The End of the Chinese Miracle?

Gordon G Chang

After two decades of uninterrupted prosperity, the initial stages of the downturn are exposing the inherent weaknesses of China's economy, and those fissures will be felt near and far.

China has the world's fastest-slowing economy. According to official statistics, gross domestic product skyrocketed a staggering 13.0 percent in 2007. In fact, in all likelihood that figure was even higher, with poor sampling procedures failing to properly take into account the output of small manufacturers, which at the time constituted the most productive part of the economy. Even without that extra bump, however, this put China in the top echelons in terms of economic growth.

Last year, however, the economy tumbled. GDP growth, was 10.6 percent in the first quarter, 10.1 percent in the second, 9.0 in the third, and just 6.8 percent in the fourth. The decline continued this year, with growth reported as 6.1 percent in the first quarter, the lowest rate since China began issuing quarterly GDP statistics in 1992. The falloff is even more dramatic if one digs a bit beneath these numbers. China's National Bureau of Statistics reports GDP by comparing a quarter with the corresponding one during the preceding year. If, instead, it compared a quarter to the preceding one–as most countries do–it would have reported essentially no growth during the fourth quarter and, possibly, a contraction.

At the World Economic Forum in Davos, in January, an apparently confident Chinese premier Wen Jiabao predicted that his economy would grow by eight percent this year, a prediction that he has since repeated. Taking into account evident trends, however, it is clear that Premier Wen has set an impossibly high goal for himself. If the decline in growth continues–and, at the moment, there is every reason to believe that it will–Chinese output will contract this year. Such a scenario has not occurred since Beijing policymakers dramatically overhauled the contours of the Chinese economy three decades ago; China's economy has not shown a year-to-year decline since 1976.

What are Chinese leaders doing about the alarming deterioration of the economy? Beijing's technocrats, to their credit, saw problems coming by the middle of 2008. In late July of that year, the Politburo officially reversed course from fighting persistent inflation to attempting to 'lift growth'. Since then, the technocrats decided, among other things, to provide tax rebates, hand out incentives for home purchases, adjust currency policies, and cut interest rates. Nothing, however, seemed to work. Late last year, Chinese leaders adopted a rescue strategy to tackle the situation, with tactics designed to increase domestic investment through fiscal stimulus.

In November 2008, China's State Council unveiled its stimulus package. The body, the central government's cabinet, said it would spend an "estimated" RMB 4 trillion, about USD 586 billion, over the next two years in ten major areas. In addition, Beijing promised to loosen credit and reduce taxation. The plan, at least as announced, disclosed few details and, therefore, had a distinct made-up-on-the-spot quality to it. Since then, the central government has adjusted the programme, but, even with improvements, the plan appears deficient in important respects.

First, as big as it is, the contemplated spending is not sufficiently large. (Indeed, this assessment comes from the government itself. The State Council's National Development and Reform Commission, the NDRC, estimates that the November stimulus plan will add only one percent to GDP over its existence.) Second, the stimulus programme does not look as though it will work fast enough. Third, the spending plan is pushing the country in the wrong direction, with the policy having an apparent bias toward large-scale infrastructure projects.

It is not clear how much of the announced spending was already contemplated in the current five-year plan, Beijing's 11th. Most likely, only a quarter of the announced outlays are actually new. Moreover, one should remember that the Chinese central government has been pumping massive amounts of cash into highways, ports and railroads since 1998, and economic 'pump-priming' is well known to lose its effectiveness over time. Governments are notoriously inefficient investors. This means that nothing but massive spending will have any appreciable effect on current economic performance.

The country, however, is already overbuilt. China is quite literally running out of places in which to profitably construct things, with the exception of its rail system, electricity grid and a few other areas.

Overbuilding has also plagued the country's great cities. In a country with too much of most everything, the government's concept now appears to be simply to build more. Eventually, and inevitably, inefficient investment is counterproductive and catches up with an economy.

Second, the plan's emphasis on infrastructure means it will take time to have an effect on economic output. Apart from already-announced projects, the government does not appear to have a sufficient inventory of 'shovel-ready' programmes for quick funding, especially because the stimulus plan was, as noted earlier, hastily prepared. As powerful as China's leaders are – and they are powerful – they cannot simply push a button and churn out, for instance, eight-lane roads or expansive ports. It takes time to conceive projects, move the peasantry, survey land, flatten mountains and pour cement. In the current situation, however, time is distinctly of the essence.

