- Perhaps the key takeaway from the just published third quarter China macro numbers is that the sky didn't fall. Start-of-the-year predictions of dramatic capital flight and currency depreciation proved incorrect.
- Instead, third quarter data signaled that economic growth has stabilized at a healthy pace, and that China's transition from a high-speed, heavy industry-based economy to a moderately-fast consumer and services-based economy is well underway.
- The challenges of completing this transition will result in gradually slower growth rates and increased volatility, but the risks of a hard landing or a housing bubble are very low.

ANDY ROTHMAN lived and worked in China for more than 20 years, analyzing the country's economic and political environment, before joining Matthews Asia in 2014. As Investment Strategist, he has a leading role in shaping and presenting the firm's thoughts on how China should be viewed at the country, regional and global level.

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Sinology

by Andy Rothman
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WHAT IF THE SKY ISN'T FALLING?

Perhaps the key takeaway from the just published third quarter China macro numbers is that the sky didn't fall. Back at the start of the year, consensus seemed to be that by now, China's foreign exchange reserves would be depleted (they remain the world's largest, at over US$3 trillion) and the currency would have experienced a dramatic devaluation (it fell just 2.8% against the dollar during the first nine months of the year).

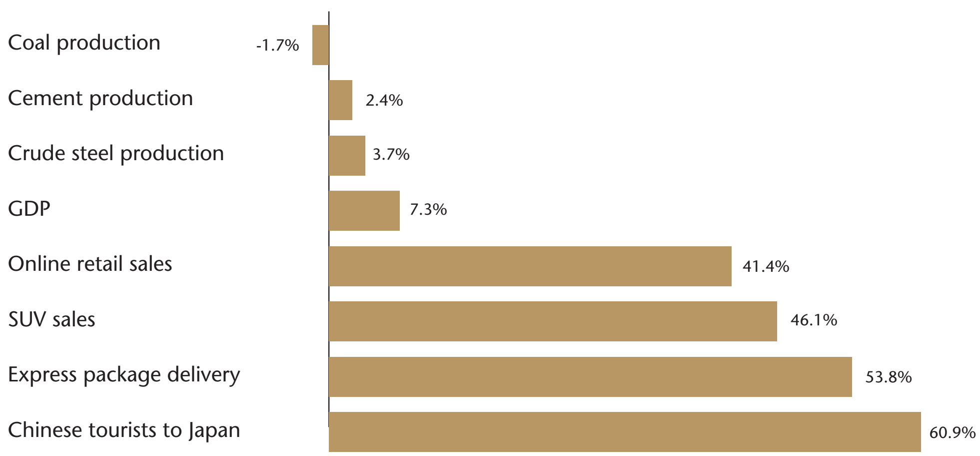
Instead, third quarter data signaled that economic growth has stabilized at a healthy pace, and that China's transition from a high-speed, heavy industry-based economy to a moderately-fast consumer and services-based economy is well underway. The challenges of completing this transition will result in gradually slower growth rates and increased volatility, but the risks of a hard landing are very low.

A Two-Track Economy

The Chinese economy has its strengths and its weaknesses. The services and consumer part is the largest and the strongest, while the part related to heavy-industry has been shrinking and shedding workers.

Figure 1 illustrates this two-track economy: production of coal, cement and steel has been anemic over the past few years, in contrast to over 40% average annual growth in sales of online goods and SUVs, as well as Chinese tourist arrivals in Japan.

Figure 1. **AVERAGE GROWTH RATE BETWEEN 2013 AND 2015**



Sources: CEIC, Japan National Tourist Office

2016 will almost certainly be the fifth consecutive year in which the tertiary part of the economy (services and consumption) will be bigger than the secondary (manufacturing and construction) part—upending the typical view of China as a simply a low-cost factory site.

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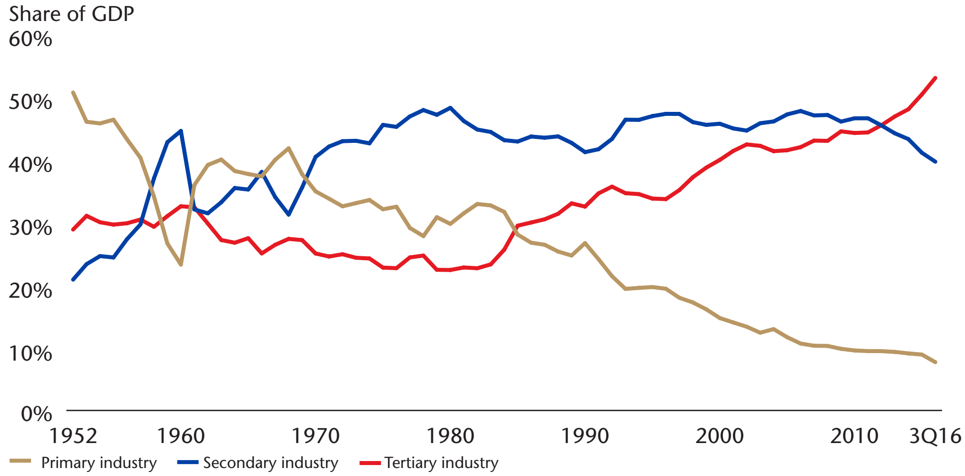
Industries defined as:

