N°15 | APRIL 2013

ECONOTE

Société Générale
Economic studies department

# CHINA: THE GROWTH DEBATE

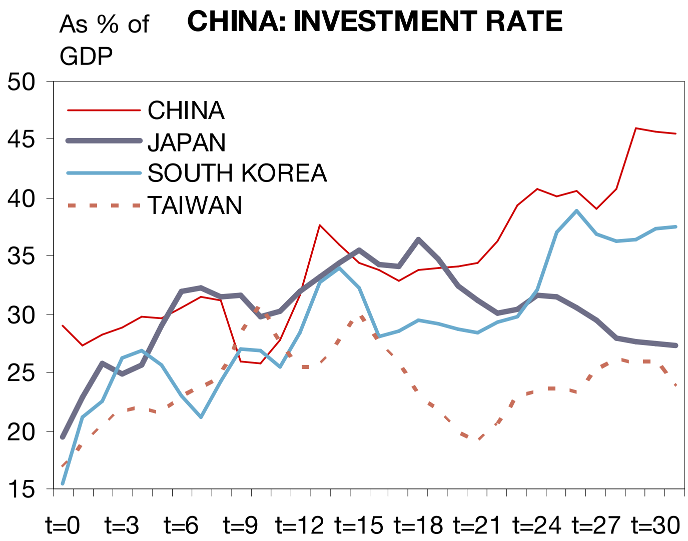
— The Chinese economy may have avoided a hard landing in 2012 but this has delayed the growth rebalancing down the road.

— The growth model seems overly focused on investment, which was exacerbated by stimulus programmes to support activity in recent years. This huge investment effort has stirred fears that the associated banking risks could flare up again thus sparking a more severe slowdown in the future.

— A gradual timetable of structural reforms seeks to rebalance the growth model from investment towards consumption, including financial liberalisation, greater flexibility in the exchange rate regime, and improved social policies.

— In the next two years, growth is expected to remain strong at around 8%. Thereafter, the transition period to a new growth model could prove to be a perilous path. The current growth model is likely to run out of steam due to factors such as more arduous technological upgrading, end of rapid urbanisation process, and ageing population.

**CHINA: INVESTMENT RATE**




*Note: T=0, start of industrialisation (1955 for Japan; 1965 for South Korea and Taïwan et 1980 for China).*

*Sources : World Bank, SG*

**Olivier de Boysson**
+33 1 42 14 41 46
olivier.de-boysson@socgen.com

**Sopanha Sa**
+33 1 58 98 76 31
sopanha.sa@socgen.com

SOCIETE GENERALE

After having decelerated in the past two years, the Chinese economy seems to stabilise at a still high level of growth (near 8%). In 2013, it should therefore be able to avoid a prolonged slowdown, or a "hard landing" that critics had feared or expected, highlighting China's capital-intensive economic development model. Today, the broad consensus is that Chinese growth would not rebound in the coming years but rather would tend to fall gradually. However, views diverge on the severity and the timing of the slowdown.

## THE "HARD LANDING" SCENARIO FOR 2012-2013 DIDN'T PLAY OUT…

After bottoming out in the second quarter of 2012, the economy has been recovering since September 2012 with a rebound in investment and exports, a marked improvement in confidence indicators (purchasing managers index and consumer's confidence index) and a pick-up in retail sales. Moreover, real estate prices have turned around since May 2012.

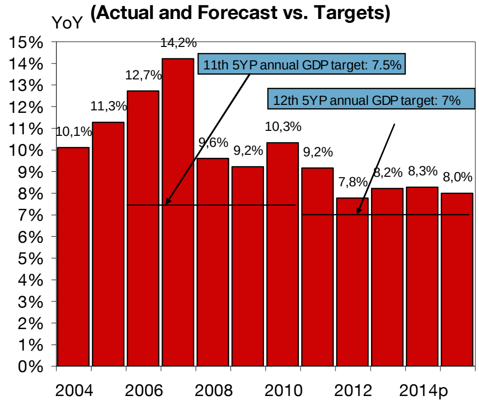
Accommodative policies taken by the authorities in the first half of 2012 staved off a "hard landing". They included monetary easing and a series of fiscal measures similar to the one implemented in 2008-2009 but on a smaller scale: tax cuts and subsidies for purchases of durable goods in an effort to boost household consumption and major infrastructure projects (railways, airports, etc.) to stimulate investment. In addition, the ambitious social housing programme (36 million housing units outlined in the 12th Five-Year Plan covering 2011-2015, including 7 million built in 2012 and 6 million planned for 2013) is ongoing.

