ECONOMIC ANALYSIS

China | Private Investment Slowdown Marks the Start of China's Long-awaited Deleveraging

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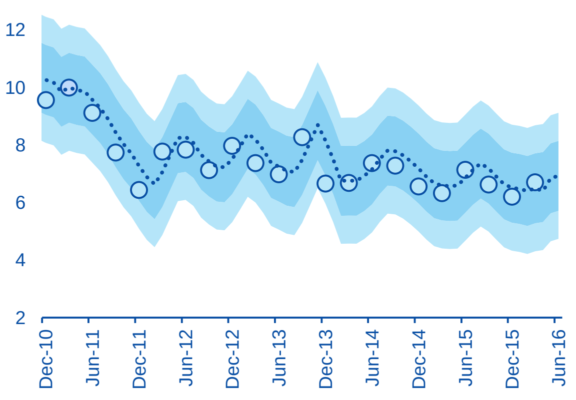
Summary

- Despite the authorities' beefed-up efforts of policy easing, China's fixed asset investment (FAI) has significantly decelerated through May, in particular for FAI by private firms. Such a trend has raised people's concerns widely since FAI by private firms accounts for the lion's share of aggregate investment, 64% as of 2015.
- More stylized facts can be found at the sectorial-level data. First of all, investment slowdown is more pronounced in the sectors with high private ownership; second, investment slowdown is concentrated in the sectors severely affected by overcapacity; last, there is a strong positive correlation between investment growth and profitability across sectors.
- The significant drop in FAI growth mirrors private firms' adjustment of their balance sheets. Unlike their SOE peers, private firms have no access to various forms of governmental support so that they need to react to the challenging environment and fast-rising debt burdens with a deep cut in capital expenditure.
- Decelerating FAI by private firms is likely to usher in China's deleveraging, which is imperative for the debt-laden corporate sector to restore its financial health. However, the authorities need to guard against associated risks and ensure that it proceeds in an orderly manner.

Investment by private firms has slowed significantly

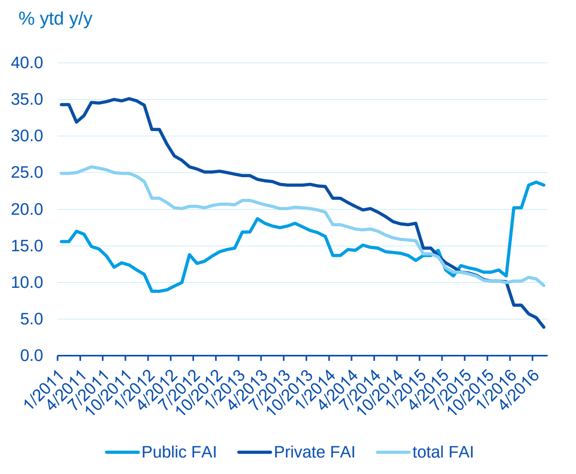
China's growth deceleration continues in 2016, despite the authorities' beefed-up efforts of monetary and fiscal loosening. As our BBVA Nowcasting MICA model suggested, the growth will slow down to 6.6% y/y in Q2 2016, the lowest level since 2009 Q1. (Figure 1)

Figure 1
Economic slowdown continues and will reach the lowest growth rate since 2009 Q1



Source: Nowcasting DF model, CEIC and BBVA Research

Figure 2
Since early 2015, private and public investment have been diverging over time



Source: CEIC and BBVA Research

In particular, the growth rate of China urban fixed asset investment (FAI), once the glaring growth driver, has slowed to 9.6% ytd, y/y in May, more than halved over the past couple of years. (Figure 2) Moreover, the growth rate of FAI by private firms has registered a steep fall since late 2015. In May, private FAI decelerated to 3.9% ytd, y/y, compared with 10.1% for 2015 as a whole. By contrast, public investment accelerated to 23.3% ytd, y/y, a sharp pickup from its annual reading of 10.9% in 2015 as the authorities have boosted infrastructure investment and continue to support state owned enterprises (SOEs) by loosening monetary and fiscal policies.