Primary industry refers to agriculture, forestry, animal husbandry and fishery and services in support of these industries

Secondary industry refers to mining and quarrying, manufacturing, production and supply of electricity, water and gas, and construction

Tertiary industry refers to all other economic activities not included in the primary or secondary industries, including real estate, finance, wholesale and retail, transportation and other service industries

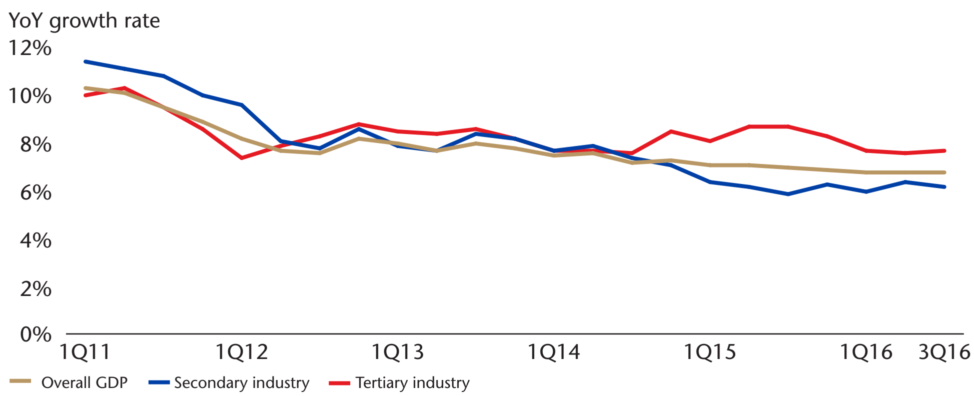
Figure 2. **GDP BY PRODUCTION APPROACH**



Source: CEIC

And during the first nine months of the year, final consumption contributed about 71% of China's GDP growth, up from roughly 58% during the same period last year and a 42% share for the full year of 2006.

Figure 3. **REAL GROWTH RATE OF OVERALL GDP, SECONDARY AND TERTIARY INDUSTRY**

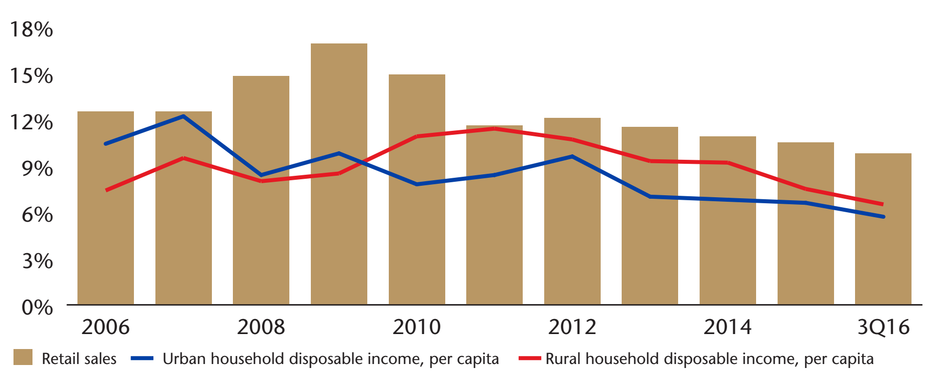


Source: CEIC

China remains, in my view, the world's best consumer story, with inflation-adjusted (real) retail sales rising 9.8% year-over-year (YoY) in the first three quarters of the year, compared to a 1% pace in the U.S. in August. That does, however, reflect a modest deceleration, from 10.5% a year ago, because income growth, while still quite fast, is moderating.

Following a decade in which real income rose 130% (compared to 11% in the U.S.), real per capita urban income rose 5.7% in the first three quarters of the year, down from 6.8% a year ago.

Figure 4. **REAL GROWTH RATE OF RETAIL SALES AND HOUSEHOLD DISPOSABLE INCOME**



Sources: CEIC, National Bureau of Statistics

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And Chinese families appear to be optimistic about their futures: 82% of those surveyed told the Pew Research Center they expect their children to be better off financially than their parents. In a similar survey by Pew last year in the U.S., only 32% of Americans said they expect their children to be better off financially.

Third quarter GDP growth was 6.7%, the same as during the first two quarters of the year and close to the 6.9% pace in 3Q15.

The producer price index, which charts changes in factory output prices, rose YoY in September for the first time since March 2012, and has risen on a month-on-month basis for six of the past seven months. This reflects improving demand, and if the trend continues it would support healthier corporate profitability and wage growth.

