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DISRUPTIVE
INSIGHTS

Will China's Economic Slump Lead to a Worldwide Recession?

LPL Financial

DOES CHINA POSE A RISK TO THE GLOBAL ECONOMY?

Is this fear warranted? This issue of *Disruptive Insights* analyzes China's economic slowdown and potential impacts to the global economy and financial markets, while providing insight into the internal workings of the Chinese economy and issues that may help or hinder it going forward.

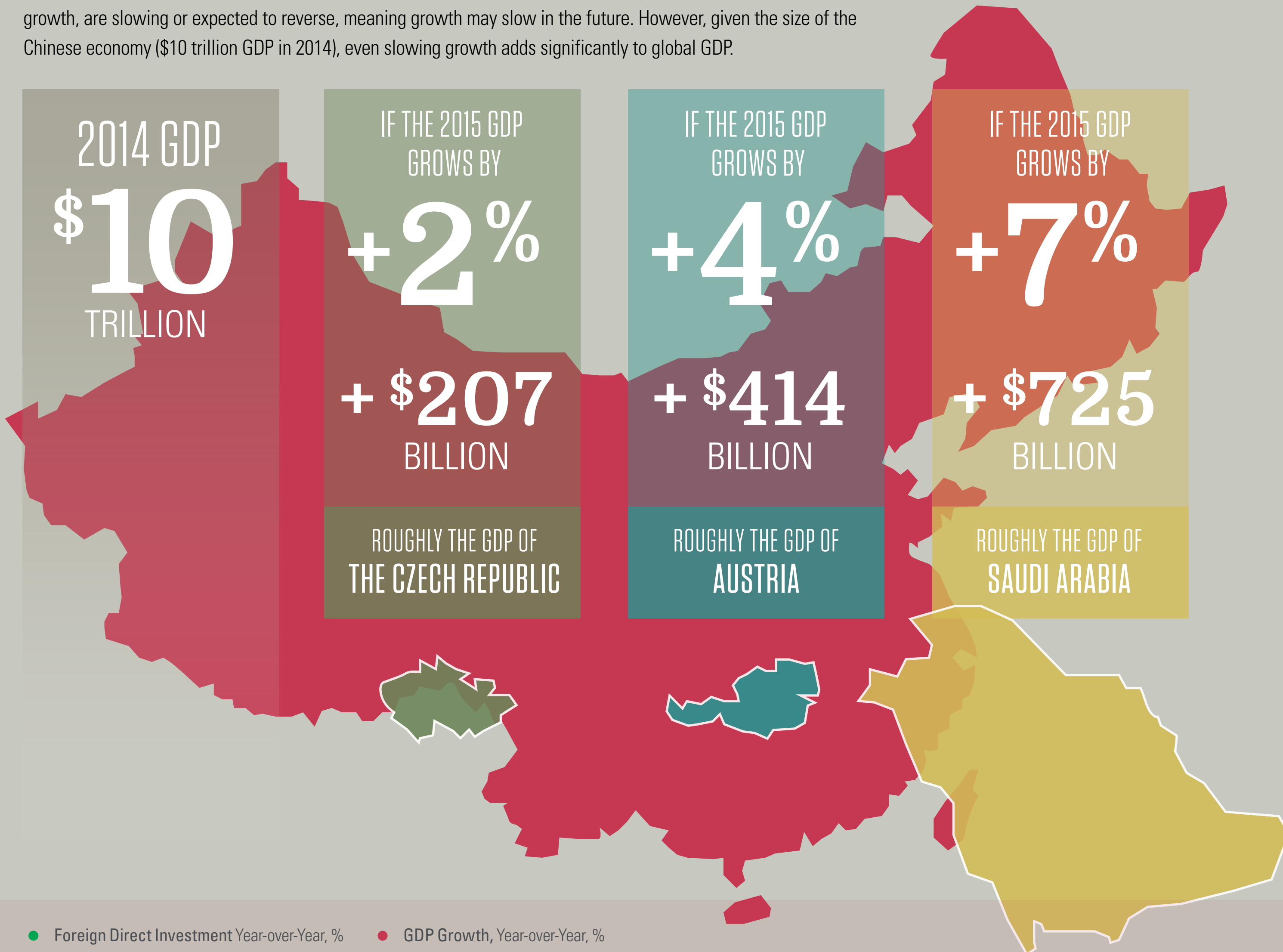
China has produced an average of 40% of the world's total growth over the past five years, adding an average of nearly 1.5% per year to gross world product over that time period. To put this in perspective, if China had only managed a 2% annual growth rate (in U.S. dollars) since that time, the world would have missed out on just under $4.7 trillion in economic output, approximately equal to the gross domestic product (GDP) of Japan for 2014.*

