ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 12TH FEBRUARY 2021

BOQ GROUP

Summary

- The Chinese economy has had a remarkable run over the past 25 years;
- And most likely that positive run will continue for a few more years;
- But the Chinese Government faces some significant economic challenges;
- How it handles those challenges will have a significant impact on the global economic and political environment over the next couple of decades.

The Chinese economy was amongst the top performers in 2020. And the forecast is that 2021 will be a strong year. China still has the same cyclical economic problems as the rest of the world (but not as large). The jobs market is weaker than prior to COVID. And service sectors are struggling.

Most analysts expect strong Chinese economic growth over the next few years, albeit down on the eye-popping numbers seen for much of the past couple of decades. But China faces a number of significant economic challenges. Debt is too high, there is a need to evolve to a more environmentally-friendly economy and it has an aging population.

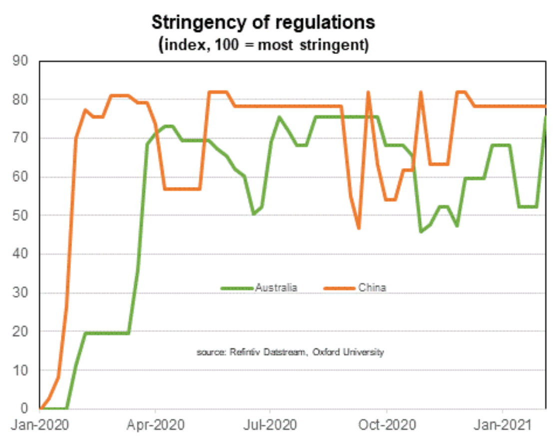
These problems are the same ones faced by OECD countries (including Australia). Except the problems faced by China are more extreme. Debt is a lot higher relative to income for its current stage of economy growth. China has an environmental problem. And thanks to its one-child policy, it has one of the most significant aging problems in the world. How China deals with those challenges will have a significant impact on the global economic and political environment over the next two decades.

Current state of the Chinese economy

The Chinese economy was amongst the top performers in 2020. And the forecast is that 2021 will be a strong year. The IMF expects Chinese GDP to increase by a touch over 8% in 2021 (after being one of the few major economies to actually grow last year). The manufacturing and construction sectors grew strongly. Export growth held up, helped by robust demand for COVID personal protective equipment that China dominates in producing.

Another piece of good news for China is that it did not need to fire every last policy bullet to support economic growth. Interest rates are low, but are comfortably above zero. The central bank did not buy a mountain of government bonds. There has been substantial fiscal support. But government debt has not had to reach the nose-bleed territory of most other developed countries (Australia and New Zealand are two exceptions). China still has the same cyclical economic problems as the rest of the world (but not as large). The jobs market is weaker than prior to COVID. And service sectors are struggling.

The Chinese Government has been tough in combatting COVID.



The jobs market has not recovered back to its pre-COVID days.

Chinese consumers have been worried about the economy.

Services spending is still recovering.

Most analysts expect strong Chinese economic growth over the next few years, albeit down on the eye-popping numbers seen for much of the past couple of decades. But China faces a number of significant economic challenges. Debt is too high, there is a need to evolve to a more environmentally-friendly economy and it has an aging population.

These problems are the same ones faced by OECD countries (including Australia). Except the problems faced by China are more extreme. Debt is a lot higher relative to income for its current stage of economy growth. China has an acknowledged environmental problem. And thanks to its one-child policy, it has one of the most significant aging problems in the world.

Issue 1: Reducing Debt

Problem:

Debt has risen across most countries over the past decade. That has reflected the decline of interest rates, although the necessity of large government support for economies post the GFC slowdown played a big role. But China has been a standout. Relative to its level of income Chinese debt is very high by global standards. Most of the debt is owed by corporates (particularly Government-owned firms). The most significant rise in debt over the past five years has been by the Government and households.

Comment:

China's growing debt burden has been a feature of virtually every macroeconomic discussion for some time. This includes by the Chinese Government. Concern about excess debt was an important reason why the Chinese central bank has not provided the same degree of monetary support as other countries have in this crisis.

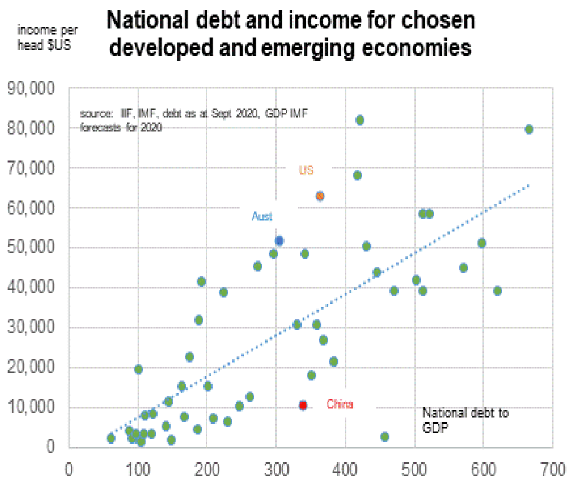
The level of debt so far has not created a significant economic problem. China has been successful in maintaining a relatively stable level of economic growth. It has been able to do this without significantly changing the level of interest rates. Decent income growth and relatively steady interest rates has made it easier for most borrowers to meet their debt repayments.

