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China: Weakened foundations

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Facing an economic slowdown, and with policy options running low, Beijing's leaders broke an old taboo and devalued the renminbi

In the thick of the Asian financial crisis of the late 1990s, as one desperate country after another slashed the value of their currencies, China was credited with halting the malaise by keeping its exchange rate pegged firmly to the dollar.

In 2008, as the global financial system stood on the edge of a precipice, China once again fixed the renminbi to the dollar and launched a huge domestic stimulus package that boosted demand for everything from Australian iron ore to American cars.

So why did China decide last week to break the great taboo and devalue its currency when there was no apparent crisis?

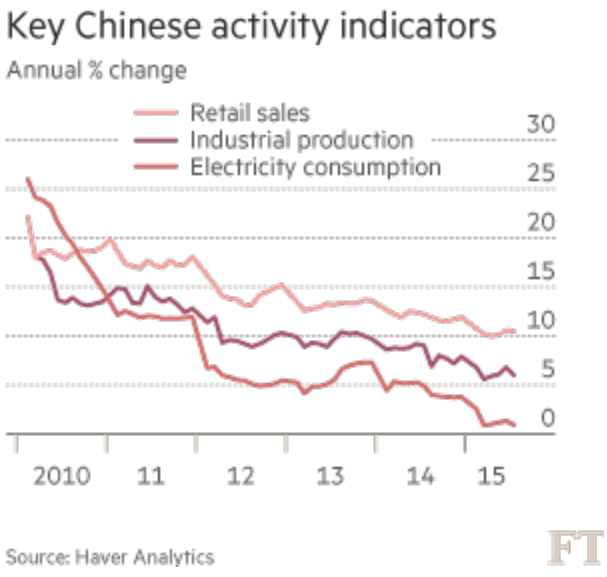
The answer is that China is already in the midst of its own creeping economic crisis and does not have enough tools to deal with it, according to analysts and even some Communist party officials speaking on condition of anonymity.

"Last week's decision to move to a more flexible currency reflects the fact the underlying economy is much weaker than the official figures show," says Rodney Jones, founder of Wigram Capital and one of the people credited with first predicting the 1990s Asian crisis. "After 30 years, China's old economic model has broken down and actual growth is much weaker than anything we've seen before. The problem for China's leaders is that their menu of possible policy options is more limited than in the past."

Filling villas and hotels

On a remote patch of swampy farmland about halfway between Beijing and the port city of Tianjin, which was hit by deadly explosions last week, the enormous "Jingjin New City" villa development provides a visual aid for anyone trying to understand the challenges facing China.

A little beyond the *Kai Xuan Men* — literally "Arc de Triomphe" — entrance gate and adjacent golden statue sits an astonishing 800-room Hyatt Regency built to resemble a European palace.



Fewer than 10 per cent of the rooms are occupied on any given night, according to staff. The indoor tennis arena and other facilities were locked up and rusting this week. Just seven years after the hotel opened, the building is falling apart and the balconies of many rooms have tall weeds growing on them.

From those balconies guests can look out over what property agents boast is "Asia's biggest villa complex", spread over 15 square kilometres. More than 2,000 villas have already been built, hundreds are still under construction and there are plans for another 4,000. The vast majority of the existing villas, built with generous loans from state-owned banks, are empty and some appear abandoned.

The Jingjin development is just part of a much larger 105 sq km planned residential zone — nearly twice the size of Manhattan — and around its edges smaller villa complexes, with

names like “Dream Life in Europe”, are frozen in various stages of construction.

“We’ve stopped building and selling villas because nobody is buying,” says the caretaker at the “Dreamland of Town” development on the edge of Jing-jin New City. “I’m not sure if these will ever be finished and put on the market.”

The nearest hospital is more than 20km away and even the most basic amenities are missing from the “new city”. Row after row of storefronts in Jingjin’s main shopping complex are boarded up, with only a couple of dingy convenience stores showing signs of life.

The problem for China’s leaders is that their menu of policy options is more limited than in the past

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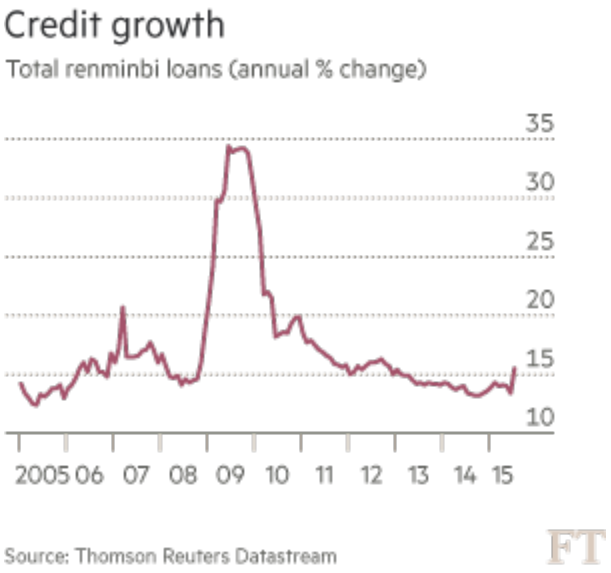
“Some people from Beijing and Tianjin have bought places here as investments and they sometimes come on the weekends, but most of my customers are workers at the hotel, security guards or people working at the showroom trying to sell villas,” says the owner of one of the convenience stores.

