Chinese Economy:
Steered Toward Future-Proofing Restructuring

April 2019

China's long-term challenge: stability with deleveraging

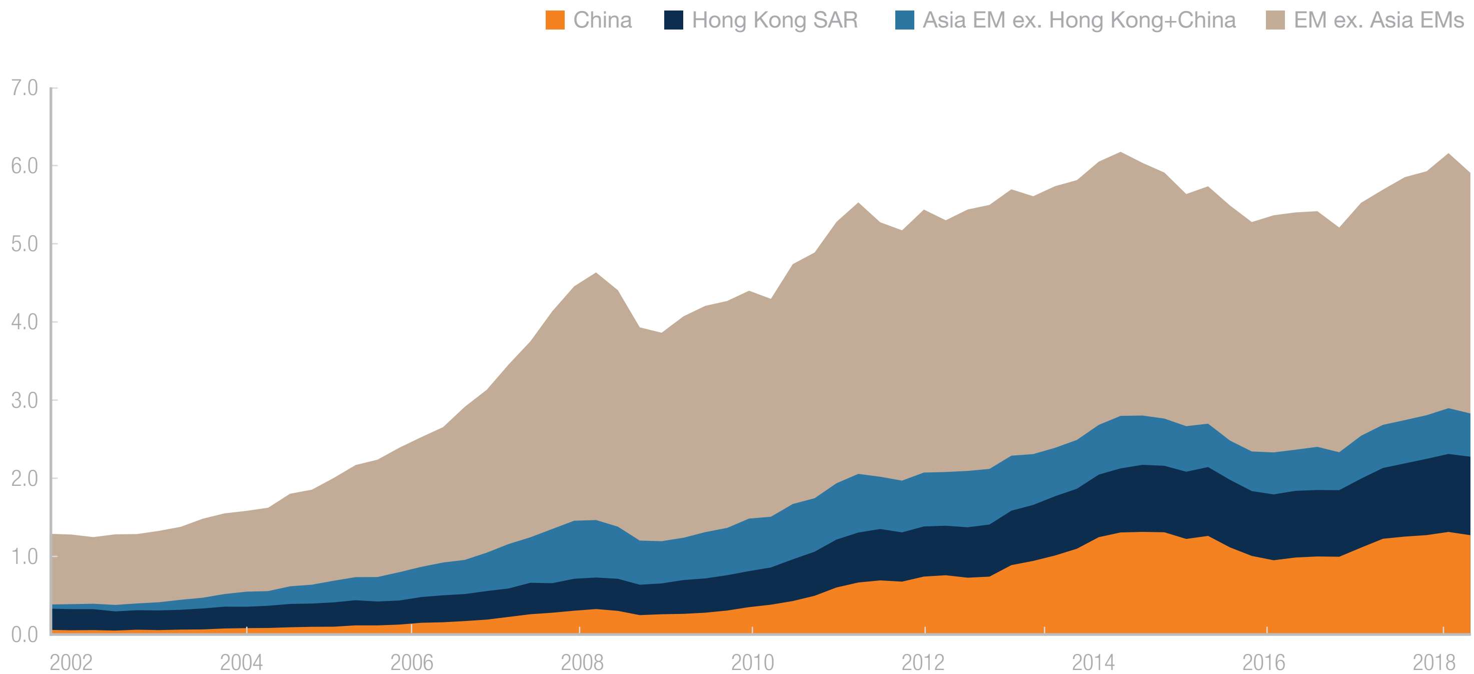
Most financial crises in emerging markets originate from a familiar formula: a currency collapse caused by a structurally weak banking system, rising corporate borrowings and high reliance on foreign debt. The crisis that hit Korea and other parts of Asia in 1998 was no exception, and the current state of China appears on the surface to share many similarities with Korea's pre-crisis circumstances. However, we believe that Japan during and after the collapse of its asset price bubble is a more apt comparison. For Japan, there was no painful one-off restructuring, as the country's well-capitalized banks stepped up at the behest of the government to serve as a backstop for the financial system. However, there was a dark side to the story: more than two decades of deflation and stagnation. By contrast, following the Asian financial crisis, Korea enjoyed the fruits of one-off restructuring ensued by two decades of strong growth. Reminiscent of Japan's case, China was the envy of the world during the subprime crisis of 2008 due to its recession-averting stimulus efforts. With the slowing global growth pressures from the trade war, China is once again seeing comparisons with its two neighbors.

