Is China the next Dubai?

Abstract: *The continuing growth of China in the wake of the global financial crisis is beginning to attract skepticism including that of hedge fund investors. The doubts are three-fold: China's stimulus package may be under-performing. The Chinese may be cooking their books at least regarding car sales, which are not correlated with gasoline consumption. The so-called growth is driven by over-investment, creating a huge bubble waiting to burst. While Chinese statistics still leave a great deal to be desired, hard facts and data show that China's stimulus has performed quite well. Most cars sold in 2009 are energy-efficient models supported by tax rebates, bought by households driving less compared with business automobiles. Most of China's investment goes into infrastructural arteries linking up new cities and towns in the inner provinces which will help create one billion consuming urbanites by 2030.*

A rapidly rising China in transition never ceases to attract diametrically opposing views (1). Now, the China bears are coming back. 'Will China be the next Dubai, a thousand times over?' they ask. This skepticism even informs celebrated hedge fund investors like Jim Chanos, who predicted Enron's collapse.

This bearishness is largely built on three premises. First, China's huge stimulus package is under-performing. Second, China is cooking the books; witness, for instance, the lack of correlation between apparently explosive car sales and mild gasoline consumption. Third, China's growth is dependent on over-investment, feeding a huge bubble soon to burst on empty buildings, highways to nowhere and products with no buyers. There is also reference to a 1994 article (2) by economist Paul Krugman, now Novel Laureate. Krugman asserted that the Asian growth, including Singapore and China, was nothing miraculous. Their rise was built merely on inputs of machinery, infrastructure, and education, just like the former Soviet Union, rather than efficiency and productivity gains.

Let's first examine the outcome of China's stimulus package. On 1 March 2010, Mainland China's PMI (Purchasing Managers' Index) dipped to 52 from 55.8 a month earlier, which was its highest level since a record low in November 2008. This sudden swing was probably due to Lunar New Year seasonal distortions and market reactions to government's recent tightening measures. Recovery trends appear strong and stand a good chance of remaining intact (3). January 2010 exports increased 17.7 % from a year earlier, breaking a 13-month long year-on-year decline. Imports surged 55.9 %, much more than the 31.0 % increase markets had expected (4). In coastal provinces, migrant workers have to be wooed back, not always successfully, with higher wages and improved working conditions. China's economy grew at 8.7% overall in 2009. Nomura's research note in mid-December 2009 on the 2010 Global Economic Outlook (5) concluded that emerging markets looked set for strong growth led by a booming China. Allowing for changing sentiments in China's overseas markets, China's stimulus package appears to have worked reasonably well by comparison.

Turning to Chinese statistics, power consumption in January 2010 reached 353.1 billion kilowatt-hours, 2.7 % higher than the preceding month. However, consumption by secondary industries, which includes manufacturing and construction, grew 46 % to 262.4 billion kilowatt-hours (6). There is a close correlation with the resurgent manufacturing data.

As for the impact of car sales on gasoline consumption, according to estimates of the Cambridge Energy Research Associates (CERA), China had a total of 48.7 million gasoline-fuel cars at the end of 2009, 24 % more than 2008. By comparison, United States has more than 250 million passenger vehicles. So the Chinese correlation between car sales and gasoline consumption should be much lower. Moreover, thanks to tax rebates for energy-efficient cars ($440 -$878), a record 70 % of cars sold in 2009 had engines of 1.6-litre or smaller. China's best-selling car in most of 2009 was battery-maker BYD's F3 multi-hybrid sedan. A further factor is that the majority of car buyers are now coming from households. As Chinese cities are generally more congested, household cars drive only a fifth as much as corporate or government cars and a tenth of the distance covered by taxis (7).

While Chinese statistics still leave a great deal to be desired, it is plausible that the realities on the ground, rather than cooked data in the books, explain the apparent lack of close correlation between car sales and gasoline consumption.

Then, is China over-investing, creating a bubble waiting to burst?

First, let's deal with the question of investment versus consumption. The trend data of sustained improvements in China's order books, exports, imports, and rising demand for labour support the picture of at least a moderating over-capacity. What is more, as imports have been rising more sharply than exports, China's trade surplus has narrowed from $18.44 billion in December 2009 to $14.17 billion in February 2010. This seems to suggest a more balanced economic shift towards internal consumption (8).

There is a popular myth of the respective contributions between export and consumption to China's GDP. While consumption accounts for only 36.8% of China's GDP, net exports (less their import component) have contributed only 10% to real GDP growth over the last 17 years, much smaller than in Japan (23.8%) and Germany (28.8%). In other words, domestic demand has long been the main *growth* contributor in China (9). Starting from a relatively low base, China's real consumption growth *rate* has been one of the strongest in the world over the last 13 years (7.2% per annum on average) – stronger than in the US (3.3%), Japan (0.9%), Brazil (4.0%) and India (5.5%) (10).

