Economist.com FINANCE & ECONOMICS

China's economy

How fit is the panda?

Sep 27th 2007 | BEIJING
From The Economist print edition

Illustration by Bill Butcher

China's booming economy is helping to support global growth as America turns sickly. So now it has to keep up the pace

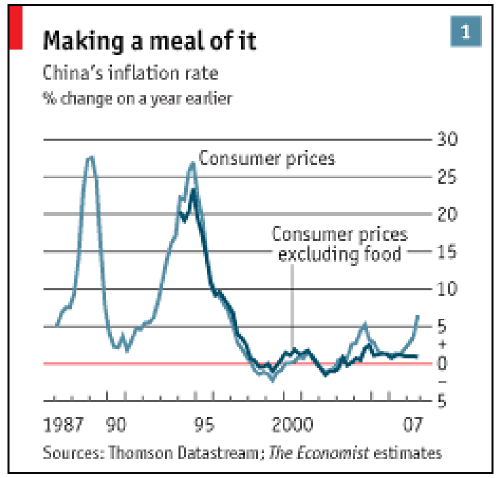
Get article background

NO COUNTRY in history has sustained such a blistering rate of growth over three decades as China. Its economy grew by a staggering 11.9% in the year to the second quarter. Since 1978 it has grown by an average of almost 10% a year—more than Japan or the Asian tigers achieved over similar periods when their economies took off. But eventually every sprinter trips. Japan's growth averaged 9.5% in the two decades to 1970, but slowed to 4.7% in the 1970s and to only 1% by the 1990s.

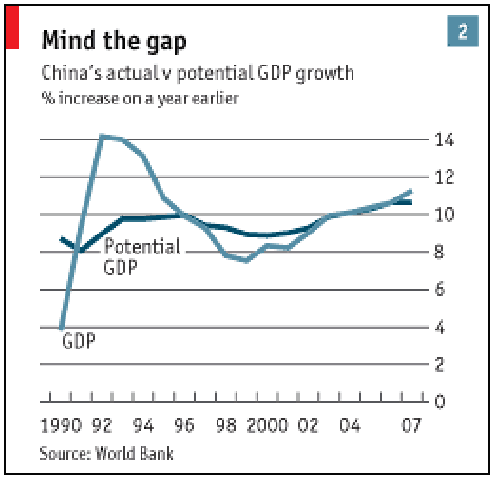
As China has grown, it has come to matter much more to the rest of the world. For the first time it is now contributing more to global GDP growth (measured at market exchange rates) than the United States is. Yet, even as growth forecasts for China are being revised upwards, America is looking at a downturn caused by falling house prices, which threaten to clobber consumer spending. The fate of the world economy now hinges not just on America, but also on China's economic fitness continuing over at least the next two years.

So what immediate threats does China face? The biggest worry is that the economy is overheating and inflation surging out of control. In August consumer-price inflation jumped to 6.5%, up from 1.3% a year earlier and its highest for more than a decade. If China slams on the brakes, its economy could suffer a hard landing, as happened after past episodes of inflation.

But inflation is nowhere near previous danger levels in 1988 and 1994, when it soared above 25% (see chart 1). Moreover, the leap in inflation does not seem to be a symptom of overheating caused by excess demand, as it was in the past. It is due entirely to the rise in food prices caused by supply-side problems. Excluding food, inflation is only 0.9%. This does not mean that food is unimportant: it accounts for one-third of the inflation basket, and rising prices could trigger social unrest. But it is not something that China's central bank can easily fix by raising interest rates. The bank has raised interest rates five times this year, but they still remain low relative to the country's growth rate.



Growing public concerns over inflation recently prompted Beijing to introduce a freeze until the end of 2007 on a wide range of government-controlled prices, such as oil, electricity and water. A more effective way to curb inflation would be to allow the Chinese currency to rise faster. This would reduce import prices of food and raw materials and also curb the build-up of liquidity as a result of rising foreign-exchange inflows.



Unless checked, excessive monetary growth combined with over-rapid GDP growth could eventually lead to more general inflationary pressures. In its latest "China Quarterly Update", the World Bank says that in the first half of 2007 China grew faster than its potential growth rate (currently estimated at around 10.5%) for the first time in a decade (see chart 2). However, excess demand is tiny compared with previous phases of overheating so the risk of soaring inflation causing a hard landing in the near future is remote.

Bubble trouble

A second much-talked-about threat is the bursting of China's stockmarket bubble. Share prices have risen by 400% in just over two years, and average price-earnings ratios based on historic profits are around 50 (based on forecast 2008 profits they are a still-racy 30). Even though almost everyone reckons this is a bubble, history suggests that a bust is not imminent and that share prices could continue to rise for a lot longer: both Japan's Nikkei and America's NASDAQ saw p-e ratios well above 100 at their peaks.

