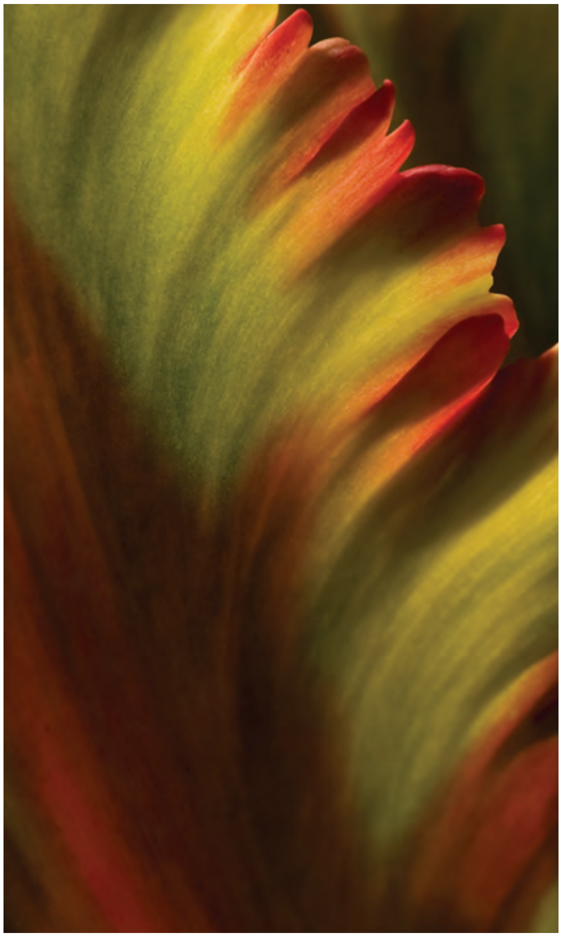

Rising Uncertainty for China

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Executive Summary

Senior investment professionals from Standish share their impressions from a recent trip to China of the delicate balancing act the country faces as it seeks to shift from an export-dependent model of growth to one based more on domestic consumption.[1] While describing the underlying strengths that continue to fuel China's growth, the Standish team point to their concerns of imbalances in the economy that could slow the pace of that growth. In particular, they call attention to remaining gaps in the social safety net that continue to drive high personal savings rates and the need to further reform the country's financial system.

"Be not afraid of growing slowly; be afraid only of standing still."

— Chinese proverb

In 1979, former Chinese Premier Deng Xiaoping outlined a plan to quadruple the size of the Chinese economy before the turn of the century. According to Deng, China would accomplish this feat by introducing elements of capitalism to its centrally planned economy. At the time, many economists said Deng's goal was unattainable because it would require China to maintain an annual growth rate of 7.2% for 20 years. Yet, China exceeded even Deng's lofty expectations with an average annual growth rate of nearly 10% between 1979 and 2010.[2]

Today, doubts about the sustainability of China's growth have resurfaced. China optimists contend that high domestic savings, a surplus of cheap labor, strong foreign direct investment, and a healthy central government balance sheet will fuel growth for years to come. China pessimists counter that overinvestment and excessive credit creation have resulted in a bubble in the real estate market that will cause a hard landing for the Chinese economy in 2012.

We believe the truth probably lies somewhere between these two extremes. Although we do not expect a hard landing for the Chinese economy in 2012, we are concerned that the build-up of fundamental imbalances will slow the pace of economic growth. The best hope China has of sustaining its high growth rates

1 This analysis is based on multiple interviews conducted by Tom Higgins and Ted Ladd during a November, 2011, visit to Beijing, Shanghai, and Hong Kong. The report, which was written with the help of Senior Sovereign Analyst Ai Ling Ngiam who is based in Singapore, represents the personal opinion of the authors who are solely responsible for its content.

