China’s Economic Challenges under Xi Jinping

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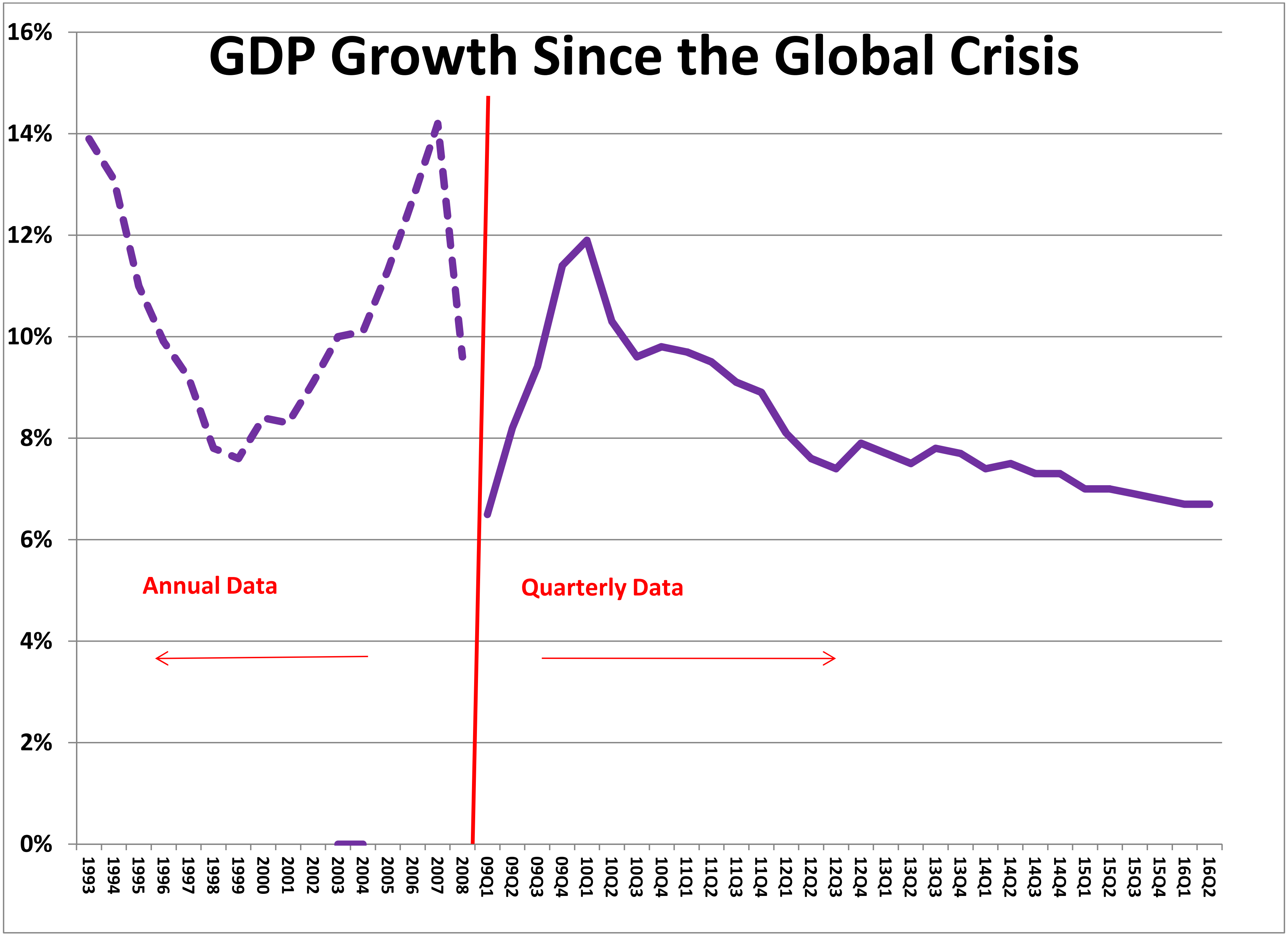
The Challenges

1. The Chinese economy is slowing –
   The "miracle growth" era is ending.
2. The investment-led growth model has run out of steam –
   China tried to prop up growth with increased investment, but this is not sustainable.
3. China has not yet found the path to economic reform –
   The "Xi Jinping model" is taking China in an unexpected direction.

End of the Miracle Growth Era

- China has grown faster, longer, than any economy in history. Growing at 10% per year for 32 years, from 1978-2010, China reached middle income status faster than anyone anticipated.
- China now equals global average GDP per capita.
- BUT, other economies have done something similar: Japan, Korea, Taiwan grew *almost as fast* for *almost as long.* We can learn from their experience.
- Labor market changes drive the transformation.
- The transformation is surprisingly difficult.