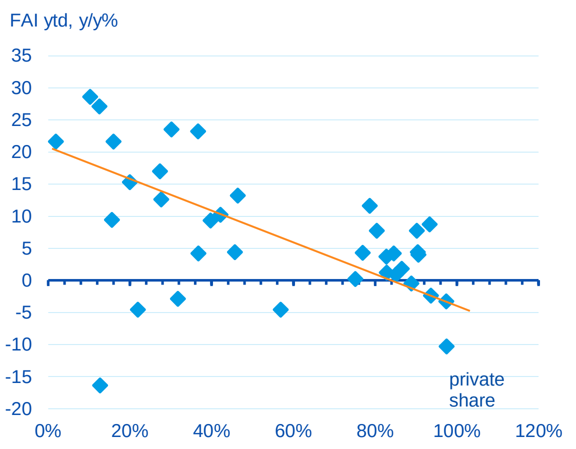
Ownership makes a difference

To gain more insights about this phenomenon, we delve into the sectorial data and uncover some important facts. First of all, investment deceleration is more pronounced in the sectors with high private ownership. (Figure 3) To a certain extent, this observation confirms that the private ownership itself does make a difference in shaping firms' investment behaviors.

The investment slowdown of private firms is easy to understand. In the face of an increasingly challenging environment and the mounting debt level (Figure 4), it is natural for enterprises to hold back their investment plans and reduce capital expenditure. As such, enterprises can maintain their financial soundness and avert the risk of financial distress.

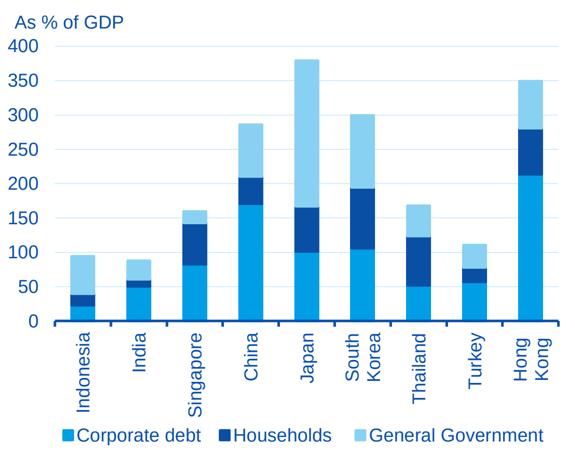
Indeed, a more relevant question should be why only private firms have introduced such adjustments in their balance sheets while not for their SOE counterparts in the same sector. The answer lies in the fact that SOEs are still basking in implicit guarantees and other preferential treatments provided by governments. As a consequence, SOEs can continue to make their investment when their private owned competitors start to claw back.

Figure 3
Among all the secondary and tertiary sectors, the higher of private share, the lower of FAI growth



