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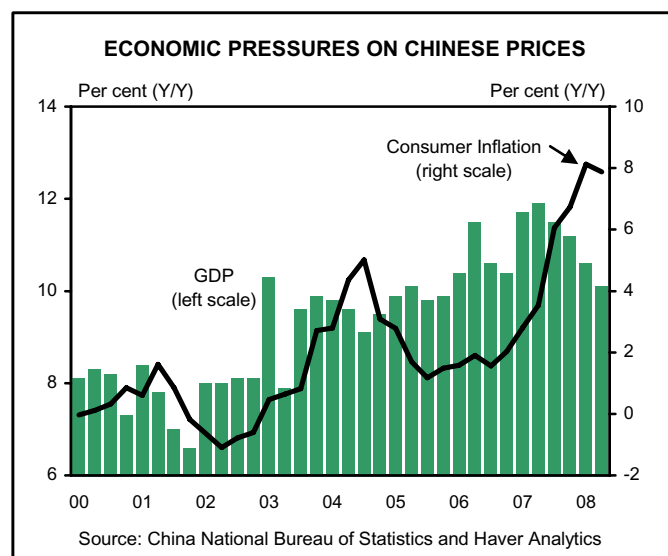
TD Economics

Special Report

August 12, 2008

THE CHINESE ECONOMY: DOMESTICATING A DRAGON

Chinese economic policymakers have found that the development of a dynamic, healthy financial system takes longer to foster than an internationally-competitive export sector. Many of the issues China continues to deal with – stock market bubbles, housing bubbles, excessive business investment, and inflation – can be traced back to this industrial-financial mismatch. Exchange rate and monetary policy are constrained by the imbalanced nature of the economy. Chinese corporate bond and derivatives markets remain in their infancy, while the banking sector continues to develop its risk assessment and lending capabilities. Moreover, massive international reserves are insurance against the type of emerging market crises that were prevalent in the past, but also represent forgone investment in the present. Developing the Chinese financial system into one capable of taking appropriate risks is the next hurdle in sustaining the impressive economic takeoff. The difficulty in domesticating a dragon is that hiccups along the way may periodically lead to uncontrollable fires.



HIGHLIGHTS

- **The Chinese economic conundrum is how to manage an economy with a massive rural-urban divide and a huge disparity between a developed manufacturing sector and a fledgling financial system.**
- **Normal economic policy tools, such as interest rates and exchange rates, are having unintended consequences as planners grapple with these mismatches.**
- **While the last decade of Chinese history was written by manufacturing, the next decade will revolve around how successful policymakers are in addressing issues in the financial system.**
- **The Chinese financial system must develop the tools to take appropriate risks in order to sustain the economy's impressive takeoff.**
- **The economic influence of China over the last decade will be small potatoes compared to the future if authorities are successful in modernizing the financial sector.**
- **With the Chinese economy already showing signs of cooling, an Olympic hangover may be more of a coincidence than a fact for the economy.**

