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## Is China's Boom In Danger?

**In the country's racing economy, overcapacity may soon take its toll**

This is how hot China's economy is: With vehicle sales soaring 30% in the first nine months of this year, executives at appliance maker GD Midea Holding Co. have decided this is an opportunity they can't miss. So Midea is planning to spend up to \$240 million on factories in the southwestern city of Kunming to make trucks and buses. And with passenger car sales up 69% so far this year, Midea is even thinking of making autos -- as are several electronics manufacturers. "China has a big market with abundant demand," says Zhu Yuanlai, a general manager at Midea. "There still is lots of room for development."

China's boom goes way beyond cars and trucks. Local companies are building shopping malls, office buildings, apartments, and suburban housing estates as fast as they can. Governments are hard at work on six-lane expressways, bridges, and tunnels. Factories are ramping up to build ever more refrigerators, cell phones, and DVD players. All of that manufacturing has produced enormous demand for commodities such as steel, aluminum, copper, and zinc, driving world prices to recent highs. As a result of this frenzy of production, China's economy grew at an official 8.5% annual pace for the first three quarters; the actual number may be higher. Investment in fixed assets such as roads and railways, new homes, and factories was up 31.4% according to the National Bureau of Statistics. Foreign investment? Up 30%.

It all sounds like great news for China and the region. So why are economists, and even Beijing officials, worried? China is producing so much so fast that it may prove impossible for the population to absorb it all. Already there are price wars in industries like autos, mobile phones, and auto parts. Excess capacity first. Price wars next. Then a drop in corporate profits and subsequent investment. According to this scenario, China's growth could slow sharply next year, damaging the mainland itself and neighboring countries increasingly dependent on China. And it could hurt manufacturers worldwide if those excess goods get exported.

This possibility is suddenly getting lots of attention. Morgan Stanley issued an Oct. 20 report titled *China Economics: Sharp Slowdown Ahead* that predicts a steep decline in property and metal prices. "Capacity is rising rapidly, but margins are decreasing" frets the report's author, economist Andy Xie. Even the government is raising red flags, accusing local cadres of spending like crazy on new plants and roads -- anything to earn accolades from Beijing. "GDP growth is actually used as a way to evaluate local officials, and that motivates unreasonable investments," warns a September report by China's National Development & Reform Commission.

### TIME TO START WORRYING

The mounting anxiety seems justified. For instance, if the real estate boom in Shanghai and Beijing proves to be a bubble, that could mean a new explosion in bad loans for China's beleaguered banks. Fueled by more than 20% growth in China's money supply, loans in the first half of 2003 exceeded the total granted in all of last year. Also unsettling is China's now-heavy reliance on big-ticket projects. With fixed-asset investment expected to account for more than 40% of gross domestic product this year, it has reached a level well above 1993, when China was forced

to slam the brakes on its racing economy, raising interest rates and ordering tight restrictions on new bank lending. The painful moves successfully curbed inflation and brought overheated property markets under control. The key question on many economists' minds is whether Beijing can pull off a softer landing next year. "This is something the government really needs to start worrying about," says one Beijing-based economist at an international bank.

To be sure, China's affluent class is growing fast. Incomes in urban China are up an average of 8% a year since 1998. That drives up tax revenues that help fund ambitious government projects. And China's huge export-oriented economy serves as an effective safety valve; what can't be consumed domestically can often be shipped overseas. But economists point out that the overcapacity in items such as houses and cheap locally made cars can't be sent to California.

Auto production may be one of the scariest examples of China's overheated local economy. In an alarming report released in September, accounting firm KPMG predicted that China would have capacity to produce 2.7 million cars this year, nearly a million more than its consumers are projected to buy. Excess capacity could grow to 2.3 million cars by 2005. And don't blame the vehicle glut just on wannabes like Midea. Foreign auto makers, including Volkswagen, General Motors ([GM](#)), Honda ([HMC](#)), Nissan ([NSANY](#)), and Toyota, have all recently announced plans to put billions of dollars into new production. On Oct. 17, Ford Motor Co. said it will invest \$1.5 billion in the next few years expanding production in China. But Ford knows the risks. "Just because to date we've enjoyed very big margins in China, along with the other producers, doesn't mean that will last forever," says CEO William C. Ford Jr. when asked about possible overinvestment.

Then there's real estate. Urban China has for years resembled a vast construction site. The pace of building is only increasing -- investment in new real estate projects was up 33% in the first eight months of this year. Some argue the country has such a huge need for new infrastructure that China is far from overbuilding.

But plenty of extravagantly expensive housing and commercial estates stall out after getting only half-built. Take Beijing's Sunny Region development. It was to include a luxury hotel, offices, and a deluxe apartment building with 206 high-end flats complete with special air filters imported from Europe, a massive garden lobby, and a 960-square-yard rooftop pool. Now the developer and investors are bogged down in disputes over what price to sell space for, and it's unclear when it will be finished.

### **LONGSHOT LOANS**

To many analysts, excessive credit and the country's shaky banking system are the main causes for concern. Many of the new loans are going to state-backed projects -- everything from new office buildings to software parks -- in which repayment is anything but sure. Others see not only artificially high prices but also a lending establishment that doesn't know how to assess risk. "Mortgage finance is relatively new in China," says James Hawkey, chief representative of the Beijing office of real estate services company Cushman & Wakefield Premas. "Banks obviously will need to develop more sophisticated ways to manage the credit they give to property developers and individuals."

The pace of construction has actually increased as Beijing has handed off authority for infrastructure development to local officials in recent years. "The government is tremendously decentralized, so local officials have a lot of economic power," says Andy Rothman, China strategist at investment bank CLSA Asia-Pacific Markets. "And everyone wants to have the latest new thing." Midea's investments in Kunming are one example. So are another dozen projects in Yunnan Province funded with billions in loans from local branches of China's state-owned commercial banks. Is all this more than the province can afford? "We know nothing about economic overheating," says an official from the Kunming office of construction and management, part of the Ministry of Construction.

### **TRYING TO CHILL OUT**

Chinese regulators have started taking measures to ice down the overheated parts of the economy. The National

Development & Reform Commission has put new restrictions on factory approvals in recent months. "They are not so concerned about current plants," says Jonathan Woetzel, a director with consultancy McKinsey & Co. in Shanghai. "They are worried about the next wave of capacity that's coming in." Meanwhile, the mandarins of Chinese finance have taken measures to soak up new money supply, and thus cut back lending. On Sept. 21 the People's Bank of China, the central bank, raised bank reserve requirements from 6% to 7% of capital. And the bank announced new regulations on luxury real estate investment in June, including a hike on the required downpayment on loans for high-end developments.

The problem is, the bubble of overcapacity and reckless lending may already be too big to deflate gently. And if the bubble breaks, the pop will be heard around the world.

By Dexter Roberts in Beijing and Frederik Balfour in Hong Kong

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