Ravi Menon: China at an inflection point – what does it mean for Asia?

Speech by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the Official Monetary and Financial Institutions Forum (OMFIF) City Lecture, London, 5 May 2016.

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Distinguished guests, ladies and gentlemen

The China syndrome

China's size and promise have long enthralled the world.

- The dream of penetrating China's market was colourfully captured in the words of a British commentator in the 1840s:

  "If we could only persuade every person in China to lengthen his shirt-tail by a foot, we could keep the mills of Lancashire working around the clock"

- Well, war, revolution, and central planning quickly laid to rest that fantasy.

Since the closing decades of the last century, the gravity-defying growth and transformation of the Chinese economy have once again stirred global imagination.

- GDP growth averaged 10% per annum during 1980–2010, ahead of virtually all other economies.

China's size, growth, and rapid integration with the rest of the world mean that no evaluation of the global economy can be complete without looking at China.

- In 2000, just 5 countries ranked China as their top export market, compared to 53 countries that ranked the US similarly.
- In 2014, 43 countries ranked China as their top export market, higher than the comparative figure for the US, at 31.

The recent slowdown in the Chinese economy and volatility in its financial markets have therefore sparked fears that the Chinese economy was headed for a "hard landing" and that it would drag down much of Asia with it. But much like the dreams of a vast insatiable market two centuries ago, today's fears are understandable but overblown.

To many, China's economy seems like what Winston Churchill described the Soviet Union half a century ago: "*a riddle wrapped in a mystery inside an enigma*". China is indeed a complex economy but is not necessarily beyond comprehension.

China's economy is at a major inflection point. It is facing three necessary but significant challenges at the same time:

- First, the Chinese economy is adjusting to a lower rate of growth. Managing this moderation without major dislocation is a key priority for China's policymakers.
- Second, China is addressing risks and vulnerabilities in its economy and financial system. Doing this without triggering a crisis of confidence is another key priority.
- Third, China's economy is undergoing perhaps the most comprehensive and ambitious structural reform programme of any country in modern times.

In the short term, these three objectives may at times be in conflict, presenting a trilemma of difficult trade-offs for policymakers. But if successfully executed, these objectives are mutually reinforcing and will lay the foundation for a more sustainable and vibrant First World economy.

Moderation in growth

Why is China growing more slowly?

As China reaches a more mature stage of development, it is simply unrealistic to expect it to grow at the same rate as before. China is confronted with the reality of supply-side constraints that every economy eventually runs into.

- According to UN projections, China's working-age population (aged 15–59), is projected to shrink by 0.6% each year over the next 15 years.

Slower growth does not mean anaemic growth. China may no longer grow at 8–10%, but it is well positioned to grow by 6 to 6.5% for the next five years. With the right mix of structural reforms, there is substantial scope for China to achieve faster catch-up in productivity and income levels.

- China's per capita GDP is modest by international standards and its labour productivity remains well below the frontier.
- The less developed regions in China still have scope to grow at rates that are higher than the national average, and this process of internal convergence is itself an important source of future productivity growth.

The large size of the Chinese economy means that, at even more moderate rates of growth, the incremental demand from China will be quite substantial in absolute terms – and this is what matters for the global economy.

- China growing at 6% today adds US$340 billion of GDP compared to US$260 billion that a smaller China growing by 10% added 10 years ago.
- China contributed to more than one-third of world GDP growth last year, more than the combined contributions of the US, Europe and Japan.

Addressing vulnerabilities

Against this backdrop of moderating growth, China is also faced with the task of addressing vulnerabilities in its economy and financial system.

The chief risk is leverage – both its level and its growth.

- According to the BIS, China's credit-to-GDP ratio stands at around 250%, having risen by 100% points since end-2008. Nearly 70% of that increase is attributable to corporate debt.
- There are concerns that part of the corporate borrowing has been used to pay off existing loans, rather than being channelled towards productive activities.
- Many of the Chinese firms having difficulty servicing their debt are from the heavy industry sector facing excess capacity.

China has the fiscal resources to backstop its financial sector's liabilities and thereby stave off a systemic financial crisis. But the debt overhang will weigh on corporate investment and present a further headwind to growth. Indeed, with continuing producer price deflation, the real debt burden will keep rising, even as profitability falls.

In a good scenario, the debt ratio stabilises at the current level, and then gradually declines as nominal GDP rises faster than credit; in other words, China grows out of its debt problem.

However, this requires that enterprises that are no longer viable are unwound in an orderly manner.

- Earlier this year, Chinese authorities announced plans to reduce excess capacity in the steel and coal sectors.
- The government has also issued directives to banks to stop extending loans to firms that are persistently loss-making, while providing credit to competitive companies which are experiencing temporary difficulties.

The road to addressing China's debt vulnerabilities is long and fraught with risks along the way. But if recent efforts are sustained and economic growth does not tank, the prospects are good for an orderly and gradual deleveraging.

Structural reforms

More than the moderation in economic growth or even the vulnerabilities in the financial system, it is the outcome of the structural reform effort that will be decisive for the long-term prospects for the Chinese economy.

The Third Plenum reform blueprint of 2013 provides a comprehensive roadmap for China's full transition to a market economy. It is a thoughtful, coherent, and well-conceived plan. While implementation has been slower than expected in some areas, China has probably made more progress in structural reforms than any major economy during the last few years. But much work still lies ahead.

Take for instance fiscal reform. China has taken several steps to improve the sustainability and transparency of its public finances, especially at the local government level.

- Changes to China's budget law last year have helped to bring more government spending on-budget.
- Local governments are now allowed to raise funds in the bond market, reducing their reliance on land sales to fund expenditures.
- And earlier this week, on 1 May, China replaced all business turnover taxes with a more efficient value-added tax (VAT).

