Analysts warn China on verge of economic crisis

John Chan
18 February 2004

The year has opened with warnings that China is lurching toward a major economic crisis that will inevitably have far-reaching global ramifications. While the Chinese regime is hailing the country's 9.1 percent economic growth last year, analysts are noting that the growth itself has produced the type of overcapacity and rampant speculation that has characterised other economies before they experienced a severe slump.

The *New York Times*, for example, warned on January 18: "As 2004 begins, China's economy looks as invincible as the Japanese, South East Asian and American economies of those earlier times. But recent excess—from the frenzy of factory construction to speculative inflows of cash to soaring growth in bank loans—suggest that China may be in a bubble now, especially on the investment side of the economy."

Over the last decade, China's combination of plentiful low-cost labour and a currency pegged to the US dollar has kept commodities manufactured in China cheap and competitive. This has enabled the country to become world's primary destination for foreign direct investment, attracting $US53 billion last year. Driven by a desire to maximise profit and corporate dividends, the feverish trend to invest in China has spawned a number of serious problems.

The explosive growth of China's export and industrial capacity has far outstripped market demands. According to a study in the December issue of the US-based *Foreign Affairs* magazine, China's fixed asset investment grew 31 percent in the first half of 2003, almost triple the growth rate in 2000, but household consumption grew only by 8.8 percent to 10.1 percent in the same period.

China's huge export sector, which is largely run by foreign-invested firms, increased 35 percent to $430 billion last year, with total foreign trade soaring to $840 billion—the fourth largest in the world. Industrial production increased 17 percent, the highest since 1995. Last year China produced 35 percent of the world's cellular phones, 40 percent of its colour TVs and 55 percent of the world's computer monitors.

The market, economists have warned, ultimately cannot absorb this production. The *New York Times* commented: "In fact, so many factories have been built that in industry after industry, from washing machines to cell phones, production capacity far exceeds domestic demand. Exports have not entirely absorbed the differences, so prices have plunged.... Business executives and economists often complain that factories are built with little attention to whether similar plants are being constructed elsewhere, or to how low prices will fall if all of them start churning out the same products at the same time."

The World Bank's investment arm, the International Finance Corporation, has stopped financing China's manufacturing sector, declaring it is "already over-invested."

The rapid growth is stretching China's infrastructure to breaking point. Electricity generation, for example, is seriously lagging behind demand, with a shortage of at least 40 gigawatts—the amount of energy required to run Australia. In Shanghai, many manufacturers were ordered to switch to night-time production during December in order to ease the strain on power system.

The fear is that the overcapacity will trigger deflationary price falls in many industries, slashing into profitability and causing firms to go bankrupt. China's auto industry for example, had undergone a huge expansion due to investments by the transnational car companies, reaching an annual production capacity of 2.8 million vehicles. Only 1.8 million are actually sold, however. Similar conditions exist in other industries such as steel and cement.

Under conditions where the export boom from China has become one of the main growth engines for other East Asian economies, an economic slowdown in China would be socially and politically devastating for the region as a whole.

The total exports from the rest of Asia to China—more than half of which is for reprocessing—grew from $72.1 billion in 1995 to $160 billion in 2002. A fall in demand from China would particularly impact on the South East Asian countries, which still have high unemployment and have not fully recovered from the Asian financial crisis in 1997-98.

A crisis in China could also trigger far more serious global financial turbulence. China has become one of the largest purchasers of US bonds over the past decade, playing an ever-greater role in assisting the US finance its gargantuan trade deficit. East Asian countries, including Japan and China, now hold $1.7 trillion in foreign exchange reserves, including half of all US government securities.

In an article entitled "China-US: double bubbles in danger of colliding", the *Asia Times* commented on January 22 that the two interdependent "growth engines" of world economy were potentially heading into problems. "If the US economy sinks and Americans stop buying Chinese goods, then it will compound the US slump as China first stops buying US bonds that have inflated the American bubble and then moves on to selling them. On the other hand, if the Chinese economy falters and it stops recycling dollars into the US economy, then the boom stops anyway," it wrote.

A potential trigger for such a scenario is the protectionist measures being advocated in the US against Chinese goods. Both Democrats and Republicans in the lead-up to the US election have demagogically declared that American unemployment is due to cheap labour competition from China. In the last three months, the Bush administration, motivated by short-term electoral calculations, has imposed trade sanctions on a number of Chinese import categories such as textiles, colour televisions and furniture.