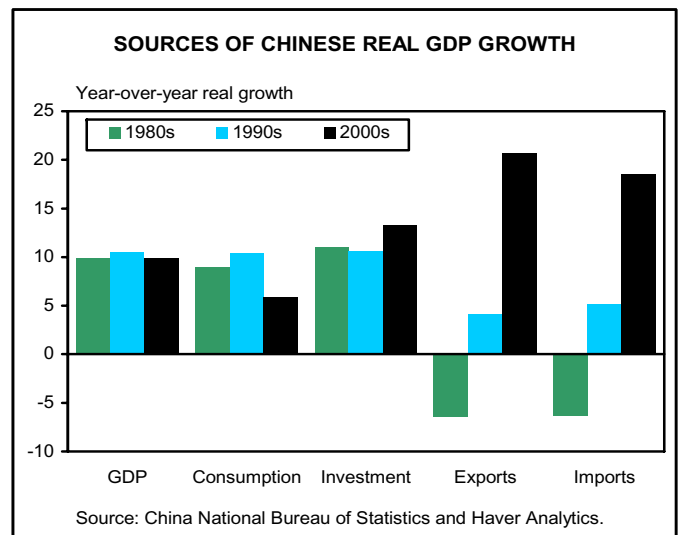
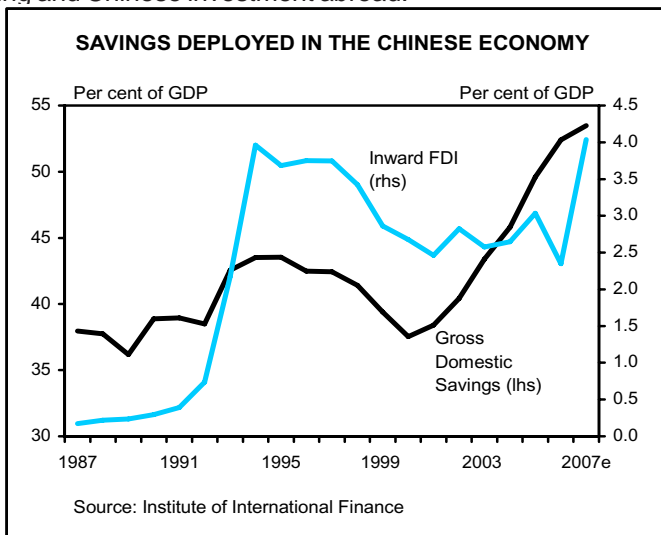
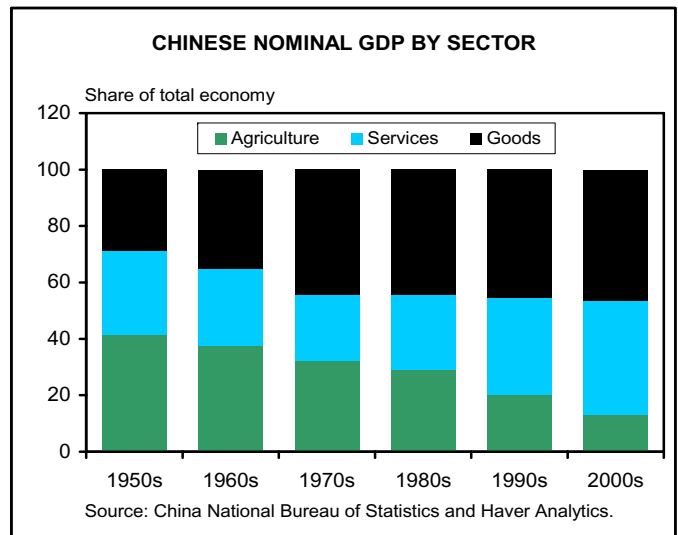
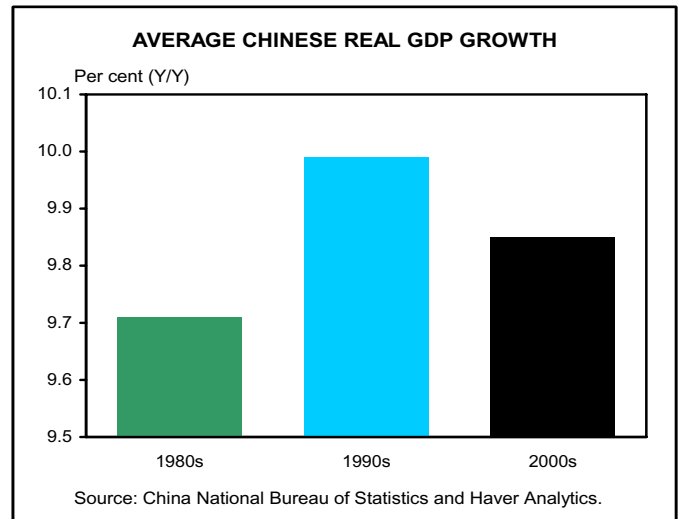
The Domestic Policy Straight Jacket

The trade-off between economic growth and inflation is a good place to start in understanding the pressures building up in the Chinese economy. Since 2000, both Chinese economic growth and inflation have trended higher together. As the economy accelerated, so did inflation. So while the recent spike in inflation has been fueled almost exclusively by rising food prices, in order to bring the trend inflation

Chinese Exceptionalism?

