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China

The Rising Tide of Uncertainty

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GMI Round Table - Marrakesh

Agenda

- The Economic Landscape in China is Shifting Quickly
- The Banking Sector is Standing on Clay Feet
- China's Hidden Debt Problem
- It Will Be Hard to See Sizable Fiscal Interventions This Time
- Monetary Policy Is Also Reaching Its Limits
- China Has Two Ways to Accumulate FX Reserves
- What Are China's Real Growth Numbers Like
- How Did China Manage to Grow All These Years
- The Chinese Government is Trying to Pivot
- What Is China Trying to Do Now
- What Could Be a More Sustainable Alternative and What Are Its Hurdles

The Economic Landscape in China is Shifting Quickly

- Since its peak in 2021, the combined market value of equities in China and Hong Kong has declined by nearly $6 trillion
- This represents a substantial drop of approximately 30%
- China's Stock Market is experiencing a downturn, coupled with turmoil in the Real Estate sector

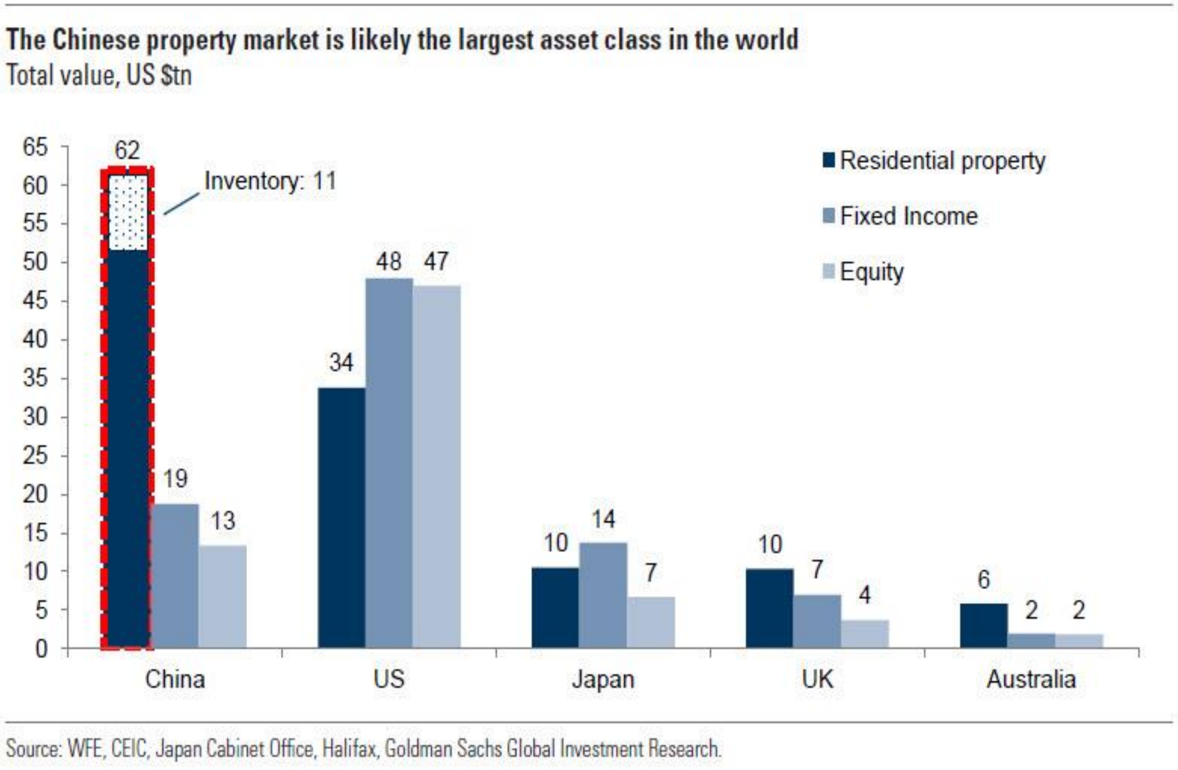
Shanghai Composite

Hang Seng Index

The Economic Landscape in China is Shifting Quickly

- Major developers are grappling with mounting debt obligations
- The property sector in 2021 was valued at ~$62 trillion
- Housing accounts for 60% of Chinese households' assets compared to 36% in the US
- Household Debt as a percentage of disposable income: 131% in 2023 (up from 18% in 2008)
- Including construction and other property-related goods and services, annual housing activity accounts for about 29% of China's GDP, far above the 10%-20% typical of most developed nations
- Real Estate losses could exceed $4 trillion.

