

HAVE WE PASSED 'PEAK CHINA'?
**(AND COULD CHINA HAVE A CURRENCY CRISIS AT SOME
POINT IN THE NEXT FEW YEARS?)**

PRESENTATION TO THE INTERNATIONAL CONFERENCE OF
COMMERCIAL BANK ECONOMISTS

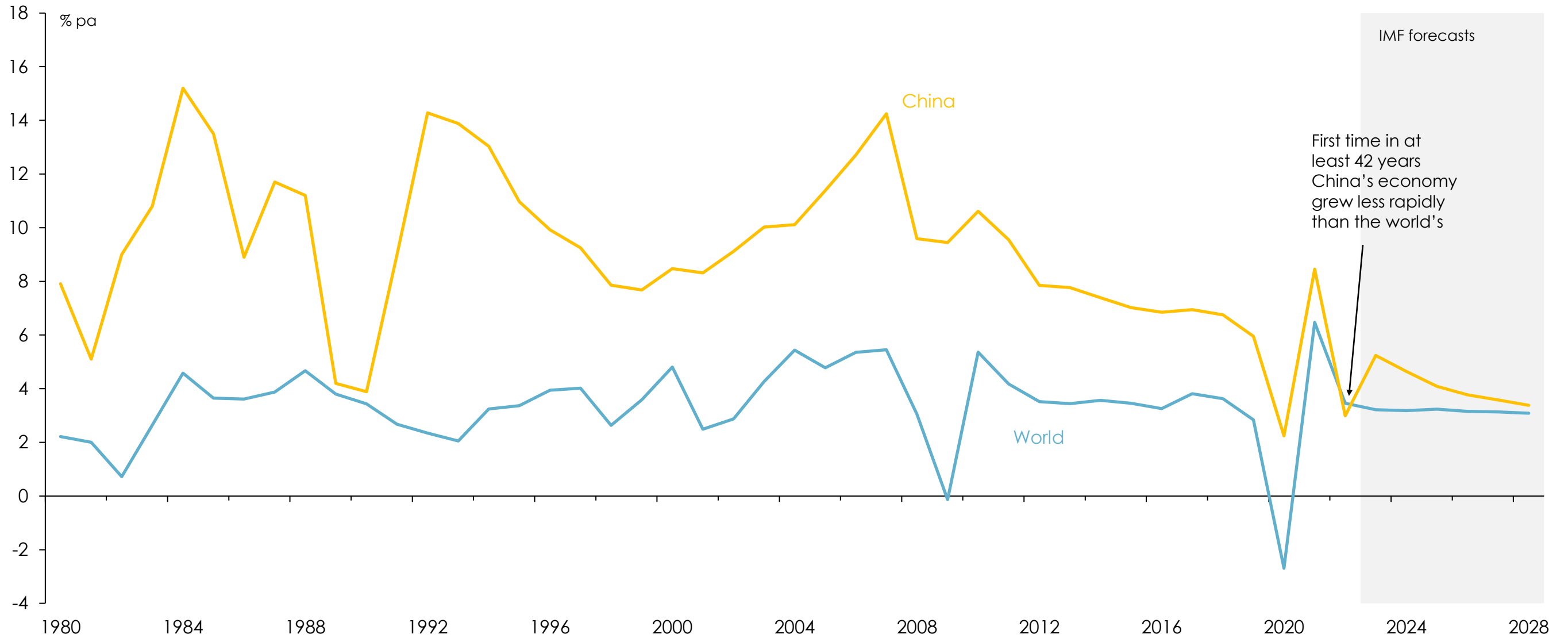
TORONTO, CANADA – 10TH JULY 2024

SAUL ESLAKE

CORINNA ECONOMIC ADVISORY
INDEPENDENT ECONOMICS

China's economy is no longer growing significantly faster than the global average

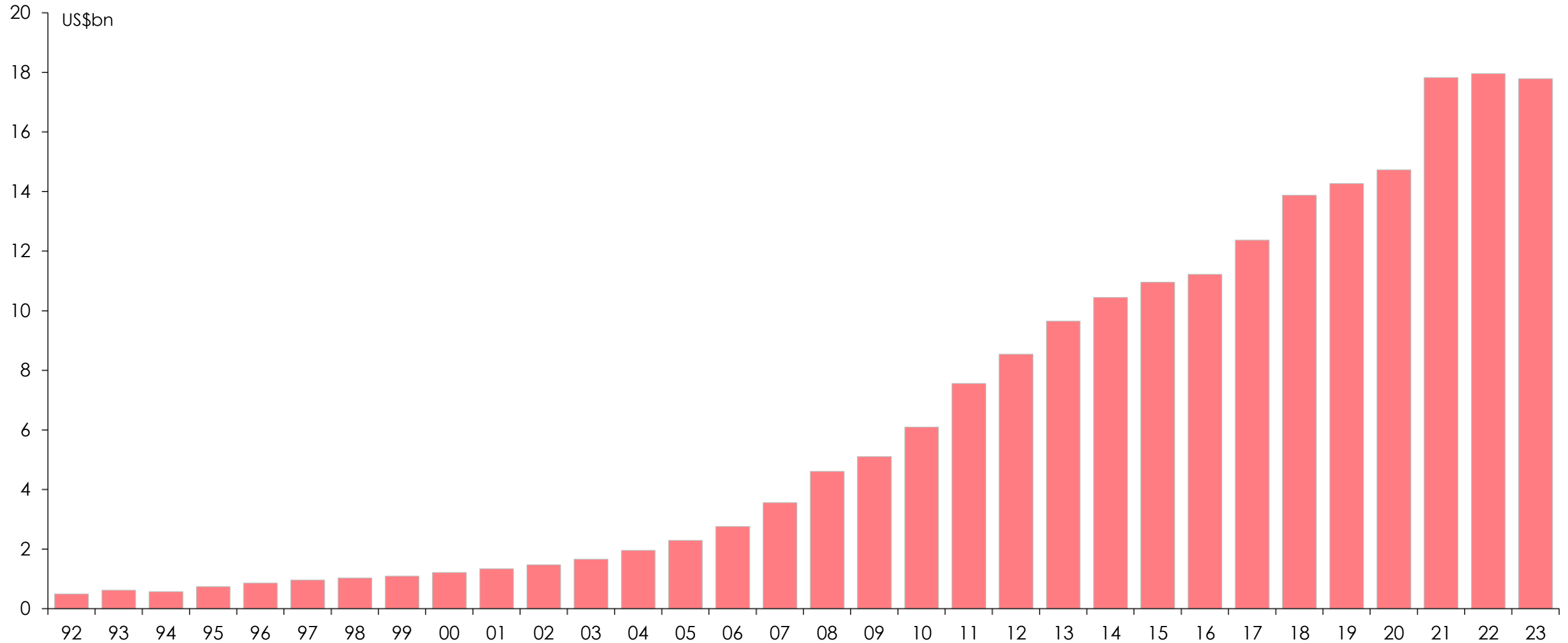
China and world real GDP growth



Sources: International Monetary Fund, [World Economic Outlook database](#), April 2024.

China's economy shrank, in dollar terms last year, for the first time since 1994, with the GDP deflator falling 1% and the yuan losing 4.3% vs the US\$

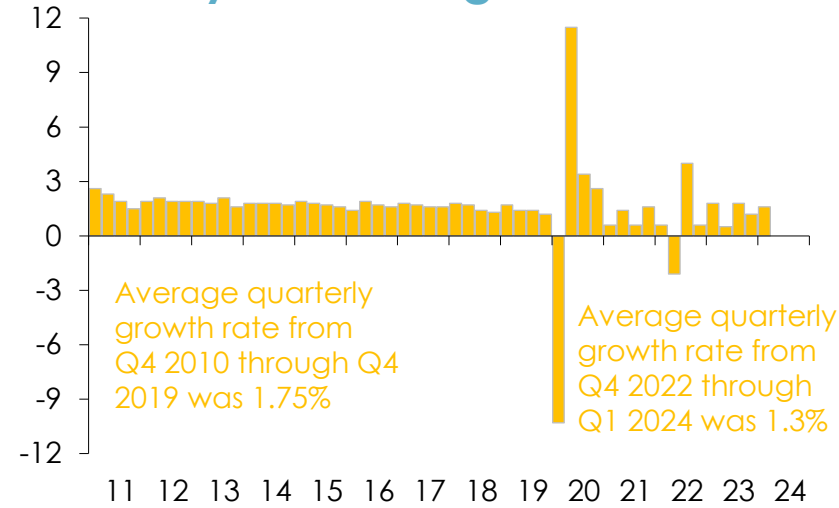
China's nominal GDP in US\$



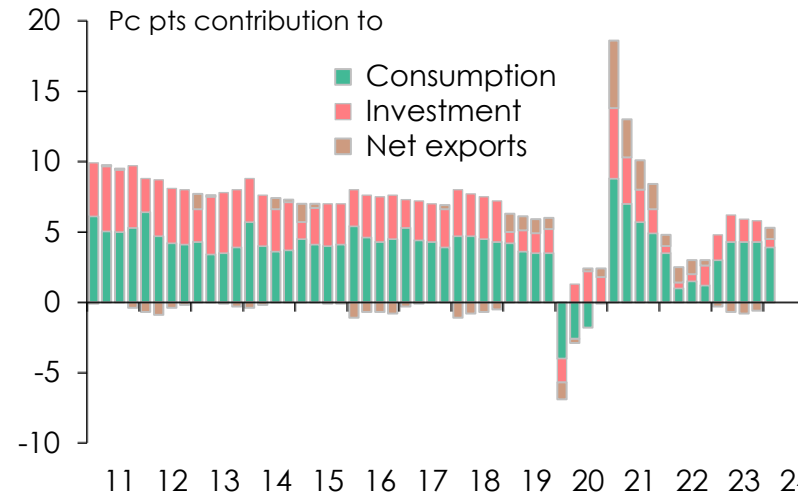
Sources: [National Bureau of Statistics of China](#); Refintiv Datastream; Corinna.

China's post-Covid recovery has been very modest

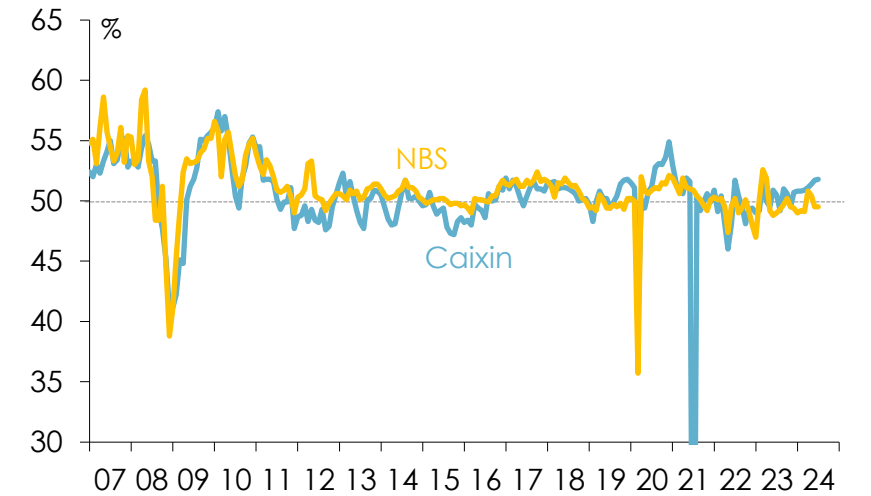
Quarterly real GDP growth



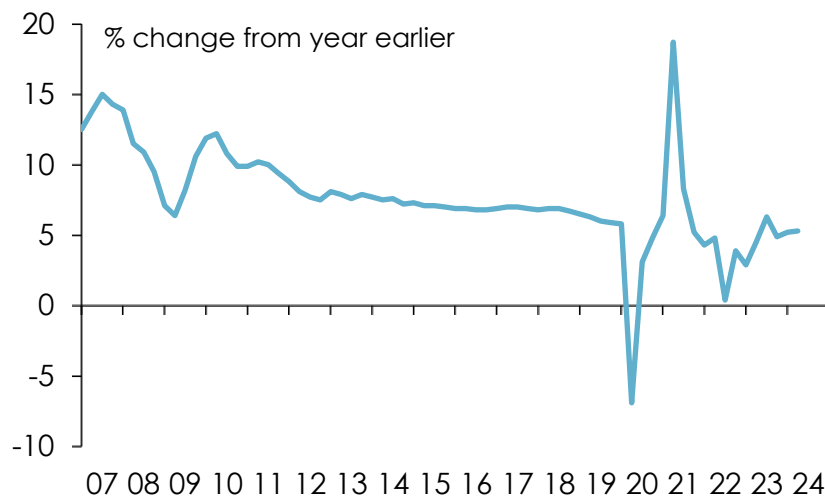
Contributions to GDP growth



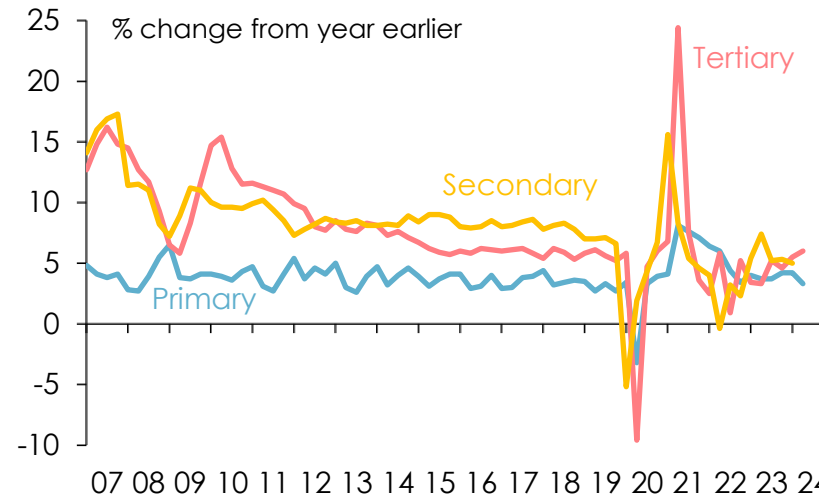
Manufacturing PMIs



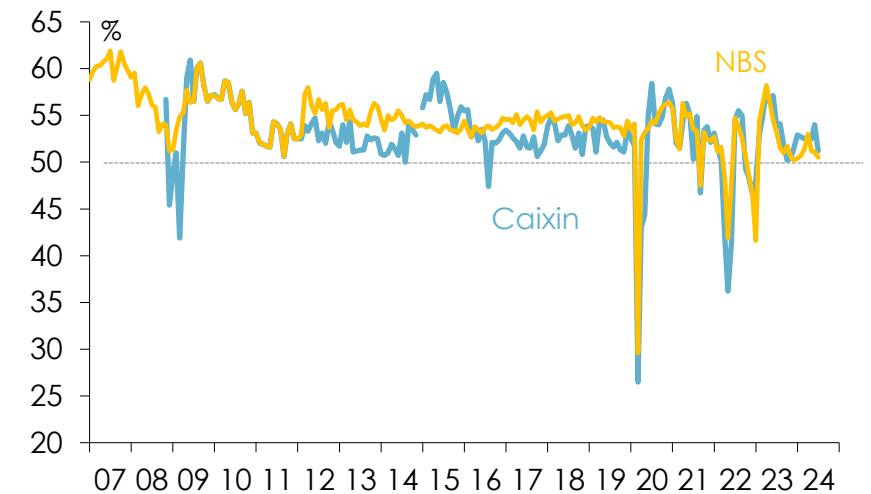
Annual real GDP growth



Annual real GDP growth, by sector

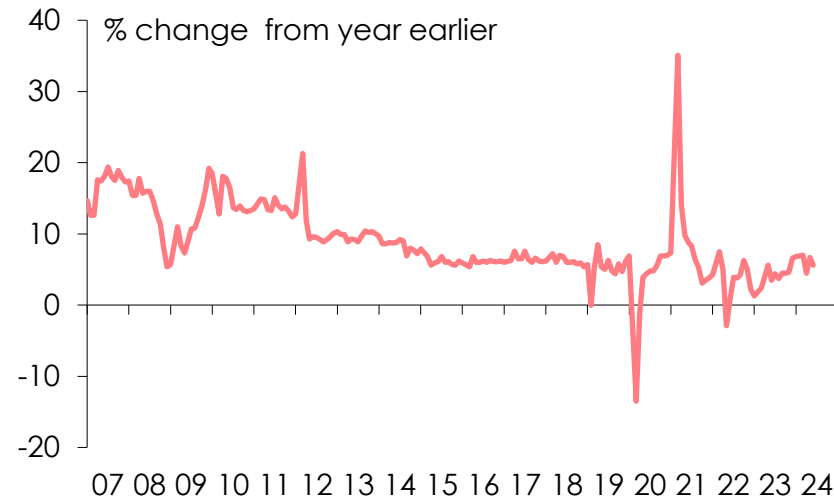


Services PMIs

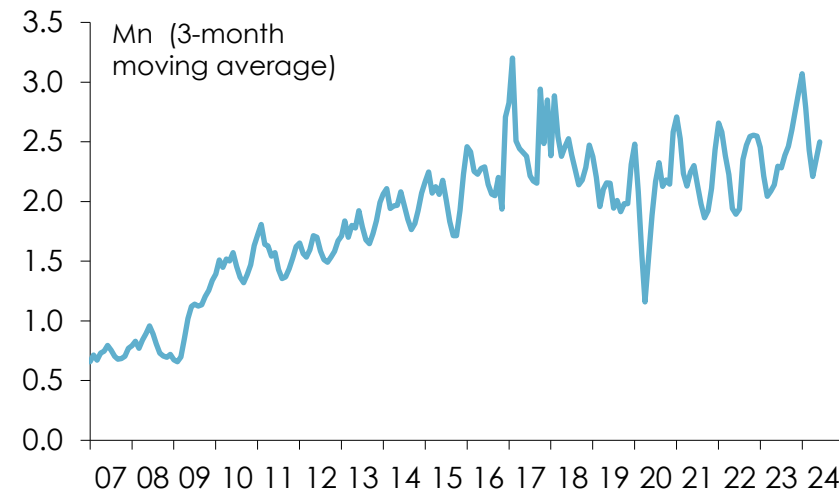


Both the 'supply' and 'demand' sides remain soft – except for motor vehicle production and sales

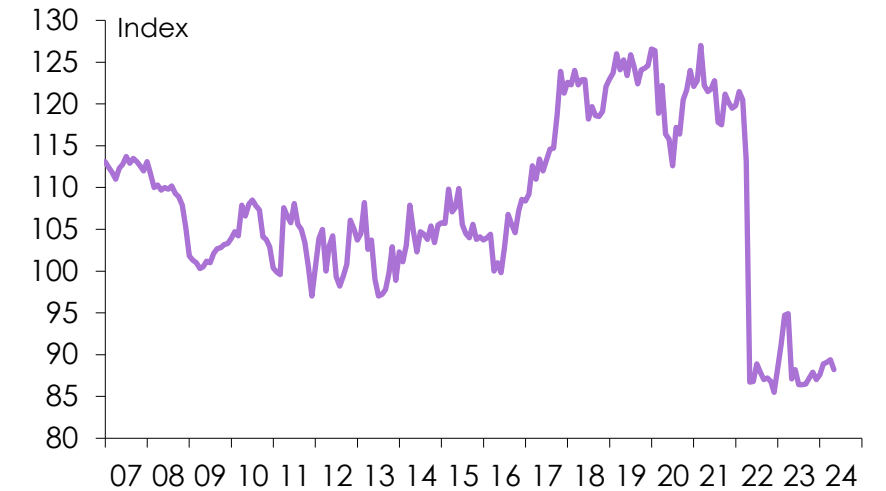
Industrial production



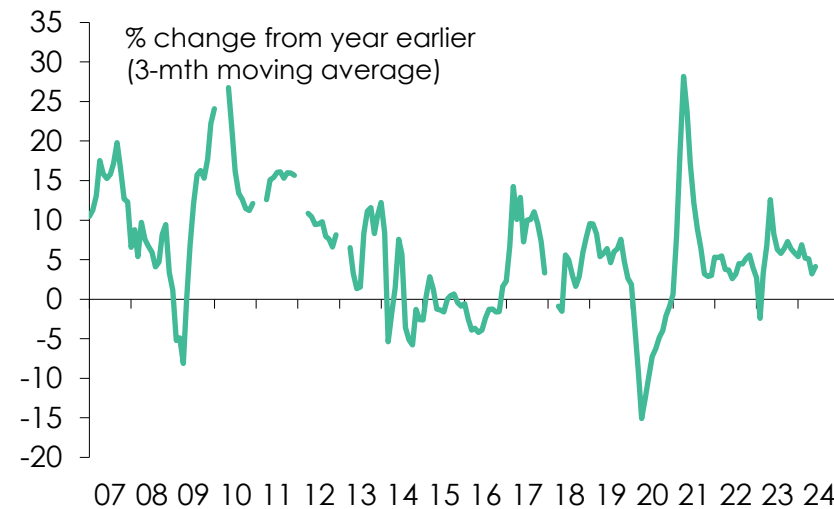
Motor vehicle production



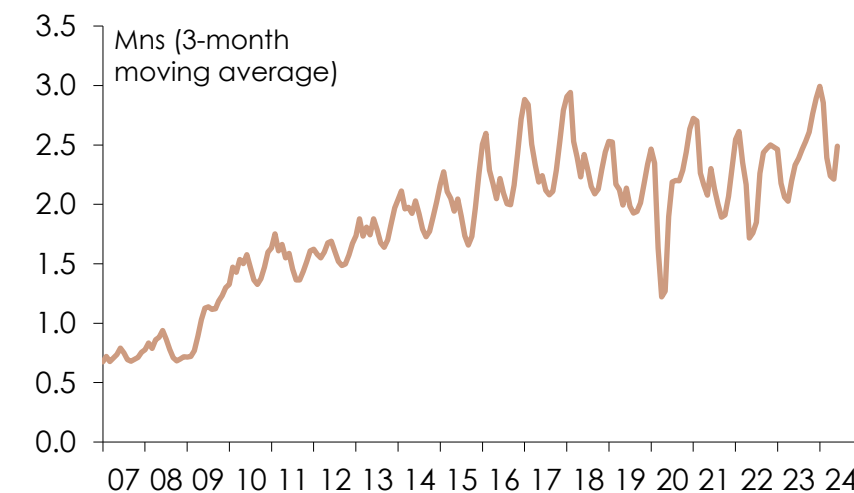
Consumer sentiment



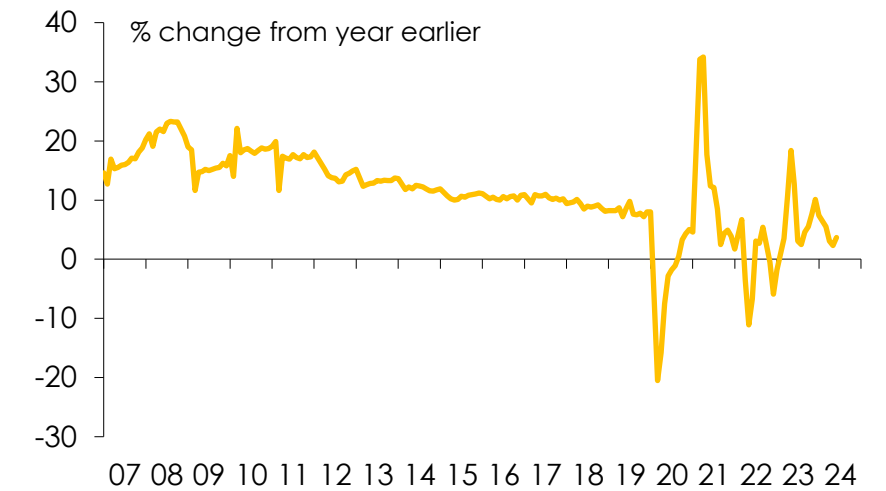
Freight traffic carried



Motor vehicle sales



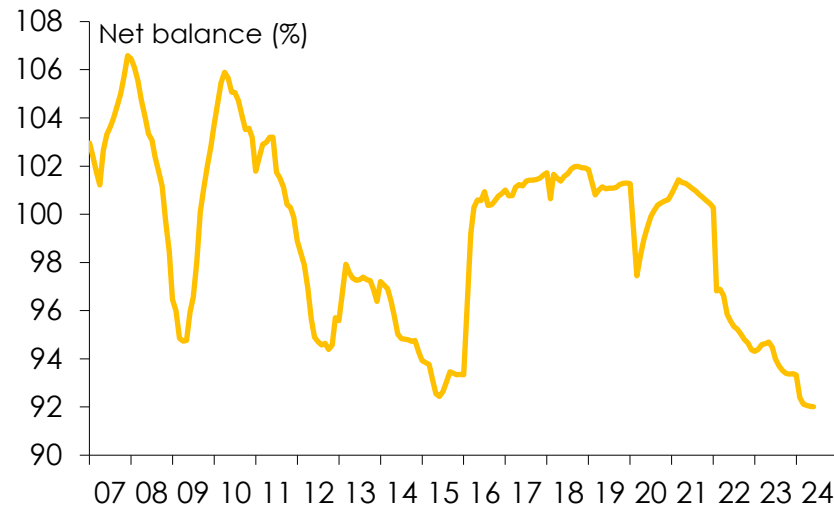
Retail sales



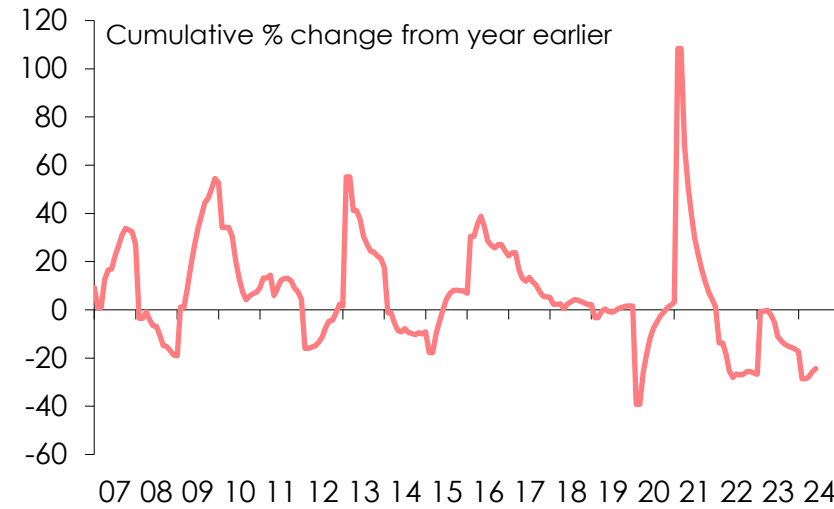
Sources: [National Bureau of Statistics of China](#).

