Panel Discussion: Assessing Structural Change in China and Its Consequences

The final part of the Conference was a panel discussion focused on assessing structural change in China and its consequences. The discussion was moderated by Stephen Green, an economist at Capital Group responsible for covering Asia, and included the following panellists:

- Andrew Batson, China Research Director at Gavekal Dragonomics
- Jian Chang, chief Chinese economist at Barclays Capital
- Lillian Cheung, Executive Director (Research) at the Hong Kong Monetary Authority
- David Gruen, Deputy Secretary, Economic at the Department of Prime Minister and Cabinet

As the Conference and panel were conducted under the Chatham House rule, no individual's comments are attributed.

1. Introduction

The session began with one panellist's overview of economic progress in China during the reform era and the future challenges China faces. The panellist emphasised the rapid GDP growth in China that has been achieved since 1978, supported by a relatively stable political environment. During this period, many people have been brought out of poverty and there has been enormous structural change, including the largest rural–urban migration the world has ever seen.

Five main challenges were identified: demographics; deregulation of the financial sector; rebalancing from investment to consumption; environmental degradation; and market reforms. The panellist questioned whether these challenges are qualitatively more difficult than those China has faced in the past; current problems always seem more serious because we are yet to see how they will be resolved, whereas past problems have been dealt with.

2. Household Consumption

Recent developments in household consumption were discussed by another panellist. They suggested that rebalancing has occurred slowly, with the household consumption share of GDP increasing from 36 per cent in 2010 to just 38 per cent in 2014. Furthermore, this has occurred via a decline in investment growth, rather than a pick-up in consumption growth. In fact, household consumption growth has slowed quite sharply in real terms, from 12.5 per cent in 2010 to 7.4 per cent in 2014. The slowdown has occurred because lower investment growth has affected corporate profitability, which has a flow-on effect to household income growth. In response, one participant agreed that the pick-up in the consumption share of GDP and the decline in the saving rate have been slow, but noted this progress should be compared with trends from the previous decade when these indicators were moving in the opposite direction.

The panellist noted that there has been a significant change in the composition of household spending. Growth of sales of many high-end consumer goods has accelerated rapidly, while the growth of mass market consumer goods has been relatively slow. This is partly because, as China has developed, the number of affluent and established households has increased remarkably, while the number of lower-income households has declined. The rapid growth of high-income consumption is potentially more important for Australia and other economies seeking to export goods and services. For example, Chinese tourist arrivals to Australia rose 20 per cent in 2015. Another panellist observed that something similar was recorded in South Korea and Taiwan in the decade after their per capita GDP exceeded US$4 000 in the late 1980s. Both South Korea and Taiwan experienced a decline in their consumption share before a gradual pick-up.

The moderator asked one panellist if we should worry about the middle income trap, given the strong growth in some consumption categories. The panellist did not subscribe to the middle-income trap theory, but was not optimistic about aggregate growth of household consumption in the current macroeconomic environment. They felt that the labour market was deteriorating gradually, with wage and income growth likely to decline. This would then likely flow onto consumption, given that the saving rate has tended to change slowly.

3. Rebalancing and Reform

One panellist focused their comments on rebalancing and reform in China in recent years. The panellist believed there has been some rebalancing to date. In line with economic theory, after China passed the Lewis turning point (where there is no surplus rural labour), there has been rising wage inflation, which supports household consumption, reduces corporate profits, lowers the return on investment and leads to slowing growth of investment relative to GDP.

China is facing structural and cyclical downturns and significant imbalances in the economy. The panellist believed that the challenges facing China now are more difficult than those in the past. In order to continue the development process, there needs to be an increase in investment efficiency or total factor productivity. To achieve this, significant reforms to state-owned enterprises (SOEs), fiscal policy and land rights would need to be implemented. However, progress since the Third Plenum in 2013 has been limited, partly because reform goals are inconsistent with the high growth rate targets the government had preferred in the short run.

When asked about the likelihood of significant reform in the next five years, the panellist noted they had become less optimistic since mid 2014. Since then, strengthening the authority of the Party and increasing government controls to achieve short-term stability have been prioritised over reforms to allow markets to play a more decisive role, a goal stated in the Third Plenum. This has increased the chance of a policy mistake, given financial markets have also become more complex and the equilibrium level of certain prices is difficult to evaluate. For example, the target level that the government set for the stock index or the exchange rate could deviate significantly from the prevailing market equilibrium or the level that is consistent with economic fundamentals. The panellist believed that the authorities should be clear about the direction of economic development, policy priorities and incentives for key stakeholders. One participant agreed with the panellist's overall assessment of the likelihood of reform, but noted that leaders regard meeting growth targets as a prerequisite for structural reform.

Also on the topic of reform, one participant asked what policy advice panellists would provide to China's leaders if given the chance. One panellist noted that SOE reform should be a high priority, but has progressed slowly so far. They noted that SOE reform would not have an effect on short-term growth, but would be beneficial in the long run. Another panellist emphasised the need for market reform, and how entry and exit of firms generates significant productivity gains in advanced economies.