Combined Stock Market & Real Estate Losses could exceed $10 trillion

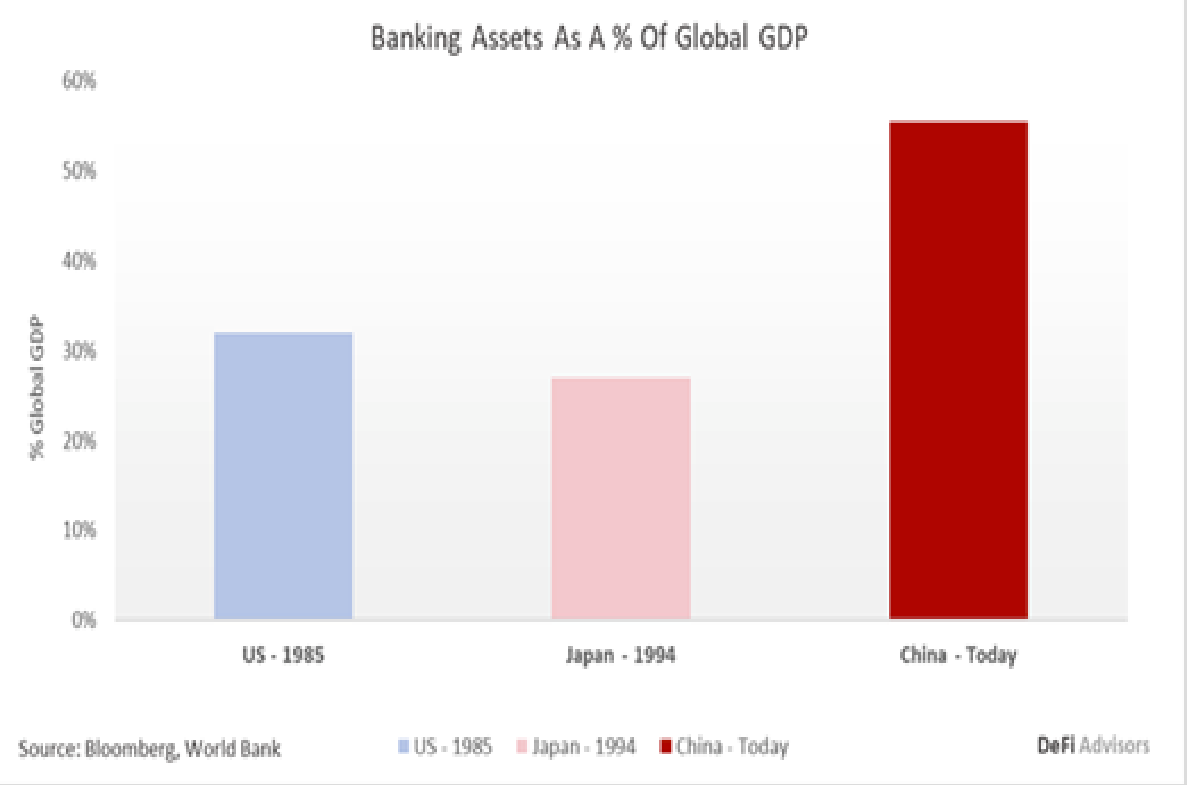


The Banking Sector is Standing on Clay Feet

+ Concerns about the banking sector being inadequately capitalized
+ Banking Assets: $57.6 trillion
+ Due to the vast undisclosed volume of non-performing loans (NPLs) Chinese banks have not taken sufficient provisions to cover the current downturn in the property sector – Reported NPLs are still less than 2%
+ Chinese banking assets constitute 54% of global GDP or 327% of China’s GDP

  Comparatively, at their zenith, banking assets in the United States accounted for 32% of global GDP in 1985, while Japan's banking assets comprised 27% of global GDP in 1994

