

# China's "overheating" threatens economic instability

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In a sign of nervousness over the danger of economic instability, the Chinese government has announced further measures to try to rein in spiralling investment in property and manufacturing. The moves follow the release on July 18 of the latest annualised growth figure of 11.3 percent for the second quarter—the highest since 1995.

Last week President Hu Jintao and Premier Wen Jiabao delivered speeches warning of the need for "forceful measures" as previous policies had done little to curb investment bubbles, overcapacity and skyrocketing energy consumption. For the first half of the 2006, China has recorded economic growth of 10.9 percent—well above the government's 8 percent target.

At a Chinese Communist Party (CCP) Politburo meeting on July 24, Hu urged local authorities who have ignored central government policies to consider the long-term stability of the entire country. He threatened to sack local officials who refuse to abide by Beijing's policies to limit investment.

Following top-level meetings, Beijing announced a series of measures last week, including restrictions on speculative foreign investment in the real estate sector, which increased 28 percent in the first half of the year. Government tax rebates for a range of exports will be trimmed by 2 percent in an effort to reduce China's surging trade surplus and slow overall economic growth.

The land ministry has established nine regional teams to supervise development approvals. According to a Deutsche Bank report on July 18, Beijing's failure to curb fixed asset investment was largely because more than 90 percent of local governments illegally supply land to investors and developers to attract investment to their regions and cities.

These latest measures are unlikely to have much more impact than previous ones. In April, following the announcement of high growth rates for the first quarter, the country's central bank—the People's Bank of

China—raised interest rates by a quarter of a percent to 5.85 percent in a bid to curb borrowing. In May, the State Council imposed further restrictions to slow real estate development and limit finance for new industrial projects.

Nevertheless, the number of construction projects increased 22 percent in the first half year, compared to the same period in 2005. In June, Premier Wen Jiabao instructed state commercial banks to address the "obvious structural problems", i.e. the growth of lending and bad debts. China's bank lending reached \$224 billion in the first five months of the year—more than three quarters of the central bank's target for the whole year.

The latest growth figure of 11.3 percent provoked considerable concern in international financial circles.

Masahiro Kawai, a leading Asian Development Bank economist, told a news briefing in Hong Kong: "We are concerned about the overheating situation in China. There is an even stronger case for tightening monetary policy and yuan appreciation."

Andy Xie, chief economist at Morgan Stanley Asia, declared: "This is out of control. The bottom line is, lending is crazy, even after repeated warnings from the government." The *Financial Times* noted that China's measures to stem investment had had limited impact. "Beijing's reluctance to apply the brakes on its \$2,200 billion economy is increasingly worrying," it warned.

The comments underscore the fact that accelerating growth in the world's fastest growing capitalist economy is far from an expression of strength. Beijing confronts the danger of a collapse of the real estate bubble and chronic overcapacity as well as heightened trade antagonisms with the US and Europe caused by surging exports.

The Chinese government is already under pressure to further revalue the yuan against the US dollar. It ended the yuan's peg to the greenback in July 2005, but continued to maintain the exchange rate within a narrow

band just below 8 yuan to a dollar. The move failed to satisfy the US Congress, which is calling for punitive trade sanctions against China unless the yuan is revalued significantly.

A comment by *Financial Times* correspondent Richard McGregor on July 17 described the revaluation of the yuan as the key to slowing China's economy. He pointed out that previous government moves to curb investment had failed because the entire financial system based on cheap credit and government incentives established in the 1990s was designed to boost production.

Retained corporate earnings in China are equal to about 20 percent of gross domestic product (GDP)—twice as high as in the US or France. McGregor explained that low interest rates and a low yuan compelled companies to reinvest profits rather than keep them in banks. "A more expensive renminbi [yuan] would trim the trade surplus or at least slow its growth, while also reducing the incentives for capital inflows. The two together—the surplus and capital inflows—have left China awash with cash."

Beijing, however, fears a major rise in the yuan's value will plunge its crucial export sector into difficulty, causing more unemployment and a financial crisis in its debt-burdened banking system. The politically explosive problem facing the Beijing ruling elite is that widespread unemployment is continuing despite the country's high growth rate.

In a comment entitled "Why isn't high economic growth creating more jobs?" on July 21, the official *People's Daily* warned that the labour market was "not inspiring". In the first six months of the year, only 9 million new jobs or 60 percent of the target for 2006 had been created, despite a far higher growth rate than planned.

The introduction of new technologies is increasing productivities and creating fewer jobs. "A single percentage point of growth in China's GDP generated at least 2 million new jobs in 1980s but only 800,000 in the 1990s," the newspaper noted. "In a market economy, there are often economic incentives for a business to operate with less staff. The government is not supposed to interfere too much in business activities, but it is supposed to create a fair work environment."

Over the past two decades, Beijing's pro-market policies have generated huge social dislocation by destroying millions of jobs in the state sector and driving tens of millions of impoverished peasants to look for jobs in the cities. This process provided a huge supply of cheap labour for foreign investors, but is running out of control

as more and more investment is required to absorb new job seekers. China faces a collapse of speculative bubbles on a scale far exceeding the Asian financial crisis that erupted in 1997-98.

To find a way out of the economic conundrum, the Chinese leadership decided in recent years to try to shift away from heavy reliance on export and investment-driven growth to a more domestic-oriented, and consumer-led development strategy. In his latest speech, President Hu stressed the need for policies ranging from lifting domestic consumption to building rural infrastructure as the long-term resolution of repeated economic "overheating".

But to lift domestic consumption requires a significant increase in real wages and the provision of government services such as proper health care and pensions to encourage people to spend rather than save for ill-health or old age. Such concessions to working people, however, are completely incompatible with the requirements of international capital for cheap labour and government spending on economic infrastructure rather than services. Beijing's response to growing social unrest expressed in tens of thousands of protests each year is police-state repression.

The latest incident took place on July 22-23. According to the New York-based *China Labour Watch*, over a thousand workers at a factory producing toys for major US companies in the southern city of Dongguan, rioted over poor working conditions and wages. In direct violation of the government's "labour regulations", the employer forced workers to labour 11 hours per day, and perform 70 hours overtime per month, and paid them just \$72 a month. Riot police and security guards joined forces to suppress the protest, injuring many workers and arresting dozens.



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