How successful is China's economic rebalancing?

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Over the past decade, there has been much talk of global imbalances, and of the need to correct them in an orderly way. But perhaps these imbalances are already moving towards some correction. The biggest sources of the imbalances were the large external deficits of the United States economy, which have been reducing for several years now. But one counterpart of that deficit was large external surpluses in China, which were also associated with extremely rapid GDP growth.

China's blistering pace of economic growth over the past three decades has certainly transformed both China and the global economy, but there are now clear signs that the pace is slowing. Chart 1 shows that quarterly rates of GDP growth (relative to the same period the previous year) have reduced to around 7 per cent or even slightly less in the past year, compared to rates higher than 10 per cent in several quarters in the period after the Global Financial Crisis. Despite the reduction, these are still high rates of growth.

Chart 1

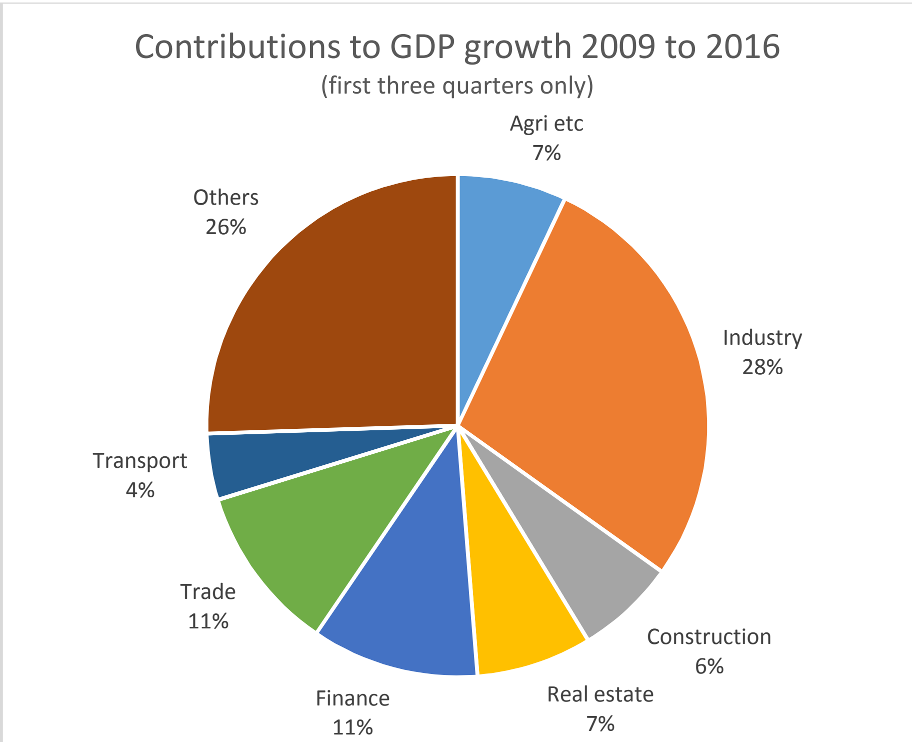
Source: Data for all charts calculated from China National Bureau of Statistics, data.stats.gov.cn

It is certainly the case that the kind of accelerated expansion of economic activity that China showed especially from the turn of this century would be hard if not impossible for any economy to sustain. In China's case, this growth was driven by extraordinarily high rates of investment, in the range of 45 per cent of GDP (and sometimes even more), which have also been historically unprecedented. Since savings rates were (amazingly) even higher, the associated current account surpluses allowed for the accumulation of huge foreign exchange reserves, at one point crossing $4 trillion in value.

China responded to the Great Recession from 2008 onwards with a stimulus package that put even more emphasis on investment, and relied on ever-rising levels of debt in all major sections of the economy. Previous editions of MacroScan have highlighted this issue, and the concern that ever more debt is now required to generate smaller increases in income. There have also been concerns about whether this current focus on investment – especially in housing and other construction – would be successful in moving the economy towards a more consumption-led (and more sustainable) economic trajectory in future.

This is obviously an ongoing process, but an examination of the composition of the growth in economic activity since 2009 suggest that in fact it has been quite diversified. As Chart 2 suggests, industry (including manufacturing as well as infrastructure and utilities) has accounted for a healthy 28 per cent of the growth. And FIRE (finance, insurance and real estate) has accounted for only 18 per cent of the expansion.