GDP Growth Since the Global Crisis
16%
14%
12%
10%
8%
6%
4%
2%
0%
Annual Data
Quarterly Data
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
09Q1
09Q2
09Q3
09Q4
10Q1
10Q2
10Q3
10Q4
11Q1
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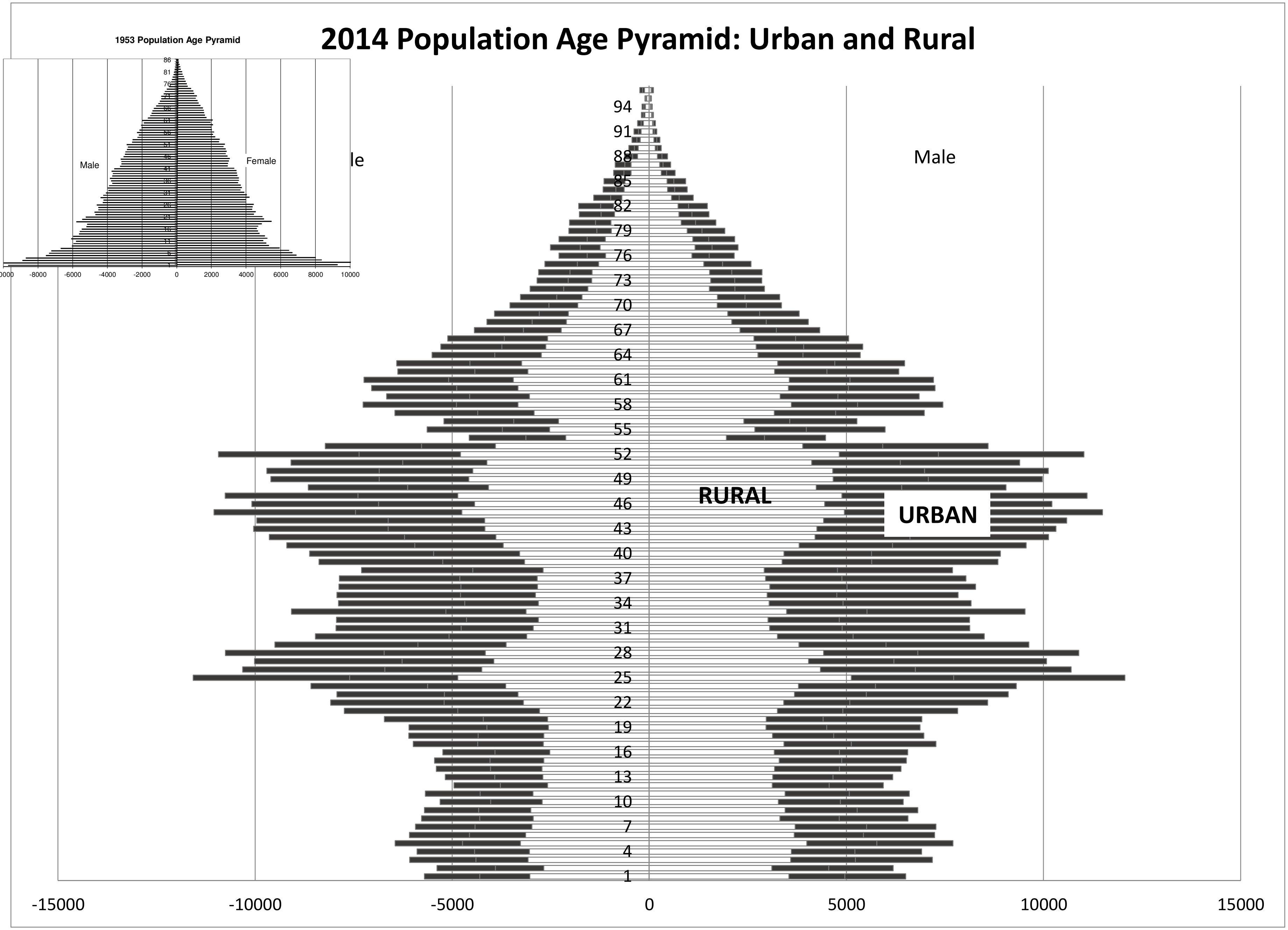
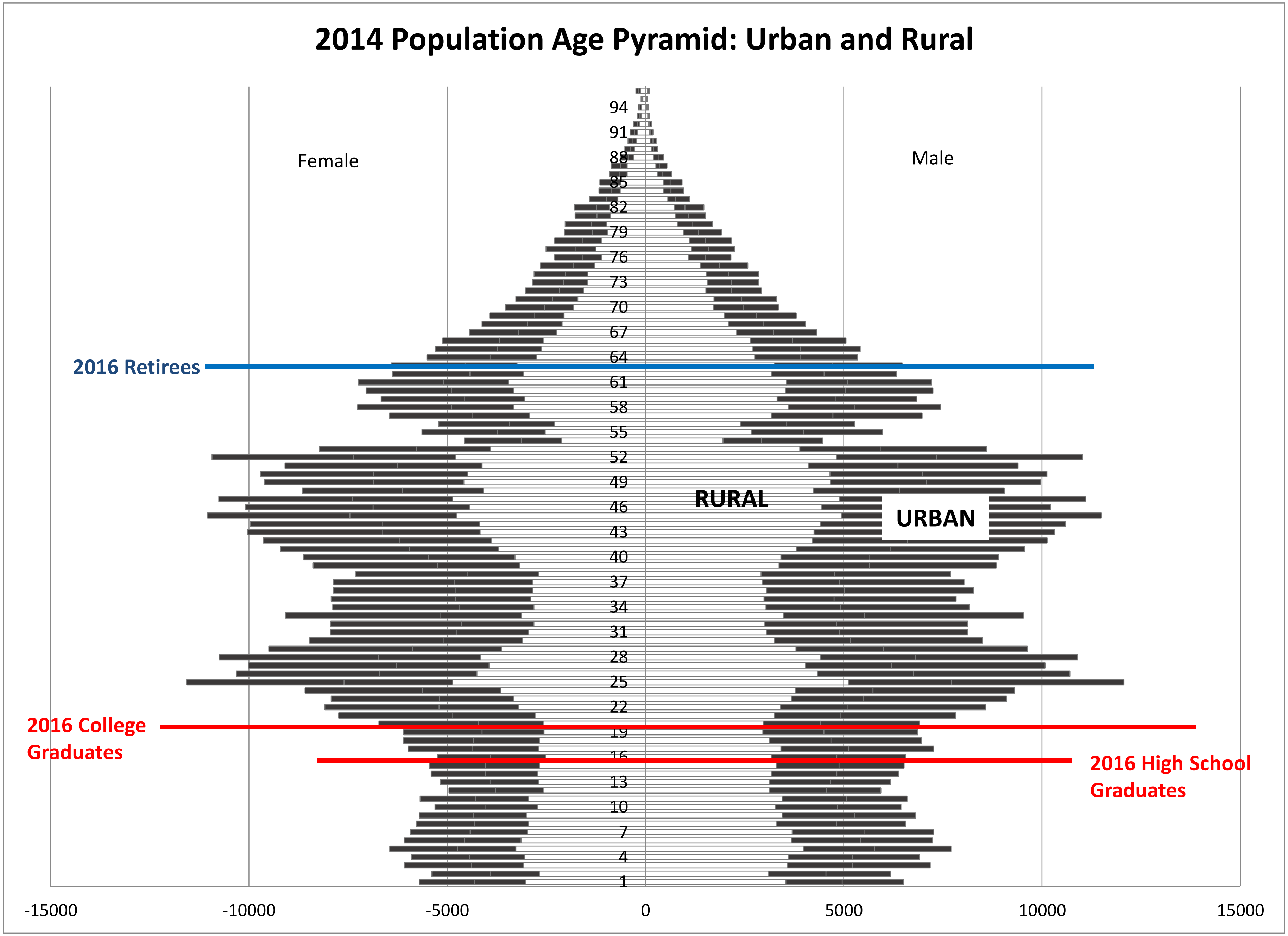
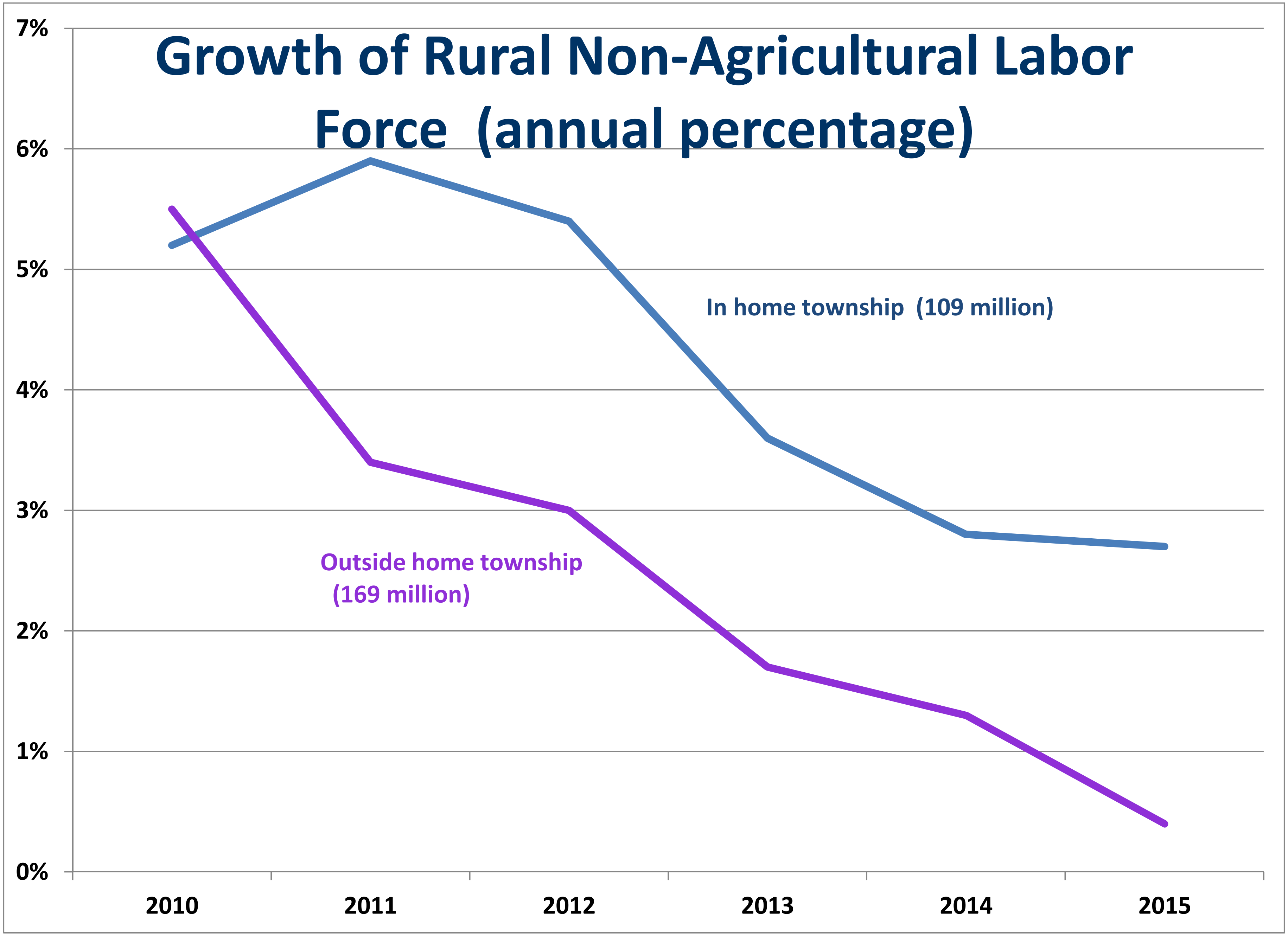
15Q4
16Q1
16Q2



