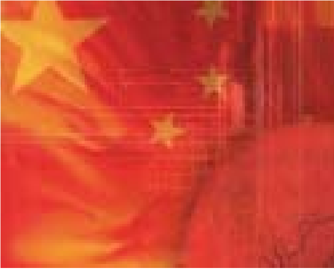

William Sterling

STERLING'S WORLD REPORT

Is China Overheating?

One of the most surprising developments of 2003 was the remarkable economic boom in China. The Chinese economy grew by more than 9% in real terms last year and many analysts believe that the official data understates the strength of the boom. The boom was surprising because the SARS panic early in the year caused Chinese consumer confidence to plummet and raised fears of a major slowdown in the Pacific Rim economies.

Instead, China's economy soared as confidence recovered. The boom was fuelled by rapid monetary growth and a powerful wave of capital spending across many of the nation's major industries. Industrial profits rose by an impressive 43%, with nearly half of the growth in profits coming from the red-hot energy, commodities, chemical and power sectors.

The expansion of China's industrial capacity has been nothing short of astonishing. Consider that capital expenditure in 2003 was up 97% in the Chinese steel industry; 93% in the aluminum industry; 122% in the cement industry; 87% in the auto industry, and 80% in textiles.

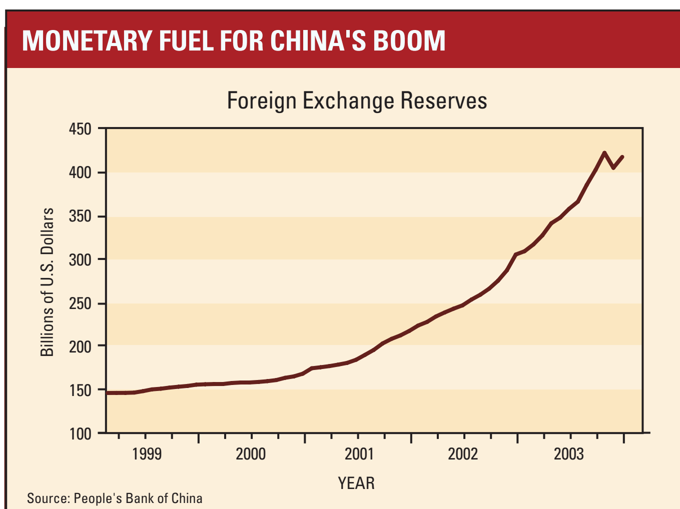

Chart 1: China's foreign exchange reserves have soared to over $400 billion based on a huge trade surplus with the U.S. and booming direct investment.

While talk of excess capacity and lack of pricing power occupied market participants in other nations, business people in China worried about increasing production bottlenecks. World commodity prices for metal and energy have soared in recent months as Chinese purchasing agents scrambled to buy raw materials from around the world to meet booming domestic demand at home.

China is not the only reason for the boom in global commodity prices. U.S. Federal Reserve Chairman Alan Greenspan's reflationary monetary policy triggered stronger growth in the U.S. and also prompted many other nations to keep monetary conditions set on full throttle. But as a swing factor in global market demand, China has now become an important player, with important implications for business around the world, including currency traders, steel buyers and oil and gas producers.

China's Boom: Made in the USA?

Economic booms are fun while they last and they can often last for quite some time. That said, they often set the stage for the next painful bust. Accordingly, investors need to pay careful attention not only to all the good news, but also to the potential bad news.

In China's case, it is important to understand the monetary and political origins of the current boom. On the monetary side, Chart 1 shows the huge growth in China's foreign exchange reserves in recent years, which has served as "high-powered money" fuelling the nation's economic boom. The surge in foreign exchange reserves has been a result of burgeoning Chinese exports, with China's trade surplus versus the United States now running at a record pace of nearly $140 billion per annum.

Under normal circumstances, a trade surplus that large would cause the Chinese currency to appreciate against the U.S. dollar as Chinese exporters converted their huge dollar receipts into their home currency. For political reasons, however, the Chinese authorities have resisted currency appreciation and have chosen simply to accumulate huge dollar reserves, largely in U.S. Treasury securities. In this regard, they have learned much from the masters of this game, namely the Japanese, who now have foreign exchange reserves of more than $700 billion.

The politics of this policy are quite straightforward: China is pursuing an export-led growth model much like mercantilist policies of yore. The thinking is that export growth creates jobs and that foreign exchange reserves – like gold reserves of yesteryear – provide a valuable cushion for the economy in the event of a "rainy day" sometime in the future. For the time being, however, the thinking about exports is simply that "more is better" and that any appreciation of the Chinese yuan would be unhelpful to the nation's growth.

China's focus on employment growth is understandable. If you think U.S. President George Bush has a jobs problem, consider the fact that China needs to create nearly 22 million new jobs per year to keep the unemployment rate from rising. That reflects not only population growth in a nation of 1.3 billion citizens, but also the ongoing impact of workers who are losing their jobs in the nation's antiquated state-owned enterprises or who are migrating from poor rural areas in search of economic opportunity in China's cities.

The U.S. is one of China's largest export markets and welcomes Chinese goods with open arms. Accordingly, the Chinese have been more than happy to finance the U.S. trade deficit – and their own export growth – by buying enough U.S. dollar securities to keep their currency value pegged to the U.S. dollar.