But work remains in the areas of reducing off-budget spending, strengthening social spending, and refining environmental and property taxes.

Domestic financial liberalisation is another area where the glass is half full and half empty. A lack of depth and sophistication in China's domestic financial market has limited the returns on household savings, indirectly crimping their purchasing power. It has also restricted financing to promising businesses.

- China has taken the important step of liberalising interest rates.
- But it also needs to develop deeper and broader capital markets. This will help better price risk capital and ensure that financing flows to more productive economic activities.

China has proceeded with capital account liberalisation in a careful and systematic way, "*crossing the river by feeling the stones*".

- Since 2008, the use of RMB outside China has been permitted for all current account transactions.
- Capital account transactions in RMB were subject to various quotas and schemes, which have been progressively expanded.
- And late last year, China allowed foreign institutions to issue bonds in China's onshore interbank bond market for the first time.

But opening up the capital account amidst a slowing economy, a still developing domestic financial system, and a debt overhang, is no easy task.

China has also made progress in reforming its exchange rate framework.

- Decoupling the RMB from the US Dollar last year – while it caused considerable anxiety in the markets – was an important and necessary step towards a more market-based exchange rate.
- The shift to a trade-weighted index for evaluating the exchange rate of the RMB will, however, take some time to gain credibility among market participants.

The most decisive yet most difficult piece in the overall reform programme is the reform of state-owned enterprises, or SOEs. The SOEs have been generating lower rates of returns on investment compared to the non-state sector, and are a drag on China's overall measured productivity performance.

- An SOE restructuring blueprint was announced last year, with the aim of improving competitiveness and efficiency but without outright privatisation, for example by consolidating similar SOEs or promoting "mixed ownership".
- This is a strong step in the right direction, but the Third Plenum's vision of a market-based economy can only be realised if SOEs are subject to competitive forces in all aspects of their operations.

China in transition: near-term effects on Asia

So, what does this all mean for the global economy, and Asia in particular?

- There has perhaps been too much focus on the slowdown in China's headline growth rate and not enough attention paid to the changes in the composition of that growth.
- More than China's economic slowdown, its economic transition will have a bigger impact on the world, and Asia in particular.

Let us consider first some of the near-term effects on Asia.

First, the slowdown in China's investment and associated imports will impact exports in the region.

- IMF data shows that China's goods import volume contracted by 0.7% in 2015, the first shrinkage in at least 18 years and a large step-down from its 10-year average growth rate of 10.5% (2005–2014).
- In value terms, China's nominal goods imports fell by a sharper 14.2%, which can be attributed to steep falls in global prices of commodities, delivering a harsh "negative terms of trade" blow on the affected countries.

Second, China's rebalancing away from investment and towards consumption will weigh on the exports of economies which are most exposed to Chinese demand for capital goods.

- Asian economies as a whole cater more to Chinese investment demand rather than its consumption demand. Therefore, at least in the short term, the impact of China's rebalancing is skewed towards the downside for the region.
- The Asian NIEs which export manufactured capital equipment to China will be adversely affected.
- In a relatively better position to weather the shift are Malaysia and the Philippines, as they export a variety of agricultural produce and consumer goods to China.

However, it would be misleading to attribute Asia's weak export performance solely to China's slowdown.

- While Emerging Asia's nominal exports to China fell by 4% y-o-y last year, the decline in the region's exports to advanced economies and other emerging markets has been even sharper.
- An MAS study shows that the ASEAN-4 economies' value-added exposure to G3 final demand is still about 1.4 times its exposure to China's final demand.

Third, the inevitable transition pains of a restructuring China will trigger periodic bouts of volatility in financial markets across Asia.

- Shocks from China's financial markets are transmitted through the banking and portfolio channels due to the substantial holdings of Chinese assets by foreign investors and lenders.
- Another avenue of transmission would be through the confidence channel, whereby events in China affect risk appetites in other markets.

China in transition: medium-term implications

In the medium term, China's rebalancing could bring more positives to Asia in spurring trade, boosting investment, and expanding regional production networks.

First, there are ample opportunities for countries which re-orientate the structure of their exports to tap on Chinese's burgeoning demand for consumer goods and services.

- Demand for final consumption goods will increase as China's middle-class grows, stimulating imports of consumption goods even as trade in intermediate goods slows.
- Indeed, at a rate of nearly 10% per annum, China's import of consumption goods has grown by more than twice that of intermediate goods over the past ten years.

Second, direct investment will increasingly be an area where China's impact on the region is felt. Since late last year, China has emerged as a net exporter of direct investment.

- Outward direct investment from China has grown by 28% per annum over the nine years to 2014.

Third, a new regional production network could emerge in Asia.

- Indonesia and the economies in Indo-China, with favourable population dynamics, are well-placed to absorb the labour-intensive and lower value-added jobs that China is shedding as wage costs rise.
- The Chinese push to finance infrastructure construction in less developed Asian countries, as part of its One Belt One Road plan, will greatly enhance these countries' attractiveness as nodes in the Chinese manufacturing network.

Conclusion

Let me conclude.

China is in the midst of an unparalleled economic transition. It is grappling with the challenge of managing a growth slowdown, addressing vulnerabilities in its financial system, and implementing structural reforms – all at the same time. It is not an easy task, juggling these three balls at the same time.

The Third Plenum blueprint shows that Chinese policymakers are keenly aware of what needs to be done to foster a dynamic, market-based economy.

- Their track record managing the rapid growth and transformation over the last three decades augurs well.
- And as they gain in confidence implementing reforms and as their economic institutions strengthen, they will grow in their willingness to accept the vagaries, fluctuations, and diminution of central control that are inherent in a market economy.

The next chapter in the China growth story has only begun.