

Global: Daily Economic
Comment

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Economic Trends

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China Pull

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- **Beijing-speak**
Overheating is the buzz in Beijing — it was all anyone wanted to talk about on my visit to China last week; excesses in selected coastal property markets, together with spillover effects on the pricing of steel, cement, and other construction materials, are on the radar screen of Chinese policy makers.
- **Policy tightens**
The People's Bank of China has already moved to tighten monetary policy; by announcing an increase in reserve requirements in late August, it sent a signal in the form of a pre-emptive strike at a bank lending bubble — a credit surge that was threatening to morph into a more dangerous property bubble.
- **The medicine is working**
In my discussions with senior officials in the Chinese banking sector, there is little doubt that lending growth has already slowed; according to their assessment, the response to the increase in reserve requirements has been almost immediate — bank lending is reported to be down in both September and October.
- **Collateral damage**
The monetary tightening should slow Chinese domestic demand — pushing down import growth, which has become an important source of pan-Asian activity over the past year; Japan, Korea, Taiwan, Singapore, Malaysia, and Thailand should be especially hard hit; commodity prices could also weaken in response.
- **Asia's new model**
In the aftermath of the Asian crisis of 1997-98, the region turned inward; it appears to have found a new way in the form of a Chinese-centric growth dynamic — a strategy that seems justified in light of China's extraordinary performance over the past five years.
- **Unprepared**
If the slowdown in the Chinese economy materializes as we suspect, the rest of Asia will have to face the consequences of its new strain of dependency; that could well unmask many of the region's lingering structural deficiencies; a complacent Asia doesn't appear to have a clue as to what's coming.

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China Pull

Overheating is the buzz in Beijing. It was all anyone wanted to talk about on my visit to China last week. Excesses in selected coastal property markets, together with spillover effects on the pricing of steel, cement, and other construction materials, are on the radar screen of Chinese policy makers. The authorities have already moved to arrest the excesses. This points to a likely slowing in the Chinese economy in early 2004, with concomitant ripple effects showing up elsewhere in an increasingly Chinese-dependent Asian economy.

The move to skim the froth off China's exceptional growth vigor was initiated by the central bank in the form of an increase in reserve requirements announced in late August and made effective in late September. The People's Bank of China (PBOC) is very much up to speed with the modern-day principles of central banking. It knows full well that policy restraint works best only when it is pre-emptive. In my discussions with senior PBOC officials, the hike in reserve requirements from 6% to 7% was depicted as just that — sending a signal in the form of a pre-emptive strike at a bank lending bubble that was threatening to morph into a more dangerous property bubble. In the first half of 2003, Chinese bank lending to the nonfinancial sector was increasing at about a 50% annual rate, double the pace of 2002. At the same time, property prices are surging in Shanghai and Beijing. While the central bank indicated that the smaller banks were especially guilty of extending too much credit to the real estate sector, there is also evidence of a sharp acceleration of lending by the four state policy banks, whose main purpose is to funnel funds into shaky state-owned enterprises. That latter aspect of the lending binge raises the risk of a new wave of non-performing bank loans, the last thing a fragile Chinese financial system needs. Under those circumstances, the PBOC action was the only responsible thing to do.

The medicine is already working. The remaining vestiges of a centrally controlled system have certain virtues — the word gets out quite effectively. In my discussions with senior officials in the Chinese banking sector, there is little doubt that lending growth has already slowed. According to their assessment, the response to the increase in reserve requirements has been almost immediate; lending is reported to be down in both September and October — responding more to the announcement effect in late August than to the actual implementation of the action a month later.

The resulting downshift has initially been concentrated in property markets but apparently is also spilling over into other sectors as well. This could be just the beginning of a shift to policy restraint in China. The PBOC is now in a “wait-and-see” mode, content to sit back for a few months and assess the impacts of its actions. Should more tightening be required, they will not hesitate to act, in my view. China has a long history of disruptive hard landings. Its central bank believes that this pre-emptive action raises the chances of a far more palatable soft landing.

These observations inside China confirm the earlier conclusions that both Andy Xie and I had reached on the coming slowing of the Chinese economy (see my 13 October dispatch, “Payback Time” and Andy's 20 October note, “China: Sharp Slowdown Ahead”). Andy expects that the monetary tightening will have a significant effect in cooling off both the property and the export sectors in 2004. The slowing in exports should also be reinforced by the recent deceleration in foreign direct investment — a temporary pullback following the post-WTO-accession bonanza of 2002 — and the government's recent moves to cut the export tax rebate by three percentage points (from 15% to 12%) effective January 2004. As bank lending slows, so should fixed investment spending. Our official forecast for the Chinese economy looks for 11% growth in fixed investment in 2004, half the excessive 22% rate of increase in 2003. The anecdotal reports from Chinese banking officials that I heard over the past few days seem to confirm this possibility, as the slowdown in real estate lending now spills over into other segments as well. Reflecting this investment-led downshift in domestic demand, we also look for a sharp slowing of Chinese import growth — a 20% gain in 2004 following a 40% surge this year.

