

Flood of numbers

China's growth figures deserve a healthy dash of skepticism

It was Friday the 13th, and stock images of Chinese construction workers and manufacturers suddenly took over web pages around the globe. The photos accompanied the headline news that China's GDP had slowed to 7.6% in the second quarter, the slowest pace in three years.

The uncertainty this news provoked – that China may be losing its potency as an engine for the sluggish global economy – was compounded by fears that local authorities had “smoothed” (read: distorted) the data. With growth still an important component of officials’ promotions, “adding water,” as the Chinese call it, has a long history in China.

Provincial GDP data is widely recognized as water-logged: In the past five years, the combined figure for the GDP reported by provinces has exceeded the nationwide figure calculated by the National Bureau of Statistics by 5-10%. But now power data, a more reliable economic indicator, was also under question. Just weeks before, *The New York Times* had reported that local officials were coercing power plant managers into under-reporting the slowdown in power consumption.

While some smoothing probably is occurring, all this scrutiny of statistics has overlooked an important factor: China's data is likely subject to far bigger distortions. As Peking University professor Michael Pettis has long argued, because a significant portion of China's wealth has gone into under-performing investments, GDP is very likely overstated – by up to 20%, by some estimates.

Fixed-asset investment (FAI) now accounts for around half of China's GDP. If even a small proportion of current investments turn out to be unprofitable, GDP figures will be revised downward in the future. The process is akin to a bank



ATLAS SHRUGS: The world is watching for signs that China's economy is slowing

pushing off default losses in order to record higher profits today, only to see its debts balloon later.

Beijing's big dig

Unprofitable investments are by no means confined to China. From the LA subway to the rebuilding of Iraq, the pre-construction estimates of a project's costs and benefits often differ wildly from actual post-construction cost and benefits.

Yet bad investment appears to be occurring on an unprecedented scale in China. FAI has accounted for more than 40% of GDP for nine continuous years – a level of investment never before seen in any other country, said Nick Lardy of the Peterson Institute for International Economics. Nearly two-thirds of China's capital stock has sprung into existence since 2003.

The threat is clear to anyone on the ground. China has far too many examples of profligate corporate spending, from an Austrian village constructed by the real estate arm of state-owned company China Minmetals in southern China to

► Silent spring: Why environmental change will come from the bottom-up

“You know, the Chinese people are a lot like crawfish,” quipped Han Han, a celebrity blogger. “They are quite good at enduring hardship and soldiering on. They can live in any kind of environment. But even though they have two claws, they're easy to stab in the back, and powerless to pinch their attackers.”

His musings were inspired by recent protests in Shifang, a city in Sichuan province. On July 2, thousands of local residents took to the streets to protest a planned heavy-metal processing factory, which they feared could pollute groundwater. Police responded with tear gas and stun grenades, injuring at least a dozen

and arresting scores of others.

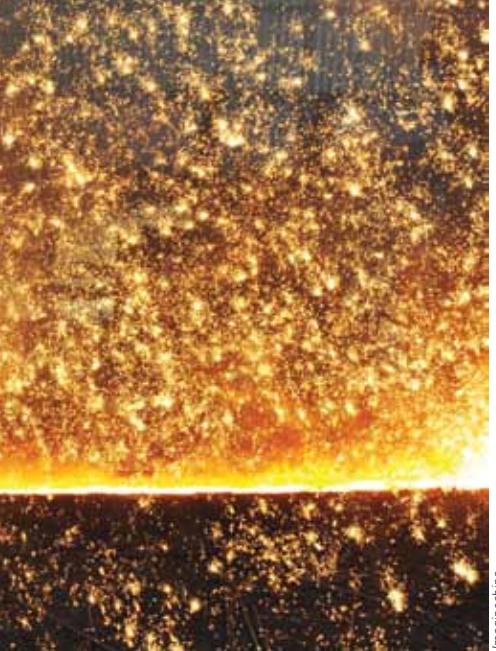
The next day, however, officials suddenly backed down in the face of mounting protests. They cancelled the project and released detained protestors. Like Han Han, many onlookers were shocked at the speed and intensity of the protests, and the sudden government clampdown.

They should not be. In the early 1990s economists developed the theory of the “environmental Kuznets curve.” The idea is that the quality of a poor country's environment follows a U-shape as the economy develops. Nature takes a nosedive as industrialization begins and factories spring up. But when the country reaches

the middle income stage – a GDP per head of at least US\$5-6,000 – the trend stalls and then shifts into reverse.

