Recent Developments in China and Implications for India

Talk at the Indian Chemical Council

AVALON Consulting

ICC
Indian Chemical Council

State-of-Play in China

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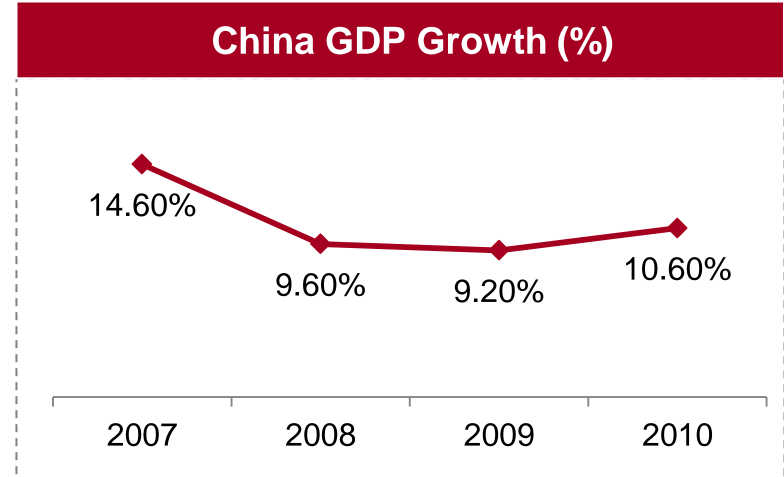
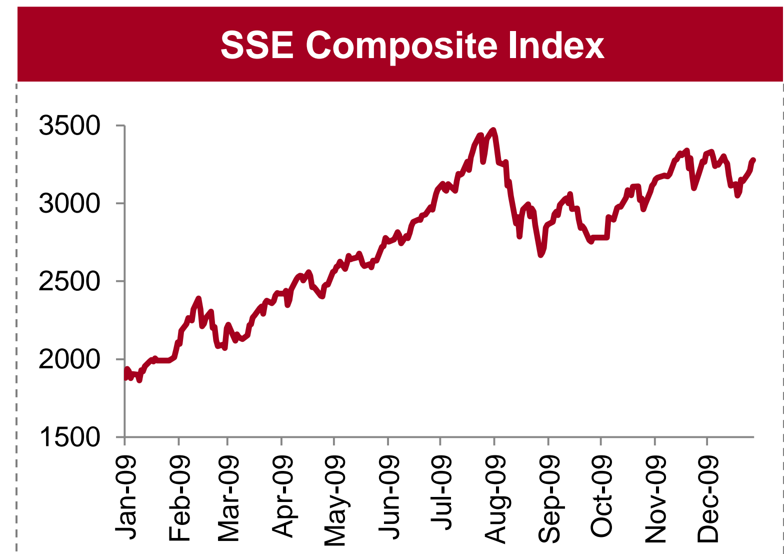
The aftermath of the 2008 global economic crisis revealed the structural challenges facing the Chinese economy

- ***Export-led economic growth model unsustainable***
  - Exports accounted for 41% of China GDP in 2007, 33% in 2008
  - Economic slowdown in key markets like US and Europe left China vulnerable
- ***Strong domestic market essential for equitable growth***
  - Weak and unsophisticated consumer markets especially in financial services, entertainment, hospitality
  - Underdeveloped services sector – IT, ITES, airlines
- ***Imminent danger of "middle-income trap"***
  - GDP per capita grew from $2000 in 1980 to $10,000 in 2014
  - Steady 6-7% growth required for 2 decades to raise it to $25,000 (comparable to Korea, Japan)
- ***High social and environment cost of growth***
  - High levels of pollution across major urban centres
  - Labour unrest in many manufacturing hubs
  - Wide ranging levels of prosperity between coastal areas and interior regions

To deal with the slowdown and manage domestic expectations in the near term, China deployed an investment-led stimulus package in 2009 and 2010

- ***Stimulus package***
  - RMB 4 trillion for 2009 and 2010 combined
  - Included new spending worth RMB 2 trillion
  - Bulk of spending on Infrastructure (72%)
- ***Additional credit expansion through banks***
  - RRR lowered from 17.5% to 13.5%-15.5%
  - Lending interest rate dropped from 7.47% to 5.31%
  - Deposit rate reduced from 4.14% to 2.25%
- ***Desired results achieved temporarily***
  - GDP growth rebounded in 2010 (2009 - 9.6%, 2010 - 10.6%)
  - Stock market rose from 1800 levels to cross 3000 during 2009
  - Increasing employment





