

# Speed bumps for Chinese economy

- China's June-September stock market crash had limited direct macroeconomic consequences. However, financial markets worry about a sharper growth slowdown ('hard landing') than envisaged by the Chinese authorities.
- A hard landing of the highly leveraged Chinese economy could cause increasing debt problems which would cascade into the banking system, triggering a crisis.
- Avoiding this scenario depends on supporting manufacturing growth and sustaining banking system liquidity. The authorities have created new growth initiatives (One Belt, One Road, development of the Yangtze river delta economic belt, and the Beijing-Tianjin-Hebei region) intended to jumpstart investment and boost exports.
- The fiscal and recent monetary policy easing, combined with the scope for further easing, make a soft landing our base case scenario.
- In terms of potential growth going forward, we think urbanisation is capable of sustaining 6-7% GDP growth until demographic headwinds strengthen in the mid-2020s. After that, higher productivity growth will be needed to avoid a slowdown in GDP growth.
- In August there was an unexpected devaluation of the renminbi currency against the USD of 2.7%. While the move unnerved financial markets, it only made a tiny dent in the overall trend of broad appreciation. The authorities underlined their commitment to a stable exchange rate and further progress towards internationalising the currency and working towards the status of reserve currency.
- So far this year, China's trade figures have disappointed. Imports have fallen the fastest, standing 20% lower in USD value terms YoY in September. A large part of this decline was caused by price declines in commodities, including oil, of which China is a big importer. Aside from the price effects, there is also the fall in exports from China, reducing the demand for imported inputs and raw materials for production. A decline in China's household demand appears to have played a role as well, evidenced by for example, the fact that most car producers are seeing a decline in demand from China.
- The fall in exports (-3.7% YoY in USD value terms in September) is slowing down and is no longer broad based. Exports to the US are showing a recovery while exports to the EU are moving towards positive territory as well. At this moment the decrease in exports is primarily caused by the worsened economic circumstances for commodity exporters and emerging markets trade partners.
- The importance of China for the Dutch economy has grown sharply over the past two decades. While in 1995 Chinese demand was responsible for 0.4% of Dutch production, the share had increased six fold to 2.4% at the start of 2012. Dutch exports of, in particular, the technical industries and agrifood goods to China have seen high growth over recent years.
- Looking past the current slump, we expect China's demand for consumption goods will continue to show significant growth as the consumer group enjoying a middle income expands rapidly and the because of the policy induced shift from investment spending to consumer spending. Demand for capital goods in China is expected to expand at a slower rate. Still, Dutch exporters of specific high-tech or niche products, or for example in the food processing industry, may be able to benefit. In the agrifood sector, Dutch produce has a reputation for safety, while also products such as Dutch beer and toiletries are popular among Chinese consumers.

**Figure 1. How difficult is it to spot a bubble?**  
Chinese stock market, Shanghai Composite Index



Source: Macrobond

### Macroeconomic setting: the recent market panic

In mid-June, following a rally that saw the benchmark Shanghai Composite stock index double in the previous six months, a correction started that by the end of September wiped out three-quarters of the earlier gain.

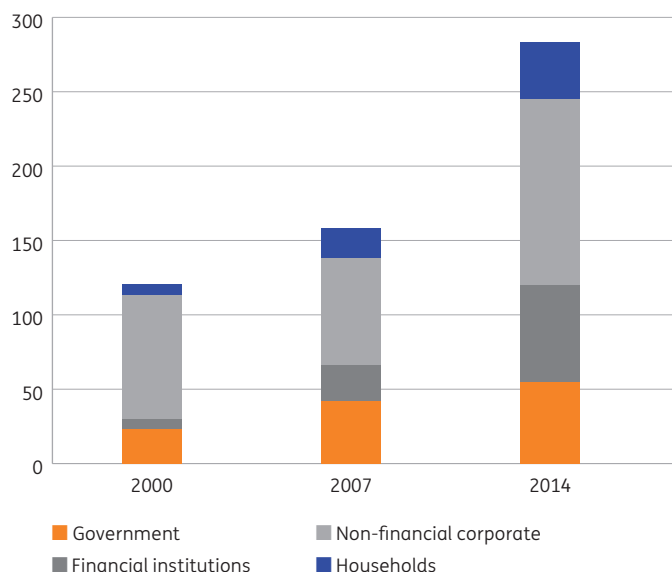
The worry about the stock market crash wasn't so much about the macroeconomic consequences of the market correction. Equities' share of Chinese household wealth is growing from a small base, 15% of financial assets and 5% of total assets. There are only about 50 million retail investors in China (7% of the urban population) and 70% of them have less than CNY 100,000 (about \$16,000) in their stock accounts.

Rather, the fear was that the stock market crash marked the beginning of a rolling crisis, a narrative that gathered steam with the August 11 devaluation. From the stock market to the foreign exchange market, the panic's trajectory toward an economic hard-landing seemed obvious.

