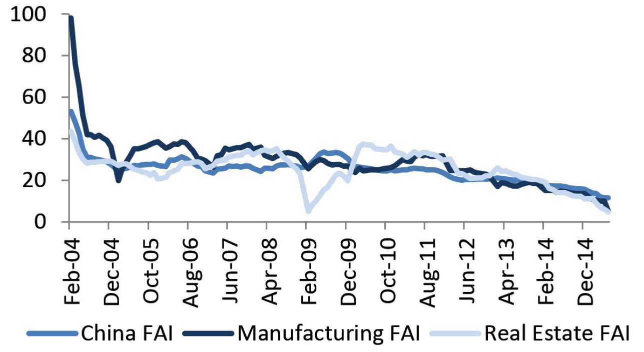


Source: Bloomberg

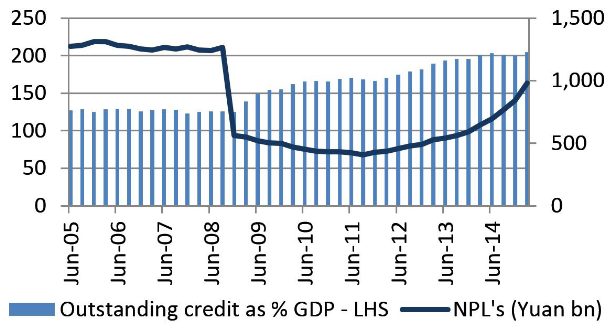
Investments Remain Stumpy as Credit Looks Overstretched

A major barometer for Chinese growth, fixed-asset investment (FAI), is facing a slowdown due to falling profits, overcapacity, and high real interest rates. In May, China's FAI grew at its slowest rate in nearly 15 years. Within that, manufacturing sector FAI has declined more sharply. China's credit expanded at a fast pace during the financial crisis and in the following years. China's outstanding credit was more than twice the country's GDP at the end of the first quarter of 2015. The overstretched credit offers little scope for further credit expansion and also fuels the fears that further lending in a slowing economy might result in higher non-performing loans.

China FAI growth slowing



Outstanding credit more than 2x GDP



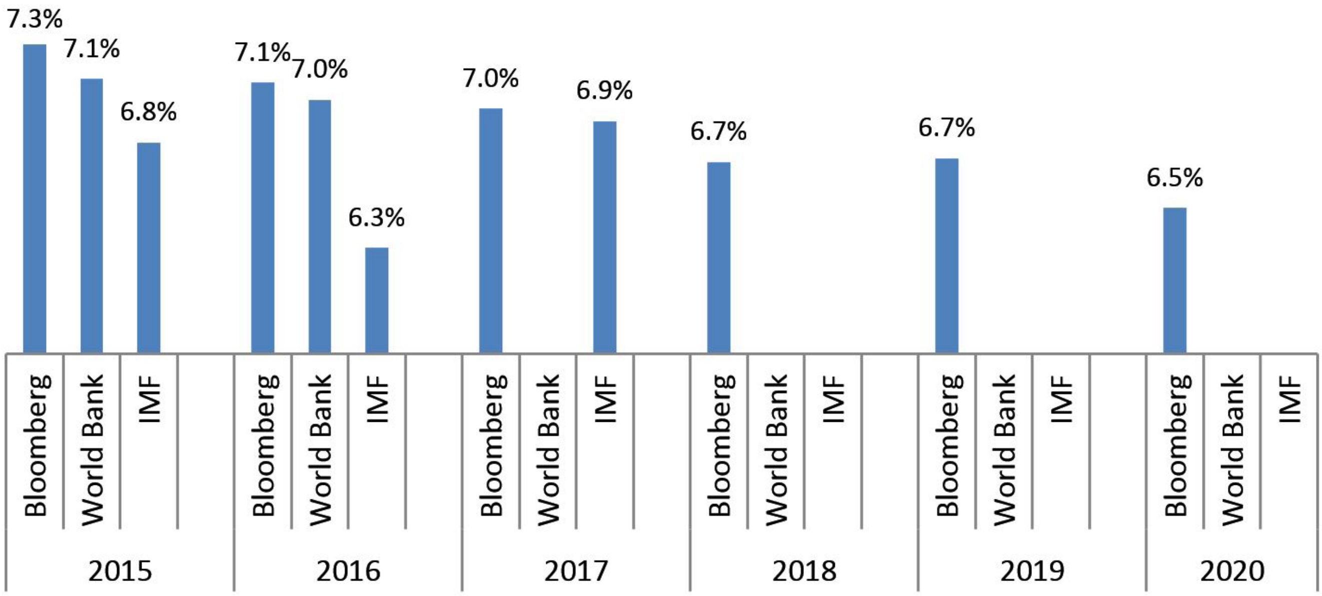
Source: Bloomberg

Economic Growth Outlook at a New "Normal"

