

SOM Macro Strategies

Macro Theme: China

June 2016
Alan Jay Brazil

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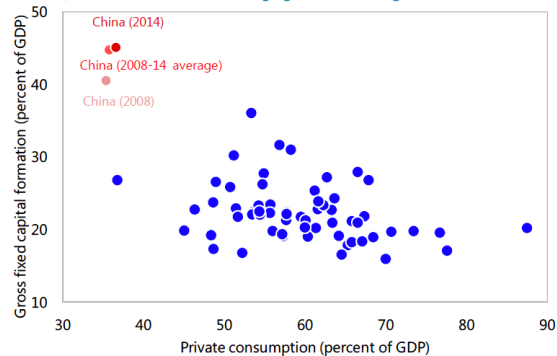
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Macro Theme: China's Failing Growth Model is A Systemic Risk

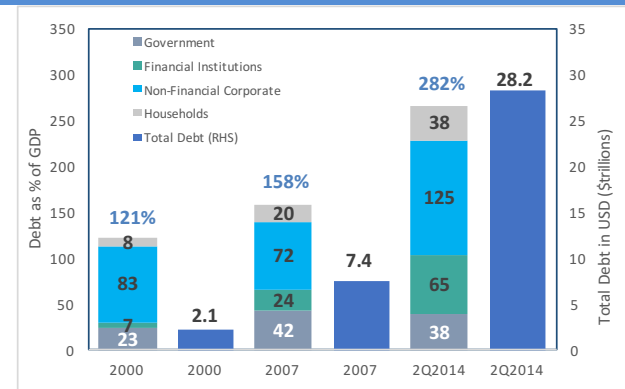
Growth Model Disaportionatly Based on Investment ¹

Private Consumption and Investment

(Industrial Countries and Emerging Markets; average, 2008-14)



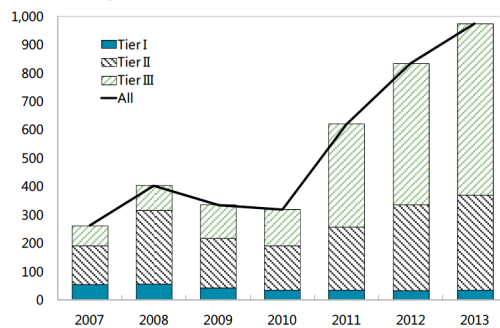
And A Credit Bubble ^{1,3}



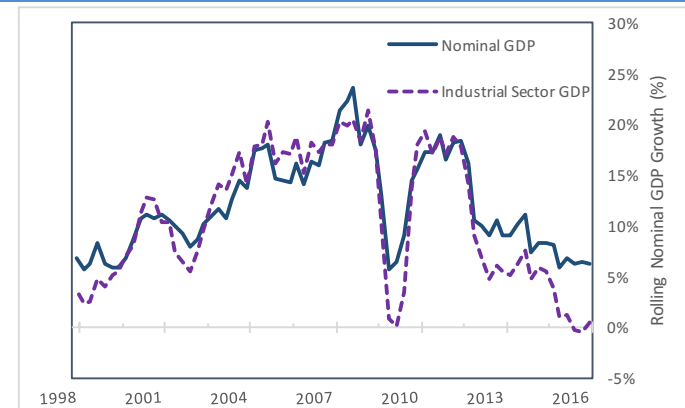
This Model Has Lead Too Many Buildings And Factories ¹

Residential Real Estate Inventory: Lower Bound Estimation

(In millions of square meters)



These Vulnerabilities Are Now Exposed As The Economy Slows ²



1. IMF Article IV China 2015
2. National bureau of Statistics China (NBS)
3. McKinsey Global Institute, "Debt and (not Much) Deleveraging", February 2015

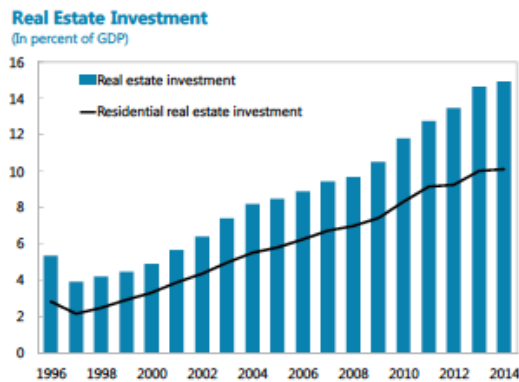
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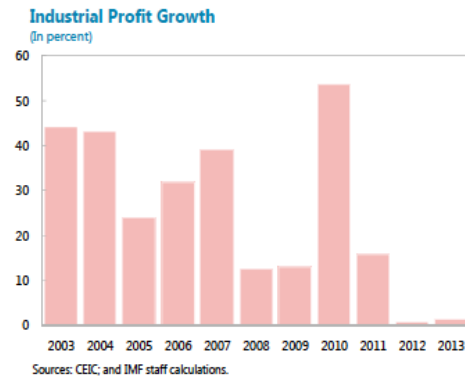
Step 2: Fundamental Economic Framework

