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China is spending nearly \$1 trillion to revive its economy. Will it work? John Garnaut reports from Wenzhou City, Zhejiang.

Wenzhou, the heartland of Chinese capitalism, is once again fighting for its survival. The city was famously forsaken by Maoist China but it stayed alive and later thrived by building one of the most entrepreneurial and dynamic marketplaces on the planet.



Map showing Zhejiang, Wenzhou, Shanghai

Wenzhou's manufacturers used to battle

against the Communist Party's efforts to control them. Now, as China's export markets collapse and they are forced to turn inland, they are fighting against the market itself.

"We had more than 1000 workers but now we are down to about 700. The rest have bolted home," says Shi Oubing, whose Triangular Cow factory made about 3million of the billion shoes produced last year in Wenzhou, a city ringed by mountains on the coast of Zhejiang province, south of Shanghai. "After another month, another half will leave and we'll just have 300 and most of them will be managers - they can sweep the floors and look after the dog," he said. "You journalists are always writing about the peasants having to go home, but where do we go? Wenzhou now is an empty city."

The story is similarly bleak in many of Wenzhou's factories, which together boast of making 90 per cent of the world's cigarette lighters, a third of all sunglasses and a sizeable chunk of the world's razors, padlocks and colored pens.



The gritty city of Wenzhou

Millions of migrant workers who had been supporting tens of millions of relatives in the Chinese countryside are returning home. China's phenomenal urbanization and industrialization has temporarily reversed.

"Our factory makes speedometers for motorbikes but half of us have left," says Deng Shoushui, a 41-year-old migrant worker, as he waits at Wenzhou station with his wife and a sack containing their doona and a wok. They are returning to neighboring Jiangxi province, where they used to own a small plot of land before village leaders redistributed it to the peasants who stayed around.



Migrant worker has lunch in Wenzhou

"I'll wait until my brother phones to say Wenzhou has recovered and then I'll check it out again in the new year," Deng says.

The Chinese economy was important to the world a year ago, when all the major regions were firing. Now it is just about the only hope.

If China grows at 8 or 9 percent, as the central bank governor Zhou Xiaochuan says it will, then China will contribute more than half of total global growth next year when measured at market exchange rates. That proportion is even greater if the purchasing power parity measure is used to take account of China's relatively low prices.

Most analysts thought the Chinese leadership would wait for an important economics work committee meeting later this month before injecting money into the system. But the data were heading south too fast for that. On Sunday night, the State Council unveiled the single biggest fiscal rescue package in global history, with a headline value of 4 trillion yuan (\$871 billion).

Australian Prime Minister, Kevin Rudd, saw parallels with the Asian financial crisis, when the Chinese Government kept the nation occupied (and helped Australia avoid recession) by laying nearly 200,000 kilometers of roads and freeways across the country.

Rudd told the ABC on Thursday: "China also, I believe, is acting not just in its national interest but has also realized that if it ... adds to growth in its own economy, it helps the wider region and it helps the global economy as well - as China did after the 1998 Asian financial crisis."

On Monday, after the Chinese announced the

stimulus package, the world's battered investors enjoyed a rare moment of optimism. Markets surged across Asia.

But the week wore on and the flow of data from China went from bad to alarming. By Thursday, investors had folded themselves back into their crash positions and the Australian sharemarket swooned to a new four-year low.

Exports were gradually slowing in October, as expected, but imports fell so suddenly that China still managed to post the world's largest-ever monthly trade surplus of \$US35 billion.

"Exports are holding up better than domestic demand, despite a global downturn," says Wang Tao, an economist at UBS.

Retail spending and inflation were also shown to be slowing faster than expected. And on Thursday, China's bureau of statistics said industrial production growth - the single biggest driver of the five-year resources boom - has suffered its sharpest decline in at least 17 years. The growth rate in cement production - keep in mind that China produces half of the world's output - fell from 26 per cent in March to 1 per cent in October. In steel - China produces nearly two-fifths of the world's output - annual production growth fell from 12 per cent in March to negative 17 per cent in October. Production of whitegoods and cars is also falling.