Source: IMF, SSE

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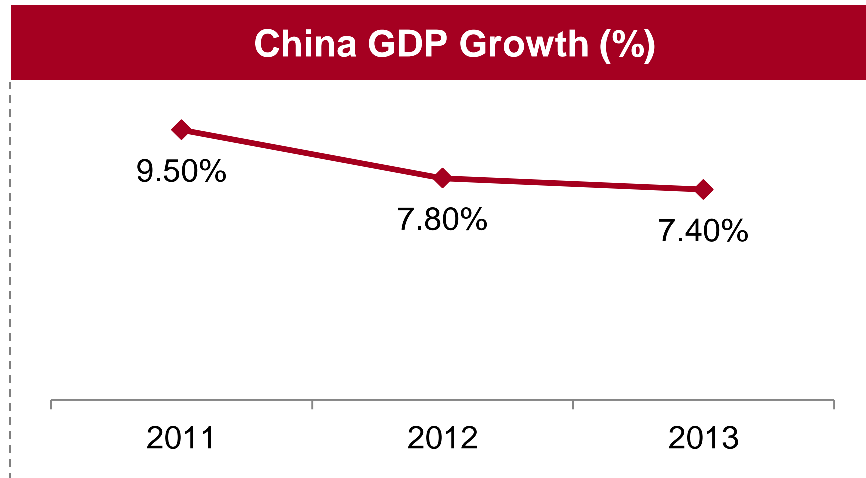
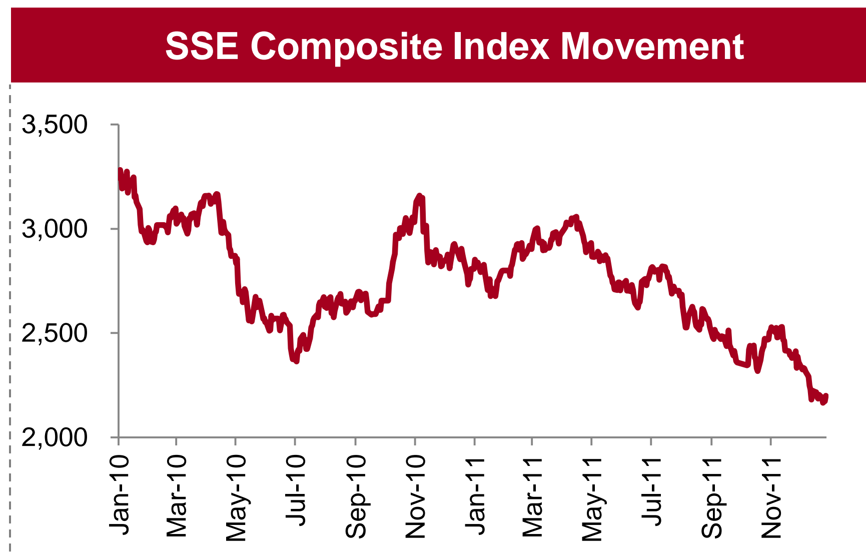
However, when the stimulus ended, growth slowed and the stock markets reacted





- ***Early successes were reversed…***
  - GDP growth dipped post 2010
  - Stock market started declining

- ***… and other problems on account of the stimulus package surfaced***
  - Looming bank defaults crisis; loans worth RMB 2 trillion out of RMB 7.3 trillion at risk
  - Elevated housing costs due to easy credit-driven demand
  - Relaxation of energy-intensive export curbs led to higher energy cost per unit of GDP

Source: IMF, SSE

Exports from China continued to see a strong rebound since 2010 and touched $2.3 Tn in 2014; trade surplus has crossed the 2008 levels

Source: UNCTAD, World Bank, Avalon Consulting Research and Analysis

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China acknowledged the need for fundamental measures by unveiling an economic reform agenda at its Third Plenum in Nov 2013 covering 4 areas

- ***Financial sector reforms***
  - liberalizing interest rates
  - establishing deposit insurance
  - strengthening financial regulation
- ***Fiscal reforms***
  - strengthening social safety nets
  - efficient and redistributive taxes
  - improving health insurance and pension coverage
- ***Structural reforms***
  - reforming SOEs
  - revising the Hukou system
  - further opening up markets
- ***External sector reforms***
  - liberalizing the exchange rate
  - capital account controls

Since the reforms were designed to correct structural flaws, they were expected to slowdown economic growth in the short term but deliver long term benefits

- ***Altered cost structures due to higher cost of capital***
  - Export competitiveness predicated on lower cost of capacity creation in China
  - Operating cost structure also benefits from low interest regime
  - Interest rate liberalisation would raise the cost of capital
  - Impact on exports (mainstay of Chinese economy) would be felt on entire economy
- ***Wide ranging impact of SOE reform***
  - SOEs enjoy undue advantage in many industry sectors
  - Level playing field could lead to closures, consolidation and correction
  - Power sector SOE reform will raise power costs impacting overall manufacturing competitiveness
- ***Exchange rate correction***
  - Imports would become more expensive
  - Could effect a slowdown in consumer spending
- ***IMF in early 2014 estimated slower growth in following years - 7.34% (2014), 7.13% (2015), 6.86% (2016), 6.59% (2017)***

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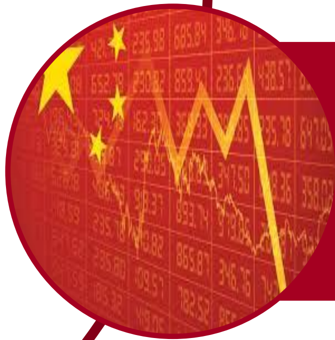
However, two recent events have brought focus back sharply on the state of China's economy