What Now? Slowing Growth and Too Many Buildings and Factories Already¹

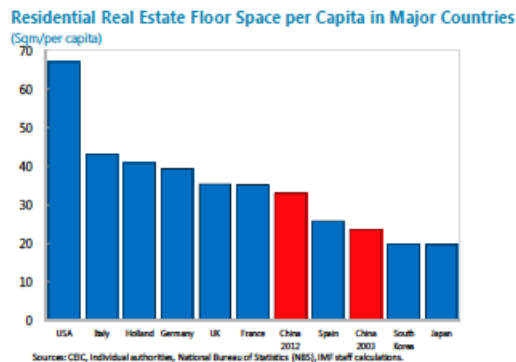
China Real Estate Investment Continues to Surge



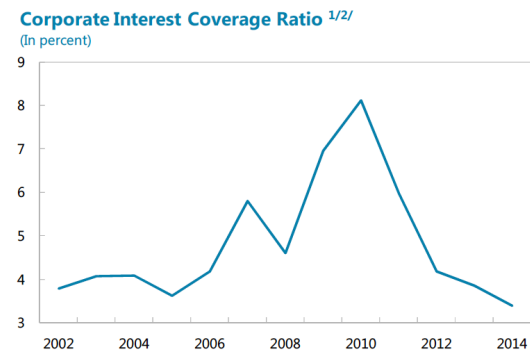
Industrial Profits Are Falling



Even Though Already at Developed Market Levels



And Repayment Issues Will Grow



^{1/} Calculated as EBIT/interest expenses.
^{2/} Includes SOEs and private firms.

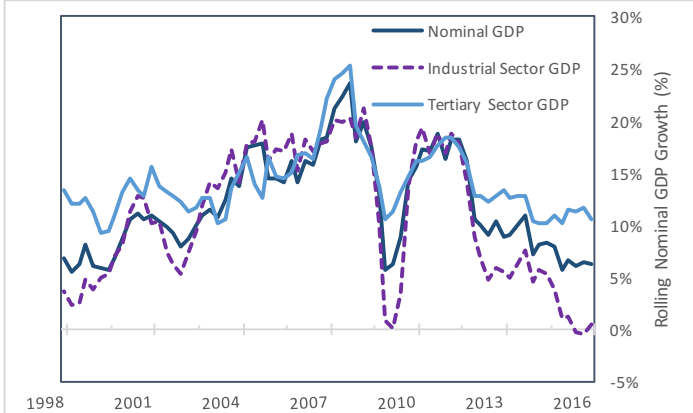
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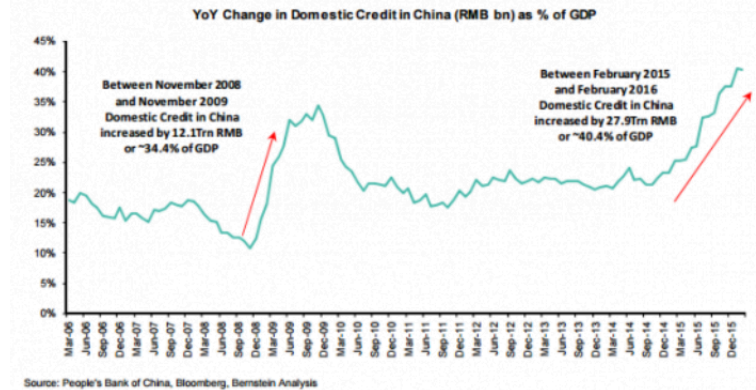
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Market Thinks The Positive More Than Offset These Issues

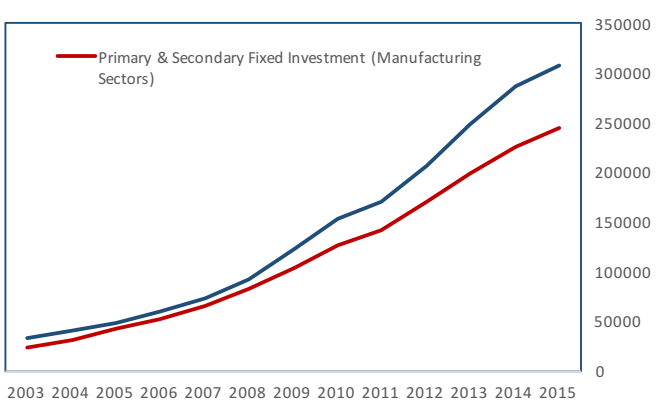
China is Transitioning to a Service Economy ¹