Another factor slowing the speed of the plan is that the government has yet to work out its funding. Soon after the initial announcement in November, central leaders revealed they would contribute less than RMB 1.2 trillion of the four trillion needed. The rest of the money, they said, would come from lower-tier governments, state enterprises, overseas investors and banks. Yet many local governments are already dangerously overextended; enterprises now respond to market conditions as much as to central dictates; and bank lending is, or at least should be, constrained by concerns over the quality of loans. Although state banks have gone on a lending spree this year, much of the cash has ended up in the stock markets and, therefore, has had little effect on the economy. Undoubtedly, the central government itself will eventually go on a spending frenzy, but the effect of its cash will not be felt until the latter part of this year.

Third, Beijing's new spending is pushing the country in the wrong direction. China already invests 45 percent of its income, with much of that on infrastructure. Increasing the government's share of the economy, which is what its stimulus plan is all about, will only lead to sluggish economic performance later. The NDRC has, not surprisingly, estimated that most stimulus spending will go into government-operated projects. This means the November plan will undoubtedly end up favouring large state enterprises over small and medium-sized private firms. Beijing's political leaders are bound to allocate funds for political reasons, and state financial institutions will divert credit to state-sponsored infrastructure. China has averaged an exceptional 9.9 percent growth in the 30 years of the reform period, largely due to the creation and expansion of the private sector, both in the countryside and the city. In short, Beijing is now relentlessly pursuing a counterproductive solution.

Of course, the stimulus plan is a work in progress, changing all the time as tens of thousands of officials at all levels of government interact. Since the November rollout of the plan, Beijing has issued announcement after announcement on new ways to distribute the cash. For instance, the central government has revealed spending plans to support the textile, heavy machinery, petrochemical, logistics, non-ferrous metals, information technology, electronics, vehicle and steel sectors. There will undoubtedly be more industry-specific stimulus initiatives announced as businesses continue to struggle.

The provinces, predictably, have also gotten into the act. In February, for example, hard-hit Guangdong (the port and economic hub that has become the country's richest province) announced 150 new industrial and infrastructural projects. Mainland China's provinces, autonomous regions and provincial-level cities have released their own stimulus plans, calling for tens of trillions of yuan of spending. Now, every town, city and county in the country is trying to get additional monies from Beijing, as is every enterprise and government unit; the NDRC, meanwhile, is now rubberstamping so-called 'beauty-show', or ornamental, projects that it had earlier rejected. As a result of the rush to spend, one analyst expects that the plan will create the greatest surge in corruption in Chinese history.

Not all of those local plans can be funded, of course, especially because the central government in 2008 ran a deficit due to a spending extravaganza that took place in December of that year.

Beijing has room to disburse more cash. The Ministry of Finance, for instance, has signalled that China's debt will increase by more than 22 percent this year to pay for the *spendathon*. At the same time, however, the government only has a limited ability to tap its enormous foreign-exchange reserves. Those reserves, on the books of the central government, have been accumulated largely by issuing debt in one form or another. While the 'greatest fortune ever assembled' (as the country's nearly USD 2 trillion foreign-exchange reserve is often referred to) gives Beijing significant flexibility, the government understands that at some point it has to pay most of this money back. And it cannot use foreign currency at home without driving the value of the renminbi through the roof, which would cripple the export sector of the economy.

Still, the worst thing about the stimulus plan is not that it weakens Beijing's finances. Nor is it that the stimulus cannot work as quickly as needed, that funds will be stolen or wasted, or that China does not need much of the infrastructure it will eventually build. If there is any significance to the stimulus package, it is that, three decades after the beginning of the country's reform period, China's leaders have shown that they remain wedded to the old ways of doing things – namely, stimulating their economy with large infrastructure projects. In what may be a once-in-a-lifetime global downturn, there are currently two urgent and related tasks facing these leaders. They must simultaneously create growth and put their economy on a sounder basis. The stimulus plan, even with improvements, looks as though it will help only with the first goal—if it helps at all.

Beijing has also registered its export-promotion policy, the government's overall strategy to maximise exports. Until July 2005, the renminbi was tightly pegged to the dollar. For the following three years, until last July, Beijing permitted a managed float, meaning that the currency's exchange rate was allowed to fluctuate but only between a preset ceiling and floor. As a result, during this period the renminbi appreciated by 9.4 percent against the dollar.

