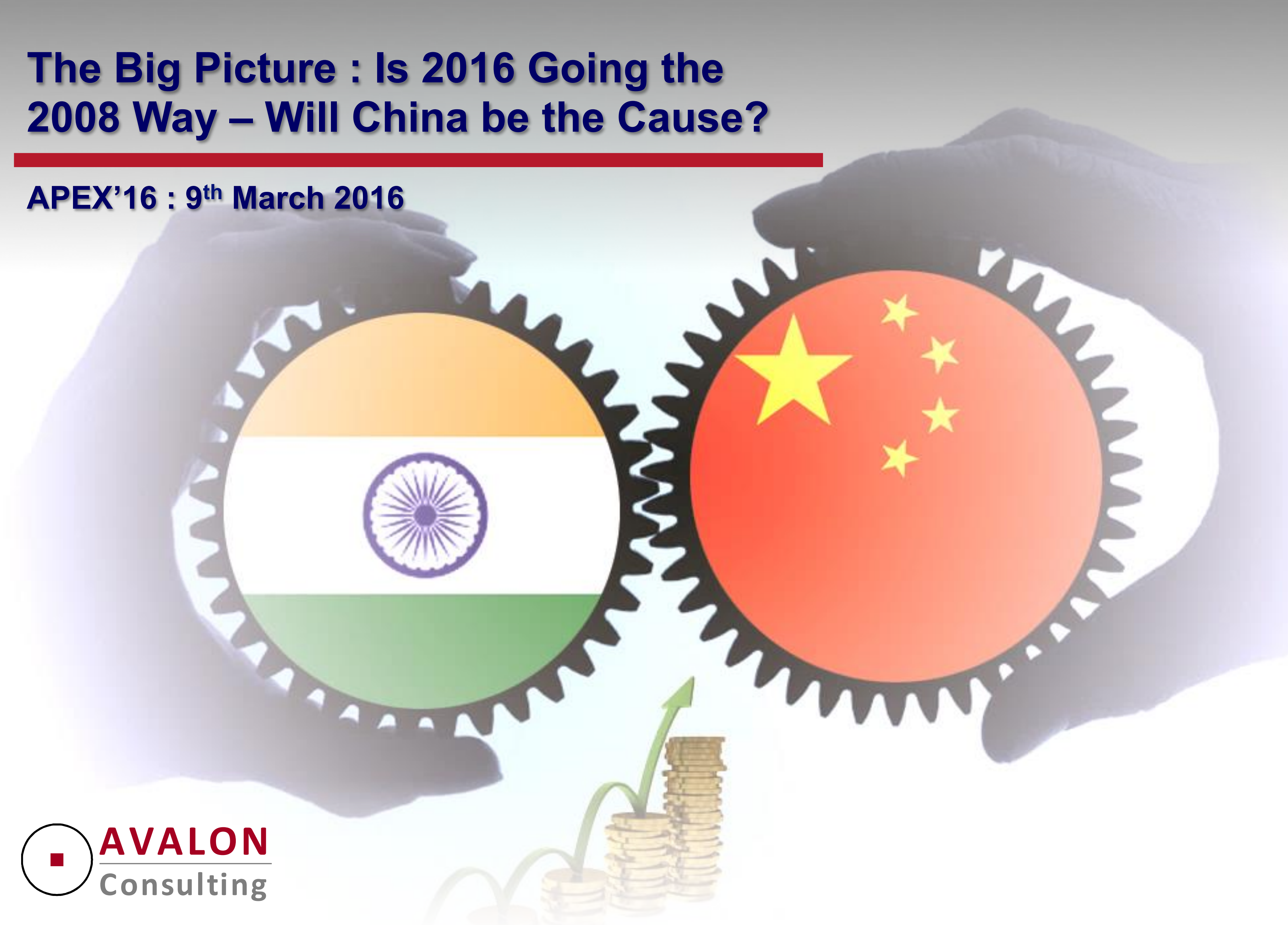
The Big Picture : Is 2016 Going the 2008 Way – Will China be the Cause?

