

# Growth, but Hidden Pitfalls

China's economic growth remains strong, but imbalances lurk

 By Patrick Chovanec



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down. It took some time for the effects to work their way through the Western economies. The financial meltdown that initially hit Wall Street and the City of London led to a tightening of industrial and consumer credit. Companies shed jobs to survive, and those lost jobs, along with lower home values and reduced credit limits, sent consumers into a funk. Only in the second half of 2008 did this falling consumer demand in the West translate into a business catastrophe for Chinese exporters.

## THE EXPORT EFFECT

Over the previous two decades, China had relied on exports as its engine of growth. Based on its competitive advantage in labor costs and rapid lead times, China became the world's factory floor. "China makes, the world takes" became the slogan, and global companies referred to the "China price" as their benchmark cost. By 2008, exports accounted for 40 percent of China's GDP, and upwards of 80 percent in key coastal provinces. Interior provinces also relied heavily on exports, in the form of remittances sent back home from more than a hundred million migrant workers employed by coastal factories.

Starting in the fourth quarter of 2008, overseas demand for Chinese exports imploded. Many factories shut their doors, others let capacity idle. According to government estimates, at least 20 million migrant laborers were let go and sent home. At a handful of factories, laid off workers rioted, raising fears of widespread social unrest. The government was particularly concerned that China might be unable to sustain the eight percent annual GDP growth believed to be needed just to

**L**ate summer last year, Chinese officials were still worried about keeping their country's economy from overheating. China's stock markets had fallen significantly, and the window for new initial public offerings in Hong Kong had closed, but there was still speculation that

China, "de-coupled" from the rest of the world, might escape the effects of the global financial crisis. Banks remained under orders to hold back lending and rein in growth. Inflation was the greatest fear. Oh what a difference a year makes!

Far from "de-coupling," China found itself on the whip end of the global slow-

keep pace with the nation's growing population.

## STIMULATING GROWTH

In November, China's State Council met and announced an RMB four trillion (US \$486 billion) stimulus program. The number was just a round figure objective, with the details to be worked out over the following months. Of the funds in the package, about RMB one trillion has been earmarked for relief and reconstruction efforts related to last year's Sichuan earthquake, and does not actually represent new expenditure. Of the remaining RMB three trillion, about half is allocated towards transportation and electrical infrastructure projects that were already on provincial "wish lists," meaning that the timeframes are being accelerated. The other half will go towards investments in rural village infrastructure, the environment, affordable housing, health care, education and technological research.

In addition to the stimulus package itself, the government restored several export tax rebates it had previously reduced in an effort to support the struggling sector. It recognized, however, that in the long run, China's economy would have to re-orient itself away from export-led growth toward one based more on domestic consumption. Such a shift would not only reduce China's vulnerability to future external demand shocks, it would also help eliminate the country's imbalance of payments with the rest of the world, which had led to a massive accumulation of over US \$2 trillion in foreign currency reserves—far more than China needs or could effectively invest. To jumpstart this process, the government offered a range of special rebates and tax breaks for Chinese citizens to buy consumer goods such as refrigerators and automobiles.

## A LIQUIDITY GUSH

Roughly half of the RMB four trillion stimulus package was to be financed by the government (including a large portion by local and provincial governments issuing bonds), and about half in the form of lending from China's state-run banking system. However, these banks were also encouraged to lend vigorously to companies that might need funds in order to support

employment and growth. The unanticipated result of this directive was an explosion of bank lending in the first half of 2009, above and beyond the stimulus package. Even at the time of the National People's Congress, when the lending surge was well underway, Premier Wen Jiabao reassured participants that overall lending for the year would not exceed RMB five trillion. By the end of June, however, lending had risen by RMB 7.8 trillion with no end in sight.

The explosion in bank lending raises three serious concerns. First, it was unlikely that such a large sum of funds—a 24 percent increase in the country's total loan portfolio—could be disbursed so rapidly without a loosening of credit standards. China's banking system had just emerged from a massive recapitalization required to rescue it from all the bad debt it had piled up in the 1990s. If the same recovery rates from politically-directed "policy lending" in the past applied to this new burst of lending, it could render the country's banking system insolvent. Yet Chinese banks appeared to be making little or no provision for that possible outcome.


Second, some economists—including myself—expressed concern that the ready availability of stimulus funds could actually retard, rather than facilitate, the difficult economic adjustment that was required. Many bank loans went to provide working capital lifelines to industries with chronic overcapacity, where some companies probably should have been allowed to fail. And by weakening banks' credit controls, and reducing them to mere conduits for state funds, the stimulus effort has turned back the clock on reforms that are vital to the long-term health of China's financial system and its ability to allocate capital more efficiently. In the meantime, the massive influx of funds, mainly to state-owned enterprises, has tilted the playing field in favor of the state sector over private competitors.

Third, the evidence suggests that at least some of the loan proceeds were used by their recipients to speculate in stocks and real estate. China's residential property prices dipped earlier this year, but have remained strangely resilient despite a massive inventory of unsold or unoccupied luxury apartments.

The Shanghai stock index surged nearly 90 percent over the first half of 2009, before peaking in early August, despite official economic figures indicating sluggish growth, at best. This unaccountable performance—and the market's extreme sensitivity to rumors of tightening credit—suggests to many the existence of dangerous asset bubbles fueled by a dramatic expansion of the money supply.

## THE STATE OF THE ECONOMY

China's officials have reassured themselves that, whatever its flaws, the stimulus effort has produced positive results. Although China's GDP growth dipped below eight percent for the first half of 2009, authorities have announced they expect it to come in at or above that magic benchmark for the year as a whole. But this pleasant picture masks growing unease regarding the accuracy of China's economic statistics. Critics point out that while officially reported GDP grew at an annualized rate of 6.1 percent in the first quarter, and 7.9 percent in the second, electricity usage—a hard input that usually tracks with economic output—declined 2.2 percent over the same period. The head of China's statistical bureau recently admitted that many key figures, such as worker income, cover only state enterprises and exclude the private sector. Many worry that China's actual condition may be more precarious than headlines suggest.

To their credit, over the course of this summer, China's leaders have demonstrated a growing awareness of the problems the stimulus has created as well as solved. But they walk a tricky tightrope. A year ago, their only goal was to rein in credit and growth. Today, they must encourage credit to sustain growth, while curbing it to avoid excess. At the same time they must manage a structural transformation of the economy. The year ahead looks challenging indeed. 

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