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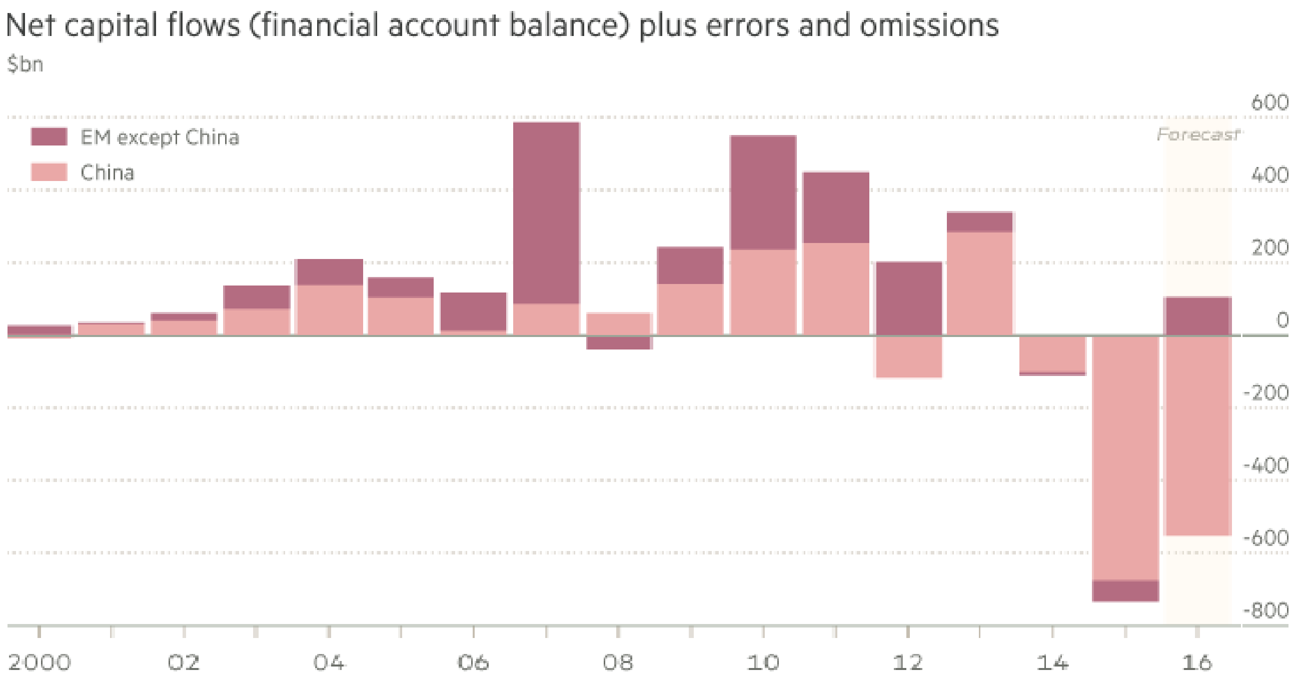
The year 2016 has begun with China-led tremors precipitating through global financial markets. But as the country now enters a critical phase in its transition to a new growth model, while making structural adjustments in its real economy, the fears appear to be somewhat overdone. As an upside to its slowing growth and weakening demand, China's broader economic plan seems to be falling in place – with the Services[1] sector (which in 2015 outgrew the once dominating manufacturing sector) taking central stage to wither out the erstwhile investment-led growth model, a promising rise in its tertiary sector (now over 50% of Chinese GDP), a low sub-2% inflation and a currency that's slated to achieve a 'reserve' status in the years ahead – leading to better employment and disposal income generation for its citizens.



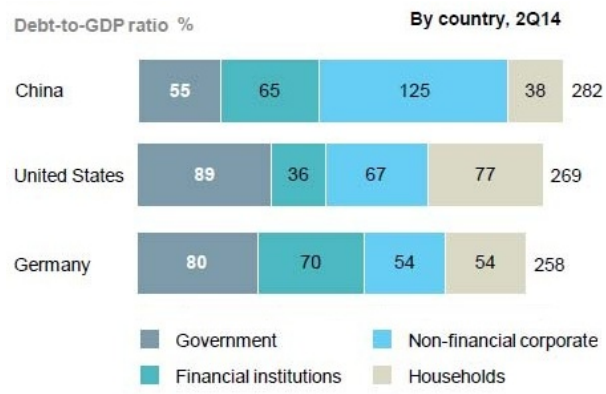
Source: IIF

Even in the face of decelerating GDP growth, urban job creation hit 11 million in 2015 (up from 10.7 million in 2014). And despite falling hugely – by $700 bn – in the last 19 months, China's forex reserves, at $3.3 tn in Dec 2015, are still enough to cover more than four times its short-term external debt[2]. Moreover, the country continues to run a large current-account surplus, in contrast to the outsize external deficits that proved fatal for Asian economies in late 1990s.

1 Chinese services require about 30% more jobs per unit of output than manufacturing and construction combined

2 China's dollar-denominated liabilities (for short and long-term debt, combined) stand at around $1 trillion

China's most daunting financial riddle however would be to deal with its debts which, at 300+% of GDP of late, while in-line with wealthier developed economies, are vastly higher than any other Emerging Market peer. In somewhat of a respite though, China's debts are held within the government-controlled bits of its economy (state-owned firms are the biggest debtors and state-owned banks their biggest creditors), and the country has the means to avoid an acute crisis akin to Japan in the 1990s or southern Europe in the 2000s. It can, roll-over bad loans as they come due or abstain from calling them in for the time being. But between allowing currency depreciation and risking further capital flight and strain on indebted firms; or not depreciating and allowing the reserves to drain; or adopting a lock-down of capital account while delaying reforms, there is no easy way out for Chinese policy makers here over the longer term. For starters, however, the Regulators are forcing banks to recognize shadow-loans on their Balance Sheets, and have used both monetary easing and a giant bond-swap program for local governments to lower the cost of servicing debts.



Source: Mckinsey

At a risk of being cautiously optimistic, the developments in China are apparently akin to an economy graduating from "the developing" to "the developed" world, and bear similarity to the US economy in the late seventies, albeit with the added complexities of a much more tightly financially integrated world of present times. And, Investors shouldn't just rush to pick sides as the economic showdown between China and US plays out over the next decade.

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