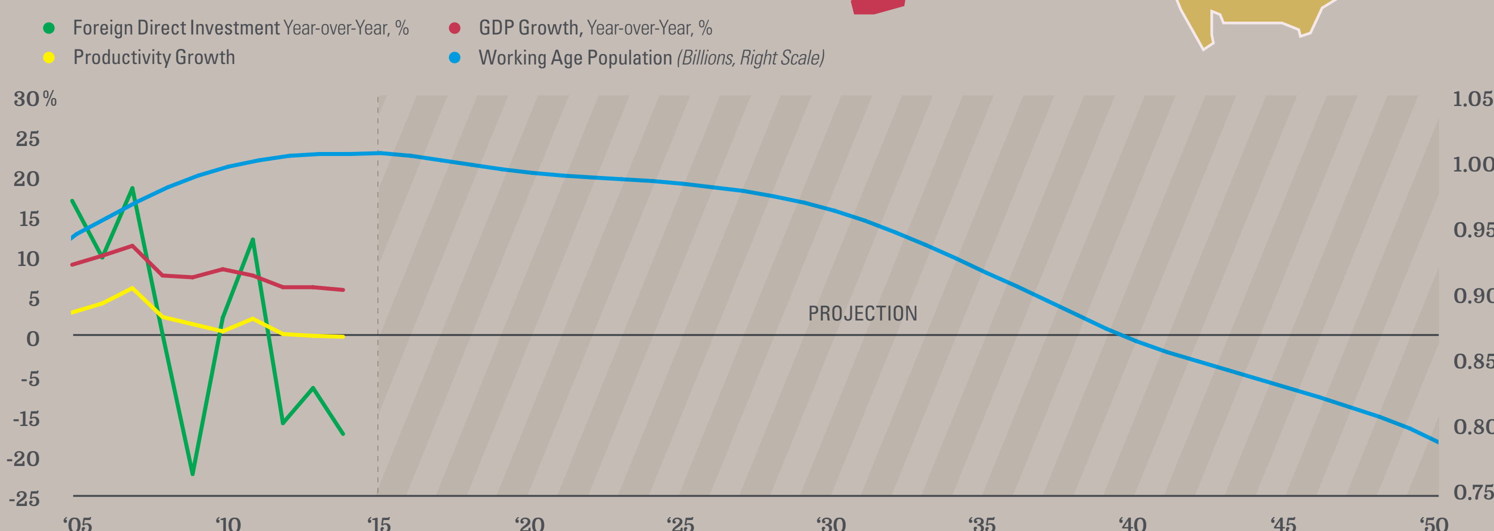
Therefore, China's economy is a big deal in terms of global growth, which explains why concerns over China's economy and stock market sparked bouts of global market weakness in recent months. A continued slowdown in the Chinese economy could put a major dent in global growth expectations for 2016 and beyond. A slowdown, our base case, could be a manageable event; but if China's economy slows more than expected, it could lead to weaker global stock market performance, as investors react to the prospect of slower growth and weaker earnings. However, a slowdown does not necessarily imply a recession.

*The World Bank, October 2015.

Even a Little Growth Goes a Long Way in China

Foreign investment and a growing labor pool have been key drivers of China's growth, but these forces, along with productivity growth, are slowing or expected to reverse, meaning growth may slow in the future. However, given the size of the Chinese economy ($10 trillion GDP in 2014), even slowing growth adds significantly to global GDP.





Source: LPL Research, Haver Analytics, The Conference Board, China National Bureau of Statistics, The World Bank 10/08/15

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

EXECUTIVE SUMMARY

Determining the effects of Chinese economic turmoil on the United States and the rest of the world is difficult to do without an understanding of China's economic structure, but the fact is that for all of the headlines, the inner workings of China remain a mystery to many in the United States. We investigate whether China poses a risk to the global economy, with these six common topics examined:

- **Currency.** The 3% movement in August 2015 came amidst a period of economic weakness, but was actually relatively minor given that the yuan had appreciated significantly against other world currencies (including the dollar) over the prior 10 years.
- **Stimulus.** The Chinese government uses targeted stimulus to help attain its goal of transforming the Chinese economy away from its reliance on exports to a focus on consumer spending. The consumer focus is simply the latest step by the Chinese government to manage growth.
- **Debt levels.** Though the rise in debt levels is unsustainable, China's financial system isn't as heavily leveraged as Western nations were heading into 2008, meaning that the chance of a massive deleveraging event is low.
- **Treasury holdings.** It would not be in China's interest to sell their Treasury holdings en masse given that market disruptions could lead to losses, and a rise in U.S. interest rates could damage demand for Chinese exports.
- **Ownership.** China is a hybrid system: socialist in the government's ownership or control of many of the factors of production and centralized economic planning, while still allowing at least partially free markets to function in certain parts of the economy.

IS CHINA'S RECENT CURRENCY DEVALUATION A SIGN OF TROUBLE?

China's currency devaluation in August 2015 must be placed in the context of sustained strength. Over the past 10 years, China's central bank, the People's Bank of China (PBOC) allowed the yuan to appreciate approximately 25% versus the dollar. Keep in mind that the PBOC pegs the Chinese currency (the renminbi, or commonly called the yuan) very close to the U.S. dollar. The PBOC does allow the yuan to trade in a small band (+/- 2%) around the predetermined price, but hasn't historically taken market movements into account when setting the next day's price. China made an announcement in August of a change to this calculation methodology, and it now takes the previous day's trading into account when setting the exchange rate. Though the market has been asking for a similar move for years, because the move followed a particularly bad international trade report, it was widely viewed as a devaluation of the yuan engineered to make

Chinese exports more affordable for other countries. Compounded by the 27% gain of the U.S. dollar against a basket of foreign currencies from May 2014 through March 2015, the yuan had appreciated dramatically against many of the world's currencies in recent years. Against that backdrop, the yuan devaluation of approximately 3% versus the dollar in early August 2015 is a very minor adjustment.*

China's currency adjustment was the latest move by a government that maintains firm control and was merely trying to manage growth. Although China continues its transition to more of a consumer-led economy, exports are still a driver of the economy, and the devaluation was one of several moves the Chinese government has made from late 2014 and throughout 2015 to assist economic growth. Market reaction to the news was negative, believing it was the latest signal of a faltering economy, but understanding the move with respect to significant currency appreciation is the correct context.

