INFOCUS

MACRO COMMENT

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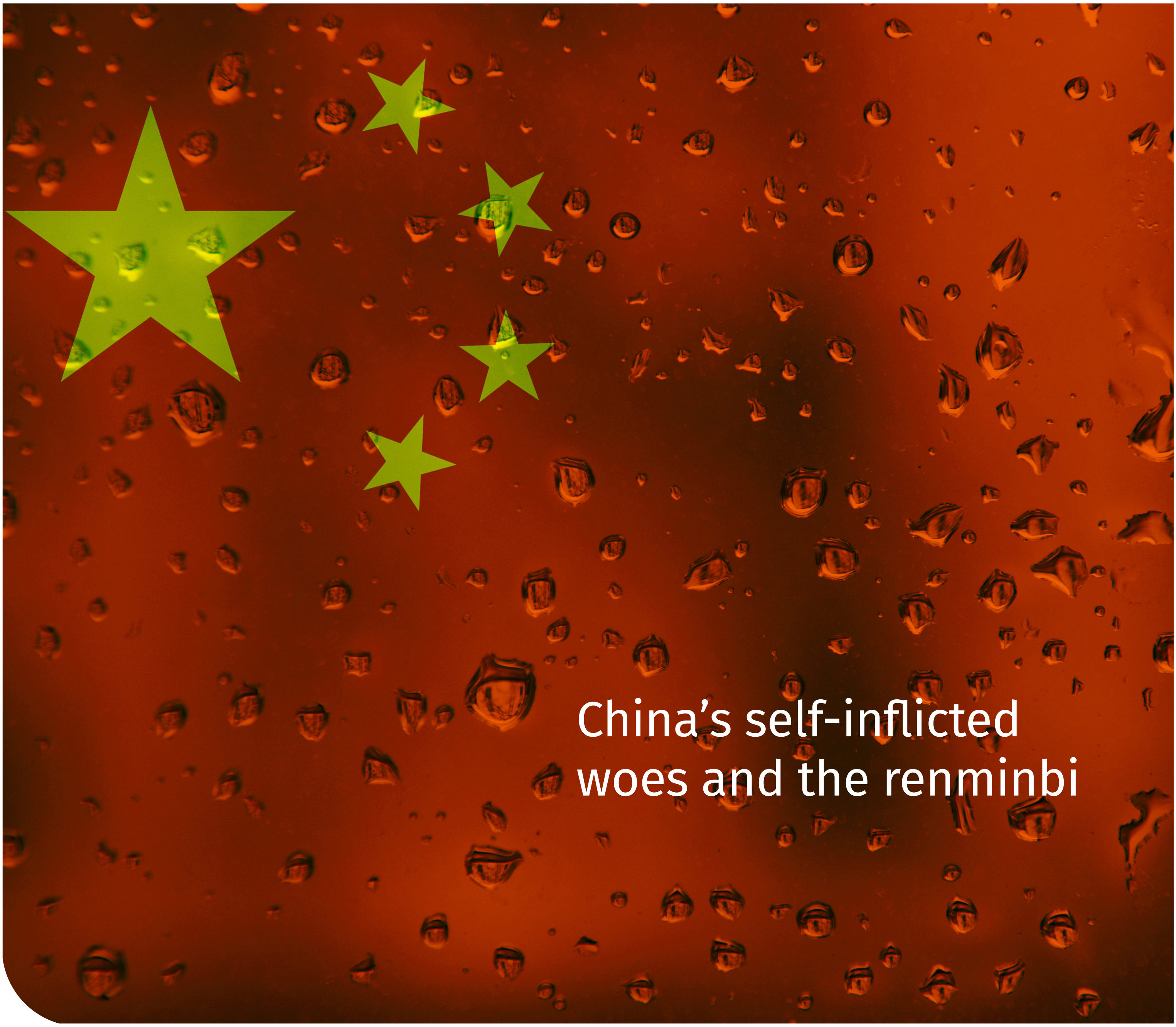

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HIGHLIGHTED IN THIS PUBLICATION:

GLOBAL STRATEGIC ASSET ALLOCATION

GLOBAL SECURITY SELECTION

REGIONAL ASSET ALLOCATION

REGIONAL PORTFOLIO CONSTRUCTION

China's economic growth slowed in 2021, raising doubts about the sustainability of the global recovery from Covid-19. Many observers fear the renminbi will depreciate – mirroring what often happens in struggling emerging countries. In this edition of *Infocus*, Daisy Li and GianLuigi Mandruzzato examine the outlook for China's growth and its currency.