2 Justin Yifu Lin, "The China Miracle Demystified," The World Bank, delivered at the Econometric Society World Congress in Shanghai, August 19, 2010.

is to transition from its export/investment-led growth model to one driven by consumption. China has made some progress on this front, but gaps in the social safety net continue to encourage households to save a disproportionately high share of their income.[3] In our view, Chinese leaders must make rebalancing the economy and reforming the financial sector top priorities if they are to prove the pessimists wrong this time around.

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Underlying Strengths

Before discussing some of the current uncertainties, it is worth noting that in our view, China's economic success has sustainable roots. These include high domestic savings; strong foreign direct investment lured by the size and growth of the Chinese market; substantial migration of workers from the relatively low productivity rural jobs to relatively high productivity urban jobs; general openness to international trade; low labor costs; a relatively strong central governmental balance sheet; and an exceedingly entrepreneurial and ambitious people. We believe most of these supports to growth will remain. Thus, the long-term economic growth prospects for China remain auspicious, especially compared to the more troubled developed world.

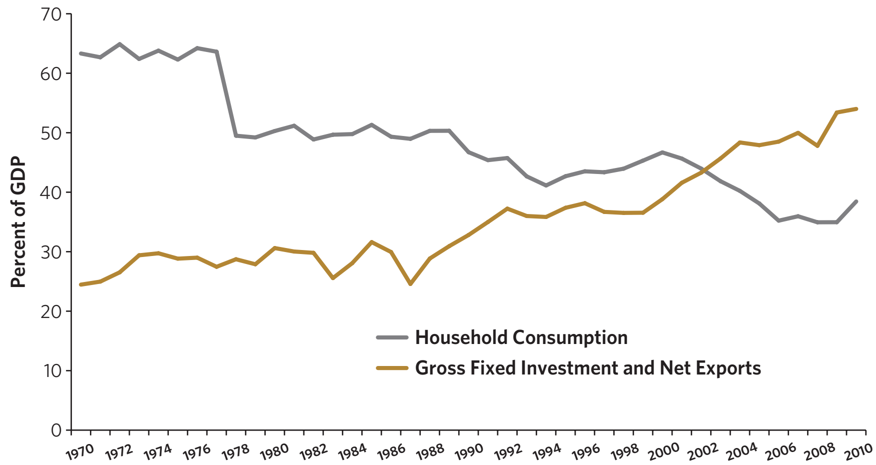
However, demographics are changing as the population ages and the surplus of labor gradually disappears; wages are on the rise, threatening China's export competitiveness versus its Southeast Asian neighbors; Chinese financial markets remain relatively immature; capital is allocated by state agencies rather than the market; and the environmental costs of rapid growth are becoming more pronounced.

China has attempted to address these challenges in two ways. First, by rebalancing the economy away from exports and investment and toward consumer spending (see Exhibit 1); and second, by introducing financial reforms aimed at gradually liberalizing interest rates and increasing the flexibility of the exchange rate. Unfortunately, progress on these fronts has been slow, while the old growth model based on export and investment is becoming less viable.

3 " People's Republic of China Article IV Consultation," International Monetary Fund, Country Report No. 11/192, July 2011, p. 16.

Net exports and fixed asset investment together accounted for more than half of Chinese GDP in 2010, yet neither looks sustainable.

Exhibit 1 – China's Growth Model Has Relied on Investment and Exports



Source: World Bank World Development Indicators Database 2011

Phasing Out the Old Growth Model

Net exports and fixed asset investment together accounted for more than half of Chinese GDP in 2010,[4] yet neither looks sustainable. In fact, the Chinese export machine is already slowing. While China still has a large positive trade balance with the United States, its trade surpluses with the rest of the world have diminished. China's competitiveness has declined as a result of the gradual appreciation of the Chinese renminbi, higher inflation, and faster wage growth.

