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"THE OPTIMAL BUNDLE"

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Special Report on the Chinese Economy

What is the state of the Chinese economy? Chinese economic growth slowed to 7.4% in 2014 from 7.7% in 2013. While this growth rate is still substantially higher than most of the world's economies, it should be noted that China's Communist Party says 7% is the minimum growth rate needed to support a population of about 1.4 billion people. The International Monetary Fund predicts that growth in China will continue to slow to 6.8% in 2015, while the government predicts a growth rate of 7%.

Chinese Central Bank to the Rescue!

The People's Bank of China has answered its call to action. Chinese economic growth declined from 14.2% in 2007 to 7.3% in the last quarter of 2014, prompting the PBOC to lower interest rates twice in the past three months. Additionally, the PBOC expanded its medium-term lending facility, a monetary tool from which individual banks can draw reserves for more liquidity. These measures attempt to reverse a declining property market and deflationary pressure induced by falling commodity and oil prices. UBS economist Wang Tao argues, "Against this backdrop, it would seem clear that monetary policy in China should be eased more aggressively." Investors, however, appear to be comfortable with the current scope of the PBOC's intervention, as fewer investors are betting that interest rates will change soon. Moreover, *Wall Street Journal* commentator Greg Ip warns that if the PBOC takes more aggressive actions like currency devaluation, it would not help global markets because China has strict controls limiting capital mobility. Has China resolved its problem or opened Pandora's box?–JK

The People's Bank of China is the central bank of the People's Republic of China. It is second only to the Federal Reserve (U.S.) in total central bank assets.

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Shanghai is the financial center of mainland China, ranking twentieth in the 2014 edition of the Global Financial Centres Index.

Shadowboxing

A string of defaults by Chinese firms could spell trouble for the Chinese economy. Debt defaults are never a *good* thing. They are even worse when the lenders are in "the shadow." "Shadow lending" is a process by which companies unable to secure traditional financing from banks turn to other companies for loans. Following the international credit crunch after the financial crisis, the Chinese government condoned shadow lending as an alternative means to provide liquidity to a still-growing Chinese economy. Shadow lending increased about 125% in 2010. As of 2015, the total outstanding balance of shadow loans in China is about 22 trillion Chinese yuan (about $3.5 trillion). It is a dangerous practice -- the potential repercussions are significant. One firm defaults on a shadow loan, endangering the balance sheet of another. Then another. And another. As the process continues, the theoretical domino effect multiplies and the trouble extends throughout the economy – beyond just the financial system. As China's government scrambles to save the faltering economy, shadow defaults could be an unanticipated punch in the gut.–KGM

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The Housing Problem: China's Ghost Cities

Imagine cities like New York City completely deserted, where the homes of millions of people are either uninhabited or abandoned. A ghost town, if you will. China faces such realities in their country, as demand continues to suffer in the housing market and prices keep falling. Based on data from China's National Bureau of Statistics (NBS), new home prices fell by 5.1% on average from the year-ago period for a majority of cities. The housing sector is significant in China, too, contributing to around 15% of its economy. Furthermore, housing is so abundant that there are not enough people to live in these properties. That is where "ghost cities" start springing up throughout the country. As business executive Michael Garrity notes, "The problem China has now is large developer inventories. Chinese developers have two to five years of inventory still to sell off." One of the main responses by the Chinese government has been more stimulus, particularly in the housing sector. While this initiative has been swift--there was a $328 billion surge in new credit two months ago--pumping in so much money to prevent housing prices from falling will not work overnight. Even if China can handle this spending now, who is to say that their money is going where it needs to in the long run?–RG

Ghost towns could soon be a reality in China, with low demand for housing and falling prices.

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Is slower economic growth here to stay for China?

Pro: The Half-Empty Economy

China's economy looked like its new cities: bright, expensive, but empty. In 2011, China became the world's leading exporter, and the largest economy, with annual GDP growth at almost 12%. Since then, growth has decelerated to 7%, causing the rest of the world to fixate on China's economic slowdown. It is easy to see that the Asian Giant's economic miracle is coming to an end by looking at the export boom and outcomes of countries that have faced banking crises in the past. The miracle is ending for China, and there is nothing it can do.

The International Monetary Fund has noted that over the past 50 years, only four other countries have experienced as rapid a buildup of debt as China during the past five years. All four—Brazil, Ireland, Spain, and Sweden—faced banking crises within 3 years of their supercharged credit growth. This debt paid for China's boom and exports have sustained it. China's current surplus of exports points to billions of dollars wasted, as countries are not buying enough Chinese goods. *The Wall Street Journal* reported that a lone steel production company in Hebei, a province surrounding Beijing, produces twice as much crude steel as the entire U.S., and no longer needs to produce this much. China's overproduction may be its downfall.

While excessive Chinese exports and consistent declines in GDP explain a bleak Chinese future, the past is also important. Harvard economists Lant Pritchett and Lawrence H. Summers argue that countries that have had long periods of abnormal growth tend to revert to around 2% growth, a meek figure in comparison to China's current growth rate. This figure has grave implications. Economist Neil Irwin explains if growth reverts to 2%, China's GDP will be $11.2 trillion by 2033. The effects are already being felt. *Wall Street Journal* writer Bob Davis explained that what was once a Chinese skyline full of construction projects has become a cluster of empty apartment complexes.

Optimists must have confused China's economy for a bright dawn instead of a dreary twilight brought on by high levels of debt, dangerous surplus of exports, and the already glaring signs of what China is poised to become: a ghost economy. –CM

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Con: The Half-Full Economy

China's economy still packs a punch. Despite this self-evident fact, *The Economist* writer Simon Rabinovitch predicts an era in which China's recent slowdown will get much more unpleasant as the Chinese economy takes harsher hits to economic growth. Rabinovitch's argument falls flat, as it neglects to note more recently aggressive monetary policy, plans for more growth-enhancing fiscal policy, and a lack of perspective on how China relates to other economies. China's economy is not just staving off decline, it is building a better future compared to the rest of the world.

The Chinese government plans to use monetary and fiscal policy to revive massive economic growth. The People's Bank of China (PBOC) recently has been cutting interest rates and plans to cut even more to evade deflation. Inflation has risen from 0.8% in early 2015 to 1.4% now, so its plan looks promising. Fiscal policy should also provide more gains. Chinese officials recently cited $18 billion of previously unallocated spending, as well as an additional $258 billion in deficit spending next year. It is doing so to boost growth from the current rate of 7.4% and overall demand. Economist Alexander Wolf cites low demand as one of China's biggest problems, and these measures are expected to help solve it. China's economy is also favorable to many economies worldwide, as its 7.4% growth is higher than the average for every continent on Earth. It ranks in the top 20 among countries and only falls behind double-digit growth in much smaller economies. China's stature still leaves room for optimism.

Changes in China's economy are ultimately a sign that economic progress is here to stay. China's more stimulative monetary policy will ensure that growth can stay above an already high percent. Its fiscal policy will also support high growth, as it has already pumped hundreds of billions of dollars into China's $10 trillion economy. The Chinese economy's 7.4% growth rate is also impressive when considering the massive struggles advanced economies in Europe have faced to achieve even 1% growth. China is primed for a second round knockout. –CL

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Interested in attending a PSUEA general body meeting to learn more about the economy and experience great networking opportunities? Come to 73 Willard at 8 p.m. on Tuesday.

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