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China slowing – but not due to Olympics

- **During the coming year China's economy will decelerate − not because investments related to the Olympic Games are ending, but mainly due to decreased net exports.**
- **The downturn will be somewhat deeper than the consensus, but China will avoid a hard landing.**
- **China will loosen it economic policy. Currency appreciation will slow. The industrial lobby is strong.**
- **Looking further ahead, China faces major challenges, but growth should remain strong for another decade.**

During August 2008 a group of representatives of the Swedish financial sector took a trip to China organised by SEB. The delegation visited Hong Kong, Chongqing and Beijing and met numerous analysts and Chinese business leaders during several intensive days. This report summarises my own impressions from the trip.

Olympics only a margin investment

For several years, pessimists have warned of a hard landing in China. One popular argument in recent years has been that once the Olympic Games are over, the stimulus from all the extra investments will vanish.

Of course they will. But no matter how impressive the Bird's Nest, the Water Cube and the other Olympic arenas may be, they cost no more than about USD 2 billion. The big investment cost for the Olympics was infrastructure – motorways, a giant new Beijing airport terminal, the Olympic village (which will become housing after the Games) etc. The cost of these was more than USD 40 billion. Investments thus totalled about USD 43 billion during the past seven years – a respectable figure that beats the cost of all previous Olympics by far.

As a result of these investments, Beijing grew perhaps 10 per cent faster in the run-up to the Olympics. But Beijing accounts for less than 4 per cent of China's overall economy, and its investments pale compared to the massive investment programme that has taken place in China over the past several years – and that will continue even after the Olympics. During the four years preceding the Games, **Olympics-related investments (including infrastructure) have only comprised between ½ and 1 per cent** of the country's total investments.

And there are no visible signs of lower infrastructure investments ahead. In Beijing alone, there are plans to extend the metro by 360 km in the coming years – more than twice the length built before the Games. Meanwhile new mega-projects are under way, such as the 2010 World Expo in Shanghai. In addition, mind-bogglingly huge general infrastructure projects will be rolled out all over China: railways, motorways, telecom systems, ports, ship locks etc.

Chongqing – a growing mega-city
The group visited Chongqing – the world's largest city (32 million inhabitants in the municipality) − and the focal point of China's inland industrialisation. Right now a major project is under way as part of China's *"Go West Strategy"*; infrastructure and special economic incentives (such as lower taxes) are aimed at driving investments inland. After a number of factory visits as well as a figure-packed meeting with the deputy mayor, we staggered out, overwhelmed by gigantic projects – everything from tree-planting and water purification to thousands of kilometres of motorways and a spectacular new opera house (eat your heart out, Sydney!).

To me, the pioneering atmosphere and dynamic of Chongqing was reminiscent of Hong Kong in the 1980s and Shanghai in the 90s. I remember thinking the first time I saw the plans for developing Pudong that *"they'll never pull this off."* But they did! The successes of Shanghai render today's investments in Chongqing high credibility. When a command economy with huge resources in the form of people and capital really decides to pursue giant projects with clear physical goals, the chances are good that it will actually achieve these goals. It should be noted, however, that so far these projects have mainly been state-run; so far the flow of private capital is modest.

Personally, I left Chongqing pleasantly surprised that the ambitious plans for environmental improvements are beginning to bear fruit. The air and water were clearly better than according to the alarming reports we have read in the Western press. The World Bank representative whom we met was justifiably proud about the water purification project (the quantity of wastewater that goes straight into the Yangtze has declined by half a million tonnes a day, and by 2012 most of the rest will be gone) and about the reforestation project.

Chongqing: Haze over the Yangtze

The earthquake
How about natural disasters? Last winter southern China was hit by severe snowstorms, and in May, Sichuan province suffered a major earthquake. So far about 75,000 deaths have been reported, 20,000 people are still missing and nearly 6 million people were evacuated from their homes. Some 100,000 hectares of rice fields were destroyed, along with more than 7,000 km of irrigation canals, which in turn will affect harvests on another 200,000 hectares.

