China Crash

Investors, your money is gone.

Anti-Japan demonstrations reveal the structure of a world economic crisis

China is not a source of success anymore but a time bomb for the world economy. We must be cautious about the burst of Chinese bubble – China crash. A key gear of the world economy may have already started to wind in reverse.

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Anti-Japan demonstrations occurred in China, as I had predicted in my article in the February 2005 issue of Chuokoron, and the relationship between Japan and China is at its worst point after the normalization of the relations between the two countries in thirty years. China bashing has begun in the U.S. with President Bush calling for China to let the Chinese yuan appreciate and to introduce floating system, which China has rejected. A China crash stemming from the burst of the bubble economy may open a Pandora's Box in the world economy.

Even though the Chinese government has been trying to tighten its economy, the risk of the bursting of the bubble is growing. A China crash will not only hit the Japanese economy, it will also trigger a sharp fall in world stock markets and turmoil in the currency markets, cause instability in the world's financial system, and increase political, military and global security risks.

Contrary to the expectation of Beijing, Europe and America's wariness of China, not Japan, was heightened because of the anti-Japan demonstrations. The view on China quickly changed; considered a driving force of globalization until last year, now it is considered the biggest risk to the world economy.

The trigger for this change was oil. The price of crude oil per barrel (World Texas Intermediate) was between 10 and 20 US dollars six years ago and reached close to $60 this year. The biggest reason for the rise is China, which has quickly become the world's second largest importer of oil. China consumes seven times as much oil as Japan does to produce the same amount of GDP. In other words, China is wasting resources. The prices of primary commodities continue to increase because of strong demand from China; the Reuter-CRB Futures Index rose more than 70% from 2002. There is talk of food scarcity within a few years. If China continues to grow at this pace, there is a concern that the world's resources could dry up.

China sends research ships to the Senkaku Islands area and trades with tyrannical nations such as Iran, Sudan and Nigeria in order to obtain resources. Some take a harsh view of this behavior. Since China comes under the scrutiny of Europe and America contrary to the expectation of Beijing, the Chinese government prohibits anti-Japan demonstrations. However, the risk still exists that anti-Japan demonstrations will lead to anti-foreign movements.

Sudden Disillusionment with China

In the U.S., concern about an inflationary recession has risen. The rise of the crude oil price depresses the consumption of other goods and leads to a slowdown at retailers such as Wal-Mart. Bonds of General Motors and Ford bonds, whose leading products are SUVs and tracks with low-mileage, were lowered to junk status. Delta Airlines is blaming fuel prices for its troubles. There is labor unrest. Even though the economy may get worse, Alan Greenspan, the Chairman of the Federal Reserve Board of Governors (FRB), continues to raise interest rates to avoid inflation. This has suppressed the American and Japanese stock markets even though Japanese corporations are enjoying record profits.

In the U.S. Congress, the belief that the Chinese economy is in bad condition is gaining momentum. The week after the anti-Japan demonstration, the Bush administration asked China to introduce floating currency system. Soon after, they strongly requested that China let the yuan appreciate within six months. The Chinese government continues to resist the pressure. Bill Clinton's and Jiang Zemin's 1997 "Strategic partnership between China and the U.S." is facing its greatest challenge.

The scenario that "China is a main actor in the win-win globalization game" is not possible any more due to the U.S. trade deficits. If American corporations close their U.S. factories and build Chinese factories, the U.S. employment numbers may fall at first. However, since the average salary in China is around one-thirtieth of that in the U.S., labor costs are dramatically lower. Workers in China are diligent and maintain high quality. Other costs, such as land, are also dramatically lower. Under good management, higher quality goods can be produced at lower cost. Even if the retail prices of goods produced in China by American corporations are lower than those produced in U.S., American corporations' consolidated profits increase. American consumers welcome goods made in China because they are cheaper. This does not create inflation.

This reality has led many corporations set up their operations in China. As the American economy is stock-oriented, most individuals own stocks, while Japanese hold most of their assets in savings accounts at banks. When American stocks rise, these investors use the proceeds to buy goods, services and homes, which creates jobs. The trade deficits expand, but American economic growth accelerates. Some even say that

China is a better partner than Japan because Japan is a closed and high-cost society.

For the Japanese economy, China is a savior. Japanese corporations rushed to transfer their factories to China and earned large profits by importing the goods back to Japan. China is also an active consumer. Prestigious corporations such as Nippon Steel, JEF, Komatsu, and Mitsui O.S.K. Lines recovered dramatically thanks to strong demand from China. Suntory, Shiseido, Lawson, Toyota and Honda boldly developed markets in China. Companies from Hong Kong, Taiwan, Korea, India and Europe also have prospered. For oil-producing countries such as Brazil and Russia, China is their largest customer.