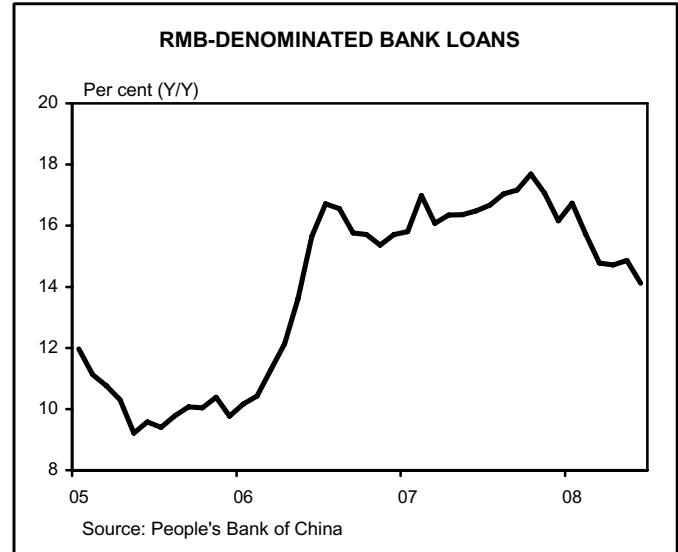
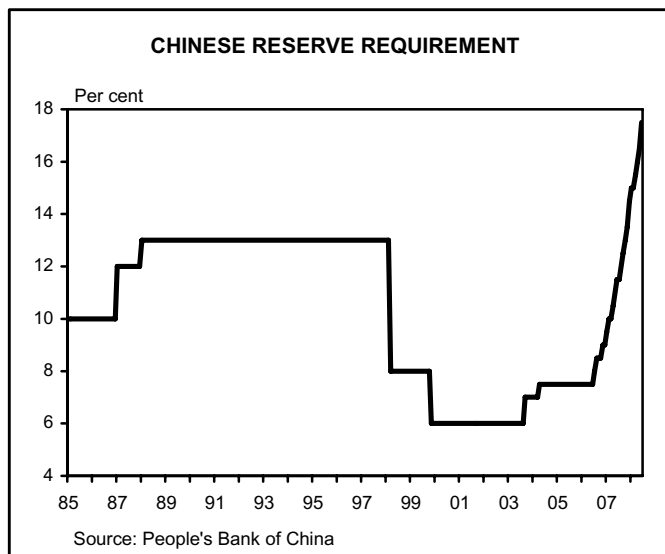
In order to understand the predicament for Chinese policymakers, it is important to clearly understand the nature of the economy and dispel some misconceptions. The Chinese economy's impact on the global economy is undeniable. In 2007, one-quarter of the growth in the global economy came from China, and in 2008, this share looks likely to rise to near one-third. However, there is nothing exceptional about the pace of Chinese economic growth this decade. In fact, its average pace so far this decade has been below its average growth rate in the 1990s. Moreover, the share of the nominal economy devoted to goods production is no bigger today than it was in the 1970s. What has changed is that the service sector has grown, while the share of the economy devoted to agriculture halved from the 1970s to the 1990s and will nearly do so again this decade. In real terms, the decline in agriculture's importance has been even more dramatic, while manufacturing's share of the economy has risen.

The crucial change for the global economy has been China's involvement in trade. While real Chinese trade flows contracted through the 1980s and saw a moderate growth in exports in the 1990s, this decade has seen a quintupling of the pace of Chinese exports. The early Chinese economic development strategies were modeled after the successful policies of their Asian Tiger neighbors, and were spurred by an active decision of Deng Xiaoping in his 1992 "Spring Offensive" speech to open up the Chinese economy to foreign direct investment and develop an outward-oriented strategy for economic growth. This has involved a long-lived phase of capital accumulation and investment spending fueled by private and international savings, at the expense of lower consumer spending and Chinese investment abroad.



rate down to the 2-3% pace authorities would be more comfortable with in the long run, they must bring the rate of economic growth closer to a 9% pace. The balancing act for China is that a rate of economic growth below 9% tends to see an insufficient number of jobs created to accommodate those moving from rural to urban centers. Meanwhile, inflation above 2-3% – especially when that is centered in food prices – tends to disproportionately strike the spending power of rural households who earn less and spend a disproportionately larger share of their income on food than their urban counterparts.