Threat of Systemic Risk



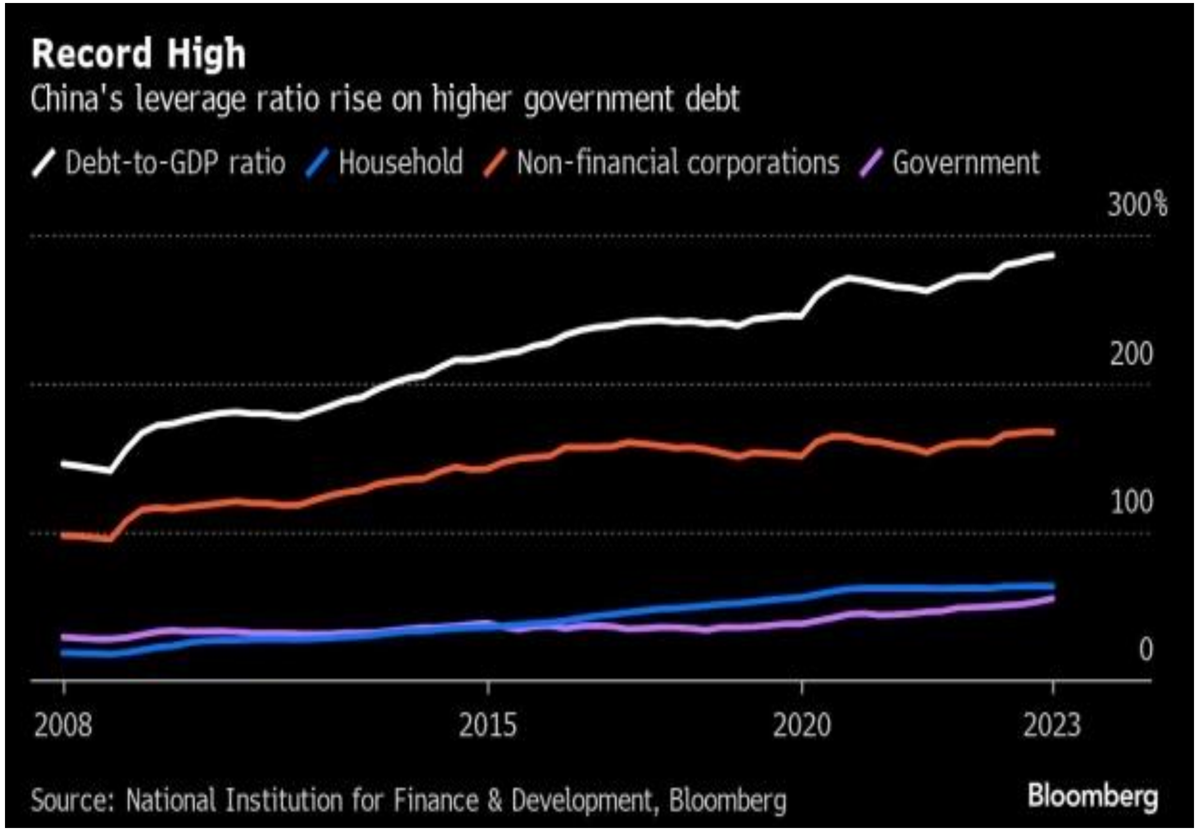
China’s Hidden Debt Problem

- China's economic landscape is complicated by its substantial debt burden
- Total debt surged to 286% of GDP at the end of 2023

  These figures do not account for the substantial debt accumulated by China's Local Government Financing Vehicles (LGFVs), estimated at 64 trillion yuan ($8.9 trillion).

  Including a considerable 40 trillion yuan ($5.6 trillion) directly owed by local governments local government obligations reach a staggering 104 trillion yuan ($14.5 trillion), equivalent to 81% of China's GDP.

  Off-Balance Sheet Government Debt is 50% of GDP



It Will Be Hard to See Sizable Fiscal Interventions This Time

+ Government interventions in real estate and stock markets - $278 billion infusion into the stock market
+ China's budget deficit: Officially close to 3% - Actual deficit closer to 7% - IMF says 15%

  Does not represent the actual fiscal situation
+ Published deficit does not include:

