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IS CHINA LOSING CONTROL OF ITS ECONOMY AND CURRENCY?

When you wake up every day, you have two choices. You can either be positive or negative; an optimist or a pessimist. I choose to be an optimist. It's all a matter of perspective.

Harvey Mackay

Worries about an economic hard-landing in China forcing Beijing to sharply devalue the renminbi have sent shockwaves through the global financial markets. Some investors even wonder if Beijing is losing control of its economy and currency. In my view, such a bearish view seems to have missed half of the picture.

Granted, traditional macroeconomic growth indicators, such as industrial output, electricity consumption, freight volume and steel and cement output, have painted a hard-landing scenario for the Chinese economy by showing either anaemic growth rates or outright contraction (Charts 1 and 2). However, these indicators only represent China's industrial- and manufacturing- based economy.

The new economy, which is represented by the service-based tertiary sector, has grown larger than the old economy, which is represented by the secondary sector, since 2013 (Chart3). This suggests creative destruction in progress, where the new growth indicators, such as movie box revenues, internet usage, online sales and insurance premium, have shown robust growth (Charts 4, 5, 6 and 7).

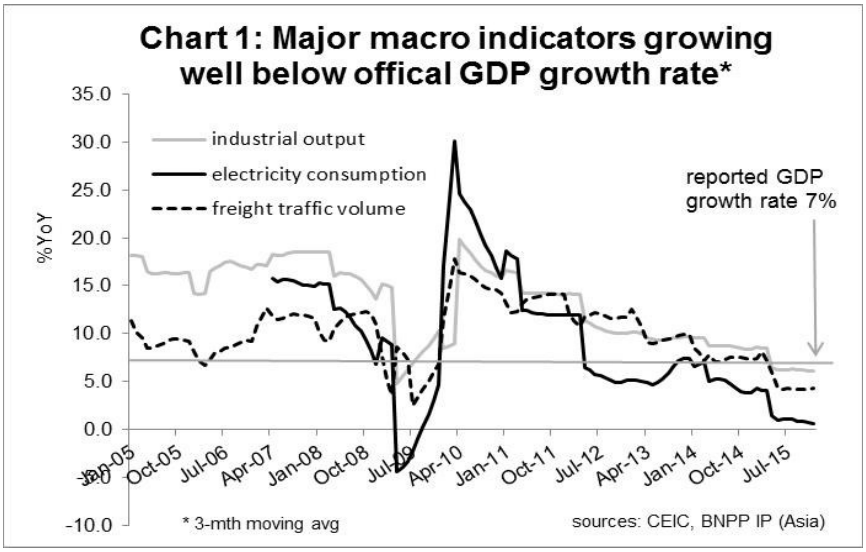


Chart 1: Major macro indicators growing well below offical GDP growth rate*
industrial output
electricity consumption
freight traffic volume
reported GDP growth rate 7%
%YoY
* 3-mth moving avg
sources: CEIC, BNPP IP (Asia)

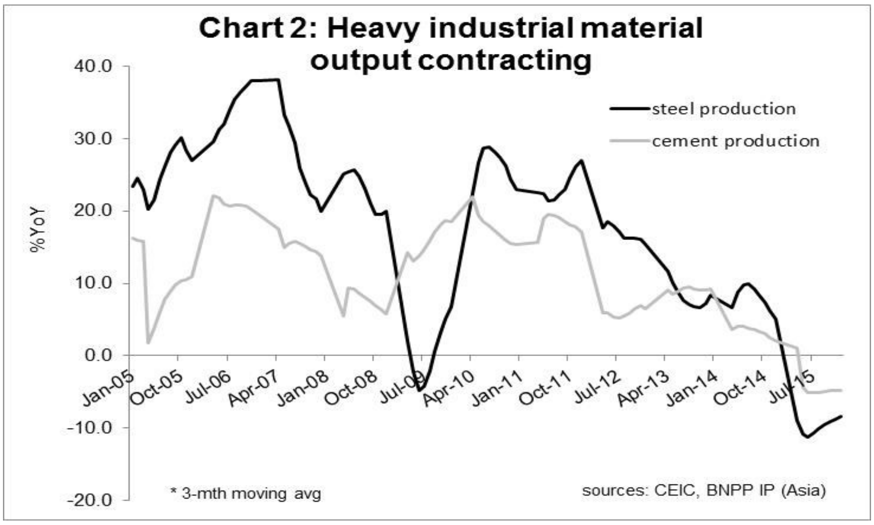


Chart 2: Heavy industrial material output contracting
steel production
cement production
%YoY
* 3-mth moving avg
sources: CEIC, BNPP IP (Asia)