The Chinese economy has recently lost momentum as shown by a wide range of indicators, including retail sales, industrial production and PMI indices. The Li Keqiang index, a synthetic measure often used to estimate Chinese GDP growth, indicates a marked decline in Q3 and into Q4 (see Figure 1).[1] In the first three quarters of 2021, Chinese GDP growth fell to an average rate of only 0.5% quarter-on-quarter. This is equivalent to 2% annualised growth, below the estimated potential growth rate of around 5.5%.[2] It is interesting to note that after the fluctuations due to the Covid-19 pandemic, Chinese GDP is returning to the trend of moderately slowing growth that has been underway for several years.

How to interpret China's slowdown?

The slowdown in Chinese GDP growth leads to two observations. The first is that it reflects structural aspects of China's development. As the Chinese economy is modernising and maturing, the service sector, which is naturally slow-growing, becomes an increasingly important share of the economy, reducing the overall growth rate.[3]

The second observation is that the intensity of the most recent slowdown raises concerns about the world economy because of the size of China. It is either the first or second largest economy in the world, depending on how GDP is measured, and it has made the highest contribution to global GDP growth over the last two decades. Markets often assume that the Chinese government is perfectly able to manage policy so that growth remains on a stable path. That indeed was the case until the Covid crisis. However, managing an increasingly large and complex economy was always likely to be difficult.

The policy measures introduced recently, although leading to slower growth, have arguably put economic growth on a more sustainable path.

These have included strict anti-Covid policies and tightening of regulation on sectors such as internet-based services, private education, real estate and those characterised by high CO2 emissions.

1. China's GDP is slowing fast

Source: Refinitiv and EFGAM calculations. Data as at 18 October 2021.

For example, tighter regulation imposed on internet-related activities, a sector deemed strategic by the Chinese authorities, has increased uncertainty among internet operators and, unsurprisingly, contributed to the moderation in fixed asset investment. Similarly, the emphasis on reducing greenhouse gas emissions has led state owned banks to tighten the provision of finance to highly polluting sectors, curbing production as in the case of steel.

The real estate sector is also subject to restrictive measures aimed at limiting its chronic excesses. This is nothing new:

2. Little credit for real estate

Source: Refinitiv and EFGAM calculations. Data as at 12 October 2021.

[1] The Li Keqiang index is named after the current Premier of the People's Republic of China who, according to media reports, in 2007 said freight traffic volumes, electricity consumption and total loans give a better gauge of Chinese activity trends than official GDP data. This version of the index is calculated as the weighted average of the annual changes in the three indicators with total loans deflated by the CPI to produce a real measure comparable to GDP.
[2] See https://www.bloomberg.com/news/articles/2021-03-26/china-s-central-bank-estimates-potential-growth-of-under-6?sref=5epPVx10.
[3] The tendency for growth to slow as the service sector increases in size has been widely discussed from William Baumol (American Economic Review, 1967) onwards.
[4] In recent weeks, tensions in the real estate market have come to the fore in the case of Evergrande, once a major player in the sector and now on the brink of default.

in recent years, the trend in construction financing has been weaker and more volatile than that of total loans (see Figure 2). In a banking market dominated by public institutions, this trend reflects government guidance.[4]

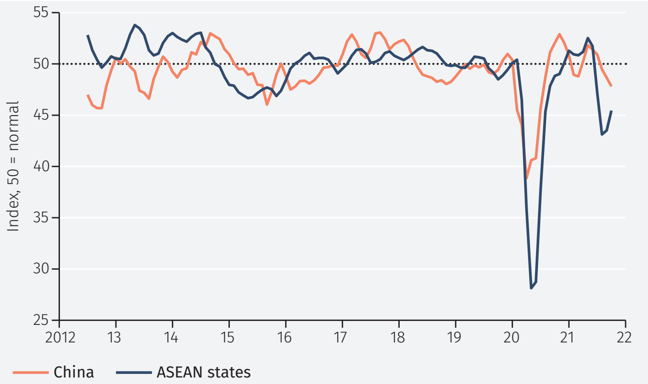
Limited impact on the exchange rate

Faced with the slowdown in activity, many observers expect the Chinese government to facilitate a depreciation of the exchange rate to support the economy.[5] However, there are several reasons to believe that the Chinese authorities will not do so at the current juncture. The internationalisation of the renminbi, including the ambition for it to compete with the US dollar and the euro as a reserve currency, is a strategic objective. In addition, the domestic bond market is opening to international investors, who have so far shown great interest. To achieve both objectives, it is preferable for the exchange rate to remain stable.[6]

