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ANALYSIS

China’s unbalanced economy

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In any ordinary economy, a triple-barrelled announcement of the kind issued by China’s central bank on Friday evening might have made more of an impression.

With an eye to today’s top-level US-China meeting in Washington, the People’s Bank of China tightened lending and eased controls on its currency, policy prescriptions that touch all their host’s concerns about Beijing’s seemingly unstoppable export-driven economy.

The announcement on Sunday that Beijing’s new state investment agency had put $3bn of foreign exchange reserves into Blackstone, the US private equity group, added further ballast to the relationship.

But such is the velocity and momentum of Chinese growth, and the sheer weight of money in the system, that financial markets soon shrugged off the monetary measures, as did China’s intended audience in Washington. “The decision will not liberalise the renminbi, as the central bank will continue to adjust the currency according to its own will, and the foreign reserves will keep piling up,” says Song Guoqing, an economics professor at Peking University.

For more than three years, Beijing has shouted from the rooftops that its economy is out of balance: too reliant on exports and investment for growth, with a dangerously high share of output from energy-intensive, polluting heavy industries.

But the plethora of policies rolled out to rebalance the economy has had little, if any, impact, partly because of their timidity and partly because the system is not responsive. Exports are still outpacing imports. Investment dominates at the expense of consumption. And heavy industry is still expanding, ensuring Beijing’s targets for increased energy efficiency have not been met.

These trends have been accelerated and amplified by the historic repositioning of the Chinese economy this century. China’s entry into the World Trade Organisation, together with Beijing’s decision to ditch the need for most exporters to be licensed, have given both ordinary citizens and local governments more entrepreneurial room to move than ever before, an opening they have grabbed with alacrity.

But with a low to negligible cost of capital, weakening central control and intense competition to grow between every locality in the country, Beijing’s policymakers are finding that the present model has no off switch.

The time-worn analogy of turning around a supertanker is often used to illustrate the government’s policy task. It might be more accurate to liken the Chinese economy to a flotilla of large and small boats, all steaming ahead at full bore, with little regard to the direction of the fleet or the diktats of its commanding officers in Beijing.

For example, the transformation of China’s financial system has lagged way behind that of its industries. Beijing’s decision to keep the currency stable means that instead of bidding up the renminbi, the dollars that flow into the country from the swelling trade surplus have to be parked by the central bank in foreign exchange reserves – leaving the PBoC working overtime to mop the extra funds out of the banking system.

“The PBoC’s policy balancing act is a precarious one,” says Haizhou Huang of Barclays Capital in Hong Kong. “It is trying to juggle the need for liquidity management, exchange rate reform and financial market stability, to safeguard banking stability and, increasingly, [to safeguard against] the potential risk posed by rising stock market prices.”

In the short term, the problem of managing excess liquidity will only get worse. The latest estimates put the current account surplus for this year as high as $400bn (£203bn, €296bn), or about 12 per cent of gross domestic product. This would be unprecedented for a big country such as China. Surpluses of this magnitude have usually been recorded only by smaller nations emerging from a crisis or by significant oil exporters.

Stephen Green, of Standard Chartered bank in Shanghai, says today’s excess liquidity is the result of a host of policies rolled out over two decades and that “there is indeed no easy way of reversing them”.

“In this regard, China has become the victim of its own success,” he says. “Unpicking the mass of decisions and entrenched interests involved in this growth model is a huge undertaking. Beijing has to change the model over time and somehow learn to cope with the liquidity, and not just this year but in 2008 and 2009 as well, since we see the trade surplus just getting bigger.”

The Blackstone deal is a first and a breakthrough for the new state investment agency, which has been tasked with chasing better returns for a portion of China’s $1,202bn in foreign reserves, the world’s largest. But such is the pace of the build-up in reserves – they are growing by about $20bn a month – that the $3bn deal will make barely a dent in the foreign currency sitting on China’s books.

Given the size of China’s challenges, it is no surprise that the measures announced on Friday, the latest in a series of small interest rate and bank reserve ratio requirement increases over the last 12 months, had little impact. Their most immediate target, the stock market, which has more than tripled in the past 18 months despite repeated efforts to talk it down by senior officials, rose by 1 per cent yesterday.

Nor did the decision to widen the maximum amount the currency can trade up or down in a day, from 0.3 per cent to 0.5 per cent, sway its most important target audience overseas, in Washington. In the nearly two years since China unpegged its currency from the US dollar, central bank intervention has never allowed the renminbi to even come near the initial 0.3 per cent band in a single day in any case, which suggests that widening it will have little effect.

The move does have the virtue of being consistent with Beijing’s promise to gradually and prudently loosen its currency, and make it more flexible. Hong Liang, Goldman Sachs’ China economist in Hong Kong, says the band widening is a “symbolic but laudable development in China’s foreign exchange reform”.

