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China can navigate rate rises and property risks

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China is not a “bubble economy”, but it is an economy prone to bubbles. There is a big difference.

Over the last decade many have predicted imminent doom for China. They have been wrong. China’s economy has soared in the wake of the west’s financial crisis. Despite this, risks have mounted. Rising wages and commodity prices are fuelling inflation. High food prices hit the poor hard. China has faced several challenges over recent decades, and come out on top. Its institutions and policy tools have worked well. Now, its immediate challenges are more intense than ever.

First, the need to rebalance its economy is greater than before. China must shift from investment and exports towards consumption. This domestic imbalance has not improved in the last two years.

The global recession showed China can no longer rely on selling low value-added goods to heavily indebted western consumers. Hence, the 12th five-year plan, scheduled to be rubber-stamped at this March’s National People’s Congress, seeks to move the economy up the value-curve and focus more on domestic demand.

Although welcome, this plan will not address an immediate problem: excessive investment, which has soared to 44 per cent of GDP. Economies that witness high investment are prone to booms and busts.

The animal spirits driving investment can change abruptly, if productivity disappoints, growth expectations dip or the cost of funding rises. In China, the added complication is the role of the government and banks in funding what might prove to be inefficient private investment spending. That too can’t last.

Second, China’s economy will become harder to control. Booming regional economies, alongside the growing private sector, make it harder to run the economy from Beijing.

Third, China’s vulnerability arises from its under-developed financial sector. For instance, there are limited options for household savings: low interest-bearing bank accounts; equities, where governance concerns persist; or real estate, where prices are already sky-high in many cities.

One reason personal savings are high is the lack of an adequate social safety net and the need to pay for education and healthcare. The last thing China needs is to burden itself with Europe’s expensive and unsustainable welfare system, but it must expand its existing social infrastructure to support consumption growth.

Unlike many other countries, China's corporate and government sectors are high savers too. This compounds the problem. Hence, firms, including state-owned enterprises, are coming under pressure to pay dividends. There is talk of a privatisation process post-2012. This would force firms to use capital efficiently.

China is developing its financial sector, but not fast enough to keep pace with its economy. Although its bond market has grown over the last decade, from $202bn to $2,700bn, corporate bond issuance remains low. China needs deeper and broader domestic capital markets to efficiently use its high domestic savings and to absorb increasing inflows.

Property is China's biggest problem. A few years ago, the "Greenspan put" kept US interest rates too low for too long to support the equity market. China can't fall into the same trap with property.

Property taxes are being trialled in Chongqing, China's biggest city, and in Shanghai, with Beijing and Shenzhen likely to follow. These are aimed at speculators and high-end investors, a small group buying multiple or expensive homes. The mass market will not be affected. For instance, the tax could raise for Chongqing the equivalent of less than 1 per cent of its revenues from land sales. The limited scale of the tax reflects China's gradualist approach to policymaking, particularly in controversial areas.

The other sources of China's instability are its low interest rates and weaker than needed currency. China needs to avoid the lethal combination of cheap money, leverage and one-way expectations, particularly in property, that hit the west. These factors make the economy prone to bubbles and raise the risk of a near-term setback – either as the bubble bursts or, more likely, as policymakers act.

China has to tighten sharply. Last year, authorities held back, given growth concerns. The economy's recent momentum seems to be strengthening their resolve. Expect further loan quotas, rising bank reserve ratios, sharply higher interest rates, targeted property taxes and likely steeper currency appreciation than expectations. Tuesday's rate increase is a sign of things to come.

If there were a setback, the market impact would be significant. There would be much comment about China's growth being a bubble. That would be wrong. China's growth is for real. Any slowdown would be temporary and present a buying opportunity. It would highlight that the business cycle exists in China, and that while the trend is up, one should expect setbacks along the way.

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