The opening of the Chinese market, closed during the administration of Mao Zedong, benefited the entire world in the globalization with market opening and factory transfer after 1990s.

Globalization brought fundamental changes to Chinese society. Until the Tiananmen Square incident in 1989, China aimed to democratize and become self-reliant using the slogan of “Learn Japan” under the direction of Hu Yaobang and Zhao Ziyang. However, with inflation at close to 20%, China could not attain its economic growth goals.

Deng Xiaoping suppressed democratization by assigning Jiang Zemin, who quelled the Tiananmen Square incident, as the next leader and attracted foreign capital in order to attain growth. China attached great importance to the U.S., which promoted globalization. The “wealthy first theory” was exaggerated and the priority was put on growth, ignoring fraudulence and the growing disparity of the distribution of the wealth. As a result, China achieved the economic growth it sought, relying on foreign capital.

This growth resulted in a mixed economy. In this economy, three parties share the tax burden; state-owned corporations which have been controlled by the Chinese Communist Party, private corporations which increased after the reform and opening-up policy in 1979, and foreign corporations that had gained power in the 1990s. Encouraged by advantageous treatment, foreign corporations brought capital, technology, branding and management power into China. Foreign currencies and employment in China increased but the management of ineffective state-owned corporations became a serious problem.

State-owned corporations still control about 70% of the employment and capital in the Chinese economy and manage schools, hospitals and pension funds as the center of life communities called "units." In state-owned corporations, a Communist Party committee is set up and leading members of the Party reign over the management of corporations. There, the government's intentions have priority over the management's policies and investment and production will occur if the Party wishes it so. Bureaucrats tend to pursue diversification in order to secure their positions and make political points. Excessive competition and poor management are common.

In order to overcome this ineffective system of socialism and to save the state-owned corporations, state-owned corporations were made public and listed on the stock market. For example, Chengdu Hongguang Industrial Co., LTD is a state-owned manufacturer of black and white televisions headquartered in Sichuan. It had financial difficulties in the 1990s when color televisions came to China. However, its deficits were hidden so it could be listed on the stock exchanges of Shenzhen and Shanghai on the pretext of its significant contribution to Sichuan's finances in the past. It is said that a senior official in the government at present strongly supported it. After listing its stock fell sharply and general investors suffered heavy losses. A lawyer with a strong sense of justice brought the first shareholders' class-action lawsuit in China against the corporation and won the case.

This is not an exception. It is common to window-dress the accounts and transfer capital losses to the investor after the company has been listed on the stock market. 95% of the listed corporations in China are state-owned and 70% of the stocks on average are held by the government and not traded. In other words, the government continues to control them. The stock exchange and supervisory authorities are nothing but a system to transfer the losses of state-owned corporations to general investors. There is no corporate governance. This is the reality of privatization in a socialistic market economy. Even though China attains high economic growth of 8% per year, the Shanghai Total Index has fallen to the half of its 2001peak and has lost the trust of investors.

Real crisis – Financial and real estate bubble

State-owned corporations are not the only problem. Almost half of financial institutions such as security, trust and insurance corporations that provide investment products and hold clients' assets seem to be in near bankruptcy. The largest group of private investment corporations, D'Long International Strategic Investment Co., LTD, has more than 10 financial institutions such as securities companies, banks and trust companies. It is said to have gone bankrupt at the end of last year. This was kept secret and the government saved it although it was a private corporation. The president of the group seems to be very close to senior officials in the government of his home region.

It is stunning that the manipulation of clients' assets, which is considered illegal in Japan, can be seen in the entire financial industry, not only in securities but also banks, and trust and insurance corporations. Corruption in financial institutions in addition to the slumping stock market prices keeps investors from purchasing financial products.

Even more serious is magnitude of the banks' problems. Banks handle 85% of the loans extended in the domestic economy and state-owned banks dominate the industry. Four large state-owned commercial banks hold 60% of the country's savings and employ 1.5 million bankers. Their management is under the Communist Party's influence so it cannot make decisions based on sound fiscal principles. 70% of the loans are extended to state-owned corporations, half of which appear to be non-performing. In order to postpone bankruptcies, banks have been extending additional loans. The China Construction Bank, the second largest state-owned bank that is preparing for listing on a foreign stock exchange, had its top management replaced and 43,000 bankers punished for embezzling 8 billion yen. This is seen as just the tip of the iceberg.

