The flagging dragon

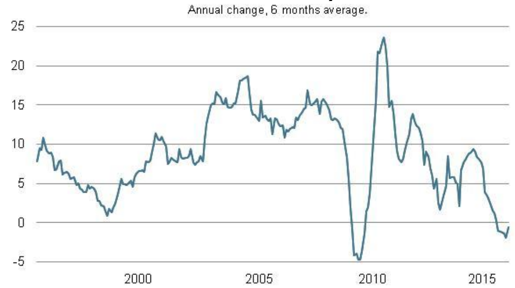
The challenges faced by China

October 2015

China has become a major issue across the globe for investors and policy makers. While a slowdown of its growth was anticipated, government policies and the share market crash created volatility across global markets and concerns for the future. This paper explores some of the short and longer term issues affecting China's economy.

There have been a number of indicators that the Chinese economy has weakened over the past year. The decline in electricity use, as shown in Chart 1, is one of these. A slowdown was inevitable though, given the unsustainable rate of apartment construction that has driven economic growth in recent years. Between 2010 and 2013, China built 15-17 million apartments per year, well in excess of underlying demand from population growth and urbanisation of around 10-12 million (this is shown in Chart 2).

Chart 1: China Electricity Production



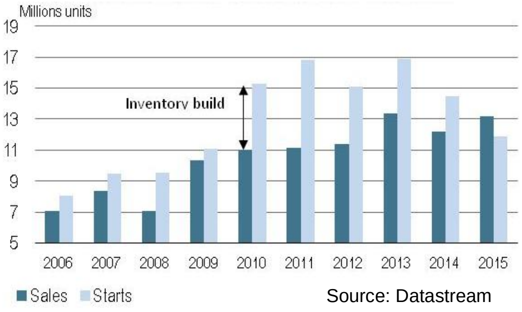
Source: Datastream

This has left a large overhang of unsold and unoccupied apartments that must now be cleared. That adjustment started in 2014 and has accelerated this year but has several years to run given the scale of the inventory problem.

This is not the only reason for the recent weakness in China. There are a number of shorter term policy errors that have exaggerated the downturn. These include policies for government financing, anti-corruption measures and policies around the share market. These are temporary and reversible, and changing these will see better growth outcomes over the next year.

More information about each is outlined below.

Chart 2: China Apartment Sales and Starts

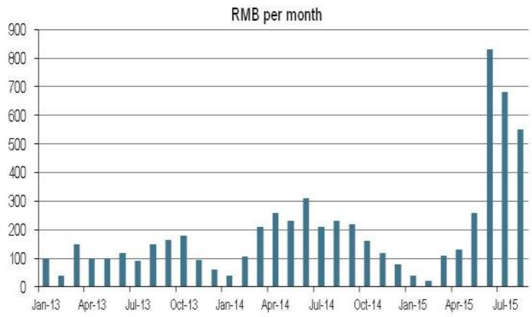


Source: Datastream

1. Government attempts to clean up local government financing

Local governments are the main builders of infrastructure but their funding arrangements have always been murky. China attempted a major reform of this from October of last year. While such reforms are necessary, the immediate effect was that local governments were starved of funds, and infrastructure projects ground to a halt. This more than anything else has been the driver of the weakness in the economy over the past year. The good news though is that the government has recognized this problem and reversed the reforms. Local government debt issuance has surged since the reforms were reversed, as shown in Chart 3. This money will be flowing back into projects now and will make a big difference to the economy over the next year.

Chart 3: Local Government Bond Issuance



Source: Datastream

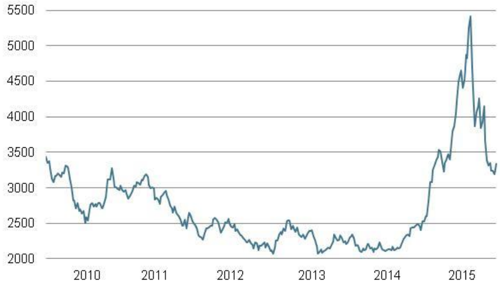
2. The anti-corruption campaign instigated by the new leadership in China in 2013

Fighting corruption is both necessary and desirable. But no one expected it to have such a large impact on the economy in the short term. The anti-corruption campaign has left many officials too scared to spend. Ostentatious spending has become dangerous particularly if you are a government official. This has had a big impact on sales of luxury goods in particular, and has occurred at the same time that China was hoping that consumption would expand to fill the hole left by construction spending.

3. Share market policies

The government actively encouraged a share market bubble by easing rules on opening accounts and margin lending. China thought it was a good idea to have a strong equity market because this would allow heavily indebted companies to raise equity and ease balance sheet pressure. They overachieved on these objectives and now have to cope with a falling market as illustrated in Chart 4.

Chart 4: Chinese A Shares Index Value



Source: Datastream

As a result of these actions, investors have lost some confidence in Chinese policy makers. This has contributed to the declines in share and commodity markets in recent months and to increasing concerns about the future of several emerging economies, particularly Brazil.

The better news is that Beijing is already responding aggressively to address growth concerns, and that markets are likely to at least partially recover when the impact on the economy becomes apparent.

BT Investment Solutions has used the recent weakness in share markets related to this as an opportunity to increase exposure to growth assets like international shares in the asset allocations used in our portfolios.

For more information about how China impacts on your investments, please contact BT Investment Solutions.