

China's economic outlook in 2015

The trump card of a yuan devaluation

V. Anantha Nageswaran

ABSTRACT

China's real economy grew at an average rate of 9.8% annually for the last thirty-four years, up to 2013. In October 2014, the International Monetary Fund declared China to be the world's largest economy measured in Purchasing Power Parity exchange rates. China has also the dubious distinction of the emerging world's second most indebted country with total non-financial debt at 217% of GDP. China's growth rate has slowed. As it sets out to tackle the debt burden, it will slow even further, complicating its stated goal of rebalancing growth away from investment to household consumption. The one potential safety valve is a huge currency devaluation – something that it resorted to in 1993, with chilling effects on the rest of Asia in the years that followed.

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INTRODUCTION

In September this year, the Chinese President Xi Jinping visited India. Despite the evident personal warmth between him and the Indian Prime Minister, many have questioned the outcome of the visit from the Indian standpoint. An investment figure of USD 100 billion was bandied about, before the visit. China committed to invest only USD 20 billion during his visit and then there were border incursions during the visit. Many wondered if China was sending me a coded message to India with those border violations. According to veteran observers who do not live in television studios but do their work silently, these were not the important aspects of the visit.

Border incursions have taken place during and ahead of almost all the previous visits of either Indian leaders to China or the other way around. In most countries, peace and aggression have their constituencies. China is no exception. The aggressive constituency is not just confined to some in the People's Liberation Army. At the same time, pragmatists are around too. That is why in the communication relating to the settlement of the border dispute, China agreed to the formulation that explicitly committed to an early settlement of the border dispute. The commitment to an early date was a departure from previous statements issued when Indian and Chinese leaders met. China had always pushed back on an early resolution. It appeared different this time. We have to wait and see.

There are reasons why they might be a touch keener to walk their talk this time. From the Chinese standpoint, relationship with Pakistan appears in need of a review. China has come around to the view that Pakistan is the fountainhead of most Islamic terrorism in the world. Second, China simply cannot afford to give easy and convenient excuses to make it easy for India to align itself more closely with the United States and Japan. China would be isolating itself in the process. That is why it has offered full membership in the Shanghai Cooperation Organisation to India. Third, the cyclical slowdown in the Chinese economy and the structural headwinds that raise big question marks over long-term growth revival mean that China would be prudent to look for sources of growth diversification. Just as the United States recycled its trade surpluses, in the immediate aftermath of the World War II, as investment into Japan and Germany thus benefiting from their growth, China might be better off investing in India and benefiting from India's growth revival.

RECENT ECONOMIC PERFORMANCE IN BRIEF

China's economic ascendancy and growth performance is no mean feat. It has grown at nearly 10% per annum in real terms since 1979 when the economic transformation of the country began. In constant 2005 US dollars, China's real Gross Domestic Product (GDP) stood at 4.86 trillion by end-2013. China's per capita GDP in constant 2005 US dollars was little under 3600 in 2013. India's real GDP growth in the twenty-three years since 1990 has averaged 6.4% annually.

In constant 2005 US dollars, India's real GDP stood at 1.46 trillion. India's per capita GDP, measured on the same basis as China's, was little under 1200. In terms of Purchasing Power Parity of the local currency with the US dollar, measured in 2011 prices, China's GDP was 15.6 trillion in 2013. India's was 6.6 trillion. Interestingly, in its October 2014 World Economic Outlook, the International Monetary Fund calculated that China's GDP in PPP terms had overtaken the US GDP. The numbers cited were \$17.6 trillion vs. \$17.4 trillion. India's PPP GDP in 2014, as estimated by the IMF, was \$7.3 trillion.¹

While the data presented in the previous paragraph helps us to understand China's economic strength in absolute and relative terms, this paper will be dealing with near-term economic challenges that China faces. Post-2008 global economic crisis, China and India both stimulated their economies and grew very strongly in 2009 and in 2010. India's growth rate stalled after that. China's continued for another two more years. That is largely due to the massive size of the economic stimulus that China announced in the aftermath of the crisis. At \$586 billion, it was 16% of the country's GDP. India's was more modest in comparison. Banks financed the stimulus spending in China through local governments. In the meantime, debt of China's non-financial corporations ballooned too, as we shall see later. Property prices zoomed. Now, five years after the crisis, China's growth rate has slowed and the costs of the stimulus in terms of a huge debt burden are beginning to hurt the economy. In contrast, India, especially due to the change in Government in May 2014, might be emerging out of its two-year long economic stagnation and its growth rate might re-accelerate.

This brief will show that China's domestic economic challenges are formidable and are not amenable to easy solutions. Hence, China might be tempted to attempt solutions, such as a currency devaluation, that transfer its growth pains on to others

THE CASE FOR ECONOMIC SOFT LANDING OF CHINA

Consensus forecasts now put China's growth rate in the coming years in the range of 6.5% to 7.5%. This is significantly lower than the average growth rate of 9.8% over the last thirty-four years. These forecasts imply that the economy glides (rather than lands) smoothly into a slower (but still highly respectable) growth path. The case for this outcome rests on the belief that as China's nominal GDP growth slows down, the gap between the nominal GDP growth rate and the level of interest rates in the country narrows. What is so important and good about it? It needs some explanation.

