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888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

Cooling China

Do international policymakers yet grasp all the global consequences of China's coming investment boom?

BY DAVID HALE

The Chinese government shocked global financial markets not long ago when it announced further measures to slow the country's buoyant investment spending. The government said that it would curtail bank lending to certain sectors where it perceived a risk of overheating (real estate, steel, cement, aluminum) and increase the amount of equity that firms provided to qualify for new loans. As capital spending has been the Chinese economy's dominant growth engine during the past eighteen months, the announcement triggered a slump in commodity prices, east Asian stock markets, and currencies sensitive to commodity prices such as the Australian dollar. Many American and Japanese equities fell as well.

China has made three attempts during the past twenty years to slow its rate of economic growth and curtail inflation. The first attempt during the late 1980s produced a *de facto* hard landing in the economy. Real GDP growth slowed from double-digit levels during the mid-1980s and 11.3 percent in 1988 to 4.1 percent in 1989 and 3.0 percent in 1990. The slowdown was successful, though, in reducing inflation from over 20 percent to barely zero during 1991.

In the policy adjustment of 1993–94, Zhu Rongji was the central bank governor. He took over the central bank because money growth was running at 30 percent and there was a clear perception that monetary policy would have to change dramatically. Mr. Zhu also attempted to improve the head office's control over lending by the regional branches of the central bank. The central bank of China plays a larger role in the economy than other central banks because during the early decades of communist rule it was the country's primary financial institution. It did not devolve lending powers to the commercial banks until the early 1980s. As recently as 1993, it imposed a reserve requirement as high as 28 percent of M2 while it used credit quotas until

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David Hale is Chairman of Hale Advisors LLC in Chicago.

Jiang Zemin

Hu Jintao

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1995. The Chinese financial system today retains many features of a command economy but the commercial banks enjoy a fair measure of independence. Reserve requirements are now equal to about 5 percent of M2. The government uses window guidance to influence lending rather than formal quotas. Bank lending exceeds 130 percent of GDP. As a result of China's high level of monetization and the large amount of cash in the economy, the central bank balance sheet is equal to 50 percent of GDP.

The policy tightening of the early 1990s slowed the growth rate of domestic demand from 15–16 percent during 1992–93 to 10.6 percent during 1994, 11.5 percent during 1995, 10.1 percent during 1996, and 6.0 percent during 1997. The growth rate of investment slumped to about 10 percent from over 60 percent. But the government took other measures with the exchange rate to compensate for the domestic slowdown. There was a 30 percent devaluation of the yuan from January 1994. The government also announced it would rebate 17 percent of export taxes from January 1994. As a result of these actions, export growth accelerated from 4.4 percent in 1993 to 36.3 percent in 1994 and 23.1 percent in 1995. As the American economy was enjoying a recovery from the slowdown of the early 1990s, exports to the United States grew at a rate of 31.1 percent during 1994 and 14.4 percent in 1995. Mr. Zhu's monetary policy conquered inflation. The inflation rate declined to zero by 1997 and there followed a period of deflation until recently.

The economic background to the concerns about overheating today are very different from the early 1990s. First, the inflation rate is only about 3.6 percent compared to 20–30 percent ten years ago. Second, the Chinese currency is unlikely to be devalued because foreign exchange reserves are growing rapidly in response to speculation about a possible revaluation. The challenge facing the central bank is to sterilize these reserves. Thirdly, there is little evidence of consumption growing rapidly because of consumers hoarding goods. On the contrary, with the exception of food, there is still deflationary pressure in many sectors of the Chinese economy. Finally, the money supply has been expanding at a rate of about 20 percent compared to 30 percent during the early 1990s.

These differences suggest that the government should be able to curtail growth without driving the economy into recession. The major concern of the authorities is the fact that the investment share of GDP has risen to about 45 percent from 35 percent during the mid-1990s. When east Asian countries such as Thailand and Korea had such high investment ratios during the early and mid-1990s, there were financial crises a few years later. The investment boom in Thailand had produced a glut of commercial real estate, especially office towers. The investment boom in Korea had produced excessive amounts of manufacturing capacity, especially in steel. The United States also experienced boom-bust cycles in railway construction during the late 19th century but its total investment share of GDP during the 1870s averaged only about 19 percent of GDP, or less than half of China's current rate.

