Beneath the Surface

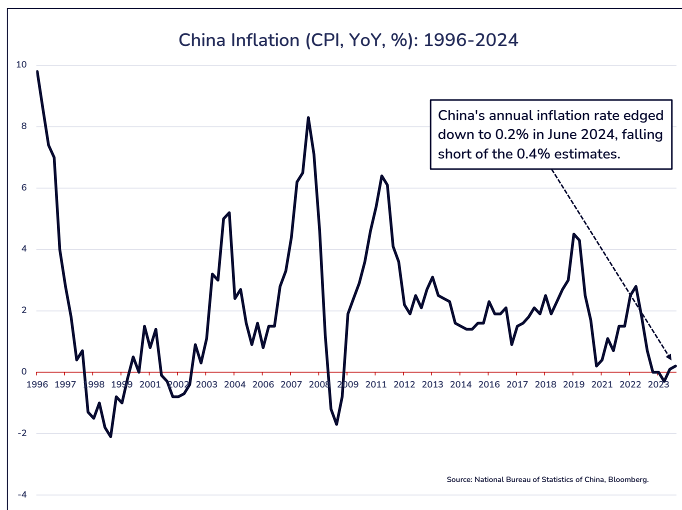
August 2024

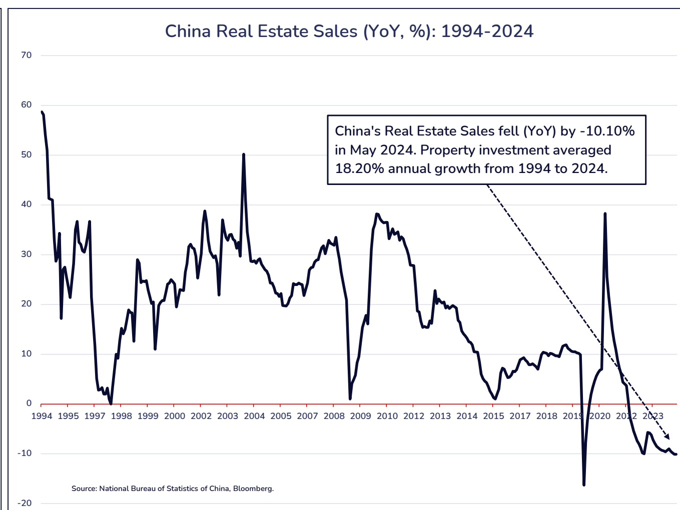
SIGNET

Factory of the World?

- In July, China released its official Q2, 2024 GDP data. The QoQ statistic grew by only 0.7%, well short of the 5% annualised target, supporting the view of a serious economic slowdown. With structural imbalances, excessive and unproductive debt, a disinflationary trend unfolding, and political friction with the West, what, if anything, might China's economic policymakers be planning next? What might the impact be for investors? Special to China is the requirement to monitor the quality of GDP growth and not the quantum of GDP growth. There is fragility: consumption's share of GDP remains low, at around 39% (the US equivalent share is 70%) and business investment is driven largely by exports, which are raising eyebrows internationally. China still relies upon (a) non-productive capital formation (e.g. infrastructure) and (b) neomercantilistic policies – a constant trade surplus and capital controls – to drive growth. Beijing's policymakers utilise local government debt to steer and implement China's industrial policy, in a process resulting in structural overcapacity. This approach has led to the misallocation of capital, specifically debt and loans, and accusations of anti-competitive practices. China's domestic overcapacity, and its historic 'factory' production focus, has provoked a jarring price war in many competing sectors, only compounding the problems further. Inflation is hovering uncomfortably near zero (chart, below left) and this is a serious problem for a highly leveraged economy. The debt service ratio for the private nonfinancial sector has peaked at an all-time high and total debt-to-GDP currently stands at 355%, versus 200% ten years ago. These issues have eroded consumer confidence, leading to further declines in domestic consumption and increasing the risk of the country sliding into a debt-deflationary trap. The real estate problems have created a serious drag on the economy over the last two years as well (chart, below right). There is no sign that the property issues have abated, despite the rescue packages, and a fall in property prices has caused some of China's largest companies to default or operate under zombie-like status.

- China's policymakers are acutely aware of Japan's economic stagnation after 1989, and they are determined not to repeat the same mistakes. However, right now, they appear to lack the political will, or capability, to change much. Without change and some Schumpeterian 'creative destruction', foreigners and the super rich will continue looking for the exits. If policymakers do shift, there are three issues to focus on: (1) restoring moderate inflation and inflation expectations; (2) driving consumption growth, perhaps via a more generous fiscal policy; (3) fix or inflate away the overbearing debt pressure and balance sheet constraints. If China decides to export its way out of an economic slowdown, it will have to undercut the competition abroad, which is disinflationary and risks an international political backlash. Note that while maintaining their existing industrial policy, policymakers are prepared to complement it with a new strategy – New Productive Forces – which will target high quality (science and technology) development. Will China strategically devalue its currency – as it did in 1994 and 2015? There is pressure for a weaker Yuan. A devaluation could have far-reaching consequences. In theory, a devaluation might mitigate risks of deflation and external shock. It might reignite interest in the Chinese stock market. However, the 2015 devaluation was mismanaged and resulted in large capital outflows, and does China really want to escalate international tensions?





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