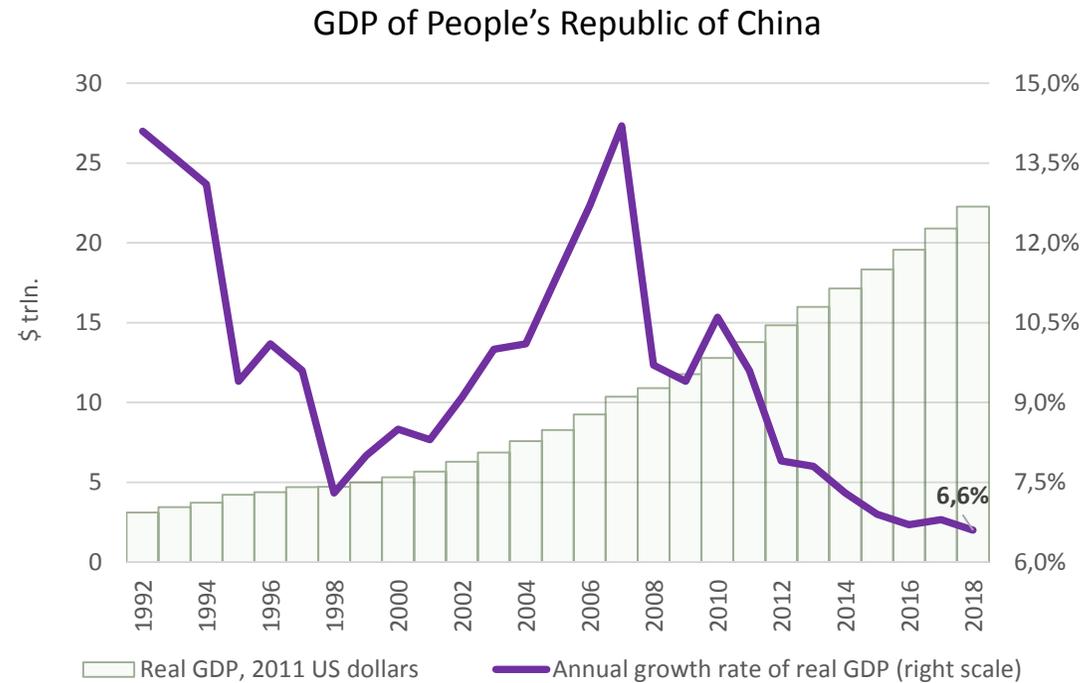


## The Economy of the People's Republic of China: The Old Growth Model Has Exhausted Its Potential

China, which was the engine of world growth for the past twenty years, is beginning to slow down more and more. Judging by the latest data, the Chinese economic miracle is close to completion, and, moreover, the country is on the verge of the need for a serious transformation of the economy.

The growth of the Chinese economy continues to slow down. Last year, real GDP increased by 6.6% (minimum since 1990), and the growth in 2017 was revised from 6.9 to 6.8%. Even such rates more than double the world average, but things are not as smooth in the Chinese economy as it may seem from a superficial glance at GDP.

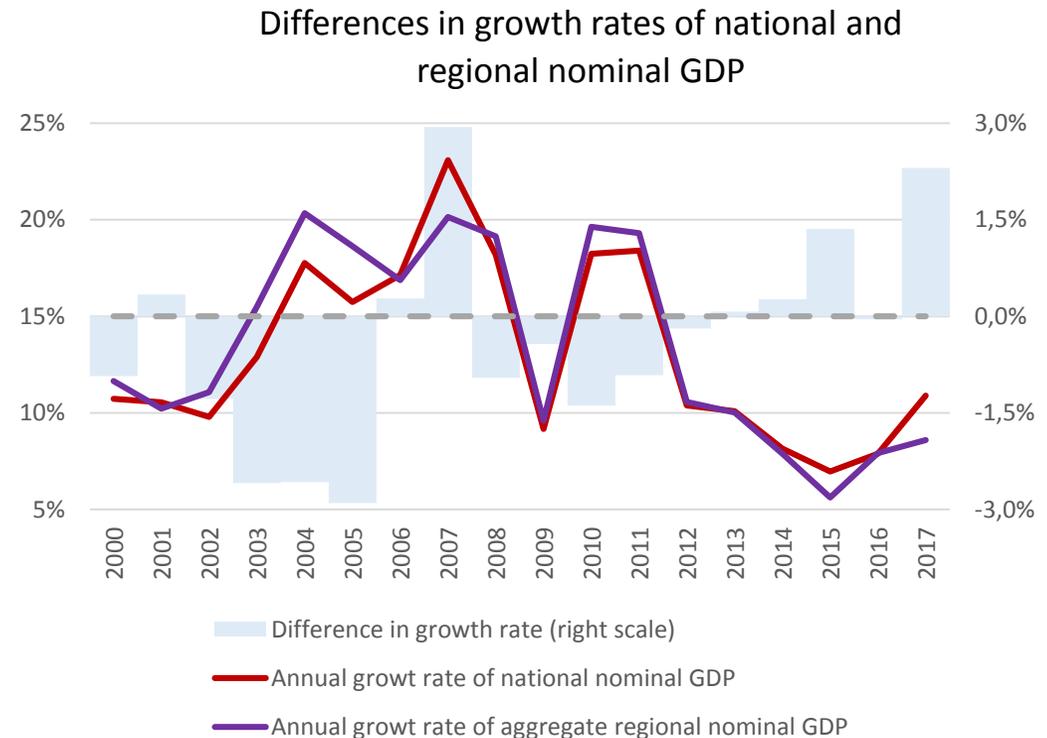


Source: National Bureau of Statistics of China

## Chinese Statistics Problem

Chinese economic statistics has several features that forces to have a different attitude to it than to that of the West. The biggest differences relate to such a popular economic indicator as Gross Domestic Product. In China, the expected growth rates of GDP for the next period are discussed at the level of central and regional governments and are more a guideline for the leadership of the province, on the fulfillment of which its relationship with the center depends, than the resulting indicator. Therefore, regional governments are interested in both stimulating inefficient activities leading to GDP growth, and simply attributing to themselves increased growth rates.

