China's transition marks a new reality for Emerging Markets

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Investment Products

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A potential slowdown of the economic growth in China?

Here, we focus on the changing composition of the Chinese economy as it transitions from a primarily investment-led to a more balanced, consumer-led growth. We also review the longer-term implications for the rest of the Emerging Markets.

Introduction

The defining feature of the Chinese economy has been its dependence on investment spending and export-led growth. Last year the investment to GDP ratio in China reached almost 50%, a record not only for China, but also for any other major economy. As China's investment level has reached unprecedented levels, the profitability of investment projects has been declining and price pressures are emerging in the labor market. Recognizing the need to change the economy's growth model, the Chinese government has been introducing measures to reduce the economy's reliance on investment and increase consumption. Such efforts include raising the minimum wage, interest rate liberalization reform and building a social safety net. Many investors have asked if the saturation in the level of investment and the reforms aimed at restructuring the economy might bring an end to China's growth, and with that, the miracle of the Emerging Markets.

In response, we argue that the urbanization trend in China will help smooth the transition of the economy from a largely investment to a more consumption-led growth. While recent woes in the property sector in China have further fueled fears about a collapse in investment and growth, in our view, the more likely outcome is stabilization in investment, accompanied by a gradual rise of consumption in China.

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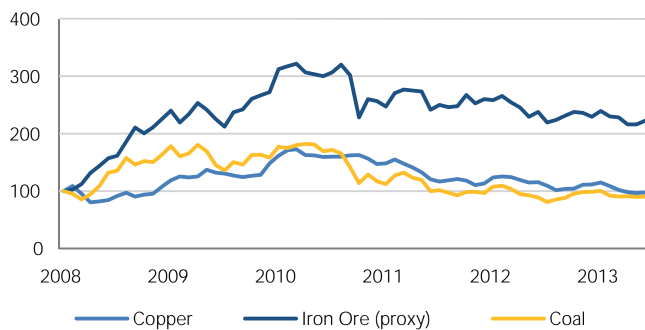
Impact of China's investment-led growth on commodities and Emerging Markets

The increase in the world's dependence on China as a growth engine indeed suggests that the imminent rebalancing of the Chinese economy will have important consequences for the rest of the Emerging Markets countries. The rapidly growing, investment-driven Chinese economy, for example, has had a decisive impact on China's demand for commodities, commodity prices and the overall growth of the rest of the Emerging Markets. In 2011, when commodity prices peaked (Figure 1), China's commodity consumption accounted for about 20% of overall demand for non-renewable energy resources, almost 50% of demand for coal and nearly 45% of demand for metals such as copper and iron ore .

In the past few years however, we have seen China's growth rate slow from double-digits in the prior two decades to between 7% and 8% in the past few years. This decline can in part be traced to a stabilization in investment levels (Figure 2), which in turn explains the decline in commodity prices over the past few years.

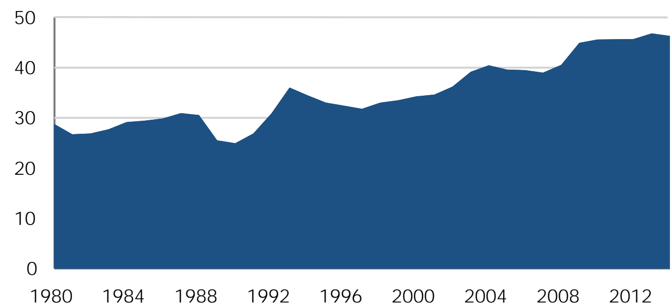
The recent slowdown in China's real estate activity in particular (Figure 3) has increased investor concerns about the potential collapse in China's investment levels; these concerns range from a permanent downturn in property development to saturation in demand for infrastructure, and the impact this may have on commodity prices and the commodity-exporting countries.

