China's 2011 Dilemma : High Growth Trajectory and Inflationary Spiral

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Introduction

China's economic growth accelerated to 9.8 per cent in Q4, beating consensus estimates of 9.6 per cent and up from the previous quarter's 9.4 per cent growth. Over all, the Chinese economy expanded 10.3 per cent in 2010.1 This is against the target of 8 percent. In the run, the gross domestic product (GDP) of the People's Republic of China (PRC) hit 39.8 trillion Yuan (US$ 6.05 trillion).

The stock markets in China reacted negatively to the better-than-expected growth figures. Shanghai stock market tumbled almost 3 percent to 2677.65 points immediately after the Chinese National Bureau of Statistics (NBS) released the report on 20 Jan 2011. Taking part in a panel discussion on CCTV Xinwen, Ma Jiantang, the Director of NBS, spoke of China facing the real life challenge in taming the inflationary spiral. Earlier, in his New Year address, the Chinese President Hu Jintao had hinted at impending 'track change' in China's monetary and fiscal policy.2 Meanwhile, opinion columns in leading Chinese dailies speak of high economic and political costs of the inflationary spiral.

This is symptomatic of a downbeat in China's national spirit. For an astute China watcher, the intensity of the remorse defies most intellectual descriptions, including David Rosenberg's dub of being 'bearish' and Jim Chanos's diagnosis of 'frenzied bubble' effects. Fear of the economic and political costs of the phenomenon of deepening Engel's Coefficient for the multitudes of poor in small cities and counties in the midst of growing affluence of a few in big cities has perhaps taken out the wind out of sails in China's national mood.3

'Track change' meant tightening of the loose ends of the easy monetary and accommodative fiscal policies brought to bear upon to fight the scourge of global economic down turn. Theoretically, 'goldilocks' scenario, featuring relatively strong growth and modest inflation, can be a bail out proposition. The paper constructively explores the horizon of China's quest to sport this 'goldilocks scenario' in the midst of counter pulls of varied hues and dimensions. The intended correctives involved a policy roll back, be it even mild in the short run. In the bargain, China is expected to put a cap on deficit financing, which ran to staggering RMB 1.05 trillion in 2010. It will force a curb on bank lending that crossed 7.5 trillion target for the year. However, nothing of the kind was possible without adverse impacts on the shape and size of the Chinese economy.

Much of it expressly depended on China's capability to withdraw the 'punchbowl' that once energised and surcharged the Chinese nation with unrivalled 'can-do-spirit'. Zhou Xiaochang, the Governor of the People's Bank of China (PBoC) has since broadly admitted the limitations of the option.4 The euphemism 'proactive fiscal' and 'prudent monetary' policies once ruled the roost when China adhered expansionary monetary and fiscal policies.5 The Chinese President Hu Jintao has given currency to the same euphemism to connote just the opposite. There is thus, premium in taking the words of the Chinese leadership at their face value.

In the run up, the paper addresses research question such as: Whether the Chinese Bust and Bang Margins had thinned to the precipice to call for policy shifts? How best the antidotes to pent-up inflation in vogue could save China's from the impending policy traps to socio-economic down slides; and, could China shed black swan image and make iconic headlines with positive references in 2011? The intent and purpose is to arouse intellectual debate to get to the truth. The paper thus schematically deliberates on: Anatomy of Policy Rethink and Rumination; Bust-Breakthrough Threshold of Policy Instruments of Growth and Inflationary Pressures; and, the Hiccups of Goldilocks Scenario.

Anatomy of Policy Rethink and Rumination

The PBoC announced a 25 basis point hike in the one-year lending and deposit rates just a week before the onset of the New Year. The two now respectively stand at 5.81 percent and 2.75 per cent. It was the second rate hike in 2010 after 2007 and 2008. Giving a break to the past, the long-term lending rate has been spiked more sharply by 26 basis points. Notwithstanding, the PBoC consecutively raised reserve requirement ratio (RRR) by 50 basis points.

