

HOW FAR WILL IT GO?

China has revalued its currency, the yuan, and linked it to a basket of currencies. By itself, this will do little to slow the economy, but it may ease trade tensions

Sooner or later, it was going to happen, and on July 21st it did. China abandoned the 11-year-old peg of its currency, the yuan, at 8.28 to the dollar. From now on, the yuan will be linked to a basket of currencies, the central parities of which will be set at the end of each day. And the currency has been revalued, although by nothing like as much as America and others have been demanding: the yuan's central rate against the dollar was shifted by 2.1%, to 8.11.

As *The Economist* went to press, it was not clear exactly how the new system would operate. The Chinese called it a "managed floating exchange-rate regime", which may well imply more management than floating. The fact that the Chinese have acted at all is important. But the eventual economic and political effects of the revaluation will depend on how far and how fast the yuan moves from now on.

In particular, such a slight revaluation is unlikely to do much to slow China's fast-expanding economy. The day before the currency regime changed, the country's official statisticians said that GDP in the second quarter of 2005 was 9.5%

higher than a year before, more than most pundits had forecast and only a shade less than the figure for the same period of 2004 (see chart). Industrial production, ahead by 16.8% in the year to June, and investment in fixed assets, up by 25.4% in the first half, year on year, have both eased from their levels at the end of 2003, but remain strong. Inflation, as measured by the consumer-price index, is mild. It slid to 1.6% last month, down from 5%-plus a year ago.

In truth, the economy is slowing more markedly than these (highly suspect) official figures suggest. Many economists say that China has an institutionalised bias to over-reporting growth at the bottom of a cycle and under-reporting it at the top, to reduce the volatility of the numbers. Judged by physical indicators, such as electricity consumption or freight volumes, GDP growth probably peaked at over 12% in 2003 and should slow to 8% by 2006. Since China's macroeconomic growth is driven more by fixed investment than by household consumption (which dominates in the West), it is especially vulnerable to any slowing of corporate investment or public spending on infrastructure.

"In investment cycles," says Andy Xie, Asia economist at Morgan Stanley, "the leading indicators are profit margins, product prices and property prices, which forecast corporate cash flow or ability to borrow." These three are slowing. For the past five years, Chinese industrial firms have enjoyed record profit margins as revenue growth has outpaced the increase in wages and raw-material costs. In 2003 and 2004, industrial production and sales grew at an annual rate of nearly 30% in real terms, analysts estimate, but in 2005 the pace has slowed to around 15%. With commodity prices high, companies' margins are being squeezed: overheated industries such as cars, steel, cement and basic materials are suffering especially.

Property prices are also moderating after a period of extraordinary growth, particularly in big cities. Shanghai house prices, up by half since 1998 and by almost 10% in the first quarter of this year, have fallen back by 10-20% since mid-April. Transaction volumes in most urban centres have also dropped, because the government has imposed a property-sales tax and tightened mortgage requirements.

Overall, however, China seems to be managing the soft landing that it wants. The authorities have acted earlier and more decisively than they did in the mid-1990s, curbing growth before it gets out of hand. Policymakers have also been more sophisticated, targeting selected sectors with administrative restrictions while shifting to market-based measures, including last October's increase in interest rates, to rein in money and credit growth. A dearer yuan-but much dearer, probably, than after this week's move-would give the economy another downward nudge.

In addition, the economy is looking better balanced: there are signs that consumer spending is doing more to support the economy, alongside fixed investment and exports. Rising incomes are boosting households' spending power, lifting retail sales by 13% in the first half of the year, compared with the same period of 2004. And the countryside is finally playing a part: after six years of lacklustre growth, rural incomes rose by 12.5% in the first half.

That said, China's policymakers cannot afford to rest on their laurels. On the one hand, there is a risk that the economy will steam away again as spending

for the Beijing Olympics in 2008 takes off. On the other, the vast amount of manufacturing capacity built up over the past few years means that a slightly sharper slowdown, perhaps triggered by lower growth in America, could tip the country back into deflation. Already, a staggering nine-tenths of manufactured goods in China are thought to be in oversupply.

In the short term, the biggest worry is that China becomes a victim of its own international success. Until recently China has been a powerful engine driving the world economy. If it slows, existing political and trade tensions could still worsen. Thus an unfortunate



side effect of China's attempts to cool its domestic economy has been an exploding trade surplus, because import growth has softened while exports have remained robust. In June, China's exports rose by 30.6%, year-on-year, while imports grew by just 15.1%, widening the monthly trade surplus to \$9.7 billion. The cumulative surplus for 2005 is now nearly \$40 billion, more than for the whole of last year. This year's current-account surplus could reach 9% of GDP. "Just one year ago, China was the world's fastest-growing importer of heavy industrial products," says Jonathan Anderson, chief Asia economist at UBS. "Today, the mainland is actually a growing net exporter, with shipments of not only textiles but also steel, other metals and chemicals accelerating visibly."

Slowing imports (of everything but commodities) are bad news for international companies, at a time when those doing business in China are already suffering

flooding Asia with cheap mobile-phone handsets it cannot sell profitably at home.

Revaluing the yuan should make some of the tensions created by all this less acute. American politicians, in particular, have been demanding a step in this direction. However, they have been demanding a much bigger stride. And investment is becoming as touchy an issue as trade has been. China is no longer using its huge stock of foreign-exchange reserves—over \$700 billion—merely to buy American Treasury bonds, but to snap up physical assets too. The \$18.5 billion contested bid by CNOOC, a big Chinese oil company, for America's Unocal is causing an uproar in Washington, DC. China's move this week may dampen calls for trade protection and revaluation for a while. But if China's domestic economy slows and thus becomes less supportive of global growth, such calls are likely to return soon.

In particular, such a slight revaluation is unlikely to do much to slow China's fast-expanding economy. The day before the currency regime changed, the country's official statisticians said that GDP in the second quarter of 2005 was 9.5% higher than a year before, more than most pundits had forecast and only a shade less than the figure for the same period of 2004

from increased competition and oversupply. And mainland firms are becoming aggressive exporters of everything from textiles and steel to electronics and even cars. Ningbo Bird, based in Zhejiang province, is

Taken from:
"The Economist", July 23rd, 2005