Chinese economy under downward pressure

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3 March 2015

The Chinese government is set to lower its growth rate target for this year when Premier Li Keqiang addresses the National People's Congress which opens on Thursday. It is expected to be 7 percent, following growth of 7.4 percent for last year, which was the lowest in a quarter of a century.

A leading government think tank, the State Information Centre, warned on Monday that China was facing significant risks of deflation and a weakening property and real estate sector, and forecast that the economy will grow by 7 percent in the first quarter. It said that China's economic growth "still faces heavy downward pressure" amid structural adjustments and would continue "searching for the bottom."

Others predict that the growth rate in the first three months of this year may even go below 7 percent, following the release of the government's Purchasing Managers Index showing that manufacturing activity contracted in February for the second consecutive month.

In response to the worsening economic outlook, the People's Bank of China (PBoC) announced a further cut of 0.25 percentage points in its benchmark interest rate on Saturday night, following a similar cut in November, the first such reduction in two years. It may not be the last such move. A central bank official said "deflationary risk" and a property market slowdown were the main reasons for the interest rate cut.

In a note issued yesterday, BNP Paribas said it expected another interest rate reduction before the end of June. "Economic growth in January and February has deteriorated more sharply than the government had anticipated," it said. "Deflation risk is looming much larger than before."

China's producer price index, which measures the price of commodities as they leave the factory gate, has been falling for the last three years, the longest period on record, while the consumer price index, the main measure of inflation, rose by only 0.8 percent in January from a year earlier. It was the lowest increase since November 2009 in the wake of the global financial crisis.

The effect of low inflation and even falling prices is to increase the real debt burden of local government authorities, property developers and others with large debts. The PBoC decision is not so much aimed at providing a stimulus to the economy at large but at relieving some of the debt pressure in these areas. The Chinese real estate market, which with associated industries such as construction and furniture forms about a quarter of Chinese gross domestic product, has been in a downturn for the past two years.

According to a major real estate data provider, the average price for new homes fell 3.8 percent in February, compared to a 3.1 percent decline in January and a drop of 2.7 percent in December. Property developers are facing difficulties because of a housing glut and are having trouble securing additional finance to complete projects they have started.

Economic problems do not end there. A recent survey of more than 2,000 industrial firms found that over one-third reported weak demand for their products, both domestically and internationally, as the main cause of their problems, indicating that loosened monetary policy will be of little or no benefit to them.

Warning that China faced another difficult year of "cyclical and structural adjustment," the chief China economist at Barclays in Hong Kong, Chang Jiang said: "Further monetary easing will help prevent a downward growth and deflation spiral, but is unlikely to lift growth significantly."

The central bank's move on interest rates appears to have been the subject of some disagreements, if not conflicts, in ruling financial and government circles. Long-serving central bank governor Zhou Xiaochuan is believed to have opposed broad moves like rate cuts because they ease credit and could worsen debt problems, especially in speculative areas such as property development. But the central bank is under pressure from the government to take measures to boost growth and reduce pressure on businesses.

In late September last year, the *Wall Street Journal* reported that there were moves to have Zhou step down because of disagreements over the direction of financial policy. Reporting on the latest interest rate cut, it cited an unnamed central bank official who said the easing measures were "a clear reversal of what Zhou has long insisted on."

The rate cut decision and lower growth projections have implications extending far beyond China. As the world's second largest economy, the China slowdown will act as a further drag on the world economy as a whole. In addition, the rate cut will tend to push down the value of the yuan, amid a series of such measures by other central banks in what has increasingly become an undeclared currency war.

In an article published in the *Australian Financial Review* yesterday, the former chairman of Morgan Stanley Asia, Stephen Roach, a long-time observer of Chinese economic trends, noted that currency wars were raging world-wide and China was bearing the brunt of them.

According to Roach, on the basis of figures provided by the Bank for International Settlements, China's real effective exchange rate, calculated against a weighted-average of its major trading partners, had risen by 26 percent in the past four years. This was leading to "sagging exports" and a growing risk of deflation. Such a situation might suggest a weakening of the yuan but he warned that any move in that direction would be a "serious mistake" and "highly problematic for the world economy."

A yuan devaluation would likely bring retaliation from the US Congress and lead to a "sharp escalation in the global currency war" where in an "era of unprecedented quantitative easing, competitive currency devaluation has become the norm for the world's major exporters."