Figure 1: Historical commodity prices (%)



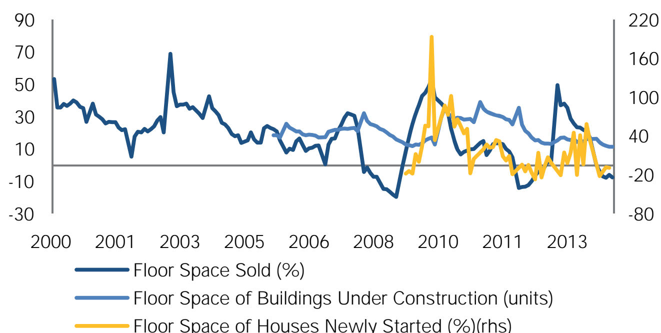
Source: Bloomberg, May 2014. Rebased to 100 on December 31, 2008

Figure 2: China gross fixed investment (% of GDP)



Source: The Economist Intelligence Unit, as of 19 May 2014

Figure 3: Chinese real estate activity (y/y)



Source: Bloomberg, National Bureau of Statistics of China, May 2014

Economic rebalancing in context: Korea in the 1990s and Japan in the 1970s

To better understand China's current economic transition, it is informative to consider the often-cited historical examples of countries that went through a shift in their economic growth models – Korea in the 1990s and Japan in the 1970s.

The South Korean economy grew rapidly from the 1960s until the 1980s, at the rate of over 8 percent per year on average, driven by the expansion of the industrial sector and exports. The investment level peaked by the mid-1980s and then started to slow. The sharp decline in investment and growth in the late 1990s set the stage for a more permanent deceleration from almost double-digit to low single digit growth. The story is similar in Japan; after rapid economic growth in the 1960s, investment levels and growth peaked and then collapsed in the early 1970s.

Upon first review, it seems that investment-fueled growth was unsustainable in both cases and the inevitable economic rebalancing meant that growth in both countries had to stabilize at lower levels of equilibrium. It is important to note however, that as investment began to slow in these countries, each experienced significant external shocks. In the case of Korea, the Asian financial crisis precipitated significant capital flight, which sharply reduced the source of funding for economic investment. In Japan, the collapse of the Bretton Woods system, or dollar convertibility to gold, led to a sharp appreciation of the yen, hurting Japan's competitiveness. In addition, the oil shock of 1973 caused energy prices to surge and put breaks on the energy-dependent economy.

External shocks are inherently difficult to predict; however, with the backdrop of the global economic recovery and in the absence of a clear exogenous catalyst, we believe that the rebalancing process in China should proceed more smoothly.

Given the backdrop of the global economic recovery and without an emerging external shock on the horizon, we think that China's economic transition should proceed rather smoothly.

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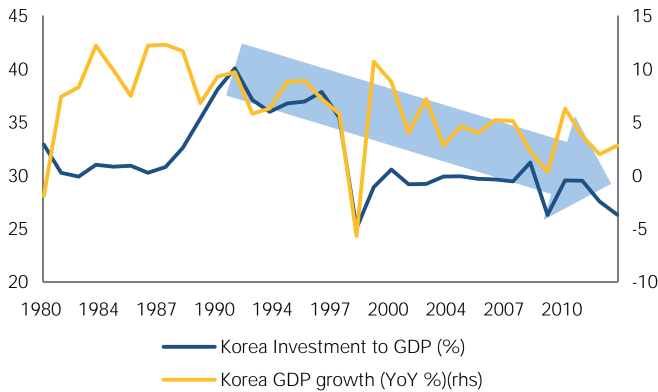
Furthermore, we believe that the key difference in China's experience versus what happened in Japan and Korea lies in the current trend where the rural population is migrating to urban areas. The drop in investment that precipitated more permanent declines in growth in Korea and Japan coincided with urbanization reaching peak levels and then flat lining (Figures 4 and 5). The longstanding tailwind of urbanization that had boosted demand for additional housing and infrastructure came to a halt at about the same time as these countries were faced with the challenge of rebalancing their economies; and, to make matters worse, they each experienced an external shock.

Figure 4: The case of Korea

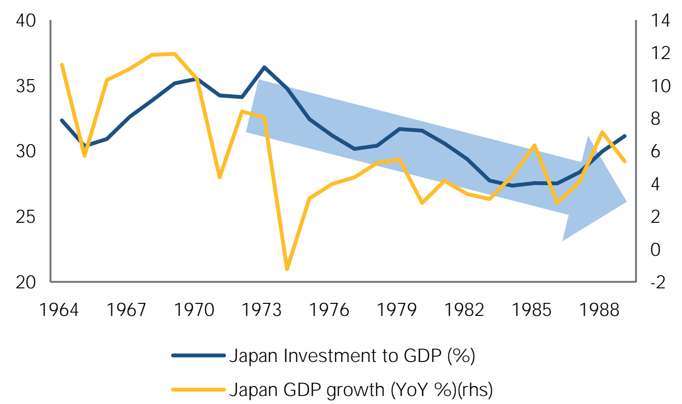
Korea: Investment and growth at the point of rebalancing



Source: Bloomberg, IMF, August 2014.

