A reheated economy
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China’s economy re-accelerated in the last quarter of 2004, despite official efforts to curb rampant investment. Is it growing too fast to keep its balance?

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ON TUESDAY January 25th, the Chinese authorities sheepishly confessed that the economy beat expectations last year, growing by 9.5%. It finished the year particularly strongly, growing at an annual pace of almost 13% in the last three months, according to J.P. Morgan. Anywhere else, this would be cause for celebration. But in China, the firecrackers remain unlit. Instead, analysts and investors are trying to reassure themselves that this is not bad news.

Economists, who freely mix their metaphors, have spent the past year worrying that China is “overheating” and hoping that it will make a “soft landing”. Their worries reached a peak in the spring, when China’s banks were lending freely, investment was expanding blindly and prices were rising quickly. This anxiety was shared by the Chinese authorities. In April, Wen Jiabao, the prime minister, said China would take “very forceful measures” to cool the economy. The authorities imposed curbs on investment in sectors such as steel, aluminium and cement, refused to release land to developers and threatened to impose price controls if inflation remained out of hand. In October, the central bank raised interest rates (if only by a little) for the first time in nine years.

By the winter, however, hopes of a soft landing were high. Inflation was ebbing, investment was cooling and output was slowing (see chart). Most economists expected Tuesday’s figures to show a further slowdown in growth. Instead, its pace has quickened. The Chinese economy has taken a puzzling detour on its gentle route back down to earth.

The world’s most populous country has vast reserves of labour and no shortage of capital. Why, then, should we worry that it is growing too fast? Since China embraced market economics in 1978, its average rate of growth has been 9.4%. By its own standards, then, last year’s pace of expansion was nothing out of the ordinary.

But economists are anxious about the balance of China’s economy as much as its speed. China may or may not be growing too fast, but it is certainly investing too much. In the year to the first quarter of 2004, spending on fixed assets—plant, property and infrastructure—grew by 43%. Investment accounted for 42% of GDP in 2003, and perhaps a still greater share last year. No economy can sustain such a colossal rate of capital accumulation. At some point, China’s investment must run into rapidly diminishing returns. Are two cement factories twice as good as one?

If investors were betting their own money, these redundant cement factories—not to mention steel mills, luxury flats and car plants—would probably never have been built. But China’s reckless investment owes a lot to the heedless lending of its banks. Chinese households still save about 45% of their income. They deposit about two-thirds of these savings in China’s four big banks.
state-owned banks, which lend about two-thirds of these deposits to state-run firms. The banks pay little attention to risk and do not expect much of a return: perhaps 40-50% of loans are non-performing. In fact, their lending is best seen as a form of state subsidy. If these subsidies were added to the government’s books, China’s budget deficit would balloon to 18% of GDP, reckons Diana Choyleva of Lombard Street Research, an economic consultancy.

Suppose, says Ms Choyleva, that China can sustain a rate of investment of about 35% of GDP, rather than its current rate of 40-45%. How does it get there from here? Such a sharp contraction in the investment rate is not, she says, consistent with a soft landing. If investment slows, the economy as a whole will plummet. China, she predicts, cannot escape “the natural violence” visited on all developing countries that go through such boom-and-bust cycles of investment.

Those who still hope for a soft landing agree that China’s rapid rate of investment must slow. But they hope that exports and consumption can take up the slack. They will draw some comfort from Tuesday’s figures. Investment in fixed assets grew by 21.3% in the year to December, its slowest pace in seven months. And yet the economy still quickened. Exports jumped by a third to $63.8 billion in December. Rural incomes, boosted by a bumper harvest, grew by 6.8%. And in the cities, real disposable incomes increased by 7.7% and retail sales by 14.5%.

Since 1978, China’s communists have let thousands of private firms bloom, from small-town enterprises, growing organically, to giant manufacturing concerns, built with foreign money. According to Tuesday’s figures, China’s economy is still sprouting vigorously. But some still fear that too much of this growth will turn out to be dead wood.