Chinese exports have also been hurt by slowing global growth. Approximately 19% of demand for China's goods comes from Europe and roughly 17% from the United States.[5] Arguably, Europe may already be in recession, and U.S. economic growth is slow. The contribution of net exports to China's incremental GDP growth has been minimal over the past three years since the global financial crisis deepened in 2008. There is a broad consensus among Chinese officials that trade surpluses will shrink further and that net exports will not be a driver of GDP growth in the next few years.

4 *Ibid.*, p. 41.

5 Direction of Trade Statistics, International Monetary Fund, June 2011.

Generally speaking, Chinese residential property owners are not highly leveraged, and loan to value ratios reportedly rarely exceed 50% of value.

The outlook for fixed asset investment is not much better. The Chinese government responded to the collapse of global demand in 2008 with a massive fiscal package aimed at infrastructure and property investment. As a result, fixed asset investment increased at 20-30% annual rates, contributing 90% of GDP growth in 2009 and over 50% of 2010 growth.[6] In other words, if it were not for fixed asset investment increases, Chinese economic growth in recent years would have been at rates of only 4-5%, not 9-10%![7]

Perhaps the most vulnerable segment of fixed asset investment is property. Real estate markets are a huge driver of economic activity. Construction directly represents about 14-15% of GDP and related activity probably contributes 25% of GDP.[8] An estimated 60-70% of household wealth is in property.[9] Residential real estate has been in a spectacular boom. According to the International Monetary Fund, property prices are up 60% since 2006 and private sector analysts suggest an even greater run-up in some areas.[10] The best one can say is that the boom is cooling. Some analysts project a severe decline in real estate; others suggest 5-10% price declines.[11]

There are mitigating factors. Generally speaking, Chinese residential property owners are not highly leveraged, and loan to value ratios reportedly rarely exceed 50% of value. This is not the 100% financing that precipitated the housing bubble in the United States. The long-term government subsidized plans to expand urban and affordable housing will provide support. Over the next few decades, urbanization is projected to increase 1% per year, which means housing for 13 million more urban dwellers annually.[12] Even so, it is worrying that median house prices in some of the top-tier cities such as Beijing and Shanghai may be as much as 15-20 times median income.

6 Emerging Markets Economic Data (EMED) Limited and Standish.

7 *Ibid.*

8 Dinny McMahon, Esther Fung and Jame T. Areddy, "China Housing Prices Decline," *The Wall Street Journal,* November 8, 2011.

9 Tom Orlik, "China's Robust Spenders," *The Wall Street Journal*, November 21, 2011.

10 "Global Financial Stability Report: Grappling with Crisis Legacies,"International Monetary Fund, September 2011, p. 40.

11 Adam Minter, "Real Estate Prices Fall in China Inciting Anger and Applause," Bloomberg, December 2, 2011.

12 Chinese Ministry of Housing and Urban/Rural Development.

An estimated one-third of local government revenues are derived from land sales where transaction volumes are shrinking and prices are declining. This poses a dilemma for local governments, as they seek to service their debt, which is mostly in the form of bank loans.

Local Governments Unable to Support Infrastructure Spending

The slowdown in fixed asset investment, and property markets specifically, will have repercussions for local governments (defined as provinces as well as cities and towns). An estimated one-third of local government revenues are derived from land sales where transaction volumes are shrinking and prices are declining. This poses a dilemma for local governments, as they seek to service their debt, which is mostly in the form of bank loans.

The central government has responded by changing regulations to allow four local governments to issue bonds. Shanghai has floated the first issue at a cost roughly in line with the central government. It is likely that other local governments will be given this authority as well. However, given the disclosure of the magnitude of local government debt, the understandable desire of bank lenders to diversify their exposure, and the natural inclination of local governments to seek longer-term bond market funding for long-term infrastructure projects, it is quite likely that much of the new bond financing alternative will be a replacement for existing financing rather than a source of incremental financing.

