What soft landing means in China

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The economic situation in China has been steadily improving. Growth and inflation rates have peaked, bank deposits continue to climb, trade deficit is narrowing, while foreign exchange reserve rises to historical high. And all these despite major taxation and monetary reform initiatives in an overheated environment.

These are no minor achievements. Yet it is not time for congratulations. To say the economy has already soft landed is certainly an exaggeration.

The plane is making an approach to the airport and there are few reasons to worry about a crash. But turbulence may still cause nasty bumps as it descends.

Moreover, given the urge to expand economically in almost every quarter, which has only been temporarily repressed, another take-off is so easy. Transit passengers may not have enough time to retrieve their luggage.

Recently I had dinner with a good friend who works in a leading Japanese brokerage firm. Knowing I put my bet on a soft landing of the Chinese economy, he half-jokingly pronounced: "I don't think there'll be any landing at all---hard or soft!"

I lost some sleep pondering his statement, but concluded it at best reminded us that the Chinese economy operates in an unusual mode transcending old thinking.

Any economy has a limit within which it can grow. Vice Premier Zhu Rongji has criticized leading Chinese economists who neglect this basic economic principle and spread one-sided views about "harmless inflation". I take it as a sign that top officials are serious about "landing", whatever it means.

Now that even the World Bank has openly supported the soft landing prediction, I could indulge in a bit of lateral thinking.

We were in a highland county in northern Sichuan in late June, after ten hours of bumpy ride from Chengdu, the provincial capital. Cash-strapped officials of a town of 20,000 said frankly they could not afford to buy us a dinner. I responded by inviting them to a feast. After rounds of hot foods and fiery alcohol, we saw in the adjacent stores abundant supplies of "Lux" soap, cup noodles and imported white wine.

Down the street, a mini-cinema was showing an allegedly category-III Hong Kong film called "The Temptation of Sex". An embarrassed official told us they had tried to stop things like that, but were "humiliated". None of us bothered to ask how and why.

The next day we drove past some of the most barren landscape of China. Suddenly in a village which grew little more than red pepper, a huge satellite dish stood above a humble-looking hut. Then came a familiar poster: "To get rich, build and upgrade roads first!" We on our battered Toyota could not agree more. Around the corner, two tractors were busily working.

Back in Chengdu, my optimism about the Chinese economy increased by leaps and bounds, not necessarily because of the secure feelings of solid ground. The economic driving force seems so pervasive. Even the folks in the distant highland know they must reform and connect with the outside world.

Pockets of prosperity have already spread far, albeit rather unevenly. Some farmers do riot, but the demonstrative effect of reforms, partially helped by satellite TV and containing objectionable elements, proves very powerful.

China has entered a new era of economic activism. It is difficult to calm such a restless economy, particularly at levels regarded as safe by conventional wisdom.

Economic growth in the 1980s was driven by consumer goods and processing industries. Now infrastructure construction and heavy industries have taken over as the locomotive.

Every week comes news of ambitious plans on ports, energy plants, or telecommunications facilities involving staggering amounts of funds. Even the villagers in northern Sichuan understand they have to build roads. Future historians may judge the infrastructural upgrading of China in 1992-2010 as phenomenal, surpassing the relative scales of the Great Wall, the Pyramids, the American railways or the Marshall Plan for Europe.

Annual economic growth averaged 9% in the 1980s in China. There is little reason why it should not be 10% or more in the 1990s, given the much stronger backward and forward linkage effects of infrastructure and heavy industries.

There are no doubt huge risks. China is in severe capital shortage compared to its needs. Uneven performance and distribution pose serious problems. And nobody is very confident about the post-Deng era. A sudden global financial squeeze or political disturbance could de-rail the whole thing.

In any case, one has to be careful when talking about a "landing" of the Chinese economy. To some, landing at 10% GDP growth is like trying to anchor on the top of windy Mount Everest. That is their own gravitational problem.

China is also tackling the most difficult aspects of her economic reform. Frictions are bound to increase. Tax reforms would inevitably lead to price hikes no matter what the government says and does. Bailing out unemployed workers may necessitate printing money. Inflation cannot be low either.

