Financial markets fear Chinese economic instability

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China's National Bureau of Statistics last week said annualised economic growth in the second quarter continued to be high at 9.5 percent, only slightly below the 9.7 percent for the first quarter. However, far from cheering the news as evidence of China's resilience, the leading financial press warned that the higher than expected figure was a sign of dangerous economic instability.

The *Financial Times* warned that the data provided "further evidence of the out-control housing and office construction boom." It continued: "Shareholders seem to have an unshakeable faith in the ability of the Chinese authorities to control the economy. The danger is growing that this is only an illusion."

The *Economist* raised similar questions. "The figures helped allay fears of a hard landing for China's economy. But they raised some doubts about whether the economy is landing at all ... The economy's pace may be steady. But is it too fast to maintain?"

According to the National Bureau of Statistics, growth was mainly driven by industrial production, which rose 15.1 percent in June from a year earlier—compared with 13.3 percent in May. But that in turn was mainly the result of real estate investment, which totalled 2.625 trillion yuan ($US405 billion) in the first half of the year, up 32.9 percent from the same period in 2010.

The frenzied activity in the real estate market continued unabated, despite five interest rate hikes since last October and a series of administrative measures to restrict home ownership. Commercial and residential property sales rose 24.1 percent in the half of the year.

Despite the obvious dangers associated with frantic speculation, Beijing cannot afford to curb the property market too sharply because it is now the main economic driving force. As a result, while new bank lending is slowing, it is still estimated to be around 7.5 trillion yuan or $US1.15 trillion this year, after pumping $2.7 trillion into the economy over the past two years.

Mark Williams from Capital Economics explained to the *Financial Times*: "Consumption, which already accounts for an exceptionally low level of spending, continued to fall as a share of GDP. This pattern of growth is not sustainable, as the government has acknowledged; the longer investment-led growth continues, the greater the risk that capital is misallocated, undermining the banking sector, and that overcapacity becomes a serious issue."

In other words, frenzied construction of new residential properties is not matched by the capacity of working people to purchase or even rent the housing stock. Housing affordability is so low that Beijing has promised to build 10 million subsidised apartments for low-income families. However, only 4 million are likely to be completed this year, due to a lack of funding.

This property speculation is the product of the Chinese government's response to the global financial crisis that erupted in 2008. Beijing announced a massive stimulus package that included a flood of cheap loans from the state banks. Much of the credit went into the property market, which offered high profits and helped prop up associated industries such as steel and cement.

Local governments borrowed heavily to fund infrastructure projects and to cash in on the property boom. Local government debt was estimated to be at least $2.2 trillion by the end of last year, or some 40 percent of GDP. The potential bad debts of local government could be as high as $460 billion, due to poorly-planned infrastructure and other property projects.

China is now building a skyscraper every six days. By 2016, the total is projected to be 800—four times the current number in the United States. To take one example, the little known city of Fangchenggang is planning to build a 528-metre skyscraper, taller than the Shanghai World Financial Centre—at present the world's third tallest building. Many of these "image projects" are unlikely to be sold or leased, and thus will become a source of bad debt.

Any slowdown or collapse of the property market will have a serious impact on China's economy and financial system. The export sector—previously the main driver of economic growth—has been hit by an end to stimulus measures, as well as slow growth in China's major markets—the US, Europe and Japan. While China's exports in June reached a record $162 billion, the growth rate of 17.9 percent from a year earlier was down from 19.4 percent in May.

Tang Jianwei, an economist at the Bank of Communications, told Reuters: "For the second half of the year, we expect exports to continue to fall due to the impact from the European debt crisis, Japan's earthquake and other factors."

Moreover, while the government's credit tightening has not slowed the property market, it has hit small and medium enterprises (SMEs), which employ 80 percent of the workforce. With state banks refusing loans to small firms, these enterprises have been forced to turn to private, black market lenders that charge annual interest rates of up to 60 percent.

Zhou Dewen, director of several Wenzhou SME associations in the eastern coastal province of Zhejiang, told the *Financial Times* last week that at least 20 percent of the city's 360,000 small and medium firms, had already cut back operations or closed.

Property speculation has also contributed to inflation. The consumer price index rose by 6.4 percent in June—the highest level since 2009—with food prices up by 14.1 percent. Rising prices are driving social discontent among workers and rural poor, who spend much of their meagre incomes on food.

The Chinese Communist Party is nervously watching rising prices, well aware that high inflation was one of the reasons that drove workers to join protests in Tiananmen Square in 1989 and threatened to undermine its rule. While the CCP brutally cracked down on those demonstrations, the working class has expanded enormously in the past two decades. Any attempt, however, to rein in inflation by drastically restricting credit would threaten to severely slow the economy.

The reasons for concern in international financial circles about an unstable Chinese economy are obvious—the global economy is now dependent on China to an unprecedented extent. Any slowdown in China will reverberate around the world. A Bloomberg comment, entitled "Preparing for the (possible) China crash," warned: "While a big slowdown would hurt the Chinese the most, the collateral damage would still be huge."