BALLINGAL PACIFIC

The Big Picture – April 2010

Outlook for the Global Economy and Markets

The China Syndrome

China has recorded a monthly trade deficit in March for the first time in six years. Leaving aside the one-off factors that might have influenced this particular data point, it is clear that the trend in the trade balance has been firmly downwards since its peak in 2008, and not because exports have fallen away but because of an extraordinary surge in imports. GDP growth will probably exceed 12% YoY in the first quarter of 2010 and economists are scrambling to upgrade their forecasts for the year back into double digits.

A falling trade surplus says very little about "re-balancing growth" – either within China, or between China and its trading partners. Investment spending remains far and away the most important driver of GDP; it is the need to import raw materials and capital equipment to support this investment drive that has contributed to the declining trade balance. China's exports have already surpassed their pre-crisis peak and, as a mark of the undervaluation of the renminbi exchange rate, China continues to increase its share of global exports.

To the casual observer, it may appear that China has brushed off the effects of the global credit crisis with some ease, successfully engineering a Keynesian reflation of its economy that has made it less dependent on external trade.

The truth is more complicated. Maintaining a high level of GDP growth has required a dramatic expansion of credit and a worrying over-reliance on public investment, well beyond what policymakers envisaged when stimulus plans were put in place eighteen months ago.

In response to the collapse in global growth in 2008, China originally announced a Rmb 4 trillion fiscal package, equivalent to about 13% of GDP, over 60% of which was to be spent by provincial and local governments. To speed up the spending process, caps on bank credit were lifted so that provinces, municipalities and others could borrow money from the banking system via "special purpose investment vehicles", with implicit support from the authorities.

Initially it was assumed that this package of fiscal measures, focused on traditional infrastructure and public works, would simply be the first round of spending, to be followed later in 2009 by a second package directed more at health and welfare reform. This second round would help promote consumption and alter the balance of demand in China.

As the year progressed, however, all talk of second packages was quietly forgotten in the face of rampant money supply and loan growth… and clear evidence that domestic spending was again taking off. What was not fully appreciated until late last year was the extent to which public sector spending and the special purpose vehicles set up by provincial governments, as well as cities and smaller municipalities, dominated the borrowing and investment splurge.

Estimates vary, but it appears that local investment companies, injected with property and public assets, have borrowed somewhere between Rmb 7 and 11 trillion, i.e. some 25% to 35% of GDP, with bank commitments for as much again over the next two years.

In short, the lion's share of new bank lending over the last eighteen months has been to finance "public works", and mainly via these entities. Little wonder that plans for further government stimulus measures have been shelved; instead, the challenge is to contain the enormous increase in credit that has already been unleashed.

By lifting lending curbs and turning a blind eye to local government finance vehicles, China has "gone nuclear"; the challenge now is to manage the risk of a possible future melt-down.

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This is the debate that now rages about the outlook for the Chinese economy. Have credit and investment excesses, particularly as they relate to the property sector, now reached crisis proportions, or will China simply grow its way out of trouble and absorb possible bad loans, albeit with a few bumps along the road?

The case for the defence is a solid one. China has successfully defused previous bad loan crises, including the closure of the "ITICs" (International Trust and Investment Companies) that were used as vehicles for local government finance in the late 1990s. Following a series of recapitalizations, involving the setting up of asset management companies, the major banks were cleaned up prior to their listings and NPL ratios have been brought down to low levels.

China's aggregate balance sheet is strong, even if local government finances are shaky. In the worst case, if we assume that local borrowing via special investment vehicles continues unchecked for another year, and even including outstanding debts of asset management companies, the total gross public sector debt is unlikely to exceed 80-90% of GDP. This must be set against the assets of the public sector that include large property holdings and valuable stakes in listed companies plus the flexibility to draw on at least a portion of FX reserves.

Given that the CBRC, China's bank regulator, is already seeking to curb loan growth and push financial institutions to raise more capital, it seems unlikely that recent credit excesses will spiral into outright crisis.

Against this sanguine view, there are a range of counter-arguments:

1. A dramatic increase in China's public sector debt, together with a rapidly ageing population, reduces the country's room for manoeuvre in the future, especially in the event that interest rates rise and push up the burden of debt servicing.
2. Recent spending has been directed to an even greater extent than in previous cycles on property and construction. Under the guise of "public works", many projects have been funded, and are now being, that are unlikely to prove viable. Whereas over-investment in manufacturing capacity or in infrastructure may be either exported or grown into in future years, empty real estate has a carrying cost and does little to improve the supply-side of the economy.
3. Poor investment may not lead to an immediate balance sheet crisis. But it will curtail China's productivity growth and damage the growth/inflation trade-off. It was the reforms of the 1990s, notably SOE reform and housing reform, which enabled China to grow at 8-10% per annum without inflation. Reform fatigue, combined with poor investment, make it unlikely that China can continue at this pace for long.

The growth/inflation trade-off that has been so favourable for China in the last decade was further enhanced by the forces of globalization that contributed to a wave of direct investment into the country as part of the process of vertically integrating supply chains between China, the rest of Asia, and the rest of the World.

China enjoyed a huge step-function surge in its trade and export growth that is unlikely to be repeated now against a backdrop of protracted Western de-leveraging and global excess capacity. At the same time, sustained higher commodity prices have damaged China's terms of trade and will make trade less profitable in the future.

The bottom line is that, even if China does not face a systemic crisis as a result of recent credit excess, there are good reasons to suppose that the rebound in activity over the last year has been somewhat unhealthy and cannot be allowed to continue if inflation – whether of consumer or asset prices – is to be held in check.

In this context, it is unsurprising that the authorities have resisted rapid appreciation of the renminbi; knowing that domestic credit and local government-sponsored investment must be reined in, they are not anxious to squeeze the export sector any more than they have to.

A face-saving deal with the US has been struck, but the real challenge is to reform the capital allocation process. If this is delayed for long, then melt-down will, eventually, be inevitable.

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