Nasty figures – but just as in the case of the Olympic Games, they almost disappear in this gigantic country. Sichuan is of course a heavily populated province, but it accounts for only 4 per cent of China's total GDP. According to preliminary figures, the immediate **effect of the earthquake totalled about 0.7 per cent of China's GDP**. But so far, central and local government authorities have allocated about USD 10 billion for reconstruction. Twice that much again is available in a special emergency aid fund.

The macro-economic effect will thus be very small, probably close to zero, viewed over a couple of years. The immediate loss of lives and economic activity is offset by reconstruction, which fuels higher growth in the affected region for a year or so after the disaster – just what usually happens after natural disasters.

Exports slowing

Whereas the Olympics and the earthquake thus had a minor impact, there are other reasons why the Chinese economy will decelerate this year and next. Exports are slowing, while the tightening measures of this past year aimed at overheating are now biting. GDP climbed by a total of 12 per cent in 2007. So far this year, the growth rate has fallen to 10 per cent, and this cooling will probably continue for another while.

The main reason is **tougher times for the export industry**. Export volume is still rapidly growing (by around 11 per cent) but last year's upturn was a full 18 per cent. The reason for the deceleration is that major export markets − the United States, Europe and Japan − have all lost momentum. Slower export growth will also mean **more subdued industrial investments**.

How far this deceleration will go will depend largely on what happens in the world economy. Those who believe in a short, mild slowdown draw the conclusion that China will grow by about 10 per cent in the next couple of years; that is also where most forecasters stand today. Personally, I would not be surprised if the deceleration is deeper than this – nearly falling to 8 per cent, because the cyclical slowdown in the West looks set to be lengthier than implied earlier by consensus forecasts.

On the other hand, I do not believe that China will lose competitiveness. On the contrary, in many places the country is rapidly gaining in sophistication. Meanwhile cheap labour is being replenished from inland. We visited two Chinese automotive factories, where we saw completely acceptable small cars that are sold for about SEK 50,000 (under USD 8,000) and are now starting to be exported to Latin America and Eastern Europe…

Imports have also slowed somewhat, but not as much. Import prices – especially energy – have climbed sharply. **The contribution of net exports (exports minus imports) to GDP growth is thus falling sharply**. During 2006-07 it was about 6 percentage points. It is now about 2 percentage points and will probably continue downward towards zero.

By way of comparison, the contribution of consumption to GDP growth is approaching 5 percentage points, and capital formation (investment) is at 4. **Consumption has thus become the single most important growth engine** − an important change compared to the totally export-dominated growth that was previously the rule.

Credit tightening is beginning to bite

In recent years, Chinese authorities have tightened credit policy in an effort to cool the economy. Economic growth has of course been well above potential – usually estimated at 9-10 per cent. Inflation has gradually crept upward; due to a sharp rise in food prices, it reached about 8 per cent last spring, but recently it has fallen.

The tools for this tightening are not the same as in the West. The Chinese credit market is not as highly developed. The banks are fragile, especially at local level (poor risk control, sizeable credit risks). Interest rate management is not as effective, since the bond market is undeveloped.

The central bank admittedly hiked its interest rates during 2006-07, but the most important economic policy tightening instrument has been a sharp **increase in the bank reserve requirement** (from 7 to 17.5 per cent during the past two years). The authorities have also set a direct **ceiling on credit growth** (14 per cent in 2008). What this means is that the central government has simply issued regulations forbidding the banks to pump up their credit volume. Meanwhile it has ordered banks to **buy debt instruments from the central bank** and has thus absorbed ("sterilised") part of the big influx of hot money from other countries.

Another strategy has been the **appreciation of the currency** against the dollar, but the renminbi (or yuan) has actually fallen against the euro, so that its effective appreciation has not been especially large.

