The Mid-Term Outlook for the Chinese Economy

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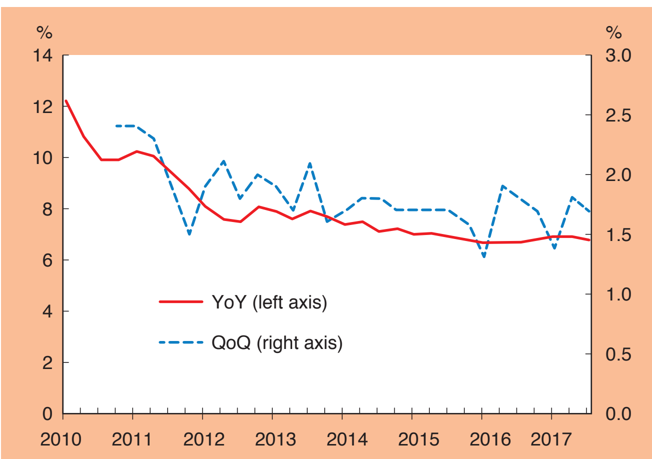
The Chinese economy gradually slowed down from double-digit growth five years ago, declining to the 6% level, but it continues to grow. Whether the Chinese economy will continue to grow in the future is an issue that is attracting attention. This article identifies the current state of the Chinese economy, considers the factors that may accelerate or hinder its future growth, and sheds light on future prospects.

Current State of the Chinese Economy

China is currently in a downcycle in its economic growth. Annual GDP real growth has continued to slow down from double digits in 2010, having been in the 6% range since 2015. It was at 6.8% year-on-year, 1.7% above the previous quarter in the third quarter of 2017 *(Chart)*. The reality of the Chinese economy can be confirmed by looking at their respective performance.

On the demand side, both consumption and investment have been sluggish. Exports have been declining, although they returned to growth in 2017. Consumption can be observed through the growth rate of total retail sales of consumer goods. It reached as high as 30-40% year-on-year during the high-growth years, but has been gradually declining since 2012. Currently hovering around 10%, it was 10.4% in 2016 and 10.3% in January-October 2017 *(Table)*.

CHART
GDP growth in China (real, quarterly)



Source: National Bureau of Statistics of the People's Republic of China

Investment can be confirmed through fixed assets investment. During the high-growth years, fixed assets grew at a feverish pitch surpassing 30% annually, but eased down to 20% in 2012; they had declined to 8.1% by 2016 and 7.3% for January-October 2017. Of this aggregate, private sector investment is even lower.

Exports, an important driver of China's economic growth, declined in 2015 and 2016 by 2.8% and 7.7% respectively due to changes in the domestic and international environments. They resumed rising in 2017, but the growth rate remains at 7.4% for January-October. Imports have also been trending in a similar direction. In short, both exports and imports were sluggish, but have turned around in 2017.

On the production side, China's manufacturing production trends are generally observed through the growth rate in real terms of value-added in manufacturing. The annual growth rate of value-added in manufacturing stood around 15-20% during the high-growth years, but has dipped below 10% since 2012, remaining at 6.0% and 6.7% in 2016 and January-October 2017 respectively.

The manufacturing purchasing managers' index (PMI) is an indicator often used to indicate the state of the manufacturing sector. Manufacturing PMI is a manifestation of the economic outlook in the manufacturing sector. The threshold is 50, meaning that the manufacturing sector is expanding when it is above 50 and contracting when lower than 50. PMI dipped below 50 in 2015 but returned to over 50 in 2016, rising to 51.6 in October 2017, telling us that manufacturing has regained its footing.

As for price levels, the consumer price index has remained steady, reflecting lower economic growth rates. The consumer price index was up 2.0% and 1.55% over the previous year in 2016 and January-October 2017 respectively. The producer price index had remained at negative levels since 2012, reflecting stagnant demand and downward pressure from excessive production capacity, but turned around in the second half of 2016, going up to 6.5% year-on-year in January-October 2017.

As these numbers indicate, the environment and conditions for growth have changed considerably from the high-growth years, making it impossible to sustain high growth. Meanwhile, various structural issues that had accumulated during the high-growth years became obstacles to economic growth, and the necessary structural adjustments proved to be a further drag on growth. Down to 6% or so, it is nevertheless considered a rational level, the "new normal".