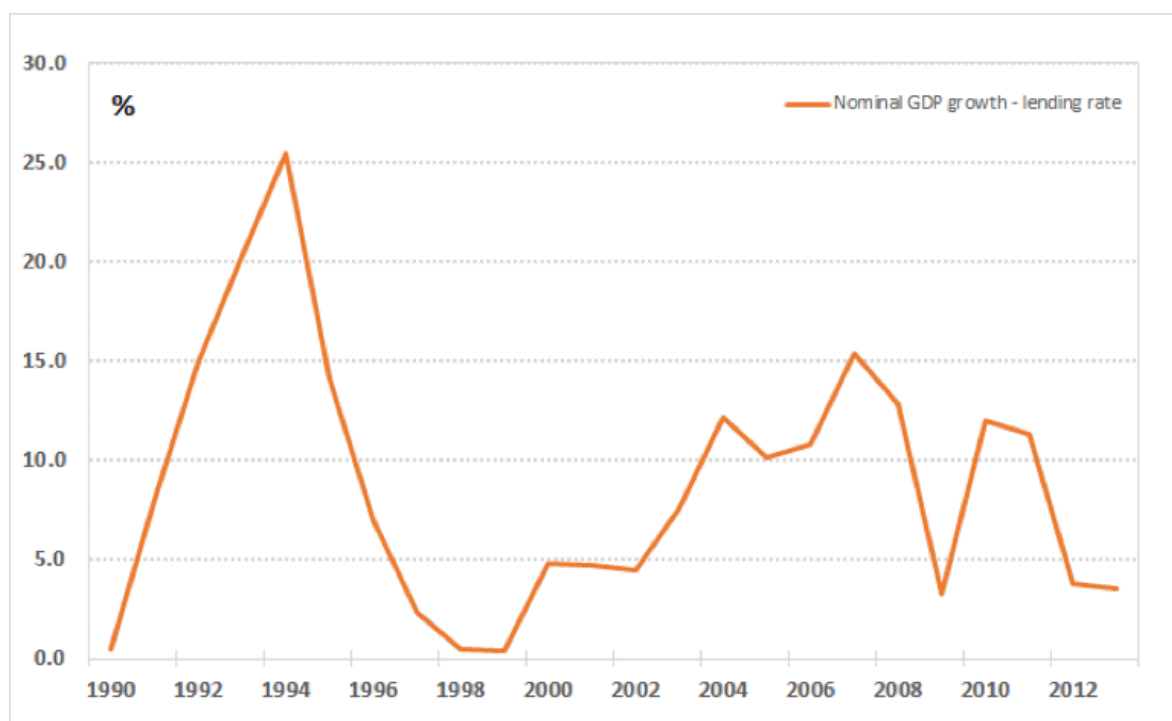
Economists often refer to the gap between the nominal growth rate of the economy and the interest rate that depositors receive as 'Financial Repression'. 'Financial Repression' means that savers are repressed for choice.

¹ Figures cited in this paragraph are taken from the relevant country files from data.worldbank.org except for the GDP in PPP terms for 2014.

Not only are they denied savings choices other than placing deposits with banks (with restrictions placed on taking money out of the country, for example) but are also given only a low interest rate on their deposits. The rate paid on deposits is kept low because lending rates have to be kept low to support investment spending and fixed asset creation. Hence, 'Financial Repression' refers to a policy framework that rewards borrowers - private or public - at the expense of savers.

Until now, China's lending rates have been far below nominal GDP growth rates creating an incentive for excess investment and overcapacity. As the nominal GDP growth rate slows, this 'free lunch' provided for borrowers disappears and hence it would reduce the incentive for borrowing and investment. Thus, the economy would be or is already on its way to a rebalancing away from investment and towards consumption. Economic growth will be lower but more stable with consumption, rather than investment funded by debt, being the main pillar of growth. This thesis is elaborated by Michael Pettis, a long-standing China watcher, in a recent essay titled, 'What does a "good" China adjustment look like?'²

Figure 1. End of Financial Repression in China?³



² www.mauldineconomics.com/outsidethebox/what-does-a-good-chinese-adjustment-look-like

³ Source: World Bank Data data.worldbank.org

SLOWING NOMINAL GDP GROWTH IS NO BOON FOR HOUSEHOLDS

The problems with Pettis' thesis are several. It is one thing for the incentive to borrow to invest to diminish but it is another thing for savers to benefit from a shrinking gap between nominal GDP growth rate and the rate of interest they receive on deposits. The former may happen. As nominal GDP growth rate slows, return on investments will also decline and thus the incentive to borrow and invest weakens. However, a falling economic growth rate does nothing to help depositors. They may experience a positive real return on deposits only if the rate of inflation drops markedly or turns negative (outright deflation). If China actually experienced deflation, then real returns would be surely positive even with zero nominal interest rates. But, that would be cold comfort for China's households. A deflating economy will not generate jobs and employment. In fact, if past bad investments come home to roost, job losses are more likely. Furthermore, as explained earlier, fresh investments will be hard to come by, as the gap between nominal GDP growth and the lending rate narrows or closes.

Charles Dumas of Lombard Street Research makes the same point:

“All the evidence, particularly unchanged import volumes for over a year now, suggests the necessary downswing of investment is beginning. When 48% of GDP slows, so does household income, eroding hopes for consumer growth – in the short term.”⁴

Further, as is evident in the chart above, the gap between China's nominal GDP growth and the lending rate dropped to near zero around the time of the Asian crisis. Yet, that did not help rebalance China's economy away from investment to consumption. Fearing a collapse in growth, policymakers once again cranked up the credit-investment machine to revive growth. This process was repeated in 2008. We have to wait and see if the present leadership is cut from a different cloth. It is too soon to say that China would follow a different path.

In any event, rebalancing will not be helped merely because the gap between nominal GDP growth and the lending rate closes. It would close only if household incomes recover sustainably and the State safety net for health and education expands. Enhanced safety net will give more confidence for households to spend more out of current income than to save a big portion of it for future health and higher education expenses. In the short-run, the government cannot provide adequately for a social safety net since it has other fires to put out, to which we turn next.

⁴ ftalphaville.ft.com/2014/10/07/1998042/more-on-the-overvalued-renminbi/

CONFUSED GOVERNMENT GOALS AND ROLE

One suggested solution for the unemployment risk is to liquidate State assets and for the government to fund employment. It is not clear how this would work in practice. Which sectors would do the actual hiring? The other mechanism that the author proposes to kickstart consumption is a large initial wealth transfer from rich households to the poorer ones. This would allegedly drive growth in services sectors. Chinese elites will be unlikely to acquiesce without protest in a large-scale wealth transfer. A recent survey by Barclays Wealth showed that nearly half of the Chinese elites surveyed do not rule out emigrating out of China in the next four to five years.

At the same time, the government is also expected or urged to assume the bad debt of local governments and State-owned enterprises and to pay off the debt through privatisation and higher taxes! Is there a real Chinese private sector, except in pockets, with capacity to manage and run large enterprises? Even if there were a real Chinese private sector, it would face a higher cost of capital with the end of financial repression. There is more. Benchmark sovereign borrowing costs too would have gone up with a higher debt burden and a likely credit rating downgrade. Overall, the cost of capital for the private sector could be substantially higher than before. Privatisation will be a non-starter under such circumstances. Lastly, higher taxes are unlikely to go down well with households and they will come in the way of a rebalancing towards consumption.

