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China: A harmonious juggernaut?

- **The Chinese industrial juggernaut keeps rolling along. In the short term, nothing will stop it. The hard-landing scenario is not going to materialise.**
- **But significant challenges lie ahead. The underdeveloped financial system needs to be reformed, if capital is to be allocated in a more efficient way, excess investment curbed and overheating risks tamed.**
- **Longer term, the most important tasks facing the government are bridging China's wide social gulfs and meeting dangerous environmental threats. But creating a "harmonious society" will take many years and presupposes the creation of a new ideological glue.**

During March 2007, I led a group of SEB clients from Norwegian and Danish financial institutions on a week-long trip to China. We met a broad array of economists, pundits and businessmen in a short period and visited several production sites in different economic zones. This memo summarises my own impressions from the trip.

Short-term risks have receded

For some years, pessimists have claimed that the lengthy boom in China must end with a bust. I have never believed it, and after this trip I do so even less.

True, growth is imbalanced – it is based on over-investment, there are a number of small real estate bubbles, the banking system is burdened by non-performing loans, etc – but these problems are not grave enough to tip the economy into recession.

A revised national accounts system has given **more weight to the private service sector,** diminishing the official share of industry in GDP. Private sector growth is rapid, and although there is a large grey zone ("co-operative companies"), most outside analysts agree that private business now makes up a larger share of the economy than the government-controlled sector. This means China's economy is becoming more nimble, flexible and market-driven.

The savings ratio has risen – from an already high level – in recent years. But according to the World Bank, this is not because households are saving more; it is the result of **rapidly rising profits in the private sector.** At the same time – also according to the World Bank – **total factor productivity growth is holding up much better** than in most other rapidly growing economies. Over the past five years, productivity growth contributed 3 percentage points of a total annual GDP growth of around 10% – quite a lot, given that over-investment causes poor capital productivity. This indicates that the Chinese economy is more robust than the pessimists assume.

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Furthermore, the **problems in the financial service sector seem to have become less acute**. Non-performing loans in the big – now partly privately owned – banks have come down sharply. True, there is still a huge amount of bad debt in the "bad banks" – the asset management companies into which many of the NPLs were pushed some years ago. But they do not pose any great risk to financial stability.

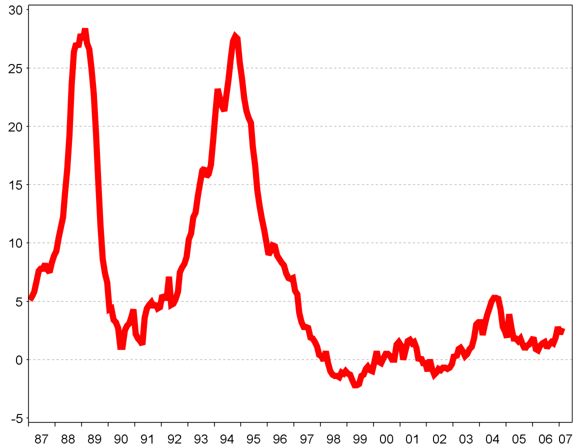
The risks today can rather be found in the remaining state-owned banks and in **medium-sized banks where regional and provincial interests dominate**. There, political lending to local megalomaniacal growth projects still abounds. And it is quite possible that the true amount of bad debt in these banks has risen during the lending and building boom of recent years. But most of these banks have no national prominence. And deposits from Chinese households are huge (because of tradition, the need for precautionary savings and the lack of alternative investments). The government also sits on massive reserves.

While a shake-up also among these banks is inevitable in the years to come, I don't see the potential problems here as a risk to macro stability for the country as a whole.

What about **housing bubbles**? Yes, there are such risks in some of the big cities, not least in Beijing as pre-Olympic construction is nearing its climax. But one reason that home prices have shot up is that some Chinese middle class families have "speculated" in buying more than one flat since there have been few alternative private investment opportunities. But government has now decided to clamp down on this practice by making ownership of second and third flats etc more difficult. Longer term, the expected wave of urbanisation is bound to fill empty dwellings. All in all, there will be smaller, regional housing bursts, but nothing on the national level.

Consumer Price Index

Year-on-year percentage change



Source: Reuters EcoWin

Some worry that rising inflation will cause the central bank to hike interest rates sharply and thereby initiate an abrupt downturn. But **stiff competition and oversupply keeps holding down inflation**. It has recently risen to above 2 percent – but that is far, far below the levels we saw in the boom-bust cycles of the 1980s and early 90s. The central bank will gradually push up rates and restrain lending, but in a controlled manner.