Property development – a major driver of growth up until 2018-19 – remains moribund

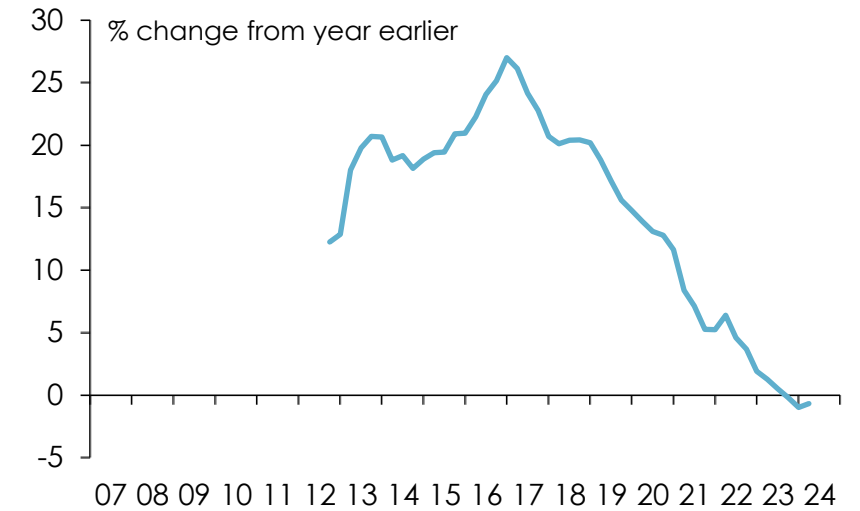
Real estate climate index



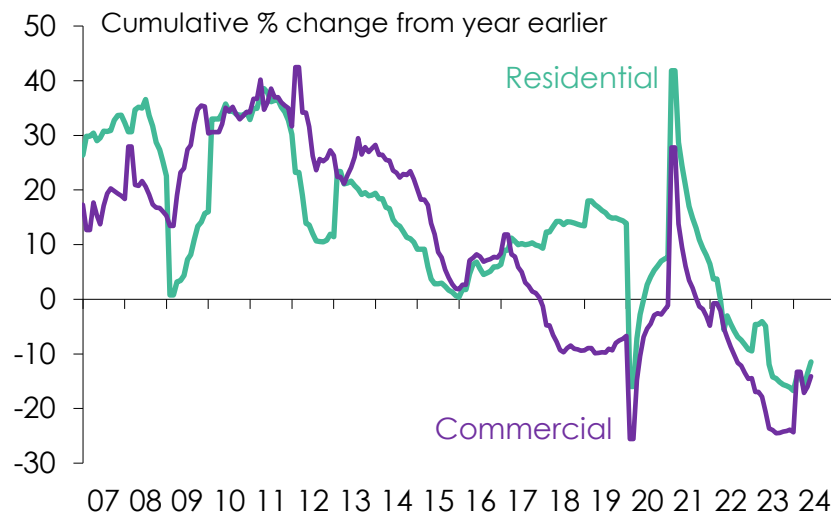
Residential floor space sold



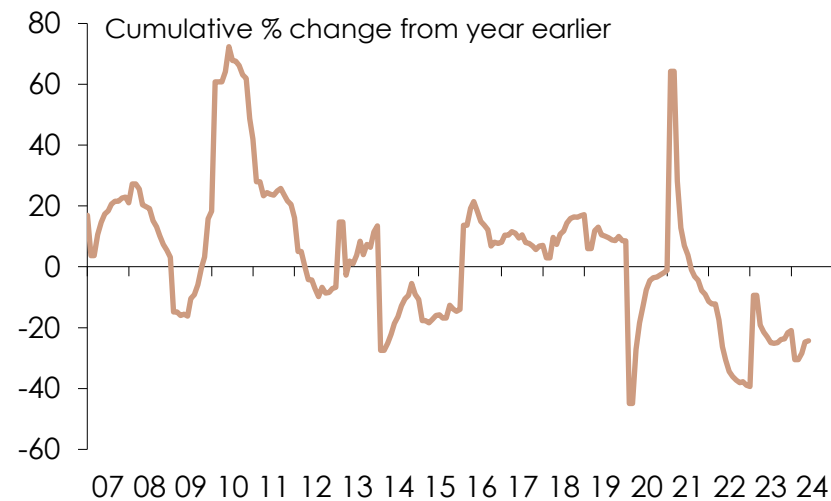
Real estate lending



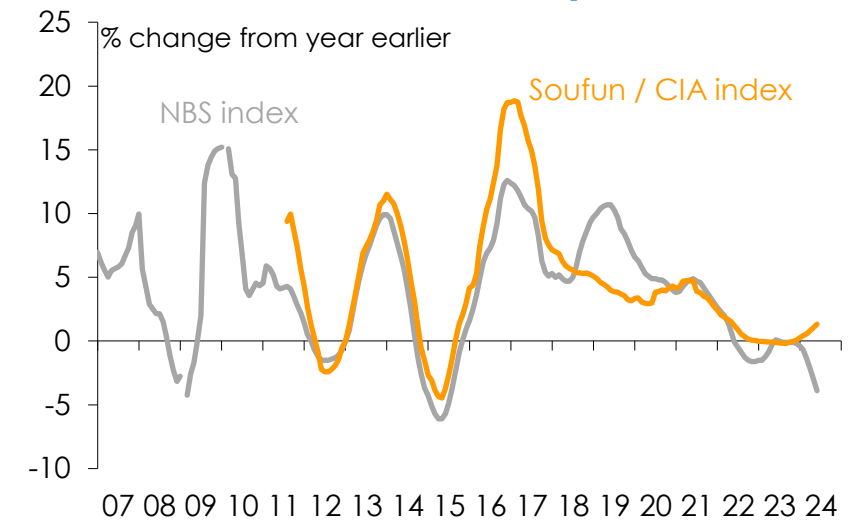
Real estate investment



Residential floor space started

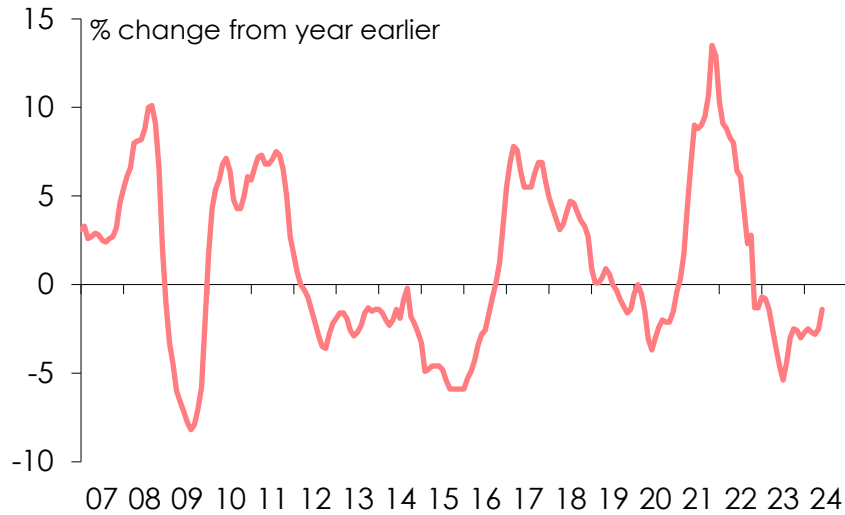


Residential real estate prices

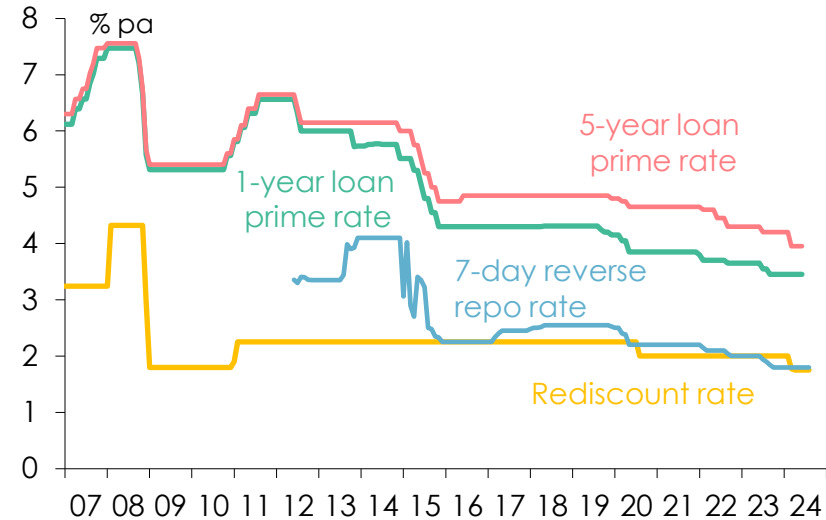


One problem China doesn't have is inflation – but the authorities remain very cautious about providing additional policy stimulus

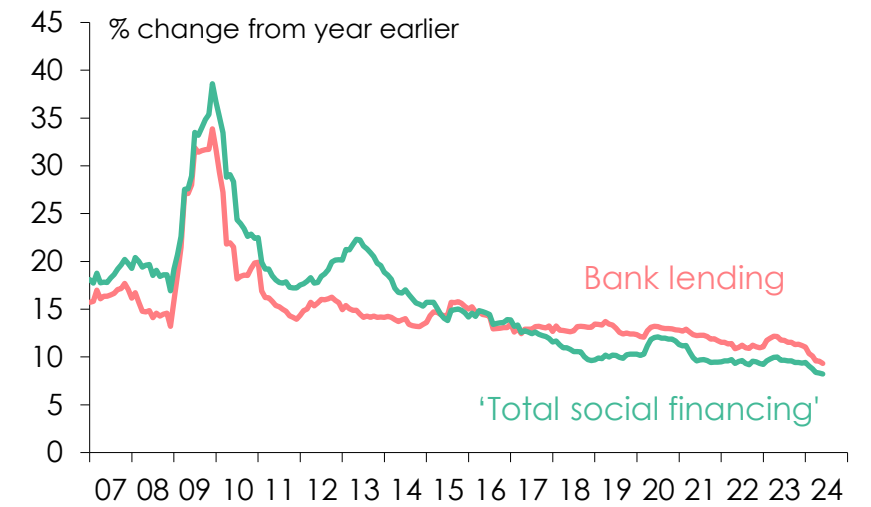
Producer prices



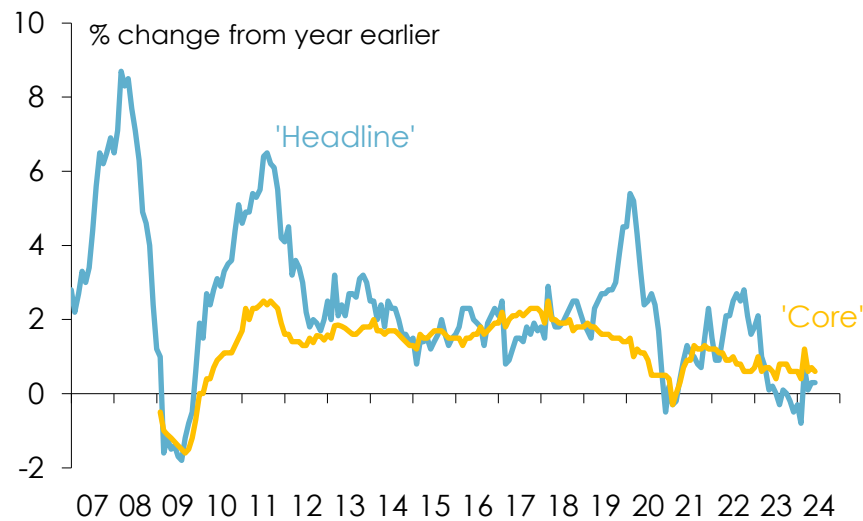
PBoC policy interest rates



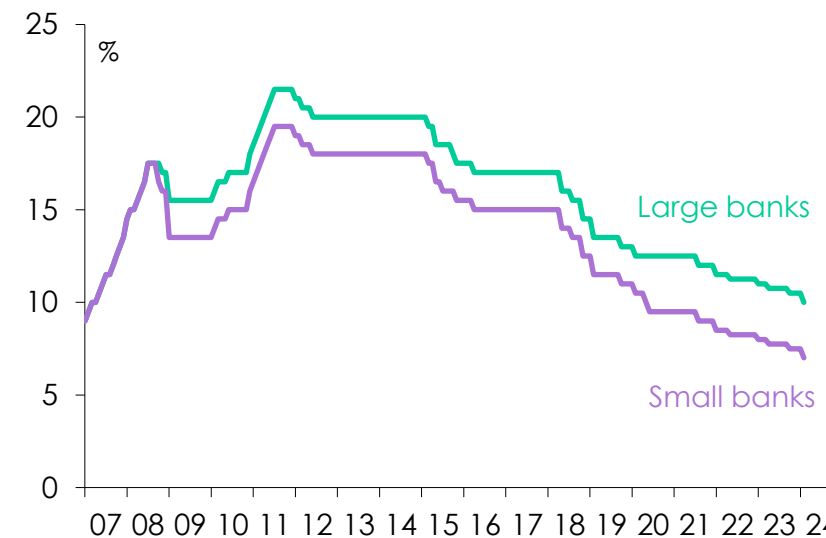
Credit growth



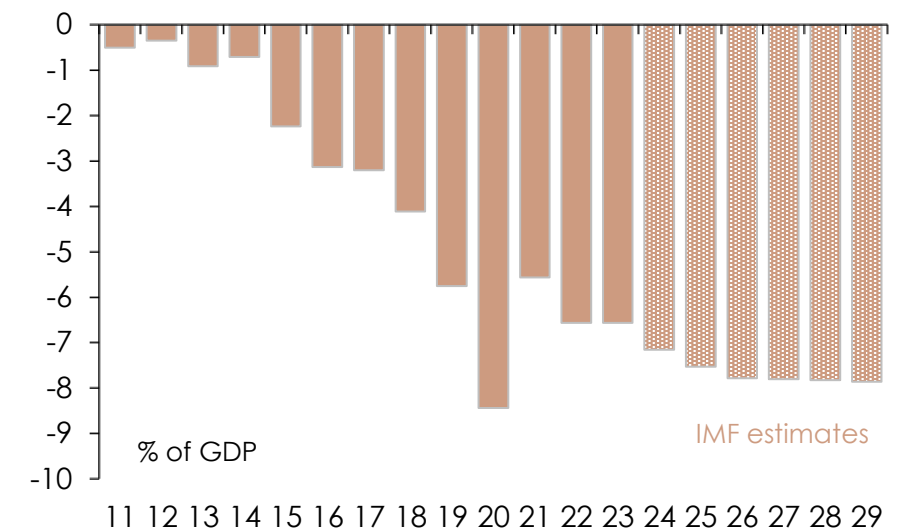
Consumer prices



Bank reserve requirement ratios

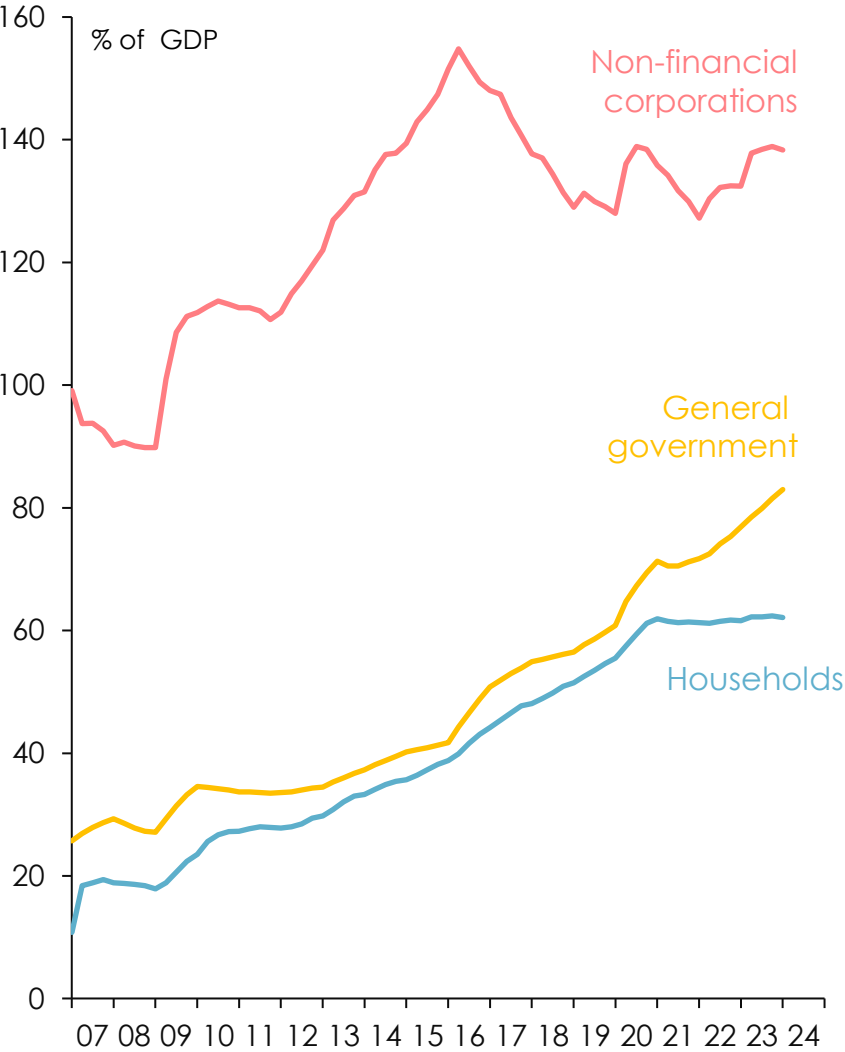


Government budget structural balance



That in large part reflects the authorities' on-going concern about China's high level of debt, especially in the corporate sector ...

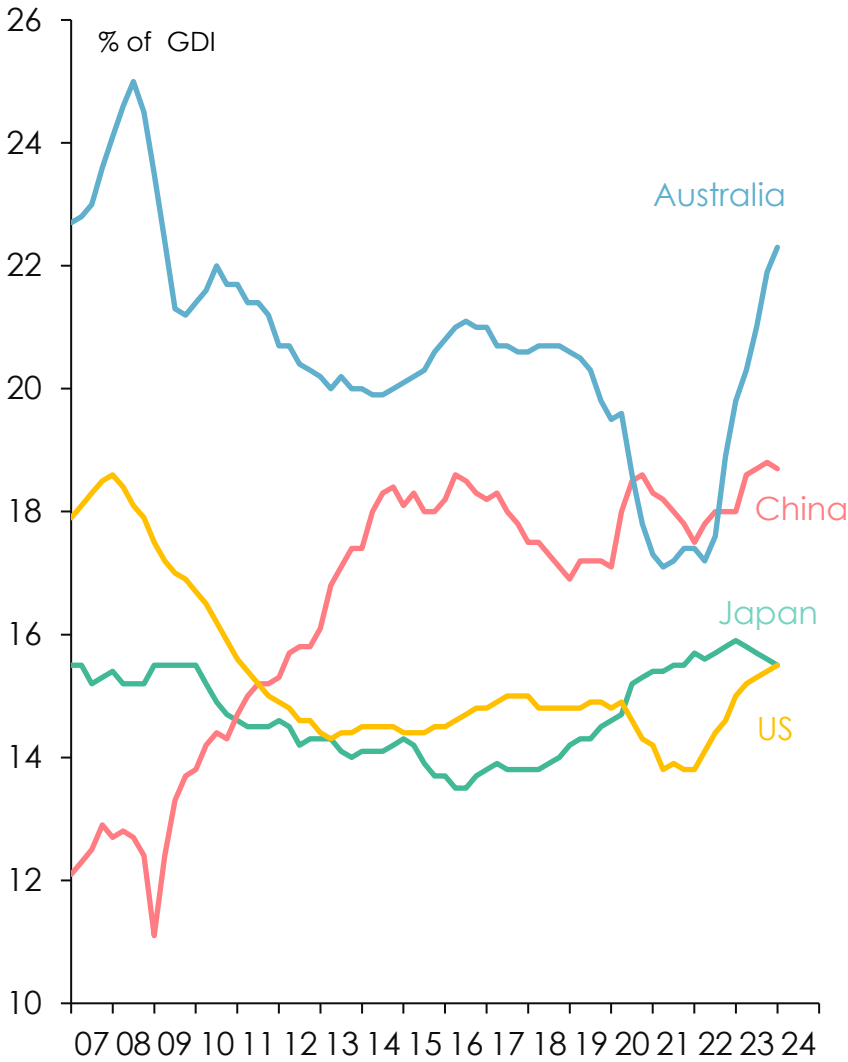
Debt as a percentage of GDP, by sector



China's debt compared with other emerging & advanced economies



Debt servicing ratios

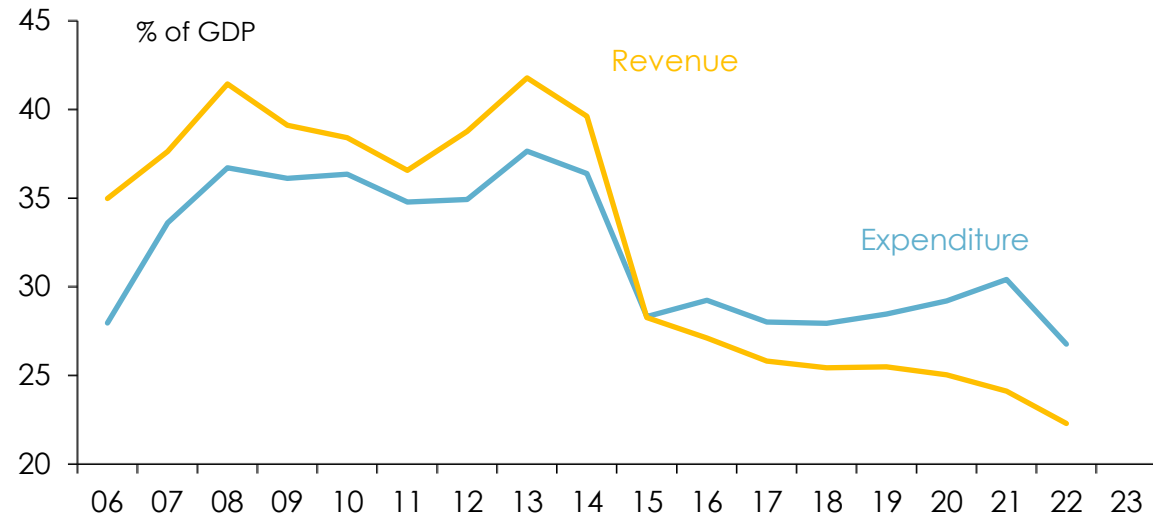


Note: 'general government' excludes state-owned enterprises, which are included in non-financial corporations.

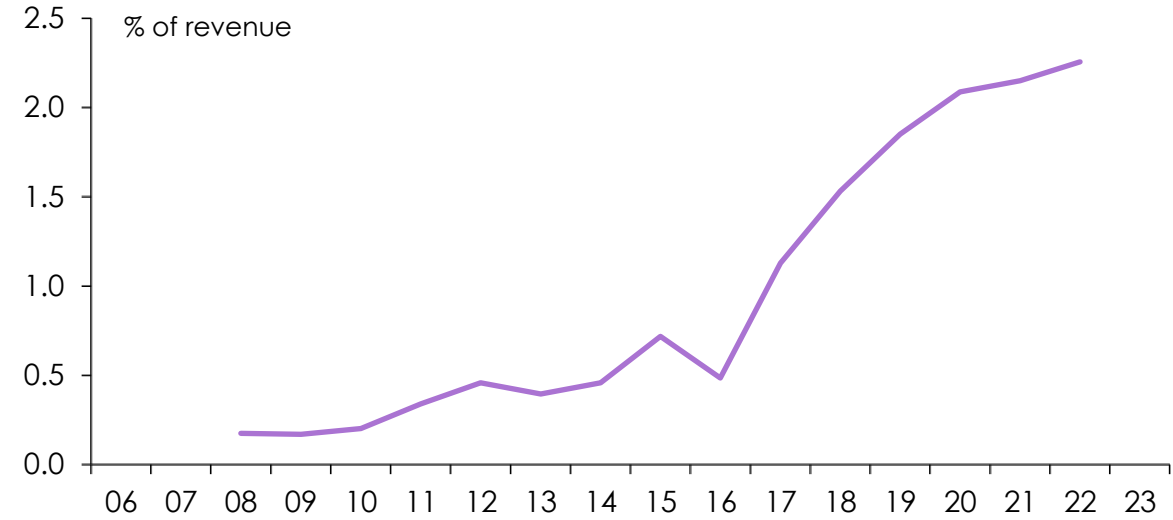
Source: Bank for International Settlements, [Credit to the non-financial sector](#), December 2023.

