China – The Tightrope Walk

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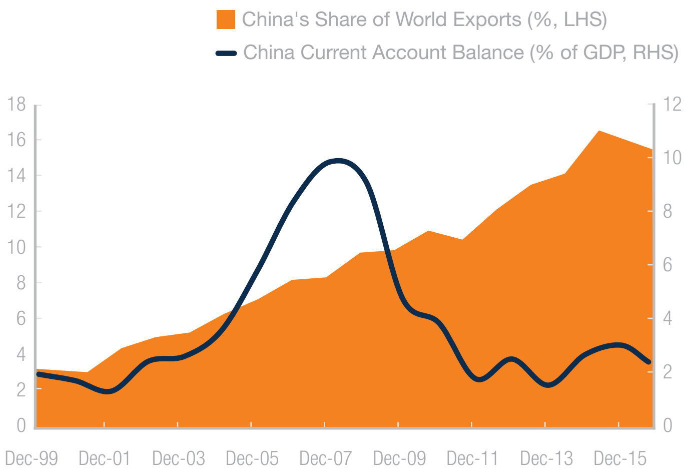
No other economy attracts as much awe and skepticism as China. What China has achieved during the last 20 years is almost unparalleled for a country of its size. In relative terms, India and China were at similar levels of gross domestic product (GDP) in 1990. Today, China's GDP has crossed the USD 11 trillion mark, nearly five times the economic size of India, even while India's nominal GDP growth has trended around 10% for much of the last decade.[1]

Growth via Trade

The inflexion point in China's growth trajectory came on the heels of its entry into the World Trade Organization (WTO) in late 2001. The country's share of world exports leapt from around 3% in 2001 upon WTO admission to more than 13% in 2015 as companies the world over discovered a new competitive location for sourcing their goods.[2]

China's Place in the World



Source: Bloomberg, Mirae Asset Global Investments (Accessed February2017)

The much talked about export growth model faced a serious challenge following the 2008/09 financial crises as aggregate demand from the developed world plummeted. Faced with stagnating wages and high debt loads, households in developed countries embarked on a multi-year period of deleveraging.

The single-minded growth focus that worked wonderfully in the 1990s and 2000s has since become a handicap for China as exports have yielded to infrastructure as the principal growth driver. Though the leadership was wise not to repeat the huge 2009 infrastructure stimulus, mini investment stimuli enacted every so often have led to a situation where the capital output ratio has deteriorated to 6.5 in 2015 from an average of 3 in 2007[3], as the debt/GDP ratio has shot up more than 70% to 260% over the same period.[4] The overcapacity looms large in heavy industries like steel, cement, aluminum, and coal where provincial governments have prioritized output and employment over stability.

The Litmus Test

The years of 2017 and 2018 will likely be when China may face its real litmus test. The rise of "Trumpism," synonymous to protectionism, is symptomatic of problems besetting all political leaders: how to create jobs domestically and keep the restless population satisfied. Even Prime Minister Modi, despite his huge win in 2014, is under tremendous scrutiny for not having been able to do much on the employment creation front for the 10 million new jobs India requires annually. In years to come, global tariff barriers are likely

[1] World Bank, IMF (Accessed February 2017)
[2] Ibid
[3] World Bank, Mirae Asset Global Investments (November 2016)
[4] Various Government Sources, Morgan Stanley Research (June 2016)

to go up rather than down, and economies such as China that have benefited the most in recent decades will encounter the most pressure. Moreover, the investment-led growth model in China is also reaching its limits. Though higher spends on metro and environmental projects may be useful, the same cannot be said about the much-touted public-private partnerships projects in the social sector where revenue streams are less clear.

The challenge for the leadership in China is to realize that out of the three factors of GDP growth – capital, labor, and productivity – two factors have been nearly exhausted: labor, because of a fall in the working population; capital due to overinvestment. Therefore, a rise in productivity is the path toward emerging stronger out of this testing situation. The supply-side reforms that started in 2016 are a welcome step, although supply cuts need to be more meaningful and go beyond steel and coal sectors. Debt for equity swaps, while good in mitigating interest burdens, should not be a pretext for keeping zombie companies alive. Most importantly, the fixation with a GDP target has to be done with; economic cycles are healthy as they prevent accumulation of excesses.

Growth issues aside, macro-economic or renminbi (RMB) stability would be keenly watched in 2017 and 2018. The risks originate more from locals than foreigners, as the Chinese still view the RMB as pegged to the dollar instead of a trade-weighted basket of currencies. A monthly trade surplus of USD 30-50 billion affords enough ammunition to ensure RMB stability, however it is important that the government authorities in their overzealous defense of foreign-exchange reserves do not create a USD shortage and an unnecessary sense of panic in the system.

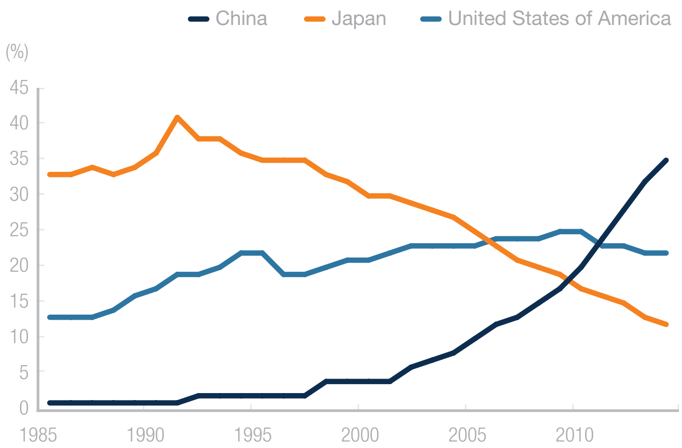
The rhetoric around protectionism will become even more intense with the election of Donald Trump. China has behaved in a mature way so far by advocating its commitment to globalization at the World Economic Forum in Davos. However, the same has to go beyond lip service to the actual opening up of sectors and improving the ease of doing business for foreign companies.

The Next Industrial Revolution

Despite the headwinds of trade barriers and overinvestment, there is enough good in the China story to keep us optimistic. Research and development spending are up nearly ten times in the last decade and China's share of global patent filing has jumped from 4% in 2004 to 35% in 2014.[5]

This emphasis on being the technology leader rather than a copycat will ensure that the country will be at the forefront of the next industrial revolution of robotics and Internet-of-things post-2020s. It is in the interim years that the Chinese leadership has to dexterously navigate the rough seas, acting with maturity and staying calm when confronted with any provocations.

Share of Global Patent Filing



Source: WIPO, Mirae Asset Global Investments (July 2016)

[5] OECD, World Intellectual Property Organization (WIPO)

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