The experience of Chinese policymakers highlights the limitations of current economic tools in the face of a massive rural-urban divide and industrial-financial mismatch. It also demonstrates the interconnectedness of many of China's current economic issues and why there are no easy solutions. The main tool generally used to control an economy is the interest rate. But there's a problem for China. While exports and investment spending were barreling ahead at a breakneck pace, consumer spending was much more subdued. Higher interest rates might have only a tangential impact on exports – since they do nothing to change foreign demand – or on investment spending – since interest rates remain low relative to the pace of economic growth. However, they would have the unintended consequence of reducing the pace of consumer spending. In 2006, authorities actually thought they could be clever, and raised the lending rate to make borrowing more expensive, but left the deposit rate unchanged so consumers had no incentive to save more. The unintended consequence, though, was that the wider spread made it more



profitable for banks to lend, which they inevitably did, helping to fuel faster GDP growth and inflation. Policymakers soon reversed course and returned the interest rate spread to normal over the course of 2007 and 2008 and tried to direct their focus to other tools to try and effectively target the investment and export sectors.

The first major tool brought to bear on controlling investment was bank reserve requirements. Over the last two years, the authorities have more than doubled the amount of deposits Chinese banks are required to keep on hand and not lend back out. This is an implicit tax on the banking system, as the banks must continue to pay out interest to the deposit-holder, but they cannot earn any interest itself by lending that money out. But there's a problem for China. Whether at the 7.5% rate required in 2006 or the current 17.5%, Chinese banks have typically held closer to 18-20% of their deposits, which means the increased reserve requirement hasn't been a concern to most financial institutions.

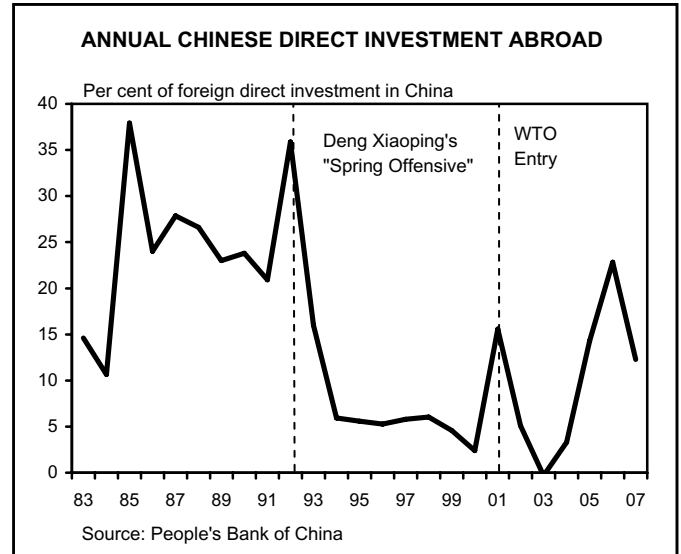
So, the authorities leaned on more draconian measures near the end of 2007 – setting direct lending quotas on banks for 2008. But, once again, there's a problem for China. In fact, there are two. Local political leaders have traditionally advanced their careers by demonstrating their ability to promote economic development and growth. This has required attracting businesses, workers, and lending. The implication is that a friction remains between what is best for the Chinese national economy and the career prospects of local political leaders. Second, compared with advanced nations, the banking sector in China remains less

diversified – meaning financial institutions in China remain more dependent on the deposit and lending channel to fuel profits – and have had less rigorous risk departments – meaning a higher share of nonperforming loans. Limiting lending not only directly hits the balance sheet, but by slowing the overall economy, it can lead directly to an increasing share of nonperforming loans and create even further pressures on the balance sheets of Chinese banks.¹