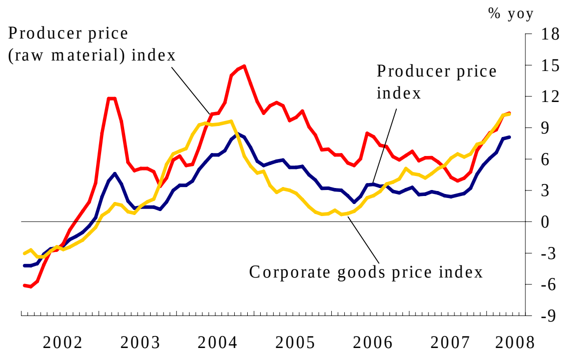
Taken together, this three-prong strategy – reserve requirements, sterilisation and minor appreciation – is now apparently beginning to bite. The economists we spoke with agreed that monetary and credit policy had contributed to a deceleration in growth.

Fine-tuning

What will happen next was a topic of heated debate, however. Via some of our invited speakers, the delegation got a glimpse into the discussion now under way among Chinese economists. It turned out to be very similar to our discussion at home.

- **The hawks** maintain that inflation pressure is too high and that growth is still above potential. It is true that food prices account for most of the upturn in inflation, but there is still a risk that inflation will persist and that inflation expectations will become established at excessive levels. In recent months, producer prices have climbed sharply (see chart). They are now higher than CPI, which many observers regard as a signal of future inflation pressure. The central bank must therefore continue tightening.
- **The doves** maintain that the hawks are exaggerating the inflation risks. They believe that China's long-term scenario is still dominated by deflationary forces such as an influx of cheap labour and good productivity growth. Underlying inflation (excluding food and energy) has admittedly risen, but not to more than about 2 per cent. Many companies are being squeezed hard by oil prices, the appreciating currency and tough competition. Investments are falling. There is a risk that the global slowdown, via weakened exports, will affect China so severely that employment will be threatened.

Producer prices are climbing



Source: Hong Kong Monetary Authority

In other words, this debate follows exactly the same pattern we are accustomed to in the West – which in itself is an interesting and edifying experience. In substance the debate has not been resolved at all, but the **political groundwork has been laid for a compromise**. China's political leaders are, of course, afraid of inflation – especially on food, since it undercuts the living standards of urban residents. But they are deathly afraid of a cyclical slowdown that may create unemployment and undermine political stability.

China is thus likely to resort to an attempt at **fine-tuning**, in which monetary policy will be somewhat less strict or will be supplemented by targeted fiscal stimuli. According to information that became available just as we were travelling home, the country is currently considering a stimulus package (both tax cuts and higher public expenditures) totalling USD 54 billion.

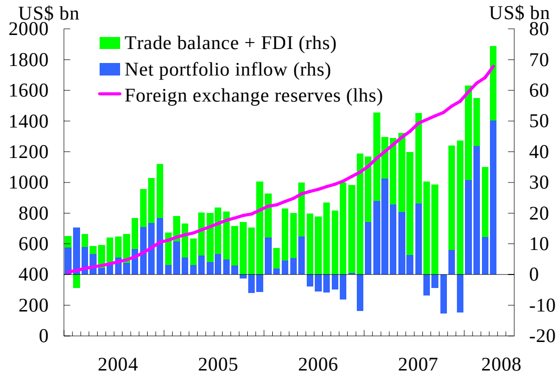
Currency and foreign exchange reserves

One part of a looser monetary policy would probably be to **slow the appreciation of the renminbi**. Exactly how – at what pace and against what currencies – is still a topic of debate. The more hawkish economists would like to see a faster appreciation, and some propose a large one-time boosting of the exchange rate in order to slow the influx of hot money. The idea is that such a rise, to a level that might be regarded as the equilibrium, would decrease expectations of continued appreciation and thereby eliminate speculative currency inflows.

My own guess, however, is that such a one-time exchange rate adjustment will not take place. On the contrary, China will continue its cautious policy, but now with even slower appreciation. Another not so daring guess is that the **euro will be accorded greater weight** in the "basket" that supposedly governs Chinese exchange rates.

The country's **foreign exchange reserves are also likely to be gradually diversified**. They are growing at a breakneck pace. One reason is that China's trade surplus is now so large that it generates a massive foreign currency influx even if exports decelerate. Another reason is sharply higher portfolio investment inflows – partly because investors expect continued currency appreciation. Altogether, the reserves have now climbed to some USD 1,800 billion and are increasing by about USD 400 billion a year.