All bear case scenarios for China start with leverage. McKinsey's estimate of total leverage, 282% of GDP as of mid-2014, has become the standard reference (figure 2). High leverage crystallizes fears about the property market, shadow banking, local government financing platforms, excess capacity, unbalanced growth and others. However, controls on capital flows and the \$1.4 trillion net international investment position, including \$3.5 trillion of foreign exchange reserves, mean a crisis would have to be triggered by something other than capital flight, the cause of most emerging-market crises.

In a more realistic rolling crisis scenario the hit to growth from the turmoil in financial markets exacerbates the cash-flow squeeze from the decline of export revenues (growth). Rising distress in heavily-leveraged corporates would cascade into the banking system, triggering a crisis. Avoiding this scenario

**Figure 2. China: Total indebtedness (% of GDP)**

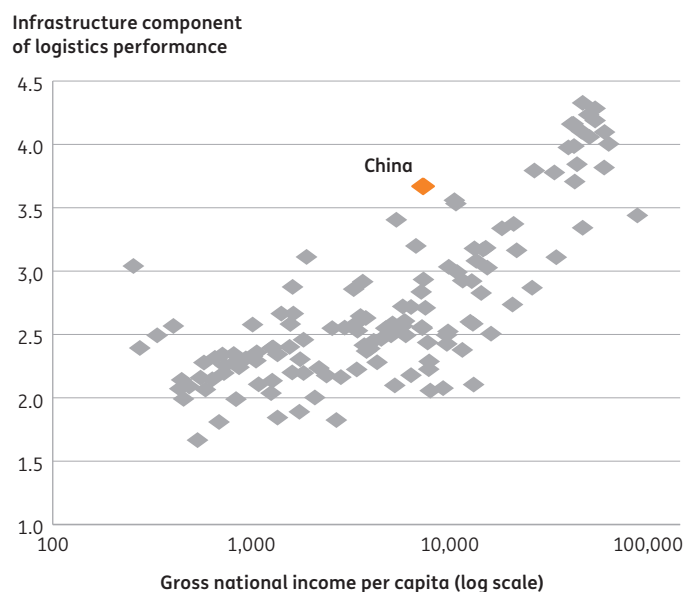


Source: McKinsey Global Institute

depends on supporting manufacturing growth and sustaining banking system liquidity.

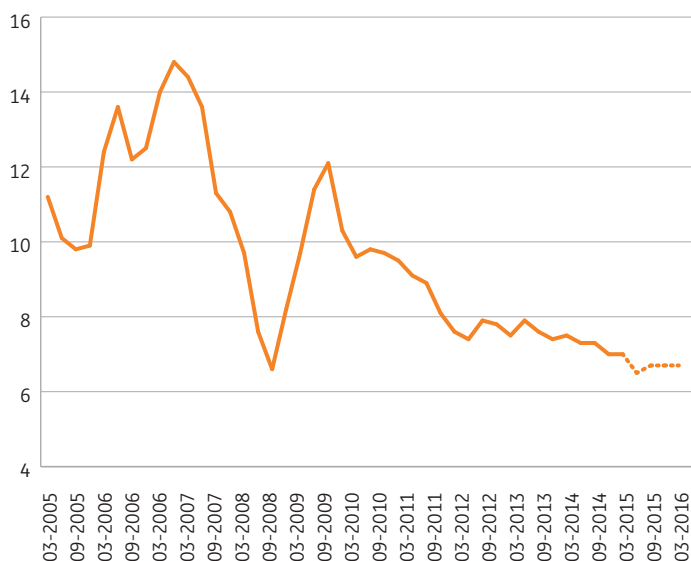
Fiscal policy is boosting infrastructure investment. China has invested heavily in infrastructure and is one of the few developing economies to obtain an infrastructure quality ranking in the World Bank's Logistics Performance Index comparable to that of high income countries (figure 3). It will continue to rise in the rankings if policies continue as planned. The authorities also have created new growth initiatives such as the 'One Belt, One Road', establishing new trade and transport links between China, Asia, Africa and Europe. Also, the development of the Yangtze

**Figure 3. Quality of infrastructure and per capita incomes versus countries globally**



Source: World Bank

**Figure 4. Real GDP growth, % change YoY**



Source: Macrobond. Dotted line is ING forecasts

River Delta economic belt and the Beijing-Tianjin-Hebei region – are being developed to support manufacturing. These new silk roads are intended to jump-start investment, boost exports and provide the access to commodities necessary for China to sustain strong economic growth.