This feature is most clearly manifested in the comparison of official data on national and regional GDP. Over the past twenty years, discrepancies between the nominal GDP of the PRC and the aggregate GRP of all its provinces have fluctuated within + -3%. For example, in 2017, the national GDP growth was 10.9%, the growth of the total gross regional product - 8.6%. In particular, the GRP of Inner Mongolia fell by 11%, and this most likely reflects the fact that the central authorities forced the province to eliminate the write-ups to the GDP of past years.

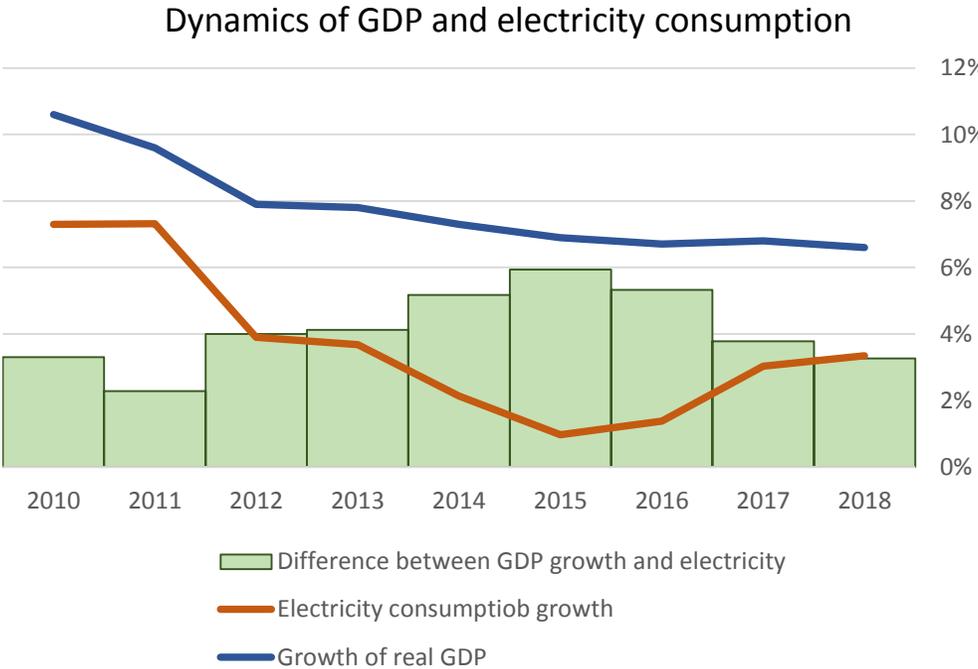


Source: National Bureau of Statistics of China

Thus, when calculating the national GDP of China, the statisticians try to level out distortions of regional indicators, but the base for calculations still turns out to be too unreliable. According to experts, the real value of China's GDP can be 12% lower than the officially declared one<sup>1</sup>.

Therefore, Chinese statistics shall be treated with caution; it's not even that it doesn't accurately reflect reality, but the statistics are used for other purposes in China, and this is especially relates to GDP.

When comparing GDP and electricity consumption, which is often used as a more adequate tool for assessing the economy, there are no obvious dissonances. Until 2015, energy consumption slowed down noticeably more than GDP, but then the situation improved - either the statistics corrected the figures, or the Chinese economy became less energy efficient.



Source: National Bureau of Statistics of China

<sup>1</sup> Brookings Institute study based on analysis of regional indicators and VAT collection, March 2019. (A Forensic Examination of China's National Accounts: <https://www.brookings.edu/wp-content/uploads/2019/03/BPEA-2019-Forensic-Analysis-China.pdf>)

## Drop in Profits and Investments

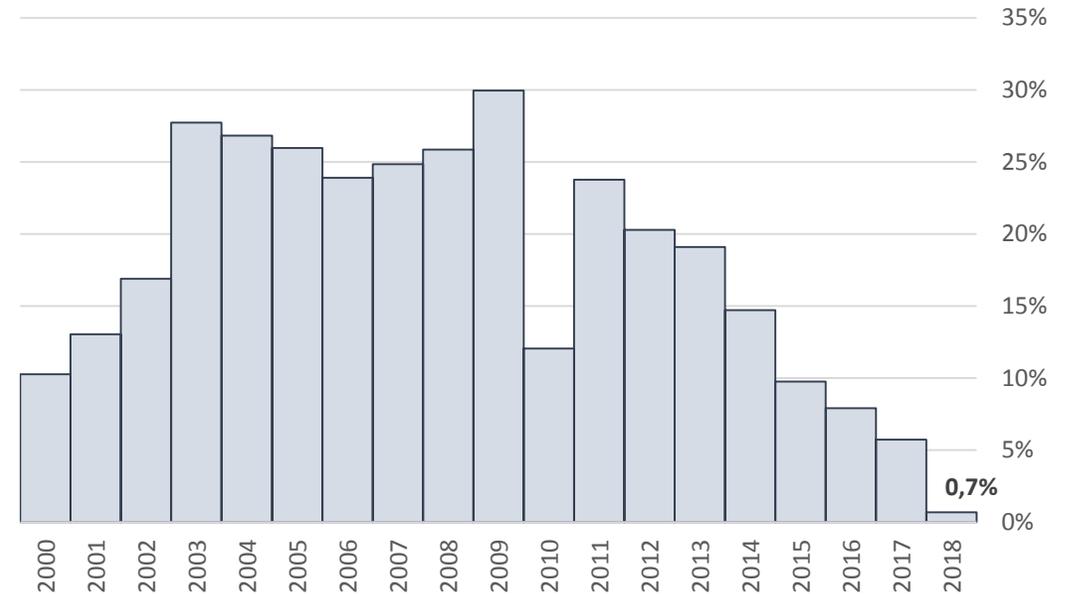
The years 2014-2016 were a difficult time for private Chinese business. Amid sluggish demand, profits practically did not grow, and corporate fixed capital investment slowed sharply in growth. The government decided to support investments with public money, increasing the rate of investment more than twice. And at the same time to convince private companies to invest in the country (at that time there was also a strong outflow of capital).