The Chinese central bank, People's Bank of China, announced that 25% of the loans of state-owned banks were non-performing. After the announcement, the non-performing loans were transferred to the government in preparation for the listing on a foreign stock exchange and amortized with the resources of foreign reserves and national bonds. The rate of non-performing loans at the end of 2004 was 13.2%, much higher than that of Japan's non-performing loans, which peaked at 8.9% at the end of March 2003. Moreover, an American rating company says the real rate is much higher than the announced rate. Although the real estate bubble has not yet burst, the rate of non-performing loans is very high. If savings cannot be withdrawn because of banks' bankruptcies, social uncertainty may occur since most Chinese keep their savings at state-owned banks. In order to avoid uncertainty, the government must take over the banks' losses. In such a case, the final financial burden will be huge.

The financial system, the arteries and nerves of any economy, is corrupt and near failure. The high saving rate, foreign capital, and concealment of the true economic situation prevent the financial system from failing. The plan to list state-owned banks on foreign stock exchanges next year is in progress while regulations for entry into the financial business will be eased. When the world learns of China's financial problems, the risk of confusion in the market will increase.

Since the domestic financial market is fragile, as stated above, and off-shore markets are not allowed, internal and external capital flows into real estate. Since foreign investors are allowed to own real estate, they have been investing aggressively in order to obtain foreign exchange earnings with the eventual appreciation of the yuan. Wealthy Chinese are also investing in real estate. Banks are also actively lending. Accordingly, the real estate market has shown unprecedented growth, mainly in large cities. Many condominiums in the center of Shanghai are increasing in value by 70% to 80% annually. The price of a 100 square-meter condominium rose to 30-40 million yen.

A manager's annual salary in a foreign corporation in Shanghai is around 2 -3 million yen and in sharp contrast to the national income per capita in China, which is around 100,000 yen. At present, it is said that there are about 3,000 buildings with over 20 floors and permits have been issued for the construction of another 4,000 buildings. Excess supply is expected even in Shanghai, which has strongest demand. The vacancy rate has already exceeded 20% in Hangzhou, one of the largest cities in the Shanghai area. Real estate prices have already fallen sharply in Shanghai because of the recent tightened lending standards and tax regulations on real estate.

Considering these facts, it becomes clear that the real estate market, which attracts capital late in the cycle, has already peaked while stock prices fall, loans become non-performing and many financial institutions are near bankruptcy. The Chinese bubble finally is coming to a climax. The burst of the real estate bubble will lead to the failure of the financial system as Japan experienced before. The current situation in China is similar to the one in Japan on the eve of the oil shock. The Japanese government opposed pressure to let the yen appreciate starting in 1971 and purchased large amounts of US dollars. As a result, yen flew into the market. Investors poured yen into real estate and caused a property boom. After that, the yen appreciated and Japan was forced to let the yen float. Real estate and stock prices fell sharply after the oil shock. It took about a decade for the Japanese economy to recover from it.

The U.S. has already forsaken China

It will not be the Olympics or the Expo, but the rise of interest rates in the U.S. that will cause the Chinese economy to fail. The largest factor in rising American interest rates was Chinese economic growth. Alan Greenspan, Chairman of the Federal Reserve Board of Governors (FRB) has boldly changed monetary policy. In 2000, he raised the Federal Funds rate (FF rate) to 6.5% in order to cool down the overheated American economy. After September 11, 2001, he promoted monetary easing and the FF rate was cut to 1% in June 2003. Accordingly, investment in the yuan increased significantly.

According to the Financial Times, a report for the Bank of International Settlement assumed that capital inflows other than foreign direct investment have accounted for nearly half of China's foreign reserve accumulation since 2003. Most of the speculative money is invested in real estate to capitalize on the appreciation of the yuan, as mentioned before. Rising expectations fuel further investment, which lead to property appreciation, and even higher expectations and even more investment, thus creating the bubble.

This game is going to end soon. Since June 2004 when oil prices started to rise, Chairman Greenspan raised the FF rate 0.25% eight times in a row to reach the current 3% rate. Because of the rate hike, share prices have been sluggish and there are signs of recession, but the Fed says it will continue to raise the rate in order to control inflation. There is a co-existence of a recession and inflation and deactivated American monetary policy. If the situation becomes more serious, there will be resurgence of 1970s-style stagflation.

Unlike the 1970s, the U.S is no longer the largest producer of oil and holds only 3% of world's oil reserves. However, the U.S. continues to consume 25% of world's oil. While Japanese makers produce fuel-efficient cars like the Prius and Insight, which can achieve more than 30 kilometers/liter, the Big Three in the U.S. have focused on SUVs and low-mileage trucks. This makes America very vulnerable to a rise in oil prices. Oil-producing countries are at their lowest level of excess capacity in the past 20 years. If the Chinese economy does not slow, a further rise in oil prices is inevitable. In order to avoid stagflation, Chinese economic growth must be stopped.

