

Is China a Ticking Timebomb? (Part 2)

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China's Rampant Credit Creation

China is flush with mountains of money. Despite efforts by the government, China's banks made loans equal to 87% of the annual loan target set by the central bank in just the first six months of this year. The People's Bank of China had planned to keep money supply (M2) growth to 16% for all of 2006. But by the end of June, money supply was up 18.4% year over year. China's banks carry more than 1.3 trillion yuan of nonperforming loans, which exceeds the 8 percent carried on their books, according to Moody's Investors Service. Chinese banks are "backward in terms of their risk management and pricing of loans," said May Yan, vice president at Moody's in Hong Kong. "It's going to take years for these banks to learn how to price risk, and they're going to get burned along the way."¹

The problem here is that to keep the Chinese yuan from appreciating against the U.S. dollar, the bank has to buy U.S. dollars and sell yuan to offset the huge inflows of U.S. dollars from China's trade surplus with the United States. Thanks to that buying of dollars for yuan, the yuan has appreciated just 1.4% against the dollar since it was revalued by just 2.1% in July 2005. So until the yuan's exchange rate comes into equilibrium with the US dollar, the Chinese will have to continue to create more yuan in order to buy all the US dollars it takes to keep the yuan artificially low.²

The government seems extremely reluctant to tackle the root causes of the bubbles that have emerged. Despite the People's Bank of China's April increase in the benchmark one-year interest rates to 5.85%, the first rate increase in 18 months, interest rates for borrowing are still ridiculously low. Companies can borrow at an after-inflation rate of about 3.5%.

On the other hand, the People's Bank left the one-year interest rate that depositors get paid at 2.25%. That worked to bolster the profits of the big Chinese banks that the government is interested in taking public with Western investors as major buyers. It also created a massive disincentive for companies to save their cash. Instead, companies are reinvesting their cash, adding to the growth of fixed assets and to capacity gluts in some

¹ People's Daily Online, China, "Growing number of economists believe China's economy beginning to overheat"

² China Daily, "China must raise interest rates further – economist"

industries. According to the World Bank, retained corporate earnings accounted for more than half of new investment last year. That's about double the ratio in the United States. An increase in the value of the yuan against the dollar would damp corporate profits, slow the speed of investment in fixed assets and reduce speculative inflows from overseas investors who anticipate a yuan appreciation. Hiking the one-year benchmark interest rate again and again, and raising the interest rates paid to depositors would have similar effects. But such actions would also slow the economy and reduce the number of jobs that the economy is creating. China needs GDP growth north of 7% a year just to stay even with the number of new job seekers thrown up by its massive population every year. Reducing unemployment and underemployment -- categories that take in about 40% of the Chinese population by some counts -- requires even faster growth.³

A significant portion of China's small ruling inner circle has fought efforts to attack the problem at the source to a standstill. Commerce Minister Bo Xilai, for example, has complained that any appreciation in the yuan will cripple profits in marginal industries such as textiles, where the profit margin is just 3%. What we found interesting is that a client manufacturer in China is having trouble attracting qualified labor as the labor is moving to higher paying jobs in technology manufacturing with higher margins. So the low-end manufacturers, such as the textiles are also fighting labor rates the WSJ has reported to have risen over 10-15% a year over the last few years.

A purely rational economic analysis would say that if Chinese textile makers can't compete after the yuan is appropriately revalued, then the least-efficient companies in the sector should go out of business and the jobs should flow to countries, perhaps Vietnam, where lower labor costs would allow textile makers to make a profit. That would mean shipping jobs out of China, however, and advocating that is political death in a country that needs to create 20 million jobs a year to keep the population governable by the Communist regime.⁴

Risks of a bust are increasing, said Robert Subbaraman, senior economist for Asia at Lehman Brothers in Hong Kong. "We have raised our likelihood on the Chinese economy slowing sharply to a one-in-three chance." A sharp slowing of China's economy would make the Asia Crisis of 1997 look like a joke.

³ Jubak's Journal, China's Economy is Out of Control, Jim Jubak

⁴ Bloomberg News, Economics: Risk of bust growing for Chinese economy, Matt Benjamin & David Tweed