Growing problems for Chinese economy

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Two sets of official data released earlier this month point to a significant slowdown in China which could have major implications for the world economy as a whole. Imports and exports both declined markedly in January, while price rises reached a five-year low, sparking fears that China could be entering a period of deflation, along with much of the rest of the world.

Exports fell by 3.3 percent compared to a year before while imports dropped by 19.9 percent. The fall in imports was particularly significant because China is at the head of a manufacturing chain which extends across much of Asia and its imports include part-finished goods that are assembled and then exported to their final markets in Europe and the US.

While some of the fall in the value of imports was the result of lower commodity prices, especially oil, coal and iron ore, it also reflected a downturn in manufacturing which contracted for the first time in two years. The trade figures were something of a surprise as Reuters had predicted a fall of just 3 percent in imports, and a rise of 6.3 percent of exports.

Price levels reflect the same trends. The consumer price index rose by only 0.8 percent on a yearly basis in January compared to 1.5 percent in December. It was the smallest rise since November 2009, in the immediate aftermath of the global financial crisis, when the index rose by only 0.6 percent. Producer prices, which record the price of goods as they leave the factory gate and which have fallen for the past three years, dropped by 4.3 percent on an annual basis in January, also the sharpest decline for five years.

These monthly figures form part of an overall pattern. According to official growth data released in January, the Chinese economy expanded by 7.4 percent in 2014, the lowest rate since 1990, and below the official forecast of 7.5 percent. The International Monetary Fund responded by cutting its growth prediction for China for next year to 6.8 percent.

Underscoring the industrial downturn, the official manufacturing purchasing managers index dropped to 49.8 percent in January, down from 50.1 percent in December, and the first time it has fallen under 50 percent since September, 2012. A figure below 50 percent indicates a contraction on the previous month. At the same time, the services sector, touted as a booming area of the economy, grew at its lowest level in a year.

Comments by Arthur Kroeber, head of an economics consultancy firm based in Beijing, cited in the *Christian Science Monitor*, point to the significance of the figures.

“The lower import volumes are a leading indicator of lower growth to come... So far it appears [to be] an orderly slowdown, not a jolting hard landing. But these things are very difficult to manage. It is quite easy to come up with scenarios of a hard landing,” he said.

The deepening crisis is a direct result of the global economic breakdown that began in 2008, and the measures carried out in its aftermath. With the onset of the financial crisis, the Chinese economy was hit by a contraction of markets, leading to some 20 million workers losing their jobs. The Chinese regime responded by launching a massive stimulus program, involving cheap credit being pumped into the economy by state banks.

This resulted in the development of a feverish real-estate bubble, and the growth of a “shadow banking” industry that has functioned as an intermediary between government banks, property developers, and highly leveraged businesses. The sector has also centred on financial products, such as derivatives, with the underlying value of the assets they represent often an entirely unknown quantity.

According to the most recent figures, China’s corporate, banking, government, and household debt now stands at 282 percent of gross domestic product,

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the vast bulk of it in the corporate sector, particularly property.

The oversupply in the property sector has led to the emergence of entire “ghost cities” of uninhabited housing blocks. According to official figures, the number of unsold houses nationally grew by 25.4 percent in 2014, with land sales slumping by over 10 percent. At 10.5 percent, the growth of property investment was at its lowest since 2009.

The slowing of the real estate boom, and fears of a collapse of the debt-laden financial sector, have prompted a major capital outflow, sparking fears of a liquidity crisis and a further fall in growth rates. According to the *Financial Times* (FT), capital outflows reached a record of $91 billion in the fourth quarter of 2014, following outflows of $56.7 billion in the third quarter.

The capital flight has prompted fears that the “carry trade”—whereby speculators take out short-term loans at low interest rates from foreign banks, and invest the funds in high-yielding Chinese assets, often in murky “shadow banks”—may be coming to an end. According to figures quoted in the FT from the Bank of International Settlements, outstanding debts of less than one year maturity skyrocketed from $121 billion in 2009, to $850 billion by September last year.

A study by Barclays and Ledbury Research late last year found that 47 percent of Chinese millionaires said that they planned on emigrating, with another 20 percent undecided. Some 73 percent of those planning to leave the country said they were doing so for reasons of “economic security”—an expression of the increasing nervousness in the ruling elite over the slowing economy, and the mass social struggles that it inevitably produce.

The unravelling of the contradictions of China’s economic development has produced a series of intractable dilemmas for the Chinese regime. Any attempt to rein in the massive accumulated debt could result in a further escalation of the flight of capital to foreign markets. However the continued growth of debt poses the risk of a deep-going, and sudden financial crisis. At the same time, any moves to depreciate the Chinese currency, while potentially boosting the value of exports, could result in further outflows, and a deepening liquidity crisis.

Thus far, the Chinese regime has proceeded cautiously. At the beginning of February, it cut the required reserved ratios for banks to free up deposits that had been effectively frozen, without lowering the interest rate. Beijing also lifted restrictions on trading companies in the Shanghai free trade zone borrowing in overseas markets. The pressure on the regime has been compounded by a new trade case launched by the Obama administration, against China’s subsidised exports.

Summing up the concerns of international finance a comment by Minxin Pei in *Forbes* late last month posed the question of how the Chinese government would respond to the prospect of years of subpar growth.

“Advocates of painful reform believe that the Chinese economy will not be able to return to a sustainable growth path unless the government aggressively tackles the interconnected mess of a real estate bubble, excess industrial capacity, and financial deleveraging (debt-to-GDP now stands around 250 percent, the highest rate of any emerging market economy).”

Any attempt to rein in credit and spending would likely lead to outright recession, rising social tensions and unrest which the Chinese government would do just about anything to avoid. Continuing stimulus, however, especially in conditions of falling growth, will only create more problems in the country’s financial system.

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