China's economic miracle at a crossroads as Olympics start

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After years of double-digit growth China's economy is at the crossroads, write Richard Spencer in Beijing and Malcolm Moore in Wenzhou

In the yard of Rise Sun Concrete outside Beijing, the trucks are parked up and the mixers are grinding ever slower. China may be in the middle of the biggest construction boom in history, but Rise Sun is no longer part of the action, a victim of pollution controls introduced in a desperate attempt to clear the city's air before the Olympics.

Volunteers walk outside the National Stadium, also known as the Bird's Nest, Beijing
The Olympic construction boom is one of many across China

"We will lose about 1.2 million yuan - about pounds 90,000," says sales manager Xiang Wancheng of his enforced two-month go-slow, and he is not alone: 150 concrete, steel, chemical and other heavy industrial units in Beijing, and hundreds more across northern China, have been forced to close down production for the same reason. Building sites have downed tools, while many other businesses have shut their doors without being told to as the lorries taken off the roads at the same time no longer provide their necessary supplies.

Nor is the rest of China free of the grip of "Olympic restrictions". Bankers trying to visit Shanghai or multinationals looking to buy Chinese products have suddenly found themselves unable to get a visa.

"Lots of my clients used to visit to source their products directly. A letter of recommendation from me was enough," said Richard Turner, vice president of Sino Mark, a consultant to Western buyers. "The trade fairs are empty. Yiwu, the world's biggest wholesale market, has seen sales drop 70 per cent to 80 per cent," he said, adding that it is not just Westerners, but also Russians, Arabs and Africans who are being denied entry.

Long-standing business relationships are being affected by the inability of quality and corporate responsibility inspectors, all-important nowadays to multinational brand names, to get into the country and check suppliers.

These steps come at a difficult time for the Chinese economy. The national export machine, so recently invincible, is shuddering under the weight of America's collapse in consumer confidence, while some look at the massive investment that has accompanied Beijing's ultra-ambitious approach to the Olympic Games - $43bn (£22bn), according to official figures - and assume any such bubble must inevitably burst.

Property prices are already falling, though notoriously unreliable statistics make it hard to say by how much. Even President Hu Jintao felt compelled to admit at a pre-Olympics press conference on Friday that tough times lay ahead.

"Uncertainties and destabilising factors in the international environment are increasing," he said. "China's domestic economy is facing increasing challenges and difficulties."

Too much can be made of the Olympics, of course. Unlike Athens, which saw a post-Olympics slump, Beijing is a small part of a large national economy - estimated at 3 to 4 per cent of overall output. The Olympic construction boom is just one, if the first among equals, of similar building sprees across China. Even if further pollution controls come in, as threatened, the effects will be limited in a national context.

To take just two examples: Shanghai is aping Beijing in its enthusiasm to further redevelop the city in time for the World Expo of 2010, Guangzhou in the south is hosting the Asian Games in 2010 and has taken the opportunity to construct a second central business district.

Total investment in China last year was $1.6 trillion. Beijing's $43bn, over three years, works out at less than 1 per cent of that.

"It's a drop in the ocean," says Stephen Green, head of research for Standard Chartered in Shanghai. "As for the shutdown, people knew and saw it coming. The effect of the Olympics on the overall Chinese economy is zero."

Even for individual businesses like Xiang's, there is reason for optimism. "We increased production 30 per cent in June and July," he said. "Then it will go higher again in October, perhaps 40 or 50 per cent higher than October last year." There is plenty of demand, he said, pointing out that the building sites that are his market which are now falling silent will be up and running again once the Olympics are over.

But there is more at work than just the investment numbers: key also is government decision-making. Like everywhere else in the world, China is caught in a vice between falling economic growth and inflation. It may sound extraordinary in a country currently growing at 10.2 per cent a year, but the leadership is under great pressure to loosen tight monetary controls.

That pressure is coming from its manufacturers. In the face of the credit crunch, the weak dollar, and rising wage costs, factories are shutting down across the industrial heartlands of Guangdong and Zhejiang, south of Shanghai, that have created the Chinese economic miracle.

Export growth fell from highs of more than 30 per cent little over a year ago to 7 per cent in real terms last month. Green says that by next year exports may well actually start falling, and predicts this will shave 2-2.5 per cent off GDP growth, giving readings of well under 9 per cent for next year - his current forecast is 8.6 per cent.

To see this in action, it is only necessary to travel to the coastal city of Wenzhou, in Zhejiang province south of Shanghai. Wenzhou may be a name unknown on the British high street, but in the world of international manufacturing it is legendary. It was here in the late 1970s and 1980s that entrepreneurs began to experiment with new models of ownership that evaded strict controls on private business in post-Mao China. The result was clusters of businesses specialising in low-end production of single items.

Wenzhou is the birthplace of 70 per cent of all the world's cigarette lighters and 60 per cent of the world's buttons. In the same province are the homes of 80 per cent of the world's ties, and 30 per cent of its socks. Wenzhou businessmen have spread across China, taken over textile towns in Italy, and are now to be found across the Middle East.