RMB Devaluation



Stock Market Crash

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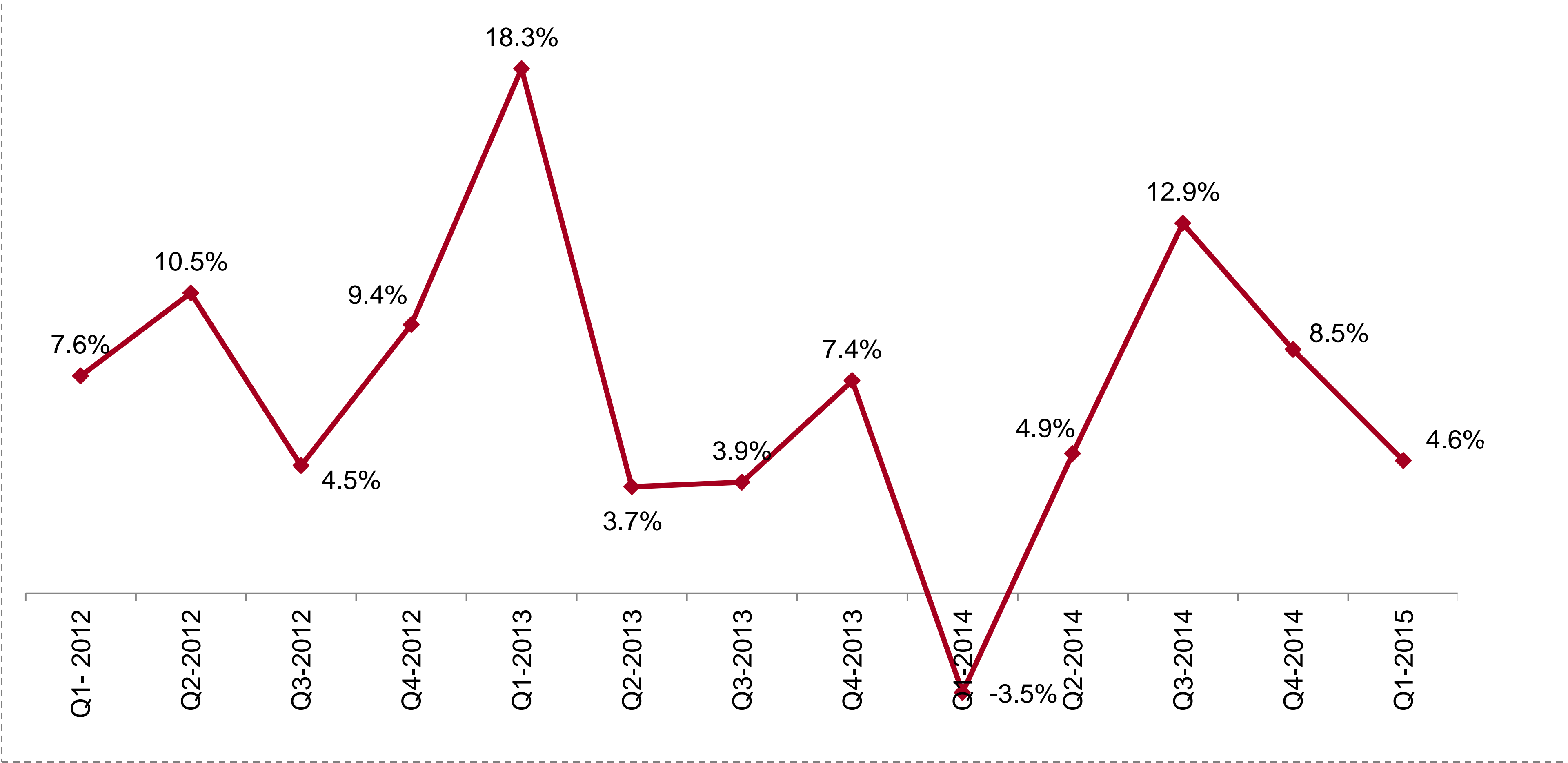
China devalued the RMB by 4% between July and August 2015

Source: XE.com

It is widely believed that this is only an attempt to shore up export performance which has been hit in the past 2 quarters