The International Policy Bind

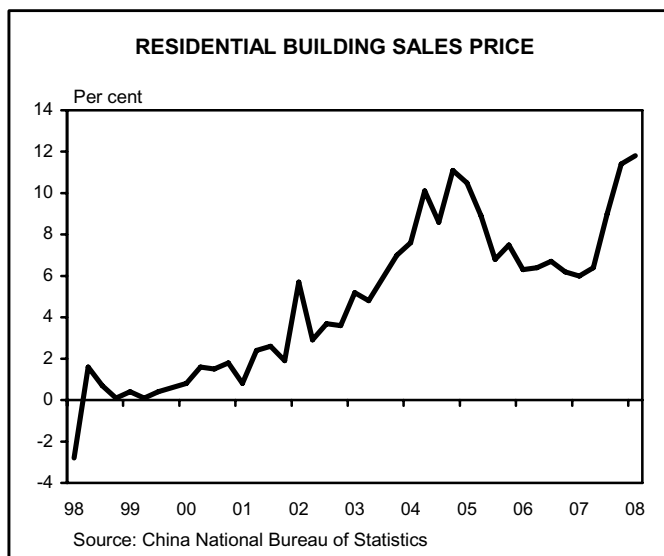
Managing the Chinese export-oriented manufacturing sector remains no less tenuous and has also complicated the efforts to manage the inflation-growth tradeoff. In the face of stiff international pressure, the Chinese broke the yuan's peg with the U.S. dollar in July 2005, but still tightly controlled the real exchange rate – the exchange rate adjusted for inflation differentials – for another year. A strong exchange rate controls the growth in exports, increases the purchasing power of Chinese workers, lowers the price of imports, and dampens domestic inflationary pressures. So far this year, policymakers have become more comfortable with this tool and the yuan has been appreciating at a near 10% annual pace. Since around half of Chinese exports are re-exports of intermediate goods imported from elsewhere, the sting of higher export prices are somewhat muted by falling import prices.

However, there are a plethora of problems for China. While the inflation-fighting camp has held the upper hand since early 2007, it is still very much an open debate within China as to whether fighting inflation through currency appreciation – and thereby reducing the competitiveness



of Chinese exports – is a desirable goal. When economic growth was in excess of 11%, it was easier to argue for some moderation. As the economy nears a 9% pace, however, the balance of power shifts. Another problem is that the yuan is still seen as very much a one-way bet. Most analysts still believe the currency needs to appreciate substantially – perhaps another 15-20% – before it reaches its fair value. While these point estimates are very contentious, domestic industries would struggle to adjust were the change made too quickly. Meanwhile, a slow adjustment drives investors to bring their money into the country in order to gain from the eventual currency appreciation, which puts even further pressure on the currency to appreciate. The more desired the currency, the more the pressure to strengthen.

So, in order to mitigate this stress, the authorities have accumulated a vast war chest of \$1.8 trillion dollars in international reserves as of June. This represents an influx of foreign money which, if left unchecked, would lead to domestic inflation. In order to offset – at least partially – these inflation risks, the central bank issues bonds, which domestic buyers purchase and in the process, remove liquidity from the system. One problem is these operations tend to be only partially effective. A second and more systemic problem is that the flood of government bonds stunts the growth of a private bond market. This means the domestic banking sector remains dependent on deposits for funding, borrowers remain dependent on bank loans for funding, and the financial sector has a more limited ability to mature.