The incident does provide an interesting look into how China's economic model differs from much of the Western world. Please see the "China Is a Command Economy" section at the end of this publication.

WHAT IS THE MOTIVE BEHIND RECENT STIMULUS MEASURES?

Like the currency devaluation, the Chinese government has not been shy about using targeted stimulus measures to help attain its stated goal of transforming the Chinese economy away from its reliance on exports to a focus on consumer spending. Following 2008, Chinese officials learned the hard way that an export-oriented economy can be at the mercy of global economic growth swings. The inward focus toward consumers reflects a desire to become less dependent on foreign economies for prosperity and growth. The consumer focus is simply the latest step by the Chinese government to manage growth.

The historical path of other countries may provide a guide. Japan, for example, started out in the 1950s as a manufacturer and exporter of relatively low value-added goods. Over time, it moved to manufacturing and exporting higher-end goods, which increased its own national wealth. South Korea followed essentially the same path beginning in the 1980s. China too has followed this path, and the quality and sophistication of Chinese goods increases annually. It is also beginning to make higher value-added items, such as airplanes and other sophisticated products.

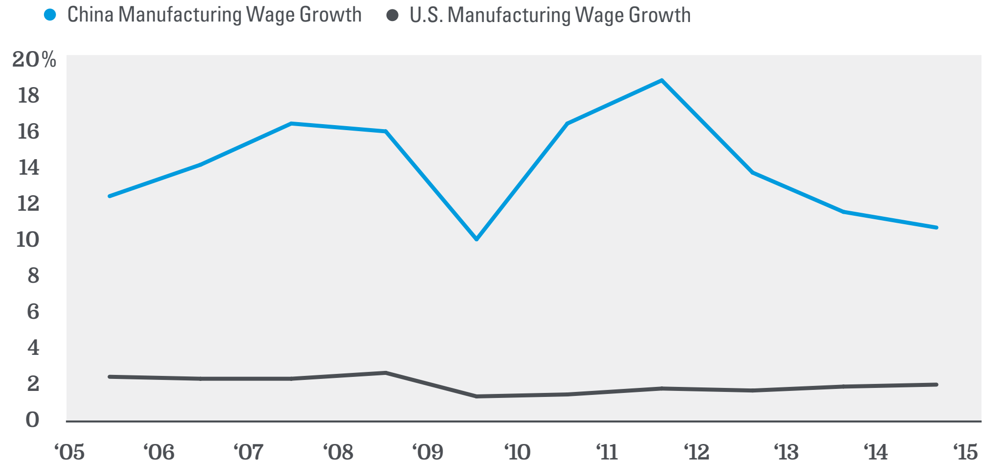
*Federal Reserve Board, October 2015

Unlike smaller countries like Japan and South Korea, China's large population raises the possibility that its future is not in continuously increasing exports, but rather in redirecting its manufacturing capabilities to its internal market. The United States did not grow after World War II through exports, but by meeting the demands of its own people for housing, transportation, consumer goods, and leisure. China also has a large population and geography that desire better goods and services. Because of its potentially large internal market, China's economic path may look more like that of the U.S. than its Asian neighbors.

Manufacturing has been the backbone of the Chinese economy for some time, as cheap labor provided a competitive advantage to foreign companies that manufactured products in China. However, over time, wage growth has eroded this advantage [Figure 1]. Other issues, such as widespread pollution, are also pushing China away from heavy industry and toward a more consumer-oriented future, though a few roadblocks related to spending habits, income, and productivity growth stand in the way.

Disincentives to spend. The household savings rate in China is approximately 20%, compared with 4.6% in the U.S. The lack of a social safety net in China is a major driver of this gap, as it forces Chinese citizens to save large amounts of income to pay for things such as medical emergencies, a sudden job loss, or retirement. The Chinese government is increasing health insurance coverage, and retirement plans are highlighted in its current five-year plan to help address this issue. Still, it will likely take time and reforms for Chinese citizens to change their behavior and spend more.