Indeed, the rise of the Chinese consumers is set to define China's economy in the coming decades. The cohort in the household income bracket of RMB100,000 to 200,000 and above is estimated to expand from a share of 9.8% of total urban disposable income in 2005 to 36.4% by 2025 (11). The bulk of China's new consumers, however, will come from new or expanded second, third or fourth-tier cities and towns in China's inner provinces, which are being linked by a vast network of new railways and expressways. These projects have been given a giant push in China's stimulus package, of which 70% has been allocated to infrastructure. By the beginning of 2009, the rate of growth of fixed asset investment (FAI) in infrastructure had overshot the FAI growth rates for manufacturing and property respectively (12).

This infrastructural boom is expected to continue as China is relocating some 350 million more people into cities by 2025. By 2030, one billion people will be living in China's cities (13). A large proportion of this enormous urbanization will be in the inner provinces (14). In addition to an inter-provincial expressway system second only to the US interstate highway system, China is embarking on the world's largest railway expansion project since the 19th century, increasing the total length from 78,000 to 100,000 km by 2020. Far from leading to nowhere, these infrastructural networks are set to become the economic arteries of China's new economy in the 21st century.

Let's turn to the risk of overheating. In 2009, M2 money supply (a key indicator used to forecast inflation) increased by 27 % year on year, and credit expanded by 34%. In February 2010, despite strict administrative control of financial credit, bank lending grew at an annual rate of 29%, on top of already strong expansion in the same period a year earlier. While inflation remains low, at 1.5%, it has been rising in recent months. Housing prices soared in January 2010, registering a jump of 9.5% compared with the preceding year. Unbridled property prices and inflation risks have already rattled the Chinese leadership. Premier Wen Jiabao, in an online video chat show with the Chinese people on 27 February, called runaway property prices 'the wild horse' that needed to be tamed.

Indeed, on the eve of the Lunar New Year, the People's Bank of China announced, for the second consecutive time in a month, an increase in the bank's mandatory reserve ratio by 50 basis points, bringing it to 16.5%. Shortly before that, Beijing acted to stop excessive borrowing by raising the down payment ratio for second house buyers and the capital adequacy ratio for developers. In February, China's big four state-owned banks, which account for 34.5% of total lending, dropped their total loans to $44 billion from $70 billion the previous month (15). February food prices registered an increase of only1.1%, lower than the previous two months, suggesting that food inflation may be lower than expected. However, general inflation rose 2.7 % in the first two months of 2010, a 16-month high, from a 1.5% rise in January (16). At the National People's Congress (5 -14 March, 2010), a cautious, moderate growth plan was announced with inflation target set at 3%, M2 expansion reduced from 28% to 17%, GDP aimed at 8%, and budget deficit at 2.9% compared with 2.4% last year.

In China, serious property bubbles and inflationary threats have happened before, last time in the mid-1990s. Now, with inflation still low, some over-capacity remaining, low public debt (only 24% post stimulus package), very low level of non-performing loans, very low investment leverage, a more robust economy, a massive foreign exchange reserve of over $2.4 trillion, and an array of administrative measures in an economy where the state holds considerable sway, the Chinese government should be well placed to rein in this 'wild horse' once again (17).

Finally, let's turn to Krugman's 1994 article. Since its publication, there has been no lack of dissenting views. While accepting that capital accumulation played an important role, a 1997 Paper by the International Monetary Fund, *Why is China Growing So Fast* (18) identified the 'sharp and sustained increase' in total factor productivity throughout China's reform period as the main contributor to her unprecedented economic growth from 1952 - 1994. Using statistics from Morgan Stanley, a feature article of the Economist in 2007 *'How Fit is the Panda'* (19) also concludes that 'China's economic success has been based on the essential ingredients of growth: high savings, openness to trade, good education and strong productivity growth'. At a keynote address to the Asian Development Forum in Manila on 12 March 1998, Joseph Stiglitz, then Senior Vice President and Chief Economist of the World Bank, did not believe that the so-called 'East Asia miracle' happened through investment alone. He was confident that factor accumulation of both physical and human capital, coupled with social inclusion and technology, enabled East Asia to achieve impressive productivity gains (20). A Jiaotong University critique of the Krugman article (21) argues that with an average, or near average, rate of total factor productivity growth, a larger proportion of investment input may generate more growth overall than marginal increases in efficiency or productivity in some sectors.

The above rebuttal should not be surprising as additional inputs are required to build up economic capacities before an economy fully matures into a more consumption-led model, i.e. transforming from a pyramid-shaped economy to an 'onion-shaped' one with the middle class as the majority.

Developments of such scale and at such speed in a country as vast and diverse as China are bound to lead to some waste and misallocation of resources. Bubbles are also prone to happen here and there, especially in the housing market. But the Chinese authorities are starting to put on the brakes before things are getting out of hand. China is right in the heart of a global paradigm shift of economic gravity to the East. All in all, it would be fair to say that rather than building castles in the sand, China is consolidating her economic cornerstones and, at the cost of some inflation, rapidly accumulating both physical and human capital in order to drive her development to become a more balanced economy in the 21st century.

