

REBALANCING OF THE CHINESE ECONOMY, ITS SLOWDOWN AND DEVALUATION OF THE YUAN

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[Abstract: China's economic growth, spanning nearly three decades since 1979, has been one of continuous ascendancy. During this phase, China became the manufacturing hub of the world. Massive investments in infrastructure and capacity creation were made with the intention of becoming the global leader in exports. It went on to become the world's second largest economy and contributed as much as 17 per cent of global GDP—world economies grew on the wings of Chinese growth! It became the world's largest trading nation. Thus, along with the US, it became the axis of the world economy. By 2007, Chinese leadership thought of rebalancing their economy by encouraging domestic consumption. It was to be transition through experimentation and consolidation of the gains of its earlier strategy of investment and growth. However, their designs were foiled by the global crises of 2008 and the economy was accorded budgetary and banking support. In 2013, it was time to rebalance the economy towards domestic consumption which required doing away with excess capacity and slowing down of exports and consequently its growth which came to be nearly seven per cent from the earlier growth of not less than 10 per cent in real terms. Covering of the growth has had a major impact on economies banking on goods manufactured in China. China took the international community by surprise when it devalued its Yuan by 1.99 per cent against the dollar in August 2015, signaling that while it will encourage domestic consumption, it will maintain its export competitiveness. This Note reflects upon the course of Chinese transition to a consumption-driven economy, the global implications of the slowing down of the Chinese economy, and the devaluation of the Yuan.]

China staged a mighty rise at the beginning of the 21st century to become the preeminent manufacturing hub of the world. China's economic development and prosperity has been miraculous.¹ After becoming the fastest growing economy in the world in over three and half decades, expanding at 10 per cent in real terms until recently, it has been on the declining trend to hover around 7.5 per cent and further down to less than seven per cent, which is the lowest rate since 1991. The Chinese economy has been rocked by the global downturn. The dented economic growth can be attributed to (i) the steep fall in merchandise growth, which is now heading towards a negative growth, and (ii) the perceived signs of economic uncertainty

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¹ Mcvey, H. (2012), "China's Rebalancing Act," KKR. Available at: <http://www.kkr.com/global-perspectives/publications/china%E2%80%99s-rebalancing-act>

fanned by the negative sentiments emanating from the capital market because of huge capital outflows in the last two years.²

By 2004, China's top political leadership had recognised what was common wisdom among the international economists: that China's economic growth model had become 'unstable, un balanced, uncoordinated and unsustainable'. In place of traditional investments and export-led development, it endorsed the transition to a growth path that relied more on expanding domestic consumption. This decision, taken at the December 2004 annual Central Economic Work Conference, continued to be endorsed in the years to follow. The decision to rebalance the economy was not only towards sustaining its strong growth of recent years, but also achieving more rapid job creation, improving income distribution and slowing down the pace of rising income inequality, and, reducing the energy consumption of recent years. Emphasis on consumption based development had the potential of reducing global economic imbalances and lessening the risk of China's submission to protectionist pressure, especially in central Europe and the US.³

It was logical to expect a major reform package for the next five years, especially after efforts, although modest, were made to bring about a change in China's underlying growth dynamic. Despite policy initiatives, China's economic expansion remained disproportionately dependent on rising investment expenditures and an expanding trade surplus, and, kept falling short of meeting several of its key domestic objectives. On the onset of the 2008 meltdown of and the recession, the Chinese leadership decided not to change the course of its development model in the midst of the crisis. Rather, the leadership promoted the export growth model more strongly; consequently, the Yuan was repegged to the dollar to maintain competitiveness. The Chinese administration implemented a huge fiscal stimulus package of 4 trillion Yuan (\$600 billion) and commanded the state owned banks to

² Dhar, B. (2015), "Yuan Devaluation and Its Impact," *Economic and Political Weekly*, Vol.50, No. 36, Pp. 15–17, September 05.

³ Lardy, N.R. (2007), "China: Rebalancing Economic Growth," in *The China Balance Sheet in 2007 and Beyond*, Centre for Strategic and International Studies and the Peterson Institute for International Economics, Chapter 1. Available at: www.iie.com/publications/papers/lardy0507.pdf

free up credit, which grew to 9.5 trillion Yuan in 2009 from 8 trillion Yuan in 2010, to maintain its position in export markets as well as the investment led growth model.

