

# Economic Insight

18 January 2016

## China's economic leaders have lost their magic

The Chinese equity markets did not slump at the start of the year due to disappointing economic data releases. Their problem was in fact a steady loss of faith among investors in government's ability to steer the economy and the markets successfully, as it has done in the past. We analyse the policy mistakes made by China's economic leaders and demonstrate that China is likely to face some lean years and will keep the Western capital markets on tenterhooks.

### First policy mistake: Too much lending to corporates

China emerged relatively unscathed from the Lehman Brothers collapse because banks followed the government's orders to be generous with their lending. Chinese corporate debt soared – more rapidly than in any other economy (chart 1). Alarming, state-owned enterprises in particular have taken on more debt in order to continue investing on government orders, despite their excess capacities and shrinking profit margins. These highly indebted businesses, few of which deserve to be kept afloat, are draining funds away from healthy, generally private businesses. This “zombification” will weaken China's economy for years.

### Second policy mistake: Inflating house prices

There is a glut of empty real estate in China, and this is hitting investment in the construction sector. The excesses arose because the government placed restrictions on how people could invest their money. They have little opportunity to buy equities or bonds abroad, and banks have been prevented by the government from paying a decent rate of interest on deposits. As a result, many Chinese have invested in property as an alternative.

### Third policy mistake: Erratic intervention on equity market

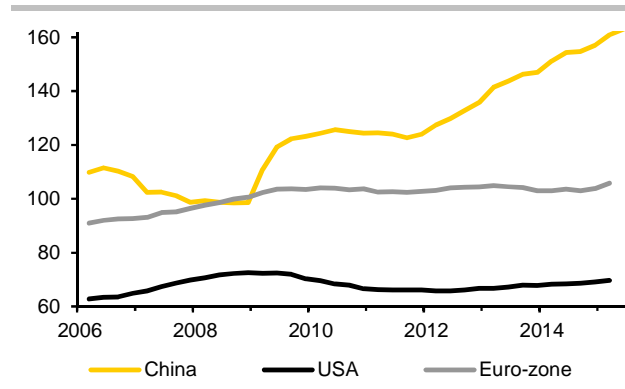
Government intervention on the equity market has been erratic and counter-productive. Last year, it advised its citizens to invest in equities, after which prices rose far more quickly than corporate earnings. When the bubble burst last summer, the government banned big investors from selling their shares. Shortly before the ban expired on 8 January, other investors sold their shares out of justifiable concern that the big players would unload their holdings and thus send prices down. The outcome was the stock market crash at the start of the year (continued on next page)

Author:

**Dr Joerg Kraemer**  
Chief Economist  
+49 69 136 23650  
joerg.kraemer@commerzbank.com

CHART 1: Chinese firms highly indebted

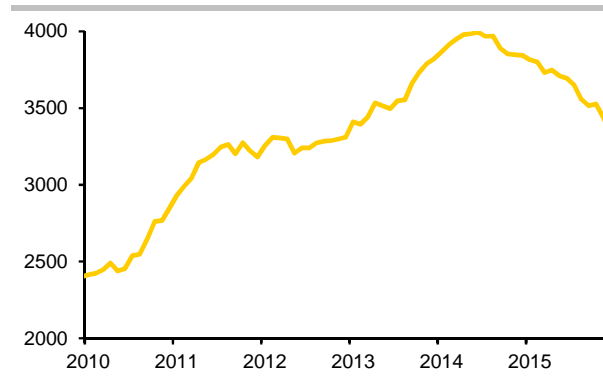
Debt of non-financial corporations as a percentage of GDP



Source: BIS, Commerzbank Research

CHART 2: China's FX reserves are declining

FX reserves in bln USD



Source: PBoC, Commerzbank Research

For important disclosure information see pages 3 and 4.

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### **Fourth policy mistake: Inconsistent liberalisation of FX markets**

Chinese leaders have created an FX market in Hong Kong on which the yuan exchange rate is largely subject to market forces. China's economic problems are thus leaving their mark on the yuan here. Nevertheless, the government wants to limit the currency's depreciation and is selling off foreign-currency reserves on a grand scale to support the yuan (chart 2). If these reserves continue to shrink at the present rate, they would be depleted within two and a half years. Deregulation of the FX market and adherence to exchange-rate targets set by the government are mutually incompatible.

### **Conclusion: Hard times ahead for China's economy**

With their reform policy of the past 40 years, Chinese politicians have managed to lead the country out of poverty. However, the economic leaders, so long highly praised, have also made mistakes. Consequently, the country is now facing some lean years and will keep the Western capital markets on tenterhooks.

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#### Commerzbank Corporates & Markets

**Frankfurt**  
Commerzbank AG  
DLZ - Gebäude 2, Händlerhaus  
Mainzer Landstraße 153  
60327 Frankfurt

Tel: + 49 69 136 21200

**London**  
Commerzbank AG, London Branch  
PO BOX 52715  
30 Gresham Street  
London, EC2P 2XY

Tel: + 44 207 623 8000

**New York**  
Commerz Markets LLC  
225 Liberty Street,  
32nd floor  
New York, NY 10281 - 1050

Tel: + 1 212 703 4000

**Singapore**  
Commerzbank AG  
71, Robinson Road, #12-01  
Singapore 068895

Tel: +65 631 10000

**Hong Kong**  
Commerzbank AG  
15th Floor, Lee Garden One  
33 Hysan Avenue,  
Causeway Bay  
Hong Kong  
Tel: +852 3988 0988