

Long-term Risks in Chinese Economy

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A slight rebound in inflation

The growth in China's CPI is expected to rebound above 2% in August, which might limit the government's room for policy easing. The increase in the food and energy prices, are the main factors in the expected increase in CPI. Excess rainfall in southern regions and drought in northern and central regions are pushing the food prices higher. Furthermore, the drought in the USA is expected to increase the price of agricultural products worldwide. China is also a major importer of soybean, cotton, meat, vegetable oils, and corn, from the USA.

People's Bank of China (PBOC) prefers to provide liquidity into the money markets by carrying repurchase agreement operations (REPO) rather than lowering the Reserve Requirement Ratios (RRR). During August PBOC already injected a large amount, ~\$55 billion USD equivalent of RMBs, into the Chinese money markets. This shows the magnitude of concerns over the slowing growth in the Chinese economy regardless of the hike in food prices. The increasing inflation is no surprise given the increasing trend in global grain and agricultural product prices. However, still due to grimy outlook of the Chinese economy PBOC seems not to stop injecting money into money markets.

China's GDP growth fell to 7.6% during the 2nd Quarter, however still the growth rate is not bottomed out yet. The downward trend is continuing even further, and yet there is no consensus on whether the government's target of 7.5% growth rate will be achieved for 2012.

Dilemma of Chinese Economy

China will be facing an important risk due to its incomplete liberalization process. The transformation of Chinese economy is nowhere complete however; the labor costs are rising very rapidly in coastal areas due to the increases in living costs.

What is the main problem of Chinese economy for the long-term?

The biggest problem in the Chinese financial system is the lack of a proper market economy. The reason is simple, Chinese currency is not convertible which forces the PBOC to keep exchanging the inflow of USDs into RMBs, at the cost of preserving a high monetary base growth for many years.

Where does this money go?

In the next stage the excess money supply went to channels such bank credits and then through bank credits to local government and companies, which invest heavily in the property and infrastructure investments. This kept the Chinese growth rates around 10% for

many years. This was also needed due to rapid urbanization and industrialization of the country. However, China failed to liberalize its money markets so far, which kept the real interest rates close to zero for long time. Furthermore, the absence of competition between banks created inefficient valuation of profitable and non-profitable investments. In this system all the major banks are state owned and works as engines of capital injection to government favored industries. Most investors lack the necessary investment tools to invest their savings. Considering the fact that even bank deposit rates are often below inflation rates, people consider property investment as the only feasible and profitable investment tool.

Finally, this unbalanced situation in the financial system keeps property prices rising for the last three decades. In Chinese economy stock market also failed to function properly due to lack of a market economy. Government often takes decisions that have impacts on various industries without prior notice. Lack of transparency in the accounting and auditing standards were another big problem. The system does not protect the rights of small investors but rather

favors state owned enterprises in many ways, that today Shanghai stock index is at its lowest levels since 2009. To inject capital into the stock market Chinese government is increasing the quotas for qualified foreign investors, however even this move did not show much effect in stopping the downward trend in the stock market indices. The stock market also shows that the real situation for the long-term prospects of the Chinese economy is actually worse than the government announced statistics.

2013 will be a difficult year for China and will face many important decisions. The leadership of the party will be replaced and the decisions of the new leadership will determine the performance of the Chinese economy in the coming years. Sooner or later China will have to liberalize its interest rates, exchange rates and financial markets. Otherwise, China will be increasingly exposed to international contagion risks. Slowing demand in American and European markets will hit China not only by lower FDI and exports, but also domestic policies such as stimulus packages will distort the economy further.