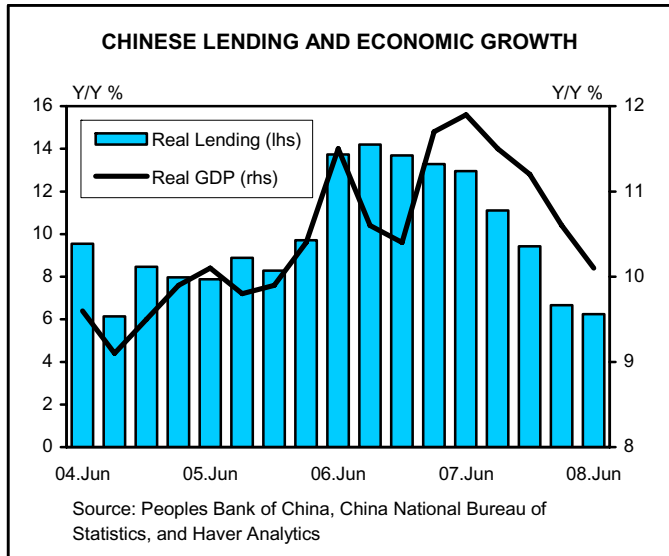


Are downside risks to growth building?

Recent comments from the People's Bank of China and the Politburo have highlighted that the balance of power among Chinese policymakers is shifting towards the pro-growth camp. Early last year, Premier Wen Jiabao called the Chinese economy "unstable, unbalanced, uncoordinated, and unsustainable," and brought policymakers' muscle to bear on the issue of rising inflation and risks of economic overheating. In July of this year, however, the central bank released a statement saying "We will use various monetary policy tools to create good conditions for stable, relatively fast growth." Meanwhile, the Politburo seems to no longer be focused on the risks of overheating, and replaced mention of "prudent fiscal policy and tight monetary policy" with a reference to 'strengthen fiscal and financial controls.'

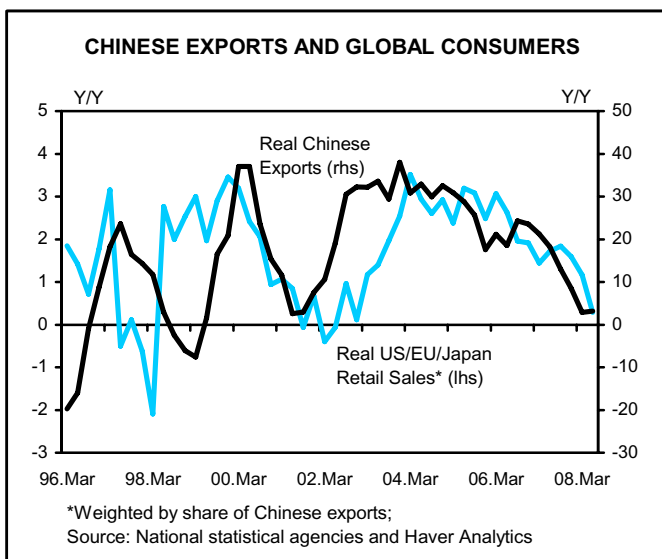
Past tightening in interest rates, reserve requirements and rapid currency appreciation have been having an effect on GDP growth, inflation, and taking the froth out of equities and housing. Annual GDP growth has slowed three straight quarters and inflation has eased from 8.7% to 7.1% and is likely to decelerate further (although core inflation is likely to pick up over the next year). Consensus forecasts for Chinese growth this year have been falling and are now close to our call for a 9.9% pace in 2008 and 8.8% pace in 2009. It is too soon to say a full easing cycle – with lower interest rates and a weaker currency – is on the horizon, but any incremental gains in GDP growth may be less commodity-friendly than in the past.

First off, you have the fact that these moves are to offset expected economic weakness. Second, "strengthen fiscal controls," is likely a reference to the need to continue to reduce energy subsidies. For exam-



ple, energy producers have been squeezed by the fact that coal prices have increased 20 times faster than electricity tariffs over the last year. This would mean further incremental reductions in Chinese commodity demand which are likely to be offset for consumers and producers by some sort of tax measures to offset these rising costs. China has plenty of fiscal room for this and more – the more subsidies they cut, the more temporary relief they can afford to provide and still be budget neutral.

