

## China may yet be the economy to lose sleep over

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Given the highly vulnerable state of the US and European economies, what would happen to global growth if the Chinese juggernaut also started sputtering? Few investors or policymakers seem to be seriously contemplating this scenario.

China's remarkable resilience to both the 2001 global recession and the 1997-98 Asian financial crisis has convinced almost everyone that another year of double-digit growth is all but inevitable. In fact, the odds of a significant growth recession in China - at least one year of sub-6 per cent growth - during the next couple of years are 50:50. With Chinese inflation spiking, notable backpedalling on market reforms and falling export demand, 2008 could be particularly challenging.

True, reality has consistently flattened China forecasters who are anything less than ebullient. With 11.4 per cent growth in 2007 and the Olympics coming up this summer, why should 2008 be different? With all due respect to the extraordinary recent performance of China's managers, the country faces economic, financial, social and political landmines just like any other emerging market, with epic environmental problems to boot. And, throughout history, no emerging market has escaped bouts of crisis indefinitely.

Inflation of more than 6 per cent is the immediate problem. Those who think inflation is caused by too little pork rather than too much money are wrong. China's relatively pegged exchange rate system has led the authorities to flood the economy with renminbi. Rampant money supply growth is the flipside of the country's \$1,400bn accumulation of foreign currency reserves. The real surprise is that inflation did not sprout earlier.

The authorities must stuff the inflation genie back in the bottle. It is not going to be easy in an economy where highly controlled financial markets render normal instruments of monetary control relatively ineffective.

Until now, China has avoided this problem, as millions of idle farm workers moved to the cities, keeping wages in check. But as many of the most able workers have already migrated, the challenge of filling China's burgeoning factories is intensifying.

Protectionism is another growing risk. With income and wealth inequality rising throughout the developed world, politicians may start lashing out at China with trade sanctions on automobile parts, steel, paper products and, of course, textiles. China's explosive export growth has made it far more vulnerable to a fall in exports than it was during the 2001 global recession.

Perhaps the greatest threat to China's expansion, however, comes from pressures created by its own exploding inequality levels. According to World Bank statistics, income inequality in China has leapfrogged that of the US and Russia, which is no small feat. Rising inequality is placing enormous strains on the political system, as is evident from a recent sequence of ill-considered policies that have been aimed at mitigating the problem. The government's recent attempt to fight food inflation by using price controls is a highly conspicuous example.

But so, too, is the dubious new labour law which, at least on paper, prevents companies from firing workers with 10 years or more experience. It is as if China hopes to transform itself into France. Indeed, the greatest danger to China's economy is that, after years of market-oriented reform, the country's leadership seems to be losing faith in markets and adopting policies such as rationing that turn back the clock to old-style communist days. With rising inflation, bloated investment and a soft global economy, now is hardly the time for China to make its system more inflexible. Historically, emerging markets get into trouble when policy reform is moving backwards at the same time as an economic or financial crisis is starting to unfold. Rather than try to deal with inequality by labour market fiat, the government would do better to improve the social safety net through provision of more and better healthcare and pensions.

Rather than deal with inflation through price caps, China should accelerate exchange-rate appreciation, thereby reining in money growth. If China were to slow dramatically, while growth in Europe and the US was still weak, recent low global interest rates, high commodity prices and strong global growth would be history. Global policymakers and investors who are losing sleep over US growth ought to pay more attention to rising risks coming from the other side of the globe.

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