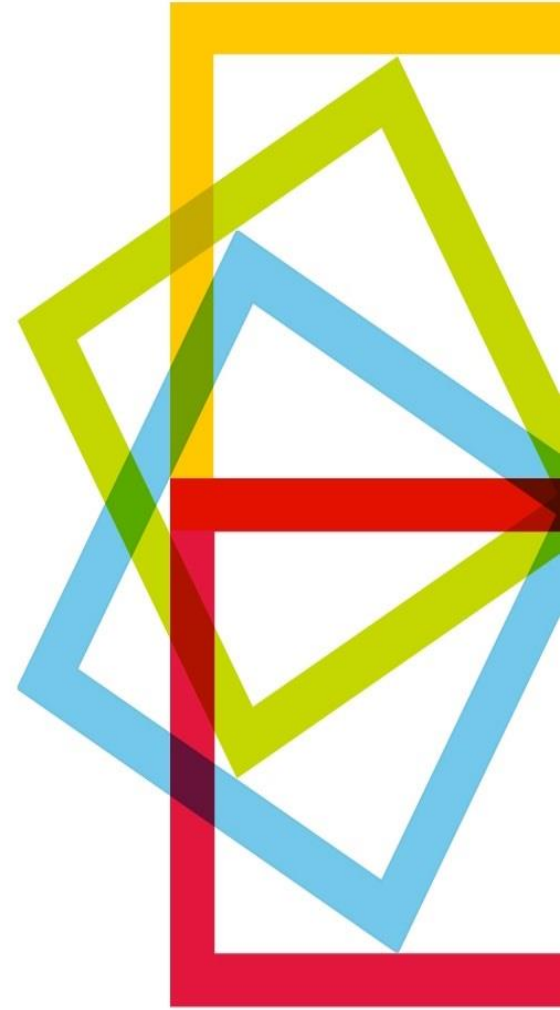


# Rethinking Chinese Growth Is 7% The New Normal?

**Dr. Paul Gruenwald**  
**Managing Director**  
**Chief Economist, Asia-Pacific**

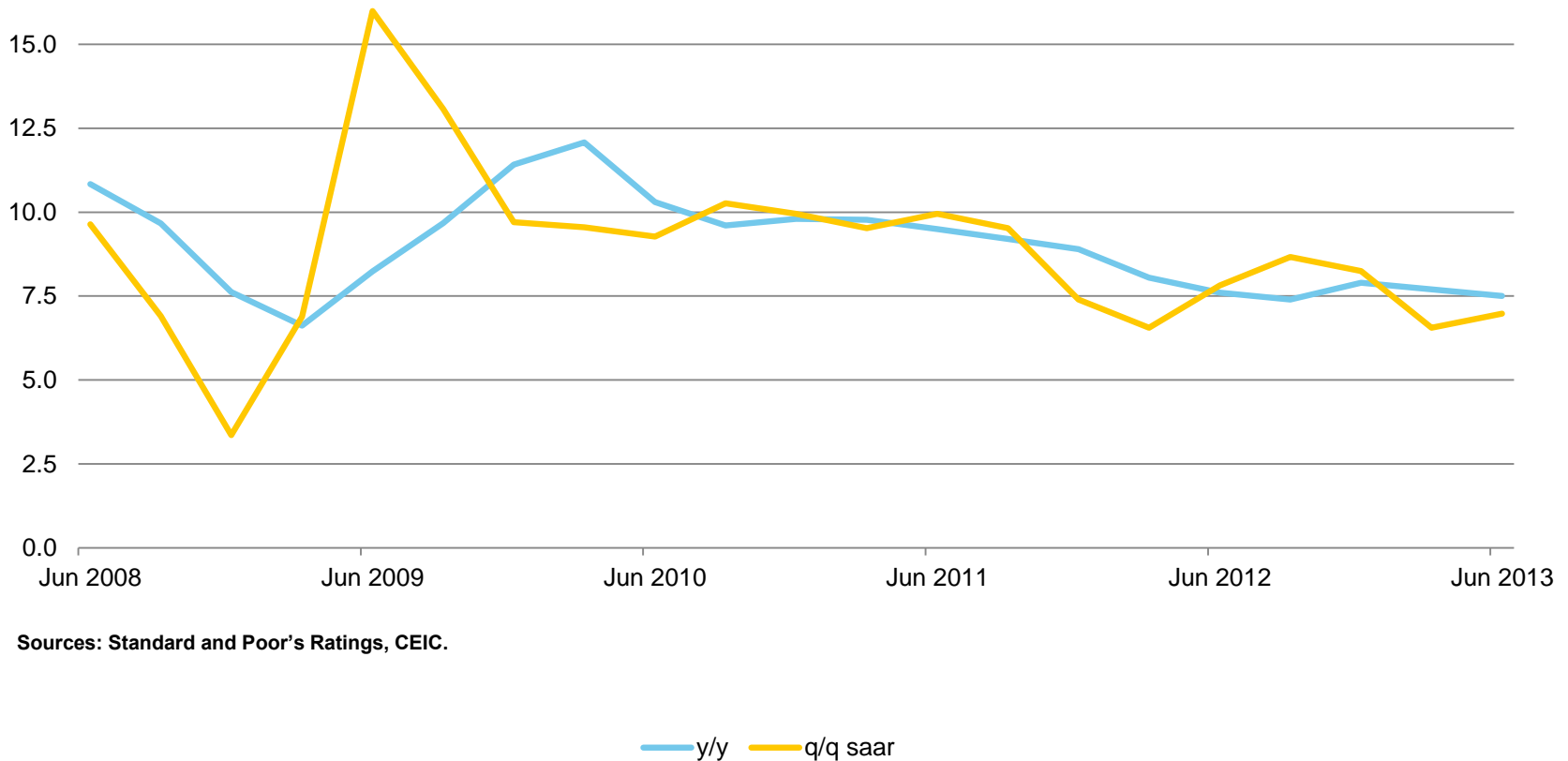
**October 2013**



# GDP growth continues to trend lower

## Momentum is now below the official target of 7.5%

China - Real GDP Growth



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# Rethinking China's growth: Why is 7-ish% now acceptable?

**What is behind the new Xi-Li government's comfort level with 7% GDP growth? We see three factors at play:**

- **Economic “gravity” applies to China as well.**
  - Chinese growth was bound to slow, like Japan and Korea's earlier; so trying to prop it up is futile
- **Growth vs. financial stability trade-off has worsened.**
  - Debt-levels have risen sharply in the post-Global Financial Crisis period, reducing “policy space”
- **Labor market has strengthened.**
  - Less need now to prop up growth to preserve social/labor market stability

**Factor 1. Economic Gravity:  
It Applies to China, Too!**

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# **The gravity argument: Chinese growth must slow It happened elsewhere in Asia, and it's in the arithmetic!**

**An economy's growth drivers can be broken down as follows:**

$$\Delta \text{ GDP} = \Delta \text{ Total Factor Productivity} + \Delta \text{ Capital Stock} + \Delta \text{ Labor Force}$$