All this is discernibly aimed at steering prices and moping liquidity back to normal. Going by the official figures, the consumer price index (CPI) in Dec 2010 eased to 4.6 per cent month-on-month from the 28-month high of 5.1 per cent in Nov, 2010. For the whole year, CPI grew 3.3 per cent in 2010. This was against official target of 3 per cent.6 Higher food and energy prices constituted the main driver of incessant rise in CPI in the past several months.7 As a story in Xinhua dispatch bears out, a basket of 18 staple vegetables had come to cost 62 per cent more during the first ten days of November 2010 than in the same period last year.8 In year-on-year perspective, the food price index for people away and at home rose by 1.3 per cent and 1.7 per cent respectively. Among major grocery store food groups, the index for meats, poultry, fish and eggs posted the largest increase at
5.5 per cent followed by a 3.7 per cent increase in the dairy index. The indexes for nonalcoholic beverages and cereals and bakery products were the only ones to decline. The index for household energy rose 0.8 per cent in 2010. The energy index as a whole increased 7.7 per cent in 2010.

Even while flatly denied by the Chinese National Bureau of Statistics (NBS), there is semblance of truth in the research findings of Zeng Wuyi, a Professor at Xiamen University and Deputy Chairman of the National Statistics Society of China that the official Chinese figure of CPI remains understated by nearly seven per cent over the past five years. Qu Hongbin, co-head of Asian economic research at HSBC in Hong Kong, expected the CPI to cross 6 per cent before long.9 Prof Patrick Chovanec, who teaches at Tsinghua University's School of Economics and Management, is again not wrong in saying that the official Chinese CPI figures do not reflect the staggering 50 per cent expansion of money supply over the past two years. Nonetheless, Marc Faber, dubbed as 'Dr Doom' has gone on record to say that the 'real' Chinese inflation rate is nearer 10 per cent a year. There is a saving grace that the period witnessed down slides in several indices. They included the new vehicles index, which fell 0.2 per cent in 2010 after rising 4.9 per cent in 2009, and the index for apparel, which fell 1.1 percent in 2010 after a 1.9 per cent increase in 2009. I find no reason for the National Development and Reform Commission (NDRC) to bemoan for failing to contain the upswing in CPI to below 5 per cent.10

The story has been no different in the case of producer price index (PPI) that rose 1.7 per cent in December 2010 from a year earlier. It has been clocking into positive territory of consecutive rise, some times quick and some time slow pace all through 2010. In November, it stood at 6.1 per cent. Prices of production materials rose 6.9 per cent year-on-year. Ma Jiantang, the head of China's National Bureau of Statistics (NBS) attributed driver role to rising prices of mining and quarrying, which jumped 14.6 per cent. Prices of products in the raw material industry then climbed 9.8 per cent and prices of products in processing industry edged up 4.4 per cent year-on-year. The November 2010 PPI had grown 1.4 per cent over October 2010 PPI.

The Chinese socio-economic life is thus, witnessing both the consumer and producer contours of a heating economy.11 Thanks to adverse Gini Coefficient of 0.47, the PBoC will have difficulty in convincing the poor lots that the scenario was little different from a temporary blip.12 Those who subscribe quantitative theory of money of Milton Friedman and his predecessors could expect little different otherwise. China's M2 money supply has since grown more than threefold. It has quite significantly pushed the PRC into throes in more than one perspective.

The impacts are tell tale on last two of the four sets of China- the affluent, the middle income, the lower middle income and the poor. With real wages sliding continuously, a majority of the 176.2 million Chinese industrial workforce, who constituted the third China, is turning far stroppier than ever before.13 As the statistics of the Chinese Supreme People's Court (SPC) bear out, the Chinese mediation and arbitration mechanism grappled with 207400 labour dispute cases in thee first eight months of 2010. The Chinese labour courts have had disposed off 295500 labour disputes in 2008 and 318300 in 2009.14 As most of this working population lives close to the edge, higher wage demands are likely to become more frequent. The implications, as several studies, including the one by this author bear out, could be far and wide.15 It has to have political cost with erosion of the legitimacy of the ruling elite.