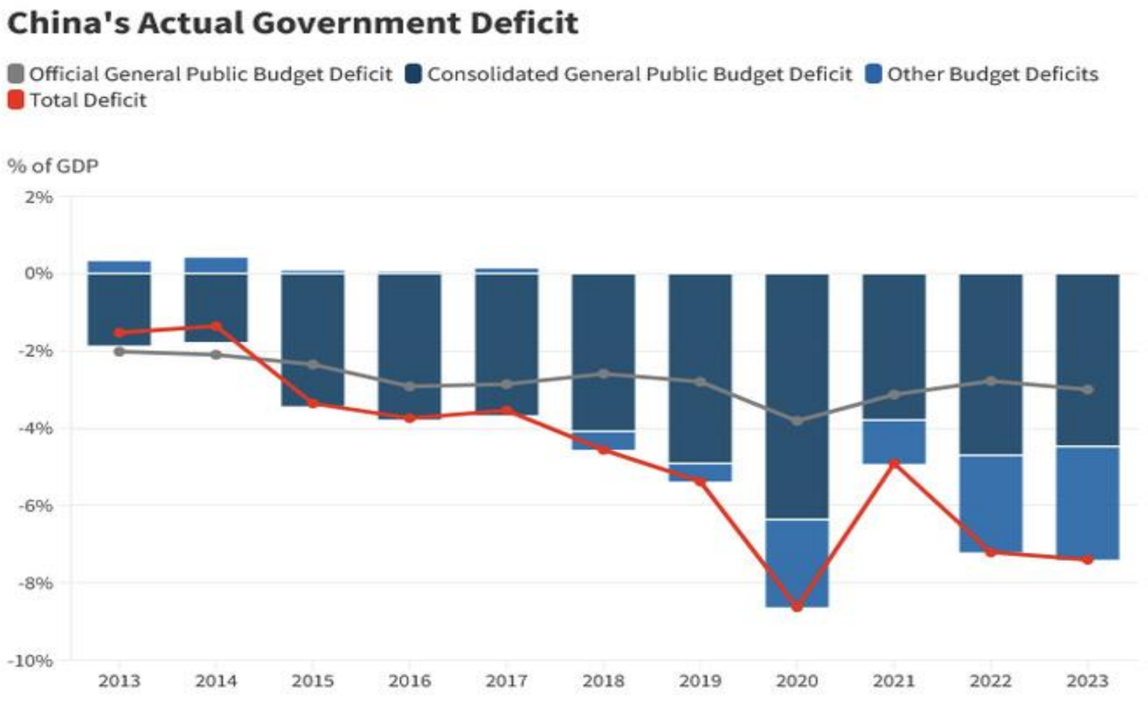
  Special government bonds managed under Government Funds Budget

  State Capital Operation Budget

  Social Insurance Budget

  Supplementary funds from past reserves

Can China continue to monetize its debt?



Note: 2023 figures are preliminary. The consolidated general public budget deficit excludes transfers from other budget areas. The official deficit includes the transfers, which leads to a reduced figure.
Source: CSIS China Power Project; Chinese Ministry of Finance

