Beijing Balancing

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Much has recently been made of the notion that China has enough serious structural problems with its economy that chances are good it will experience a "hard landing," defined as economic growth quickly slowing from 7.5% today to the low single digits. This slowdown would weaken commodity prices, hurting developing nations, and reduce Chinese imports of high-quality finished goods from developed nations, also hurting the US, Europe and Japan. While the Chinese economy has problems, many are chronic and I believe the government has sufficient resources to manage the acute ones and avoid a hard landing.

The key problems the Chinese economy suffers from are threefold; a profound overreliance on large trade surpluses, massive government overinvestment in infrastructure and a weak financial system that has resulted in both bad loans made by irresponsible local and regional governments and a highly leveraged and lightly regulated shadow banking system (sound familiar?) that may well implode.

The first problem is fading away. After running trade surpluses in the $45 billion/year range through 2003, they skyrocketed to $400 billion/year by the end of 2008. However, that highpoint coincided with the Great Recession which resulted in a huge contraction in trade and simultaneously an effort by many nations to boost exports to help their domestic economies. As a result, Chinese trade surpluses have averaged about $300 billion/year (about two-thirds of that with the US) since early 2009 and show no discernable upward trend. Moreover, as the Chinese economy is about twice as big today as it was in 2005, the economic impact of the now smaller trade surpluses on the overall economy is much smaller.

The second problem of roads to nowhere, massive over building of plant leading to ruinous excess capacity along with the construction of uninhabited ghost towns is being rectified. And rectified they can be, because these destructive outcomes are the direct result of policies pursued by the central government that are now being overhauled. GDP growth targets are being reduced, artificially low interest rates earned by savers are likely to rise in the near future and the currency, which has been profoundly undervalued, is slowly appreciating. Collectively these policies will curb wasteful overinvestment and slowly replace it with increased domestic consumption and reduced exports.

As for the substantial dodgy debt on the books of local and regional governments and shadow banks due to weakening housing prices and raw land values that act as collateral for many loans, here the problem is serious. That said China's debt is about 25% of GDP, giving the central government ample room to borrow should it be necessary. Moreover, the central government is beginning to force local and regional governments to sell some of the $7 trillion in assets they own in an effort to shore up their financial condition.

Moreover, with $4 trillion in foreign reserves and the ability to weaken the Chinese currency at will to boost exports, China has tools other nations don't have. Lastly, expect Beijing to re-stimulate sagging housing markets by relaxing home-purchase requirements, and local governments to augment this policy by giving residency benefits to out-of-towners to further boost demand. Combining the above with looser monetary policy makes me think that those making key policy decisions, the brightest minds in the nation, will see to it that China comes through this relatively unscathed.

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