

# Signs of Chinese financial instability provoke market nervousness

John Chan  
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News that the Chinese central bank will tighten credit for the second time this year provoked a nervous reaction in share and commodity markets. While the measure was relatively small—an increase in the reserve requirement ratio for banks by half a percentage point from February 25—investors took it as a further sign of instability in the Chinese economy.

The reaction highlights the importance of China and its continued growth to the global economy. Massive bank lending was the main component of the stimulus measures that kept China growing at 8.7 percent in 2009. However, last year's flood of easy credit—9.6 trillion yuan (\$US1.4 trillion), double the 2008 figure—has fuelled speculation in real estate and shares that it is simply unsustainable.

Despite Beijing setting a lower lending target of 7.5 trillion yuan for 2010, new loans in January alone reached 1.39 trillion yuan—more than for the previous three months. Property prices were up 9.5 percent in January from a year earlier, generating fears in ruling circles that China could face an asset bubble collapse on the scale of Japan in the early 1990s. At the same time, the government is concerned that further tightening of bank lending will slow economic growth.

The government carefully timed its credit-tightening announcement for February 12, just before the Chinese New Year holiday period, when share markets in China, Taiwan, Hong Kong, Singapore and Malaysia were closed. Japan's Nikkei index nevertheless fell 0.4 percent, despite an announcement of better-than-expected growth in the last quarter of 2009. The stock markets in both Australia and New Zealand fell 0.3 percent last Friday.

Generally economic commentators played down the impact. The *Financial Times* observed: "Here we go again. Markets have been spooked by China taking another twist on the monetary garrotte ... [However] a gradual constriction of

overly buoyant lending is sensible approach and even with China doing much of the heavy lifting in terms of worldwide demand, it is extremely unlikely that such action will somehow halt global economic recovery."

But the newspaper did note that the Chinese decision was compounded by turmoil in Europe. "Hopes that the European Union's promise to stand by Greece would deliver a period of relative market calm were shattered on Friday after further monetary tightening by China saw traders suddenly cut risky positions," it wrote.

Europe and China, however, are interlinked. The sovereign debt crisis in Europe—China's largest export market—will impact on Chinese export industries. Chinese exports have barely recovered from the huge downturn during the global financial crisis in 2008-09. Overall figures were up in January year-on-year—exports by 20 percent and imports by 81 percent. By trade volume, however, exports totalled \$109.5 billion in January, down from December's \$130.7 billion. Imports fell from December's \$112.3 billion to January's \$95.3 billion.

China's efforts to keep the economy growing have focussed heavily on infrastructure building and one-off consumer subsidies for durable goods like home appliances and cars. The key problem of a relatively small domestic market—the inevitable by-product of keeping labour cheap to attract investors—remains unresolved. The lack of productive investment opportunities has led to rampant speculation in shares and property.

One staggering example of property speculation has been in Hainan province where 500 billion yuan or \$73 billion was poured into the island during January, compared to total housing sales last year of just 36 billion yuan. Even the 2009 figure was up 73 percent from 2008. Average property prices rose 30 percent in January alone. A previous property bubble in the early 1990s, when Hainan became a special

economic zone, burst in 1993. The backlog of unfinished buildings took 10 years to tear down and left banks with 30 billion yuan in bad loans.

Fearing a repeat, Hainan authorities suspended land sales and new projects in January, but the decision only drove up property prices further. An *Asia Times Online* article wrote: “Building lots were sold out with their foundations barely laid, and in the teeming sales offices, loaded mainland investors did not bother to haggle over prices. Local hotels are filled with house-hunters who grab a taxi to new projects as soon as they touch land. Some media say selling a house in Hainan is much easier than peddling vegetables, and that real estate ads already outnumber coconut trees.”

Hainan is a microcosm of China’s chaotic economic development. Beijing is unwilling to implement forceful measures to curb the property speculation, as construction is a major factor stimulating basic industries such as steel and cement.

Writing in the *Caijing* magazine late last year, economic commentator Andy Xie stated that China’s current speculative bubbles were not so different to those in South East Asia before the 1997-98 financial crash. He explained that the South East Asian “miracle” was built on “a bubble that diverted business away from production and toward asset speculation”. Underpinning the speculation was cheap credit that resulted from the regional currencies being pegged to a weak US dollar.

Xie warned that China was facing a similar situation today. “While visiting manufacturers in China, I’ve often been discovering that their profits come from property development, lending or outright speculation. While asset prices rise, these practices are effectively subsidising manufacturing operations—an asset game that can work wonderfully in the short term, as the US experience demonstrates.” When asset prices start to fall, however, the reverse process can quickly provoke a devastating financial crisis.

The unravelling of the Chinese “miracle” is intimately bound up with global economic processes. The vast industrial expansion in East Asia over the past 30 years was driven by the needs of global capital to exploit cheap labour to counteract falling rates of profit in the 1970s. China’s industrial expansion has been dependent on low profit margins, the super-exploitation of workers and access to Western markets.

In turn, cheap Chinese goods helped underpin the enormous growth of financialisation in developed economies, especially in America, where much of the economic expansion was based on speculation and the manipulation of cheap credit and risky derivatives. China’s huge trade surpluses were used to purchase US bonds, keeping the value of the yuan low and adding to the speculative binge on Wall Street.

The financial crisis that erupted in US and Europe in 2008 has fundamentally undermined the basis of China’s rapid economic expansion. China is under significant pressure from the US and EU to revalue the yuan against the dollar and is facing punitive US tariffs against Chinese goods. Beijing, however, has refused to consider a revaluation, knowing that it would mean a sharp decline in exports, rising factory closures and unemployment, and a dangerous increase in social tensions.

At the same time, to keep the yuan pegged to the dollar at the present levels, the Chinese central bank is compelled to buy large quantities of US dollar assets and to print huge quantities of yuan domestically, which is only compounding speculation. If Beijing were to halt or even slow this process, it would immediately impact in the US, affecting Chinese exports and heightening economic tensions.

To counter rising trade tensions with the US and Europe, Beijing has increased exports to the so-called emerging markets, which now account for 54 percent of its total. However, this is only fuelling greater protectionist sentiment against China. According to the Chinese commerce ministry, India filed more trade complaints against China than any other country last year, after China’s trade surplus with India in 2009 increased by 46 percent to \$16 billion.

The nervousness in markets following Beijing’s second decision to tighten credit only highlights the unsustainable character of these economic processes in China. Whatever form it takes, an economic shock in China will inevitably resound around the world.



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