China's Lesson for The World

BY YONGHAO PU

Beijing's take on combating deflationary woes.

There has been a notable increase in concerns about global deflation. A recent economic report from the International Monetary Fund suggests that Germany is likely to join Japan in the falling-price club, which includes Hong Kong, China, and other Asian economies. Now even the U.S. Fed has been keeping interest rates at a historically low level to avoid declining prices. However, what the IMF and many economists fail to notice is that China is already on the verge of being out of the deflation quagmire.

China has experienced a continuously falling consumer price index (CPI) since early 1998, except for a brief recovery in 2001 due to an adjustment that included more service components in the index. The retail price index (RPI), which did not suffer from any measurement inconsistency, was firmly in the negative territory in the past five years prior to 2003. However, the deflation started to ease from April 2002 onwards,

Yonghao Pu was a senior economist at Nomura International, and a consultant for the Asian Development Bank. The article only reflects the author's personal view.

THE INTERNATIONAL ECONOMY

THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY

888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

and both the CPI and RPI have eventually moved back to the positive region this year. The CPI recorded a 0.6 percent increase in the first half of 2003,

The impact of an undervalued renminbi has been blown out of proportion.

while the producer price index rose by 2.9 percent in the same period. Given a sluggish Asian and European economic environment, it is still too early to conclude that China has completely shrugged off the problem. Nevertheless, the country is moving in the right direction, even encountering overheating in some sectors, such as real estate.

It is widely believed that there were two causes for China's falling prices: rising productivity and an exchange rate pegged to the U.S. dollar. Policymakers and economists concluded that, because of these, China boosted its competitiveness and exported deflation, and thus should revalue the renminbi. Since both causes firmly remain, China's deflation should stay. Facts tell otherwise. The country is delivering remarkable economic performance and deflation is receding.

China is already on the verge of being out of the deflation quagmire.

A simplistic view may argue that China's strong economic growth is mainly driven by fiscal stimulus spending, and buoyant exports are tied to an artificially weak exchange rate. Deflation, therefore, may return to haunt the economy once the government runs out of fiscal ammunition, external demand dries out, and the value of the U.S. dollar rebounds.

Both lines of arguments are flawed. The impact of China's expansionary fiscal policy peaked in 1998–2000, and has been diminishing since. For example, the government has been issuing RMB 150 billion worth of special bonds every year since 1998 to support the economy. Because the amount of special bond issuance was constant each year until 2003, the stimulus effects on growth died down after the first year. Second, the fiscal deficit as a proportion of GDP jumped from 0.7 percent in 1997 to 2.8 percent in 2000, but moderated considerably in 2001, and only edged up to 2.9 percent in 2002. Admittedly, this year's deficit is expected to marginally overshoot 2.8 percent of GDP, the budgeted shortfall, due to the unexpected SARS epidemic.

It is puzzling that, in the case of the sharp weakening of the dollar-pegged renminbi in late 2002, the demand for overseas goods surged ahead.

Recently, there have been urgent calls from the United States and Japan for China to share global economic responsibility by revaluing the renminbi. In my view, the impact of an undervalued renminbi has been blown out of proportion. In fact, the renminbi's trade-weighted real exchange rate only weakened about 5 percent over the year up to April 2003, in contrast to a nearly 20 percent depreciation of the greenback itself against the euro in the same period. China's gain in competitiveness through the renminbi pegged to a weakened dollar has been undercut by a sharp recovery in producer prices, which rose over 7 percent in the same period.