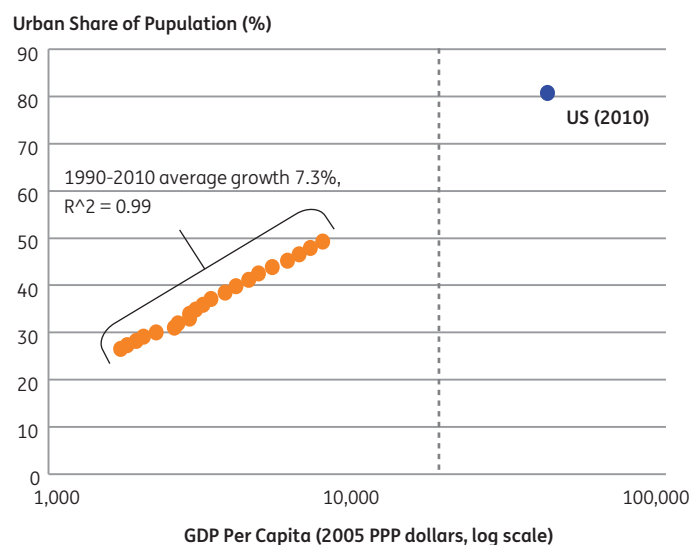
The central bank cut the policy interest rates by 25bp in late August, the fifth cut since November 2014, and cut the required reserve ratio for commercial banks by 50bp in early September, the third cut of the year. It has ample scope to ease further. The recent removal of the loan-to-deposit ratio requirement will ease bank funding constraints. The expansion of the Ministry of Finance local government debt swap to CNY 3.2 trillion (5% of 2014 GDP) will help sustain financing for local government projects. It also resolved the problem of rolling over maturing local government debt, at least for 2015. The recent recapitalisation of the policy banks – \$48 billion for the China Development Bank and \$45 billion for the China Export-Import Bank – will enable them to expand bond issuance to fund loans. The policy easing already implemented and the scope for further easing make a soft landing our baseline scenario. We now expect 7% real GDP growth (official definition) for FY15, down from 7.4% in 2014 (figure 4).

### How high is potential growth?

China's growth has slowed from the supercharged double-digit (11.5%) pace of the WTO Dividend period, 2002-07, to an average of 7.6% since 2011. The official growth target for both 2014 and 2015 was 'about 7%' and President Xi has said the economy has entered a 'new normal.' The authorities will announce the growth target for the 13th Five-Year Plan (2016-20) at the Communist Party Fifth Plenum to be held later this month.

Against China's unparalleled record of sustained rapid growth, even the new-normal growth rate looks unrealistic to many,

**Figure 5. Urbanisation and per capita income**



Note: the vertical dashed line represents the high-income threshold in 2010, defined as the 75th percentile of the distribution of GDP per capita. The high income threshold was about \$19,050, 46% of the US level.

Source: World Bank, Penn World Tables

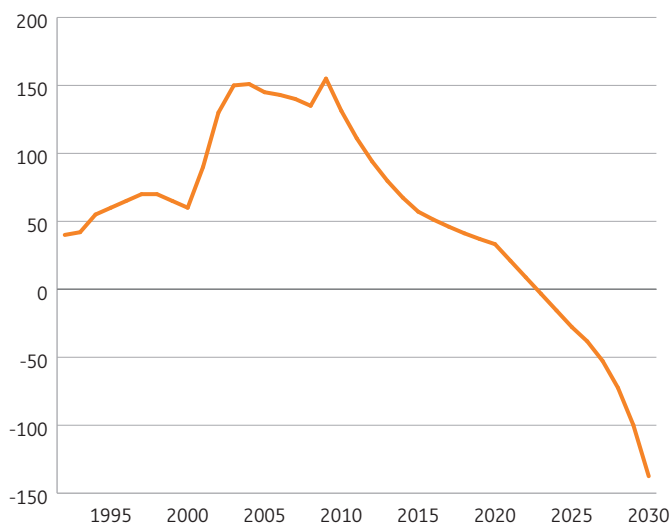
with the worry that surely the economy will hit a speed bump – the rolling crisis scenario? a large adverse external shock? – or the authorities will make a huge policy mistake and growth will slow significantly.

Rapid urbanisation since 1990 has generated impressive growth and can be an underlying driver of much more growth. Urbanisation's potential to boost growth was evident at the outset. Urban residents were only a quarter of the population in 1990 but accounted for 40% of household consumption growth. Over the next 20 years the urban population caught up to the rural population at 670 million and accounted for 80% of the growth of household consumption.

The government targets a 60% urbanisation rate. It has demonstrated the ability to manage the challenges of rapid urbanisation. Extending the 1990-2010 trends, urbanisation could drive 'new normal' GDP growth sufficient to enable China to avoid the middle-income trap and transition to high-income status by the end of the 2020s or in the early 2030s (Fig 5).

Demography poses the biggest threat to the forecast for China. Demography will cease being a tailwind to growth within the next decade and will be an outright headwind by the time we estimate China would be graduating to high-income status. China is rapidly running out of surplus labour (Fig 6). The early stage of catch-up economic growth gave underemployed rural sector workers a full-time job, often in a city. China's surplus of rural labour will disappear in the early 2020s. Higher productivity growth then will be needed to avoid a slowdown in GDP growth.

