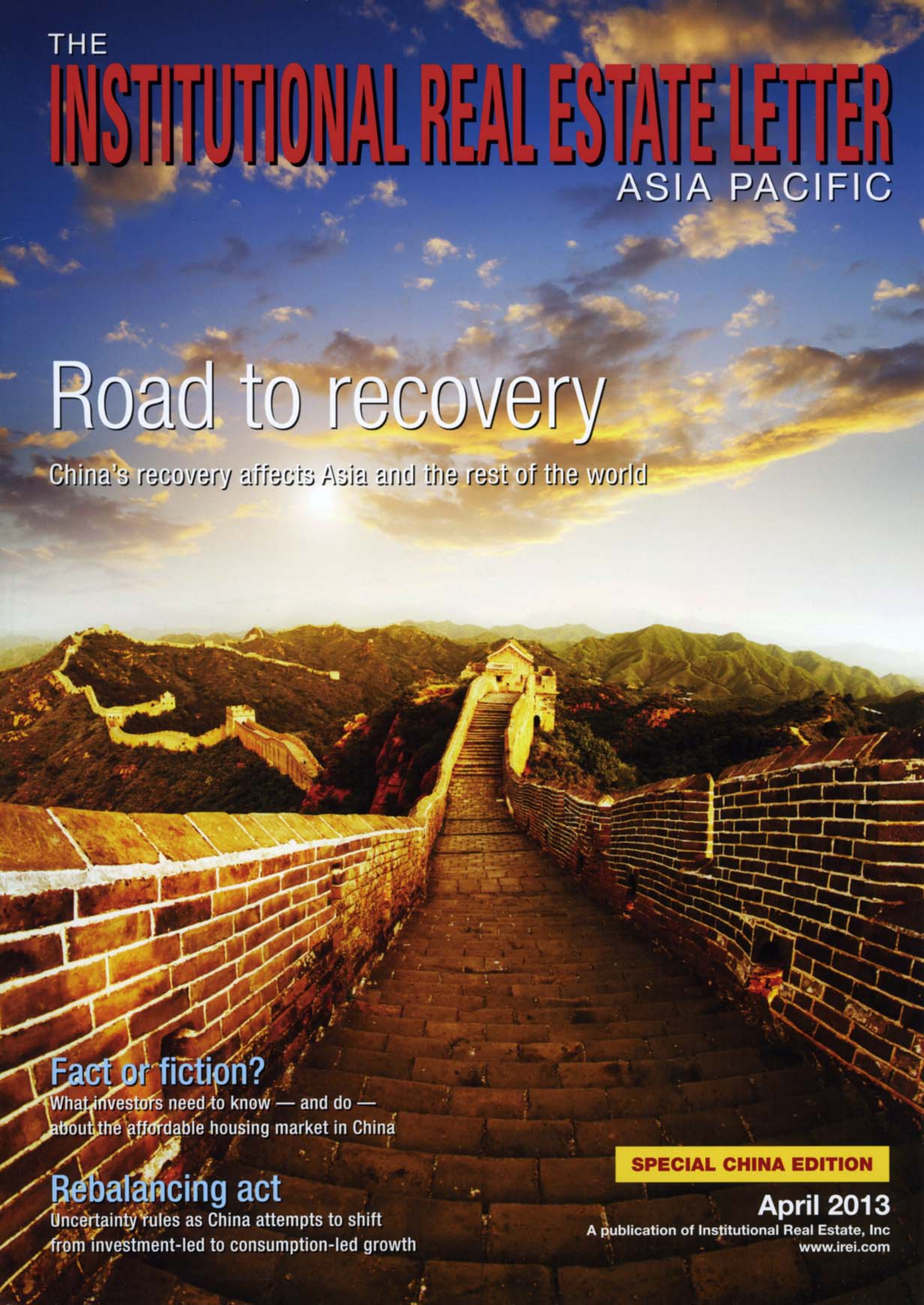

THE

INSTITUTIONAL REAL ESTATE LETTER

ASIA PACIFIC

Road to recovery

China's recovery affects Asia and the rest of the world

Fact or fiction?

What investors need to know — and do — about the affordable housing market in China

Rebalancing act

Uncertainty rules as China attempts to shift from investment-led to consumption-led growth

SPECIAL CHINA EDITION

April 2013

A publication of Institutional Real Estate, Inc

www.irei.com

Rebalancing act

Uncertainty rules as China attempts to shift from investment-led to consumption-led growth

by Jack Rodman

China watchers, much like the US Congress, have not found much common ground of late, but recently, pundits have come together around a cautious optimism for China's economic outlook. This is primarily the result of two factors. First, China's economy gathered steam in the late half of 2012, which has carried over to the beginning of this year, causing many to conclude a "hard landing" is out of the question. Second, China's leadership seemingly has embraced the widely-acknowledged need to rebalance the economy away from investment and toward consumption-led growth.

Pundits and investors are right to be heartened by these developments. But they should not lose sight of the very real challenges that China must contend with to transition its economy while maintaining politically palatable levels of economic growth. Its ability to do so is by no means certain, and a "hard landing" is not off the table.

Jack Rodman
Crosswater Realty Advisors

China must contend with very real challenges to transition its economy while maintaining politically palatable levels of economic growth.

