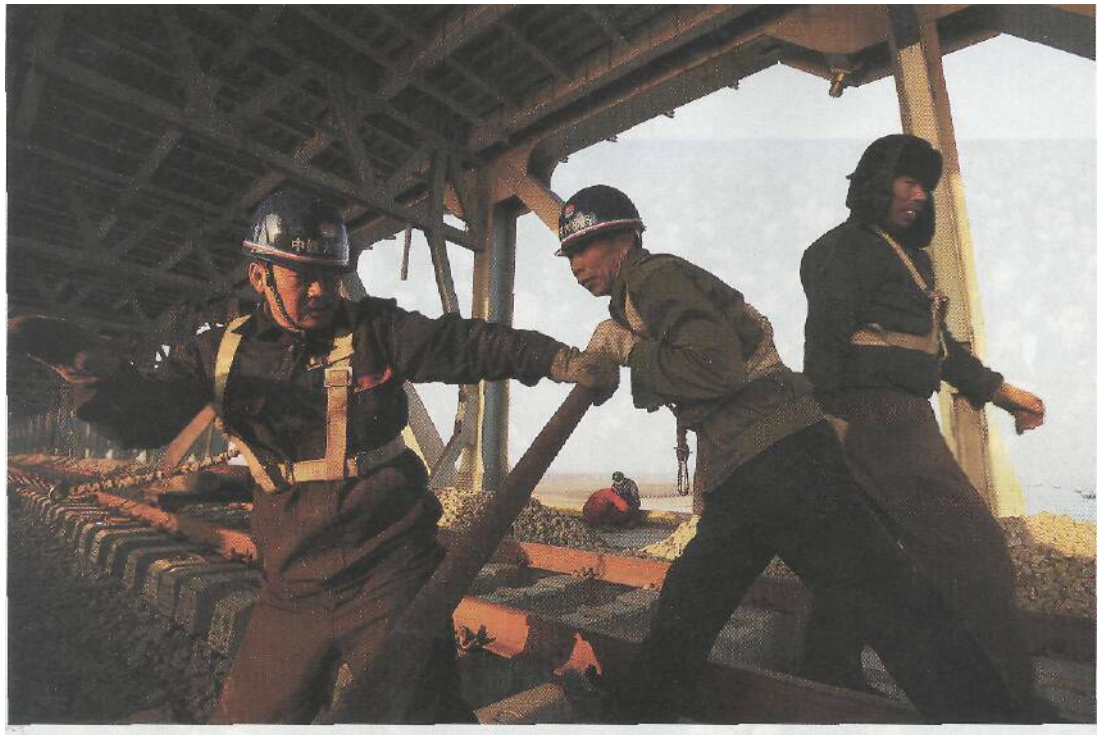
HUNGRY FOR WORK CROWDS OF JOB HUNTERS FEEL THE CRUSH AS THEY ENTER A RECENT EMPLOYMENT FAIR IN ZHENGZHOU, CHINA.

CHINA'S HARD LANDING

With exports shrinking and unemployment rising, China must find a way to recover. That will take longer than most think.

BY BILL POWELL

IN THE EARLY EVENING LIGHT, on a block that once bustled but is now deathly quiet, Li Zhong-he walks to the front gate of the factory where he used to work. There he looks for his name on a sheaf of papers. They are notices from a local administrative court, granting small unemployment payments to workers like Li and the hundreds of others who were left without jobs when their company, Hejun Toy Manufacturing, ceased operation. Nearly a decade ago he had come from the countryside to Dongguan, a sprawling manufacturing town in southeast China that for much of the past decade had boomed. Li had made decent money, the equivalent of about $250 a month, worked his way up to shift supervisor on the factory floor, and unlike many of China's migrant workers—an army of an estimated 115 million people nationwide—he had asked his wife and young son to join him so that they could have what he calls a "normal life." Now, he says quietly as he turns away, disappointed that his name was not



THE BIGGEST DIG CHINA IS EMBARKING ON A MASSIVE BUILDING PROGRAM LIKE THIS RAIL BRIDGE PROJECT IN HUBEI.

on the list, "I don't know what I'm going to do."

For most of this decade China lived up to its hype. This, we were told incessantly, was the Chinese century, when the world's most populated nation would eventually become its most prosperous and powerful. China grew at or near double-digit rates for the past five years and turned lots of people like Li from impoverished peasants into members of a surging middle class—people with "normal" lives. When Beijing joined the World Trade Organization in 2001, it was, for multinational companies worldwide, as if someone had fired the starting gun for the Oklahoma land rush: Multinationals raced to China, both to use it as an export platform and to tap the rapidly growing market. China's momentum was so powerful that a year ago straight-faced economists talked about "decoupling"; even if the U.S. went into a housing-led recession, the argument went, China could continue growing and perhaps even help much of the rest of the world avoid a slump.

