China’s Economic Prospects in Turbulent Times

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The magic story of China’s unstoppable economic growth has very recently been adjusted when talking about its prospects for 2009. In the wake of the global financial crisis it would have been surprising that China would not at all have been affected by the economic downturn that we see in the developed countries.

The problems

On the basis of China’s new story lie structural difficulties that need some explanation before the outlook for the near future can be described. I do not intend to discuss every problem, nor discuss them into detail. Some of China’s future challenges are hot topics in the various media and are often of political nature (e.g. the call for more democracy and less Han-involvement in Xizang).

However, China’s main issues at this moment are economic and concern its continuous transition to a ‘socialist market economy’: currency adjustments, the reform of State Owned Enterprises (SOEs), the much plagued banking system, (more recently again) growing social unrest by massive layoffs, a (still) far from satisfying regulatory environment and the lack of rule of law, worsening environmental pollution etc.

These problems are not related to the global crisis, but it is important to have this background when we do want to talk about China’s outcome of the financial crisis.

Since the open up and reform process has been initiated by Deng Xiaoping, SOEs have been at the core of China’s transition. Due to an unsatisfying performance lots of SOEs have been closed down or transformed into private organisations in recent years. Unfortunately a lot of the remaining SOEs still operate at loss and have structural overcapacity. Although the overall importance of SOEs in the economy is declining (only 25 % of GDP in 2004 was for the account of SOEs), it is obvious that the Chinese government considers the SOEs still to be a strategic part of the economy (an estimated 65 % of the bank loans was directed to SOEs).

This brings us to a second important deficit in the Chinese economy: non-performing loans (NPLs). Chinese banks can probably happily announce that they are not plagued by the subprime crisis, as they do not invest in subprime mortgages. As mentioned higher, SOEs receive a part of lending from banks that is far more than proportionate. Bank lending is mostly based on policy conformity and not on market attractiveness. SOEs encountering difficulties can easily obtain additional financing to get through their difficult period. Of course, when an SOE manufactures outdated products and is only continued to be operated to prevent workers from being laid off, it is not very likely that this SOE is going to perform better. As a consequence the company is not going to be able to pay back its loans and this is exactly what an NPL is all about. The Chinese government claims to have solved this problem by transferring the NPLs to asset management companies. The problem is that the creation of asset management companies has not structurally changed this policy lending and the big four of the Chinese banking system are undoubtedly still burdened with NPLs that diminish their solvency seriously. Luckily these banks always enjoy a state guarantee (even without the presence of a crisis).

The crisis

It is worth stressing that one of the distinctive features of the Chinese economy is its reliance on exports and its lack to propel domestic consumption. Although Chinese politicians want to move to an economy largely driven by consumption, GDP growth is still largely driven by (over)investment and by foreign trade. Overinvestment obviously contributes to overcapacity that results into large stocks in warehouses.

China is highly dependent on exports, but the countries to which the bulk of its products are shipped are officially in recession. Importers in the US and the EU have stopped ordering more often larger quantities of goods. Thus the overcapacity in factories is exacerbating even more. As a result companies lower wages or sack their employees.

Earlier in 2008, China has known a heightened inflation, mainly caused by rising food prices; wages that rose by 20 % p.a. in the Eastern part of the country surely contributed to this phenomenon as well. But now there is a realistic possibility that this inflation will turn into a deflation, if the earlier mentioned stocks need to be liquidated quickly, combined with lowered wages and consumption following this falling trend.

The BBC reported on the 18th of November that only in one province (Shandong) 700 000 people already lost their jobs. More than ever China needs an adequate social welfare system, that provides solutions in case of unemployment, pension, ... A system that makes sure that education, health care and housing are affordable.

China's growth rate

Possibly China's magnificent GDP growth figures with an average of 9 % p.a. since 1978 have come to an end with this global recession. On the 9th of November the Chinese government has announced a major fiscal package of 4 trillion RMB to stimulate the economy. But this cannot prevent in the short term that China's growth is slowing down. Growth could have slowed to 8.5 % by year-end and projections for 2009 are already being adjusted by monitoring agencies and important banks to a growth of 6-7 %.

Due to China's reliance on exports, it is not very likely that China's economy will recover before the developed countries – that are the buyers of China's products – have climbed out of their recession. Nouriel Roubini states that several sub indices of the Chinese Purchase Management Index show that “the decline in total orders has been even stronger than in export orders, thus suggesting a weakening in both domestic and export demand.”

Without questioning the validity of investing in infrastructure, it is probably not going to help the overall economy in the short term to invest in rural infrastructure. Therefore it is the question if it wouldn’t be better to concentrate on tax cuts and subsidies that will carry a more direct reduction of burden to the people.

Measures to take

The most basic solution that the Chinese government needs to adhere to, is to increase domestic consumption and to make sure that the economy becomes mainly driven by domestic indicators. Unfortunately this is a process that takes time and that is linked to income levels and social security; simultaneously China also tries to move to the production of high-value added goods instead of being the ‘workshop of the world’.

It took the Chinese government a global financial crisis to make sure that banks lend to private enterprises as well and not merely engage in policy lending. By ‘stimulating’ lending to the private sector, the government officially admitted for one of the first times that money was less readily available for the private sector than for SOEs.

Moreover as the crisis is worsening for the Chinese economy, the government must take urgent measures in the banking sector to alleviate the consequences of NPLs. As factories go bust or others cannot sell their stocks anymore, NPLs will surely gain importance again as a major financial problem.