China Risk Rising

A glass-is-half-empty scenario.

BY CHI LO

Things seem to be going too smoothly in China. Its stock market keeps going up and setting record highs, and its financial system complains about too much liquidity when the global markets are suffering from a liquidity crunch brought about the subprime crisis. Let's play devil's advocate and ask ourselves, what could go wrong in China that would end the bull run in the Chinese asset prices and wreak havoc the economy? When might these potential risks unfold and what are signs to watch out for?

External risk. The external risk to China is a sharp slowdown in external demand stemming from the U.S. subprime woes. China's exports are already vulnerable to slowing world demand growth even without the subprime crisis. The impact of China's self-imposed export restraint measures, like the cut in export tax rebates and the introduction of export tariffs and quotas for some products, will aggravate that vulnerability.

Since net export has been a major contributor to China's GDP growth in recent years, an export slowdown will hurt economic growth. However, there are offsetting forces from the domestic front limiting the negative trade impact on China's growth. First, the central government has room for fiscal expansion to boost economic growth, if needed. Beijing has been reducing its fiscal stimulus to the economy since 2002, when the fiscal deficit turned from 3 percent of GDP to a surplus of over 1 percent recently. With an improved fiscal balance, Beijing can afford to restore fiscal stimulus by raising spending, especially on much-needed social programs such as medical, pension, and education initiatives.

Second, domestic consumption growth has been steady, and it is going to continue to trend up due to Beijing's effort in boosting private consumption's contribution to GDP growth, rising income growth, accelerating urbanization, and

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improving social security coverage. Third, domestic capital spending will remain strong, and this will offset some of the negative impact of slowing exports on manufacturing capacity expansion. Fast income growth and urbanization will create demand for housing and, hence, property investment. The central and western regions of the country will continue to enjoy an investment boom under the central government's policy of equitable income distribution. Hence, a growth slump due to external factors is unlikely.

Domestic risk. A more serious risk stems from domestic policy. The authorities' efforts to cool investment and asset price growth have not been effective. Despite repeated interest rate and bank reserve requirement hikes and various administrative measures to curb lending and asset punting, the A-share market has moved further into a bubbly stage and property price growth has sped up again this year after a brief slowdown.

The undervalued renminbi is complicating Beijing's cooling policy effort by adding fuel to the domestic growth momentum. The renminbi's trade-weighted exchange rate has fallen, despite its bilateral appreciation against the U.S. dollar (Figure 1). Hence, Chinese exports to the United States have fallen, but to the rest of the world, especially Europe, they have continued to grow at 30 percent a year.

The authorities seem to have no conviction in determining the right monetary policy balance for achieving expenditure-switching (from export- and investment-led growth to consumption-led) and deflating the asset bubble. Ample liquidity, an undervalued exchange rate, and indecisive policy tightening will combine to increase the risk of a drastic policy shock later.

Policy indecision. The lack of a policy conviction for monetary tightening is reflected by ineffective measures. Despite repeated hikes, China's interest rate is still too low to be compatible with its high GDP growth rate. And despite its hawkish policy rhetoric, the People's Bank of China has scaled back its sterilization effort—the recent fall in the net issuance of central bank bills (issuance minus redemption on maturity) means that the People's Bank of China is not mopping up as much liquidity as it used to (Figure 2).

Meanwhile, the liquidity impact of the RMB200 billion special bonds issued (to fund the new China Investment Corporation) is limited, as they pale in comparison to the People's Bank of China's average RMB400 billion monthly notes sales since early this year. Lastly, despite repeated hikes in the bank reserve requirement ratio, banks are still holding, albeit less, excess reserves at the People's Bank of China. There is no liquidity crunch, as many have feared. Crucially, in the face of tens of billions of funds inflow via China's current account surplus every month, the People's Bank of China's reserve requirement ratio hikes have only been a passive liquidity management tool to mop up this extra liquidity inflow rather than a move to drain liquidity outright.