... and among local governments

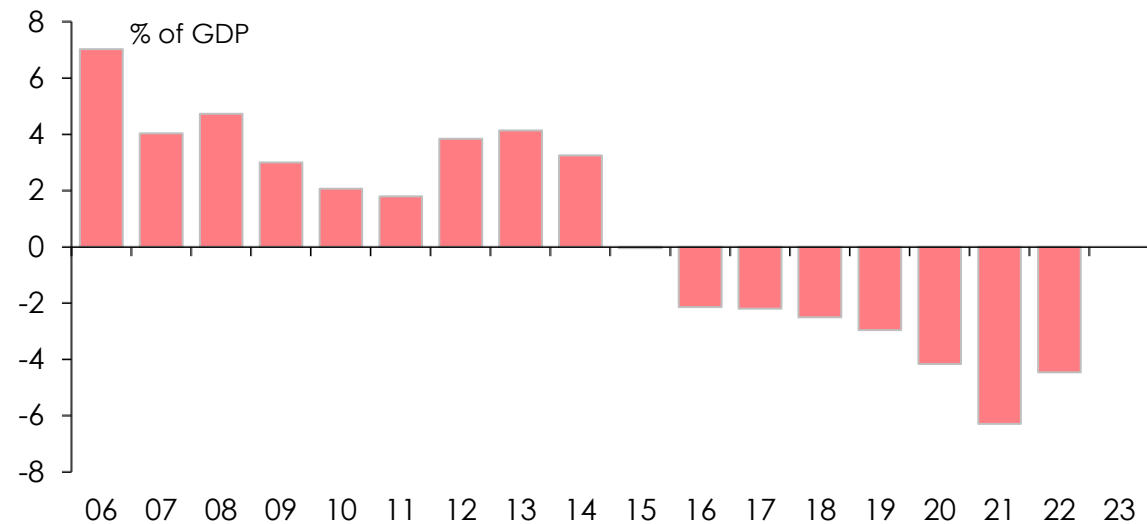
Local government spending and revenue



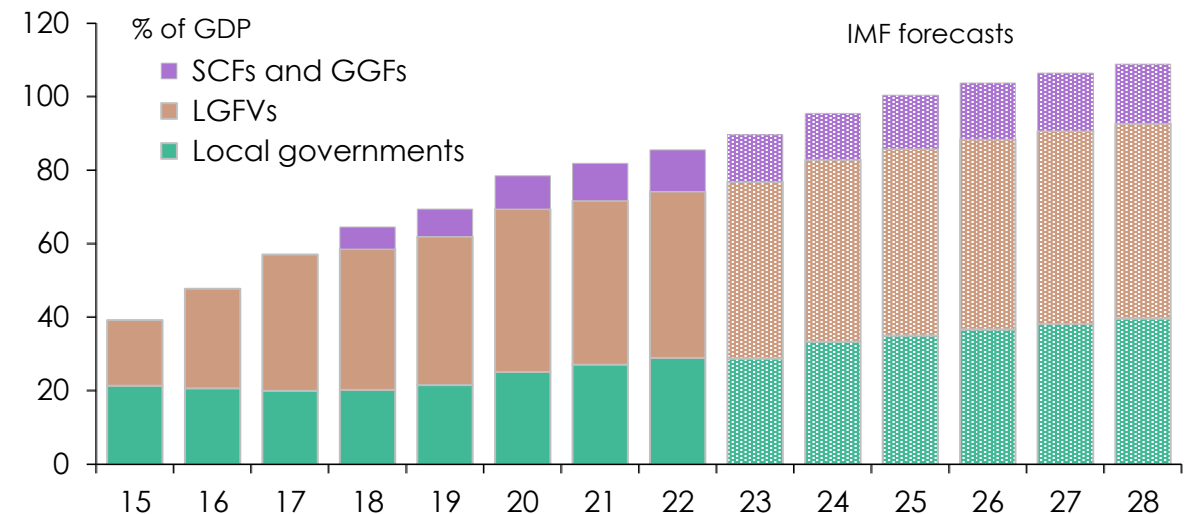
Local government interest expense



Local government surplus/deficit

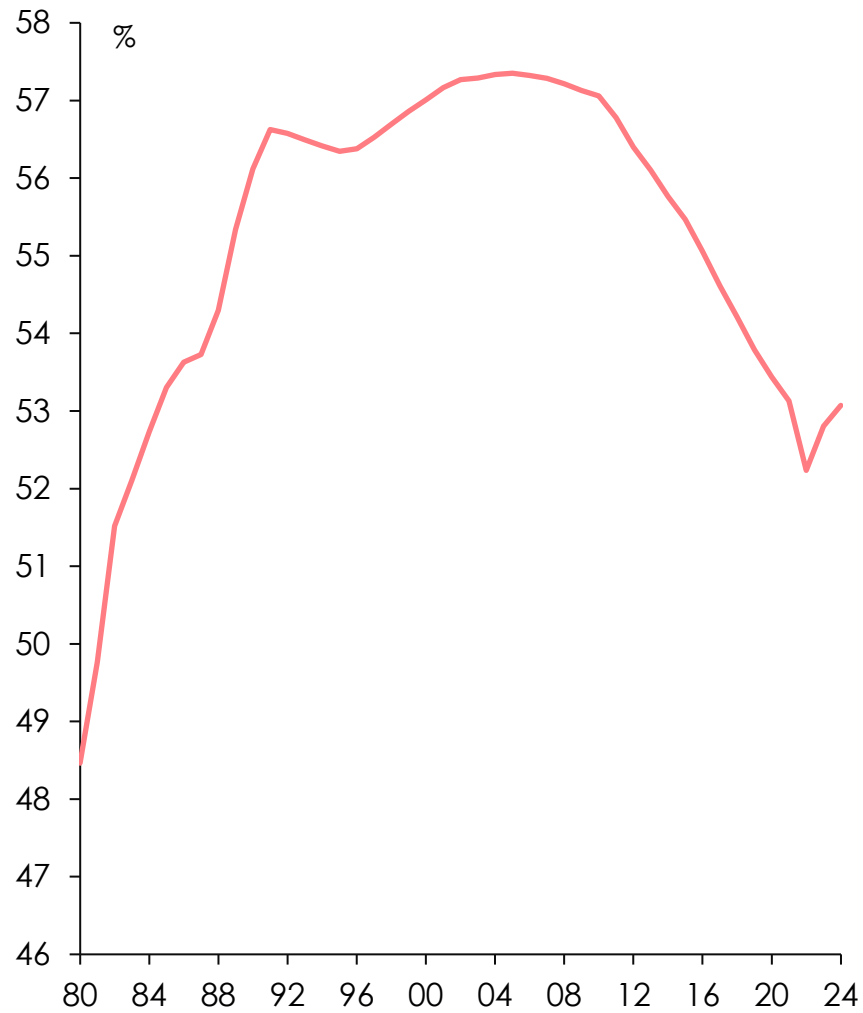


Local government debt

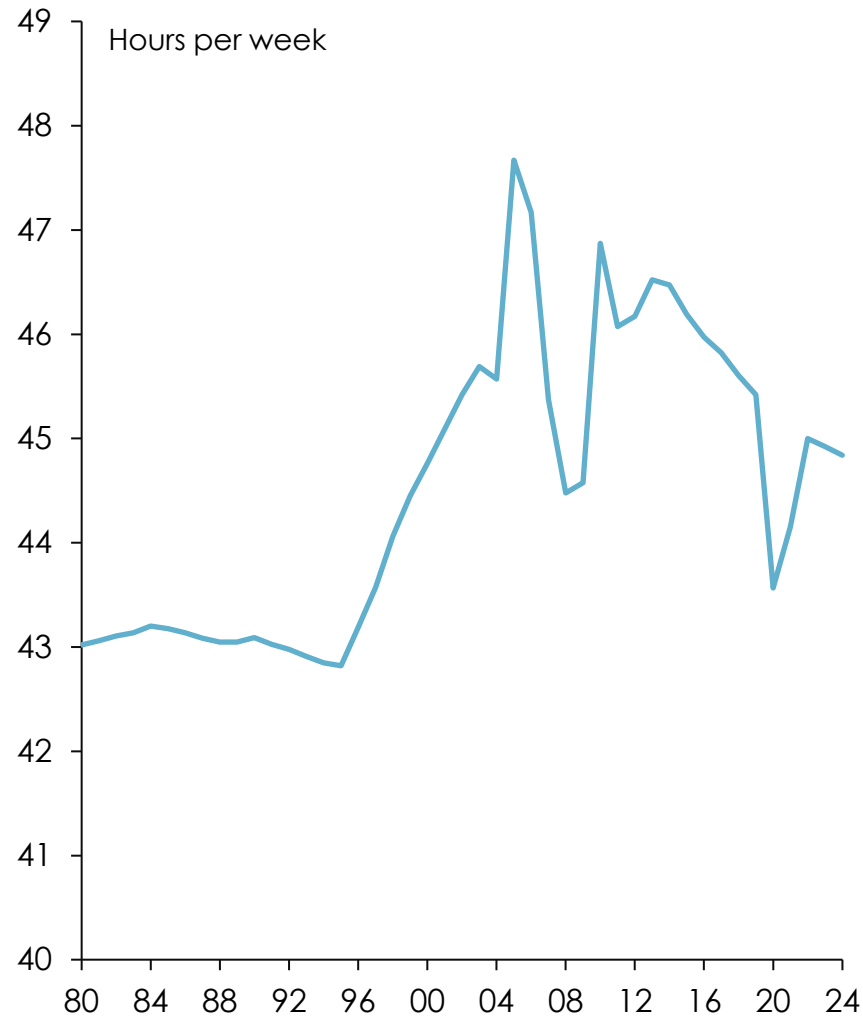


China's economic slowdown is structural, not cyclical ...

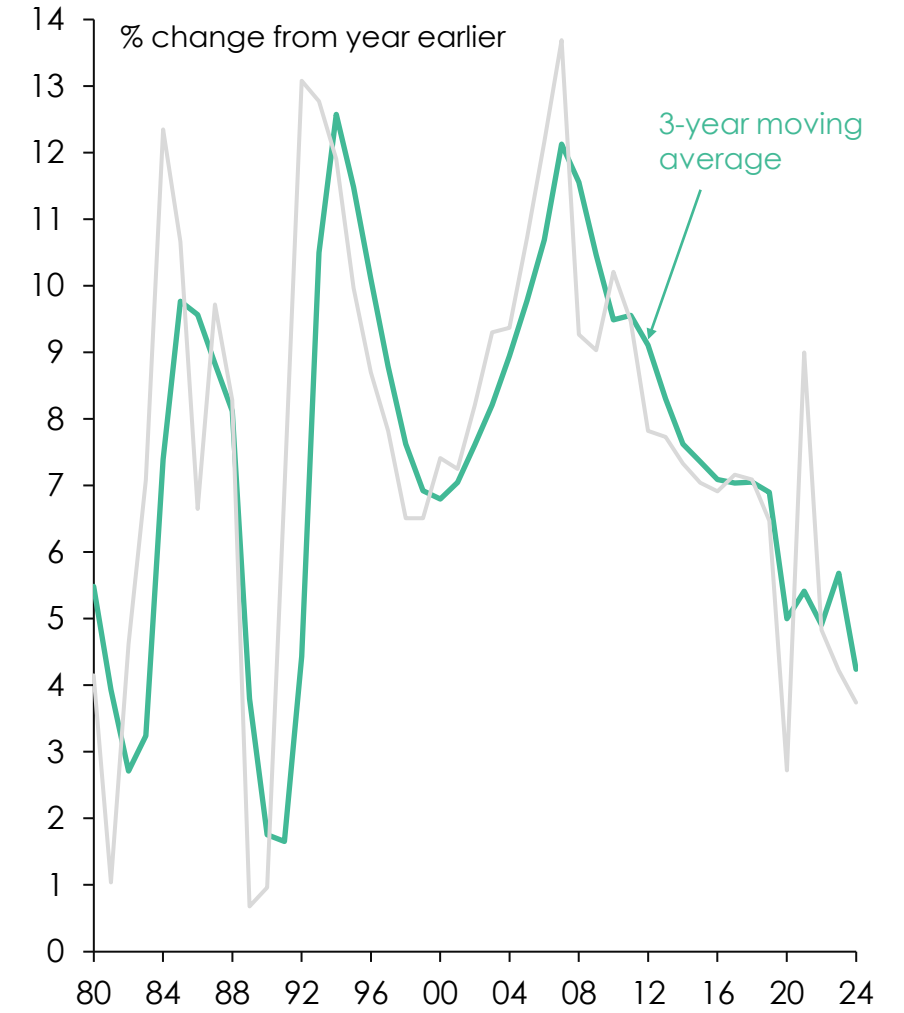
Employment as a pc of population



Average hours worked



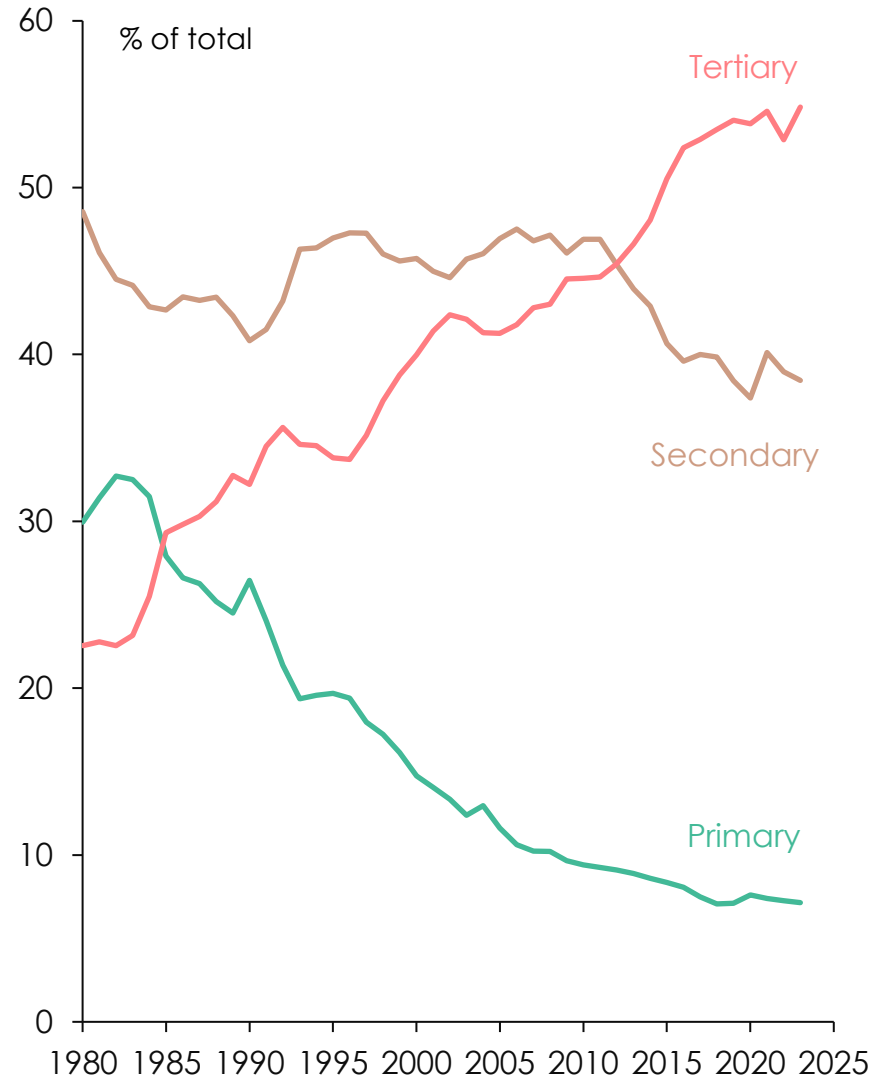
Output per hour worked (aka labour productivity)



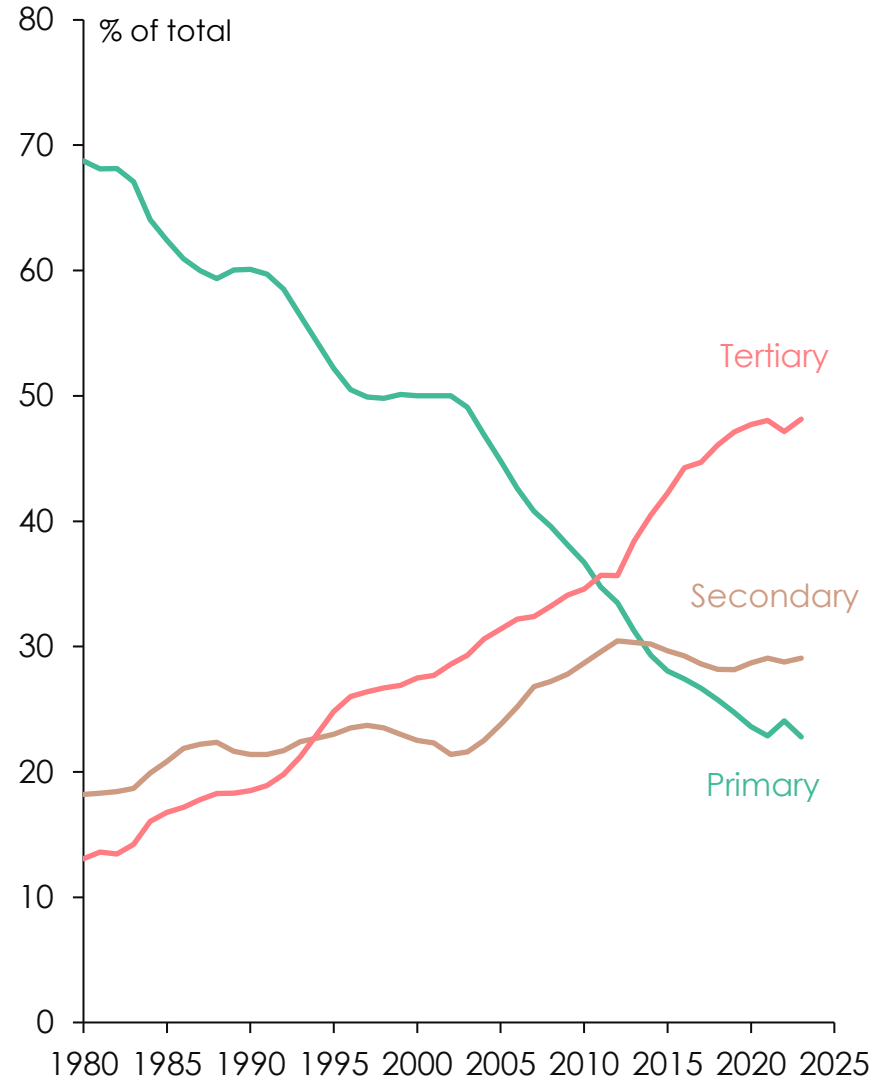
Source: The Conference Board, [Total Economy Database](#), May 2024.

Rapid labour productivity growth will be much harder to achieve given long-term changes in the structure of output and employment

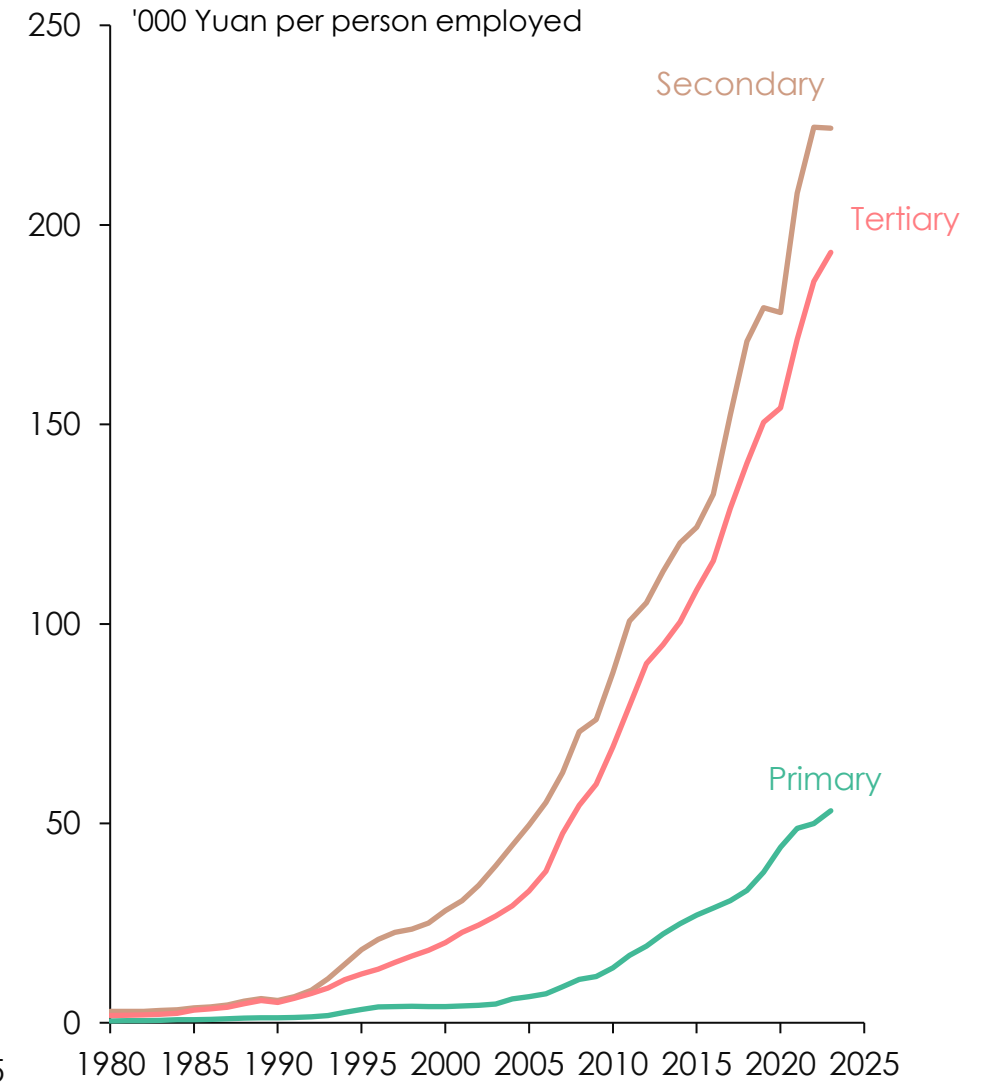
Sector shares of GDP



Sector shares of employment



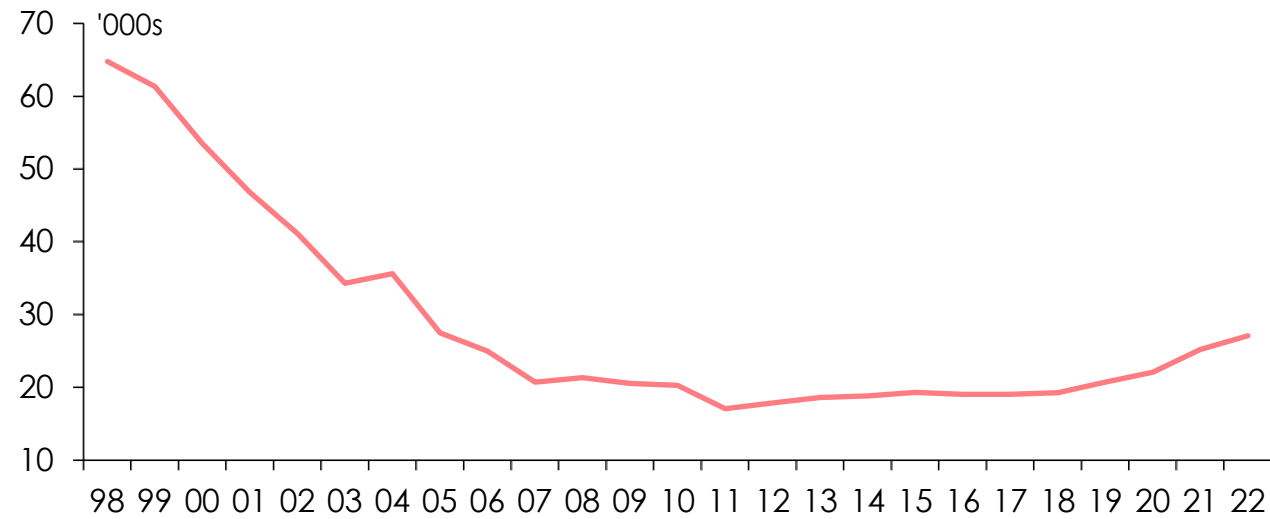
Sector labour productivity



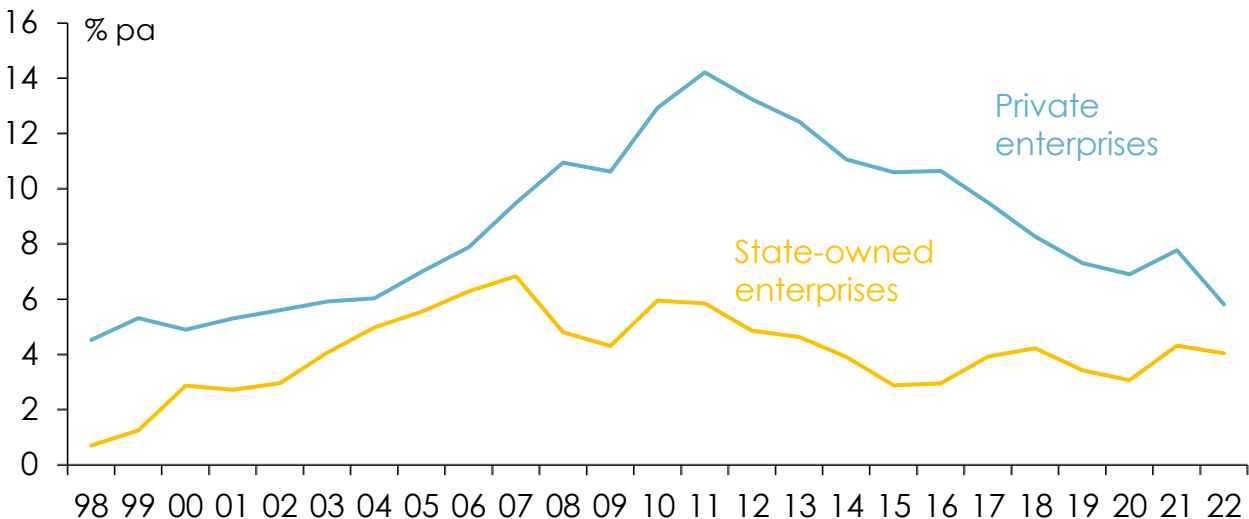
Sources: National Bureau of Statistics, [China Statistical Yearbook 2023](#).

