China “overheating” spells trouble for world economy

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5 May 2004

The increasing dependence of the world economy on continued expansion of the Chinese investment boom was sharply underlined last week when a tremor went through world markets following warnings of action to restrain the “overheating” Chinese economy.

Amid a growing money supply, soaring bank credit and rapid increases in fixed investment, Chinese authorities have been indicating from the middle of last year that they would like to see the economy slow down. But their words have had no effect.

Figures released last month show that the economy grew at an annual rate of 9.7 percent in the first three months of the year, compared to a target rate of 7 percent. Loans were up 21 percent compared to the same period last year, the money supply rose by almost 20 percent and fixed investment jumped by 43 percent.

Now stronger measures, including interest rate increases and quantitative restrictions on bank lending, are being considered.

The firmest indication of these moves came on April 28 in a Reuters interview with China’s Premier Wen Jibao who pointed to problems arising from the expanding money supply, bank credit and fixed investment. “We need to take effective and very forceful measures to resolve those problems as soon as possible,” he said.

There was a quick reaction on world markets. Stock markets in Hong Kong, Thailand, Singapore and Australia fell by between 1.2 percent and 2.4 percent as currencies plunged in value throughout the region. The shock waves were also felt on Wall Street, where the market dipped in the wake of the interview.

Over the past year, there have been continuous warnings of the growth of a Chinese financial bubble as money pours into the country, leading to an investment and property boom. Some analysts have even described the situation as “eerily similar” to that which prevailed before the Asian economic crisis of 1997-98. But the effects of a crisis in China would be even more serious.

One of most widely canvassed proposals to try to ease situation is the revaluation of the yuan against the US dollar. Chinese authorities have been spending large amounts of money in international markets to buy US dollars and so keep down the value of their own currency. This has led to an inflow of money into the Chinese banking and financial system, which has been used in turn to finance investment and property speculation. There has also been an inflow of “hot money” from speculators hoping to make a large gain from any revaluation.

With estimates that up to 45 percent of all lending consists of bad loans, however, the Chinese authorities are very reluctant to float the yuan or even to revalue it because they fear this could lead to losses and a crisis in the banking system.

“If we change the system rashly,” Wen told Reuters, “it will certainly bring unpredictable problems to the domestic economy, and at the same time could affect the financial stability of the region and even the world.”

The chairman of the US Federal Reserve, Alan Greenspan, had issued a similar warning a week earlier. “If [the Chinese] run into trouble, they will create significant problems for Southeast Asian economies, for Japan, and indirectly for us,” he said in testimony to the US Congress.

The growing reliance of both the Asian region and the world economy as a whole on Chinese economic expansion is demonstrated by a series of statistics.

Last year China accounted for more than 60 percent of the growth in world trade. It holds $420 billion worth of foreign currency reserves and accounts for 10 percent of world trade. Its share of global output has doubled to 4 percent over the past decade.

China consumes 7 percent of the world's oil supply, a quarter of its aluminium, 30 percent of its iron ore, 31 percent of all coal, and 27 percent of all steel products. It consumed 40 percent of the world's concrete last year.

The Chinese economic boom, fuelled by an inflow of foreign investment of $57 billion per year, is almost entirely responsible for the upturn in the Asian economy over the past year.

Exports to China accounted for 32 percent of Japanese export growth in 2003 and Japanese capital spending is largely being driven by investment in those industries trading with China. In South Korea, some 36 percent of export growth in 2003 was linked to sales to China. Exports to China were up 68 percent in April over the level a year ago. It has been estimated that Korean export income would fall by 3 percent for every 1 percent decline in the Chinese gross domestic product.

Ten years ago, when Chinese authorities took action to rein in an economic boom, there was little impact on the global economy as a whole. It may well be a different story this time because China has become much more integrated with the rest of the world, and particularly with the US economy.

In the final analysis the Chinese boom is being pulled along by increased investment to produce goods for the American market. US consumption spending, however, is not being financed by expanding employment and higher wages—real wages and job numbers have both declined over the past three years. Rather, the Federal Reserve Board's low interest rate policy has led to an upsurge in housing prices and financed an increase in consumer debt.

Far from pointing to a new era of economic expansion, the feverish growth of the Chinese economy is an expression of deep-going problems in the world economy as a whole, signified by the fact that the collapse of the Chinese bubble or an increase in US interest rates, or a combination of both, could have severe global consequences.