Unbalanced China

GLOBAL ECONOMY

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When the tide is low, one can readily observe who is swimming naked. And not everything revealed is nice. Likewise, when an economic growth slows, the imbalances accumulated during the upturn become readily observable. Managing them requires much skill. At this juncture, it is the emerging economies that are attracting the attention after the water level has receded. China's economy is no longer growing at double-digit rates, although it is still expanding quite rapidly at a rate of 7.5 percent. This matters externally because China already is the world's largest trading nation, and soon to become the largest economy. The greatest concern, however, is internal, and has to do with perhaps the most important imbalance facing the Chinese economy, namely, the high rate of credit growth to the private sector over the last decade and amount of bad loans.

The new Chinese leadership, which came into office a year ago, is familiar with the extent of the problems associated with the growth of bank and non-bank financing. The IMF, in its latest report on the Chinese economy, also focused the attention to credit growth and to the property sector. These vulnerabilities are a continuing source of concern. Will policymakers be able to monitor and correct the imbalances? In particular, the IMF warned about the growth of "shadow banking," a sector in which conventional risk management practices are not observed.

The magnitude of the problem is hard to overestimate. Over the last five years, credit to the private sector has grown at a rate twice as fast as GDP. The recipients of credit have not always been the most deserving or most efficient firms. In fact, a considerable part of new credit flows have funded physical assets, especially real estate, whose prices have increased considerably in recent years and continue to rise, especially in the large cities.

Last June, Chinese authorities reacted to credit expansion by raising interest rates. More recently, they have let a corporate bond issuer default, in a sort of warning to investors and lenders that the government intends to use market-oriented procedures to resolve any episodes of distress. The concern in this regard can be significant when you consider that Chinese institutions are not as suited to deal with liquidation or restructuring processes as those in the most advanced economies. The discretionary nature of China's decisions on corporate bankruptcy does not contribute to a reduction in uncertainty.

The biggest concern, however, is not that major bankruptcies might take place but rather what the impact of the credit slowdown might be on economic growth. A rapid deleveraging of the private sector can generate excess capacity in many companies, and limit global economic growth. Some clear signs of these ill effects include the decline in prices for certain raw materials for which China is the main buyer, such as copper or iron ore. One must also keep in mind the recent decision to broaden the yuan's fluctuation band, and its recent depreciation.

The Chinese authorities will likely contain or avoid a repetition of the U.S. or European financial crises, but will find it hard to manage a sudden slowdown in economic activity to a rate of 6 percent or less. That is the level that would trigger the alarm for both the Chinese and the global economies. The official goal of 7.5 percent growth for this year now seems beyond reach, unless the financial imbalances are corrected swiftly.

Changes in China's economic equilibrium

GLOBAL ECONOMY

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China's economic equilibrium has changed immensely in two directions. First of all, the growth engine has been changing. It is no longer production and exports of goods with a high labor content, but rather "urbanization": construction of cities, infrastructure, transport and energy. We seek to determine the effects on the rest of the world of this change in China's growth model.

Second, there has been a marked change in China's monetary and foreign-exchange policy in the recent period. The Chinese authorities probably no longer accept the considerable liquidity creation caused by the massive capital inflows to China, and seek to eliminate these capital inflows by generating currency risk; this also has potentially significant impacts on the global financial equilibrium.

The traditional Chinese growth engine is running out of steam: it was traditionally production and exports of goods with a high labor content, and which therefore benefited from China's low production costs. From 2003 to 2011, with the exception of the period following the Lehman bankruptcy in 2008, Chinese industrial production increased by 15 to 20 percent per year, and Chinese exports by 30 percent per year.

Things changed dramatically from 2012: growth in industrial production decelerated, and is now close to 9 percent; but light industry output, including consumer goods, household capital goods and electronics, has been increasing by only 3 percent per year in early 2014.

With regard to exports, if we smooth short-term fluctuations, we see a very small increase since the start of 2012 between 0 and 5 percent per year, with a drastic decline in exports in early 2014.

So it is no longer export industrial production that drives Chinese growth, and this is particularly due to the very rapid rise in production costs in China: from 2002 to 2013, the unit labor cost increased by 6 to 10 percent each year, which pushed Chinese production costs for the industrial sector as a whole to 80 percent of the U.S. level. In certain industries, such as aeronautics, production costs are higher in China than in Europe.