In any case, local government balance sheets already appear stretched. Indeed, local government debt stands at 37% of GDP compared to central government debt at 16.5% of GDP.[13] The central government will likely provide support for local governments that get into financial trouble, but local government capacity to support new infrastructure projects is eroding. Hence, there is a material risk that infrastructure investment will slow, along with property investment and net exports.

13 EMED, Dragonomics, and Fitch Ratings.

The Critical Role of the Household Sector

The household sector can probably pick up some of the slack from the slowdown in investment and exports. Evidence to date suggests that consumer spending is both strong and less cyclically sensitive than other sectors. In fact, consumption has contributed a rather persistent 4+ percentage points to annual Chinese GDP growth in recent years.[14] Forces supporting household spending growth are strong income, based in part on government-mandated wage increases, low household sector leverage, and high savings rates.

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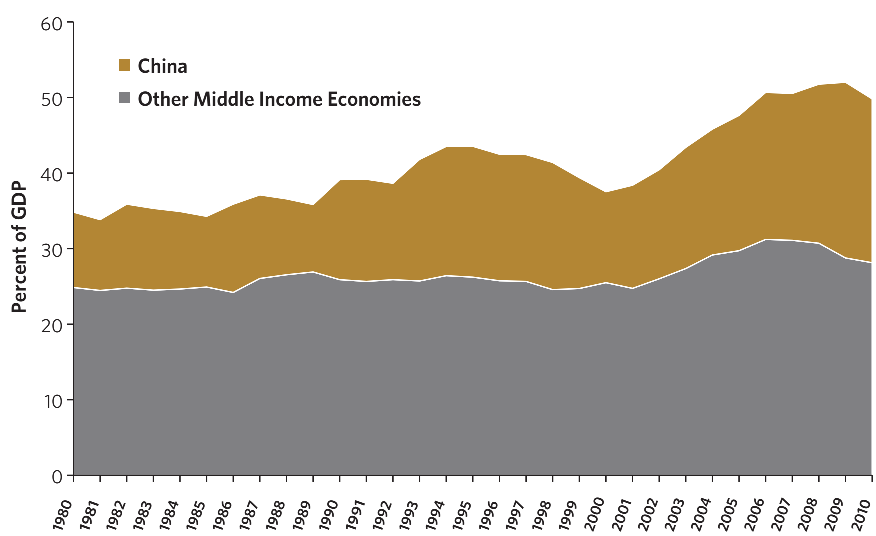
Yet, consumption still only represents about 38% of GDP compared to an average of 58% in other middle income economies and close to 70% in the United States.[15] Part of the problem is that Chinese households save a much higher portion of their income as a precaution against illness, to further the education of their children, or for retirement (see Exhibit 2). To counteract this desire to save, China needs to expand its social safety net.

Exhibit 2 – China's Gross Domestic Savings Rate is Much Higher Than Other Countries at the Same Stage of Development



Source: World Bank World Development Indicators Database 2011

To its credit, the government has allocated significant resources to improving the pension, healthcare, and education systems. Yet there are still high out-of-pocket expenses for medical care and inadequate coverage for catastrophic illnesses.[16] On balance, the prognosis for household consumption growth is generally good. However, given the cyclical fragility of other sectors of the economy, we believe robust household consumption growth is no longer optional but mandatory to sustain the high growth of the Chinese economy.

14 EMED.

15 World Development Indicators Database, World Bank, 2011.

16 *Op. cit.,* People's Republic of China Article IV Consultation, p. 16.

Financial Reforms Could Aid the Transition to New Growth Model

China's financial system has played an important role in supporting its export/investment-led growth model and reforms to the system could aid in the transition to a new consumption-led growth model. At the present time, interest rates are set by the state rather than the market and the exchange rate is heavily managed vis-à-vis the U.S. dollar. Although these policies aided the development of the Chinese economy over the past three decades, more recently they have produced fundamental imbalances such as overinvestment and excessive credit growth.

