Four things to remember about China’s economy

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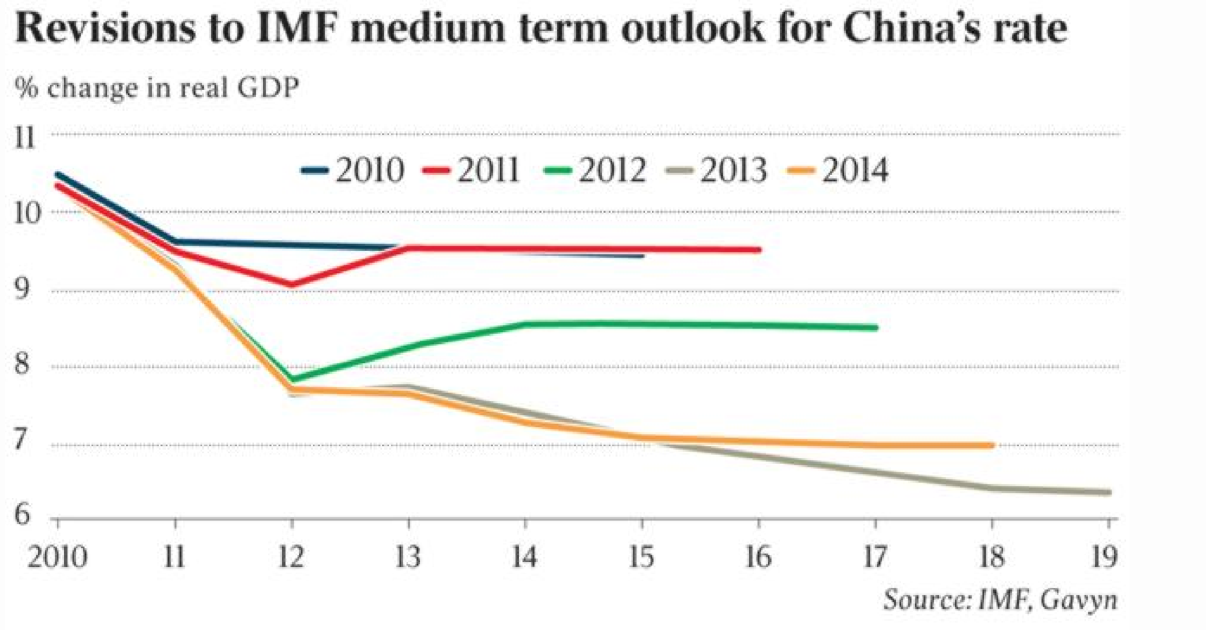
- THE AUSTRALIAN
- MAY 05, 2015 12:00AM



China outlook. *Source:* TheAustralian

Observers on the outlook for the Chinese economy and investment markets often fire their thoughts from extreme positions. Either China’s rapid growth is ending, cyclically and structurally, or its impressive trend growth will, in a decade or two, position China as the globally dominant economic power.

In my view, the forces shaping the Chinese economy and investment markets are diverse and conflicting; we need take an informed view on how they are likely to balance out. Here are four aspects of today’s China particularly relevant to Australians.

1. China’s growth is slowing cyclically — but early recession is unlikely.

A couple of weeks ago, investment banks and stockbrokers peppered the cyber world with their comments that GDP growth of 7 per cent — the lowest since 1994 — highlighted China’s property overbuilding, excessive capital spending, and the sharp increase in indebtedness after 2009; on this basis they suggested a hard landing was in prospect.

In fact, China’s GDP is a highly political number; GDP statistics are compiled and released within a month of the end of each quarter; and they’re rarely revised. A better reading of China’s economic pulse comes from combining retail sales, the purchasing managers’ index for the services sector, and industrial production. Certainly, that trio of numbers shows the Chinese economy is slowing.

However, the pace of decline in property prices now seems to be moderating. Also, monetary policy has been eased — and the signs are it will be relaxed further. It's becoming less likely China will experience the hard landing long forecast for it.

As a result, China's demand for Australia's exports of bulk commodities should turn out somewhat stronger than is now generally expected. Nonetheless, a sustained recovery in our commodity prices will probably await significant cutbacks in global oversupply.

2. China's long-term trend rate of growth is declining, and will fall away further.

That's mainly because China's growth is coming off a higher base. For example, in terms of additional goods and services produced, 6 per cent growth this year is the equivalent of more than 20 per cent growth in 2000.

Gavyn Davies of Fulcrum Asset Management reminds us how the International Monetary Fund, with its huge team of researchers, used to predict that the trend growth rate in China would remain in the 9-10 per cent region "as far ahead as the eye could see". But trend growth in China couldn't continue at that rate and it didn't. Indeed, it will probably slow further — perhaps to 3-4 per cent a year — by the mid-2020s.

3. China's plans to rebalance its economy are ambitious, and there will be many successes and lots of failures.

The intention is to encourage spending by households (especially on services) and to cut back on China's dependence on exports (especially low-value goods) and heavy capital spending.

These transitions in the economy are massive and, to succeed, would have to be disruptive. But progress is being made; for example, spending on services now exceeds spending on manufactures and construction.

A detailed report on the Chinese economy by KKR Global Institute notes the risks and resistances to the proposed rebalancing, but concludes that "the current rebalancing effort is likely to accelerate even more in the quarters ahead". Industries that would benefit most include the internet, healthcare, entertainment and leisure, environmental remediation and food imports.

4. China's sharemarket has moved strongly higher.

In recent decades, China has had a fast-growing economy but its sharemarket has markedly underperformed. Despite the recent slowing in Chinese growth, the Shanghai sharemarket has doubled in the past 12 months; since February, it has gained by 40 per cent.

Currently, middle class Chinese investors prefer shares to real estate, at least while inflation is low; monetary policy is easing and is likely to be relaxed further; and closer links between China's sharemarket and Hong Kong's exchange are helping to build interest in Chinese shares.

Over the medium term, Chinese shares will become more important in the globally diversified share portfolios of many Australians.

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