

China Outlook 2015

The Chinese government has focused on a number of things some of which include:

- An anti corruption initiative.
- Rebalancing the economy towards domestic consumption.
- Maintaining financial stability and a certain level of economic growth.

The anti corruption initiative is a long term structural reform to strengthen the rule of law in China. The government appears to be serious about the rule of law despite doubts from many observers who see the law as a means of control. The Fourth Plenum saw an elevation of the Constitution which may signal that China is, albeit gradually, shifting to a rule by institution than by person. The anti corruption initiative is, however, a brake on growth, as many investment decisions and projects have corrupt elements in them and these projects may either fall away or need to be reorganized in a more acceptable form. Expect delays.

The rebalancing of the economy is an important factor in assessing China's prospects. Most countries must by now recognize that globalization has been slowed if not reversed post 2008 as countries struggle to grow. In the aftermath of the crisis, the calculus recognized the constraints on fiscal policy, consumption and investment and naturally defaulted to exports to fuel growth. This placed the world in a state of a cold trade and currency war. In such an environment, currencies would range trade. Logical tolerable bounds would be 2007 levels for JPY and 2008 levels for the European currencies. These countries must also realize that the cold trade war is nearly over and that long term solutions need to be found besides beggaring thy neighbor. Cold wars are sometimes a balance of tacit collusions and conflicts. The end of such conditions will likely drive countries to pursue greater self sufficiency. A base of domestic demand and consumption is an important resource in the face of slowing or reduced globalization.

For many reasons, China's growth is slowing. One reason is that unless one is the generator and owner of intellectual property, one's economy is hostage to being a low cost producer. When costs rise, business moves elsewhere. China has long had a technological disadvantage compared with the West. It clearly recognizes this. The number of patents filed by Chinese firms has accelerated recently relative to the rest of the world.

It is hoped that this push to improve its competitiveness in intellectual property will result in higher productivity and a higher long term growth rate. In the meantime, however, growth has slowed from the double digit pace in the early 2000s to 7.3% at latest count. Some observers are quoting a rate of just sub 6% actual growth this year, slowing in 2015 and the coming years. If the economy indeed slows along this path, policy must be expected to adjust to a more accommodative state.

It can be argued that the PBOC misread the impact of the US Fed led global QE and easing policy on price levels in China. Certainly inflation rose steadily from 2009 to 2011 during which food price inflation ran into double digits. Concerned about

inflation through tradable goods markets, the PBOC has been too tight. The low inflation in Europe, the US and Japan, the falling domestic inflation and the end of US QE has prompted the PBOC to switch to a more accommodative state. This will likely steady tradable goods while creating inflation in services and semi-closed asset markets.

If growth should slow more than planned it is likely that **China** will resume growing the economy through investment in infrastructure. This could provide some respite to commodity metals and energy markets regionally as well as globally. (Miners have been acutely weak of late and could represent a buying opportunity if **China** growth slows much more.) Another area of potential interest would be European and US industrial equipment companies.

Generally, the outlook for **China** is positive. Equities are relative cheap and growth is robust. The one impediment to the Chinese stock markets has been an overly tight PBOC. With a neutral to accommodative stance, the latent investment themes can be animated.

Longer term risks:

There are of course risks associated with investing in **China**. The anti corruption drive will deal, if tangentially, with corporate governance. There is a risk that the campaign might be a cynical and politically motivated power consolidation exercise. Only time will tell but the focus on constitutionalism is an optimistic signal.

The growth of leverage in the corporate and local government sectors, enabled by the bond and nascent securitization markets has been an area of concern. However, most of the debt is local currency denominated and therefore within the control of the government. Central government and household balance sheets are not overly leveraged. This will allow the government to bailout any credit issues that threaten to become systemic. A strong current account is not entirely relevant to the potential imbalances in Chinese credit markets but is a help in case of contagion into the hard currency credit markets.

Perhaps one of the most intractable risks to **China** is its irrevocable

progress and the concomitant social change. The Umbrella Movement in HK, the troubles in Western China and Tibet, threaten the status quo. Government has to address the needs and wants of a new generation facing rising wealth and at the same time greater inequality. Greater freedom of information complicates this task. China's vagueness about whether it is a secular (prescribed by the constitution) or atheist (preferred by the party) state remains unresolved, a dangerous condition given the correlation between ethnicity and religion in a country with significant diversity.

Geopolitically, the world has become a harsher place. The years leading up to 2008 saw relatively little turbulence between the major powers as credit fuelled prosperity tempered old rivalries. The world was, is and ever shall be a contentious place, however, pre 2008, the conflicts were localized and fragmented. The deceleration of globalization, the cold trade war, the competitive devaluations and monetary debasement make the post 2008 environment more fractious and fraught. The relationship between China, the US and Russia will have important strategic implications. One country is governed by institutions and offices, another by a party apparently shifting towards governance by institutions and offices, and the third by a man. The scope for policy miscalculations and mistakes are high.