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ASIA ECONOMY

China's challenges amidst stunning transformation

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Vehicles move slowly on a highway covered with ice and snow in central China's Hubei Province, Feb. 18, 2014. Many parts of Hubei witnessed heavy snow from Monday evening through Tuesday. Photo: Xinhua

China faces challenges amidst a stunning transformation and in a large economy, changing the trajectory of growth after a period of blistering expansion, would never be easy.

There are the bears and the optimists and if annual growth was to dip below 7%, it wouldn't be a disaster but it would set off a market horde stampede - - for a week or two.

Jim Rogers, the American investor who co-founded the Quantum Fund with George Soros in 1970, lives in Singapore and in an interview with 'Business Insider' published this week, said:

> "Few seem to understand the historical significance of what is happening there. E.g. Gordon Chang has been writing books and articles since 2001 predicting the collapse of China and the disappearance of the Communist Party. Jim Chanos has been predicting the collapse of China since 2009 saying it will be '1000 times worse than Dubai'. [I explained at the time that showed no understanding of Dubai or of China.] Many in China do not fully understand either.
>
> As the US was rising to its power and glory during the 19th Century, we had a horrible civil war, 15 depressions [Yes, with a D.], few human rights, little rule of law, periodic massacres in the streets, etc., etc. yet we still became the most successful country in the 20th Century.

> China will have plenty of setbacks along the way as does every country, company, family, and individual that rises."

The IMF has estimated China's public debt at 45% of GDP (gross domestic product) in 2012 while the "credit gap," or the rise in private sector credit as a proportion of economic output over the most recent five-year period, has risen since 2008 **by a stunning 71 percentage points, taking total debt to about 230% of GDP.**

Quarterly data released in January showed that China's foreign exchange reserves rose by a massive US$323bn for the H2 2013 six-month period. That compares to relatively modest growth of $185bn in the first half of 2013, and $130bn for 2012. China's foreign exchange reserves ended the year at a record $3.82tn.

Hong Kong's 'South China Morning Post' reported that Daiwa Capital Markets' Kevin Lai delved into the latest data and concluded that the surge in foreign exchange reserves might be an indication of tight credit conditions and the growing desperation of mainland Chinese companies to source external funding.

Lai estimates that about US$256bn of the foreign exchange reserves growth is "unexplained" or cannot be accounted for in terms of China's trade surplus, foreign direct investment (FDI) inflows, or other line items.

I was in the Pearl River Delta industrial heartland province of Guangdong last week and the evidence of the development in the past two decades has been spectacular.

Today HSBC, the banking giant, reports that non-Japan Asia's wealth is set to eclipse that of the US by next year.

The bank's economists led by Frederic Neumann looked at countries' total financial assets, not the net worth of households.

And "not everyone in Asia is revelling in new-found wealth," HSBC says.

The region's financial assets were a quarter of those of the US in 2000.

Wages and struggling

Young middle class couples struggle (often with single children having to also support their parents) as they do in most countries while the minimum wage despite rises in recent years, does not afford a very modern standard of living.

Food isn't cheap and in the port city of Jiangmen, the per head lunch-time price in a moderate-style restaurant in a factory area, was ¥90 yuan (US$15).

A 3-bed 1,250 sqft apartment in Huadu, a satellite town near Guangzhou's international airport, would cost ¥1.5m while a Grande Americano in the local Starbucks is priced at ¥25 ($4) compared with $2.40 in Kuala Lumpur.

Basic monthly wages for factory workers in eight major Chinese cities range from $281 to $466, while those for the Cambodian capital of Phnom Penh are only $74, according to Japan External Trade Organization (Jetro) data for 2013.

According to the Nikkei Asia Review, Shenzhen, a major Guangdong city where many Japanese companies operate factories, raised the minimum monthly wage for factory workers by 13% in February, to ¥1,808 ($298), the highest in China, up from ¥610 in 2004. The minimum monthly wage in Guangzhou was raised by 19% in May 2013 to ¥1,550, three times the level of 10 years ago.

China's working-age population continued to fall in 2013, suggesting that labour shortages would further drive up wages in the years to come.

The working-age population - - those between the ages of 16 and 59 -- was 920m in 2013, down 2.4m from a year earlier and accounting for 67.6% of the total population, the National Bureau of Statistics said last month. The country's workforce fell in 2012 for the first time in decades, raising concerns about a shrinking labour force and economic growth prospects.

Among the reforms planned by China's new leadership is a revamp of the 'houkou' residence permit system that dates from the 1950s.

In Guangzhou last week a young executive who is a native of the city said he was against reform as allowing rural migrants to have residency for their families would clog the school and health services. Meanwhile a colleague who has health insurance with a rural houkou top-up charge paid by her company, could only afford to move to another job if the same rare benefit was available.

Rebalancing from investment

On Tuesday night in the UK, **Robert Peston, BBC business editor**, presented a programme, 'How China Fooled the World.' He said that the economic slowdown evident in China, coupled with recent manifestations of tension in its financial markets, can be seen as the third wave of the global financial crisis which began in 2007-08 (the first wave was the Wall Street and City debacle of 2007-08; the second was the Eurozone crisis).