In July 2008, however, the ruling Politburo, reacting to weakness in the Chinese economy and sensing the downturn in the global economy, switched gears. It went back to a pegged currency: the renminbi now is fixed against the dollar. China's currency, unfortunately, has been kept at an artificially low level in order to give the country's exporters important price advantages. But due to Beijing's day-to-day intervention, no one today knows the true value of the renminbi. The discount to market value, however, is thought to be somewhere in the vicinity of 35 percent – although some say it is more. The United States and other countries, naturally, want the Chinese currency to trade more freely. To persuade Beijing to loosen its policy, former US Treasury Secretary Henry Paulson had worked behind the scenes. For this reason, George W Bush's administration never cited China as a currency manipulator in any of its twice-yearly reports to the US Congress. Doing so would have required the Treasury Department to open formal negotiations with China on the issue. But Paulson was not especially successful, all of his gentle efforts notwithstanding.

Today, Beijing evidently feels little pressure to change its policies. When the new US Treasury Secretary Timothy Geithner stated, during his confirmation hearings in January, that "China is manipulating its currency," he – not Beijing – received criticism. The criticism evidently had an effect as Geithner, subsequently confirmed as treasury secretary, refused to cite China as a manipulator in his first report to Congress. Yet he should have done so, because China is indeed manipulating its currency. The Bush administration's failure to confront Beijing surely emboldened Chinese officials, and made it harder to persuade them to take steps that would be in everyone's interest. The real risk for the global community is that Beijing will take too long to bring its practices in line with those of its trading partners. Asian countries are already depressing the value of their currencies to make their exports more competitive with China's.

In the 1930s, tariff walls deepened the Great Depression in the US, and subsequently prolonged it. This time around, more subtle – but probably as destructive – measures look as though they could produce the same effect. The risk for Beijing is that the Chinese, extraordinarily dependent on selling to foreign markets, could end up being the biggest victims of new trade barriers.

As they survey the global economic crisis, Chinese officials must know that their infrastructure-heavy stimulus plans and related tactics make sense only as stopgap measures. Yet economic problems for China are potentially more serious than they are for almost any other country. The steep downturn in the Chinese economy is an indication that Beijing's economic model, which received near-universal praise in recent years, is particularly ill-suited to the crisis. China appeared strong during a benign period of almost two decades of uninterrupted globalisation and resulting prosperity. Now, however, even just the initial stages of the downturn are exposing the inherent weaknesses of its economy.

A potent example comes, again, from the Great Depression. At that time, the countries that had the hardest time adjusting to deteriorating economic conditions were what are known as current-account-surplus countries (which almost always export more than they import). That is proving to be the case now, as well. China, a surplus country, is dependent on foreign markets for its manufactured goods and agricultural products. About 38 percent of its economy is attributable to exports, but global demand at this moment is either flat or slumping.

In March, the World Bank said the global economy would contract this year for the first time since World War II, and global trade would suffer its sharpest decline in eight decades. Globalisation, which looked like an inevitable trend just a few months back, is now very clearly going into reverse, at least temporarily. As such, the Chinese economy is being held hostage to events transpiring well beyond its own borders. Yet whatever happens, it is now apparent that China, for all its apparent strength, does not have within its power the ability to solve its own problems. (Current-account-deficit countries, on the other hand, can import less and save more, and thereby achieve recovery on their own.) As announced at the end of December, Beijing's export incentives – value-added-tax rebates for certain goods – seem inadequate to keep exports at 2008 levels. In fact, China's exports are now falling precipitously, declining a greater-than-expected 17.5 percent in January, 25.7 percent in February and 17.1 percent in March.

In this declining environment, China's trade relationships with other countries are deteriorating. During the boom years, for instance, commerce with India grew. Now, it is in rapid decline. Trade between the two giants fell 37 percent in January alone, and many now foresee a *trade war* beginning between the two. In late March, India moved to ban Chinese toys, in addition to having recently opened probes of the quality of Chinese goods and launching anti-dumping investigations. Beijing, for its part, thought of retaliating against New Delhi by filing a complaint with the World Trade Organisation alleging unfair trade practices, but the ban was eventually lifted with restrictions. The erosion in trade ties with India is bound to set a pattern for Beijing's relationships with its other trade partners, leading to increasingly bleak prospects for Chinese exports this year. □□□