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Chi on China

China Loses its "Animal Spirits"

People who think they know everything are a great annoyance to those of us who do.

Isaac Asimov

SUMMARY

- Debt-financed public spending has been sustaining China's GDP growth since 2013 as private investment growth has been falling. In other words, China's private sector has lost its "animal spirits", and the economic engine has mainly been running on "public fuel".
- While commodity price decline and policy failure to boost private incentive are identified as causes for the drop in private investment growth, the true cause of shrinking structural demand for what the investment sector produces has not been fully understood.
- The key to understand this is the secular slowdown in China's housing demand which is, in turn, due to structural changes in China's growth model. The revival of animal spirits needs adaptation by the private sector to the new China and genuine supply-side reforms to unlock private investment incentive.

China's gross fixed capital formation has been falling since 2010, driven mainly by a steady decline in private investment (Chart 1). Credit-fueled public infrastructure spending has replaced private investment (Chart 2) to keep GDP growth from falling significantly below 7% since the current economic down-cycle began in 2013. The persistent weakness in private-sector investment on the back of rising credit growth is puzzling. It prompted Beijing to send in May 2016 nine inspection teams across the country to find out why the private sector was not investing.

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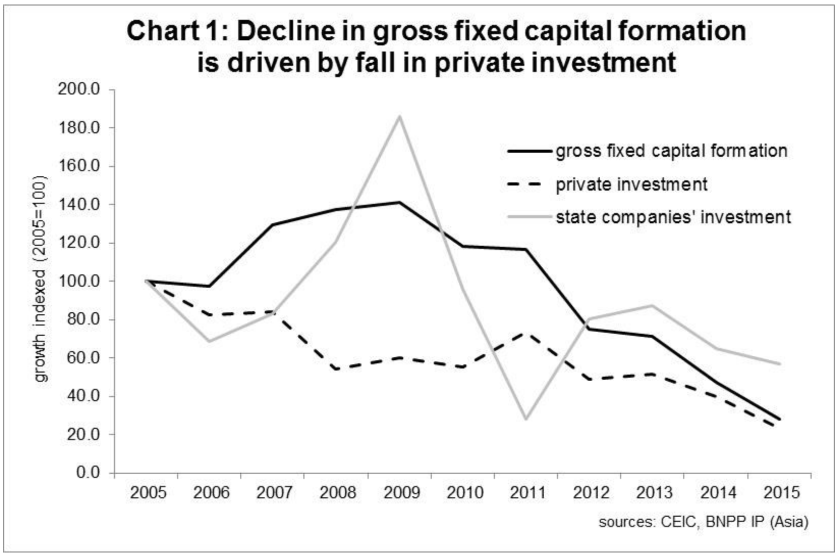
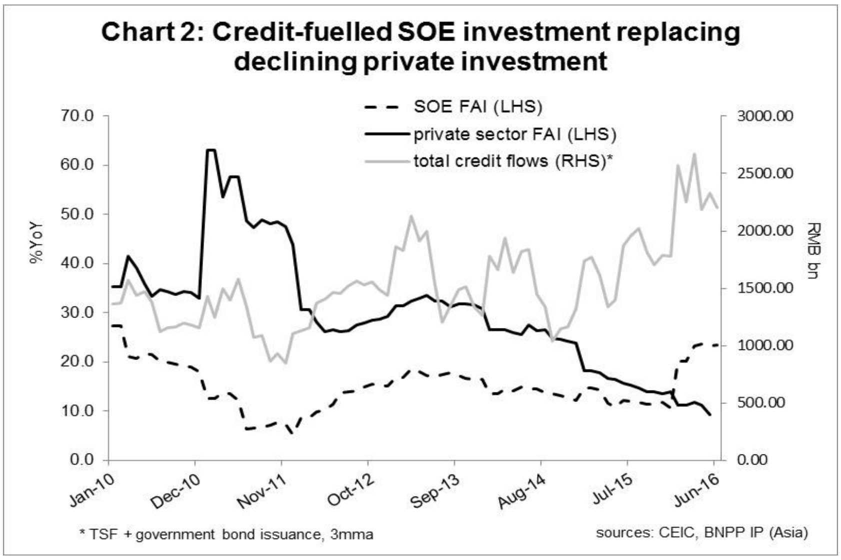




Cyclical and technical factors

After a two-month study, the investigators concluded that slowing macroeconomic growth momentum, favouritism towards state-owned enterprises (SOE), failure of the local governments to implement effective measures to boost private investment and corruption crackdown were the culprits for stymieing China's "animal spirits".

