China's Post-Olympics Economic Outlook

Rethinking Investment Strategy for Japanese Firms

By Ke LONG

The Chinese economy is going to experience a mini-recession from the second half of this year. Although the real GDP growth rate still maintained a double-digit figure of 10.4% in the first half of this year, it is clear from last year's 11.9% growth that economic development has started to slow down. Generally the stock market plays a role as a barometer in a market economy. In China, it seems that stock investment peaked out in the first half of this year. The Shanghai Stock Exchange Composite Index dropped 65% from 6,100 points in October last year to 2,200 points in September this year. Meanwhile, the property market also started to decline, showing price cuts of about 20% in July comparing with June this year. In Shenzhen, certain individual investors have stopped debt repayment to commercial banks, although I am not sure whether it will become the Chinese version of the US subprime loan problem. It is clear, however, that Chinese economic development will be damaged if nonperforming loans increase in commercial banks' balance sheets.

Furthermore, the attitude towards investment has become more negative, not only among foreign investors but also domestic investors. The cause of the mini-recession is quite complicated. First, the cooling-down effect of policy mix by the People's Bank of China (PBoC, central bank) since the last second half has made most small and medium-size enterprises (SMEs) face some problems related to a lack of monetary liquidity. I visited some SMEs in Zhejiang, Fujian and Guangdong in the past few months, and found that many of the SMEs are facing a bankruptcy crisis. The lack of monetary liquidity is due to misguided monetary policy by the PBoC, and also to the recession in the United States. Most of the SMEs in China's coastal areas are small export-oriented manufacturers. Some of these exporters only export products to the US market, but there has been no payment from importers since the first half of this year. So the shortage of operating capital has hurt management directly. The State Council has decided to allow commercial banks to increase their combined lending by 200 billion yuan to help the SMEs.

It is difficult to predict how the mini-recession will continue to impact the Chinese economy and society. The Olympic Games are over. It seems that both the government and investors expect the World Expo 2010 in Shanghai to help China restore confidence in investment in the stock and property markets, and in direct investment from foreign companies.

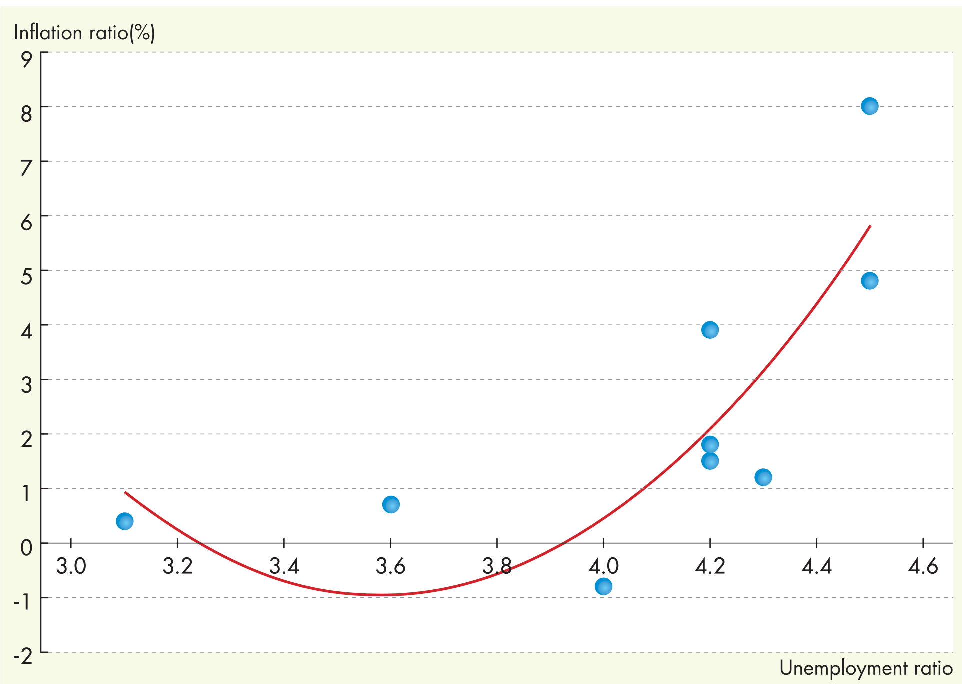
It is true that the World Expo is a big global event. In preparation, the central government increased fiscal expenditure to invest in some national infrastructure projects such as express railways, highways and airport terminal buildings. Such development of transportation networks absolutely will contribute economically not only to the Yangtse Delta area, but also to the Chinese economy as a whole. As a result, the current mini-recession could be considerably overcome by the end of 2009, although of course it still depends on the policy mix by the State Council and PBoC.