2014 Population Age Pyramid: Urban and Rural
1953 Population Age Pyramid
Male
Female
-10000
-8000
-6000
-4000
-2000
0
2000
4000
6000
8000
10000
Male
RURAL
URBAN
94
91
88
85
82
79
76
73
70
67
64
61
58
55
52
49
46
43
40
37
34
31
28
25
22
19
16
13
10
7
4
1
-15000
-10000
-5000
0
5000
10000
15000



2014 Population Age Pyramid: Urban and Rural
Female
Male
RURAL
URBAN
2016 Retirees
2016 College Graduates
2016 High School Graduates
94
91
88
85
82
79
76
73
70
67
64
61
58
55
52
49
46
43
40
37
34
31
28
25
22
19
16
13
10
7
4
1
-15000
-10000
-5000
0
5000
10000
15000



Growth of Rural Non-Agricultural Labor Force (annual percentage)
7%
6%
5%
4%
3%
2%
1%
0%
In home township (109 million)
Outside home township
(169 million)
2010
2011
2012
2013
2014
2015

In past transitions from "hyper-growth," (Japan and Korea, especially) four simple stylized features were evident:

- First, long-term structural changes began to signal the coming end of the hyper-growth period.
- Second, the government tried to sustain rapid growth through expansionary monetary (and fiscal) policy.
- Third, a sudden, sharp drop in growth was triggered by a seemingly unrelated exogenous event.
- Fourth, growth never fully "bounced back," but instead recovered to a lower, more moderate long-term growth path.

