Signs of Chinese slowdown add to global market fears

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Signs of a significant slowdown in China's economic growth, and fears that the country may be on the precipice of a sharper contraction, contributed to the falls on global share markets this week.

Investors were worried by the release of government indicators showing slower growth in investment, industrial output, retail sales—especially for autos—and imports. All the statistics point to a decline in internal demand in a country that continued its hothouse growth as much of the global economy was in recession.

The Chinese government responded to the global economic crisis that erupted in 2008 with huge stimulus measures aimed at maintaining the country's growth rate at more than 8 percent. A flood of cheap bank loans, amounting to $1.4 trillion in 2009, led to rampant speculation in property and shares, threatening to destabilise the financial system.

The latest slowdown is in part a product of government efforts to rein in bank credit and property speculation. Government representatives insisted that the figures showed a healthy correction, but fears remain that the downturn could prove more serious. "There are still worries that China's slowdown could end being sharper and more disruptive than intended," Aaron Back wrote in the *Wall Street Journal*.

Nervousness about the state of the Chinese economy—now the world's second largest—contributed to fears of a return to recession in the United States and Europe. Wall Street fell yesterday for the third consecutive trading day, with the Dow Jones Industrial Average down 58.88 points or 0.57 percent, after the number of new claims for jobless benefits jumped unexpectedly last week to the highest level in six months. Major European stock markets also fell.

China's import growth—an important indicator of future economic activity—slowed in July. A large portion of Chinese imports consists of raw materials, components and capital goods that are used in manufacture of industrial exports. Falling imports foreshadow a decline in manufacturing output. Imports climbed by 22.7 percent in July compared with a year ago to $116.8 billion—less than half the 53 percent expansion seen in June.

Official figures released last month suggested that the Chinese economy grew at an annual pace of 11.9 percent in the first quarter of 2010, slowing to 10.3 percent between April and June. The latest data point to a further cutback.

Industrial output remains well above 2009 levels, but there has been a distinct slowing in recent months. Manufacturing production rose 13.4 percent in July from a year earlier, down from the 16.5 percent year-on-year rise recorded in May. A similar pattern was evident in fixed-asset investment, which was up 24.9 percent last month compared to a year earlier, after being 25.5 percent ahead in June.

The greatest contraction occurred in auto sales, which declined 11.9 percent from June to 1.2 million vehicles, according to the China Association of Automobile Manufacturers. Sales were still up 14.4 percent year-on-year, and sales are forecast to grow by 20 percent this year. But that is sharply down from 2009's staggering 45 percent rise, which was driven by sales tax cuts, subsidies to rural buyers and incentives to switch to cleaner vehicles.

The fall in sales was regarded as a setback for global manufacturers like General Motors which hoped China would offset falling demand elsewhere. Automakers also face rising costs and worker unrest, highlighted by recent strikes at parts suppliers affiliated with Honda and Toyota, over wages and conditions.

Despite a slowing economy and government efforts to minimise inflation, consumer prices rose 3.3 percent in July from a year earlier, accelerating from an increase of 2.9 percent in June. Food prices shot up by 6.8 percent in July compared to a year earlier, up from a 5.7 percent rise in June. Beijing fears that higher prices, particularly for basic items such as food, will fuel further social unrest and strikes by workers.

The government's decision to restrict bank lending reflects concerns in Beijing and internationally about the stability of the Chinese banking system amid frenzied speculation particularly in the property market. China's official central government debt is about 17 percent of gross domestic product (GDP), but the British-based Standard Chartered bank estimates that the actual debt to GDP ratio could be as high as 80 percent if hidden liabilities, such as local government debt, were included. That figure is well above what used to be considered healthy before the 2007-08 global financial crash, although lower than European debt levels and Japan's debt to GDP ratio of 200 percent.

According to the *Financial Times*, 20 percent of Chinese local governments are likely to default on their share of the $1.1 trillion lent by banks to local authorities as part of the stimulus measures announced in November 2008. Analysts told the newspaper that as long as strong growth continues, China is unlikely to suffer a banking or financial crisis as a result of the hidden liabilities. "But if growth is insipid or we get an inflationary shock ... things could get a lot more dire," Stephen Green, head of greater China Research at Standard Chartered, said.

The *Financial Times* noted there was alarm among Beijing officials about a related risk of an "implosion in China's fragile financial system"—the rapid emergence of a virtually unregulated market in exotic repackaged financial products and off-balance sheet bank lending. From almost nothing two years ago, these off-balance sheet loans had grown to more than 2.3 trillion yuan by the end of June, with more than 1.3 trillion yuan issued in just the first six months of 2010. During June alone, 33 banks and 38 trust companies issued 568 such products with a total value of 890 billion yuan, far exceeding the official 603 billion yuan increase in bank lending.

There are also question marks over the overseas demand on which the Chinese economy is so dependent. Although figures on Tuesday showed stronger than expected Chinese export growth of 38.1 percent year-on-year, rising to $145.5 billion in July, that was lower than June's 43.9 percent rise. This week's indicators of a slowdown in the US and a worsening sovereign debt crisis in Europe signal that China's artificially-stimulated expansion is running into the limits created by the intractable recession in its primary markets.

Last month's slowdown in import growth meant that China's trade surplus widened from $20.02 billion in June to $28.7 billion in July—an 18-month high. This is already generating renewed protectionist demands in the US for measures to force a revaluation of the yuan. A number of bills have been drafted, backed by US Democrats and Republicans alike, to mandate retaliatory measures against Chinese goods unless Beijing pushes up the yuan to make Chinese exports more expensive on world markets.

There are indications that such legislation could be brought forward in the lead up to the US congressional elections in November, as the Obama administration, congressional candidates from both of the major parties, and trade union leaders strive to divert working class anger over rising unemployment in a reactionary nationalist direction. The US imposed a series of tariffs earlier this year on various Chinese imports including steel products and tyres, prompting threats of trade retaliation from Beijing and raising tensions.

Despite its continuing high growth rates, China is particularly vulnerable to any measures restricting its export markets. Falling exports would inevitably lead to a new round of factory closures, rising levels of unemployment and growing social unrest among its huge working class—which Beijing is desperate to avoid.