Insights

Taking seriously China’s risks

A stopped clock is right twice a day. But it is of no use in telling the time. This is worth bearing in mind when looking at the Chinese economy this year. For much of the last decade there have been some who have predicted imminent doom and gloom for China. Like a stopped clock they have said the same thing for some time.

Meanwhile China has continued to go from strength to strength. Its economy has soared. Its influence grown. Asia has benefited.

The question that needs to be asked is whether this is the year that problems in China emerge. Is now the time when the stopped clock is right?

China’s risks are different from those in the West, where debt problems persist. Across Asia, inflationary pressures are rising and policy needs to be tightened.

The challenge for China is that in recent years it has tied itself too closely to US monetary policy. In doing so, it has kept interest rates lower than necessary and its currency weak. Resolving these issues is vital and is now underway.

The US and China both need to set monetary and fiscal policies to suit their domestic needs. The US is doing this. Last year’s second round of quantitative easing, or QE2, was justified, despite the criticism it received outside America. Facing deflation, the Fed needed to do more. The government has followed with a huge fiscal boost over the new year. The net effect is the US economy will grow strongly this year, particularly in the first half.

Although the stimulus has reignited fears about US government debt, the reality is the US had no choice. A staggering 43 million Americans now receive food stamps, a clear indication of the scale of poverty. Chances are, US policy will work in terms of ensuring growth, if not in solving all the country’s problems.

All of this highlights the need for Asian policymakers to follow the US. Not by copying US policy but by setting monetary policy to suit their own domestic needs. The challenge is especially daunting for China.

The longer it takes China to tighten policy, the greater its eventual problem! Last year saw the authorities impose a loan quota. But concerns about growth prevented them from tightening enough. This year there is no reason to hold back as growth looks set to be strong, boosted by the twelfth five-year plan.

Although China’s policy tools worked well during the global crisis there are now risks.

First, the growing size of the economy and of the private sector makes it harder to control the economy from Beijing.
Second, there is a need to rebalance the economy away from investment, towards consumption. Whilst investment always sounds good, it is now so high in relation to GDP not all of it may be worthwhile.

Third, China’s vulnerability arises from its under-developed financial sector. Thus, as income rises, there are limited options for household savings: into low interest-bearing bank accounts; into equities, where governance concerns persist; or into real estate, where prices are already sky-high in many cities. This makes the economy prone to bubbles. China needs to avoid the lethal combination of cheap money, one-way expectations and leverage. A few years ago the talk in the US was about the "Greenspan put": that interest rates were kept low to support the equity market? China can't fall into the same trap with property. All this raises the risk of a near-term set-back in China. Rising food prices and wages add to the sense of urgency. Either the authorities don't address problems sufficiently, delaying the day of reckoning. Or, more likely, they tighten policy sharply. This tightening will entail further loan quotas, rising reserve ratios, sharply higher interest rates, property taxes in some regions, and possibly steeper currency appreciation than the market expects. The authorities would not want to derail the economy. But if there was any set-back where growth suffered it would have global ramifications, hitting commodities and trade, amongst others. Of course, if there was a growth set-back, the stopped clockers would say they were right, and there would probably be much speculation about China's growth being a bubble. That would be wrong.

Instead, any slowdown in growth would probably be temporary. It would show the business cycle exists in China, and that, whilst the economic trend is up, there will be set-backs along the way. These would provide a buying opportunity and not a reason to doubt the economy's rise. China's growth is for real. It is not a bubble economy but it is an economy prone to bubbles. There is a big difference.

In recent years the markets have discounted the bad news in the US and finally taken seriously the flaws in the eurozone. The near-term risks facing China, like many countries across Asia, need to be taken seriously.

Yet they also need to be kept in context, as they are unlikely to alter the longer-term positive outlook for growth. In our view, the world economy is in a super-cycle: a sustained period of high economic growth, lasting a generation or more. The global economy is twice the size it was a decade ago and is already above its pre-recession peak.

A central feature of this super-cycle is the shift in the balance of economic and financial power, from the West to the East, led by China.