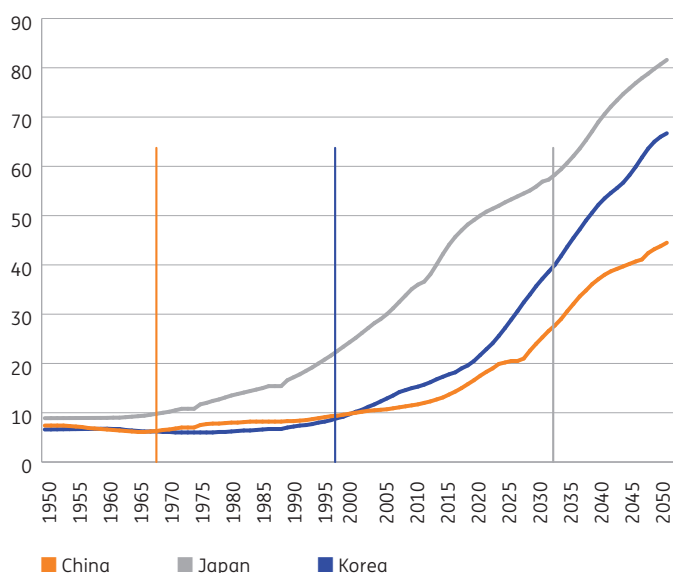
Figure 6. Surplus rural labour (millions)



Source: IMF

'China will grow old before she grows rich' is a succinct way of saying that a rising dependency ratio will slow growth. The dependency ratio is the ratio of old people, those 65 and older, to working-age people, those aged 15-64. When Japan and Korea graduated to the high-income group in 1965 and 1995, respectively, their dependency ratios were 10% (Fig 7). China's ratio is 14% and by 2030 when we estimate China would graduate to high-income it will be 25%. Again, productivity growth will need to accelerate to prevent the higher dependency ratio from dragging down economic growth.

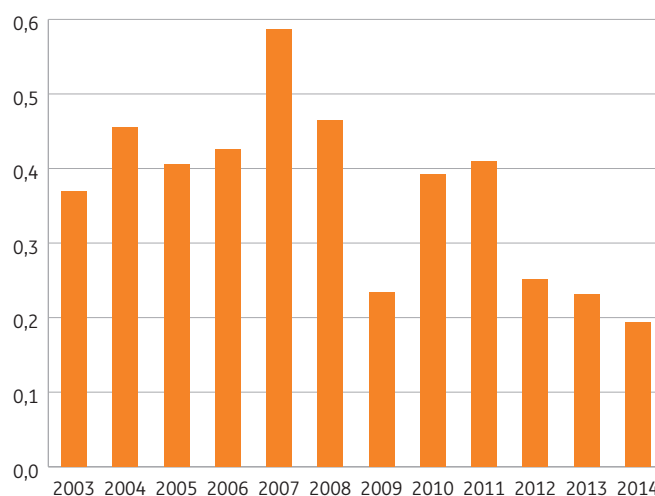
Figure 7. Dependency ratio a/



a/ Ratio of population aged 65 and over to working age (15-64) population.  
Note: Vertical lines denote the year of graduation, for China expected graduation, to high-income status

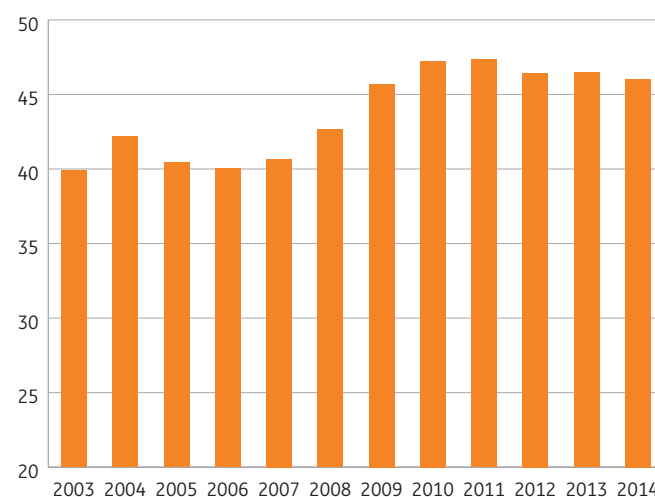
Source: US Census Bureau, ING Bank

Figure 8. High investment...  
Fixed investment % GDP



Source: EMED data service, ING Bank

Figure 9. ...led to decline in investment efficiency  
GDP growth divided by fixed investment growth