But suddenly, the city is in crisis. "We have cut our staff from 170 to 100 in the last year," said Zhou Zhaoping, sales manager of Lucheng Huanglong Mite, a clothes manufacturer. "We have seen a 50 per cent drop in our order books." She blamed the higher cost of raw materials, a universal problem, and higher wages, propelled by the need to meet higher inflation. She reckoned that 30 per cent of all businesses in Wenzhou had gone bust in the past couple of years.

Over on the other side of town, the story with cigarette lighters, the very product which made Wenzhou famous, is the same. Half the work stations at Yikang, founded in 1989 and once supplier of between three and four million a year, lay empty this week. Outside in the streets, ex-employees lolled around snooker tables set up on the pavements. Xu Peng, its manager, has cut his workforce from 300 to 100 in two years, saying raw material costs were up more than 30 per cent, wages 15-20 per cent, while the rising yuan was hitting exports.

One extra problem was that in its effort to control inflows of speculative "hot money" into a rising but still not freely tradable currency, the government was imposing extra controls. The export checks have also delayed Xu's cigarette lighters.

The threat of an industrial downturn gives Chinese policy-makers two recurring nightmares. Joblessness, the government believes, equals instability, which is an existential threat to the Communist party.

The long-held mantra is that the economy has to grow by at least 7 per cent every year in order to provide jobs for the millions of new arrivals to the job market.

The second worry is that collapsing businesses will trigger a run on China's opaquely-run state-owned banks. China's unchecked growth in the 1990s led to the build-up of huge bad loans, which eventually had to be bought out by the government.

The exuberant years since China joined the World Trade Organisation in 2001 have seen another enormous pile-up of loans: in theory they have not gone bad at the moment, but the banks could be fragile in the face of any major slow-down.

"How much damage could there be to the banking system?" asks Arthur Kroeber, director of Dragonomics, a China economics consultancy. "The banks are sitting on big profits and can probably ride it out, but it's a risk."

GDP growth of 8-9 per cent might be a figure other countries dream of, but China was getting used to double-digit success. And herein lies the real danger, according to Kroeber. Compared to its neighbours, China's use of bank loan restrictions to tame inflation, currently running at 7.1 per cent, have had some effect.

Yet while food prices may have peaked, underlying inflation still threatens, particularly via the rise in factory gate costs. The long-term danger to the Chinese economy remains that of overheating.

Instead, the government may be tempted to loosen the purse strings too soon.

"The main risk actually is that the government panics too early," Kroeber says. "We used to hear that 7 per cent was a necessary growth rate for China," Mr Kroeber says. "Now it seems to be 9 per cent - the bar has been raised for no good reason?.?.?. They have got wedded to this higher rate. But if they loosen up, the flood gates open to inflationary risk."

Many analysts, including China's own, say consolidation of low-end manufacturing may be just what is needed to improve productivity, send industry higher up the value chain, and maintain China's long-term high growth through another cycle.

Rising wages - and peaking demographics - suggest unemployment may no longer be the problem it once was. "The fact that wages are still rising across the board and migrant workers still do not have any problems finding jobs suggests to us the situation is not as bad as that," said Standard Chartered's Stephen Green in a recent report.

Consolidation is certainly the aim of Zhou Dewen, head of the government's small and medium size enterprise committee for Wenzhou. He believes that the crisis will impel the city's businessmen to turn their attentions to higher-tech, and thus more profitable products, in line with government intentions.

"There are over three million small businesses in Wenzhou, and there is only a small proportion of large businesses," he says, adding that the government wanted the small businesses to consolidate in order to form companies with enough money to invest in their industries' futures. Companies that did not merge would find it increasingly hard to compete and would find no sympathy from the authorities.

"People in Wenzhou are too innovative to allow their companies to go bust. The companies here have £44bn of cash, apart from their fixed assets, which they made during the good years. That money will help them to survive now," he said.

On a national level, $1.8 trillion of foreign exchanges reserves are a similarly healthy cushion.

Nevertheless, the central authorities may already be answering to business. In the same press conference on Friday, Hu said fast growth remained a priority, a comment interpreted by the markets as a sign of government support. At the same time, leaks suggested the lending limits on the state banks would be raised 5 per cent. On Thursday, increases had already been announced in tax rebates to exporters.

There is little doubt that the fundamentals of the Chinese economy remain sound: the miracle will continue, at least for the time being. Although its export, high investment and low consumption rates are disturbingly reminiscent of Japan's once fearsome model: Beijing is still where Tokyo was in the 1960s or 70s, rather than the 1980s turning point. There are still hundreds of millions more people to be accommodated in expanding cities, huge productivity gains to be made: China's productivity is perhaps a tenth of America's.

Yet the speed of change makes the tightrope act tougher. On Beijing's railway stations in recent weeks, streams of migrant workers have been sitting waiting for trains to take them back to their villages across China. Laid off during the shutdown, they fully expect to be back in two months' time. If not, said a Mr Fang from Hubei province, sent home by the construction site where he was building luxury villas for China's new rich, he would try his luck elsewhere. "One thing's for sure," he said. "There's no shortage of building sites in China."

With China now the main driver of world economic growth, we are all depending on him being right.

Source: Telegraph UK

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