Growth therefore remained strong at 7.8% in 2012 and should be close to 8% in 2013. These figures are evidently down sharply from the average growth of 10.8% over the last decade but they are higher than the targets set by the authorities (7.5% for 2012 and 2013 and 7% on average for the 12th Five-Year Plan).

Growth momentum seems presently to be quite stable and price pressures have been decreasing. In fact, inflation dropped[1] to an average of 2.6% in 2012, down from 5.4% in 2011. It is expected to remain under control in 2013 at around 3%.

[1] *Lower food and residential (rent and energy) prices, which account for 2/3 of the price index, were the main drivers of the decrease in inflation.*

**GDP GROWTH RATE**
**(Actual and Forecast vs. Targets)**




*Sources : CEIC, SG Forecasts*

## …. ALTHOUGH THE GROWTH REBALANCING ISSUE IS STILL UNRESOLVED

### The Chinese growth debate is not a new one

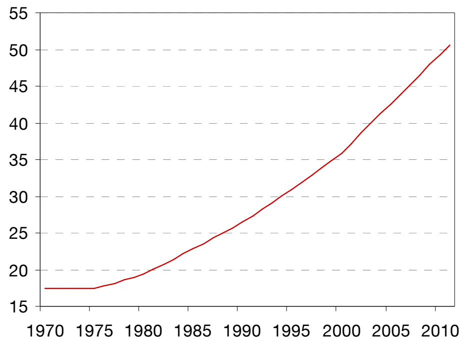
The Chinese growth model was already a concern in the aftermath of the Asian financial crisis in 1999 and then again in 2004-2005. Growth was seen as being too capital intensive. The poor marginal allocation of capital was supposed to lead to lower corporate margins in a wide array of sectors suffering from overcapacity. In particular, the real estate sector was considered to be dangerously speculative.

The fact is that these pessimistic analyses at the time never materialised: growth was very robust while productivity gains and corporate margins remained high. The property bubble remained relatively contained to the major cities without spreading to the rest of the country and without significantly impacting the rest of the economy. Therefore, China was able to manage issues stemming from the opaque allocation of capital and steering the country through a long period of very strong growth.

Structural factors have been suggested to explain the success of this high-growth path story. First, high productivity gains are generated automatically via the country's urbanisation process (through allocation of labour force to more productive manufacturing sectors). Second, the capital stock per capita is still low compared with industrialised countries. Technological upgrading is facilitated by this because growth still remains essentially a "catch-up" growth. Another factor specific to China, argues that fast economic growth comes from the dissolving of a historical anomaly: until the 1980s productivity was abnormally low, and this was part of the legacy of incredibly poor allocation of production factors during the Maoist period.

Structural factors such as urbanisation and China's technological "catching up" thus partially explain the fast growth path. These factors are currently at work and will be in effect for another decade or so until the urbanisation rate reaches a tipping point (60% in 2020 versus 51% in 2011). Beyond this period, constraints related to the ageing population would prevent the Chinese economy from financing this tremendous investment effort.

**URBANISATION RATE**
**(As a % of total population)**



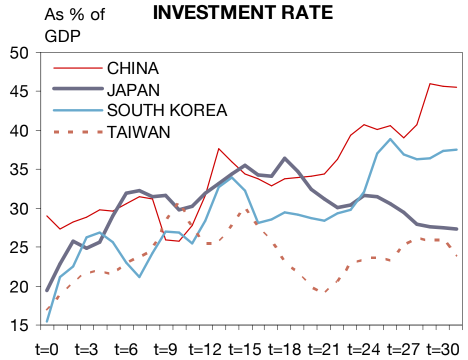

*Sources : World Bank, SG*

These factors could therefore make this high investment rate sustainable, despite the fact that it is very high in terms of international comparison.