Further, if the State has to do massive transfer payments, assume bad debts and privatise State assets, the Communist party would become a pale shadow of its former self and its control over the economy would be so considerably reduced as to render it almost irrelevant. Moreover, even if China's household consumption remained steady in the face of falling GDP growth, there is little chance that China would accept 3% to 4% real GDP growth as it would hurt its international standing and affect its power projection in the neighbourhood and beyond.

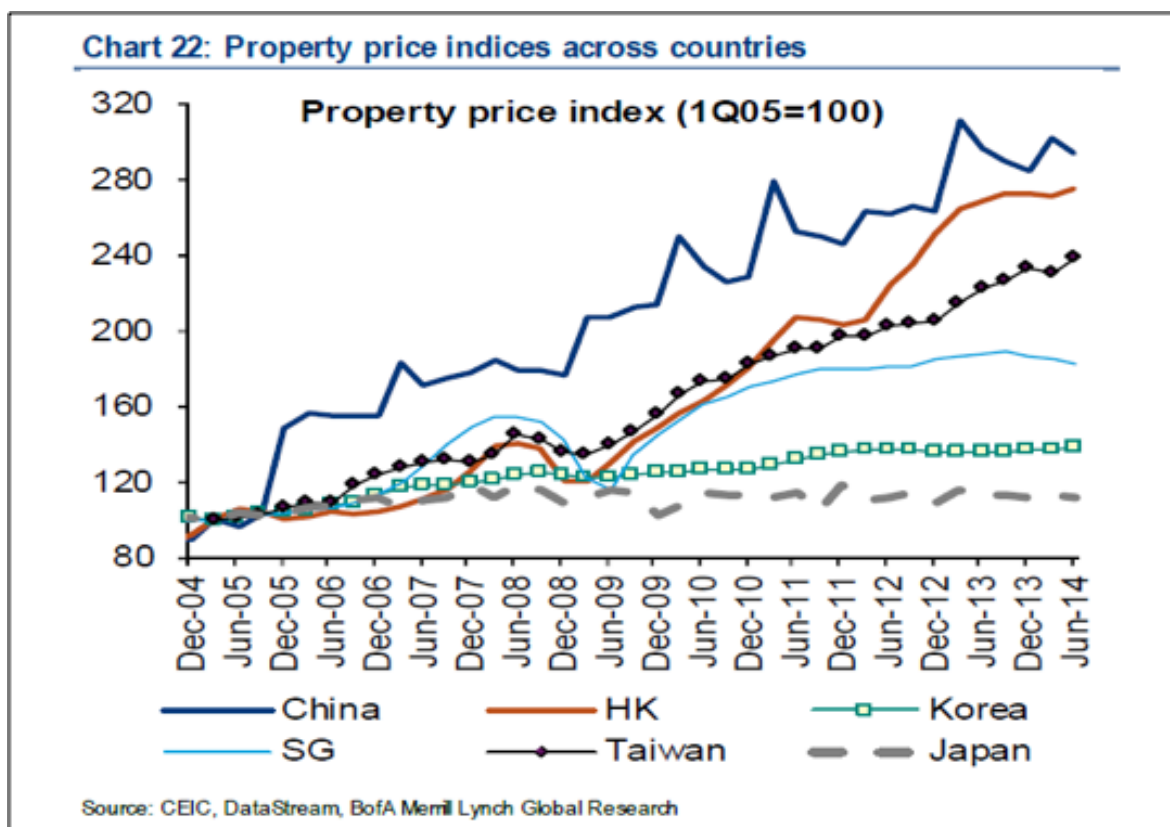
Most forecasts of China economic growth slowing gently down to around 6% to 7% refuse to recognise the possibility that, as China's housing and credit booms turn into busts, a growth rate of 6% to 7% might be unachievable for several years.

CREDIT AND HOUSING BOOMS TURN INTO BUSTS

In a research note published recently, ('will China repeat Japan's experience?' September 2014), economists at Bank of America-Merrill Lynch leave us with little doubt as to the formidable nature of the problems that China faces in the years ahead:

"In general, it appears to us that the problem facing China today may be more serious than Japan's in the late 1980s and early 1990s: China's growth was more imbalanced, its reliance on external demand was heavier, the government's monetary policy in response to the external demand shock was looser, debt growth was faster, over-capacity was worse, and asset price appreciation had been just as rapid. These, in our opinion, likely mean that the ultimate scale of bad debt in China may be higher than what Japan's banking system experienced."

Figure 2. Property price indices across countries



The chart above taken from their report is clear that China's property price index has risen the fastest in the last decade. Hong Kong is a close second. Hong Kong – SAR, thanks to its currency board arrangement with the United States, has followed an extremely accommodative monetary policy in tune with that of the United States even as its small City-State economy boomed along with that of China's. Of course, our attention, for the purposes of this note, is on China.

In its annual report for 2013-14, the Bank for International Settlements (BIS) examined where countries stood on its indicators of credit and real estate booms which are seen as early-warning indicators of banking crises. The table, reproduced below, tells its own story. No country comes off worse than China. China's property prices, relative to historical trends, might not be at extreme levels as per the BIS. However, the inventory of unsold homes and the number of ghost cities are strongly indicative of an overextended and financially stretched housing sector.⁵

Table 1. Early Warning Indicators for domestic banking crises signal risks ahead⁶

Early warning indicators for domestic banking crises signal risks ahead¹ Table IV.1

		Credit-to-GDP gap ²	Property price gap ³	Debt service ratio (DSR) ⁴	Debt service ratio if interest rates rise by 250 bp ^{4,5}
Boom	Asia ⁶	19.9	16.7	2.4	4.4
	Brazil	13.7	3.7	4.0	6.3
	China	23.6	-2.2	9.4	12.2
	India	-2.7		3.4	4.4
	Switzerland	13.1	13.0	0.6	3.6
	Turkey	17.4		4.5	6.2
Mixed signals	Australia	-6.9	-2.0	1.5	4.5
	Canada	5.6	5.1	2.0	4.9
	Central and eastern Europe ⁷	-10.5	-0.1	1.6	2.9
	France	-0.9	-9.3	2.6	4.9
	Germany	-8.8	5.4	-2.7	-0.9
	Japan	5.3	2.8	-4.4	-2.0
	Korea	4.1	4.1	0.8	3.5
	Mexico	3.7	-1.6	0.5	0.9
	Nordic countries ⁸	-0.5	-2.2	1.5	4.7
	Netherlands	-13.2	-24.2	1.8	5.2
	South Africa	-3.1	-7.5	-1.0	0.2
	United Kingdom	-19.6	-11.1	0.9	3.6
	United States	-12.3	-5.7	0.3	2.6
Bust	Greece	-11.3	-2.8		
	Italy	-6.4	-16.6	-1.0	0.9
	Portugal	-13.9	-7.4	0.3	4.0
	Spain	-27.8	-28.7	2.3	5.4
Legend		Credit/GDP gap > 10	Property gap > 10	DSR > 6	DSR > 6
		2 ≤ Credit/GDP gap ≤ 10		4 ≤ DSR ≤ 6	4 ≤ DSR ≤ 6

⁵ Check out this news-story in Caixin Online on the 'Ghost city index' in China english.caixin.com/2014-10-17/100739980.html

⁶ Source: Annual Report 2013-14, the Bank for International Settlements. In the table above, Credit-to-GDP ratio gap and Property Price Gaps are measured as deviations of actual from their long-run trends.

