

An intimidating but brittle colossus

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Published: October 9 2007 08:48 | Last updated: October 9 2007 08:48

The 2008 Olympics has been billed as the biggest coming out party in history, delivering a stage on which China can reclaim recognition as one of the world's great and powerful nations. But in truth, the Olympics will simply provide a high-grade political gloss for a nation that has already well and truly returned to a position of pivotal global influence.

After nearly three decades of uninterrupted economic expansion, and five straight years of double-digit-plus increases in output, China has become a motor of growth for the global economy and is on the verge of becoming the largest trading nation in the world.

The reconstruction of its cities and the building of new ones to absorb millions of rural migrants each year has translated into a huge demand for resources, lifting global prices for commodities such as copper, nickel and iron ore.

China is also staking its claim to the management and ownership of global resources, striking deals in central Asia, Australia, and, most controversially, in Africa, where state companies have been backed by concessional loans from Chinese development banks.

Chinese technology, telecommunications and shipbuilding industries are striving to compete on the world stage. They are laying the ground for a stronger indigenous military capability, delivering not just the ability to mount a decisive attack on Taiwan, but also, eventually, to project power into south-east Asia and the Indian ocean with a blue-water navy.

Although consumption continues to grow more slowly than investment and exports, China has also become the most promising new market in decades for a host of multinationals – from carmakers to fast-food companies and industrial goods suppliers.

China's transformation has been backed with a relentless and, for the most part, highly effective diplomacy, which embraces international institutions and global multinationals, even as it tries to leverage them for domestic interests.

Beijing's position on the United Nations Security Council has ensured that it has become an indispensable, if not always enthusiastic, partner for Washington, carrying messages to North Korea, and to a lesser extent, Burma, and cautiously moving in tandem with the west on issues such as Iran. At the same time, China has been willing to defend robustly its interests in places such as Africa, remaining loyal to the regimes in Sudan and Zimbabwe, despite mounting criticism from many western governments and activists.

Business criticism of Beijing in the US and Europe has been relatively muted, largely because of the huge investments of multinationals in China and the growth they foresee in the market. But the downside of high speed economic growth has seen China set other, less enviable records. Even with an economy that is a quarter to one-fifth the size of the US, China is set to surpass the US this year as the world's biggest emitter of greenhouse gases, largely because of a surge of investment in capital- and energy-intensive industries since 2000.

The cost of China's headlong growth is evident across the country in the biting air pollution in the cities, and the factory waste that has damaged agricultural land and rivers. The fruits of China's growth have also not been evenly shared. China is now more "unequal" than the US and Russia, according to a recent study by the Asian Development Bank. It is a galling achievement for a country that claims to be still "in the early stages of socialism", and has been identified as a big political problem by Hu Jintao, the president.

Even some statistics cited as signs of strength, such as the country's bulging foreign exchange reserves, which stood at \$1,400bn at the end of August, are increasingly a sign of weakness, and a millstone around the government's neck.

China's decision to manage tightly its currency, the renminbi, means it has no choice as to its level of foreign reserves. The dollars coming into the country have to be bought by the central bank to keep the renminbi basically stable.

With the trade surplus running at about \$25bn a month, the reserves have been swelling rapidly, and for the most part earning a relatively paltry return in low-yielding securities overseas. Over time, as the US dollar declines, China will inevitably suffer huge losses on reserve holdings.

China's refusal to allow its currency to appreciate faster remains difficult to fathom. A stronger currency would help damp rising inflation and capital inflows, and provide reduced incentives for exporters – a stated aim of government policy.

But caution, a byword in financial reform, and the need for consensus among powerful ministries, continues to stay the hand of policymakers. So too, according to many critics of the government, does the weakness of Wen Jiabao, the premier, who seems incapable of putting his personal stamp on financial and economic policy.

China is attempting to encourage an outflow of capital, and has also established a sovereign investment agency to chase higher returns for a portion of its reserves, but neither measure will be able to stem the tide of incoming funds for the moment.

All in all, a China that can look intimidatingly powerful from the outside can equally seem dangerously brittle when examined up close.

Senior Chinese officials offer a similar mixture of confidence and trepidation in interviews. Liu Mingkang, chairman of the China Banking Regulatory Commission, has presided over a generational reform of the country's big state banks, but says "their progress is very initial and sometimes very superficial".

China's development model, and the struggle of the government to change it, also puts Beijing on a potential collision course with the US and Europe. The European Union, to which exports have been growing at twice the rate of sales to the US this year, has taken over as China's largest trading partner.

The current account surplus is set to reach 12 per cent this year, a level unheard of for a country of China's size and weight in the global economy. Guo Shuqing, a former central bank vice-governor who now heads China Construction Bank, says the problem is not external imbalances, in the form of the current account surplus, but "the internal imbalances".

"Although it is under-reported in several areas, consumption is too low, particularly in education, medical care and other areas, like financial services," he says. "Government-financed public services are too small, especially compared with the growth rate." If the US economy continues to slow, there are few other countries in the world that could make up for the demand that America generates in the world economy. Without China stepping up to the plate, any global downturn would be steeper and longer.

The Chinese supertanker, however, continues to change direction at a frustratingly slow pace, according to not just the benchmarks set by its trading partners, but also those mandated by the central government. Without an acceleration of policy change, a nasty collision may be just over the horizon.

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