Social Europe

Managing The Economy Politically: Chinese Pitfalls

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After eight months of continued contraction, the Chinese manufacturing juggernaut is officially stranded. The rollercoaster ride of the summer of 2015 with its market crashes and sudden policy changes has unleashed widespread fear in government offices of losing further points of GDP growth. The latest estimate (probably optimistic) of a 6.9% growth rate appears disappointing compared with the double-digit growth of some years ago when China was overtaking Germany and Japan and directly menacing US economic leadership.

The government response to the crisis has been to exercise yet more control on the economy, but in its present state it's hard to evaluate if this cure is really helping to shore up the Chinese economic structure or is weakening its foundations. In the aftermath of the Lehman shock in 2008, Beijing reacted effectively, pegging the yuan to the US dollar in the FOREX market and thus reducing currency oscillations to a very limited bandwidth. Moreover, the People's Bank of China injected additional liquidity into the real economy to support investments and the property sector.

Unfortunately, this abundant liquidity has had the common adverse effect of igniting massive asset bubbles and of allowing investments in dubious or even disastrous projects (e.g. the Macao casino and part of the high speed rail system). Real estate bubbles are destined to burst and so they did in China. In order to compensate for the loss in nominal wealth, the government's controversial strategy has been to further inflate the stock market bubble; from October 2014 robust propaganda encouraged over 100m ordinary Chinese to invest their savings in the stock market. Of course, equity indices have surged (the Shanghai stock exchange gained more than 110% in 7 months) and eventually peaked, with a subsequent panic selling-off.

The government's next move has been quite shocking: aiming to limit the losses and stop the panic, asset sales have abruptly become difficult and even illegal. Accordingly, the new 100m "smart traders" have been forced to stick inside a bear market, a situation very alien to 21st century standards. Even though the main goal of stopping the markets' crash has been achieved and values are now floating around the levels of early 2015, other serious problems loom.

In fact, Chinese macro data are signalling a structural weakness: the export market (the traditional destination of manufacturing) is slowing down, with a sharp -3.7% fall on an annual basis, domestic demand is not picking up and the inflation rate is consistently low. On the financial side of the economy, total debt (public and private) has reached the staggering value of 280% of GDP, while bad loans in the Chinese banks' balance sheets have increased 35% in a year.

No wonder that the Chinese government has tried something radical: in mid-August the PBOC decided to un-peg (or re-peg) the yuan from the dollar, sending shock waves through world financial markets. The aim of the measure was to devalue the currency in a "controlled way", in order to stimulate exports and simultaneously promote the yuan as a primary reserve currency through negotiations with the IMF to enter the currencies' elite club. While the IMF is still evaluating China's request, the PBOC struggles to balance an accommodative monetary policy (multiple cuts of target interest rates, reduction of the minimum reserve ratio for the Chinese banks, more flexibility in the collateral acceptance criteria) with control of the exchange rate in a regime of weaker capital controls.

The yuan is, in fact, devaluing, but not at a rapid rate, since the central bank is selling huge foreign exchange reserves to counterbalance downward pressures on the exchange rate. But this strategy has come at a cost: the outflow of "hard currencies" is having a notable impact on other economies, since over 35% of the PBOC's foreign reserves are US Treasuries. In other words, China is selling what the Fed (US Federal Reserve) has bought with its Quantitative Easing, partially reducing global liquidity with a "QE in reverse direction".

This strategy may or may not work, mainly depending on moves by other big players in the world economy, but surely it can only succeed for a limited time. It's now clearly emerging that the weakening of the yuan has hurt Eurozone exports (notably those of Germany), thus threatening the "export driven" recovery envisioned by the ECB; probably the main driver of the jawboning of a QE 2.0 by ECB President Draghi is deeply rooted in China's domestic crisis.

The main challenge in reigniting China's growth is to boost domestic demand by encouraging private consumption; this remains at low levels compared with those of developed countries. A strong signal in this direction arrived a few days ago with the reversal of the one-child policy; maybe this is the right direction to follow for the world's second-largest economy and could prove that in some cases a strong political drive is better than just "*laissez faire*". For sure, this will not be easy. Since the economic reforms of the 1980s China has been remarkably successful in following a "goldilocks" path between orthodox neo-liberalism and a planned economy, with huge external pressures endured by Chinese workers and the environment. Now the path is narrower, but realistically it is the only one China can hope to follow.