Another independent report, popularly known as the Geneva report, published in September 2014 (two months after the BIS Annual Report), provides more eloquent and elaborate evidence of the debt burden that the Chinese economy carries. China's total debt (excluding financials) is only the second highest among emerging economies and is double the average of other Emerging economies. See their table 2.1 reproduced below:

Table 2. Global debt excluding financials⁷

2013	Total ex-financials a = b + c	Govenment b	Private c	External	Net external position
World	212	78	133	83	—
Developed markets	272	108	164	141	-1
Japan	411	243	168	57	57
Sweden	293	41	252	200	-16
Canada	284	89	195	73	-17
UK	276	90	186	371	-11
US	264	105	160	98	-26
Eurozone	257	93	164	126	-19
Korea	232	37	196	34	-9
Australia	209	29	180	89	-56
Emerging markets	151	48	102	23	-9
Hungary	223	79	144	148	-103
China	217	49	168	9	18
Czech Republic	131	48	83	56	-51
Poland	137	57	79	73	-71
Thailand	150	45	105	36	-26
Argentina	129	47	82	28	2
South Africa	127	45	82	39	-11
India	120	67	54	23	-25
Brazil	121	66	55	22	-36
Turkey	105	36	69	47	-56
Mexico	77	46	31	32	-40
Indonesia	65	26	39	30	-37
Russia	43	13	29	34	4

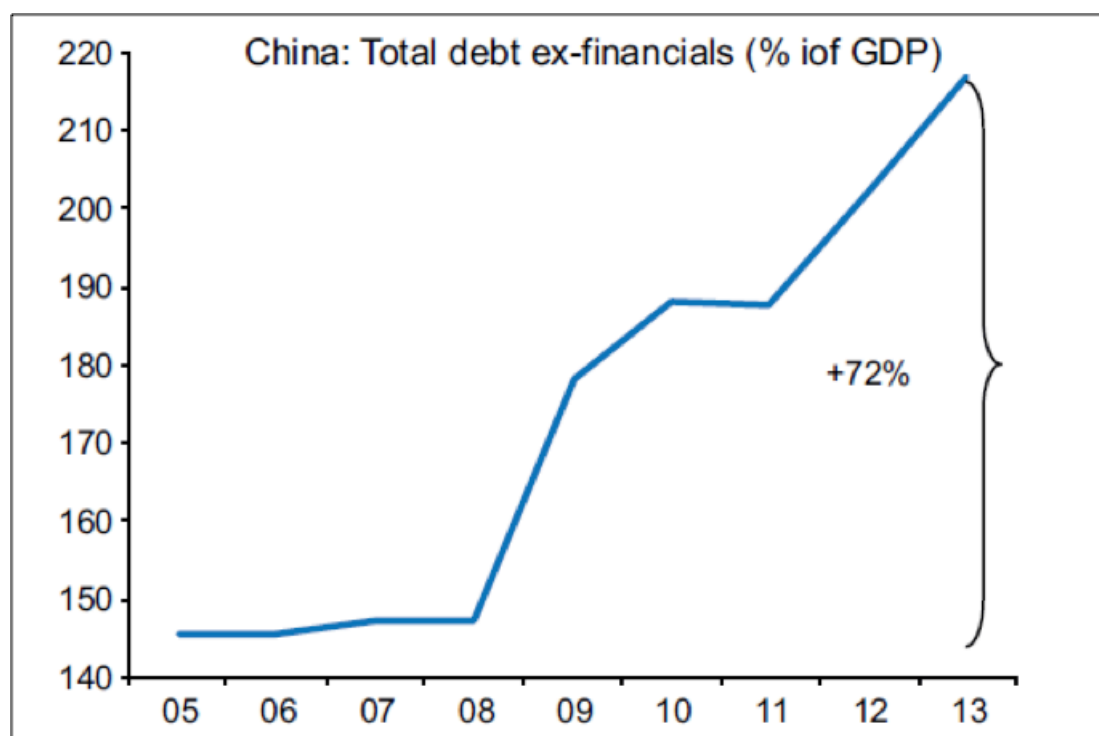
Source: Authors' calculation based on OECD, IMF and national accounts data. See Data Appendix at the end of the report. Net external position data are 2012 values.

⁷ Source: Table 2.1, 'Deleveraging? What Deleveraging?', Geneva report on the World Economy published jointly by the International Centre for Monetary and Banking Studies and Centre for Economic Policy Research (September 2014)

The report is blunt on the growth consequences of reducing this enormous debt mountain. We should let the authors of the Geneva report speak:

- “Since 2008, Chinese total debt (ex-financials) has increased by a stunning 72% of GDP (see chart below), or 14% per year, a shift almost double that experienced by the US and UK in the six years that preceded the beginning of their financial crisis in 2008. This brisk acceleration has brought the overall leverage of the Chinese economy to almost 220% of GDP.

Figure 3. China: Total debt ex-financials (% of GDP)⁸



- The debt situation in China is made even more fragile by two further considerations. First, the recent increase in debt was raised especially by relatively weak borrowers, such as local governments with fragile income streams and, in particular, companies active in construction and other sectors (e.g. the steel producing industry) plagued by overcapacity. Second, credit was granted by relatively weak lenders, as shown by the sharp increase of the weight of shadow banking (trust funds, etc.) within total lending.