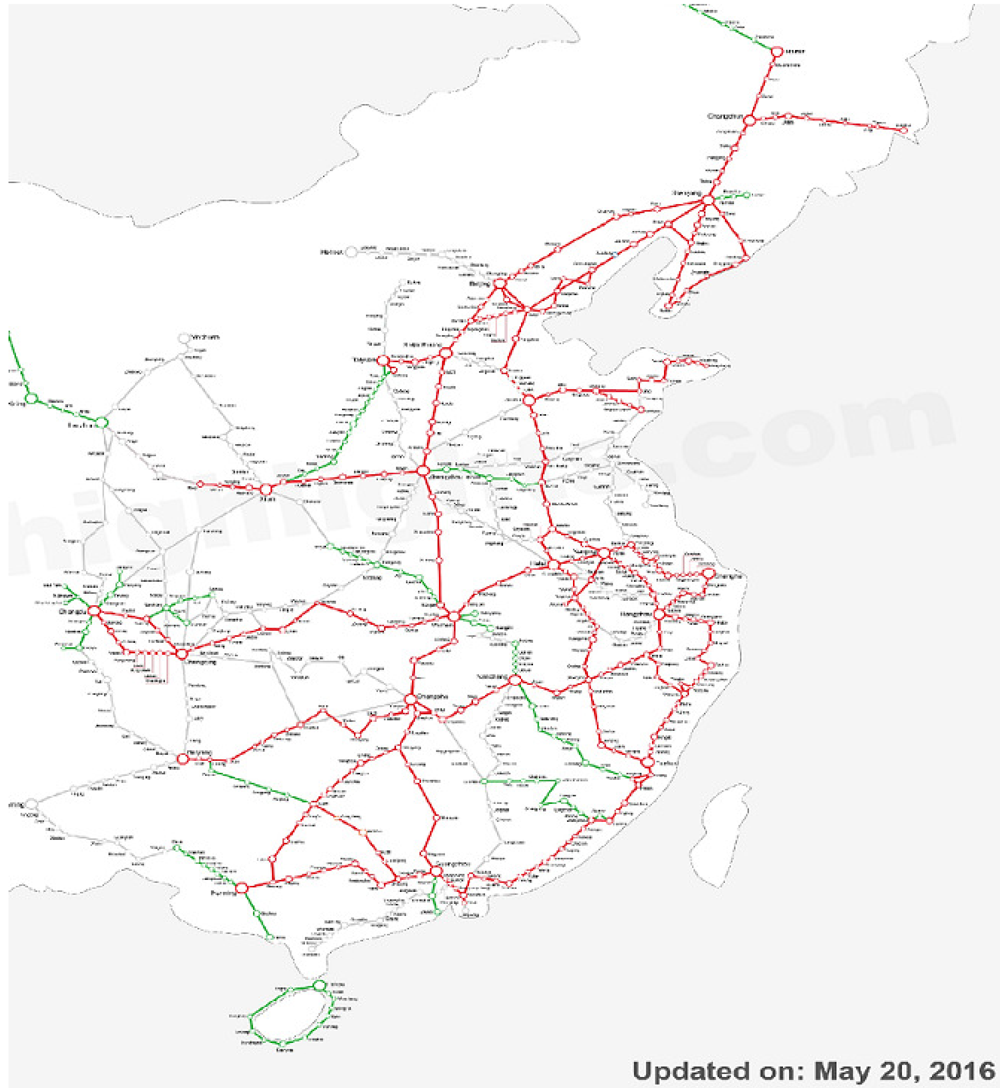
A MYSTERY: This pattern has never been adequately explained! Also, the associated pattern of "boom and bust" has created substantial long-term headaches and costs.

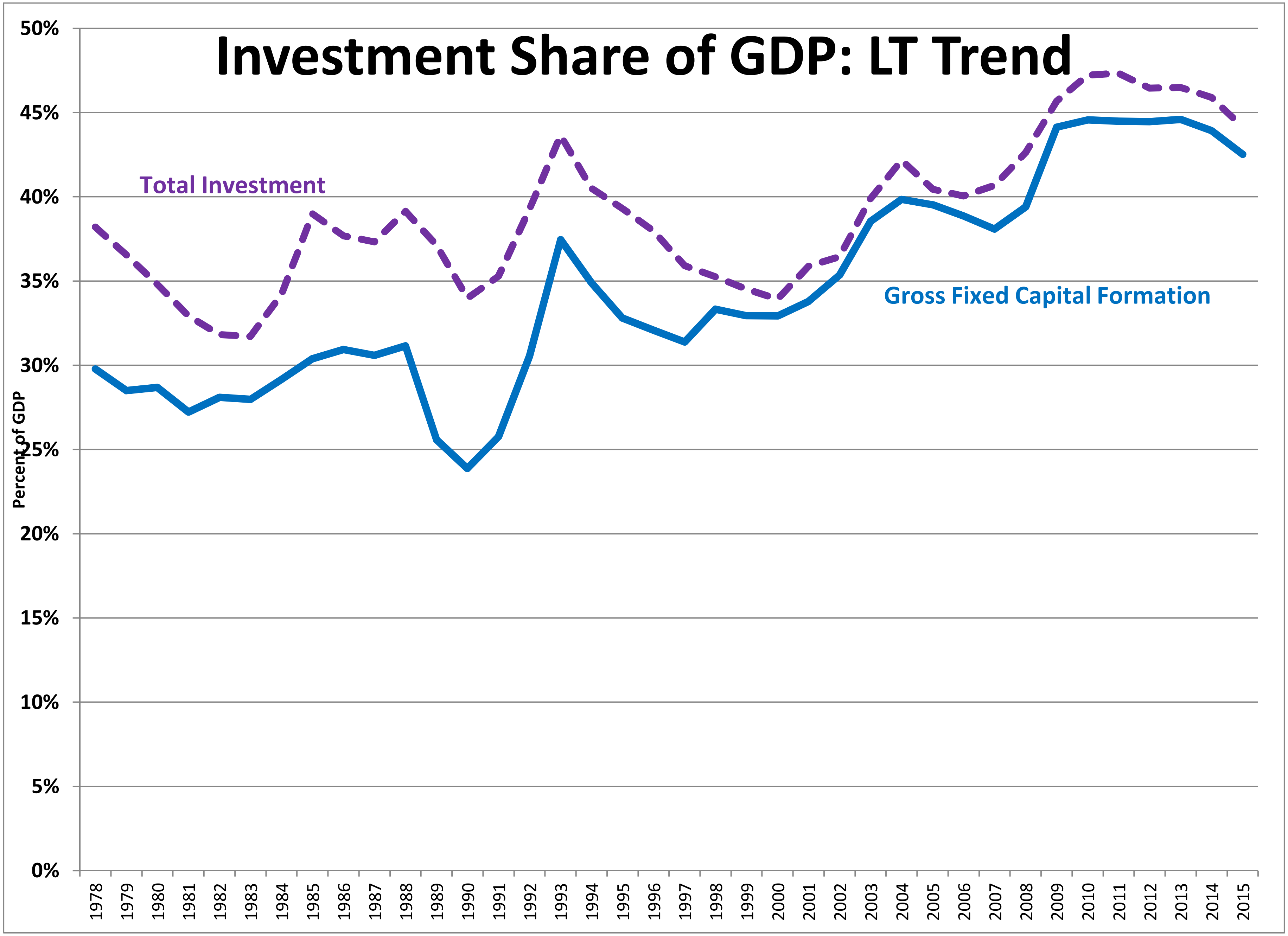
At the end of the period of hyper-growth, some of the basic rules of macroeconomic management does not apply.