Moreover, an opportunistic devaluation of the yuan would be frowned upon by Washington, which in the past has often complained about Beijing's exchange rate policy. Now that the Biden administration has adopted a more conciliatory approach, the Chinese government has no interest in risking ratcheting up tensions again.

In policy terms, a weak renminbi would also make little sense. Foreign demand for Chinese products is benefiting from production bottlenecks caused by Covid in ASEAN states (see Figure 3). Furthermore, the slowdown is driven by domestic sectors, insensitive to the exchange rate. Rather, a strong yuan aids domestic demand by limiting imported inflation, supporting real incomes and allowing the PBOC to remain accommodative.

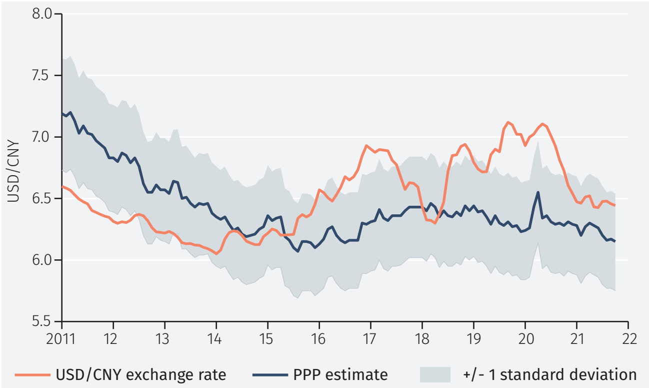
3. PMI manufacturing export orders



Sources: IHS Markit, Refinitiv and EFGAM calculations. Data as at 12 October 2021.

Finally, Purchasing Power Parity estimates suggest that the renminbi should be stronger *vis-à-vis* the US dollar, which would correspond to a lower USD/CNY exchange rate (see Figure 4). Furthermore, based on our PPP model, the USD/CNY equilibrium exchange rate tends to fall over time, which means that keeping the renminbi stable increases its undervaluation and thus moderately supports the economy.[7]

4. US dollar/renminbi exchange rate and PPP



Source: Refinitiv and EFGAM calculations. Data as at 12 October 2021.

Conclusions

The recent decline in Chinese growth is a source of concern for investors. However, it is the result of a mix of structural and cyclical factors. The former reflect the strong economic development of the last decades and the fact that the economy is maturing: as such, this is not a reason for concern. The latter relate to government policies adopted to strengthen long-term economic and financial stability which have led to an over-reaction by economic agents: while the degree of cyclical slowdown justifies the market's worries in the short-term, it should eventually be transitory.

In this context, it seems unlikely that the Chinese authorities will again weaken the yuan to boost activity. The stability of the exchange rate meets the strategic objective of increasing its use in international trade and making it attractive as a reserve currency. Moreover, a weaker exchange rate would be ineffective in counteracting shocks affecting the domestic sectors of the economy. Finally, the fundamentals indicate that the yuan's equilibrium exchange rate continues to rise: a stable exchange rate would be sufficient to provide moderate support for Chinese growth without compromising the improved relationship with the United States since the advent of the Biden administration..

[5] The incomplete liberalisation of Chinese capital movements allows the People's Bank of China to control the exchange rate of the yuan against other currencies.

[6] For the same reason, it is likely that the Chinese authorities will intervene to prevent the Evergrande crisis from undermining the real estate sector and the Chinese bond market.

[7] Other measures regarding the renminbi exchange rate cannot be excluded, although they look unlikely. Since the renminbi is a managed float against a basket of currencies, the authorities could change the basket in a way that results in devaluation. A more drastic alternative could be to simply abandon the basket and aggressively manage a currency depreciation. However, both alternatives would damage credibility and act against China's aims to open up its capital account over time and reduce the attractiveness of the renminbi as a reserve currency.

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