Monetary Policy Is Also Reaching Its Limits

+ China's M2 is 12.7x larger than its FX reserves

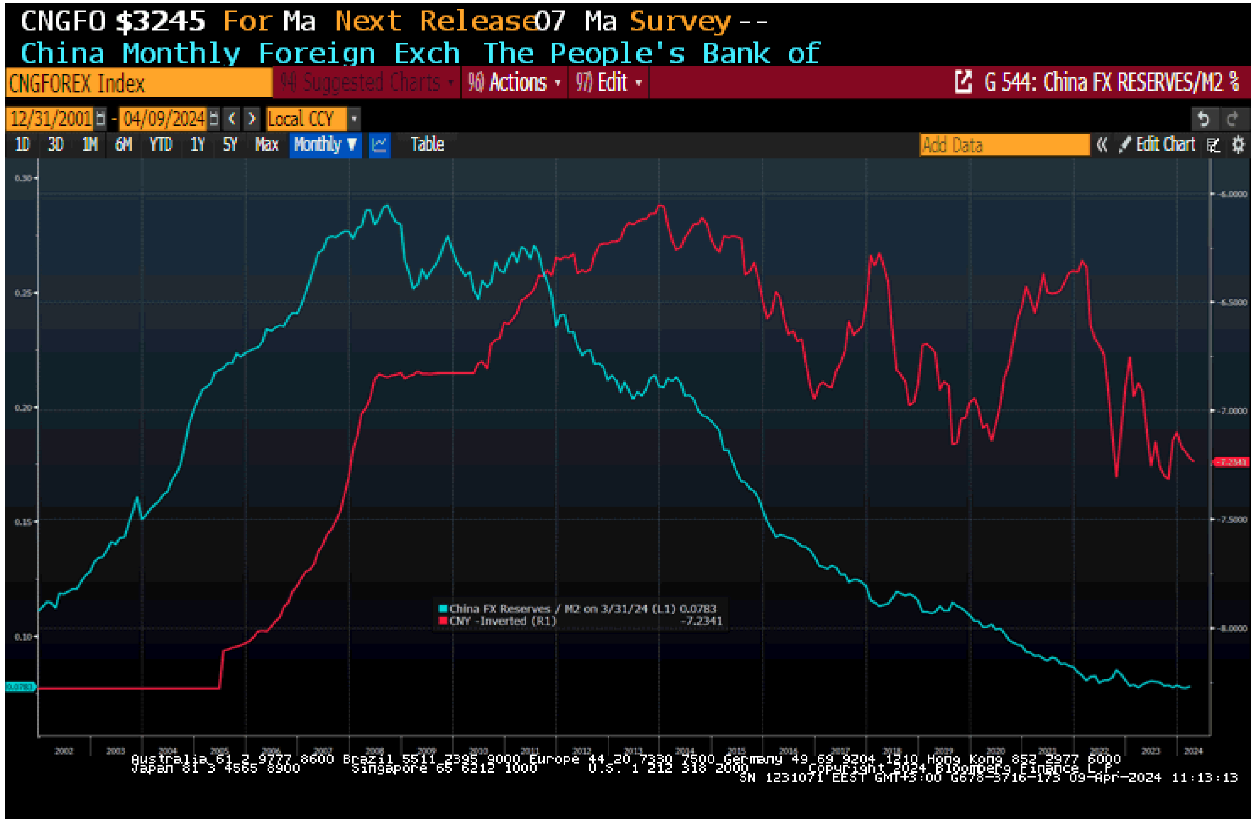
  Highlights vulnerabilities to capital outflows during crises

+ The 1997 Asian financial crisis saw currency devaluations of over 50%

  Due to insufficient foreign exchange reserves - Currency pegs failed when the M2 was roughly 4x greater than FX reserves

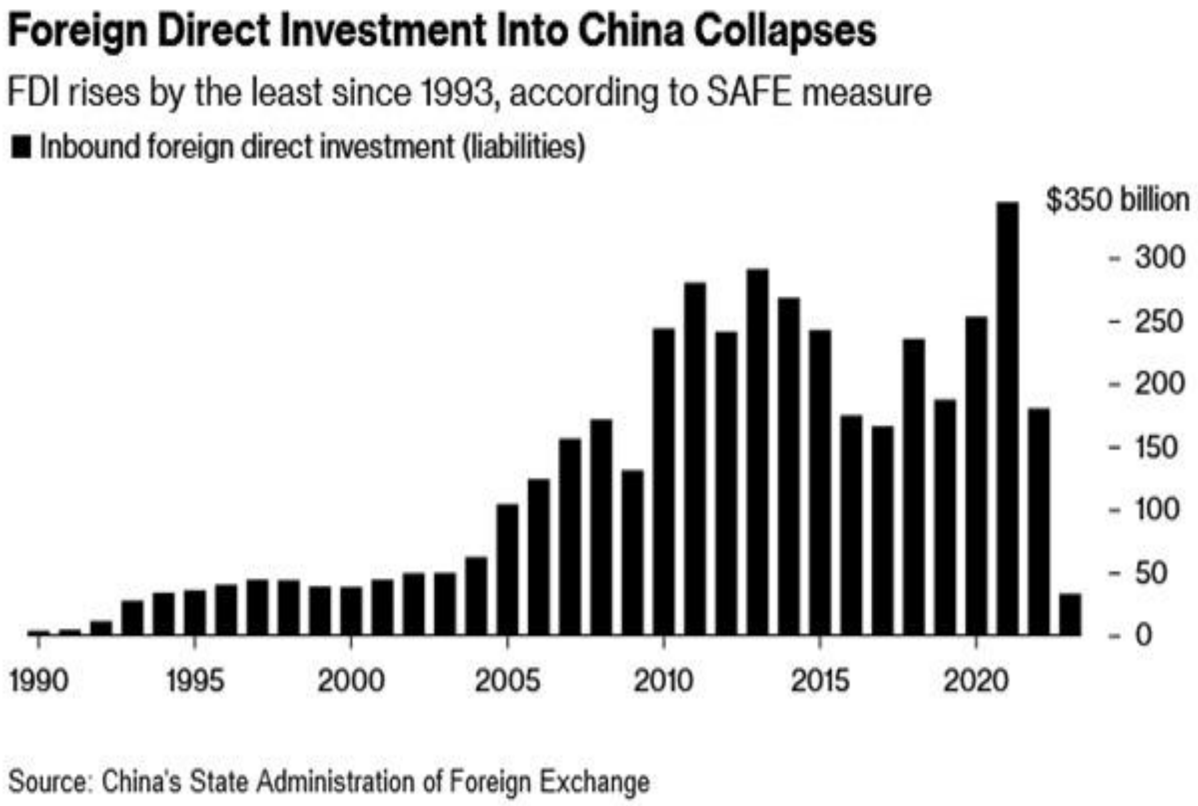
+ China's implementation of capital controls may not be sustainable