1. Inflation Targeting Boosting Jobless Rate

In every economics textbook there is an important theoretic expression about the relationship between inflation and unemployment, called the Phillips curve. The Phillips curve tells us that the inflation ratio and the unemployment ratio will not rise at the same time. As a situation under inflation usually means a weakness in

CHART 1

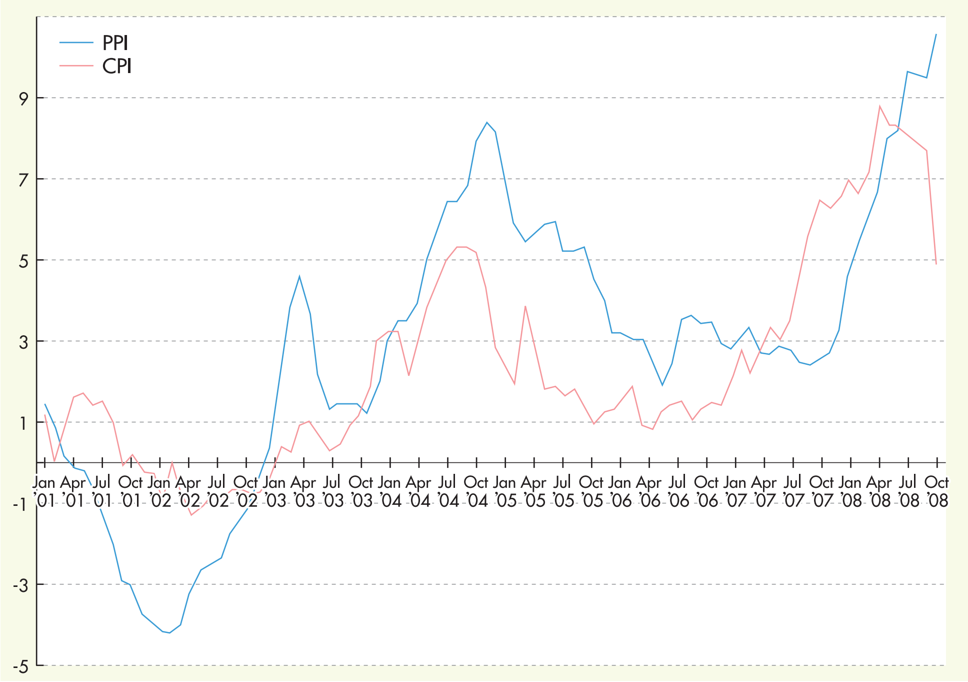
Divergence from the Phillips curve in China



Source: Chinese State Statistic Bureau

CHART 2

Inflation could hit Chinese economic growth



Source: Chinese State Statistic Bureau

supply, suppliers will be more optimistic to do investment to increase the supply of goods and services. As a result, investment will contribute to the creation of employment opportunities. In addition, when the unemployment ratio goes up, it means demand is not strong enough. Then, we could consider that the inflation ratio will not rise continuously.

However, there has been a divergence from the ordinary Phillips curve in China. The inflation and unemployment ratios have turned to rise together since 2003 *(Chart 1)*. For the PBoC, it is difficult to set a target to operate financial policy because the two indexes are a tradeoff. To cool down inflation, the central bank needs to raise interest rates to decrease monetary liquidity, but this kind of policy would reduce employment opportunities as well. In addition, if the central bank chooses to relax its macroeconomic control, the inflation ratio could turn to rise much more rapidly and sharply.

