# Communists Can't Outspend Capitalists as China Jobless Increase

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By William Mellor

May 11 (Bloomberg) -- Over bowls of chili tofu and mushrooms at a restaurant in Shenzhen in China's humid Pearl River Delta, Terence Yap says he's not alarmed that U.S. investors drove his company's share price down 58 percent over the past year.

"We are in the right business in the right place at the right time," Yap, 38, says as he gestures toward a gray industrial landscape that disappears into a pollution-blurred horizon. His occupation: selling surveillance equipment to a Chinese government that's stepping up security spending as the economy slows, unemployment rises and the population grows restless. "We are in the business of providing peace of mind," he says.

Peace of mind is getting harder to find for China's leaders. Premier Wen Jiabao has pledged to ensure "social stability" as the government estimates that as many as 30 million rural migrants -- those Chinese who work in factories or seek urban construction jobs -- may have no income.

"We will launch intensive campaigns to ensure public security and maintain law and order," Wen told the National People's Congress in Beijing on March 5. China's unemployment rate is about 9.4 percent, according to an estimate by the Chinese Academy of Social Sciences -- more than double the government's March figure of 4.3 percent for the registered urban unemployed it officially tracks. Adding to the burden are a record 6 million Chinese college graduates who are entering the job market this year.

Jobs Jostle

Demand for work is so high that 5,000 students jostled at a Shanghai employment fair in March for 400 jobs available in the funeral industry. One woman with a management degree applied for a position as a mortician's assistant to "make up the faces of the dead," state media reported. The attraction: It paid 4,000 yuan ($585) a month, equal to what she might have earned in an office job two years ago.

By global standards, China is growing at a brisk pace; its 9 percent expansion in 2008 made it the best performer among the 10 largest economies. Gross domestic product slumped to 6.1 percent in the first quarter of this year, still a world-beating rate as the global recession cut demand for Chinese-made goods. Even as the country's leaders assert themselves on the diplomatic stage, they are preoccupied with keeping a lid on popular discontent as the 20th anniversary of the crackdown on the democracy movement at Tiananmen Square draws near.

'Sensitive Year'

"This is a very sensitive year," says Jimmy Lai, chief executive officer of Hong Kong-based Next Media Ltd., who was banned by the Chinese government from the mainland in 1994 after condemning Beijing's leaders for crushing the democracy movement. "If the economy implodes, the risk of instability is high." Lai, 59, founder of Hong Kong-based clothing retailer Giordano International Ltd., was forced to sell his Giordano shares after China shut down mainland stores in retaliation for his criticism.

As the country's leaders fret about unrest at home, they've stepped up their rhetoric about the economic policies of trading partners in the west such as the U.S., where China has invested some $1.2 trillion, which includes $744 billion in U.S. Treasury bonds. "We lent such huge amounts to the United States, and of course, we're concerned about the security of our assets," Wen said at a press conference in Beijing on March 13. "And to speak truthfully, I am a little bit worried."

China now holds almost $2 trillion in foreign reserves. "The Chinese Communist Party is now the world's most liquid financial institution," says Andy Rothman, a Shanghai-based strategist at CLSA Ltd., the Asian brokerage unit of Credit Agricole SA.

## Chinese Demands

Before the Group of 20 summit meetings in London in April, Chinese officials demanded that western nations strengthen bank supervision and shun protectionism. At the same time, China central bank Governor **Zhou Xiaochuan** proposed a new reserve currency to replace the dollar.

In London, China deployed its economic clout to win a pledge that the International Monetary Fund and World Bank would no longer be dominated by Western leadership in exchange for its $40 billion contribution to the IMF's $1 trillion emergency fund. At the summit, Chinese President **Hu Jintao** also faced down a French demand to target specific tax havens, a move that may have placed China's two autonomous territories, Hong Kong and Macau, in danger of international sanctions. Instead, in a deal personally brokered by U.S. President **Barack Obama**, the G-20 agreed to language criticizing tax avoidance.

## 'China Has Bounced'

The U.S. leader's attentiveness to China's views, which included his pledge to visit Beijing later this year, underscored the wary relationship between the two nations, according to **Eswar Prasad**, a senior fellow at the Washington- based Brookings Institution and a former China division director at the IMF.

"They're jockeying for position," Prasad says. "The U.S. is still the most important economy in the world, but it's by no means the dominant economy it once was."