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Based on the Chinese authorities' estimates of "total social financing," which is supposed to capture both the official and shadow banking sector, the stock of domestic loans reached 173% of GDP at the end of June.[17] This places them well-above the levels of credit in countries at similar stages of development.[18] Such excessive credit growth is often used as a leading indicator of banking crises. It is easy to imagine a scenario in which slower Chinese economic growth results in an increase in non-performing loans. This, in turn, may require further bank recapitalization efforts by Chinese authorities at a time when China's public finance profile is becoming more constrained. According to the IMF's Public Debt Sustainability Framework, stress-test scenarios show contingent debt recognized on a net present value basis could add another 84.6% of GDP to China's estimated public sector debt of 16.5% of GDP in 2011.

There is a heavy dependence on the banks for credit and a high concentration of banking assets among four very large state-owned banks. The primary bond market has developed, but secondary market activity is limited. Many observers suggest that the Chinese financial markets are still not good in pricing risk. While there have been vast strides in improving regulation, accounting transparency and legal recourse, it is perceived that the rule of law and fiduciary principles are still not sufficiently strong and that financial markets are opaque.

17 Computed as the sum of total bank loans and the cumulative flow of net new credit since 2002 from similar Total Social Financing components (trust loans, bank acceptance bills, and entrusted loans).

18 *Op. cit.,* Global Financial Stability Report, p. 40.

Government authorities in China have been working assiduously to enhance and modernize the financial system through interest rate and exchange rate liberalization. However, progress has been slow on both fronts. Deposit rate ceilings and lending rate floors continue to encourage speculation and lead to an inefficient allocation of capital in the banking sector. Indeed, capital has continued flowing into infrastructure and property investments in recent years, even as the People's Bank of China (PBoC) was moving to restrict credit and the return to these projects was falling.

The Chinese government has also recognized the need to increase the flexibility of the yuan exchange rate. In July 2005, the PBoC announced it was moving away from the peg to the U.S. dollar and adopting a managed-float exchange rate regime with a reference to a basket of currencies.

According to Fitch Credit Ratings Agency, one yuan in credit expansion yielded 0.76 yuan in GDP growth in 2006, but this ratio fell to just 0.42 yuan of GDP by 2011.[19] Allowing interest rates to be determined by market forces would encourage banks to use risk pricing to allocate capital which should improve asset quality and lessen systemic risks in the financial sector. It may also encourage more lending to the consumer sector where balance sheets are arguably stronger.

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19 Charlene Chu, "Chinese Banks: Growth of Leverage Still Outpacing GDP Growth," Fitch Ratings, July 13, 2011.

The prospects for China's reform agenda will be decided by new leadership in 2012.

Will Political Change Mean Faster Progress?

The prospects for China's reform agenda will be decided by new leadership in 2012. Candidates from various persuasions seem to be vying for seven of the top nine seats on the standing committee of the Politburo.[20] One astute observer in Beijing suggested this is a generational change in Chinese leadership, from engineers and scientists to lawyers and economists, which may bode well for financial reform.

An interesting side issue is the relative power of the PBoC. Several observers suggested that the PBoC, while announcing monetary policy changes, has to negotiate heavily with competing interests such as the National Development and Reform Commission (overseeing infrastructure), the Ministry of Finance (which owns the state portion of large banks), and the Ministry of Commerce (which wishes to spur exports). Many of the results of these negotiations are deferred to decisions of the State Council. Furthermore, commentators report that the Governor of the PBoC is likely to be replaced relatively soon, with the leader of one of the four big banks (probably from the Industrial and Commercial Bank of China) assigned the post.

Domestically, the growth rate of the Chinese economy is incredibly important, both in the reality of employment and the perception of rising Chinese stature in an uncertain world. As this report suggests, there is a major challenge as the economy undergoes structural change from the old model based on exports and investment to the newer model powered more by household consumption. The new leadership will be influenced by and will also attempt to direct this transition.

