More signs of a weakening Chinese economy

By Nick Beams
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Concerns over the outlook for the Chinese economy increased yesterday with the release of a closely-watched index of manufacturing activity.

The HSBC-Markit "flash" manufacturing purchasing managers' index fell for the fifth consecutive month in March. It was a clear indication that the reported downturns in January and February were not statistical aberrations caused by the lunar new year holidays.

March's reading was 48.1—below the level of 50 that separates expansion from contraction. It was the lowest result since July last year. Within the overall data there was an additional cause for concern. The output component of the index, which measures the views of company executives on employment, new orders and prices, fell to 47.3, an 18-month low.

While the overall index did not fall as much, because new export orders increased, the sharp output decline points to weakening domestic demand.

A series of reports have pointed to overcapacity in many key sectors, above all, steel. Last month, a government survey found that 71 percent of respondents indicated "relatively or very serious" overcapacity in iron and steel, aluminium, cement, coal, solar panels and shipbuilding.

A Chinese Iron and Steel Association executive recently described the problem as "probably beyond anyone's imagination." China's overcapacity is estimated to be as high as 300 million tonnes—almost twice the total output of Europe last year.

There is a broad expectation among financial analysts and commentators that the continuation of the slowdown during the first two months of the year will prompt the government to launch stimulus measures in an effort to ensure that its growth rate target of "about 7.5 percent" is reached.

UniCredit economist Nikolaus Keis said he expected selective actions to stimulate the economy, including public housing, railway and subway expansion, and possibly some monetary stimulus. "However, while all these measures may … soften the growth slowdown, they will most likely not be able to prevent growth from weakening progressively towards the pain threshold of 7 percent this year, given the cyclical and structural headwinds."

Chief among those structural problems is the growth in debt and fears that increases in credit to stimulate the economy will only further expand the credit bubble. While a credit expansion may ease economic problems in the short term, it will create the conditions for a crash further on.

Expanding credit, both from domestic and international sources, has boosted the property boom that has played a critical role in sustaining Chinese growth.

Amid the emergence of "ghost" cities—massive real estate developments with no inhabitants—a sharp fall in the property market could provoke a "systemic" crisis in the country's financial system because property developers have complex financial ties to major banks.

The head of the Development and Research Centre at the State Council, Li Wei, warned that "it is undeniable that the property bubble is getting bigger and has become the most unpredictable risk for China's economy."

Last September, Wang Shi, the chairman of China's largest property developer, Vanke, said property prices were "strikingly similar" to those experienced in Japan during the late 1980s and which led to a crash in 1990. That collapse ushered in a period of economic stagnation, coupled with a huge build-up of government debt, from which Japan has never recovered.

Seeking to avert an uncontrollable financial crash, Chinese financial authorities have started to take action to lower the value of the yuan (renminbi) in international currency markets. These efforts are aimed at cutting back the supply of “hot money” that has flowed into the country on the premise that the yuan could only keep rising.

These measures to deflate the Chinese financial bubble could spark the very financial crisis that authorities are trying to avert. After falling for the past two months, the yuan is now around 6.20 to the US dollar, a level considered a “red line” for a series of complex derivative products. Analysts have warned that if the currency devalues further, this could cause heavy losses, running into billions of dollars.

A complex system of “carry trades” has developed. Investors borrow in dollars to buy yuan assets in China, on the expectation that the Chinese currency will continue to rise and they will make financial gains. If the yuan falls, they stand to make large losses and face a possible cash crisis if the banks decide to call in collateral. The potential losses on these funds are estimated to be $3.5 billion and could reach $7.5 billion if the yuan drops to 6.38.

A financial crisis sparked by the collapse of a major industrial corporation, a significant bankruptcy in property and real estate, or losses by financial market speculators, would have far-reaching global consequences.

Already, the slowdown in China is having a marked impact on “emerging markets” that depend on non-food raw material exports to China.

An article in yesterday’s *Financial Times* noted that “the spectre of weakening Chinese imports of iron ore, copper and other resources looms large for Brazil, South Africa and Indonesia,” with a “negative” outlook for Chile, Colombia, Russia and Peru. China’s downturn seemed likely to preclude any improvements in the trade position of a number of Latin American countries “for some time to come.”

Non-food commodities, all of which are experiencing price falls, account for 80 percent of total exports to China from Colombia, Chile, Brazil and Peru. Exports to China from Russia, South Africa and Turkey also chiefly comprise minerals and other industrial raw materials.
