

## The Perils of Success and Excess: Is China's Economy Overheated?\*

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Siva Yam, CPA, CFA (Any comments? [sivayam@usccc.org](mailto:sivayam@usccc.org) or tel: 312-368-9030)

The report on China's economic growth continues to be on the upbeat note. It accelerated at its fastest in more than a decade with 11.3 per cent growth in the second quarter over the same period a year earlier. It was propelled by record trade surplus; rapid, uncontrolled expansion in capital investments; and unstoppable rise in real estate value. Just like an old Chinese saying, "Mr. Cai lost his horse, but it might be the best thing that had happened for him;" the celebration of the accelerated growth in China's economy in recent months needs to be reevaluated.

The continued excessive investment and rapid credit growth have created an excess capacity in the manufacturing sector. In the last five years, I have visited over 350 factories in China. Not a single one that I visited was operating on a three shift schedule, and most of them admitted that they were operating at well below 50% capacity. Yet, I was so amazed to see that, in my return visit to some of those factories, they continued to expand including the construction of new, large facilities. Without any doubt, China's economic growth has created genuine wealth for many people not just in China but in other parts of the world. However, the continued growth could have a backfire effect on China's economy. This will ripple through to Japan and Korea, which have become very much reliant on China. It is paramount that the perils of China's success and excess are well understood and managed properly.

For those who travel frequently to China, they could probably appreciate the meaning of grand scale in almost everything ranging from dinner banquets to infrastructure projects. China will be the home of the world's tallest building, longest bridge, and largest dam.

China is the only country in the history of mankind that has achieved an envious growth in such a large scale in such a short period of time. The growth was primarily

driven by a seemingly unlimited supply of low cost labor, huge capital investments and reinvestments, and the aggressiveness in attracting foreign direct investments, initially from the overseas Chinese. The growth is further fueled by the eagerness of the financial institutions to lend to those who have hard assets, particularly land. The continued rise in real estate value has allowed many companies to leverage their operations for insatiable growth. The excess in growth is partially the result of the Chinese culture, but ironically it is also the tool for survival. If factories do not expand, they seem to be on a faster track to fall. However, these are potentially dangerous because:

- *Excess capacity has created cut throat competition in the manufacturing sector. Hence, many factories are forced to sell at or even below cost to keep their factories running. (Anti-dumping cases are filed against Chinese exports based on: (a) Chinese are selling below cost; and (b) China is not a market economy. Ironically, Chinese are selling at or below cost because of market force.)*
- *To keep their factories in operation, many of them manufacture goods that do not have a ready market. This is a poor utilization and waste of resources.*
- *An artificial redistribution and a widening gap of wealth have favored those who have access to real property, raw materials, and energy sources. These create social tension and will possibly result in social unrest.*
- *Many Chinese manufacturers will face financial distress in five to ten years. The effect will ripple through to the financial institutions which have lent relentlessly in favor of real*

*estate speculation and capital expansion.*

- *The emphasis on real property and equipment has created a speculative culture. Insufficient investments have been channeled to innovation, product development, intellectual property rights and intangibles, which have a longer term of horizon but are essential for long term success.*

The problem is that without continued capital expansion, China will face an impossible task in keeping its most capable 1.3 billion people gainfully employed. However, with its continued unchecked rapid capital expansion, it will face a more dreadful challenge in 10 years.