

Chinese economists warn of the “biggest adjustment” in 30 years

The domestic market

John Chan**12 September 2008**

While last weekend's bailout of Freddie Mac and Fannie Mae received plaudits from Wall Street, it was also warmly welcomed by the Chinese government. Most immediately, Beijing was concerned about the tens of billions of dollars in bonds that Chinese banks hold from the two mortgage giants. At the same time, China's manufacturers are desperate for any sign that the US will emerge from the subprime crisis, which has sapped consumer spending and therefore purchases of Chinese exports.

Several leading economists in China have begun to warn of major difficulties flowing from the economic slowdown in the US, Europe and Japan. After the expansion of the economy on the basis of selling cheap consumer goods to the US and other Western markets in the 1990s, a sharp decline in demand could lead to mass unemployment and provoke widespread social unrest.

In an interview with the *First Financial Daily* published on September 1, Li Xiangyang, deputy director of the World Economic and Political Research Department of the official Chinese Academy of Social Sciences (CASS), admitted that the subprime meltdown was a rude awakening for Chinese economists, who had long understated the risk of major global crises.

Li was referring to the fact that many Chinese economists adapted to Western neo-liberal theories in the 1990s, believing that the global recession in the 1970s and the Great Depression of 1929 were events of the past. “This conception has been dominating China’s economic circles for years,” Li said, adding that it had weakened an awareness of the emerging global downturn.

Since the Chinese Communist Party (CCP) regime turned to the capitalist market in 1978, the official Stalinist ideologues and academics have all but dropped their “socialist” window dressing and now openly serve the new capitalist elite. Dismissing the Marxist theory of capitalist breakdown as “outdated,” they claim that world capitalism has learned to regulate its contradictions and that the economic depressions, social revolutions and imperialist wars of the first half of the twentieth century will never return. Such arguments are now looking seriously flawed.

Li admitted China was facing the “the most serious external shock in the 30 years of reform and opening up”. China was a closed economy throughout the mid-1970s period of world stagflation—a combination of economic stagnation and high inflation. Its market reforms only began in earnest in 1978. Even during the Asian financial crisis in 1997-98, China escaped most of the impact because the developed economies in North America and Europe were largely unaffected. China still had a closed capital market, unlike today when

hundreds of billions of dollars in “hot money” or speculative capital has flooded into the country. Li warned that it was now impossible for China to “decouple” from the global economic crisis.

The restoration of capitalism in the former Soviet Union in 1991 and China’s transformation into a vast sweatshop following the crushing of protests in Tiananmen Square in 1989 provided a much-needed boost to world capitalism. The low-cost goods made in China enabled US economic policy makers to maintain a cheap credit policy without the fear of inflationary pressures. Low interest rates formed the basis of the housing bubbles and debt-driven consumption in the US over the past decade, which in turn provided a huge market for Chinese goods.

Now this process is coming to an end. Li explained: “The subprime crisis was actually a ‘correction’ to years of debt-driven consumption in the US, marking the end of unsustainable economic growth based on ‘spending tomorrow’s income today’. However, the cost of this ‘correction’ was borne by the rest of the world. Within the US economy, the ‘spend tomorrow’s income today’ debts of private companies were socialised. The savers paid the bill for the lavish spenders, through government interventions. Meanwhile, American debts were globalised: global savers paid the bill for American consumers, through inflation and devaluation of the dollar. This is the privilege of being the holder of the world currency.”

The comments reflect a certain bitterness among the capitalist elite in China, which now confronts declining global demand and rising commodity prices, while the giants of US finance capital are being bailed out. Li called for China to develop its own transnational corporations, rather than simply remain an assembly line for Western multinationals.

Rising debts and insolvencies

Andy Xie, a former chief Asia analyst for Morgan Stanley, also warned in the financial magazine *Caijing* on September 1 that China was facing its biggest challenge in three decades. He pointed out that for the first time in 30 years, Europe, Japan and the US were contracting simultaneously, creating enormous difficulties for Chinese exports. In addition, a huge inflow of speculative capital had created unstable asset bubbles in China. Many companies and local governments confronted a crisis of insolvency if the bubbles burst.

More fundamentally, rising production costs were undermining the entire basis of China's economic expansion as a platform for cheap manufacturing. Exports accounted for 40 percent of China's gross domestic product (GDP) and contributed 4 percent of the country's total annual growth. Xie said problems with exports could be traced back to 2004, when global commodity prices started to rise. Rising prices led to demands for wage increases. As a result, large numbers of labour-intensive firms, which had always operated on thin profit margins, had been pushed to the edge.