Dynamics of private and public investment in the fixed capital (change in comparison with the same month of the previous year)



Source: National Bureau of Statistics of China

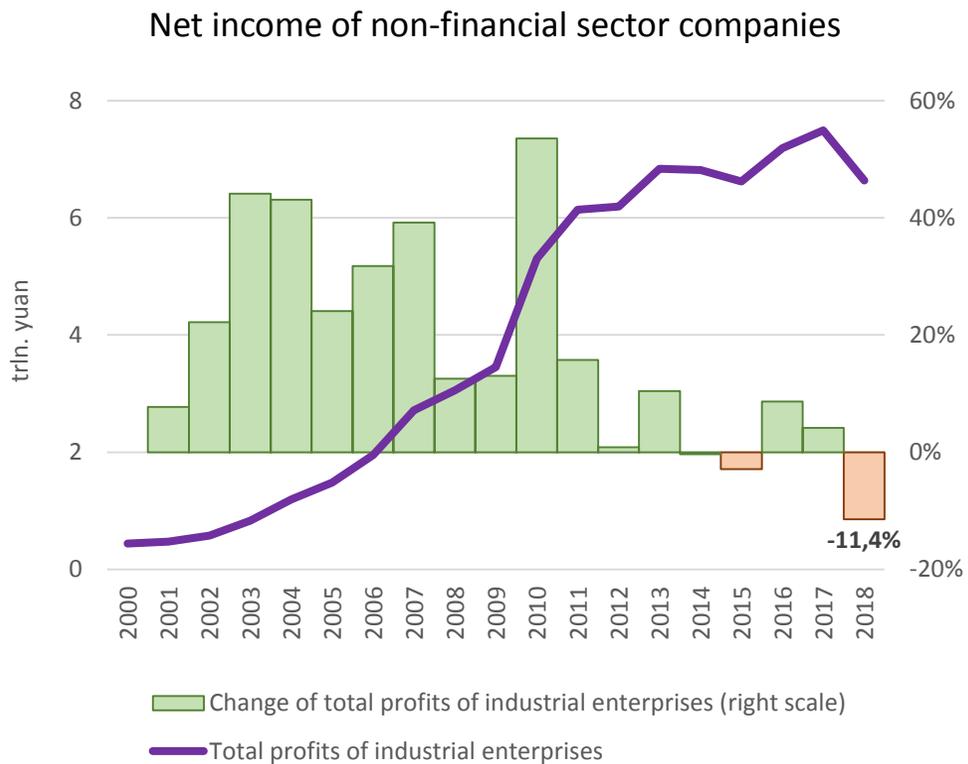
Dynamics of total investment in the fixed capital<sup>2</sup>



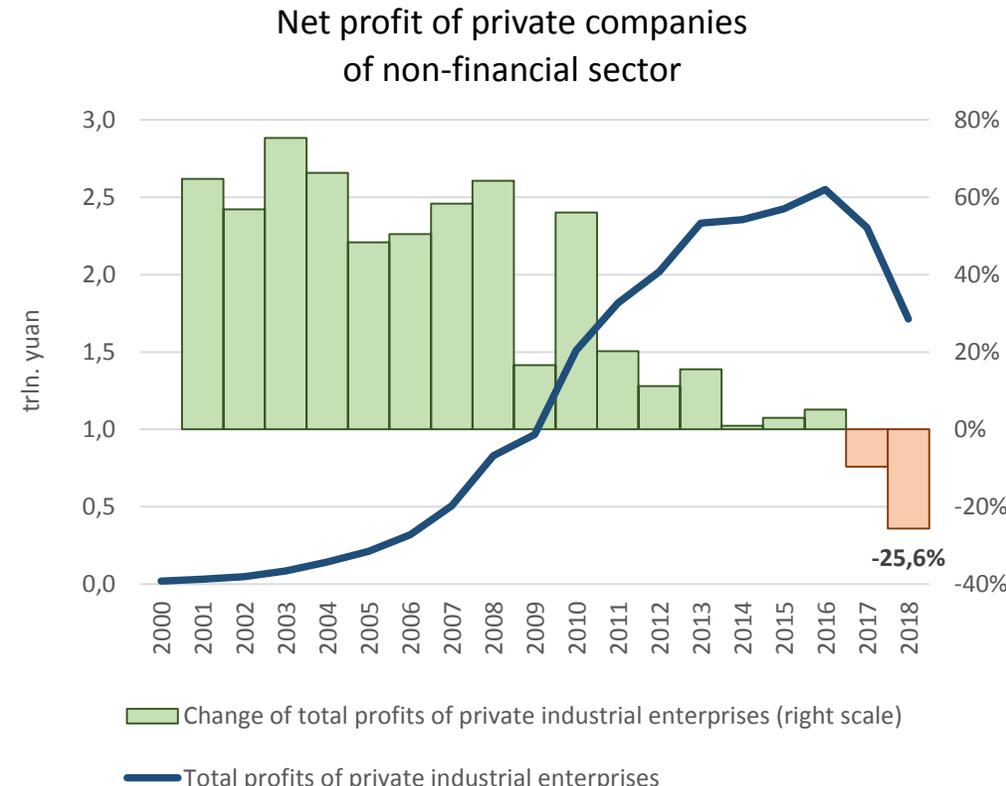
Source: National Bureau of Statistics of China

<sup>2</sup> The discrepancy in this and the previous chart shows problems with Chinese statistics, where alternative indicators often do not coincide with each other.

Judging by the data of the last year, the government has reached its goal, the private investment has reached a stable level of 8-9% annual growth. However, the profits of private companies at the same time showed an impressive fall, having fallen by a quarter in 2018. At the same time, state investments are practically stagnating, so the growth of total investments in 2018 was only 0.7%.