Incredibly, growth in electricity production - which some economists use as a quick proxy for GDP - collapsed from 17 per cent in the year to March to 4 per cent in the year to October. The November figures will be far worse because the top five power companies only began slashing production in the last two weeks of October, according to industry insiders. Among other things, this means global

demand for coal - Australia's most important export - is collapsing and prices will soon follow. Declining building activity suggests the industrial downturn will get worse before it improves.

China's construction sector and the heavy industries that supply it are clearly in a savage recession. Millions of workers are being laid off. Real estate prices are falling, commodity prices are tumbling, and consumers and investors are running for cover.

All this is happening while the official figures suggest that the decline in export growth has only just begun.

If forward orders are any guide, the growth in export volumes will fall from 10 per cent in the year to October to below zero in the early months of next year.

Zhou Dewen, at the Wenzhou Business Association, says the city's factory owners have greater fortitude than those who are shown on TV to be fleeing from Guangdong. He estimates 20 per cent of local manufacturers are in trouble and 80 per cent are OK.

But a local businessman, Shou Minghuan, whose sunglasses factory has closed four of its five production lines, says it's the other way around.

"This is a recession," Shou says. "Wenzhou people are all face but now they're really poor. In the past few years they've gambled all their savings on the stock market and property, and they've lost."

Shou says the Government is "foolish" to suggest shifting from exports to domestic

customers, even if China's domestic consumers had money to spend. "I'm not game to do business with Chinese businessmen, because they don't pay," he says.

The market, it seems, has judged that the Chinese Government's enormous fiscal resources are not enough to save China, let alone the world.

Analysts pointed out that the Chinese stimulus package was so vague that it was impossible to tell what money was new and what was already spent. Morgan Stanley cut its China growth forecast. Others noted that exports are now twice as important to GDP growth as they were 10 years ago, and that no amount of Government assistance can restore the country's export markets.

Many analysts, particularly outside mainland China, said rapid privatization means that China is a vastly different enterprise to what it was 10 years ago. They said the Chinese Government no longer had the power to override the business cycle.

"Capitalist China will prove exceptionally difficult to control," wrote CLSA in a research note. "Even assuming that government spending is able to add 2 to 3 percentage points to GDP, we would be surprised if GDP growth much exceeded 5 percent in 2009."

But perhaps the world has overestimated how far China has evolved towards a private market economy - and therefore it has underestimated the power of the Communist Party to cushion the fall of the world economy.

Even in Wenzhou, birthplace of Chinese capitalism, the most successful entrepreneurs

are not as independent as they seem. Li Anlian boasts that she started with just 5000 yuan and a backyard assembly line in the late 1980s and has risen to become one of China's free-market success stories. Last year, earnings at her Juyi shoe and property company exceeded 2 billion yuan.

Her company's most important market, Germany, was revealed yesterday to be in recession. But management is taking the financial and economic crisis in its stride.

"We raised production in September and October and we have switched our focus from overseas to domestic markets," says Qi Yinong, vice-general manager of Juyi's shoe operations. "The Government is helping us to expand."

Juyi is a well-run enterprise, but no successful Chinese entrepreneur can display such confidence without earning the patronage of the gatekeepers of China's land, finance, labor and government largesse. These patrons are prominently exhibited throughout the elaborate corridors of Juyi's corporate headquarters.

Some photos show Ms Li and her son with local government officials. One shows her touring Germany with President Hu Jintao and another has her with President Hu's anointed successor, Xi Jinping. In one corridor is a life-size photo of Li's son holding the Olympic flame. It is an unmistakable sign of favor to be trusted with the "Sacred Flame".

More surprisingly, at least to a foreign observer, the company has a luxurious Communist Party Members Room, which is lined with portraits of Karl Marx, Friedrich Engels, Vladimir Lenin, Joseph Stalin, Mao Zedong and Deng Xiaoping. The large

character caption reads: "The Communist Party of China is the Core Power that Leads Us."

