Opinions

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The Chinese Economy's New Normal: The Way Forward

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In 2014, China's economic growth rate dropped to its lowest point in 24 years; and economic growth in 1Q 2015 was 7 percent, dropping by a further 0.3 percentage points compared to 4Q 2014. Such figures point to an economic slowdown, and give rise to doubts about whether China can continue to sustain its economic growth. In contrast to the deceleration of China's real economy, the stock market in China has been showing rapid development. The Shanghai Composite Index, which hovered around 2500 points in 2H 2014, nearly doubled to hit 4400 points as of late. This jump can be traced back to the Hu-Gang Tong program (Shanghai-Hong Kong bourse linkage), which came into effect in late 2014 and has directed speculative funds, which had lost aim due to the real estate downturn, toward the stock market. As speculation in the stock market became overheated, the Chinese government announced it would more strongly regulate credit dealings as a control measure. This is a reflection of instabilities in the Chinese economy.

The Chinese economic slowdown can be attributed to the downturn in export and investment growth due to dampened overseas demand and domestic restructuring; this trend is expected to continue, with this year's growth rate forecast at 6.8 percent, lower than last year. Consumption only rose 12 percent in 2014, sustaining the downward trend for four years in a row since the 18.4 percent rise in 2010. Fixed asset investments only grew by 15.7 percent, likewise continuing on a downward journey for five consecutive years since the 30.5 percent growth recorded in 2010. The recession in the global economy is not helping the situation; export growth rates have been listing single digits since 2012. In response to such changes, the Chinese government has defined this as a new normal for the Chinese economy, and is asking its people to accept this overall slowdown instead of regarding it as an abnormal state.

The Chinese economy's new normal can be defined by several features. The first is changes in the pace of economic growth. China's economy was growing swiftly at an annual average just below 10 percent; the speed has dropped, now down to about 7 percent. Last year in particular, for the first time ever since 2004, China failed to reach its yearly economic growth target of 7.5 percent. The second feature is the shifting economic structure. The role of investment, which had been driving China's growth, has slightly diminished in the past few years, leading consumption to make a larger contribution. The industrial structure is likewise undergoing changes, as in 2013, for the first time ever, the service sector trumped manufacturing in its share in GDP. In 2014, that share reached 48.2 percent, gaining 5.6 percent over manufacturing in a show of expansion. The last feature is shifts in China's growth engine. If the economy ran on factors like capital and labor before, economic growth is now led by productivity. This implies that China's abundant resources and population bonus, formerly the drivers of economic growth, are now losing power and giving way to the necessity for innovation and reform across the country. China already became an aging society (7 percent or more of the population aged over 65) in 2001, and since 2010 the growth rate of the working population has started to drop. The dependency ratio of the population will soon embark on an upturn, and the population bonus is set to vanish around 2030. The Chinese government is planning to prevent a downward spiral in economic growth by making up for the working population shortage with accumulated human capital and higher productivity based on improved education opportunities. As a consequence, the 27 percent college enrollment rate for 18 to 22-year-olds is forecast to jump to 40 percent in 2020.

The above features are evidence that China, a G2 economy, is moving ahead with restructuring measures. Will China be able to sustain its structural reform? Given the several economic risk factors China is riddled with, improving the economic regime through structural reform is a necessity, not an option, if the country is to seek sustainable and stable economic growth. The first risk factor China faces is excessive production facilities. Investment-centered growth strategies have led to an oversupply of production facilities and the disproportionate development of capital-intensive industries; this is undermining economic efficiency. China's NDRC estimated that USD 6.8 trillion - half of the investment from 2009 to 2013 - was wasted due to real estate speculation, excessive facility investment, and lax supervision in the wake of economic stimulus measures. Deteriorating business conditions caused by overproduction ultimately resulted in bankruptcies and a rise in bad debt. According to the annual reports of 14 listed banks, manufacturing and wholesale/retail loans accounted for around 30 to 36 percent of total bank loans, but their bad debt was responsible for 80 to 90 percent of bad debt in total. The government is considering industrial restructuring to liquidate certain over-producing companies, to encourage entry into overseas markets and relocate industries marked by overproduction. The second risk factor is local government debt, which continues to expand. Local government debt tends to rise rapidly, and also has the potential to be affected by the real estate economy since most of it is related to income from transfer of land and real estate development investment. Although the Chinese government has rolled out measures to enhance financing ratios of loan platforms, this is not expected to draw results any time soon. The third risk is the downturn in the real estate market. Along with a slowdown in the rise of housing prices, the increase rate of new housing construction projects and sales area have also been falling, sustaining the downward trend. Such contraction in the housing market is caused by complexities including both trend and cyclical factors, and is expected to affect the real economy decline for some time. Since 2H of 2014, the government has been carrying out various measures to boost the real estate market - lowering deposit and loan interest rates, relaxing restrictions on housing purchases - but are expected to have a gradual impact. The last risk factor lies in the financial sector. The expansion of shadow banking and bad loans are examples of potential risk factors. The government has been accelerating financial restructuring by establishing private banks and adopting deposit insurance systems, and more recently has been working to enhance financial stability by easing regulations on foreign capital banks.

The last point to underline is that China, along with structural reform, is seeking to boost economic growth by identifying new growth engines. This year, again, the Chinese government announced that it would lay the foundation for stable economic development by further reforming and opening up the economy and carrying out industrial restructuring, and seek economic growth led by domestic demand. To find a solution for overproduction and spur the structural transition of traditional industries, the government will "innovate" the industrial structure and create a business environment friendly to innovation and start-ups. Another measure being implemented to secure new growth engines is the strategic fostering of emerging industries. The "Made in China 2025" strategy in particular promotes innovation, smart technologies, infrastructure and green development to transform China from a manufacturer of quantity into a manufacturer of quality by 2025. Meanwhile, regional development strategies have lost the power to drive new growth; thus, the emergence of three comprehensive regional development strategies that link regions with development gaps. The three strategies are: the "One Belt, One Road" strategy, the integrated development of the Jing-Jin-Ji (Beijing, Tianjin, Hebei) region and the Changjiang Economic Belt. Many efforts are underway as part of the One Belt, One Road strategy, i.e. reinforced cooperation between the midwestern region and neighboring countries, land and maritime infrastructure establishment, the foundation of the Asian Infrastructure Investment Bank (AIIB) and the Silk Road fund. Given the government's swift measures, now more than ever is the time to closely monitor China's next move. KIEP