Whist we, the British public, have been worn down by three years of Brexit debate, we should perhaps have some sympathy for the Chinese who have been confronted with debate that their economy will suffer a hard landing for close to seven years now.

Back in August 2012 after Wen Jiabao, the then Chinese Premier, had announced that their revised annual growth target for 2012 was a measly 7.5% the Financial Times led with the headline - Economists weigh Chinese 'hard landing'. Four years later George Soros, the veteran hedge fund manager, declared - 'A hard landing is practically unavoidable'

Yet the Chinese economy has ignored these doom-mongers and has continued to march onwards, albeit with a few faltering steps along the way.

However, given the durability of these negative headlines, the breadth of commentators willing to predict the economic collapse of the second largest economy in the world and with the enduring concerns about trade wars, we review whether decline is imminent in the Chinese Year of the Pig and also whether a hard landing is a real cause for concern.

The definition of a 'hard landing' is when an economy that has recorded a period of very rapid growth experiences a sudden, sharp slowdown. This slowdown is normally as a result of that economy 'overheating' - when growth is so strong that inflation escalates, and the central bank then tries to dampen that growth by tightening monetary policy aggressively. In other words, by increasing interest rates or boosting the value of their own currency. The problem comes when the central bank over does it, hiking rates too quickly and derailing the economy in the process.

Previous instances of an economy suffering such a hard landing include the US, during the 'Great Recession' in 2008, Japan after their exuberant growth in the 1980s and Russia post the introduction of capitalism in 1991. The US and Russian hard landings resulted in actual falls in output and in the case of Russia, by 1998 their GDP was 39% lower than its level in 1991.

Japan's economy did not suffer the same violent downturn but rather a prolonged, horrible economic stagnation. Between 1980 and 2018 GDP growth averaged 0.49% having reached an all time high of 3.20% in the second quarter of 1990.

Why have concerns resurfaced?

The Chinese economy has averaged growth of 7.96% over the past ten years and 9.5% over the past 40 years.

economic growth rate(%)

	1978	2017	average growth rate from 1979 to 2017
World	4.0	3.0	2.9
China	11.7	6.9	9.5

In the final quarter of 2018, the Chinese economy grew by a 'disappointing' 6.4% which was slightly below market expectations. Whilst this is more than double the expected growth of western economies, it was the lowest quarterly growth rate for China since the global financial crisis in 2009 and as a result, through 2018 the economy expanded by only 6.6%, which was the weakest annualised pace since 1990.

To put this into some context however, the official GDP growth figures for the Chinese economy over the past ten years have been quite staggering:

Year	Real Growth (%)	GDP In billions (USD)
2018	6.60%	13027.07
2017	6.90%	12,237.39
2016	6.70%	11194.69
2015	6.90%	11063.07
2014	7.30%	10483.4
2013	7.80%	9611.26
2012	7.90%	8560.28
2011	9.50%	7575.72
2010	10.60%	6101.34
2009	9.39%	5110.25

During this ten year period China has leapfrogged Japan to become the world's second-largest economy, a title Japan had held for more than 40 years.

Many have suggested that a slowdown was therefore inevitable as the economy had become so large so quickly and that this growth rate could not last forever, but it is perhaps the pace of the slowdown in growth in the final quarter that has led to the resurfacing of the concerns of a hard landing in China.

What have been the growth drivers?

To determine whether the Chinese economy is likely to suffer in the same way as Russia, USA or Japan did, it is important to firstly understand what has driven growth rates over the past 40 years.

Prior to 1979, under the leadership of Chairman Mao Zedong, China maintained a command economy. A large share of the country's economic output was directed and controlled by the state, which set production goals, controlled prices, and allocated resources throughout most of the economy.

Then in 1979 the Chinese implemented free market reforms, opening their economy up to foreign trade and investment. At the time the then leader, Deng Xiaoping, highlighted his indifference to whether the private or public sector drove growth, commenting 'Black cat, white cat, what does it matter what colour the cat is as long as it catches mice?'

After years of central control, the State made every effort to try to foster a more entrepreneurial environment and to liberalise trade. Economists generally attribute much of China's rapid economic growth to two resulting factors: large-scale capital investment (financed by large domestic savings and foreign investment) and rapid productivity growth.