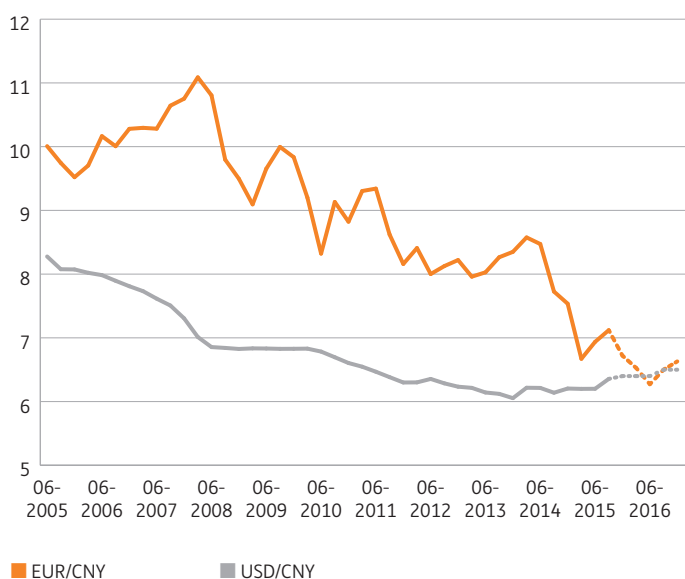
Source: EMED data service, ING Bank

Our baseline scenario is that urbanisation is capable of sustaining 6-7% GDP growth until demographic headwinds strengthen in the mid-2020s. We think this scenario is consistent with modest economic re-balancing away from investment toward consumption. 'Modest' because rapid growth requires high investment. China's policy response to the Global Financial Crisis – a credit-fuelled spending boom – raised the investment rate from 40% to 45% (Fig 8). But over-investment in manufacturing investment led to a decline in investment efficiency (Fig 9). A re-balancing toward infrastructure would reverse the decline in investment efficiency and allow the investment rate to retrace to 40% without slowing GDP growth.

### Renminbi currency policy

In two days in August, the authorities allowed the renminbi to devalue against the USD, resulting in a weakening of the

**Fig 10. Depreciation only a tiny dent in broader appreciation (renminbi against US/dollar and euro)**



Dotted lines are ING forecasts

currency of 2.4% (against USD) in the third quarter. While this move unnerved financial markets, it only made a tiny dent in the overall trend of broad appreciation, as figure 10 illustrates.

The central bank explained the devaluation as an improvement in the method of setting the central parity to make it more consistent with market forces. The authorities underlined their commitment to a stable exchange rate and further progress towards internationalising the currency and join the Special Drawing Rights (SDR) basket. Should RMB join SDR, this would imply the IMF in effect recognises the RMB as a reserve currency. A decision on the latter is expected in early November.

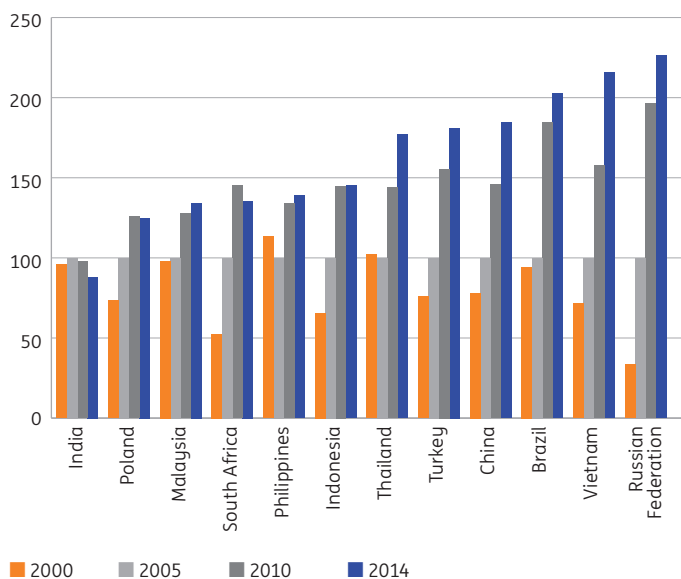
### Competitiveness and business environment

Regarding competitiveness, China has been impacted negatively by the increase in labour costs: As figure 11 shows, unit labour costs have increased significantly since the start of the millennium, while India, for example, has maintained constant unit labor costs in the same period.

Developments in the price of Chinese products and services measured in domestic currency are driven by, among others, unit labour costs and costs of imported resources. Combining price and exchange rate developments, the real effective exchange rate gives an indication of competitiveness vis-à-vis its trade partners. This measure indicates that China has become less price competitive since the start of the global economic crisis, with the currency appreciating (in real effective terms) by around 30% (figure 12).

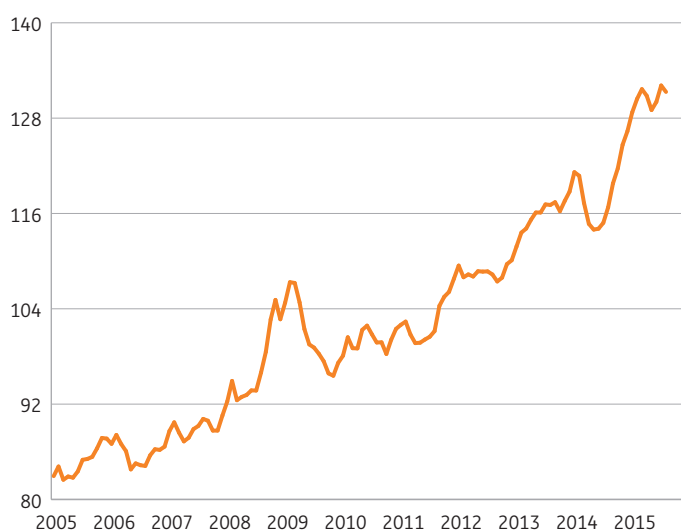
Despite the above, however, average absolute wages in China remain low. Absolute monthly wages are only 18% of labor compensation in a developed economy such as Japan (figure 13). China has lost only part of its offshoring appeal