Even if share prices did tumble this year, the impact on the economy would probably be relatively modest. The total value of tradable shares—that is, excluding those held by the government—is only 35% of GDP compared with 180% in America at its peak in 2000. Equities account for less than 20% of Chinese households' total financial assets, compared with half in America, so price swings have less impact on spending. When Chinese share prices collapsed by 55% from 2001 to 2005, GDP growth remained robust. Over the past year there has been little sign that people are saving less and spending their capital gains, so a slump in share prices should not have much impact either.

Share prices can also affect the cost of capital. But only a small proportion of Chinese companies are listed on the stock exchange and those that are rely mainly on internal finance. Only 10% of total financing for investment this year has come from equities. A more serious problem is that because firms have invested in other companies' stocks, a slump in share prices could directly hurt their profits and hence their investment. According to a study by Morgan Stanley, one-third of listed companies' profits in the first half of 2007 came from share-price gains and other investment income. If share prices sink, so will profits, which would make shares look even more overvalued.

Some analysts also worry that a sharp plunge in equity prices could seriously hurt banks' balance sheets, causing them to squeeze their lending. Chinese banks are officially not allowed to lend to investors to buy shares, but anecdotal evidence suggests that households and firms have taken out loans disguised as mortgages to buy shares. If so, the effect of the bubble bursting could be larger than the direct impact on consumers' wealth—especially if, as seems more likely, the bubble continues to swell for another couple of years before it finally bursts.

In many ways China today looks ominously similar to Japan before its bubble burst at the start of the 1990s, resulting in a decade of stagnation. Like Japan, China has high rates of saving and investment, low real interest rates, soaring asset prices, a big current-account surplus and upward pressure on its currency. After the Plaza accord between the big industrial countries in 1985, the Japanese yen rose by 80% against the dollar in three years.

Many in China have concluded that the blame for Japan's economic malaise in the 1990s lay largely with the appreciation of the yen. Beijing has therefore allowed the yuan to rise by only 10% since July 2005. But Japan's real mistake was its loose monetary policy to offset the impact of the rising yen—which further inflated the bubble—and then its failure to ease policy once the bust had happened. By holding down the value of the yuan and allowing a consequent build-up of excess liquidity, China risks repeating the same error.

However, Paul Cavey, a China economist at Macquarie Securities, suggests that China may have more in common with Taiwan in the 1980s than with Japan. Taiwan's bubble was even bigger, with share prices rocketing by 1,800% between 1985 and 1990. In Japan, reserve accumulation did not play a big role in the bubble. By contrast, the foreign-exchange inflows into Taiwan were greater in relation to its GDP than those seen recently in China. Taiwan, like Japan, saw a big rise in its exchange rate, by 60% in the four years to 1989.

In 1990-91 the Taipei stockmarket slumped by 75%, even more than the Tokyo market did. But Taiwan's growth remained fairly strong because policy was eased much sooner than it was in Japan. In other words, contrary to Beijing's fears, a big exchange-rate rise does not inevitably lead to economic depression.

The other big difference between China and Japan in the late 1980s is that Japan had a serious property bubble against which banks had lent heavily. Although a house-price crash would have much nastier consequences for China's economy than a share-price crash, because 80% of China's urban households now own their home, there is no evidence of a nationwide housing bubble. Average house prices across China are rising at an annual rate of 8%, with double-digit gains in some cities, such as Shenzhen and Beijing.

In a developed economy such increases might seem a little bubbly, but not in one in which nominal GDP is growing at an annual pace of 15%. The ratio of house prices to average income has fallen by 25% in China since 1999. In contrast, at their peak last year American house prices had risen by 45% relative to incomes. A collapse in house prices therefore seems unlikely in China.

If America sneezes

If neither a surge in inflation nor a bust in asset prices seem likely to derail China's economy over the next year or two, what about a recession in America? Exports account for over 40% of China's GDP, so some economists predict that a fall in exports as a result of a downturn in America would create massive excess capacity and a sharp fall in profits and investment—the making of a nasty hard landing. But the popular notion that China is dependent on export-led growth is a myth; domestic demand is much more important. This year the increase in China's net exports (ie, less imports) is likely to account for about one quarter of its growth—a record amount. But even without this external boost, GDP growth would still have been a respectable 9%.

During America's 2001 recession, China's export growth fell by 25 percentage points, but imports also slowed sharply, so GDP growth (as officially reported) remained strong. Since then, the share of its exports to America has shrunk; the European Union and other emerging economies are now more important markets. In the three months to August, Chinese exports to America increased by 14% compared with a year earlier, whereas those to the EU grew by 40%.

America's slowdown so far largely reflects a collapse in house-building, but if consumers cut their spending, the impact on Chinese exports would be harsher. The World Bank estimates that if American consumption falls by the equivalent of 1% of GDP, this could knock 0.2-0.5 percentage points off China's GDP growth, depending on how much the Federal Reserve does to cushion the downturn.