Source: Tradestat

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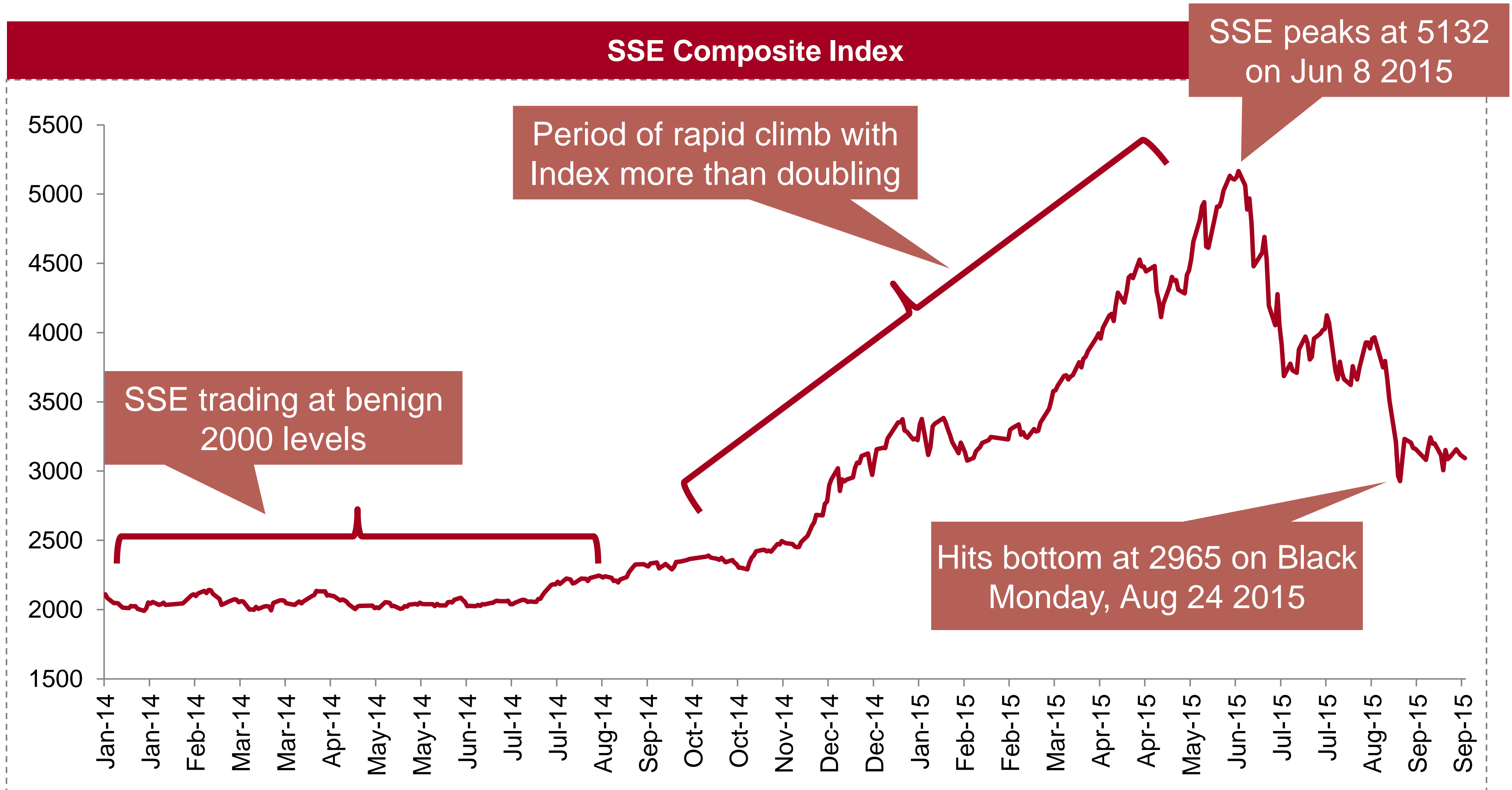
However, the devaluation of the RMB appears to be a part of the economic reform process and a planned strategy towards making it a global currency

- ***View of China's action as knee-jerk response to exports dip is one-dimensional***
  - **Easing control over RMB peg is part of economic reforms**
    - PBoC has been pegging rate of RMB to USD
    - A 2% band was allowed for fluctuations; this is up from 1% earlier
    - Going forward the band will be expanded to 3%
  - **China is moving to make the RMB a global currency**
    - China lobbying with IMF to get RMB included in Special Drawing Rights
    - SDR is basket of currencies including USD, EUR, GBP, YEN
    - IMF preconditions for SDR inclusion is to make RMB freely floating
  - **Devaluation result of this endeavour**
    - RMB rose steeply against USD after Nov 2014 (peak of 2.4%; settling at 1.5%)
    - In July, PBoC changed method of pegging RMB resulting in devaluation of ~4%
- ***Further devaluation may be expected to the tune of ~10% depending on the relative movement of USD and the decision on interest rates later in the year***

The other event - SSE Composite Index crashed by almost 60% between June and September 2015 including an 8% drop on Black Monday



Source: SSE

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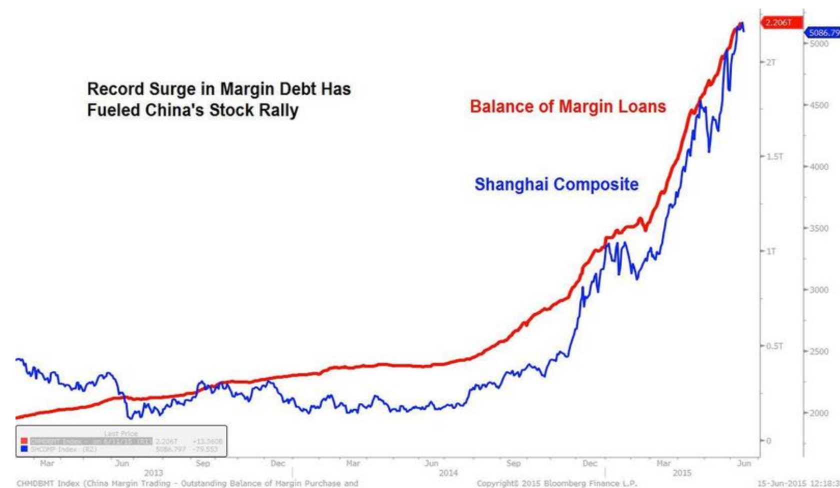
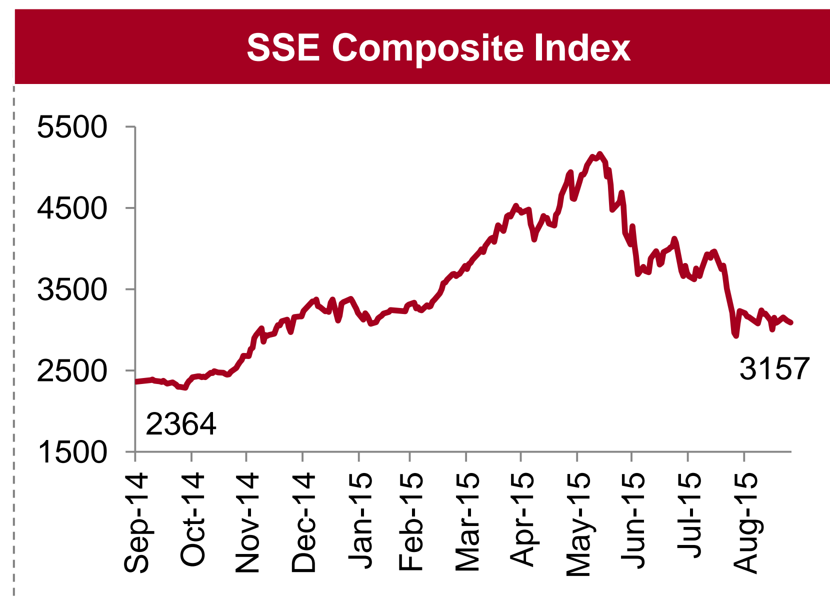
Crash linked to sluggish economic performance, but China slowly moving away from command economy model and is serious about economic reforms