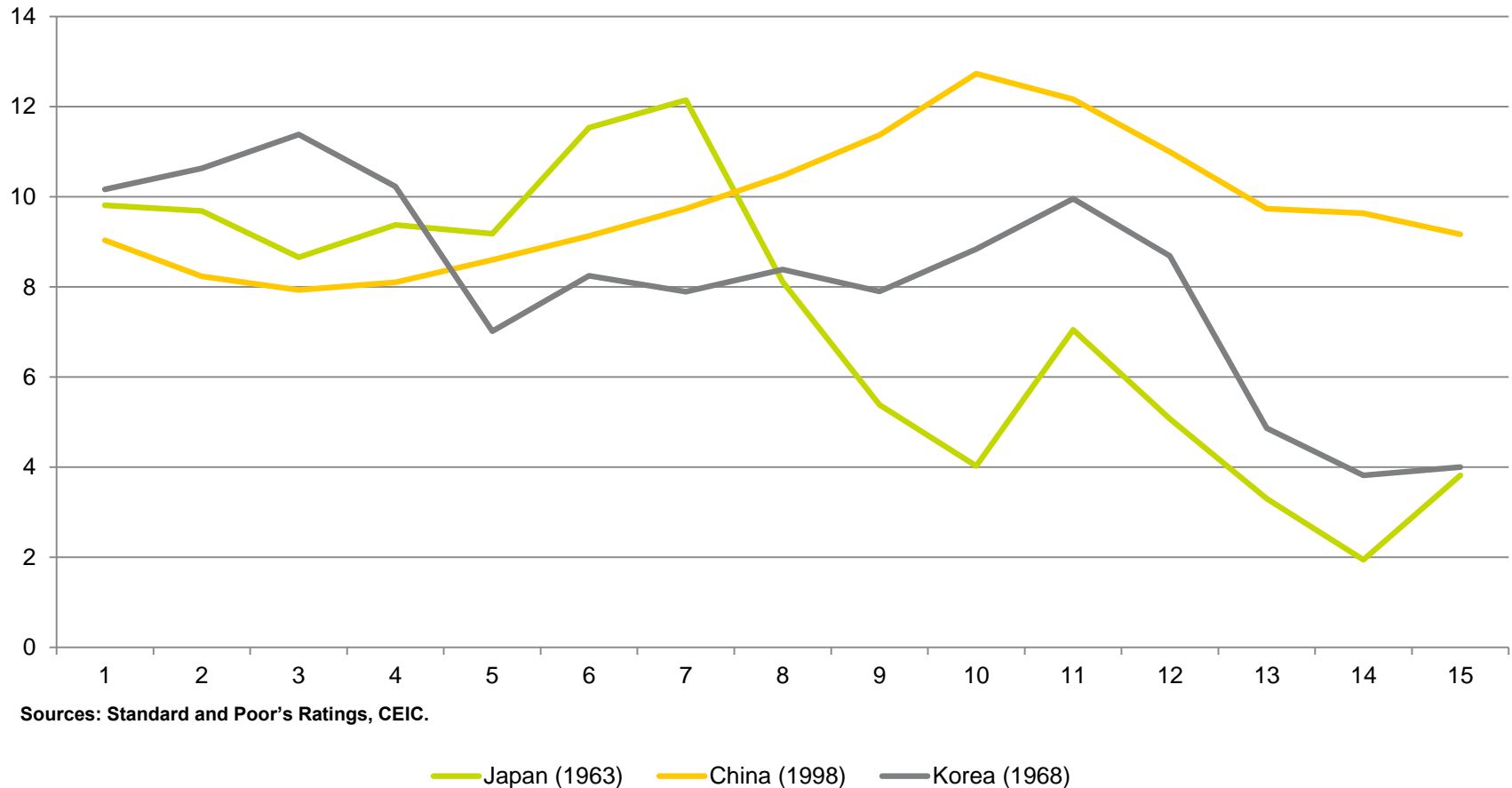
- TFP growth falls as an economy approaches the global frontier.
- With the investment/GDP ratio at close to 50% and a push for more consumption-driven growth, “ $\Delta$  Capital Stock” must decline.
- China's population (and labor force) growth are close to their peaks and should ease.