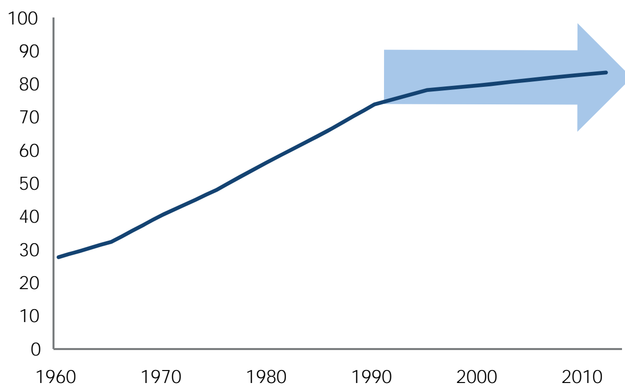
Figure 5: The case of Japan

Japan: Investment and growth at the point of rebalancing



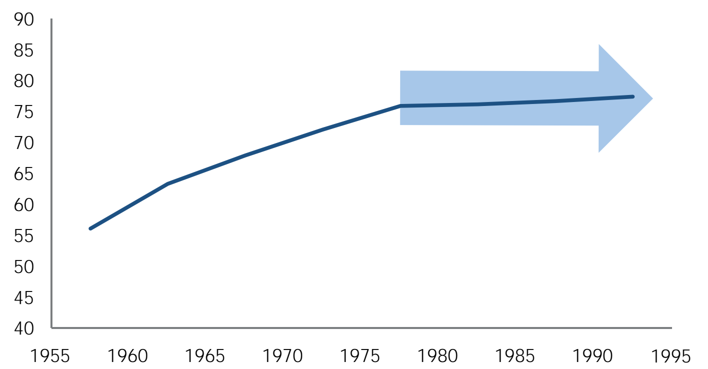
Source: Bloomberg, IMF, August 2014.

Korea: Percentage of urban area population (%)



Source: UN , World Urbanization Prospects as of December 2013

Japan: Percentage of urban area population (%)

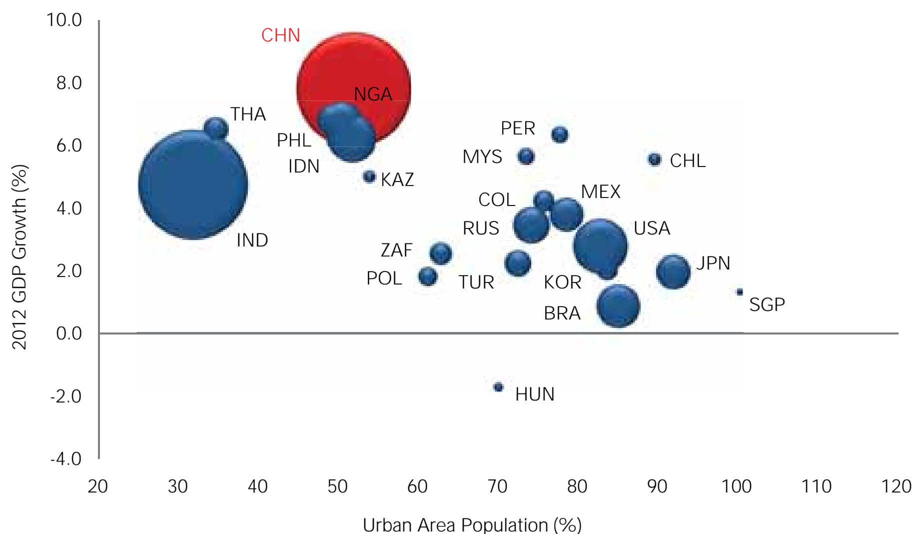


Source: Population Census Japan as of May 2014

Urbanization is the game-changing factor in Chinese economic transition

Looking at levels of urbanization around the world (Figure 6), we can see that the majority of countries, especially developed countries such as Japan and the United States, have reached urbanization levels of 70 percent or greater.