CHINA HAS GROWN so fast for so long—and has generated such optimism from so many quarters—that some hard truths about its economic reality, both short and long term, can be hard to swallow. Time to grit your teeth and bear it: It is now obvious that China has no immunity from the vicious global slump (some economists contend that its economy actually contracted in the fourth quarter of last year). Moreover, the slowdown may be deeper and last longer than most had anticipated. The export sector is obviously moribund, shrinking 17% in the fourth quarter, and will remain so until the U.S., by far its biggest market, begins to recover.

Another key driver of growth, fixed-asset investment, is also weak and getting weaker. Companies both domestic and foreign have spent a fortune building out industrial capacity in China since the early part of this decade. In 2000, to take but one indicator, there were 364,000 foreign-owned companies in China. By the end of last year that number had soared to more than 661,000, many of them small and medium-sized manufacturers. Total investment in new factories and other assets in China last year was no less than 40% of GDP, or about $1.76 trillion, a thoroughly "ridiculous" figure, as Diana Cboyleva, an economist at Lombard Street Research in London, puts it.

And because that number was so preposterously high, it will be a long time (if ever) before China comes anywhere close to reaching that level of investment. Indeed, in an increasing number of cases, companies that recently spent millions on new factories are now laying off the people who worked in them. The weak labor market, which has savaged low-tech toy and textile employees like Li Zhong-he, has now moved up the technology ladder. TMSC, the world's largest contract computer-chip maker, has a factor)' in suburban Shanghai that opened in 2003; last month it started "involuntary unpaid leaves" of a few days a month for the majority of its 1,500 workers.

Layoffs, of course, will mute consumer demand—precisely at a time when some economists still hold out the hope that China, as the last major economy still growing (albeit more slowly), could be a "global locomotive," as Choyleva puts it, helping drag the U.S. and others out of recession. "That's not going to happen," says Shanghai-based economist Andy Xie. A just-released survey by the American Chamber of Commerce in Shanghai showed that of the 108 foreign manufacturing companies it queried in November, fully 40% reported that their sales in China had plunged 10% or more year on year. Of course, the survey was taken right in the middle of a worldwide panic that brought buying to a halt everywhere. Demand has picked up a bit in China since then. Still, the "question now isn't Ts China going to have a hard landing?'" says Xie. "It's 'Just how hard will China's hard landing be?'"

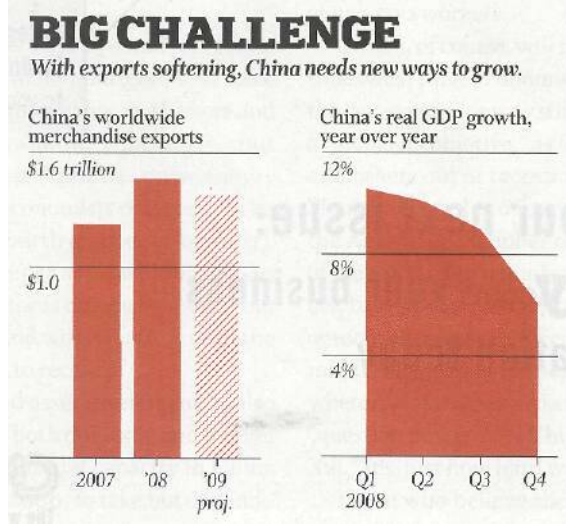
Those who believe the slump will be shorter and shallower

in China than almost anywhere else put their faith in the Chinese government. Last November, as it became clear that the U.S. economy was cratering, Beijing wowed a lot of people by announcing a fiscal stimulus package it said was worth $565 billion, or about 8% of GDP. (The U.S. stimulus, by contrast, is about 5.6% of GDP.) Economists since then have spent a lot of time trying to figure out how much of that headline number would be new, additional spending, and how much was already in the pipeline. Three months later that's still not clear, and the government is already talking about another round of stimulus.