TABLE

Main indicators of the Chinese economy: annual growth rate (%)

	2010	2011	2012	2013	2014	2015	2016	2017
Real GDP	10.6	8.8	7.9	7.8	7.3	6.9	6.7	6.9
Contribution Share by Final Consumption Expenditure	44.9	61.9	54.9	47.0	48.8	59.7	64.6	64.5
by Gross Capital Formation	66.3	46.2	43.4	55.3	46.9	41.6	42.2	32.8
by Net Exports of Goods and Services	-11.2	-8.1	1.7	-2.3	4.3	-1.3	-6.8	2.7
Total Retail Sales of Consumer Goods	18.8	18.5	14.5	13.2	12.0	10.7	10.4	10.3
Investment in Fixed Assets	24.5	23.8	20.6	19.6	15.7	10.0	8.1	7.3
Export	31.3	20.3	7.9	7.9	6.1	-2.8	-7.7	7.4
Import	38.7	24.9	4.3	7.3	0.4	-14.1	-5.5	17.2
Value-added of Industry, Real	15.7	13.9	10.0	9.7	8.3	6.1	6.0	6.7
Manufacturing PMI (average)	53.8	51.4	50.8	50.8	50.7	49.9	50.3	51.6
Consumer Price Index	3.3	5.4	2.6	2.6	2.0	1.4	2.0	1.5
Producer Price Index	5.5	6.0	-1.7	-1.9	-1.9	-6.1	-1.4	6.5

Note: The 2017 index is January-September for GDP, January-October for all others. Export and Import converted to US$. Manufacturing PMI is the arithmetical average of the monthly figures.

Source: National Bureau of Statistics of the People's Republic of China, Ministry of Commerce of the People's Republic of China

And China still leads the world at 6%.

As the growth rate declined, positive changes also emerged. Final demand expenditure has increased its contribution share to GDP growth while gross capital formation has seen its weight decline. This shows that there has been some success with the shift in its growth pattern that China has been seeking, a shift from a reliance on external demand and investment to expanding domestic demand.

The latest data in 2016 and 2017 confirms that the Chinese economy has righted itself somewhat. The quarterly real GDP growth rate has risen slightly from 6.7% (YoY) in 2016 to 6.9% in 2017. From this, it can be assumed that the Chinese economy bottomed out in 2016.

Although the indicators for consumption and investment trends remain stagnant, they cannot be called poor, even at current levels. Both exports and imports turned positive in 2017, indicating that external demand had recovered while the rapid growth of imports is a powerful indication of the recovery in domestic demand.

As for production, recovery, albeit slight, can be confirmed through indicators related to industrial production. The manufacturing PMI has sustained a relatively high level in 2017, showing more confidence over future prospects among manufacturers. Meanwhile, rising price levels, particularly with regard to the producer price index speaks to a background of recovery in demand and progress in the elimination of excessive production capacity.

Mid- & Long-Term Structural Issues

Turning to the mid to long term, the Chinese economy is saddled with various structural problems that impede economic growth. The first challenge is changing the growth formula. The Chinese economy achieved success during the high-growth years by expanding exports and investment. Specifically, to drive economic growth, China relied more on external demand than on domestic demand, while the latter if anything was driven by massive government-led investment in infrastructure, urban development, and new industries. Meanwhile, consumption made relatively lower contributions to economic growth.

However, it has become difficult to increase exports in recent years due to such factors as the global economic downturn, growing trade friction, and rising production costs. Meanwhile, swelling investment has led to a decline in economic efficiency, creating problems such as the growing debt burden of local governments and excessive production capacity that are acting as a serious drag on the Chinese economy.

Given these circumstances, turning to consumption as the driver of economic growth has become a serious challenge. The Chinese government recognized this in the wake of the global financial crisis and attempted a shift to growth led by expanding domestic demand and consumption. The *Table* shows that this adjustment has already had some effect, as investment has been accounting for a smaller share of growth while consumption has been contributing more. This is still a work in progress and will affect economic growth well into the future. Specifically, consumption-led growth does not have the immediacy of investment-led, with a concomitant effect on future growth patterns.

Next, there is the deficiency in labor supply and rising labor costs. Three decades under the "one child policy" have already pushed China into the low-birth, aging stage with the result that labor shortages are beginning to emerge. The turning point was 2010, when the job opening-to-application ratio in urban areas rose above 1; it reached 1.11 in the second quarter of 2017. A labor shortage reduces the potential growth rate. Together with rising wages, it drags down labor-intensive industries and affects exports. Thus, the labor shortage and the related rise in wage levels will have a serious negative effect on the Chinese economy over the long term.

The third problem is excessive production capacity. Massive investments as well as the measures taken to boost the economy in the wake of the global financial crisis have contributed to the rapid increase in production capacity in various sectors. This in turn has become a deflationary drag on the economy as the excess capacity was exposed during the downcycle.

