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China Refuses to Adjust Its Economy

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For those worried that China is rising to replace a declining America, take heart: If the U.S. is headed in the wrong economic direction, the PRC is moving in that same direction—only faster. Official statistics from the first six months of the year show a Chinese economy that strengthened noticeably in the spring but at the cost of recreating some of the worst policy mistakes of the past.

Quicker Growth, Announced Too Quickly. It is reasonable to simply dismiss Chinese economic results. Despite starkly limited resources and a dynamic, complex economy, the State Statistical Bureau again needed only 15 days to survey the economic progress of 1.3 billion people.[1] Revisions are a farce: No growth figure has ever been revised down, and announcements of upward revisions are incomplete to the point of uselessness. At best, earlier activity is measured; at worst, results are manufactured to suit the Communist Party.

Real second-quarter GDP growth is said to have accelerated sharply to 7.9 percent.[2] That left real first-half growth as a whole at 7.1 percent, nicely demonstrating the clear improvement from the first quarter upon which the party insisted. Note that, even if accurate, this growth does *not* mean the PRC is leading a global recovery. In purely numeric terms, because China runs a trade surplus, its GDP gains come at the expense of global GDP.[3]

Beijing is cautious about the sustainability of the recovery, as it should be. The reliability of the numbers is low, but on one read, there is no chance that the current economic structure can be maintained. The main engine for growth, again, was fixed investment, which rose by one-third—twice the speed of retail sales. More important, investment was equivalent to a staggering 65 percent of GDP, an unprecedented figure for an economy that is supposed to have a significant market element and a figure that cannot be reconciled with a transition to the market. Either investment recedes or the market does.

On the other hand, the share of investment in GDP could be significantly exaggerated. For China, components of GDP are difficult to reconcile with GDP itself. Retail sales are a poor measure of consumption, but they are the official benchmark, and they were ostensibly equal to 42 percent of GDP. Investment and consumption are supposed to be two GDP components, but adding them already gives 107 percent of the total. The $97 billion first-half trade surplus raises that figure to 112 percent.[4] The claims of an accelerating economy need to be taken with a grain of salt.

Irresponsibility with Chinese Characteristics. Inconsistent data are old hat for the PRC. The more noticeable change this time around is that China's economic policies have shifted from being unsustainable over the very long term to being unsustainable for any more than one year. The core of this degeneration is the role of investment, but behind that investment, and making it possible, is bank lending.

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In the past, the People's Bank would report loan growth in the 15 percent range, supporting better than 10 percent GDP growth.[5] Through June, those numbers radically shifted. Bank loans soared an astounding 33 percent, supporting the weaker 7 percent growth.

This is an utterly unsustainable pace for lending and indicates severe damage to banks. With the old ratio, banks were at best holding their own in terms of bad debt. With the new ratio, tens of billions—and perhaps hundreds of billions—of dollars of loans will not be repaid. Official denials will flow like water, but the simple numbers are inescapable: China's economic recovery is being constructed on the back of a savaged banking system.

This scenario should sound familiar: Many countries, including the U.S., are pursuing short-term recoveries with unwise policies, such as mushrooming fiscal deficits.

While pontificating about fundamental structural adjustment, these countries are spending far beyond their means, just as consumers and financial institutions did prior to the crisis. Apparently, these governments believe magic will eventually transform utter irresponsibility into a sound world economy. The only difference in the PRC's case is that the command elements of the Chinese economy enable faster mobilization of resources and therefore a faster trip in precisely the wrong direction.

Dangers to China and the World. The peril of this path is already clear. Some analysts warn of the PRC exporting inflation caused by too much liquidity. There is indeed too much liquidity: Broad money expanded close to 29 percent, an unofficial record. Despite talk of tightening, interest rates have not budged, and the People's Bank continues small net injections into an already engorged monetary system. But money growth in China does not breed spending-happy consumers who push up prices, as it would in the U.S.

Chinese money growth is being led by lending, which is overwhelmingly dispersed to state firms for the sake of maintaining or increasing output. Another component is a sharp increase in on-demand deposits, as individual and firms look to have cash immediately available to invest in various assets. The true dangers that follow from these developments are:

- A surge in supply despite continued weakness in demand; and
- Price bubbles in stocks, property, and other assets.

The implications for both the Chinese and the global economy can be summarized as a return to some conditions that existed prior to the financial crisis. On the asset side, bubbles are already reforming in stocks and some urban property markets, mimicking 2006–07. Speculative capital flows to the PRC that seek out these bubbles reemerged in force in the second quarter, despite a real depreciation of the yuan and no movement against the U.S. dollar at all. This is also reminiscent of 2006–07.

On the output side, demand cannot match supply fueled by a one-third leap in bank loans. Beijing will need to choose between deflationary pressure in consumer and producer goods—the first half saw nearly 2 percent consumer deflation and 6 percent producer deflation—and pushing the excess output onto a now unwilling world via massively subsidized exports.

There is also an ecological component: For example, coal production is accelerating to fuel the Chinese industrial machine. That suggests the development of more asset bubbles in global commodities such as copper, just as occurred pre-crisis.

1. This is regarded as embarrassingly slow in Vietnam, where GDP growth for the first half of 2009 was announced on July 1.
2. All official data can be found here: Li Xiaochao, "China's Economy Stabilized with a Better Performance Trend While Its Upturn Yet to Consolidate," National Bureau of Statistics of China, July 16, 2009, at *http://www.stats.gov.cn/english/newsandcomingevents/t20090716_402572483.htm* (July 16, 2009).
3. Simple GDP growth includes trade surpluses as positives and trade deficits as negatives. China's trade surplus enters as a negative in the rest of the world's GDP, meaning it is lowering world GDP growth in that superficial sense.
4. Data on first-half net government spending are not yet available, but through the first five months they show a fiscal surplus, which would detract from GDP and bring the component sum back to around 108 percent.
5. China Monthly Statistics, National Bureau of Statistics, Volumes 85–204, 1999–2008.

Back to the Future. China's participation in the pre-crisis world economy featured gigantic exports, equivalently gigantic capital inflows, and imbalances in both stocks and flows that harmed international economic stability in the short term and harmed China in the long term. Prior to the crisis, calls for restructuring were rejected in Beijing on the grounds of the apparent success of high growth and low inflation.[6]

The PRC's response to the crisis has been to intensify pre-crisis policies. The damage caused by a global demand bubble inflated by overly loose American money is to be healed by Chinese production and asset bubbles inflated by overly loose Chinese money. Restructuring is to be put off to some indefinite future when the external situation is better. Of course, at that time, the economy will appear to be hitting on all cylinders and reform will—again—be dismissed.

Keeping one's eyes pinned to current GDP growth shows an improving Chinese economy. A broader view shows the PRC trying to drag itself and the rest of the world back along the trail that led to the current economic crisis.

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6. Derek Scissors, "Deng Undone," *Foreign Affairs*, Vol. 88, No. 3 (May/June 2009).