

Is China's economy overheating?

OVERVIEW

CHINA surprised by producing spectacular 7.9 per cent GDP growth in the second quarter. And its annualised GDP growth was an astonishing 16.5 per cent in Q2 compared with Q1. Meanwhile, a surge of fund flows has re-ignited fears of a new asset bubble forming in property and shares.

In an ongoing Business Times-Nanyang Business School Roundtable discussion series, senior professors at Nanyang Technological University's business school and its economics division looked at the sustainability of China's high economic growth model and discussed the implications of overtaking Japan to become the world's second-largest economy within a few years.

Narendra Aggarwal: As the key Western economies remain recession-hit, China has produced strong headline economic growth numbers. Are we seeing full-fledged recovery and is this kind of growth sustainable?

Professor Tan Kong Yam: China was quite fast in responding to the crisis by announcing a 4 trillion yuan (\$584.9 billion) fiscal stimulus package last November. It was able to mobilise resources quite fast. The Chinese authoritarian centralised system, despite its many weaknesses, is a big strength in a crisis because you can mobilise resources, provide bank loans, ask state-owned enterprises (SOEs) to take action and get infrastructure projects started and move into the implementation stage quickly.

China also implemented monetary stimulus by cutting interest rates and reducing the bank reserve requirement, which made more money available. All these actions laid the foundation for the economic recovery we see today.

There had been loss of business and consumer confidence due to the global recession and weak exports. But the Chinese government's swift stimulus actions had a huge psychological impact in preventing any further decline.

Second, the government was able to ask the state-controlled banks to start lending. This mobilisation at a political level was able to garner bank loans. We have to look at it from a political economy perspective, as the key priorities were growth, job creation and social and political stability. If, in the process, you end up with some resource wastage, that is acceptable to the system as a cost.

It was quite a V-shaped recovery. Q1 growth was about 7.2 per cent over the previous quarter, and it was around 16 per cent in Q2 over Q1. So it is a very sharp rebound, even if there is some slowdown of the momentum in the second half of the year.

While in Q1 the recovery locomotive was infrastructure and SOE investment, in Q2 the growth widened as it spread and broadened the recovery to real estate investments, some domestic demand and private consumer spending. Eventually it will boost private sector investment in the second half of the year.

I see the big jump in Q2 growth figure as the manifestation of broad-based recovery taking hold and the private sector wagons joining the recovery train spearheaded by the state investment locomotive. The growth momentum will be sustained.

Associate Professor Tan Kok Hui: Whether the recovery will be sustained depends on several things. While the government stimulus has worked so far, it remains to be seen if China is able to promote domestic demand. You need to give confidence to the people for them to increase domestic spending.

The recent property and stockmarket increases are the result of the wealth effect. Whether even this is sustainable is still to be seen, as it seems that some of the 4 trillion yuan stimulus package money has actually found its way into these sectors and may not have been invested in the real economy to promote long-term growth.

I think China actually missed out on the opportunity in this crisis to help its companies restructure themselves. A lot of companies, especially SOEs, are still doing the same thing and have not upgraded. There is not much going on there to restructure, as the private sector is rather at a loss about what to do. Profits have gone down with export-driven demand having gone down. How to increase selling into the domestic market is a question that needs to be addressed.

In my view, China never went into a recession. It just experienced an economic slowdown for a while due to global developments.

Associate Professor Cao Yong: According to the latest data from China's National Bureau of Statistics, investments accounted for 6.2 per cent of GDP growth, contributing 88 percentage points of the total 7.1 per cent GDP growth in the first half of the year. So we know that clearly, most of the first-half growth, particularly in Q2, came from investment and not so much from domestic consumption. And the investments resulted from liberal bank lending policy.

In terms of the three growth engines – investments, consumption and exports, because exports have been hit very badly by the global financial crisis and domestic consumption has been slow, what the government has been doing in the past few months is to use investments to boost growth. This is a very traditional Chinese growth model. But using easy bank loans to support investments for economic growth is definitely unsustainable.

Before the financial crisis, the Chinese government already faced the dilemma of the export-oriented and labour-intensive industrial sector becoming too big in the economy, and there was talk of making a transition to a higher tier economic growth model by technological upgrading to move into higher value-added production.

But when the financial crisis hit, the country had no choice but to save jobs and maintain economic growth by increasing money supply through bank loans, thus slipping back into the fixed investment-driven growth model. Unfortunately the monetary expansion resulted in, first, a property market boom, and then a stockmarket boom. Significantly, the Chinese banks lent 7.37 trillion yuan in the first half of the year. Even if the full-year figure is restricted by the monetary authority to 10 trillion yuan, it will be double that of the previous year.

Given this huge increase in the money supply, the big question for China going forward will be how to contain inflation.

