



China: Pick your poison

By CK Wong 2006.08.21

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Introduction

This commentary is a spoof of my mentor Eric Sprott & his colleague Sasha Solunac's commentary *Pick Your Poison, Ben [1]*. What China facing now is how to cool down its economy properly. There are only a few free economy methods: interest rate, money valuation and trade balance. Some can be controlled by the Chinese central bank and government, some cannot. The process has to be effective without causing any loss of wealth to the business and government. Whether it could benefit the trading partner would be secondary consideration.

The Dilemma

The Chinese manufacturing industries, tangible goods (such as merchandizes) and intellectual (such as research work subcontracted) have been dramatically increased. The nominal growth rate has not been under 9% for the last two years. This creates two situations:

1. Trade imbalance. The export surplus to China becomes the deficit of current account for the trading partners such as US and EU countries. Reducing export means reduction of GDP. There is also an implication: the export of deflation will be slowed down which has a global economical impact which could create a global recession which could be a vicious cycle that hits China hard and fast.
2. Accumulation of US\$ based foreign exchange reserve. Through the payment, the Chinese has accumulated over US\$941B FX reserve in July 2006 [3]. Any change on RMB's value will imply a tremendous loss in wealth. The faster the RMB appreciates, the faster the loss of national's wealth.
3. Continuous generation of jobs. China has created millions of jobs for the high school and university graduates. Without jobs, the burden to the social security program will be very heavy. The program has been running in deficit for years.

Chinese Consumer Market

The export is not the only thing that heats up; the increase in job market creates wages inflation and domestic demands. The manufacturing sectors generate millions of works fulfilled by local labor market. In turn it improves the Chinese's purchasing power. We have to focus a moment here. The increase is basically from the 10% of the population around the coastal area. As the manufacturing moving west, which is pushed by the government, the domestic consumer market will continue to grow. We could easily deduct that the continuous GDP should not be the result of export. It also includes the domestic consumer market. As the coastal labor force increases its purchasing power, the less developed area, such as the west, could be benefited from producing consumer good for the east.

Of course, some of the expensive consumer good such as LCD TV and automobile will also be consumed locally. However, we have to watch the domino effect of developing the productivity of the western and northern area. Let's use steel as an example. At the beginning of the year, the imported steel price was so high that the domestic industry could supply cheaper steel either through local smelter of mine or scrap. China has such a large market that it has the flexibility to use domestic or import source, as long as the price is right. At least for a short period of time.

Interest Rate

China has raised interest rate two times for a total of more than 0.5%. The effect is minimal in the past but hurts the stock market [2]. Hong Kong's Hang Seng Index is down 1.86% on 2006.08.21 with many Chinese stocks down heavily. The message may be definitely misread by many but it reflects the worry. To make it effective, the rate has to increase to a level that consumer will feel hurt to borrow money. It should be note that credit purchasing is not popular yet. Credit cards are for the privileged. The majority of consumer uses the cash for the transaction.

Who will bear the blunt of higher interest rate? Those who could afford the housing, the business and the speculation. Raising interest rate does not have much effect on the general consumer. But higher interest rate will hurt the already high residential market. In an inelastic market, the rate will not deter the rich or those speculate on the housing market until it is really high.

The bottom line is China could not raise the interest rate too high because it will slow down the economy which will reduce the millions of jobs churned out each year. It also has the side effect of slows down export because the cost will increase. In another word, the deflation exported will be lower as the exporters have to pass the cost to the importer, i.e., US or Europe. This is not what the West wants.

Valuation of RMB

China has attempted to float the RMB in the international market. It started with the Euro last year. At the beginning of this year, RMB has a daily floating range. A drifted RMB is not a good thing for both China and the Chinese trading partner. Any uncertainty will just make the trade budget much more difficult. If the RMB appreciates, the importer has to pay more or hedge the RMB. Both create complication for the RMB value. Since the RMB has US\$ as its reserve, by the depreciation of the US\$ will implicitly appreciate the RMB. Since the US\$ is manipulated by the US Treasury, the fluctuation by two dominating factors create more volatility which as not been considered by the Western economists. China also has no rush to do that.

It may be a surprise to many people that it is not just lost the value of the reserve. Chinese government lends out the reserve to support the import payment. To some extend, the value is hedged. Also, unconfirmed report indicated China has replacing the reserve by gold. Until it is confirmed lets do not speculate. One thing for sure is that if American

Treasury wants China to finance the current trade, the T-bill interest rate has to be get higher which is contradicting the Hank Paulson's wish.

For a larger scheme of things, China has started to promote the use of RMB for trade settlement starting with the banks at Hong Kong. It is a pioneer project which will quickly be accepted because of the instability of the US\$. The reason is RMB is seen as a strong currency. Everyone has a hard time to depreciate against US\$ but would be easy to do it with RMB.

Should this be accepted by more countries, it is a good alternative to appreciate RMB. First, the accumulation of US\$ for reserve through trade will be slowed down. Second, it aligns with the Chinese world free trade circle strategy; free trade with China in Asia, Africa and South America using RMB.

With a strong currency, it reaches an effect of lower compatibility. This would cool down the export which is the main fuel for the runaway real estate market.

There is a side benefit for import due to lower cost of imported commodity.

Bottom Line

China could not afford to slow down the economy but it also could not afford social imbalance. When western economists look at the issue, they think of the conventional situation. To cool down the economy, is actually cool down unwanted business sector not the monetary system to reduce unrest caused by social imbalance. The increase in the salary of civil servants is one of the counter measures for the first interest rate hike.

Resources

- [1] *Pick your poison, Ben*, Market at a Glance, May 2006 by Eric Sprott & Sasha Solunac of Sprott Asset Management, <http://sprott.com/pdf/marketsataglance/05-2006.pdf>
- [2] *Hong Kong shares close sharply lower after China rate hike*, 2006.08.21, AFX News Limited, <http://www.forbes.com/markets/feeds/afx/2006/08/21/afx2961649.html>
- [3] *China is awash with liquidity*, by John Ng, Asian Times, 2006.08.16, http://www.atimes.com/atimes/China_Business/HH16Cb02.html
- [4] *China's Central Bank Raises Lending, Deposit Rates*, by Nerys Avery, 2006.08.21, Bloomberg.com, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aQl8u6Iml8d8&refer=home>
- [5] *Beijing raises interest rates to curb speeding growth*, by Keith Bradsher, 2006.08.18, The New York Times. <http://iht.com/articles/2006/08/18/business/chirate.php>