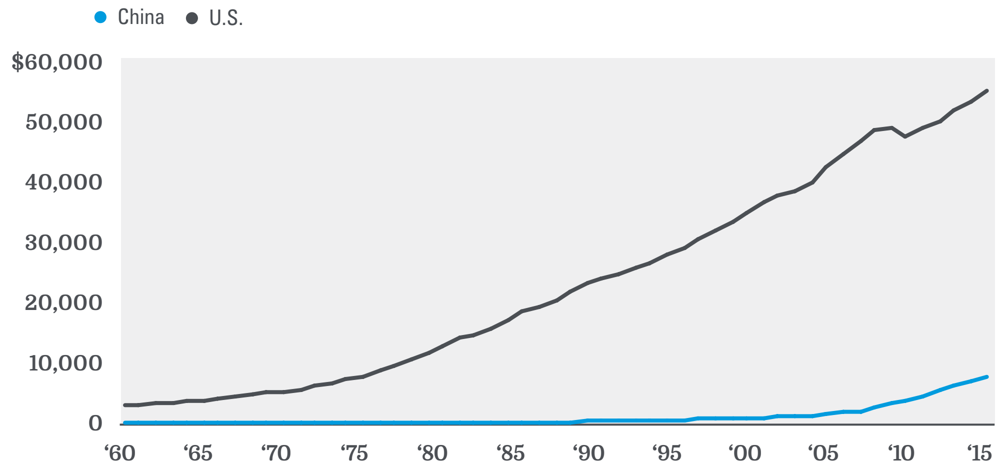
1 China's Manufacturing Wage Growth Has Far Exceeded the U.S. over the Past 10 Years



Source: LPL Research, Haver Analytics, Bureau of Labor Statistics, China Ministry of Labor and Social Security 10/08/15

Income gap relative to developed nations. Although China's total economic output is moving toward U.S. levels, it is important to remember that China has 1.4 billion people, while the U.S. has 325 million. In 2014, China's per capita GDP was $7,593, while the U.S. stood at $54,629, according to the World Bank. Thus, while China may be on its way to a successful transition to a consumer-based economy, it will likely be decades before domestic spending will be on par with developed economies [Figure 2].

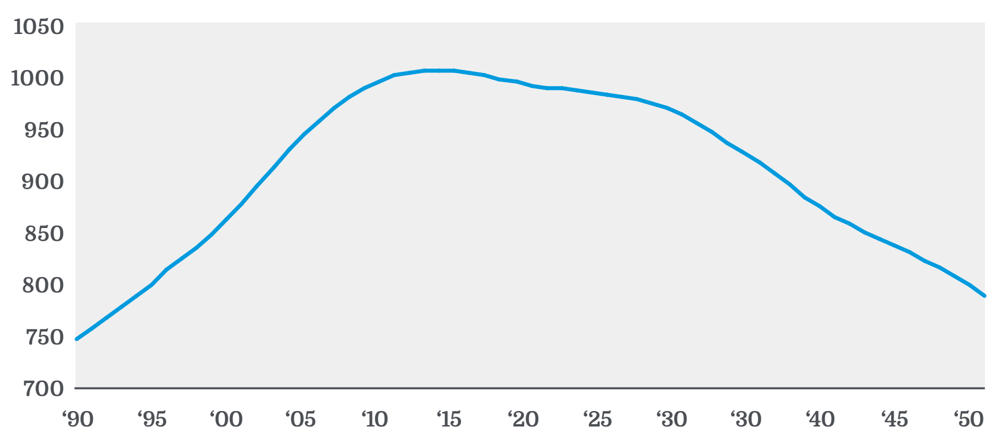
2 China's Per Capita GDP Is Much Lower Than the U.S.



Source: LPL Research, The World Bank 10/08/15

Reported in U.S. dollars.

3 Projections of China's Working Age Population Through 2050



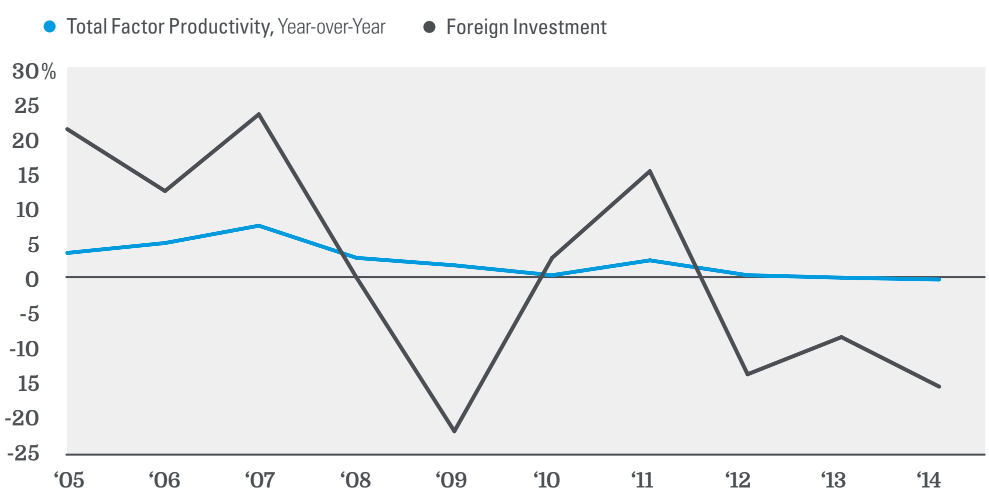
Source: LPL Research, The World Bank 10/08/15

Working age population is defined as ages 15–64.

