# Chinese leaders brace for European crisis

**John Chan**
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The surprise move by the People's Bank of China on June 7 to cut its main interest rate—for the first time since the 2008 global financial meltdown—is another sign that the Beijing regime fears the impact of the escalating economic and political crises in Europe.

The unexpected 25 basis point cut in the benchmark one-year lending rate to 6.31 percent came after the National Bureau of Statistics released data showing that growth in industrial production, retail sales and fixed asset investment (like equipment and building) changed little in May.

Senior Chinese officials have urged the euro zone leaders to take more "decisive" action to impose austerity measures and ensure long-term stability. Beijing is fearful that violent class and inter-state conflicts are emerging in Europe.

A key comment by the Communist Party's *People's Daily* warned: "Fundamentally, Europe is facing a problem of systemic integration and survival. Overcoming the crisis depends on whether the debt-ridden countries can decide on painful reforms and rouse their spirits to tackle them."

At last weekend's G20 summit in Mexico, President Hu Jintao committed $43 billion to a $456 billion International Monetary Fund bailout package for Europe—the largest contribution after those of Japan and Germany.

The Chinese leadership is facing a dilemma. "Painful" austerity measures are necessary to stabilise the global financial markets, but these will also devastate the living standards of the European population—collectively the largest consumer of the cheap goods manufactured in China.

Because of the ongoing turmoil in Europe and the weakening US economy, Chinese growth slowed to 8.1 percent year-on-year in the first quarter of 2012, the lowest rate in three years. A leading government think tank, the China Centre for International Economic Exchange, warned that the figure might drop below 7 percent in the second quarter.

The clearest indicator of a weakening economy is that electricity consumption rose only 1.5 percent in April, year-on-year, and 3.2 percent in May, far short of the customary double-digit growth. The two months' figures are the worst since the spring of 2009, when many export factories shut down, retrenching 20 million workers, following the 2008 crash.

HSBC's purchasing manager index (PMI) for May recorded the seventh consecutive month of manufacturing contraction. A major real estate property developer, Vanke chief executive Yu Liang, declared in early June there were about 114 million square metres of unsold property inventory in major cities, enough to last for 11 months. This glut has contributed to slowing activity in construction and related industries, from truck manufacturing to steel making.

The only recent "good news" was higher than expected export and import growth in May—up by an annualised 15.3 percent and 12.7 percent respectively. Nevertheless, economists were not optimistic about China's trade outlook.

Ken Peng at BNP Paribas told AFP: "We're in a period where external demand is not improving, the RMB [Chinese currency] has increased sharply versus most of its competitors, and especially versus the euro. So there's no reason (the rise in) exports should be

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seen as a sustainable improvement at this point."

Concerned that a dramatically slowing economy would trigger social unrest, Beijing has begun moving toward economic stimulus. Since December, the Chinese financial authorities have three times cut the capital reserves that banks must keep, encouraging them to lend. From January to April, the National Development and Reform Commission approved more than 8,000 new industrial and infrastructure projects. On May 21 alone, it reportedly sanctioned more than 100, including two giant steel projects in Guangdong and Guangxi provinces.

An expansionary policy is likely to exacerbate the unresolved crisis left by the previous stimulus package in late 2008. Beijing unleashed a 4 trillion yuan program that ultimately led to a flood of cheap credit from the state banks. Rather than generating new domestic consumption, the state-led investment aggravated overcapacity in some industries, including infrastructure, and actually depressed consumption as a proportion of gross domestic product.

The steel industry, for instance, has a severe crisis of overproduction. Total capacity surpasses 900 million tonnes a year, but consumption and exports last year totalled less than 700 million tonnes. The surplus capacity almost equals the annual steel output of the US and Japan combined.

The lack of profitable investment in production has spurred huge movements of funds into real estate speculation. In an article on the BBC Chinese-language site, He Qinglian, a dissident economist, said endemic official corruption had consumed 20 to 30 percent of the state funds in the stimulus package since 2009. She wrote: "A portion of the money had gone into the banks or overseas through laundering, but the vast majority had gone into the frenetic property market, creating real estate wealth with Chinese characteristics." Up to 80 percent of government officials and their families were directly involved in the real estate business, "making them huge and complex vested interests."

The economist estimated that of the total real estate sales of 15 trillion yuan between 2008 and the first half of 2011, less than 3 trillion yuan were funded by personal mortgages provided by banks. This indicated that massive amounts were poured in for speculative rather than housing purposes.

Over the past two years, Beijing has promised to stabilise housing prices amid popular anger over soaring costs. Any return to encouraging property speculation as a means of keeping the economy growing rapidly, could backfire politically, and ultimately lead to a collapse of the property bubble in China. That outcome would shake not only the Chinese, but the world capitalist economy.

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