**Taken together, these drivers point to slower growth ahead.**

# China is not a special case

## Double-digit growth has been seen before, but then faded

**Selected Asia Growth Profiles**  
(3 year moving average; 15 year horizon)



**Factor 2. Growth vs. Financial Stability:  
The Trade-off Has Worsened**

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# **The growth-financial stability argument: The trade-off is much starker than before the GFC**

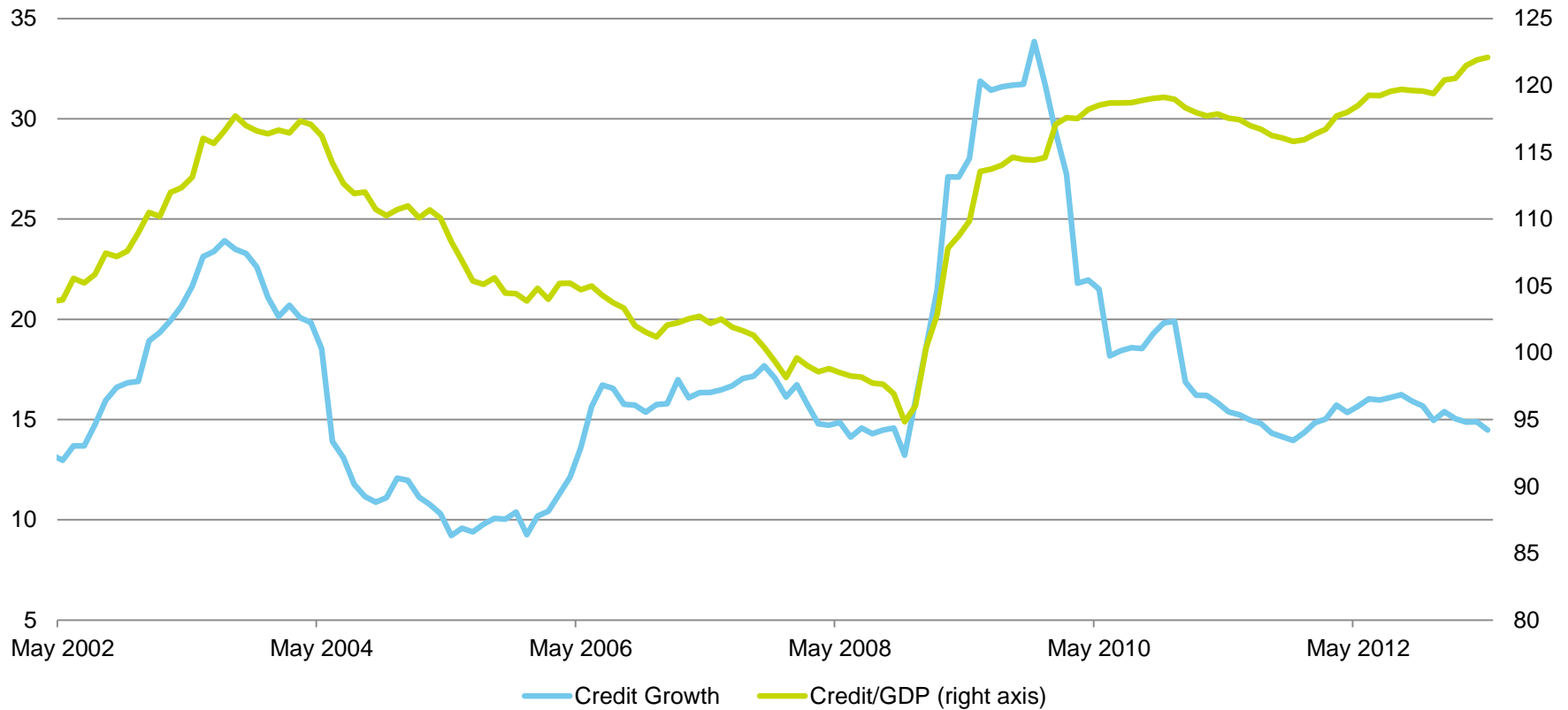
## **The health of the financial sector now puts a brake on stimulus plans:**

- Following the onset of the Global Financial Crisis, then-Premier Wen Jiabao launched a massive (and largely successful) stimulus plan.
- On the downside, the debt-to-GDP ratio jumped sharply at the banks as well as the non-bank (and corporate) sectors.
- As a result, China now has less “policy space” that can be utilized to combat growth slowdowns.



