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The wobbly panda won't fall yet

By David Pilling

April was a truly gripping month for Chinese politics. Bo Xilai, the nearest thing in China to a politician running for national office, was purged with a brutality reminiscent of the Mao era he had so enthusiastically invoked. But while the country, and the world, was spellbound by the unfolding political drama, something strange was happening to the economy – nothing at all.

Economic activity in China appears to be running into the ground. In the first quarter, growth slowed to 8.1 per cent as measured officially, and to about 7 per cent on an annualised basis. But in April, things took a sudden turn for the worse. Import growth stalled and this month Chinese customers sought to defer, or even default on, contracts for iron ore and thermal coal. That suggests all is not well in Chinese steel plants, on its

building sites or in its factories. Other economic proxies, from electricity output to rail cargo and bank loans, also suggest a sudden screeching of economic brakes. Even official numbers – rightly held in much scepticism – have markedly slowed. Industrial production, fixed-asset investment and retail sales have disappointed one after the other.

The authorities have acknowledged the sudden change. Until recently, Beijing had been trying to damp things down, worried about high inflation (which peaked above 7 per cent) and speculation in the property market, particularly at the luxury end. But in the past few days – with the alacrity with which Scotty used to shift the Starship Enterprise from cruising speed to full thrust ahead – Beijing has cranked up the economic levers.

Last week the People's Bank of China cut the share of deposits that banks must set aside by half a percentage point. More importantly, Wen Jiabao, the premier, sprang into rhetorical action, saying the government should now prioritise growth. That should include a "proactive fiscal policy", he said, with more loans to big infrastructure projects, lower financing costs, tax cuts and credit for smaller businesses. Bank bosses, who take their cue from party hacks not market forces, can expect a phone call any day now.

In some ways it is autumn 2008 all over again. Then, as now, China had spent the previous several months trying to cool the economy down only to slam policy into violent reverse when economic conditions deteriorated sharply. Beijing embarked on one of the biggest fiscal stimulus packages ever implemented, worth by some reckoning about 15 per cent of gross domestic product.

Like the typical voyages of Starship Enterprise, there have been some frightening moments. Binge spending comes with side-effects. Inflation got temporarily out of control, raising the spectre of social unrest. So did parts of the property market, prompting a government clampdown. Tragically, injudicious investment in the high-speed rail network may have contributed to last year's fatal crash in Wenzhou, which for many became a symbol of an economy hurtling along at an uncontrollable speed.

There could be more to come. The surge in credit will inevitably lead to a jump in bad debt. Off-balance sheet loans are also likely to turn sour, including money funnelled into local governments. The concern is that China is now setting off on another fiscal stimulus package – albeit almost certainly on a much smaller scale – before it has fully paid for the old one. To the growing crowd of China bears, that means doubling up on an already wayward bet.

To be sure, there are reasons to be concerned. To shore up the economy, Beijing has increased investment to about 50 per cent of GDP. That is a higher proportion than the other Asian tigers ever spent. Eswar Prasad, professor at Cornell University, says a rerun of the 2008 stimulus would come at a heavy cost – "a retreat from the goal of a consumption-driven economy, more wasteful investment spending and additional bad loans in the banking system". He sensibly advocates spending on different things, mainly on "softer infrastructure" such as a decent social safety net. The World Bank in its twice-yearly report this week said much the same thing.

China's economic model is indeed inefficient by almost any measure. In terms of energy input, for example, in 2010 it used 2.4bn tonnes of oil equivalent, according to BP, a little more than the US, which used 2.3bn tonnes. With that China produced just $5.88tn of gross domestic product, not much more than a third of the US, with $14.66tn. Some of China's GDP involves digging a hole and filling it up again.

But the China bears are unlikely to be proved right just yet. China still has the firepower to engineer growth, something it badly needs in a year of fraught political transition. The budget deficit is negligible and central government debt is only 25 per cent of GDP. Even if it were to double as a result of the most recent stimulus, it remains manageable.

Nor is China's bad-quality growth quite the liability it appears. GDP per capita is still at a fifth of US levels. That means it is still about where Japan was in the late-1960s, argues Arthur Kroeber, managing director of Dragonomics, in an article in Foreign Policy magazine. "For catch-up countries, growth is mainly about resource mobilisation, not resource efficiency," he says. In other words, China can probably go on spending inefficiently for several more years yet. Even if it gets less bang for its buck, there is plenty of room for further growth.

The World Bank thinks China will grow at 8.2 per cent this year. Andy Rothman, China macro strategist at CLSA, thinks that when Mr Wen says 7 per cent, what he really means is at least 8 per cent. The days of warp speed for China's Starship Enterprise may be coming to an end. But, for growth, this is most unlikely to be the final frontier.

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