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# End of the Chinese Miracle?

## Spate of Factory Closures, Soaring Transportation Costs Shatter 'Decoupling' Myth; May Signal End to 30 Years of Unprecedented Growth

Last update: 9:22 a.m. EDT July 23, 2008

TUCSON, AZ, Jul 23, 2008 (MARKET WIRE via COMTEX) -- Think an investment in Chinese stocks makes good financial sense? Think again.

The Shanghai Composite Index is down 55% since October, the worst performer of all global stock markets, and this may be only the beginning of a long-term decline. China's economy is headed for real trouble, and the 'China boom' may be in for a hard landing following the Olympic Games, attributable primarily to rising transportation costs and the economic downturn underway in China's two largest export markets: the U.S. and Europe.

A recent OECD report predicts wage and price inflation will erode China's export competitiveness, stating that "coupled with ongoing weakness in external demand, exports and the pace of market share gains are projected to slow markedly." As China's export-driven economy contracts, the limited purchasing power of China's domestic consumers is insufficient to replace the loss of demand for exports.

"We expect a lag of 2-3 quarters before the real impact appears," commented Kevin O'Brien at risk analytics firm Sovereign Advisers. O'Brien cited this year's drop in trans-pacific containership traffic and the miles of idled railroad container freight cars placed into storage by Burlington Northern as early signs of the reversal of China's past economic boom. O'Brien added, "The accelerating global economic slowdown will have a pronounced adverse effect on China's economy. As a producer nation and net importer of oil, China is particularly vulnerable to commodity price inflation, and its economic and political stability is dependent upon hard currency earnings derived from export manufacturing. China's vast wealth and income disparity means a seamless transition to a domestic consumer economy is not possible." (Click to read Sovereign Advisers' current China trends report).

### China Dependent on Export Earnings as Largest Markets Slide Toward Recession

With home foreclosures surging 53% in June and an economy that is "shaping up to be the worst in a generation" according to a Harvard University study, the debate is over as to whether the U.S. economy is in serious trouble. With Europe also headed toward recession, China will suffer a loss of demand from its two largest customers, making China (and the 250 million workers employed by mainland factories which produce exclusively for the U.S.) acutely vulnerable to the global downturn.

### 'Decoupling' Myth Debunked

The notion that global economies including China have 'decoupled' from the U.S. and will thus avoid the fallout from a U.S. recession is patently false. Macroeconomist Nouriel Roubini reports this theory has largely been promoted by Goldman Sachs and Treasury Secretary Paulson, a former chairman of Goldman Sachs. As Roubini points out, the U.S. consumer remains the engine of global growth, and with U.S. consumer spending in retreat, export-producing countries will be especially hard hit. Roubini states in regard to China that "its overheating is unsustainable and its dependence on exports to the U.S. make it massively vulnerable to a U.S. slowdown. So, expect a massive Chinese slowdown."

Zhang Tao, an official of the People's Bank of China, also refuted the notion that China's economy can decouple from the United States, stating, "If U.S. consumption really comes down, that's bad news for us." Wang Jian, head of the China Society of Macroeconomics, agrees, stating that "global demand is ultimately driven by the United States."

Echoing Mr. Tao's remarks, Diane Swonk, chief economist for \$32 billion asset management firm Mesirow Financial, stated, "We are seeing weakness in the U.S., and the whole idea of a 'decoupling' of the U.S. and external economies is being debunked."

With per capita income just \$2,800, demand from China's domestic market is far too small to replace the loss of demand from export markets, as the vast majority of the country's population remain too poor to participate in China's nascent consumer culture.

### China Losing Competitive Advantage

The yuan's 16% appreciation against the U.S. dollar since 2005 has placed enormous pressure on low-margin exporters. Xinhua reports 2,331 shoe factories in China's Guangdong Province, half the total, closed in the first five months of 2008.

Factory owner Tim Hsu, whose lighting fixtures plant is operating at just 60% of capacity, predicts that half of China's lighting factories will close their doors this year. "Shoe factories, clothing, toys, furniture, everyone is shutting down," he says. Philip Cheng, chairman of Strategic Sports and producer of half the global supply of motorcycle, bicycle, and snowboarding helmets from 17 plants, says, "Now we are dying."

The OECD study predicts the end of China's competitive advantage in manufacturing, as rising transportation costs cause relocation of manufacturing industries away from China and closer to U.S. and European consumer markets. Coupled with weak domestic demand, factory shutdowns will likely accelerate.

"The Asian outsourcing game is over," says CIBC World Markets chief economist Jeff Rubin.

"Clouds are now forming over China's economy," warns Stephen Green, chief economist at Standard Chartered Bank in Shanghai, adding that "the golden years are over..."

In the face of a contraction of consumer spending in the U.S. and Europe, and with the majority of China's population too poor to replace lost export earnings via the domestic market, China's heyday may well be in the past.

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