Back to Earth
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With the Olympics over, it is time for China to face some unprecedented challenges including lower foreign demand, rising costs at home, and liquidity.

No other country has spent even close to the money China has on the Olympics. But with the largest domestic gold haul in the nation's history, Michael Phelps and Usain Bolt, all that money seems worth it. That China could spend that kind of money on the Games is due to its economic successes in the past three decades. Of course, Deng Xiaoping's 'Reform. and Opening Up' policy led the country down the path of success. That policy should have received the shiniest gold medal at the games.

The Olympic Party is over. We must come back to real world again, which can be unpleasant. China's economy is facing unprecedented challenges, though most have nothing to do with the Olympics. First, for the first time in three decades, the economies of Europe, Japan, and the U.S. may be contracting simultaneously. It is putting severe downward pressure on China's exports. Second, China's own assets bubbles, fueled by hot money (partly due to optimism related to the Olympics), have burst. Many businesses and local governments have over-expanded on bubble-related revenues or borrowings. They are facing a liquidity crunch as asset prices decline. Third and more fundamentally, rising production costs are casting doubts on China's low-cost expansion strategy.

There are right ways and wrong ways to cope with the challenges. The wrong ways are to deal with symptoms of falling asset prices and the rising CPI with price-targeting administrative measures. Such policies may ease the pain in the short term but could lead to a general economic crisis later. The right way is to combine short-term demand stabilization policies with efficiency-improving reforms. China could and should (1) increase the share of fiscal revenue allotted to local governments to ease their liquidity problem, (2) accelerate infrastructure projects to cushion the economic deceleration, and (3) reform. the financial sector to improve economic efficiency.

China's per capita income is only one third of the world's average and one tenth of the OECD level. Improving efficiency – the foundation for economic catch – up must remain China's overwhelming priority. Demand stimulus should be used primarily for preventing systemic crisis, not for sustaining growth over medium term. Even when demand stimulus is necessary, it should be used in areas where future productivity could be enhanced. The highway building program ten years ago, for example, provided the infrastructure for the growth afterwards.

Urban infrastructure and railroads should be the focus of any demand stimulus this time. Railroad is the most energy-efficient mode of transportation. Energy prices will likely remain high for years to come. China's preferred mode of transportation should shift from highway to railroad. Subway should receive similar priority. High-energy cost makes mega-city more desirable. Concentrated, population-sharing infrastructure decreases resource needs and costs for environmental protection. Subway should be the backbone for urban transportation. Automobile should be avoided as much as possible. It is not environment friendly or affordable as a main mode of urban transportation.

In the past, China always deepened reforms during crunch time. For example, to deal with the Asian Financial Crisis, China reformed the state-owned enterprises, privatized public housing, joined the WTO, and built a nationwide highway system. These policies laid the foundation for the boom in the following decade. The choice was easy then as the economic pie was too small for a defensive strategy. With a US$ 4 trillion economy now, when offense can bring acute pain, defense becomes appealing. I hope that China will resist the temptation of taking painkillers only and again launch a wave of reforms to lay the foundation for another decade of fast growth.

On top of the challenge list is the demand weakness for China's exports. China's exports are about 40 percent of its GDP in gross value and probably one fourth of GDP in terms of value added. Since 2003, the exports have been growing above 20 percent per annum in dollar terms. Discounting for price increase, the export sector has probably contributed four percentage points directly to China's GDP growth rate per annum in this boom. Obviously, if exports stagnate or even decline, the economy would slow significantly.

In addition to the demand problem, the export sector has experienced a cost problem since commodity prices began to surge in 2004. RMB appreciation and wage increases add to the problem. The labor-intensive exporters have a thin profit margin to begin with. The pressure pushed a substantial portion of the export businesses into the red. Production lags behind profitability. With fixed costs and hope for improvement, businesses tend to stick with production plans during the initial stage of profit decline. This is why China's exports have remained strong for the past three years. However, as these businesses begin to view the cost problem as long term, they will scale back production.

The demand and cost problems are working together to pressure China's exports over the next twelve months. Over the past three decades, China's exports have never suffered a serious downturn. In 1998, other Asian economies devalued and cut export prices, which depressed China's exports, though the global economy was in reasonable shape. China now also suffers a competitiveness problem due to rising costs. The demand problem is even more serious. It is possible that China's exports could experience significant decline over the next 12 months.