⁸ Source: Figure 4.26, ‘Deleveraging? What Deleveraging?’, Geneva report on the World Economy published jointly by the International Centre for Monetary and Banking Studies and Centre for Economic Policy Research (September 2014)

- These factors help to explain the Chinese effort for structural reforms aiming at supporting potential growth and breaking the formation of a vicious spiral between leverage and growth. The success of this effort will be crucial to the future of China. However, it is legitimate to be sceptical about the potential of reforms to boost short-term growth, even reforms that are successful in the medium term.
- In China, as elsewhere, it is hard to identify in advance the leverage breaking point beyond which a crisis enfolds. It is less hard, however, to interpret the current debt dynamics of debt as unsustainable.
- Most likely, the Chinese government is aware of the adverse dynamics that we have described and is willing to start a process of deleveraging. At least initially, this process should be in the form of a moderation in the pace of the leveraging up of the economy.
- However, there will be a price to pay for this policy since slower credit formation, the main support for growth in recent years, would likely translate into a substantial slowdown in activity. If rapid leveraging up was indeed the reason why China kept growing at a slowing, but above potential, rate since 2008, a phase of deleveraging through slower credit formation would imply a significant slowdown, with growth possibly falling below potential.
- Chinese policymakers are likely to remain for some time between the 'rock' of slowing nominal growth and the 'hard place' of high and rising leverage."

Given China's low external debt, there is no incentive for external default. Any deleveraging adjustment would fall on the government, on domestic lenders and on Chinese households, in some combination. Therefore, in order to minimise the domestic fallout and to support economic growth, the Geneva report notes that China might opt for a combination of inflation and currency depreciation. However, even here, China is caught between a 'rock and a hard place' as in the case between the twin imperatives of reducing debt levels and maintaining economic growth.

ENGINEERING INFLATION & CURRENCY DEPRECIATION – NO EASY FEAT

First, China's officially announced inflation rates suggest that the economy is disinflating and could be on the cusp of deflation, brought about by a slowdown in real estate activity, slower loan growth and lower economic growth in general, etc. Generating inflation in this environment is not easy unless China engages in a massive fiscal stimulus. Funding it without raising taxes would mean reliance on domestic credit. That would raise red flags all around – among investors and credit rating agencies. Second, the recent drop in the international price of crude oil has a further dampening effect on China's rate of inflation. Therefore, domestic inflation looks set to remain low.

Hence, the case for a currency depreciation cannot be based on higher domestic inflation even though some measures of Real Effective Exchange Rate (REER) of the Chinese currency suggest that the currency is overvalued (chart). The inflation-adjusted weighted average exchange rate of the Chinese yuan has appreciated (lost exchange rate competitiveness) by 20% since 2010.

Figure 4. CPI based Real Effective Exchange Rate for China (2010=100), updated up to September 2014⁹



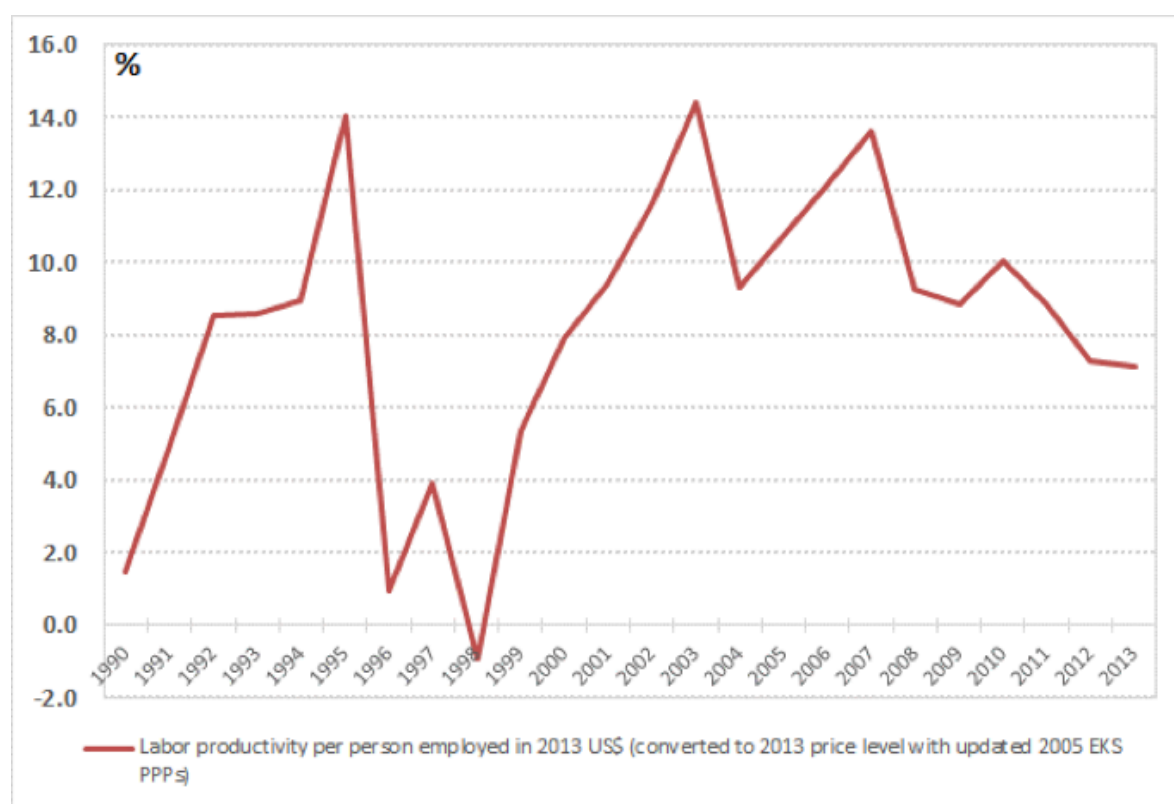
James Kynge, former FT correspondent in China, who had documented this extraordinary obsession and the lengths to which China would go, to achieve it in his book, 'China shakes the world' has recently written a blog post¹⁰ on whether China would let its currency slump. He cites the note from Lombard Street Research that we had cited earlier to make the case that a currency depreciation might be on the cards ("When 48 per cent of GDP slows, so does household income, eroding hopes for consumer growth in the short term. So export growth is the only palliative.") However, China might be shooting itself in the foot by printing strong export growth numbers as it did in September.