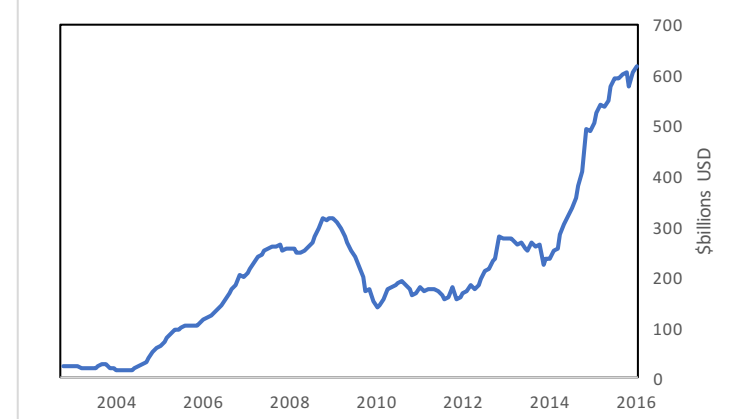
Government is Turning to Stimulus Both Through Credit and Infrastructure ²



Investment in the Tertiary Sector Is Larger than Industrial Sector and Growing ¹



China Export Engine is Growing (Net Goods Export ¹



1. National bureau of Statistics China (NBS)
 2. FTAlphaville, "What if China lands hard, they asked in 2013", April 27. 2016

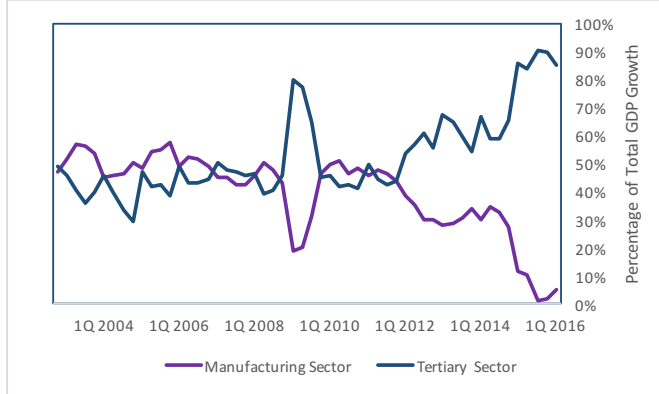
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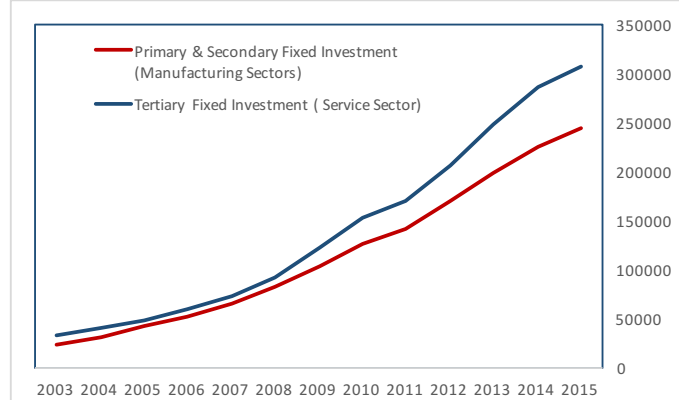
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These Positives Are Illusory: Tertiary Growth \neq Consumer Growth¹

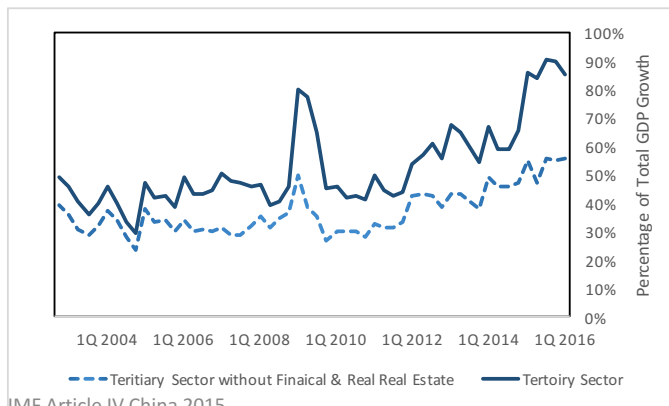
Yes, The Service Sector Has Taken Over From The Manufacturing