**Figure 11. The unit labour cost index in US-dollar rebased to 2005 = 100**



Source: EIU

**Figure 12. Renminbi Real Effective Exchange rate (index)**

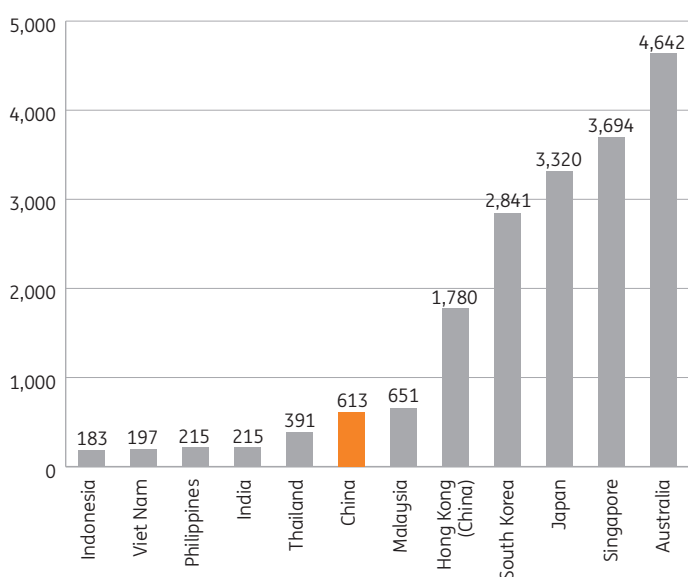


Source: Macrobond

for international enterprises because non wage factors that determine competitiveness have improved.

On the 2015 'Ease of Doing Business' ranking list of the World Bank, China is ranked 90th (out of 189 participating countries, the Netherlands ranked 27<sup>th</sup>), similar to the Philippines and Kuwait. This is an improvement from the previous rank (which was 96), with the improvement largely the result of improvement in the area of 'starting a business' (costs and time needed for getting the paperwork in order) and 'paying taxes' (tax burden and administrative burden). Starting a business nevertheless still is one of the weakest features.

**Figure 13. Average monthly wages for countries in the Asia & Pacific region**



Source: ILO (2014). 2013 values in

**Table 1. Ease of Doing Business in China: Top 3 of weaknesses and strengths**

Weaknesses*	Strengths*
① Dealing with construction permits	① Enforcing contracts
② Protection of minority shareholders	② Registering property
③ Starting a business	③ Resolving insolvency

\* relative to China's overall ranking.

Source: World Bank

## Business opportunities in China

While the golden age of extremely high import growth (22% annually over 2000–2008) is clearly over in China, the 'New Normal' of lower but balanced growth still offers business opportunities. Despite the slowdown of the Chinese economy, it is still expected to grow faster than the economies of EU countries.

In the 'new normal' phase as defined by President Xi, slower but higher quality growth takes place, that takes into account quality of life and pollution. In this new phase, domestic spending will be the main driver of economic growth.

Demand for consumption goods will be growing, as the country's growth is increasingly driven by consumption demand. The consumer group enjoying a middle income is growing rapidly, and should reach about 300m in 2020. At this point, four out of ten people in China will then belong to the middle class. This is about the same as the total population of the EU. This means opportunities for suppliers of consumer staples, consumer goods, and imported foods.

2014 marked the first year in which more people in China were living in cities than in rural areas. This urbanisation trend is expected to continue on a large scale, with every year millions of people moving to the cities in search of a higher income and more opportunities. This will continue to drive a need for infrastructure, affordable health care, education and clean technology in the growing urban areas as well as productivity growth (and food imports) in the agricultural sector. The ageing population may offer possibilities for exporters and providers of services in the area of health care.

Sales of (foreign brand) luxury products, however, have been weak recently. Already hit by President Xi Jinping's anti-corruption policy, luxury goods took a further hit from the stock market turmoil. Also, more than half of luxury products are being bought by Chinese while travelling abroad. In this way they circumvent high import tariffs and VAT and take advantage of – for example – the weak euro.

While the demand for consumption goods is expected to continue to expand at a significant pace in the next few years, demand for capital goods is expected to expand much slower towards the end of the decade, as the investment boom moderates. Still, opportunities for EU /Dutch companies can be found by looking at China's ambitions in its 5 year plan. We expect the authorities to continue to show strong commitment to its five year plans, despite the stronger-than-initially-expected economic slowdown.