Associate Professor Jiang Luo: Whereas any growth in GDP must come from consumption, investments and exports, in the past, China's high growth has come from investments and exports. The Chinese government recognised the problem with its growth model even before the crisis.

By becoming the world's factory, based on cheap labour exporting its products to developed regions such as the European Union, the US and Japan, China did not make much money for its 1.3 billion people.

The profit margins became thinner and thinner as prices of raw materials and commodities rose globally and export prices fell. I believe that for China to rely on the export model of tiny Newly Industrialised Economies (NIEs) for growth is not sustainable in the long run, as it is a huge country.

Even before the crisis, some provinces such as Guangdong had this idea: "Keep the cage and change the bird."

Panellists from Nanyang Technological University

- ◆ Professor Tan Kong Yam, Director, Asian Research Centre, Division of Economics, School of Humanities & Social Sciences
- ◆ Associate Professor Tan Kok Hui, Associate Dean, China Programmes, Nanyang Business School
- ◆ Associate Professor Cao Yong, Division of Banking & Finance, Nanyang Business School
- ◆ Associate Professor Jiang Luo, Division of Banking & Finance, Nanyang Business School

Moderator: Narendra Aggarwal, Director, Public Affairs, Nanyang Business School



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Narendra Aggarwal: China has clearly succeeded in reviving its economy fairly quickly, whereas other countries have yet to see similar results. Is its strong economic stimulus too much of a good thing?

Assoc Prof Jiang Luo: It is not such a good idea to try to rely on building the economy in a sustainable way with a stimulus like the 4 trillion yuan package. You have to spend the money in the right way from a long-term point of view.

China must think of a way to try to boost domestic consumption by giving people confidence so they will spend money. For instance, if there were to be a by-product of the stimulus package that could boost the income of the people in the rural areas, and if they are willing to spend it, China could probably switch to a different model of not relying on exports or investments for growth, but based on domestic demand and consumption for more sustainable growth on a long-term basis.

Prof Tan Kong Yam: I think we have to differentiate between the immediate need to address the impact of the global financial crisis and the long-term growth model. Over the longer term you have to improve consumption as a big engine of growth and the necessary adjustment of the growth model in the long-term is still a priority.

In the longer run, exports cannot be a major engine because the whole export-oriented development strategy that China followed was designed by the NIEs and others who are small to medium-size countries. For instance, when China comes in and grabs 80 per cent of the global market, what more can it expect?

My analogy would be that when the Asian countries were climbing the ladder, they were held up by the US and European markets and they did well. But when the huge panda bear comes in and starts climbing, the ladder rungs will break and eventually the whole ladder will collapse. So the export growth model is not viable eventually. You have to go in for fixed-asset investment as an engine, which can be for quite a while, as China still needs a lot of infrastructure like highways, power plants, housing, and so on, before moving to consumption as the main engine of growth as in the developed Western countries.

But for consumption to take place, wealth must be in the private sector. Remember, in China the bulk of the wealth – big companies, banks, stock ownership, resources and land are all held by the government, which itself is a constraint for consumption to take place. This is something that needs to be addressed over the longer term and will not be easy due to the political and other geo-strategic considerations involved.

Assoc Prof Tan Kok Hui: I think that a change in mindset in that direction is beginning to take place. For instance, over the past five years, quite a few SOEs have been turned into private-sector companies through management buy-outs and similar steps. But it is true that a lot of giant enterprises are low in terms of efficiency and are accumulating huge surpluses and not pumping the money back into the economy or generating new business or new ventures. This problem is likely to continue for another five to 10 years at least, given that China has a central government controlled kind of economy.

Narendra Aggarwal: Is China's US\$4.4 trillion economy really in danger of overheating? Could the country be heading for an economic meltdown of its own due to the liberal lending creating asset bubbles in some sectors?

Assoc Prof Cao Yong: I think that China has an asset bubble too early, considering it is still a developing country. Already in many first and second tier cities, property prices are as high as in developed world cities. That is a problem – you have such a mass scale asset bubble too early. There are some fundamental reasons for its happening.

As China's economy is growing rapidly through the massive expansion of export-oriented and labour-intensive industries, the surplus thus generated is not effectively invested back into these industries in the form of technological upgrading, due to the vast availability of cheap labour from the rural sector. Instead, a substantial part of the surplus has gone into speculative activity, fuelling an asset bubble. Plus the housing and stock markets also benefited from ordinary people's savings too.

In its huge stimulus package, the Chinese government wanted the rescue funds to go to meet both the short-term and long-term needs of the economy, and in fact identified 10 key sectors needing huge investment to generate long-term growth. Unfortunately, investments in these

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government-promoted sectors will take a long time to effect, but huge production capacity in the export sector is lying idle everywhere. As banks were lending liberally to promote economic growth, the money found its way into the property and stock markets, leading to a sharp upturn in Q2.