Chart 3: China's structural rebalancing in progress
secondary sector
tertiary sector
the tertiary sector is now bigger than the secondary sector in the Chinese economy
share of GDP
sources: CEIC, BNPP IP (Asia)

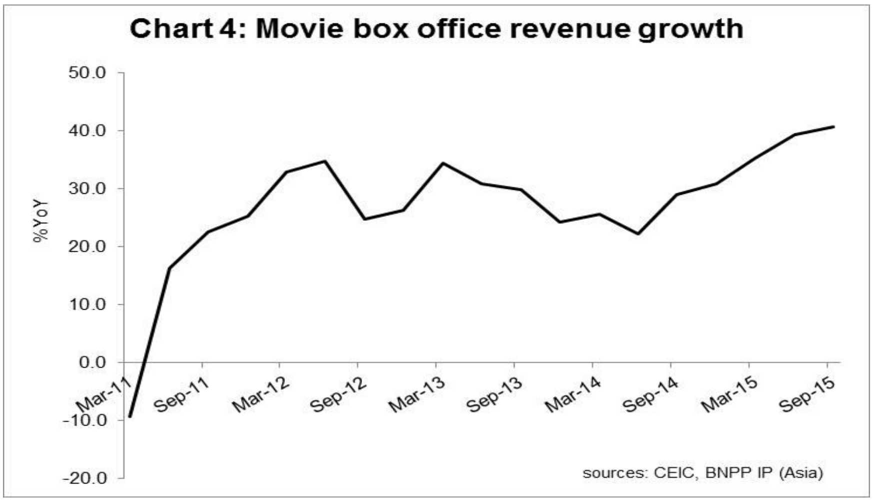


Chart 4: Movie box office revenue growth
%YoY
50.0
40.0
30.0
20.0
10.0
0.0
-10.0
-20.0
Mar-11
Sep-11
Mar-12
Sep-12
Mar-13
Sep-13
Mar-14
Sep-14
Mar-15
Sep-15
sources: CEIC, BNPP IP (Asia)

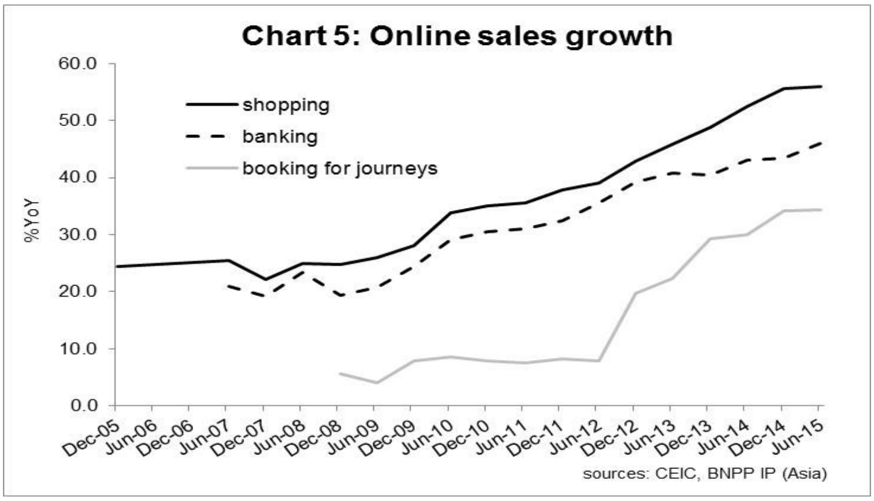


Chart 5: Online sales growth
%YoY
shopping
banking
booking for journeys
60.0
50.0
40.0
30.0
20.0
10.0
0.0
Dec-05
Jun-06
Dec-06
Jun-07
Dec-07
Jun-08
Dec-08
Jun-09
Dec-09
Jun-10
Dec-10
Jun-11
Dec-11
Jun-12
Dec-12
Jun-13
Dec-13
Jun-14
Dec-14
Jun-15
sources: CEIC, BNPP IP (Asia)