China has entered a new era of "high growth, high inflation, and big reforms". It is struggling with an "inflation-unemployment-reform" triangle, rather than the conventional "Phillips Curve" (unemployment-inflation trade-off) of a market economy.

The peak of present economic cycle came around the first quarter of 1994. Both the GDP growth rate and inflation have since come down.

Real GDP in the first half grew by 11.6% over the same period of last year. The rate was a further dip to the 12.7% for the first 4 months. Barring significant relaxation in government policies, a year-on-year rate of 10% may be achieved by late 1994 or early 1995.

Inflation has also cooled, but the picture is mixed. Retail inflation remains uncomfortably high. Nation-wide retail prices and consumer prices in 35 major cities were up by 19.8% and 22.7% respectively in the first half, compared with 20.2% and 24.7% in the first quarter.

The dips were less than optimists had hoped for. Indeed, June saw some renewed inflationary pressure, because of agricultural price adjustments, the floods and a regained momentum in retail sales and the state sector. Industrial output of state-owned enterprises grew by 7.91% in

June, compared with 2.2% in the first quarter. Selective credit injection by the monetary authority, which partly went into wage payments, was the major factor.

But producer inflation is much more subdued. Average prices of producer goods rose by 15.8% in January, 10.3% in February, 5.2% in March, and 0.4% in April. They remained stagnant in May. Prices of many items, including iron and wooden materials, actually dropped quite markedly.

The trend reflected the dip in investment expansion. In the first six months of 1994, total investment in fixed assets was up 25.2%, with investment by the state-owned sector rising 37.5%. These were a far cry from the 70% growth witnessed in the first half of last year, although the decline adjusted for inflation was less impressive.

China is caught in a combination of stubborn consumer inflation and rapidly alleviating producer inflation. Further down the road, the situation should improve as producer prices are a leading indicator to prices consumer pay. The key is that the government can control investment.

But other factors are also at work. The culprits for unrelenting retail inflation have been the prices of food, and to lesser extent, clothing, housing and services. Payments on food represent 48.5% of the total expenditure of a typical urban household, while clothing, housing and services account for 14.1%, 6.3% and 4.7% respectively. In May, food inflation was 27.4%, compared with the 18.9% hike in average retail price.

Retail inflation has been a cost that China has to pay to pacify her irritated farmers. Procurement prices for agricultural products particularly grain have been raised substantially this year.

Retailers are tempted to pass the burden to buyers, despite price caps by Beijing. Many consumer markets in China are still far from competitive, the country's "fair trade act" notwithstanding.

But the government seems determined to put the squeeze on the commercial sector. Shanghai, which saw 20% plus inflation and a negative growth in retail sales volume in the first six months, has just announced a ceiling on vegetable prices.

The taxation and foreign exchange reforms have also been inflationary, as sellers used the excuses of the VAT and the unification of the dual rates to put up prices. Such behavior would however have only a one-off impact. Comes 1995 there should be little detectable effect on year-on-year inflation rates.

In this tug of war, retail inflation would head south more slowly than one hopes. But both urban and rural incomes in real terms have grown handsomely, and deposits keep on rising. The danger of open class warfare seems remote.

A gradual decline in nominal benefits and consumer prices that does not seriously erode real earnings can be engineered. I think chances are high that we can see a year-on-year retail inflation of 12% in early 1995, unless the government chooses to substantially mark up agricultural prices again.

An economist from the World Bank told me earlier this year that the Chinese economy could live with 10% GDP growth and 10% inflation in the 1990s. I would venture to suggest an alternative combination 10% growth and 12% price increases.

Effective microeconomic reforms, particularly for state enterprises and the labour market, may reduce inflationary pressure. But those depend on systemic rather than cyclical measures, and take years to have real effects.

Overall, if China continues to keep investment under a lid as it has done in the past nine months, I am confident about a soft landing around 1994-95. My only proviso is a plea to understand what "soft" means in a hyper-active Chinese economy.

**An edited version of this piece must have appeared some time on the SCMP in late 1994. Unfortunately I've forgotten the exact date and lost the version.*