⁹ Source: Bank for International Settlements

¹⁰ 'Is the Renminbi set to slump?' blogs.ft.com/beyond-brics/2014/10/10/is-the-renminbi-set-to-slump/

For one, the strong export numbers defied logic since the world economy, particularly Europe, had cooled considerably in the third quarter. Second, vigorous export growth from China is usually accompanied by equally strong imports from Asia since China imports semi-finished goods, only to process them further, package and ship them off. Exporters from other Asian countries find it cheaper to put the finishing touches in China. That is not happening. China's imports from the rest of Asia have sagged considerably in recent times. Third, strong export growth is inconsistent with the recent appreciation of the Real Effective Exchange Rate of the Chinese currency as shown earlier and China's slowing labour productivity (chart).

Figure 5. China: Labour productivity measured in terms of GDP per person employed¹¹



Of course, statistical issues with export data is not the only obstacle standing in the way of China engineering a weaker exchange rate. China has another objective for its currency that stands in the way of a devaluation to support the economy. China wants to internationalise its currency. It covets an international role for the Renminbi, including the status of a reserve currency.¹² In September, the UK government announced that it would sell Renminbi-denominated bonds to add to its foreign exchange reserves.

¹¹ Source: Conference Board (USA)

¹² 'U.K. to Sell First Yuan-Denominated Bonds for Currency Reserves' bloomberg.com/news/2014-09-12/u-k-to-sell-first-yuan-denominated-bonds-for-currency-reserves.html

The United Kingdom does not need to maintain foreign exchange reserves since it rarely intervenes in the foreign exchange market. In any case, George Soros is no longer interested in currency speculation. The UK did so to create a benchmark in Renminbi denominated international debt and that would further bolster the claim of London to be the world's leading financial centre over New York. Yet, the fact UK did so suggests that China's persistent lobbying efforts are paying off.

Having done so, China would not want to embarrass itself by letting its currency weaken. Further, it is not clear if the rest of the world would look benignly upon a China strategy of deliberately debasing its currency and triggering a race to the bottom, a race that is already underway with the Euro joining the depreciating yen in the second half of the year. We will have a little more to say on this matter from a geopolitical perspective later.

Even more importantly, the real issue is whether Chinese residents might vote with their feet when China engineers a significant depreciation of the currency. The foreign claims that China would acquire in the process of weakening the currency (central banks add foreign reserves when they target a weak currency) need to be allocated. Hitherto, they have all accumulated in the books of the People's Bank of China. Continuing with that approach might run the risk of earning China international opprobrium and retaliatory action. To deflect that, it might want to let ordinary Chinese own foreign assets. The risk is that they might make a big dash for it if they sense a bigger risk of a maxi-currency depreciation, converting that possibility into a reality in short time.

The other area of vulnerability is China's external debt obligations. Based on data available from China's SAFE on its net international investment position, one notes that China's external debt obligations (excluding trade credit) were around \$1.2 trillion in June 2014 (Table). It was barely \$491 billion in March 2011. This has more than doubled. A sharply lower dollar value of the yuan will make meeting these obligations that much more challenging. Of course, we are not at all suggesting that China's external debt is a major source of vulnerability. That distinction stays with China's domestic credit mountain and what we have done here is to highlight that the exchange rate depreciation, a potential safety valve in such situations, might not be so easily achievable for China, given the extraordinary global economic context, its geo-political and economic aims and the risk of triggering an exodus of domestic capital.

Some reckon that the alternative to not devaluing the currency would be a slow and long deflation with political and social consequences with a build-up of market speculation on the eventual devaluation of the yuan. China might do a maxi-devaluation to forestall that. That would set off a trade war with sanctions on China for currency manipulation.¹³

¹³ 'The Logic of Strategy: Yuan Devaluation and the Road to Trade War'
investinginchinseestocks.blogspot.sg/2014/02/the-logic-of-strategy-yuan-devaluation.html

CHINA'S ECONOMIC OUTLOOK IN 2015: THE TRUMP CARD OF YUAN DEVALUATION

Is the above sequence of events plausible, let alone probable? Will the United States turn the screws on China? Does geo-politics offer us clues on China's economic policy choices in the months ahead?

Table 3. China's International Investment Position (Quarterly)¹⁴

China's International Investment Position (quarterly)														
Unit: in 100 million of US dollars														
Item	31-Mar-11	30-Jun-11	30-Sep-11	End of 2011	31-Mar-12	30-Jun-12	30-Sep-12	End of 2012	31-Mar-13	30-Jun-13	30-Sep-13	End of 2013	31-Mar-14	30-Jun-14
Net position	17595	17888	16577	16884	17435	17006	17999	18665	17882	17453	18052	19716	19915	19921
A. Assets	43440	45607	45944	47345	49309	49677	50755	52132	53632	54338	56510	59368	61290	63084
1. Direct investment abroad	3234	3347	3506	4248	4402	4541	4685	5319	5241	5420	5590	6091	6215	6402
2. Portfolio investment	2269	2224	1934	2044	2397	2405	2518	2406	2438	2411	2470	2585	2665	2612
2.1 Equity securities	960	935	670	864	971	1006	1035	1298	1312	1246	1410	1530	1626	1650
2.2 Debt securities	1309	1289	1264	1180	1427	1398	1483	1108	1125	1165	1060	1055	1039	961
3. Other investment	6781	7330	7726	8495	8678	9583	9898	10527	10796	10936	11190	11888	12314	13512
3.1 Trade credits	2135	2314	2716	2769	2765	3101	3232	3387	3322	3476	3762	3990	3708	3884
3.2 Loans	1508	1492	1687	2232	2428	2671	2852	2778	2970	3055	3037	3089	3277	3672
3.3 Currency and deposits	2122	2567	2484	2942	3026	3363	3345	3906	3515	3395	3364	3772	4290	4909
3.4 Other assets	1015	958	839	552	459	448	470	457	988	1011	1027	1038	1039	1046
4. Reserve assets	31156	32706	32779	32558	33831	33148	33653	33879	35157	35570	37260	38804	40096	40558
4.1 Monetary gold	485	508	550	530	565	542	600	567	541	418	450	408	435	450
4.2 Special drawing rights	126	125	120	119	122	118	115	114	111	110	112	112	113	112
4.3 Reserve position in the Fund	99	97	91	98	95	88	87	82	79	75	72	71	67	65
4.4 Foreign exchange	30447	31975	32017	31811	33050	32400	32851	33116	34426	34967	36627	38213	39481	39932
B. Liabilities	25845	27720	29368	30461	31874	32672	32756	33467	35749	36885	38459	39652	41374	43163
1. Direct investment in China	16439	17142	17694	19069	19389	19732	20077	20680	22092	22582	23232	23475	24154	24748
2. Portfolio investment	2289	2424	2487	2485	2892	3008	3129	3361	3518	3585	3744	3868	4050	4223
2.1 Equity securities	2063	2140	2148	2114	2447	2466	2516	2619	2685	2658	2759	2980	2970	3054
2.2 Debt securities	226	284	339	371	445	542	613	742	833	927	985	889	1080	1169
3. Other investment	7117	8154	9187	8907	9592	9932	9550	9426	10139	10717	11483	12309	13170	14192
3.1 Trade credits	2191	2397	2566	2492	2711	2901	2995	2915	3036	3095	3268	3365	3190	3282
3.2 Loans	2647	3138	3570	3724	4086	4110	3686	3680	4076	4832	5107	5642	6411	6775
3.3 Currency and deposits	2039	2350	2780	2477	2548	2580	2500	2446	2674	2523	2839	3051	3290	3861
3.4 Other liabilities	240	270	272	214	247	341	369	384	353	267	269	252	278	273