The good news, for China and the world, is that the government can afford it. It came into this year with a slight budget surplus, and new spending on massive infrastructure projects will put a floor under steelmakers and other basic industries that desperately need it. It will also provide jobs for some of the 20 million or so migrant workers now jobless—without question the government's major goal, Ask anyone in China what keeps President Hu Jintao awake nights, and you'll get the same answer: the possibility of widespread social turmoil that massive unemployment could plausibly trigger. China probably has sufficient resources to "cushion the downturn," as Xie says, to avoid further unrest. Jun Ma, chief China economist for Deutsche Bank Securities in Hong Kong, sees government spending helping China to 7% growth in the current quarter before the economy weakens again later in the year. Still, that's not nearly enough growth to provide all the jobs that China needs.

THE OPPONENTS OF REFORM IN THE PARTY SAY TO THOSE OF US LOOKING TO CHANGE THE FINANCIAL SYSTEM, "YOU SEE, LOOK WHAT'S HAPPENING IN THE WEST. THEY'RE NATIONALIZING THEIR BANKS."

THE REAL PROBLEM for the leaders in Beijing isn't just the here and now. Many large multinationals seem to think that once this global downturn ends, China will go back into hyperdrive, growing at 10% and moving millions of citizens a year from near poverty to something resembling middle-class status. That's probably a fantasy. Even absent the U.S.-led global crisis, China's leaders knew that the comparative advantages they leveraged into rapid growth—vast amounts of relatively well-educated low-wage labor, a welcoming attitude toward foreign direct investment, and exports, exports, and more exports—had pretty much run their course.

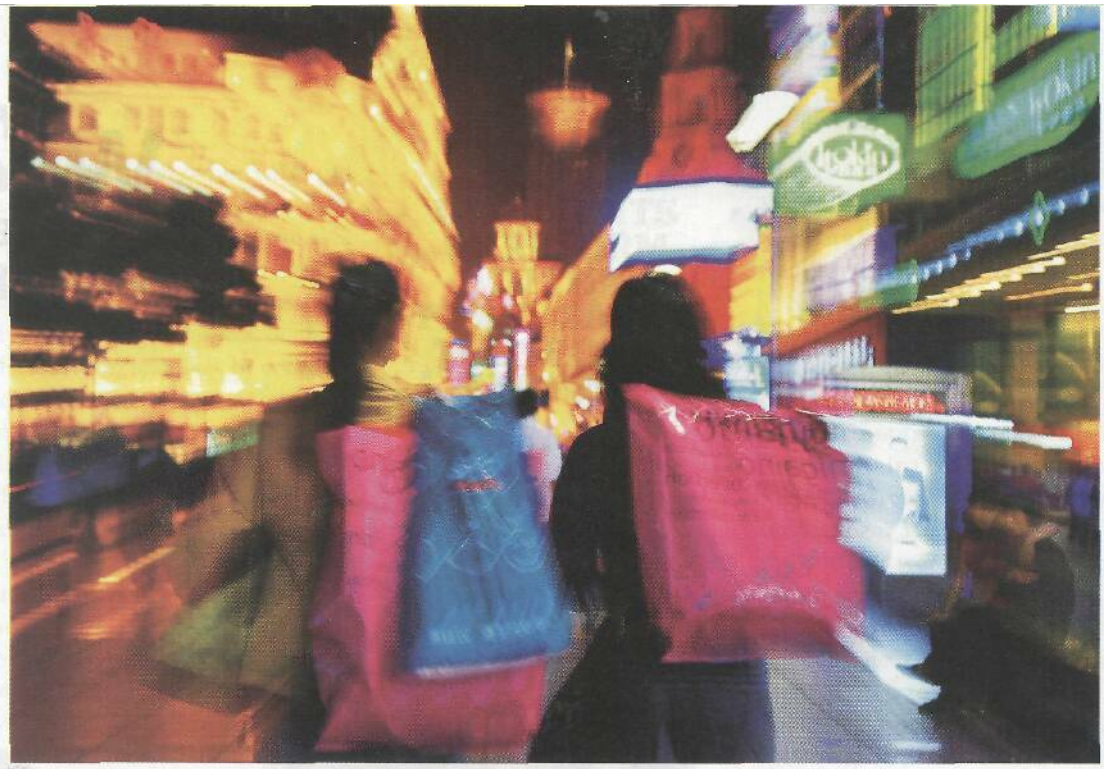


China's current-account surplus hit a record 8% of GDP in 2008; going higher would probably have brought a serious backlash from its trading partners. The jig was up.