In December 2015, the Chinese government identified 14 industries including iron and steel, cokes, steel alloys, copper refining, cement, glass, papermaking, and leather making as sectors with excessive production capacity. Crude steel production for example totaled 0.81 billion tons in 2016 against production capacity of more than 1.2 billion tons. Coal presented a similar picture. According to an announcement by China's National Development and Reform Commission, production capacity for iron and steel was reduced by more than 100 million tons and coal by more than 400 million tons, while 1 million members of their workforce were redeployed to other industries. Steel and iron and coal prices began to rise in the second half of 2016 partly as the result of the reduction in production capacity. However, administrative action to reduce production had a larger role in this; the reduction of production capacity still has some way to go. As long as excess capacity remains, so will its deflationary pressures, and the distortions in the industrial structure will continue to have a negative effect on economic growth. At the same time, continued reduction of production capacity will also necessarily have a negative effect on economic growth.

The environment is a similar challenge. Putting a stop to environmental destruction and undoing the damage that has been done require the use of more resources; declining economic growth will be one of the costs that will have to be paid.

Fourth is the existence of major financial risks that will have a negative impact on economic growth if and when they materialize, directly and through measures taken to deal with them. The Chinese renminbi fell significantly beginning in August 2015 due to the economic slowdown in China and interest rate hikes in the United States. Interventions in the offshore market by China's central bank, have brought recovery and stability to renminbi exchange rates, but the weak currency led to significant outflows of capital and a sharp decline in China's foreign reserves and its US bond (Treasury security) holdings. Capital controls were tightened significantly to stem the outflow of capital, but this in turn has led to difficulties in business activities. The risks from a weak renminbi and capital outflows have not been fully eliminated; they continue to exist.

Another aspect of financial risks is corporate debt. According to IMF documents, the ratio of corporate debt to GDP reached 165%, one of the worst in the world, at the end of 2016. The chances are small that the risk will materialize in the immediate future; the ratio of total debt to GDP in China is not high at all while the domestic savings rate is high. However, the monetary authorities are beginning to take measures to reduce corporate debt, and this is having a negative impact on the business activities, particularly in the private sector.

Fifth, there exists an atmosphere that downplays manufacturing, and a situation where businesses are seeing their bottom lines harmed. Manufacturers, particularly private sector businesses, exporting businesses, and labor-intensive businesses are being weighed down by multiple difficulties such as an economic downturn, rising wages and other costs, poor demand in the international market, and financing issues including difficulties in borrowing. Meanwhile, policy support for manufacturing has been cut back significantly as a result of the structural adjustments aimed at a consumption-driven economy and pushing an upgrade in manufacturing as well as debt reduction. In addition, manufacturing has been losing its allure in the face of high profits in financing and real estate. The number of businesses going bankrupt, moving into different lines of business, or simply closing down have been on the rise in recent years. This is not a good thing for the development of Chinese industry, as "the world factory".

All the mid- to long-term issues and challenges that I have explained here will impact the Chinese economy going forward.

Factors Supporting Economic Growth

Although the Chinese economy is saddled with many mid- to long-term problems that stand in the way of growth, there also exist various factors that support growth.

First, the policies and projects that the Chinese government is currently promoting continue to spur economic growth. Examples of this include policies that promote urbanization, policies that encourage innovation aimed at upgrading industry, and high-speed railway construction and other infrastructure projects.

Second is the development of new industries. For example, China leads the world in electronic commerce and Internet payments. They have permeated every corner of the everyday lives of ordinary people, making consumption convenient, which has a major, positive impact on consumption. In 2017, online shopping on Nov. 11, known as "Singles Day" in China (just like "Black Friday" in the US), reached 235.9 billion yuan ($35.6 billion) in sales with 1.38 billion packages delivered, up 43.5% and 29% respectively from the previous year.

China is also putting its effort into artificial intelligence (AI), where it is more or less on the same starting line as developed countries. On Nov. 15, the Chinese government determined and immediately published measures to promote research and development and adoption in four areas: automatic driving, urban management, health care, and language. China also leads the world in the production and sales of electric vehicles. The development of these new industries will be new agents of economic growth.

On the international front, China has been forcefully pushing regional economic cooperation since 2013 through its new Silk Roads initiative over land and sea entitled "One Belt, One Road". It has seen significant progress in the four years to date, a pace that is set to accelerate going forward. The returns for China in terms of economic growth should also swell through growing exports of construction materials and infrastructure as well as by securing supplies of energy and other resources.

Mid-Term Prospects

To sum up, the Chinese economy is currently in a slowdown phase, but has already bottomed out this year and is on the road to recovery. Looking to the next five-year mid-term stage, it is saddled with various structural issues whose resolutions will somewhat impact economic growth. However, positive growth factors will also continue to play themselves out.

All things considered, the Chinese economy should continue to grow over the medium term, maintaining an annual 5-7% pace. Even if it does wind up with an annual growth rate as low as 5%, that will still be as good if not better than other emerging economies, not to mention developed countries, and China will drive the world economy and see its global influence rise. JS

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