Since the 1990s, China has spent roughly 9% of its annual GDP on infrastructure, now annually exceeding in absolute terms that which North America and Western Europe spend combined. These massive infrastructure projects are almost entirely domestically funded and range from telecommunications, highways, sanitation, power generation, rail and air travel.

The second main driver of growth - rapid increases in productivity - was driven by a 'reallocation of resources' within inefficient state -run enterprises, especially in sectors such as agriculture, trade and services. Rapid urbanisation and a structural shift away from farming and into services is a good gauge of this transformation. In 2017 59.4% of the total population lived in urban areas, a significant increase from just 26% in 1990.

In addition, foreign direct investment in China brought with it new technology and processes which further helped to boost efficiency.

Every five years, the Chinese politburo writes a new economic plan outlining goals for the new period. Until recently, an elected president was able to serve a maximum of two consecutive five-year terms before handing over power, a much more stable solution than in the US and the UK, which hold elections every 4-5 years. This ensures that the government can focus on longer-term goals even if there may be short-term pain suffered as a result of implementing these goals. In March of last year, the National People's Congress in China voted to allow the abolition of the two-term limit, thus ensuring that President Xi can remain in power for life if he so wishes. Whilst this raised major concern in Washington, it means that China can now look far beyond even a ten-year time horizon when setting economic policy.

Can the Chinese learn lessons from Japan?

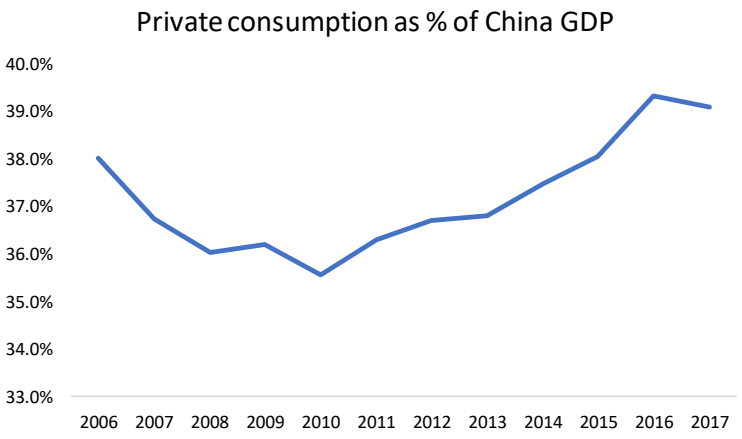
Japan achieved similar economic growth success to China prior to the 1990s but has since suffered from a period of sustained economic stagnation.

To avoid a hard landing, it is apparent that the Chinese are going to have to devise a differing secondary growth policy to that of the Japanese. Whilst we have witnessed another short-term stimulus through increased infrastructure funding, in the long-term they are going to be unable to continue to rely on this level of infrastructure investment, particularly when it is locally funded.

Given the size of its population, perhaps the best solution for the Chinese is to adopt a model akin to that in the United States and focus on domestic consumption first. The United States is wealthy because its consumer-based economy is the largest in the world by a wide margin. Its entrepreneurial culture means that the US is very good at finding innovative ways to not only meet high demand but also to create new demand by coming up with new products and services to sell around the world.

Analysis shows that China is gradually adjusting its growth model to one relying more on consumption and less on investment. The share of household consumption in China's gross domestic product was 40% last year, which is still low relative to the likes of US but a significant improvement from five years ago. Meanwhile, the investment (infrastructure) share of GDP growth fell to 32.4% last year, down from 55.3% five years earlier. In other words, the balance of the economy is shifting in the right direction, towards the consumer and away from investment.

Key to further improvements in consumer spending is the growth



of household disposable income and the pace of this income growth was slightly lower in the last quarter of last year, just 6.2% compared with 6.9% a year earlier. At this stage this is not a significant concern, as the growth levels are still akin to that in 2016, but the next data release will be closely monitored by the market.