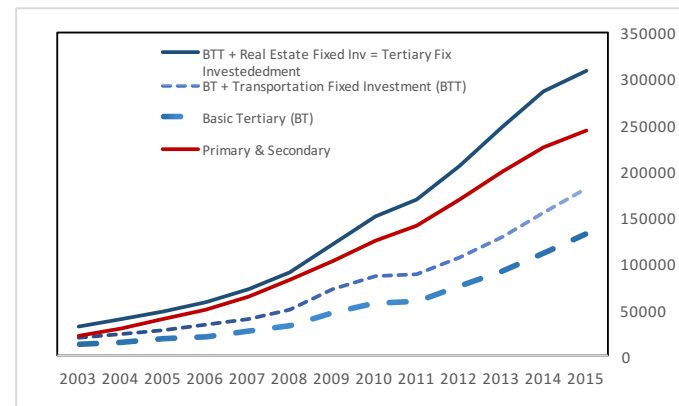
Yes, Investment in The Service Sector Is Growing



But The Growth is Through Financials and RE



But that Growth Has Come Through Real Estate



1. IMF Article IV China 2015
2. National bureau of Statistics China (NBS)
3. McKinsey Global Institute, "Debt and (not Much) Deleveraging", February 2015

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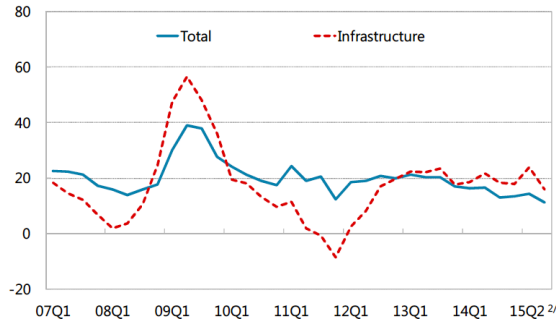
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Step 2: Fundamental Economic Framework

These Positives Are Illusionary: Infrastructure Growth Is Part of the Problem

Infrastructure Growth Has Been Substantial Already ¹

Real FAI Growth ^{1/}
(In percent, year-on-year)

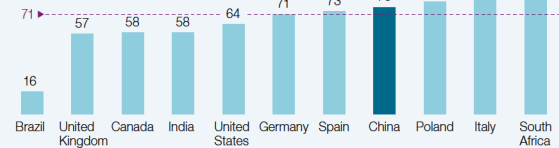


1/ Deflated using quarterly FAI prices published by authorities.
2/ 15Q2 is average of April-May 2015.

Infrastructure Look At a Par With Most Developed Nations Already ²

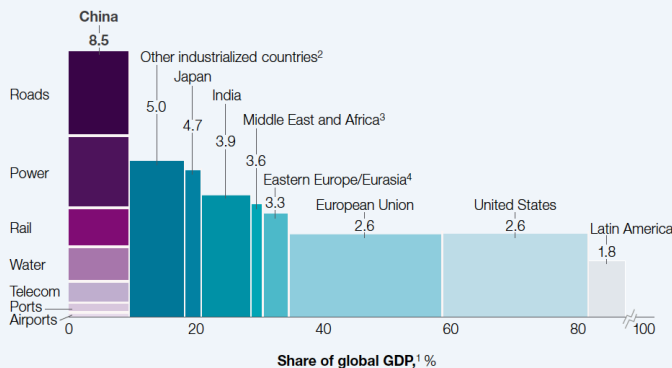
Total infrastructure stock, 2012,
% of GDP

Average excluding outliers,
Brazil and Japan



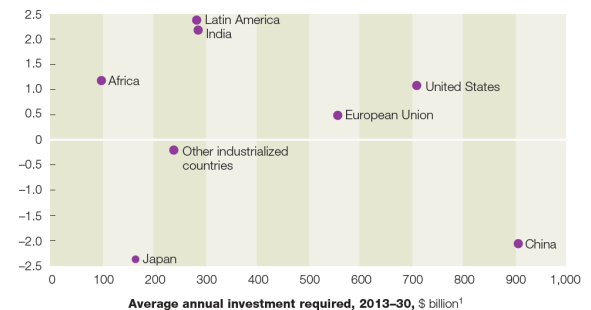
Source: IHS Global Insight; Global Water Intelligence; International Transport Forum, Organisation for Economic Co-operation and Development (OECD); OECD's perpetual inventory method; McKinsey Global Institute analysis

Investment Infrastructure Is Already Sizable ²



China Should Reduce Infrastructure Investment Not Grow it ³

Change in required investment, 2013-30 vs 1992-2011,¹
% of GDP



1. IMF Article IV China 2015
2. McKinsey Quarterly, "China's Next Chapter", November 2013
3. McKinsey Quarterly, "A dose of innovation to ease infrastructure strains?", September 2014