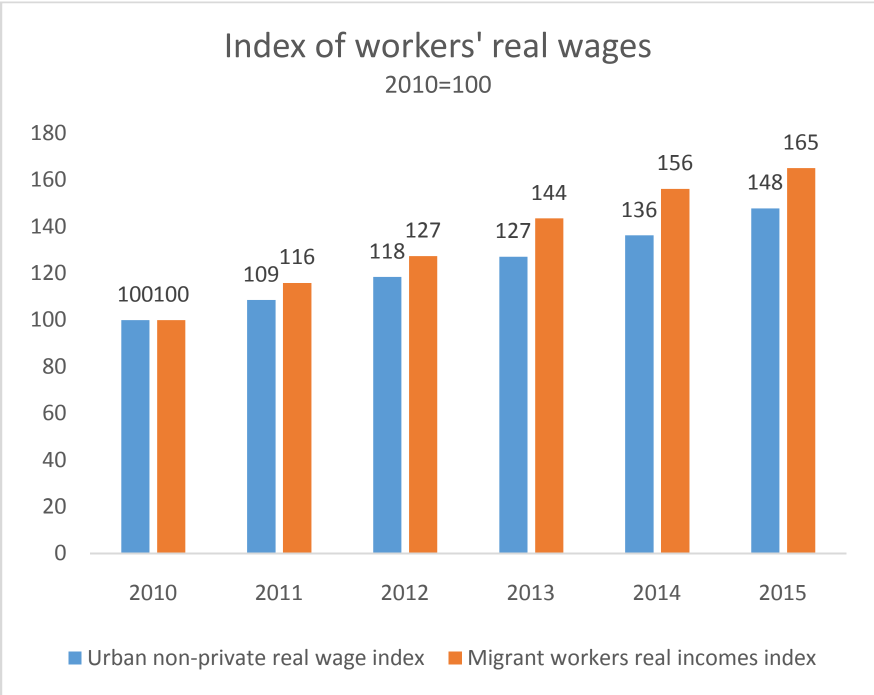
Chart 2



What is more, this period has been marked by continuous increases in wages. Chart 3 indicates that workers' real wages have risen quite sharply, reinforcing the argument that many have made about China reaching the Lewisian turning point after which the presence of large amounts of surplus labour no longer prevents real wages from rising with aggregate economic expansion. Of course, wage increases also reflect political economy considerations and the relative power of workers vis-à-vis employers, which is also critically affected by government policies. (The Chinese experience is very different from the Indian case; in India, real wages haveactually fallen recently even as GDP growth is estimated to be well over 7 per cent.)

Chart 3 admittedly shows the real wage index only for urban employees with the state or state-owned or collective enterprises and other non-private employment, so it may not reflect the conditions of the labour market for other workers in private units or those who are self-employed. But the index of real earnings of migrant workers (currently estimated to number around 176 million, largely from rural to urban areas) also shows very buoyant growth over this period.