**Jing Ulrich**, Hong Kong-based head of China equities at JPMorgan Chase & Co., predicts that China, now the world's third-largest economy, will overtake the U.S. as No. 1 in 30 years. For now, investors say, China is helping propel a worldwide recovery with a 4 trillion-yuan stimulus program.

"China has bounced, and I think it's very important," Barclays Plc President **Robert Diamond** said in an interview with Bloomberg News on April 15. "As you look at the numbers -- credit creation, industrial production -- the stimulus is working there."

## Spending Power

On May 6, China's central bank said the economy's performance in the first quarter was better than expected in a published monetary policy report. The bank didn't provide figures for the assertion.

Regardless of when or whether China becomes the world's biggest economy, the new realities of global financial power are already becoming clear, says **Donald Straszheim**, a former Merrill Lynch & Co. chief economist who runs Los Angeles-based Straszheim Global Advisors, a consulting firm for investors in China. "The U.S. and China are the G-2," he says.

To achieve the growth levels needed to expand its factories, clean up its environment and fund a promised social safety net, the government must unleash the spending power of 1.35 billion consumers. Domestic private consumption accounts for just 35 percent of Chinese GDP, about half the rate in the U.S., according to government figures.

## 'My First Pick'

In its new role, China is helping to lead the worldwide effort to reawaken consumer demand, upgrade infrastructure and put people back to work. The country announced its stimulus program in November and has cut interest rates five times since September, to 5.31 percent from 7.47 percent, to spur consumers to buy products and new homes. China's stimulus amounts to the equivalent of $585 billion, compared with the U.S. plan for $787 billion in spending.

The IMF expects China's economy to expand by 6.5 percent this year, compared with the government's target of 8 percent growth. In contrast, the IMF estimates that the global economy may shrink by as much as 1.3 percent in 2009, with U.S. GDP falling by 2.8 percent.

Based on those forecasts, some investors see China as the best growth option this year.

"China's my first pick," says **Mark Mobius**, who oversees $20 billion of emerging-market assets in Singapore for San Mateo, California-based Templeton Asset Management Ltd. "Stocks are cheap on a valuation basis, and China's big stimulus package plus lots of foreign reserves means high GDP growth."

## Currency Wrangle

The country's financial clout may quickly propel it back to strength, says **Nicholas Lardy**, a China specialist at the Washington-based Peterson Institute for International Economics. "China is in a much better position than the U.S. or U.K. or most other advanced economies to come out of the crisis," he says. "It is going to emerge with a bigger global footprint than when it went into it."

To boost the status of the yuan, which isn't convertible, the government has established accords with five nations -- including Argentina, Indonesia and Malaysia -- to let traded goods be paid for in the Chinese currency. The government has also resisted the Obama administration's call for the yuan to rise in value against the dollar to help spur U.S. exports.

"President Obama -- backed by the conclusions of a broad range of economists -- believes that China is manipulating its currency," U.S. Treasury Secretary **Timothy Geithner** said in a written statement at his January confirmation hearing.

Change of Tone

He **backed off that accusation** in an April 15 survey of America's trading partners. "In the current report, Treasury did not find that any major trading partner had manipulated its exchange rate for the purposes of preventing effective balance- of-payments adjustment or to gain unfair competitive advantage," Geithner said in a press release accompanying the survey.

Obama has said the dollar should remain the world's reserve currency. He's also warned that the U.S. can't be relied on to spend its way out of recession. "The world has become accustomed to the United States being a voracious consumer market and the engine that drives a lot of economic growth worldwide," Obama said in London on April 1. "It can't just be the United States as the engine. Everybody is going to have to pick up the pace."

China's government is so eager to get shoppers to spend that it's using subsidies and tax cuts to slash the prices of some 20 consumer products, including cars, motorcycles, computers and mobile phones. In Shanghai and other major cities, local officials are even handing out shopping vouchers. "We need to vigorously expand domestic demand, including consumer demand," Wen told the National People's Congress.

Sales Spur

Those incentives helped drive retail sales up 15 percent in the first quarter. The stimulus will also fund reconstruction efforts following the May 2008 earthquake in Sichuan province that killed almost 70,000 people and left 15 million without homes.

China's communist leaders, steeped in the history of their land, know that their country was the world's biggest economy for almost 2,000 years until the West fully industrialized.