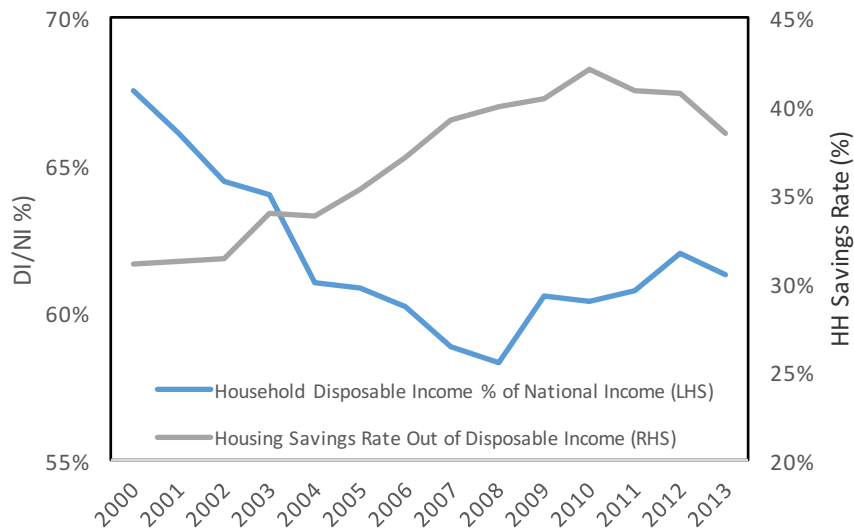
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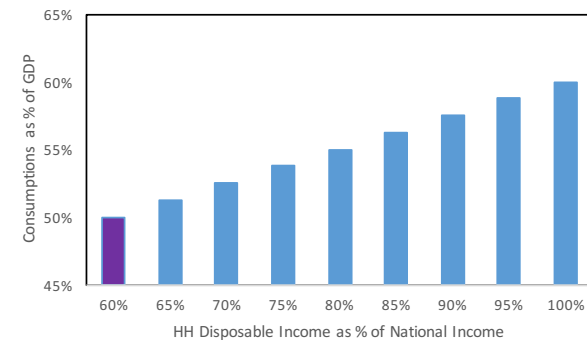
Step 2: Fundamental Economic Framework

These Positives Are Illusory: Consumer Growth Is Constrained By Savings and Income¹

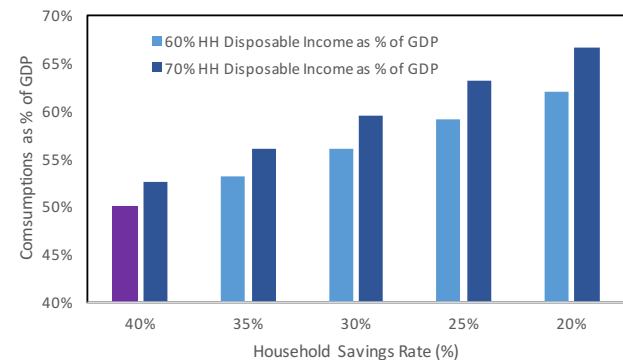
Consumer Receives Too Little And Saves Too Much



Increasing Consumption By Giving HH More Income Will Not Work



Savings Rates Need to Come Down Substantially



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Step 2: Fundamental Economic Framework

These Positives Are Illusionary: High Savings Rate Structural Not Easy to Change

One Child Policy Has Reduced the Number Children ¹

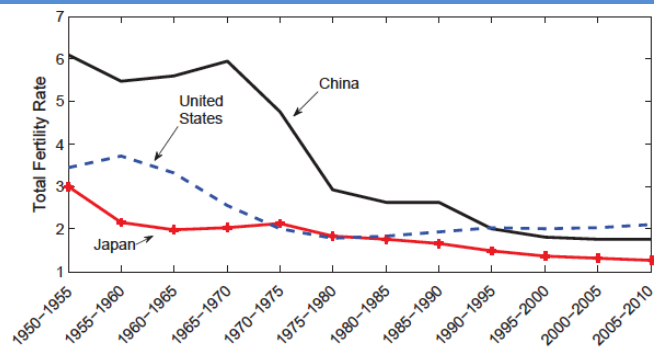
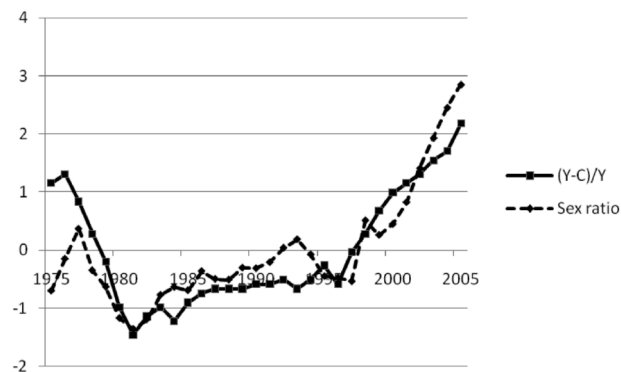


Figure 4: Total fertility rates 1950-2010. Source: *United Nations World Population Prospects 2010*.