Chart 3

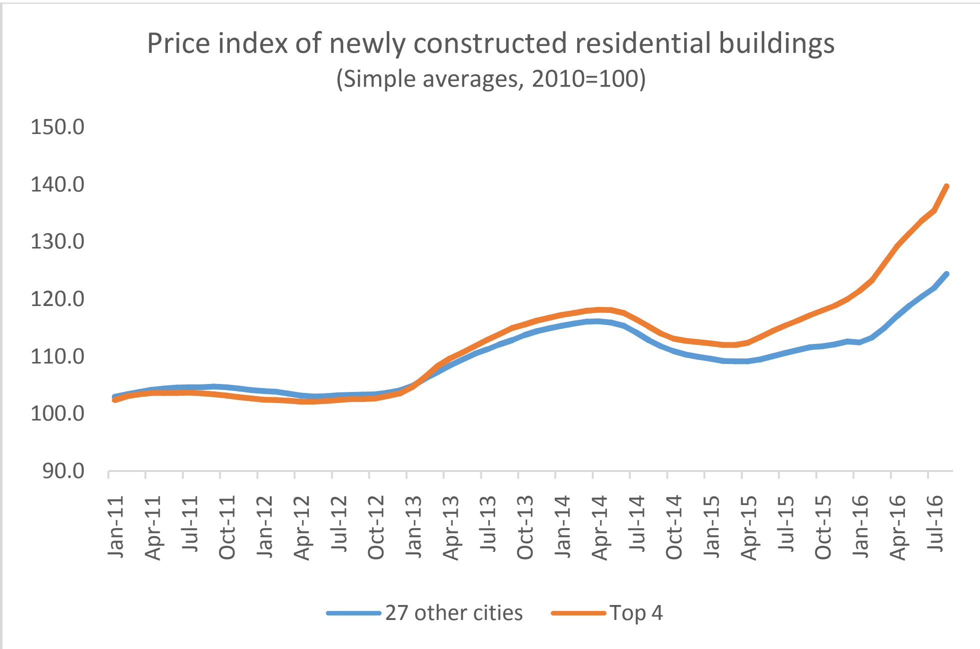


From this perspective, it appears that the deceleration of growth may be part of the desirable rebalancing of the economy towards one based on employment and wage growth, thereby generating consumption-led rather than investment-led growth over time, and reducing the extremely heavy dependence on the external economy that had marked the previous expansion. But some caveats are necessary. First, much of the recent expansion has been driven by rapid accumulation of debts that may well become unsustainable and certainly will require careful management in the immediate future. Second, since many of these debts were taken on for the purchase of housing and real estate, what happens in these markets is going to be very significant. Third, while the importance of exports is diminishing, theystill remain significant, and the continuing slowdown in the global economy and in world trade will definitely have adverse effects on export-oriented enterprises and the large number of workers they employ. Fourth, all this ignores another serious threat to the Chinese growth process: the rowing environmental pressures, particularly resulting from pollution and degradation of natural resources, that are now affecting both production and the quality of life.

The behaviour of real estate and the housing market deserves further elaboration. The urban housing market in China is experiencing a bubble that is driving property prices to unbelievable levels in some of the major cities. But the divergence in recent trends in house prices suggests that this bubble may soon burst. Over the past year, there has been a dramatic rise in prices of residential property in many cities, and especially in some of the large metros. This comes after a period just before, when everyone was talking about the "softening" of the Chinese real estate market as the authorities sought to clamp down on what they believed was speculative activity that was leading to excessively high prices and making housing unaffordable for many ordinary Chinese. But since then – and especially from early 2015, as Chart 4 shows – prices seem to have gone completely berserk, increasing at unprecedented rates.

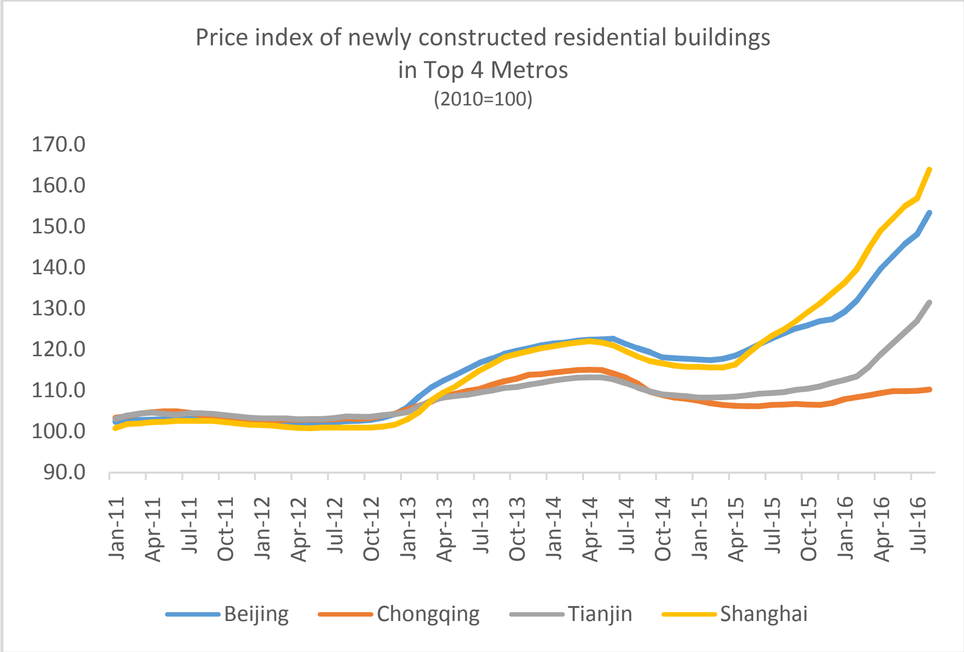
The biggest increases were in the Top 4 metros (Beijing, Shanghai, Tianjin and Chongqing) but many other cities have also showed very rapid increases. Chart 1 shows the simple averages of the price index for the Top 4 and 27 other cities: this indicates that from April 2015 to August 2016 (16 months) average prices in the Top 4 metros increased by 24 per cent and those in 27 other cities increased by 14 per cent.

