Fears of an economic meltdown in China

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Mounting instabilities in the Chinese economy have provoked fears among international analysts that world capitalism is about to be hit by another shock.

A clear indicator of global concern over a crash in China is the rising net value of outstanding credit default swaps (CDS) on Chinese sovereign debt—a type of insurance against a Chinese government default. This now stands at $US8.3 billion—the world's 10th largest total, ahead of Portugal and the Bank of America. Just two years ago, the CDS total for China was $1.6 billion and ranked 227th in the world.

An editorial by *Bloomberg News* on October 3 entitled, "China's fall, not its rise, is the real global threat," summed up the sentiment. It warned that China's expansion, based on "cheap labour, undervalued currency, heavy investment in manufacturing and focus on exports," had reached its limit, with "far-reaching consequences for the US and Europe, both of which are increasingly dependent on China."

The editorial listed the stresses facing the Chinese economy. First, "labour costs are surging" as young factory workers now expected a higher living standard and wage, threatening China's role as the world's largest cheap labour platform. Second, stimulus measures since late 2008 had unleashed cheap state bank credit to the tune of trillions of dollars, which, "has driven overinvestment and pushed up real estate prices to levels many families can't afford, adding to social tensions and possibly setting the country up for a bust."

The conventional answer provided by Western economists and politicians to China's mounting crisis is to call for a "re-balancing" of the Chinese economy: Since fixed investment has reached the grotesque and unsustainable level of nearly half the country's GDP, domestic consumption must be expanded to absorb the output from China's vast industrial overcapacity, taking up the slack from declining exports.

In reality, China has little room to enlarge domestic consumption. Over the past two years, limited wage rises following a wave of strikes have resulted in the rapid erosion of China's global market share as manufacturers have shifted to rival cheap labour platforms like Vietnam and India. *Bloomberg* noted that expanding consumption was "tricky": "Consumers need more income, so companies will have to pay their workers more. Consumers also need a strong currency to boost their buying power, so exporters will lose some of their competitive edge. Savers need to earn a high enough return to guarantee their retirement, so banks' and companies' borrowing costs will rise."

The editorial continued: "As a result, vast swathes of Chinese industry could be rendered unprofitable. Bad loans could force the government to step in and recapitalise banks. Fixed investment, which makes up 46 percent of the Chinese economy compared with only 12 percent in the US, could fall sharply, undermining the employment growth needed to boost spending. In short, China's export-driven model could fall apart before consumers are able to pick up the slack. In such a crisis, China's economic weight would become a liability."

The impact would be especially severe for commodity-based economies like Australia, whose minerals and raw materials exports to China have boomed in recent years.

Expressing concerns in Australian business circles, David Potts wrote in the *Sydney Morning Herald* on Monday: "Our dependence on China is indisputable and, by the way, [Australian treasurer] Wayne Swan should be sharing his treasurer-of-the-year award with his Chinese counterpart who threw more at its economy to avert recession than even he did." He noted that in the global crisis in 2008, China's stimulus package had driven up demand for commodities, thus shielding the Australian economy and averting recession.

This time China could not save Australia, Potts warned. The "worrying thing" for Australia, he noted, was not just

that China was slowing, but that it could no longer rely on exports and investment in plant, equipment and infrastructure for growth—all of which consumed huge amounts of steel, thus stimulating imports of iron ore, nickel and coking coal from Australia.

An even "bigger bubble than commodity prices," Potts commented, was China's holding of US bonds. "Not that it wants to be," he added, "but it's a victim of its own policy in holding down its exchange rate against the US dollar" to maintain export competitiveness. Now Beijing could not sell its massive holding of over $1 trillion in US Treasury bonds. "Having bought them it's trapped. If it tried to dump them, it would bring the global financial system down with it," he explained.

Potts noted that China's $3 trillion in foreign exchange reserves did not mean it was "debt-free". While the official debt level was just 27 percent of the GDP, "Economists suspect it could be as high as 90 percent because so much has been run up by municipal authorities using land as collateral that doesn't appear in the official accounts. As you'd expect when a local council is allowed to run wild, many of the loans have been wasted on uneconomic projects."

Not long ago, analysts like Potts talked about a Chinese-style "subprime crisis" erupting as heavily indebted local governments defaulted on loan repayments. Now the risk of bad loans has unexpectedly expanded to include highly-leveraged small and medium enterprises. Even as Beijing proclaimed its success in reining in rising prices, its policy of tightening credit forced small and medium businesses to turn to "underground" lenders charging annual interest rates of up to 180 percent.

The focus of this latest crisis is Wenzhou—once the country's model of export-driven expansion. Since April, over 90 companies have shut, with owners simply fleeing or committing suicide and workers protesting over unpaid wages. The unrest prompted Prime Minister Wen Jiabao to tour Wenzhou this week and order a crackdown on illegal loan sharks.

Commentators have warned that these closures were only the tip of the iceberg. The underground lending market emerged last year with an estimated total capital of some 2.5 trillion yuan ($US391 billion). About half the loans were from state commercial institutions re-lending at extortionate interest rates, and the rest was private capital.

There are deeper economic problems. Given the depressed profitability of manufacturing, many companies are using their businesses as collateral to borrow from non-bank sources, then in some cases re-lending at higher rates or engaging in property speculation. As Societe Generale's chief Asian economist Yao Wei put it, that these small and medium businesses "are willing to borrow money at such high interest rates reflects that they are either desperate for cash or that they are involved in speculation, because no real business can generate that high a return to cover the repayment."

Wenzhou's manufacturing base has been transformed into a speculative "fictitious" economy, according to the *Shanghai Morning Post* on Tuesday. In 2001, for instance, there were 4,000 enterprises in Wenzhou making cigarette lighters—accounting for 80 percent of the world's output. Ten years later, only 100 remain. Instead, capital has been channelled into real estate speculation. An unnamed businessman told the newspaper that his factory of 1,000 workers made profit of less than one million yuan a year with "hard labour", while his wife had invested in just 10 properties in Shanghai and brought in 30 million yuan over eight years.

As property prices fall and export orders plummet due to the global economic slump, the collateral on which the small and medium businesses have borrowed will also drop in value, leading to widespread bankruptcies and job losses.

Far from seeing any solution, the *Bloomberg* editorial admitted that "there is little the leaders of the developed world can do to influence China's fate." It went on: "Instead, Europe and the US need to focus on limiting their own vulnerability: The longer they keep growing at rates not far above zero, the more likely it is that an unexpected shock—such as a Chinese crisis—will tip them back into recession."

The comment underscores the fact that rather than being able to rescue world capitalism, China itself is rapidly becoming a major source of economic instability, feeding the deepening global crisis.