While these initiatives averted the economic disaster at home, they were to leave a trail of side effects. By 2013, the new Chinese administration led by President Xi Jinping and Preme Minister Li Keqiang had to face a number of ills surrounding the economy: overreliance on exports and investments, overcapacity in several capital intensive industries, environmental degradation, low household consumption, increased inequality, worrying debt accumulation with public bodies and the corporates.

To tackle these structural issues, the new leadership unveiled an ambitious roadmap for economic reform in November 2013, which is to be completed by 2020. In fact, before the reforms were formally laid bare in 2013, some of its elements were already under implementation. The neck breaking growth rate was brought down by restricting credit in sectors like real estate and the industrial sector. The growth rate came down from 10 per cent to 7.5 per cent. Current account surplus was brought down from 10 per cent in 2010 to 2.5 per cent in 2013. Such advanced directives by the Chinese administration—before the formal announcement of the reform plan in November 2013—reiterated the fact that the Chinese government not only has a strong control over the levers of economic development, but also determines the pace of transition without compromising on political stability. It has to reckon with some hard facts like the need to raise its per capita income from the current level of US \$7000 and increase its urban population from the current level of 48 per cent. It will be prudent to increase investments in consumption sector. It will not lose sight of its continuing need to invest and invest better. It may move away from the highly capital intensive polluting industrial sectors to greener high-tech, service related and labour intensive businesses. From the Chinese perspective, the concept of rebalancing is beyond a simple switch over from an export- and investment-led growth to a consumption-led growth. It will aim not only at economic reform, but also broader social and political reforms.

Reform programmes initiated in 2013 recognized the relationship between the market and the government. In other words, market rules are defined by the government. The Chinese leadership believes that the market has a role in allocation of resources in order to realize productivity maximisation and efficiency optimisation. It also stresses that in order to comprehensively deepen reforms, China must hold high the banner of socialism with Chinese characteristics. Thus, the marketisation of the economy will be done the Chinese way, that is, through experimentation and progressivity. Theoretically, there may be a market-based price mechanism in place for vital sectors like water, oil, natural gas, power, transport and telecommunications, but it may not result into a free competitive market. Ubiquity of Party will stay.⁴

Thus, the scenario is that China will continue to rebalance the economy on its own terms and pace. Consumption will be allowed to rise gradually but exports and investment will remain the main drivers of growth. Even in consumption related priorities, the State will have a significant role to play. While slowly upgrading the Chinese manufacturing sector, industrial and technological upgradation and capacity building will continue to get primacy. Chinese companies are gaining increased share in consumer durables like laptops and mobile phones, and in pharmaceutical, automobile and aviation sectors. Hitherto, development of underdeveloped regions like Western China is receiving attention and the outlay for the silk route that will connect Europe and countries in between through land and sea routes has been made. The Asian Investment and Infrastructure Bank (AIIB) has been specifically set up for this purpose. The market will play a more decisive role in determining the prices of resources across different sectors; however, market equilibrium will have to be managed. Along with maintaining capital mobility and a fixed exchange rate, China will have to keep interest rates in control with a view to give direction to the flow of savings, as deemed appropriate. In the same vein, foreign capital will be

⁴ Otero-Iglesias, M. (2014), "Is China Rebalancing? Yes, but with Chinese Characteristics," Elcano Royal Institute. Available at:
http://www.realinstitutoelcano.org/wps/portal/web/rielcano_en/contenido?WCM_GLOBAL_CONTEXT=/elcano/elcano_in/zonas_in/ari592014-oteroiglesias-is-china-rebalancing-yes-but-with-chinese-characteristics

allowed for the sake of building infrastructure capabilities and technological capacity in order to ensure high value addition. This, in turn, will result in an increase in productivity and growth in wages, thus raising the standard of living, but foreign capital will not be more than 20 per cent in strategic sectors. China had in the early phases of development (during the closing years of the last century) demonstrated the “opposite” of the Western Development Model that relied on free-market democracy and liberal values. Despite being deeply authoritarian, it had achieved phenomenal growth and industrialization; democracy and liberal values did not figure remotely in China’s economic rise. It developed through strict control over all segments of the market. Being centrally-driven, it had been able to direct its resources in one direction, thereby propelling into a regional power and the second largest economy in the world after U.S.⁵ It has come to believe that a centrally-driven ‘nation first’ policy can help attain success.⁶ It is continuing with the same belief and proposes to balance the economy at its own pace and not be driven by models propagated by the West. It wishes to maintain the Beijing consensus.