Figure 6: Urbanization in China



Source: UN, World Urbanization Prospects, World Bank, WDI as of 2012. Sphere size represents the size of population.

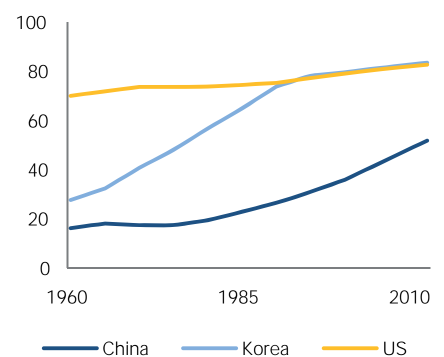
China stands out in terms of the large size of its population (represented by the size of each sphere) and also its relatively low level of urbanization. Migration to urban areas has picked up steam however, over the past two decades, with urban population rising at about 1% per year (Figure 7). Based on the experience of most developed countries, such as the US, and newly industrialized countries, such as Korea, this trend could be expected to continue for at least two or more decades before stabilizing at close to 70% or possibly greater, judging by historical precedents. In fact, the government's recently announced urbanization plan sets an ambitious goal of reaching 60% urbanization by 2020.

The rising urban population in China should continue to generate demand for housing, mass transit, and infrastructure, and should also be supportive of growing wages.

It is important to acknowledge here that to the extent that the new home supply in China exceeds the pace of urbanization, the risk of a temporary slowdown in the near-term is elevated. Inventories of unoccupied homes have been increasing in the lower tier cities and there may be an adjustment necessary to absorb the accumulated stock, leading to lower construction activity. In the long run however, we do not see a collapse in China's investment, but rather stabilization, extending the trend of the past few years.

Rising urban population in China should continue to generate demand for housing, mass transit, and infrastructure, and should also be supportive of growing wages.

Figure 7: Urban area population (%)



Source: UN, World Urbanization Prospects, May 2014

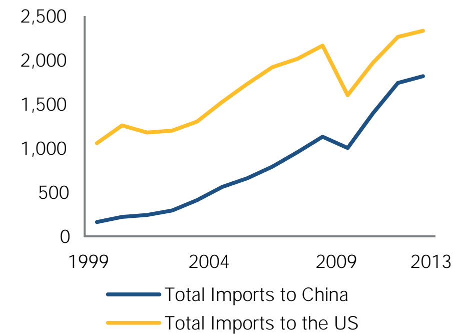
China's rise of the consumer and the changing composition of its imports

The gradual increase in the level of urbanization should also be supportive of a rise in personal wages and consumption. The increasing importance of Chinese consumers in turn means that the composition of China's demand for the world's goods is likely to change.

The importance of China for the global economy becomes striking when we compare China's import goods with those in the US and note that China is quickly catching up in terms of the absolute volume (Figure 8).

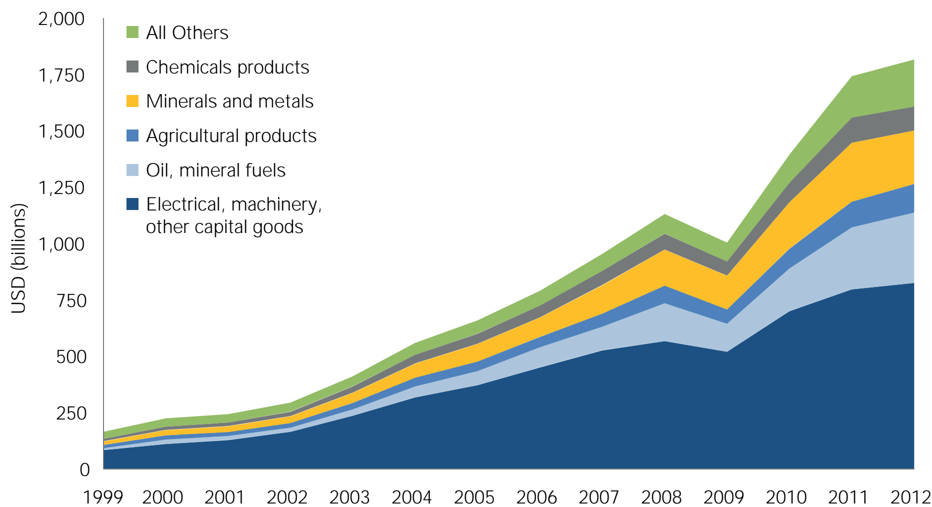
Looking now at the composition of imports (Figure 9), we can see that all categories are growing, but two categories in particular, food and consumer goods, are becoming relatively more important. In fact, as China's economy gradually relies more on consumption versus investment for growth, we would expect to see lower demand from China for commodities, particularly metals, and more demand for consumer goods, higher value-added products, and also for food.

