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China: all bets are off

The economic miracle has been halted in its tracks

Michael Sheridan in Hong Kong

FROM Hong Kong to Shanghai, shuttered factories and laid-off workers tell a tale of how the world credit crisis may end the Chinese export miracle and pose the greatest threat to economic reforms since they began in 1979.

Bankruptcies and unemployment are climbing, while political pressure is mounting from the left on policymakers. Some officials are openly challenging the export-driven model that led China to stack up foreign reserves of $1,800 billion (£1,060 billion). There has been little effort to cover up the distress, perhaps because of rivalries between factions of the Communist party.

China Central Television, for example, recently broadcast a report prepared for the cabinet saying that 67,000 companies have gone bankrupt in the first half of the year and 20m workers have lost their jobs.

The latest phase of the crisis, in which stock markets fell sharply across Asia, forced the authorities to reverse policy by cutting interest rates and restoring subsidies to exporters.

However, the most important, if understated, signal of China’s response came in the currency-futures market, which now prices in a 2.5% fall in the value of the yuan against the dollar over 12 months.

That is a defeat for the strong-currency policy urged on China by US Treasury secretary Hank Paulson, who boasts of his leadership ties forged during 70 visits to Beijing on behalf of Goldman Sachs.

The yuan has strengthened by more than 20% against the dollar since 2005. Halting its rise is the one sure way to restore a cost advantage to exporters, although it would infuriate China’s trade partners in Europe and America.

This crisis has already cast doubt on fundamental assumptions about global trade, though, and presents China’s leaders with another serious domestic challenge.

Their propaganda triumph at the Olympics was overshadowed by riots across Tibet, terrorism in the Muslim far west and an earthquake that killed 60,000 people. There were also scandals over fake or contaminated goods, most recently milk products tainted with melamine that have killed and hospitalised many children.

Now their main claim to legitimacy – a strong economy – is under pressure as Chinese stock markets have fallen more than 60% while real estate in

the nation's most liberalised city, Shenzhen, is down by 40%.

Critics at home have openly challenged their policy of investing dollar reserves in US Treasury bonds. China holds $519 billion, second only to Japan, which has $593 billion.

These investments kept US interest rates low, funding the sub-prime mortgage boom and the war in Iraq. For China, though, they could turn out to be a bad deal.

Most ordinary Chinese are unaware that foreign-exchange reserves are not free assets but represent liabilities against domestic currency issued by the central bank to "sterilise" dollar inflows earned by exporters. Even so, public opinion does grasp that every percentage point fall in the value of the dollar against the yuan represents a loss for China in its own money.

There is also angry popular debate about state-directed forays into foreign acquisitions, such as loss-making investments in Morgan Stanley, the US investment house, and Fortis, the recently nationalised European bank.

A significant fall in exports, leading to more unemployment and company failures, could intensify unrest and destroy confidence in private enterprise.

That would strengthen the hand of Marxist intellectuals – who, contrary to wishful thinking in the West, have not vanished from China. That is why economic reformers are striving to avert a sharp slow-down.

In August, production of fridges fell 14% compared with a year earlier, said Huo Dufang, chairman of an industry association. Output of air-conditioning units fell 7.7% and of microwave ovens by 6.5%, he said.

"As more and more developed countries run into a financial crisis, China's exports will contract exponentially," said Wang Jie, an economic analyst in Shanghai. "I forecast that a third of small and medium-sized enterprises in the export sector will go bankrupt by the second quarter of 2009," he added.

In the export-orientated provinces of Guangdong, Zhejiang and Jiangsu, the slowdown has already cut a swathe through businesses.

Out of some 6,000 shoe factories in the Pearl River Delta, 2,331 have gone bankrupt, according to a trade magazine.

One in five small or medium-sized enterprises in Zhejiang have also gone under, said the Securities Daily, a business newspaper.

Scenes of angry workers and creditors besieging the premises of the Golden Sun group were shown on local television, which reported that its boss, Zhang Zhengjian, had fled owing almost £100m.

And last week the China Youth Daily told the story of how an employee, Xiao Gao, showed up early for work at the biggest printing and dyeing group in Zhejiang to find the offices stripped of computers and strewn with documents.

Police were looking for the owner and his wife, who are reputed to owe £85m to state-owned banks and a further £57m to the institutions known in Chinese as "underground banks".

The latter, which levy interest at up to 40% a year, have proliferated in a landscape of commercial desperation despite the fact that Chinese businessmen fear their sinister figureheads and their drastic methods of debt collection.

"At first the government thought that Chinese companies could export more to Europe while America was in a slowdown but now the crisis has spread," said Wu Jian, an analyst at Ping An insurance.

Optimists can argue that China is a vast country of 1.3 billion people, which has absorbed far worse shocks in the past 50 years than a down-turn in exports. This ignores the reality that the export zones of south and east China have been the locomotives of economic reform, generating prosperity and helping to create a class of Chinese with a stake in political stability.

Not surprisingly, some officials are openly arguing that China has got its priorities wrong. Wen Zongyu of the Ministry of Finance research centre, said: "We need to admit that most of our exports were low-quality, without brand value or added knowledge, which meant that most of our exports to America and Europe were sold to poor people."

Speaking on state television, Wen said: "Poor people in America and Europe are having a hard time, so the fall in consumption will directly affect China's production and exports."

British businessmen visiting China last week to attend the big annual trade fairs disagreed with this analysis. "In a recession, the top end and bottom end of the market do well but the middle market gets squeezed," said one. "Unfortunately for China, that's exactly where they've been trying to shift their exports."

Yet some Chinese thinkers are already exulting, saying the crisis is proof of the superiority of the Beijing model of state-dominated capitalism over its free-market counterpart.

Vindication of that theory will come at a high price.

The title of a banned book by an economist, circulating to great enthusiasm on the internet in Chinese last week, said it all: China - The Twilight of a Miracle.