Deflation accelerates further opening of Chinese economy

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20 September 1999

A major factor in the negotiations being held last week on Chinese membership of the World Trade Organisation is the continuing deterioration of the country's economy. The August issue of the *China Financial & Economic Times*, published by the Ministry of Finance, was the first official organ to state that China is in recession. Referring to it as “slight”, the journal cites declines in energy consumption, falls in the volume of goods transported and the existence of 15 million urban unemployed—nearly triple the official figure of 5.7 million.

Other indices point to a more serious state of affairs. China is the victim of the same global deflationary pressures, reflected in over-capacity and unsold stock, which produced the Asian economic meltdown of 1997-98. Much of China's output, which doubled in the 1990s, is now surplus to the requirements of a contracted world market.

Over-capacity affects 80 percent of industrial, consumer and agricultural commodities. Goods churned out on the expectation of export opportunities and expanding domestic demand have not been sold. In the case of cotton, textile mills in some provinces are holding 18 months of supply and do not need this year's harvest. Over-capacity has seen consumer price indexes fall for 22 consecutive months and unemployment soar as firms scale back production.

This year the Chinese economy is expected to record its first decline in exports since 1983. Low demand and increased competition from Asia, a 50 percent drop in exports to Russia, and a fall in European orders have caused exports to fall 2.8 percent in the first seven months of 1999. The only major export market still holding up is the United States.

The frenzied construction of new factories, offices, hotels, roads, power plants and real estate along the entire Chinese east coast—all predicated on a continuation of the growth that saw China's exports increase from US$62 billion in 1990 to US$183 billion in 1998—has stopped. The real estate market is now so over-supplied that Shanghai, Beijing and Shenzhen have enough office space to meet present levels of demand for the next five years.

With imports soaring by 16.6 percent, China's US$30.9 billion trade surplus in 1998 is expected to drop to less than US$20 billion this year. Any rupture in consumer demand in the US will send China toward a balance of trade deficit.

The decline in exports has impacted on foreign direct investment. For the first seven months of 1999, investment fell 10 percent to US$21.49 billion. Further falls are anticipated from an expected downturn of the US economy.

A recent survey in Shanghai found that half of the foreign-invested enterprises, particularly smaller firms, were losing money. Throughout China, 40 percent of 150,000 foreign companies are making losses. In July this year the government allowed former employees of foreign and privately owned companies to claim unemployment benefits, an indication of widespread layoffs.

Doubts about China's economic future have triggered capital flight. A World Bank report released last month estimates that capital outflows in 1998 soared to $US71 billion, up from $US44 billion in 1997. The report warns that capital flight may reach $US68 billion in 1999 and similar levels the following year, causing large balance of payments deficits.

China is not as vulnerable to capital flight as other Asian economies were in 1997-98. It currently holds US$150 billion in foreign currency reserves—the second highest amount in the world after Japan—and still receives the largest flow of foreign direct investment of any developing country. An ongoing decline in these reserves, however, will create enormous pressure for a devaluation of the yuan, China's currency.

It has been estimated that the yuan would have to be devalued by 25 to 30 percent in order to restore export growth rates to pre-1998 levels. The Chinese government has been reluctant to pursue such a course of action.

Much of China's exports are in the processing trade, where raw materials, components or unfinished goods are imported into the country for final assembly and re-export. This activity amounted to US$104.5 billion, or 56.9 percent of China's total exports in 1998. Imports to supply the processing trade made up 48.9 percent of the national total or US$68.6 billion. It is debatable whether a devaluation, which would raise import costs, would assist or hurt such trade.

Of greater concern, however, is the impact devaluation would have on China's most fundamental economic malaise—the level of bad debt within the financial sector, especially the dominant state banks.

Moody's credit rating agency estimates that China's state

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banks have over US$180 billion in non-performing loans, or 20 percent of total lending. Other estimates place the figure as high as 30 percent. The primary source of the non-performing loans is the state-owned enterprises.

By the mid-1980s, most of China's state-owned enterprises, by international standards, were suffering from technological backwardness and low productivity of labour. They consumed ever growing and unsustainable proportions of national investment.

Throughout the 1990s, the Chinese government, using a combination of state banking funds and various economic regulations, has attempted to restructure and modernise the state-owned enterprises into profitable corporations. While the entry of foreign capital into China has been actively sought and facilitated, the state-owned enterprises have been protected from international competition. Production by foreign companies is predominantly for export with strict controls on domestic sales. Privately-owned Chinese companies were not granted export licenses until 1999, in order to protect export opportunities for state firms.

The banks have extended billions of dollars in loans to state-owned enterprises to finance mergers, factory re-tooling, and the wage payments to millions of workers sent home by redundant industries but unable to find alternative employment. Up to 30 million jobs have been eliminated and thousands of firms amalgamated into larger conglomerates or bankrupted. Last year alone, six million jobs were lost and 40,000 enterprises merged or bankrupted. Over seven million jobs will be cut this year.

Despite the years of radical restructuring, a third of China's state-owned enterprises are still unprofitable and the government target of eliminating losses by next year will not be met. In order to continue financing this restructuring, China's banks have been forced to borrow internationally in foreign currency-denominated loans but receive virtually all revenue in yuan. The danger of a devaluation, which would increase servicing costs on foreign denominated loans, is that some Chinese banks would be unable to meet debt obligations.

Even if the yuan is not devalued, the potential for a financial crisis is acute. Interest rates have been cut in the last three years from 9 percent to 2.25 percent to stimulate consumer spending. This has squeezed bank margins, already under pressure from the increasing number of state enterprises unable to maintain loan repayments. This month the Hong Kong arm of the Bank of China announced a 46 percent fall in profit, with mainland non-performing loans increasing from 1.96 percent to 8.26 percent of its total lending.

The ability of the state banking system to finance economic restructuring has reached its limit. A credit crunch is now developing as banks become more reluctant to extend loans, except to the safest of customers—the largest state companies backed by the government. Investment by China's new class of entrepreneurs and capitalists has fallen, as have the number of employees in China's 30 million private businesses. News articles are appearing complaining about the difficulty that this sector of the economy has obtaining credit.

The central government is attempting to stave off economic depression by means of unprecedented levels of budget deficit spending and last year launched a US$24.3 billion infrastructure-spending program. But fixed asset investment by the state, which was almost entirely responsible for China's 7.8 percent economic growth percent last year, has now exhausted its impact. After pushing economic growth to 9 percent for the last quarter of 1998, growth fell back to 8.3 percent in the first quarter and 7.1 percent for April-June 1999. Fixed asset investment figures for July plummeted to 3.1 percent, compared to 11.3 percent for the first half of the year.

Another $US7 billion government infrastructure program has been announced but such policy measures are unsustainable. Government debt is rising rapidly and interest payments on loans make up a growing proportion of the national budget.

An attempt to deal with the weight of bad debt held by the banks is being made through the proposed transfer of up to US$100 billion in debts from the banks to four asset management companies, in return for equity shares in the indebted companies. The plan is that the asset management companies will then sell the equity—a de-facto form of privatisation.

The question that looms over China's policy makers is where to obtain the capital needed to buy this equity, or required by profitable Chinese firms for expansion. Increasingly, the only possible sources are international, be they transnational companies, banks or stock markets. China is being driven toward opening its financial system to international penetration, its state-owned enterprises to foreign ownership, and its domestic market to foreign competition. This is at the heart of China's striving for WTO membership.

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