Chinese economic conference warns of downturn

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A four-day Central Economic Works Conference convened by the Chinese leadership, which concluded on December 13, warned that the world's second largest economy is facing downward pressure, with industries confronting serious overcapacity, and huge local government debts threatening financial stability.

President Xi Jinping's government is caught in complex economic contradictions created by the impact of the deepening global slump on the country's role as a cheap labour platform for major Western corporations. No official growth target has been announced for next year, but official sources told the media the discussed aim was 7.5 percent, much lower than the above-10 percent rates of the 2000s.

Although few policy details were released, a conference statement depicted the pro-market "reform" plan adopted at last month's Chinese Communist Party (CCP) central committee plenum as the only answer to the looming problems.

The statement emphasised the severity of the local government debts that financed infrastructure and real estate projects, declaring that Beijing would "strictly control the process by which governments raise debt." The conference ruled out any major national bailout, warning that "every level of government will be responsible for their own debt." This means that local governments, which are responsible for already limited social services, such as pensions, will have to impose harsh austerity on the working class and rural poor.

Following the global financial crash in 2008, China announced a massive stimulus package to counter the immediate loss of 23 million jobs, but the result was a massive expansion of debt. Local governments and their enterprises, unable to raise funds by issuing bonds, set up financing vehicles to borrow heavily from the banks. Lacking profitable returns from industrial production, due to the ongoing slump in China's main export markets in Europe and America, capital was channeled into speculation, especially in real estate.

According to a Chinese Academy of Social Sciences report yesterday, total government debts reached 28 trillion yuan, or 53 percent of gross domestic product (GDP), in 2012, while non-financial corporate debt totalled 113 percent of GDP—higher than the average levels of 90 percent for the developed economies of the OECD. Moreover, the report identified a huge gap of $US1.24 trillion between net increased assets and GDP, as an indication of "ineffective investment" that accounted for 18.7 percent of GDP, mainly due to large overcapacities built into the economy.

In the last official audit in 2010, local government debts totalled 10.7 trillion yuan ($1.6 trillion). However, there are indications that the debts have increased because governments borrowed more to repay the old, financed in part by a poorly regulated shadow banking system. In order to determine the extent of the problem, the central government initiated a secret audit in July, but the results are yet to be announced.

Australia's *Business Spectator* noted: "Local governments have been using innovative financial structures such as trusts and even wealth management products to raise debt. Auditors have reportedly clashed with local governments over classification of debts." China's banking regulator estimated that by the first quarter of 2013, up to 10 trillion yuan had been lent to these local financing vehicles.

A partial National Audit Office tally earlier this year put the total debts of the 36 provincial capitals, such as Guangzhou and Nanjing, at 3.85 trillion yuan. Nearly one third of these cities had a debt-to-GDP ratio of more than 100 percent. China's Haitong Securities estimated the total local government debts at 20-30 trillion yuan. This is larger than the GDP of Germany, the world's fourth largest economy.

To name just one area, China's pension crisis is set to escalate. Many local governments have taken money from current workers' retirement accounts to foot the bill for retirees, leaving a shortage estimated at $330 billion.

Another reason for the debt buildup is borrowing by state-owned firms or private companies subsidised by local governments. Despite serious overcapacities in industries such as steel, solar panels and shipbuilding, these companies received financial support to keep their production lines running in order to avoid mass layoffs that could spark social unrest.

Just before the Economic Works Conference, the Chinese Communist Party's Central Organisational Department, which oversees the appointment of senior party, government, military and state firm officials, said reducing debts would be a key criterion in evaluating performances. In other words, officials who ruthlessly cut debt will be promoted.

The conference also pledged to "unswervingly resolve industrial overcapacity," which means implementing the pro-market agenda of eliminating most remaining second-tier state-owned firms. This drive is in direct contradiction to the economic conference's stated goals to "make efforts to free up demand, giving full play to the fundamental role of consumption."

"Resolving industrial overcapacity" will produce rising unemployment and insecure retirement forcing workers to save, however, rather than spend. Household consumption, which only accounts for 36 percent of the GDP, just half of America's, will remain low. In turn, that will only compound the "overcapacity" problem as domestic consumer markets will not expand, even as overseas markets remain stagnant.

Since a wave of auto strikes forced Beijing to lift minimum wages across the country in the past few years, transnational corporations have bitterly complained of "rising labour costs" and shifted production to lower-wage countries. The global financial media has criticised the flood of credit into construction activities as a waste of capital, insisting the funds should be used to restructure industry and ensure workers produce more for less wages.

Such "financial reform" is at the heart of President Xi's pro-market blueprint, which seeks to pressure businesses, as well as local governments, to increase their so-called capital efficiency and productivity to make up for the loss of cheap labour advantages.

At a forum last week, central bank governor Zhou Xiaochuan said borrowing costs could rise once interest rate controls were lifted. This could provoke unforeseen financial turmoil. A clear sign came last weekend as banks struggled to meet their short-term financing needs after inter-bank lending rates doubled in just five days. The seven-day repurchase rate soared to a level similar to the last credit shortage in June, when China's money markets almost froze up.

The danger of a credit crunch in a country awash with credit appears paradoxical. In fact, the banks have made huge loans to real estate companies and local governments, leading to rampant speculation, while those desperate for credit, especially small and medium firms, found it difficult to obtain loans. They turned to the underground bankers who charge extortionate interest rates and in turn borrow from the major banks. As a result, despite unleashing massive amounts of credit, the banking system has repeatedly faced a credit crunch, as financial institutions are deeply suspicious of each other's large and murky debt exposure. The deregulation of the state banking system will only generate further uncertainty and crises.