- ***No fundamentals supporting stock boom***
  - economic growth during this period was sluggish
  - boom driven by RMB 4 trillion of margin money channeled through CSFC (more stock traders than Communist Party members!!)
  - clearly unsustainable conditions
- ***Govt. attempted to manage the crash…***
  - Banned large scale trading in listed companies
  - Devalued RMB to shore up economic growth
- ***…but allowed correction in long term interest - CSFC withdraws from daily intervention***
- ***However, even post-crash, market still 30% higher than a year back***





Source: Vox, SSE

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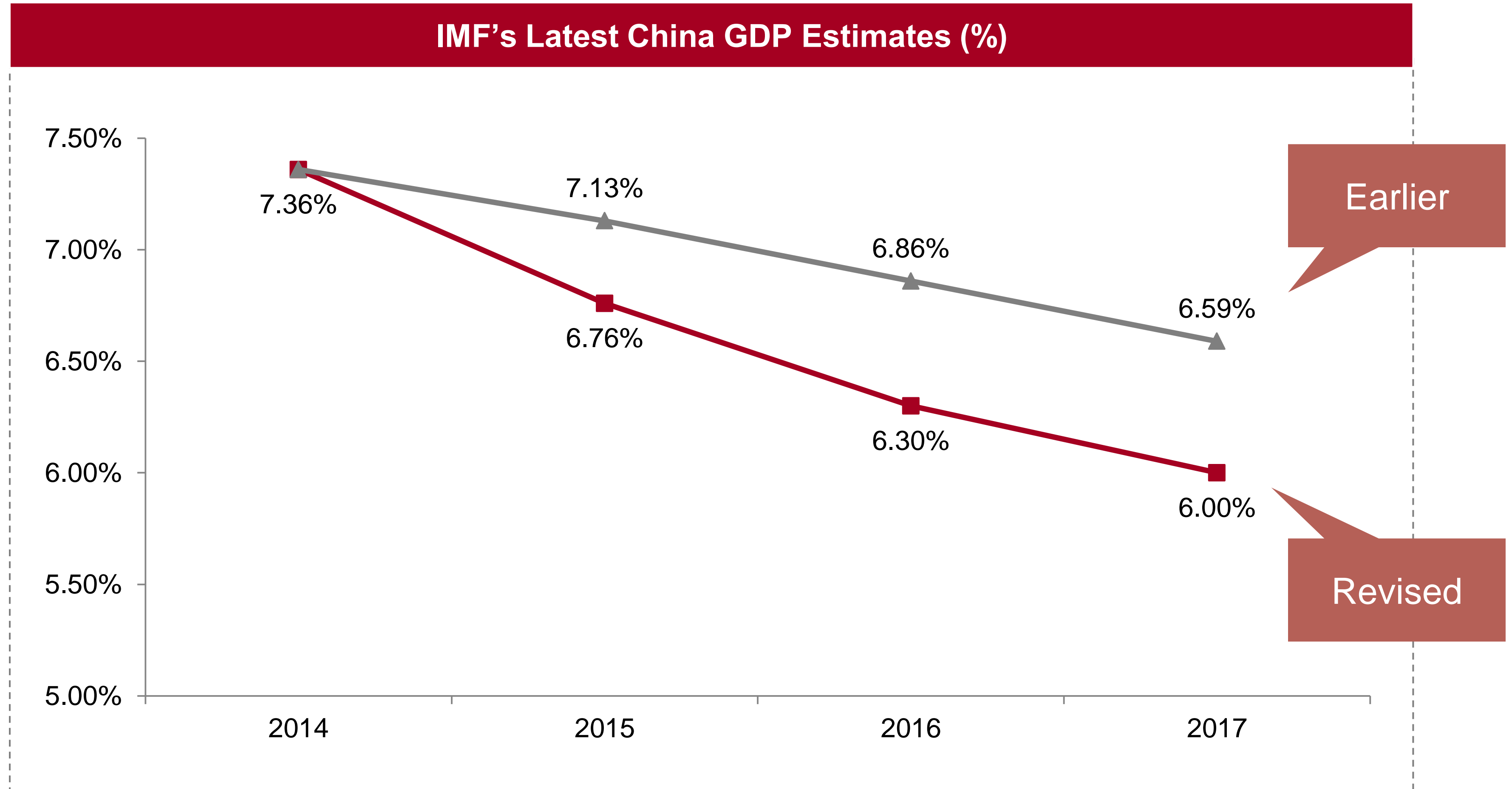
Hence, a further slowing of the economy is expected as per recent IMF estimates



