Walking a Fine Line

Beijing's policy shift to picking losers.

BY CHI LO

China's cyclical growth may still be too strong for the authorities' comfort. A tight policy bias will remain in the short term, especially with inflation risk still on the upside. But the country's structural growth quality may have started improving in subtle ways. The structural changes are driven by Beijing's "loser-picking" strategy, which is the opposite extreme to the "winner-picking" policy that the Asian economies used in the 1960s and 1970s for economic development. While the signs of China's growth improvement are still tentative, if the trend continues, it will help sustain China's long-term economic growth. However, growth and policy risks are mounting in the short term due to a larger-than-expected drag on growth from the export slowdown.

THE EXPORT DIVERSIFICATION ILLUSION

The bursting of the U.S. asset bubble and the subprime-induced global credit crunch are crimping demand for Chinese exports. The conventional wisdom is that China's push for market diversification in recent years will help reduce the impact of weaker demand from the developed markets. But the conventional wisdom is wrong because it ignores the spillover effect of exports on China's domestic investment and job growth.

In addition to weakening external demand, the strong RMB exchange rate against the U.S. dollar is also hurting China's export growth. Adjusted for RMB appreciation, China's export growth has in fact dropped to its slowest pace since 2001 (see chart). With more downside risks to China's key export markets (the United States, Europe, and Japan), but more upside risks to import costs and RMB appreciation for the rest of 2008, China's export growth will likely slow further. This will certainly drag on GDP growth as the share of net exports has risen to 8 percent of GDP from less than 2 percent in 2000. They have also been a significant contributor to GDP growth since 2005, accounting for about 30 percent of total GDP growth each year.

Despite China's diversification of export destinations, the U.S., European, and Japanese markets still account for half of China's total exports. Crucially, export diversification has been inflated because many Chinese exports to Asia are re-exported to the developed markets. Hong Kong is an extreme example, with over 80 percent of Chinese exports to the territory being re-exported to third markets in the United States, Europe, and Japan. Adjusting for Chinese re-exports through Hong Kong pushes up the share of Chinese exports to the developed markets by an estimated 11 percentage points (see chart).

Thus the United States, Europe, and Japan still absorb 62 percent of China's exports. The reason why China cannot shake off the influence of these developed markets is simple: The three are the world's largest consumers, accounting together for over 70 percent

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of global private consumption, and China has become the world's supplier of consumer goods.

THE DOMESTIC IMPACT

China's export growth has played a crucial role in absorbing its manufacturing excess capacity. From a different angle, robust export growth has propelled massive capacity expansion in recent years. Investment by the export-oriented manufacturing sector has outpaced the total urban investment growth by a wide margin since 2004, with the former rising by an annual average of 35 percent versus the latter's 26 percent. The share of manufacturing investment has also jumped to 31 percent of the total from only 12 percent in 2002.

There is also a second-round effect of exports on domestic investment and job growth which conventional analysis often overlooks. Some analysts argue that to assess the economic impact of exports, we should examine their value-added by stripping out the trade flow of processing exports. This is because the import components in the processing export trade do not contribute to economic growth. So they should be stripped out to calculate the net export revenue actually accrued to the domestic economy.

However, processing exports does affect domestic investment and job growth via investment in assembling plants, machinery, and logistic services, and hiring of local labor to assemble the imported inputs into end products before exporting them. An expansion in processing exports has also been an effective channel for technological upgrading, a key engine for productivity growth. Thus, cutting them out will lead to underestimation of the economic impact of exports on the domestic economy.

Rapid expansion in manufacturing capacity has also created spillover demand for energy, freight and transportation, and trade-related services, boosting investment in power generation, coal mining, highways, railways, ports, and real estate in industrial parks. These areas combined account for at least another 20 percent of total urban investment. This means that the manufacturing sector drives more than half of total urban investment.

On the job front, the manufacturing sector hires over 120 million workers, or about 40 percent of the total urban employment. However, among the rest of the 60 percent of jobs in the tertiary sector, almost two-thirds are casual, low-pay, temporary jobs. Manufacturing jobs are a significant income and spending growth driver because formal jobs are more secure than low-pay informal jobs.

MARKET IMPLICATIONS

China's integration into the global economy implies that the links between global demand and Chinese domestic investment and job growth are much tighter than before. Despite export diversification, the United States, Europe, and Japan are still the key markets for Chinese exports. A significant slowdown in their growth will have a bigger-than-expected impact on slowing China's growth.

Thus the Chinese export sector will be hit, especially the low-value-added labor-intensive segment, including toys, textiles, white goods, and shoes. Many small- and medium-sized Chinese exporters may fail in this external shock. Service providers, such as banks, transport and communications, information and technology, logistics, and property, in cities and provinces with large exposure to the export sector and a focus on low-end export products, will see a significant rise in risks to their operating environment.

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THE CYCLICAL CHALLENGE TO BEIJING'S POLICY

Although the expected export slowdown will have a negative impact on China's GDP growth, strong internal growth momentum will provide a crucial cushion against this external shock. Since 2005, when the government started tightening macroeconomic policy, investment growth has slowed from excessive levels of over 40 percent to more sustainable 20 percent levels, retail sales growth has sustained an average of 15 percent a year (supported by income growth, urbanization, and financial liberalization), and import growth has averaged 20 percent a year.

Meanwhile, loan demand has continued rising according to the People's Bank of China survey, despite tight administrative controls crimping the credit supply. So any easing of the credit controls could revive business activities swiftly. Finally, if the drag from the external sector proves to be too painful, the government's sharply improved fiscal position, from a deficit of over 3 percent of GDP a few years ago to a surplus of over 1 percent of GDP recently, will allow it to boost GDP growth by increasing fiscal spending.