Stable Property Prices Despite Tight M1

Source: Bloomberg (2019)

Asian Debt is Conservative Relative to Rest of EM

Source: BIS (2019)



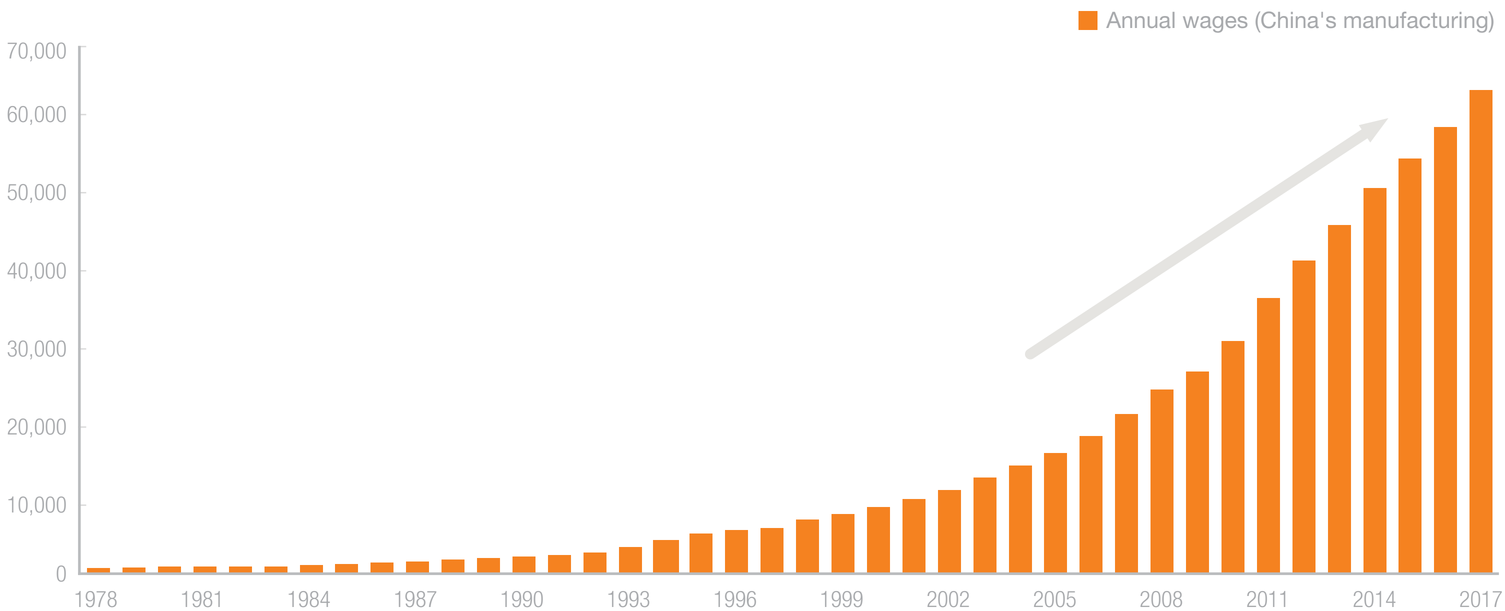
China needs more time for structural reform

We believe that both global and domestic investors are waiting for true reform signaling long-term improvements to the profit structures of mainland companies. Provided that meaningful progress materializes, it could encourage long-term investors to return to China. Adding more to the point, in 2019, it is likely that determined efforts by China to balance the economy will pave the way for healthier long-term growth. Then, the key question is: to what extent will short-term growth be sacrificed?

