

ECONOMY

Don't worry about China

Fears that China's economy is overheating are overblown

DESPITE recent concerns about weakening growth, China's economic prospects remain solid.

Mounting fears over excessive fiscal tightening and rising wages, are overstated. China's economy has been decelerating for some time, and it is now in a softening phase. Growth peaked at 11.9 percent in the first quarter of 2010. Recent data showed slower manufacturing growth. But the country was growing too quickly, and the ongoing deceleration is healthy. Importantly, the government remains in the driver's seat: it is deliberately cooling the economy.

As the fiscal stimulus is withdrawn, the deficit is narrowing. And, as monetary stimulus decelerates - this year, loan growth is expected at 17 per cent versus last year's 30 per cent - local governments' investment vehicles are getting less and less bank financing.

The bottom line is that if it is needed, the government has the financial means for an additional stimulus plan.

On economic tightening, the sequence so far shows the government's strong preference for targeted policy interventions. At first, administrative measures curbed lending, to contain excessive price growth and speculative real estate purchases. Then, the appreciation of the Renminbi - largely a political move - is expected to cool import prices. Interest

by **Alessandro Magnoli Bocchi**
thegulf@tradedearabia.net



rates hikes are kept as a last resort, because they affect the whole economy and negatively impact growth.

Given this very practical approach, it is fair to assume that if the economy were to excessively decelerate, the tightening would be reverted.

On wages, it is true that dissatisfaction is mounting, especially in the South, but China is not moving into a new era of large wage increases and declining competitiveness. The minimum wage is set by local governments, and over the last decade it has been rising, on average 10 per cent per year. After the 2008 crisis, wages were frozen and the recent wage growth is just catching up to the trend.

In sum, beyond the near term the overall outlook remains very positive. In the ongoing global slowdown, growth is just declining to potential (a healthy 9 per cent), with the bottom expected in mid-2011. It is unlikely to drop below potential, as the government, if growth were to falter, will intervene. China's growth model still works very well; in 2010, growth is expected above 10 per cent.

Of course, there are risks. In the short term, the government needs to get the timing of two important policies right. First, the withdrawal of the stimuli: if resources were to be pulled back too early, the economy could contract

faster; if too late, inflation might rise. Secondly, shifting the economy from an "export-led growth" model to one driven by local consumption is key. On the one hand, a weaker global demand and faster-than-expected Renminbi appreciation - forecasted at five percent over the year, with potential of 20 percent over the next 3-5 years - could excessively hit the export sector. On the other hand, a strong global recovery could promote Chinese exports, and alas, a good crisis would have been wasted: China would still grow thanks to external demand, with large reserve accumulation, and no rebalancing of the global economy.

In the medium term, three risks need to be addressed. First is the debt of local governments. Yet the total debt of China's local governments is estimated at 20 per cent of GDP. Given that central government debt is also around 20 per cent, a total debt of 40 per cent of GDP is a level that many developed countries only dream of. Secondly, the country's external reserves need to be managed better. Thirdly, as income disparity rises, complaints about the "class

with special rights" are on the rise.

In the long run, these three challenges need concrete mitigation strategies. The demographic profile is becoming unfavorable: an aging population, the one-child policy, and poor pension provisions will be compounded by a labor force that will start contracting in 2020. Secondly, environmental constraints - especially desertification and water scarcity - can hamper long-term growth prospects. Thirdly, China needs to correct its current inefficient allocation of resources, for example by reducing the size of the state and dismantling monopolies.

Overall, these risks are manageable. The government is aware of the challenges and has the financial resources, human capital, and administrative capacity to successfully tackle them. ■

Alessandro Magnoli Bocchi is chief economist at the Kuwait China Investment Company (KCIC). The author and KCIC accept no liability for investment decisions based on this article.