

# **China's Economy will Face Six Major Challenges in the Future**

Xu Hongcai, Nov 07, 2016

The National Bureau of Statistics (NBS) has released data tracking China's economic performance in the first three quarters of this year. In my opinion, China's economy generally shows a momentum with a steady pickup and improvement, but the challenges it will face in the future should not be overlooked.

The positive momentum of China's overall economy is mainly illustrated by the following factors.

**First, China's economy generally holds stable and turns for the better, with the service sector being the highlight.**

The NBS concluded that the economy grew steadily with progress being made and quality improved. China's economy really ran stable as reported by the NBS. PPI turned positive in September with 0.1% increase year on year, 0.9% higher than the previous month, shaking off the negative growth of 54 months. It signifies that China's industrial output has got out of the difficulty of deflation.

In recent years, the service sector became the largest industry and the first pillar of employment in China's national economy. In the first three quarters of this year, the service sector continued to maintain fast, steady growth of 7.6% — slightly higher than that in the first half of the year.

The general improvement of China's industrial output is mostly attributed to an external factor: the increase in commodity prices boosted profits and added-value growth, and bolstered the development of relevant industries. Of course, its side effect is that the reduction of overcapacity was disturbed because the price increase brought better days and the reduction of overcapacity was less urgent. Meanwhile, the employment situation was remarkable.

However, trade displayed negative growth on the whole, which was closely related to the global trade doldrums. Nevertheless, trade grew more steadily from January to September over the same period and declined in a narrow magnitude, thus taking more global market share. Meanwhile, China's trade surplus over the past years was good, reaching \$600 billion last year and in the previous year. The trade surplus this year is expected to be close to this figure.

**Second, capital outflow was stable and economic growth force was strong.**

In terms of balance of payments, by the end of last year, the proportion of capital account deficit in GDP reached a new high, close to 6%. But the deficit dwindled somewhat this year, indicating that China did a better job in the exchange rate expectation management and market regulation this year. In contrast, the other non-dollar currencies severely depreciated against the dollar. Overall, from the application to join the SDR in 2015 to the inclusion into SDR in October this year, the RMB bilateral exchange rate against the dollar depreciated within a controllable range. The capital outflow was stable, demonstrating a stable economic situation.

At the same time, new consumption grew fast, such as tourism, communication, old-age services, culture, sports, etc., obviously fueling the economy. Generally, it shows a positive trend of structure optimization and quality improvement.

Energy consumption index edged down. The overcapacity reduction of the iron and steel industry and of the coal industry all attained the expected effect. In addition, real estate inventory in the fourth-tier cities continued to fall down.

Additionally, weak links were strengthened. After the G20 Summit, a suggestion was made to provide RMB500 billion to improve the weak links, which helps economic restructuring and is significant for future sustainable development.

**Six big challenges should not be ignored in the future:**

First, the US Federal Reserve will inevitably increase the interest rate by the end of the year, possibly producing a great external impact on China's economic operation. Be cautious and observe the further risk of the RMB depreciation.

Second, the regulation policy targeted at real estate during the National Day was very effective and prevented a potential financial risk. While the short-term problem was resolved, the market is shrinking, which will have a negative effect on consumption and investment in the future. I expect that the real estate contribution to GDP growth this year will be 0.5 percentage point at the most. Weighed down by real estate, economic growth will face a bigger downward pressure next year.

However, the overheated real estate in some places is under control, which will have a big impact on the local governments' fiscal income. This July, more than 460 billion yuan credit almost all flew into the housing sector, i.e. the property industry. In August, almost over 70% of more than 900 billion yuan credit went to the property industry. I find that in September, only about 50% of the 1.2 trillion yuan credit flew to the property industry, in other words, the capital that flew to the real economy rose to 50%. It proves that the real estate regulation in recent months and the policy of channeling the capital to the real economy were effective.

But the local governments have more responsibility in overall spending. Under the economic downward pressure, people hope that the government can play a greater role, so the conflicts in fiscal income will be more serious in the future.

Third, although the downward trend of private investment has been curbed, private investment will not easily pick up. At present, a series of policies and measures have been rolled out but will meet big challenges in implementation.

Fourth is the credit risk. More attention should be paid to the frequent bond market defaults and the increase of bad bank loans.

In the meantime, due to the shift of the processing trade to the Southeast Asian economies, China's relevant industries face the risk of hollowing-out, which is extremely disadvantageous to the industrial development in the future. How to

revitalize foreign trade and step to the high end of the global value chain demands serious study.

Fifth, the income of Chinese urban and rural residents grew slower than the economy in the first half of the year, which will have a negative impact on income distribution. Of which, the income of the urban residents only grew 5.8% and this will affect the consumption to some extent.

Last, a new round of “the State advances while the private sector retreats” phenomenon should be avoided, whether it be overcapacity reduction, deleverage or debt-for equity swap. In the first three quarters, government infrastructure investment took the lead and the proportion of the private capital was not high. High attention should be paid to this deteriorating investment structure.

All in all, I still anticipate a steady economic growth in the future. But the economic growth in the fourth quarter could decline to some degree at a possible 6.6% rate and the average growth will remain 6.7% for the whole year. If the short-term steady growth policy and the long-term structural reform policy can be carried out, the economic growth is expected to be over 6.5% next year.

<http://www.chinausfocus.com/finance-economy/chinas-economy-will-face-six-major-challenges-in-the-future?from=timeline&isappinstalled=0>