Remember that even the developed US economy could not sustain the asset bubble, and that is why we have the current financial crisis. But luckily, China's asset bubble is not securitised, and that is why we do not see it clearly through mark-to-market in the secondary security market trading.

But very importantly this burden of potential bad debt is being shouldered by the banks. While the banks will surely do well this year due to the current massive expansion of bank loans and will produce good numbers probably for this year's financial reports, the problems resulting from liberal lending will surface sooner or later and could have negative implications in the long term.

Assoc Prof Jiang Luo: I have a different idea of measuring an asset bubble. The housing price in Beijing – price per square metre/per capita GDP – may be higher than, say, in New York. But when a Chinese couple buys a property, they usually get financial help from their parents. The situation in the West may be different.

What may be an asset bubble in America, with one person holding the property, may not be so in China due to three or four members of the family behind it. This is an important distinction that needs to be remembered in the case of asset buying in China.

Prof Tan Kong Yam: Because of the repressed financial sector and very low or negative real interest rates, China's high savings and high liquidity results in money flowing to assets like property and stocks due to their higher returns. And due to capital controls, you cannot buy Micro-soft shares or invest in Australian property, so there are no legal external outlets for the high savings.

This means the problem of the asset bubble is partly institutional. But over time, as China deregulates interest rates and allows capital outflow and overseas investment, this tendency towards bubbles could be reduced.

Narendra Aggarwal: China could soon surpass Japan to become the world's second-largest economy. What would be the implications for the world when that happens?

Assoc Prof Cao Yong: In purchasing power parity terms, China has already surpassed Japan. But by market exchange rates it has several years to go before it can overtake Japan. Looking ahead, I think China can surely maintain 8 per cent economic growth for the next 10 years.

Assoc Prof Jiang Luo: China's economic growth of the past 20 years has been mostly concentrated in the eastern region. The infrastructure in cities like Beijing and Shanghai is as good as metropolitan cities in the West. But the middle and western parts of China are lagging and very under-developed.

Going forward, China's growth must come from these parts for it to have a sustainable growth rate before it becomes the second-largest economy and a global economic power.

Prof Tan Kong Yam: When China was smaller in economic terms, what it did was not so significant. For example, in January 1994, China devalued the yuan 33 per cent and nobody elsewhere even noticed, let alone protested. Now, China has more than US\$2 trillion of reserves and is investing all over the world. It has a big share of the market – for instance, it is buying 80 per cent of Australia's iron ore.

So now, when China moves, the ripples it creates become tidal waves for other countries. In that sense, more transparency, more accountability and a liberal system would make the rest of the world feel more comfortable.

When you are a small panda nobody cares, but when you are so big and jump into the lake, the water splashes all around and some people's boats can be capsized. So today, the ramifications of China's actions are much larger. I feel that going forward, China will have to be much more conscious of its international image and its actions so people do not see the cuddly panda bear as a menacing polar bear with sharp claws coming at them.

Assoc Prof Cao Yong: To put it politely, China has the hardware to get into the world market but has a lot of work to do for the software part. It has to prepare itself to be an international player. China has the strengths and the power already to be a world player, but the soft part is still to be built up.

At the same time, the world should prepare to accept China also. As some internationally well-known cases of recent would-be acquisitions by China show, its generous offers were turned down without reasonable business reasons. I feel those investment should have been given to China on economic grounds and not denied to it for non-business reasons.

Prof Tan Kong Yam: The problem is that usually the transition takes longer period. It took 150 years for the US to gear up, and Japan also took quite a while after the Meiji restoration. China is telescoping it into too short a period. When you try to change in too short a period, you get dislocation because the world around you cannot adjust quickly enough.

Modern technology allows China, and to some extent India, to bring about change in a short period. But the rest of the world cannot adjust too quickly to this change, and this is part of the problem. The rate of change is huge. Newton's second law of motion says that force is equal to mass times acceleration. When you have India and China as a huge mass and you have rapid change – that is, acceleration, when the two multiply together – it is a huge force. It is very overwhelming.

I think not only the world needs to adjust to China but that the Chinese government and people have enormous adjustments to make. The average Han Chinese is very nationalistic and sometimes even chauvinistic. Given the recent history of painful victimisation, not surprisingly there is a tendency of over-reaction now the country's moment has finally arrived.

So ironically for the rest of the world, compared with an authoritarian China, a democratic China could be a more nationalistic China unless the people have greater sensitivity to their impact on the rest of the world. This is going to be an enormous challenge over the next two decades, for China and for the rest of the world.

Assoc Prof Tan Kok Hui: But this is where opportunity comes. The world needs China to grow for it to help contribute to a global recovery.