Lack of productivity growth. At the heart of China's problems is productivity growth. Over the years, China's growth has largely been driven by a growing labor market (more workers) and increases in capital equipment (more machinery and plants to get work done), and not productivity growth. Foreign investment, both into labor and capital, drove this growth through the allure of low labor costs. However, these two growth engines appear to be sputtering, as China's labor pool is likely to start declining due to an aging population [Figure 3]. At the same time, foreign investment has fallen, as wages have risen and China's currency has appreciated over the years. This leaves productivity growth as China's best hope for economic growth in the near future, but productivity growth has actually been declining over the past few years [Figure 4]. This is one of the reasons there has been so much recent talk about state-owned enterprises (SOE) reform and a push toward manufacturing higher-end goods, as well as a push toward further urbanization that would increase the labor pool available to manufacturing and service industries.

The Chinese government knows that if it fails to turn the corner on productivity growth, it is likely to end up in the "middle income trap," a term for a country that is able to move from low income to middle income, but isn't able to break through to the higher levels of income enjoyed by developed nations. Typically, countries that fall into this category (such as Brazil, Malaysia, and others) are able to emerge from poverty level incomes to middle incomes through industrialization.

4 Total Factor Productivity and Foreign Investment in China Are Entering Negative Territory



Source: LPL Research, China National Bureau of Statistics, Haver Analytics, The Conference Board 10/08/15

However, they are unable to shift their workforce from producing items like commodities and lower value-added manufactured products to innovative technologies and higher value-added items. There are examples of countries that have emerged into higher incomes in recent times, such as South Korea and Taiwan, so the shift is possible, but the transition remains a challenge for China.

DO RISING DEBT LEVELS POINT TO A FUTURE LEHMAN MOMENT?

China's debt levels have increased sharply since the start of the financial crisis, raising the fear of a Lehman-like deleveraging event that could cripple not only the domestic economy but damage global financial markets. China's overall debt, government and corporate, has increased by more than $20 trillion since 2007.* Adding to these fears are reports that loans either directly or indirectly related to real estate and construction represent nearly 45% of total debt, and reports of ghost cities (newly built cities that are not yet inhabited), raise worries of defaults on the debt incurred to build them.

China's banking system, not financial markets, is the main source of funding for most companies. China's central bank (the PBOC) sets monetary policy, but a few state-controlled banks, including the Bank of China, the China Construction Bank, the Agricultural Bank of China, and the Industrial and Commercial Bank of China control a large part of the banking industry. These banks were completely state owned prior to 2004, and the government maintains a majority shareholder position today, giving them effective control of these institutions.

SOEs are generally able to borrow freely from the banking system given their implicit government guarantee, but smaller private businesses have historically had a harder time receiving funding, even though they drive a higher percentage of China's economic growth. One estimate indicates that private enterprises contributed 60% of China's GDP growth in 2012, but only received between 20% and 30% of total bank loans.** If these smaller enterprises aren't receiving financing from the banking system, and are too small or risky to issue stock or bonds in Chinese markets, where do they go for funding? The answer is the Chinese shadow banking system.

Approximately 30% ($6.5 trillion) of China's total debt is estimated to come from lending within the shadow banking system.* Shadow banking is a catch-all term for lending that occurs outside the traditionally regulated banking system. Financial firms outside of the banking system are less regulated, and therefore,

* McKinsey Global Institute, February 2015.

** Brookings Institute, March 2015.

are often able to offer credit to those who may not receive it from the large banks. At times, this can be beneficial, as it gives private companies and higher-risk ventures a way to obtain credit that they may not otherwise be able to secure. However, the practice creates risks for abuse; and if loans go bad, the shadow banks may not have as much capital to absorb losses.

Even China's big banks have used the shadow banking system in order to skirt regulations. A bank could allow a trust company (one type of shadow bank) to borrow funds that the trust company will use to lend out to a client. The trust company then packages the loan into a trust vehicle that receives the principal and interest payments from the loan, and sells this trust vehicle back to the bank. In this way, it looks like the bank has made a loan to the trust company, when in reality it has made a loan to the end client and has retained all of the risk and most of the reward (minus the trust company's fee). Banks can then package these types of loans into their own wealth management products, which may be sold to customers who are looking for a higher rate of interest than deposit regulations allow. Regulators have attempted to put a stop to transactions like these with some initial success, but here too, more work needs to be done.

The potential for questionable activities in the Chinese banking system and the increase in debt levels (especially in the real estate sector) understandably draws parallels to the U.S. in the run-up to the financial crisis. However, there are a couple of important differences between China today and the U.S. in 2008. One of the major causes of the financial crisis was the use of leveraged products sold by a leveraged institution where a missed payment could be magnified across financial markets and the economy.

Risks of a 2008-like deleveraging event as witnessed in the U.S. and Europe are low. Products created by the Chinese shadow banking system aren't generally leveraged. An increase in defaults could cause deeper problems, but the lack of inherent leverage reduces the risk of a chain reaction. With respect to real estate, China's down payment requirements are much higher than the U.S., with lenders requiring at least 20% down for a first home (down from 30% previously), and 40% for a second home (down from 60% previously). These higher down payments mean Chinese citizens are less likely to walk away from their homes, given higher levels of equity.

China's tight grip on the banking market and large level of reserves (including over $3 trillion in foreign reserves and additional assets that are owned by SOEs)* mean that it can likely delay large-scale defaults through restructuring or even direct bailouts. China's tight grip also means that exposure for foreign banks (doing business in China) is limited; therefore, the transmission mechanism to spread bad debt is also limited.

