How To Think About The Chinese Economy.

- The world is engaged in a trade war which hits manufacturing and industry more than services and consumption. The composition of the Chinese economy makes it vulnerable. The Chinese are a proud people and will claim that the rebalancing is an intentional project rather than a phenomenon forced upon them.
- China's markets are still closed albeit becoming more open. A financial crisis in China will have less contagion effects than a financial crisis in a more open economy.
- China's contagion risk lies in the real economy through trade. But world trade is already stagnating and the world becoming more insular. Also, the weakness in the Chinese economy is over 5 years old and not new. Its effects have already been felt.
- China's nominal output is some 10 trillion USD per annum. To expect even a balanced economy to grow at 6% is very optimistic. For an economy plagued with overcapacity in heavy industry and state owned enterprises to grow at 6.5%-7.0% will require more stimulus.
- The central bank has been stimulating the economy with Open Market Operations (repo operations), interest rate cuts and reserve ratio cuts. This will accelerate. Even so, monetary policy will be insufficient given the examples of the Bank of Japan and the European Central Bank. The Chinese government recognizes this and will engage fiscal policy, budgeting for a 3% deficit, officially, but in fact more, to boost demand. Other countries may learn from the Chinese experience, positive or negative, as their policy unfolds.
- China's debt stands at over 2.5X GDP. Government debt is circa 40% of GDP and is not a problem. The bulk of China's debt is corporate debt and raised in local currency. Being mostly in local currency, China's debt is less sensitive to exchange rate fluctuations. However, most of the debt was raised by unproductive SOEs and heavy industry and will face increasing defaults. The government has the financial ability to bail out or to absorb debt write-downs on behalf of the banking system and domestic investors without depleting its foreign reserves.
- The government has been encouraging refinancing of USD debt in local currency, with extended maturities, and lowered debt costs by changing collateral rules and capital requirements for specific assets such as municipal bonds and LGFV debt. The total

debt may rise before it falls.

- China’s non-manufacturing economy is healthy. Despite declining, non-manufacturing PMI’s hold above 50, whereas manufacturing PMI’s have now been below 50 for close to a year. There are good sectors, industries and companies in China. Unfortunately, investing in China is a very risky endeavour. 90% of capital accounts are owned by retail investors leading to a highly sentiment and technically driven market often subordinating fundamental factors such as earnings and cash flow.
- The macroeconomic conditions in China imply a weakening RMB. The weakness in RMB has not been entirely due to capital flight. The government’s efforts to get corporate China to refinance USD debt in RMB must result in capital outflows and a reduction in foreign reserves, which we have seen. The solution to private capital flight is a sharply weaker RMB which the PBOC is unwilling to allow.