This was highlighted at the recent Obama-Hu summit in Washington. Soon after becoming president, Obama changed the relationship with China. Under his predecessor, President Bush, the US had a strategic economic dialogue with China. Obama turned it into a strategic “and” economic dialogue. This was significant. It emphasised the twin aspects of the relationship. Yet, as the US recovery has disappointed, there has been less of the strategic and more focus on the economic dimension of the relationship. Although the US is the far larger economy, the relationship increasingly resembles one of equals. In modern times, the economic importance of China to the world economy has never been greater. It is vital for the world, for Asia, as well as for China that it addresses its inflation challenges now. This is no time to wait.

Gerard Lyons, Chief Economist and Global Head of Research
Published in the Gulf News in the UAE on 25th January 2011
Disclosure Appendix

Global Disclaimer:

This document is not research material and it has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. This document does not represent the views of Standard Chartered Bank, particularly those of the Global Research function.

Banking activities may be carried out internationally by different SCB branches, subsidiaries and affiliates (collectively “SCB”) according to local regulatory requirements. With respect to any jurisdiction in which there is a SCB entity, this document is distributed in such jurisdiction by, and is attributable to, such local SCB entity. Recipients in any jurisdiction should contact the local SCB entity in relation to any matters arising from, or in connection with, this document. Not all products and services are provided by all SCB entities.

This document is being distributed for general information only and it does not constitute an offer, recommendation, solicitation to enter into any transaction or adopt any hedging, trading or investment strategy, in relation to any securities or other financial instruments. This document is for general evaluation only, it does not take into account the specific investment objectives, financial situation, particular needs of any particular person or class of persons and it has not been prepared for any particular person or class of persons.

Opinions, projections and estimates are solely those of SCB at the date of this document and subject to change without notice. Past performance is not indicative of future results and no representation or warranty is made regarding future performance. Any forecast contained herein as to likely future movements in rates or prices or likely future events or occurrences constitutes an opinion only and is not indicative of actual future movements in rates or prices or actual future events or occurrences (as the case may be).

This document has not and will not be registered as a prospectus in any jurisdiction and it is not authorised by any regulatory authority under any regulations.

SCB makes no representation or warranty of any kind, express, implied or statutory regarding, but not limited to, the accuracy of this document or the completeness of any information contained or referred to on the document. This document is distributed on the express understanding that, whilst the information in it is believed to be reliable, it has not been independently verified by us. SCB accepts no liability and will not be liable for any loss or damage arising directly or indirectly (including special, incidental or consequential loss or damage) from your use of this document, howsoever arising, and including any loss, damage or expense arising from, but not limited to, any defect, error, imperfection, fault, mistake or inaccuracy with this document, its contents or associated services, or due to any unavailability of the document or any part thereof or any contents.

SCB, and/or a connected company, may at any time, to the extent permitted by applicable law and/or regulation, be long or short any securities, currencies or financial instruments referred to on this document or have a material interest in any such securities or related investment, or may be the only market maker in relation to such investments, or provide, or have provided advice, investment banking or other services, to issuers of such investments. Accordingly, SCB, its affiliates and/or subsidiaries may have a conflict of interest that could affect the objectivity of this document.

This document must not be forwarded or otherwise made available to any other person without the express written consent of SCB.

Copyright: Standard Chartered Bank 2010. Copyright in all materials, text, articles and information contained herein is the property of, and may only be reproduced with permission of an authorised signatory of, Standard Chartered Bank. Copyright in materials created by third parties and the rights under copyright of such parties are hereby acknowledged. Copyright in all other materials not belonging to third parties and copyright in these materials as a compilation vests and shall remain at all times copyright of Standard Chartered Bank and should not be reproduced or used except for business purposes on behalf of Standard Chartered Bank or save with the express prior written consent of an authorised signatory of Standard Chartered Bank. All rights reserved. © Standard Chartered Bank 2010.

THIS IS NOT A RESEARCH REPORT AND HAS NOT BEEN PRODUCED BY A RESEARCH UNIT