China still seeks growth while navigating new challenges

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China's markets were under tremendous pressure during the past year from fears of a slowing economy and the impact of a trade war with the U.S. The benchmark Shanghai SSE Composite Index fell by roughly 25% in 2018 and China's bond markets and currency, the renminbi, also fell.

Ivy Global Economist Derek Hamilton traveled extensively through China to better understand the current situation, the views of policymakers and business leaders, as well as the potential policy response from China's government. He found that concerns about the economy had increased. While policymakers expressed a more constructive tone and focused on protecting the downside, companies were concerned about falling demand.

Hamilton provides his analysis of the challenges China faces now and the potential responses from its leaders.

LIMITING DEBT INCREASE WEAKENED ECONOMY

During the Global Financial Crisis, China decided to boost economic growth with a large increase in government debt. The increase in debt spread to the private sector, and corporate and household debt rose during the last decade. In 2017, policymakers in China decided to slow the increase in debt because of concern that total debt would reach an unsustainable level, especially when considering a rising debt burden in the face of a rapidly aging population. The screws were tightened throughout 2018, especially for shadow bank lending and local government borrowing. But this resulted in a dramatic slowdown in economic activity, especially in investment and consumer spending, during the first three quarters of the year.

In addition, the viability of the private sector was called into question, with some in China's Communist Party wondering if the private sector would become too large at the expense of state-owned enterprises. Policymakers began to talk about less need for tightening in the middle of 2018 but didn't really become concerned about the pace of the economic slowdown until the fourth quarter.

President Xi Jinping has come under mounting pressure to act. Citizens in China have shown they are willing to accept less personal freedom in exchange for improvements in their personal well-being. If the economy slows and unemployment rises rapidly, the people of China only have one party to blame.

Thus, the legitimacy of the Communist Party rests on a contented population. I believe the government is likely to become increasingly accommodative in a variety of areas in order to stabilize growth in gross domestic product and prevent a large increase in unemployment:

TAX CUTS

The central government cut personal income taxes in 2018. The next round of tax cuts is likely to focus on corporate taxes and value-added taxes.

INFRASTRUCTURE

I think infrastructure spending is likely to reaccelerate. Projects that were put on hold are being released. In addition, the central government is allowing local governments to issue debt at an accelerating pace to fund infrastructure projects. I believe these initiatives are likely to focus on environmental protection, water conservation, subway/railway expansion and rural development.

China likely to pursue railway expansion

PROPERTY

During the last several years, China has tried to limit home price appreciation by dramatically increasing the cost of buying a home, upgrading a primary residence or buying a second home by imposing higher down payments and other onerous restrictions. Home sales began to weaken rapidly in late 2018. Weaker home sales can lead to less property development, and land sales for such development are a key source of revenue for local governments.

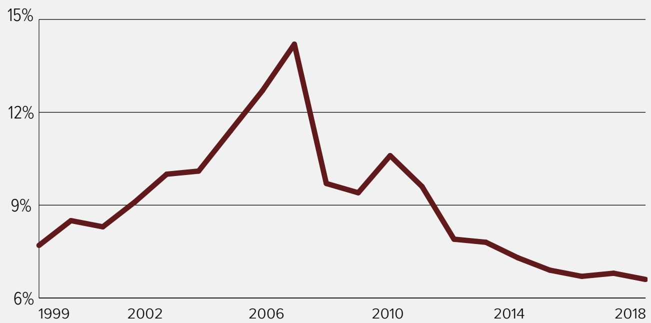
While taking steps to limit home price appreciation, China also supported demand for housing through a plan called shantytown redevelopment. Originally intended to demolish old units and rebuild new ones in their place, the plan was changed several years ago to deal with an oversupply of housing by introducing cash payments from the central government in order for families to buy new units. The government in recent months has been reverting to a process of giving units to families, rather than cash for individual purchases.

China seeks to manage urban migration; *sign in Shanghai with a farmer greeting a city resident and the word "Equality"*

Given the importance of housing to the overall economy and to local-government revenues, I think local governments are likely to begin reducing down payments and removing some purchase restrictions. I have seen signs of this on a small scale since returning from China. If property markets weaken further, then the central government could mandate changes in these areas, which would be a more powerful and effective signal. In addition, I think the shantytown development program is likely to continue for the foreseeable future.

Chinese cities are typically classified in a tiered system based on population. It is worth noting that Tier 1 cities, which include five of the largest cities, continue to have an undersupply of housing. Inventories remain quite low in Beijing and Shanghai. There is a need in these cities for local governments to release more land for development. Policymakers continue to want migration from rural to urban areas, but they want those migrants to move to smaller cities. By contrast, many migrants want to move to Tier 1 cities. Given that urbanization will continue to be an important driver of economic growth, local governments are pushing urban residents to accept rural migrants into their communities.

