The Insight Bureau Briefings

From the Desk of...

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Issue No.68 - June 2012

China's Economy Has Stopped Growing: Richard Duncan, economist and author of *The New Depression, The Dollar Crisis* and *The Corruption of Capitalism*, shares his observations and considers the consequences of China's slowdown for the world.

I have just returned from a short trip to Beijing and Shanghai. My impression is that China's economy has stopped growing. If I am right, the consequences for the global economy will be profound.

Since the late 1980s, China has pursued an economic strategy of export-led growth with extraordinary success. Its trade surplus with the United States rose from $10 billion in 1990 to $268 billion in 2008. And, with the dollars it earned from that trade surplus, China bought commodities from South America, Africa and South-East Asia and precision machine tools from Germany, Japan and Korea. Thus, by spending the dollars it earned in the US, China became a "new engine of global economic growth."

Last month, China's exports expanded by only 4.9% compared with the same month last year. Its imports rose by just 0.1%. In other words, Chinese demand contributed nothing to economic growth outside China last month. This was a tremendous change from years past when Chinese imports generally grew by more than 20% every year. No growth may be the new normal for China. Export-led growth strategies don't work when exports don't grow.

The credit-fuelled booms in the United States and Europe have ended in crisis. The heavily indebted Americans and Europeans cannot afford to continue buying more from China every year as they have in the past. I believe this new reality spells the end of China's great economic boom.

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Having a large population with a low average income is not a sufficient condition to guarantee rapid economic growth. If it were, China (and India) would have become wealthy a long time ago. Sustainable economic development requires income growth, or, in other words, rising wages. Wages have been rising in China, but roughly 80% of China's population still earns less than $10 per day. The minimum wage in Beijing and Shanghai, China's two leading cities, was just increased to $13 per day. Wages are much lower elsewhere around the country.

Wages are determined by the supply and demand for laborers. Approximately half of China's 1.3 billion people still live in the countryside. Urbanization is taking place, but bringing people into the cities does not cause total consumer demand to rise unless the wages of those people actually increase. In fact, a growing number of city dwellers could actually push wages down in the cities if there are not enough new jobs to absorb the increasing workforce. Thus, China's huge population is a curse rather than a blessing unless a way is found to make average wages increase.

Since 1990, millions – tens of millions – of Chinese have been employed in factories making things to sell to the Americans. That increased the demand for labor and allowed wages in China to rise to where they are today. Now, however, the American households, after increasing their indebtedness from $4 trillion in 1993 to $14 trillion in 2008, are incapable of taking on any more debt. Therefore, they will not continue to buy more from China each year. China's trade surplus with the US is not going to continue skyrocketing as it has since 1990. Consequently, US demand for Chinese goods is no longer going to continue absorbing more Chinese labour each year. That means it will not continue to put upward pressure on Chinese wages. And, if demand from the US ceases to put upward pressure on Chinese wage rates during the years ahead, then what will?

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In 2009, the year after the economic crisis began in the United States, China's trade surplus with the US contracted. It fell from $268 billion in 2008 to $227 billion in 2009. This had an appalling impact on Chinese employment. International newspapers reported that 20 million Chinese factory workers lost their jobs and were forced to return to the countryside to look for work as agricultural laborers. China's leaders responded to this destabilizing crisis by allowing China's banks to increase the total outstanding amount of bank loans by 60% over a two-year period. Sixty percent loan growth in 24 months! Just imagine what impact a 60% increase in outstanding bank loans would have on the US economy or the Japanese economy or any economy. Property prices would skyrocket, everyone would have a job and wages would increase sharply. But then, a couple of years later, the borrowers would be unable to repay those loans and a banking crisis would ensue.

That 60% increase in total loans, combined with the rebound in the US economy (brought about by trillion dollar US budget deficits financed with trillions of dollars of paper money creation) worked miracles for the Chinese economy. The 20 million displaced factory workers got their jobs back and China's economy continued growing by 8% to 9% a year.

But now what? The global economic crisis is intensifying and China's export growth is slowing very rapidly. Within China, the newspapers are reporting that there is no demand for new loans. That is hardly surprising after the explosion of bank credit since 2009. That new credit financed an extraordinary expansion of investment and production. As a result, there are now very few profitable new investment opportunities left in China.

After two decades of very rapid investment and production growth, China now has excess capacity across almost every major industry. On this trip I was shocked by the lack of construction of new high rise buildings in Beijing and Shanghai. Every other time I have visited those cities, hundreds of cranes were visible on the skyline. This time, in Beijing I saw one; and in Shanghai, I saw dozens instead of hundreds.

As I learned during the six years I did research on Thailand's economy in the 1990s, a property construction boom not only employs a very large number of construction workers, it also affects a wide range of related industries: steel, cement, glass, carpets and sanitary ware being the most obvious ones. During the boom, all those industries invest and expand their production capacity many fold in order to meet the growing demand for their goods. That investment contributes to the overall economic boom. When the construction boom ends, industries which supply construction materials are then left with massive excess production capacity. New investment in those industries ceases. Many of those businesses fail and default on the bank loans they took out to expand their capacity.

Skyscrapers are easy to see and to count. Either hundreds of new ones are being built or they are not. The logic of how a boom and bust of construction affects the related building material industries (as outlined above) is also easy to follow. However, a boom of capacity expansion in other, non-building related industries is not so obvious. In Thailand's case, it was nevertheless just as great as the building boom during the bubble years. Almost every industry expanded its capacity many-fold. And, when the boom ended (due to excess capacity relative to affordable demand), every industry suffered from excess capacity and excessive debt. Many businesses failed. The Thai banking system spiraled into a systemic crisis as a result.

After a two-decade long boom of unsurpassed proportions, China is now in much the same position that Thailand faced in 1997. It has far more production capacity than its 1.3 billion people can afford to buy given the country's very low wage structure. As long as China could sell more and more to the United States every year, its economy could continue to grow. Now that the US is in crisis, there is no one to absorb China's excess industrial capacity. Consequently, there is no reason for China to invest more to build even more excess capacity. That means China's great economic boom is coming to an end. Unless rapid economic growth soon resumes in the West – and there is no reason to expect that it will – then China's leaders will struggle just to prevent a severe contraction of the economy. China's "economic miracle" is very close to following the Japanese miracle, the Asian miracle and America's NASDAQ and property bubbles into the history books as just one more credit induced boom and bust.

About Richard Duncan and The Insight Bureau

Richard Duncan is a global and Asia economist, writer and author of several hard-hitting books about the realities of our recent financial crises, including an international bestseller that predicted the current global economic disaster with extraordinary accuracy. He has been a leading financial analyst in Asia for more than 25 years, conducting research and publishing investment reports on companies, industries and economies from India to Korea. He was one of the first people to warn of the impending collapse of the Thai Economy and the Thai stock market in a series of reports and presentations to institutional investors. More recently he predicted the current global economic disaster with extraordinary accuracy. www.insightbureau.com/RichardDuncan.html

His most recent book, launched this year, *The New Depression: The Breakdown of the Paper Money Economy*, explores why the global recession is now in danger of becoming another Great Depression and how we can stop it.

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The Insight Bureau provides speaker placements and briefings as a service that helps achieve a better understanding of the world in which we do business and to ultimately help senior executives to make better business decisions. The Insight Bureau represents Richard Duncan for speeches and briefings.

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