

Chinese economy: some macro issues

Even as volatility in the Chinese financial markets has continued since last August, economic growth has slowed (to below 7%), and the exchange rate remains under downward pressure despite a significant surplus on the current account.

The reason is capital outflows, not so much now by foreign portfolio investors but through China's infrastructure investments in Africa and Latin America, and in pursuance of its One Belt, One Road strategy of increasing integration with Eurasia, from Indonesia in the east to Poland in the west. This apart, last year, for the first time, China's private investment abroad exceeded \$ 100 bn; this level has already been exceeded in the first couple of months of 2016, through investments in manufacturing, in hotels, in golf courses, etc. etc.! In fact, the scale and speed of Chinese acquisitions abroad reminds one of the 1980s when the west was scared of Japan "buying the world" taking advantage of the appreciated yen. Many of these investments turned out to be loss making; will China's experience in the 2010s be much different?

The exchange rate has fallen about 6% against the dollar since the middle of last year, despite huge intervention by the People's Bank of China in the currency market. (The country's reserves of foreign exchange have fallen from \$ 4 trillion, to around \$ 3.3 trillion.) However, the 6% fall has to be seen in the background of a 25% appreciation over the previous 10 years in nominal terms, and as much as 50% in terms of the real effective exchange rate. A part of the recent fall is clearly due to speculation in the offshore market against the yuan. It seems the authorities are looking at the imposition of a "Tobin Tax" on short term capital speculating against the yuan – even as China has recently opened its domestic bond market, which is the world's third largest, for investment by foreign portfolio investors. And, internationalisation of the yuan for both trade and deposit/bond markets continues. By one estimate, about a quarter of China's own trade is now invoiced in the yuan, and the percentage may well double by 2020 if recent trends continue.

Whatever the long term impact of China on the global economy, the rebalancing of the domestic economy from savings to consumption has led to slowdown in growth – and not only in China. Large exporters to China like Korea are also feeling the impact. And, globally, the major reason for the softness in commodity prices is the lower demand

from China. Domestically, there is a major drive to improve the efficiency of state-owned enterprises: one measure under consideration is a reduction of millions in the workforce. So much for the “workers' paradise”, which communist economies are supposed to be; to be sure, since the revolutionary changes in economic policies by Deng Xio Ping in the late 1970s, China has remained “communist” only in name, although there is a large public sector. Interestingly, many of the richest Chinese businessmen are members of the Communist Party – crony communism?

One corollary of the slowing domestic economy is the sharp increase in bad debts, particularly in the real estate sector. China's household and non-financial corporate debt is as high as 200% of GDP, the highest ratio amongst large economies. Apart from the regulated commercial banking sector, there is a huge shadow banking sector in China, including around 3600 peer-to-peer lending platforms: one of the largest failed recently, provoking a typically snobbish comment from *The Economist* (February 6), “*China is probably no more prone to financial fraud than other emerging markets.*” – as if the mis-selling of mortgage securities leading to the financial crisis of 2008; manipulation of the LIBOR; foreign exchange settlement prices; etc. etc. occurred in emerging markets!

The central bank recently cautioned commercial banks against lending to local authorities, which are heavily exposed to the real estate sector. It seems that with the economic slowdown and falling exports, there is huge over-capacity in the manufacturing sector. Many producers have had to reduce prices, and are incurring losses. Since domestic savings continue to be high, investments have got diverted to the real estate sector – which too is now incurring losses. No wonder the banking system's non-performing assets have gone up to the equivalent of \$ 200 bn. The authorities are now trying to solve the problem of bad debts through debt equity swaps, securitisation, etc.

Would China be able to achieve the re-balancing without a recession?

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