In view of this loss of production, exports and competitiveness, why has Chinese growth remained so robust at close to 7.5 percent per year? Because it is driven by urbanization, construction of new cities and transport infrastructure, and the resulting development of the water and energy sector. Investment in these areas — construction, transport, water, electricity, natural gas, refining and nuclear energy — is increasing from 15 to 30 percent per year; production of cement, steel, glass and aluminum, which the construction industry needs, is increasing by 10 to 25 percent per year.

Chinese growth is therefore becoming far more domestic, driven by construction and the related sectors and no longer by industry and exports. Chinese imports are closely linked to Chinese exports; China is an assembly plant for many exported products: the import content of exports is 55 percent on the whole, but more than 90 percent for computers and electronics.

Chinese imports, which account for 11 percent of global trade, are also slowing down markedly. This obviously has a negative impact on countries with large-scale exports to China.

They account for 16 percent of gross domestic product in Taiwan; 12 percent in South Korea; 8 percent in OPEC countries and Chile; 7 percent in Asian emerging countries and Australia; 5 percent in Africa; close to 3 percent in Japan and Brazil, and much less in other countries such as the United States, Europe, Russia, Canada, India and Mexico. China's Asian and Pacific neighbors and Africa will therefore suffer as a result of China's new growth model.

We also have to look at the Chinese authorities' change of direction in terms of monetary and foreign-exchange policy. Since the start of 2013, China has been faced simultaneously with a large trade surplus and large capital inflows.

This has led the country to very rapidly accumulate additional foreign exchange reserves to prevent an appreciation of the yuan: more than $500 billion from the beginning of 2013 until today.

Currently, the central bank clearly wants to discourage these capital inflows; to this end, it has prompted a 3 percent depreciation of the yuan, in order to generate currency risk.

INSIGHT

Reinvigorating Asian economy requires innovation, creativity

KOREAN ECONOMY

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Recently the global investor community seems to be divided about the future of the Chinese economy, which may be strongly linked to that of the Asian economy.

There has been news about a series of defaults, a real estate bubble, shadow banking rumors and the fall of commodity prices, even signs of an export and manufacturing slowdown. All these dismal indicators were plausible enough to make some investors feel nervous about the future economic growth and the financial stability in China.

On the other hand, there still remains hope the future of the Chinese economy will eventually recover its position as a fast-growing economy like Japan in 1980s. Even if the Chinese economy goes through temporary downturns, China may still outperform other advanced economies for decades to come.

Despite that kind of optimism, the sharp fall of the yuan against the dollar is rather unprecedented and evokes a constant sense of deja vu. The recent volatility inherent in yuan-trading may reflect the divergence in market sentiment about the future path of the Chinese economy. Otherwise, it may not be radically unreasonable to accept the harsh criticism raised by some pessimists as advice to assess the key challenges ahead for the Chinese economy to regain its growth momentum and to eventually transform itself into a middle-income nation as quickly as possible.

The Chinese economy is without a doubt, one way or another, a form of the Asian growth model. The Asian growth model is an export-driven, open, globalized and industrialization one. It has produced at the cheaper cost, and for the wider market, through faster technological adoption. In particular, the Asian model has been accelerated, and proliferated through policy-led or somehow centralized allocation of resources. Without such effective coordination and massive investment funneled through public administration, large Asian economies including China would have hardly been successful nor surpassed other competitors such as Latin America and Eastern Europe.

However, it is highly questionable if a publicly managed economy is fully adaptable into the next new decade when growth opportunities become stable and steady, and especially if the diminishing marginal productivity of scale has already set in and seemingly accelerated without fundamental reform in the real estate and financial sector.

Looking back, Asian economies initially without technology and capital have inevitably relied on debt financing through the banking sector. The debt financing, given the low level of sophistication and underdeveloped financial systems, were inevitably collateralized on real estate since the economic growth has been unnecessarily coming led with the high inflation of real estate.

The boom in the real estate market has been a safe haven for domestic financial institutions and even a tax base for public expenditure. Such a boom, which was founded on the economic fundamental ex post, does not mean that the Asian economy may maintain its financial stability in the near future when the potential economic growth rate may be hard hit by the monetary tightening of the U.S. or new forms of production technology with less labor but higher sophistication.

In other words, financial stability in Asia was duly dependent on windfall gains in the real estate boom, which may either disappear or be less prevalent in the future.

There may exist some long-term transformational issues if the technological competitiveness disappears, or if the Asian economy as a whole cannot create its own competitive edge similar to or surpassing other advanced economies, not unlike what Japan enjoyed in home appliances, communications and automobiles.

Clearly, the Asian economy, including China and even Korea, may be faced with the problem of creating their own market leadership through technology innovation or creativity.

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