A recession in America would reduce China's growth, but since Beijing's policy-makers are fretting that the economy is starting to overheat, weaker exports and hence slower GDP growth might be a good thing. Not only would it reduce the risk of inflation, but it would also help to trim China's embarrassing trade surplus.

If a fall in exports threatens to slow growth by more than desired, the government's strong fiscal position means that it has plenty of room to boost domestic demand by spending more on infrastructure, education or health. The budget was in small deficit in 2006, but may now be in surplus—even excluding the large surpluses of state-owned enterprises. China's public-sector debt is only 18% of GDP, much lower than the 75% average in developed economies, giving the government ample room for a fiscal stimulus.

In the short term, therefore, an American downturn is more likely to cause sniffles in China than a heavy cold. Indeed, an American recession might be a blessing in disguise to China: if weaker exports forced the government to do more to boost domestic demand it would help to rebalance the economy and make growth more sustainable in the long run.

The bigger danger is that an American recession would inflame America's increasingly protectionist mood and make trade sanctions against China more likely. In an election year, politicians will need a scapegoat. But import barriers would do more harm to America's economy than China's. If China was forced to depend less on exports and more on consumption it would gain in the long run.

Running out of fuel?

In recent months there has been much talk about a new threat. China, it is claimed, is running short of cheap labour—the main source of its extraordinary growth. This is nonsense. It is true that average wages have risen by around 15% over the past year, but labour productivity in manufacturing has risen even faster. Indeed, wages have been rising at double-digit rates for a decade with no harmful impact on growth, because higher labour productivity has actually reduced wage costs (see chart 3). There are localised skill shortages, but it is hard to believe that China's labour surplus is exhausted when almost 60% of the population still lives in rural areas. The wide income gap between rural and urban areas will continue to attract workers from farms to factories.

In any case, it is not true that China's growth has been based primarily on cheap labour. Over the past decade, the increase in the labour force has contributed an average of only 1% a year, or one-tenth of its GDP growth. It is true that the population of working age will peak by 2015 and then start to shrink. But an analysis by the World Bank argues that China is unlikely to face a labour shortage for many years. The decline in the working-age population can be offset by making it easier for surplus labour to migrate into cities.

One thing China does not seem short of is capital investment. Indeed, some economists have long predicted that overinvestment as a result of an artificially cheap cost of capital will lead to China's downfall. Sooner or later, it is argued, overcapacity will lead to a plunge in capital spending, bringing the economy crashing to earth.

According to government figures, China's investment amounts to over 45% of GDP and is growing at 25% a year. But many economists reckon that is grossly overstated. For example, land purchases are wrongly counted as new investment when they are really just a transfer of ownership. If China were massively overinvesting, one would expect the return on capital to be falling. Instead, corporate profit margins have been rising. Mr Cavey estimates that average capacity utilisation, measured by the ratio of sales to assets, has been rising not falling—in strong contrast to Japan during its 1980s bubble.

Worries about rising excess capacity feed another long-standing concern that China's banks, groaning under the weight of non-performing loans, are heading for a crisis. Official figures show that non-performing loans had fallen to 7% of all loans early this year from almost 30% in 2001. But independent analysts suggest the true figure may be closer to 20% (down from over 50% at its peak). The fear is that an economic downturn and falling profits could lead to a surge in new bad loans.

China's fragile and inefficient banking system is certainly a drag on its economy, but the risk that a banking crisis could bring down the economy seems small. China has huge foreign-exchange reserves available to protect its banking system. Capital controls limit capital flight. And the government, unlike Japan's in the 1990s, has plenty of money if necessary to write off bad loans.

The list of potential threats to China's economy is long and some might shave a couple of percentage points off its growth rate (leaving it close to 10%). But none seems likely by itself to cause the economy to collapse in the next two years—ie, during the time when America's economy is likely to stumble. But what if several blows land at the same time? For example, an American recession breeds greater protectionism, global financial turmoil unnerves Chinese stockmarket investors, share prices collapse and a downturn creates social unrest. The overall impact on the economy would then be more painful.

China's best insurance against this is that its budget finances are in better shape than those of any other big economy. China's leaders are acutely aware of the risks of social unrest and they will be willing and able to try to spend their way out of trouble. That makes a sharp downturn in China less likely in the near future. But what about farther ahead?

China's economic success has been based on the essential ingredients of growth: high savings, openness to trade, good education and strong productivity growth. This means its long-term prospects remain strong, although its trend growth rate will inevitably slow as its economy matures and its labour force starts to shrink.

Tao Wang, Bank of America's economist in Beijing, says she is optimistic about China's economy in the short term and the long term, but thinks the medium term looks risky. There is a high chance of a sharp slowdown sometime within the next ten years. The problem with years of rapid growth is that it hides problems that are then painfully exposed when times are hard. But for the time being, the chances are that China can keep sprinting even if America takes to its sick bed. That is good news for the world.