IS CHINA 'TOO BIG TO FAIL' FOR THE US?

Earlier in October, China sprang a surprise on Australia by deciding to impose a 3 per cent import tariff on coking coal and double that on low-grade thermal coal imports from Australia. The Sydney Morning Herald noted that the crucial final stages of free trade talks between the two countries had been thrown into turmoil.¹⁵

Popular blog site, 'Investing in Chinese stocks' noted that this was standard Chinese tactic: "Chinese strategy sometimes calls for initiating a conflict in order to bring an issue to the table."

¹⁴ Source: SAFE, China.

¹⁵ See 'Shock China coal tariff decision throws Australian free trade talks into turmoil' smh.com.au/business/china/shock-china-coal-tariff-decision-throws-australian-free-trade-talks-into-turmoil-20141009-113vul.html

It went on to advise that retaliation might be the best option if the goal was to restrain China's power, observing that China had the most to lose if global protectionism increased.¹⁶

However, the American response remains a big question mark. According to Edward Luttwak, the author of 'The Rise of China vs. The Logic of Strategy', the United States has three policies for China:

The first is the Pro-China Treasury Department. This wing also represents the capture of American government by Wall Street and the financial industry: Treasury doesn't care about manufacturing and pursues a China policy solely almost aimed at profits for Wall Street. The Treasury also represents the idea of free trade as ideology. Manufacturers have almost no voice in American policy these days.

Next is the State Department, which confronts China in Asia. The State Department is mainly concerned with the "Asia Pivot." It was not U.S. policy to encircle China by forging closer alliances with Southeast Asian nations, rather China's own aggressive posturing pushed these nations into proactive efforts to attract the United States. There are areas where the U.S. was proactive though, such as working to strengthen ties with India.

Finally, there is the national defence establishment. They view China as potentially the main enemy of the future, though this is as of yet undecided. China is a cyber-threat and potential military threat. The Defence Department is involved with strengthening regional military ties, such as the naval visits to Vietnam.¹⁷

Edward Luttwak explains US Treasury Department's pro-China tilt in benign terms as something that arises out of their support for free-trade ideology and the absence of representation of the manufacturing sector in the US Treasury Department. Of course, he mentions the symbiotic relationship between the US Treasury and Wall Street. He could go further there.

Professor Yanis Varoufakis, teaching currently at the University of Texas at Austin, has argued in his book, 'Global Minotaur' that, since the 1980s, the United States decided to maintain and project hegemonic power based on the premise of preserving economic growth through running deficits and giving Wall Street a free hand so that it could garner savings from the rest of the world and direct them to the cause of funding US deficits.

¹⁶ www.investinginchinesestocks.blogspot.sg/2014/10/china-ups-protectionist-ante-with-coal.html

¹⁷ See footnote #4 and the video of an interview of Edward Luttwak on his book, youtu.be/WejSKbicS00

This is a highly plausible premise since by the Eighties, for the developed world, organic sources of economic growth had dried up. Hence, growth has to be created through borrowing (leverage). Wall Street was given the task of selling financial ideas and products to the rest of the world that would mobilise its savings and finance American trade and current account deficits. On its part, the US Treasury would use its prestige, influence and status to prise open foreign markets for Wall Street firms.

However, as with most things in life and in world affair, means to an end become ends in themselves. Wall Street's access to foreign markets and its profits have become the main goal relegating the task of funding the US deficit to the background. Wall Street loves China because the latter has nearly four trillion dollars of foreign reserves to recycle. There is much money to be made in performing that task for China.

Hence, from the perspective of Wall Street, it is important that China continues to receive foreign direct investment directed at manufacturing export products and that it earns enough through exports to continue to build up reserves and recycle those foreign currencies either through the official channel (Sovereign Wealth Funds) or through a liberalisation of the capital account for Chinese residents.

That makes it imperative that the US economy continues to grow through consumption by Americans such that China's exports can continue to grow. Hence, US macro-economic policies – fiscal and monetary – should be as growth-supportive as possible. The logic of Wall Street supporting US economic growth by helping fund its trade deficits has thus been turned on its head, in reality!

China has another ally, besides the US Treasury Department. Luttwak had forgotten to include the US Federal Reserve Board in his list of pro-China actors in the United States. Raghuram Rajan, the Governor of the Reserve Bank of India, has been quite eloquent on the effects US monetary policy has on emerging economies with their fragile institutions and mechanisms to cope with sudden influx and exodus of massive capital flows.¹⁸ In the past, the United States had been dismissive of criticisms of the spillover effects of its monetary policy on emerging economies. Raghuram Rajan's blunt messages too received a similar response. However, somewhat unexpectedly, in an important and interesting speech delivered on 11th October, the Vice-Chairman of the US Federal Reserve Board turned his attention unusually to the spillover effects of US monetary policy on emerging economies.¹⁹

¹⁸ See 'Competitive monetary easing: Is it yesterday once more?' - Speech by Raghuram Rajan at Brookings Institution delivered on 10th April 2014 rbidocs.rbi.org.in/rdocs/Speeches/PDFs/SPBOOKING10042014.pdf