China's foreign exchange reserves



Source: HKMA

No official statistics on the structure of the reserves are published, but most outside observers guess that the dollar accounts for more than 2/3 of the total reserves. This disproportionately high percentage will certainly be reduced, but cautiously; China has no reason to announce sell-offs and thereby push down the dollar.

One source of concern was mentioned by one of the Chinese economists we met, however. The country's foreign exchange reserves reportedly include nearly USD 400 billion in "structured" **mortgage bonds from Fannie Mae and Freddie Mac**. These were bought on the assumption that they were safe and government-guaranteed. If the US federal government fails to rescue these two institutions, China will thus suffer major losses. We understood from various comments that this would cause bad blood – to put it mildly. It would make China less interested in continuing to buy American bonds.

In other words, here is a **geopolitical element** of the American mortgage loan crisis that has not received much attention so far. A couple of years ago, Larry Summers, a former US Treasury Secretary, spoke of the "financial balance of terror". By this he meant that American deficits were being balanced by Chinese holdings of American financial securities. So far, both sides have had a common interest in stability. But the repercussions of the mortgage crisis may now jeopardise this delicate balance.

More balanced growth

In the years ahead, China's main economic task will be to continue the current **rebalancing of growth** away from investment and export dominance to more consumer-driven growth. Now that China will soon be the world's largest trading nation, it simply cannot continue to expand its exports by 20 per cent a year. As indicated above, in recent years consumption has increased as a share of GDP. The service sector has grown.

But the **industrial lobby is strong**. It consists of company executives and local party leaders schooled in the belief that the path to advancement is through rapid industrial growth. This lobby also underscores its calls for continued credit expansion and a weak exchange rate with threats of higher unemployment. And we have seen that it is capable of forcing the adoption of less stringent credit policy even when growth slows down only a little bit from high levels.

China will gradually modernise, and this will include its structure and governance. But due to the strength of the industrial lobby, progress in these areas is slow. The real interest rate is still low. In other words, capital is cheap, while over-investments and waste are still common.

Robust long-term growth

Even so, it is impossible to leave China without the impression that long-term growth will remain strong. **Potential growth is around 10 per cent**, the country's labour reserves are unlimited (200 million farmers are expected to leave rural areas in the next few decades), productivity potential remains good, and so on.

Another factor is the country's totally **mad pursuit of infrastructure investments**. Within a few years, China will leave behind the United States in terms of the motorway network, every major city is building a big new airport, telecommunications have leapt over a whole stage of development since China is moving directly into mobile networks without needing to lay copper wires underground, a whole United Kingdom is being added to electricity capacity every year, and so on ad infinitum. Landing at Copenhagen Airport – which is nevertheless one of my favourite airports – the place feels Lilliputian after you have taken off from Norman Foster's gigantic new airport terminal in Beijing.

Many difficult challenges

This does not mean that China face no challenges. On the contrary, they are larger than in most other countries. Here is a brief list:

- China is still **subsidising energy and food** at the consumer level. All decision makers agree that these subsidies must eventually be removed. When this happens, however, it will boost inflation and there will be a risk of civil dissatisfaction.
- The **climate and environmental threats** are larger than in other countries – water pollution and smog are just the beginning of the story. Rapidly growing energy needs are increasing China's dependence on coal – which in turn pours out both soot and carbon dioxide.
- The **class differences** between urban and rural areas are gigantic. There is still no functioning social safety net for China's large rural population. "Floating" construction workers are practically without rights. In 2006 the number of "mass inci-

dents" totalled some 80,000 – authorities have now stopped providing such figures…

- Looking ahead, the country will face a **demographic shock** when the number of older people grows rapidly, as the working-age population shrinks due to the one-child policy.
- And then, of course, we have the **political challenge**: How to reconcile a rapidly growing market economy with a one-party system?

However, these question lie far outside the limits of this brief report, with its narrow economic perspective. My conclusion here is that the coming year will see a deceleration in economic growth, but that a softening of economic policy will prevent a hard landing. Looking further ahead, China will remain the biggest, most dynamic engine of the world economy.

Klas Eklund
klas.eklund@seb.se