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CHINA: TOO MANY QUESTIONS

Today's China is widely associated with a swift economic expansion and a dynamic stock market. But aren't cheerful reports of western investment banks that have been promoting Asia for quite some time and triumphant communiqués of the Chinese Communist Party distorting the reality? Let's assume for a while that life is not always fun and figure out if there is something we haven't known about China.

No one knows (yet many would love to) when the Chinese stock market bubble is going to burst. The recent index decline has been a mere correction. Since March 2007, the Chinese stock market has increased by 70% (according to the CSI3001 index), while stocks in the developed markets fell by 7% in the same period (according to the MSCI World index). Although the fundamental indicators point to a likelihood that the boom might go bust, investors remain optimistic: just remember the phenomenal latest IPO results. The stock market downfall will occur unexpectedly, as usual, and will perhaps badly affect the real economy as the population and banks engagement into the stock exchange activities is high. Yet, the range of the problems China faces at the moment is somewhat wider than just an overheated stock market.

A Japanese trap for the Chinese model

China's bad loans have been the tool that ensured an unprecedented growth of the economy. There are a number of estimates of the Chinese banks' portfolios the majority of which agree that these are the economy's most troubling area. In 2006, the accounting firm of Ernst & Young estimated the total amount of non-performing loans at $900 billion, which is only a dab less than China's entire gold and foreign exchange reserves ($1 trillion late in 2006).

The underlying factor of this and a host of other problems tackled here is the government-led policy that keeps on applying regulating instruments to the economy. On the one hand, loans are often issued upon the authorities' directives; on the other hand, the interest rates are strictly planned and thus understated – so they are basically disregarded when taking decisions to invest. This points to discrepancies in the investment process. It's no calamity however, as the world doesn't know perfect stock markets. What is even worse is that the Chinese banks are run under open paternalism. The management is absolutely convinced that, with guaranteed stabilization loans and subsidies, they are protected from any troubles. Banks are not very particular about loan request selection. In fact, it's quite a challenge to evaluate the Chinese real production sector enterprises. The majority of loan applicants are unable to provide any sound accounts; therefore no reliable and unbiased assessment of credit risks can be performed.

At the same time, bank loans constitute a basic source of income for Chinese-based companies. Bank lending in China is climbing at the rate of 16 to 17% a year, giving us the ground to establish a fact of a moderate loan expansion. With inflation likely to surge (which brings losses to creditors), the said circumstance poses a serious problem to the banks. In February, the CPI climbed to 8.7% (the highest rate since 1996), but, according to the banks' forecasts, it is likely to fall to 5.9% later this year and to 4.8% in 2009. Housing and land price growth outstrips consumer inflation, with prices in Beijing and the coastal areas tending to grow faster than throughout the country on average.

It is generally known that the bad debt problem appears more dramatic when economic expansion slows down. Should this happen, won't Chine get trapped, like Japan, by a continuous economic depression following the banking collapse? Presently, the Chinese economy surge largely depends on exports. In the latest three months of 2008, China's GDP grew by 11.2% (against the 11.5% in the preceding three months). According to the banks predictions, in 2008 the GDP may increase by 10.2 to 11%, and fixed investments in the GDP shares will decline - first in a long time. In 2009, the GDP growth is likely to be tamed and consumption could decline while the net exports (in the GDP shares) might halve. The economy is being restructured, with heavy industries (metalworking and machine-building) taking an increasingly important position both in production and exports. The investment sector is overheated, and the economy in general rests on the extremely successful exports.
The question is whether China will be able to refigure its economy to a new model based on the domestic demand – in other words, whether the domestic needs could push the economy forward.
On the one part, only 37% of the GDP is domestically consumed - half as much as in the USA - representing the lowest index among the Asian countries; so seemingly, there is a high potential for a structural shift. On the other hand, the existing (traditions) and missing (pension system) institutions dictate a stable support of the today's highest savings standard (more than 25%). Clearly, years will pass before this situation changes, even provided the state leads a proactive policy (the beginning of the internal demand support was announced back in 2004, but the reforms are not yet large enough to deem them a crucial factor). Such efficient instruments as shifting the tax burden from consumers to enterprises, social infrastructure development and consumer lending encouragement are not widely used. A transition to a more flexible yuan exchange rate and its appreciation could cause the domestic consumption to rise. But, despite years-long pressure from the USA, the Chinese authorities are committed to the weak currency regime.