*The People's Bank of China, October 2015.

CHINA'S TREASURY HOLDINGS

Fears over China dumping Treasuries and posing a risk to financial markets are overdone. China typically turns to the largest and most liquid bond market in the world, U.S. Treasuries, to earn a return stream on its steady flow of cash. In theory, China could sell its $1.3 trillion in Treasuries at any time, but this is highly unlikely for a few reasons:

- Selling such a large amount would likely cause some market disruption, and lead to possible losses. Losses could be compounded as the value of their remaining holdings is also impaired.
- The relationship between China and the U.S. is one of codependence. At a high level, the U.S. buys China's imports, and China uses the cash to buy Treasuries. If China sold Treasuries suddenly, a possible rise in interest rates could damage the U.S. economy and, in turn, reduce demand for Chinese goods.

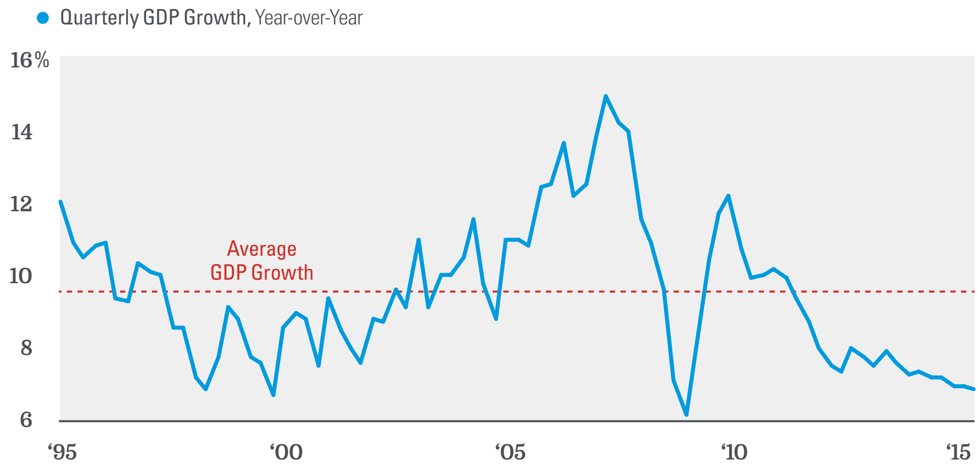
It is likely that China has been selling Treasuries over the past couple of months in order to support its currency, and some estimates by the U.S. Treasury International Capital (TIC) System (as of October 2015) put the amount sold at more than $100 billion. Despite the rumored increase in Treasury sales, however, Treasury yields decreased recently, suggesting that Chinese sales may not be as market moving as many feared.

THE RELATIONSHIP BETWEEN CHINA AND THE U.S. IS ONE OF CODEPENDENCE. AT A HIGH LEVEL, THE U.S. BUYS CHINA'S IMPORTS, AND CHINA USES THE CASH TO BUY TREASURIES.

IS CHINA HEADED FOR A "HARD LANDING"?

In the context of China's strong growth, we would consider a temporary decline in China's growth rate to about 2% to be a hard landing, a substantial further deceleration from recently announced growth of 6.9%. Figure 5 shows China's officially reported quarterly economic growth rates over the past 20 years. The overall growth rate has been strong, to say the least, with an average GDP reading of approximately 9.5% over the period.

5 China's Official GDP Growth Rate over the Past 20 Years Has Averaged 9.5%



Source: LPL Research, Haver Analytics, National Bureau of Statistics of China 10/08/15

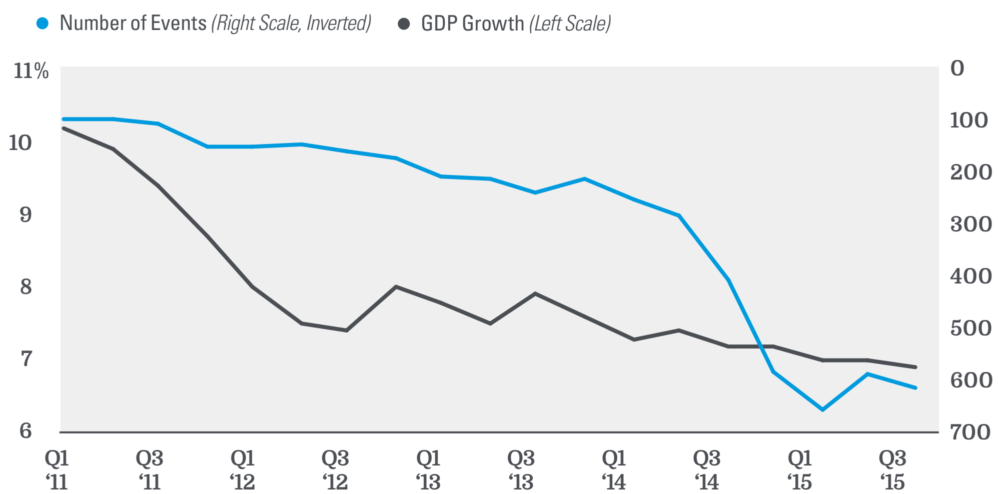
No China publication would be complete without at least a mention of data accuracy. While the 9.5% average GDP growth number may not be exact, market-derived proxies for economic growth in specific areas, such as property sales for real estate activity and electricity use for manufacturing, have shown that while official data may be smoothed, both sets of data generally corroborate the pace of growth. Whether the discrepancies are because of political pressure to meet predetermined targets or just a result of faulty methods is another question. But the level of attention this topic receives and the market's ability to define alternative proxies of activity mean that official data generally stay within a reasonable range of reality.