The overinvestment in east Asia produced a financial crisis because it was heavily financed by external borrowing. In that period, Thailand, Indonesia, Korea, and Malaysia had large current account deficits. When it became apparent that Thailand's real estate excesses would produce an upsurge of non-performing bank loans, investors took fright and sold the baht. After initially resisting the currency pressure with capital controls, Thailand devalued and set the stage for a wave of financial contagion which engulfed all the east Asian currencies.

China's situation is totally different. Despite the high investment rate, China was still running a current account surplus last year. As a result of the dramatic growth of China's exports (40 percent plus), there has been a speculative build-up of foreign exchange reserves because of perceptions that China may have to revalue the currency in order to lessen trade

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Not Another Asian Meltdown

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tensions with the United States and other countries. There is little risk of capital flight triggering a devaluation of the yuan and defaults on dollar loans by Chinese companies, as happened in east Asia. The risk instead is that China's banks will make domestic loans which turn bad because of excessive investment in real estate and unprofitable manufacturing businesses. At present, analysts estimate that China's leading banks have non-performing loan ratios of 30–40 percent. About 10 percent of the non-performing loans are in the property sector while the rest are spread over a variety of manufacturing and commercial sectors. There is no way to determine what share of the recent lending upsurge will prove to be non-performing, but the risk is high that the boom will produce new speculative excesses in both real estate and manufacturing.

The best way to gauge the potential risks posed by China's investment boom is to decompose it by sector. In 2003, there was 5511.8 billion rmb of capital spending. Infrastructure spending represented 41.2 percent of the total, real estate development 18.3 percent, and industry 40.4 percent. The central government was responsible for 20 percent of infrastructure outlays and local governments for 80 percent. The central government intends to reduce local spending by imposing more controls at the provincial level, especially on access to land. Many infrastructure projects are currently financed by land sales to developers.

In the first quarter, there was 705.9 billion rmb of investment spending by all the leading sectors of China's economy, or a level 47 percent higher than one year ago. The major components of the investment spending were manufacturing (37.2 percent), real estate development (27.9 percent), utilities (9.2 percent), hydrological and environmental spending investment (8.2 percent), transportation, postal, and communications investment (10 percent), mining (3.0 percent) education (3.0 percent), and software and information technology services (1.7 percent). In several sectors, the year-on-year growth of investment exceeded 100 percent. These sectors included ferrous metal mining (+207.8 percent), nonferrous metal mining (+127.2 percent), textiles (+100.7 percent), shoes and garments (+103.1 percent), education and sports (+147.8 percent), non-metals mining processing (+117.5 percent), iron steel mills (+106.4 percent), metal goods (+130.4 percent), electrical and mechanical (+120.9 percent) and water transport (+123.5 percent).

The major sectors where the government is trying to curtail credit are property development, steel, cement, and aluminum. The property development sector represents about 27 percent of all investment or 197.6 billion rmb. In the last four quarters, it grew at a 38.4 percent annual rate. The steel and metal goods sector represents about 5.5 percent of investment or 38.8 billion rmb. Spending in both sectors exceeded 100 percent during the past year. There is no data available on investment spending in the cement sector.

The central bank has been reluctant to pursue a broad-based investment adjustment through traditional macro measures such as raising interest rates. The central bank governor has ruled out changes in the level of interest rates during the short-term because of concern that rising rates would attract larger capital inflows and further swell the growth of foreign exchange reserves. The Hong Kong financial secretary has said that China will not raise interest rates until the Federal Reserve begins increasing U.S. interest rates. The Federal Reserve tightened rates at the end of June by 25 basis points. Instead of interest rate hikes, the central bank of China will rely more heavily on administrative measures, such as window guidance over bank lending, higher reserve requirements, and moral suasion over local government infrastructure spending. In the early 1990s, by contrast, the central bank attempted to curtail monetary growth through large increases in short-term interest rates next year.