As a result of the Opium Wars of the mid-19th century, a weakened China had to cede territory -- including Hong Kong and Shanghai -- and give trading concessions to colonial powers. From 1933 to 1945, much of the country was occupied by the Japanese. More than a century of humiliation ended in 1949, when **Mao Zedong** climbed atop Beijing's Gate of Heavenly Peace at Tiananmen Square to declare the establishment of the communist People's Republic, although the U.S. continued to recognize the defeated Nationalist government that had retreated to the island of Taiwan.

Starvation

Maoist economic planning proved disastrous. Millions starved during the Great Leap Forward program that began in 1957. The country was plunged into further turmoil during the Cultural Revolution of 1966 to 1976, which targeted urban elites while doing little to modernize what was still a feudal agrarian society.

Following Mao's death in 1976, a new leader, **Deng Xiaoping**, initiated free-market innovations, including special economic zones and a shift away from collective agriculture. In January 1979, seven years after U.S. President **Richard Nixon** opened a dialogue with China, Deng visited Washington. The U.S. abandoned its formal recognition of the Taiwanese government.

Winning Gamble

China's emergence from diplomatic and economic isolation sparked a boom, in which growth averaged 9.9 percent annually from 1978 to 2008. The country was stable enough to use the Asian financial crisis in 1997 and 1998 to shake off state central planning. Deng's successors took the opportunity of a slowing economy to shut down many of China's unprofitable state- owned enterprises.

It was a gamble that paid off even as 46 million Chinese lost their livelihoods in the late 1990s, CLSA's Rothman says. In the past 10 years, an emerging private sector has created some 50 million jobs, says **Liu Yang**, who helps manage $2 billion in Hong Kong for London-based Atlantis Investment Management Ltd. Private companies now account for 70 percent of China's GDP, up from 17 percent in 1990, Rothman says.

Yet China still maintains a great wall protecting its local industries from the full effects of capitalism. Although most big state-owned Chinese companies have issued shares, overseas investors still find themselves blocked from taking over controlling interests in Chinese assets, even after government promises of more-open markets.

Investors Blocked

On March 18, China vetoed Atlanta-based Coca-Cola Co.'s $2.3 billion bid for Beijing-based **China Huiyuan Juice Group** Ltd., a company that accounts for 8.5 percent of fruit and vegetable juice sales in China. At the same time, China's companies are looking for acquisitions, including a $19.5 billion plan by state-owned Aluminum Corp. of China to buy 18 percent of Rio Tinto Group, the world's No. 3 mining company.

Chinese leaders stepped up security measures to be prepared in case activists use the June 4 anniversary of the Tiananmen Square democracy movement to challenge the government. In March, protesters from the Tibetan minority in Qinghai province marked with riots the 50th anniversary of the failed uprising that forced the **Dalai Lama** into exile.

**Howard Wang**, who oversees $12 billion as head of the Greater China team at JPMorgan Chase's JF Asset Management unit in Hong Kong, says there's no chance of another Tiananmen. "Social stability and the stability of the government depend critically on lifting economic livelihood," Wang says. "But China now has a big middle class that has a stake in the stability of China, and that changes the dynamics." More than 300 million people -- almost a quarter of the population -- have been lifted out of poverty since 1978, according to a United Nations estimate.

Corruption, Strikes

The Chinese government has said that about 200 protesters died in the Tiananmen crackdown, although western media and some historians put the death toll at more than 1,000. One legacy of Tiananmen is endemic corruption, says Han Dongfang, a leader of the protests who was jailed for two years and is now a Hong Kong-based labor activist.

"Starting from that night, officials came to believe the Communist Party would not last forever, and they decided to grab what they can while they still had the chance," says Han, 46, founder of the China Labor Bulletin, a worker pressure group. Corruption costs China $86 billion a year, according to the Washington-based Carnegie Endowment for International Peace.

'Enemy' Forces

Even in 2005 during the boom, China had to deal with 87,000 mass protests, according to the Ministry of Public Security. The government-controlled China Daily reported in March that the number of labor disputes had nearly doubled in the aftermath of the economic slump. Now, strikes of more than 1,000 people occur daily in the manufacturing belt of Guangdong province alone, says Han, who conducts Hong Kong-based radio call-in shows carried by Radio Free Asia, a U.S.-funded broadcaster, in which workers discuss mainland labor issues.

Such cross-border activism has been condemned by **Sun Chunlan**, vice chairman of the government-approved All-China Federation of Trade Unions. "We must prevent domestic and foreign enemy government forces from using the troubles facing some enterprises now to infiltrate and destroy the ranks of migrant workers," she said on state television on Feb. 17.

