CHINA'S ECONOMY 2015/16: ADJUSTING TO A SUSTAINED SLOWDOWN IN UNCERTAIN STRUCTURAL TRANSITION (II)

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Executive Summary

1. China's economic growth in 2015 is expected to be 6.9%, substantially lower than the 7.3% of 2014. Growth for 2016 is likely to be still lower as the slowdown is expected to sustain.

2. The main thrust of China's current economic policy is to slow down the downward growth momentum while carrying out the essential economic reform and rebalancing its major growth drivers.

3. For years, China's economy has been pulled by a "three-horse carriage", namely, exports, investment and consumption, which constitute the three major sources of economic growth.

4. In the first three quarters of 2015, of the 7% total GDP growth, consumption contributed 58.6% and investment added 42.9% while exports gave a negative 0.1% to growth.

5. Exports' direct contribution to growth has always been relatively small partly because China's exports have high import contents (i.e. lower domestic value-added).

6. Specifically for 2015, export plunged to negative growth due to global recession and the erosion of China's export competitiveness from its rising unit labour cost. Increasingly, external demand (i.e. net exports) will cease to be China's dependable engine of growth.

7. China's economic growth used to be investment-led. However investment growth in the third quarter of 2015 shrank to only 8.5% growth from 20% a few years ago due to industrial overproduction and excess capacity as well as the property slump.

8. In any case, the “growth effect” of new investment projects has waned substantially as a result of the declining marginal efficiency of capital. Investment as an engine of growth for China has also started to splutter.

9. This leaves consumption as China’s most important source of growth for 2015. For a more balanced and sustainable growth, China’s future growth will have to be driven by the consumption of not just goods, but also more services.

10. For 2016, at least two dominant issues are crying out for greater attention from the government. The first is the serious debt problem, as total debt in mid-2015 had soared to 250% of GDP from 180% of 2008.

11. China’s debt problem is manageable and can be defused, given China’s high foreign exchange reserves and high domestic saving rates. However a serious debt overhang is always a drag on economic growth and any debt deleveraging is counter-growth in nature.

12. The other burning issue is how to maintain the exchange rate stability of the Renminbi (RMB), which had depreciated 5% against the US dollar in 2015, and is still under increasing pressure for greater devaluation in 2016.

13. As the RMB has recently been included in the IMF’s Special Drawing Rights basket, China is under additional pressures to speed up its capital-account opening and steer the RMB towards more flexible, market-based exchange rate.

14. Given China’s penchant for keeping an independent monetary policy, its main challenge ahead is how to manage the reasonable stability of the RMB exchange rate against mounting domestic and international pressures for its greater devaluation.