- In normal economic times, a growth slowdown calls for an increase in the monetary growth rate to bring real growth to the desired level (a Taylor-type rule). In other words: step on the gas!
- During the transition from hyper-growth this advice does not apply.
- The growth slowdown causes us to revise the desired level of growth downward: more rapid monetary growth is not needed. In fact, it is harmful.

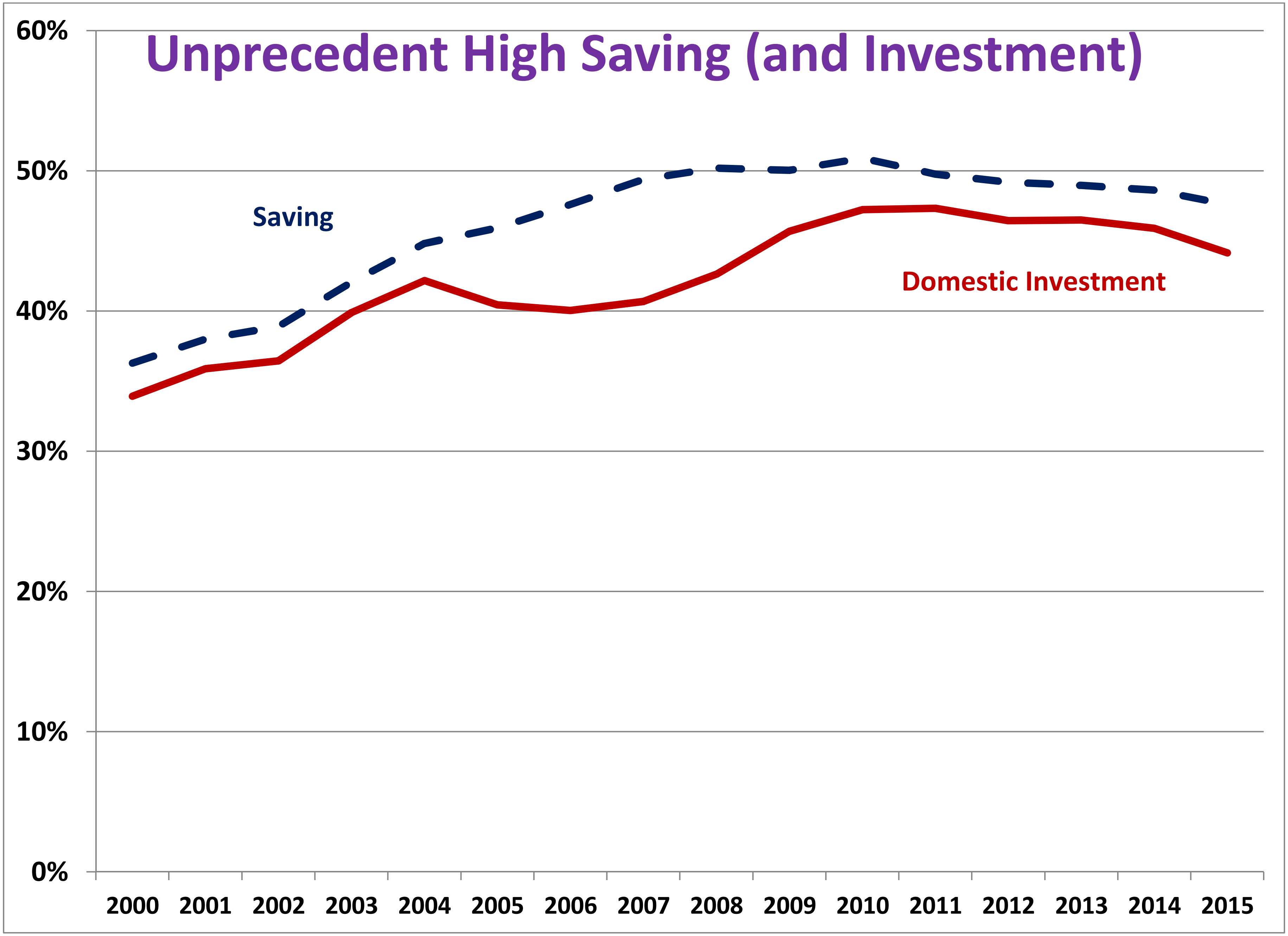
2. Investment-led growth model is coming to an end