Figure 8: China vs. US imports



Source: World Bank, December 2013

Figure 9: China imports by category



Source: World Bank, December 2013

Implications for Emerging Markets countries

Bringing all of this together, we believe that growth in China will likely stabilize at current levels over the next decade, rather than collapsing, as some may fear, . The composition of Chinese growth will change gradually and this development will carry a number of far-reaching implications for the rest of the Emerging Markets countries. Winners and losers are likely to emerge. Just as heavy investment and reliance on industrial production benefited commodity-exporting countries until recently, slowing investment will mean more stable and lower commodity prices, benefiting commodity importers. This development should support commodity-importing Asian and Central European economies, but will be negative for commodity-dependent countries, especially those with weaker governance and institutions (Table 1).

At the same time, the rise of the consumer in China will likely create demand for higher value-added goods produced by neighboring Korea and Japan. Also as wages rise in China and the costs of manufacturing become greater, lower-cost producers in countries such as Vietnam and Thailand will also benefit.

Table 1: Effect of Chinese economic rebalancing on emerging markets countries and select developed countries

Stable Commodity Prices		
Commodity importers	**Commodity exporters with strong governance**	**Commodity dependents with weak governance**
▸ Asia ▸ Central & Eastern Europe	▸ Mexico ▸ Chile ▸ Columbia	▸ Russia ▸ Africa
🟢	🟡	🔴

Increasing China Consumption		
High value-added producers	**Substitution to lower-cost producers of goods**	**Cheap labor, good demographics, but need improved gevernance**
▸ Korea ▸ Taiwan ▸ Japan ▸ Germany	▸ Vietnam ▸ Thailand	▸ India ▸ Sri Lanka ▸ Bangladesh
🟢	🟢	🟡

Source: HSBC Global Asset Management.
Legend: The groups of countries denoted by green should benefit the most, the countries denoted by red will be negatively impacted, while the countries denoted by yellow stand to benefit with adequate governance.

Conclusion

The ultimate impact on the economies and capital markets of EM countries will depend on a number of factors, including in large part the response of their policy makers to the changing external conditions. For example, this year we have observed divergent policies in Mexico and Chile, the countries that are likely to be adversely impacted by a gradual decline in global commodity prices. In Mexico, the government recently began to tackle a number of structural reforms in the energy and other sectors, which lifted investor sentiment and led to the outperformance of Mexico's external debt in 2014 . In contrast, policymakers in Chile, faced with declining prices of copper (Chile's leading source of export revenues), have maintained a dovish monetary policy stance and have allowed their currency to depreciate by almost 11% in 2014 (as of September 2014). The monetary policy stance which was negative for the currency, however proved favorable for hard-currency denominated bonds and local currency bond returns in Chile. Therefore, in the context of portfolio management, the imminent change in China's impact on the Emerging Markets should be considered in conjunction with country-specific factors and asset class differences. It is clear is that investors may be well served not to not rely blindly on structural EM beta to lift all boats, but rather, to take a closer look at the individual country allocations and exposures in their portfolios.

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Binqi Liu is a portfolio manager on the Emerging Markets Debt team responsible for local markets. She is the co-manager of HSBC Emerging Market Local Debt flagship fund (HGLEMIC LX Equity). She joined the firm in June 2008 focusing on sovereign analysis and became a portfolio manager since Jan 2010 focusing mainly on local markets. Besides managing portfolios, she is also the economist for the investment team to decide global macro themes as well as specific country risks. Before joining the firm, she worked as a research assistant for Robert A. Mundell, Nobel Prize winner in Economics, since June 2007. Ms. Liu has a B.A. from Hunan University in China and an M.P.A. from Columbia University.

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