Global trade is cyclical. One could interpret the current downturn as another cycle. China can just wait it out. This strategy will eventually work, but the wait could be long. China could implement reforms to accelerate the trade recovery. On the demand side, the market is shifting. Rising commodity prices, especially oil prices, have reallocated global income from OECD and East Asia to Africa, Latin America, Middle East, and Russia. Oil inflation alone has reallocated three percent of the global GDP, equivalent to China's total export value, to oil exporters. Strong demand in the next few years should come from resource exporting economies. China's exporters should invest in developing markets there.

Rising cost is a more intractable problem. Most of China's exporters are OEM contractors that rely on price competition for business. They have no access to end users nor possess technologies. They are factories attached to multinationals and would have difficulties living an independent life. Their bargaining power versus their multinational buyers is minimal. When costs rise, multinationals ask them to bear it. This dynamic has devastated China's exporters. The extent of their suffering is reflected in their stock prices. Among Hong Kong-listed exporters, stock prices have declined by 50 to 80 percent in the past two years, even though they didn't enjoy big increase before. They are worth a small fraction of their sales revenues. Financial markets essentially say that their business model has stopped working.

China's exporters must leave their multinational corporate masters and strike out on their own on both demand and supply side. On the demand side, as growth markets shift out of the OECD block to resource-rich economies, they must develop sales channels on their own. Some companies like Huawei Technologies and China Communications Construction have already done so. Such efforts require heavy upfront spending. Hiring foreign staff, probably necessary in most markets, could be expensive. However, being low cost is useless when one can't sell. In today's world, the cheapest products may not win.

On the supply, China's exporters must upgrade their technologies, design and branding capabilities. Unfortunately, few Chinese exporters have such qualities. Developing them would be a time consuming process. A shortcut would be to buy technologies and brands abroad. The financial crisis may offer a perfect opportunity for such a strategy. Most small-medium sized companies in Europe, Japan or North America that possess such qualities are quite cheap now. However, because China's exporters are on such hard time, they even can't afford them at the low prices. On the other hand, China's foreign exchange reserves are bulging at US＄ 2 trillion. It makes sense for the government to support China's exporters to acquire such assets. The money should earn good returns. When the buyers are revived, their share prices should go back to their previous peaks and would be in a position to reward their financial sponsors.

There is obviously a liquidity problem in China's economy. Triangular debts, especially in the form. of receivables, are piling up. Lack of money at local government level may be the root cause. Local governments are quite dependent on land sales and taxes in the property sector to fund their expenditure. That dependence motivates them to spice up the property market, which is a major reason for the bubble. At a deeper level, the declining share of fiscal revenue for local governments in the past ten years has motivated local governments to search for new revenue sources, which eventually ended in the property market. The massive land sales last year at record prices may not bring the promised cash for local governments. The property bubble has burst. Developers cannot sell properties like before and can't keep their promises of paying for last year's land purchases. Slowing property sales also decrease their taxes. The cash-short local governments cannot pay their contractors that in turn can't pay their suppliers.

The quickest solution to this liquidity problem is to increase the revenue share for local governments. China's tax revenue is at a record level. Budgetary revenue may top 6 trillion yuan (it's already at 3.67 trillion yuan in the first seven months), or 21 percent of the GDP, twice as high as the lowest level in the 1990s. The off-budgetary revenue is another 30 to 40 percent of that. The profits of state-owned enterprises could top six percent of GDP. Overall, the government coffer could absorb one third of the GDP or 40 percent of net national product, which is GDP minus capital depreciation. China's economy has clearly shifted to the government side in the past ten years. Reversing that trend may be the solution to many economic problems that the country faces today.

Before reversing the government share in the economy, redistributing it within could solve the liquidity problem. The central government clearly has money to spare. Allocating any surplus at the central government level to local governments could go a long way towards easing the receivable problem in the economy. Indeed, the central government could issue bonds to go into deficit to solve this liquidity problem.

