ASIA

China's Re-Balancing Act

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In the face of slowing economic growth, the Chinese authorities appear ready to act. Franklin Templeton Emerging Markets Equity's Sukumar Rajah and Jason Zhu explain how measures announced at the 13th National People's Congress are designed to shore up China's growth prospects.

Measures announced at China's 13th National People's Congress (NPC) suggest to us that the Chinese authorities are taking the threat of an economic slowdown seriously and are prepared to act.

While China faces slowing gross domestic product (GDP) growth, a trade standoff with the United States and disputes over China allowing foreign companies market access in return for technology transfers, we see policymakers stepping up to the plate to readjust and rebalance targets for a more sustainable economy.

In the face of an economic slowdown, Chinese officials have lowered the country's 2019 GDP growth forecast to a range of 6% to 6.5%, compared to last year's target of 6.5%. However, we feel that a slowdown is not a crisis. We believe there are ample strengths in China's institutions and economy to prevent a hard landing.

Against this backdrop, our near-term view on China is slightly more cautious. We expect China's economic growth to slow in the next few years as it focuses on resolving an array of challenges.

Never Underestimate China's Strengths

In spite of these hurdles, the historical ability of the Chinese authorities to implement their policies efficiently and effectively underpins China's potential strengths. A strong government presence in Chinese markets is nothing new.

China's ability to implement policies stems from a system of central rule that has allowed it to resolve problems at a speed and scale that is virtually unmatched by other large developing nations, such as India.

Consider the steps that China has taken to tackle excess capacity, high leverage and other economic and financial risks. In the coal industry, for example, the government shut thousands of coal producers and put numerous coal-fired power projects on hold to reduce overcapacity.

The high degree of compliance underscored the administration's ability to implement new policies. And a result of this was a sharp recovery in coal prices, which supported cash flows and the debt-servicing capability of many coal-related companies.

Such supply-side policies, replicated across several industries, have helped address one of the key systemic risks in China—the concentration of debt owed by "old economy" state-owned enterprises. More importantly, these policies are part of a bigger package of reforms that government agencies have rolled out—all without dealing a major blow to overall GDP growth.

External Pressures Accelerate China's Next Move

China's transition from a manufacturing-driven economy to a services and consumption-led economy has been no mean feat. However, trade tensions with the United States have created roadblocks for China's growth trajectory and softer domestic demand for key sectors in the country.

This has intensified pressure for the Chinese government to act. Authorities unveiled tax cuts worth 2 trillion Chinese yuan (US$298 billion) at the NPC, which the Chinese government hopes will alleviate pressure from the manufacturing, transportation and construction sectors.

We'd expect a reduction in current value-added tax (VAT) rates to be a welcome boost for industries that are currently embroiled in the US-China trade spat, including construction material that include steel and aluminum.

The trade dispute has also put China's commitment to opening up its markets under the microscope. Questions were raised over market access, protection over intellectual property and forced technology transfers. Debates at the NPC over foreign investment laws suggest Chinese officials could be ready to revise current laws to put foreign companies on equal footing with local firms.

In our view, the longer-term outlook for China still holds promise, if its rebalancing efforts result in an economy that is sturdier and more sustainable. Nonetheless, we believe that the complex investment landscape is where active stock-picking can thrive.

Our Approach to Active Stock-Picking

We think buoyant economic growth and loose liquidity previously had helped some companies flourish in a fast-growing economy. But amid slowing growth, waning liquidity and increasing consolidation across industries, we think there will be a greater dispersion between the winners and losers. And experience has shown us that solid fundamental research will be needed to identify them.

The encouraging news, however, is that these obstacles do not appear insurmountable for a country that has an array of proven tactics and new economic opportunities.

The age-old desire for progress is a powerful force, and we expect it to lead China toward sound policies that promote higher incomes and a better quality of life for its citizens. We believe this bodes well for the next chapter of its secular growth story.

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