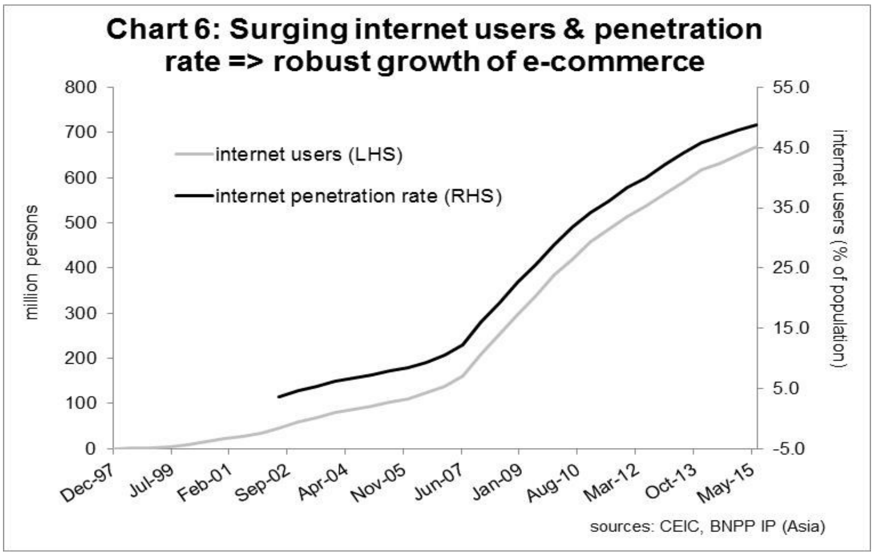
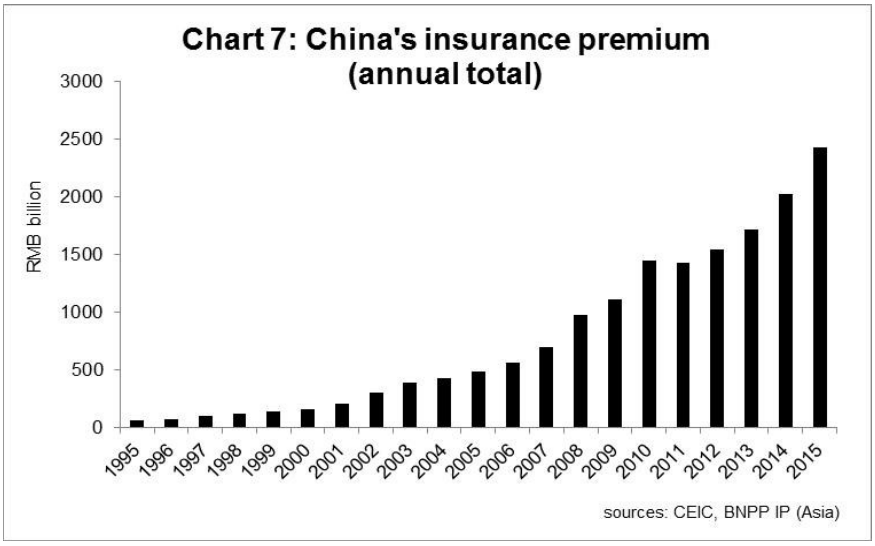