The fiscal redistribution should coincide with boosting infrastructure spending. The economy seems to be decelerating fast. Considering the liquidity problems among exporters and property developers – the two sectors that have directly accounted for half of China's growth – the economy could slide too quickly for comfort. Some fiscal stimulus can serve as insurance for a soft landing. Luckily, China is strong enough for such a package. The core elements of such a package should be urban infrastructure and rail network.

What's coming is clearly the biggest adjustment for the Chinese economy since 1998. The demand weakness must take time to heal and could be cushioned by fiscal stimulus. The supply side problem-rising cost requires a pro-market approach. Price mechanism should be relied on most for the adjustment. Many businesses will go bankrupt, but many more efficient ones will rise to replace them. The economy will become more efficient as a result.

As some businesses face bankruptcies, the first reaction from local governments is how to save them. This attitude, unfortunately, is wrong. Many businesses have got into trouble for neglecting their main business and getting into property or financial dealing. As cost rise made manufacturing difficult, many businesses went into property or stock market for quick money. As the bubbles burst, they are caught with debts surpassing asset value. It is impossible to estimate the extent of the problem, but as I travel across the country talking to businesses, the problem seems ubiquitous to me. I believe that non-performing loans would rise sharply among banks over the next twelve months due to the ongoing asset deflation. The problem is quite severe. But, what is the solution? The problem was made yesterday. We can't change today because we can't change yesterday. Businesses go bankrupt because they made stupid mistakes in the past. The government cannot bail out all the bankrupt companies. Otherwise, we go back to planned economy and poverty.

Instead, local governments should watch the businessmen that are in trouble to prevent them from fleeing with their assets. Many did ten years ago. Many will do so again this time. Their escape can cost China dearly. Before they flee, they will wire as much money as they can from their bankrupt companies to their offshore personal bank accounts, which would lead to bigger holes for Chinese banks. It would be more foolish for local governments to give them money in bailout attempts. The money will likely be stolen. To safeguard China's financial security, the most useful policy could be to prevent businessmen highly indebts from leaving the country.

China is facing a cost or competitiveness challenge. It requires efficiency improvement to revive growth. Of course, efficiency improvement should take place mostly at company level, guided by the price mechanism, but policy inefficiencies could make a big difference too. China's financial system, in particular, is a heavy burden on the economy.

You might find my assertion strange. Chinese banks are among the largest banks in the world in terms of bank capitalization and profits. Chinese brokers made big profits last year, although they are down this year in a slumping market. If profitability is the best guidance for efficiency, China's financial system should be the most efficient. The problem is that China's financial institutions have made profits from licensed monopolies and government-regulated interest rates. As credit is rationed and, hence, is in short supply and government mandates interest rates, Chinese banks can make fat profits from their credit quotas. Their profits don't reflect their efficiency. Rather, their profits are a tax on the economy.

China's securities industry is more ridiculous. Stock market is the most capitalist market. Securities firms that service stock market should be the most capitalist too. In China, securities firms are mostly state-owned. It is impossible to find an example of a successful state-owned securities company in the world. It is surprising that China doesn't see the problem in its approach.

The inefficiency of China's financial system is a huge cost for the economy. My guesstimate is that the burden could be five percent of the GDP, i.e., China's financial sector has negative value added of five percent on the economy. Addressing the inefficiency in the sector could be a significant stimulus for the economy. China should start by raising deposit rates to narrow the lending spreads to a normal two percentage points. Of course, the central bank should likewise lower the deposit reserve ratio in order to normalize the banking system. The outflow of hot money provides a good environment for cutting the ratio.

China's stock market is a big failure. The Shanghai A-shares index surged from 1,000 to 6,000 in two years and then dropped to 2,400 in one year. You can't blame people for thinking that China's is a Mickey Mouse market. China should completely revamp its market to prevent future crisis like this one. The most important change should be to disentangle the government from micro interventions in the market. When laws are laid down, the market should function on its own. It is the only way to have a healthy market.

The coming challenges are daunting, but China still has many cards to play. Strong fiscal position and trade surplus are cushions against a hard landing. There are still plenty of opportunities for improving trade. There are obvious areas like finance for improving efficiency. As long as the government adopts reasonable policies, the economy could roar back in two years.