In a nutshell, the robust internal growth momentum in the Chinese economy will provide a crucial support to GDP growth when external demand is slowing sharply. The risk of an economic slump in China is low. Meanwhile, rising inflation expectations on the back of rising wage growth and government subsidies to households to fight high energy and food costs sug-

gest that the risk of inflation remains on the upside. Under these circumstances, Beijing will keep its tight policy bias to preempt the inflation risk.

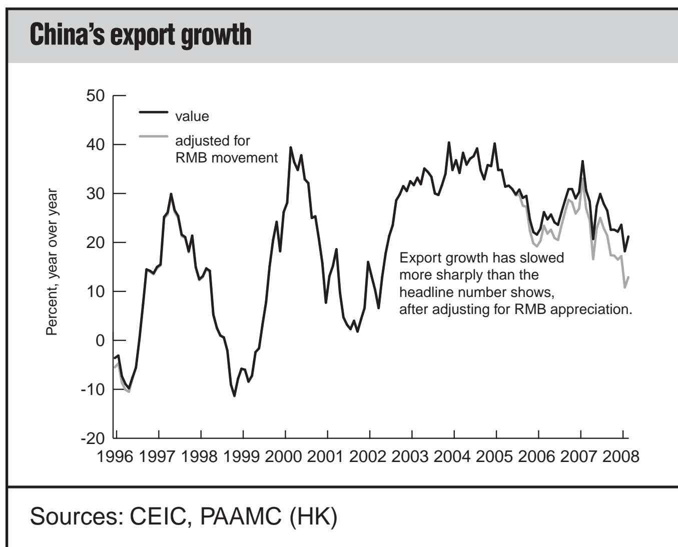
However, when the export slowdown bites and the domino effect starts to drag on the domestic sector, Beijing's macroeconomic policy focus may need to shift away from fighting inflation to protecting growth. In this case, the pressure on monetary tightening will ease and the pace of RMB appreciation will slow. If Beijing fails to respond in a timely way to this changing environment, its tight policy bias may result in policy overkill, inflicting damages in the economy and the markets.

THE STRUCTURAL "LOSER-PICKING" POLICY

China's structural outlook is more positive. In recent years, Beijing has been engineering a strategic policy shift from boosting growth quantity to improving growth quality. Arguably, its controlled and selective macro tightening measures since 2005 are part of the expenditure-switching initiatives. Beijing has never wanted to cut growth across the board. Instead, it has tried to pick "losers" (those sectors and industries that are deemed excessive and redundant) and eliminate them by selective administrative means.

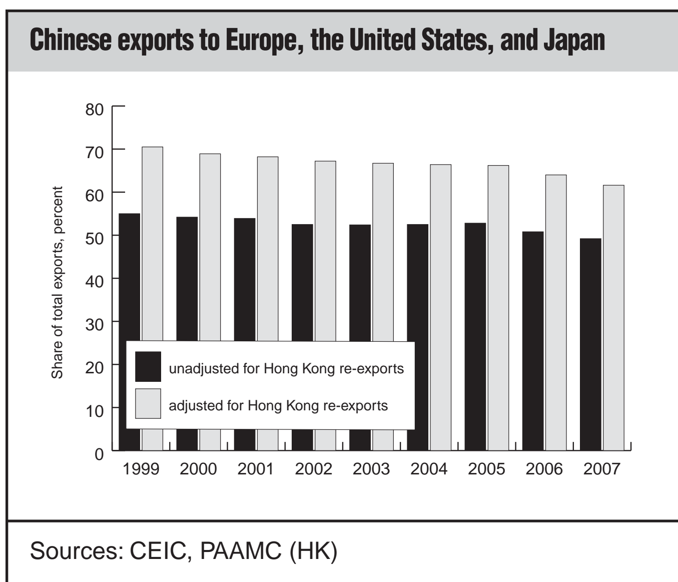
This "loser-picking" exercise is the exact opposite of the "winner-picking" policy that the Asian economies used in the 1960s and 1970s for economic development. Back then, industrialization began with the Asian governments picking industries and sectors which they favored. But China's growth has been driven by supply-side expansion from industries of all sorts since the 1990s, creating massive excess capacity across the board, from beer to cars and from white goods to metals, just to name a few. Thus, Beijing is trying to clean up its economic development strategy by shifting away from quantity growth to quality growth to sustain the country's long-term growth potential.

China's export growth



Sources: CEIC, PAAMC (HK)

Chinese exports to Europe, the United States, and Japan



Sources: CEIC, PAAMC (HK)

Some initial signs are showing that this expenditure-switching strategy might be starting to shift China's growth structure towards the right direction—less growth in exports and investment but more in consumption. To boost consumption, the authorities have been implementing policies to facilitate urbanization, improve the social safety net, increase labor mobility and protection, and shift income distribution towards the rural poor, though there is still a long way to go for these measures to reach their end goals. Meanwhile, measures have been put in place to cut export and investment growth.

The government's efforts to downsize and discourage export industries with excess capacity and significant environment damages have also shown some initial results. For example, output growth of steel and cement has plunged from over 20 percent a year to below 10 percent, while the export share of metals has fallen by over half since 2006. Finally, investment growth has been shifting from the rich eastern seaboard to the poorer central and western regions, reflecting the initial success of the government's investment re-shuffling strategy to boost the regional laggards.

To conclude, Beijing is walking a fine line between rebalancing growth and preventing too much economic damage during this structural shift. Rising inflation is complicating its efforts in the short term. However, strengthening consumption is providing a benign backdrop for the growth rebalancing efforts and a cushion against the economic attrition stemming from the structural changes. While it is too early to declare victory for Beijing's strategic policy shift, if the trend continues, it will help sustain China's long-term growth and provide a strong structural underpinning for Chinese asset values. ◆