REUTERS

Fast-charging China sets course correction for economy

By Alan Wheatley, China Economics Editor

On the principle that if it ain't broke, don't fix it, China's policy makers should be able to put the economy on auto pilot, sit back and relax.

Instead, Beijing is urgently reviewing an economic model that has delivered growth approaching 10 percent for nearly 30 years, lifted 400 million people out of abject poverty and vaulted the country into fourth place in the global economic rankings.

China's pursuit of rapid industrialisation, the platform of its astonishing ascent, will not change. A factory job in the city is still the key to a better life for tens of millions of economically unproductive peasants.

But the breakneck investment and ruthless pursuit of export markets that have gone hand in hand with China's transformation into the world's factory have started to ring alarm bells.

Too much is being spent on dirty industries such as cement, smelting and coking that gobble energy and ravage the environment but create too little in the way of value for China's economy.

Record trade surpluses are not only triggering a slew of protectionist measures against China but are also flooding the economy with cash. The result is inflated asset prices and easy credit to finance even more low-value, export-slanted factories.

In the words of Premier Wen Jiabao, "The biggest problem in China's economy is that the growth is unstable, imbalanced, uncoordinated and unsustainable."

Some of the contours of the policy response of Wen's government are already clear.

To brake exports, China has removed or reduced value-added-tax rebates that exporters could claim on some 2,800 products; it has also imposed export taxes on more than 80 types of steel products and on aluminium rods and bars.

Beijing has introduced a range of administrative measures to curtail the processing trade, whereby cheap Chinese labour assembles imported components for re-export.

And hardly a day goes by without a policy initiative to weed out wasteful capital spending, especially by factories, mills and mines that guzzle energy and spew out pollution.

Planning regulations have been tightened, some projects have been halted and banks have been told to go green and cut off credit to environmental offenders.

To spur consumption as the economy is gradually weaned off investment and exports, Beijing has cut taxes and increased outlays on health, education and social security so people feel more confident about spending instead of saving for a rainy day.

Yet sceptics say these and myriad other measures address only the symptoms of China's imbalances and not their cause.

What risk-averse Beijing policy makers have failed to do, these critics say, is to allow market forces to set the price of key inputs. As a result, everything from the cost of money to utilities is underpriced, creating huge incentives to invest.

The exchange rate is perhaps the most distorted price.

China's record stockpile of $1.43 trillion in foreign exchange reserves and current account surplus of 12 percent of GDP surplus are proof enough for most economists that, if market forces were to determine the yuan's rate, the currency would be worth much more.

Because the central bank targets the exchange rate, intervening massively to hold down the yuan, it cannot set interest rates high enough for its fast-growing economy.

This introduces another major distortion. Nominal GDP growth is running around 16 percent, yet companies can borrow from banks for around 8 percent. With corporate profits growing at a 40 percent clip, the decision to go for growth is an easy one.

On the face of it, the chances that China will let the yuan off the leash any time soon are not high.

The ruling Communist party is understandably nervous that a surge in the yuan could wipe out millions of jobs in export industries and make it tough for peasants, who make up over 60 percent of its population, to compete against cheaper food imports.

An economic downturn would deal a body blow to the credibility of a party whose standing depends largely on its ability to deliver ever-rising living standards.

The lessons of the Asian financial crisis a decade ago have also been learned in Beijing: freeing the exchange rate while bank reform is still a work in progress could trigger capital flight in the event of an economic shock. China's porous capital controls would not stand in the way.

Seen in this light, continued financial reform holds the key to addressing China's imbalances for it would pave the way for greater yuan flexibility and ensure a more rational allocation of credit and economic resources.

Indeed, an International Monetary Fund working paper concludes that a dysfunctional banking system is to blame for China's anaemic household consumption by starving small firms of the working capital they need to create income-generating jobs.

China has made good progress in cleaning up its banking system; albeit at a cost to the taxpayer of as much as $500 billion. After its stock market listing, ICBC has overtaken Citigroup as the world's largest bank by capitalisation.

Much remains to be done. Banks' internal controls are weak, their ability to price risk is poor and tales of embezzlement form a staple of the state media's diet.

But China is eager to learn the tricks of global finance -- hence the new state investment company's purchase of a stake in U.S. private equity giant Blackstone and China Development Bank's tie-up with British bank Barclays.

They are likely to be the first of many such deals, aimed at acquiring expertise as much as maximising investment returns.

China is also making strides in other financial areas.

Beijing is leaning on more blue-chip companies to sell shares at home, raising standards of the country's casino-like stock exchanges, while an end to turf battles between regulators could see the corporate bond market take off.

The fundamental factors that have made China the fastest-growing major economy in the world remain in place: urbanisation, a lofty savings rate and a high degree of openness to trade and investment.

As such, the economy has the potential to remain strong in the medium term.

But the risks are mounting, from protectionist legislation in Washington to inflationary pressures. The quality of growth is deteriorating, witnessed in widening income gaps and frequent environmental accidents. And the imbalances within the economy are increasing, exemplified by those surging foreign exchange reserves.

China will need all the instruments in its policy tool-kit to address these problems. Above all, it needs a market-driven exchange rate.

18 October 2007

Alan Wheatley

As China Economics Editor based in Beijing, Alan coordinates economics and treasury market coverage for China, Hong Kong and Taiwan.

In a 27-year career with Reuters he has reported from 40 countries. Before moving to Beijing in 2005 he was Asian Economics Correspondent based in Singapore and before that in Tokyo, analysing economic and financial trends across the region.

In a similar role in Paris in the early 1990s, he was European Economics Correspondent in the run-up to the Maastricht Treaty on EMU and headed up economic reporting from France. In between, Alan was in charge of parliamentary coverage and then UK general news reporting in London.

Earlier postings included Frankfurt, where he covered Germany's financial markets and the Bundesbank. After that he spent seven years in the United States: in New York he reported on the financial markets, the Latin American debt crisis and landmark events such as the Plaza Accord on the dollar and the 1987 Wall Street crash; in Washington he covered the Treasury, the Federal Reserve and the IMF.

Born in York, UK, in 1956, Alan took a degree in translating and interpreting in French and German. He taught at Leipzig University and worked as a translator in Belgium before joining Reuters.

Published by Reuters Limited, The Reuters Building, 30 South Colonnade, Canary Wharf, London, E14 5EP