Source: National Bureau of Statistics of China

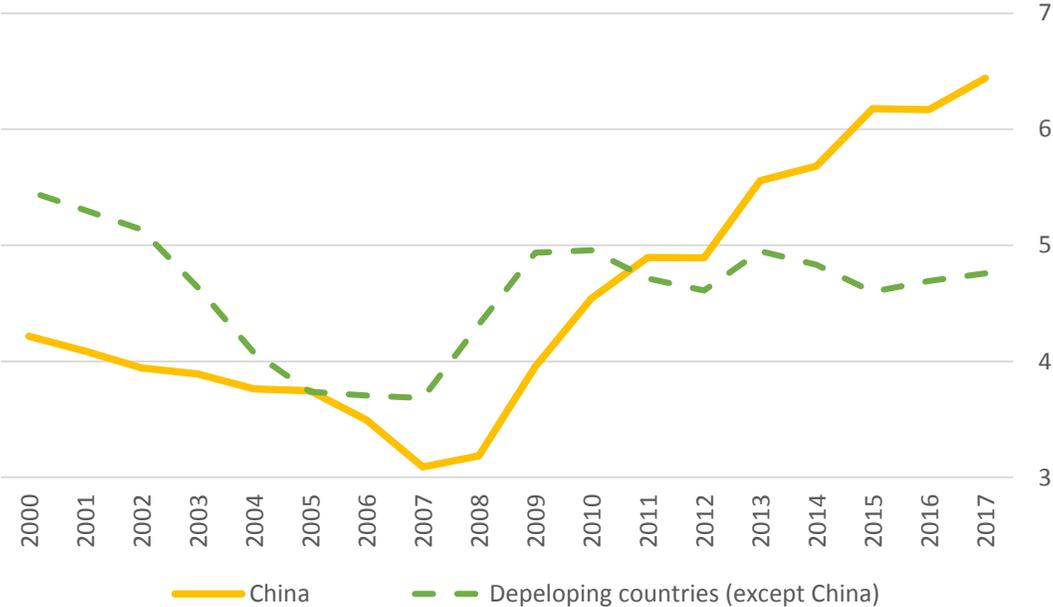


Source: National Bureau of Statistics of China

The peculiarity of the Chinese economy of the last decades was precisely that the investment rate was extremely high. When China was turning from a third world country into an industrial power, the high investments were justified. The economy grew at such a rapid pace that even inefficient investments were not a big problem. But now the situation has changed, and the old concept of growth is no longer working.

You can evaluate the effectiveness of investments using the ratio of the share of investments in fixed assets in GDP to the GDP growth . The bigger this indicator is, the less GDP is created by each conditional dollar of investments. Until the beginning of the year 2010 China's investment efficiency was on average higher than that of developing countries. But then the latter managed to keep efficiency at a stable level, while China's indicator continued to grow steadily, approaching the values of developed countries (on average, around 7.5).

The ratio of the share of investments in fixed assets in GDP to the GDP growth (on average over the past three years)



Source: World Bank, calculated by Standard Capital

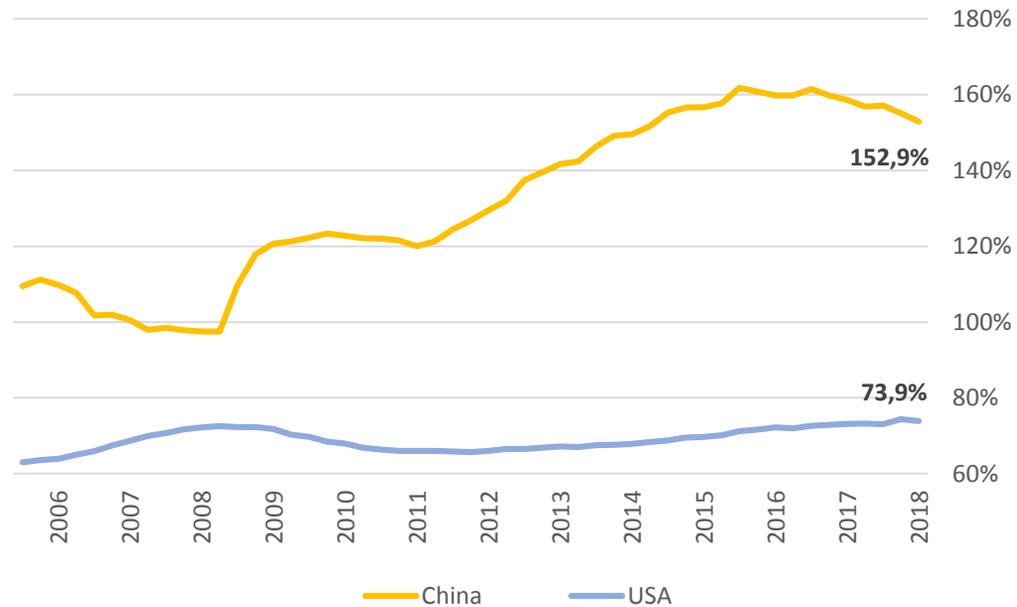
<sup>3</sup> This indicator is called the ICOR (Incremental capital-output ratio), the incremental capital-output ratio.

## Reduction of Corporate Credit Load

To combat the 2008 crisis, China chose the path of intensive credit stimulation. The volume of credit debt of non-financial companies began to grow rapidly. However, in recent years, the growth has not only stalled, but also reversed, reaching a three-year low.

On the one hand, the excessive corporate lending was one of the most vulnerable places in the Chinese economy, and the volume of loans to GDP was twice as high as that of the United States. On the other hand, the reduction of credit load occurs in a difficult environment of falling profits and an increase in the proportion of bad debts. Uncollectible loans reached a ten-year high (1.89%), the share of problem loans is about 3.2%. The amount of the nominal value of the bonds, for which the default was allowed, in 2018 amounted to over 110 billion yuan, which is four times more than the value of the year 2017.