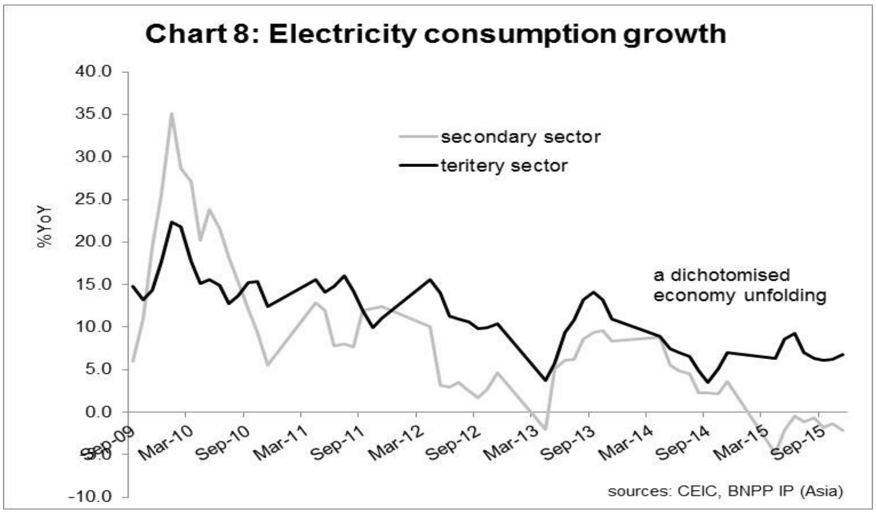
Chart 6: Surging internet users & penetration rate => robust growth of e-commerce
million persons
internet users (% of population)
internet users (LHS)
internet penetration rate (RHS)
800
700
600
500
400
300
200
100
0
55.0
45.0
35.0
25.0
15.0
5.0
-5.0
Dec-97
Jul-99
Feb-01
Sep-02
Apr-04
Nov-05
Jun-07
Jan-09
Aug-10
Mar-12
Oct-13
May-15
sources: CEIC, BNPP IP (Asia)

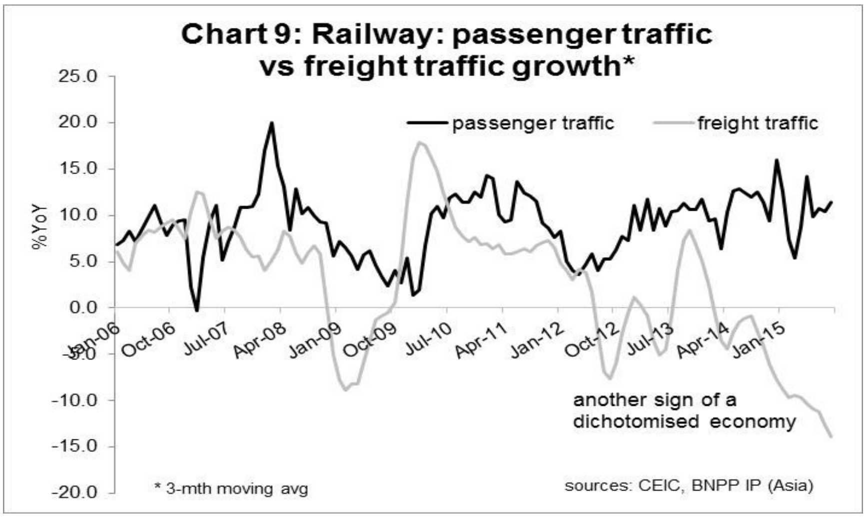


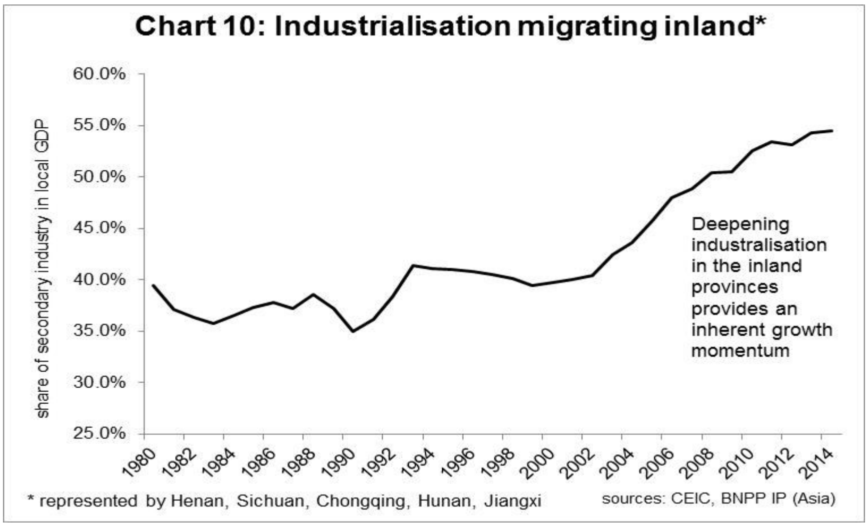
The traditional macroeconomic indicators fail to capture such structural changes. The fact that China is going through a difficult transition from the old to the new economy with some setbacks in financial reforms does not necessarily spell an economic crisis.

