Inflation, manufacturing contraction and property bubble haunts Chinese government

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Recent figures on the Chinese economy demolish claims that the country's rapid growth would allow it to "decouple" from the US financial crisis. In fact, an emergency meeting of the Chinese Communist Party (CCP) Politburo on July 25 called for urgent action to combat slowing growth, rising inflation and a serious decline in exports to US and European markets.

A statement issued after the meeting declared: "China is facing increasing challenges in maintaining fast and stable economic growth amid growing international uncertainties and domestic economic difficulties."

In the second quarter of 2008 China's gross domestic product (GDP) growth rate slowed to 10.1 percent, down from 11.9 percent for the whole of 2007. Year-on-year based export growth also fell sharply in June to 17.6 percent, compared to 28.1 percent in May. The consumer price index (CPI) rose 7.1 percent in June—down from a decade high of 8.7 percent in February. However, the producer price index hit 8.8 percent, raising fears that it will be translated into higher CPI in the second half of the year.

Analysts have pointed out that Beijing's emphasis on the economy just two weeks before the Olympic Games indicated the seriousness of the situation. The Politburo meeting also marked a shift from its previous stress over recent years on attempting to control economic "overheating" and high rates of growth.

According to the *South China Morning Post*, the Politburo meeting was held after fact-finding tours by top CCP leaders to China's economic growth centres; where local officials have complained bitterly about weak export markets, increasing raw material costs and the rising value of the yuan against the US dollar.

The Guangdong economy grew 10.7 percent in the first half of the year—3.6 percent lower than a year ago. Some 2,331 shoe factories have closed in the first five months of the year with many firms relocating to low-cost production centres in Vietnam and India. Shanghai grew 10.3 percent, down 2.7 percent from 2007. In Zhejiang, 20 percent of the private firms in two leading manufacturing-export cities, Wenzhou and Yiwu, have stopped production.

The situation in eastern Zhejiang province typifies the manufacturing crisis. In the first five months of the year, nearly one fifth of local firms reported losses due to higher interest rates and the rising costs of raw materials and transport. With an average profit margin of just 4.3 percent, 90 percent of exporters can only tolerate yuan appreciation of less than 5 percent. The yuan, however, has appreciated 6.56 percent against the dollar since the beginning of 2008.

The Shanghai-based *Oriental Morning Post* reported on June 19 that the province's "Wenzhou model", once hailed as an example of China's export miracle, is struggling, with 60,000 firms in the province or 20 percent of the total now on the verge of bankruptcy. The *Post* pointed out that local enterprises have focussed on expanding their volumes and trimming margins to undercut competition at the expense of developing their own technology. Most are family-run businesses, often developed by well-off peasants. These poorly-educated factory owners, who are reluctant to accept modern management methods, are the most vulnerable to sudden economic changes.

Small and medium enterprises have also been particularly hard hit by the tight monetary policies to fight inflation, such as restrictions on bank lending. Commenting on the decline of manufacturing output, Xing Ziqiang, an economist with China International Capital Corp, the country's largest investment bank, told Bloomberg: "The size of the slowdown is unexpected. The government may use a more active fiscal policy, slowing gains by the yuan, and encourage lending to small companies."

Such pro-growth measures, however, are likely to compound inflation problems, as a weak yuan will increase imported raw material costs, such as oil and iron ore, which are priced in US dollars. A more active fiscal policy, such as increasing state investment in infrastructure projects will stimulate growth, but also add to the inflationary pressure.

President Hu Jintao has singled out inflation as China's biggest challenge, reflecting the CCP leadership's fear of its explosive political implications. Some new studies estimate that in 1989, high inflation propelled 100 million people, mainly urban workers, into anti-government protests throughout China. The movement was only ended with the brutal military suppression of mass protests in Tiananmen Square. Under conditions where the working class has grown exponentially since 1989, Beijing is fearful that social unrest will erupt again on a far broader scale.

China's industrial expansion in recent years has been fuelled by the debt-driven consumption in the US. During this boom President Hu called for a transition to a Chinese economy based on increased domestic consumption and the creation of world-class Chinese corporations in place of low-tech, labour-intensive assembly line production. Beijing leaders complained that huge exports were causing trade tensions with the US and EU and

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suggested that the most polluting industries should be cut to save the environment. A labour-contract law was enacted in January requiring employers to provide more stable long-term employment and other benefits for workers.