Sources of Anxiety

As fears about foreign exchange reserves and the exchange rate faded, they were replaced by concerns over China's debt levels and the possibility of a housing bubble.

Debt is a State Problem

The debt problem is serious, but the risk of a hard landing or banking crisis is, in my view, low. The key reason is that the potential bad debts are corporate, not household debts, and were made at the direction of the state—by state-controlled banks to state-owned enterprises. This provides the state with the ability to manage the timing and pace of recognition of nonperforming loans. It is also important to note that the majority of potential bad debts are to state-owned firms, while the privately owned companies that employ the majority of the workforce and account for the majority of economic growth have been deleveraging. Additional positive factors are that China's banking system is very liquid, and that the process of dealing with bad debts has begun.

Cleaning up China's debt problem will be expensive, but this process is likely to result in gradually slower economic growth rates, greater volatility, and a higher fiscal deficit/GDP ratio, not the dramatic hard landing or banking crisis scenarios that make for a sexier media story.

For more details on the debt issue, please see the September 12, 2016 issue of *Sinology: Cleaning Up China's Debt: Q&A*.

Housing is Overheated, But Not a Bubble

In my view, bubbles are all about leverage, and the main reason China doesn't have to worry about a housing bubble is cash.

The minimum cash down payment for a mortgage for a primary residence is 20% of the purchase price, and most banks tell us they require 30%. This is far from the 2% median cash down payment in the U.S. in 2006, which was the primary cause of the financial crisis here. While there are lots of rumors about homebuyers using P2P loans to make their down payments, this isn't supported by evidence, and seems unlikely to be occurring on a large scale, given the very high interest rates for P2P loans and the very small scale of total P2P loans (total P2P loans are equal to less than 1% of all bank loans outstanding).

Additionally, China doesn't have subprime or no-doc loans, and it is extremely difficult for speculators to obtain a mortgage, so most of those sales are all-cash. In any event, historically about 90% of new home sales across the country are for primary residences.

Overall, household debt is relatively low in China. For example, household debt was equal to 40% of GDP in China last year, while in the U.S., household debt was equal to 80% of GDP. Mortgage loans were equal to only 19% of China's GDP last year, compared to a 77% ratio in the U.S. and 69% ratio in the U.K. As a result, even a long period of weak housing prices would be unlikely to have a dramatic impact on China's financial system.

Housing prices are too high for a country at this stage of development, and new home prices have risen at a ridiculous pace in some China cities in recent months, but this too should be viewed in context. In the medium and smaller-sized cities which account for 96% of new home sales, average prices rose between 3 to 18% since the start of 2011. It was primarily in the four largest cities (Shanghai, Beijing, Shenzhen and Guangzhou) where prices jumped sharply, up 77% since the start of 2011. But, keep in mind that those four cities account for only 4% of all new home sales, and that nationally, nominal urban income rose 76% during that same period.

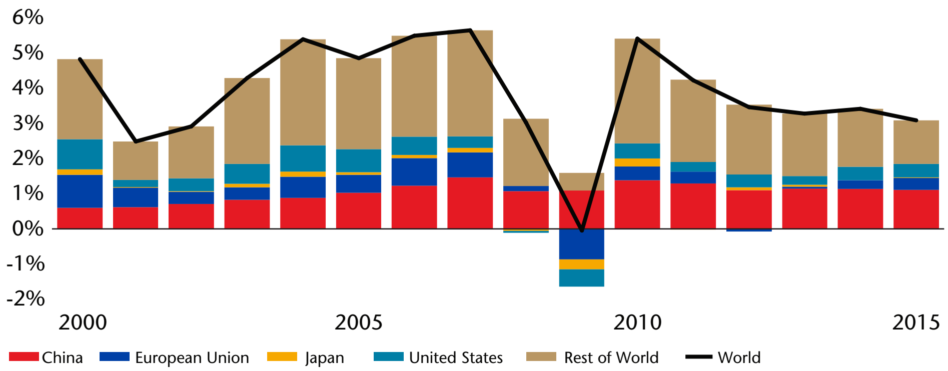
China does have a housing problem, but it is a social problem rather than a bubble: a large share of residents of China's largest cities are priced out of the market, and may never be able to afford to buy a home, a problem that is common to most major cities around the world.

We will address this topic in more detail in the next issue of *Sinology*.

China Should Continue to Drive Global Growth

Last year, with a GDP growth rate of "only" 6.9%, China accounted for about 35% of global economic growth—a higher share of global growth than from the U.S., Europe and Japan combined. It was also a higher share than in 2005, when China's GDP growth was 11.4% and it accounted for 21% of global growth.

Figure 5. **CONTRIBUTION TO GLOBAL GDP GROWTH**



Source: IMF

While I expect almost every aspect of the Chinese economy to grow a bit more slowly, on a year-on-year basis, every year, it is likely to remain the largest contributor to global growth, making it important for investors to understand the structural changes underway and the probability of delivering gradually slower growth versus delivering a hard landing.

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