The Coming China Crisis

Trouble in paradise.

BY CARL DELFELD

That China has been an incredible growth story pulling many millions from poverty is undisputable. In 1990, China's GDP was roughly equal to that of Taiwan. Now it is ten times bigger.

But China's investment-led industrial growth, already into its twelfth year, is looking long in the tooth. Real fixed investment has increased at a faster rate than GDP in nine of the past ten years. Furthermore, research by Pivot Capital Management shows that the longest previous period of investment-led economic growth was nine years, experienced by both Thailand and Singapore.

As China's leadership celebrated the sixtieth anniversary of Communist party rule with chants of "Nothing can stop us. Go. Go. Go," I have some unwelcome news. The country has substantial overcapacity in manufacturing, real estate, and infrastructure as well as deteriorating credit quality and weakening export markets. Unfortunately, its brittle political system will make the chances of adjusting to consumer-led economic growth remote at best.

All of these factors will lead to a growth rate far below that expected by the markets and that will, in turn, lead to a China crisis, circa 2010.

China's approach to producing double-digit economic growth is not new but drawn to a great degree from the Asian model playbook. Heavy investment in industry leads to rapid growth in manufacturing output and this leads to rapid export growth and huge trade surpluses. From 2001–07, the export share of China's output rose from 20 percent to 36 percent, a surge that coincided with a rise in the global export share of world output from 24 percent to 31 percent.

This is not much different than the model which Japan, Thailand, or Singapore followed and it was coupled with policies that kept interest rates and wages low and respective curren-

Carl Delfeld is President of Chartwell Partners, Chairman of the China Committee of the America Unbound Foundation, and author of Red, White & Bold: The New American Century *(iUniverse.com, 2009).*

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com

cies weak, all in the name of attracting foreign direct investment and increasing export competitiveness.

For China though, investment (gross fixed capital formation) is at 70 percent of GDP and the return on every marginal dollar invested in China is decreasing. In 2000, it took $1.5 of credit to generate a dollar of GDP but by 2008, it took $7 of new credit to generate a dollar increase in GDP. The global macro picture will accelerate the China crisis because it will shine a spotlight on China's shrinking export markets and industrial overcapacity. Some examples of Chinese overcapacity are its steel capacity equal to that of America, Japan, Russia, and the twenty-seven countries of the European Union all put together, and an aluminum capacity eight times larger than America's on a per capita basis.

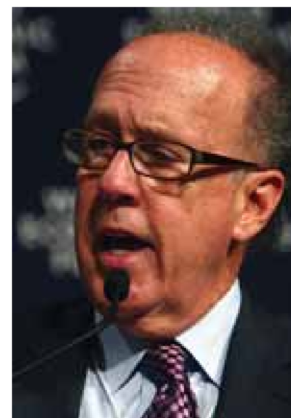
China's attractiveness as a low-cost base for global manufacturing is also less compelling given all the logistical issues that go along with supply lines spanning the Pacific. Apix Partners studied five manufacturing segments over a five-year period and found that China's pricing advantage for goods arriving in California relative to domestic prices have declined from a 22 percent advantage to just 5.5 percent.

This may be reflected in China's slowing exports. Import growth continues to outpace the nation's export growth and China is now on a path to start reporting trade deficits soon, perhaps as early as the first quarter of 2010, according to Eric Fishwick, head of CLSA Asia-Pacific Markets' economic research.

Although most believe that China's substantial stimulus package announced earlier this year is being invested in infrastructure, many analysts agree with my perception that most of it is ending up in overheated stock and real estate markets. The Chinese refer to this as "stir-fried" markets.

This inevitably leads to the issue of credit quality and the possibility of China's own homegrown debt bubble.

Stephen Roach *puts it this way. "There are worrisome signs that China just doesn't get it, that it is clinging to antiquated policy and economic growth strategies that presuppose a classic snapback in global demand."*



WORLD ECONOMIC FORUM/PHOTO BY NATALIE BEHRING

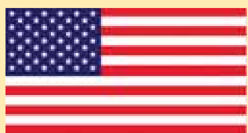
Pivot's research shows that rather than China having a manageable public debt-to-GDP ratio of 35 percent, inclusion of off-balance sheet items like guarantees of local government bonds brings this number up to closer to an uncomfortable 62 percent.

In addition, China's non-performing loan data is clearly being managed and does not even include the $200 billion of bad loans from China's top four state-owned banks that were moved "off-balance sheet" to state-run asset management companies. In return, the banks received $200 billion of bonds that are still on the books of the banks at face value even though their real value is a small fraction of face value. As the bonds come due, they are being rolled over for another ten years.

China's bank lending explosion has led to credit-to-GDP during the first half of 2009 rising to 140 percent, levels equal to America in 2008 and Japan in 1991 just before their market meltdowns. Chinese financial institutions extended $1.2 trillion worth of local currency loans in the first eight months of this year, an increase of 164 percent from the same period in 2008. China's top banking regulator, Liu Mingkang, warned of growing risks to the country's financial system as a result of the rapid expansion of new loans. "This year, all kinds of risks have arisen in the banking sector along with the rapid credit expansion," said Mr. Liu in a recent written statement.

This expansion in state-owned bank lending power should also end cherished hopes that China over time will turn more control and ownership to private capital and management. Instead, we see an unmistakable trend known as *guojinmintui,* literally the state advances as the private sector retreats. Some state-owned and -led companies that have received massive stimulus

Continued on page 53



China's bank lending explosion has led to credit-to-GDP during the first half of 2009 rising to 140 percent, levels equal to America in 2008 and Japan in 1991 just before their market meltdowns.

—C. Delfeld

Continued from page 31

loans have used these cheap resources to buy private enterprises that are struggling in the downturn. One example: a consortium led by state-owned China National Oils, Foodstuffs, and Cereals Group, the country's largest importer and exporter of food, grabbed 20 percent of Mengniu, China's largest milk producer. Mengniu's founder was promptly replaced by a state-appointed executive.

Just take a look at China's ten largest companies which are all state-owned or state-controlled, as are thirty-four of the top thirty-five companies listed on the Shanghai exchange.

All this means trouble not just for China's economy, politics, and stock market, but has the potential to derail what many view as a global recovery.

Stephen Roach in the "The Next Asia" puts it this way. "There are worrisome signs that China just doesn't get it, that it is clinging to antiquated policy and economic growth strategies that presuppose a classic snapback in global demand." He cites as evidence the make-up of the $585 billion two-year stimulus package that, he says, is biased towards old-fashioned infrastructure projects and not toward promoting consumption.

The 10 percent GDP growth rate that everyone seems to assume as a given will be around 5 percent for 2010. Since the Communist Party of China bases its legitimacy largely on producing high levels of economic growth and employment, internal pressures and sharp divisions as to how to deal with the slowdown within the party will emerge. Unemployment is thought by many analysts to already be greater than 10 percent and will worsen to uncomfortable levels.

The recent bounce in the Shanghai index has stocks trading at vulnerable levels. When it sinks in that China, rather than being a provider of global growth, is actually in the same slow-growth high-debt boat as America and Western Europe, all bets will be off the table.

This realization may already be occurring as openings of new A-share trading accounts by Chinese investors have fallen lately, and are now less than half of the peak volumes of late July. Foreign investors have also become cautious as China equity funds tracked by EPFR saw $477 million redeemed just last week.

China's sharply lower economic growth, rising unemployment, and overcapacity in real estate, manufacturing, and industry will hit markets hard not only in China but emerging and developed markets around the world.

Only the highest level of statesmanship and economic diplomacy can avert the China crisis or prevent it from becoming a world crisis. ◆