China has the advantage that nearly all creditors are local. The level of Chinese investment is high but is more than matched by the domestic saving rate. This makes it easy for the government/regulators to get both creditors and borrowers around the table to reach an agreement. A highly regulated financial system provides regulators with a lot of fire power to enforce outcomes.

While the current financial system structure has its short-term advantages it also has longer-term disadvantages. A highly regulated financial system is not very efficient. The perception that the Government can make problems go away creates incentives for lax lending. The Government has recognized this and is making changes. The financial system is being (cautiously) de-regulated. Companies are being allowed to default on the debts as regulators send the message that poor lending decisions has consequences.

The big picture though is that China will need a continued run of decent (and stable) economic growth to ensure that the debt burden does not become a major economic problem. And it will need to change the structure of its economy to ensure that debt does not continue to increase.

China stands out as having a lot of debt for its level of income.



Much of the borrowing done in China is funded from domestic savers.

Issue 2: Changing economic model from investment to consumption

Problem:

The main reason for the large level of debt in China is the high rate of national investment. Partly the high rate of investment reflects natural progression. Twenty five years ago China turned its economy to be export-focussed and the world's cheap source of manufactured goods. This led to a big demand for workers in cities. In turn this created a big demand for residential construction and infrastructure. In more recent years the Chinese Government has turned to infrastructure to support activity in periods when it looked like the domestic economy would slow.

Chinese household spending has grown strongly. But it has lagged the strength of investment spending. The result is that household consumption as a proportion of the economy is smaller in China than in most OECD countries.

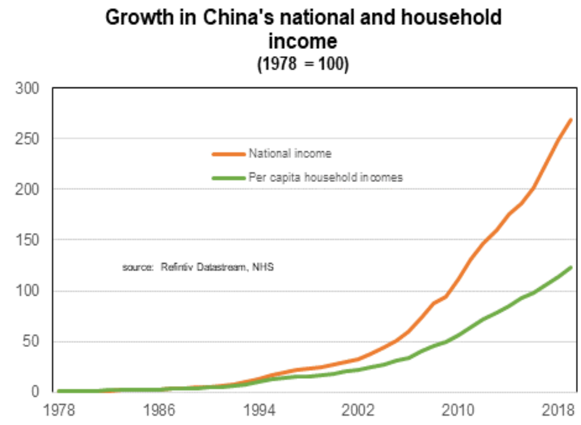
Comment:

The need to change the structure of the economy to become more reliant upon household spending is recognized by the Chinese Government. For consumption to pick up household income growth will need to rise faster, having lagged economic growth (profits have nabbed a bigger share of national income). Chinese households also need to become confident to spend more of their income. Currently their saving rate is very high given their need to self-finance education and health needs, as well as any period of unemployment. In recognition the Government has begun implementing a widespread 'social safety net' (the government funds more services).

In time it is likely that the consumer will become a bigger part of the Chinese economy. As households become wealthier they should become more comfortable to spend more of their income. Developing a strong 'safety net' will be important. So will having a more efficient financial system (making it easier for households to borrow).

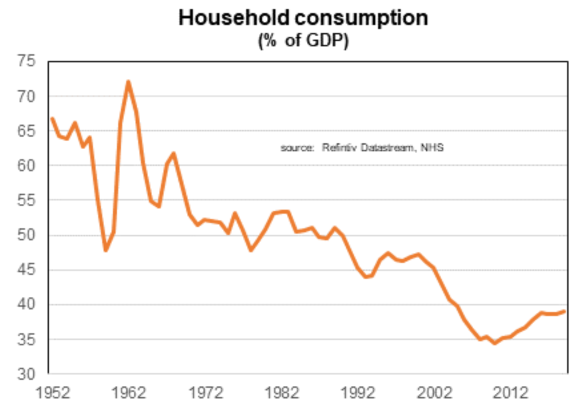
But becoming more reliant upon consumer spending has been a focus for years. Despite that the household saving ratio has gone up. The proportion of consumer spending in the economy has risen. But remains low by global standards. Becoming a 'spending culture' takes time. And that is proving difficult for China given that it has a rapidly aging population that needs to save for retirement.

The growth of household incomes has lagged the growth of national income.

