ByInvitation

What lies beneath China's financial tremors?

China's financial fluctuations have sent world markets reeling. But fears of an imminent collapse in the Chinese economy are unfounded

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For The Straits Times

The recent volatility in global currency and stock markets has continued to hog newspaper headlines around the world. It was triggered first by the devaluation of the Chinese yuan on Aug 11 and then the Shanghai stock market crash earlier this week ("Black Monday"). Such are the financial tremors in China that have wreaked havoc on the world's foreign exchange and capital markets.

Stripped of various media hype and sensational headlines for a cool analysis, many would view these developments as rather incomprehensible. The Chinese yuan, after ending its de facto peg to the US dollar in 2005, has been steadily appreciating over the years. Just how could its initial 1.9 per cent devaluation against the US dollar be dubbed "sharp devaluation" by Western media?

It was merely a small step primarily meant to correct the yuan's exchange rate misalignment caused by China's weaker macroeconomic fundamentals, including slower export growth and increasing capital flight.

Even after a second day of equally small devaluation, the yuan has since depreciated only about 3.8 per cent against the US dollar while it has since appreciated heavily against all major currencies: Up over 10 per cent against the South Korean won and the euro, and almost 20 per cent against the yen.

The contagion effect of the Shanghai stock exchange rout on the global capital markets is even more unfathomable. Granted, financial markets everywhere are often driven by sentiment, expectations and herd instinct, but it is difficult to explain and justify why "Black Monday" could have been triggered by the 8.5 per cent sell-off in the Shanghai market, which has been going up and down for several months.

Before this, it had already experienced three large single-day drops of 8 per cent since January. At its peak this June, the market had gone up 150 per cent in one year.

The market was over-valued, with the average price/earnings ratio more than 30 at its peak. Hence the inevitable but normal correction.

Furthermore, the Shanghai Stock Exchange is still a relatively small market (only the fifth in the world), which is essentially not widely open to foreign investors.

It is therefore hard to understand how a single-day market correction in Shanghai could have caused the Dow Jones to shed 1,000 points!

Is this just "irrational gloom"? Or we have over-exaggerated China's real financial muscles?

During the 1997 Asian financial crisis, as the region's stock markets all plunged, Wall Street held its ground. This eventually stabilised the global financial markets.

Why not this time? Has the US lost its former financial dominance? Or we have given too much credit to the rising yuan? When China catches a cold, does the US also sneeze?

MISINTERPRETING CHINA'S ECONOMIC SLOWDOWN

Behind all the panic and gloom was the heightened concern about the health of the Chinese economy – even to the extent of fearing its imminent collapse!

As China is the world's second-largest economy accounting for 13.4 per cent of global GDP (or 16 per cent by the purchasing power parity measure), as compared with 22.5 per cent for the US economy, its ebb and flow is apt to produce a significant contagion effect across the world.

Since 2009, China has become an important economic growth engine of the world, regularly accounting for a third of annual global growth. Not surprisingly, China has become the leading trade partner for 75 countries. Countries from Australia (one-third of its exports go to China) to Brazil have come to depend heavily on China as a market for their primary commodity exports while China is also an important market for manufactured exports from industrial countries, from South Korea (one-quarter of its exports) and Japan to Germany.

Any major slowdown in China's growth will therefore herald a potential global slowdown.

Economists have long been sceptical about the tenuous relationship between real economic growth and the performance of the stock market, with the former recording its activities at yearly or at most quarterly intervals, whereas the financial markets operate mostly on short term, daily or even instantaneously.

But this has not prevented financial journalists and market pundits from using certain macroeconomic indicators to generate the required "sentiment" to move the market.

This time round, the obvious culprit was China's economic "slowdown". Indeed, it is this perceived China slowdown that fuelled the contagion of the financial tremors. Unfortunately, China's economic slowdown has been grossly exaggerated and the nature of its slowdown widely misunderstood.