  Real estate market downturn and stock market collapse could exacerbate economic decline



China Has Two Ways to Accumulate FX Reserves: FDI

- In 2023, FDI rose the least since 1993 – 82% lower than in 2022
- The Economist Intelligence Unit (EIU) notes that a substantial part of China's FDI comes from Hong Kong. Between 2017 and 2020, Hong Kong contributed 70.4% to China’s overall FDI
- The World Bank estimates that "round-tripping" may constitute as much as 25% of the total FDI inflows into the PRC
- 50% of the FDI from Hong Kong to the PRC, as reported by the PRC, lacks verification or confirmation from statistics collected in Hong Kong
- A significant portion of the FDI is retained earnings, which foreign firms cannot extract



China Has Two Ways to Accumulate FX Reserves: The Current Account

- Current Account Surplus has diminished from 10% in 2007 to 1.5% of GDP in 2023
- In a world where most countries are reshoring due to economic costs and geopolitical tensions, the dependency on exporting goods will likely take a hit
- If we consider trading between China and Hong Kong and see the numbers in detail, a significant portion of the current account is recycled through Hong Kong, making it clear that a portion of China's current account might be inflated

Dependency on exporting goods may take a hit

- Both FDI and Current Accounts are deteriorating

FX reserves of $3.2 trillion are not sufficient -7.8% of M2

What Are China's Real Growth Numbers

+ China's economy grew by 5.2% in 2023, hitting the government's official target. However, overall investment was broadly flat last year, meaning GDP data "significantly overstated" China's growth in 2023
+ Investments = 43.5% of GDP in 2023
+ Doubts about China's official investment statistics – have been fueled by frequent revisions in recent years, and the latest data implies an unusually large adjustment
+ Brookings Institute suggests a potential overestimation by as much as 20%
+ The underperformance of the MSCI China Index, which has declined 16% since its inception in 1995, further fosters skepticism regarding the accuracy of the data on China's growth.
+ GDP has gone from $800bn to $18 trillion, and for the last 30y the market has remained basically flat