Now, however, the slump shines a harsh light on the significant economic vulnerabilities that the boom years managed mostly to obscure amid all the chatter about the Chinese century. The road ahead, says Dan Rosen, a China consultant and principal at Rhodium Group, based in New York City, "is terra incognita for the leadership." Over time the outlines were pretty clear as to where China needed to go: Just as the U;S. must save more and spend less, China has to do the opposite. China's personal savings rate is more than 20%, and while GDP growth has soared over the past ten years, per capita income growth has not. "Growing individual income is the key to unlocking the next phase of growth in China," says Huang Yasheng, a political economy professor at MIT's Sloan School and author of the just-published Capitalism With Chinese Characteristic,[1];.

How to do that was the question Beijing was dealing with when the crisis hit. It wasn't easy, and more to the point, it wasn't under any circumstances going to be quick. And ironically, one of the keys to rebalanced growth, as the economists call it. is further reform of the financial sector. China wastes a vast amount of capital to get the growth it currently has. Its savers are penalized by low interest rates at government-owned banks—and those banks dole their capital out in ways that often reflect political rather than economic judgments. In other words, huge state-owned enterprises are still first in line.

In the midst of the current global implosion, brought on by allegedly "efficient" Western financiers, it is fashionable now, inside China and out, to lament the Western banking system and praise China's for its relative health. There is, of course, an element of truth to that. But it's myopic, and if it prevents further reform in the financial sector (as it probably will), it will hurt China's transition to a more balanced economy. "One of the tragedies of the timing of this crisis," a former People's Bank of China official said recently, is that "we were on track to further reform the financial system, to offer more options for savers and investors, to move toward a more



GET 'EM BUYING BEIJING'S $565 BILLION STIMULUS PACKAGE SHOULD BOOST SHOPPERS, LIKE THESE YOUNG WOMEN IN SHANGHAI.

efficient system. Now there will be a delay. The opponents of reform in the party look at those of us who have been pushing for these kinds of things, and they say, 'You see, look at what's happening in the West. They're nationalizing their banks,'"

Optimists say that finance may be the only phase of China's next stage of economic development that gets sidetracked by the crisis—and even then only temporarily. The nation also urgently needs to scale its way up the technological ladder, generating jobs and income growth via innovation. For all the gleaming high technology on display in industrial parks across China, most of it remains foreign owned and foreign generated. And Beijing needs to protect innovators, both foreign and domestic, from intellectual-property theft, which is rampant. On this score, no less an authority than Microsoft vice president Liu Fenming says the company has seen "real progress." In early January, in fact, Chinese officials busted a large ring of pirates who were ripping off Microsoft software and exporting it to a bunch of countries, the U.S. included.

THE PROBLEM for China's senior leadership is that all the changes needed to generate the next round of Chinese growth take time. Better intellectual-property protection, a national pension and health system, financial reform: It's nose-to-the-grindstone stuff, not the sort of policy changes that can come overnight. "Now," says the former central bank official, "everyone's running around trying to put out fires. You have to understand, no one in China ever expected that we'd be this badly affected [by the financial crisis]. No one. They are stunned at the depth of this."

Stunned and a little angry—which, since China is now by far America's largest creditor, is not an idle point. After a recent speech in New York—and, it must be said, with a smile on his face—Luo Ping, an official at the China Bank Regulatory Commission, told a Financial Times reporter, "We hate you guys, but there is nothing much we can do," Except continue to buy Treasury debt. To repatriate China's foreign exchange, earned via its massive trade surplus, would only drive up the value of its currency, the renminbi, making the nation's exports more expensive in the midst of the biggest global slump since the early 19805. That's the equivalent of throwing an anchor to a drowning man, and it won't happen.

China may continue to diversify its foreign-exchange holdings—buying more gold and euros—but there is as yet no sign that it has given up on Treasuries. And some in Beijing don't mind the political leverage being a creditor provides. No one in Hu Jintao's government was displeased to have Hillary Clinton play down human rights concerns in her maiden voyage to Beijing as Secretary of State. For America, Beijing's appetite for U.S. debt is about the only bit of good economic news coming out of China these days.

For ordinary Chinese, seeing so much money flow into a foreign country at a time of mounting economic pain at home is infuriating. They never expected to be in this position, and they don't think it's their fault. This was the era of China's rise, after all, and now it's floundering, trying not to sink, and the next era of solid, sustained growth—on which so many have bet so much—may not arrive anytime soon.

In the meantime, millions of men like Li Zhong-he are unemployed and headed back to their home provinces. Li was lucky. He ended up getting some money from the local government in Dongguan as unemployment compensation. Millions do not. This is what a hard landing in China looks like. And it's not clear how it ends. Q

POWELL, Bill, China´s hard landing, **Fortune**, Amsterdan, n. 5, p. 64-70, Mar. 23, 2009.