In the past 12 months, the PBoC focused policy on cooling down inflation as food prices had increased by 40% and meat prices by 68% in 2007. Zhou Xiaochuan, governor of the PBoC, announced repeatedly that lowering the inflation ratio is the only target. The PBoC will make efforts to fight against inflation definitely. According to "The law of the People's Bank of China," the aim of financial policy for the central bank is to maintain the value of the currency, so policy targeting inflation could not be considered as a mistake.

But here it should be pointed out that the PBoC cannot adjust the RMB interest rate independently when the foreign exchange rate of the RMB is kept basically stable in a narrow band. The Chinese foreign exchange system was a fixed one, pegged to the US dollar at the level of $1=8.28 yuan until July 21, 2005. Since then China has started to adjust the foreign exchange rate, and has reformed the system to peg the RMB to a currency basket including the US dollar, the euro, the Japanese yen, and some other Asian currencies. But the real operation is not a basket-peg system. The RMB foreign exchange rate is still managed by the State Council and PBoC. The State Administration of Foreign Exchange (SAFE) decides the rate according to international economic and political situations. For example, SAFE usually revalues the RMB when US Secretary of the Treasury Henry Paulson visits China. This is because China wants to engage Washington to work together instead of revaluing the currency under pressure from the United States.

2. Inflation & Deflation Could Hit Chinese Economy Together

Due to the PBoC's tight monetary policy, the inflation rate has come to decrease, falling from 8% in January to 4.9% in August this year. However, the PBoC has not announced that the tight monetary policy has succeeded because the producer price index (PPI) is still rising and recorded a 10.1% surge in August *(Chart 2)*. Generally it is considered that a rise in the PPI could hit the manufacturing industry because it will mean higher costs and lower profits for firms, eventually boosting the consumer price index (CPI) and cooling down household consumption.

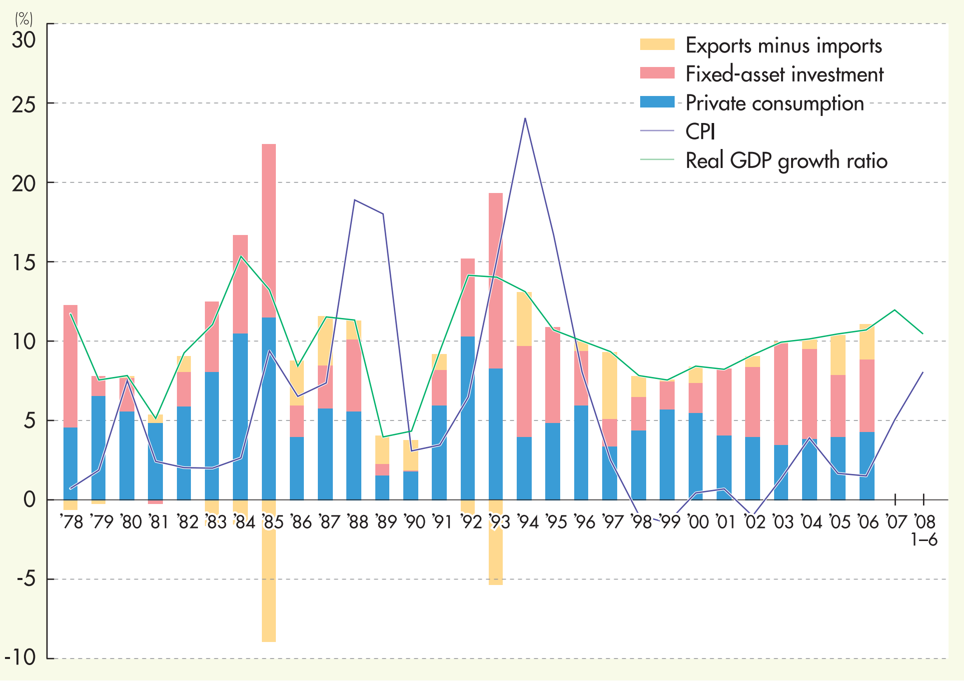
In most countries, rapid economic development stimulates household consumption positively and actively, but not in China. Chinese households seem very hesitant to consume, preferring instead to save money for future security. Over the past two decades, the Chinese household consumption ratio against income declined 10 percentage points from 88% to 78%, a development not likely to occur in other countries.