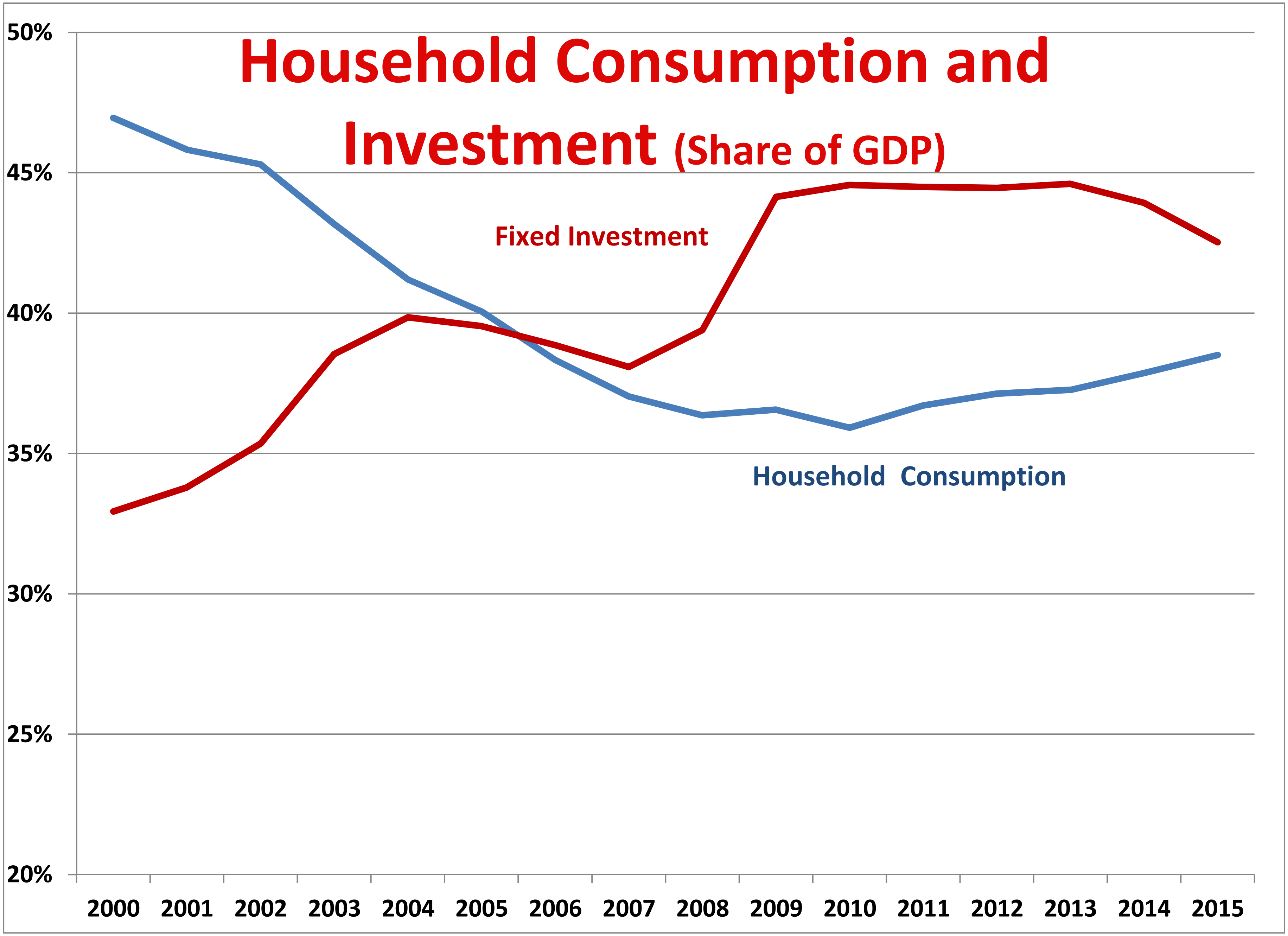
- Extraordinarily high investment rates powered Chinese growth.
- A modern infrastructure was built at blazing speed: for example, High Speed Rail and expressways.
- Even higher investment was used to brake the growth slowdown in recent years.
- This practice is no longer sustainable.



