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China: Why the Giant May Stumble

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Emerging Markets[1]

NEVER, IN OUR RECOLLECTION, has an emerging market economy "emerged" without hitting bumps along the way. The road that leads from an agricultural society with few financial institutions to a diversified manufacturing and industrial-based economy with rich capital markets is paved with pitfalls.

China is unlikely to be the first exception to this pattern. We have all been told many times about how important China has become to international commerce and to the market for U.S. Treasuries and other reserve assets. We all appreciate by now the risk of China's production mechanism severely faltering, or of a halt to capital flows into and out of China. Here, then, is a synopsis of how it all could go sour very fast in an emerging market -- and a list of symptoms to look for if China's massive economy gets sick.

The most important thing to remember about China is that it very much is an emerging economy, albeit a huge one. Yes, it is difficult to think of a $1.4 trillion economy as emerging. After all, it exported $440 billion worth of goods last year, consumed half the world's cement production, absorbed a third of the world's steel output and generated half the GDP growth on the planet. Numbers of this magnitude are usually reserved for G-7 economies.

However, the size of the economy should not be confused with its stage of development. China lacks both private capital goods and infrastructure -- roads, railways, power -- and thus is stuck well within its production-possibility frontier. The economy is largely dependent upon foreign inflows of fixed investment: Last year, foreign direct investment was almost one-half of the nation's entire economic growth. Finally, and most importantly, China lacks a deep capital market and stable financial-sector institutions.

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These factors all explain why China's dependence on foreign capital inherently destabilizes its developing economy, more than such a dependence would in a developed market economy. The story starts with money: Consider what happens when foreign companies pump $54 billion worth of direct investment into the economy in a year. The foreigners bring dollars, yen and euros into China and convert them into yuan, which are spent on setting up factories and offices and equipping them. While some of the capital goods have to be imported, most of this money is spent on local goods, services and labor. The part of the money that is used for locally produced goods and services is called the domestic currency counterpart to the fixed foreign investment inflow. It is an increase in the money supply that, in China's case, is equal to 20% of the monetary base.

In a developed market economy, with developed capital markets, the central bank would view an inflow of foreign money of this order of magnitude as an undesirable increment to its money supply, big enough to distort the objectives of domestic monetary policy, whatever they may be. The central bank would mop up this excessive liquidity by selling bonds to the general public, removing the proceeds of those sales from the monetary base. If these open-market operations, as they are called, equal the amount of the undesired inflow of funds into the economy from overseas, then the central bank is said to have sterilized these inflows.

This sterilization trick does not work for an emerging market like China, where there is no developed capital market. (This is one reason we call it an emerging market, right?)

The central bank does not have enough private-sector bond investors to sell extra bonds to. In fact, it hardly has any domestic bond investors at all -- so the domestic currency counterpart cannot be sterilized. It increases the growth rate of China's money supply to a pace that is inconsistent with price stability. In short, a 20% jolt to the monetary base leaves a lot more money chasing around the economy than there are goods to buy. Either prices have to rise, starting an inflation process, or imports must become a vent for the excess demand caused by the rise in money, or both -- all because the central bank of China has lost control of the money supply to foreigners.

Foreigners may see rising inflation risks as unsettling, and cut back the pace of their investment spending sharply, or even postpone projects indefinitely. If the foreign direct investment flows seize up, GDP growth will be halved at once, and probably halted altogether when the secondary effects work themselves out. Imports for assembly and re-export -- where a country like China receives "bits and kits," say, of a Sony DVD player, has workers put them together to make finished DVD players and then ships them -- may halt, pulling a $400 billion importer of goods and services out of the market. China will cease to be an engine of growth for its regional economy and, to a lesser extent, the world economy. If domestic financial stability is threatened by all this, domestic businesses may falter too should inflation become severe, and the already shaky banking system could implode.

When foreign investors get really nervous, they try to take money out of a troubled economy. We saw this in the 1998 Asia crisis. When this happens, the money supply decreases and, once again, the central bank cannot sterilize the outflow of funds. If the withdrawals become substantial, the money supply will implode and the whole economy will stop. The central bank does not have the scope to control this monetary contraction in an emerging capital market.

This is not science fiction. Students of emerging markets have seen this kind of scenario occur over and over again in recent decades, most recently in the Asian economies in 1998. A variant of this process brought down the largest Latin American economies in the early 1980s. Just because China is huge and looks so wonderfully robust today -- and is sitting on a big pile of international reserves -- is no guarantee that things cannot sour quickly. Foreign currency reserves of $400 billion are huge in absolute terms, but they cover the import bill for only 10 months.

What signs of irregularity should an individual investor watch for in China's economic pulse? The easiest thing to monitor is inflation, a ready reckoner of excessive monetary growth in an emerging economy. When foreigners see inflation rise, offshore financial flows may slow or dry up. At last report, China's consumer-price index was 3.2% higher than it had been a year ago in December. This is not much inflation, but it is a big change from a year earlier

when prices were actually falling. If inflation goes up by another four percentage points -- or more -- over the next year, foreigners may really start to get nervous. Money-supply growth, by the way, has moved up to 20% from 13% in mid-2002, when the inflows of foreign capital really took off. And, yes, foreign direct investment flows -- which had been running at a 60% year-over-year pace early in 2003 -- had dwindled to flat by the end of last year.

So even individual investors can monitor the writing on the wall. China surely will have a bump -- possibly a very big one, and possibly more than one -- as it moves through the development process. No emerging market economy is too big to fall.

ASIAN STOCKS RALLIED last week, with strong gains recorded by markets in Malaysia, Indonesia, Taiwan and Japan.

In Kuala Lumpur, shares closed 4.4% ahead of their level the previous week, helped by foreign buying of bank stocks like AMMB and **RHB Capital**. Indonesia's stock market hit a record high during the week, and finished up 2.6%, with prices buoyed by the government's sale of minority holdings in four private banks. In Taipei, strong interest in electronics shares moved prices ahead 1.7%, while moderate foreign interest in blue chips edged prices forward in Tokyo by 1.6%, in Singapore by 1.4%, and in Hong Kong by 1%. Markets in South Korea and the Philippines ended the week flat.

The worst performer of the week was Thailand, where rising concerns about the deadly avian-flu virus depressed stock prices by 4.4%.

-- Neil A. Martin

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