Third, "strengthen financial controls," is likely a reference to the need to stem the flow of hot money into the country masked as trade, FDI, or portfolio flows. FX reserves increased nearly 20% in 2008H1 even as the yuan was allowed to appreciate at a much faster rate and a large share of this was "remainder flows" which could not be explained through traditional channels alone. The 10% pace in yuan appreciation in the first half of the year was unlikely to be sustained, especially with Chinese export growth now nearing a single digit pace. But currency appreciation remains the easiest way to reduce domestic inflation without further hurting domestic demand – especially if offset with some targeted tax measures such as the recent increases in VAT rebates for textile manufacturers. Also, it is difficult for China to both diversify its U.S. dollar reserve holdings and limit yuan appreciation. Less appreciation means more intervention against the dollar, which means more accumulation of U.S. dollar assets and less diversification. More appreciation means more diversification. Lastly, rather than cutting interest rates or reserve requirements – which certainly could happen if the slowdown shows signs of worsening – the immediate response has been a loosening in the lending restrictions placed on banks at the end of 2007.



The controlled nature of the currency appreciation further stymies this maturation process by limiting the need for hedging strategies and derivatives markets. This is exacerbated by government restrictions on investing abroad which are only slowly being loosened. In keeping with the trend of unintended consequences, this immaturity further exacerbates the Chinese “home bias” – the tendency of investors to invest only within their own country – given future yuan appreciation would be a capital loss for Chinese investors investing abroad and investors don’t have the tools to hedge all of the currency risks even if they did invest abroad. This, in turn, feeds back into the problem of too much liquidity staying within China and the limited amount of Chinese direct investment in the rest of the world. One can’t help but be reminded of the little boy plugging holes in the dike with his fingers, hoping someone

addresses the structural issues with the dam before he runs out of fingers. However, once China does address these structural issues, the influence of China on the global economy over the last decade will seem like small potatoes in comparison.

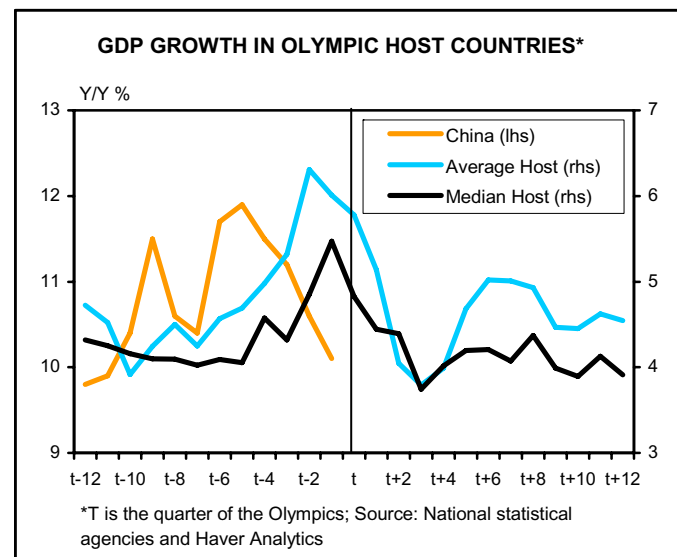
The Law of Unintended Consequences

As clever as much of Chinese economic policy has been, China remains a centrally-planned market economy – meaning the Chinese economy’s evolution into a market economy is centrally planned and tightly controlled. It is much easier to mandate industrial design – you may build your plant here and export your products from there – than it is to align financial incentives. An increasingly large share of the Chinese economy lies outside of the direct control of central planners. And it is in this imperfect union be-

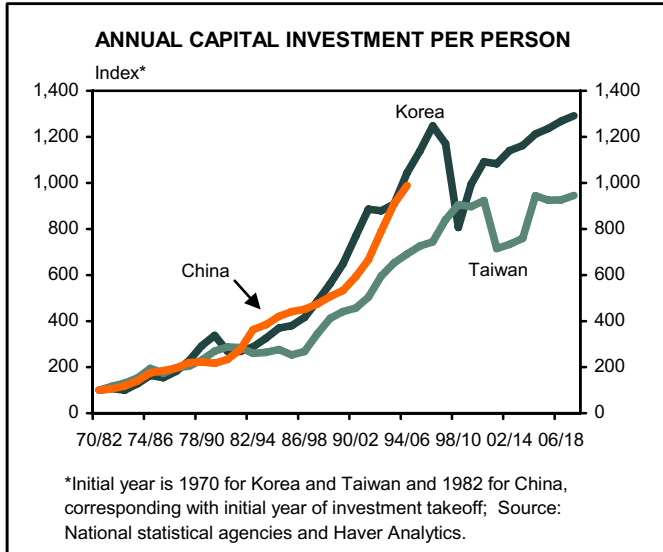
The Olympic Hangover?

