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Economics Group

Special Commentary

Jay H. Bryson, Global Economist
jay.bryson@wellsfargo.com • (704) 410-3274
Abigail Kinnaman, Economic Analyst
abigail.kinnaman@wellsfargo.com • (704) 410-1570

Chinese Economic Outlook: Further Slowing in Store?

Executive Summary

The Chinese economy continued to expand in Q4, with real GDP growth coming in slightly above consensus at 6.8 percent on a year-ago basis. However, we look for the Chinese economy to slow in the coming quarters, and in this report we discuss key risks to our outlook that remain areas to watch. While the Q4 expansion was likely supported by a resilient consumer sector and improving international trade, a slowdown in investment spending seen over the past several years presents a downside risk to China's more rapid pace of economic growth. Although the ramp-up in investment spending over the past decade initially contributed to productivity and output gains, China's corporate sector is now highly leveraged.

We look for the Chinese economy to slow in the coming quarters, and in this report we discuss key risks to our outlook.

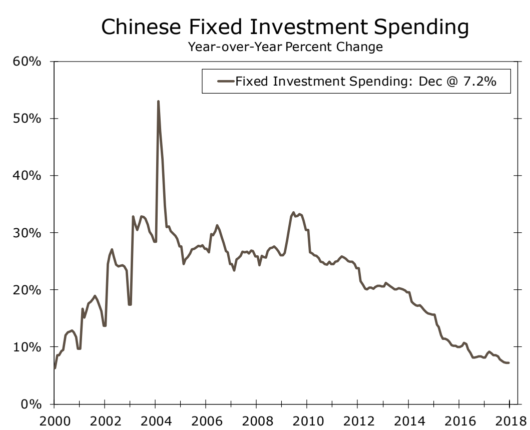
In addition to a highly-leveraged corporate sector, trade relations with the U.S. have led to a large bilateral trade imbalance that could result in trade restrictions against China. A return of capital outflows like those seen in 2015 and 2016 as the renminbi depreciated could also weigh on the Chinese economy, should investors become worried about future growth prospects and/or move capital to countries with higher interest rates. While these points remain areas to watch, our forecasts for 2018 and 2019 see these risks as largely manageable for the time-being, with output rising 6.4 percent and 6.0 percent, respectively, as China's growth falls in line with its more advanced counterparts.

Chinese Economic Growth Remains Steady in Q4

Data released today showed that real GDP in China rose 1.6 percent sequentially (not annualized) and 6.8 percent on a year-ago basis in Q4 (Figure 1). While the sequential growth rate came in slightly below consensus, the Q3 number was revised upward to 1.8 percent. The year-over-year print came in slightly above consensus, demonstrating likely broad-based expansion in the quarter. Today's release puts China's 2017 growth rate at a solid 6.9 percent, up from 6.7 percent last year.

Figure 1

Figure 2



Source: Bloomberg LP and Wells Fargo Securities

Together we'll go far

Investment spending in China has slowed significantly over the past several years.

A breakdown of the real GDP data into its underlying demand components is not readily available, but previously released monthly data offers some insights into the current state of the Chinese economy. Consumer spending as measured by real retail sales remained solid in 2017. Real retail sales were up around 9 percent in 2017, roughly matching the pace of growth in 2016. Solid retail sales growth supports a generally resilient consumer sector, also likely aided by only moderate inflation, up 1.8 percent in December. In terms of international trade, 2016 was a year of slower export growth for the Chinese economy. However, through the first 11 months of 2017, real exports were up 4 percent compared to 2016, contributing to the overall expansion.

Although the consumer sector remains solid and international trade has accelerated in recent months, growth in investment spending in China has slowed significantly over the past several years. Fixed investment spending was up 7.2 percent in 2017, compared to roughly 17 percent on average for the 2012 to 2015 period (Figure 2). This slower pace of growth will likely restrain China's economic expansion in the coming quarters, as we discuss in more detail below.

Is There Too Much Investment Spending in China?

The overall debt-to-GDP ratio in China has risen sharply over the past decade due largely to the increasingly leveraged non-financial corporate sector.

Investment spending has accounted for 35 to 45 percent of Chinese GDP for the lasts 25 years or so (Figure 3).[1] The good thing about robust growth in capital spending is that it can help to deliver strong economic growth on a sustained basis via its positive effect on productivity growth. Indeed, the period of supercharged growth in capital spending has coincided with heady GDP growth that has transformed China from an economic backwater into the world's second-largest economy today.

The bad thing about robust investment growth is that it can potentially lead to a financial crisis if the spending is financed by excessive debt. In that regard, there is some cause for concern about China. The overall debt-to-GDP ratio in China has risen sharply over the past decade due largely to the increasingly leveraged non-financial corporate (NFC) sector (Figure 4). However, it is our view that the problem is largely manageable.[2] There does not appear to be general debt-servicing issues among non-financial businesses at present, and the Chinese government has the financial ability to recapitalize the banking system, should that measure eventually prove necessary.