There are scores, if not hundreds, of “ghost cities” across the country. It seems perverse that developments such as these should exist in the world’s most populous nation, where land is scarce and many people are still too poor to afford decent housing. The Jingjin New City project and many others like it exemplify the government’s dilemma as it tries to keep growth from tumbling below its annual target of around 7 per cent, already the slowest pace for China in a quarter of a century.



For well over a decade, China’s economy has been powered by two main engines: its enormous export-oriented manufacturing sector and its scramble to build cities from scratch, even if no one actually wants to live in them.

In the aftermath of the 2008 crisis, as China’s exports collapsed, the government ordered its state-owned banks to unleash a wave of credit that has been described by economists as the greatest loosening of monetary policy in history.

Total debt in the Chinese economy quadrupled from $7tn in 2007 to $28tn by the middle of last year, according to the McKinsey Global Institute. At 282 per cent of gross domestic product and climbing, China’s debt load was already bigger last year in relative terms than

those of Germany and the US.

Heavy lifting

The majority of new credit has gone into property and associated industries such as steel, cement, glass and factories to produce fridges, televisions, light bulbs and the other products people need to put in their new homes.

Much of the debt and construction was taken on by local governments, which were expected to do most of the heavy lifting in boosting GDP and maintaining employment at any cost. The investment and construction boom continued even after Beijing began tightening restrictions on lending and housing purchases as it tried to rein in the resulting credit and property bubbles.

The ornate arch marking the entrance to Jingjin New City

When investment in real estate finally began to decline this year it prompted the government to reverse its restrictions on credit and property purchases, and significantly loosen monetary policy through interest rate cuts and state-directed bank lending.

In recent months, China's leaders have been in continuous crisis mode, rolling out one stimulus measure after another in their efforts to prop up sagging growth.

The most obvious examples have been Beijing's extraordinary efforts to reverse a stock market collapse last month, which included everything from government stock purchases to criminalising share sales by large investors.

But attempts to support the real economy have been almost as significant.

Last month, the People's Bank of China pumped nearly $100bn into two state-owned "policy banks" that will fund local government infrastructure projects. The central bank has also allowed these banks to issue trillions of renminbi in bonds to support lending.

Beijing has launched a huge programme that some describe as "quantitative easing with Chinese characteristics", to swap short-term local government debt for longer-term, lower-cost bonds. But even after this debt swap, local governments will have to make Rmb1tn ($156bn) in interest payments on their existing debt this year alone, according to estimates from JPMorgan.

Yet income from land sales, which had

The Hyatt Regency hotel in Jingjin New City

accounted for an average of 40 per cent of local government revenues, has plummeted in the past year. This means local governments are struggling just to service their growing debts and pay for basic public services, and are in no position to contribute to another stimulus programme such as the one in 2008.

"Local governments' fiscal constraints were a key cause of the slowdown at the start of the year and have limited the effectiveness of growth stabilisation measures," says Zhu Haibin, chief China economist at JPMorgan.

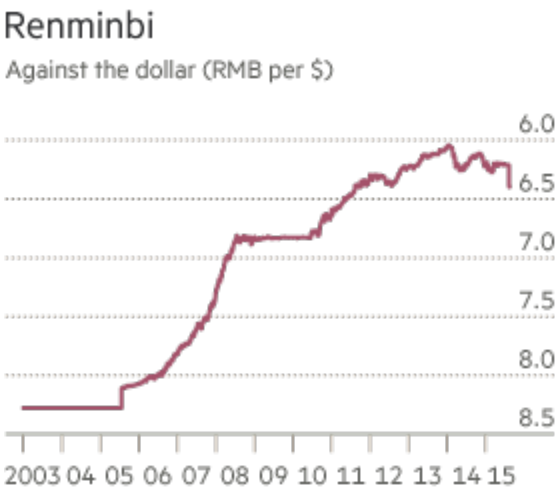
The central government has tried to encourage private investment in public infrastructure projects and has poured trillions of renminbi into huge national projects this year, such as rail and road networks, sewage treatment facilities and shantytown redevelopments.

But this has not been enough to offset falling investment in factories and apartment blocks. Last month, fixed asset investment across the country rose by its slowest pace in 15 years.