It is hard to estimate a precise economic impact of hosting the Summer Olympics. So many of the benefits are expected to flow in the distant future – more tourism and gains from improved infrastructure, for example – and it is hard to say with certainty what would have happened in those later years had the Olympics not occurred. Looking at past Olympics, though, gives the appearance of an Olympic hangover. While we lack data for Russia and Spain, the other six of the last host countries – Canada, South Korea, Australia, Greece, and the U.S. (twice) – have seen average GDP growth of 6% in the four quarters before the Games, 5% in the quarter of the Games, and 4% over the four quarters after the Games. The slowdown comes in sectors one might expect – with investment spending stalling, inventories falling, and a temporary boost in consumer spending fading. Only the U.S. in 1996 seems to have escaped this trend.

However, this hangover seems to be very much an unfortunate coincidence – like the infamous Madden Curse where an NFL player is somehow more prone to injury and problems the year they are placed on the cover of the Madden videogame. In 1976, a U.S. recession just after the Games pulled the Canadian economy down shortly after hosting the Olympics. In 1984, the U.S. saw a post-recession recovery return to normal, right around the time of the Summer Games in Los Angeles. In Australia in 2000, a revised tax code and advent of the tech bust sank the economy just after the Games. And



the coincidence seems likely to play itself out again as the Chinese economy should continue to decelerate through 2009 and show the same pattern – and ironically Brett Favre’s appearance on the cover of Madden 2009 seems to be bringing it’s own unfortunate coincidences for him, as well. Unlike the advanced economies hosting the Games in the past, though, infrastructure is a dire need for the Chinese economy, so there is some reason to think some of this investment may provide long-term gains for the Chinese economy – even if the local real estate market in Beijing cools in the near term as expected.



tween the market and the planner, between the mature industrial sector and fledgling financial system, where mismatches, imbalances, and concerns arise.

Controls limit the ability to invest abroad, so the ample liquidity floods into the few areas where investment is possible – deposits, real estate, and the domestic stock market. The bubbles in these markets, while easing off in 2008, can be seen as the natural byproduct of the limitations above. While the Chinese economy is now showing signs of slowing down, the underlying issues have not been addressed and so these pressures are likely to build again. This phenomenon is not unique to China. Korea and Tai-

wan, two of the Asian Tigers whose successful growth strategies China modeled its own export-led strategies on, are examples where industrial expansion fueled by capital accumulation eventually reached a hiccup when it overstretched the maturity of the domestic financial system. In these cases, there were issues with overvalued currencies, hot money flows, and too little oversight of too much foreign currency debt held by the private sector. The lead up to this saw an acceleration in the accumulation of capital per worker in the economy with the overhang addressed through sharp corrections.

For China, this does not mean this same fate is inevitable or unavoidable, but it is not unprecedented. China has learned from the past. They have controlled foreign transactions, have a currency struggling to strengthen, and have enough international reserves to pay for 18 months of imports even if foreign capital flows and exports were to dry up overnight. Policymakers must address the weaknesses in the financial system as meticulously as they have tended to the details in industrial policy. This may prove difficult, as a healthy financial sector is not one based on delivering mandates but on managing incentives and may not provide the tangible immediate output that a new factory does. Future Chinese success will not depend on manufacturing prowess, but on banking soundness.

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Endnotes

- ¹ In 2003, the government had to inject nearly \$70 billion into four state-owned banks in order to address undercapitalization as policymakers prepared to open up the domestic financial system to international competition.

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