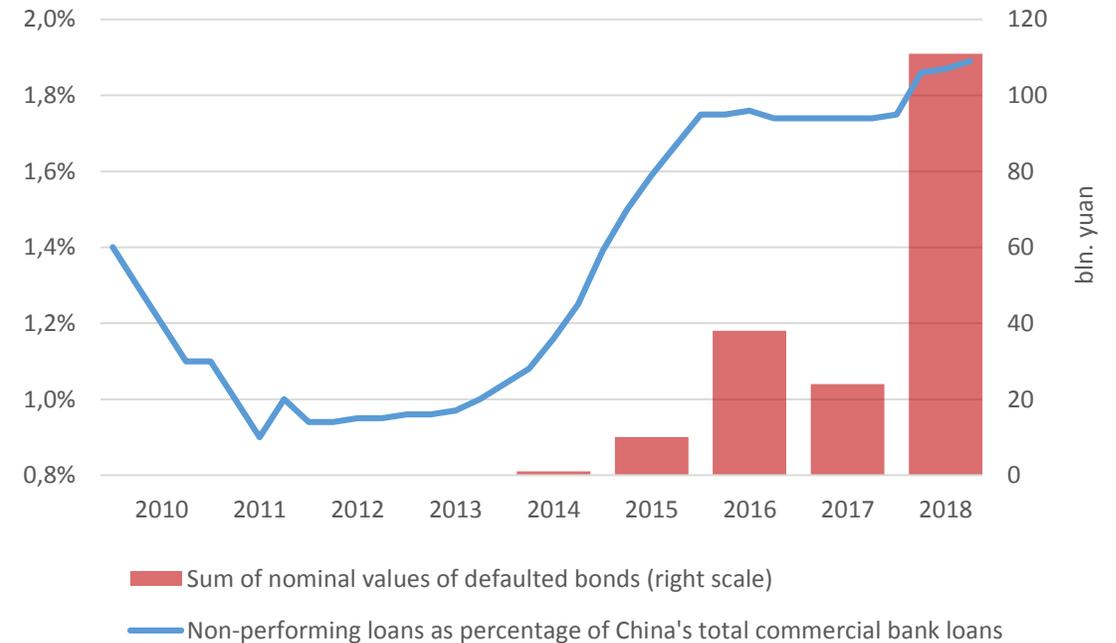
Loan to non-financial companies, % of GDP  
(including debt securities)



Last values for the third quarter of 2018.

Source: Bank for International Settlements

Share of bad loans of commercial banks in China  
to the total amount of loans and the sum of defaults on bonds

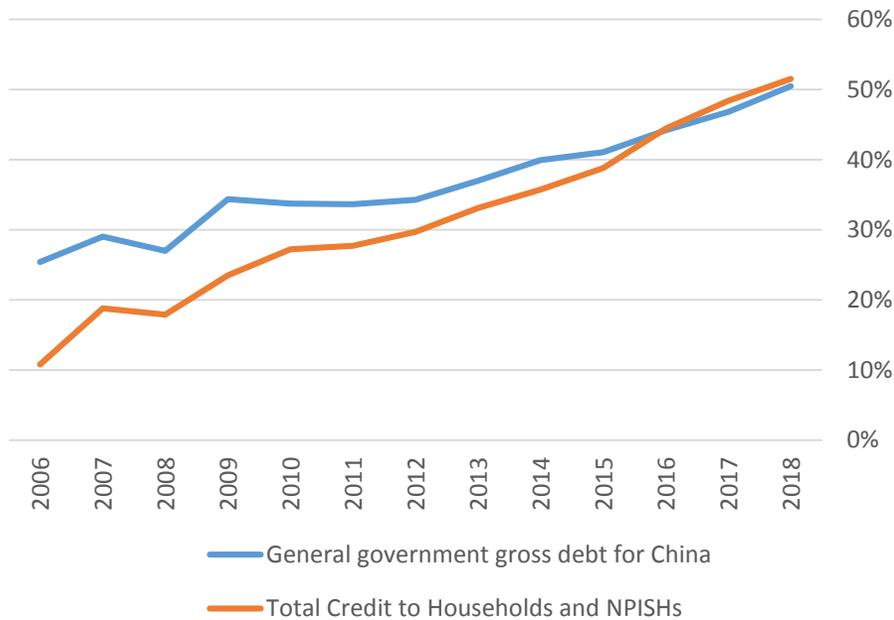


Last values for the third quarter of 2018.

Source: China Banking and Insurance Regulatory Commission

Debts of the government and households are growing at the same pace, but by the standards of developed countries, they are still low, and they do not pose a particular danger to the economy.

Government and household debt, % of GDP



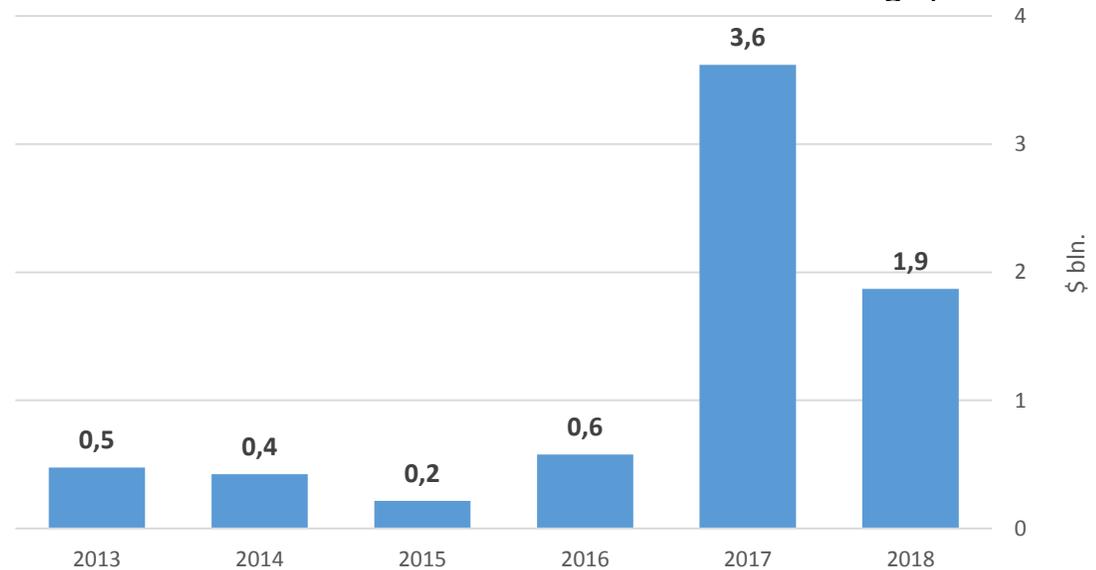
Source: Bank for International Settlements