APEX’16 : 9th March 2016



China and the Global Economy

In the aftermath of the 2008 crisis, China employed an investment-led stimulus program - however its gains were short lived

- **The aftermath of the 2008 global economic crisis revealed the structural challenges facing the Chinese economy**
  - *Export-led economic growth model unsustainable ;* Strong domestic market essential for equitable growth
  - *Imminent danger of "middle-income trap" ; High social and environment cost of growth*
- **China embarked on a stimulus program with credit expansion and achieved desired results temporarily**
  - *RMB 4 Trillion package; lowering of RRR, lending rate and deposit rate*
  - *GDP growth increased from 9.6% in 2009 to 10.6% in 2010 and rise in stock market*
- **However early successes were reversed and other problems resurfaced**
  - *GDP growth dipped 2011 onwards and stock market declined*
  - *Looming bank defaults crisis; rising housing costs and a property bubble; relaxation of energy intensive exports led to higher energy cost per GDP*
- **Exports from China continued to see a strong rebound since 2010 and touched $2.3 Tn in 2014**

In Nov 2013, China announced fundamental reform measures – this was expected to adversely impact growth in short term but deliver long term benefits

Reform Measures..

- ***Financial sector reforms -*** Liberalizing interest rates, establishing deposit insurance, strengthening financial regulation etc.
- ***Fiscal reforms -*** Strengthening social safety nets, efficient and redistributive taxes, improving health insurance and pension coverage
- ***Structural reforms -*** Reforming SOEs, revising the Hukou system, further opening up markets
- ***External sector reforms -*** Liberalizing the exchange rate, capital account controls

...and its Impact

- ***Altered cost structures due to higher cost of capital***
  - Interest rate liberalisation would raise the cost of capital – both for capacity creation and for operating costs
  - Significant impact on exports (mainstay of Chinese economy)
- ***Wide ranging impact of SOE reform***
  - Level playing field would impact SOEs negatively
  - Power sector SOE reform will raise power costs
- ***Exchange rate correction***
  - Imports would become more expensive
  - Could effect a slowdown in consumer spending

However, China has embarked on an explicit devaluation strategy in 2015 – allowing the RMB to decline gradually along with two sharp devaluation bursts

- ***Sharp drop on 11th August 2015 :*** *2% devaluation in July-August 2015 ;* ***Further crash on 7th Jan 2016*** *: 3% devaluation in Dec-Jan 2016*
- ***Conventional wisdom is that the devaluation is aimed at increasing exports and driving import substitution***
- ***However, viewing China's action as a knee-jerk response to exports dip is one-dimensional***
  - Easing control over RMB peg is part of economic reforms
    - PBoC has been pegging rate of RMB to USD
    - A 2% band was allowed for fluctuations; this is up from 1% earlier
  - China is moving to make the RMB a global currency
    - IMF pre-conditions for SDR inclusion is to make RMB freely floating
  - Devaluation is a result of this endeavour
    - RMB rose steeply against USD after Nov 2014 (peak of 2.4%; settling at 1.5%)
    - In July, PBoC changed the method of pegging RMB resulting in devaluation of ~2%. Similarly, there was a de-valuation of 3% in Jan 2016

Doomsday scenarios fear that further bad news from China could trigger a 2008-like global crisis

- ***Some commentators believe that it is impossible for China to manage reasonable growth and curb the credit bubble at the same time***
  - Symptoms of a typical crisis are present in China – rapid credit growth, poor public finances and asset bubbles
  - Underlying debt levels are unmanageably high – 300% of GDP with very high levels of local govt debt (USD 3.5 Tn) and corporate debt. Local govt. debt is strongly linked to property market (land given as collateral by local govt.)
  - Need to lower local govt. debt and restructure corporate debt (and re-direct it to productive assets)
- ***The trigger point for a global crisis could be either***
  - A property market crash which exposes the conventional and shadow banking system (which has heavy exposure to local govt. debt)
  - Further devaluation by China leading to competitive devaluation by other EMs which would trigger foreign debt repayment issues in EMs and potentially cause a global recession (EM and Developed markets). Trade wars with EU / USA also possible
- ***Transmission to the global economy could be through – direct trade, loss of business confidence, impact on commodity markets etc.***
- ***Interest rate hike by US Fed would further compound the problem***

Implications for India

Recent rise in labour wages has resulted in costs in China being nearly 1.5 - 3 times higher than in India

Manufacturing Cost Drivers: Labour

Monthly Pay of Manufacturing Employees in China (USD)(2014)

USD per month

Role	Low	High
Fitter	250	600
Welder	400	800
Painter	400	600
Material handler	400	500
Line Supervisor	600	1300

Monthly Pay of Manufacturing Employees in India (USD)(2014)

USD per month

Role	Low	High
Fitter	135	250
Welder	200	300
Painter	200	300
Material handler	175	250
Line Supervisor	400	700