State-owned enterprise reform appears to have stalled – but at least in the industrial sector the performance of private enterprises has also faltered

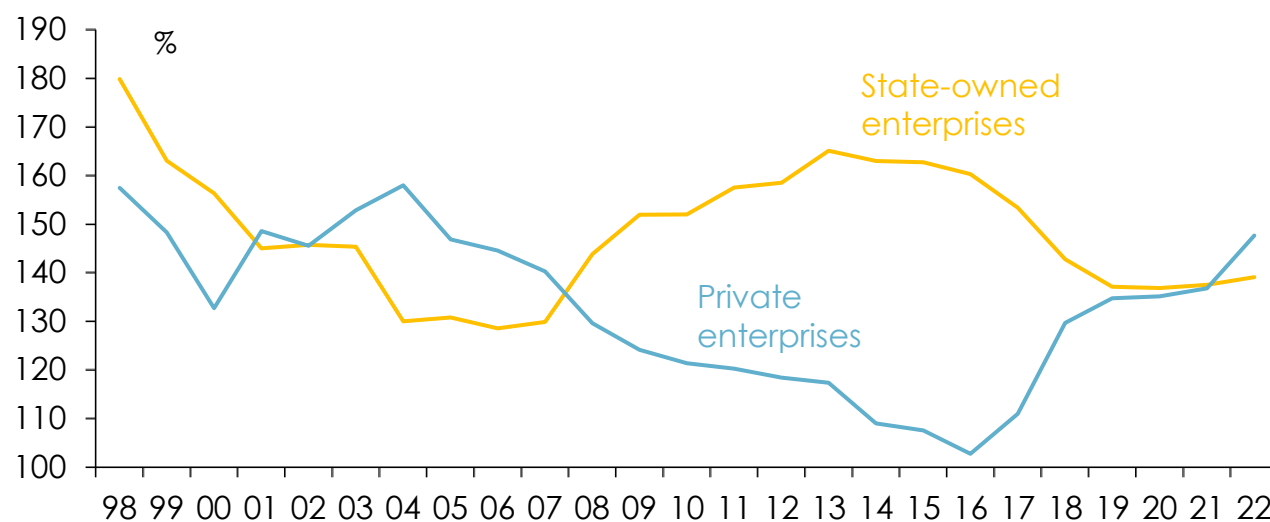
Number of state-owned industrial enterprises



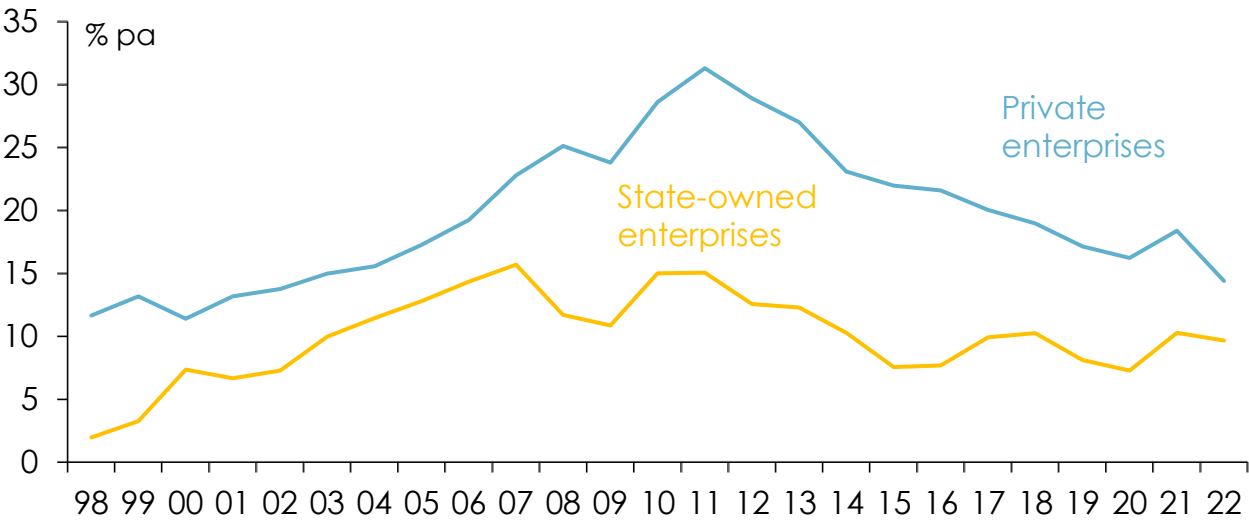
Return on assets of industrial enterprises



Debt-equity ratios of industrial enterprises

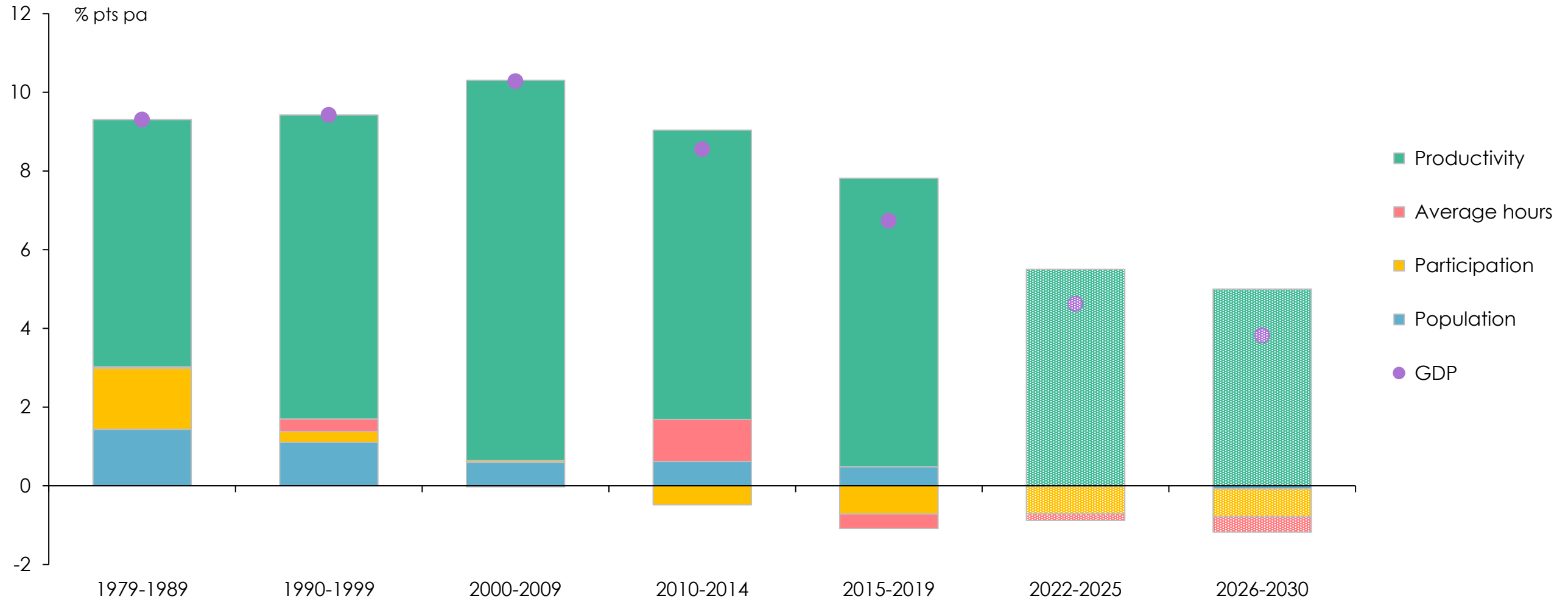


Return on equity of industrial enterprises



Source: China National Bureau of Statistics, [China Statistical Yearbook 2023](#) and previous issues.

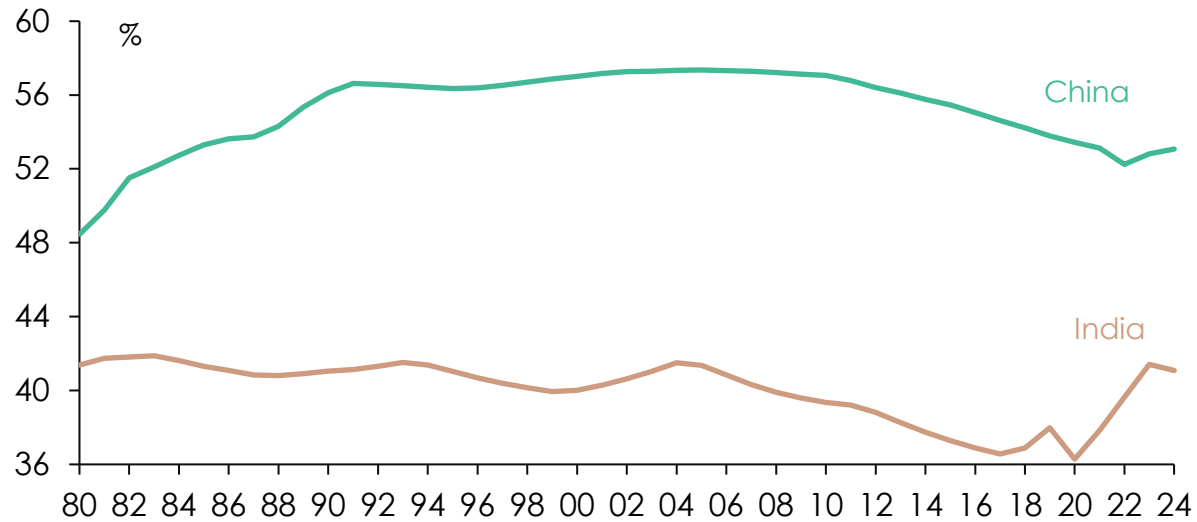
China's average annual real GDP growth rate seems bound to slow to less than 4% during the second half of this decade



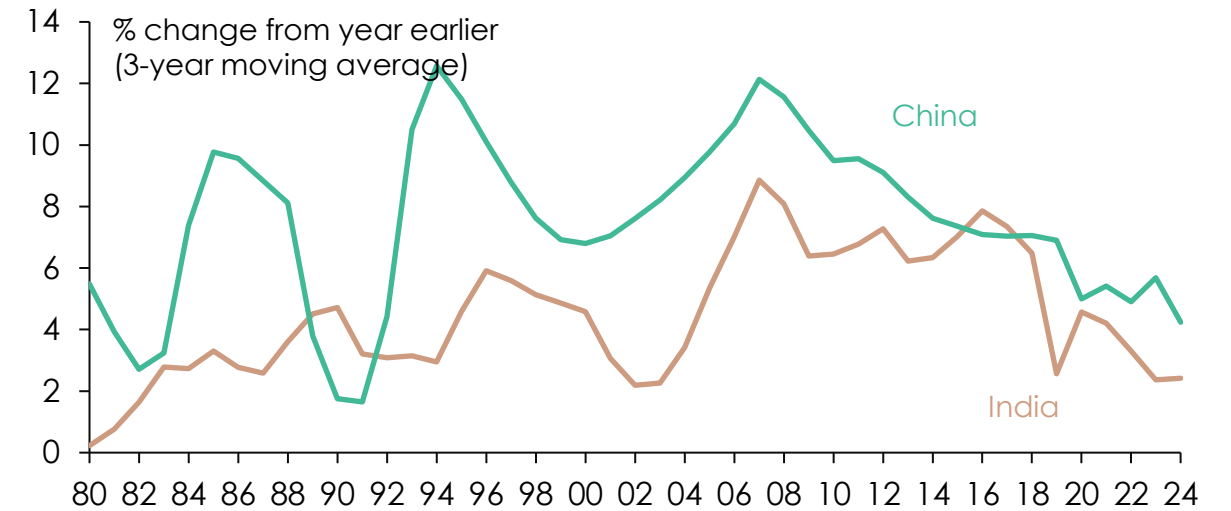
- ❑ Total and working-age population projections from UN World Population Prospects (medium variant)
- ❑ Employment-to-working-age population ratio (optimistically) assumed unchanged from 2022 value
- ❑ Average hours worked assumed to decline by 0.4% pa (2015-2019 average)
- ❑ Labour productivity growth (arbitrarily) assumed to average 5½% pa over 2022-25 and 5% pa over 2026-2030

Incidentally, the 'three Ps' framework helps explain why India will never be another China

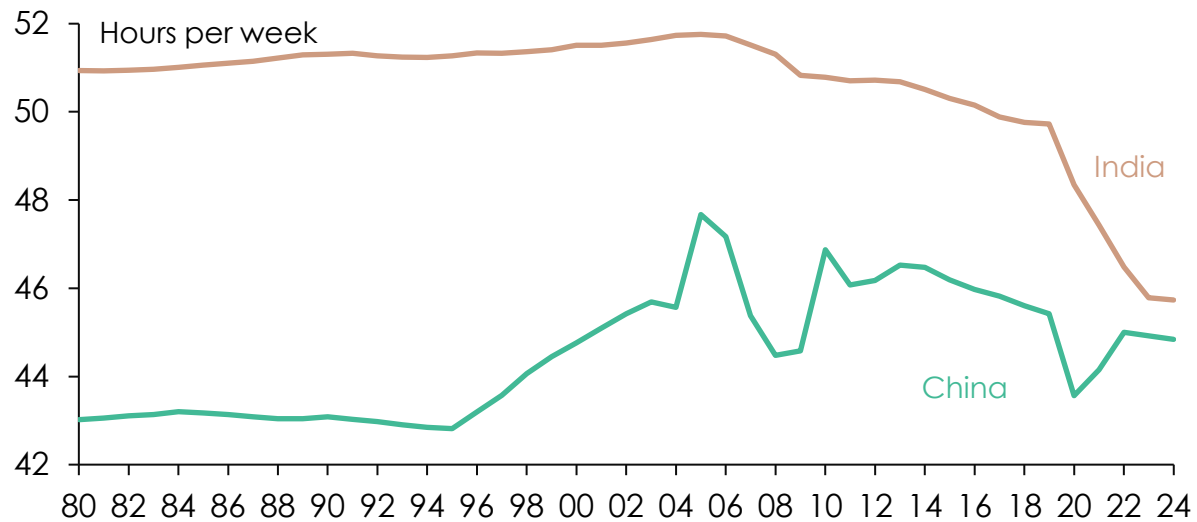
Employment participation ratio



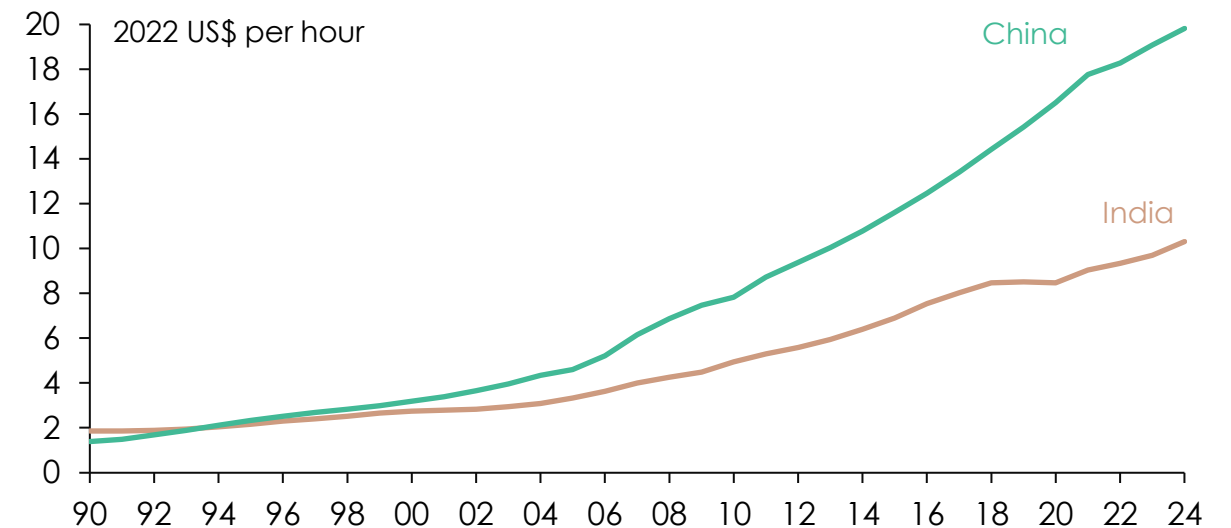
Labour productivity growth



Average hours worked



Level of labour productivity



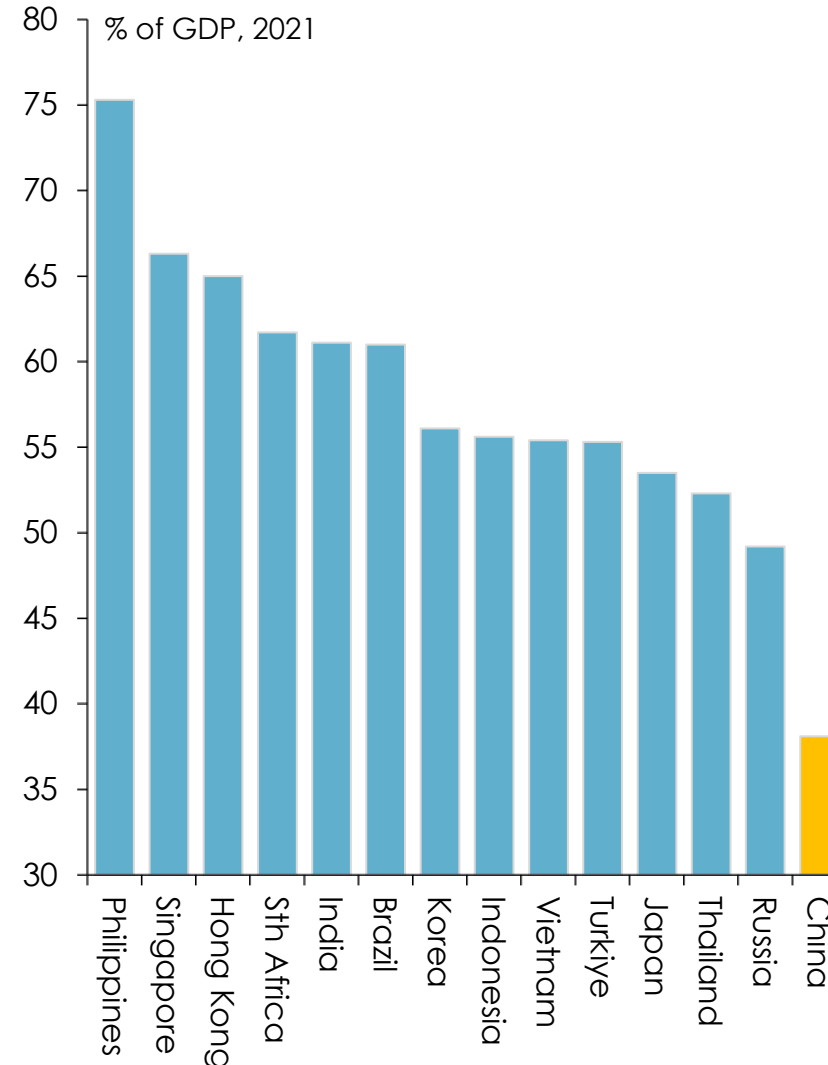
Source: The Conference Board, [Total Economy Database](#), May 2024.

In principle, China could sustain stronger growth by lifting household spending, but that won't happen while households feel obliged to save

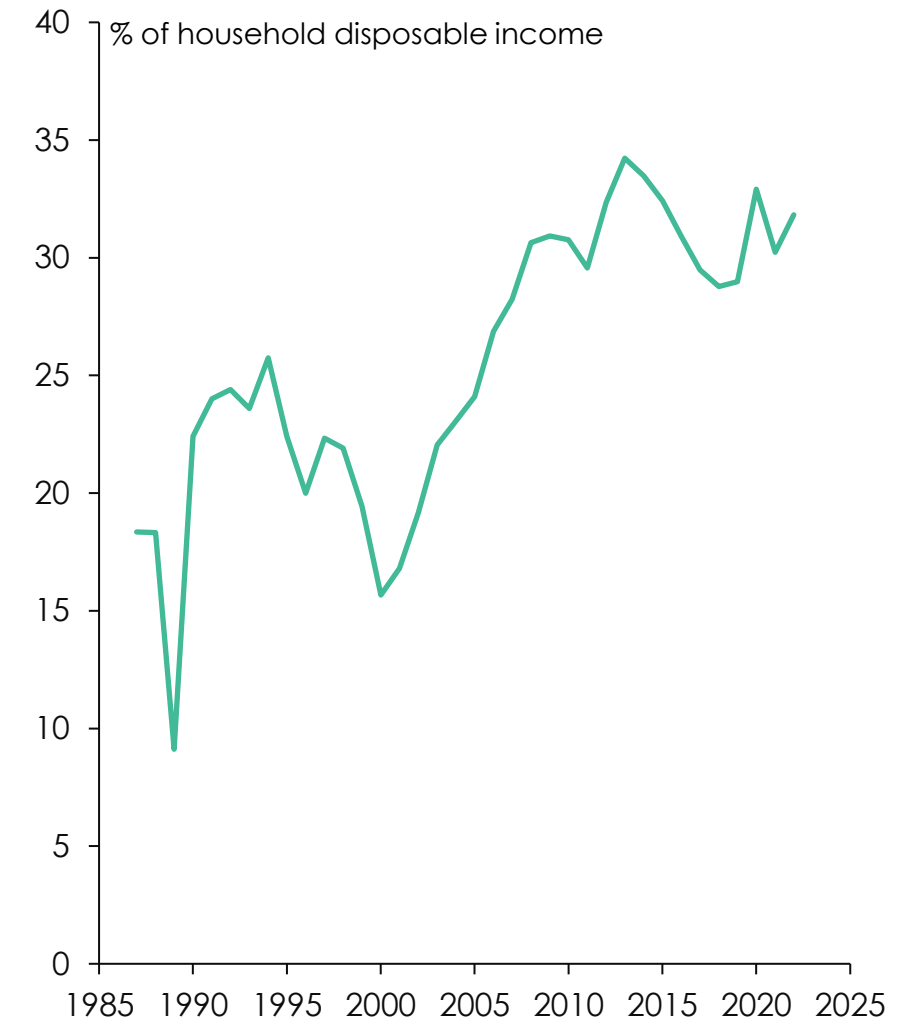
China household consumption as a pc of GDP



Household consumption as a pc of GDP, China & other countries



China household savings rate



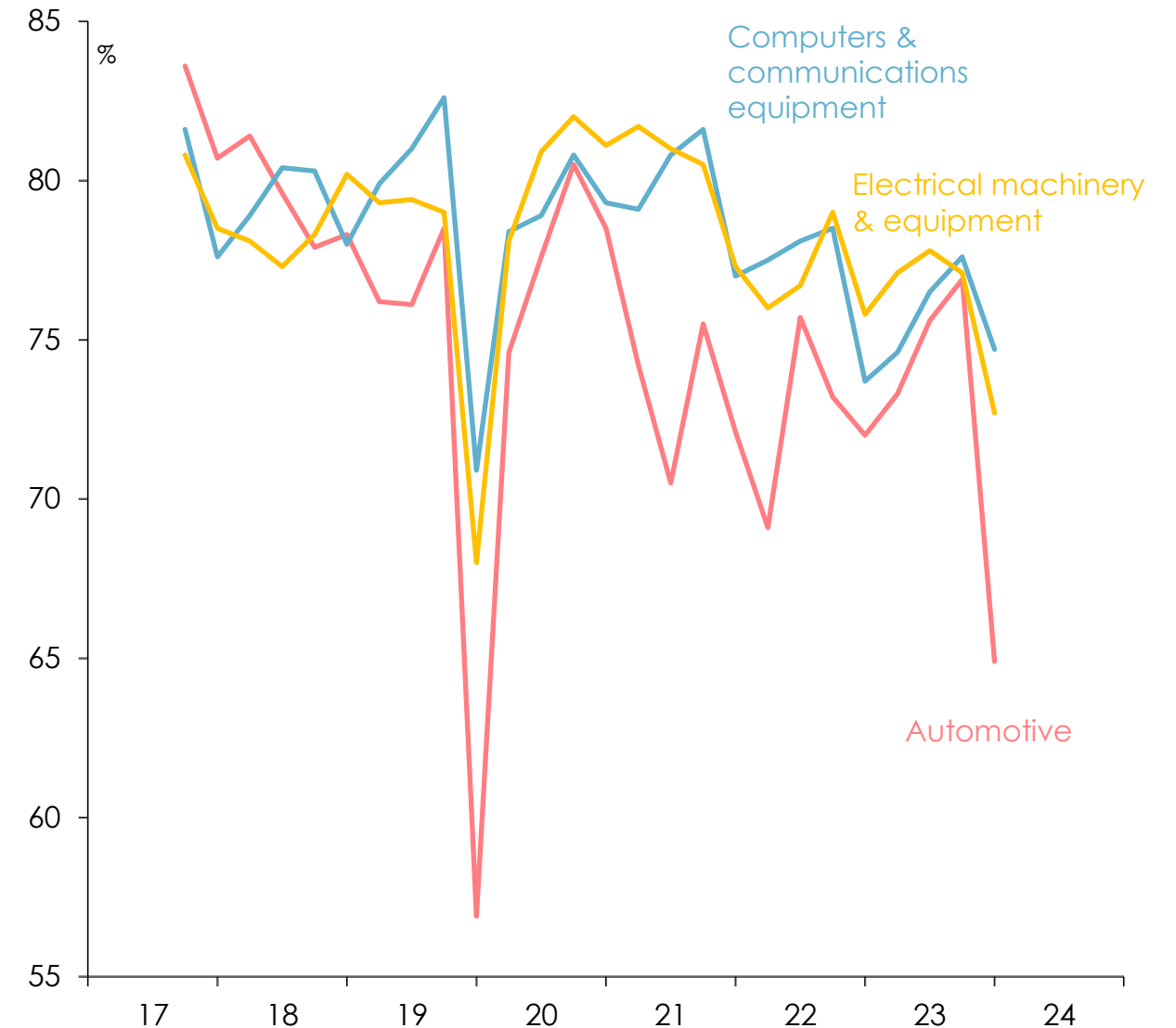
Sources: The World Bank [Data](#); Oxford Economics, [China](#).

China's 'over-capacity' problem is, in a sense, the mirror image of its 'under-consumption' problem

Capacity utilization in industry



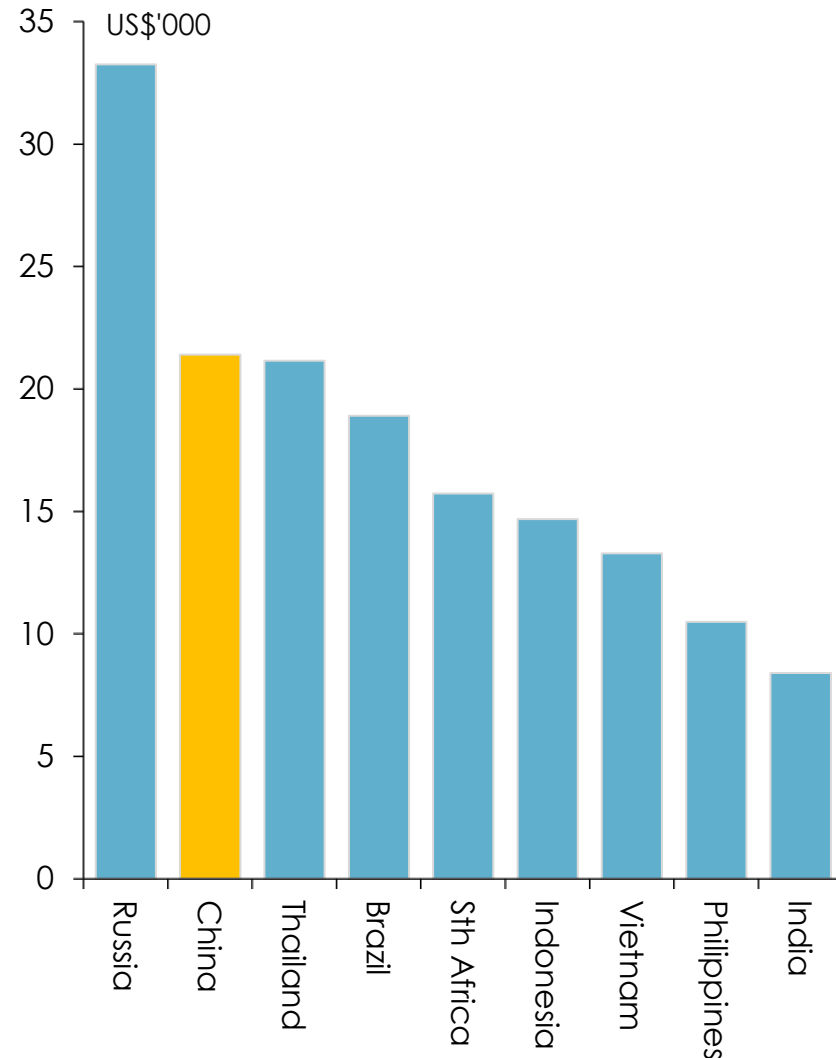
Capacity utilization rates by sector



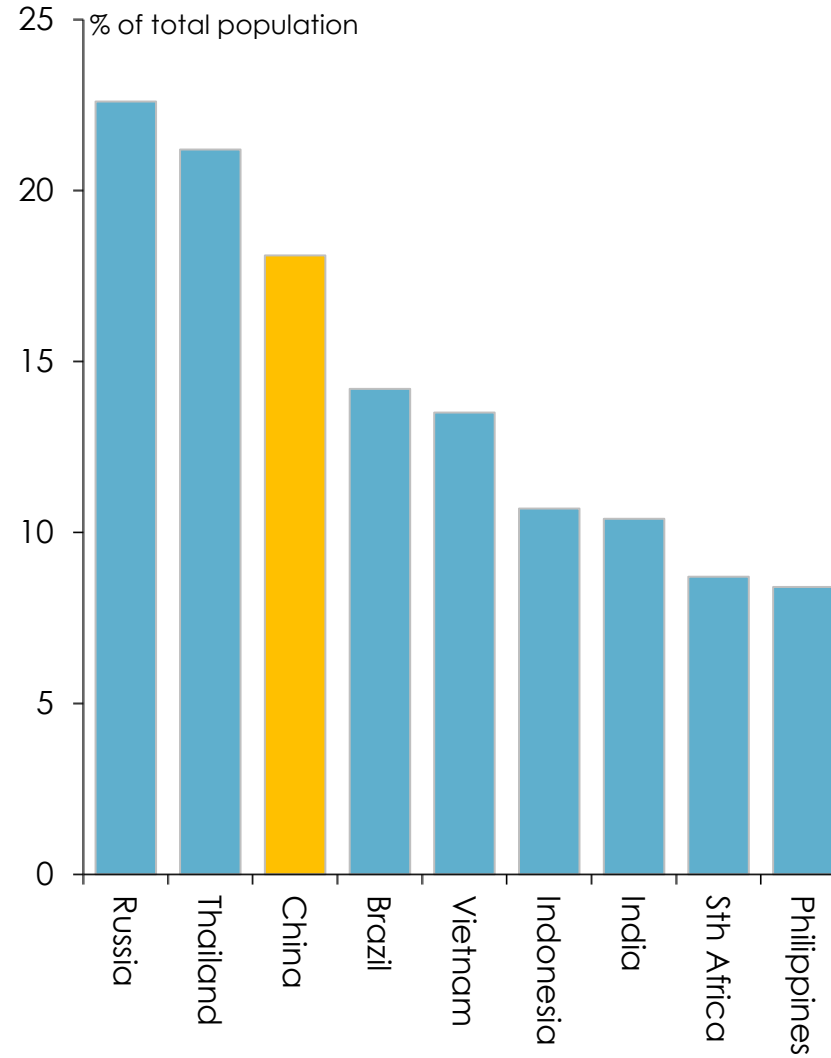
Source: [National Bureau of Statistics of China](#).

