China's credit tightening exacerbates global financial instability

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An announcement last week by Liu Mingkang, the head of the China Banking Regulatory Commission, temporarily halting lending among some major state banks, sent shock waves through global share and commodity markets.

Liu declared in Hong Kong that the official target for this year's bank lending would be limited to 7.5 trillion yuan ($US1.2 trillion), sharply down from last year's 9.6 trillion yuan, but still well above the 4 trillion yuan in 2008. The previous week, the Peoples Bank of China raised the capital reserve requirements for banks by 50 basis points to curb surging lending levels—the first increase since the global financial crisis erupted in 2008.

The tighter monetary policy had been decided late last year at Beijing's annual economic conference. Nevertheless, last week's announcement provoked fear among investors that China's massive stimulus bank lending, which was critical to the high growth rate of 8.7 percent in 2009, was coming to an end.

On Tuesday, Hong Kong's Hang Seng Index fell 2.4 percent—its fifth day of losses, while in Japan the Nikkei tumbled 1.8 percent. Shanghai's Composite Index fell by 2.4 percent to its lowest point in three months. Taiwan's Taiex slumped 3.5 percent. The FTSE Asia-Pacific index dropped 1.8 percent—its biggest fall since the Dubai World debt crisis rocked world markets last November.

For most Asian stock markets, it was the seventh successive day of falls—the longest in more than two years. US and European markets also slumped, partly in reaction to Standard & Poor's downgrading of Japan's long-term "AA" sovereign credit rating from stable to "negative" because of Tokyo's ballooning public debt.

Poorer company prospects in China are expected. Goldman Sachs's downgrading of major Chinese banks helped push the Industrial & Commercial Bank of China, the world's largest bank by capitalisation, and the Bank of China, down 3.4 percent on the Hong Kong share market. Foxconn International Holding, the world's largest contract manufacturer of electronics, tumbled 8.7 percent due to a predicted significant decline in profit in 2010.

The *Financial Times* warned on Wednesday: "The axis of worry has shifted to Asia. Just as the Pacific Rim led world markets out of their slump at the end of 2008, so they are now leading the first true correction since the relief rally took hold."

The financial instability in Asia has underscored the temporary and unstable character of the global economic "recovery". China was only able to act as a so-called growth engine through massive stimulus measures that led to a frenzy of speculation and compounded the contradictions of the world economy.

By reining in credit, the Chinese regulators are reacting to a staggering 1.1 trillion yuan in new lending during the first two weeks of January. The *Financial Times* noted on Monday that if loans were to continue at that rate throughout the year, the total would have reached 30 trillion yuan before the end of 2010 and triggered hyper-inflation.

The Chinese Communist Party (CCP) regime is

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deeply fearful that inflation and job losses will provoke social unrest on a scale that would far outstrip the last major wave of protests in May–June 1989 that was bloodily suppressed by the military.

The CCP expanded bank credit as part of its huge stimulus package in November 2008, when the key pillars of the economy—the export and construction industries—were in free fall and tens of millions of workers lost their jobs. Only a third of the $590 billion package was directly financed from the national budget. The rest relied on state enterprises and banks, leading to a surge of credit to expand infrastructure and heavy industry.

The stimulus packages have compounded the imbalances in the Chinese economy. Industrial overcapacity has continued to grow. Domestic consumption remains low in relation to the growth in capital investment. These imbalances flow from China's role in the global division of labour. It is the world's premier cheap labour platform, manufacturing primarily for export, not for domestic markets.

Much of the bank lending over the past two years has been used for speculation in real estate and shares. Housing prices in major cities such as Beijing and Shanghai soared by more than 50 percent last year, forcing the government to announce measures to cool the market. At the same time, the regime is concerned not to undermine one of the key driving forces of the economy, the construction industry.

Pointing to these economic dilemmas, the World Bank's annual report last week warned: "The potential formation of a 'new' financial market bubble in the [Asian] region is an increasing cause for concern." By contrast, IMF chief Dominique Strauss-Kahn enthused on Tuesday that it was "a historic moment for Asia" that China now represents "a new model that can deliver sustained growth". The IMF predicts 10 percent of growth for China in 2010. The contradictory assessments underscore the underlying fears and hopes as these international institutions prepare for more economic turmoil ahead.

Despite pressure from the US and Europe, China has not revalued the yuan against the dollar, compounding the growth of speculation. To revalue the yuan would undermine Chinese exports and lead to further job losses. To maintain the de facto fixed exchange rate, Beijing has to print massive amounts of yuan to purchase dollars on the foreign exchange markets. The scale of the purchases is indicated by China's foreign currency reserves of $2.4 trillion—an increase of 23 percent last year.

In the second half of 2009, China's reserves increased by $268 billion. It is estimated that more than half of the increase was driven by "hot money" speculating on a possible rise of the yuan against the weak dollar. China's decision to try to rein in speculation by restricting credit could be just as destabilising. American economics professor Peter Morici warned it could cause "a second crisis on both sides of the Pacific".

The collapse of China's speculative asset bubbles would trigger financial instability at home and could lead to the slowing or even reversal of Beijing's purchases of US Treasury bonds and other dollar investments. The result would be a fresh round of financial crises in the US, which is dependent on the inflow of money, particularly from Asia.

For all the talk of China representing a new "model" of capitalism, its financial instability could well be the catalyst for a deeper global economic crisis.

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