The major risk posed by the new policy measures is that they are based on administrative guidance rather than market measures such as rising interest rates. Japan has a long history of using administrative guidance rather than interest rates to manage bank lending. But in contrast to China, Japan used such policies during the 1950s and 1960s when it already had a market economy and privately owned banks. China still retains many

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features of a command economy while the banks are largely state-owned. As a result, the risk is high that China's attempt at restraining lending will produce a severe credit crunch.

There are many signs that a credit crunch is already underway. Bank lending during May fell to a level less than half of what it was one year ago whereas in the three previous months it exceeded last year's levels. China's airlines have had to defer purchases of new equipment because the banks slashed their credit lines during May. Komatsu reports that orders for new construction equipment plunged during May.

There is an informal lending market for firms with surplus liquidity to provide funds to companies which need capital. The interest rate in the informal kerb market has shot up to 20 percent from 10 percent six months ago. The sharp rise in the kerb lending rate is a confirmation that there has been a sharp curtailment of lending from banks. If companies could borrow from the banks, they would be paying only about 5.5 percent for their money.

The May data for fixed investment suggests that capital spending has already begun to slow from the robust levels apparent during the first quarter. Its growth rate slowed to 18 percent from 47 percent during the first quarter. The slowdown could turn into a full fledged slump this summer and autumn. Instead of a declining growth rate, there could be an actual contraction of capital spending during the next two or three quarters. In such a scenario, China's growth rate could slow to only 2–3 percent compared to widespread forecasts from stockbrokers that it will remain at 7–8 percent.

The government does not want to promote a hard landing in the economy because it remains very concerned about employment stability. The state-owned enterprises continue to shed several million jobs annually. There are at least 5–10 million people each year attempting to move from the countryside to the cities. If China actually experienced a recession with slumping investment, unemployment could increase sharply and threaten the country's political stability.

The boom in real estate spending also reflects a long-term structural shift in the composition of the country's population. China is at present 38 percent urban and 62 percent rural compared to only 20 percent urban during the early 1970s. Demographers expect the urban share of the population to rise to 65–70 percent by 2030. In such a scenario, there will be a movement of over 300 million people from the countryside to the cities. Such a large-scale movement of people would require China to construct ten new Shanghais or thirty new Los Angeles cities. Such massive residential and commercial real estate needs virtually guarantee that the property development sector will remain robust on an indefinite basis.

The political emphasis on employment stability suggests that the government will not permit the credit crunch to persist indefinitely. Recently, some senior officials have expressed concern about the change in the credit environment. The director of the bank regulatory agency has appealed to the banks to resume lending to healthy customers. Bank officials will probably remain apprehensive about new lending during the next few months because of concern about their job security after the excesses of 2003. But as the economic data turns negative during August and September, the government will probably take steps to encourage a modest lending revival during the fourth quarter. But it will not return to the free lending environment which prevailed last year, so the upturn will be gradual rather than robust.

The risk instead is that China's banks will make domestic loans which turn bad because of excessive investment in real estate and unprofitable manufacturing businesses.

The government will also be anxious to avoid a prolonged downturn because of the continuing power struggle between former President Jiang Zemin and current President Hu Jintao. Mr. Zemin will probably attempt to retain the leadership of the military commission this autumn. He still influences policy from behind the scenes while his Shanghai faction might attempt to stage a coup against the new leadership.

When China had a slump in domestic demand ten years ago, it compensated by devaluing the currency and promoting an export boom. China cannot get away with a devaluation today because the United States, Japan, and Korea have been demanding that China revalue her currency.

The major risk posed by the coming investment recession is that reduced import demand could produce an upsurge of the current account surplus and increase global demands for an exchange rate revaluation. If China's current account surplus rises to $100 billion during 2005 as a consequence of an investment slowdown, the Americans and Japanese will intensify their demands for an exchange rate realignment. China has not yet grasped all the global consequences of its coming investment slowdown, but they will certainly include an expanding current account surplus and further international debate about the country's exchange rate policy. ◆