CCTV Sales

China's security concerns are reflected in the manpower of its armed forces. In addition to the People's Liberation Army's 2.3 million members, China also has an 800,000-strong paramilitary force named the People's Armed Police, which is in charge of internal security. In March, China announced a 33 percent rise in security spending this year to the equivalent of $17 billion.

"You must take concrete actions to defend national security, maintain social harmony and stability," Hu told police officers on Jan. 4, according to the official government Web site.

That's helping to keep Yap's New York-listed China Security & Surveillance Technology Inc. profitable. The company's headquarters in Shenzhen, just across the border from Hong Kong, features a control room full of live closed-circuit TV monitors.

Thanks to its "preferred supplier" status for government contracts, CSST's sales jumped 78 percent last year to $426 million. Even so, investors drove the share price down 58 percent to $8.24 in the year ended on May 8.

Spending at home hasn't balanced out the declines in China's exports, which fell 17 percent in March after a record 26 percent slump a month earlier. Unable to sell their shoes, toys and computers overseas, 20,000 of China's small and medium- sized enterprises in Guangdong province closed down last year, a state-owned newspaper reported in February. Nationwide, about 7.5 percent of all such businesses have shut down or suspended production, Industry and Information Minister **Li Yizhong** said in March.

Export Slump

"In Beijing, it's all about control, but China's leaders have got to learn that they have no control over what people spend in Wal-Mart on Chinese-made goods," Straszheim says. "There's a buyers strike in America, and the Chinese have built an economy that's heavily dependent on exports. Now it's coming back to haunt them."

Although modern China may be symbolized by the gleaming towers of Shanghai, 800 million people still live in rural areas, dependent on agriculture and manual labor for employment. As many as 30 million who migrated to the cities have lost their jobs, a government researcher said on April 22. Urban entrepreneurs are making money -- and spending it.

Du Xueqian, CEO of 1ting.com, a Beijing-based music Web site, doesn't need any encouragement to splurge. Last year, Du, 27, earned the equivalent of $440,000, and he says he's spent it all -- including $88,000 on a Mercedes-Benz E280. "I am the answer to the problem," Du says. "I don't save anything."

Money Troubles

Ordinary workers are too nervous to spend so freely. Zhou Chaolan, a ruddy-cheeked mother of two, is one of the migrants who has lost steady work. Six years ago, Zhou, 32, and her husband traveled 14 hours by train and bus from their village in Henan province to Beijing, where she found employment as a domestic helper for a South Korean businessman for 1,800 yuan a month.

Zhou's job ended in January when the businessman went back to Seoul. She has found only part-time work that pays 1,000 yuan a month. Meanwhile, her husband's monthly earnings as a decorator declined to 2,000 yuan from 4,700 yuan as opportunities dried up. Zhou sends money home to support her children and in-laws, who grow rice, wheat and medicinal herbs on a 12-mu (2-acre) farm.

Last year, Zhou took advantage of a 200-yuan government subsidy to buy her first refrigerator for 1,500 yuan, though she doesn't think the family will ever be able to afford a car. "This is the toughest time of my life," she says.

Short-Term Pessimism

Those attitudes won't change until the Chinese people have a social safety net they can rely on, says **Michael Pettis**, a former Wall Street banker who's now a professor of finance at Beijing's Peking University. Pettis, 50, gave up his job as managing director of emerging markets at Bear Stearns Cos. to take the teaching position for less than $40,000 a year. He's also bet some of his savings on China by opening a Beijing nightclub named D-22.

"In the short term, I'm very bearish," Pettis says, dragging on a Zhongnanhai-brand cigarette as **Iggy Pop**'s "Lust for Life" blares out of the club's speakers. "Assuming you put in the world's best Scandinavian-style welfare system tomorrow - - and that's a heroic assumption -- it's going to take three, four or five years."

Student Zhao Shengkui, the son of peasants from impoverished Shaanxi province in western China, agrees that his country is a work in progress.

Ambition on Hold

"When I was in elementary school, buses didn't come to our village because the roads didn't go there," Zhao, 24, says. "Even now, if a child goes to college, that probably means both parents will have to go and work as migrant workers to have enough to support him. Under those circumstances, how is the government going to depend on these people to buy refrigerators and cars?"

