



China: Is Economic Growth Out of Control?

Pablo Bustelo *

Theme: Some analysts consider that China's economic growth in the second half of 2006 is starting to get out of control, and that it could eventually lead to a very sharp deceleration, whose impact on the rest of the world economy would be very negative. This analysis argues that we should not exaggerate the extent of overheating, but that additional cooling measures should be implemented to reduce the risk of a hard landing in the world's fourth-largest economy.

Summary: This analysis begins by pointing out that the figures for the first half of 2006 indicate that the Chinese economy is presenting real overheating, although limited to certain sectors. Policy-makers have taken restrictive actions in quick succession, which could be a sign of frustration and concern in the government. Secondly, the analysis argues that further cooling measures are called for, especially to slow down export growth and decrease the huge rate of savings, but that the yuan is unlikely to appreciate substantially. Thirdly, the paper asserts that, in the absence of the aforementioned measures, and especially if there are significant external shocks, the risk of a hard landing could increase considerably.

Key words: China, growth, GDP, investment, exports, economic policy, administrative measures, monetary policy, exchange rate, public spending, social security.

Descriptors: China, growth, overheating (2004-), hard landing, soft landing.

Analysis: China's strong GDP growth in the last few months (11.3% in the second quarter of 2006) has led some analysts to argue that there are signs that the Asian giant's growth could be out of control. According to this view, the measures implemented by the government since the end of 2004 in order to rein in rapid growth have failed. Excessive lending and investment would already be creating massive surplus capacity in many sectors, which, in the short term, could lead to a decline in prices and profits, causing bankruptcies and creating major difficulties for the financial sector: in short, a hard landing for the economy. In line with this strand of thought, the deceleration in Chinese growth could be extremely severe. Some specialists even talk of a rate of GDP growth of barely 5% in 2007.

If a scenario of this kind does materialise, the impact on the rest of the world's economy would be highly significant, since China ranks fourth in the world in terms of GDP, has attracted huge foreign investments (a stock of US\$600 billion) and has been the world's growth driver for the last few years.

* Senior Analyst for Asia-Pacific at the Elcano Royal Institute and Professor of Applied Economics at Universidad Complutense de Madrid.

This analysis argues that this catastrophic view is not sufficiently backed by the available data and that it exaggerates the risk of a hard landing.

What do the Economic Figures and Policy Measures Indicate?

After an increase of 10.2% (recently revised from 9.9%) in 2005, GDP grew by 10.9% year-on-year in the first half of 2006 and by no less than 11.3% in the second quarter of this year. Such high growth figures are unheard-of since the mid-nineties. Furthermore, fixed asset investment jumped by 29.8% in the first quarter and by 31.3% in the second (and by more than 40% in the automotive and textile sectors), whereas exports increased by 26.5% and 24.0%, respectively. Investment gained pace in 2006, as it posted 25.4% growth in the first half of 2005 and 27.2% in the year as a whole. Export growth exceeded forecasts as a rate of growth of less than 20% had been projected at the start of the year.

As the year 2006 progressed, the authorities were becoming increasingly aware that growth was too high. At the end of April they raised the interest rate on loans by 27 basis points for the first time since October 2004, bringing it to 5.85%. In mid-August, they again raised interest rates on loans (to 6.12%) and increased the deposit rate (from 2.25% to 2.52%). They also increased the bank reserve ratios, twice for loans denominated in local currency (in June and July) and once (at the end of August) for those denominated in foreign currencies.

At first glance, this would seem to indicate that the cooling measures implemented since the end of 2004 have not worked and that the government is very concerned, perhaps even nervous, about the situation.

However, while it is true that cooling has not materialised as expected and that this has frustrated the authorities, we should not exaggerate the extent of overheating and the government's concern. Firstly, GDP growth in 2006 (around 11%), although high, is not much higher than the annual average figure posted in 1999-2005, which was 9.9%. Secondly, the situation two-and-a-half years ago (in the first quarter of 2004) was clearly worse and, nevertheless, cooling came in the following quarters: the year-on-year growth rate of investment in fixed assets declined from 47.8% in the first quarter of 2004 to 25.3% one year later; export growth dipped from 34.1% in the first quarter of 2004 to 21.7% in the final quarter of 2005. Thirdly, it is not accurate to talk of widespread overheating, since it is specific to certain sectors of the economy, where there is strong overinvestment and massive surplus capacity: steel, aluminium, cement, auto assembly, electricity production, textiles and real estate (in this case, with the significant exception of Shanghai, where prices have slowed down their increase and even fallen in some segments). Finally, growth in the consumer price index (CPI) is low (1.3% in the first half and 1.0% in July, compared with 1.8% in 2005 and 2.3% in the first half of that year), although it is true that in China inflation is not a reliable indicator of economic heating or cooling.