With major export markets in US, Europe and Japan in trouble, these promises are in question. Chinese businesses are now pressuring Beijing to reverse cuts on tax rebates on exports, slow down the yuan appreciation against the dollar and scrap the new labour law. In fact, the labour law is coming into direct conflict with the flexible "hire and fire" principle in export production cycles and has already been flouted by many businesses. It is now possible that the legislation will be completely scrapped in order to preserve China's status as the premier sweatshop of the world.

Beijing has already raised the tax rebates on exports of textiles and garments from 11 percent to 13 percent on August 1. The Peoples Bank of China also told commercial banks that it was loosening its tight control of lending and would intervene to slow the yuan's rise in order to protect the export industry.

Zhang Yansheng, senior economist at the National Development and Reform Commission, told Reuters that the strong yuan policy, which began with the abolition of the peg of the yuan against the dollar in 2005, was coming to an end. "Over the past few years, expectations for yuan appreciation have been based on economic growth and a huge trade surplus. The fundamental situation facing China's economy and trade has now changed and so will expectations for currency policy and exchange rates," he said.

Although China's 9-plus percent annual growth rate is still high by world standards, it is not enough to achieve Beijing's aim of creating 10-20 million jobs per year in order to prevent rising unemployment and maintain social stability.

The financial magazine *Caijing* noted on July 21 that China faced serious employment distress this year with a record number of college graduates (5.59 million), a series of natural disasters including the Sichuan earthquake in May, closures of state-owned enterprises, generally low skills of the workforce—which no longer meet the demands of business—and growing global economic uncertainties.

Caijing also pointed out that rising productivity was leading to a declining capacity to generate jobs. From 2001-2005, the average annual number of new jobs created was 560,000 less than from 1996-2000, even though the average annual growth rate in the earlier period was one percent slower. China is expected to only create 40 million new jobs by 2010, compared to an estimate rise of 50 million in the urban workforce. The "surplus" workers will join the existing large army of the unemployed.

Already, as part of a four-year program, more than 2,000 indebted state enterprises will declare bankruptcy this year and lay off large numbers of workers. The largest state-run oil giant, China National Petroleum Corp (CNPC), announced in July that it will cut 5 percent of its total workforce or 83,500 jobs after posting a 39 percent decline in pre-tax profit in the first half of the year. The losses were produced by the fact that domestic fuel prices are capped amid surging global oil prices.

On top of the manufacturing crisis there is growing financial instability. The declining US dollar is driving a flood of speculative "hot money" into China, especially the property markets. Speculators, who lack confidence in the US financial markets, are betting on a further appreciation of the yuan and inflationary pressures forcing the Chinese central bank to lift interest rates. The country's foreign currency reserves reached $1.81 trillion by June, up from $1.53 trillion in March. Economists have warned that a large proportion of the increase ($200 billion in the first five months, according to one estimate) is speculative capital.

Beijing has instructed banks to tighten mortgage lending after the US government bailed out two housing mortgage giants, Fannie Mae and Freddie Mac, in July. There are concerns that China's housing market is in danger of meltdown. By the end of June, average property prices in China's 70 largest cities were up 12 percent from a year ago, but sales in major centres such as Shanghai, Shenzhen and Beijing, have fallen sharply.

Yi Xianrong, a leading economist of the official Chinese Academy of Social Sciences told the *Financial Times* on July 23: "If financial institutions of Freddie Mac and Fannie Mae's calibre could get into such a bad situation, then what does that mean for Chinese financial institutions? The only reason we haven't seen similar problems here is because property prices have continued to rise rapidly." Yi explained that Chinese mortgage lending criteria were loose, due to the rampant speculation and insider dealings with the bank officials. "Anyone can get a mortgage loan in China, no matter who they are," he said.

Speculative capital is also concentrating in real estate because of dwindling stock market returns. As in other Asian countries, following the US financial shocks the key Shanghai Composite Index has fallen drastically from the peak level of more than 6,100 points last October to just 2,600 in July. The market is so fragile that any major issue of new shares could trigger more sell orders. The China Security Regulator Commission (CSRC) has turned down a third of initial public offerings (IPO) in July in order to stabilise the market.

Growing concern about financial instability is indicated by CSRC's instruction to local fund managers not to make negative comments about the share markets. "Fund company executives, fund managers and other important staff should be very careful about their speeches and blog content, which may cause market fluctuations," it declared. The authorities have also urged top executives at local managed funds and securities brokerage firms not to go overseas until after the Olympic Games.

These attempts to provide stability cannot alter the fundamental contradictions facing the Chinese regime. After integrating China into the global economy over the past 30 years, Beijing is powerless before the vast forces of international capital now dominating the country's industrial production and financial system.

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