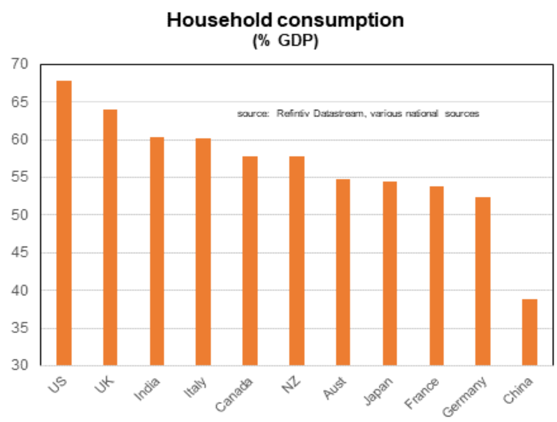


And household saving rates are very high in China.

Household consumption within the economy has started to rise.



But it is well behind the contribution in most developed economies.



Issue 3: Income inequality

Problem:

By some measures China has one of the most unequal income distributions in the world. Partly that reflects the share of national income going to profits and the lack of a widespread social safety net. Workers at state-owned firms are doing better than those that in the private sector. Average incomes in most provinces are only around half the level of Beijing (and Shanghai). Unequal incomes also makes it more difficult for China to change its economic model towards domestic spending.

Comment:

The implementation of a widespread safety net will be important. Perhaps the biggest inequality is the large difference of incomes between rural and city residents. The Government has historically not made it easy to move around the country in search of jobs. This is starting to change. In time the reduction in the size of the labour force could result in higher wages for workers. As a higher proportion of workers become more skilled they should be rewarded with higher salaries.

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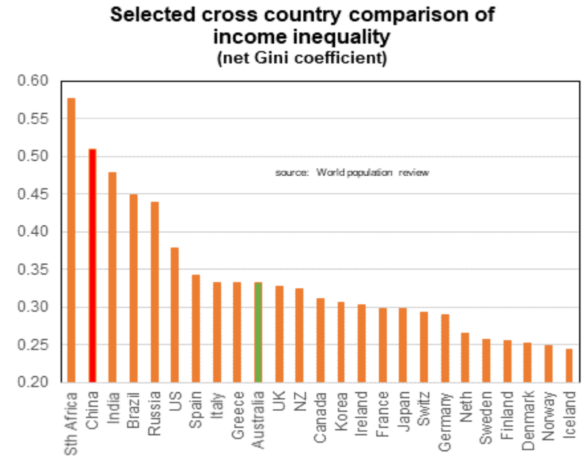
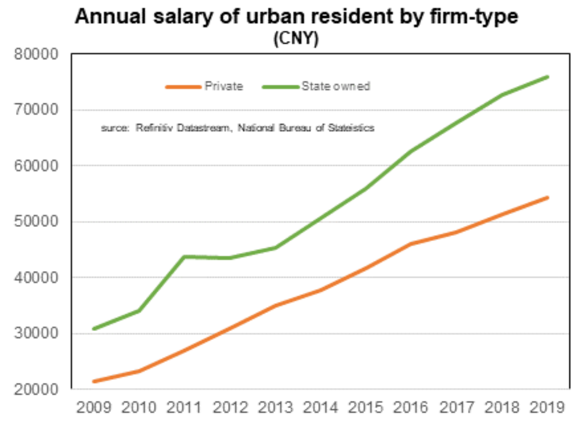
Income inequality is high in China.



Workers for Government owned firms have typically done better than those that work in the private sector.



Issue 4: Improve the environment

Problem:

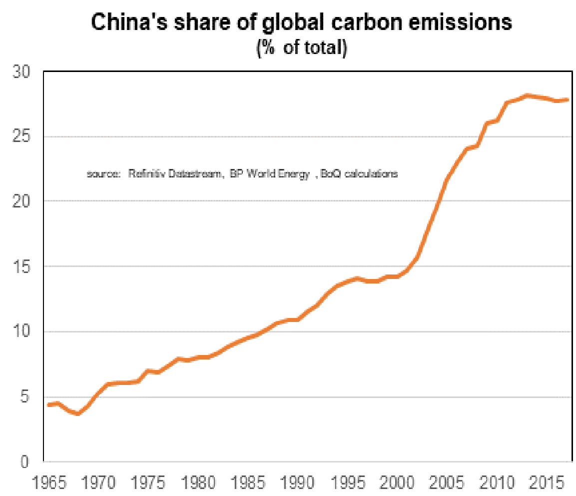
China is the world's biggest producer of carbon emissions. More generally its environmental standards are relatively low. Partly that is a function of being one of the world's largest economies. But it also reflects that the economic choice that has been made to focus on creating jobs and improving household incomes at the expense of higher pollution. But environmental awareness has risen significantly around the world. And Chinese standard of living has risen to a point where there is a greater demand for a cleaner environment.