However, even official data show that China's growth has slowed over the past few years; China also faces some potential issues with respect to debt growth and transforming to a consumer-based society, among others. But China has massive resources that could be used to offset any potential debt crisis, and to stimulate the portions of the economy that need it (as it has been doing recently).

China also maintains much more control over the economy than most Western nations, which may help them to limit or delay the impacts of a slowing economy. We expect official economic growth will be in the 6–7% range for next few years, and while we don't expect to see a return to the 10% plus growth rates of a few years ago, a slowing economy is much different than a hard landing in our view.

There are also other repercussions (beyond stock market volatility and the potential for a banking crisis discussed earlier) from a hard landing that could be more difficult for the government to stop, including the Communist Party losing its grip on power. While a political change may sound far-fetched, it is believed that the Communist Party's legitimacy has largely been driven by its ability to foster strong economic growth, and ultimately, keeping 1.4 billion Chinese employed, fed, and housed. Although the centralized messaging from China's political apparatus makes it difficult to see what the party is really thinking, a recent anti-corruption drive, talk of improving income equality, and an uptick in labor unrest (strikes, protests, etc.) that seem to correlate with slowing economic growth [Figure 6], mean this risk—though likely remote at this point in time—is at least worth being aware of.

6 Instances of Labor Unrest in China Have Picked Up as Economic Growth Has Slowed



Source: LPL Research, Haver Analytics, National Bureau of Statistics of China, China Labour Bulletin 10/08/15

UNDERSTANDING CHINA'S COMMAND ECONOMY

The Communist Party of China adopted a Soviet-style structure shortly after it came to power in 1949. The Soviet Union actually helped China develop its first five-year plan in 1953, which focused on developing industry at the expense of agriculture. After the death of Communist Party Chairman Mao Zedong in the late 1970s, China started to break away from Soviet-style economic policies and implemented reforms based on free-market principles and opened up trade with the West. These reforms included:

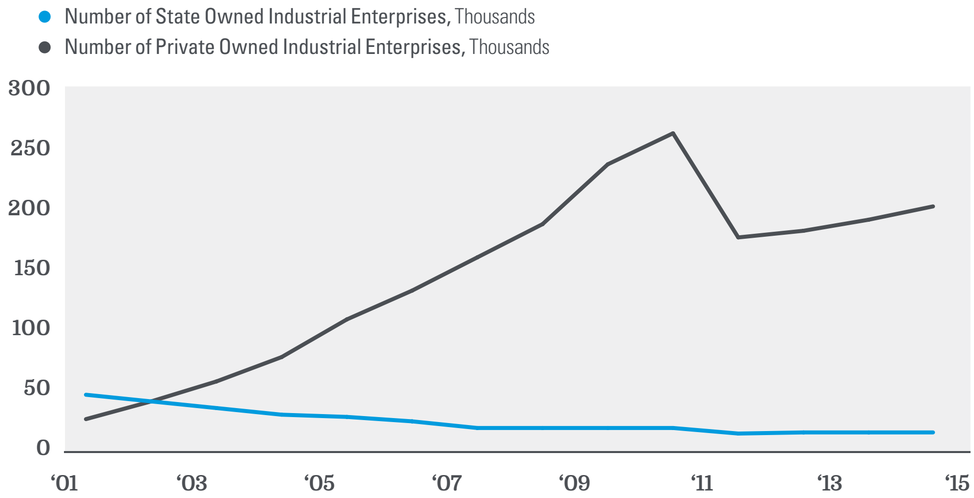
- Allowing farmers to sell a portion of their crops on the open market
- Encouraging citizens to start businesses
- Phasing out price controls for certain industries
- Removing trade barriers to encourage foreign investment
- Ceding control of some SOEs to local governments, which were allowed to operate them based on the market environment, rather than driving production schedules through central planning

China's leaders describe the economic model of today's China as "socialism with Chinese characteristics." This makes clear that China is a hybrid system: socialist in the government's ownership or control of many of the factors of production and centralized economic planning, while still allowing at least partially free markets to function in certain parts of the economy.

Expanding on this concept, the Chinese economy is characterized by a high degree of integration between the government and its largest and most important companies. These companies are often referred to as a "national champions," and typically are in strategically important industries such as energy, mining, construction, and transportation, and are owned in part by the government, leading to the name "state-owned enterprises" (SOE).

Through the SOEs, the Chinese government is very much involved in the economy, including directing investments both domestically and abroad. It is difficult to determine the exact percentage of China's GDP that comes from state-owned versus private enterprises, as the state does not publish these statistics. However, it does publish data that show the number of each type of firm, which can help identify trends over time [Figure 7]. These data do show that the number of SOEs has declined over time. SOEs, however, are much larger than most private enterprises and their contribution to GDP is likely much higher than their numbers suggest.

