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China's challenges and their global risks

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For two decades China's economy – second in size only to that of the US – roared ahead at annual double-digit rates of growth. This year, according to official data, it is growing at 6.7 per cent. The current rate would be significantly less were it not for the continued willingness of China's authorities to pump increasing amounts of cash into overheated real estate, financial and state owned enterprise sectors.

The risks of this policy are substantial, not just to China's economic prospects, but to world financial markets.

Every time I visit China I come away impressed by the expertise of the country's economic and financial policy leaders. My most recent visit confirmed both the depth of understanding in the financial community of the serious challenges that the economy is facing, and a sense that the government is not going to push ahead with necessary economic reforms until after the 19th National Congress of the Communist party in Beijing in the autumn of 2017.

President Xi aims to consolidate his power as he enters the second half of his 10-year term of office. There could be changes in the State Council in the first few months of 2017, followed by the replacement of the majority of members of the Politburo Standing Committee at the 19th National Congress.

In November 2013, one year after he took control of the Communist party, President Xi addressed the party's Central Committee and announced a vision of a China Dream, or the "great rejuvenation of the Chinese nation". This envisaged substantial economic

advances to 2020 – the centennial year of the Communist party's founding. Now, much of the "Dream" is being put on hold, as are plans to curb rising debt in the economy. The leadership is not going to risk a further slow-down of economic growth until the composition of the new Standing Committee is determined and takes office.

Meanwhile, China's debt-to-GDP ratio has soared from around 150 per cent of GDP in 2008 to approximately 280 per cent today; the currency continues to be under pressure and stands at an eight-year low at over Rmb6.95 to the US dollar; and each month sees further declines in the country's foreign exchange reserves, which have fallen by more than $1tn to $3.121tn in the past 18 months, largely due to having to defend the Rmb.

At the core of China's problems is the continuing willingness of state owned enterprises in steel, coal, shipbuilding and other sectors to swallow up funds as if there were no tomorrow. Then the housing boom has long been in an unsustainable bubble, while municipal governments continue to borrow heavily. Non-performing loans at banks are piling up, and zombie companies have not been closed as they need to be. Now the authorities are being forced to consider new regulations to control the worrying shadow banking market, estimated at over $8tn (equal to about 80 per cent of China's GDP).

In addition, the authorities are actively considering the conversion of non-performing bank loans into debt-for-equity swaps. This is not a solution, but at best a means to postpone tough and essential action. These bad debts need to be written off – the sooner the better.

This unwillingness to confront forcefully China's economic problems is encouraging wealthy individuals and Chinese corporations to seek opportunities to invest outside the country. A significant further weakening of the currency could accelerate the capital flight and this is a major reason why the authorities are willing to intervene and use their foreign exchange reserves so substantially.

The immediate period ahead will be testing for the government's economic leadership. Maintaining financial stability, which more than ever I believe is the prime mandate for the People's Bank of China, will be difficult as domestic debt continues to rise and as many Chinese seek the safe havens of foreign currencies. Adding to pressures will be a further interest rates increase by the US Federal Reserve Board's Open Market Committee when it meets on December 13 and 14. Moreover, uncertainties are widespread about Washington-Beijing economic relations as the Trump Administration takes office.

The Rmb is likely to fall further, while nervousness in global financial markets increases due to China's major economic challenges.

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