Fewer Children Means Fewer Females = More Savings ²



Fewer Children Means = More Savings ¹

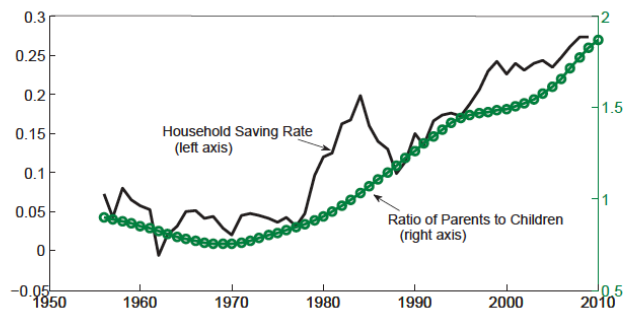


Figure 3: Household saving rate (left axis) and ratio of parents, age 20-50, to children, age 0-19 (right axis).

Housing Privatization in The 90s = More Savings ³

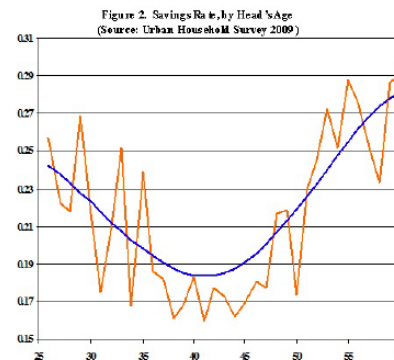


Figure 2: Savings Rate by Head of Age (Source: Urban Household Survey 2009)

1. Curtis, Chadwick, Lagauer, Steven and Mark, Nelson, "Demographic Patterns and Household Savings in China", March 2014
2. Wei, Shang-jin and Zhang, Xiaobo, "The Competitive Saving Motive: Evidence from Rising Sex Ratios and Savings Rates in China", JPE, Vol 119, No 3, (June 2011)_
3. Rosenzweig, Mark, and Zhang, Junsen, Economic Growth Center, Yale University, "co-residence, Life-cycle Savings and Inter-generational support in Urban China" April 2014

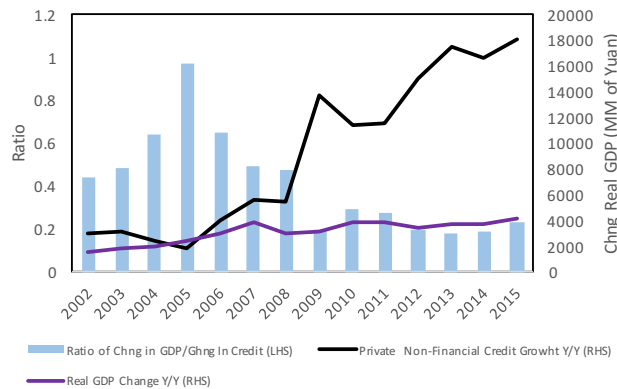
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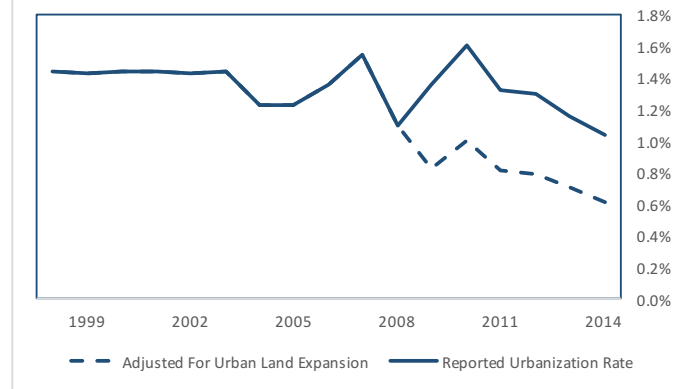
Step 2: Fundamental Economic Framework

These Positives Are Illusory: Credit Growth ≠ Economic Growth

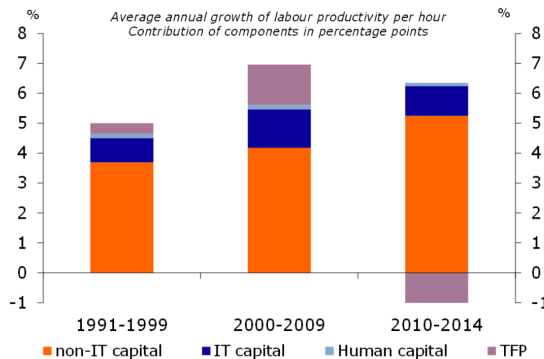
China Needs An Ever Increasing Level Of Credit To Grow ¹