The room, like the banners proclaiming President Hu's "Harmonious Society", is a shrine of corporate loyalty to the party rather than any indication of ideological bent. Ultimately, loyalty is shown at times of crisis. And now, facing an economic crisis and massive unemployment, the Communist Party's leadership is signaling to all tiers of government and all varieties of enterprise that it is time to spend, spend and spend.

Juyi has been following the Government's long-standing instructions to switch to domestic markets, upgrade technology and consolidate. After this week's encouragement, they are accelerating plans to build a huge factory in the neighboring Jiangxi province where labor is cheaper and it is more convenient to supply domestic consumers.

Juyi's enthusiasm hints at the central leadership's vast power to shape the economy, even in a capitalist bastion like Wenzhou. Elsewhere, the levers of control are more direct. The Government can spend the money directly. Or it can lean on the executives of large state-owned companies, who are all appointed by the Communist Party's personnel departments and who account for one-fifth of China's GDP.

Huang Yiping, Citigroup's chief economist for Asia, believes some analysts have vastly underestimated the Chinese Government's ability to command the economy, including its capacity to increase the supply and discount the price of land, labor, credit and natural resources.

"We should not underestimate the Government's ability to

mobilize resources to support growth," he says. "Its ability has probably strengthened compared with 10 years ago during the East Asian financial crisis."

China's GDP growth rate dipped below the Government's self-imposed minimum of 8 per cent during the Asian financial crisis, in 1998 and 1999. But Huang reels of a list of reasons why the Government won't fall short this time.

Since then, Government revenue has doubled to 21 per cent of GDP, state sector profits have quadrupled to 23 per cent of GDP, non-performing bank loans have shrunk by 75 per cent and foreign exchange reserves have swollen 13-fold to \$US1.9 trillion. China's bank deposits now stand at 150 per cent of GDP - which is similar to the ratios of household debt in English-speaking Western countries.

Chinese banks, enterprises and households have money to burn - and the Government can lean on them to burn it. Private banking channels considered illegal last week are suddenly patriotic. Governments are bailing out distressed companies everywhere. Local Governments are dusting off their shopping lists and banks are being directed to finance them.

On Monday morning, hours after the State Council published its 4-trillion-yuan stimulus press release, the Guangdong Government announced plans to spend more than \$US40 billion on a new round of rail and other infrastructure projects. The Herald understands that a large Guangdong bank received instructions to provide the money that very afternoon.

While Western analysts were estimating that

only about a third of the State Council's promised 4 trillion yuan would be fresh money, local media saying the announcement will trigger 5trillion, 6trillion or even 10 trillion yuan of new investment at all levels of Government. These figures are vastly exaggerated but the phenomenon is real. The Chinese Government will spend, command and ultimately persuade the economy to grow - because it thinks its life depends on it.

Perhaps the best analogy is not the 1998 Asian financial crisis but Deng Xiaoping's famous "southern tour" of 1992. Deng didn't promise any new money and he didn't say very much. But by touring the market-focused factory lands of Guangdong he signaled to entrepreneurs that China was reopening for business after the political and ideological mayhem that followed the Tiananmen massacre of 1989.

Wenzhou's economy had plunged with the political temperature, with GDP growth hitting close to zero in both 1990 and 1991. After Deng's tour in early 1992, conservative local ideologues were replaced, private banking controls were loosened and entrepreneurs came back out into the open. Wenzhou's economic growth rate soared to 18 per cent in 1992, 31 per cent in 1993 and 42 per cent in 1994 - with hardly a penny of central Government spending.

Wenzhou is now too big to grow that fast again and its export markets are too sick. But many of China's business leaders can now see a way through.

"The Government's macro control policy has made most enterprises see hope," says Zhou Dwen, the Wenzhou business association head. "It will mean that private [underground] banking will be legalized, taxes

are cut, demand will be restored and China's small and medium businesses will survive."

II Informal lending threatens China's financial stability

Chinese regulators have no idea how to control private lending.

Huang Weijian says he is not an underground banker or even a private banker. Normal bankers make money from interest payments and lose money at times of financial crisis. But Huang makes his biggest profits when borrowers go bust.