Source: CEIC and BBVA Research

Figure 4
Enterprises hold back investment plans due to the mounting debt level

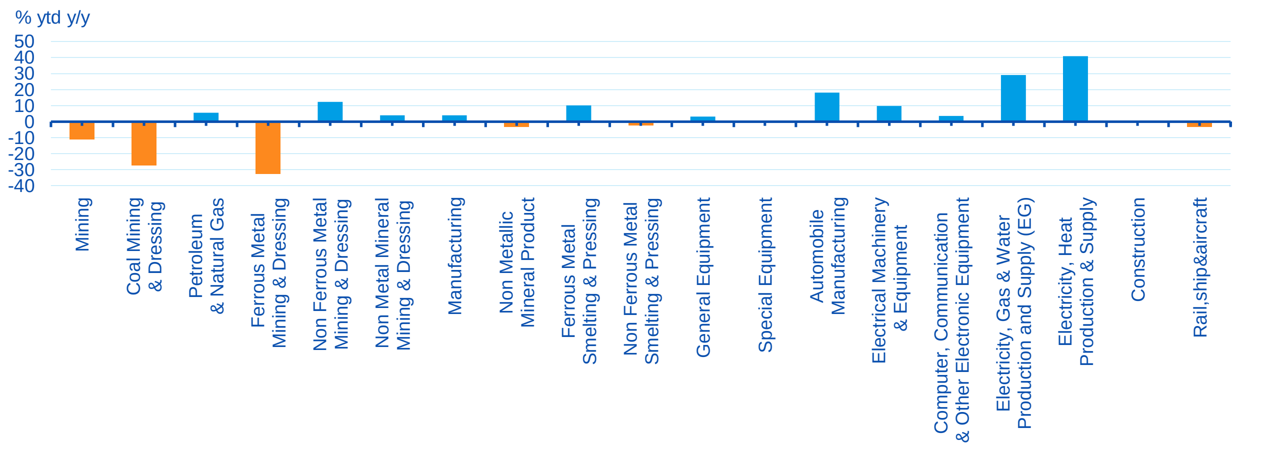


Source: CEIC and BBVA Research

FAI slowdown, over-capacity and profitability

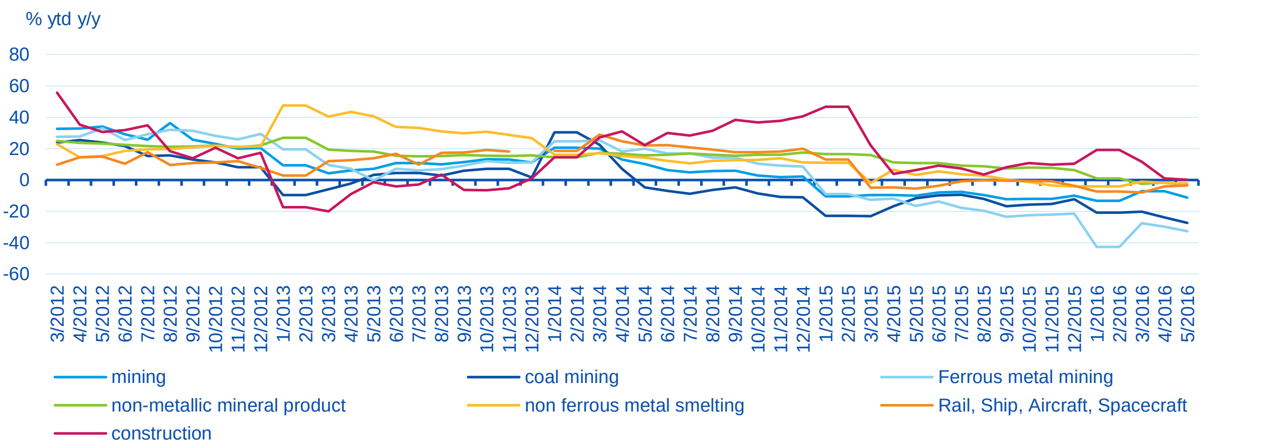
Deceleration of private investment also concentrates in a number of industries with severe overcapacity problems. China's authorities have announced five sub-sectors with lowest rates of capital utilization, namely: coal mining, iron and steel, cement, plated glass and electrolytic aluminum. Indeed, all these five industries belong to or closely relate to the sectors which registered the largest drop in private FAI: mining, coal mining & dressing, ferrous mining & dressing, non-metallic mineral product, rail & ship building, etc. (Figure 5) Moreover, we have plotted the dynamic of private FAI in these sectors (figure 6) and have found that in most of them, investment growth rates have entered into a negative territory since last year.