Figure 3

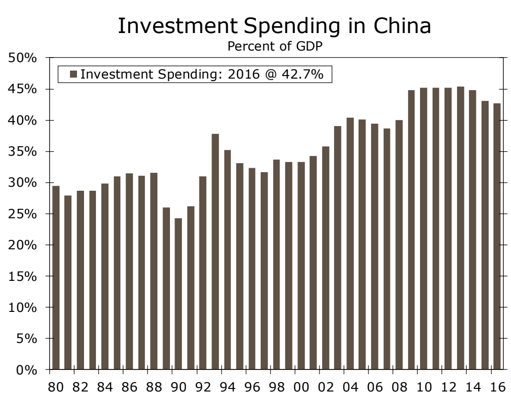
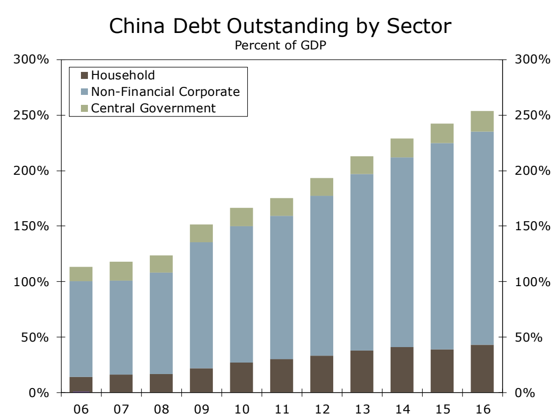


Figure 4



Source: CEIC, Bank for International Settlements and Wells Fargo Securities

That said, the sharp increase in NFC leverage in China is attention-grabbing and, as we discuss below, could potentially be problematic. The Chinese government is clearly cognizant of the debt build-up that has occurred, and it has taken steps in recent years to rein in excessive investment spending. As discussed above and shown in Figure 2, investment spending rose about 7 percent in

[1] As a point of reference, fixed investment spending has accounted for 16 percent of U.S. GDP over the past 25 years. Investment-to-GDP ratios of 15 percent to 20 percent are typical in most advanced economies.

[2] See "China Mid-Year Economic Outlook" (August 2, 2017) and "Should We Worry About Chinese SOEs?" (September 14, 2017). Any Wells Fargo reports mentioned herein are available upon request.

2017, down from 8 percent in 2016, not to mention the double-digit growth rates that were achieved during the preceding fifteen years or so. Moreover, the debt-to-GDP ratio in the NFC sector has edged lower in recent quarters, although at 163 percent of GDP it remains elevated.[3]

After growing nearly 11 percent in 2010, real GDP in China has decelerated over the past few years and we look for economic growth to slow further. Specifically, we forecast that Chinese GDP will grow 6.4 percent in 2018 and 6.0 percent next year. Our forecast ends in 2019, but most long-run forecasts look for further economic deceleration in China after 2019, which seems reasonable to us.[4] Not only will growth in investment spending need to remain constrained in order to bring about better balance in the Chinese economy, but unfavorable demographics—the working-age population has already peaked and is expected to decline by nearly 2 percent between 2015 and 2025—will also weigh on the rate of economic growth in coming years.

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What Could Go Wrong?

Although real GDP growth in China has clearly slowed over the past few years, Chinese authorities have engineered an economic "soft landing." That is, the economy has gradually decelerated with few economic or financial disruptions. But are there scenarios under which economic growth in China could downshift more abruptly than we and most other forecasters envision? In our view a credible downside risk emanates from the opaque nature of the Chinese financial system and economy. Perhaps the NFC debt situation is actually more problematic than what our analysis suggests. Although we believe that the probability of a debt-fueled collapse of the Chinese financial system and economy is rather low, we acknowledge that economic growth in China could decelerate sharply if non-financial businesses attempt to rein in their liabilities in an abrupt manner.

Figure 5

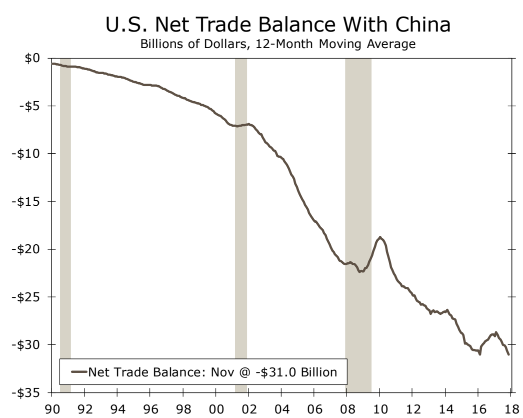
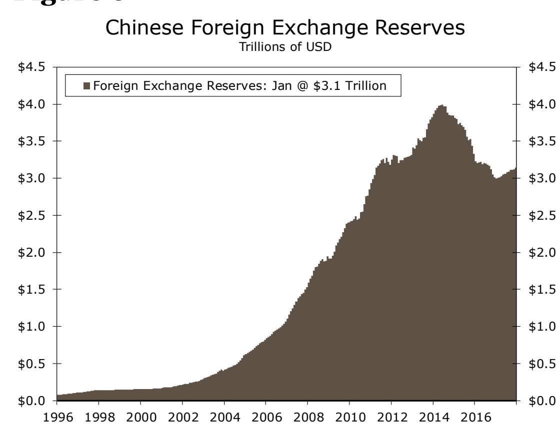


Figure 6



Source: U.S. Department of Commerce, Bloomberg LP and Wells Fargo Securities

Potential Sino-American trade tensions represent a second downside risk for the Chinese economy. As we wrote in a recent report, the overall current deficit in the United States does not seem to be much of a "problem" at present from a purely economic standpoint.[5] However, the significant widening that has occurred in the bilateral trade deficit that the United States incurs with China has not gone unnoticed in Washington DC. Should American authorities attempt to rectify this "problem" through trade restrictions, a trade war could potentially break out between the two largest economies in the world, which would be in nobody's interest.