Recent decision of China to devalue its currency by 1.99 per cent has been widely commented upon, reflecting the slowdown of the Chinese economy in its bid to have the Yuan recognised as an international trading currency by the IMF, even though the devaluation of Yuan has been modest compared to the dramatic devaluation in history—think of the Sterling crises of 1967 and 1992, or the Argentina crisis of 2001–02. When currencies decline, they do so in a big way. China’s devaluation of less than two per cent is being made into a big story. BBC went on to term it bigger than the Greek crisis or the crisis that would have set in had Fed raised its rates. Bears predicted that a Chinese devaluation will send a new wave of deflation round the globe. It will force Asian competitors to respond with devaluations of their own, reducing import prices in the developed world. This might lead to job losses in the West or reduce profit margins. In addition, countries that became notably overvalued, such as the US and the UK, could be weakened as cheap

⁵ Sardana, M.M.K. (2011), “Limit Consumption or Perish,” ISID Discussion Note DN2011/16, December.

⁶ Buttonwood (2015), “The Curious Case of China’s Currency,” *The Economist*, August 11. Available at: <http://www.economist.com/blogs/buttonwood/2015/08/markets-and-economics>

imports cut into margins. This is how, it was stated, the current bullish cycle in stock markets could end. A two per cent devaluation is neither here nor there and is unlikely to give a massive boost to Chinese exports which fell by 8.3 per cent in July 2015. This may be a mere signal, signifying Chinese initiatives in linking the Yuan to the market and thus having it recognised as a part of the SDR (Special Drawing Rights) basket. Clearly, such a minor signal will hardly justify recognition by the IMF. Characteristically, China at this stage will have to juggle several balls simultaneously: to move from an investment-led economy to a consumption-led model without letting growth slip too far, to rein in properties and equities without damaging industry, to engage with markets without being hit by volatility, and, to expand its financial sector without suffering hot money flows.⁷

With a modest devaluation of the Yuan, China is at least indicating that it wishes to maintain an export led growth as it seeks to tilt the balance towards domestic consumption-led growth. This is despite the choice of expanding domestic consumption faster by running down its trade surpluses and buying more from the rest of the world owing to balanced cushioning. However, to accelerate domestic growth, it chose to maintain the incremental growth of exports. Whether the strategy will work out in view of the stagnancy in world export growth is anybody's guess. Had China revalued the Yuan and reduced its trade balance further, there would be greater demand for rest of the world products. However, it was not to be as the fascination to maintain the level of trade surplus remained unabated. Since international players were driven to liquidate their positions to generate cash balances, there was turbulence in the stock markets around the world.⁸

China's slowdown in export earnings has also been occasioned largely because of the slowdown of other economies whose consumption pattern has been limited because of falling wages and stagnancy in employment. The underlying

⁷ Pant, M. (2015), "Yuan Devaluation: China Cannot Just Export Its Way Out of Trouble," Catch News, August 17. Available at: <http://www.catchnews.com/business-economy-news/yuan-devaluation-china-just-cannot-export-its-way-out-of-trouble-1439786924.html>

⁸ Bremmer, I. (2015), "These 5 Facts Explain the Global Impact of China's Impending Slowdown," Time, August 28. Available at: <http://time.com/4014687/these-5-facts-explain-the-global-impact-of-chinas-impending-slowdown/>

fundamentals of China's economy remain strong. World economy, however, got used to China's continued ascent. Inevitable slowdown in exports from China and the consequent fall in its growth rate which was being sustained by non-stop exports ascendancy have come about because of Beijing's transformation from an export-led to a consumption-oriented economy. This year, the Chinese leadership is aiming at about 7 per cent growth, which had reached 14.2 per cent in 2007 only to come down to 10.4 per cent in 2010. Rest of the world does not appear to be ready as of yet to adjust to China's 'new normal' growth rate. Countries that export oil to China are in for a shock due to the falling demand from China following its rebalancing act; these countries have experienced sharp declines in their revenue realizations. For the same reasons, commodity prices all round have experienced sharp fall owing to a decline in the Chinese manufacturing activity. According to an estimate, countries that produce oil, gas, metals, minerals and other commodities have, just in the past year, lost about \$2 trillion—the size of India's entire economy. The shift in the Chinese strategy—to move away from manufacturing—has jeopardized the economies of countries like Australia, Chile, Indonesia, Brazil, and South Africa who are dependent on their commodity exports to China.

