

Market Monitor

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Valuing China

“Economic imbalances” was a heated topic of debate when finance ministers and other leaders met recently at the World Bank and International Monetary Fund meetings in Singapore. The tension behind this dry term is that the ministers are worried that an economic downturn in the U.S., the world’s largest economy, would deeply affect much smaller economies in some fast-growing developing countries. In the U.S., people and firms import a lot more goods and services than they export to many developing countries, while many developing countries export a lot more to the U.S. than they import. The People’s Republic of China is at the top of a lengthy list of such countries and during a recent visit to Beijing, Shanghai, and Singapore we gained some insight into the story behind the statistics.

Our themes for today are these:

- The export-import trade imbalance between the U.S. and China matters in some ways and not in others
- China’s political past continues to deeply affect decisions affecting its trade, currency, and economy
- To see the most vibrant part of China’s economy, we should perhaps look small

The finance ministers’ Singapore debate had a lot to do with the huge U.S. trade deficit, particularly with China. The Chinese have chosen to loan many of the extra dollars they get from selling goods and services to the United States by buying U.S. Treasury bonds. These bond sales, or loans, have made it possible for

the U.S. government to fund a large budget deficit while keeping interest rates low. In turn, this has improved the chances for U.S. firms to make profits on the goods and services they produce. So the two countries support each other’s economic growth.

All this sounds great in the short run, but the Chinese may not be able or willing to keep loaning us money forever at this pace. For example, Chinese GDP growth has averaged a breathtaking 9%-11% (the U.S. GDP growth rate averages 3%-4%) and it appears that the state would like to moderate that growth a bit. And, up to this point China has kept value of its currency — called renminbi yuan or yuan (renminbi translates to “people’s currency”) — artificially low relative to the dollar by dictating an official exchange rate target. That means that Chinese stuff is relatively cheap for us to buy and U.S. stuff, including our bonds, is relatively expensive for them to buy. As a result, some U.S. firms and members of Congress want to pressure China to let its currency float in order to make our stuff more attractive to the Chinese and perhaps make Chinese stuff less attractive to us, thus improving the trade deficit. In addition, as China uses more of its money to invest in internal projects it could reduce its demand for U.S. Treasury bonds and for dollars. That could have two effects: the dollar could fall even more relative to the yuan and longer-term U.S. interest rates could rise.

In the long run, a truly floating exchange rate is a good thing since it allows both countries’ goods, services, and bonds to be priced efficiently. In the medium run, however, it could produce wrenching results.

The Chinese government’s control of its currency exchange rate is a holdover from the Maoist era when everything — land, production, consumption, and foreign trade — was almost completely controlled by the state. This began to change after Mao’s death and to accelerate in the 1990s. Recently we saw hundreds of tall construction cranes, huge new office complexes in Beijing and Shanghai, and parts of Shanghai can almost outdo the Beverly Hills shopping experience. In addition, China is encouraging its firms to invest in natural resources projects in Africa and Latin America.

Despite these changes we shouldn't think that China's economy is similar to the U.S. or even Western Europe. Rural areas in China lag far behind the vibrant cities and this is a source of considerable tension. Most important, the central government, the military, and the provincial governments still control a high percentage of the country's economic assets, including shares in the Bank of China, CNOOC (the oil company that wanted to buy Unocal earlier this year), PetroChina and other companies listed on the Shanghai and Hong Kong stock exchanges. For example, although the government has been helping state-owned banks clean up enormous bad loan problems before going partially public, can those banks resist pressure from the state to make future politically motivated loans? In addition, the state still severely restricts foreign ownership of Chinese companies and payoffs and inside deals are still common in China. Finally, as we've seen, the state still controls the currency exchange rate.

On the other hand, the state has encouraged small-scale entrepreneurship. Among many other things, it offers initial funding with no strings attached for educated overseas citizens who return with an idea and a business plan. And regulations have been relaxed for new non-tech, low-tech, and high-tech startups. Obviously, few of these firms represent immediate or perhaps even eventual investment opportunities, but the

spirit and reality of capitalism is alive at this smaller-scale level.

To draw together our two main themes of the trade deficit and investing in China, we think that although China's finance ministry and the central bank will not give in to U.S. pressure to deregulate their currency immediately, they do mean over the next few years to let it increase gradually in value against the dollar. So careful, judicious investments in China could get an extra boost from changing exchange rates. The Chinese are also taking steps to encourage more foreign investment by relaxing foreign stock and private equity ownership rules and by tightening financial accounting rules. The result, we think, will be to gradually make China a far more interesting place, especially for those willing to bear the higher risks of investing in smaller, developing-country firms.

What does this mean for long-term investors today? We think that, taking into account its unique past and current restrictions, China is an instructive case study of what is going on in emerging markets more generally. Conditions in these countries can be quite different than in the U.S., Canada, Europe, Japan, and Australia, but they are beginning to become more investor friendly. We would support careful research and small measured steps to increase exposure to developing country assets.

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