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(1) Earlier books like *The Coming Collapse of China* (Gordon Chang, Random House, August 2001) have given way to more recent catchy titles like When *China Rules the World* (Martin Jacques, Allen Lane, 25 June, 2009)

(2) *The Myth of Asia's Miracle. A Cautionary Fable*, Paul Krugman. Foreign Affairs; Nov/Dec 1994; Vol.73, Iss. 6; pg. 62, 17 pgs, based on earlier research by Professors Alwyn Young and Lawrence Lau with associate Jong-Il Kim

(3) *Mainland PMI dips, but recovery trend remains intact*, Reuters in Beijing, reported in the South China Morning Post at http://www.scmp.com/portal/site/SCMP/menuitem.2af62ecb329d3d7733492d9253a0a0a0/?vgnextoid=8fbf7f61ca717210VgnVCM100000360a0a0aRCRD&ss=Companies&s=Business (accessed on 1 March, 2010)

(4) *China exports, imports surged on economic strength*, Zhou Xin and Tom Miles, in Beijing for Reuters, 10 January 2010, at http://www.reuters.com/article/idUSTRE6090FS20100111 (accessed on 27 February, 2010).

(5) *A Tale of Two Recoveries*, 2010 Global Economic Outlook, Nomura Global Economics, 16 December 2009

(6) Bloomberg New, 12 February, 2010 at http://www.bloomberg.com/apps/news?pid=20601072&sid=aM0is9tQq4K4 (accessed on 27 February, 2010)

(7) *China car craze won't dent gasoline exports*, Reuters News, 28 January 2010, at *http://news.alibaba.com/article/detail/energy/100241376-1-analysis-china-car-craze-won%2527t-dent.html* (accessed on 2 March, 2010)

(8) In February 2010, month-on-month imports jumped 85.5% compared with an export increase of 21%. Even allowing for Lunar New Year distortions, this may signal a marked shift towards internal consumption.

(9) *China: Gauging the importance of exports*, Global Weekly Economic Monitor, 27 March 2009.

(10) *China: Dispelling some myths*, Mingchun Sun, in *A Tale of Two Recoveries*, 2010 Global Economic Outlook, Nomura Global Economics, 16 December 2009

(11) *The Value of China's emerging Middle Class, Exhibit 1, page 63 in Serving the New Chinese Consumer*, Mckinsey Quarterly, 2006 Special Edition

(12) *China: Dispelling some myths*, Mingchun Sun, in *A Tale of Two Recoveries*, 2010 Global Economic Outlook, Nomura Global Economics, 16 December 2009, Figure 2, page 39

(13) *Preparing for China's Urban Billion,* McKinsey Global Institute, March 2008

(14) Global Macro Issues - *China's provinces – Digging one layer deeper*, Deutsche Bank research note dated 18 February 2010

(15) *Big Four banks slow loan growth in February*, China Economic Review,4 March,2010 at http://www.chinaeconomicreview.com/dailybriefing/2010_03_04/Big_Four_banks_slow_loan_growth_in_February.html (accessed on 4 March, 2010)

(16) *China: February CPI inflation may be lower than expected*, Nomura International (HK) Ltd, 2 March, 2010. But see reference to rising general inflation in first two months of 2010 in the South China Morning Post report dated 15 March 2010 at http://www.scmp.com/portal/site/SCMP/menuitem.2af62ecb329d3d7733492d9253a0a0a0/?vgnextoid=67c14df762d57210VgnVCM100000360a0a0aRCRD&ss=China&s=News (accessed on 15 March 2010).

(17) *Fears about an overheated mainland economy triggering a collapse seem premature at best*, Fang Gan, Member of the Monetary Policy Committee of the People's Bank of China, South China Morning Post, 1 March 2010 at http://www.scmp.com/portal/site/SCMP/menuitem.2af62ecb329d3d7733492d9253a0a0a0/?vgnextoid=3b40db4648417210VgnVCM100000360a0a0aRCRD&ss=China&s=News (accessed on 1 March, 2010)

(18) Zuliu F Hu and Mohsin S Khan, IMF Staff Papers, volume 44 No 1, March 1997

(19) The Economist, September 29, 2007
(20) *The Allocation of Investment and Productivity Growth* in *Sound Finance and Sustainable Development in Asia*, Keynote Address to the Asian Development Forum, Manila, Philippines, 12 March,1998
(21) *Comments on Paul Krugman and Alwyn Young on The Myth of Asia's Miracle - why 'quantity' may be more important than 'quality' in economics*, *China in the International Financial Crisis* on China's Jiaotong University website at http://ablog.typepad.com/citifc/2009/05/comments-on-paul-krugman-and-alwyn-young-on-the-myth-of-asias-miracle---why-quantity-may-be-more-important-than-quality.html (accessed on 28 February 2010)