All in all, growth will slow down a bit in 2007 and the coming years, but it is difficult to see what would trigger a hard landing.

The need for a new growth strategy

Nonetheless, the government is frank about the need to change the old growth strategy. It is too extensive and capital-intensive – which means the economy is wasteful and resource-devouring while consumers (especially in the countryside) are squeezed. At the recent National People's Congress, Prime Minister Wen Jiabao was surprisingly outspoken in his critique against the strategy that has so far been dominant.

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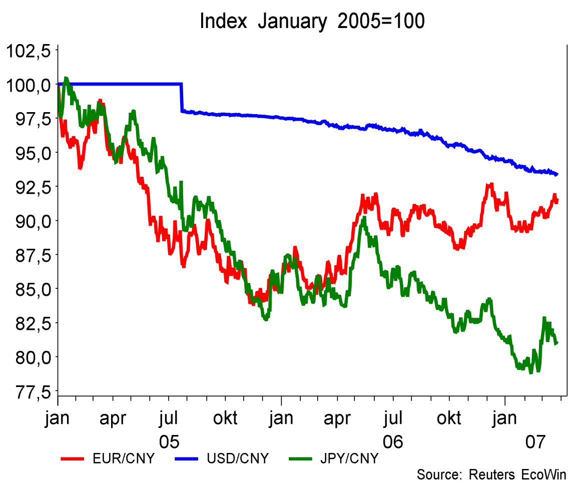
Shifting to a new, more efficient growth path implies a **better-functioning capital market** which is able to allocate more efficiently between projects. This in turn means a continued influx of foreign banks to stiffen competition with domestic lenders, improved accounting standards and regulations, a functioning bond market and a gradual opening up of capital controls.

All this is actually taking place, albeit in a gradual and very cautious manner. Under the WTO treaty, the Chinese banking system is supposed to have been opened by now. But in practice, the authorities are **raising thresholds to prevent foreign banks from entering the domestic market** at a pace that may threaten local banks. One such example is the red tape and difficulty in obtaining a licence to trade in Chinese currency. Another is the fact that interest rates are still set in an administrative manner, over the entire yield curve. In reality, rates are set to give domestic deposit takers a great advantage.

CNY exchange rate



The pegged and undervalued currency has been an important element in China's growth strategy. Here, too, we are seeing slow, gradual adjustment. The trading band between the yuan and the US dollar is widening at a snail's pace – but it is widening. The window for capital exports is opening at a snail's pace – but it is opening. The opportunities to trade in foreign exchange on the capital account are increasing at a snail's pace – but they are increasing.

China will not speed up this process. The banking system is not robust enough to handle a fully convertible currency with a flexible exchange rate. Observers vary in their predictions of how long it will take, but most believe **full convertibility will have to wait another five years** – assuming there are no big crises along the way.

As regards the exchange rate, the best prediction is a slow appreciation. China had no problems in handling the gradual appreciation of the USD/CNY rate last year. Rapid productivity growth, low inflation and the USD's slide against most other currencies have actually strengthened Chinese competitiveness.

The reformers want a more rapid appreciation, to put pressure on industry and speed up the shift to consumption-led growth. The industrial lobby, naturally, wants a slow appreciation. The end result will be **a compromise, probably around 5% annually vs the USD** in the next couple of years – a pace which will mean continued strong competitiveness.

China's huge foreign exchange reserves – now at more than USD 1,100 billion – will be used in a more active way. Around USD 200 billion will be set aside in a special investment fund, similar to Singapore's Temasek. The fund is likely to grow, since USD 200 billion is just the annual increase in reserves. It will invest in stocks and commodities, but Chinese authorities have

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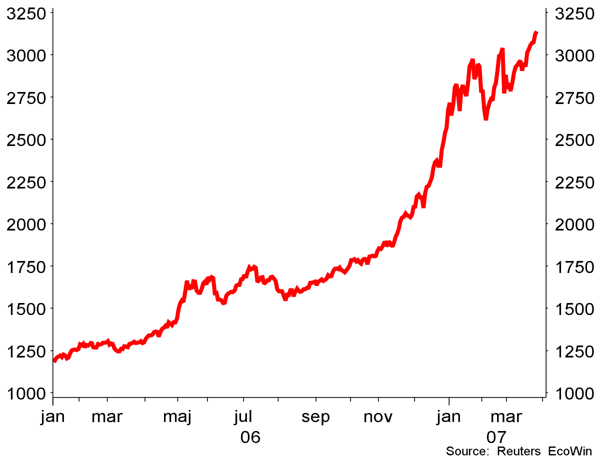
clearly stated this will be done in a way which will not disrupt FX markets.