### A high level of investment...

The investment rate reached 48% of GDP in 2011. It is very high in comparison with other major emerging markets (35% of GDP in India, and around 20% in Brazil and Russia). Moreover, it is higher than the ones experienced by the Newly Industrialized Asian Economies (Japan, South Korea, and Taiwan) during their industrialisation process in the decades of the 1950s to the 1980s.

**INVESTMENT RATE**




*Note: T=0, start of industrialisation (1955 for Japan; 1965 for South Korea and Taïwan et 1980 for China).*

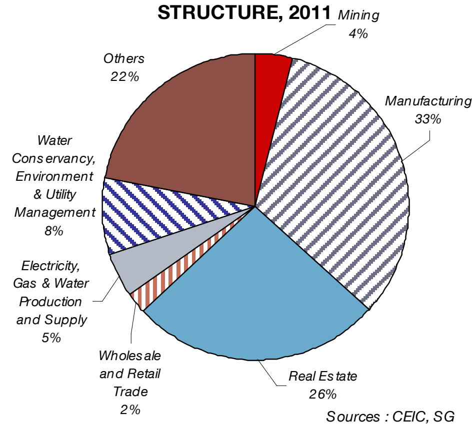
*Sources : World Bank, SG*

For analysts critical of Chinese development model, the fact that the cost of capital is too low explains why the investment rate is so high. Low capital costs are the result of many cheap factor inputs (land, water and energy) and low-cost financing from public banks, which is made possible by financial repression (credit granted on political motives rather than on a commercial basis, captive deposits, and capital controls). Lastly, the undervaluation of the Renminbi (RMB) would artificially inflate the profitability of the export sector, as part of a mercantilist strategy to gain market shares.

### ...and deemed dangerous by a number of analysts

This high rate of investment makes the Chinese economy highly exposed to a possible downturn in the property sector and in the export manufacturing sector, which concentrates half of total investment. Investment being the most volatile component of GDP, its contraction could thus have a very severe impact on the economy.

**FIXED ASSET INVESTMENT STRUCTURE, 2011**



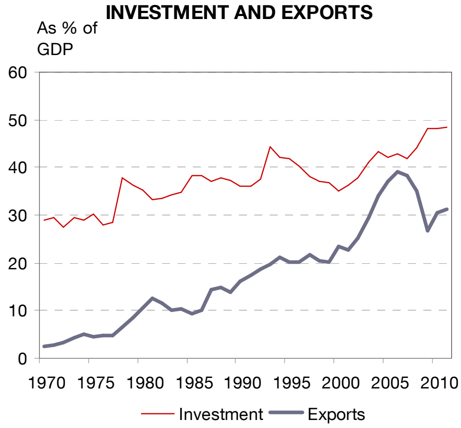

*Sources : CEIC, SG*

In addition, this high rate of investment could conceal huge financial risks including a surge of non performing loans in the event of a slowdown, which would amplify the "hard landing" cycle.

### The debate on the quality of Chinese growth has deepened since the 2008 financial crisis.

After the 2008-2009 fiscal stimulus, the share of the investment to GDP increased from 41.5% in 2005 to 48% in 2011. However, the export engine slowed and there are few chances of it taking off in the near future.

**INVESTMENT AND EXPORTS**



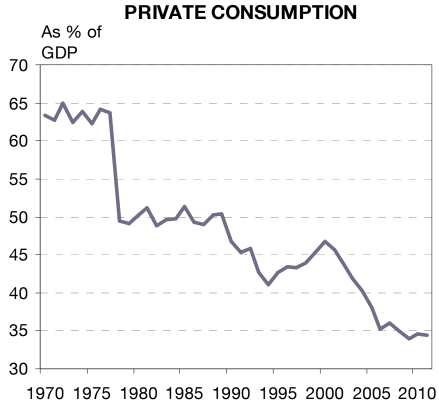

*Sources : World Bank, SG*

The Lewis turning point[2] may not have been reached but seems to be looming on the horizon. China's excess supply of labour is currently estimated at 150 million migrant workers. According to the IMF, this will dwindle rapidly, falling to 30 million in 2020. Structural reforms such as relaxing the one-child policy and the Hukous[3] policy could enable the country to push this back somewhat.

In addition, growing inequalities have become a source of concern. Despite the recent publication by the Chinese authorities of a lower Gini coefficient[4] (falling to 0.47 in 2012 vs. 0.49 in 2008-2009), there is a strong perception that inequalities are getting worse in the country[5].

