**The overblown China factor**

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Since opening up in a big way in the early 1990s, China has made amazing progress on the economic front, thanks mainly to its highly pragmatic, market-friendly policies.

China has emerged as the manufacturing warehouse for the whole world, facilitated by the massive inflows of foreign investment into the country. China has moved up the development ladder rapidly, fuelled by blazing double-digit growth rates.

Its export-led growth strategy has paid handsome dividends. It is already the fourth largest economy in the world and the second largest in Asia. In purchasing-power-parity terms, China has recently replaced Germany as the third largest economy in the world.

But this growth strategy has rendered China's economy vulnerable to external fluctuations, as trade accounts for more than 40 per cent of its gross domestic product (GDP), which is very high for a continental economy.

China is affected by the current global crisis, not only by the slump in external demand for its manufactures, especially in the United States and Europe, but also by its own exposure to the financial meltdown in the US, now that a large chunk of China's vast foreign exchange reserves is shackled to dollar-denominated papers.

The global economic crisis has made huge dents into China's exports, with exports shrinking month after month at the rate of 30-40 per cent year-on-year, in the first half of this year. This has understandably taken a toll on China's growth performance, with GDP growth slowing down to 7-8 per cent from 12-13 per cent previously.

Still, China is not in recession, unlike many other economies. China continues to attract foreign direct investment, while such inflows have dried up for many others. Its external reserves are still growing, recently surpassing the US$ 2 trillion level, despite falling exports, while many others are headed in the opposite direction.

The World Bank has recently upgraded China's growth for this year to 7.2 per cent, up from 5.5 per cent. China posted an even more impressive 7.9 per cent growth in the second quarter.

In short, China is seen as the beacon of hope in these days of gloom and doom. This has led some observes to think China will lead East Asian economic recovery and thereby spearhead a global economic turnaround. But this faith in China as the savior may be misplaced.

China's imports from the rest of East Asia consist mostly of raw materials, intermediate products and components and parts, the bulk of it turned into manufactures for exports. China's imports of consumer products from the region account for no more than a small proportion of the total.

China's imports from its neighbours have plummeted in the wake of the slump in China's own exports, although the Chinese economy is growing at 7-8 per cent, because China depends largely on domestic production for its own consumption, which does not spill over to the rest of the region through trade.

Therefore, China will import more only if it can export more. For this to happen, the demand for China's exports in the US and European markets must first recover.

In other words, the global economic crisis must end where it began, namely the US. A modest three per cent growth in the US would mean a lot more to the global economy, especially the East Asian economies, than double-digit growth in China.

And China cannot possibly grow at double-digit pace until the US economy is completely out of the woods. China cannot substitute the US as the main locomotive for the world economy, even if it were to replace the US as the world's largest economy. Chinese consumption is unlikely to be anywhere near that of the US, even if the Chinese economy were big enough to rival the US$14 trillion American economy.

China is by no means free of woe. Current growth of 7-8 per cent is as painful to China as negative growth is to, say, Japan. In China, one per cent less growth means four million fewer jobs.

Official unemployment numbers conceal massive underemployment and disguised unemployment, especially in the western provinces. Likewise, China's debt-GDP ratio of 18 per cent understates the weight of the debt burden, as it excludes many indirect debt items, such as local government borrowing, debt of state-owned enterprises and bad loans of state-owned financial institutions. All in, the ratio of debt to GDP could exceed 50 per cent.

Fiscal problems are emerging. A fiscal deficit of less than three per cent targeted for this year looks fairly sanguine, but government revenue has fallen by 2.4 per cent in the first half of the year, a far cry from the planned eight per cent increase, while forgiven debt is expected to balloon along with development expenditure.

Some analysts believe that China's 2009 fiscal deficit could soar as high as 10 per cent of GDP.

More worrisome is the bubble in the making, creating the illusion of economic recovery. Some of the fiscal stimulus seems funneled into equities, contributing to China's booming equity markets. There is the danger of asset bubbles being mistaken as harbingers of economic recovery.

The rebound seen in the second quarter was largely attributable to massive government spending from a stimulus package of four trillion yuan (US$ 585 billion), which is to be spread over a two-year period. As investors become addicted to stimulus, they may ask for more, while budget deficits will limit the space for more.

China could become an epicentre of a new crisis if the bubble grows and bursts. This is not to suggest equity market bubbles exist only in China: while stocks in Shanghai were up 85 per cent in the first half, they climbed by 83 per cent and 61 per cent in Jakarta and Mumbai respectively, not necessarily backed by strong fundamentals. It appears that the stocks are running ahead of fundamentals, which is scary.

But stock markets are no substitutes for export markets. Stock indices are not a good barometer of the real sector of the economy. For economic recovery, the real sector must rebound. The signals thus far are pretty mixed, with some reported improvements in industrial production in several countries, including China. What is unclear is whether these are just blips or the beginning of an uptrend.

It is the US, and not China, that can lead the recovery. Indeed, China's own recovery is contingent upon the US recovery in the first place.

China's asset bubbles bursting would be a double whammy for East Asia, in which case China will become a part of the problem rather than the solution.

**Adapted from "China's economic clout may be an illusion", New Straits Times, 19 August 2009**