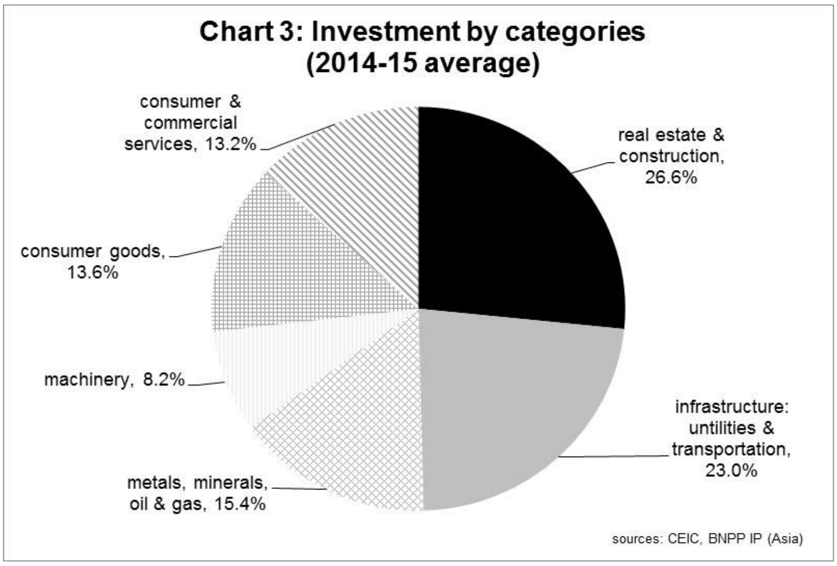
The global commodity price slump since mid-2014 has aggravated the weakness in China's growth momentum and corporate profits by hitting China's commodity producers hard. Since commodity producers are big buyers of machinery and other industrial and capital goods, weak demand in this sector has also weakened pricing power for many manufacturers. Meanwhile, the service sector, which has grown bigger than the manufacturing sector since 2013, is not that insulated from the weakness of the industrial sector because industrial firms are big customers for logistic, trade, financial and commercial services companies.

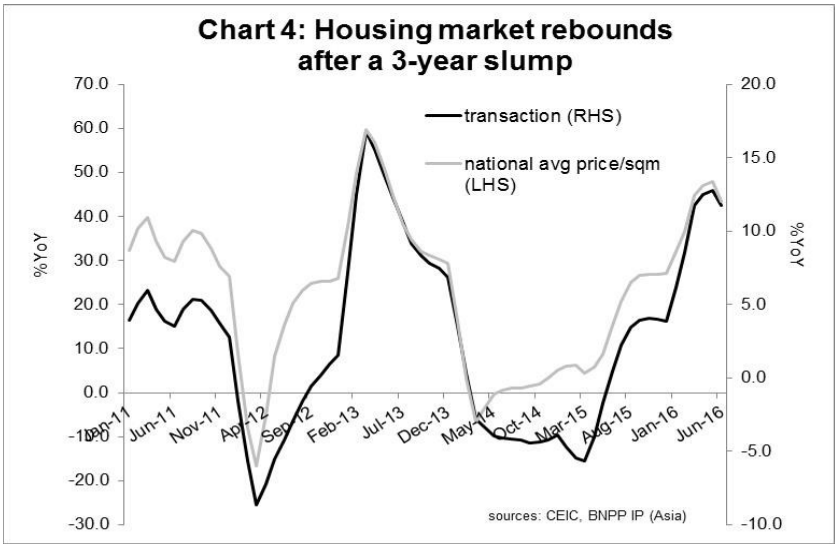
Some argue that the most important driver for the decline in private investment was declining profit growth. This is not an explanation. Profit growth is an endogenous variable that cannot be used to explain another endogenous variable, private investment growth. We need to understand what lies behind the decline in profit growth in order to explain the loss of animal spirits.