In the meantime, the share of household consumption to GDP dropped to 34% in 2011 versus 40% in 2005. Since 2005, average real wages have slowed to 8% in 2012 (from 12% in 2005), suggesting that the 2009 rise in nominal wages was only a temporary "catch-up". Household savings remain high (around 24% of GDP) despite recent progress in social protection policies (healthcare and pensions).

**PRIVATE CONSUMPTION**

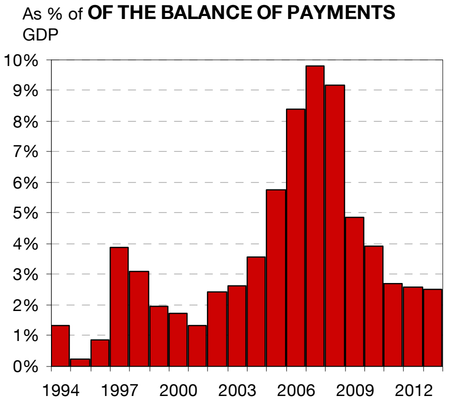



*Sources : World Bank, SG*

### An external rebalancing of the balance of payments has occurred somewhat

While the rebalancing of internal sources of growth between consumption and investment has not materialised, the same cannot be said of the external account between exports and imports. The current account surplus dropped from 10% of GDP in 2007 to 2.6% in 2012 driven by the decline of the trade surplus.

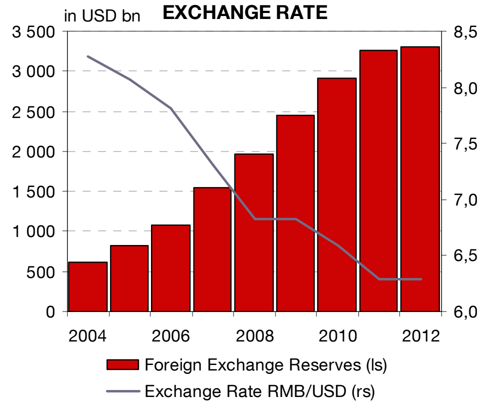
**CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS**




*Sources : CEIC, SG*

At the same time, the build up of foreign reserves which stood at USD 3.3bn in 2012, has slowed; and the undervaluation of the RMB compared with the dollar was reduced on the back of a gradual nominal appreciation of the RMB[6] (30% since the July 2007 revaluation).

**FOREIGN EXCHANGE RESERVES AND EXCHANGE RATE**




*Sources : CEIC, SG*

## THE DEBATE ON THE SEVERITY AND TIMING OF THE LANDING

In the long term, the consensus is expecting a slowdown in growth. The ageing population would result in a drop in the working age population starting in 2015 and an increase in the dependency ratio[7],

---

*[2] The Lewis turning point, named for the 1979 Nobel Laureate for economics Arthur Lewis, is the point from which excess labour in the agricultural sector is fully absorbed, which begins to increase wages.*

*[3] The Hukou is a household-registration system providing access to all public services (education, medical treatment and housing) and social protection (illness and care for the elderly) offered by a specific region/province.*

*[4] The Gini coefficient measures the extent to which incomes are unequal in an economy. A coefficient close to 1 expresses maximal inequality. A coefficient close to 0 expresses perfect equality.*

*[5] Other non-official research has pointed to rising disparity in incomes. For instance, the Survey and Research Centre for China Household Finance published at end-2012 a Gini coefficient of 0.61 for 2010.*

*[6] In 2012, the IMF qualified the RMB as a "moderately" undervalued currency compared with "significantly" undervalued in 2011.*

*[7] The demographic dependency ratio is defined as: the number of people under 15 years of age and older than 64 divided by the working age population (15-64 years of age).*

which would lead to a drop in the savings rate. In addition, productivity would slow as the economy goes more "upscale" in the value-chain, shifting from industry to services.