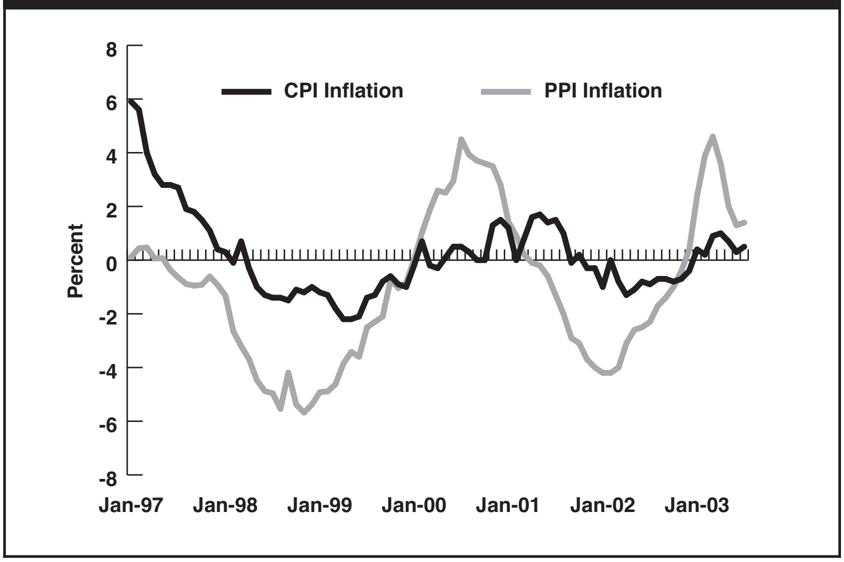
The central bank has also been trying to prevent bank loans being used to illegally enter the stock markets.

China's current account surplus peaked at 3.3 percent of GDP in 1997 and has stayed below 3 percent thereafter. In other words, China's double-digit export growth in recent years has been consistently matched by similar import growth. Theory says that if a currency is undervalued, exports are boosted while imports are dampened. However, it is puzzling that, in the case of the sharp weakening of the dollar-pegged renminbi in late 2002, the demand for overseas goods surged ahead—following a 21 percent increase last year, demand rose 42.9 percent in the first seven months this year and the trade balance registered a modest surplus of $6 billion, less than 1 percent of GDP on an annualized basis.

People may attribute the rapid growth of imports to the rise of commodity prices, such as oil. Indeed, China's spending on crude oil imports rose 66 percent in the first seven months of this year from a year earlier. However, nearly half of the increase was due to a rise in volume. After all, oil imports account for only 5 percent of total overseas purchases in the first seven months of this year, against about 27.2 percent for machinery, computer, and telecom equipment imports, which were little affected by the changes in oil prices, but still recorded a 48 percent year-on-year increase in the same period. Steel sheet and plate imports, also little affected by the oil price increase, rose 65 percent in volume terms in the same period. An undervalued renminbi does not seem to have dampened the country's imports.

So how did China successfully halt the falling prices without using common prescriptions such as debasing its currency? Conventional wisdom has taught us to look at financial policy first, since deflation is primarily a monetary symptom. The central bank has made six consecutive cuts in interest rates since 1997. But cutting interest rates and increasing the money supply alone would not do the trick. Economists were puzzled how in China in the past years, the growth of savings has been accelerating

CHINA DEFLATION



and prices have continued to fall, and as interest rates were reduced, money supply and loans remained at double-digit growth.

The explanation lies in the country's stock market, which was bullish from 1994 until the middle of 2001. Many state-owned enterprises (SOEs) took advantage of their access to bank credits, and instead of using these loans to expand production or upgrade technology, invested the funds in the stock market. Since the middle of 2001, China's securities watchdog has tightened regulatory policing through the so-called "squeeze the bubble, and conform to the standard," reinforcing the requirements in information disclosure, accounting practices, corporate governance, and so on. As a consequence, the price-to-earning ratio of Shanghai A shares dropped from over 60 in 2001 to around 40 at present. Meanwhile, the central bank has also been trying to prevent bank loans being used to illegally enter the stock markets. Subsequently, the fall of the stock markets prompted the flow of liquidity back to banks, and deposit growth accelerated and deflation persisted.

China's deflation stems more from the real economy—supply or demand side, or both, although it has also shown a monetary symptom. I believe that structural change—promoting private business and domestic demand—was a key reason for the country's success in curbing deflation, in contrast to Japan's nearly ten years of failed efforts which hardly addressed the structural faults. In the past six years, China bankrupted thousands of lossmaking SOEs and the state sector reduced its workforce by more than 30 million people. The short-term consequences were deflationary, and rising unemployment not only depressed consumption of the jobless but also increased the sense of insecurity of those employed and drove their income into banks.