Source: IMF

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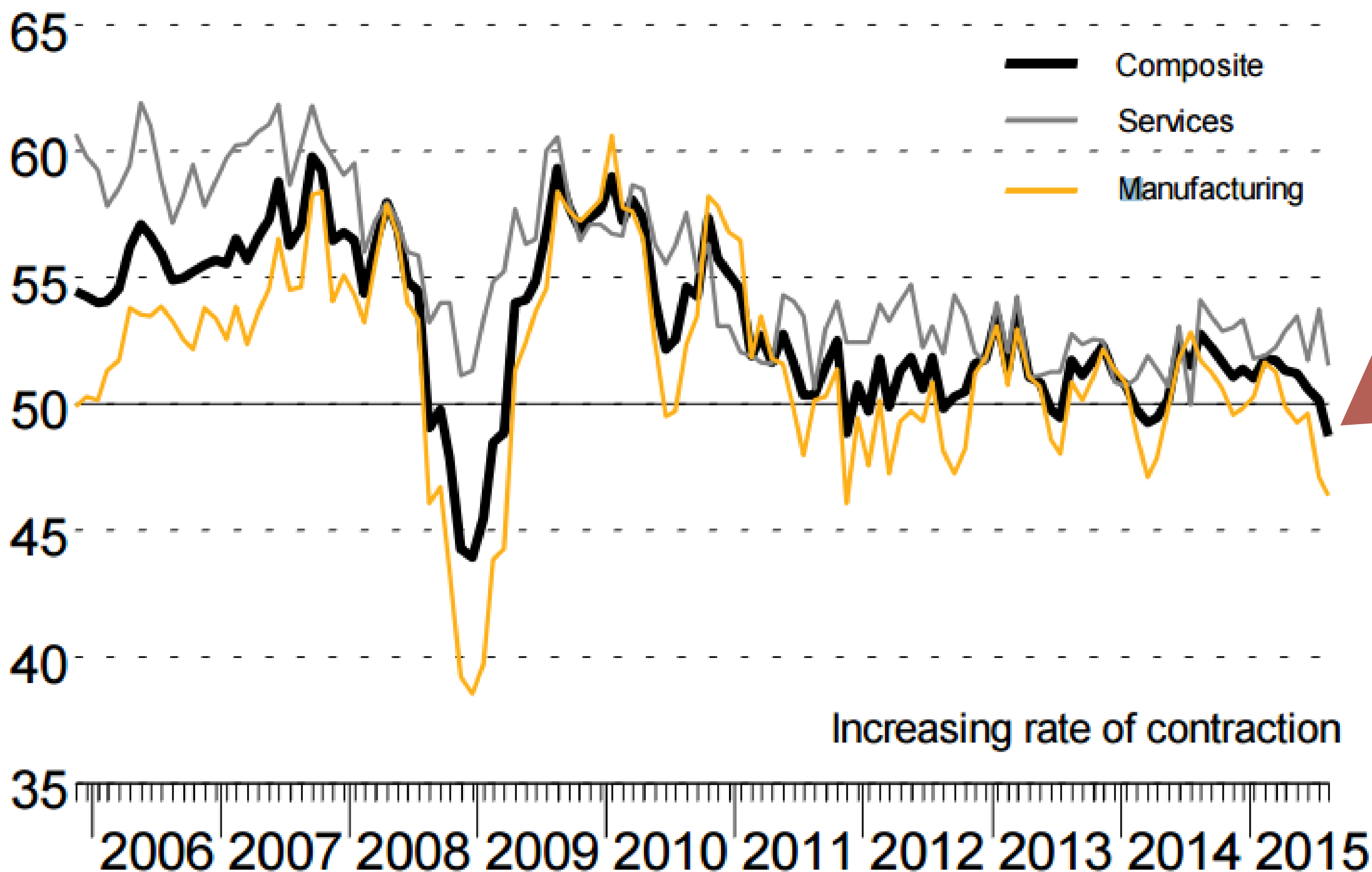
However, China committed to reform agenda; long term prospects remain positive; a more calibrated approach likely given the recent backlash

- ***Reforms agenda to continue***
  - Interest rate liberalisation to be completed by end of 2015
  - Deposit interest scheme to be announced next month
  - Total financial regulation will take more time but expected to be completed by 2020
- ***More pain in the near term due to economic slowdown***
  - China accounted for ~30% of global growth in 2014
  - Slowdown will hit commodity prices as demand drops
- ***However, China will need to balance domestic concerns***
  - Further devaluation of RMB to spur exports and protect domestic industry
  - Financial reforms will directly impact consumers positively
- ***In the long term, many reasons for optimism in the Chinese economy***
  - Capital and labour allocation efficiency can be improved significantly
  - China can catch up with the West on technology through further liberalisation
  - Interiors need to catch up with the coastal areas providing room for growth

We also need to re-visit our interpretation of conventional lead indicators of Chinese economy – like Manufacturing PMI. Given the shift towards services, this may not be reflecting the true prospects of the economy