Apart from the impact of oil and commodity supply and demand effects, the slowdown in China will also significantly impact world trade. China accounted for 10 per cent of global trade in 2014 after it became the world's leading trading nation in 2013, edging past the US. In 2014, China alone accounted for about 17 per cent of the world's overall GDP but its demand for imports had already fallen by 14.6 per cent over the first seven months of 2015, signifying that China's downward trend in growth will have an impact on virtually every country in the world.⁹ The underlying concern remains as to what extent will a slowdown in the Chinese economy affect the rest of the world?

Since the 2008 global crisis, China has notably emerged as one of the twin engines of growth worldwide. China has contributed as much to world GDP growth as the US in the past decade and a half; even more than the US since the 2008

⁹ *Ibid.*

financial crisis. Together, the U.S. and China are expected to generate as much world output as the rest of the world together. As China slows from the nearly 10 per cent growth rate—that it clocked in the first three decades of its reform period, which began in 1979—to what is thought to be a more sustainable seven per cent or so, the world economy is likely to slow with it. The main areas where the impact will be felt include both commodities and consumer goods, including luxury goods.¹⁰

For China, rebalancing of the economy means that consumption will become a bigger part of the domestic economy than investment, and services will become a more important driver of growth than manufacturing. As a result, a Chinese slowdown will affect not just commodities and capital goods, but also global consumer demands and thus the profits of multinational companies in Europe and the US.¹¹

Rebalancing of the Chinese economy will include downsizing the capacity in its manufacturing and capital goods industry. India will be directly impacted by China's overcapacity workout and the challenge may remain for a few years till a new equilibrium is reached between supply and demand. India is already facing a massive influx of cheap steel from China. Since 2014, steel imports have risen by an unprecedented 70 per cent, mostly from China and that, too, when the domestic industry had doubled its own production capacity over the past decade. Domestic steel industry has defaulted on its \$50 billion capital loans raised for increasing its capacity, which has affected the banking sector.¹² Likewise, the Indian Tyre industry is also bearing the brunt of overcapacity in China.¹³ Some optimists comment that with the fall in commodity prices worldwide owing to the slowdown in China, India should be feeling comfortable as the bulk of its imports are those of commodities. In

¹⁰ Segar, M. (2015), "How a Chinese Slowdown Will Hit Global Growth," Reuters. Available at: <http://theconversation.com/how-a-chinese-slowdown-will-hit-global-growth-46655>

¹¹ *Ibid.*

¹² Venu, M.K. (2015), "China is Headed for a Slowdown. Here's Why India Should Be Worried," The Wire, July 31. Available at: <http://thewire.in/2015/07/31/china-is-headed-for-a-slowdown-heres-why-india-should-be-worried-7621/>

¹³ Kanwar, O. (2015), "Indians No Match for the Yuan Game," Business Line, September 01. Available at: <http://www.thehindubusinessline.com/opinion/indians-no-match-for-the-yuan-game/article7604211.ece>

fact, 70 per cent of India's trade deficit is on account of commodity imports, given the cushioning effect of lower commodity prices internationally due to the slowing down of the Chinese economy.

These commentators believe that trade deficit is widening between India and China on account of increasing competitiveness of Chinese exports due to overcapacity and the devaluation of the Yuan that will be counterbalanced by advantages accruing on account of falling commodity prices. India stands to regain its export competitiveness on account of falling commodity prices, provided it overcomes its infrastructure constraints.¹⁴

¹⁴ Bhandari, P. (2015), "As China Slows, India has What It Takes Provided It Strengthens Defenses," Reuters, August 27. Available at: <http://blogs.reuters.com/india-expertzone/2015/08/27/as-china-slows-india-has-what-it-takes-to-consolidate-growth/>