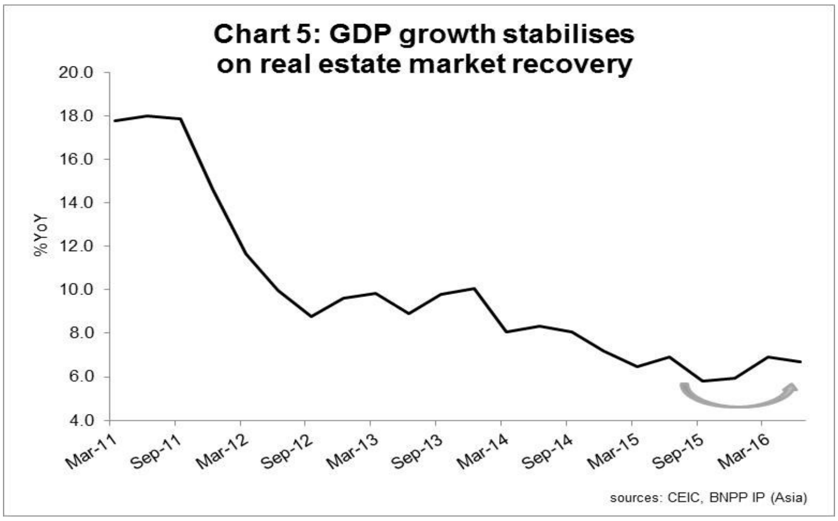
The real estate super-cycle

While the cyclical and technical factors have been thoroughly discussed by the public and private circles, little attention has been paid to the underlying structural factor that is hurting private investment incentive. This is the weakening of the final demand for output produced by the investment or capital-intensive sector in China. The key to understand this puzzle is China’s housing market, which followed the growth pattern of the country’s supply-expansion development model until President Xi Jinping took office in 2013.

The substantial slowdown in the housing sector since 2013 explains most of the decline in investment growth because residential investment is a large part of total investment and it is primarily driven by private firms. Real estate and construction account for 27% of total investment. But if we include their spillover effect on related sectors such as metals and minerals, machinery and consumer goods (notably white goods, furniture and cars), real-estate-related investments account for more than 50% of total investment in the economy (Chart 3).



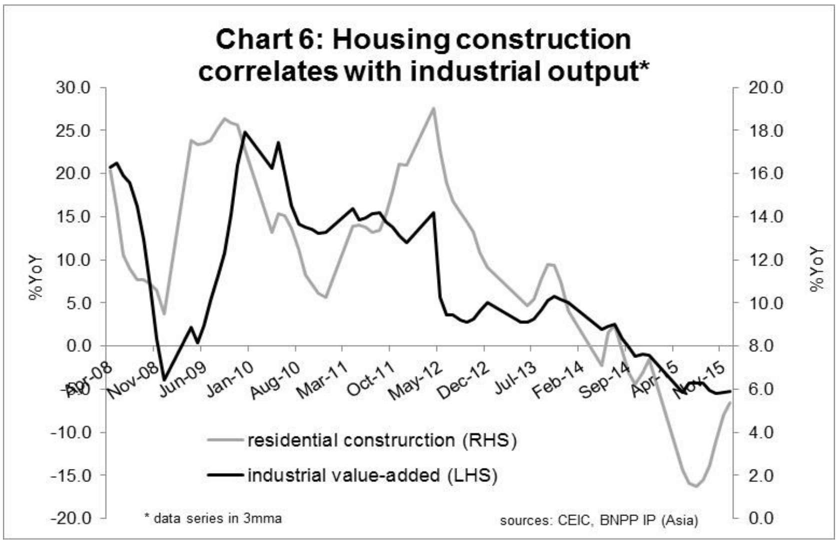




It is thus not surprising that a rebound in the housing market since early this year (Chart 4 and 5) has helped stabilise the economy. This is seen in the better-than-expected 6.7% real GDP growth rate in 2Q 16, which has helped calm market fears about an economic-landing. The real estate sector and its spillover effect should be large enough to keep GDP growth within the government’s medium-term target range of 6%-7% a year.

The question is how sustainable is the era of fast growth in the housing market and to what extent the resultant pick-up in construction will induce companies in other industries to invest? This is where the structural problem for reviving China’s animal spirits lies. China’s housing demand has likely passed its high-growth phase, with housing construction growth expected to go into a secular decline soon. This means that the capital-intensive sector, which has focused on producing all this housing units through the decades, is facing a structural decline in demand for its output.

China’s housing market has long been a key driver of GDP growth, as real estate is a big source of demand for industrial output (Chart 6). When housing demand started to take off in 2003, the mining and manufacturing sectors also boomed as the surge in the housing construction drove demand for steel and other construction materials, equipment and household appliances. This resulted in a virtuous investment cycle as the makers of those products expanded their capacity and demand for more capital goods.



However, housing demand peaked in early 2013 and residential investment growth fell. So the multiplier effect on the economy went into reverse, dragging on total investment and GDP growth. Weakening demand for goods related to construction created widespread deflationary pressure in the industrial sector. Until the industrial sector can adjust to the “new normal” of slow growth in housing demand, investment growth will be stuck in low gear.

The structural problem

China’s housing demand is not collapsing, but its high-growth era is over and this will lead to a structural decline in construction growth. From a market perspective, urban population growth and changes in per-capita living space determine the future of housing demand growth. While urbanisation will continue, the growth rate of urban population is declining due to declining population growth. This will constrain future demand for housing.

Per-capita living space refers to upgrading demand for housing. As households move from factory dormitories and crowded slums to modern flats, average living space rises. When most of the population lives in modern flats, average living space will stop rising. The movement of upgrading demand towards the maximum level of per capita space determines how long the high-growth phase of housing demand will last.