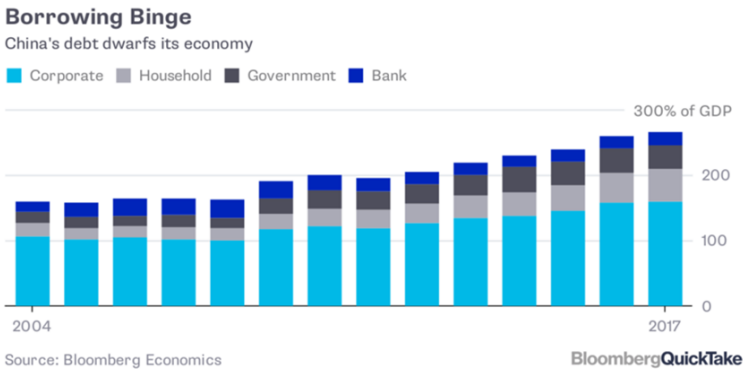
China's average monthly wages (converted into U.S. dollars) in 1990 were $37, compared with $54 for Vietnam and $505 for Mexico. Compare this to 2016, when China's average monthly wages (at $854), were 306.7% higher than Vietnam's wages ($210) and 122.3% higher than Mexico's ($384).

Why does talk of a hard landing persist?

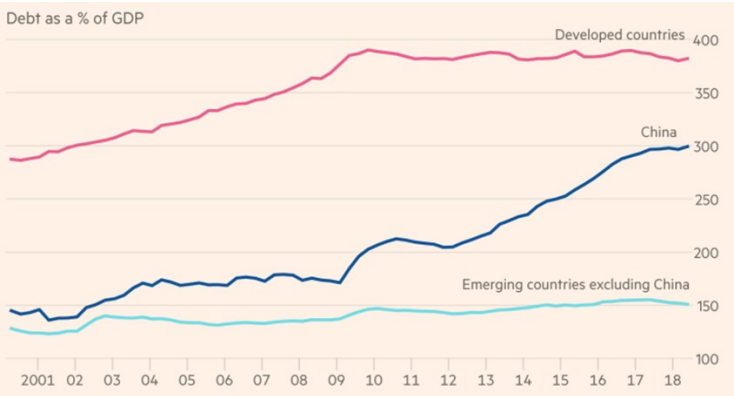
So growth is still strong and the economy has tilted more towards the consumer, who on average is earning and spending more. Why then does talk of a hard landing persist? The primary reason is undoubtedly the fear that the GDP data will deteriorate markedly as a result of the trade war with the U.S. While China's consumers are shifting their spending to services such as education and entertainment, theirs and global investors' confidence has been dampened by this US led action (see overleaf):

The Chinese stock market has tumbled since Trump first announced a trade war with China:

The second major concern relates to the Chinese debt mountain. The quantum of public and private debt in China has quadrupled over the past seven years and borrowing now represents 266% of GDP:



That level of debt growth is larger even than the UK and US prior to the financial crisis in 2008. Total debt in China now exceeds that of the US and is estimated to be twice as high as the average of other emerging economies:



Source: FT

Also, the Chinese property market, which has been a major indicator of both consumer confidence and projected growth, has started to slow dramatically. Sales of existing homes fell to a four-year low in November 2018 and in September new home price growth also slowed.

These are both warning signs and good reason to be cautious.

So, is a hard landing likely this year?

Short-term growth and sentiment is likely to be very correlated to the rhetoric that emanates from the US and China on the ongoing trade wars. It seems at this stage that Trump is willing to adopt a more sympathetic view, with a 90-day amnesty placed on all new tariffs in December, but if there is no further progress on discussions over the next few weeks it is likely that we will witness another round of tariffs imposed after March 3rd. At this point, the Trump administration has pledged to more than double tariffs on over $200bn of Chinese imports. If this goes ahead, we anticipate that GDP data in the first half of this year is likely to disappoint slightly, but not be horrendous.

The longer-term growth trajectory and ability to avoid a stagnation is dependent upon the ability to continue to transition towards consumption-led growth. The longer China continues to accumulate debt to support short-term GDP growth, like it did in Q4 2018, the greater the risks of a hard landing. Disposable household income growth and the non-performing loan ratio (debt unlikely to be repaid) are key metrics to review on this front. However, at this stage household income growth is stable and whilst the bad-debt ratio is rising it is not at critical levels.

As the world's second largest economy and an increasingly important component of equity market stability, the health of the Chinese economy will have a significant bearing on equity returns. Whilst we believe that China is likely to stave off a hard landing again this year, we continue to prefer the growth dynamics in other emerging economies such as India.