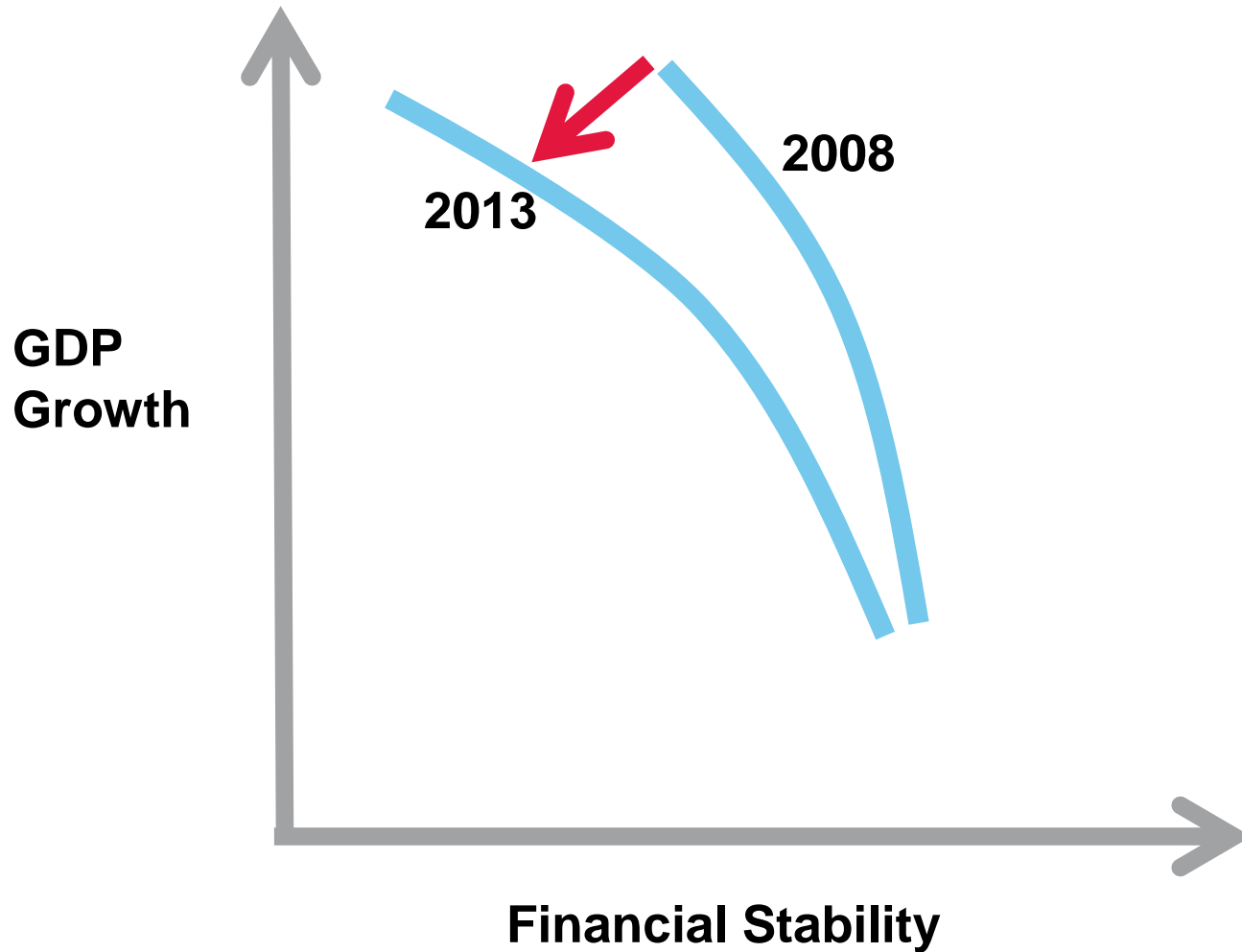
# China's policy response to the GFC restored growth But at a cost of much higher debt levels

## China - Credit Extended by Banks



Sources: Standard and Poor's Ratings, CEIC.