Chart 4



This certainly suggests something approaching a bubble, especially as house prices were already seen by many as being far too high even before the recent surge. The house price to average income ratio was 9.2 at the end of 2015; and since then prices have increased even more dramatically than before. However, not all cities show the same trend, and even among the Top 4 metros there have been significant differences. The most dramatic increase in prices has occurred in Shanghai, as Chart 5 indicates, with new house prices there going up by more than 40 per cent in the 16 months to August 2016. Beijing follows with a 30 per cent increase, but the increase in Tianjin has been more moderate at 21 per cent. Most remarkably, prices in Chongqing have barely increased at all over this period, despite the apparent frenzy in residential real estate markets in general.

Chart 5



Clearly, it is not only macroeconomic policies such as interest rates, banking and financial regulations and so on, that are at play here. Such sharp regional variations suggest that there are specific factors affecting particular cities more than others, and that authorities in some municipalities have been better able to control residential prices even through this more generalised bubble. Indeed, in recent weeks, some other local governments in other cities have moved to institute regulations to curb house prices. The municipality of Hangzhou this week brought in rules that require purchasers of high-priced land at auctions to pay the entire amount within a month, so as to reduce speculative activity by developers and others. Nanjing in Jiangsu Province became the fourth city to limit those without residence permits to a single ownership and disallow more than two properties even for those with resident status.

Interestingly for a country ruled by a Communist Party, the home ownership ratio in China is now one of the highest in the world, at nearly 90 per cent compared to around 64 per cent in the US and the UK, for example. This is largely because the Communist Party allowed residents to buy their homes at prices that were steeply discounted relative to market value. Thereafter, there has emerged a flourishing market particularly for urban real estate and particularly for residential housing. Most of this relates to apartments rather than standalone homes (or "villas" as they are referred to in China), and the market is still generally driven by those who wish to reside in their own homes, mostly in newly constructed apartment buildings.

The pace of urbanisation has assisted in the continued demand for residential housing. While the sheer pace of price increase may appear to suggest a strong speculative element, it is not necessarily driven only by financial players and "land kings" who are real estate dealers interested in capital gains, but by individual buyers and potential occupiers. It has been estimated, based on data collected by sales managers across the country, that in the past three years less than ten per cent of buyers were investors. However, this does not rule out the speculative element, since individual buyers also see residential property as a secure investment (especially because of the various fiascos in the stock market since mid-2015). There are many instances of individuals and families holding multiple properties. But the craze for new housing is doubtless being fed by speculators and real estate agents, such as those in Shanghai who brought on a spate of divorces by suggesting that new rules would exempt unmarried couples from higher down payment requirements.

Obviously, this bubble cannot continue to expand at the current rate for much longer, and house prices in many cities and towns must stabilise or come down eventually. The problem, as in most housing booms, is that house purchases are leveraged (albeit to a lesser extent in China than in other countries because of higher down payment requirements). The extent of debt flowing into housing has increased sharply in the current year. According to Bloomberg, outstanding housing mortgages in China increased by 31 per cent just in the first half of 2016, three times more than the increase in overall lending. Loans to households increased to account for as much as 71 per cent of total new lending in August 2016, compared to 24 per cent in January. And this excludes the shadow banking activities that are also dominantly geared to real estate and construction lending.

This means that there is bound to be a knock-on effect on banks and other lenders, once the bubble bursts and house prices start coming down. The Chinese authorities are trying to walk the tightrope to bring stability and greater affordability into the housing market without simultaneously destabilising finance, but this is a difficult task. Indeed, the problem may be urgent, because in fact in many cities the downslide in house prices has already started – and indeed it is evident that in recent months the trend has got aggravated.