### Prohibition of Cryptomining

Cryptocurrencies, more than 70% of which are mined in China, are disturbed by the authorities of this country as a tool for capital outflow. Operations with cryptocurrencies are not amenable to accounting and control, and it is very easy to withdraw funds abroad with their help. Therefore, in April of this year, the Chinese authorities decided to ban the mining of cryptocurrencies.

16. Compared to real capital outflow figures, cryptocurrency mining is very small. For example, in 2017 in China, bitcoins were mined for the amount of \$ 3.6 billion. Given that the capitalization of all other cryptocurrencies combined is less than that of Bitcoin, the total amount of cryptocurrencies extracted by Chinese miners in 2017 is unlikely to exceed \$ 7 billion. While in the years 2015-2016, the outflow of capital in the balance of payments was \$ 400 billion a year.

The volume of bitcoins mined in China at annual average prices



Source: CoinMarketCap

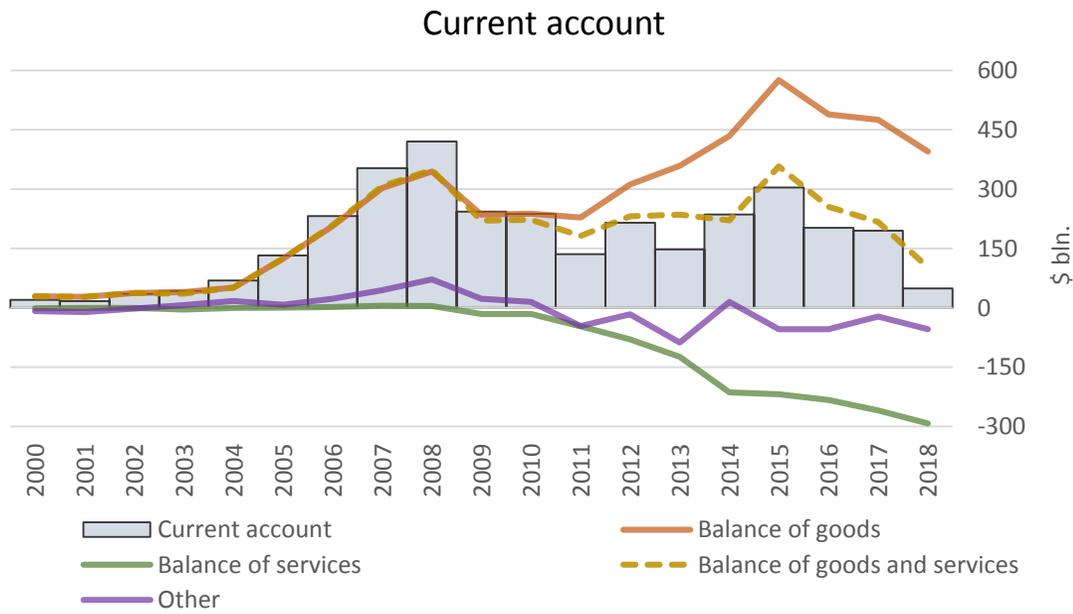
## The Threat of a Double Deficit

For the first time in this century, the quarterly value of China's current account was in the negative zone (the first quarter of 2018, -\$9.7 billion). And by the end of the year, the current account dropped to a figure unprecedented since 2003 - \$49 billion.

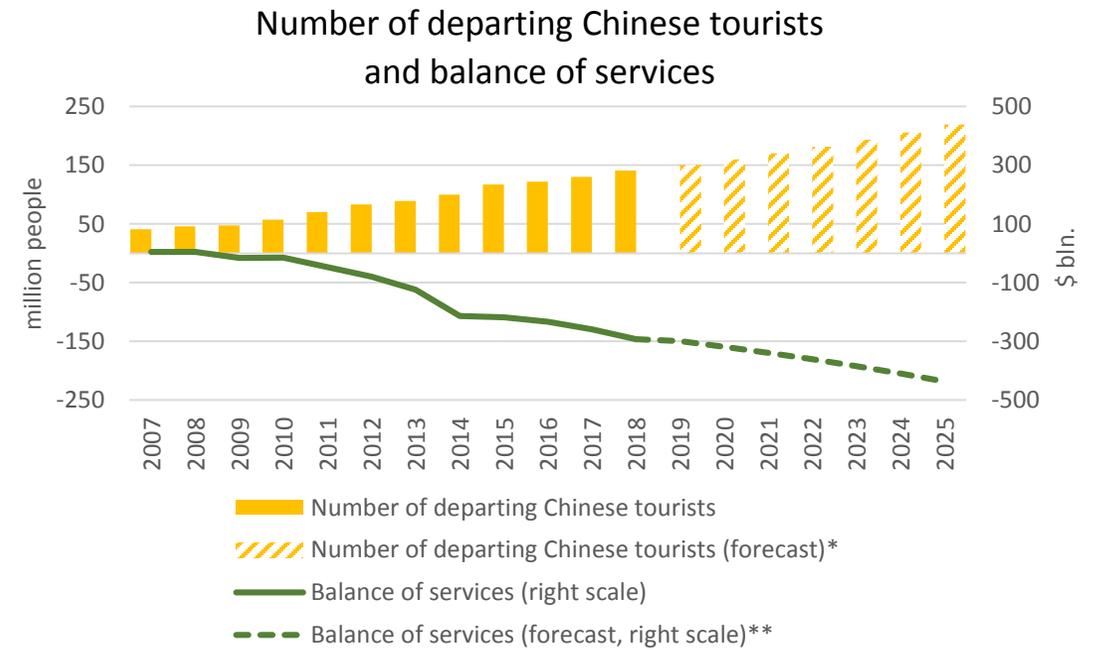
Both of its main components are guilty in reducing the current account. The balance of trade in goods has continued to decline since 2015. The balance of services is also declining, mainly due to the growing activity of Chinese tourists, who leave more money abroad. More than 70% of the deficit of services is due to this aspect despite the fact that the government limits the amount of tourist spending by using national payment systems.