After-miracle Life

Perhaps, the state's negligence is caused by the fact that households tend to consume more all the same, including due to imports. A transition to the domestic growth model can occur on its own - even faster than it seems now. Indirect indicators show that Chinese consumers spend more than official statistics report, and the actual share of income available for spending is not that low. Hence, any active measures undertaken by the state to create 'a consumer boom' might turn redundant!
If, due to any reasons (for instance, political), the state stimulates the customers to spend more, the transition period will be inevitable with exporters unable to push the economy forward equally fast and the customers not ready for this either – simply because alterations in the consuming system take much time. Besides, budget-related problems caused by the expenses for creating the health and social welfare systems might grew sharper and inflation might increase in this period. If negative export shock occurs in the same period (due to any problems faced by the major trading partners like the US), the transition period will be very painful and its consequences – hard to predict. Social contradictions, which are not explicit so far because China is a command economy and because of the rapid increase in production and demand for human resources, might sharpen as well.
Social stratification, worsening despite the Communist Party efforts to rein it, can cease to be a powerful economic instrument (leaving rural areas in an attempt to find a better life, the poor are providing an unprecedented migrant labour supply in the industrial centers) and turn into a delay-action mine. What would become of

China should this soar stop and mass unemployment become critical for both the poor regions and millions-strong staff attracted to urban areas? The vim of potential social conflicts in China can be hardly foretold, but one thing is for sure: a big country will face big troubles. Estimating how inequality influences the households' behaviour we should mention two intertwined factors. First, this is unevenness of China's economic growth which is faster in the four basic industrial zones, coastal areas and the capital while the western part of China does not benefit from globalization and economic rise, so will hardly be able to fend on itself without the state's support. Secondly, this is an imbalance of the rural and urban population's incomes accounting for 26 to 40% of the total inequality level (depending on the method of estimation) - the world's largest inequality rate. After the 2005 surge, the rural citizens' incomes and expenses growth rate re-fell to less than 10%, while the urban population is becoming wealthier at the nearly 15% rate. On the whole, the numerical inequality indices do not look that scaring – the Gini coefficient is 0.45 (equal to that in the USA and higher than that in Russia), but the local specificity (above all, the town-countryside divide) can result in social unrest. All in all, the inequality problem could markedly impede the Chinese authorities' efforts, especially during the transition period when urban people would acquire wealth faster than their rural counterparts.

Yet another hidden problem in China is the economy's vulnerability to external shocks. What would be its response to a possible deep correction in the world's security and housing markets bubbles? There is an opinion that the Chinese real economy simply won't notice the stock index fall, even if it will be plunging down (by 30% or more). First, the Chinese stock market is not yet large enough compared to the economy – the total capitalization of the shares of a public offering accounts for around one-fourth of the GDP. Secondly, investments into shares equal one-fourth of all households' assets (with liquid assets totaling just 11%), while on average this index approaches 40% in Asian developing states. Bank statements can be also affected by a drastic correction of the global stock market. However, according to the World Bank estimates, the Chinese banking sector's capital invested in the stock market is not significant either – totaling just 6% of the shares in circulation.

Do all this figures mean that China is not confronted by the threat of an all-embracing crisis in connection with possible external shocks and domestic banking troubles? Actually, the threat is quite real and is yet aggravated by spreading of the financial instruments triggering multiplication of losses. Negative influence of the stock market on the consuming power can be greatly strengthened under the probable housing crisis (in especially overheated markets of Beijing, Shanghai and Guangzhou agglomerations). There are no guarantees that in case of an overall financial crisis the Chinese government will take adequate measures. It still lacks experience of anti-crisis management and, pressed by various groupings, will most likely pump up the banking system with stabilizing loans and subsidies. This will lead to a further inflation surge and mark the end of the epoch of monetary stability in China. Tough administrative restrains and lack of financial instruments will aggravate the problem of adaptation to external shock impacts.

All problems tackled here can grow sharper within a short period. Budgetary problems caused by investments in the social sphere, the banking crisis and the stock market upheavals can occur when the Chinese economy will be in the artificially accelerated transition from one growth model to another. The said crisis factors are very likely to intertwine. One of the crisis reasons, as has been already said, can be a negative external economic shock - for instance, stagnation in the US that no longer seems impossible. In case of such shock, all unwanted things of which the Chinese economic rise advocates hate to think – abrupt slowdown, index decline, investors' withdrawal and political instability - might happen. Then it will no longer be smart to consider China an investor's paradise, however luring the Chinese stock market might look today.