Restructuring the Chinese relationship with government

Under China's "Red Capitalism" investment-led system, individual Chinese maintained large savings, parked in stated-owned banks. The state relied on these funds to channel investment toward specific industries across the economy. The individual Chinese relied on these funds to provide for old age and rainy-day events. China's shift to consumption-led growth requires this pattern to be broken and for individuals and Beijing to be comfortable in a new arrangement. Individual Chinese, now being asked to spend instead of save, must trust that Beijing is capable of establishing an adequate social safety net and providing public services to its citizens (something the central government has yet to prove). The government, meanwhile, must tolerate greater levels of economic liberalisation, a larger, more powerful middle class, and the resulting social liberalisation that will come as a result.

This historic cultural change would be difficult under the best of circumstances. In contemporary China, there are several factors that make it even more challenging. First, it is taking place at a time of rising concerns of inequality, environmental and social injustice and amidst mounting allegations of corruption in government officials. These issues are amplified by the Internet and China's microblogs. Witnessing these developments, Chinese officials may be reticent to liberalise the economy and further relinquish control. Secondly, rebalancing requires confronting the vested interests in the export sector and state-owned enterprises that stand to lose out. It is uncertain whether incoming Chinese leaders have the clout or the stomach to organise such a structural change.

Third, China's economy remains vulnerable. The fourth quarter boost in GDP growth was primarily the result of an injection of investment in infrastructure projects. While China is also looking to rebalance away from the low-cost, export-driven model, the transition will be a long process, and in the interim, its export sector is suffering from anaemic global demand — brought about by ongoing global deleveraging and poor economic performance in the United States and euro zone — and increased competition from burgeoning low-cost production centres in countries such as Vietnam and Indonesia. Further, China's demographic dividend, which has kept wage rates low, is coming to an end. McKinsey & Co, a consultancy, predicts from 2012 to 2030 the over-65 cohort in China will grow at an annual rate of 3.9 percent while the 0–14 cohort will decline by 1.2 percent per year. While placing upward pressure on wages, this would also place increasing pressure on the public safety net, as fewer workers' earnings would support a growing retiree base. China is on track to be the first nation that gets old before it gets rich. In this environment Chinese savers, many of whom already cannot afford homeownership in certain cities, may be loath to switch their habits and start spending.

China's leaders seem to be facing a more challenging economic, social and political environment than they did a decade or two ago (and we have not even mentioned the geostrategic risks from territorial disputes in the South China Sea with Japan over the Senkaku/Diaoyu islands, and the potential problems that may arise as China seeks to balance its China-first strategy with an emerging role on the world stage). It is against this backdrop that China is attempting a historic rebalancing of the economy and redefinition of the relationship between citizen and state.

Don't lose your balance (further)

Chinese GDP growth rates are widely watched and are often taken as a barometer for social and political stability. It is likely Chinese leaders will be tempted to augment GDP growth during the transition to a consumption-led growth model (which already will be lower than GDP growth rates during the investment-led years) with periods of investment splurges. While likely to suffer from diminishing returns due to pre-existing overcapacity, the more grave threat from such action is that it exacerbates already dangerous imbalances in China's economy, threatening both near-term and long-term growth and stability.

China's investment-led strategy has left the country with a number of problems. After its most recent investment surge in 2009 to offset the global financial crisis, China faces diminishing returns from investment, overexposure to real estate, rapid credit expansion and growing towers of debt.

Corporate and government balance sheets are highly leveraged. Standard Chartered estimates systemwide leverage reached 206 percent of GDP in 2012 — significantly more than the early 2000s when Beijing last bailed out the banking system. China's public debt, which officially is said to be approximately 30 percent of GDP, is grossly understated. When local government debt, bank policy debt, asset management company borrowings and other factors are included, total public debt is close to 90 percent of GDP.

Beijing has tried to curtail credit expansion by implementing restrictions on real estate, but this has only forced developers and local governments (who depend on land sales to raise revenues) to join private-sector small and medium enterprises in seeking informal financing mechanisms. In 2012, Chinese banks' share of total lending fell to only 52 percent of total credit creation, down from 92 percent a decade ago. As at the end of 2012, the size of the shadow banking system was estimated to be 20 trillion yuan (US$3.2 trillion). Local government financing vehicles, known as LGFVs, have emerged as the dominant borrowers from trust companies, and a large majority of banks' off–balance sheet wealth management products (WMPs) are financing corporate bonds and loans tied to developers and local governments.

Apart from being opaque, WMPs are characterised by a maturity mismatch between their short-term liabilities and the long-term assets they finance. Already, there are reports of Ponzi scheme financing where new WMPs are being sold to meet payments due on existing WMPs. In the case of default, it is likely that banks will have to step in and make customers whole despite these assets being "off balance sheet". As such, defaults could spread contagion and ripple through the entire financial system. Cracking down on shadow banking may create an unwanted credit crunch that threatens economic growth. The high leverage in the financial sector makes the system extremely vulnerable to such a downturn.

In short, China is losing control of its credit system. GMO, an investment management company, believes China's credit system exhibits a number of indicators associated with acute financial fragility. Acute financial fragility brought on by bad credit booms often culminates in banking crises and periods of slow economic growth. If this were to materialise, China's economic rebalancing would certainly suffer.

Uncertainty rules

We are learning just how difficult it is to transition an economy, especially one with China's size and characteristics. Any number of issues may have an impact on economic growth and China's ability to complete its transition smoothly. A misstep can take a generation to remedy. Unfortunately, China's size means a false step could have drastic implications both within and outside its borders.

No wonder uncertainty is the watchword of the day. ❖

Jack Rodman (rodman.china@gmail.com) is a senior advisor of **Crosswater Realty Advisors,** based in Seattle.