

China Opts for *Quantity over Quality*

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On the surface, China appears to be leading the world from recession to recovery. After coming to a virtual standstill in late 2008—at least as measured on a sequential quarter- to-quarter basis—Chinese economic growth accelerated sharply in the spring of 2009.

A back-of-the envelope calculation suggests China may have accounted for as much as two percentage points of annualized growth in inflation-adjusted world output in the second quarter of 2009. With contractions moderating elsewhere in the world, China's rebound may have been enough in and of itself to allow global GDP to eke out a small positive gain for the first time since last summer.

That's the good news. The bad news is that China's recent growth spurt comes at a steep price. Fearful that its recent economic shortfall would deepen, Chinese policymakers have opted for quantity over quality in setting macro strategy, the centerpiece of which is an enormous surge in infrastructure spending funded by a burst of bank lending.

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Sure, developing nations always need more infrastructure. But China has taken this recipe to an extreme. Infrastructure expenditures (including Sichuan earthquake reconstruction) account for fully 72 per cent of China's recently enacted Rmb4,000bn stimulus. The government urged the banks to step up and fund the package. And that they did. In the first

six months of 2009, bank loans totaled Rmb7,400bn—three times the pace in the first half of 2008 and the strongest six-month lending surge on record.

This outsize bank-directed investment stimulus leaves little doubt as to how bad it was in China in late 2008 and early 2009. An unprecedented external demand shock, stemming from rare synchronous recessions in the developed world, devastated the export-led Chinese growth machine. That triggered layoffs of over 20m migrant workers in export-intensive Guangdong Province. Long fixated on social stability, Beijing moved quickly with massive firepower to arrest this worrisome deterioration. The government was adamant in doing whatever it took to restore rapid growth.

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Yet there can be no avoiding the destabilizing consequences of these actions. Surging investment accounted for an unprecedented 88 per cent of Chinese GDP growth in the first half of 2009—double the average contribution of 43 per cent over the past decade. At the same time, the quality of Chinese bank lending most assuredly suffered from the rash of credit disbursements in the first half of this year—a trend that could sow the seeds for a new wave of nonperforming bank loans. Indeed, just this week, Chinese regulators sounded the alarm—telling banks new loans must be used to bolster the real economy and not for speculation in equities and real estate.

A little over two years ago, Premier Wen Jiabao warned of a Chinese economy that was becoming increasingly “unstable, unbalanced, uncoordinated, and ultimately unsustainable.”

Prescient words. Yet rather than act on those concerns by implementing a pro-consumption rebalancing, growth-hungry China was seduced by the boom in global trade and upped the ante on its most unbalanced sectors. By 2007, investment and exports collectively accounted for about 80 per cent of Chinese GDP. And now in the face of a severe global recession, China has compounded the very problems the Premier warned of—aiming a massive liquidity-driven stimulus at its most unbalanced sector.

Record bank lending growth of Rmb 7400 billion in the first half of 2009 could sow the seeds of a new wave of nonperforming loans.

This is not a sustainable outcome for any economy—nor sustainable support for the world economy. China must redirect economic growth toward internal private consumption. This may require a compromise on the quantity dimension of its growth outcome. But to the extent that leads to improved quality in the Chinese economy, a short-term growth sacrifice is well worth the effort.

China is aiming a massive liquidity-driven stimulus at its most unbalanced sector — ignoring the most critical lessons of this post-crisis era.

Unlike most, I have been a steadfast optimist on the Chinese economy. Yet I am starting to worry. A macro strategy that exacerbates already worrisome imbalances is ultimately a recipe for failure. In many respects, that's what the global crisis and recession of 2008-09 are all about. China will not get special dispensation from the most critical lesson of this post-crisis era.

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