Credit where credit's due for China's economic authorities

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Nobel prize winning economist Paul Krugman recently said with reference to China's President Xi Jinping: 'Are you starting to have the feeling that when it comes to economic policy Xi-who-must-be-obeyed has no idea what he's doing?'

Krugman's comment came after the Chinese authorities had decided to allow the renminbi to fall modestly in value, as opposed to a more ambitious reset or cutting it loose entirely. Other commentators have spent the past couple months chiding the government for its response to the stock market collapse, or accusing it of stalling on market-orientated reform more broadly. If China is making a habit of getting economic policy wrong, countries with a deep trade and investment exposure such as Australia will pay a higher price than most.

But wait. The main job of macroeconomic policy in the short run is to keep demand ticking over at close to the capacity of the economy to supply goods and services. Faster than that and there will be inflation; any slower and there will be above natural unemployment. Former senior economist at the Bank of International Settlements, Guonan Ma, also argues that unless there is an overall balance between demand and supply, it becomes that much harder for China to implement much-needed structural reforms.

So where does the level of demand in China currently stand? According to an IMF report released in August 2015, it stands almost exactly where it should. This policy success is easily missed amid all the hyperventilation about the ongoing gyrations in the Shanghai Composite Index.

Yet how is this possible when growth in 2015 will almost certainly be the lowest in 25 years? The IMF emphasises that it is not the level of demand that is slowing the growth rate but the capacity of the economy to produce output.



At first blush this supply side slowdown may appear worrying. But it's also what you would expect to see in an economy that the World Bank now regards as having reached upper middle-income status. China can only benefit from a rapid 'catching up' to OECD economies for so long.

At the same time, the Chinese authorities have had and will need to continue to manage an orderly slowing in the overall growth rate, they've needed to engineer a shift in productive capacity away from manufacturing and construction towards services. The sectors that once drove the economy have become victims of overinvestment and excess capacity. An IMF report released in April 2015 said that a glut of residential property would likely take until 2020 to clear.

But since Xi and his team came to power at the end of 2012, the services share of GDP has risen from 45 to 48 per cent of GDP. There's still a long way to go: in the United States the services share is 78 per cent. Still, the transition is clearly underway. And the outlook for services is also bright with forward indicators such as the Caixin/Markit Services Purchasing Manager's Index (PMI) soaring in July to an 11 month high.

On the demand side, the big task has been to rebalance the structure of spending towards domestic consumption and away from investment and exports. In the first half of 2015, consumption spending in China accounted for 60 per cent of GDP growth. This compares with 54.4 per cent at the same time in 2014 and 45.2 per cent midway through 2013. Despite the trouble in the stock market, the Westpac MNI China Consumer Sentiment Index has increased for three straight months since June 2015 and is now higher than it was a year ago.

Companies on the ground are also not reporting any collapse in consumer spending. On 'China's Black Monday', in response to a plunge in Apple's stock price on the back of fears about China, CEO Tim Cook reassured investors: 'I get updates on our performance in China every day … and I can tell you that we have continued to experience strong growth for our business in China through July and August'.

The challenges for China won't stop coming. Former Morgan Stanley Asia boss, Stephen Roach, observed that the country's leaders are grappling with enormous complexity as '[t]ectonic shifts are occurring simultaneously on several fronts — the economy, financial markets, geopolitical strategy, and social policy'.

In that context, it's easy to pan some interventions as having been clumsy, and there's nothing wrong with being impatient for more reform. But it shouldn't be missed that China's authorities appear to know their economy a good deal better than many give them credit for.