

THREE ANIMALS OF THE ADJUSTMENT PROCESS OF CHINESE ECONOMY

When we forecast the adjustment process of the Chinese economy, three animals (elephant, swan, and rhino) will become the focuses of analyzing the characteristics.

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White elephant as to Belt and Road Initiative (BRI)

BRI is not the current version of the Marshall Plan which activated the reconstruction process of Western European economies after World War II. President Xi called this a Public-Private-Partnership approach, parts of

which would be financed by project -recipient countries. When we consider the effectiveness of each BRI project some may become a white elephant which means wasteful infrastructure. Examination whether white elephant or not from the market viewpoint will become very important for BRI.



The appearance of 3 animals came from the global financial crisis in 2008. After the crisis, the Chinese government decided to support the demand levels in China. That prompt action was appraised very high in a global context because of its 4 trillion yuan size.

Very rare possibility of systemic risk as well as having a black swan

In China, private sector depend on finance from foreign financial institutions. However, there Key Performance Indicators were not good in recent months. In case of refinancing bonds in dollar terms, interest rates reach double digits. If defaults continue, there is a possibility of shutting down of financial mechanism in China.

Very difficult phase of deleveraging of the Chinese economy

It resembles gray rhino that is very difficult to manage if it becomes unstable. That possibility is not so rare.

President Xi mentioned gray rhino in last January. That showed a difficult situation of unleveraging Chinese economy. It means increase in low productivity, increasing non-performing assets in bank balance sheets, forbearance policies which show carrying over the burdens to adjust toward the future. If President Xi wants structural reform in China, it means they want to manage gray rhino very differently and substantially.

The appearance of 3 animals came from the global financial crisis in 2008. After the crisis, the Chinese government decided to support the demand levels in China. That prompt action was appraised very high in a global context because of its 4 trillion yuan size. After this decision, the terminology of G2 (the great two, US and China) penetrated into global thinking as to geopolitics. But it became the source of traps which the Chinese government has to manage to escape. I am going to describe the causal relationships between remedies for crisis and new sources for instabilities.

4 trillion yuan projects were planned within the Chinese Communist Party's resume. Just piling up of infrastructures were considered. It was a tradition that projects which build road, harbor, railways etc. were done by state-owned enterprises (SOEs). Through 4 trillion yuan projects, the rebirth of SOEs was accomplished. Before that, "Private enterprises in progress, SOEs in retreat" was a crude reality. However, "SOEs in progress, private enterprises in retreat" became

a new reality after 4 trillion yuan projects. That meant the dismissal of market significance as to prices and loan interest rates. Under quota allocation systems, significance and implication of prices will not play any role. Systems of resource allocation through prices did not work. Because of this, the Chinese economy became inefficient from the viewpoint of the dynamic allocation of resources. As to BRIs, there is a possibility that this type of inefficiency may spread over to neighboring countries. A lot of wasteful allocation of resources meant the low return of investment. High investment ratio did not reflect the higher growth rate of the economy. And price signals were dismissed. Chinese economy took the route without a chart. After that, the potential growth rates of China became lower, and bad loans increased for loans to SOEs.

Black swan appeared from both demand and supply conditions as to high-yield bond issues. As to demand, quantitative easing (QE) played a very important role. Central banks in developed countries took very low rate monetary policies to combat the deflationary economies. These were very contrary to investor's viewpoint. Institutional investors wanted high yield bond to compensate for their poor performances. Within the Chinese economy, 4 trillion yuan projects gave impetus to investments for real estates. Bubble mentality penetrated into the whole economy. As we see, very low interest rates prevail in the world context. It was very lucky timing for Chinese entrepreneurs who wanted to invest in the property. They issue a relatively high yield bond in foreign currency terms. However, the situation changed very radically. Within the Chinese economy,

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buyers of real estate are disappearing. That means bust of bubbles are approaching.

Even the banking sector did not want to see a bankruptcy case to appear when they have to face difficult refinancing situations. Forbearance policies have become very popular in the banking sector in China. Actual non-performing assets for banks increased. This is the result of poor monitoring system by banks. Dynamic allocation of resources in China was hindered through forbearance policies by banks. Even President Xi Jinping mentioned "gray rhinoceros" last January in his talk to economic managers in Beijing.

Even if China could avoid black swan case, white elephant and gray rhinoceros will bother the growth paths for China. In China, labor input will decrease because of shortages of labor supply. Foreign Direct Investment toward China has decreased in recent years. It is the reflection of poor performances in profits. Capital inputs will not increase at a higher speed. Total factor productivity which shows the innovation of the economy will not be reliable because of the lack of efficiency as to resource allocation. The potential growth rate of the Chinese economy may be around 2%.

We have to examine the path very carefully.

One Belt, One Road