As stories in some of the online national dailies and blog posts go to suggest, the 60.5 million strong Chinese rural poor, the constituent of the fourth China, living on per annum income ranging between US$ 90 and US$ 125, suffer the pang of double digit food inflation worst.16 In most cases, they are not producers of food stuff. As such, the rise in the prices of food stuff does not add up to their disposable income and hence, neutralise even partly the net impact of food inflation. The phenomenon is again hurting quite severely an estimated 230 million migrant workers as well as those who, in part constitute third and in part fourth China. Erosion of real wages limits their marginal propensity to save, and concomitantly affects their potentials to remit earnings to back home dependant populace. This has led to outcry at both ends of the Chinese migrant workforces.

Average per capita income for rural and urban residents in China in 2010 respectively worked out to be RMB 5919 Yuan (US$ 898) and RMB 19109 Yuan (US$ 2900). The Impact of the inflationary spiral on 712 millions strong rural populace is thus, far severe.17 The pang of ever falling real worth of their earnings again do not enjoy neutralisation effects of affirmative actions due to skewed hukou system in favour of urban inhabitants. The Chinese ruling elites are not expected to be oblivious to the fact and hence, the policy rethinks.

Bust-Breakthrough Threshold of Policy Instruments of Growth and Inflationary Pressures

Chinese banks had lent a total of 7.95 trillion Yuan (US$1.19 trillion) in 2010. It was against the official target of 7.5 trillion Yuan (US$ 1.12 trillion).18 In addition, the Chinese banks have had estimably released another 2-4 trillion Yuan of off-balance-sheet. In all, the Chinese banks added RMB 10-12 trillion Yuan (US $ 1.5-1.8 trillion) to over all liquidity in 2010. This is a huge number, especially on the heels of a 9.6 trillion Yuan (US$ 1.44 trillion) lending spree in 2009. Nonetheless, the Chinese central government spent respectively RMB 8.9 trillion Yuan (US$1.3 trillion).19 This officially reported spending figure reflects only about three-quarters of total government spending. The total Chinese central government spending was thus, around 11.8 trillion Yuan (US$ 1.77 trillion) Extra-budgetary spending, social security outlays and central government bond financing of local projects are not part of the official budget. This is besides the gray market liquidity. These measures, inter alia, led China's all time high economic breakthrough with a GDP of RMB 39.8 trillion Yuan (US$ 6.05 trillion).

The cascading effect of these measures has been equally pronounced. M2, the broad measure of money supply, rose by 19.7 per cent in 2010 over the corresponding period last year. The official estimate was 17 per cent. The PBoC has set its goal to limit growth of M2 in 2011 to 16 per cent. Political mandate to the measure augured in the Central Economic Work Conference, held in Dec 2010. Reining inflation and controlling financial risks were the two express concerns behind the resolutions. The PBoC has since set credit target of RMB 7.5 trillion Yuan (US$ 1.4 trillion) for 2011. In Jan 2011, the Chinese banks have already released loans of nearly RMB 1 trillion Yuan (US$ 0.151 trillion). Over the next 11 months, the overshoot of the PBoC target is thus, not at all unlikely for a simple reason.20 In an economy as large and complex as China, the "spigot/mop" approach to monetary policy can seldom be adequate. Nevertheless, the latest PBoC move to rein in banks from their lending frenzy with varying doze of dynamic differentiated reserve requirement ratio (DRRR) to large, medium and small size banks is yet to prove its credentials in the face of complex operating mechanism.21 Besides, the Chinese Central Government will pump in RMB 9.79 trillion Yuan in 2011, RMB 1.3 trillion Yuan more than what it did in 2010. The liquidity problem in China has thus, come to stay without much respite.