Moving beyond this consensus, the debate splinters into two camps. The first camp includes those who, like Nicholas Lardy[8], an expert on the Chinese economy at the Peterson Institute for International Economics, believe that the slowdown is likely to be moderate in the coming years, with growth of around 7-8%. Private consumption would be supported by an increase in households' disposable income, which would offset the slowdown in real estate investment. The second camp is more critical and includes those who think, like Michael Pettis, Professor of Finance at Peking University's Guanghua School of Management, that the poor allocation of capital in some sectors combined with the uncontrolled expansion in credit as well the increase in public debt would contribute to a growth meltdown (less than 4%) in the coming years.

It is possible that both schools of thought are right, but that one will follow the other. In fact, even if growth remains high (around 8%) in the next 2-3 years, the growth model could break down structurally in the longer term under the combined effects of aforementioned weaknesses (poor capital allocation, non performing loans, etc.) and factors exhausting growth.

## WELL-IDENTIFIED STRUCTURAL REFORMS WOULD BE NECESSARY

To prevent a structural breakdown in the Chinese growth model, a series of well-identified reforms could favour a gradual rebalancing of the economy. This would involve transitioning from quantitative management of credit and budget to a more qualitative and flexible approach by introducing market mechanisms. However, there are a number of political obstacles to this transition. It would be, in fact, difficult to change a system that seems to have worked well thus far. In particular, the authorities would need to relinquish some control over credit, which is its main, if not to say the only, way of efficiently regulating the economy.

The liberalization of interest rates would enable capital to be allocated more efficiently by making the capital cost more expensive. In June and July 2012, the People's Bank of China made progress on liberalising interest rates. Although interest rates are still administered, the banks can now offer their customers a 30bps discount (vs. 10bps before) on the floor benchmark rate. They can also offer depositors interest rates that are 10bps higher than the cap benchmark rate (versus 0bps before). The development of local capital markets would allow corporate to access other sources of finance for their investments besides the banks or shadow banking system. For households, improving access to credit would enable them to consume more while deepened local capital markets would diversify their savings.

Greater flexibility in the exchange rate regime would reduce the incentive to allocate investments into the export sector. The appreciation of the RMB[9] would encourage a reorientation of investment towards the domestic market, by lowering the cost of imported capital goods and by improving its profitability compared with the one of exporting activities.

An improvement in social policies (healthcare, education, pensions) would boost consumption. If state owned enterprises were to pay dividends to the state budget, it would help to finance greater social transfers. Thus, household savings would drop in favour of consumption.

## CONCLUSION: NO "HARD LANDING" IN SIGHT BUT RISK INCREASING FROM 2015

The risk of a "hard landing" (i.e. growth of less than 6%) seems highly unlikely in the next two years. The Chinese authorities have considerable leeway in terms of monetary, exchange rate and fiscal policies to deal with a strong slowdown in economic activity. In 2012, they demonstrated their capacity to overcome the combined effects of a deflating property bubble and a slowdown in exports.

However, beyond 2015, the current growth model could breakdown due to a combination of factors exhausting growth including the end of the phase of rapid urbanisation, scarcity of rural labour force, and ageing population. These factors would translate into new constraints: increased wage pressures and lower savings, while the authorities would have smaller room of manoeuvre to stimulate the economy.

These changes will push for the transformation of the growth model, but they will also make it a more perilous shift. The goal of the 12th Five-Year Plan is to move to more sustainable and more equitable growth that is focused on domestic demand. The new Chinese leaders would undoubtedly want to manage the growth

[8] *"Debating China's Economic Future", M. Pettis and N. Lardy; China Real time Report, November 2, 2012. http://carnegieendowment.org/2012/11/02/debating-china-s-economic-future/ebo4*

[9] *In April 2012, exchange rate controls were loosened when authorities allowed the RMB to fluctuate up to 1% in trading whereas previously the peg was set at 0.5% versus the dollar. Since the end of July 2012, the RMB has appreciated 2% versus the dollar. It is projected to appreciate by about 2-3% in 2013-2014.*

model transition but the context is likely to be more difficult than the one the previous duo of Hu Jintao-Wen Jiabao had to work with. The social situation is more tense, with increasing inequalities, growing unrest, and numerous cases of corruption involving the country's top leaders. Another, more long-term challenge will be to prevent the country from falling into the "middle income country" trap. The easy growth phase, driven by cheap labour and technological transfers, is drawing to a close. The decline in rural labour force should lead to wage increases while the growth effect from catching up for the country's technological lag could shrink.

