Continuing fears of a Chinese economic slowdown

John Chan
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The world's stock markets, commodity prices and a number of currencies suffered a sharp drop after Chinese Premier Wen Jiabao announced on April 29 that Beijing would take "effective and very forceful" measures to slow down China's "overheating" economy.

This collective economic shudder serves to underscore both the fragile character of China's hothouse economic development and the degree to which the world's major economies are dependent on it.

All the indices point to a frenzy of economic activity in China. The official annualised growth rate for the first quarter of 2004 was 9.8 percent, compared to the official target of 7 percent. According to many Western economists, the actual growth rate could be far higher—up to 12 percent.

A massive inflow of speculative capital is continuing to fuel investment, particularly in real estate. The growth of fixed asset investment slowed a little in April but was still $US48 billion, 35 percent higher than the same month last year. The rate for March was up 43 percent, while February's influx marked a 55 percent jump from the previous year.

Loans to construction companies and developers grew by 40 percent in the first quarter of this year. In Shanghai, property prices rose 28.3 percent in the first month of the year, while other major cities reported an average 8 percent increase.

Beijing has literally become the world's largest construction site, with one million workers building thousands of projects, ranging from apartments, hotels and condominiums to shopping malls. Whole sections of the city are "ghost towns" with newly completed buildings standing empty.

Real estate speculation along with continued investment in other industries has in turn produced huge demands for raw materials. In the first quarter of 2004, investment in the steel and iron industry grew by 172.6 percent and in cement by 133 percent.

China has doubled its steel production since 2000 and is now the largest producer in the world. China consumes twice as much steel as the US and half of the output goes into construction projects. Auto market, led by German and US companies, saw its sales jumped 80 percent from 2002 to 2003 and is another major factor behind the boom in steel making.

The *New York Times* warned this month that any Chinese economic slowdown would flood the international market with cheap steel and "could wreck profits and touch off mass layoffs at steel mills around the world, including those in the United States".

The newspaper noted: "If demand in China fell back to where it was in 2000, enough surplus Chinese steel would be freed to meet nearly one-fifth of the rest of the world's demand; it would almost equal the total amount of steel now traded internationally."

Domestic inflation is another indicator of economic "overheating". The official consumer index rose 2.8 percent in the first quarter of the year, and, according to figures released last week, 3.8 percent in April—higher than the officially announced "tolerable" level of 3 percent.

But this composite index obscures far higher price hikes that are hitting ordinary consumers. According to official statistics, the overall price index of raw materials, intermediate products and finished goods rose 8.8 percent in the first quarter. The main category of food—rice and other grains—was up 10.8 percent, with the wholesale price of rice increasing by 33.2 percent.

Since April, Beijing has announced a series of measures to try to slow the economy without precipitating a catastrophic collapse of the investment bubble. These include a curb on bank lending for speculative construction projects, as well as for steel, aluminum, cement and auto ventures. With the announcement of the latest inflation figures, the restriction could extend to machinery, textiles, other construction materials and pharmaceuticals.

The new loan rules require companies to put up at least 40 percent of the capital for new steel projects and 35 percent for other industries, compared to 25 percent previously. Inspection teams have been established to enforce the new regulations and punish local officials and businesses that ignore the policy. At least eight officials, including a branch manager of the Bank of China, have been arrested for illegally approving loans for a steel project in eastern Jiangsu Province.

At a recent economic conference, central bank vice-governor Wu Xiaoling appealed to investors to control themselves. He warned: "If we come to a point where the central bank has to take tough measures [to increase interest rates and revalue the

Chinese currency], that will not be good for anyone."

State-controlled media outlets have also called on local governments to immediately "halt constructing repetitive, low-level projects and stop investing blindly". Local government investment rose by 60 percent for the first quarter of the year, slowing only slightly in April to 54 percent, as compared to the same month last year.

Several analysts have warned, however, that the restrictions will have little impact because investors can split their loans by registering different companies. Moreover, the efforts of the central government to slow the economy are being impeded by the actions of local governments that are competing with each other to maximise foreign investment in their particular areas.

On May 11, an article in the *South China Morning Post* pointed to the domination of "economic warlords" whose "mafia-like rule covers districts, towns and counties, where provincial authority stops".

The newspaper warned: "Twenty-five years of reform has seen increasing power go to the regions, and it is now out of control. This is why efforts since last year to control runaway growth have not succeeded. Regional officials do not want growth to slow, as it will affect both their constituencies and their pockets. While they give lip service to central government policies, they do not implement them. This underscores an underlying fragility in the system, which is not reflected in statistics."

Wen Jiabao and other Chinese officials have played down the prospect of an economic crash, declaring that China's macroeconomic measures will produce a "soft landing". During his recent visit to Europe, Wen told 400 British executives that he was a driver who "has to press the brakes gently" to avoid an emergency stop.

The fears remain, however. Standard & Poors estimated in March that hot money to the tune of $40 to $50 billion has been flowing into China in the expectation that the yuan will appreciate against the US dollar. That money could easily flow out again if the yuan revaluation does not occur.

The Institute of International Finance, a US-based financial group representing the world's 330 largest banks, warned last Friday that "the difficulties inherent in fine-tuning the Chinese economy suggest that the adjustment to more moderate growth is likely to be bumpy with implications for the rest of the region and the world."

So sensitive are the financial markets that a vaguely worded announcement by Beijing on May 10 about "limited price increases" provoked an immediate reaction. Hong Kong's Hang Seng China Enterprises Index fell 7.7 percent—the biggest fall in four years—while stock markets in Shanghai and Shengzhen dropped 2.2 and 2.5 percent respectively.

Andy Xie, the chief economist for Morgan Stanley Asia, warned last month that the "hard landing scenario likelihood is rising fast. Something bad could happen in the next three to four quarters." He has repeatedly likened the investment bubble in China to that of other regional economies prior to the Asian economic crisis in 1997-98.

A huge global imbalance has developed as China has become what is dubbed the "workshop of the world"—a massive cheap labour platform for transnational corporations. One of the consequences has been a trebling of global shipping costs over the past two years, due to the huge quantities of raw materials and components being imported by China.

Increased transport costs have translated into rising prices for production inputs. As labour is so cheap in China, raw materials and components account for most of the cost of finished products, putting enormous pressures on Chinese manufacturers to raise their prices despite cutthroat competition for export markets. If the prices of Chinese manufactured goods do start to rise, it could translate into global inflation, forcing central banks around the world, including China's own, to increase interest rates.

The Chinese government is acutely conscious of the political implications of inflation or a financial collapse. The anarchic process of market reforms over the past two decades has opened China up to a flood of foreign investment and created a deepening social divide between a small wealthy, corrupt elite and the vast majority of working people.

Sharp increases in the cost of living in 1988 directly contributed to the mass anti-government protests in May-June 1989. Five years later, in 1993-1994, a carefully-managed "soft landing" of the economy to end the feverish growth associated with property speculation resulted in social unrest as millions of Chinese were thrown out of work.

An article entitled "Fears grow in China that boom will go bust" in the *Chicago Tribune* on May 2 warned: "A crash could destroy the real estate market, wreak havoc with already weak banks, throw millions of people out of work, cast farmers into deprivation and lead to the one crisis China's authoritarian government fears most: social unrest."

Beijing is faced with an unpalatable dilemma. On the one hand, it cannot afford to let the speculative frenzy continue unchecked because the inevitable collapse of the financial bubble will have devastating social and political consequences. On the other hand, slower growth will discourage further foreign investment and lead to higher unemployment and rising discontent.