Cross-country evidence suggests that China’s upgrading demand growth is set to fall going forward. For example, average per-capita living space in the European Union is about 35 square metres, and that in Taiwan is 40 square metres. China’s national average per-capita living space was already 31.5 square metres in 2015, and the average annual increase slowed from 0.9 square metres in 2007-2012 to 0.7 in 2013-2015. This evidence suggests that the Middle Kingdom’s upgrading housing demand is approaching the limit of 35-40 square metres typically seen in other countries; few countries in the world have per-capita living space more than 40 square metres.

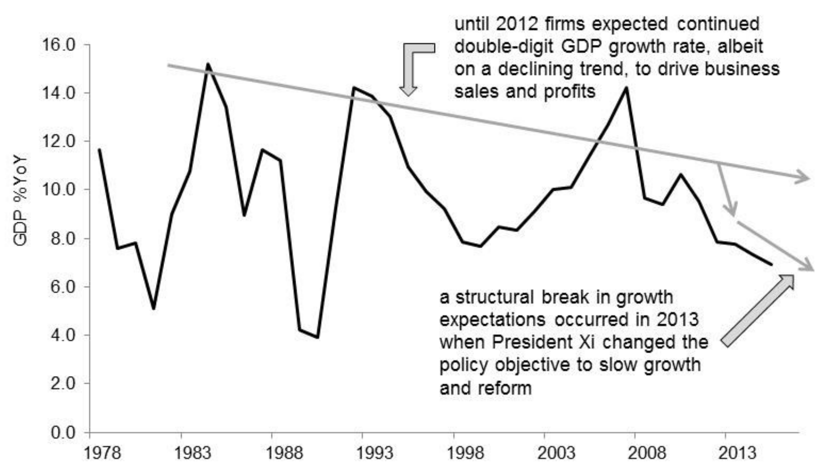
From a macroeconomic perspective, the structural change in China’s growth model marks the end of high-growth housing demand and construction. The growth of China’s housing market follows the nation’s supply-expansion development model, in which economic agents build/invest/produce first to expand supply and create jobs so that demand catches up later. This growth model worked for more than 30 years when the country was chasing high growth rates creating swift demand catch-up.

The supply-expansion model began to break down when President Xi Jinping took office and changed the country's policy objective from chasing growth quantity to achieving growth quality through structural reforms. Beijing aims at keeping GDP growth at 6%-7% in the coming years to create a macroeconomic backdrop for facilitating structural reforms. This means no more swift demand growth to absorb all that supply/production/investment excesses that economy has built up.

China's housing market and construction are facing the same structural adjustment. This implies that the capital-intensive sector has produced a stock of output (houses) under the old economy that the new economy no longer wants. It also means that the decline in housing has created a structural demand-supply imbalance in the capital-intensive sector, inflicting damages in private investment incentive by hurting growth expectations.

While profitability and credit availability determines the ability of firms to invest, it is their growth expectations that determine their incentive to invest. Until 2012 Chinese companies could expect continued high (double-digit) GDP growth rates to boost their sales and profits. But since 2013, the change in the government's policy objective to a combination of slow growth and reform has forced a structural decline in the market expectations on future profit growth (Chart 7). This hurts private investment incentive.

Chart 7: A structural decline in growth expectations



sources: CEIC, BNPP IP (Asia)

Will animal spirits return?

Regaining animal spirits requires not a revival of housing construction, which is entering a secular slow-growth phase, but finding new sources of final demand. Yet, in China's "new normal" economy, many of the new growth sectors are not in the capital-intensive industries but in services and high value-added manufacturing and industries that are protected by government monopoly.

This structural change in the growth model argues that Chinese companies will have to adapt to the slow-growth economic environment and the country will have to unwind the supply-expansion distortions that it has built up over the years by implementing supply-side reforms to unlock the potential private-sector capital spending. This could be done by genuine state-sector reform to force the exit of the inefficient SOEs and allow the entry of new competitors into the service and other new economic sectors that are closed to private

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investment. There are some signs of progress in this direction, with Beijing implementing stricter environmental standards, closing some high-pollution industries and excess-capacity sectors, notably iron & steel and coal mining, and opening up some protected sectors, such as banking.

However, genuine supply-side reform has yet to be implemented, as we argued recently[1]. In the short-term, China's supply-side reform will only focus on improving operation efficiency of the SOEs while minimising the impact on employment. Under these circumstances, the return of animal spirits will be slow-coming. *Ceteris paribus*, the onus of sustaining GDP growth at the government's 6%-7% growth range will rest on public-sector investment.

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[1] See "*Chi on China: China's Supply-side Reform is not What You Think*", 25 May 2016.

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