For a country with its average income and demographic profile, China doesn't spend much on social security – one reason for high saving

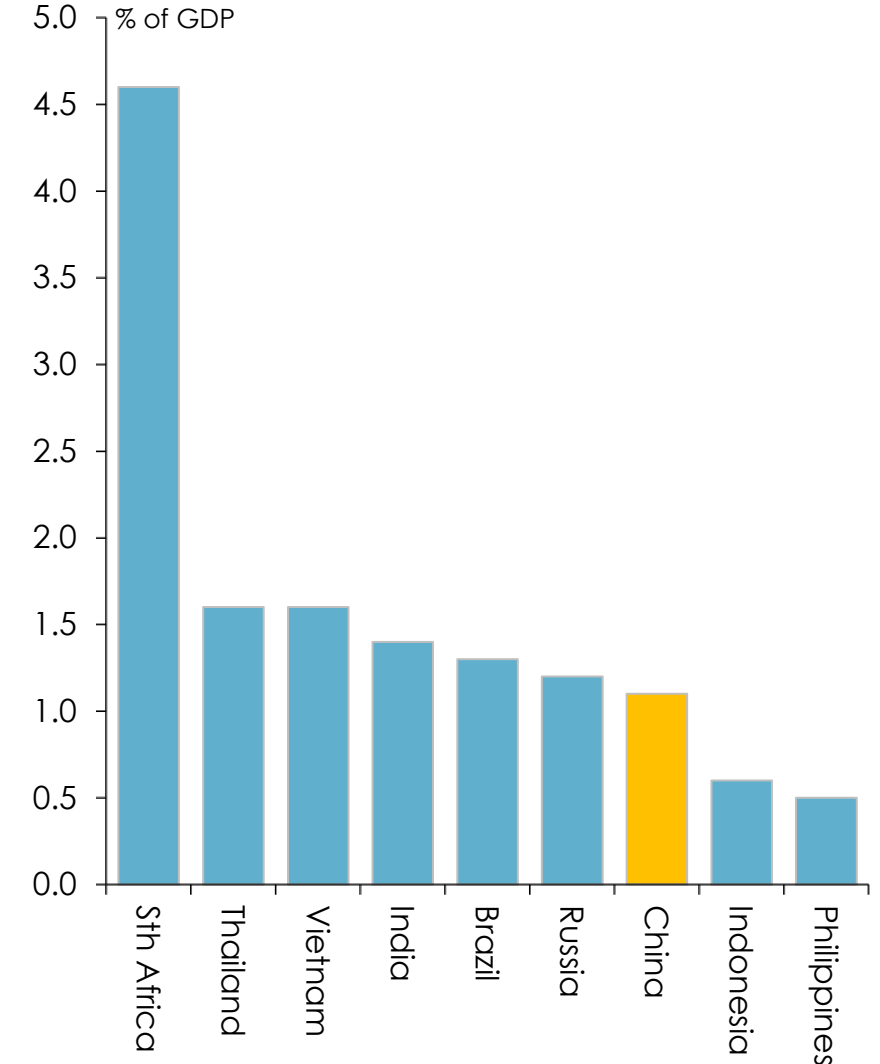
Per capita GDP (at purchasing power parities, 2021)



Population aged 60 or over, as a pc of total, 2021



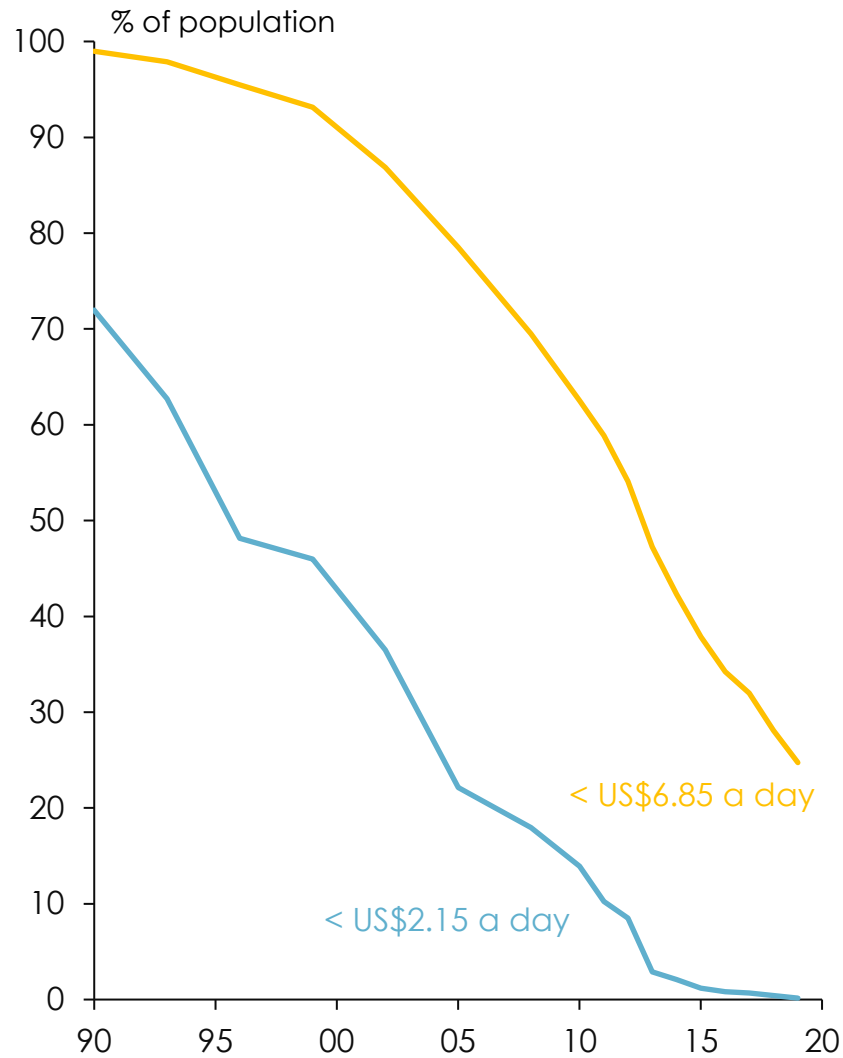
Social assistance spending as a pc of GDP, 2015-16



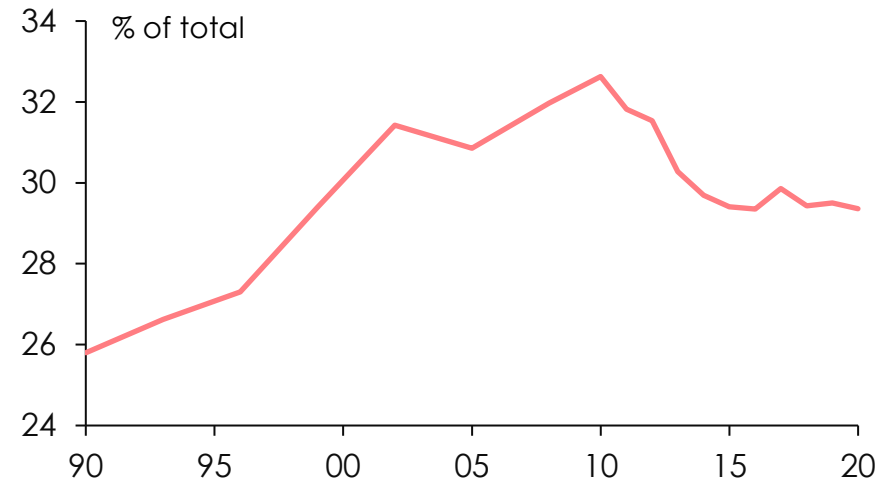
Sources: International Monetary Fund, [World Economic Outlook database](#), April 2024; United Nations Department of Economic and Social Affairs, [World Population Prospects](#), 2022; The World Bank [ASPIRE Social Protection Expenditure indicators](#).

China has eliminated extreme poverty – but for an ostensibly and overtly ‘socialist’ country has a surprisingly high degree of income inequality

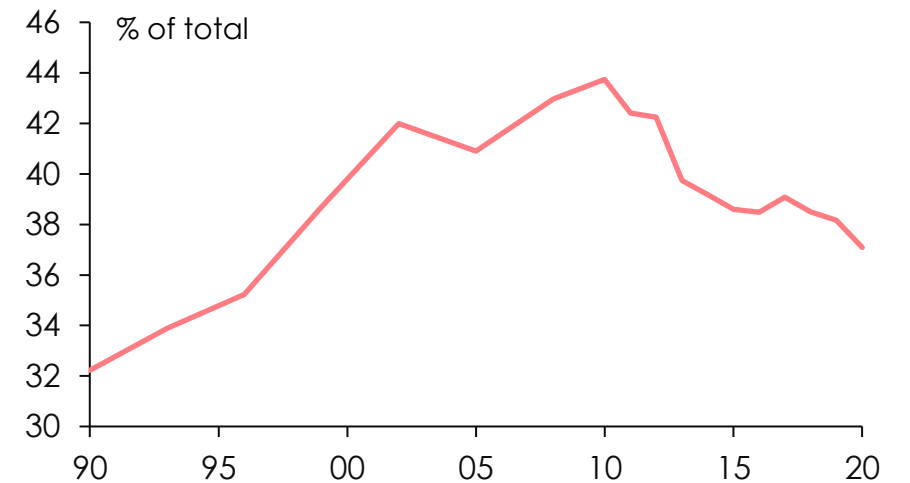
People living below World Bank poverty lines



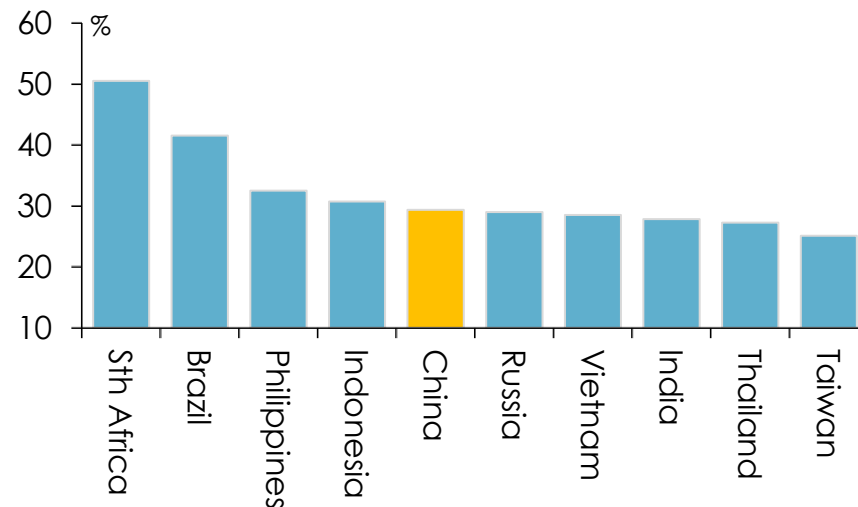
Top 10% share of consumption China



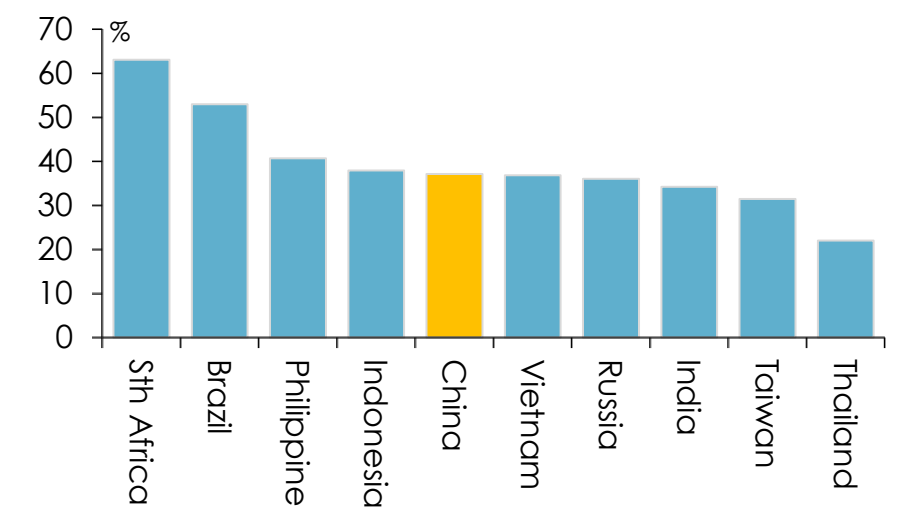
Gini coefficient of income inequality China



China and others



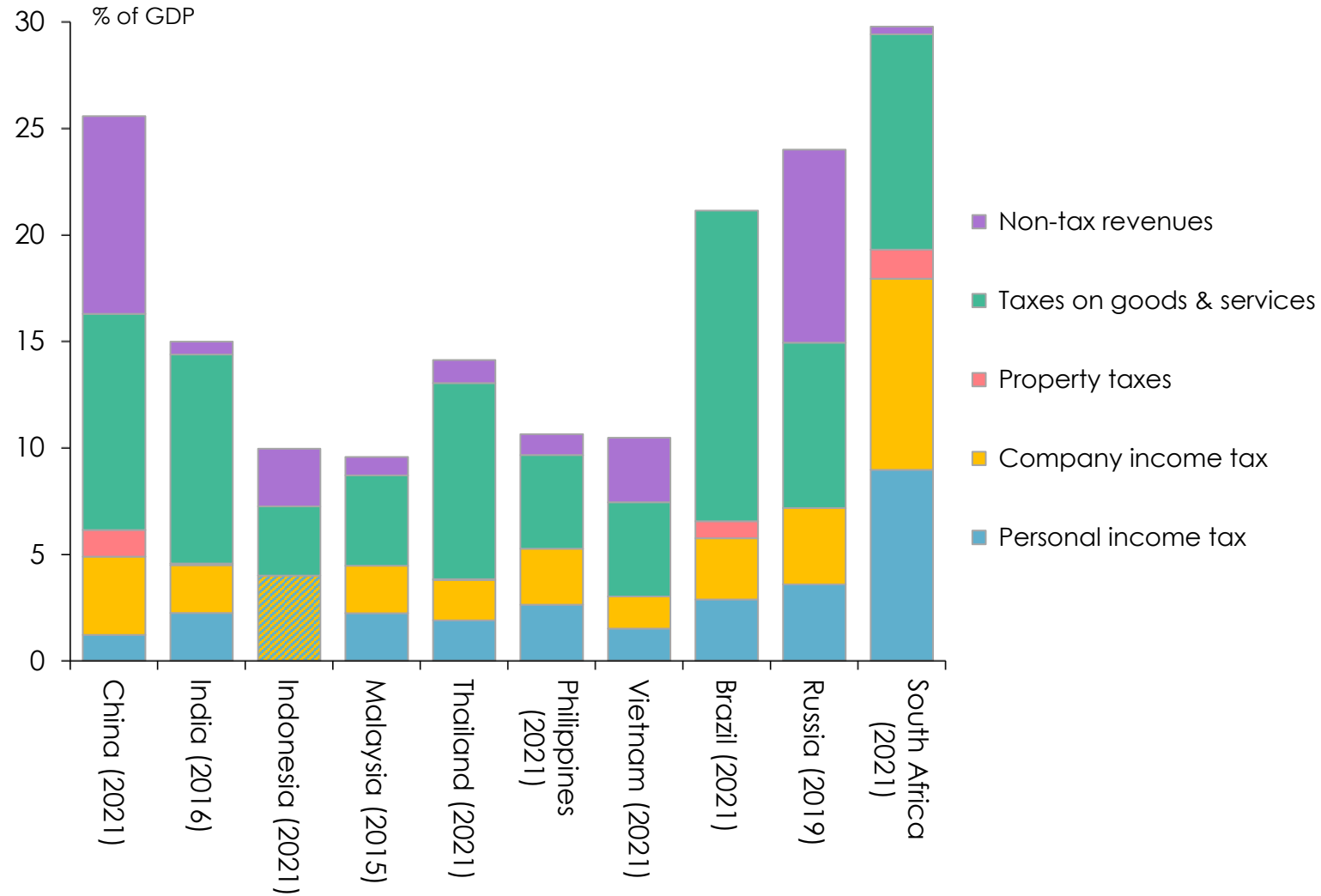
China and others



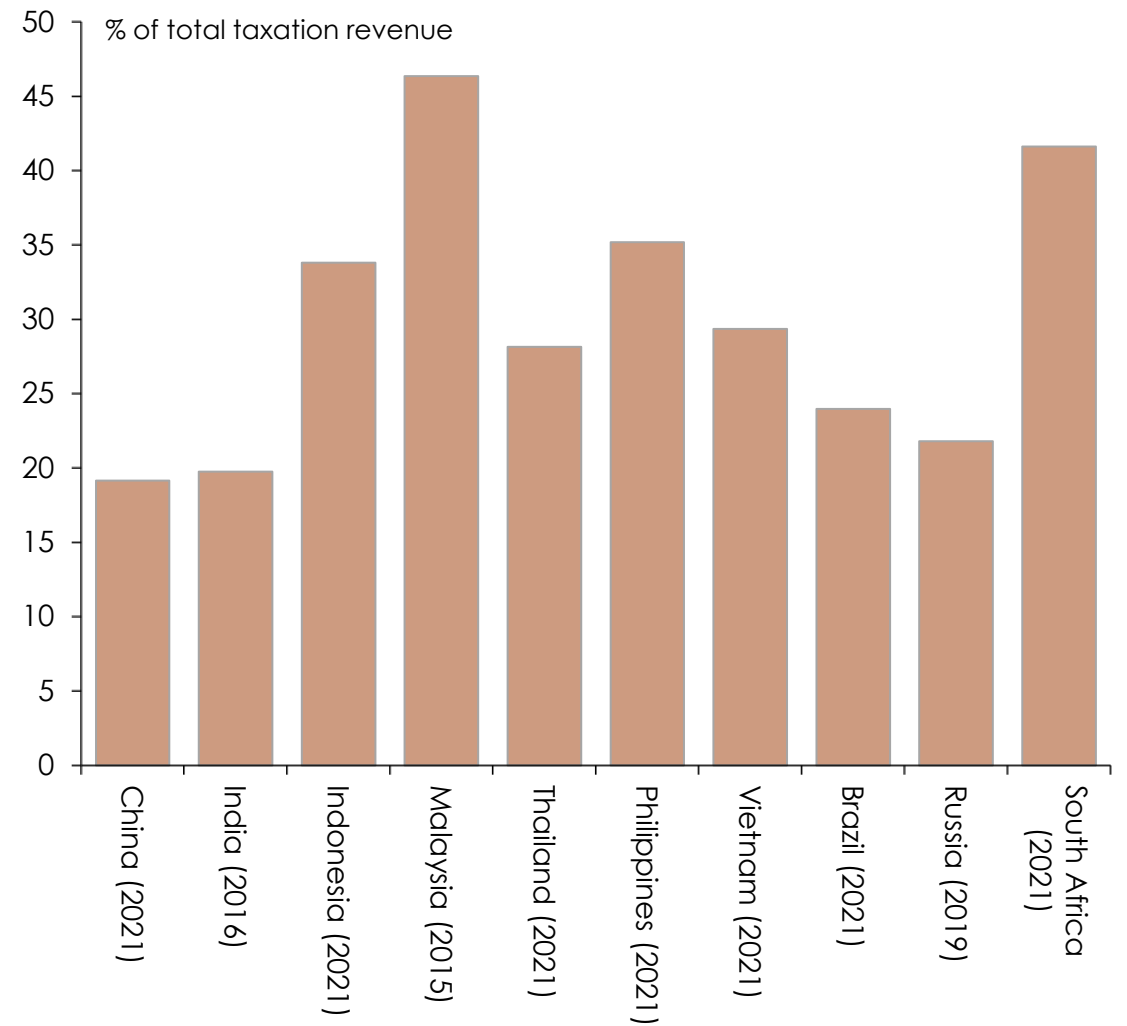
Note: World Bank poverty lines are in 2017 dollars at PPPs. The Gini coefficient is a measure of the extent to which a country's income distribution diverges from 'perfect equality' (value zero) and has a notional maximum value of 1 if a country's entire income accrued to one household. Values for the top decile share of total consumption and Gini coefficients are latest available, in most cases 2020 or 2021, exc. for South Africa (201) and Taiwan (2016). Source: World Bank, [Poverty and Inequality Platform](#).

Likewise, for an ostensibly and overtly 'socialist' country China makes surprisingly little use of 'progressive' taxation instruments

Composition of government revenue – China, other 'emerging' Asian economies and 'BRICS'



Taxes on income, profits and capital gains as a pc of total taxation revenue



Note: Non-tax revenues includes 'social contributions'. Source: UN University, [UNU-WIDER Government Revenue Dataset](#), Version 2023.

The World Bank (among others) has for years been recommending lifting SOE dividends to pay for a social safety net – but China doesn't want to

Effective Discipline with Adequate Autonomy: the Direction
for Further Reform of China's SOE Dividend Policy

The World Bank¹ (7th July 2010)



WP/18/277

IMF Working Paper

China's High Savings: Drivers, Prospects, and Policies

by Longmei Zhang, Ray Brooks, Ding Ding, Haiyan Ding,
Hui He, Jing Lu, and Rui Mano

(December 2018)



CHINA ECONOMIC WATCH

SOE Dividends and Economic Rebalancing

Nicholas Borst (Federal Reserve Bank of San Francisco)
May 11, 2012 8:30 AM

CHINA 2030

BUILDING A MODERN,
HARMONIOUS, AND CREATIVE
SOCIETY

The World Bank
Development Research Center of the State Council,
the People's Republic of China

(2013)

Instead, the Government is focusing on things like ‘patriotic education’

China's new *Patriotic Education Law* (爱国主义教育法) came into force on January 1.

It mandates that patriotic education must "uphold the leadership of the Communist Party," follow its ideologies, and cultivate love for the nation, the Party and socialism.

The law outlines nine key areas for patriotic education:

1. Ideologies ranging from Marxism-Leninism to Xi Jinping Thought.
2. The histories of the Communist Party, the evolution of China, and socialist development.
3. The characteristics and achievements of socialism with Chinese characteristics.
4. Traditional, revolutionary, and socialist cultures.
5. National symbols, such as the flag and anthem.
6. Landscapes and cultural heritage.
7. The constitution and laws.
8. The deeds of heroes and martyrs.
9. Other patriotic content.

Expanding beyond governmental boundaries, the law extends the responsibility for patriotic education to entities such as trade unions, women's federations, schools, parents, and others. It notably targets specific groups for focused patriotic education, including religious groups, overseas Chinese, and residents of Hong Kong, Macao, and Taiwan.