The let up in price rise in the case of staple food in the past two months is squarely an outcome of administrative actions.22 The life conditions of most Chinese masses remain gruelling. Shopping list of groceries and fuel in China cost more than the USA. The price of a dozen eggs is over twice as expensive, and a litre of milk is nearly three times as costly, in China as in America.23 The incidence and impacts is tell tale when seen in terms of adverse per capita earning differentials, be it 11 times nominal or 6 times Purchasing Power Parity (PPP).24

While yet above the bust threshold of 50 for the last 23 months in a row, the gnawing dip of the purchasing manager's index (PMI) in the last two months from 55.2 to 52.9 testifies the slow down in the manufacturing sector of the Chinese economy.25 However, this official PMI figure is suspect in its validity. In the face of continuous fall in new export orders sub-index and rise in input prices sub-index, the prospect of expansion of the Chinese secondary industry to this level is hard to take place. Nonetheless, with an accelerated growth in Q4 of 2010 to 9.8 per cent, it is hard to digest that inflation actually went in the opposite direction.

The urban unemployment rate in the PRC in Jan 2011 stood at 4.1 per cent.26 It was got to when the Chinese PMI stood
2.9 points above the bust threshold of 50 and the GDP had grown 10.3 per cent.27 As the PMI dips following estimated deceleration of the Chinese economy in 2011 to below 8 per cent growth, there shall estimably urban be job loss of at least 31 million workforces. Thanks to Lewis Turning Point effects, the growth story of China awaits a measure of weakening henceforth until equilibrium is achieved by unexpected turn of events.28

Hiccups of Goldilocks Scenario

'Strong growth' as against 'high growth' and 'modest inflation' as against 'stable prices' in a combination constitutes the roadmap of 'goldilocks scenario' of a development paradigm. The cliché has found currency in the Chinese media after the publication of the JP Morgan report, authored by Qing Wang and Earnest Ho, *China Economics: A Goldilocks Scenario in '10*, November 22, 2009. While more reasonable than the cliché 'growth and stability', it suffers clarity on the basic point as to 'how' strong and 'how' modest before one could sit on judgments about its on-ground workability. This terminology had received rather frenzied reference earlier in 1999 before the dot-com bubble bust in 2000. It was again heard in 2005 and 2007 before the 2008 global economic down turn.

As the discussions in the preceding sections bear out, the Chinese Central Government spending of RMB 11.8 trillion (US$1.77 trillion) and the Chinese bank credit of RMB 10-12 trillion Yuan (US $ 1.5-1.8 trillion) together made for pumping of RMB 21.8-23.8 trillion Yuan (US $ 3.28- 3.57 trillion) into the Chinese economy in 2010. It accounted for 54.8-59.8 per cent of the Chinese RMB 39.8 trillion Yuan (US $ .05 trillion) GDP. It excluded the extra-budgetary spending, social security outlays and central government bond financing of local projects. It makes a clear case of over spending beyond all justificatory arguments as Qing Wang and Earnest Ho duo have made out to suggest otherwise. The inflationary spiral, demonstrated both in CPI and PPI rise as such testify the hypothesis conclusively. This is what was inevitable in a policy trap situation for any economy as it happened in the case of Chinese economy.

Given the scenario that China's modest trigger with the monetary and fiscal policies would not bring China anywhere near to 'goldilocks scenario'; given the risk factors of deceleration below the sensitive 8 per cent GDP growth, the PRC has to live with the existing inflationary socio-economic life, with supply side administrative corrections to the volatile public response. However, in our view, the crisis should serve as a catalyst for a more profound rebalancing with a shift in growth drivers from tradable to non-tradable sectors for times to come. Nonetheless, the cyclical conditions of the Chinese economy suggest that the year 2011 shall be more or less a year of reflation and pose significant risks to fixed asset investments.

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