Can China fund the US and European bailouts?

John Chan 23 October 2008

With American and European governments having pledged huge bailouts for their respective banking systems, the obvious question has arisen: where will they get the money? The US in particular is so indebted that an estimated \$1.3 trillion in new bonds may have to be issued next year just to cover its initial \$700 billion Wall Street bailout package. Faced with dwindling currency reserves, some eyes are turning to China and other Asian countries, which hold \$4.35 trillion in foreign reserves, as a possible source of cash.

A comment in *Forbes* magazine on October 14 asked who would foot the bill for the American and European bailouts, and provided the answer "Foreigners First". It noted that the French government had announced that it would raise the money in the international credit markets, promising taxpayers that they would not have to pay a cent, at least for now. "That is certainly possible," *Forbes* wrote, pointing to the central banks and sovereign wealth funds in Asia, the Middle East and Russia. Although returns on US Treasuries and German bonds are presently "unattractive", *Forbes* continued: "Yet Western governments can be rest assured that the likes of China will still want to buy up their newly-issued debt."

China certainly has a huge stake in ensuring the viability of the US economy—the largest market for Chinese goods—as well as the Europeans. Moreover, as the world's largest holder of foreign currency reserves—some \$1.9 trillion—it would appear superficially to be in a good position to help out. Although denied by Chinese officials, some reports have indicated that the Chinese People's Bank may consider buying another \$200 billion in US debt in order to help finance the Bush administration's \$700 billion bailout package.

A closer examination of China's currency reserves, however, reveals that Beijing's financial clout is much more limited. Analysts estimate that between 60 and 70 percent of China's \$1.9 trillion in reserves is already invested in the dollar-denominated assets such as US Treasury bonds and the government-backed corporations, mainly the mortgage giants, Fannie Mae and Freddie Mac. As a result, China only has between \$600 to \$760 billion in reserves—some of which are in euro-denominated assets—to make new purchases of US debt. This is only a tiny fraction of total US public debt, which hit the \$10 trillion mark at the end of September, double the figure

in 2000.

By August, two countries—Japan (\$585 billion) and China (\$541 billion)—own more than 40 percent of the foreign holdings in US Treasury securities. Japan had already cut its holding from a peak of \$600 billion last year amid fears of huge financial losses. While China continued to increase its portfolio, some Chinese officials commented that this represented a huge favour to Washington. The concern in Beijing is that any further purchases of US debt could result in huge financial losses as its dollar assets devalue.

Even if China were to help fund the US and European bailouts, its assistance would not necessarily be welcome. The Wall Street Journal admitted on September 29 that the US dependency on foreign creditors "has been hard to swallow politically". It recalled that the main weapon used by Washington in 1956 to force Britain to relinquish control of the Suez Canal was "its threat to slash financial support for Britain, whose economy had been battered by World War II." After reassuring readers that the US was in a better position than postwar UK, the Wall Street Journal continued: "Even so, foreign lenders have a great deal of sway. If they were to dump US government debt—or be unwilling to buy more—the interest rates needed to attract buyers of Treasury would soar. The already fragile US economy would absorb yet another hit."

European commentators have expressed similar doubts. British economist Andrew Graham argued in the *Guardian* on October 15 that if China spent its "trillions", the world could avert a recession, so the G7 must include China. He admitted, however, that the consequences would be increased Chinese influence at the expense of the "Anglo-Saxon model". A BBC comment on October 15, entitled "Will China bail out the West?" concluded that Beijing would have to focus more on its own slowdown and that its lending to other countries was "likely to come with strings attached".

Increasingly China will be compelled to use its resources to try to prop up the economy at home. The latest official statistics show that China's gross domestic product (GDP) growth dropped back in the third quarter to 9 percent—worse than the expected 9.7 percent and well below the 2007 figure of 11.9 percent. A Chinese cabinet meeting last Sunday called for measures to maintain high growth rates. The likely steps

include cuts to interest rates and bank lending rates, tax rebates for export goods, subsidies for farmers and increased infrastructure spending. According to Standard Chartered China economist Stephen Green, the Finance Ministry has deposited \$400 billion in the country's central bank to pay for this stimulus package.

The figure gives a clue as to how much is required to keep the Chinese economy growing fast enough to prevent a sharp rise in unemployment and avert a social explosion. According to Sherman Chan, an analyst from *Moody's Economy.com*, a growth rate lower than 8 percent in China—still very high for the rest of the world—"would be equivalent to a recession in advanced economies", due to the need to generate more than 24 million jobs a year.

A global crisis

The crisis unfolding is not primarily American or European, but global in character and is shattering longstanding economic relationships in which China played a central role. Over the past two decades, China emerged as the preeminent cheap labour platform to boost the flagging profit rates of corporations around the world. China, Japan and other Asian countries recycled their huge export earnings back into the US, keeping the value of their currencies low—a process that helped fund massive US trade and budget deficits. The influx of money enabled the US Federal Reserve to maintain a cheap credit policy, fuelling the housing bubble and debt-driven consumption in the US, which in turn maintained the market for Chinese goods.

The breakdown of these processes not only has drastic consequences for the American economy but for China's as well. In terms of value-added, China's manufacturing industry is now almost at the same level as America's. But its per capita income ranks 100th in the world. Its 1.3 billion people consumed only \$1.2 trillion in 2007—compared to \$9.7 trillion by 300 million Americans. In other words, China's industry has been built far more for foreign markets than for the limited domestic one. Recessions in US and Europe inevitably produce massive overcapacity in China, leading to swelling inventories, falling prices, plant closures and dramatically rising unemployment.

Social unrest is already emerging. China produces 70 percent of the world's toys, but more than half of the country's toy firms ceased operation in the first seven months this year. Last week, a major Hong Kong-based toy maker, Smart Union went bankrupt, leaving 6,500 workers jobless. That was followed by an announcement from Hong Kong-based home electrical appliances manufacturer, BEP, slashing 1,500 jobs. Thousands of workers from the two firms staged protests, which were only

ended after local authorities promised to pay their wages. But how will the government pay tens of thousands or millions of laid-off workers?

An avalanche of job losses is already on the horizon. Chen Cheng-jen, chairman of Federation of Hong Kong Industries, told the *South China Morning Post* on October 19 that a quarter of small and medium Hong Kong-invested companies in the Pearl River Delta, one of China's major export zones, will be closed by January, throwing 2.5 million workers out of work. Other foreign investors in the Pearl River Delta face similar troubles, threatening to unleash widespread unrest among 45 million industrial workers throughout the region. Other manufacturing zones like the Yangtze River Delta centred around Shanghai are no different.

The global financial crisis is also producing signs of instability in China with increased outflows of speculative capital. Glenn Maguire, chief Asia economist of Societe General SA, told *Bloomberg.com* that \$10-\$20 billion in "hot money" may have left China every month since July. The Chinese central bank warned in June of "massive outflows" of capital if the yuan weakened significantly against the US dollar, causing financial turmoil similar to the Asian crisis in 1997-98.

No doubt considerable pressure will be brought to bear on Beijing at the G-20 summit announced for next month to help stabilise the world financial system. Preoccupied with its own looming economic and financial crises, however, the Chinese regime is in no position to underwrite the huge US and European bailouts, even if it had the necessary funds to do so. The astronomical cost of these packages will be borne by workers in the US and Europe in the form of savage cutbacks to social spending and declining living standards, just as workers in China will be compelled to pay for the anarchy of global capitalism through huge increases in joblessness and poverty.



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