The current rally from Chinese equities is driven by recovering investor sentiment and anticipation of the accommodative policy response to slowing growth. For China's policymakers, there is added pressure of balancing short-term stimulus with long-term structural reform. A critical element of striking that balance would be for China to achieve an even shorter-term resolution on its trade war with the US. Should China fail to achieve relief on the trade front, a stronger stimulus that provides short-term growth will be required to meet investor expectations. Furthermore, in ten years, we will see increasing demand from investors for “three arrows” from China, involving PBOC’s (Public Bank of China) engagement in the areas of credit funds, bond issuance and equity financing, to pull out of its long-term growth rut. However, the long-term consequences will be China inching closer to the path taken by Japan, where debt becomes the main driver of growth, and efficient allocation of capital could be nullified almost permanently.

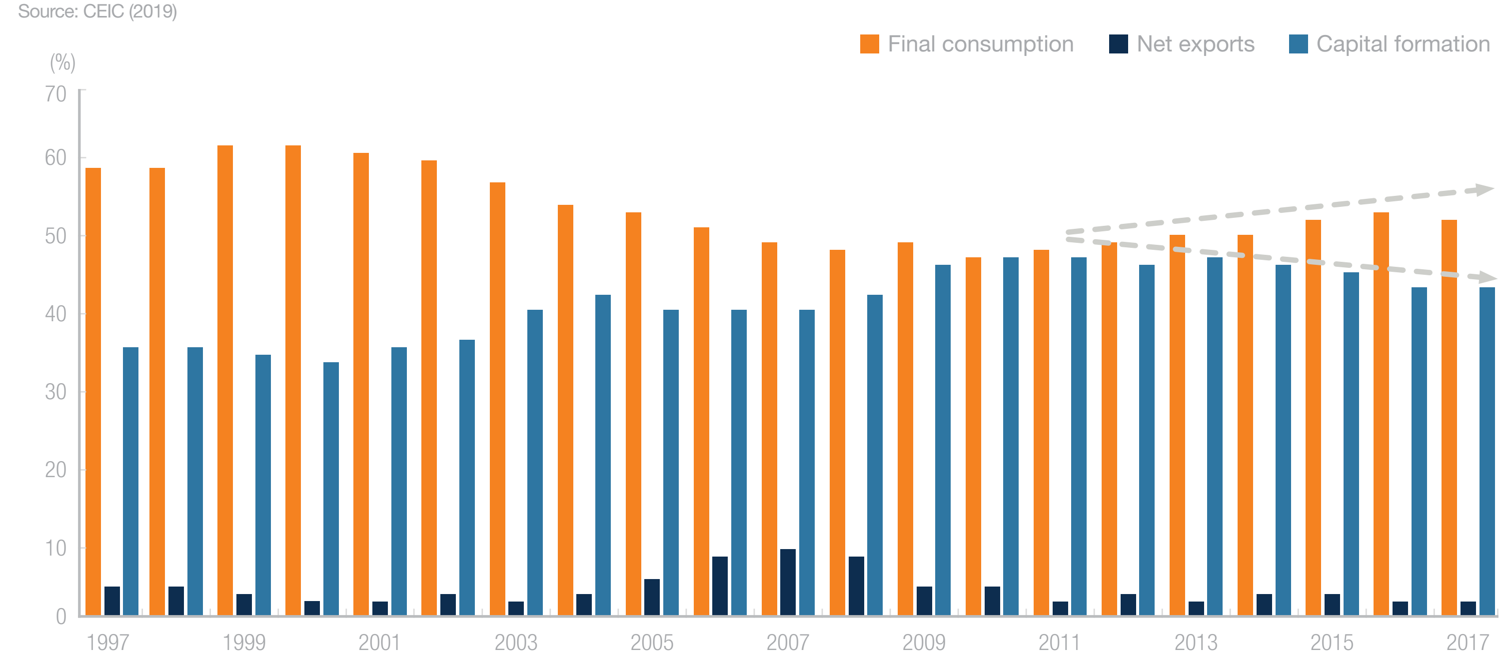
China Wages Going Exponential

Source: CEIC (2019)



China Rebalancing Started From 2011

Source: CEIC (2019)



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