The economic crisis means Zhao's career plans are on hold. "I was hoping to get a position in finance, and now there is almost nothing open," says Zhao, who studies at the University of Shanghai for Science and Technology.

In the face of such setbacks, Chinese students display no interest in reprising the Tiananmen protests of 20 years ago. "I was only 3 years old at the time," says Zhou Xiaocui, 23, who's studying for her master's degree in environmental engineering at Beijing Normal University. "It's ancient history. All governments make mistakes." Her friends Sha Bo and Liu Chang, both 21, nod in agreement.

Stock Market Disconnect

As they mull China's future, investors can't rely on China's stock market as a guide to the country's true economic fortunes, says Jin Bei, Beijing-based director general of the Institute of Industrial Economics at the Chinese Academy of Social Sciences. **The Shanghai Stock Exchange Composite Index,** which tracks the performance of companies on the bigger of China's two bourses, lost half of its value in the four years ended in June 2005 at a time when GDP grew at almost 10 percent a year. This year, the index has soared 44 percent to May 8. "The stock market is not much related to the real economy," Jin says.

Building Site

More significant is the performance of China's real estate industry, which provides 10 million jobs, Jin says. Home prices and commercial office rentals have plunged as much as 40 percent in some city centers. Construction is still going ahead full tilt in Pudong, the financial heart of Shanghai. Until 1990, the area was a 580-square-kilometer (224-square-mile) expanse of rice fields, marshes and warehouses. Today, it's home to a business district centered on the 468-meter (1,535-foot) **Oriental Pearl Tower**, which resembles a futuristic Eiffel Tower.

The most spectacular addition to the skyline is the 101- story Shanghai World Financial Center, a bottle-opener-shaped tower that was completed last August. The $1.1 billion SWFC, built by Mori Building Co., Japan's biggest private developer, was still half empty in March, according to the company. Visitors to the building's observation deck can see through its glass-bottomed floor a cleared circle of land marking the spot where an even taller building, the $2.2 billion, government-owned Shanghai Tower, will rise by 2014. A few hundred meters away, the International Finance Center -- backed by the group that built Hong Kong's tallest building -- is already under construction.

Over the next three years, almost 3 million square meters of office space -- the equivalent of 1 1/2 Hong Kong downtowns -- may be added to Shanghai's skyline, according to Colliers International, a Boston-based commercial real estate company.

Big Banks

Even with such overcapacity, China's banks are profitable, solvent and willing to lend. **Industrial & Commercial Bank of China Ltd.**, Bank of China Ltd. and **China Construction Bank Corp.** are now the world's three biggest lenders by market value.

While free-flowing credit is key to China's revival in the short run, the country and its lenders may ultimately pay a high price. Even years after Deng's reforms, China's banks were awash with bad loans because the government directed them to lend billions to insolvent state-owned enterprises. When China wanted to sell bank shares to foreign investors, it transferred toxic assets into companies set up specifically for their disposal and pumped $650 billion into the lenders starting in 1998.

As a result, ICBC was able to slash its nonperforming loans at the end of 2008 to 2.29 percent of the total from 34 percent in 2000. By the end of March, bad loans at domestic Chinese banks averaged 2.04 percent. "They have started to get the banks under control and now they are telling them to go out and lend," the **Brookings Institution's** Prasad says. "We will once again face a resurgence of nonperforming loans unless world demand rises strongly."

Lending Soars

In March, new lending in China soared to 1.89 trillion yuan, a sixfold increase from a year earlier. In the first three months of 2009, Chinese banks loaned businesses and consumers about 5 trillion yuan -- almost meeting the government's credit target for the entire year.

Overseas investors remain optimistic -- especially if they invest in the Hong Kong stock market, where equities trade at a discount compared with their equivalent listings on the mainland's two bourses, in Shanghai and Shenzhen. **The Hang Seng China Enterprises Index,** which charts the biggest Chinese companies listed in Hong Kong, rose 27 percent in the year to May 8 compared with a 3 percent gain in the **Standard & Poor's 500 Index**.

"Even if the Chinese economy grows at only 5 percent, which is most likely, that's still growth," Straszheim says. "It is easily going to be the best-performing economy this year and for many years to come."

The Chinese word for crisis consists of two characters: "wei," which means danger, and "ji," which denotes opportunity. As China's leaders fight the global recession and seek to keep the lid on political unrest, investors are betting that the ji will outweigh the wei.

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