**Growth and financial stability trade-off has worsened.  
As a result of higher debt, the curve is now flatter.**



**Factor 3. The Labor Market/Social Stability  
Higher Wage Growth Gives Breathing Space**

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# **The labor market/social stability argument: Higher wage growth allows for slower GDP growth**

**Old view: Excess pool of labor implies that policy should aim for fast GDP/manufacturing labor demand growth to ensure stability.**

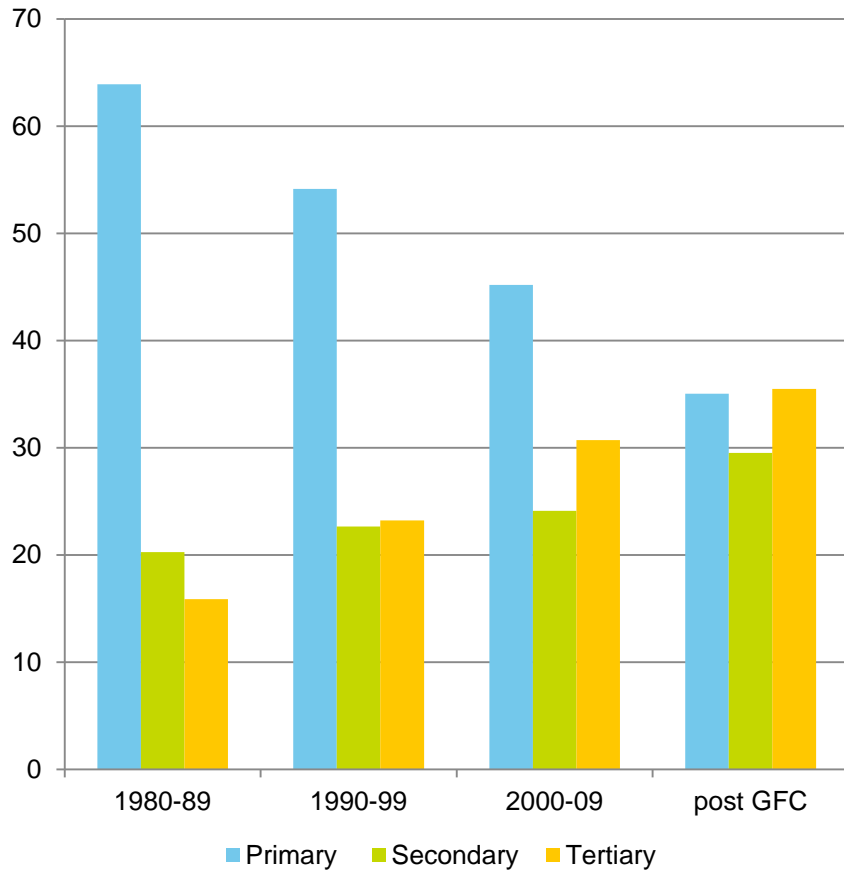
- Labor released from agricultural sector as China industrialized and urbanized created an “excess pool of labor” driving down wages.
- To offset this and to preserve social stability, China was thought to have a minimum growth rate of around 8%.