Figure 5
Among the secondary industry, private FAI decline concentrated in over-capacity sectors



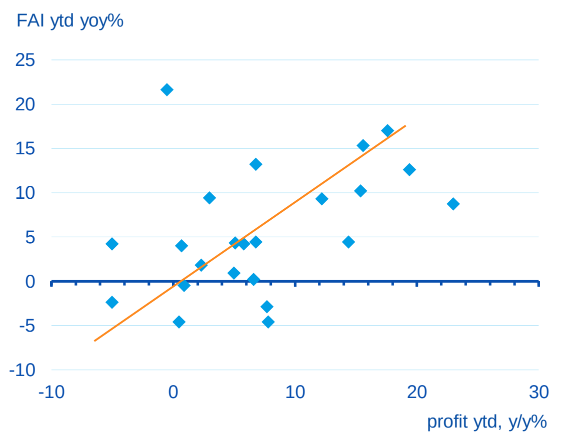
Source: CEIC and BBVA Research

Figure 6
Private FAI decreased significantly since 2015 among various over-capacity sectors



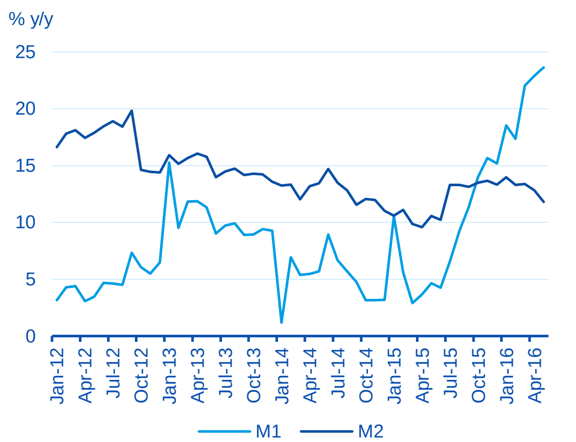
Source: CEIC and BBVA Research

Figure 7
FAI and profit growth have positive relationship



Source: CEIC and BBVA Research

Figure 8
Diverging of M1 and M2 growth in the recent months



Source: CEIC and BBVA Research

Another interesting finding is that the growth of private FAI has shown a strong and positive correlation with profitability of the sector. In the sectors with sluggish profit growth, private FAI tends to have steeper deceleration. (Figure 7) In the meantime, some booming sectors continue to attract more private FAI (such as automobile manufacturing, electric machinery & equipment etc.) as well as the public utility sectors (such as electricity& heat production and supply, electricity, gas and water supply, etc.).

The relationship between private FAI and sector-wide profitability suggest that private capitals are sensitive to their expected investment returns and therefore flow to the sectors with higher profitability. That being said, the decelerated FAI investment looks like a natural reaction of private investors to the challenging environment on a market-based consideration.

Policy implications for the start of deleveraging phase

The phenomenon of private FAI deceleration could mark the start of China's deleveraging. Although investors have long warned of the indebtedness in China's corporate sector and pointed out the necessity of deleveraging, the overall debt level of Chinese firms have continued to rise over the past several years. In our opinion, a deleveraging process must involve the necessary adjustment of firms' balance sheets featured by the slowdown of their investment. Moreover, the widening gap between M1 and M2 growth rates (Figure 8) also reflect the fact that firms have been hoarding cash, another signal of corporate deleveraging.

The deleveraging process could be bumpy as observed in other countries' experiences. The slowdown in investment not only tends to drag down growth in the current term (as a component of GDP) but also weigh on long-term growth by hampering capital formation for production in the future. Moreover, the deceleration in investment can also add more headwinds to growth by slowing job creation and affecting related sectors. When the deleveraging proceeds in a disorderly manner, the odds of triggering a growth hard-landing loom large.

However, it doesn't mean that policymakers should stop or delay this process. Indeed, any effort to delay the deleveraging process will be futile. Instead, the authorities should let market forces direct private capital to flow to the sectors that can provide higher investment returns. Apart from ensuring that such cross-sector flows go smoothly, the authorities shouldn't aim to boost investment in specific sectors by more intervention. Instead, the authorities should continue to focus their policies on maintaining aggregate demand and guide against potential financial risks through the process of deleveraging.

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