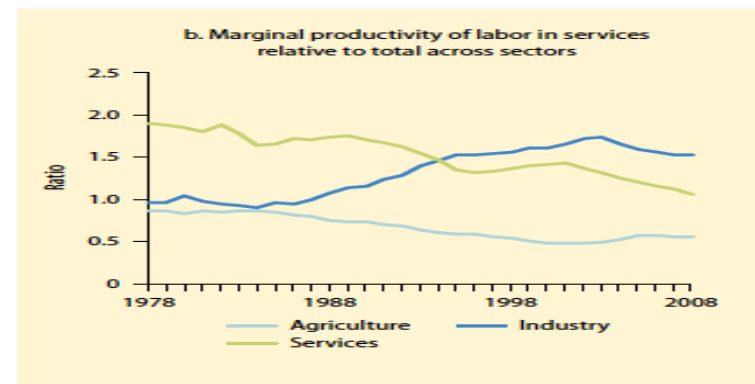
Productivity is Declining in Part Because of Falling Urbanization ³



Impact of Credit Growth Is Declining With Productivity ²



Urbanization Creates Productivity Growth ³



Source: World Bank staff calculations.

1. NBS
2. Rabobank Economic Research, "How fast is China actually growing?", April 07, 20
3. World Bank, "Urban China", July 2015

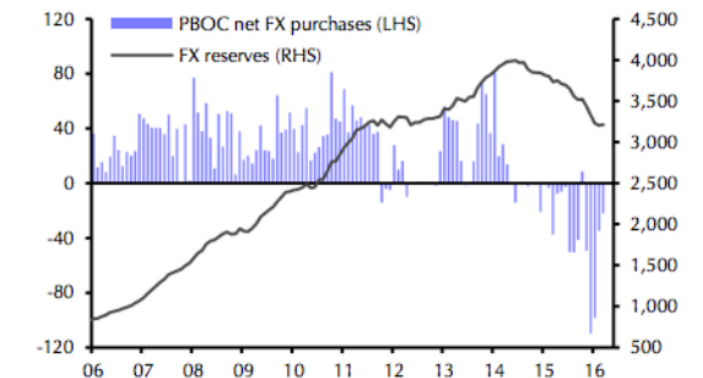
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Step 2: Fundamental Economic Framework

These Positives Are Illusionary: Trade Growth Masks Larger Problems¹

Positive Traded Balance Offset By Capital Outflows



Trade Balance Growth Comes From Falling Imports



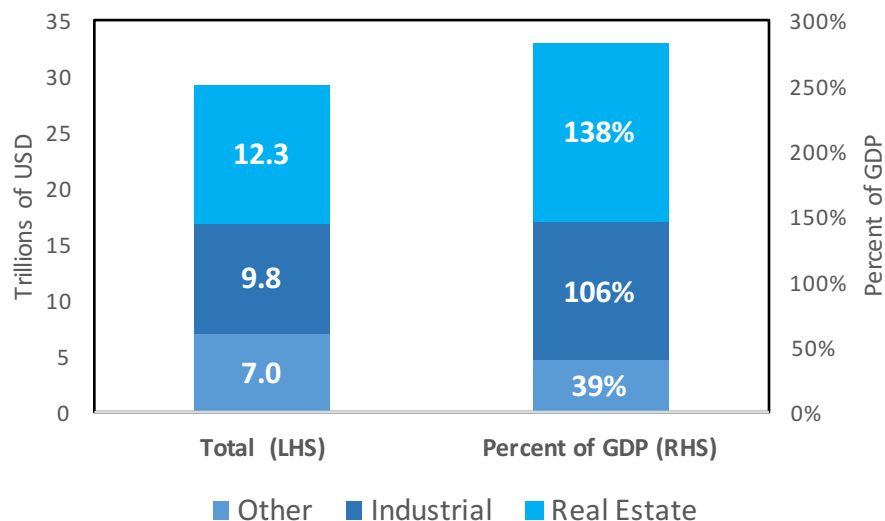
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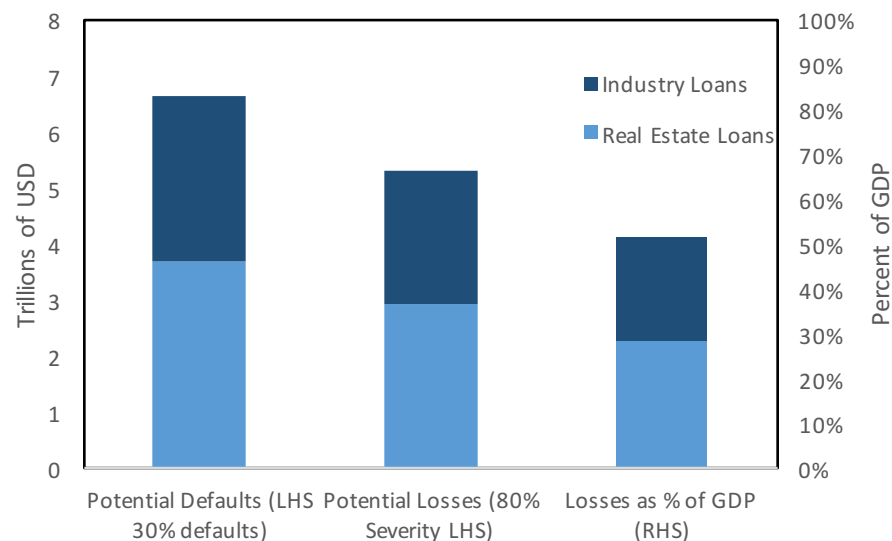
Step 3: Potential Catalyst

