China: Hard or Soft Landing?

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In recent years, China has been an engine of global growth, not only for its direct contribution, but also by indirectly fueling the economies of its trading partners. As China transitions from a manufacturing economy to a service economy, growth has started to moderate. To better understand the outlook for China as well as the rest of the world, we recently sat down with Marc-Antoine Collard, Chief Economist at Rothschild.

Q. When discussing emerging markets, most observers immediately think of China. Recently, MSCI took the initial step of adding more than 200 A-shares stocks to the developed market index. With China being the world's largest economy and having significantly modernized, is still relevant to classify China as an emerging market?

Marc-Antoine Collard: There is no clear or universal definition of what categorizes a country as an emerging market. However, when you collect different factors such as gross domestic product (GDP) per capita or life expectancy, the structure of the economy in emerging countries tends to be mostly in the primary and secondary sectors (e.g., manufacturing), whereas developed economies tend to have a service sector that is much more extensive, along with developed education and healthcare programs.

So when you look at all these factors, China would fall under the category of an emerging country. But of course, through the years we have seen a real improvement in different indicators, such as standard of living. In brief, we can describe China as an emerging country that is converging towards an advanced economy's standards.

“A hard landing is not the baseline scenario.”

Q. Let’s discuss the level of debt in China. I know this is something that has concerned you for a couple of years now. What is the potential risk here?

Collard: The credit-to-GDP level in China is currently very high and increasing. Today, the private credit-to-GDP ratio is north of 200%, whereas it was around 100% before the financial crisis, so over a short period of years, it has doubled. What history tells us is that when you have a sharp increase in the debt level over a short period of time, usually you get stress in the banking system. That represents real risks for the Chinese economy.

Q. These factors were likely part of Moody’s decision to downgrade China’s debt, correct?

Collard: Exactly; this was the first downgrade for china in almost 30 years (1989). I think that it was a reflection that at these levels, and with this increase that is still in this upward trend, rating agencies are starting to become more concerned about the sustainability of this growth.

Q. What do you think comes next? Do you see a hard landing for China or no?

Collard: Well, I still think that we have a stop-and-go scenario, so the Chinese authorities have to strike a balance between financial stability and growth. For the past few months, I’d say that the Chinese authorities have been more on the “stop” than “go mindset. They have been much more focused on financial stability than growth, which is why we have seen a deceleration in different economic indicators in China—namely industrial production, retail sales, and investment.

We have also seen the Markit Purchasing Managers Index (PMI) of manufacturing data start turning around. It is now only marginally higher than the 50 threshold, so it gives you the sense that you have deceleration. I think that the hard landing scenario is still a risk, but at this point, it is not the main risk baseline scenario for China.

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