Due to the negative attitude towards consumption, domestic demand is still very weak, and could not support the robust 10% annual economic growth. As a result, the Chinese economy has to depend on investment and exports. So it is difficult to consider that the CPI could rise continuously for a long time. During the past 12 months, the CPI uptrend accelerated to 8% partly due to the rise in oil and food prices. Since July this year, oil prices started to decline partly because of the US recession, and food production in China increased in the second and third quarters of this year. According to the State Statistics Bureau's announcement, the pace of rise in the CPI slowed to 4.9% in August 2008 *(Chart 2)*.

However, this could be bad news for China. As is common knowledge, slower growth in the CPI could weaken manufacturing compa-

CHART 3

Investment contributes to GDP more than consumption



Source: Chinese State Statistic Bureau

nies' competitiveness; especially most SMEs will suffer because of weak demand. Again, manufacturing companies are facing a very high-cost market and very weak demand. I visited several department stores and supermarkets in China to find that most industrial products are still under deflationary pressure. Even the motor vehicle market is now in a deflationary spiral because of strong competitive pressure not only domestically but also from abroad.

Actually, the Chinese economy is at a critical turning stage towards a market-oriented economy. It seems the government still doesn't know what kind of role it needs to play. Not only the State Council but also PBoC seem to easily interfere in the market and corporate management directly. The government function needs to be changed to be more market-oriented. Government officials are not controllers or managers of the market, but rather only participants in market activities as players.

3. Post-Olympics Growth & New Strategy for Japanese Companies

Personally I don't predict that Chinese economic growth will slow down to under 8% in the coming years. Otherwise the State Council will have made a serious mistake about policymaking. We don't need to be concerned about potential demand domestically. We only need to worry about policy decisions because of the lack of transparency.

There are some arguments about Chinese post-Olympics economic growth. Some economists show us a positive vision in which the Chinese economy would sustain rapid development after the Olympics, while others seem a little negative about the macroeconomic picture.

Recently I conducted a survey to observe the driving forces behind the Chinese economy over the past six months. First of all, we can check the basic economic development model in the past three decades *(Chart 3)*. We could find that investment and exports contributed to GDP growth more than expected. From such a macroeconomic structure, I found there are good news and bad news for Chinese economic development in the coming years. The good news is potential demand is still very strong; the bad news is China will face some structural problems. First, infrastructure investment could be continued for another two or three years. Second, Chinese exports to the United States have declined, but this could be covered in part by exports to the EU and Asian countries. Third, policymakers have recognized the necessity to change the policy to relax macroeconomic control selectively.

Here I also want to point out uncertainties surrounding the Chinese economy. The asset markets including the stock and property markets have switched into an adjustment stage, and if China fails to rebuild confidence, the asset markets will not rebound in the coming years. In this case, commercial banks, especially state-owned ones, would hold a glut of nonperforming loans. That could mean a credit crunch hitting China. It is difficult to think that this would only impact the Chinese economy; it would influence the regional economy definitely and absolutely.

Finally, let us take a look at Japanese direct investment in China. Major companies need to do more to localize business in China, and to strengthen sales strategies. Meanwhile, they need to reallocate their resources in China. On the other hand, for most SMEs, market competition will be increasingly difficult because competitors from South Korea, the United States, the EU and other Asian countries will present a significant challenge to Japanese companies, especially SMEs. It is said there are 70,000 SMEs from Taiwan and Hong Kong in Guangdong Province, but now 5,000 of them are planning to leave China for Vietnam or India. So the investment environment in China could not be expected to turn for the better. Although the Chinese GDP will increase in the coming years, that doesn't mean every investor can secure a big share. The key point here is to do market research first, and then rebuild and rearrange investment strategy. JS

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