Can China cool its economy?
Dexter Roberts

With a white-hot property market and double-digit growth, China's overheated economy may be heading for trouble. Why Beijing needs to act—and fast.

Early in 2009, when the Dow Jones industrial average hovered at 6,500 and economies in the U.S., Japan, and Britain were contracting, China revved its economy. The country's central bank opened the monetary floodgates while financial authorities ordered state-owned banks to crank up lending. A $586 billion stimulus package assembled by Chinese President Hu Jintao's government in late 2008 sent even more money flowing to large state-controlled construction and energy companies.

As a result, the Chinese economy helped propel global growth—and now runs the risk of overheating. The government was expected to announce on Apr. 15 that the economy expanded at about a 12% rate in the first quarter vs. 8.7% in 2009, the fastest pace in almost three years. Property bubbles in major Chinese cities such as Shanghai and Shenzhen and a 22.5% jump in March in the broadest measure of money supply (M2) are ominous signs. "China's economy clearly needs to be slowed down," says Isaac R. Souede, chairman and CEO of Permal Asset Management, a hedge fund that manages $20 billion globally. "The critical question is whether it will be [a] soft or hard landing." Adds Dell China (DELL) President Amit Midha: "The government took bold, decisive, and swift action to stem the effects of the financial crisis. Now the concern is the recovery may be too fast."

China's hybrid economy, in which elements of free markets coexist with a one-party state that has a huge say over how credit is allocated, is about to be put to an interesting test. Can Beijing really slow a complex, $4.9 trillion economy when so much of its political power comes from, well, delivering high-speed growth rates?

Shrewd players within the government, such as Premier Wen Jiabao, People's Bank of China Governor Zhou Xiaochuan, and Chinese banking regulator Liu Mingkang, have signaled their willingness to cool the economy. Yet austerity is a tough sell in a country that needs growth rates of about 8% to generate jobs for 10 million Chinese who enter the workforce every year.

Currency Debate

After diplomatic nudging from U.S. Treasury Secretary Timothy F. Geithner, Beijing may ease the yuan's peg to the U.S. dollar by further widening a trading band that would result in modest appreciation. Yet China is a long way from letting the yuan trade freely against foreign currencies or lifting restrictions on the flow of capital in and out of the country by citizens and companies. And the currency debate is just one facet of the gargantuan effort China faces to resolve the structural issues bedeviling its economy. Liberalizing its currency will be much

easier when domestic demand, now representing only 36% of GDP, rises to the 50% level typical of other emerging economies. "We must develop the economy mainly by relying on the domestic market," said Vice-President Xi Jinping on Apr. 10 at the annual Boao Forum on China, an economic conference on the southern island of Hainan.

Domestic consumption won't grow until China frees up its tightly regulated service sectors and allows more funding to flow to job-creating small and midsize enterprises. Also key: lowering health-care costs and taxes on China's middle-income consumers, argues Chinese economist Fan Gang. "China must increase the spending power of its middle class," says Fan.

In the corporate world, state-run steel, auto, and telecom companies get a disproportionate share of credit from government-controlled banks. "State-owned enterprises still dominate the economy, and the private sector has no access to some sectors," says Fred Hu, managing director and chairman of Greater China for Goldman Sachs (GS). "In order to unleash the power of China's economy as a whole, we have to be committed to deregulation [and allowing more private companies to compete]."

Lending Guidance

Local governments wield considerable power and can also easily tap the regional branches of government-controlled banks for quick loans. The head of the China Banking Regulatory Commission, Liu, is pushing the nation's banks to submit reviews of their loan books by the end of June, in part to get a handle on lending to locally controlled government investment vehicles for pet investment projects, a contributing factor to the overheating economy. "Better lending guidance is necessary to prevent potential financial risks to avoid bad loans emerging from property lending or local-government borrowings," says Lu Ting, a Hong Kong-based economist at Bank of America Merrill Lynch (BAC).

Beijing is making some headway in getting its state-run banks to lend less. Following two moves by the People's Bank of China requiring lenders to place more money with the central bank as reserves, new-loan growth fell 27% in March from the previous month. Interest rate hikes could be coming soon as well, since the consumer price inflation rate for March is forecast to hit a 16-month high of 2.6% when the number is released. Still, the government isn't dramatically cutting state-supplied credit. This year's loan target, although down considerably from last year, is still more than 50% higher than that of 2008.

Geithner and European trade officials have argued that letting the yuan appreciate more is enlightened self-interest. A stronger yuan would effectively lower the price of foreign currency-denominated imported products such as oil, cars, and wheat. A revaluation and stronger Chinese currency would counter the "risk of considerable overheating in the economy," says former European Union Trade Commissioner Leon Brittan, now vice-chairman of UBS Investment Bank (UBS).

Chinese leaders instinctively recoil when they feel pressured by foreign governments to free the yuan. Yet Hu's government will need to come up with some policies to throttle the economy this year or risk a crash in property prices that would have social and political ramifications. And make no mistake: A crisis in China would hit trade flows in Asia, rock commodity exporting nations such as Australia and Brazil, and even hurt rich world economies like the U.S., Japan, and Europe just as they are starting to emerge from severe recessions. Much is riding on how well Chinese leaders turn down the economic thermostat.

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