7 State-Owned & Private Industrial Enterprises in China



Source: LPL Research, Haver Analytics, National Bureau of Statistics of China 10/08/15

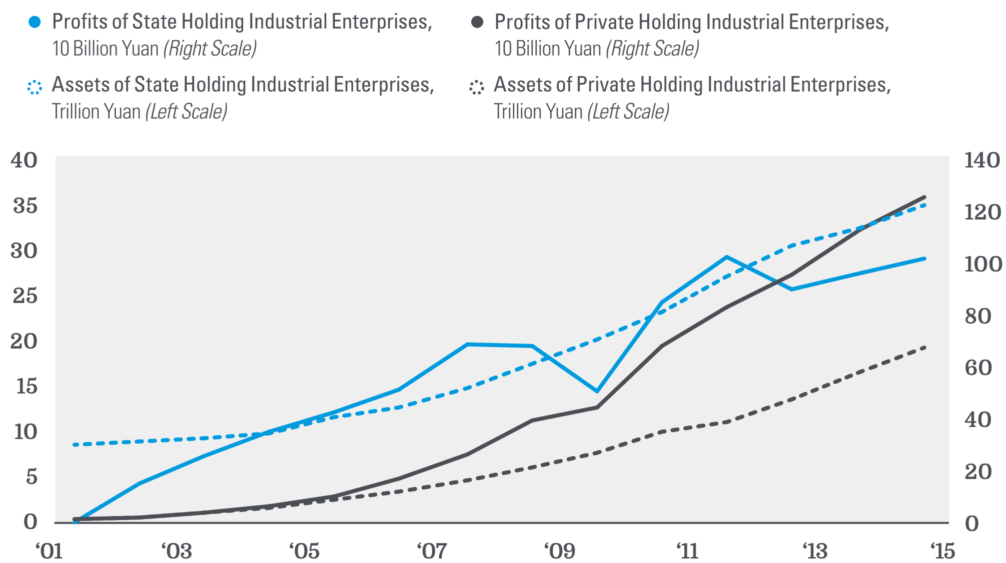
Data is year to date as of August 31st of each year.

Numbers only include firms specifically registered as shown, do not include several other types of businesses including joint stock companies, collectively owned companies, and others.

SOEs have likely fallen as a percentage of economic output over time, partly because there are fewer of them, but also because they are generally less profitable than their private counterparts. Figure 8 illustrates this disparity by comparing assets and profits for SOEs and private enterprises: SOEs have more assets but produce less profit than their private counterparts.

The Chinese government has had a tendency to support SOEs over private businesses, which has restricted economic growth and productivity. The government has chosen to favor control over expansion and profit making, a reflection of the centrally planned nature of the economy. Some reforms to allow nongovernment companies to compete with the SOEs for funding and other resources have begun, but such reforms should be expanded to help boost sustainable growth.

8 SOEs Hold More Assets, but Produce Lower Levels of Profits Than Private Firms



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China is currently operating under their 12th five-year plan, which covers the years 2011–2015 and focuses on three broad areas:

1. Economic restructuring, focusing on the transition from a manufacturing-based economy to a stronger consumer orientation
2. Promoting social equality, focusing on spreading the wealth created by strong economic growth
3. Protecting the environment, including goals such as increasing usage of renewable energy and cutting industrial water usage and carbon dioxide emissions

Underlying these three main themes are 24 targets, half of which are binding. A few high-level highlights of this plan include:

- GDP growth of 7%
- Expansion of the service sector
- Coastal regions to turn from "world's factory" to hubs of research and development, high-end manufacturing, and the service sector
- Focus on alternative energy (wind, solar, hydroelectric, nuclear)
- Expansion of transportation systems (high-speed railway and highways)
- Increase incomes faster than the rate of GDP growth

The 13th five-year plan is currently under development, and will likely be discussed at an upcoming meeting of China's Communist Party (5th plenum of China's 18th Communist Party Congress in late October 2015). Markets will watch this release closely, not only because it will likely give an updated GDP target for the next five years, but because it will probably include potential reforms to the SOE system and details on which industries will be emphasized in the future (and which won't).

CONCLUSION

If China's economy had grown at just 2% in 2014, global GDP would have been reduced by approximately 1%, meaning the world would have dropped from its 2.2% growth rate to approximately 1.2%, enough to cause considerable pain, but not enough to push the world into a recession. The brunt of the impact would be felt by nations that depend on commodity exports, while the impact to the developed world would likely be limited by the fact that most developed nations import far more from China than they export to China. There may even be some positives for developed economies, such as lower commodity prices, which would put more money in the pockets of consumers and lower input costs for businesses.

In our view, the main risk from China comes from a potential global economic slowdown and not the popping of a debt bubble or linkages to overseas financial markets. Furthermore, sudden large-scale selling of Treasuries is unlikely and fears over a spike in U.S. interest rates are misguided.

We don't see a hard landing as likely, given the considerable financial resources and policy measures that are able to be implemented to support economic growth. The ongoing slowdown may continue, but slower growth seems to be the probable negative outcome rather than more gloomy scenarios feared by some investors. ■

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