The indecisive monetary tightening reflects a lack of consensus among senior leaders for the need to address the economic and financial imbalances. The current

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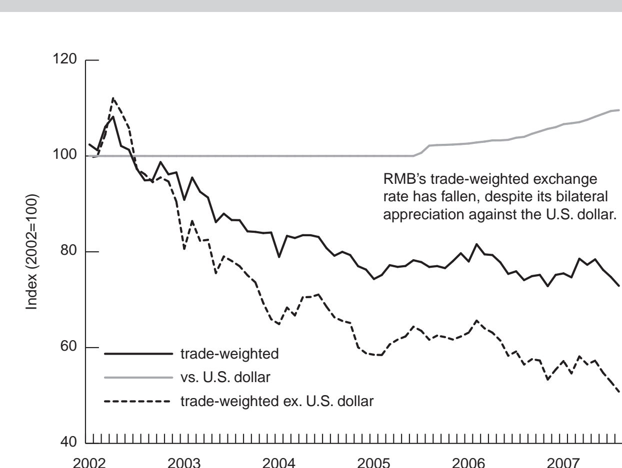
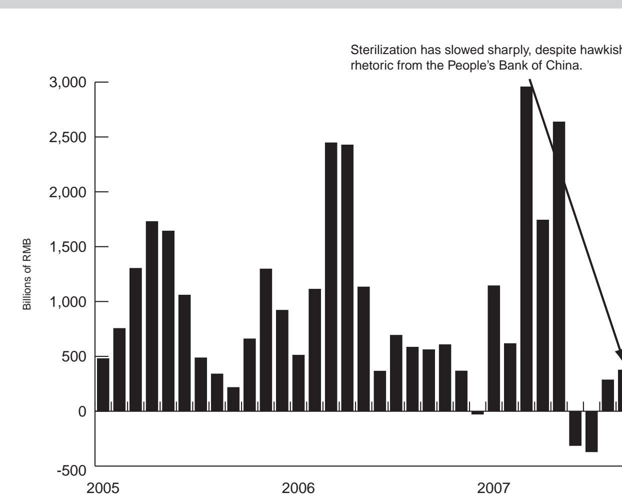
Figure 1 Renminbi Exchange Rate



Sources: CEIC, Ping An Asset Management (Hong Kong).

Figure 2 Net Issuance of People's Bank of China Bills
Three-month moving average



Source: Ping An Asset Management (Hong Kong).

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environment is not yet threatening to kill the bull market. However, the leadership's preference for gradualism, especially in liberalizing the renminbi, has aggravated the policy indecision problem and increased the risk of a drastic policy shock later as the economic imbalances intensify.

Risk signals and timing. China's low inflation cannot be taken for granted, given ample domestic liquidity and an undervalued currency. The risk of wage growth fueling inflation should be monitored, as the government is starting to provide subsidies to pensioners and low-income households in the wake of surging food costs.

If inflation fails to fall below 5 percent through the first half of 2008, inflationary expectations will start to rise. By the second half of 2008, all important political events will have passed and the new government should have settled in. The authorities may then be ready to act aggressively to address asset price inflation, with the risk of creating economic shock waves in late 2008 and 2009.

What to expect? In my view, the People's Bank of China's primary focus at this stage of the economic cycle is on controlling inflationary expectations, but not on setting real interest rates as most analysts believe. In the third-quarter policy meeting in early September 2007, the People's Bank of China specifically called for a closer coordination between interest rate and exchange rate policies and appropriate monetary control to guide money and credit growth. These same policy calls were made in the first-quarter policy meeting. Subsequently, the People's Bank of China raised both interest rates and the reserve requirement ratio and allowed the renminbi to trade higher at the same time.

If this experience is any guide, there will be more interest rate and reserve requirement ratio hikes in the short term, and the People's Bank of China will tolerate more, albeit still very slow, renminbi appreciation. The lack of policy conviction suggests that there would not be harsh tightening. But things may change by mid-2008 when the new government is all set and the political constraint on aggressive demand management policies is lifted.

What does all this mean for China's asset market? The structural underpinning for the asset market remains robust. However, Chinese investable stocks, including the A, H, N (traded in New York) shares, and those listed in Singapore, have moved into a bubbly state. This will mean violent price movements, and the rising risk of a domestic policy shock is making them vulnerable to a sharp correction in 2009. ◆