4. Recent Developments and Economic Risks

There was also a discussion of the risk of a hard landing in China, and the effect that might have on currencies, commodity prices, assets and credit markets. One panellist placed a 10–15 per cent chance of a hard landing occurring in the next 18–24 months, noting that challenges are growing quickly without a noticeable improvement in the role for markets to allocate resources efficiently. They sensed that market participants had become less concerned about near-term hard-landing risks of late, following the credit expansion and policy stimulus in the first quarter of 2016, but have become more worried about medium-term growth and the outlook for rebalancing because of unsustainable monetary and fiscal stimulus. In contrast to the view that strong growth facilitates structural reform, the panellist believed that cyclical adjustment and lower growth in the short run would be needed in order to undertake necessary structural reforms, such as capacity reduction and supply-side reform, which would be necessary for more sustainable growth over the medium term.

Another panellist suggested that residential housing investment is the driver of short-term cycles in China, similar to many developed countries. Indeed, the current cycle has been driven by housing investment, with a peak in fundamental demand for housing, high inventories and therefore declining housing investment. They noted that the industrial sector has already had a hard landing, with growth close to zero in nominal terms in 2015. The services sector has grown relatively rapidly, but if that were to reverse, China's economy as a whole could face a hard landing. This could occur via a disorderly outcome in the labour market flowing through to household consumption. The panellist noted financial markets are a more likely cause of a slowdown in the services sector. For example, if China was forced to float the exchange rate, asset prices would collapse (at least temporarily) and this would have a flow-on effect to the real economy. A third possible cause of a slowdown in the services sector put forward by the panellist was a banking crisis in the domestic financial system, which could have a big effect on confidence, asset prices and credit availability.

A third panellist noted that while economists are reasonably good at identifying what might cause a crisis, they should have some humility in their ability to assess the probability of these events occurring. Very few economists forecast the global financial crisis; the vast majority did not, and were unaware of the build-up of systemic risks that became clear only after the crisis occurred.

Financial deregulation was also noted as a risk, with one panellist stating that this process has rarely gone smoothly for other economies. A participant noted that official reserves had declined in defence of a currency which had been allowed to depreciate a little, and questioned whether the recent corruption drive had contributed to capital flight from China. One panellist commented that foreign reserve depletion and capital outflows largely reflect residents rebalancing assets and liabilities, rather than cross-border outflows from non-residents. Another participant questioned whether the quality and the transparency of Chinese statistics had declined recently, and whether we are underestimating risks in China as a result.

5. Implications for Asia and Australia

The implications of developments in China for Asia and Australia were also discussed at length. One panellist emphasised how cyclical and structural change in China were likely to have different effects on economies in Asia. A cyclical downturn or hard landing in China would likely affect all economies in the region, with little difference in the effect across economies. On the other hand, structural change is likely to have different consequences for different economies. Trade is the main link between most economies in the region and China, but different economies are involved at different parts of the supply chain. Some economies depend on China as part of the supply chain for processing exports, while others export commodities or high-end capital goods.

The panellist noted two developments affecting the composition of China's imports. First, as China rebalances from investment to consumption, they are likely to import fewer commodities for construction purposes and more consumer goods and services. Second, preliminary analysis suggests China is exporting more high-end capital goods and importing more primary goods and fewer intermediate goods. This suggests China may be producing more intermediate goods and covering a larger part of the supply chain, which contrasts with the conventional wisdom that China is moving up the value chain.

The moderator asked one of the panellists about the financial linkages between Hong Kong and Mainland China. The panellist observed that the Hong Kong banking system's mainland-related bank lending has grown rapidly over recent years. While this may cause some concern to outside investors, there is little exposure to over-capacity sectors and property developers, with most of the mainland-related lending to multinational companies, large SOEs and top-tier private listed companies. The panellist believed the resilience of the Hong Kong banking sector is high, as shown by stress tests done by the banking regulators and the IMF. This is because of good risk management practices by the banks, tight supervision and the collateralisation of many loans.

The moderator questioned how Australia is placed to respond to developments in China in the next decade. A panellist responded that Australia has done remarkably well in recent years given the income shock and decline in mining investment. This is partly because of institutions and previous reforms in Australia, such as the floating exchange rate, an independent central bank and less centralised wage setting. The panellist noted that this experience should provide some confidence in Australia's ability to respond to developments in China.

One participant questioned whether Australia needs a new economic narrative following on from the Asian Century report (Australian Government 2012). If China is successful in rebalancing from investment to consumption, demand for Australia's iron ore and coal may have already peaked and there may be less demand for liquefied natural gas than previously forecast. One panellist agreed it was a good idea to update the analysis, but noted that the Asian Century report described the mining boom as the first stage of very rapid growth in Asia. The next stage outlined in the report is the rise of the middle class in Asia. Australia will need to compete with the rest of the world in this next stage, rather than rely on its natural endowments.

Reference

Australian Government (2012), *Australia in the Asian Century*, White Paper, Australia in the Asian Century Implementation Task Force, Department of the Prime Minister and Cabinet, Canberra.