Lastly, there is the tension between the Chinese model of a very successful but administered economy and a more open model that alleviates societal tensions. It is very difficult for an outside observer to assess the degree of existing tensions. Anecdotes suggest there may be as many as 100,000 annual riots as Chinese protest environmental transgressions, local oppression and taxes, or even property price implosions. So far the evidence suggests these protests are directed at local problems and that the central government is perceived as a source of remediation rather than the problem. Nonetheless, the tension between a free market economy and a controlling political structure (with one of the main lubricants between these forces being corruption) seems to be controllable, but the government is clearly aware of and concerned about this tension. While China has been a force for world economic growth and stability, it is not isolated from the external forces, particularly at a time when the internal dynamics are changing dramatically as well.

20 Jamil Anderlini, "China's Leaders Jockey for Politburo Positions," *Financial Times*, November 23, 2011.

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Conclusion

China is clearly one of the great economic success stories of all time. While there are many reasons to believe that China can sustain high economic growth, the next few years will be a testing period. Net exports have already dropped and are likely to decline further. The large portion of economic activity derived from fixed asset investment is in question. Property markets are weakening in price, while the volume of land transactions is slowing. Local government investment, which has relied in part on land sales, is at risk. Overall credit growth has been excessive and unsustainable.

The continuation of high Chinese growth rates will probably require acceleration in household spending, but household savings remain high, given nascent efforts to create a social safety net. Last but not least, the transition in senior government leadership will occur in 2012 . The next few years will represent a significant test of the sustainability of Chinese economic growth, and there is a wider than normal range of potential outcomes.

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Tom is the Global Macro Strategist for Standish. He is responsible for developing views on the global economy and making relative value recommendations among global bond markets, currencies, and sectors. Before joining Standish in 2010, Tom was employed as the Chief Economist for Payden & Rygel Investment Management in Los Angeles and served as International Economist at The Conference Board. Tom received his Ph.D. and M.A. degrees in Economics from Fordham University and holds a B.A. in Economics from Drew University. Tom has eighteen years of experience analyzing financial markets. He is a member of both the American Economics Association and the National Association of Business Economics (NABE). Tom was President of the Los Angeles Chapter of the NABE from 2006-2007. He is a past board member of the Los Angeles Economic Development Corporation and the California Council on Economic Education. Tom was the 2010 Recipient of the Robert T. Parry Award for Exemplary Contributions in the Field of Economics.

Edward H. Ladd, CFA

Ted's distinguished career began at Standish, Ayer & Wood in 1962, and he was named Chairman in 1989. He became Chairman of Standish Mellon Asset Management in 2001 and Chairman Emeritus in 2004. He is a Director of the Conservation Law Foundation, Land Trust Alliance, A Better City, The Trustees of Reservations, and The Boston Company Asset Management. Ted is Chair of the Board of Trustees of the Beth Israel Deaconess Medical Center and a Trustee of Wheelock College. Ted is also Chairman of the Boston Committee on Foreign Relations, a member of the WGBH Board of Overseers, and Vice Chairman of the Massachusetts Taxpayers Foundation. He is a former Director of Citizens Financial Group, Harvard Management Company, and the Federal Reserve Bank of Boston. Ted has an M.B.A. from Harvard Business School and a B.A. from Yale University, holds the CFA® designation and has 47 years of investment experience.

Ai Ling Ngiam, Senior Sovereign Analyst

Ai Ling is Senior Sovereign Analyst responsible for research on emerging market economies. She joined Standish in 2011 as a BNY Mellon contracted employee from Fitch where she was Director of Asian Sovereign Ratings. Prior to Fitch, Ai Ling served as an economist at United Overseas Bank in Singapore and began her investment career as an economist for ABN Amro (Asia) Securities in Singapore, where she also served as a research officer at MUFJ Bank, Singapore. Ai Ling has a B.S. from the National University of Singapore, a B.A. in Economics from the National University of Singapore and has 11 years of investment experience.

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 1/12