The current 5 year plan focuses on green technology (reduction of energy use and development of nuclear, wind and solar power); services (in 2013 the services sector overtook the industrial sector for the first time ever as the main contributor to GDP; continued development of the service sector is an important element of the 12<sup>th</sup> 5-year plan); food safety, and affordable health care (upgrading social welfare is a key part of the 5-year plan). The next five year plan (the current plan expires this year) is expected to have a similar focus.

During the People's National Congress in March 2015 a number of measures were announced in the context of the working towards a new growth model. Focus was on research and development in innovative sectors, such as e-commerce. E-commerce is one of the fastest growing sectors in China, enabling huge and growing retail and wholesale trade, while also providing efficiency gains and logistics at low cost. Particularly SMEs could benefit, with cloud computing reducing the need for hefty IT investments and allowing smaller companies to sell to overseas customers on B2B marketplaces.

The high-tech sector is in general consistent with China's ambition to move up the global value chain. Priority is on sectors such as biotechnology, rare earths and semiconductors. Spending on Research & Development is generally already very high in China. Specialized electronics, new IT, broadband networks, internet security, are also a priority.

Significant investments in infrastructure were announced as well, such as in railroads, highways, water projects, and gas



and oil pipelines. For investors, it may be interesting to note that restrictions on foreign investment will be lifted in half of the sectors where foreign investments are currently not allowed. The downside for investors is the continued upward pressure on factor costs, particularly labor.

In general competing on price with Chinese local competitors is not a good idea. Chinese consumers are brand oriented and many successful foreign companies in China rely on their brands and quality to build a sustainable business.

### Free trade zones

A separate point of attention is the free trade zones, instituted as pilots on a limited scale. Doing business in these zones can be more attractive than in the rest of China. Normally entrepreneurs in China have to take into account the general rule that 'everything is prohibited, unless it is explicitly allowed'. In the free trade zones, the opposite applies 'everything is allowed, unless it is explicitly prohibited'. Entrepreneurs may be able to benefit from the free climate in these zones: Business services and transport, for example, may provide services to Chinese companies looking to start international activities from the free trade zone. Health care service providers can benefit from rules that allow foreign hospitals on Chinese soil. The Shanghai Free Trade Zone, which covers an area of about 29 square kilometres, opened in September 2013. Financial institutions operating in the zone were recently allowed to trade financial products – spot, forwards, swaps and forex options – with domestic and foreign companies. They will also be allowed to trade RMB-denominated interbank loans and certificates of deposit. However, the pace of deregulation in the zones has disappointed some observers, with the initial “negative list” of things prohibited quite long.

### Trade flows

China is the largest exporter of the world and its economy depends significantly on trade. Total exports of goods were \$2,342bn in 2014, which is 23% of Chinese GDP. Total imports of goods amounted to \$1,958bn (19% of GDP).

So far this year, significant developments have taken place in China's trade flows. The most recent data currently available, of September, shows a sharp import decline of 20.4% YoY, against 13.8% YoY in August (in USD value terms). Exports decreased 3.7% in value terms in September, which is a slower decline than the -5.5% in August.

The recent external environment has been less favorable for **Chinese exports**. The link to the strong US dollar caused an appreciation of the renminbi, hitting competitiveness of Chinese goods and services. Also, the worsened economy in commodity exporters and other emerging market trade partners played a large part in the most recent downturn this year. Commodity (including oil) exporters have seen a large drop in their export and budget revenues as a result of the slump in the price of commodities: oil price halved over the past year, while the price of primary commodities dropped 10-20%. This has led, in turn, to reduced import demand from these trade partners. The sharpest fall is in exports to Russia,

Brazil, and Indonesia. In Russia, import demand is also hit by generally worsened economic circumstances and the rouble drop. The same holds for Brazil. The dismal export figures were further exacerbated in 1Q15 by the fact that there were fewer working days than usual in the first quarter

The slower decline of exports in recent data fits the pattern of improvement after Chinese exports plummeted in 1Q2015. Exports to the US are recovering particularly strongly while those to the EU also show improvement. Exports to emerging markets are edging up as well but remain more muted relative to a year ago.

**Various reasons for the drop in Chinese imports.** The drop in commodity prices (including oil) of which China is a major importer, is an important explanation for the drop of Chinese imports in value terms. Import data by product group show that the largest value declines took place in imports of inputs such as fuel oil, coke, rubber, copper, and edible oil.

But there is more at play than price effects alone. In 1Q15 Chinese import **volumes** declined 13% QoQ. This is related to two factors. First of all the fall of Chinese exports, especially in Q1. Less production for exports reduces the need to import inputs and raw materials.

However, this is not the whole story: domestic demand seems to have played a role as well. Analysing Chinese domestic demand is notoriously difficult, but data suggest that household demand may have added to the decline in imports in 1H15. For instance, imports of motor vehicles slumped 25%. Most car producers are reporting a decline in demand from China. Anecdotal evidence suggests that imports of luxury goods are down as well.