Furthermore, the law explicitly prohibits actions contrary to patriotic values, encompassing:

- (1) *Insulting the national flag, national anthem, national emblem, or having other conduct that harms the dignity of the national flag, national anthem, or national emblem;*
- (2) *Distorting, smearing, desecrating, or negating the deeds and spirit of heroes and martyrs;*
- (3) *Advocating, glorifying, or denying wars of aggression, acts of invasion, and massacres;*
- (4) *Occupying, destroying, or defiling patriotic education facilities;*
- (5) *Other conduct prohibited by laws and administrative regulations.*

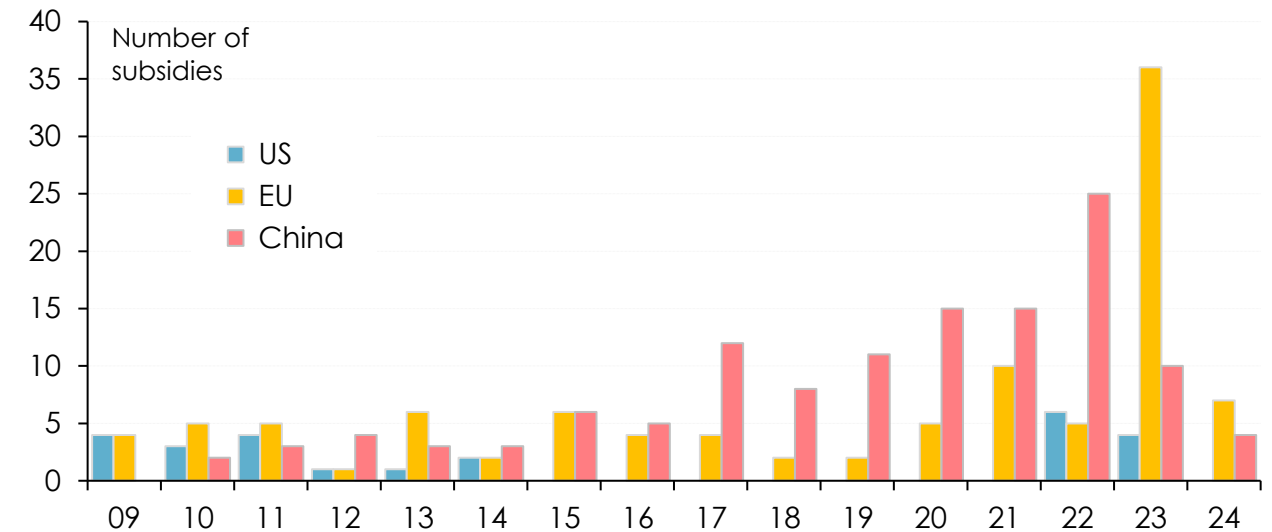
Next week's 'Third Party Plenum' isn't expected to yield much by way of substantive reform

- ❑ **The (delayed) Third Plenum of the 20th Chinese Communist Party Central Committee will be held on 15-18th July**
 - ordinarily this would have been held late last year, and the fact that it wasn't was widely interpreted as signalling either a lack of interest in economic policy on Xi Jinping's part, or an inability to build a consensus on economic policy direction
 - the date for this meeting was only formally announced on 27th June
- ❑ **'Third Plenums' typically focus on economic policy**
 - memorably, the Third Plenum of the 11th Central Committee held on 18th December 1977 launched Deng Xiaoping's 'reform and opening up agenda'
 - the Third Plenum of the 14th Central Committee set out the framework for Zhu Rongji's reform of state-owned enterprises
 - Xi Jinping's first Third Plenum, held on 9-12th November 2013, resulted in a 'Decision on Some Major Issues Concerning Comprehensively Deepening Reforms' which foreshadowed that "the market" would play a "decisive role in allocating resources" – but almost none of the reforms outlined at the 2013 Third Plenum eventuated
 - the Third Plenum of the 19th Central Committee was (unusually) held in February 2018 and focussed on government institutions rather than economic policies
- ❑ **Expectations for major reforms coming out of next week's Third Plenum are generally low**
 - there is talk about 'innovating Party theory' on the role of the private sector (the National People's Congress is considering a 'Private Economy Promotion Law', but that is subsidiary to 'theory')
 - the official read-out from the 27th June Politburo meeting said that the draft decision of the Third Plenum "fully accentuated the initiative of the Party Central Committee with Comrade Xi Jinping at its core to improve and develop the socialist system with Chinese characteristics" ...
 - ... and that "it is essential to remain committed to upholding fundamental principles and breaking new ground, adhere unwaveringly to socialism with Chinese characteristics, keep pace with the times, adapt to the evolution of practice, and adopt a problem-oriented approach to promote innovation in practice, theories, institution, culture and all other sectors from a new starting point

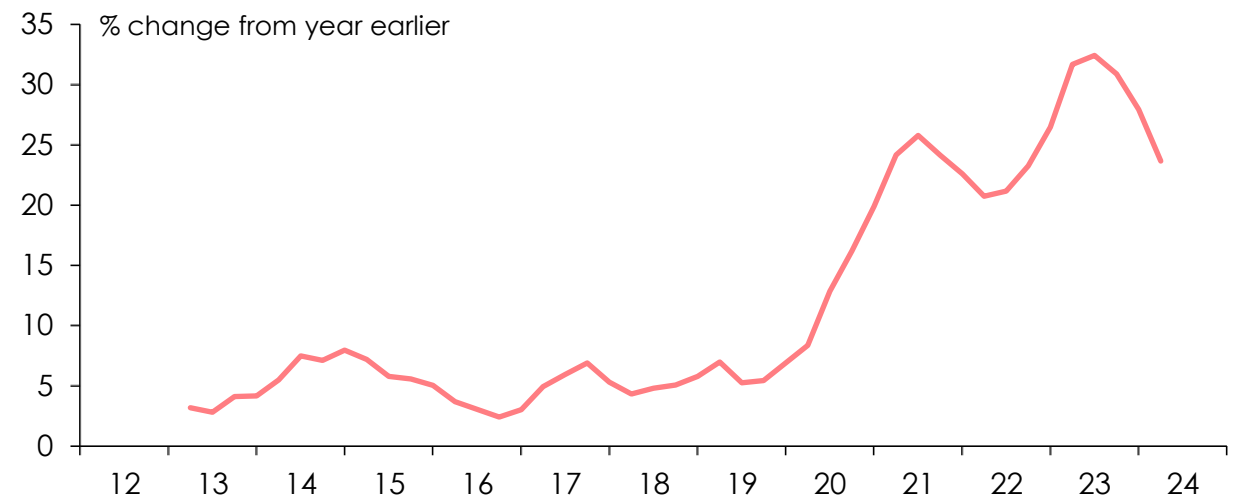
China isn't taking 'de-coupling' / 're-shoring' / 'friend-shoring' lying down – it's doing its own versions of all these things

- ❑ Xi Jinping's '[dual circulation](#)' strategy is no less about 'de-coupling' and 'on-shoring' than the US' '[Inflation Reduction \[sic\] Act](#)', the EU's '[Green Deal](#)' and Japan's '[Economic Security Promotion Act](#)'
 - “in essence, dual circulation is part of China's masterplan to become self-reliant in terms of resources and technology but also in terms of demand through its huge market as well as through third markets available through the BRI”
- ❑ China is seeking to dominate global production of [solar panels](#), [wind turbines](#), [batteries](#), [electric vehicles](#), and '[critical minerals](#)' (among other things) both for its own 'security' and to weaken its perceived
 - this entails a 'full court press' of [subsidies](#), protection, procurement contracts and [state-directed lending](#)
- ❑ China continues to seek to marshal support in what it calls the 'Global South'
 - the 'BRICS' grouping (which China dominates) now [formally includes](#) Saudi Arabia, the UAE, Egypt, Iran and Ethiopia
 - and [Malaysia](#), [Thailand](#), [Nigeria](#) and [Algeria](#) have applied to join (although [Indonesia](#) and [Argentina](#) have decided not to)
 - the China-sponsored Shanghai Co-operation Organization now includes Russia, the five 'stans' in Central Asia, India and Iran

Subsidies for local solar panel production

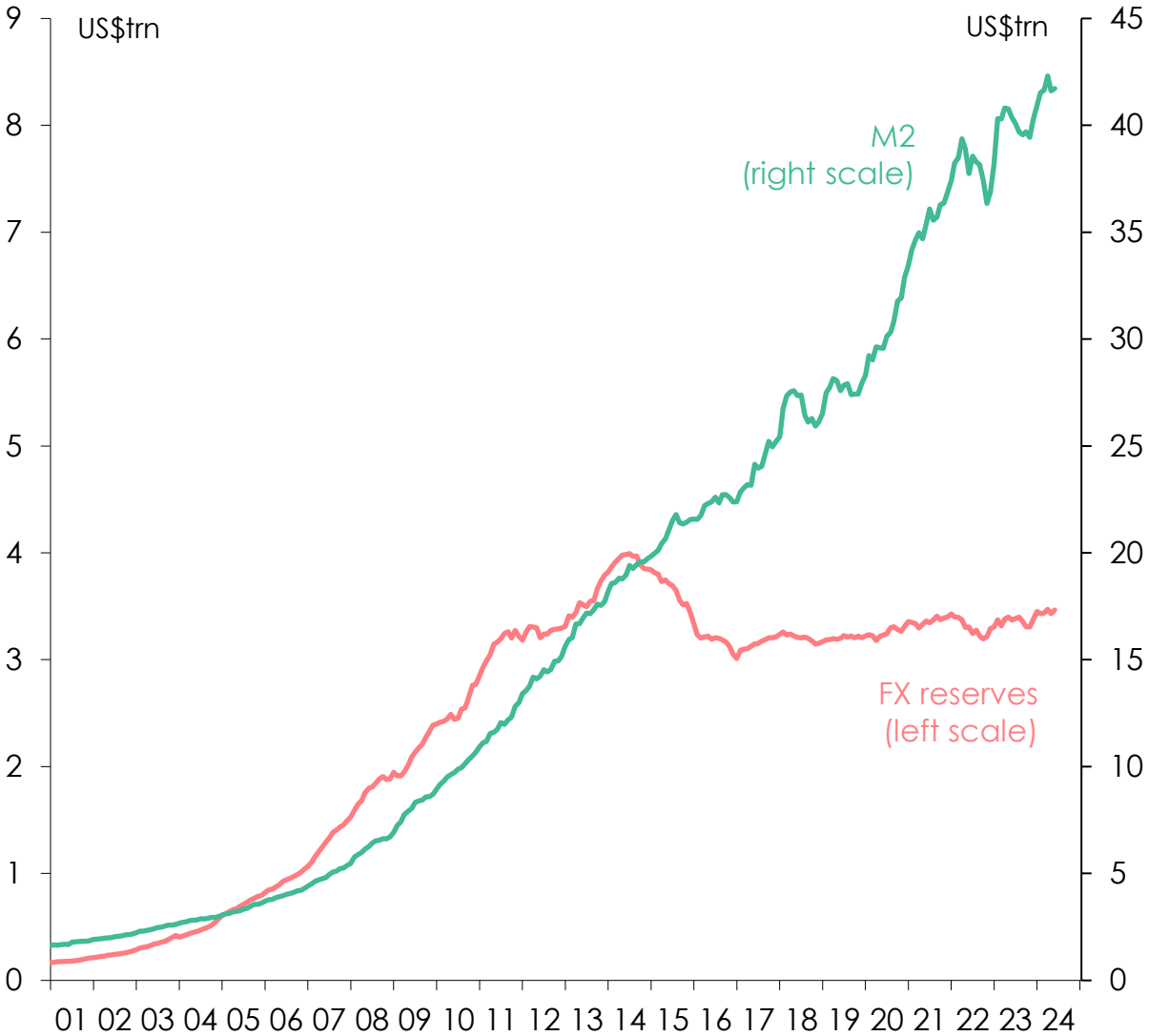


Bank lending to industry

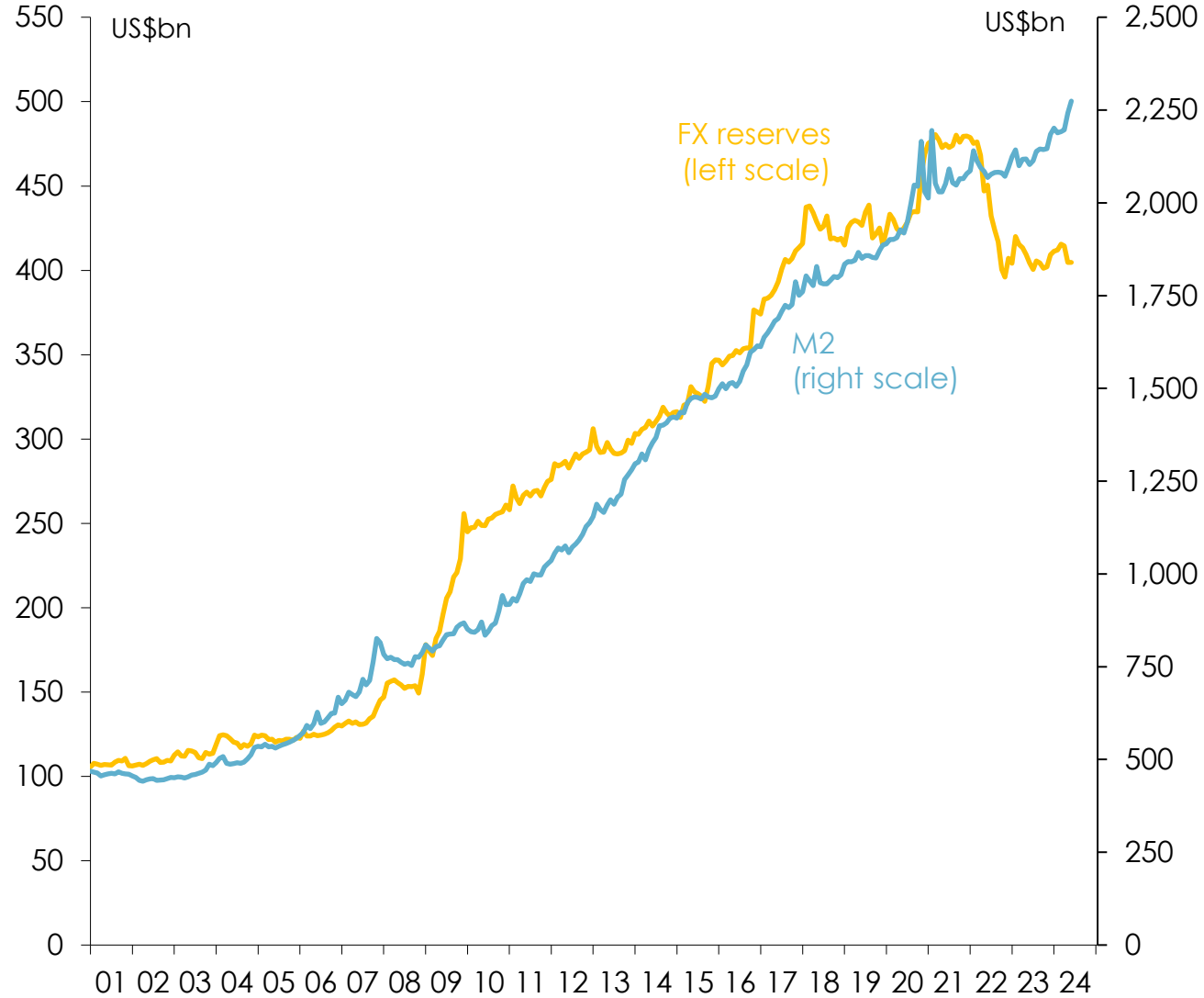


Since 2015 China hasn't maintained a roughly linear relationship between FX reserves and its domestic money supply

China's FX reserves and M2 money supply



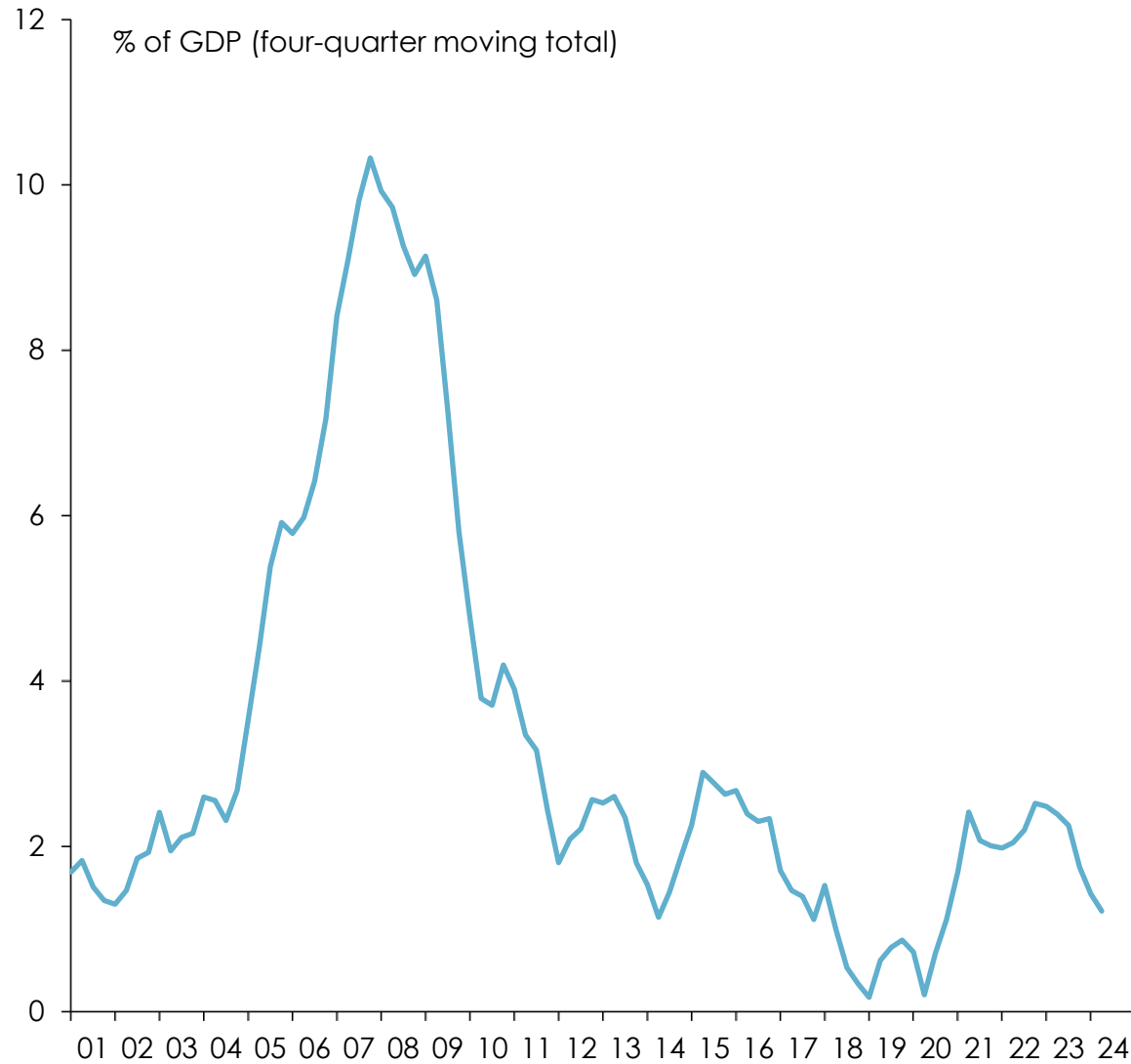
Hong Kong's FX reserves and M2 money supply



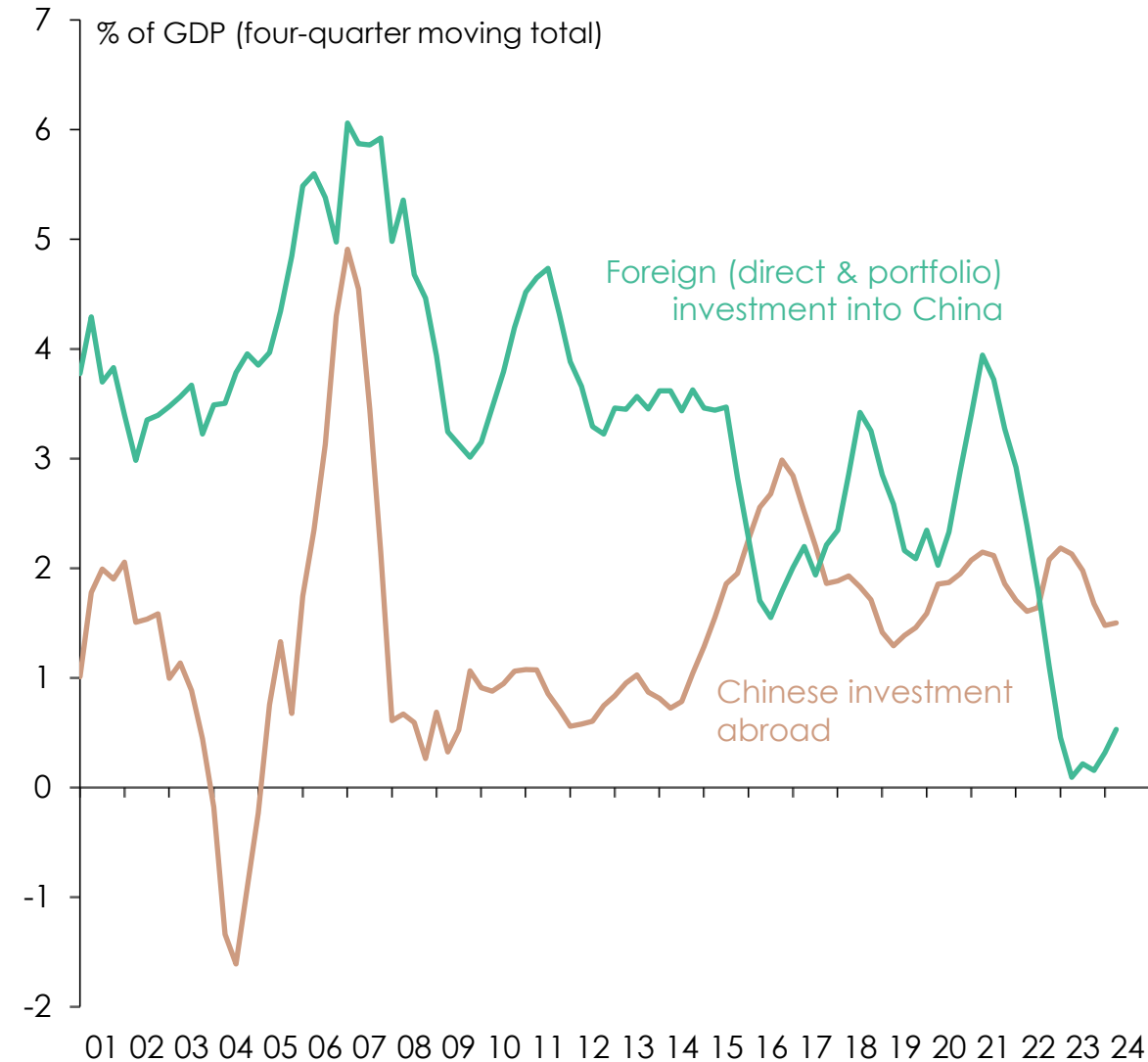
Sources: [People's Bank of China](#); [Hong Kong Monetary Authority](#).

China's 'basic balance' surplus has shrunk from over 14% of GDP in 2007 to a still-large 3.2% of GDP in 2021 but then to just 0.3% of GDP in 2023

China's current account surplus



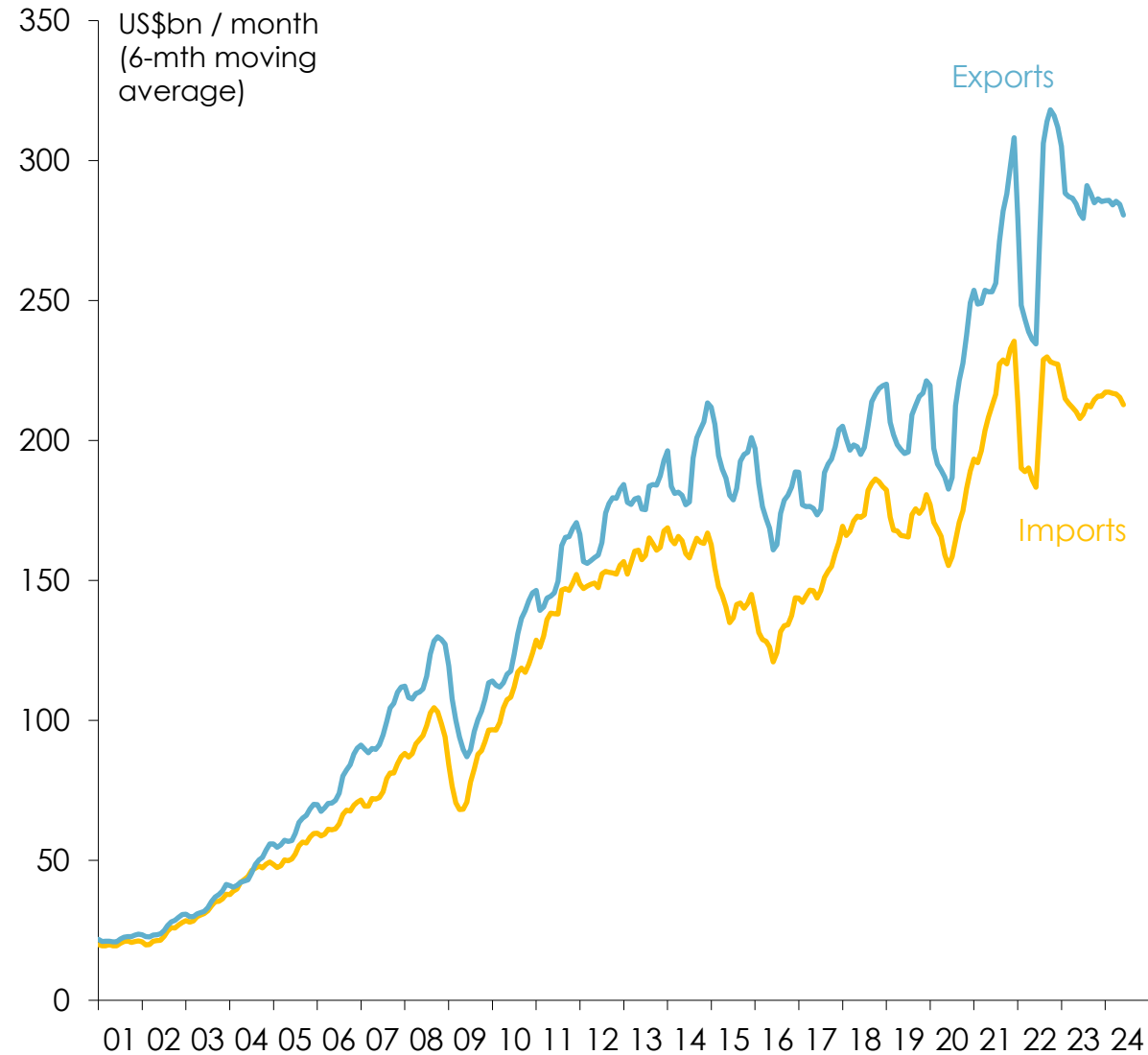
China's foreign investment inflows and outflows



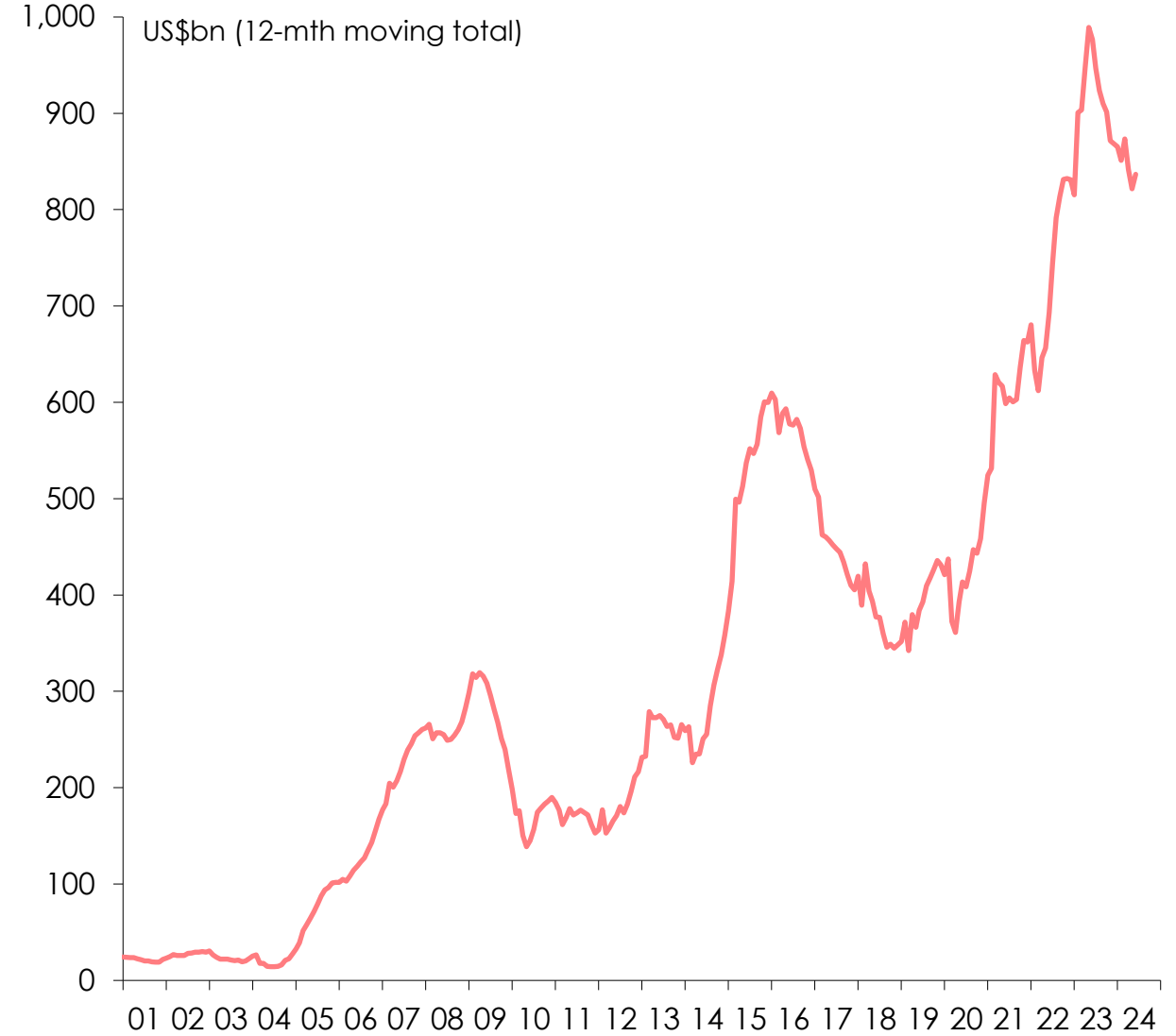
Sources: China [State Administration of Foreign Exchange](#); [National Bureau of Statistics of China](#).