As for the government's concern, rather than nervousness or even panic as some analysts have described it, it would be more appropriate to talk of frustration in view of the scant results of the measures implemented in 2005 and the first half of 2006. Some observers suggest that the campaign for cooling has not been successful because of the reluctance of local governments to obey guidelines from Beijing. Consequently, in early August the National Development and Reform Commission peremptorily ordered provincial authorities to re-assess the investment projects they had undertaken since January and threatened to fine those who had incurred in 'bad practices'. President Hu Jintao himself signalled at the end of July that it was necessary to 'restrain blind growth in high energy-consuming and polluting sectors'.

Partial Overheating: Causes and Responses

There is no doubt that there is overheating, although it is only partial. Investment growth (above 30% per year) is well above the desired level (15% to 20%) and exports are growing (at 25%) faster than advisable (15% to 20%). These are the two demand components which explain the impressive GDP growth, since domestic consumption is still proportionally low as a percentage of GDP and is posting slower growth: retail sales increased by 12.9% in 2005 and by 13.3% in the first half of 2006.

Excessive investment, which has pushed the investment rate to spectacular levels (49% in 2005), is, in turn, due to excessive liquidity, based on three fundamental causes: strong growth of net exports; high inflows of foreign capital based upon expectations of a revaluation of the yuan; and fast growth in bank lending.

The trade surplus totalled US\$76 billion between January and July, 51% more than in the same period one year previously, and is on course to reach US\$120 billion or more in 2006, compared with US\$102 billion in 2005.

Foreign capital inflows mainly consist of direct investment (FDI) and speculative investment. FDI totalled US\$60.3 billion in 2005 and US\$28.5 billion in the first half of 2006, a figure which could point to a slight decline for the whole year. However, foreign investment other than FDI, carried out mainly for speculative reasons (placements in yuans pending a possible appreciation in China's currency), which was around US\$50 billion in 2005, totalled US\$33 billion in the first half of 2006, which could suggest substantial acceleration in this item in the year as a whole.

By buying dollars in the national and international markets to sterilise the upside pressure on the yuan, the monetary authorities inject yuans into the economy. The increase in currency reserves totalled US\$209 billion in 2005 and US\$122.3 billion in the first half of 2006, bringing reserves to the huge figure of US\$941.1 billion in June. Forex reserves in China, the highest in the world, will no doubt exceed US\$1 trillion in 2006. The increase in reserves partly translates itself into the monetary base, since the policy-makers cannot sterilise it completely by restricting domestic credit, so that the effect is a boost in liquidity and in lending by the banking sector. In the first seven months of the year, new loans in yuans totalled 94% of the target set by the central bank for the whole year.

As for exports, they are growing fast, partly due to the recovery in Europe and Japan and partly because of China's low inflation rate.

So far, the authorities have reacted to strong economic growth with administrative measures and monetary policy moves (increasing interest rates and reserve ratios). Among the administrative measures, it is worth noting the establishment of limits on real estate investment, the control of land supply, the restrictions on bank lending in some overheated activities (steel, aluminium, cement, etc.), an easing of controls on capital outflows (to try to stem net inflows) and stronger inspections on investment projects.

Administrative measures and monetary tightening do not seem to have had the desired effect and the modest interest rate hikes on 18 August are unlikely to have significant repercussions. There will be probably followed by one or more further increases in interest rates, especially those applied to deposits, which are extremely low and which explain why firms are reinvesting their profits on a massive scale. Nevertheless, further measures must be put into place.

The Need for Further Measures

Since administrative measures and monetary actions have had what might at best be described as meagre results, the time has come for an additional therapy.

In order to reduce growth in exports, the yuan might be allowed to appreciate further and subsidies on exports could be reduced.

