



China Matters.

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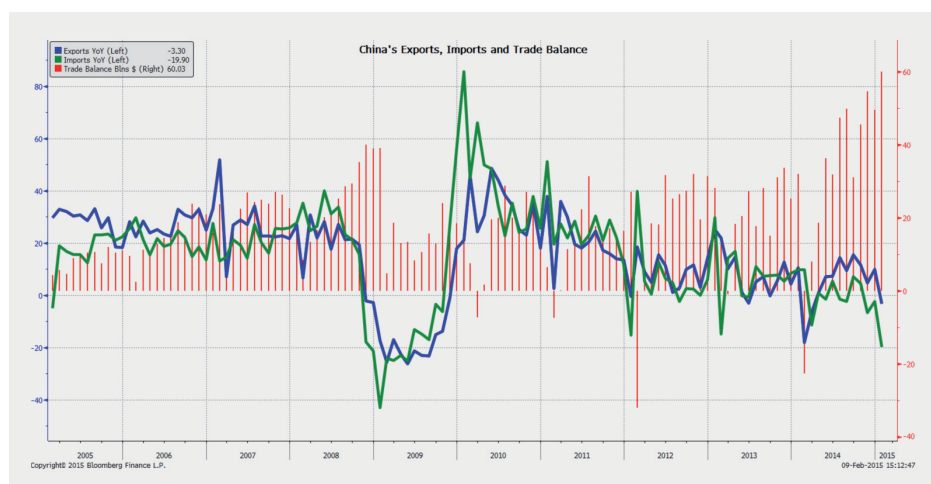
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16.02.2015

It matters a lot. It's probably the biggest single economy in the world, though the Chinese leadership is trying to suggest otherwise. Just how fast it is growing, importing, exporting, indeed changing, is a key issue for investors, corporates, consumers and governments.

Most observes would agree that the growth trajectory in China is slowing. The 2014 outcome of 7.4% was the slowest since 1990 and that was when the country was still facing sanctions following Tiananmen Square in 1989. By way of contrast, the 2014 outcome should be seen in the context of the period 1980 -2012, when the Chinese economy averaged a growth rate of 10% per annum.

Indeed some even doubt the 2014 number, believing a number between 5 and 6% is more plausible and that official figures overstate the situation on the ground. This lower number would be more consistent with what we are seeing in global commodity markets, money supply numbers and Chinese electricity consumption figures. The near 20% drop we saw in Chinese imports in January also raises concerns.



Sharp fall in Chinese Imports

(Source: Bloomberg)

More important than the actual number is the trend; and that clearly seems to be lower. The IMF forecasts that official Chinese growth will fall to 6.8% this year and closer to 6% in 2016. The World Bank is slightly more optimistic but still sees economic growth at 7% in 2016 and falling to 6.9% for 2017. Private sector forecasts are even more downbeat. Goldman Sachs are looking for growth to fall from 7% this year to 6.2% for 2018.

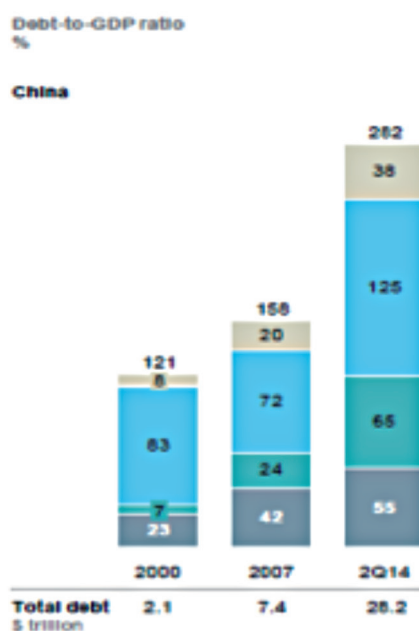
Looking under the bonnet of these GDP numbers, to the extent that we can, reveals further concerns, concerns that will be somewhat familiar in an Irish context. When support industries are taken into account, construction accounts for about a quarter of China's GDP. This is a higher proportion than here in Ireland or Spain at the height of the property bubble. In the past decade property prices in the major cities quadrupled. Prime residential space in Shanghai is now only 10% behind prices being paid in New York and Paris. This property boom ended in 2014 with a decline of 4.3% year on year posted in December. The situation on the ground is one of massive overcapacity with swathes of empty apartment blocks and with unsold floor space up by 26% in the year. Current estimates for the amount of unsold residential property are quite staggering ranging from 12 months' worth in major cities such as Beijing and Shanghai to close to 50 months in Tier 3 and Tier 4 cities.

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Investment in property never slackened even as the amount of floor area being sold cratered. Much of the investment has been funded at the local government level where debt financing was incurred in spite of what the centre was "advising". By the middle of 2013, local government debt had risen by 80% in just two years. And it has continued – local governments issued bonds in 2014 that were twice what they had gathered in 2013. The picture gets more complex when we note that local governments rely on sales of land for 35% of their revenues.

Debt overall is increasingly a feature of the China story. A recent McKinsey report highlighted how between 2007 and 2014, China's debt quadrupled to \$28 trillion or 282% of GDP. For the period before that, from 2000 to 2007,

the economy was much less propelled by borrowing and total debt only grew in line with GDP. China's debt build up since then is one of the largest in recent history according to Goldman Sachs. McKinsey also highlighted the concentration in property and the "off-balance sheet" borrowing by local governments. According to their numbers, nearly half of China's debt is related to the property market. China has more than 89,000 property developers who contribute close to 30% of overall investment in the economy.



(Source: McKinsey)

So, rapid growth in debt levels concentrated in the property sector with clear signs of overbuilding – sound familiar?

So what happens now? Historical evidence across a range of countries shows that rapid build-up in debt levels has often been followed by financial crises. In Ireland, we know how that plays out. At the very least, it has usually meant lower levels of growth as policy makers seek to rebalance the economy.

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China's policy makers are very aware of the role and impact that these elevated levels of debt may have on overall financial stability, and they are actively seeking ways to manage the situation. Steps have been taken to curb the growth of the "shadow banking" system which has often seen savings funnelled into property development. The centre is also looking to reform local government funding to make it less reliant on property sales and perhaps introduce and give local policy makers access to property tax revenues. Other reforms such as more comprehensive bankruptcy procedures could also improve the functioning of the market.

Even if loan defaults did reach crisis levels, according to the McKinsey research, Central Government has the capacity to rescue the financial system. Total government debt is currently about 55% of GDP with Central government

debt at just 27%, so Beijing has the borrowing capacity to bail out the financial system if default rates rose to 50%.

China's debt is mainly domestic so policy makers will want to avoid a sharp shock to the system so any action is likely to be at a measured pace. So while the Chinese economy and financial system are notably opaque, with huge levels of interconnectivity between state and "private" enterprises, it is plausible that China's policy makers could navigate a path away from high overall indebtedness. Any path will certainly involve a rebalancing away from investment towards consumption, and that transition can often be challenging to overall GDP growth.

To sum, high debt levels in China can be managed lower and a major financial melt-down is not predestined but it will likely be another headwind for a Chinese economy already on a lower trajectory, facing into a lacklustre global growth picture.



To discuss any of this further please contact:

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