The import impact is of critical importance in understanding the pan-regional and broader global implications of the coming slowdown in the Chinese economy. China's powerful import dynamic has turned into an important growth engine for its major trading partners. Notwithstanding the politically-inspired focus on China's 32% year-over-year export dynamic in the year-to-date through September, the real news, in my view, is the 40.5% burst of imports over the same period. As I noted in the above-cited dispatch, surging exports to China accounted for fully 73% of the total increase in Japanese exports in the

first eight months of 2003. For Korea, the share was 40% and for Taiwan it was an astonishing 99%. Even in the United States, China accounted for fully 24% of total export growth in the first eight months of this year. The bottom line is that any material slowing in Chinese import growth — precisely what we expect over the next year — will have important implications on Asia's increasingly Chinese-dependent trading partners. It could also have a significant impact on global commodity markets, where recent trends in both demand and prices appear to have been heavily influenced by the upside of the Chinese growth cycle (see Andy Xie's 22 October dispatch, "China Slowdown Impact: Minerals vs. Metals").

The newly recovering Japanese economy could be especially hard hit. Last week in Japan, I encountered more hope and optimism than I had seen in years. The Japanese businessmen I met with, like their American counterparts, remained cautious. But a cyclical lift in the stock market and the economy was all that investors really needed. There was widespread conviction that Japan's current cyclical uplift could last well into 2004. But this conclusion appears to be on very shaky ground, in my view. Japan's improvement in domestic demand has been concentrated in capital spending — an impetus that few, including our own Japanese economics team, believe is sustainable in a still deflationary Japanese economy that remains awash in excess supply. And the impetus to external demand seems likely to be adversely impacted by a downswing in the China factor — the bulk of the recent impetus — together with the impacts of the recent strengthening of the yen. That underscores one of the great ironies of the New Asia: Japan — once the unquestioned leader of the Asian economy — is now increasingly dependent on China as a source of what little growth it can eke out. As China now slows, the Japanese economy could be in for yet another tough reality check.

The same could be true elsewhere in Asia. That's not just the case in Taiwan and Korea, as noted above. The current export dynamic of the ASEAN economies of Malaysia, Thailand, and Singapore is also heavily dependent on Chinese import demand; in the first eight months of this

year, China accounted for between 20-30% of the total export growth of these three economies. With Asia's smaller economies still suffering from a deficiency in domestic demand, to say nothing of a lack of foreign capital inflows in this post-crisis era, a slowdown in China would hardly be a trivial consideration.

Asia is not prepared for a China-led slowdown, in my view. Midway through this two-week Asian tour, I am struck by a growing sense of complacency in the region. Memories are amazingly short these days. A seven-month run in the stock market did the trick, I guess. Not unlike the case in post-bubble America, the post-crisis Asian economy seems to have all but wiped out the painful lessons of five years ago. I spent a few days over this past weekend at the Boao Forum for Asia in Hainan, China — a relatively new pan-regional celebration of the Asian miracle modeled after the World Economic Forum in Davos. Heads of state and policy makers spoke eloquently and predictably of the new potential for pan-regional integration and resilience. But the real message, in my view, was the widespread acceptance of an unmistakably Chinese-centric character to the region's growth dynamic. To some extent this is the inevitable outgrowth of the Asian crisis of 1997-98 — a region that has subsequently turned inward after having been burned by the hot-money capital flows from the West. There was a real sense of self-congratulations in the air in the halls of Boao. China's spectacular performance over the past five years has given the rest of the region great confidence in the payback from such a strategy.

But there are no guarantees that this latest incarnation of the Asian model will perform any better over time than earlier growth strategies. If the slowdown in the Chinese economy materializes as we suspect, the rest of Asia will have to face the consequences of its new strain of dependency. And that could well unmask many of the region's lingering structural deficiencies — namely, shaky financial systems and inefficient corporate sectors. Reluctant to embark on the heavy lifting of post-crisis restructuring, Asia thought it had found in China a new recipe for prosperity. As China now slows, my sense is that the region doesn't have a clue as to what's coming.

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