

Chinese dragon feels the heat

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Does the Chinese dragon need to take a cold bath? Recent data releases suggest that the risk of overheating is there. China's inflation rate reached a 10-year high of 5.6 per cent in July, prompting hawkish noises from the central bank. A growing trade surplus also masked strong growth in imports in July, up 27 per cent year on year. Yet the real risks spring from the fact that the Chinese economy looks hopelessly unbalanced.

The inflation spike itself looks manageable. Blame an epidemic in the pig population, and so high pork prices, for some of it. Indeed, leaving aside the admittedly important food sector, inflation is less than 1 per cent a year. The import surge, too, can be partly blamed on high oil prices; oil imports were up 39 per cent year on year in July. It is part of the Chinese problem: so large is the economy these days that everything it imports becomes more expensive while everything it exports becomes cheaper.

As the Chinese economy becomes ever more market-oriented, the old command-and-control tools wielded by the authorities become ever less effective. Interest rates cannot rise without sucking yet more capital into a country drowning in it, while quantitative controls on bank lending have led to all the clumsy distortions one would expect.

Cheap capital, subsidised energy, lax bank lending to state enterprises and – thanks to the largesse of eager local authorities – free land, have all played their part in skewing China's economy towards capital-intensive industry. This is perverse. China's prime policy anxiety is jobs for the rural masses and the growing urban underclass, but capital-intensive industries create few such jobs. They also consume scarce natural resources.

All the while, Chinese households are earning derisory income on their savings, and in rural, inland areas poverty remains widespread. The Asian Development Bank was right when it recently fretted about China's income distribution, the most unequal in Asia alongside Nepal's.

The policy prescriptions are well known: a more realistic price for energy and for capital; reform of the state enterprise sector and restructuring of the banks; eventual liberalisation of the capital account. Some sort of social safety net is going to be essential, too, if any of that is to work. Simply to read the list, though, is to realise how complex and interconnected China's policy challenges have become. China's growth has been, arguably, the biggest economic success story of all time. But the next chapters may contain a twist or two.

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