Property woes

Despite a rebound of housing transactions and prices in recent months in larger cities, the downturn is expected to continue because 70 per cent of property investment happens in smaller cities and places with chronic oversupply such as Jingjin New City.

Even with a recovery in major cities, the property sector will probably subtract 1.5 per cent from GDP growth this year, according to estimates from Wang Tao, chief China economist at UBS.



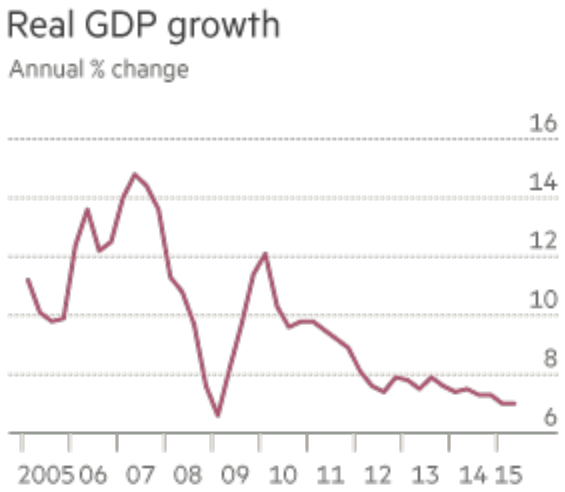
The construction slowdown has hammered global commodity prices, with Chinese production of steel, cement, glass and other materials falling by record levels in recent months. As a result of massive overcapacity in these and other industries, average producer prices have been falling for more than three years.

"In the near term, [government] infrastructure investment can directly contribute to GDP growth but may not have much of a multiplier

Source: Thomson Reuters Datastream

effect in the immediate following years," says Ms Wang. "In other words, the government will need to more than double the level of new infrastructure investment just to keep overall investment growth steady."

That seems impossible, especially in the context of existing overinvestment embodied by places such as Jingjin. And thanks to the country's existing debt load, rampant overcapacity and the bursting of property and equity bubbles, China's available options for stimulating growth are far fewer than they were during past crises.



Source: Thomson Reuters Datastream

It is in that context that Beijing reached last week for a weapon it has refrained from deploying for more than two decades. As China's leaders have long known, devaluing the currency is a risky move because it can trigger currency wars — ultimately leaving the country no better off. In the wake of China's move last week, Malaysia's ringgit and Indonesia's rupiah both fell to their lowest levels against the dollar since the depths of the 1998 Asian crisis.

But China's crucial export sector has performed worse this year than at any point since 2008. Last week's devaluation came just days after the government said exports in July fell 8.3 per cent from the same month a year earlier.

"We believe that the renminbi [foreign exchange] devaluations are aimed at stimulating the export sector after the authorities recently realised that domestic demand alone is unable to stabilise the economy," says Li Junheng at JL Warren Capital.

China's central bank has publicly ridiculed the idea that it wants to devalue the renminbi by at least 10 per cent against the dollar. But with growth rates still falling and few other options left, that is exactly what some mid-ranking and retired officials in Beijing think the country's leaders would like to see in the coming months.

Facing a sharp slowdown at home and few tools to deal with it, China does not seem to be in a position to show the resolve it displayed in the late 1990s and 2008. Instead, its leaders appear to have concluded that they must risk a currency war abroad.

Devaluation messages: A 'market reform' in the national interest

Two days after it announced a historic devaluation and shift to a more market-based currency, China's

central bank held a rare press conference in a basement room under its imposing headquarters in Beijing.

The message was simple if logically inconsistent — China's exchange rate would now be decided by the market but the People's Bank of China had the power and the resources to make sure the currency trades at whatever level China's leaders feel is appropriate, without any messy volatility. "We need to believe in the market, respect the market, fear the market and adapt to the market," said PBoC deputy governor Yi Gang. "But we also can't forget that the government must play a more important role."

In the week since it has become clear that the central bank will intervene whenever it wants to make sure the currency continues to trade in a tight band around the US dollar.

But many global investors are asking why Beijing decided to move now and what it hoped to achieve. People familiar with Chinese bureaucracy say the devaluation was a classic reformist move by the PBoC, which has been trying for years to move to a more freely tradable currency. That would remove some of the distortions in the economy and allow Beijing to run a more independent monetary policy. But this is opposed by several agencies, such as the commerce ministry, which represents the interests of exporters.

In selling this move to Beijing's leaders, the PBoC dressed it up as a devaluation that would help exporters and sold it as being in the national interest. But to the outside world, it has tried to portray the move as a market-based reform on the road to a more freely traded exchange rate.

"The [central bank] has orchestrated a clever combination of a move to weaken the renminbi with a shift to a more market-determined exchange rate, blunting foreign criticism of the renminbi devaluation," says Eswar Prasad, the former IMF China head. The coming months will reveal whether devaluation or market forces were the more powerful motivation for the move.

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