Pressure is also being applied by US politicians and trade union officials for a revaluation of the Chinese currency, the yuan, which would make Chinese exports more expensive. The anticipation that China will ultimately back down to the US demands has fueled a speculative inflow of capital into China, with investors buying up yuan-denominated assets in the expectation their value will be increased by a revaluation.

The increased demand for yuan has caused an excessive growth of money supply and credit in China, fueling a real estate bubble in the country's major cities. According to official statistics, investment in real estate reached $99.82 billion in the first 11 months of 2003, an increase of 32.5 percent. The irrationality of the property boom is demonstrated by the fact that at the end of November, vacant commercial building space exceeded 100 million square metres, an increase of 6.5 percent.

Like the periods preceding the Asian crisis in 1997-98 and the collapse of high tech stock bubble in the US in 2000, speculative investment is vastly inflating stock and property prices. So while manufacturing experiences deflation, the stock market and property sector are experiencing inflationary pressures. The initial public offering (IPO) of shares in Hong Kong by China Green Holding, an exporter of vegetables, for instance, generated 1,600 times more buy offers than were available for sale—the most oversubscribed IPO ever in Hong Kong's history. The share price of the virtually unknown company has soared astronomically.

Both economists and government officials have repeatedly warned that such speculative investments will fail to make a return. The inevitable collapse in stock market and property values will place even greater pressure on China's financial system, which is already believed to be burdened with anywhere between $384 billion to $864 billion in non-performing loans. But little is being done to prevent the looming crisis.

The ratio of bad loans to lending on the books of China's four largest banks has fallen since the government transferred some $US170 billion worth of debt to asset-management companies in 1998-1999. The banks were injected with $32 billion in fresh capital and bank governance reforms were implemented. In December, the Chinese government provided another $45 billion to two of the banks—the China Construction Bank and the Bank of China—to boost their capital base.

Last year, however, the banks increased lending by 21.4 percent to finance the property market boom. There are fears that if, or when, the real estate bubble collapses, the number of borrowers unable to pay back the banks will once again soar.

The January issue of the *Far East Economic Review* outlined a blunt list of "must do's" for the Chinese banks. It declared the primary objective of banking reform had to be to "cut off loans made to state firms for political reasons." In other words, to stop giving loans to state-owned companies that provide their employees with healthcare, education and other limited services—a measure that will fuel China's already acute social tensions.

With uncertainty growing about China's economic prospects, some analysts are beginning to pay serious attention to the immense social inequality in the country and the fact Chinese workers and farmers are likely to respond to any downturn with protests and political unrest. While a minority of government officials and businessmen have benefited from the growth of the last decade, the vast majority of China's population have not.

The Singapore-based *Strait Times* warned on January 27 that explosive internal social contradictions have built up behind the economic growth. "Since most growth activities are concentrated in areas along the coastal regions and selective pockets in the interior, they have not managed to narrow China's regional development gaps or reduce rural-urban income disparities, or ameliorate the plight of the rural poor," it wrote.

"More seriously, China's unemployment remains high, with the 'registered unemployment rate' (which does not include new layoffs from state-owned enterprises in urban areas) recently increasing to 4.7 percent from 4 percent in 2002."

More than 40 million workers have been laid-off by state-owned industries since the late 1990s. According to a report by the *China Daily* in mid-January, the further "restructuring" of state-owned enterprises will cost three million jobs every year until 2006. A February report by Xinhua, the official news agency, indicated that 400 large state-owned companies in north-eastern China alone would be bankrupted over the next three years.

Both urban and rural incomes are stagnating or declining due to the intense competition for jobs. The economy of Guangdong province, China's major export zone, for example, has grown by more than 10 percent annually in last decade, but factory workers, most of whom are migrants from rural areas, still earned an average of $50-70 a month. This is the same level as 1993 but it buys far less today.

The *New York Times* warned on January 18: "Nobody knows how harmful a sharp economic slowdown would be to China, a country undergoing huge social changes, like the migration of peasants to the cities. The Communist Party rests its legitimacy on delivering consistent annual increases in prosperity... if the economy slows sharply, political instability could follow. That would be a serious problem, not just for China, but also for the rest of the world."

The *Times* did not explain what it meant by "political instability". The implication, however, is clear. With a large proportion of world manufacturing production dependent on the ruthless exploitation of Chinese workers, mass unrest against the Beijing dictatorship, particularly under conditions where the numerical size and social weight of China's working class is far greater than in May-June 1989, would be seen in US ruling circles as a risk to the stability of global capitalism.