Comment:

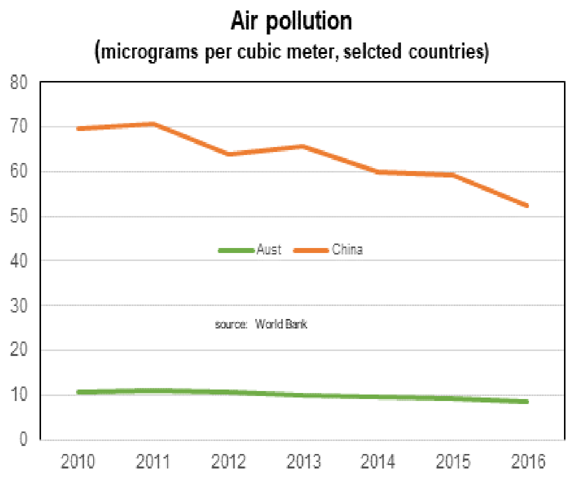
Reducing pollution is another one of the key strategic priorities for the Government. They have been shutting down a number of high-polluting (loss-making) firms, as well as increasing the proportion of energy sourced from renewable resources (although the number of new coal-generators has started to rise again).

The cyclical rebound will help the economy to become more environmentally friendly (a better economy can provide more jobs to those that lose employment on environmental grounds). Changing the structure of the economy towards services will help (service sectors are less polluting and uses less resources than agriculture, mining and manufacturing). A shift to renewable energy will also be a plus. China has become a global leader in batteries used for storage for renewable energy.

China is the world's largest producer of carbon emissions.



But is starting to be a greater focus on the environment.



Issue 5: Aging and declining population

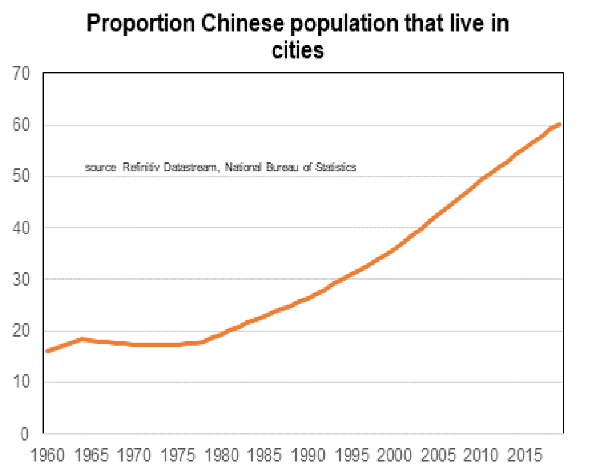
Problem:

The world population is aging. But it is aging particularly fast in China a result of the one child policy that was implemented for over thirty years. The size of the Chinese labour force peaked almost a decade ago. And the population is projected to start declining in the 2030s. Although the one child policy has been largely unwound it will be difficult to get the birth rate back up to the level that will stop the population declining.

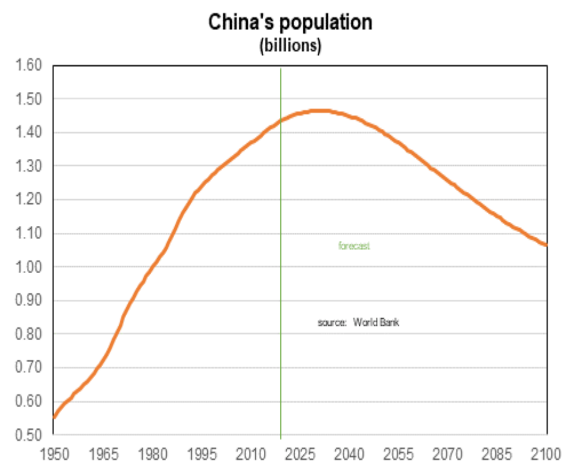
Comment:

Regardless of Government policies it is almost certain the population will decline substantially as this century progresses. But there are a number of things that can be done to mitigate the economic impact. One is to increase the productivity of the workforce by allowing more people to immigrate to the cities. Currently around 60% of the population live in cities in China. This is only a little more than the global average (about 55%). And well below the average for high-income countries (82%). Another is to increase worker skills through better education. Worker shortages can increasingly be met through the use of robots and artificial intelligence, areas that China is increasingly leading the world. More generally there is the capacity to boost economy-wide productivity. The IMF has estimated that the level of Chinese productivity level in most industries (notably wholesale and retail trade) is well below that of the US.

Chinese cities have been getting bigger.



But we are approaching peak population for China.



The Chinese economic growth miracle has been the standout feature of the global economy for the past twenty five years. Strong economic growth is likely over the next few years as the Chinese and global economies recover from COVID. But China faces some significant economic challenges. How it deals with those challenges will have a significant impact on the global economic and political environment over the next two decades.

We live in interesting times.

Regards,

Peter Munckton

Chief Economist
Bank of Queensland