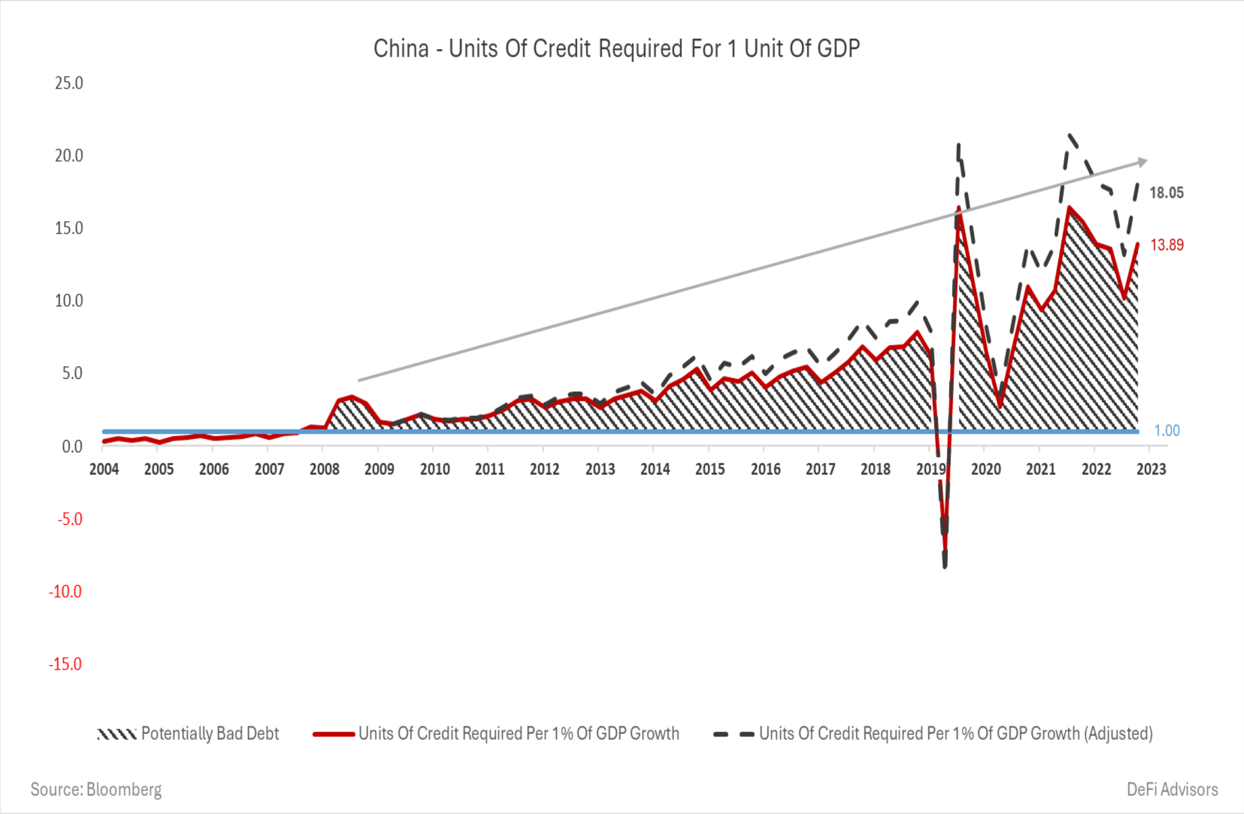
How Did China Manage to Grow All These Years

+ China's economy boomed due to massive capital investments (Productive + Unproductive)
+ Including construction and other property-related goods and services, annual housing activity accounts for about 29% of China's GDP
+ Investments comprised 43.5% of GDP in 2023. Higher than the global average, which is between 20-25% of GDP (To get a perspective, the US is at 21.5% and India at 32.6%)
+ Reliance on investments has created a monster, unproductive debt and as a result, bad debt has skyrocketed

  13.89 units of credit needed for 1 unit of GDP

  18.05 units of credit needed if GDP is inflated by 20%

  So, more and more debt is needed to create the same growth



The Chinese Government is Trying to Pivot

- The Chinese government is trying to pivot from an investment-heavy model to a model centered around manufacturing
- Diminishing yields on unproductive investments in industries that propelled rapid expansion
- Ghost Towns - deserted buildings are a clear example of misallocated capital - entire urban areas filled with deserted buildings
- China has struggled to regain momentum as the property sector and consumer spending remain weak
- The viability of past economic strategies is being questioned
- China needs to sustain its growth