The Shanghai stock market
index



The stock market has been turbulent. After a 130% rise in 2006, this year has seen **wild swings**. These are likely to continue, as more private investors are lured into the market while transparency is still low. The government is gradually forcing listed companies to clean up their act, requiring them to adopt international financial accounting standards (IFRS). This, however, will take many years.

The best way to view the Chinese stock market for now is to regard it as a casino. While the p/e ratios are hard to assess, they seem very high (fluctuating around 25-30). Nonetheless, there is a huge inflow of fresh private money from the middle class, whose real estate investment opportunities are shrinking due to government action.

Long-term challenges

My major impression from this trip is not about cyclical swings or even growth strategy, however. It is an even bigger issue: the **trade-off between growth and social equity.**

To simplify, China's market reforms have gone through two stages.

- The first was in the 1980s, under Deng Xiaoping. He freed economic markets and said it was OK for some to get rich – others would be able to catch up later. During this first stage, the peasants were doing relatively well.

- The second stage was under Jiang Zemin in the 1990s. Industrialisation now became an almost military-like endeavour. Huge resources were piled into a first-class infrastructure (industrial parks and zones with modern communications), while a massive inflow of cheap labour was furnished via a stream of peasants from the countryside. Estimates vary, but some 150 million people may be involved. Roughly one third are peasant girls who sleep in dormitories in the industrial zones and staff the conveyor belts and production lines of the big, foreign-owned companies. One third are male construction workers, building tall office towers, blocks of flats and new superhighways. And about one third have been able to become regular urban dwellers, primarily working in the new, private businesses.

Chinese society has become extremely segregated. The bulk of the population (total 1.3 billion) are peasants – around 800 million, most of whom still live in poverty, tied to their land and at the bottom of the social ladder. On the rung above them we find the 150 million migrant workers mentioned above plus some 50 million workers still in state-owned or co-operative enterprises. Then, on the third rung we find the aspiring new urban middle class, some 250 million strong, investing in flats and in the stock market, buying cars and becoming consumers. Finally, on the top rung we find

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the rich (the new capitalists) and the powerful (the party hierarchy).

The gap between the people on the bottom two rungs and those on the top two rungs has grown sharply in the past decade. It is becoming troublesome. Social protests, especially in the countryside but also in some industrial zones, have spread. Peasants and migrant workers are increasingly protesting against corruption, low wages and lack of influence.

This is a long-term threat to **social stability** – which is the top priority of the party. The party's mandate is to preserve this stability while promoting a new, strong China. During the second stage of reforms, the glue holding society together was economic growth itself. But this is no longer possible, since the dark side of this growth – corruption, widening social gulfs and environmental disasters – is becoming too costly.

Thus President Hu Jintao's and Premier Wen Jiabao's **call for a third stage of reform – creating a "harmonious society"**. This means clamping down on corruption, extending the infrastructure into inland and rural areas, lowering school fees and improving health care in the countryside. The efforts undertaken so far have already yielded some positive results – for example, the number of "mass incidents" fell in 2006, compared to 2005.

The two recent National People's Congresses have – not surprisingly – supported this call for a harmonious society. More importantly, this autumn the 17th Party Congress will probably do the same, reelecting Hu and Wen and giving them the mandate to continue in the same direction.

This will mean continued market reforms, as described above – but in a **more socially conscious manner.** More concretely, foreign investors should expect a gradual increase in environmental controls, higher minimum wages and higher taxes (the corporate tax has just been hiked). It will still be possible to hold down labour costs by moving inland, tapping the countryside of its vast human resources. But costs are definitely on the rise in the developed coastal regions.

The Communist Party leadership, for its part, will need to find a **new social and ideological glue** to bind the Chinese together again. It may mean a mixture of Social Democracy (the Nordic welfare states are *en vogue* again), Buddhism and a twist of Mao – not his economic policies, of course, but his aura and his status as a unifying symbol. The Chairman is seen as the founder of modern China as well as a good-luck talisman (amulets with his picture are in all taxis and buses, since they prevent accidents). The government needs this father figure towering over the present, more earthly leaders.

Whether this conflicting mixture of ideas actually can be tied together in a convincing way remains to be seen. But this is the true challenge facing the party and government today – not controlling short-term cyclical swings, as some myopic Western analysts sometimes believe.

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