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Third, capital outflows have some potential to become destabilizing. The Chinese renminbi came under significant downward pressure in 2015 and 2016 as capital poured out of the country.

[3] **The comparable ratio in the United States at present is 70 percent.**

[4] **The panel of forecasters in *Consensus Forecasts Global Outlook: 2017-2027* looks for GDP growth in China to average about 5 percent per annum between 2023 and 2027.**

[5] **See "U.S. Trade Deficit Widening: Trouble Brewing?" (January 8, 2018).**

Chinese authorities responded by draining liquidity in the banking system, tightening capital controls and spending about $1 trillion worth of foreign exchange (FX) reserves (Figure 6). The capital outflows have largely subsided in recent months, and the currency has appreciated versus the dollar. China's FX reserves have stabilized around $3 trillion. But there remains some risk of capital outflows resuming in coming months if Chinese investors get nervous about growth prospects in their country and/or interest rates in foreign countries rise markedly. A resumption of significant capital outflows from China could lead to volatility in financial markets, not only in China but in major economies as well.

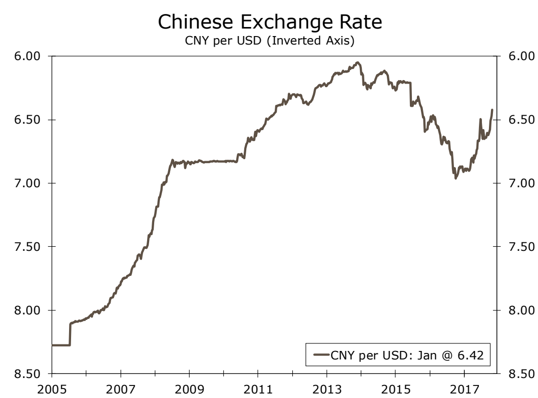
Currency Outlook: Further Renminbi Gains versus the Dollar

The depreciation of the U.S. dollar versus most major foreign currencies implies that the renminbi will continue to appreciate modestly.

Chinese authorities have shifted their exchange rate focus from the value of the renminbi vis-à-vis the U.S. dollar to the value of the renminbi versus a basket of currencies. That is, Chinese authorities are now trying to keep the renminbi more or less stable against a basket of currencies. Consequently, the U.S. dollar depreciated about 5 percent against the renminbi last year as the greenback experienced weakness against most major currencies (Figure 7).

Looking forward, the Wells Fargo currency strategy team expects that the dollar will continue to trend moderately lower versus most currencies as market participants begin to price in expected tightening moves by major foreign central banks. If, as we expect, Chinese authorities continue to maintain a rather stable value of the renminbi versus a basket of currencies, then the depreciation of the U.S. dollar versus most major foreign currencies implies that the renminbi will continue to appreciate modestly against the greenback in coming quarters.

Figure 7



Source: IHS Global Insight and Wells Fargo Securities

Conclusion

Our forecasts call for Chinese growth to slow over the coming years.

Economic growth remained steady in China through the end of 2017, up 6.8 percent in Q4 and likely buoyed by a solid consumer sector and improving international trade. However, our forecasts call for Chinese growth to slow over the coming years, likely due in part to an overall slowdown in investment spending. Although the initial acceleration in investment spending boosted productivity and supported robust economic expansion over the past decade, the resulting build-up of debt in China's corporate sector remains an area of concern. Other risks to our growth outlook include the possibility of trade restrictions with the U.S. and increased capital outflows should investors become wary of a potential growth slowdown in China. That said, our currency strategy team looks for the renminbi to appreciate modestly against the dollar in the coming quarters, and capital outflows have largely subsided over the past few months as the renminbi has strengthened against the greenback. Although our forecasts look for a slowdown in GDP growth to 6.4 percent in 2018 and 6.0 percent in 2019, we see these risks as largely manageable for the foreseeable future, as China's growth continues to fall in line with that of more advanced economies.

Wells Fargo Securities Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Jamie Feik	Economist	(704) 410-3291	jamie.feik@wellsfargo.com
Erik Nelson	Currency Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@wellsfargo.com
Harry Pershing	Economic Analyst	(704) 410-3034	harry.pershing@wellsfargo.com
Hank Carmichael	Economic Analyst	(704) 410-3059	john.h.carmichael@wellsfargo.com
Ariana Vaisey	Economic Analyst	(704) 410-1309	ariana.b.vaisey@wellsfargo.com
Abigail Kinnaman	Economic Analyst	(704) 410-1570	abigail.kinnaman@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

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