Many state-owned enterprises took advantage of their access to bank credits, and instead of using these loans to expand production or upgrade technology, invested the funds in the stock market.

Structural change—promoting private business and domestic demand—was a key reason for China's success in curbing deflation, in contrast to Japan's nearly ten years of failed efforts.

However, in the long term these changes injected new life into the economy. Slashing overcapacity eventually helped to halt the decline in prices and restore corporate profit, and withdrawing subsidies to lossmaking SOEs and liberalizing the market made room for profitable private business. Employment in the private sector has more than doubled since 1997. In one aspect, credit has to be given to some SOEs which reinvested their bank loans into private firms after the stock market collapsed, and this contributed to growth of the private sector. Since China joined the World Trade Organization (WTO), the process of market opening has speeded up, but private firms still have little success (albeit gradually improving) in accessing state funds, and must rely on underground financing channels with borrowing interest rates as high 20 percent or more. Fortunately, rising unemployment kept firms' labor costs low, while falling prices forced them to improve productivity relentlessly in order to maintain their profit margins. Since China's WTO accession in the end of 2001 and last October's Communist Party congress, the government has accelerated reform and announced a series

The Chinese government should consider taking advantage of the increasing capital inflow and surging currency reserves to import technology and update capital equipment, and to accelerate banking reform, instead of mainly investing in U.S. Treasury bills.

of new policies aimed at creating a level playing field. Investments made by the non-state sector rose 16 percent in 2002 and 24.3 percent in the first half of this year, in contrast to 6 percent average annual growth registered in 1997–2001. Liberalizing the domestic market also attracted foreign direct investment, which recorded a high 34.3 percent increase in the first six months, against an average of 3.1 percent growth in 1998–2002.

On the demand side the government is pushing hard to create new consumption catalysts. Autos, housing, and information technology have attracted wide purchasing enthusiasm and have cushioned weakness in consumption caused by massive layoffs. Consumption loans rose at exponential rates—outstanding consumer loans rose 77 percent by the end of June 2003 from a year earlier, while auto sales registered a more than 70 percent year-on-year increase in the first seven months of this year. Demand boom also fueled overheating in the property and auto sectors, prompting authorities to put in place some measures to cool down property development. Recently, China's central bank increased the reserve requirements for banks in order to rein in their lending.

The economic restructuring also paved the way for the recovery of corporate profit, which in turn allowed more firms to expand their businesses or invest in new ventures. Corporate profit had been falling or grew sluggishly at best since 1997, except in 2000 when oil prices increased and large SOEs' interest payments were reduced after a debt worth 10 percent of GDP was shifted off their balance sheets. In the second half of 2002, the manufacturing sector turned around and, in the first half of this year, the sector posted 30 percent profit growth, and 56.7 percent growth in the first half of this year. Strong investment and infrastructure demand and big ticket sales have also helped to reverse the fortunes of many SOEs, which are mostly engaged in heavy industry such as coal, steel, autos, petrochemicals, and utilities. SOEs, which accounted for 47 percent of manufacturing profit in 2002, also posted a sharp profit rebound of 77 percent in the first half of this year after contractions in 2001 and 2002. The rise of investments in the state sector surged to 32.8 percent in the same period. Clearly, it was primarily structural changes which induced high investment growth and led to a new phase of economic growth and recovery in prices and hopefully a virtuous cycle afterwards.

Needless to say, a number of daunting issues, such as high rates of non-performing loans and unemployment, remain to be addressed in China, and the economy may now face some overheating in certain sectors. In addition, due to rising foreign direct investment and speculative hot money inflow, China's surging foreign exchange reserves are already causing external imbalances, and exerting pressure on the renminbi to appreciate. To alleviate such pressures, the Chinese government should consider taking advantage of the increasing capital inflow and surging currency reserve to import technology and update capital equipment, and to accelerate banking reform, instead of mainly investing in U.S. Treasury bills. Nevertheless, China's intriguing experience in combating deflation offers valuable lessons to Japan, and probably Germany, and many other countries. ◆