IT'S THE END OF HIGH GROWTH, NOT A COLLAPSE IN GROWTH

China's economy experienced phenomenal growth of 9.8 per cent a year during 1979-2013.

Growth first started to decelerate in 2012 to 7.8 per cent; and then to 7.7 per cent for 2013. The decline got more dramatic last year, with only 7.4 per cent growth, the lowest in more than two decades. For this year, growth is likely to come down to 7 per cent, or, as predicted by the International Monetary Fund, just 6.8 per cent.

No economy can keep growing at close to double-digit rates forever without running into various constraints. China's hyper-growth for well over three decades has been historically unprecedented, and was much longer than what Japan, South Korea, Taiwan, Hong Kong and Singapore had experienced before – just a little over two decades of such high growth for Japan, South Korea and Taiwan, and substantially shorter for Hong Kong and Singapore.

China has been the most remarkable for sustaining such a long period of high growth, partly because it has far greater internal dynamics in terms of having much bigger hinterlands along with a larger labour force, especially compared to other dynamic East Asian economies.

Still, China's growth must come down after so many years, due to the inevitable weakening of its major growth drivers or the drying up of its sources of high growth.

For years, its growth was primarily fuelled by the rise in fixed assets investment (growing at over 20 per cent a year) and exports (at over 10 per cent a year). In the first seven months of this year, investment was up only 11 per cent while export growth experienced a contraction of 1 per cent.

Clearly, its era of high growth is over.

China's economic slowdown had been widely reported and indeed expected, although some international media mischaracterise it with sensational labels like "hard landing".

Put into proper perspective, China's present "lower" growth is "low" only in its own context, as its current 7 per cent level of growth is still remarkably high by any regional or global standard, and certainly well above the average global economic growth of 2.8 per cent for last year.

In fact, given China's mammoth economy of over US$10.4 trillion (S$14.6 trillion) in GDP, a "mere" 7 per cent growth would enlarge its GDP in a single year by an amount equivalent to 80 per cent of Indonesia's total GDP or one-third of India's.

CHINA IS WELL-PREPARED FOR SLOW GROWTH 'NEW NORMAL'

This explains why the present economic deceleration has not much worried the Chinese leadership, which has officially embraced slower growth as the "New Normal".

Chinese President Xi Jinping had dismissed fears of 7 per cent growth as "actually not all that scary". He also pointed out that China's 7.7 per cent growth in 2013 had added to China an increment of GDP in a single year that was equivalent to its entire GDP of 1994.

Mr Xi clearly understands that economic growth is all about increases in GDP at compound interest rates.

What is more crucial to Mr Xi is whether the Chinese economy is on track to rebalancing its pattern of growth. China wants to have growth that is less dependent on investment and exports and more dependent on domestic consumption. It wants to continue to upgrade its economic structure towards a more efficient growth based on higher productivity.

China's present economic slowdown is also not just about the change in the magnitude of growth, but also the nature of its growth.

Years of hyper growth have left behind a lot of "excesses" in terms of over-production and over-capacity as well as a huge domestic debt overhang. Thus, the manufacturing sector that used to grow at double-digit rates, registered only 6 per cent growth in the first seven months of this year.

China currently has huge stocks of surplus raw materials and minerals, and this explains why it currently faces low import demand from primary-producing countries. This also explains why it is pushing hard for its One Belt, One Road project as a way to digest its industrial over-capacity.

More significantly, its growth pattern has started to shift, with growth increasingly driven by domestic consumption. This means that its future 7 per cent or so growth generates more GDP in consumer goods and services, and less in output from the heavy industry sector like iron and steel.

China's imports of certain raw materials and minerals are set to decline further. This is bad news for some primary-export Asean countries. In short, it is not just China itself, but the world at large that also has to adjust to China's economic slowdown.

But the story of China's growth has been well-forecast and is by no means unexpected.

The critical thing right now is not to misinterpret the fluctuations in the yuan and stock markets, which are just corrections to overvaluations in the past, certainly not a signal that the Chinese economy is about to collapse.

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