Conversion rates: 1 USD = 60 INR, 1 USD = 6 RMB

Salary costs for employing lower category of workers is significantly lower in India

Source: Field Research, Avalon Consulting Research and Analysis

The relative movement of the CNY vs. INR to USD has significantly improved the competitiveness of India vs. China

Currency fluctuations over the last 5 years indexed to 100

USD to INR
USD to CNY

120
100
80
60

USD to CNY: 100, 100, 104, 105, 108, 107, 109, 110, 112, 111, 111, 112, 107, 106, 104, 104

USD to INR: 100, 99, 101, 103, 90, 82, 85, 79, 74, 77, 74, 73, 70, 69, 68, 67

36.5%
36.7%

Jan-10, Jul-10, Jan-11, Jul-11, Jan-12, Jul-12, Jan-13, Jul-13, Jan-14, Jul-14, Jan-15, Jul-15, Nov-15, Dec-15, Jan-16, Feb-16

Source: Oanda.com

Despite this, India's trade deficit vs. China has ballooned in recent years and is expected to cross $50 bn in 2015 driven by electronics and mobile phones

China India Trade Deficit Trends

	2004	2008	2009	2010	2011	2012	2013	2014	2015	CAGR (04-08)	CAGR (08-15)
Imports from China	6.0	32.0	30.6	41.2	55.4	54.1	51.6	58.2	61.5	**52%**	**9.8%**
Trade Deficit	2.0	22.0	20.3	23.8	38.7	40.1	35.2	44.8	52.0	**82%**	**13.1%**
Exports to China	4.0	10.0	10.3	17.4	16.7	14.0	16.4	13.4	9.5	**26%**	**-0.7%**

Source: Trade Map, News Reports, Avalon Consulting Research and Analysis

However, this pace of growth of the trade deficit is expected to slow down and potentially Indian exports to China could grow faster than the reverse trend

- ***India has made significant changes to the tax structure of electronic products (including mobiles) which has enabled assembly in India and this will accelerate***
- ***The volumes and scale economics (coupled with investment incentives) will potentially enable a component ecosystem to develop in India – possibly led by Chinese investment***
- ***There are several industries in light engineering where China is losing competitiveness to India and Chinese companies have invested / exploring investments in India***
- ***If India gets its act right, sectors like pharmaceuticals, tourism, IT services, auto components have potential for exports to China in the coming years***

This is already evident in the surge in Chinese investment in India in the last year and in FY16

FDI Equity Inflows from China (USD mn), FY01-16

FY 2001-12	FY 13	FY 14	FY 15	FY 16 (upto Dec)
126	152	124	495	426

Source: DIPP, Avalon Consulting Research and Analysis

This rise in recent investment has been driven by new economy businesses but there is great interest in manufacturing and infrastructure as well

Investment in New Economy Businesses		
Investor	**Target**	**Amount Invested, USD**
Alibaba.com	snapdeal.com	500 mn
TAXI 快	OLA	Undisclosed
Alibaba.com	Paytm	880 mn
Tencent 腾讯	practo	90 mn
HILLHOUSE CAPITAL	CARDEKHO	50 mn

Actual/Proposed Investments in Manufacturing Sector	
Investor	**Comments**
LONGi 隆基	USD 250 mn for a Solar module plant in Andhra Pradesh
SAIC	Plans to buy factory of GM in Gujarat
万达集团 WANDA GROUP	USD 10 bn in an Industrial Park in Haryana
LESSO	~USD 15 mn by China Lesso near Pune for plastic components
KINGFA 金发科技	~USD 50 mn by Kingfa near Pune for plastic components
GiONEE	USD 50 mn in 3 years to make handsets
SANY	Already has manufacturing set up in Pune; USD 5 bn proposed in Renewable energy Construction equipment & Housing
FOTON	USD 400 mn for CV manufacturing near Pune committed in 2011
ZCW 万丰奥威 WANFENG AUTO WHEELS	~USD 53 mn invested in plant in Rewari (Haryana) in 2013

Thus our engagement strategy needs to be to Increase Gross Trade and Reduce Net Deficit Growth

Leverage India's Importance - Market and Investment Destination for China.

Push for Market Access in Key Sectors where India can Add Value to Chinese Economy – Pharma, IT, Tourism, Media and Entertainment, Auto Components

Priortise Chinese FDI in 18 identified industry sectors and a Sovereign Deal to Attract Investment in Indian Infrastructure

Set up an institutional basis (Government cum industry) within the PMO or MOCI to direct and monitor the achievement of Goals

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