China's merchandise trade surplus is being sustained by weakness in imports, not strength in exports

China's merchandise exports and imports



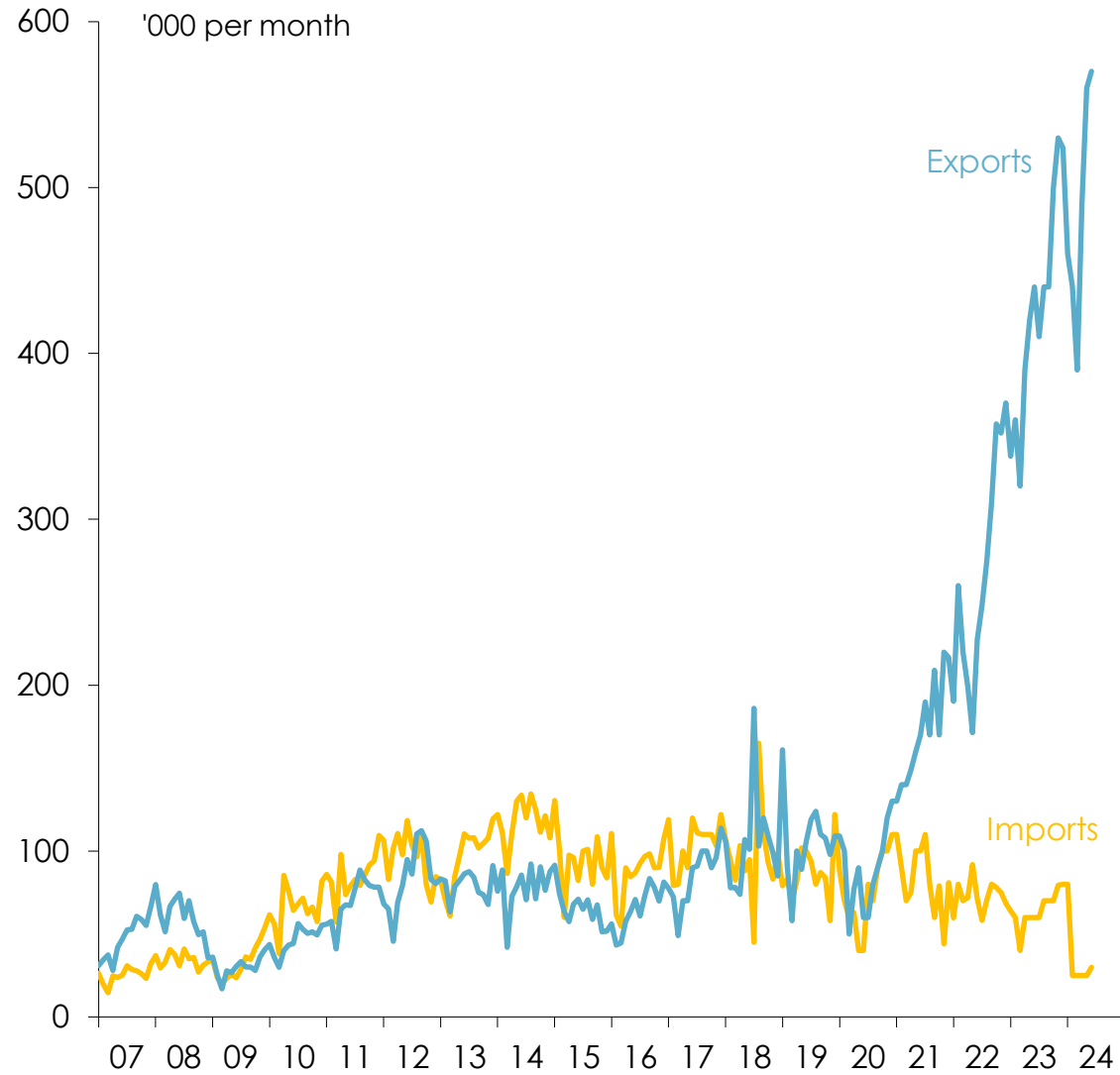
China's merchandise trade surplus



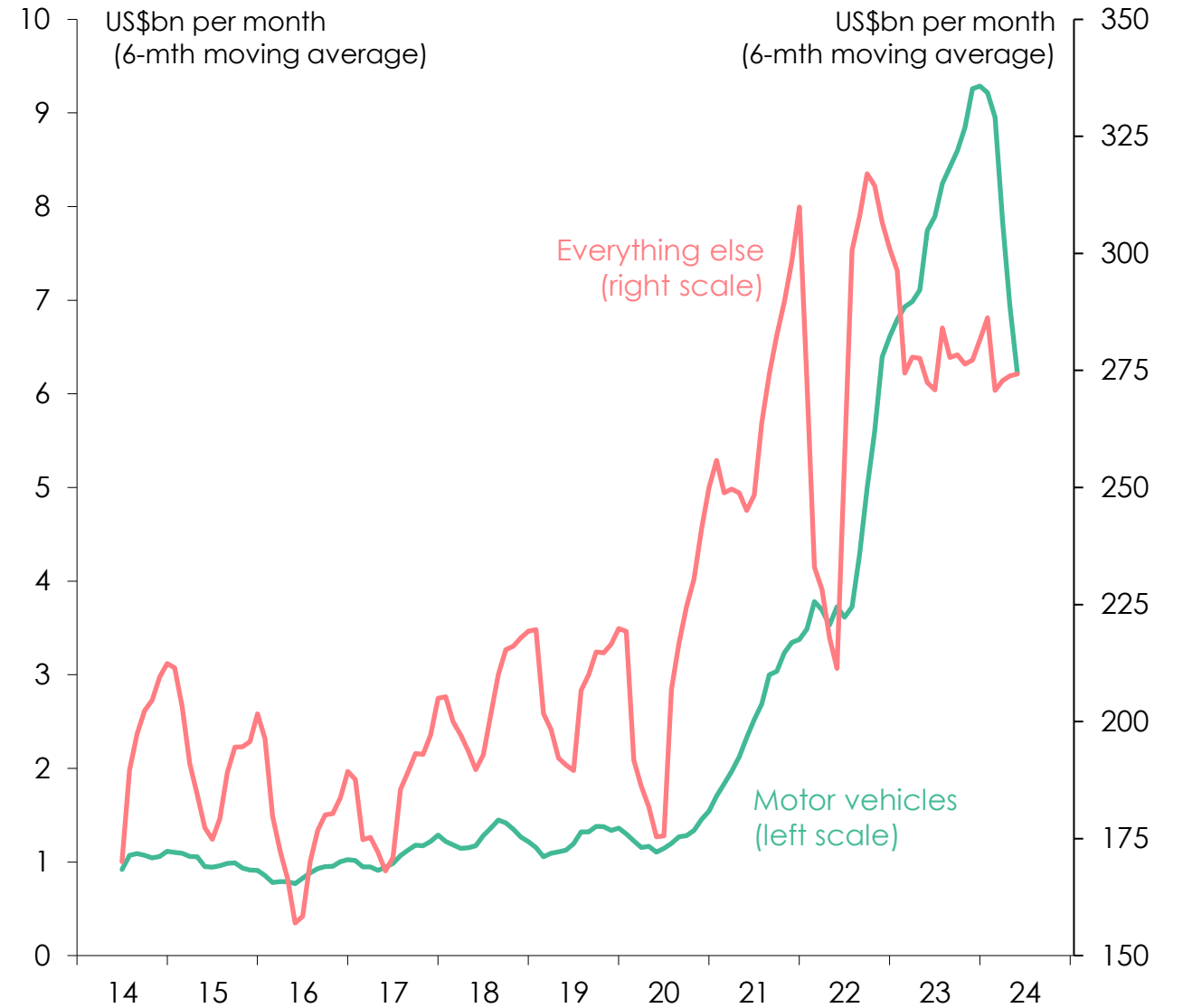
Source: [General Administration of Customs](#).

China's motor vehicle exports are booming – but that also highlights the weakness in China's other exports

China's motor vehicle exports and imports



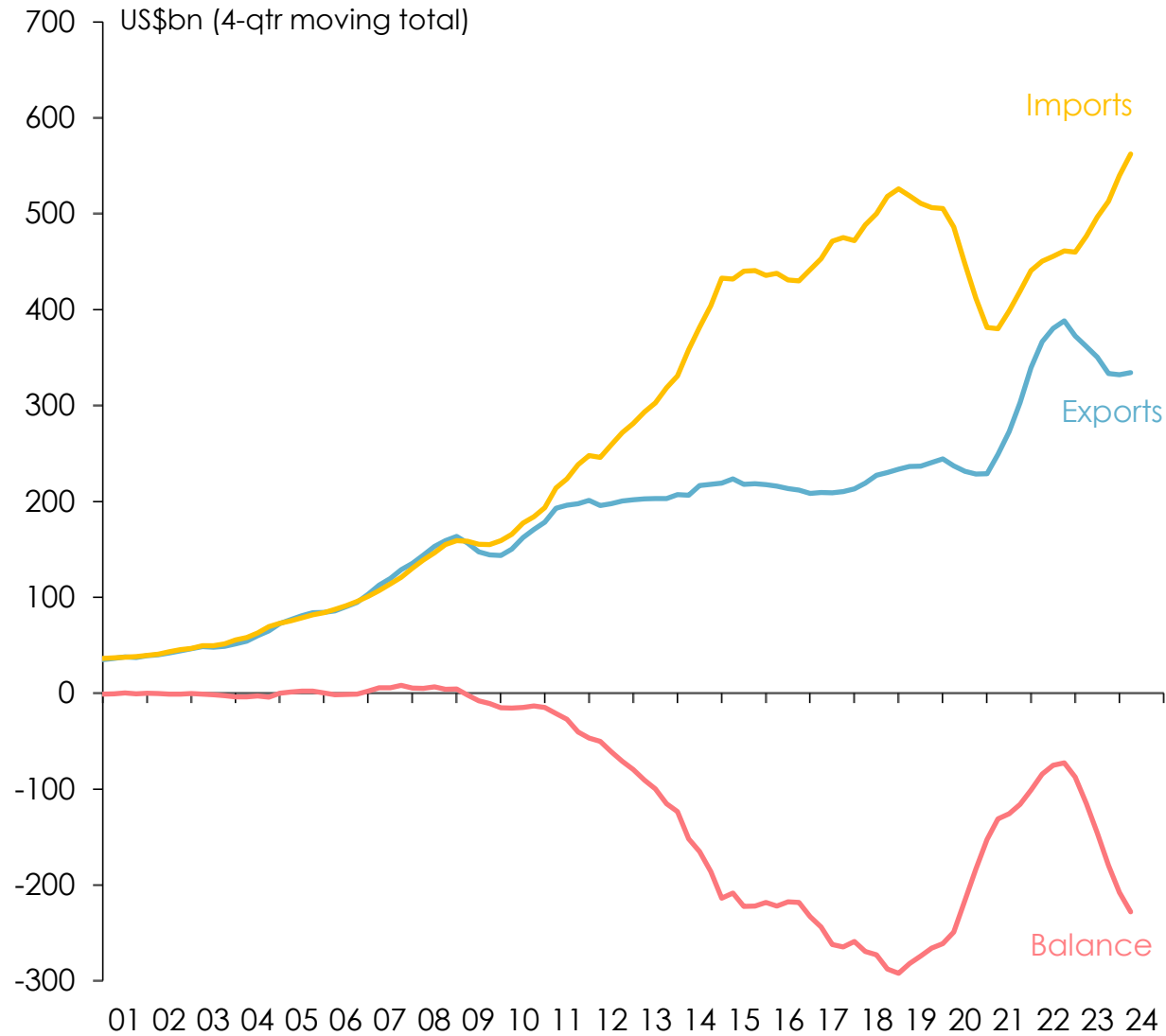
Motor vehicle and other merchandise exports



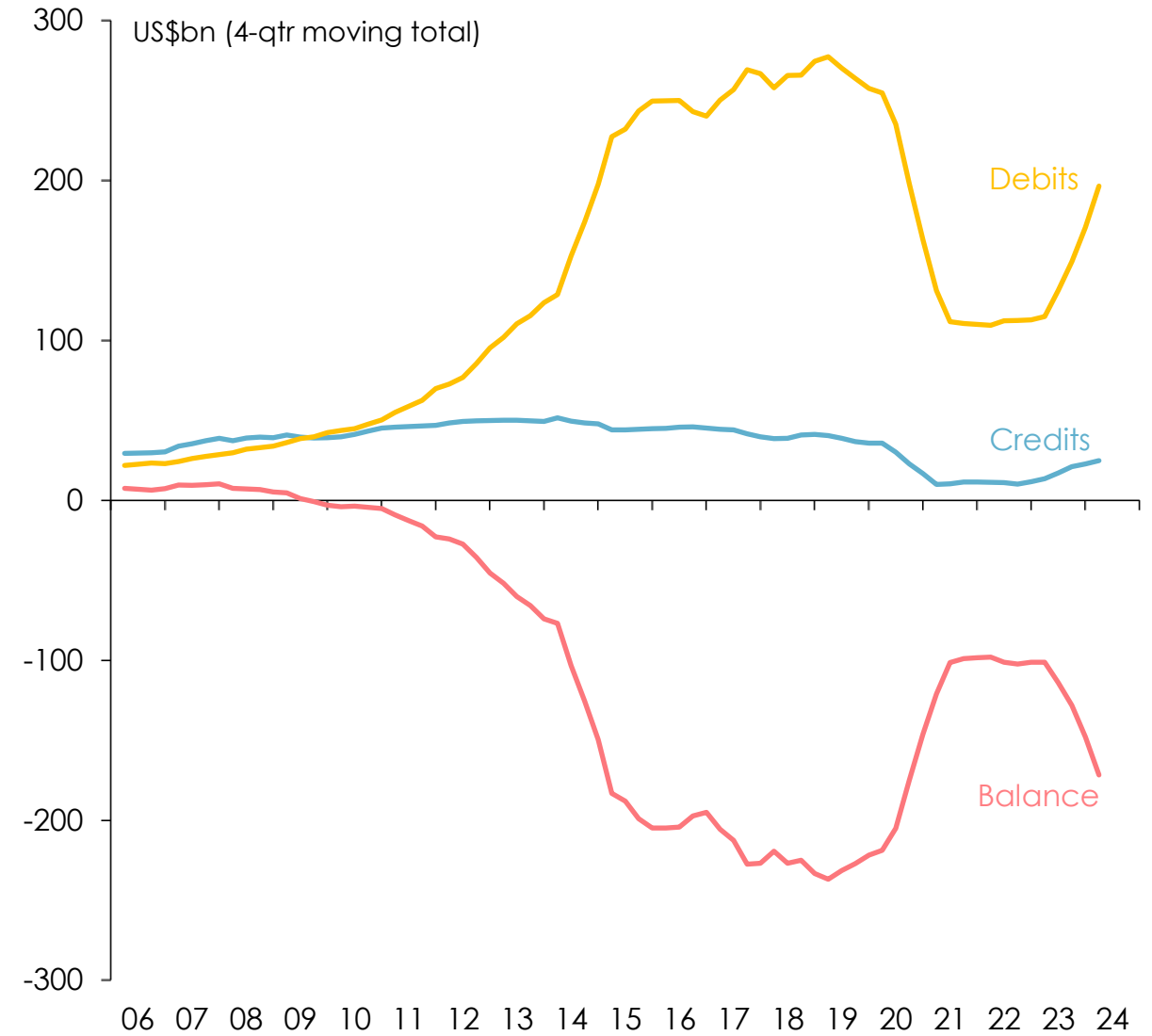
Sources: China [National Bureau of Statistics](#); [General Administration of Customs](#);

China's services trade deficit is widening – largely because while lots of Chinese want to travel abroad, not many foreigners want to go to China

China's services trade



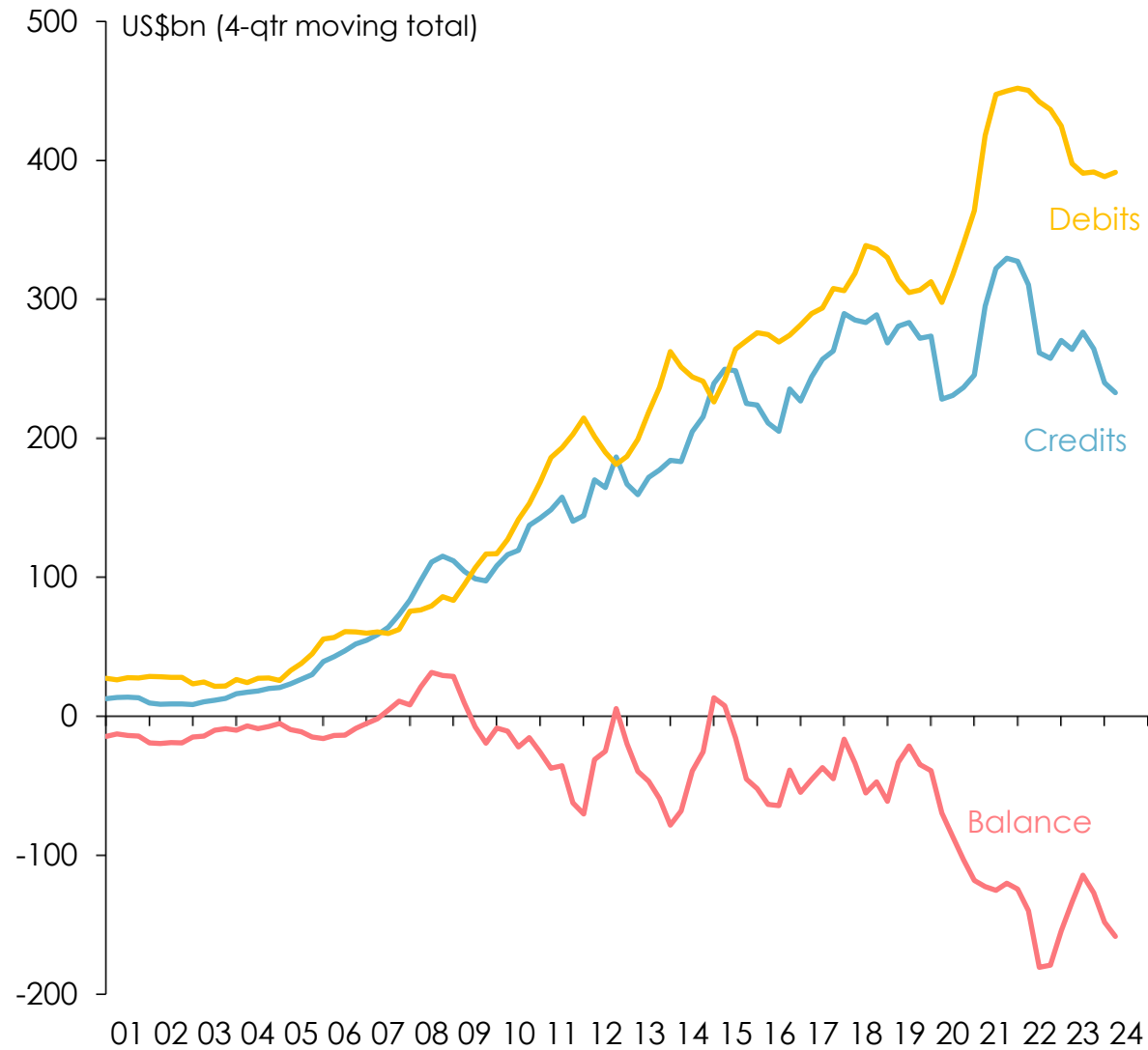
China's travel credits and debits



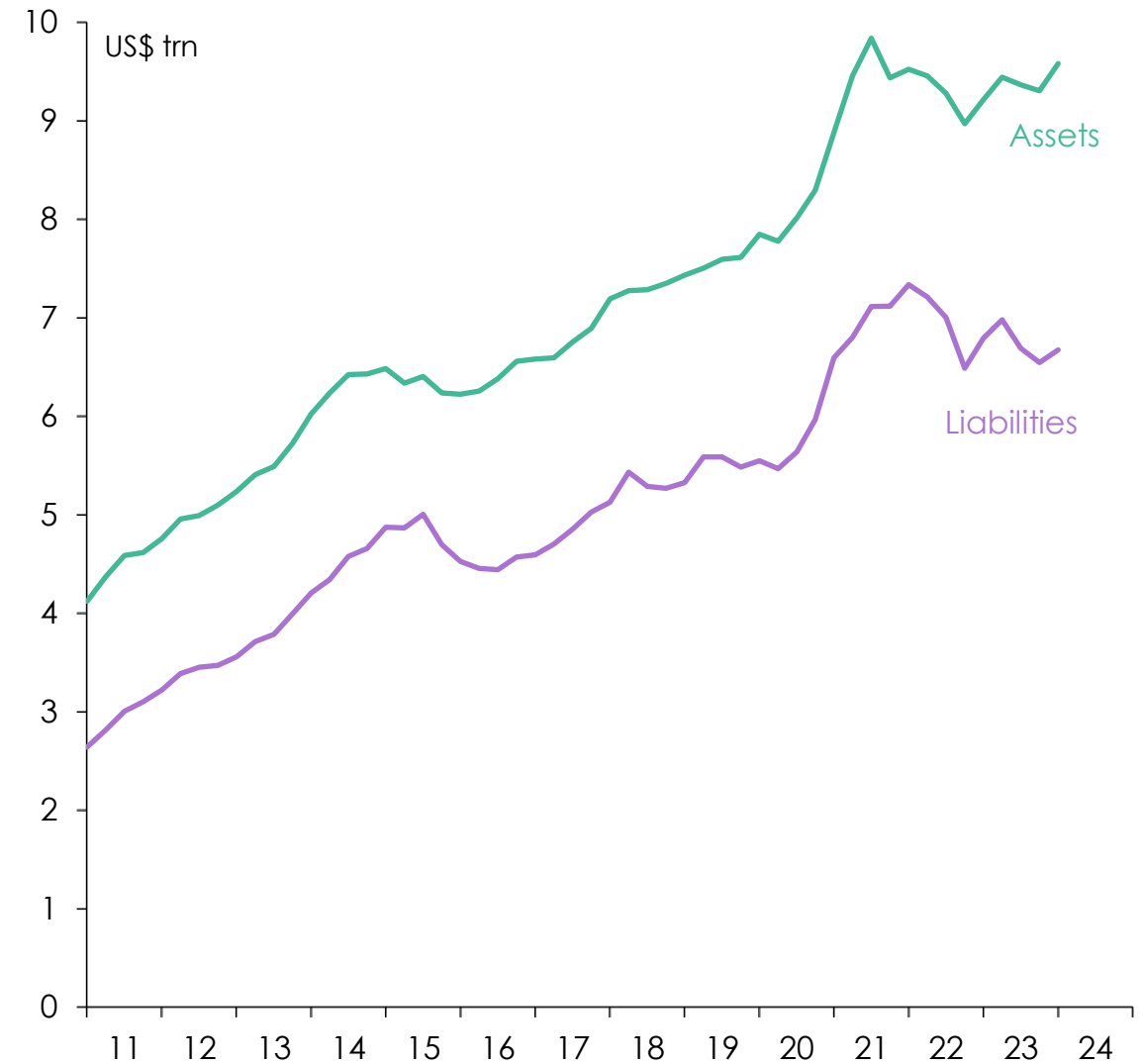
Source: China [State Administration of Foreign Exchange](#).