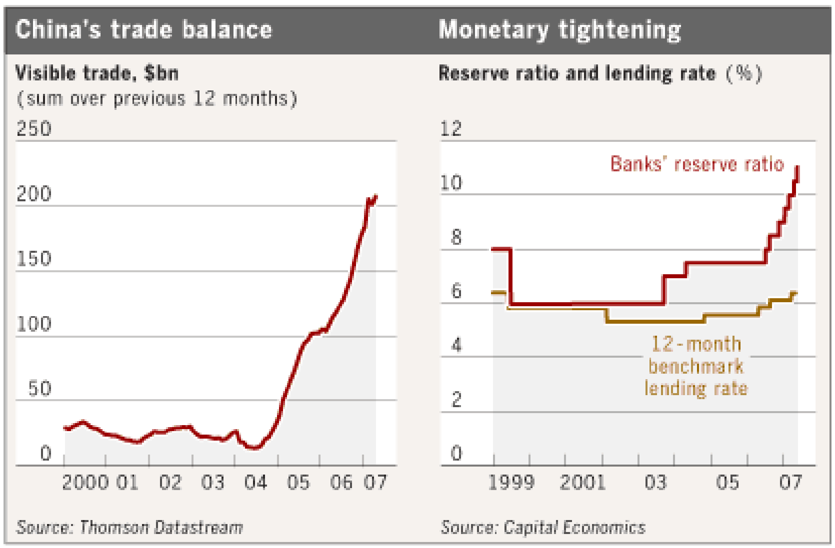
Meanwhile, China’s political calendar, and the caution of Wen Jiabao, the premier, who is in charge of economic policy, makes any radical deviation from the incremental approach to reform unlikely in the near-term. Senior policymakers have become even more risk-averse and resistant to overt foreign pressure than normal in advance of the ruling Communist party’s five-yearly congress later this year, which is expected to usher in sweeping changes to the leadership. The US, which is entering its own political season earlier than usual in the run-up to next year’s presidential election, acknowledges the timing may not be right for the kinds of changes Washington wants.

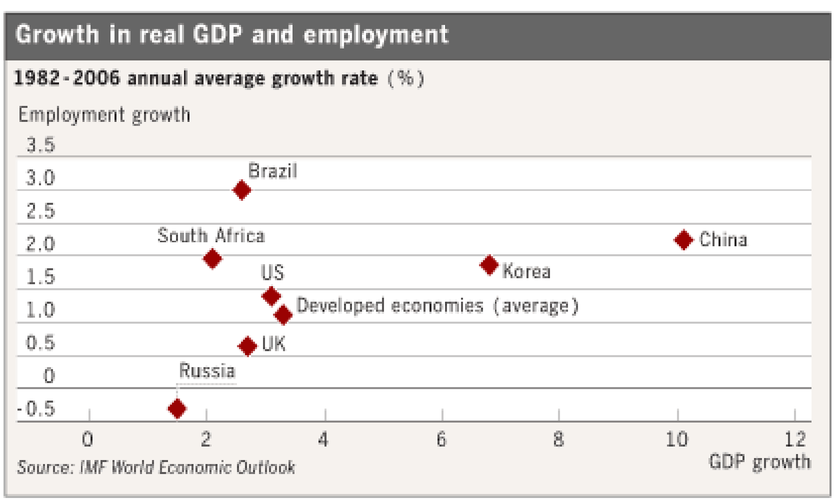
“The great risk we face is that our respective political calendars are out of sync,” said David Loevinger, the US Treasury representative in Beijing, in a recent speech. “The problem faced is: just at the point the US, for our own political reasons, really need a response by the Chinese, the Chinese are unable to provide it.”

In the meantime, China's extraordinary economic energy and its deep supplies of cheap capital and labour continue to make it an ever more formidable competitor.

China has been happy to facilitate this trend through protectionism. In a little noticed decision, China in March ended tariff exemptions for nearly 200 kinds of industrial equipment, such as smelting and mining machinery and packing materials, imported for use by local companies. The finance ministry said the 30 per cent tariff had been restored to "create a fair environment for domestic equipment makers to compete with foreign rivals through innovation".

Exports of the output of China's rapidly expanding heavy industries, such as steel, aluminium and chemicals, are also picking up. Overseas sales of finished steel rose by 159 per cent in April year-on-year, according to Macquarie Research. In this case, the surge is partly attributable to manufacturers front-running the government's well-signalled decision, announced yesterday, to tax steel exports, the kind of product that can bring trade tensions to a head.





But if the trade surplus is the problem, neither appreciation of the renminbi nor random administrative measures to restrain exports, such as the ones applied to steel, will be a panacea. China's increased labour productivity alone over the past two years has been enough to wipe out any cost increases – and therefore any decrease in export competitiveness – from the roughly 7 per cent appreciation in the renminbi against the dollar since mid-2005. Even if China's currency rose rapidly, the bilateral trade surplus would remain high in any case.

The decision to manage the currency tightly distorts the economy in more profound ways, notably in tying the government's hands on interest rates. China keeps rates low for two main reasons: to reduce incentives for capital inflows and to maintain a spread with US rates to ensure a return on the investment of its foreign exchange reserves in US Treasuries.

Such policies – low interest rates combined with cheap labour and land – make much investment in China highly profitable for enterprises, with little of the windfall going to workers. "Households are in effect subsidising this low cost of capital because of the ceiling on deposit rates," says one China economist, who asked not to be named. "There has been a huge increase in profits, but they are not getting their share of it."

At precisely the time the government is trying to slow capital spending and reduce the gaping rich-poor divide, the policy incentives are pushing in the opposite direction, according to International Monetary Fund research.

A focus on capital-intensive industry also runs counter to the economic task Beijing often professes to be its most pressing: creating enough jobs for the 15m workers who enter the labour force every year. China created fewer jobs (as a percentage of the workforce) between 1982 and 2006 than Brazil, even though it grew by an annual average of more than 10 per cent compared with Brazil's 3-4 per cent, the IMF found.

China's spectacular growth rates for the moment are camouflaging the fact that the country and its citizens are getting a lousy return on the billions the country invests and the raw materials they use. It is a problem that officials in Beijing understand well. Whether they can do much about it in the timeframe they have set themselves is very much up in the air.