As it is well known, in July 2005 China abandoned the fixed exchange rate with the dollar and now has a system of trading bands with respect to a basket of currencies. The immediate appreciation by the yuan against the dollar was scarcely 2.1% and, because of the narrow width of the bands (0.3% per day), since then the yuan has gained only 1.7% more. Some specialists defend greater appreciation, by way of a new central parity or a broadening of the bands. Not only would this revaluation reduce trade friction with the United States and other countries which consume Chinese products, but it would have various positive macroeconomic effects, including lower growth in exports and, therefore, in the trade surplus, fewer speculative foreign capital inflows and, therefore, less need to offset the upside pressure on the currency by issuing yuans, and the possibility of increasing interest rates without attracting more foreign capital. However, a substantial appreciation of the yuan has significant pitfalls, so it is unlikely to happen: it could hamper the export sector, which often operates with very low margins; it could trigger a relocation of foreign direct investment towards other Asian countries; by making purchases from abroad cheaper, it would import deflation, which can be counterproductive in a context of a low CPI growth; it would be a fitting measure if net exports had a clear replacement (domestic consumption, since investment is already too high) as a growth driver, but this is not yet the case.

Another way to make exports more expensive is to cut subsidies on foreign sales. The government could remove VAT discounts for exports and tax exemptions on profits for exporting companies. This kind of measure should not be ruled out in the next few months.

But these measures would not be enough since they would scarcely affect investment. What China really needs is a series of structural reforms aimed at reducing the savings rate, in order to boost consumption and help it to replace investment and net exports as a growth driver. The 11th Five Year Plan (2006-10), approved by the National Popular Congress last March, points precisely in that direction, but so far little has been done to undertake the reforms.

In order to boost average consumption by cutting household savings it would be possible to raise wages, increase public spending in education and health (sectors in which poor conditions and high costs explain the high propensity to save) and, particularly, undertake a reform of the pension system, in order to ensure that people receive a dignified remuneration when they retire. Some Chinese economists even suggest that part of the vast forex reserves could be well spent on the pension system.

At all events, the fact is that the measures implemented so far have been inefficient, at least in part. Other actions are necessary, although it should be taken into account that China's growth will remain on a knife-edge for some years to come. The reason for this is that the government's targets are contradictory: on the one hand, the authorities seek general high growth, to create enough jobs and decrease poverty even further; on the other hand, they seek to substantially reduce the expansion of some sectors, which are overheating, to reduce the risk of a hard landing for the economy as a whole.

The Risks

There is a potential risk of widespread overheating and, therefore, a hard landing, if the authorities are too slow or shy in implementing the additional measures mentioned above. They could show excessive confidence in the medium-term effects of the actions already in place, or fears (most likely unfounded) about the pernicious social effects of a lower GDP growth. At all events, it seems clear that it is better to err on the side of prudence and that an increase in export prices and a cut in household savings are indispensable. It is to be hoped that Beijing is aware of this need.

Furthermore, we should not rule out external events which could compound the situation even further: sharper-than-expected deceleration in the United States, disorderly solutions to global financial imbalances (with excessive declines for the dollar) or additional and prolonged increases in raw material prices, both energy and non-energy, since China is a major importer of both. In such scenarios, the risk of a hard landing would increase substantially.

Conclusions: Three main conclusions can be drawn from the foregoing.

First, we should not exaggerate the problem of overheating in the Chinese economy, which nevertheless is real, although it is partial and not general. Despite the striking GDP and investment figures in the second quarter of 2006, the fact remains that overinvestment is specific to certain sectors, such as steel, aluminium, cement, electricity, auto assembly, textiles and real estate (and in the latter case, not in all provinces).

Secondly, as well as the cooling measures already in place (administrative restrictions and increases in interest rates and reserve requirements), which could indeed turn out to be insufficient, there are other possible measures. These measures include removing tax credits on exports and fostering domestic consumption through structural reforms. A substantial appreciation of the yuan is unlikely, because the authorities, at least so far, see more disadvantages than advantages in such a move.

Thirdly, the main risk is that excess optimism regarding the effects of the measures already in place or unjustified fears of a lower growth might induce the government not to implement these additional measures or to implement them too late. If the government waits too long to undertake structural reforms aimed at making domestic consumption a replacement for investment and exports as the main growth driver, the risk of a hard landing will increase considerably. This risk is, for now, scant, but it could become greater if excessive growth in lending and investment is maintained.

Pablo Bustelo

Senior Analyst for Asia-Pacific at the Elcano Royal Institute and Professor of Applied Economics at Universidad Complutense de Madrid.