**New view: China has reached the “Lewis turning point.”**

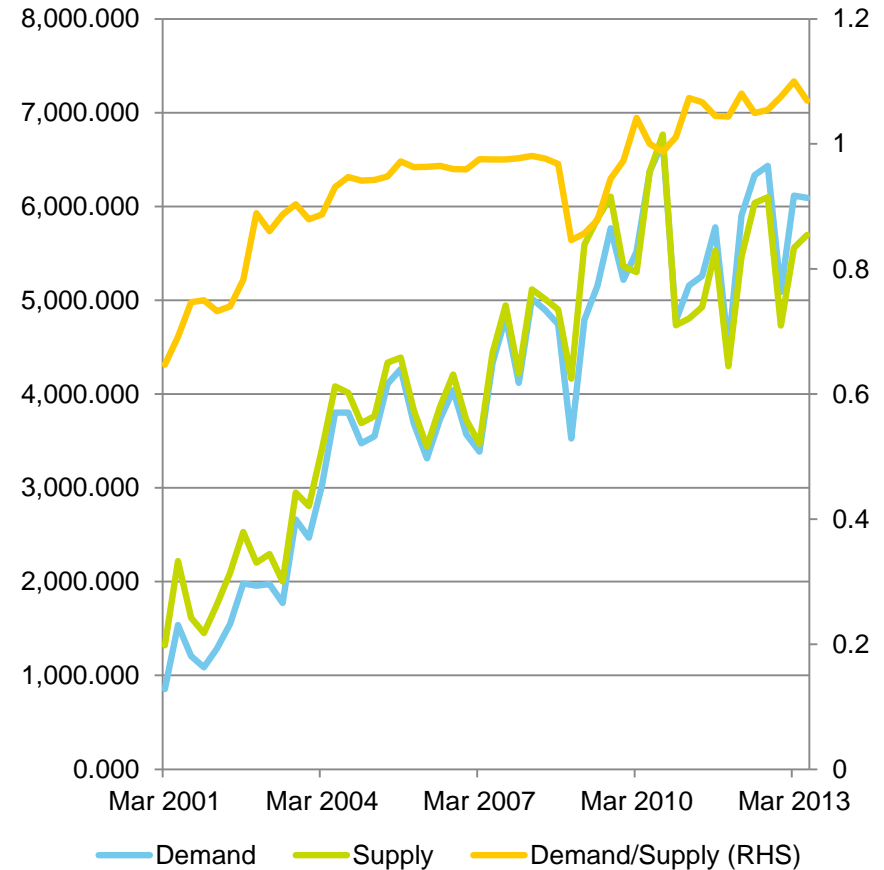
- The labor market has tightened; we now see high wage growth.
- This loosens the lower bound on growth; social stability is easier

# China's labor market developments: Less primary employment, more market tightness

## China - Share in Employment



## China - Labor Market



Sources: Standard and Poor's Ratings, CEIC.

## Summary and Final Thoughts

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# Summary: Rethinking China's growth