Xie pointed out that the sentiment among entrepreneurs was that things would get better. As a result, firms kept their production plans and attempted to maintain export growth over the past three years. Now, with the danger of a downturn in major markets, many exporters faced serious problems. Export corporations listed on the Hong Kong stock market had seen their share values fall by 50-80 percent in the past two years, raising fears of a collapse in the export industry.

Corporate debt had grown as manufacturers turned to real estate and share markets, only to suffer more losses. So far this year, China's share markets had plunged by 59 percent, wiping out \$US2.86 trillion in value. Local governments, which were dependent on selling land rights and taxing real estate transactions, were also heavily indebted.

Xie predicted that non-performing loans would increase substantially in the next 12 months as the property boom flattened out. "The problem is very serious," he warned. According to one official estimate, some 65,000 small and medium firms went bankrupt in the first half of this year, throwing 20 million people out of work. Many employers simply fled without paying wages to workers or debts to the banks.

Xie, a staunch advocate of the market, opposed any government assistance for ailing enterprises. Instead, he called on the government to prevent bankrupt businessmen from fleeing with their assets and creating major difficulties for banks. "[T]he action of local officials to spend money to rescue them is very stupid. The money could be stolen. To protect China's financial security, the most effective policy is to ban heavily indebted entrepreneurs from leaving China," he wrote.

Xie's solution to China's problems is another round of economic restructuring—as was carried out in the aftermath of the Asian financial crisis a decade ago. At that time, Beijing implemented sweeping privatisation of state enterprises and public housing, joined the World Trade Organisation (WTO) and built a national highway network. Tens of millions of jobs in the state sector were destroyed, even as the costs of housing, education and health care skyrocketed due to the lack of public funding. According to Xie, these draconian "market reforms" laid the basis for the boom of the past 10 years.

Xie's proposals to address the current crisis include developing Chinese transnationals, investing more in infrastructure and further deregulating the state-controlled financial system. Such a perspective is in line with calls by many economists in recent years for China to reduce its reliance on exports and expand the domestic market. But the transformation of a cheap labour platform into a consumer-driven economy inevitably confronts obstacles.

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The *Wall Street Journal* on September 2 pointed to some of the

difficulties in expanding domestic consumption in China. Far from increasing, consumption in China has declined as a proportion of GDP from around 50 percent in the 1980s to just 37 percent. Fixed asset investment accounts for 45 percent of the GDP, which has led to massive overcapacity. "Behind China's macroeconomic imbalances lies a political calculation," the newspaper explained. "With 10 million job seekers migrating into urban areas every year, China had to provide lots of jobs to avoid mass unemployment and social unrest. Because consumer income and spending were so weak, the government felt it had no choice but to pump up capital investment and exports."

Huge vested interests oppose any shift to domestic consumption and higher wages. For local officials, jobs are already becoming harder to create. In the past decade, China has eliminated an estimated 20 million manufacturing jobs due to improvements in productivity. High wages are the last thing that provincial and local governments want as they confront growing competition for investment, not only within China, but from Vietnam and India.

Other methods of putting money into the pockets of consumers also face opposition. The government could lift interest rates on consumer deposits, but businesses would oppose any increase in their loan repayments. Further appreciation of the yuan would increase domestic purchasing power for imported goods but at the expense of export competitiveness. The government could reduce personal income tax but if that meant increased corporate taxes, it would be resisted by the powerful business elite.

A new labour law was introduced this year mandating employers to provide pensions, social insurance contributions and other benefits for workers. As is the case with other regulations in China, many businesses simply flout the law and enforcement is weak. China could increase domestic consumption by investing in public schools, healthcare and unemployment compensation, so that workers and the rural poor would not have to save in case of illness or job loss. But as the *Wall Street Journal* explained: "These measures are opposed by many local governments that often prefer to spend money on building roads and bridges. That behavior may boost GDP more quickly, but it also provides more opportunity for corruption and payoffs."

So far, the economic slowdown has been gradual. But there are danger signs. The Chinese finance ministry recorded a 13.8 percent annualised growth in tax revenues in July—almost a fifth lower than the rates in the same month last year and the first half of this year. The announcement raised concerns that China has little room for stimulatory policies such as tax cuts to compensate for falling growth rates.

While it is still growing at around 10.4 percent, the Chinese economy is riddled with internal contradictions that could rapidly produce an economic, not to mention political and social, crisis should it be hit with a major external shock. That is why Chinese economists are nervously watching events in the US where a further financial meltdown could not only cause huge losses for Beijing, which holds hundreds of billions in US investments, but end the flood of foreign investment that has sustained the so-called Chinese miracle.



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