The number of Chinese tourists leaving the PRC is steadily increasing, and if the rates (+ 6.5%) persist over the past three years, then by 2025 the number of tourists will reach 220 million. Accordingly, other things being equal, it will put a lot of pressure on the balance of services - in addition, in 2025 it will amount to \$ 430 billion. Taking into account the declining trade balance and stagnant other items, the current account will go into a deep minus.

The remaining items of the current balance, which mainly include revenues and expenses from investments, continue to remain generally scarcely deficient, not showing a clear focus and not much affecting the final account.



Source: Organization for Economic Co-operation and Development



Source: China Tourism Research Institute, Organization for Economic Co-operation and Development

\* forecast based on extrapolation of average growth rates over the past three years

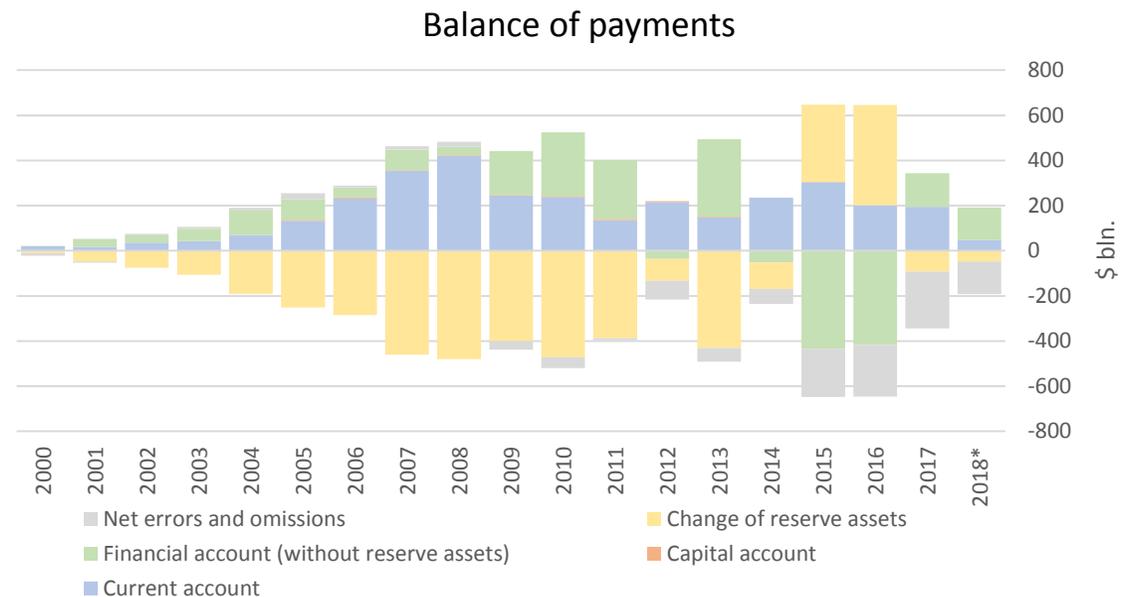
\*\* forecast based on extrapolation of the average ratio for the last three years

So, epochal changes are taking place in China's current account. It is quite possible that already this year we will see an annual negative value, even if the US-China trade negotiations end successfully. Both the trade balance and the balance of services have been steadily declining for three years, and this cannot be attributed to random deviations. There shall be noted that the figures for 2018 are preliminary, and may change slightly.

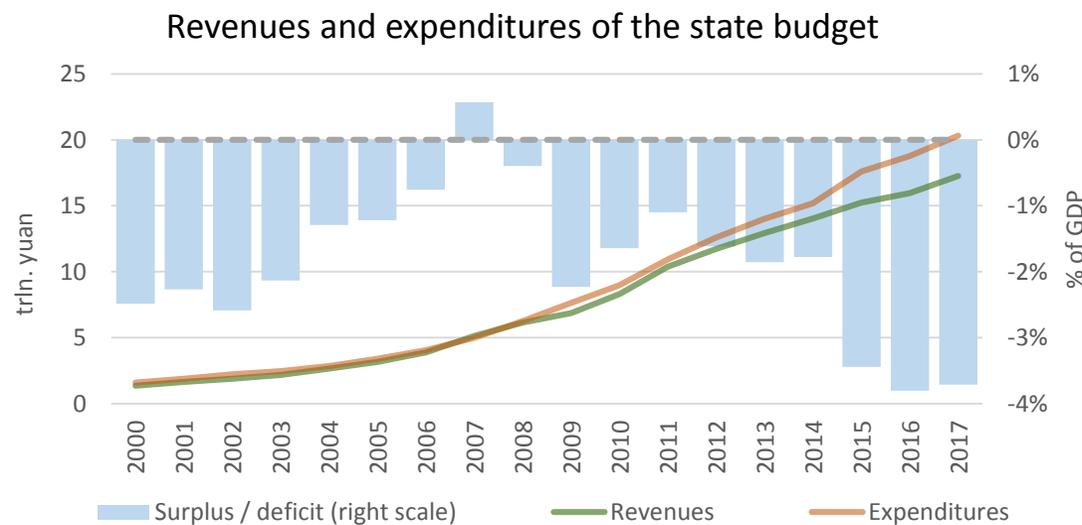
The balance of payments for 2018 as a whole, judging by three quarters (there are no more recent data) should not bring surprises and will be similar in structure to 2017. There were fears that under conditions of a trade war and the devaluation of the yuan, the capital outflow could resume as in the years 2016-2017. But this did not happen, although the article of errors and omissions is still very large and it is not known what it hides.

