China economy slows amid fears of credit bust

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The latest growth figures have heightened fears that rather than providing a much needed boost to the world economy, the China boom is starting to run out of steam.

Growth fell in the third quarter to an annual rate of 9.1 percent, down from 9.5 percent in the second quarter and 9.7 percent in the first. The slowdown prompted a fall on world stock markets amid fears that the tightening credit policies of the Chinese government, partly responsible for the slowdown, could have further to run.

Most predictions are still that China will experience a so-called soft landing. But there is no doubt that the slump in the US, coupled with the financial crisis in Europe—China's biggest export market—along with credit tightening are having an adverse impact on the world's second largest economy.

The credit tightening has had two main effects. Small and medium businesses are finding it more difficult to obtain loans while property investment, which comprises 13 percent of the country's gross domestic product, is being adversely affected.

Writing in the *Financial Times* of October 16, senior economic adviser at UBS, George Magnus, noted that property transactions in 20 major cities were about a third lower than a year ago, while depressed share prices were fuelling fears that the property bubble was about to burst.

Magnus pointed out that while Chinese authorities had managed a property slowdown in 2004, China had a major problem with the level of debt held by the local and provincial governments responsible for infrastructure and land development. The situation had been likened to the subprime crisis in the United States.

"Local governments have significant exposure to property values and collateral and are heavily indebted with liabilities of at least 30 percent of GDP," Magnus commented. "Many are facing cash-flow problems and are prone to default, with large refinancings and repayments due in the next two years."

According to Magnus, some $470 billion worth of bad loans, equivalent to around 8 percent of gross domestic product, are being examined by regulators and the National Audit Bureau. "A spate of failed land auctions, falls in land transactions and weakness in property prices could have far bigger consequences for China's capitalist model," he noted.

For the past year, the Chinese government has been sitting on the horns of a sharpening dilemma. Fearing that rising inflation will spark a significant wages movement in the working class, larger than that of 2010, it has instituted a tight money policy to try to keep prices in check. But five interest rate hikes plus nine increases in bank reserve requirements over the past year have adversely affected the property market, as well as small businesses that are highly dependent on the flow of credit.

Much attention has focused on Wenzhou, a city of nine million in the south east of the country, where the tight money policy has had a major impact. There are fears that developments there signal the start of a national trend.

In Wenzhou, industry is dominated by small and medium-sized enterprises that operate on tight profit margins and depend on cheap labour and credit to sustain themselves. Faced with cutbacks from official sources, many businesses have turned to private lenders that charge interest rates of up to 90 percent. This has led to a situation where money is being borrowed to pay back previous loans.

Shanghai-based economist and long-time China analyst Andy Xie, who recently spent two months carrying out an investigation in Wenzhou, told Associated Press: "I have to conclude that this is a Ponzi scheme, relying on new money to pay off the old money. If not checked, this could lead to a national calamity."

In some cases, legitimate business operations are unable to continue production because raw material suppliers fear their owners will follow others who have skipped the city to try to escape their debts.

The credit squeeze is so tight that Zhou Dewen, the head of Wenzhou's association for small businesses, told Associated Press that "up to 40 percent of the country's small and medium-sized business enterprises may have to close or at least cut back production in the coming months due to lack of working capital."

The events in Wenzhou are increasingly being viewed as an indication of what is to come in the economy as a whole. Huang Yiping of Barclays Capital told the *Financial Times*: "What's happening in Wenzhou is a reflection of the current Chinese model [based on exports and high investment] coming to an end. China's economic success over the last 30 years has been built on cheap capital, cheap labour, cheap energy and cheap land but this has now produced huge imbalances and inefficiencies that are causing more and more problems."

According to World Bank President Robert Zoellick: "The drivers of China's meteoric rise are on the wane. Resources have largely shifted from agriculture to industry; as the labour force shrinks and the population ages, there are fewer workers to support retirees; and productivity increases are on the decline."

Chinese authorities are acutely aware of the imbalances and contradictions within the economy. President Hu Jintao stated recently: "China suffers a serious lack of balance, co-ordination and sustainability in its development."

The latest five-year plan calls for a shift toward domestic consumption and away from the reliance on exports and high investment as a means of sustaining economic growth. But there is a basic contradiction at the heart of the plan. Increased consumption spending means increased wages, thereby worsening China's competitive position vis-à-vis even cheaper labour countries such as Bangladesh and Vietnam.

Far from providing a way forward for the world economy, China's growing economic problems are themselves an expression of the deepening crisis. Three years ago, in the wake of the Lehman Brothers collapse, China experienced a slump in exports and a flood of 23 million workers from the cities back to the rural regions as factories shut down.

The government responded with a $500 billion stimulus package and a massive expansion of credit through the banking system. The very measures it instituted, however, have now created the conditions for a major crisis that will have a severe impact throughout the Asia-Pacific region and the rest of the world.