Charts 6 and 7 indicate the number of cities (including the top 4 metros, first tier cities and second tier cities) that showed rising, stagnant or falling prices (relative to the same month of the previous year) for new residential property and for the secondary market. They indicate that both for newly built homes and existing houses in the secondary market, there was a phase of several months when almost all the 70 cities in the dataset showed increasing year-on-year prices. But from September 2015 the number of cities showing falling prices has started increasing, to the point that in August 2016, as many as 62 cities experienced falling house prices and only 6 still had increasing prices (including Shanghai, Beijing and Tianjin) while 2 showed no change. The decrease is less widespread in the secondary housing market, but even here as many as 53 out of 70 cities showed declines.

Chart 6

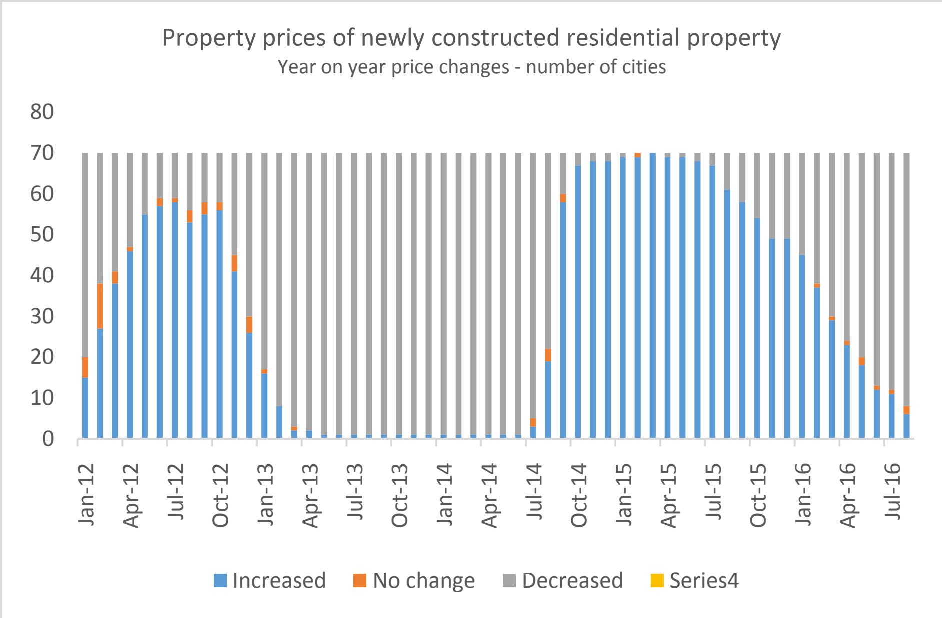
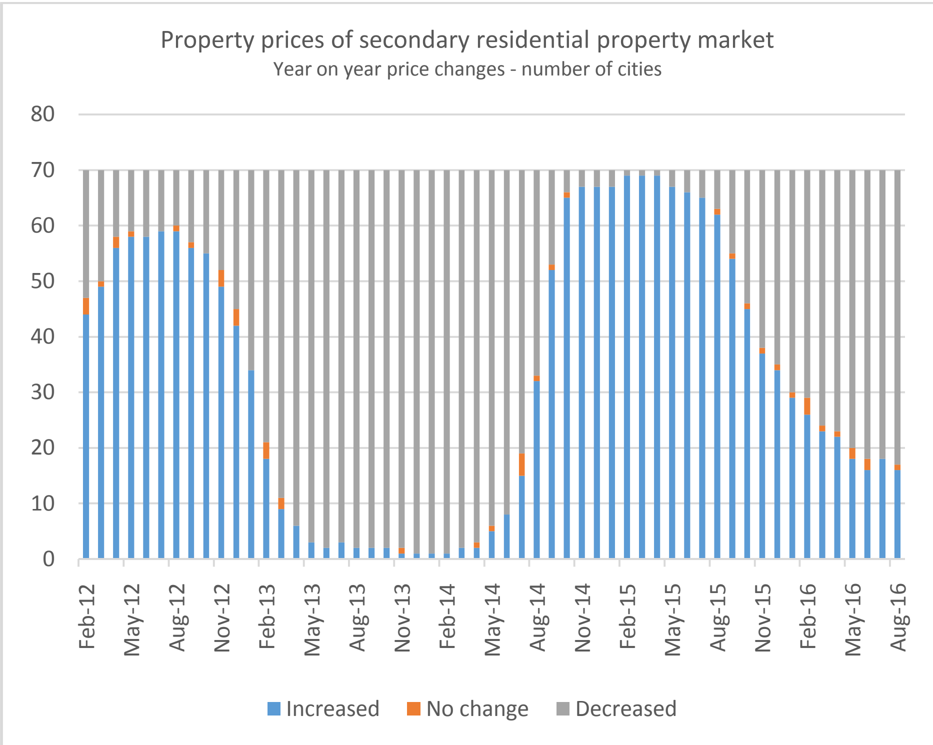
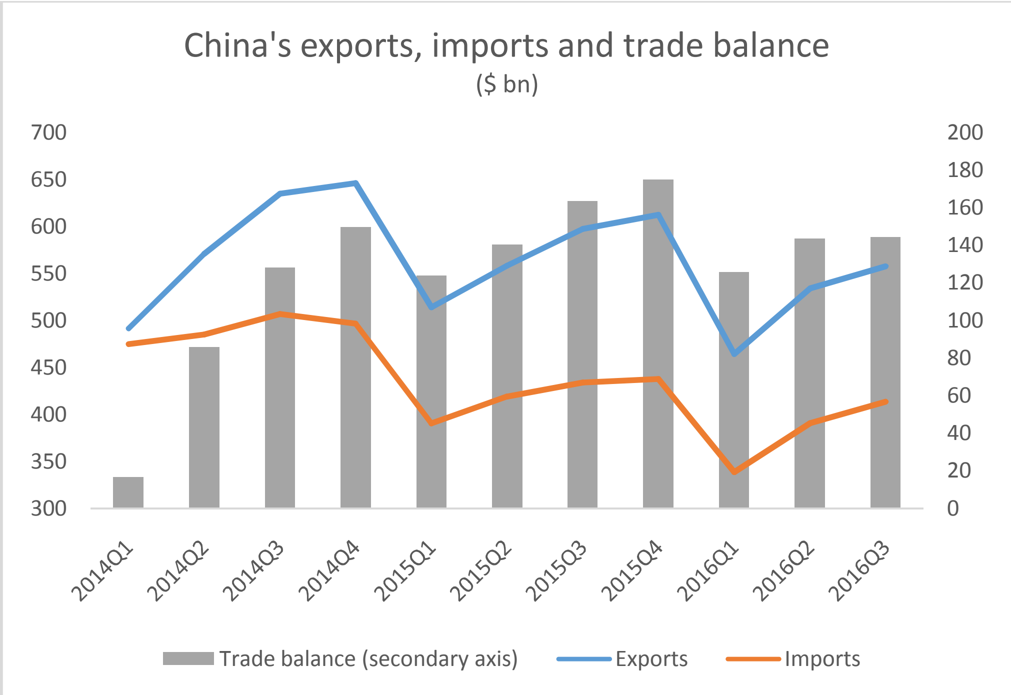


Chart 7



There is a further issue with respect to the Chinese economy that is of great relevance for the rest of the world. While some significant changes are certainly under way in China, thus far they do not point to a rebalancing, at least in terms of the external account. Indeed, the trade surpluses generated by China show no signs of diminution, and have even increased in the recent past. Chart 4 shows quarterly trade indictors from the first quarter of 2014, and it is evident that while exports over all have not grown and have declined over the past year, imports have declined even faster. For the period from January to September this year, exports fell by 7.5 per cent but imports fell even more by 8.2 per cent. Over a two year period, the picture is even worse. Since their peaks in the last quarter of 2014, exports have fallen by 15.8 per cent in the most recent quarter, but imports have declined by as much as 22.6 per cent. So, far from reducing, the trade surpluses have been rising again – but this time because of import compression rather than export expansion.

Chart 8



This is obviously very bad news for China's trading partners, and particularly for those in developing Asia for whom China had emerged as the dominant source of imports and well as the main destination for exports. China is no longer a source of positive stimulus either for the global economy or for the Asian region, at least in trade terms. And that is going to have severe consequences that are still not factored in by most analysts.