Manufacturing PMI continues to show contraction while Services PMI is growing. Similarly, low growth of electricity consumption does not truly reflect the situation as a services oriented economy will be less electricity intensive

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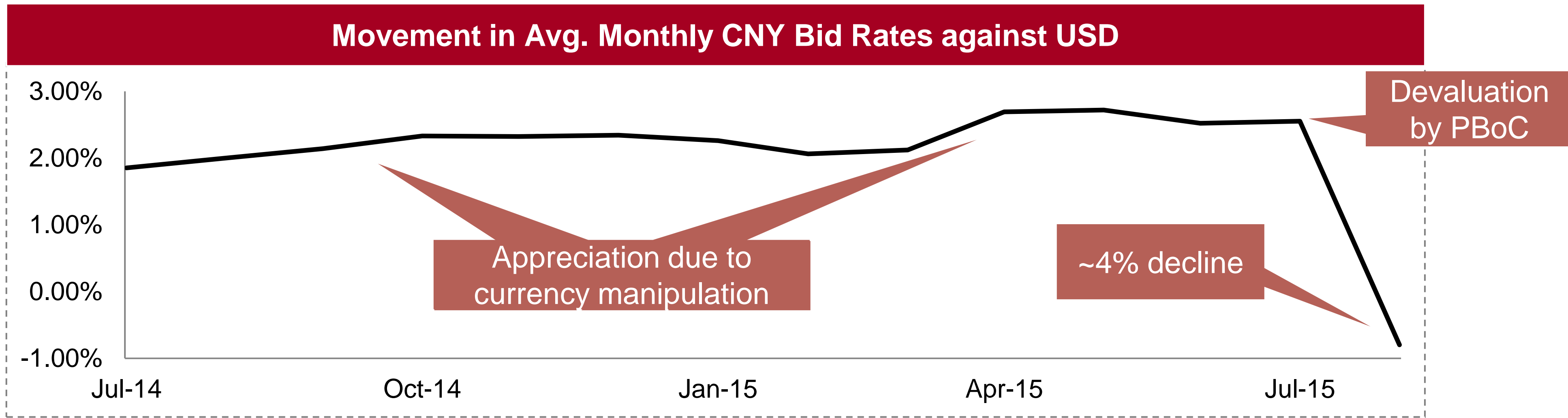
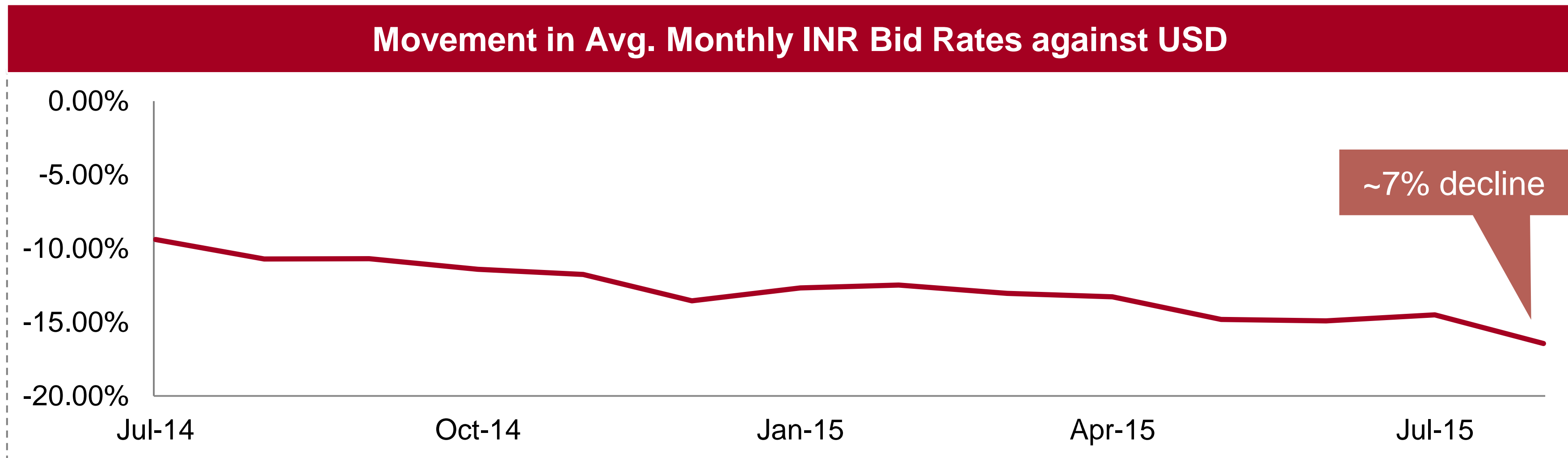
Implications for India

The INR has devalued more than the RMB vis-à-vis the USD and hence India's competitiveness remains unaffected





