China is a critical engine of global growth. Concerns about trade tensions with the US and elevated domestic debt levels are real, yet we see the near-term outlook as resilient. The composition of growth in China is undergoing fundamental changes, with the focus shifting to quality (sustainability of growth) from quantity (GDP targets). An important transition is taking place: private consumption is making up an ever-greater share of activity relative to investment. This shift has wide-reaching implications for investors in China and for how China influences the global economy in the near term. We view the build-up of leverage in the country’s large and opaque financial system as the greatest threat to China and the global economy in the long run. Highlights:

- China’s economy is proving more resilient than sceptics have expected. Yet a fine balancing act lies ahead. Recent industrial production and retail sales data have underwhelmed. Beijing is not overreacting to moderating growth. Instead, it is cracking down on financial leverage and a red-hot property market.
- Our China Growth GPS points to activity holding up. Rising trade tensions with the US present a potential hurdle.
- Greater reliance on consumption and a move to quality of growth from quantity will put the world’s second largest economy on a more sustainable path. We highlight the challenges China faces in making this transition. In the medium term, financial vulnerabilities are the biggest risk.

**Growth GPS: The G7 backdrop**

The BlackRock Growth GPS for G7 economies is holding at levels that point to above-trend growth, but consensus expectations have inched above the GPS. Much of the increase since last year appears to be driven by greater expectations of a US fiscal boost to global growth. The outlook for Europe looks cloudier.

**Economic snapshot**

BlackRock Growth GPS vs. G7 consensus, 2015-2018

**Sources:** BlackRock Investment Institute, with data from Bloomberg and Consensus Economics, June 2018. Notes: The GPS in green shows where the 12-month consensus forecast may stand in three months’ time for G7 economies. The blue line shows the current 12-month economic consensus forecast as measured by Consensus Economics.
Steady as she goes

China’s economy is proving resilient. The moderation in activity in the first half of 2018 has been gradual. Solid external demand helped first-quarter GDP growth beat expectations. This could be undermined going forward if trade tensions with the US morph into a full-fledged trade war. The export sector has so far escaped a blow from an ongoing trade spat with Washington – exports posted double-digit gains in May from a year ago. Our BlackRock China GPS points to activity holding firm going forward. See the Resilience chart. The current slowdown is in line with our expectations.

Big data signals developed by BlackRock’s Systematic Active Equity teams are an important component of the China Growth GPS. They include earnings guidance from Chinese companies and references to China in global earnings calls. These signals paint a rosier picture about growth than what recent data suggest. This is illustrated by the difference between the nowcast (grey) and the GPS (green), which incorporates the big data signal. Growth is expected to slow only slightly to 6.6% in 2018 from 6.8% last year, according to International Monetary Fund forecasts as of April 2018. This comes against a backdrop of progress in implementing reforms, financial de-risking and slower credit growth.

China has adopted a more nuanced approach to tackling the slowdown – one that is consistent with the goal of rebalancing its economy towards domestic demand. See China’s tricky transition of February 2017. The People’s Bank of China (PBOC) has made modest cuts to bank reserve ratios. It has widened the range of acceptable collateral to lower funding costs for corporates. The PBOC’s actions suggest it is stabilising leverage rather than aggressively deleveraging. A moderate economic slowdown is welcome, in our view, as China shifts to a more sustainable pace of growth less reliant on credit.

Resilience

China Growth GPS vs. composite PMI, 2015-2018

When special mentions are bad

Souring Chinese commercial bank loans, 2004-2018

High corporate debt – particularly at non-viable firms – is a big risk. The overall level of non-performing loans at Chinese banks is low. But a bigger proportion of loans fall under the “Special mention” category – a relatively new classification. See the When special mentions are bad chart. These are loans that are not yet impaired but borrowers could face problems ahead. Supply-side reforms that began in 2016 seek to address this problem, particularly in sectors such as steel. About 40% of Chinese steel companies’ debt is classified as “debt-at-risk” – borrowing by companies unable to cover interest payments from earnings. Sectors, such as tech and consumer discretionary, appear better placed. Only 9% of debt in the tech sector is classified at risk.

China faces constraints in making the shift to a consumption-driven economy. Achieving a smooth hand-off to households and consumers is not easy after decades of investment-led growth. Household debt has risen as real estate prices have soared. A worse-than-expected cooling in the property market will hurt spending. Demographics also stack up against China. An ageing population lacks a sufficient safety net, explaining China’s high savings rate. Improved productivity, higher incomes and government policies that strengthen social security must support the transition to a more consumer-based economy.
A near-term hurdle
A period of trade threats has turned into actual tariffs and trade action. The market has taken notice, as illustrated by BlackRock’s Geopolitical Risk Indicator (BGRI) for US-China tensions. See the Bubbling risks chart. The rise of integrated global supply chains means that traditional trade metrics are a less accurate measure of the balance of trade between countries. Global supply chains have become critical inputs to global trade. About 30% of finished products from China have inputs from other countries and many of China’s inputs rely on materials from other countries. See Intricate links chart. These countries, mainly in Asia, depend on China for finishing their products for final export.

The negotiations over the bilateral trade surplus with the US is, in many ways, fighting yesterday’s war. China’s current account surplus has shrunk to below 1.5% of GDP from about 10% a decade ago. The dispute over reciprocity – equal treatment of inbound investments – is more important because it carries significant economic implications. Intellectual property and technology are only the start. The outcome of this spat will determine whether global supply chains remain integrated and the terms and conditions under which international companies will have access to Chinese consumers.

Another potential implication to trade actions? Reduced capital spending in developed markets that look to China for steel, machinery, technology and equipment. We have written previously of the tight relationship between DM capex demand and world – particularly EM – exports. See Macro uncertainty on the rise of March 2018. The symbiotic relationship between China and the West means that both sides have incentives to reach an agreement. Yet tech-related security concerns will keep tensions on a boil.

Bubbling risks
BlackRock’s BGRI for US-China tensions, 2005-2018

Intricate links
Origin of value added in manufacturing exports, 2011

A fine balance
The risk of a financial crisis in China is a significant threat to the global economy. As China’s linkages to international financial markets deepen, the risk is higher of a home-grown crisis spilling over to the rest of the world. Yet we do not see this as a near-term story.

These risks are well known: Much of its financial system is opaque. A great deal of risk sits off bank balance sheets, making it hard to understand the extent of hidden weakness. Short-term financial products promising high returns to domestic investors are tied to myriad forms of debt. The build-up of such products has created a complex web of linkages. Unresolved, these could lead to a large shock.

China’s ability to navigate a domestic credit crunch has not yet been tested. Tolerance for defaults is still low. Yet steps to curb credit growth are underway. The creation of the Financial Stability and Development Committee late last year and work towards a unified regulatory framework have put authorities in a better position to address financial stability risks. Policymakers have recently tightened requirements for banks to recognise NPLs. Deepening vigilance of mortgages and payday lenders suggests the desire to control rising debt levels now extends to households and not just corporates.

Bottom line: Global investors are adjusting to China’s expanding role. The deepening of its economy presents opportunities. Yet the rest of the world needs to account for lower demand than in the past from China. Inclusion of Chinese stocks and bonds into global indices will reshape capital flow dynamics. Consumption’s share of the economy needs to increase further if China is to pull off the balancing act of reining in credit, sustaining GDP growth and shifting away from export- and investment-led growth. The trend on these fronts is good – yet much more progress is needed.
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