

## **Re-balancing the Chinese Economy**

Much of our business media has been focused on a possible change in U.S. monetary policy: this is always a difficult task. (As Ben Bernanke's predecessor Alan Greenspan once said, *"I know you think you understand what you thought I said but I'm not sure you realize that what you heard is not what I meant"*.) It is perhaps equally important to pay some attention to what the People's Bank of China (PBoC) and, more broadly, the Chinese economy is doing.

The latter is in the midst of a gigantic re- balancing, from investment and exports driving growth, to lower investment and higher domestic consumption, thanks in part to the pressure from trading partners to reduce China's external surplus. While China continues to manage the exchange rate, the yuan has gradually appreciated against the dollar, the latest rate being CNY 6.135 per \$. The authorities have also increased wages in the coastal provinces thus making Chinese exports costlier. The result has been a 50% fall in the external surplus from a peak of \$ 426bn in 2008. The former model had worked very successfully for China, leading to double digit growth over three decades; in the process, it has become not only the world's largest exporter but also the world's largest manufacturer. A major shift in exports from labour intensive goods to high value electrical machinery, vehicles and parts, optical and photographic equipment, telecom hardware, etc., is ongoing. At purchasing power parity exchange rates, China's GDP probably already exceeds that of the U.S.

Another major shift is urbanization: from just 18% of the population in 1980, more than 50% now live in urban centers: it is expected that this would go up to 70% by 2030! Urbanization is expected to give a big fillip to the services sector.

The other side is that China continues to suffer from growing income inequalities; an ageing population; water shortages; smog and environmental problems – and a major

dispute with Japan about the ownership of some small Islands in the East China Sea, which both claim.

When global output fell after the 2008 financial crisis, China sharply increased domestic investments: as the economy slows (the growth was 7.5% in Q2), surplus capacity is likely to inflict losses on the companies concerned. And this has implications for the financial sector, particularly the shadow or secondary banking system in China. With the low rates of interest offered by the commercial banks to the saver, short term Wealth Management Products (WMPs), promising much higher returns, have attracted a lot of savings. The repayment is not guaranteed by the issuers, generally the so-called trust banks, and the money has been invested in long term loans to riskier borrowers, creating an asset: liability mismatch. Again, since many of the trust banks are subsidiaries of the commercial banks, a loss of confidence in the secondary or “shadow” banking sector can escalate into a major banking crisis. One estimate of the direct and indirect loans of the secondary banks is as high as 40% of China’s GDP!

After a sharp growth (CNY 1 trn, or \$ 160 bn) in commercial bank loans in the first 10 days of June, PBoC tightened money: interbank rates shot up. It has since eased its stance, and promised sufficient liquidity to the banking system. The Chinese banking system is huge by any standards with the Industrial and Commercial Bank of China (ICBC) being the world’s largest. In fact, 4 out of the top 10 banks in the world are Chinese; the aggregate commercial bank assets are CNY 131 tn or 250% of GDP (India: 85%).

Another interesting aspect is the growth of off-shore markets in yuan deposits in Hong Kong, Taiwan, Singapore and London, now estimated at around CNY 1 trn: an increasing number of borrowers have been issuing the so-called “Dim Sum” bonds in these markets. The International Finance Corporation recently made a bond issue in the off-shore market, having been active as an issuer in the domestic market since 2005. The off-shore market helps the internationalisation of the yuan. As it is, as much as 15% of China’s exports are now invoiced in CNY. In order to promote the use of the yuan,

PBoC has entered into currency swaps with other central banks, the latest one being with the Bank of England.

But to come back, as this rebalancing of the economy continues, a “soft landing”, if achieved, would be as much a miracle as three decades of 10% p.a. growth. It has been a “long march” from the humiliation of the opium wars to becoming a superpower. The Indian Express reported last month that the Prime Minister, in his address to the 2011 batch of Indian Foreign Service probationers, described China as a “phenomenon” stressing that Indian diplomats need to study that country in depth. He is absolutely right: we have far more to learn from the east than blindly trying to follow the west, particularly the Anglo-Saxon countries, on issues like the exchange rate policy. Perhaps our familiarity with the English language, which has helped a lot in the growth of the IT and IT-enabled services exports, is a also handicap: the Japanese finance minister was recently quoted as saying that the reason why Japan escaped relatively unscathed from the 2008-09 financial crisis in the Anglo-Saxon countries, was its unfamiliarity with the English language!

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