ECONOMIC GROWTH HAS SLOWED FROM PEAK YEARS



Source: China National Bureau of Statistics/Haver Analytics; percent change year over year in growth in gross domestic product

HEADWIND FROM U.S.-CHINA TRADE WAR

The trade war between the U.S. and China has been a headwind for markets in both countries. Companies doing business in China, both domestic and foreign, are increasingly worried about the long-term implications of the trade war. Many are looking for opportunities to move production to other countries. This is putting further pressure on China's policymakers to stimulate the domestic economy.

Several months ago, China thought it had struck a deal with the U.S. during negotiations with Treasury Secretary Steve Mnuchin, only to have the deal overturned by President Donald Trump. While this made China nervous about future negotiations, it appears that China is now willing to meet many of the U.S. trade demands.

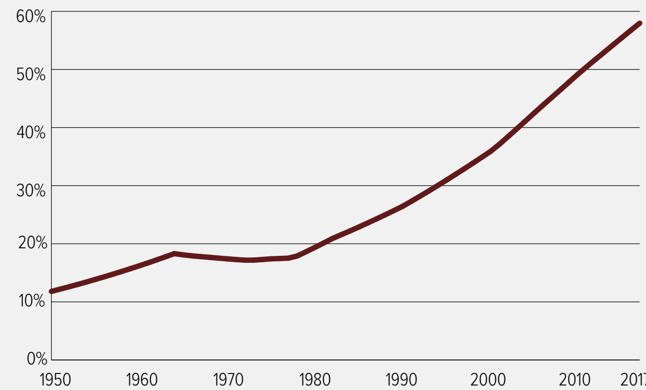
For example, Chinese officials realize that something needs to be done about intellectual property (IP) violations – a key issue for the U.S. in the trade dispute – and recently released new rules to protect IP. However, it remains to be seen how well these rules will be enforced. It is in China's interest to act soon, as domestic companies continue to innovate and are increasingly developing their own IP. Those companies will want to protect that IP, just as U.S. companies are seeking protections.

Increasing income shapes consumer preferences; *Shanghai is home to the world's largest Starbucks Reserve Roastery*

CONSUMER CULTURE CONTINUES TO EXPAND

Urbanization continues to increase in China. As more people migrate from rural to urban areas, income and productivity also increase. Per-capita income for urban residents in China continues to rise at a rapid clip, with the latest data showing an increase of nearly 8% in 2018. Rising disposable income brings a change in buying preferences, with more consumers choosing to spend on services or higher-quality goods versus basic necessities. Despite the slower economy, this trend was apparent when I was in China.

URBAN POPULATION TAKES GROWING SHARE



Source: World Bank/Haver Analytics; urban population in China as percent of total population

Credit availability has become a short-term headwind. Peer-to-peer (P2P) lending exploded in China over the last few years and was a driver of consumption. Given the rapid development in such lending and the lack of regulation, the government's concerns about rapid debt growth spread to the P2P industry. There have been many instances of P2P companies defaulting on loans, and individuals who depended upon financing now find it more difficult to get credit. While I believe P2P lending will continue to be constrained, the government is working to lower the cost of, and increase the availability of, credit for consumers.

ENVIRONMENTAL ISSUES COME INTO FOCUS

Environmental control has become a key focus of the central government. The term "Beautiful China" was included in the country's 13th Five-Year Plan, introduced in late 2015. President Xi has made it clear that officials now must consider the environmental impact when making decisions. In other words, political careers are now judged on their impact on the environment as well as on economic growth.

Air pollution was the initial focus, with water pollution and soil contamination quickly following as a concern. The government has mandated shutdowns of heavy-polluting factories in the winter. Air pollution in Tangshan, China's steel-producing capital, was better when I visited, but it still can be very bad at times in many cities, including Beijing.

Air quality is a growing issue in major cities

The government's mandates on pollution are important for health reasons, but they are raising costs for companies. For example, the central government has mandated steel companies must move production outside the city limits of Tangshan. In addition, companies must transport all raw materials from ports via rail instead of truck by late 2020, which will require more rail lines to be built. This type of environmental crackdown in one city is being duplicated all over China.

CHINA FACING CHALLENGES AHEAD

China's need to reduce the pace of debt accumulation must be balanced with the downside risks to the economy, which are coming from both domestic and external sources. China is likely to temporarily stimulate domestic demand, but doing so risks eroding progress made on the debt front. The country's aging population will continue to lead to slower GDP growth. If China is unsuccessful in permanently slowing the pace of debt growth, then the aging population will make the debt load even more unsustainable.

Officials could strike a trade deal with the U.S., but longer-term pressures from the U.S. and other countries are likely to remain, especially as such countries try to slow China's economic and military rise. I believe the Chinese economy will begin to recover in the second half of 2019, but the larger challenges will remain for an extended period.

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