# PREVIOUS ISSUES ECONOTE

**N°1 – The dollar: the American's currency, their problem?**
*Benoît HEITZ (March 2011)*

**N°2 – Is Africa about to take off?**
*Clément GILLET (May 2011)*

**N°3 – United States: State and local governments are dampening the recovery**
*Clémentine GALLES, Kim MARCH (June 2011)*

**N°4 – China: Internationalization without convertibility of the Renminbi**
*Sopanha SA, Meno MIYAKE (December 2011)*

**N°5 – Eurozone periphery adjustment: is Latvia an example?**
*Anna SIENKIEWICZ, Ariel EMIRIAN (January 2012)*

**N°6 – United Kingdom: Is the spectre of inflation back?**
*Marc-Antoine COLLARD (February 2012)*

**N°7 – China: Foreign direct investment outflows— much ado about nothing**
*Sopanha SA, Meno MIYAKE (May 2012)*

**N°8 – Turkey: An atypical but dependent monetary policy**
*Régis GALLAND (July 2012)*

**N°9 – UK Quantitative Easing: More inflation but not more activity?**
*Benoît HEITZ (July 2012)*

**N°10 – Housing market and macroprudential policies: is Canada a success story?**
*Marc-Antoine COLLARD (August 2012)*

**N°11 – The Euro Zone: a Unique Crisis**
*Marie-Hélène DUPRAT (September 2012*

**N°12 – Germany's export performance: comparative analysis with its European peers**
*Marc FRISO (December 2012)*

**N°13 – Financing government's debt: a vehicle for the (dis)integration of the Eurozone?**
*Léa DAUPHAS, Clémentine GALLÈS (February 2013)*

**N°14 – China: Housing property prices: Failing to see the forest for the threes**
*Sopanha SA (April 2013)*

# ECONOMIC STUDIES DEPARTMENT CONTACTS

**Olivier Garnier**
Group Chief Economist
+33 1 42 14 88 16
olivier.garnier@socgen.com

**Olivier de Boysson**
Deputy & Emerging Markets Chief Economist
+33 1 42 14 41 46
olivier.de-boysson@socgen.com

**Marie-Hélène Duprat**
Senior Advisor to the Chief Economist
+33 1 42 14 16 04
marie-helene.duprat@socgen.com

**Ariel Emirian**
Country Risk Analysis / CIS Countries
+33 1 42 13 08 49
ariel.emirian@socgen.com

**Clémentine Gallès**
Macro-Financial Studies & United States
+33 1 57 29 57 75
clementine.galles@socgen.com

**Benoît Heitz**
Global Economic Forecasting & Euro zone and Europe
+33 1 58 98 74 26
benoit.heitz@socgen.com

**Constance Boublil**
Central & South-eastern Europe
+33 1 42 13 08 29
constance.boublil@socgen.com

**Marc-Antoine Collard**
Gulf States, Latin America, Commodities
+33 1 57 29 62 28
marc-antoine.collard@socgen.com

**Marc Friso**
Euro zone, Northern Europe & Sub-Saharan Africa
+33 1 42 14 74 49
marc.friso@socgen.com

**Régis Galland**
Middle East, North Africa & Central Asia
+33 1 58 98 72 37
regis.galland@socgen.com

**Audrey Gasteuil**
OECD ex. Euro zone & Macro-Financial Studies
+33 1 57 29 52 26
audrey.gasteuil@socgen.com

**Sopanha Sa**
Asia
+33 1 58 98 76 31
sopanha.sa@socgen.com

**Isabelle Ait El Hocine**
Assistant
+33 1 42 14 55 56
isabelle.ait-el-hocine@socgen.com

**Valérie Toscas**
Assistant
+33 1 42 13 18 88
valerie.toscas@socgen.com

**Sigrid Millereux-Beziaud**
Information specialist
+33 1 42 14 46 45
sigrid.millereux-beziaud@socgen.com

**Société Générale | Risk division**
**Economic studies department | 75886 PARIS CEDEX 18**
**http://www.societegenerale.com/en/Our-businesses/economic-studies**
Tel: +33 1 42 14 55 56 — Tel: +33 1 42 13 18 88 – Fax: +33 1 42 14 83 29



SOCIETE GENERALE