The dichotomy in China's economy is apparent in the electricity consumption and railway transport data. While electricity consumption by the old economy has been contracting, usage by the new economy has been growing steadily (Chart 8). Notably, passenger traffic (which is related to the new economy of personal travel and domestic tourism) has been growing briskly while freight traffic (the transportation of industrial goods and materials etc.) has been falling (Chart 9).

Growth of the tertiary sector has underpinned urban employment growth so far, which is crucial for generating personal income and, hence, consumption growth. Meanwhile, China's industrialisation is also migrating westward (Chart 10), generating growth momentum by tapping unused and cheaper resources. The trouble at this stage is that growth of the new economy is not strong or large enough to offset the contraction of the old economy. This argues for a policy-easing bias until economic momentum stabilises.







Furthermore, China's progress on economic restructuring has run into some setbacks in its financial reform, notably the bursting of asset bubbles and a clumsy renminbi policy shift. This has led to an exodus of capital recently. However, setbacks do not mean crises. Beijing is walking a fine line between sustaining reasonable GDP growth and implementing structural reforms. The resultant creative destruction is dragging on growth and creating volatility. This situation should not be seen as a sign of Beijng losing control of the economy.

What about the currency? Some market players have used the Impossible Trinity theorem to argue that with capital fleeing China, it would not be able to keep the renminbi stable while easing monetary policy simultaneously. If Beijing wants to cut interest rates to stabilise domestic GDP growth, it would have to allow a sharp devaluation in the renminbi, as the pessimists argue.

However, the application of the Impossible Trinity analysis to China is flawed. In reality, there are no signs of capital flight. Otherwise, one should have seen a significant depletion in domestic deposits, which has not been the case. Indeed, onshore renminbi deposits are still growing at double-digit rates (Chart 11).

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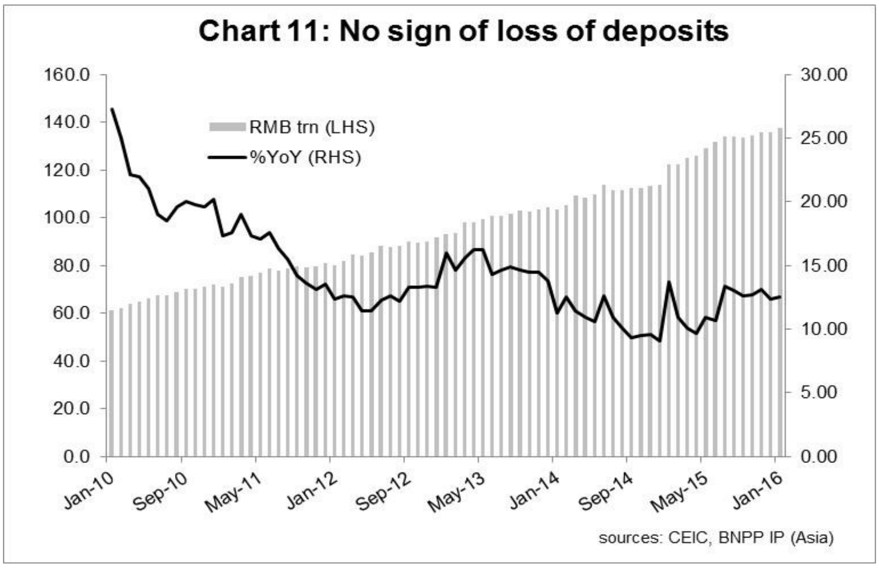

More crucially, the Impossible Trinity is not as pressing a constraint to China as many have claimed. Despite the seemingly big strides in financial reform that China has made in recent years, its capital account remains relatively closed. Most of the liberalisation measures have been aimed at official institutions' investments. Beijing has only been opening up the capital account asymmetrically by allowing capital inflows but still restricting capital outflows.

Sure, China lost about USD700 billion in FX reserves last year, despite a basic surplus (current account surplus + net FDI inflows). But a big chunk of the decline came from the valuation effect, Chinese companies repaying their foreign debt and a one-time transfer to recapitalise the policy banks. These factors accounted for more than two-thirds of the decline in FX reserves, according to my estimate.

There is no denial that there are capital outflows from China, but they do not signify Beijing losing control of the renminbi. Since there is still no full capital account convertibility, China's monetary policy will only be partly compromised if the PBoC wants to keep the control of the renminbi in the medium-term.

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