

China's fragile "economic recovery"

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Desperate for any sign of economic revival, financial commentators cheered China's second quarter GDP growth figure of 7.9 percent, up from 6.1 percent growth in the first quarter. In reality, the export-driven Chinese economy will not return to the previous levels of expansion as its major markets in North America, Europe and Japan continue to be mired in recession.

Even as the Chinese National Bureau of Statistics reported the statistics last week, spokesman Li Xiaochao cautioned that the recovery was "still infirm". Acknowledging that prices were falling (a sign of deflationary pressure) and massive overcapacity continued in many industries, he declared: "The momentum ... is unstable. The recovery pattern is unbalanced and thus there are still uncertain volatile factors."

Despite these uncertainties, major financial institutions are lifting up their growth forecasts for China. HSBC released an estimate last week of 8.1 percent for 2009 and 9.5 percent next year. Earlier this month, the IMF lifted its forecast for China by 1 percent to 7.5 percent for 2009. The IMF warned, however, that "the recent acceleration in growth is likely to peter out unless there is a recovery in advanced economies".

Chinese trade is continuing to contract. Exports fell 21.4 percent in June from the same month in 2008, following decreases of 26.4 percent in May and 22.6 percent in April. Imports fell just 13.2 percent in June on an annualised basis, an improvement from 25.2 percent fall in May and 23 percent drop in April. Trade with major partners is falling dramatically. In June, China's trade with the EU contracted 20.9 percent from the same month in 2008. For the US and Japan, the contractions were 16.6 percent and 23.1 percent respectively.

Officially urban unemployment is just 4.3 percent, up

from 4 percent last September, but the figure excludes some 20 million rural migrant workers who have lost their jobs over the past year. BNP Paribas economist Isaac Meng told the *China Economic Review* earlier this month that the real unemployment rate was close to 7 percent. He warned that capital-intensive infrastructure projects would create only limited jobs. As the exports continued to fall sharply, Meng warned of higher unemployment levels in 2010 and 2011. The export sector accounts for one out of 10 jobs in China.

The improved second quarter growth figure was heavily dependent on surging lending by state banks and on government-sponsored infrastructure projects. Last November the regime, concerned that high unemployment would lead to social unrest, responded to the global financial crisis by announcing a 4 trillion yuan (\$US580 billion) stimulus program, mainly financed by state banks, state enterprises and government fiscal spending. Bank lending has now reached extraordinary levels, fuelling speculative spending and raising the danger of a financial meltdown.

According to UBS economist Wang Tao, new loans of 1.53 trillion yuan (\$224 billion) in June brought the total in the first half of 2009 to 7.4 trillion yuan, or almost one quarter of the estimated 2009 GDP. "We now expect total new lending in 2009 to reach Rmb9,000 billion [\$1.31 trillion], a speed of re-leveraging unprecedented in China's history," Wang told the *Financial Times* on July 16.

The *Financial Times* reported on July 15 that because of surging lending, in addition to the rush by local governments to boost their embattled economies, total spending on stimulus measures would reach 10 trillion yuan (\$1.46 trillion). Wu Xiaoling, a former central bank vice-chairman, warned that this "speed first" policy by all levels of government had "laid potential problems of a huge waste" and would result in massive

bad loans.

At the same time, the stimulus spending will do little to prevent rising joblessness. It is estimated that less than 5 percent of direct lending has gone to small and medium enterprises that account for most of China's jobs. Major corporations awash with easy credit are not necessarily using the money for productive investment, but are lending it out or simply putting it into bank deposits, resulting in rampant speculation in the share and property markets.

The Shanghai stock market has risen sharply this year, but this does not reflect a healthy economy. The Lex Column in the *Financial Times* commented on July 16: "Growth, translated into jobs, is designed to quash the risk of social instability. But there are plenty of risks here, too: bubbles in the stock market, up 75 percent to date, for one, and real estate, for two. Property investment in the year to June rose 18 percent, 6 percent points above the May reading. With money available for the asking, industry is torn between bagging some to increase capacity further or to decant into the stock market."

Foreign speculative capital is also being attracted to China, contributing to the country's rising currency reserves, which reached \$2.132 trillion by the end of June. The reserve jumped by \$177.9 billion in the second quarter, including a monthly record in May of \$80.6 billion. This compares with an increase of just \$7.7 billion in the first quarter as foreign firms repatriated profits and international banks facing a credit crunch demanded the repayment of loans.

The jump in foreign currency reserves in the second quarter cannot be accounted for by trade surpluses or foreign direct investment, which declined by 17.9 percent compared to 2008. It is the result of a huge inflow of foreign speculative investment. Chen Xingdong, a BNP Paribas analyst, has estimated that \$70 billion in speculative capital flooded into China in the second quarter—compared to \$65 billion being withdrawn in the first quarter.

Expanding foreign currency reserves, most of which are held in US dollar based assets, also compounds the dilemma facing Beijing. Despite its calls for a new "super-national reserve currency", China cannot simply to ditch the dollar, a move that would destabilise the international financial system. At the same time, with an estimated 65-70 percent of its currency reserves in

the US dollar, Beijing is facing mounting losses as the dollar weakens.

China continues to buy dollar-denominated assets, especially US Treasury bonds, in order to keep the yuan stable at about 6.8 to a dollar and to assist its struggling export industries. The yuan's value has barely changed over the past year, after appreciating by 21 percent since China officially ended its dollar peg in July 2005.

According to the US Treasury Department last week, China increased its holding of US Treasury bills by \$38 billion to \$801.5 billion in May—even as Japan, Russia and Canada were reducing their exposure. China now holds more than one fifth of US federal debt held by foreign central banks. Its stake is nearly equal to the combined holdings of Japan and Russia. China's continued bond purchases are crucial to the Obama administration, which plans to borrow an estimated \$3.25 trillion for the year ending September 30—almost four times the 2008 figure—to fund its massive stimulus measures and bailouts.

Zhu Baoliang, chief economist for China's State Information Centre, told Bloomberg on July 16: "Over the short-term, there isn't much China can do but continue to buy [US] Treasuries while hoping the US economy can recover as soon as possible so that the investment won't suffer too much loss."

However, the prospects for a recovery of China's markets in the US, Europe and Japan remains bleak. With unemployment rising to 9.6 percent in June in the US and 9.5 percent in the eurozone in May, consumer spending in these countries is falling. Consumption will only fall further as the US administration makes further inroads into essential social services to pay for the massive debts incurred by its bailouts for Wall Street.



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