China is confidently moving towards the so-called "double deficit" when a country has both a current account deficit and a state budget deficit. The current account, as was shown above, is not far from the negative territory, and the state budget in China has long been in short supply, and the situation has worsened over the past three years.

The double deficit forces the government to actively borrow abroad. Many developed countries, in particular the United States, have long been living with a double deficit, and the activity of huge China as a borrower can greatly complicate the situation on the international financial market.



Source: Organization for Economic Co-operation and Development  
\* data for the first three quarters



Source: National Bureau of Statistics of China

## Consumer Sector

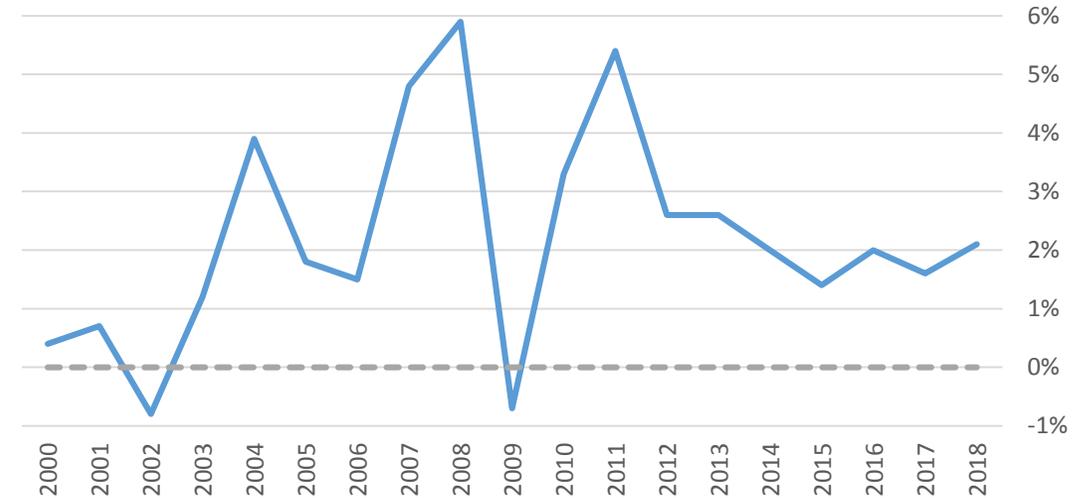
Chinese consumers clearly feel insecure - despite a steady increase in disposable incomes, the retail sales growth sharply collapsed to 3.5%. The consumer inflation at the same time is stable, the deflation, as a possible cause of deferred purchases, is not observed.

### Dynamics of real retail sales and disposable income



Source: National Bureau of Statistics of China

### Consumer price index (CPI)

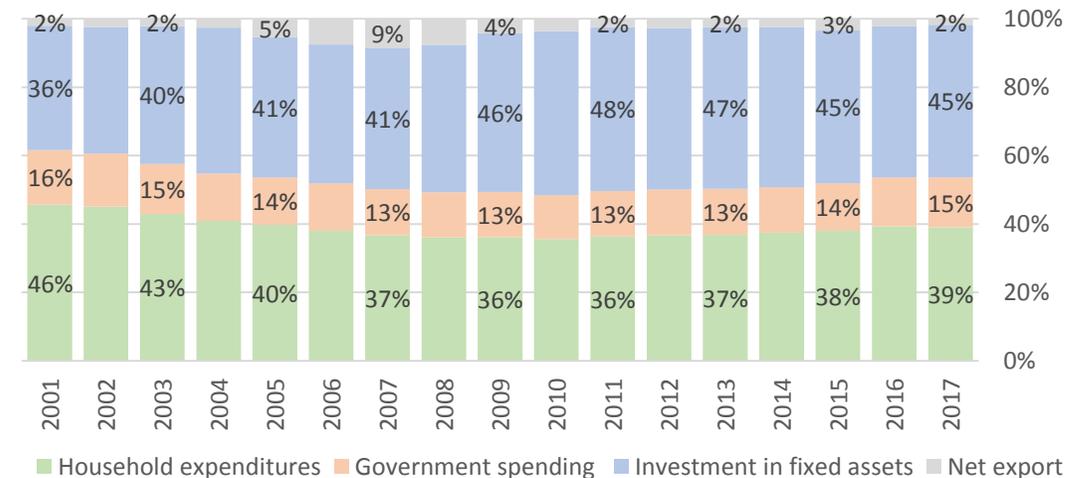


Source: National Bureau of Statistics of China

Overall, the reversal of the economy towards domestic consumption, about which the Chinese leadership spoke after the crisis of 2008, is still rather sluggish. Investments in fixed assets still occupy a little more than half of GDP, and the household spending cannot reach even 40% (in developed countries this figure is about 60%).

It is noteworthy that at present net exports constitute in China a small part of GDP, after 2008 its share was reduced by more than four times.

### GDP according to expenditures



Source: National Bureau of Statistics of China

In 2018, the Chinese economy established a whole range of anti-records — a drop in corporate profits, a contraction of the current account, a decline in retail sales growth rates and the actual stagnation of investments in fixed assets. At the same time, according to Chinese statistics, the economy has only slightly slowed down, which is more indicative of the “quality” of statistics than of the “quality” of the economy.

This year promises to be difficult for China. The PRC is going through a phase of transformation from a developing country, which growth is based on investment, into a developed, consumption oriented one. This direction was set by the Chinese leadership ten years ago, after the 2008 crisis, but it seems that in recent years the changes have accelerated dramatically. China will have to say goodbye to the same growth rate and seriously restructure its economy.