China runs a deficit on primary income despite being a significant international creditor (the opposite of the United States)

China's primary income credits and debits



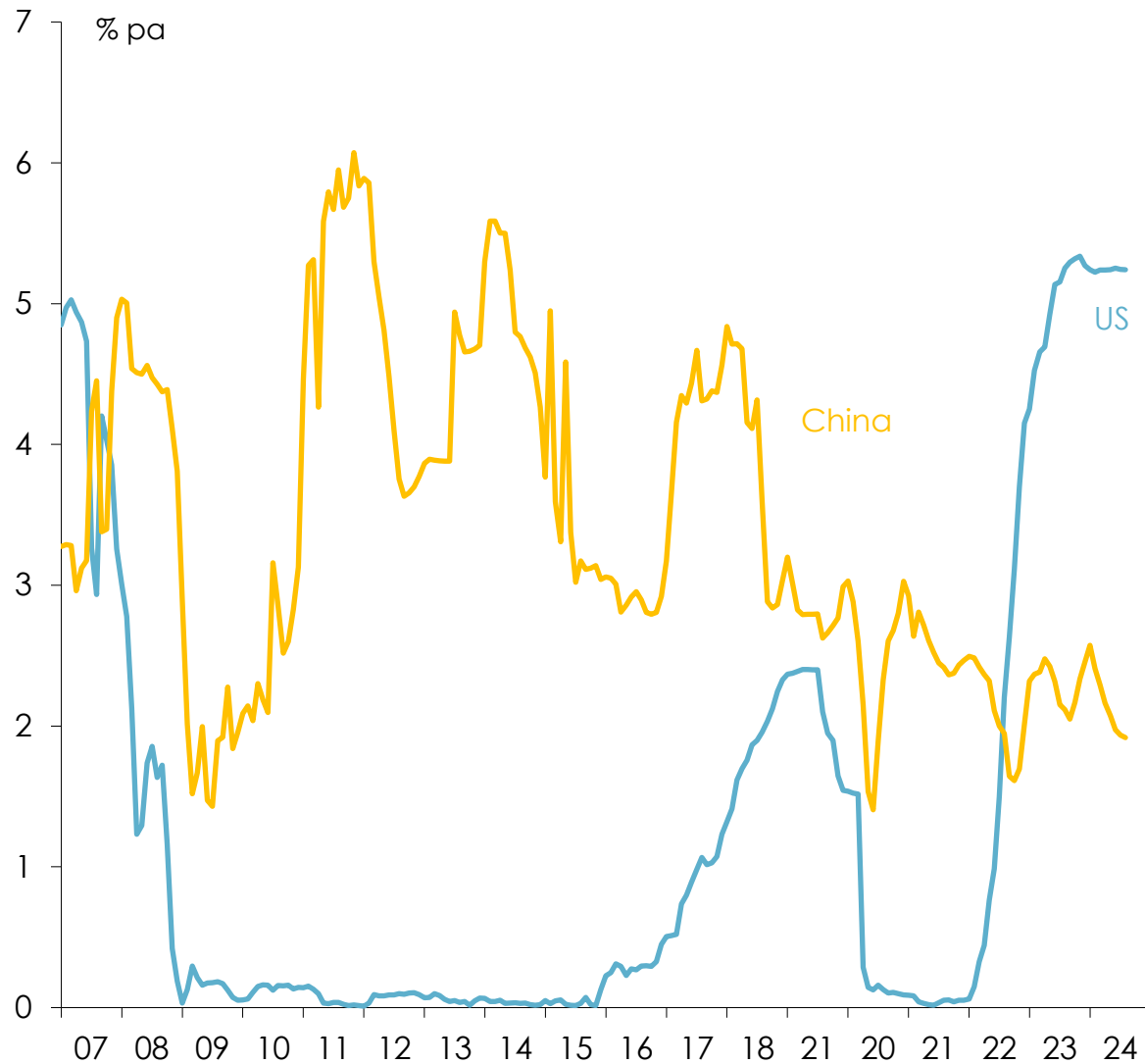
China's net international asset position



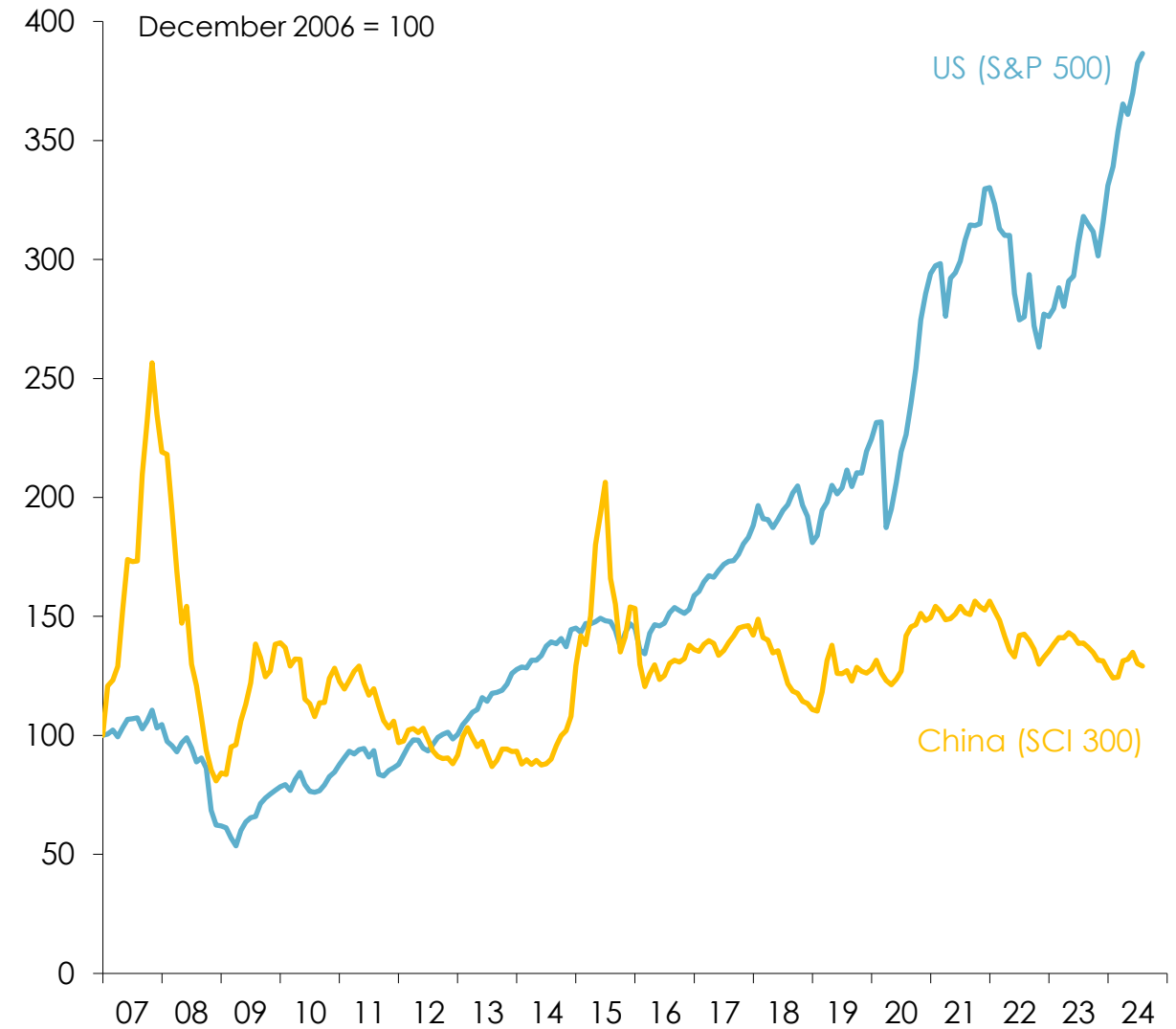
Source: China [State Administration of Foreign Exchange](#).

US interest rates are (unusually) now much higher than Chinese interest rates, and the US stock market has significantly out-performed China's

China and US 3-month interest rates



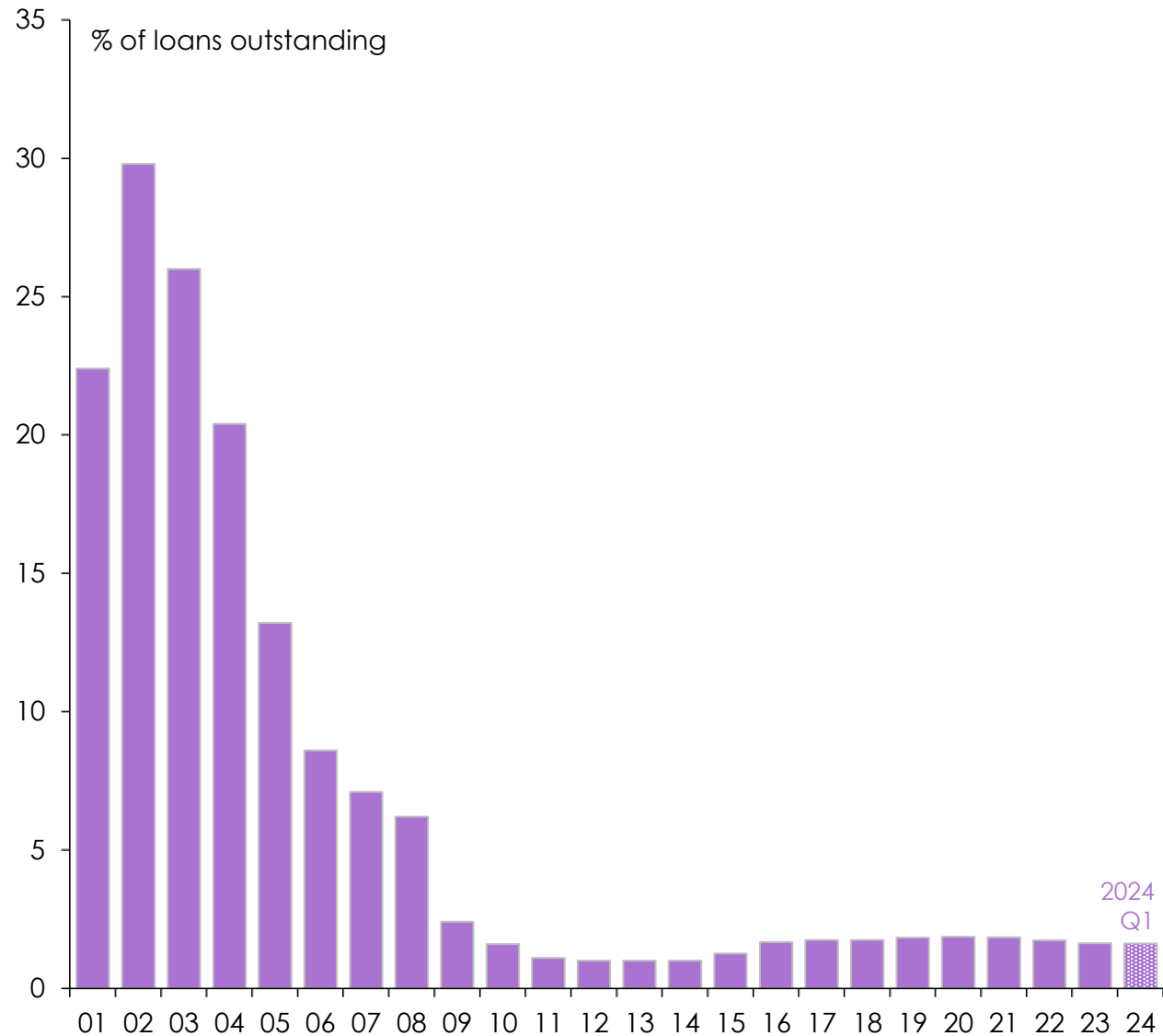
China and US stock markets



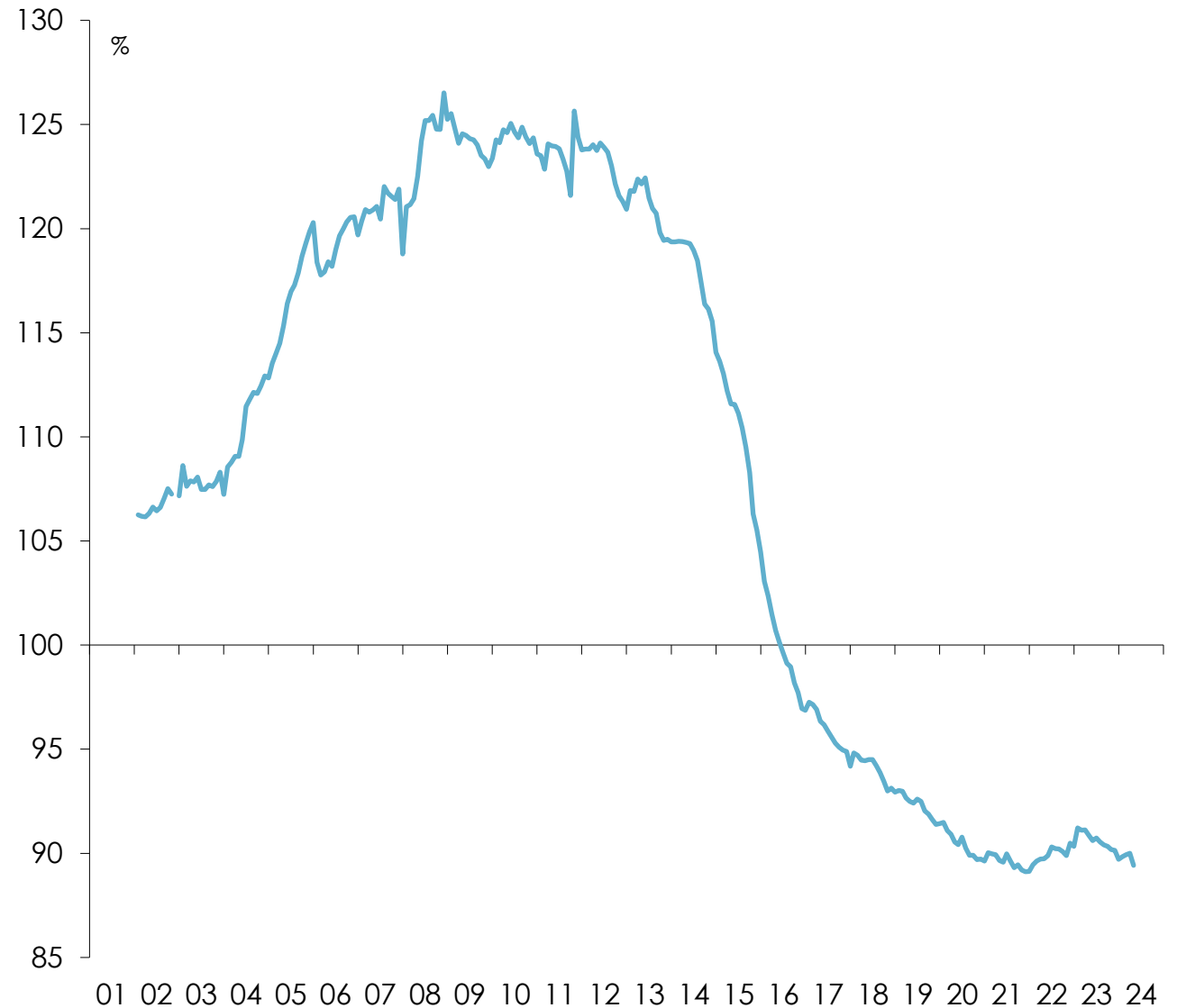
Source: Refinitiv Datastream.

One possible prompt for large capital outflows, and hence a big fall in the renminbi, could be revelation of large loan losses at Chinese banks

Chinese banks' non-performing loans



Loan-to-deposit ratio of Chinese banks



Source: China [National Financial Regulatory Administration](#); [People's Bank of China](#).

China's financial regulators appear to be taking a tougher line on 'pretend and extend'

China's banks have a bad-debt problem

As is becoming increasingly obvious

BANK OF JIUJIANG, a mid-tier lender from a southern Chinese river town, imparted some bad news on March 19th. In a rare disclosure, it told investors profits for 2023 might fall by 30%, because of poorly performing loans. This is just the sort of information Chinese banks are normally reluctant to reveal. Indeed, they often go to great lengths to avoid doing so.

Typically, the subterfuge works as follows: the bank lends to an asset-management company (AMC) that in return purchases its toxic loans. The contracts drawn up between the two parties include stipulations that enable the AMC to avoid the credit risks of the bad loans they are buying. Confidentiality clauses keep these arrangements from being disclosed, sometimes even to courts.

The authorities are now catching on. They have hit financial institutions with a flurry of penalties for improper handling of debts. The National Administration of Financial Regulation (NAFR), a new banking regulator, has handed out more than 20 punishments. In December Citic Bank, a commercial lender, was fined 220m yuan (\$30m) for mismanaging bad debt, a record amount. Agricultural Bank of China, a large state lender, received a 27m yuan fine for similar transgressions.

Increased surveillance can in part be attributed to the new watchdog's increased vigilance. Established last year, the NAFR has stronger enforcement capabilities than its predecessors. Supervision of banks had been divided among several agencies, allowing corruption and producing lapses in oversight, which contributed to the collapse of several banks, starting in 2019. The NAFR now seems to be taking the concealment of bad debts more seriously.

But some of the progress began earlier. A decade ago, instead of declaring the true size of their problems by identifying debts as "non-performing loans", banks shoved them into other categories of assets, signalling to regulators that there remained a good chance borrowers would repay (in fact, many of the companies had gone bankrupt). In 2017 one of the NAFR's predecessors began leaning on lenders to be more truthful. The result has been an outpouring of undesirable loans. Bank of Jiujiang's bad loans, for instance, increased seven-fold between 2015 and late last year.

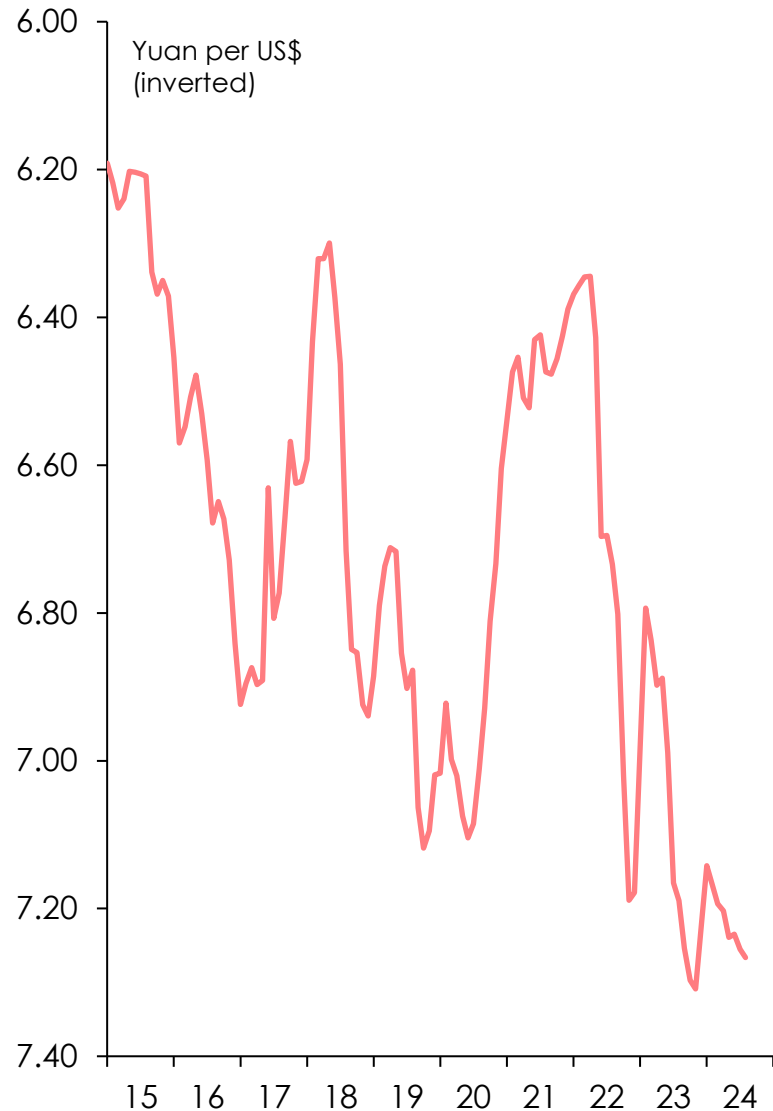
How much of this surge in activity can be trusted? Recognising and digesting bad debts is difficult. Discovering such lending weakens financial institutions' balance-sheets since they are forced to use capital to provision for future bad debts, which in turn makes it harder for the government to direct financial support to favoured industries in pursuit of other policy goals. Some revelations will happen legitimately as local governments recapitalise banks, pumping in funds to enable them to continue to write off bad debts.

Others will happen via AMCs, and thus will only sometimes be legitimate. China created four centrally controlled AMCs decades ago to Hoover up bad debts. They are now struggling. One needed a \$6.6bn bail-out in 2021. Others are poorly capitalised and as a result buying fewer and fewer bad debts, even as banks crank out more. In 2016 the four state AMCs bought nearly 1trn yuan of about 1.5trn yuan in total non-performing loans. By 2022 their purchases came to less than 500bn yuan, despite bad debts rising to almost 3trn yuan.

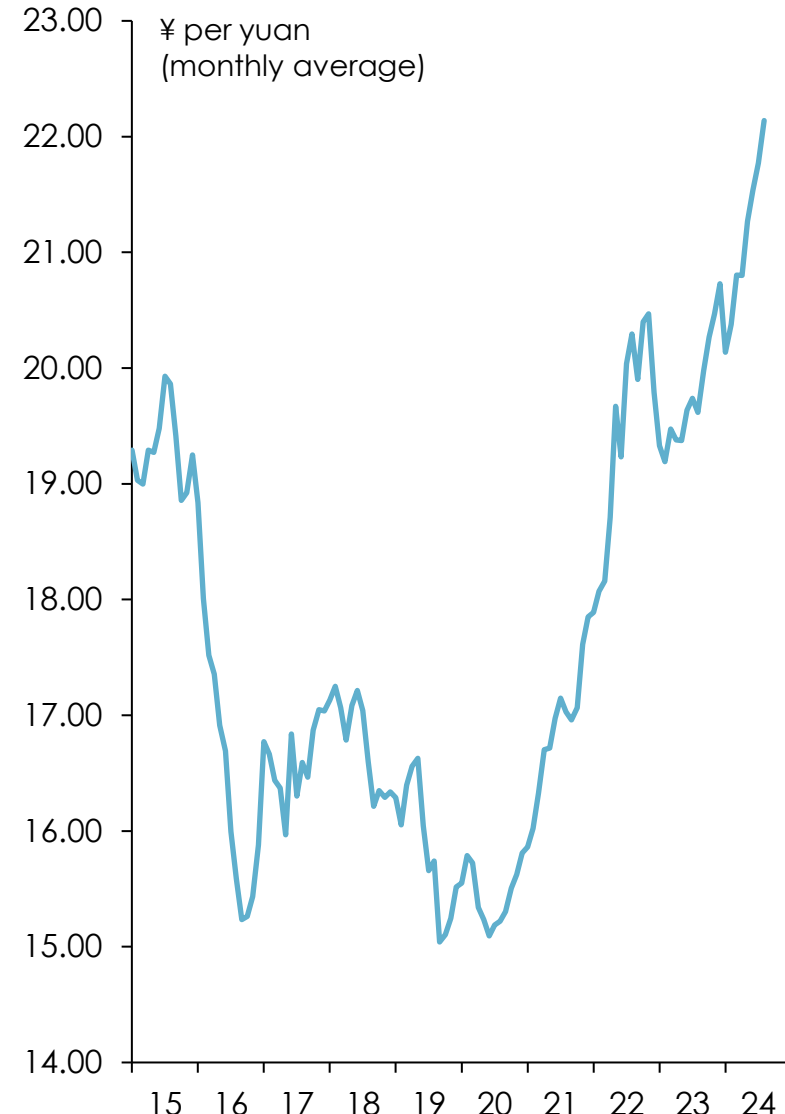
In late January state media reported that three of them would be merged with China's sovereign wealth fund. They have become distressed financial institutions in their own right and can hardly perform the debt clean-up work for which they were created. That is bad news for Bank of Jiujiang. It is also bad news for hundreds of other similar lenders. ■

Alternatively, the 'Chinese authorities' could engineer a big depreciation of the renminbi in response to the weakness in the yen and won

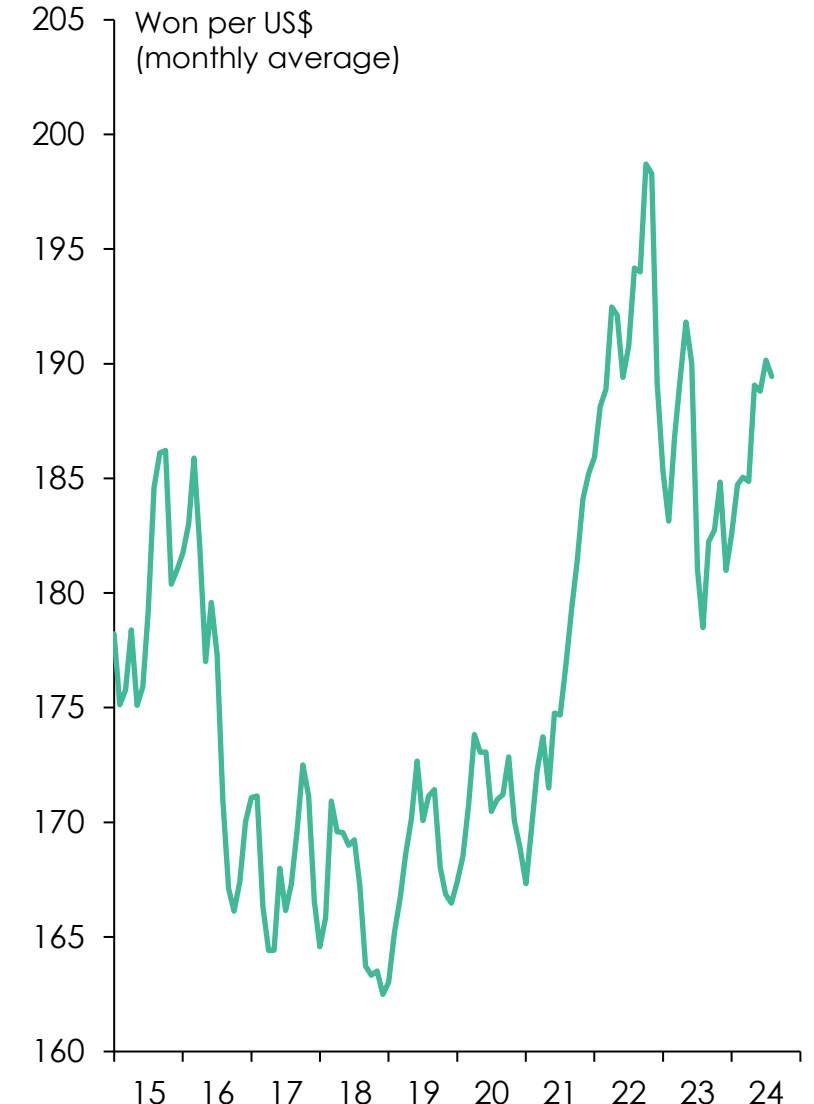
Yuan vs US dollar



Yuan vs Japanese yen



Yuan vs Korean won



Conclusions

- ❑ **China's days of heady, double-digit growth are well and truly behind it**
 - partly as a result of 'cyclical' factors, including the slow (Japanese-style) deflation of China's 'property bubble'
 - but importantly also as a result of entrenched 'structural' factors, in particular a now shrinking and rapidly ageing population, and steadily slowing productivity growth, as well as very high levels of corporate and local government debt
- ❑ **China's policy makers seem unwilling to – or unsure how to – respond to these forces**
 - despite very low inflation, 'the authorities' remain reluctant to deploy monetary or fiscal policy with the same force as they have in response to previous slowdowns
 - while official pronouncements emphasize the importance of 'new productive forces' as drivers of growth there appears to be no enthusiasm for policy shifts that would lift productivity growth
 - nor does there appear to be any willingness to embrace policy changes that would sustainably boost household consumption
 - instead the emphasis is on 'security' and 'stability' rather than economic growth
- ❑ **China's balance of payments position is weakening**
 - it's still running large merchandise trade surpluses (partly because of weak import demand)
 - but its services and income deficits are widening
 - and it's no longer a magnet for foreign investment
- ❑ **The renminbi could experience a sharp depreciation at some point in the next 1-3 years**
 - either as a result of capital flight prompted eg by a 'banking crisis' similar to Japan's in 1998
 - or deliberately engineered by 'the authorities' in response to Trump tariffs, or the decline in 'competitor currencies'
 - China's capacity to defend a quasi-fixed exchange rate isn't as strong as it once was
- ❑ **Despite all this China is, and will remain, a 'big' country (with all that that means)**
 - it will continue to seek to assert its position and its interests, both in the Asia-Pacific region
 - and it will continue to challenge what it regards as 'Western' (and especially US) hegemony in global governance

Important information

This document has been prepared by Saul Eslake on behalf of Corinna Economic Advisory Pty Ltd, ABN 165 668 058 69, whose registered office is located at Level 11, 114 William Street, Melbourne, Victoria 3000 Australia.

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