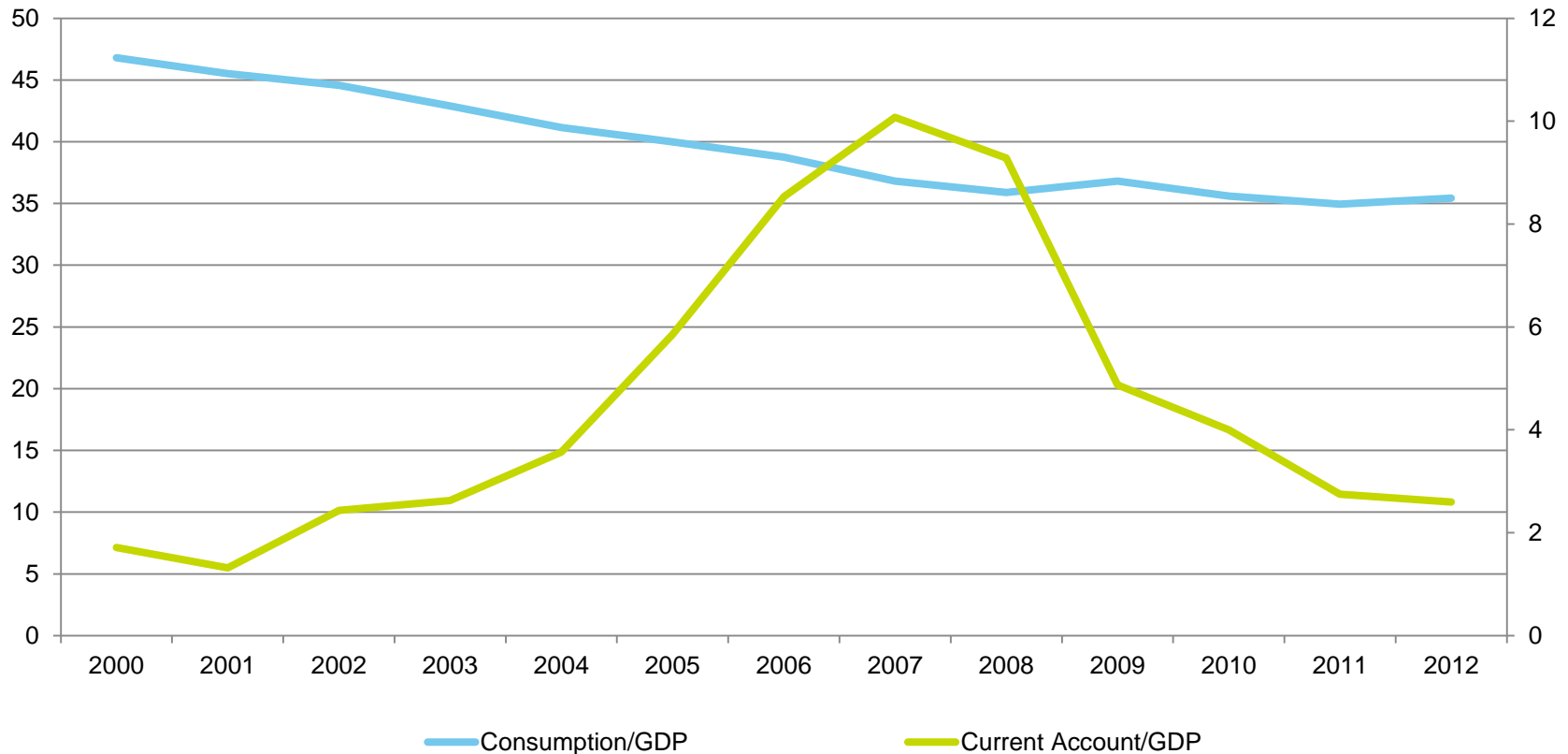
**By not acting to stimulate the economy as momentum slowed to around 7%, the Xi-Li team “revealed” its preference or tolerance for lower growth compared with the previous Hu-Wen team. Why?**

- Economic “gravity” is driving growth lower, so trying to prop up the growth rate to previous levels will be difficult and expensive.
- With the rise in leverage post-GFC, the financial sector needs time to mend, and faster growth would risk rising impaired assets/NPLs.
- A healthier labor market means that the authorities can tolerate slower growth without damaging social stability.

**Finally, is there a growth pain threshold? Of course, but we think that growth would need to fall well below 7% in order to spur action.**

# Final Thoughts: How Does This Relate to Rebalancing? Some Things Have Improved, Some Have Not!

China: Two Key Macro Indicators





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# **China's Unfinished Homework**

## **How to Rebalance the Economy (= raise C/GDP)**

**Usual suspects:**

- **Liberalize interest rates (reduce this subsidy to investment, raise interest incomes, reduce savings)**
- **Make the SOEs pay more dividends (increase household wealth and/or fund the social safety net, more market discipline for SOEs)**
- **Strengthen social safety nets (to reduce precautionary savings)**
- **Let CNY appreciate (lower subsidies to exporters/manufacturers, increase purchasing power to consumers)**



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# Thank You & Questions?

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