¹⁹ See 'The Federal Reserve and the Global Economy' – Speech by Stanley Fischer, Vice Chairman Board of Governors of the Federal Reserve System to be delivered as the Per Jacobsson Foundation Lecture 2014 Annual Meetings of the International Monetary Fund and the World Bank Group, Washington, October 11, 2014 federalreserve.gov/newsevents/speech/fischer20141011a.pdf

Not once in his speech did the Fed Vice-Chairman take direct cognisance of Raghuram Rajan's speech and concerns expressed therein. His speech does not figure in the list of citations either. On the other hand, this paragraph was a give-away on how the Federal Reserve would react to any attempt on the part of China to boost its exports:

"....the tightening of U.S. policy will begin only when the U.S. expansion has advanced far enough, in terms both of reducing the output gap and of moving the inflation rate closer to our 2 percent goal. Thus, tightening should occur only against the backdrop of a strengthening U.S. economy and in an environment of improved household and business confidence. The stronger U.S. economy should directly benefit our foreign trading partners by raising the demand for their exports, and perhaps also indirectly, by boosting confidence globally. And if foreign growth is weaker than anticipated, the consequences for the U.S. economy could lead the Fed to remove accommodation more slowly than otherwise."

Not only does it appear that the Federal Reserve would react kindly to any exchange rate adjustment on the part of China but also that it would delay its own monetary policy tightening should the Chinese economy remain weak or weaken further. These inferences are too obvious to be missed. In other words, far from exploiting the Chinese economic situation to assert its superiority²⁰ and status as the world's leading economic power, US authorities appear keen to go out of their way to reassure China of their support.

We do not know if this attitude represents cognitive or other forms of capture and it is pointless speculating on those. Perhaps, Wall Street reckons China 'Too Big To Fail' and that the US authorities have bought into that argument. After all, a sharp economic slowdown in China with a large impairment of banking assets could have knock-on effects on the world's financial system directly and indirectly through the impact it would have on the economies of commodities producers. Further, the United States might like to have China keep up its purchase of US Treasury Bills, Notes and Bonds since the Federal Reserve would no longer be buying them.

Whatever be the reason, we reckon that the United States appears disinclined to let China fail to the extent that its economic fundamentals dictate. Of course, that is no guarantee that the Chinese economy would not stumble. In a working paper²¹ that has been released recently, Lant Pritchett and Lawrence H. Summers note the following:

²⁰ We should record here that the International Monetary Fund noted in October, while releasing its World Economic Outlook, that China's GDP, measured in terms of Purchasing Power Parity exchange rate of the Chinese yuan with that of the US dollar surpassed the US GDP in the course of 2014. These calculations do little more than to inflate national egos. These measurements only underscore the extent of undervaluation of currencies such as the yuan as calculated by these agencies. India's nominal GDP is barely at \$2.0 trillion whereas its PPP based GDP is pegged at \$7.277 trillion. Source: [en.wikipedia.org/wiki/List_of_countries_by_GDP_\(PPP\)](http://en.wikipedia.org/wiki/List_of_countries_by_GDP_(PPP))

²¹ 'Asiaphoria meets regression to the mean', Lant Pritchett and Lawrence H. Summers, Working Paper 20573, National Bureau of Economic Research, October 2014. nber.org/papers/w20573

“Regression to the mean is the single most robust finding of the growth literature, and the typical degrees of regression to the mean imply substantial slowdowns in China and India relative even to the currently more cautious and less bullish forecasts. India and, even more so, China are experiencing historically unprecedented episodes of growth. China’s super-rapid growth has already lasted three times longer than a typical episode and is the longest ever recorded. The ends of episodes tend to see full regression to the mean, abruptly.

It is impossible to argue that either China or India has the quality institutions that have been associated with the steady dynamic of growth in the currently high productivity countries. The risks of sudden stops are much higher with weak institutions and organizations for policy implementation. China and India have very different modalities of this risk, but both have tricky paths to continued prosperity.”

We may wish to question their pessimism on India, almost in equal measure to their pessimism on China, for no other reason than the fact that India has not had such a history-defying record of a sustained spell of rapid economic growth of over three decades as China has done. However, that is a different topic for a different occasion.

IMPLICATIONS FOR INDIA AND REST OF ASIA

More than the assertions of M/s Pritchett and Summers on the impending abrupt and sharp slowdown of the Chinese economy, India should take note of the strong support that China enjoys in the US Treasury and the Federal Reserve circles. In other words, in the course of 2015, India should be prepared for a substantial yuan depreciation, which attracts only symbolic condemnation but no significant international condemnation or sanctions.

Indeed, for the sake of completeness, we have to note here that the competitiveness risk for East Asian nations is higher, including the ASEAN nations. The Asian crisis of 1997-98 was triggered, in large part, by the maxi devaluation of the Chinese yuan in December 1993. That pushed their currencies into overvalued territory, trade balance into deficits and their foreign liabilities into an unsustainable financing mode. The result was the economic crisis of 1997-98. An encore is a possibility. India can and should consider making common cause with some of these nations, particularly Japan and Indonesia, on this matter, among other things. With new leaders at the helm in India and in Indonesia, both countries should set about establishing direct flight connections between the two capitals, for starters.

Should the mid-term elections for the US Congress due later this year force the American government to grow a spine, that is all for the good for Indian export competitiveness and that of East Asian nations. However, neither India nor they should take that outcome for granted.

The Indian rupee is not undervalued no matter what the IMF and the World Bank say about PPP exchange rates. For practical purposes, we look at the merchandise trade deficit and we can conclude that one of the reasons for the persistently high merchandise trade deficit is the lack of competitiveness. Given India's current level of labour and capital productivity and the rate of increase in the general level of prices, the Indian rupee might be slightly overvalued. A maxi China yuan devaluation in 2015 will place India, once again, at a huge competitive disadvantage in third country markets and vs. China too. The windfall that the fall in the global price of crude oil has generated for India's external and fiscal deficits will shrink. India's bilateral trade deficit with China might balloon further. Hence, it is imperative that India keeps an eye on the developments in the Chinese economy and, at the same time, continue to take measures that would raise India's productivity levels. Indeed, the new government's USP must be ESP – Energy and Education, Sanitation and Productivity.

Lastly and as important, the security implications of the outbreak of an economic crisis in China should not be lost sight of, either. After all, many commentators believe that China springs bad surprises on others (the sudden imposition of tariff on Australian coal is the most recent example) in the hope that it would bring others to the negotiating table with China holding the upper hand, in view of its unilateral actions.

With the Middle Kingdom, a middle path is a tough ask.