In the second quarter there was some overall recovery in imports in volume terms, and this trend continued in July. After a general dip in underlying economic activity in 3Q15, we expect higher economic growth in 4Q15 and consequently a more convincing recovery of imports. Growth of domestic demand will rise due to expansive monetary and fiscal policy.

In terms of product groups, this scenario suggests that imports of consumption goods may show stronger growth than imports of inputs of industry like commodities, intermediate products, or investment goods.

Examples of consumption goods expected to show significant growth are office, telecom and electrical equipment, pharmaceuticals and road vehicles. The demand for road vehicles and transport equipment is expected to focus on clean energy and energy-efficient vehicles.

Despite the slowdown of the Chinese economy, it is still expected to grow faster than the economies of EU countries. As such, although at a slower pace than in the past, demand for investment goods and inputs for production can still be expected to grow faster than in the EU. For instance, significant growth can still be expected in import demand for industrial machinery. Dutch exporters of these products of machines

for the food processing industry, could well benefit. Large manufacturers, such as in the automotive industry, often require their suppliers to produce in China. This means that opportunities for exports seem to lie particularly in the high tech or niche products of which production cannot be easily replicated in China.

### Dutch exports to China: current situation

The importance of demand from China for the Dutch economy has grown sharply over recent decades: In 1995 only 0.4% of Dutch production was related to meeting Chinese final demand. At the start of 2012, this percentage had risen sharply to 2.4% of Dutch production going – directly or indirectly – to meet final demand in China. This makes China the fourth most important export destination for the Netherlands (in value added terms), a jump from number 13 in 1995.

The Chinese share in Dutch exports has not only increased because of the rise of direct exports to China. Important is also the rise of exports to China via other countries. Dutch automotive products, for example, are used in German cars that are widely sold in China.

Switching to the traditional gross export numbers, Dutch exports to China more than tripled over the past decade. Growing 12% annually (in nominal terms), total gross exports from the Netherlands to China reached \$10.8bn in 2014.

A large portion of Dutch exports to China consist of goods predominantly made in the Netherlands (three quarters of the total). This compares to a mere 46% of total Dutch exports of The Netherlands consisting of real “Dutch product”. As a result, in value-added terms China is a more important export destination than the ninth position according to the gross export figures.

Besides mineral fuels, the electronics industry, machines and transport equipment have also contributed markedly to the increase of Dutch exports to China. The technical industries’ exports grew by a yearly 17%. In addition, the Dutch agrifood sector also showed a steady growth of 15% annually. Exports from this sector amount to more than €1bn yearly. Dairy products are a well-known example of a Dutch export product that is popular in China. In fact, the single most important Dutch export product to China is baby formula. This product alone accounted for 7% of total Dutch exports to China in the first seven months of this year. In the agrifood sector generally, Dutch food has a reputation for safety, while the trend towards consumption as a growth driver may increase demand for these products. Besides food, also products such as Dutch beer and toiletries are popular among Chinese consumers. So far this year, Dutch exports to China have held up relatively well: re-exports have been stable, while exports of Dutch products continued to grow significantly.

**Table 2. Dutch (re) exports to China, by product group, 2014**

	Yearly growth 2006-2014		Value 2014 (€bn)	
	NL product	Re- exports	NL product	Re- exports
Total	13.4%	10.2%	5.8	2.1
Agrifood	15%	7%	1.2	0.3
Mineral fuels	19%	8%	1.0	0.2
Chemicals	10%	11%	1.0	0.3
Metals, rubber, plastics	11%	18%	0.4	0.1
Electronics, machines, transport equipment	17%	9%	1.9	0.9
Other products	-1%	19%	0.3	0.3

Source: CBS, ING calculations

### Import tariffs

In the previously mentioned World Bank ‘Ease of doing business’ survey, there is also an indicator of the extent of import tariffs and regulations regarding cross-border trade. For this ‘trading across borders’ China is ranked 98 of the 189 countries in the ranking (1 is best), which is slightly worse but almost in line with its overall Ease of Doing Business rank of 90. China has been a member of the World Trade Organisation since 2001. Its Simple Average Most-favored Nation (MFN) tariff is currently 9.9%, which compares favorably to India’s and Brazil’s 13.5%. This same tariff is 5.47% for the EU. Comparatively high tariffs are applicable to product groups such as sugar, beverages, cereals and cotton, while comparatively low tariffs apply for wood, chemicals, petroleum, minerals and metals.

An important issue in the area of trade and tariffs is the impending European Commission’s decision on whether or not to designate China a ‘market economy’. Should China be designated as such, it would become much more difficult for the EU to impose tariffs, as the price structures of a market economy are supposed to be set fairly by definition. It would thus largely strip the EU of the ability to hit back against unfair export practices, such as dumping, with countervailing tariffs. The debate will come to a head in the coming months.



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