"We are Wenzhou's first true venture capital company," he says, sprawling on his office couch, with his neon blue skivvy and designer jeans shining through the fog from his cigarette. "What we do is put money into banks and let the banks lend to companies," says Huang, who intends to invest a billion yuan (\$226 million) this year. "If they repay the loan in time, that's fine, but if they don't, we acquire them. We target companies that are about to go bankrupt but still have a good economic foundation - we like firms to run out of money so they become ours."

In all its infinite variety, and despite 20 years of sporadic Communist Party campaigns to stamp it out, the informal banking system remains the lifeblood of entrepreneurial China.

While the state-controlled banks tend to confine their lending to state-controlled firms and friends of the local Communist Party

secretary, informal creditors take great risks to supply credit to small businesses that deserve it.

Chinese regulators and analysts are mostly confident that the state-controlled banks are strong enough to withstand the global financial crisis. But they are sweating over informal banks, which they can't see. They know informal money has pumped up the share and housing markets and also the "unexplained capital flows" column of China's balance of payments data, but they have no idea how to quantify or control it.

"Private banking is often enforced by standover men," says Zhu Qiren, director of Peking University's prestigious China Centre for Economic Research. "A lot of that money didn't go towards production. It went into the sharemarket, pushing the index from 1000 to 6000. That is the problem."

More precisely, many regulators and analysts believe the collapse of the share and property markets might imply that private lenders are in trouble, posing a major threat to the Chinese financial system.

But in Wenzhou, the centre of what is probably the world's largest informal finance network, it seems the private lenders are more than capable of looking after themselves.

Wenzhou's webs of private lending are held together by a gentleman's code. Borrowers are introduced and implicitly guaranteed by friends and relatives.

Huang Weijin (who puts his special "venture capital" lending arrangements into a separate conceptual category) explains why local

business people would rather lose their lives than default on a private loan.

"I can fly to Europe or Africa with only 300 yuan because other Wenzhou businessmen will look after me. They drive to Germany from Italy to pick me up, and I would do the same. "It doesn't matter if you lose money. But if you lose trust, you lose everything."

Those bonds of business kinship, extending across China and the global Wenzhou diaspora, are far stronger than the contracts that bind borrowers to faceless state-owned banks.

"It's more secure than a state-controlled bank because if someone doesn't repay they have no place to play in Wenzhou any more," says Zhou Dewen, who heads the Wenzhou Small and Medium Enterprise Development Association.

Zhou says private interest rates are sometimes 10 times the official lending rate, but the quantity of informal credit nevertheless ballooned earlier this year when the central bank closed official lending channels. More recently, he says, local bank deposits have swelled to 200 billion yuan as Wenzhou business people have cashed in their real estate and sharemarket investments.

"Wenzhou people are full of strategies and know when to take risk and when to take a low profile," he says.

It is the state-controlled banks that regulators should be worried about. In recent years the state banks have been cleaning up their non-performing loans and risk management systems. They have accumulated fat capital reserves, thanks to their privileged official

status and regular government bail-outs. Now they're going to need it.

A week ago the central government abandoned its five-year effort to clean up bank balance sheets by ordering them to open their vaults to save the economy. Officials at all tiers of government promptly scrambled to order local branch officers to fund ill-conceived infrastructure projects and bail out officially sanctioned businesses that had gone bad.

The recent experience of Shaoxing County, a few hours drive from Wenzhou in Zhejiang province, foreshadows what will soon be occurring across the country.

On October 20, Chen Yueliang, deputy major of Shaoxing, told a news conference attended by local bankers that efforts to overhaul four favored textiles companies "should be accelerated, regardless of cost. The Government will be responsible for any problems that emerge in the restructuring progress."

Private bankers accounted for about one-third of their debts, according to *Caijing* (Finance) magazine. Those loans are non-negotiable. But the state banks were ordered to keep the businesses alive.

While the informal banks protect themselves, the state banks are being forced to act as a tool of macro-economic policy and local government cronyism.

The state banks will power the economy through the current economic crisis, fuelling ever-greater economic imbalances and postponing the financial system account for another day.

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