The slowdown in the Chinese economy was inevitable, as any country cannot sustain at double-digit growth for long. China's investments have peaked out and working age population has started declining since 2012. Slowing investment and labor shortage would affect productivity, thereby impacting economic growth in the long term. This new, slower growth model of China is expected to be more sustainable.

However, the visibility of a further slowdown in the economy has been raising concerns globally. Property downturn, factory overcapacity and high levels of local debt are expected to weigh down on China's economic growth. Bloomberg estimates potential growth at 7.3% for 2015, with the World Bank and IMF projecting 7.1% and 6.8%, respectively. The Chinese government has set a target of 7% growth for 2015.

China GDP growth expected to decline



Source: Bloomberg

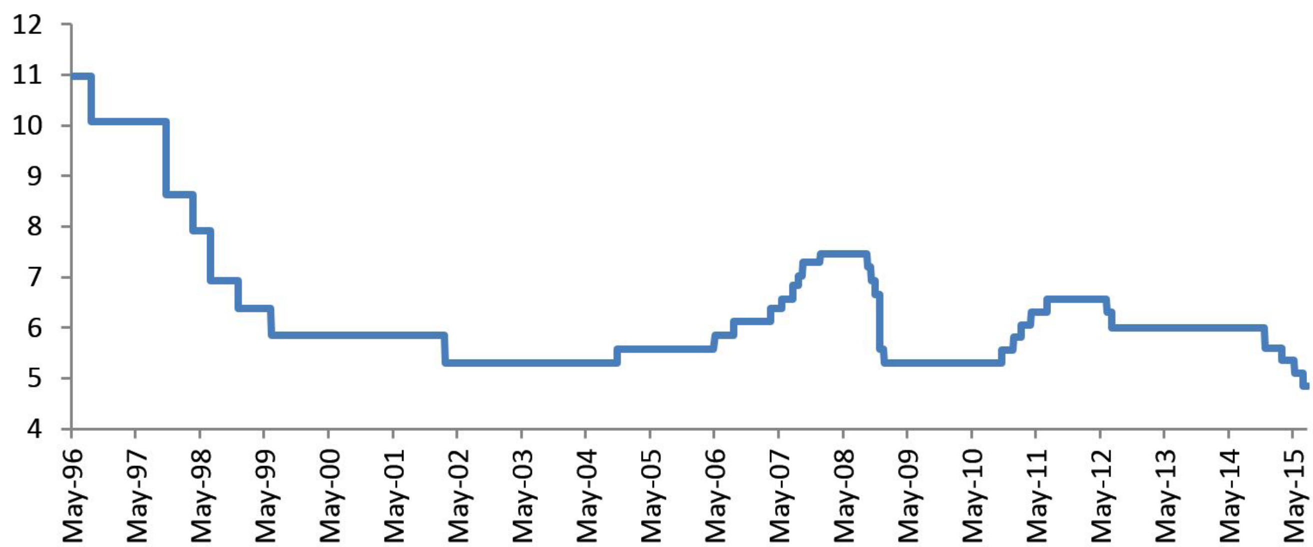
Government Taking Monetary and Fiscal Measures to Prevent a Hard Landing

The Chinese government has been trying to engineer a controlled slowdown through structural adjustments and policy efforts to shift the country's growth model from manufacturing to services, from investment to consumption, and from exports to domestic spending.

In 2014, property restrictions were eased for the first time since the global financial crisis, as housing affordability took a back seat in the face of real-estate slump's threat to economic growth. Second-time home buyers would benefit in the form of lower down payments and mortgage rates, which were previously available only to first-time home buyers, provided they have paid off their initial mortgage. Moreover, the People's Bank of China eased the ban on mortgage for people buying a third home.