When the one-two punch of Alan Greenspan's interest rate cuts and George Bush's tax cuts turbocharged U.S. consumer spending, China's exports soared and so too did China's foreign exchange reserves. In other words, when Wal-Mart sells Chinese-made DVD players for $29, those export earning have tended to end up boosting China's foreign exchange reserves. So in that sense, the Chinese monetary boom is Made in the USA.

Chart 2 shows that China's domestic money supply has also surged in recent years, with recent growth in the broad monetary aggregate, M2, running at nearly 20%. The reason is simple. When Chinese authorities buy dollars, they pay for their purchases with Chinese yuan. That tends to boost the domestic monetary base and encourages Chinese banks to boost lending.

And that is exactly what has happened. Chinese banks have been aggressively providing credit to Chinese companies for capital expenditure programs across a variety of industries. Some China analysts are worried that the banks have become too aggressive, and that excess capacity will end up haunting the Chinese, as it has Japan over the past decade.

A case in point is the cellular phone industry. Three years ago, the Chinese produced approximately 35 million units per year. They have since boosted capacity to nearly 200 million units per year, which is roughly 45% of world supply. In the next three years, it is estimated that they will double capacity yet again, which could flood the world with cheap cell phones. Similar stories are being played out in other industries.

Inflation Heating Up

What is the biggest risk currently facing China's economy? The answer is inflationary overheating. As Chart 2 indicates,

Chart 2: The Bank of China has let annual money growth accelerate to around 20%. That has helped fuel a powerful boom but also raised fears of accelerating inflation.

China's money supply growth is on a tear and early signs of overheating are already evident. Chart 3 shows China's consumer price inflation rate, which has recently accelerated to around 3% after having been negative as recently as 2002. Many analysts expect inflation to continue rising in coming months, moving above 5% by mid-year. If this happens, rising resource prices are likely to eat into companies' profit margins and force price hikes at the consumer level. We would also not be surprised to see production bottlenecks, including urgent problems such as power shortages.

Such developments will get the attention of policymakers at the Bank of China. They have already expressed concern about economic overheating and began to modestly tighten credit conditions toward the end of last year. However, we expect that further evidence of accelerating inflation is likely to lead to more aggressive monetary tightening in the second half of this year.

Of course, one other way for them to cool off the economy would be for them to finally let the Chinese yuan appreciate against the dollar. Speculation that they will be forced to move to some kind of new currency regime is rising, which complicates their job of monetary management by creating speculative capital inflows. One widely held scenario is that they will begin to adjust the currency's value against the dollar by moving toward a system used by Singapore, where the currency is pegged to a basket of foreign currencies, of which the U.S. dollar is but one component. That would be a measured response that would give Chinese export industries time to adjust.

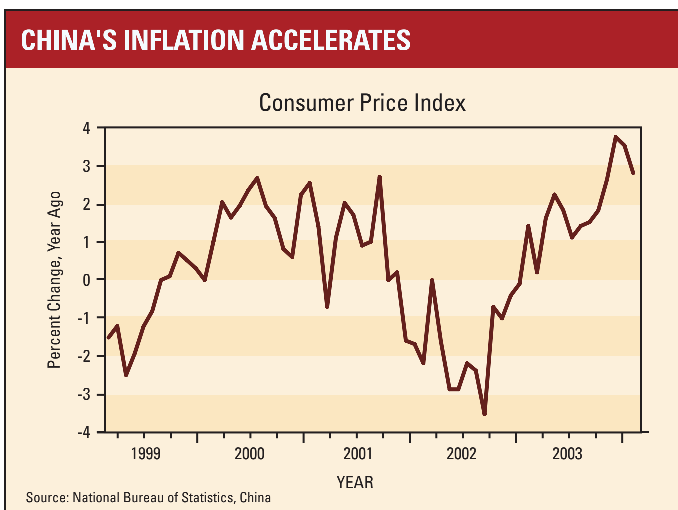

Chart 3: Inflation was non-existent in China in 2002, but has since accelerated to around 3%. This raises the prospect that China will tighten monetary policy decisively sometime this year.

A Soft Landing?

A key issue is whether China will be able to engineer a soft landing for its soaring economy, or whether monetary tightening and potential currency appreciation will trigger a more severe economic correction. Our bet is that China's capital spending boom is likely to face a hard landing over the next 12 to 18 months, but that overall consumer spending growth will keep the economy moving forward.

That said, more aggressive tightening by the Bank of China later this year is a significant risk that may not be fully appreciated by many investors focusing on China-related investment themes.

China's decision on whether to let the yuan appreciate will also be of key importance to global foreign exchange markets. Up until now, China's currency peg has meant that floating currencies like the euro and the Canadian dollar have borne the brunt of adjusting to the large U.S. trade and current account deficits. However, if China's currency experiences a big adjustment, that will relieve some of the downward pressure on the greenback versus other currencies.

Finally, we will be watching closely for what potential impact a Chinese slowdown would have on global commodity prices and commodity currencies (including the Canadian dollar). If Chinese monetary tightening coincides with Fed monetary tightening later this year or into next year, then presumably many of the "reflation trades" that have dominated the markets since early last year will stop working.

We may well be early in expressing these concerns about the Chinese economic miracle. Furthermore, the long-term prospects for China's economic rise are likely to remain favourable, despite this year's challenges. But when we see Chinese IPO's that are 600 times oversubscribed and Chinese capital spending rising 100% in major industries, our contrarian instincts begin to kick in.

Whatever the case may be, one thing is clear. What happens to China's economy will begin to matter more and more to global financial markets. And we suspect that will remain the case for the rest of our investment lifetimes.

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