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China Economic Impact:
Reflections on Reforms

By / Sitao Xu

Despite a challenging external trade environment and domestic stock market turmoil, the Chinese economy still managed to grow at 6.9% in 2015. And though the year was dogged by investor's concerns of an economic hard landing, there were and are quite a few bright spots in the economy. For example, the labor market is strong because of a booming service sector which is being propelled by the transformation of the economy and consumers' desire for upgrading certain 'big-ticket' items (e.g., cars). Contrary to the many gloom and doom scenarios doing the rounds during the first half of last year, the housing market has shown itself to be surprisingly resilient, with first tier cities even seeing significant price increases thanks to a healthy pent-up demand and an ultra-low consumer leverage (consumer debt/GDP at less than 40%). Our base-line scenario on the residential housing market is that the price levels in 1st and 2nd tier cities will hold up well in 2016 -- despite a general economic slowdown.

Compared to the previous year, 2016 is expected to be a far more challenging year for China, but the Chinese Government still has many tools in its tool box. The key issue is whether China will be able to implement certain reforms amidst persistent economic deceleration. In addition, policy mix and policymakers' communication with the market would be crucial in 2016 (hence People's Bank of China Governor Zhou Xiaochuan long-awaited interview on the exchange rate during the Chinese New Year holidays).

How should China confront the twin challenges of a slowing economy and rising debt and capital outflows? To start with, China needs to clarify its position on the RMB exchange rate which has been under persistent downward pressure after the People's Bank of China made the initial adjustment of less than 3% on August 11 2015. China's intention was to remove the perceived exchange rate misalignment (the RMB has appreciated against most currencies for years) and to inject some flexibility into its relatively rigid exchange rate regime. However, due to a lack of proper communication about the timing of the (minor) devaluation, investors who were already rattled by the interventions in the stock market interpreted the adjustment of the RMB exchange rate as a sign of loss of control. PBOC Governor Zhou, who enjoys the nick-name of 'Mr RMB' and is known for being the driving force behind the RMB's internationalization, publicly articulated his views on the RMB during the spring festival break. The gist of Governor Zhou's views on the RMB can be summarized as the following: 1) there is no economic basis for the RMB's persistent depreciation; 2) The Chinese economy can maintain a relatively high growth rate; 3) the PBOC will improve its communications with the market, but it won't reveal its all its cards; 4) China will peg to the basket but won't necessarily be free floating. His words are given credence by the fact that indeed, China continues to run a healthy current account surplus (expected to be 3% of GDP this year), and foreign reserves are adequate for over 20 months of imports.

Unfortunately Governor Zhou's deliberations have come on the heels of a negative interest rate policy by the Bank of Japan who is determined to reflate its' flagging economy with unorthodox monetary tools. As China is preparing for the official inclusion of the RMB into the SDR (Oct 1 2016), its exchange rate policy, which has been constrained by domestic considerations, could be subject to more external shocks. We will expect the annual G-20 meeting (to be held in September in Hangzhou, China) to unveil further pledges on preventing competitive devaluation but coordination of monetary policies among major economies is likely to be difficult. In the economy, what is becoming increasingly apparent is the growing dichotomy between a slowing manufacturing sector beset by overcapacities and inventories and a booming service sector with the latter absorbing many jobs. Unlike in 2008 when over 30m migrant workers suddenly lost jobs, the labor market is in a much better shape this time round. That is why there are no compelling reasons for boosting GDP growth. According to directions set by the Central Economic Work Conference, the main objectives in 2016 will be to cut capacities, reduce inventories, bring down leverage, lower costs and make up deficiencies.

How should the policymakers prioritize the goals which are highlighted above? Is a 6.5% GDP growth rate a binding target? If the unemployment rate can be contained, and assuming that the New Economy can successfully absorb those who are being made redundant from certain sectors (e.g., steel, coal, cement and etc.,) which will have to be consolidated, such target would not have been necessary. Of course, we do not expect a drastic de-leveraging process because of the existing large weight of investment of the economy. Therefore, continued build-up of leverage in the next couple of years must be accompanied by rapid credit growth, which would in turn bringing about renewed pressure on the RMB exchange rate. In short, deterioration of asset quality would be the price to be paid for a relatively modest GDP growth target.

The optimal policy mix, therefore, seems to be pro-growth measures of fiscal expansion and monetary easing. There is no doubt that China has ample room for increasing Central Government deficit (to maybe 4-5% of GDP) and reducing reserve requirement rates (still at very high level after the 1st reduction in late February). But quite possibly short term interest rates have bottomed out because China has been undergoing interest rate liberalization which is being propelled by both policy initiatives and innovations of e-commerce companies.

Another important question that may arise in the near future is this: if reductions of the reserve requirement rate were to produce a diminishing impact, should China contemplate exchange rate adjustment, not necessarily on the ground of competiveness, but as an additional tool of monetary easing?

In conclusion, China will face many difficulties in 2016 but will also seize the opportunities born out of crisis to implement important structural reforms, thus safeguarding its economic health. In fact, if SOE reform, which is the center piece of supply side reform, could see meaningful progress, the economy would be on a much sounder footing. But the reality is that China still enjoys immense policy leeway and a booming service sector and therefore can put off the more difficult parts of SOE reform for a while.

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