In June, China's central bank cut its benchmark lending rate to a record low and lowered reserve-requirement ratios for some lenders in order to lower borrowing costs and stabilize growth. In the fourth reduction since November 2014, the benchmark one-year lending rate was reduced by 25 bps to 4.85%. The one-year deposit rate was reduced by 25 bps to 2%, while reserve ratios for banks lending to the farm sector and small and medium-sized enterprises were cut by 50 bps.

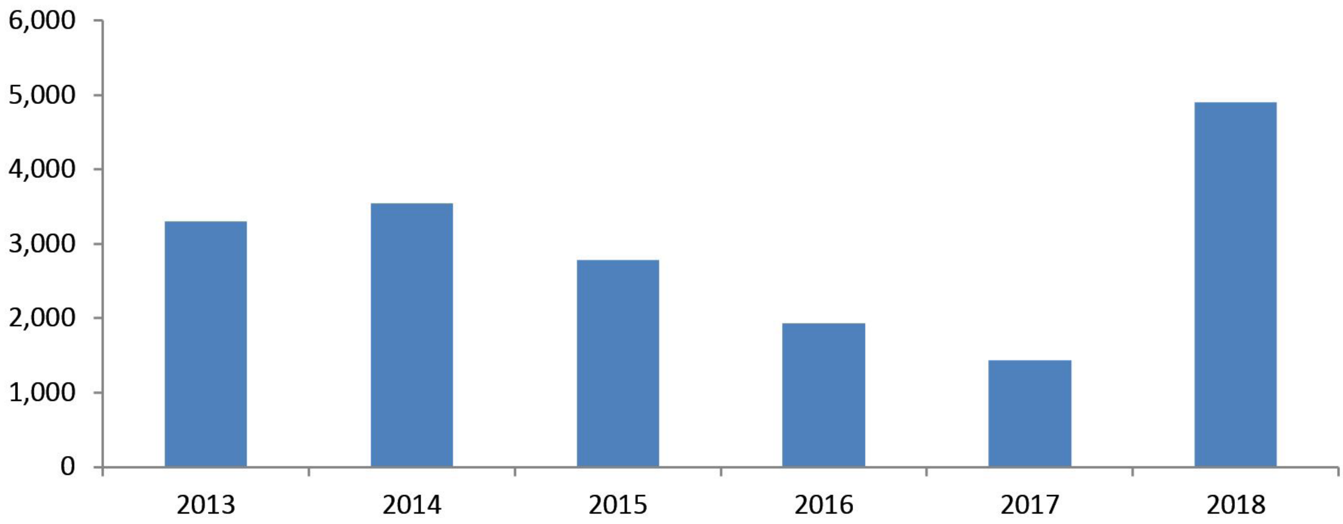
Chinese benchmark lending rate at a record low



Source: Bloomberg

In order to boost liquidity and alleviate the local government's funding crunch, the Chinese government doubled the size of its debt swap program. In June, China approved a second batch of local government debt swaps worth Yuan 1 trillion, doubling the size of the existing swap program announced in March. China's local government has incurred debt through unbridled borrowing during the investment and construction binge following the 2009 global financial crisis. As a result, the size of debts is unclear; however, the cost of the debts is much higher than it would have been had the government issued bonds in the first place. The new debt issuance and swaps will help the government refinance its debt at low cost, though this would make only a small dent in their overall liabilities.

Chinese local government debt up for repayment (Yuan bn)



Source: National Audit Office, Ministry of Finance

Would Stimulus Help Sustain China's Economic Growth?

The Chinese government has been quick in recognizing the looming slowdown. It has undertaken steps to minimize any potential impact of the slowdown on the economy. However, the adequacy of these measures (some of which were introduced in early-to-mid 2014) on controlling the slowdown is yet to be seen.

The fact that the government has been easing the monetary policy since last eight months, and so far, the impact of these initiatives has been limited, indicates a not-so-effective policy transmission process. While the government focuses on increasing the liquidity in the system, the low demand and utilization scenario does not encourage industries to borrow and expand. Moreover, the banks are reluctant to lend to focused sectors amid concerns over collateral and risk. Furthermore, an increase in the debt swap program would merely aid the local governments in 'refinancing' their debts at lower rates.

While China exits the era of high-speed economic growth, the government will continue to navigate policies toward a new 'normal'. However, even with the accommodative policies, the shift to a slower economic growth is not likely to be a smooth one.

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