So, As China's Growth Engine Fails, Problem With Loan Losses Will Mount ^{1,2}

Over 2/3 of Debt Backed By the Problem Sectors



This Could Result in Substantial Losses



1. IMF Article IV China 2015
 2. McKinsey Global Institute, "Debt and (not Much) Deleveraging", February 2015

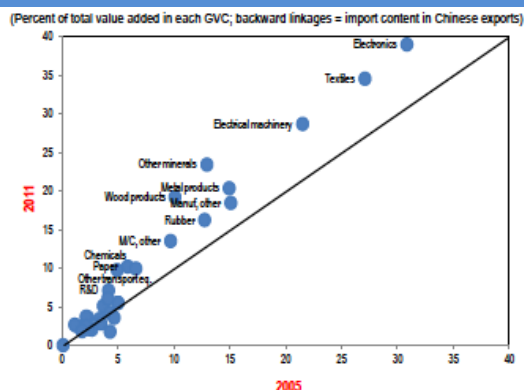
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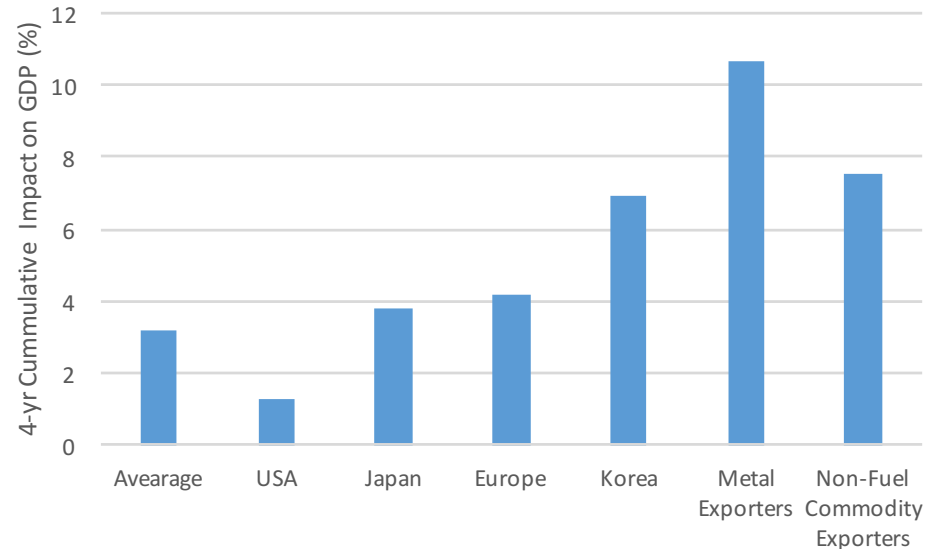
Step 3: Potential Catalyst

The ROW Economies Could Slow As China Imports Slow

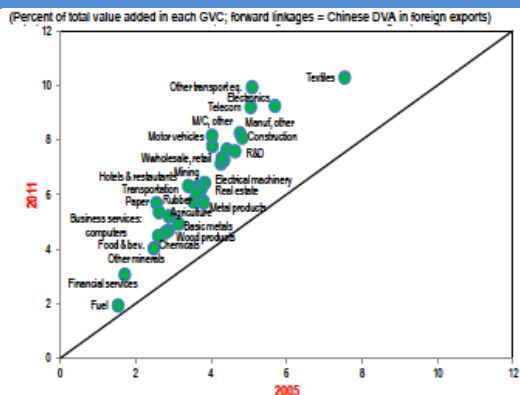
Imports Content of China Exports Growing ¹



A 10% Decline in China Imports Could Have a Substantial Impact on Growth in ROW ²



Imports From China For Other Countries Exports Growing As Well ¹



1. IMF Working Paper, "China and Asia in Global Trade Slowdown", Hong, Lee, Liao and Sneviratne, May 2016
2. IMF Working Paper, "China's Imports Slowdown: Spillovers, Spillins, and Spillbacks", Kierye, Alexei, and Leonididov, Andrei, March 2016

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