What Is China Trying to Do Now

- China's policymakers are trying to shift from an unsustainable model

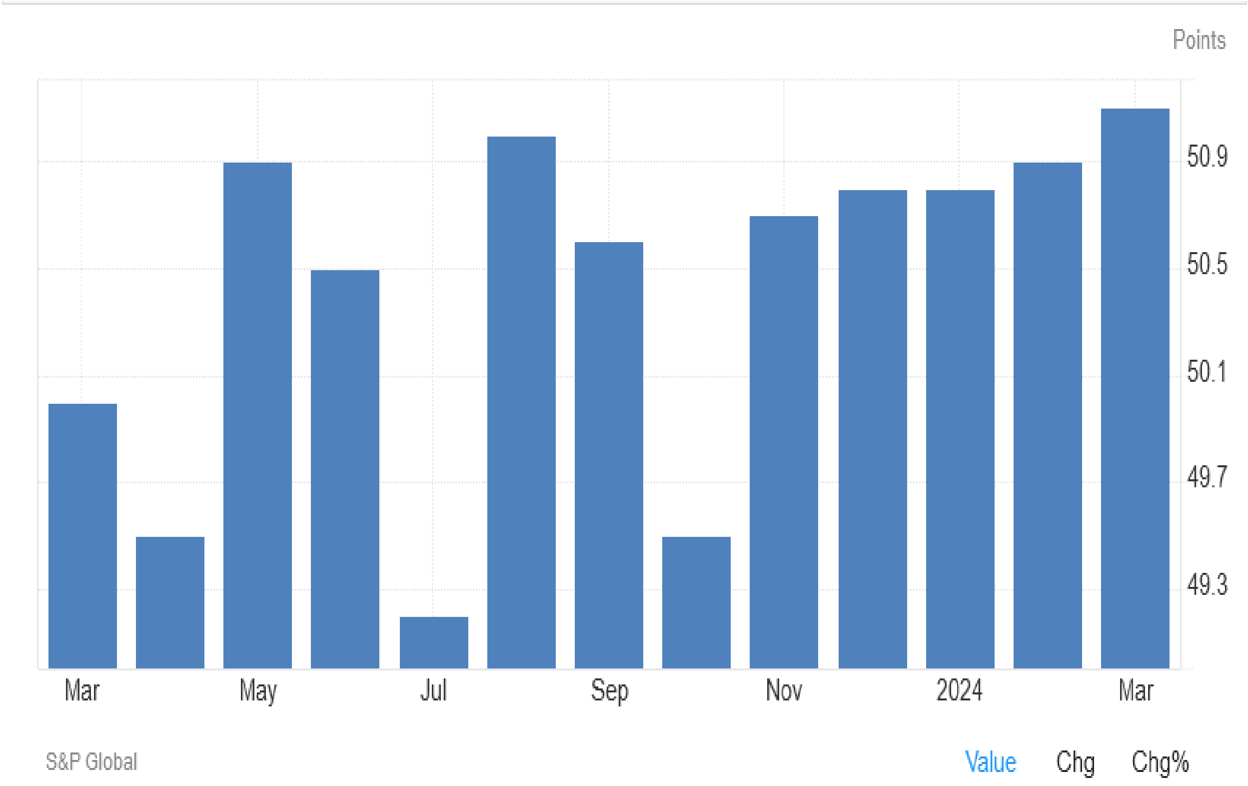
  Prevent property-sector slowdown from affecting overall investment

  Divert funds from property sector to the manufacturing sector

- Data so far this year have shown green shoots in factory activity and trade
- China's PMI was 51.1 in March – its strongest since February 2023 – after coming in at 50.9 in February
- **Risks:**

  Manufacturing already makes up 27% of China's GDP vs Global average of 14% and 10% for the US

  Reshoring, Global growth?



What Could Be a More Sustainable Alternative

- Transitioning to a more consumption-oriented economy is a more sustainable alternative
- Compared to the US, China's private consumption as a percentage of GDP is significantly lower

  US: 68%

  China: 38%
- However, this is difficult to achieve
- Chinese household debt has skyrocketed, limiting future consumer spending

  Household Debt as a percentage of disposable income: 131% in 2023 (up from 18% in 2008)

  Most debt is tied to the property market

Country	Private Consumption (% of GDP)
United States	68%
China	38%

Concluding Remarks

- China faces challenges in shifting towards a consumer-led economy

  Transitioning from an investment-driven model to a sustainable, consumption-led growth path poses immense challenges

  High debt levels, fostering domestic demand, and navigating structural imbalances are key issues
- The severity of China's real estate crisis surpasses that of the United States during the financial crisis
- Capital controls have prevented capital from leaving, keeping the M2 in the country

An economic downturn in China would have global repercussions - Deflationary

Indicator	Value
GDP (Official)	$17.7 trillion
GDP (Unofficial)	$14 trillion
Money Supply (M2)	$41 Trillion
Banking Assets	$57.6 Trillion
Non-Performing Loans (NPLs)	Less Than 1.7%