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Struggling to keep the lid on

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The economy just grows and grows



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JUST when many were predicting a gentle easing of China's economic growth this year, figures for the first quarter suggest the opposite. Driven by a surge of investment and easy credit, the economy grew by 10.2% year-on-year, even faster than last year's annual rate of 9.9%. Now officials fret that it is close to overheating. On April 27th, the central bank raised interest rates for the first time in 18 months, by 0.27%, and announced "guidelines" to control lending to a dozen industries. As *The Economist* went to press the details of these were not clear, but there was speculation that further measures would be forthcoming in the near future.

There was much for the authorities to be anxious about. GDP growth in the first three months compared with the same period a year ago was the highest quarterly rate since at least 2004 (data revisions make earlier comparisons difficult). That was the year in which China began trying, with limited success, to put on the brakes. Investment in fixed assets, such as roads, factories and machinery, surged by 27.7%. In urban areas it grew by 32.7%, year-on-year, in March alone. The government had been hoping to keep growth in such investment to 18% this year, down from 27.2% last year. And in that same first quarter, China's state-owned banks lent nearly as much money—1.26 trillion yuan (\$157 billion)—as the government had targeted for half of the year (see [article](#)). The broad money supply grew by 18.8%, up by 4.7 points over the same period last year and higher than the central bank's target for 2006 of 16%.

China's trade surplus continued to grow briskly too, rising to \$23.3 billion in the first quarter, with exports up by 26.6% and imports by 24.8%. This was 41% bigger than the surplus of January to March last year. This will hardly help to ease concerns, particularly in America, that China is profiting unfairly from an undervalued currency. On the strength of the latest figures, this year's trade surplus may not be far off last year's record of \$101.9 billion.

China's leaders relish high growth and flourishing export-oriented industries. They help generate employment in a country where the urban jobless rate is estimated at more than 8% (far higher in some cities), and where at least 150m people in the countryside have little or nothing to do. Much slower growth could pose a threat to social stability. But they worry that the current high rate is being sustained by irrational and resource-wasting investment. This could further weaken the bad-debt burden of state-owned banks and eventually result in an abrupt and painful slowdown as credit dries up.

So why is it proving so difficult to engineer the "soft landing" that the government has been trying for? This year's GDP growth target is 8%. Even before the latest figures were announced, this appeared conservative. Many economists have now revised their estimates upwards. The Chinese Academy of Social Sciences, in its latest report, predicted growth this year would be only fractionally slower than last year's, at 9.6%. Its last quarterly report said it would be around 9%.



China's exchange-rate policy is part of the problem. In recent months the country has been awash with cash. The trade surplus leads to large inflows of foreign currency, which is bought up by the central bank in order to hold down the exchange rate. But this boosts the supply of yuan deposited in banks.

The central bank usually curbs this money-supply growth by borrowing back much of the excess yuan. But Stephen Green of Standard Chartered Bank says that, for a few months in the middle of last year, it relaxed these efforts to offset the potential impact of an upward revaluation of the yuan in July. The result was a surge of cheap credit. This will inevitably mean bad news for the banks when some of these loans eventually turn bad. In the first quarter, industrial profits rose by 21.3%, but losses by 32.3%. With huge oversupply in some industries, and big rises in raw-materials costs, many manufacturers are having to endure wafer-thin margins.

Although efforts to rein in the money supply resumed in October, investment grew rapidly as local governments, heedless of central efforts to tame the economy, raced to boost local growth rates. This was encouraged by the launch this year of their new five-year economic plans, traditionally a time for starting big new projects. Many local five-year plans project double-digit annual growth rates, even though the central government is aiming for a modest average of 7.5% until 2010.

To help reduce net foreign-currency inflows, the government announced plans earlier this month that would make it possible for the first time—though still subject to quotas—for firms and ordinary Chinese to invest in foreign securities markets. And it is widely predicted that the central bank will soon announce measures to curb credit growth by increasing the ratio of bank deposits that must be kept with it in reserve.

Still, with big events approaching—a five-yearly Communist Party Congress late next year and the Beijing Olympic Games in 2008—China's leaders are anxious that the economy keep growing fast enough to ensure stability. This may make them reluctant to take the really tough measures necessary to ensure more rational growth: lifting controls on energy prices, for example, and removing restrictions on bank interest rates. Chang Qing, of China Agricultural University, says he believes that central-government efforts are unlikely to have much impact, and that China will find it difficult to avoid a hard landing in a couple of years' time. Government officials, however, still insist that the economy is not overheating—yet.

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