Changes in China's economic equilibrium

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Natural Resources

China's economic equilibrium is changing along two dimensions. First, all the growth engines have been changing. It is no longer production and exports of goods with a high labor content, but rather "urbanization", construction of cities, infrastructure, transport and energy. We seek to determine the effects on the rest of the world of this change in China's growth model.

Second, there has been a marked change in China's monetary and foreign exchange policy in the recent period. The Chinese authorities probably no longer accept the considerable liquidity creation caused by the massive capital inflows to China, and seek to eliminate these capital inflows by generating currency risk; this also has potentially significant impacts on the global financial equilibrium. The traditional Chinese growth model in running out of steam: it was traditionally production and exports, costs were high in labor content, and which therefore benefited the rich countries, which benefited from low wages. Costs from 2003 to 2011, with the acceleration of the global financial equilibrium, the Lehman bankruptcy in 2008, the Chinese industrial production increased by 15 to 20 percent per year, and Chinese exports by 20 percent.

Things changed dramatically from 2012: growth in industrial production declined, and is now close to potential, but light industry out, including consumer goods, household capital goods and electronics, has been increased by only 3 percent per year. With regard to exports, if we smooth the short-term fluctuations, we see a very small increase since the start of 2012 between 0 and 5 percent per year, with a dramatic decline in exports in early 2014.

There is no longer export-oriented industrial production that drives Chinese growth, and this is particularly due to the very rapid rise in production costs in China. From 2002 to 2013, the unit labor cost increased by 6 to 8 percent per year, whereas Chinese production costs for the industrial sector as a whole to 80 percent of the U.S. level. In certain industries, such as automobiles, pro-

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Recently the global investor community seems to be disturbed about the future of the Chinese economy, which may be strongly linked to that of the Asian economy. There has been news about a series of defaults, a real estate bubble, shadow banking and other risks as those in the most advanced economies, not unlike what Japan enjoyed in home appliances, electronic products: the import content of these goods is low. From 2003 to 2011, with the acceleration of the global financial equilibrium, the Lehman bankruptcy in 2008, the Chinese industrial production increased by 15 to 20 percent per year, and Chinese exports by 20 percent.

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The Chinese economy is a safe haven for domestic financial institutions and even a tax base for public expenditure. Such a boom, which was founded on the economic fundamental end, does not mean that the Asian economy may maintain its level of high growth in the near future when the potential economic growth rate may be hit by the monetary tightening of the U.S. or new forms of production technology with lower labor but higher sophistication.

In other words, financial stability in Asia was due to the depression or even in the real estate boom, which may either disappear or be less prominent in the future. There is also the possibility of some long-term transformational issues if the technological competitiveness disappears, or if the Chinese economy as a whole cannot create its own competitive edge signal of or surpassing other advanced economies, not unlike what Japan enjoyed in home appliances, communications and automobiles. Clearly, the Asian economy, including China and even Korea, may be facing major challenges in the future in terms of the own market leadership through innovation or creativity.

GLOBAL ECONOMY

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The new Chinese leadership, which came into office a year ago, is familiar with the extent of the problem of serving the growth of bank and non-bank financing. The IMF, in its latest report on the Chinese economy, also focused on the attention to credit growth and to the property sector. These vulnerabilities are a continuing source of concern. Will policymakers be able to monitor and correct the imbalances? In particular, the IMF warned about the growth of “shadow banking”, a sector in which conventional risk management practices are not observed.

The magnitude of the problem is hard to overestimate. Over the last five years, credit to the private sector has grown at a rate twice as fast as GDP. The recipients of credit have not been the most deserving or most efficient firms. In fact, a considerable part of new credit flows have funded physical assets, especially real estate, whose prices have increased considerably in recent years and continue to rise, especially in the large cities. Last June, Chinese authorities reacted to credit expansion by raising interest rates. Recently, many financial institutions, they let a corporate bond issuer default, in a sort of warning to investors and lenders that the government intends to use market oriented procedures to resolve any episodes of distress. The concern in this regard can be significant when you consider that Chinese institutions are not as suited to deal with liquidation or restructuring process as are those in the most advanced economies. The discretionary nature of China’s decisions on corporate bankruptcy does not contribute to a reduction in uncertainty.

The biggest concern, however, is not that major bankruptcies might take place but rather what the impact of the credit slowdown might be on economic growth. A rapid deleveraging of the private sector can generate excess capacity in many companies, and limit global growth.

Some clear signs of these are visible in the decline in prices for some raw materials for which China is the main buyer, such as copper or iron ore. One example is the decline in the raw material prices to decide the yuan’s fluctuation band, and its recent depreciation.

The Chinese authorities will likely contain or avoid a repetition of the U.S. or European financial crises, but will find it hard to manage a sudden slowdown in economic activity to a rise of 6 percent or less. That is the level that would trigger the alarm for both the Chinese and the global economies. The official goal of 7.5 percent growth for this year now seems beyond reach, unless the financial imbalances are corrected soon.

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