Source: XE.com

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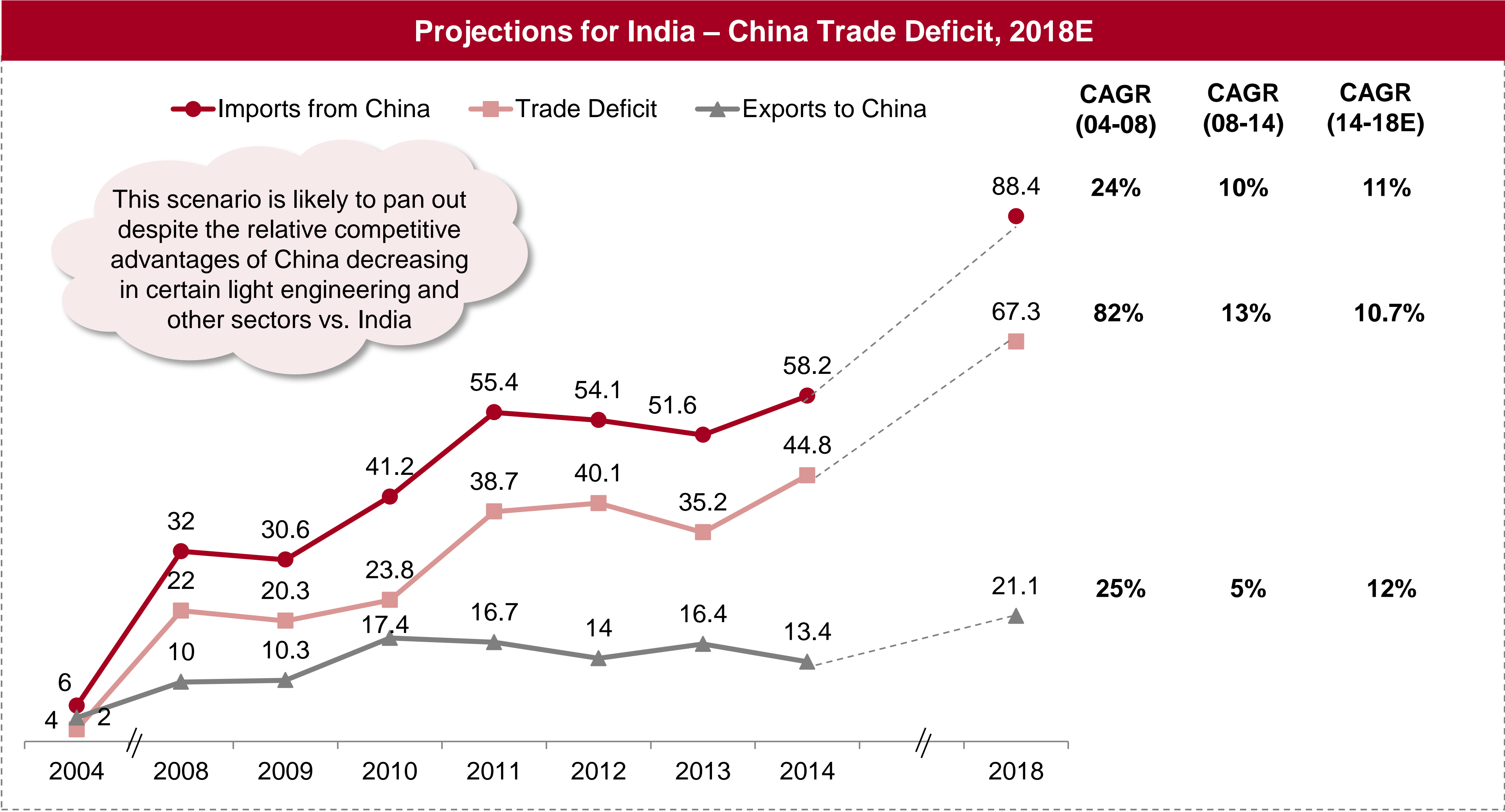
However, the trade deficit with China will continue to endure and grow



Source: Trade Map, Avalon Consulting Research and Analysis

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China will continue to invest strategically in India – this has accelerated in new economy businesses but manufacturing investments are also evident

Snapdeal raised $500 Mn in a recent round of funding led by Alibaba, Softbank and Foxconn

Didi Kuaidi invested an undisclosed amount in Ola cabs to rival Uber in India

Alibaba group has acquired 40% stake in Paytm amounting to $880 Mn

Tencent 腾讯

Practo raised $90 Mn in latest round of funding led by Tencent

HILLHOUSE CAPITAL

Cardekho raised $50 Mn in latest round of funding led by Hillhouse Capital

LONGi 隆基

LONGi is setting up a solar module plant in Andhra Pradesh at an investment of RMB 1.5 Billion

Manufacturing investment

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Hence, India will continue to remain important in China's strategy for the future – both as a market and an investment destination

India will become a substantially important market / investment destination for China…

- China is diversifying its exports markets and investment destinations
- China is intent on becoming more global and open in its economic outlook (including taking Chinese brands global)

- Likely slowing growth rate of China in future
- China's competitiveness gap with India is narrowing
- This will make India an attractive destination of Chinese investment in certain select sectors

- Growing strategic and geo-political importance of India-China ties - hence the need for China to proactively engage with India

The strategic initiatives to be made by Indian companies and economic bodies will centre around actively engaging with China from a position of strength

1. **Leverage India's Importance - Market and Investment Destination for China.**
2. **Push for Market Access in Key Sectors where India can Add Value to Chinese Economy – Pharma, IT, Tourism, Media and Entertainment, Auto Components**
3. **Priortise Chinese FDI in 18 identified industry sectors and a Sovereign Deal to Attract Investment in Indian Infrastructure**
4. **Set up an institutional basis (Government cum industry) within the PMO or MOCI to direct and monitor the achievement of Goals**

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