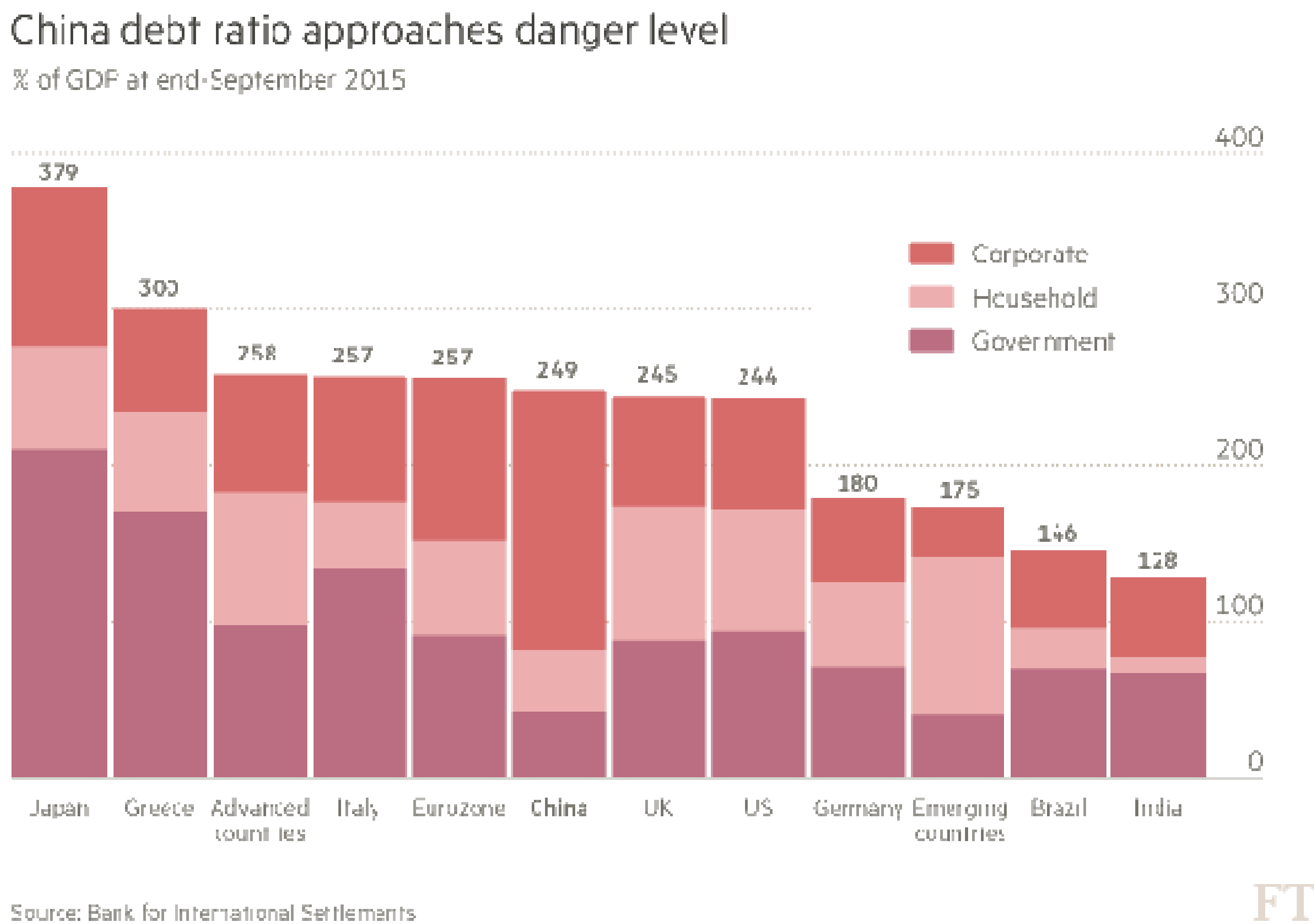


Investment Share of GDP: LT Trend
Total Investment
Gross Fixed Capital Formation
Percent of GDP
50%
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
1978 1979 1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015


Unprecedent High Saving (and Investment)
60%
50%
40%
30%
20%
10%
0%
Saving
Domestic Investment
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015


Household Consumption and Investment (Share of GDP)
Fixed Investment
Household Consumption
50%
45%
40%
35%
30%
25%
20%
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015

Rapidly increasing debt approaches warning lines…



3. Economic Reform is Floundering

“Normally,” a country reaching the end of the miracle growth era liberalizes its economic policy, opens its markets (including financial markets), and adopts a “light touch” approach to government intervention.

China announced a bold economic reform program in November 2013 (the “Third Plenum” reform) that had some potential of moving in the same direction.

Third Plenum Reforms

- Market as the “decisive factor in resource allocation.”
- State enterprise reform: shift to wealth management model and mixed ownership.
- Sharply reduce barriers to urban citizenship for migrants.
- Reduce government limits on private businesses and foreign investors.
- Fiscal restructuring and reform.
- Liberalize interest rates, open stock and bond markets.

MOST of these ambitious policies have either failed, been scaled back, or run into roadblocks.

“Supply-Side Structural Reforms”

- An alternative approach, but not necessarily one that will be more successful:

1. Reduce excess capacity (steel, coal, cement)
2. Sell-off excess housing inventory.
3. De-leverage.
4. Reduce costs (the original “supply-side”!)
5. Strengthen weak points.

What does Xi want? Can he make those decisions himself?

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