The logic undergirding the theory is simple: Wealthier people are in a better position to protect their surroundings. Shifang is a prime example of how this works in practice. The decision to build a metal processing plant requires trade-offs. The factory might damage the nearby environment, but it also brings jobs and higher wages for locals.

Thirty years ago, when most Sichuan residents practiced subsistence farming, they might well have taken up the offer. But Sichuanese today, while not rich, are



taking on an unsustainable level of debt from the banks. When this asset bubble burst in the early 1990s, the government took over much of the debt. Twenty years later, Japan has a lower nominal GDP than it did in 1992, and its gross public debt is 200% of GDP.

There's another reason that China's growth may be overstated: the dramatic toll that economic activity has taken on the environment. As Michael Pettis writes, "... it is worth remembering that if an individual earns US\$100, but in so doing destroys US\$100 worth of his own assets, then a strict accounting would say that he earned nothing."

A new report unveiled by the United Nations at the Rio+20 summit in late June illustrates this principle. Under the UN's new "Inclusive Wealth" index, which factors in the cost of externalities such as pollution and environmental resources, China's economy has been growing at 3% annually, rather than a blistering 10%, and still trails Japan as the third largest in the world, roughly on par with Germany.

Cause for alarm

Economists have long counseled Beijing to rebalance its economy away from investment and toward consumption, focusing on the quality rather than quantity of investment. Some argue that government officials appear to recognize this need: When Premier Wen Jiabao called for greater investment to stabilize growth in early July, he emphasized the quality and cost-effectiveness of investment.

Yet Wen was still calling for more

the gilded Versailles-like halls of Harbin Pharmaceuticals' headquarters.

This issue of **CHINA ECONOMIC REVIEW** includes several other cautionary tales: Our cover story (pg 30) examines the inefficient use of capital among state-owned enterprises, including Citic Pacific's massive iron mine in Western Australia. Our review of James Fallows' new book, "China Airborne," (page 26) also provides an example of how local actors persuade officials to undertake bad investments in the name of growth. The threat of projects such as these, of course, is that while they are recorded as growth today, their losses will result in lower GDP later, as the cost of servicing huge debts dissuades banks, companies or the government from further investment.

This is the reason for Japan's "lost decade." Japan's blistering growth in the 1980s was fueled by the corporate sector

certainly in a better position to be choosy. They opted for a cleaner environment, even if it meant forgoing a few more jobs.

Pinching back

Of course, residents of most Chinese cities don't decide such things, officials do. But the Shifang protests – like strikingly similar protests to close a paraxylene plant in Dalian last year – are important because they are a barometer of public opinion. Few officials will ignore the overwhelming (and uncensored) support for protestors online. Fewer still will fail to notice that Beijing sacked the local party secretary of Shifang immediately after the protests. That should encourage other local officials to compromise on environmental issues, rather than

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risk a protest that could end their careers.

According to the Kuznets curve theory, change comes about almost imperceptibly. Behind-the-scenes negotiations in towns across China will incrementally affect mundane decisions, from where to place a new railroad to how often to clean the local river. But the bottom-up push for a cleaner

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investment. As the economy slows, the government appears to be losing motivation to rebalance. China's central bank has carried out two interest rate cuts within one month, and new bank loans jumped 16% in June. The value of the yuan against the dollar has also weakened in recent weeks, helping to support export businesses but punishing consumers.

This is cause for alarm. China must make room for slower, better-quality growth and investment. Of course, there are painful consequences to slowing growth. Local governments are struggling to make ends meet, and property developers are exhausting methods to evade bankruptcy. Yet by propping up growth with excess investment, Beijing will only invite a more painful reckoning.

Some non-performing investments are clearly the result of honest mistakes and the inherent uncertainties of prediction. But many more are due to a system that places undue emphasis on local officials' ability to generate GDP. Until this incentive structure changes, observers should be aware that some of China's economic bulk may just be excess water weight.♦

environment will be pervasive and unrelenting. It is therefore preferable to the headline-grabbing, but easily corrupted, top-down environmental policies championed by bureaucrats in Beijing – the sort that failed to protect the residents of Shifang in 2008, when an earthquake destroyed two chemical plants and forced the evacuation of thousands.

Some economists go so far as to argue that the best way for activists to protect poor-country environments is to throw out tree-hugging legislation entirely and focus instead on growing the economy as quickly as possible. China's leaders have been cultivating just such a policy, for different reasons. They may now be reaping an unexpected harvest.♦