China launched a massive ¥4tn stimulus program in 2009 in response to the global financial crisis, that at then dollar exchange rates was valued at $487bn - - Investment surged to an unprecedented 50% of GDP, where it has more or less stayed.

Peston says the analyst **Charlene Chu, late of Fitch,** gave a resonant synoptic description of this credit binge:

"Most people are aware we've had a credit boom in China but they don't know the scale. At the beginning of all of this in 2008, the Chinese banking sector was roughly $10tn in size. Right now it's in the order of $24 to $25tn.

"That incremental increase of $14 to $15tn is the equivalent of the entire size of the US commercial banking sector, which took more than a century to build. So that means China will have replicated the entire US system in the span of half a decade."

Meanwhile, **Charles Liu, a prominent Chinese investor**, explained to Peston how far China's growth rate is likely to fall from the current 7-8%: "I think China could do very well if the quality of the growth is transformed to higher value add." He said. "You're really looking at 4% is fine."

However, Robert Peston notes that as yet the reforms are at a very early stage of implementation, and the lending boom goes on. **What is more, the current building splurge so enriches many thousands of communist officials, from a system of institutionalised kickbacks, that there are concerns about the ability of the central government to force the changes through.**

Also, the social and political consequences of Charles Liu's 4% growth could be profound: it is unclear whether that is a fast enough rate to satisfy the people's hunger for jobs and higher living standards, whether it is fast enough to prevent widespread protest and unrest.

And what if the lending and investing bonanza can't be staunched? Then we would be looking at the kind of crash that would shake not just China, but the globe.

> "It boosted our living standards, by selling us all those material things we simply had to have, cheaper and cheaper. But its exporters killed many of our manufacturers. And the financial surpluses it generated translated into our dangerous deficits, the secular and risky rise of indebtedness in much of the West.
>
> Also its appetite has led to huge increases in the price we all pay for food, for energy, for commodities. What's more, China's influence in Asia and Africa has profoundly shifted the global balance of power.
>
> So would an economically weakened China be good for us in the West? Well, it wouldn't necessarily be all bad.
>
> But a China suddenly incapable of providing the rising living standards its people now see as their destiny would be less confident, less stable, and - - perhaps for the world - - more dangerous."

An example of the flexibility China has to reduce capacity in an industry was provided last December.

China announced that it would force a drastic shakeout of the solar cell industry by mandating that official support such as credit would only be available to 134 of an estimated 500 firms - - in a clear signal of official intent to address overcapacity in several industry sectors (public subsidies for listed companies rose by 23% in 2012). Since 2000, total solar/ photovoltaics (PV) production has increased by almost two orders of magnitude, and over the last decade the CAGR (compound annual growth rate) has been about 55 %, which makes photovoltaics one of the fastest growing industries at present, according to the European Commission's 'PV Status Report 2013.' The most rapid growth in annual production over the last five years was observed in Asia, where China and Taiwan together now account for more than 70% of worldwide production. China accounts for over 80% of the European Union market and annual exports of over €20bn.

US academics Usha C.V. Haley and George T. Haley wrote last year that since 2008, through government subsidies, the manufacturing capacity of China's solar-panel industry grew tenfold, leading to a vast global oversupply. A surge in exports of Chinese panels depressed world prices by 75%. In 2012, China's top six solar companies had debt ratios of over 80%. "Our research showed that without subsidies, these companies would be bankrupt. If the Chinese government sticks to its decision to stop funding unprofitable solar-panel manufacturers and support a revamping of the industry, more bankruptcies and restructurings are sure to follow."

The researchers say that in the industries they studied — solar, steel, glass, paper, and auto parts — labour was between 2% and 7% of production costs, and imported raw materials and energy accounted for most costs. **Production mostly came from small companies that possessed no scale economies**. Yet, Chinese products routinely sold for 25% to 30% less than those from the US or European Union.

Even though its highly fragmented industry has no scale economies or technological edge, Chinese steel sells for 25% less than US and European steel. Similarly, $33bn in subsidies from 2002 to 2009 helped China triple paper production and overtake the US. to become the world's largest paper producer. This is despite the fact that its industry has no scale economies, is geographically fragmented, and the country has one of the smallest amounts of forest in the world per capita.

The authors warned: "Some have argued that Chinese subsidies help consumers by keeping prices low. Our research leads us to conclude that like other monopolies, Chinese companies will raise prices as international competition retreats."

A Bloomberg China debate:

Michael Pettis of Peking University and Eswar Prasad of Cornell University debate the future of China's economy. Pettis argues that reforms will push growth down rather than up. Prasad argues that by releasing productive potential, policy shifts can maintain growth near the current levels.

Michael Pettis's Main Arguments:

- China's growth has been artificially supported by excess credit and investment.
- Unwinding the excesses will push the growth rate down.
- Expect growth to fall by 1 percentage point to 2 percentage points every year for the rest of the decade.

Eswar Prasad's Main Arguments:

- Risks are real, but China's leaders have shown commitment to reforms required to sustain growth.
- With proper implementation of these reforms, growth can be maintained around 6 to 7%.
- Low government debt and vast hoard of FX reserves reduce the chance of financial crisis.

Bloomberg Brief on the debate [pdf]

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