Chairman Greenspan is forced to make a very difficult decision; should he make the

Chinese bubble burst by raising interest rates and ask the world economy to endure the shock? Or should he stop hiking the rate and risk an uncontrollable Chinese crash.

It is a concern that Chairman Greenspan will resign in January 2006 and President Bush will appoint his successor. Former Chairman Volker, appointed by President Carter, was successful in fighting inflation with strong monetary tightening. But interest rates exceeded 20% at the beginning, and the recession spread, helping Reagan to defeat Carter in the presidential election. Mr. Volker, forced to resign by the Reagan administration, was succeeded by Mr. Greenspan.

Chairman Greenspan's monetary policy has been the driving force in boosting the American economy for the past 18 years. His successor must fight inflation without fearing recession and market unrest and be able to hold his own against the President. It is doubtful that President Bush, who reveres Reagan, will appoint such an independent chairman. The FRB Chairman may actively raise the interest rate to avoid inflation or he may raise it as a follow-up measure. In both cases, it is highly likely that the U.S. interest rate will rise, which increases the risk of a Chinese crash.

What the crash may bring

The more difficult issue is how to prevent the burst of the Chinese bubble from causing—on a global scale—a financial system failure, a downturn in stocks, and a recession. The losses caused by the collapse of the Chinese bubble may exceed what China can cover by itself. As stated above, in the government-led Chinese economy, financial institutions will have to bear the loss and real estate values will inevitably fall. If taxes are increased to cover the losses, the economy will slow. Nor is the government bond market large enough to be of much assistance.

China's largest resource is its foreign reserves but most is investment capital from foreigners, as noted above, so this capital will flee China in a crisis. Over half of the trade surplus was raised by foreign corporations, not Chinese corporations. Therefore, only 20-30% of China's foreign reserves, which amount to 70 trillion yen, may belong to the Chinese government. This amount is not sufficient to cover the current non-performing loans.

If the bubble bursts, non-performing loans will skyrocket. Foreign reserves will dry up and the Chinese yuan will collapse before it appreciates. The housing bubble is even more worrisome. Extensive real estate development produces excess supply for a long time. No one can stop the sharp fall of real estate prices since there are no buyers when foreign investors rush to dispose of their holdings to limit their losses. The failure of foreign corporations that produce in China, foreign investors, and wealthy Chinese individuals and corporations becomes possible. The chain of crises in real estate, stocks, and financial institutions may be seen both in China and abroad. In the Asian currency crisis in 1998, although foreign capital rushed mainly into short-term financial products, the Indonesian rupiah fell by half against US dollar in a short period.

Due to the economic sanctions after the Tiananmen Square incident in 1989, the Chinese economy recorded negative growth and the yuan depreciated. Stock prices in Hong Kong fell by a third from their peak before the incident. On the other hand, the world markets continued to grow. However, if the Chinese bubble bursts, it will directly hit the world economy, which is interdependent with China. When foreign investors realize that their money is propping up the Chinese yuan, the drop in the yuan will be unpredictably large.

The IMF saved the Asian countries in the currency crisis. China is too big and has rejected joining international frameworks such as the G7. The strongest supporters in the Chinese yuan crisis should be the U.S. and Japan but public opinion in both countries is negative toward China and is only exacerbated by certain politicians and mass media. If the world's financial authorities cannot cooperate effectively and move quickly, the China crash will spread throughout the world rapidly.

It is ironic that once China crashes, China and Japan will both realize the other is an important partner. China will not be able to solve its bubble without support from Japan. There may be many things that China can learn from Japan; for example, energy saving, environmental technology, and how to attain economic growth without disparity in rural and urban areas. China is an important production base for Japan, which suffers from aging society with low birthrate, financial deficits, a concentration of population in Tokyo and high costs. Now China is Japan's largest trading partner. China is important for us in order to become a permanent member of UN Security Council and to solve the problems we have with North Korea over abductions.

Unfortunately, neither government seems to intend to co-exist peacefully. China, since the Jiang Zemin administration, thinks much of the U.S., bashes Japan for historical issues, and deflects Chinese People's attention away from domestic dissatisfaction. Prime Minister Koizumi continues to upset China by visiting the Yasukuni Shrine. In both countries, real national interests were set aside to foster domestic growth. Japan's national interests need to be supported by all Asians, not just Japanese. If Japan establishes a "memorial day for all the war dead in Asia" to pray for not only the Japanese war-dead but also the Asian war-dead, invites all the nations' leaders to Japan, apologizes, and comforts the spirits of the war-dead and confirm peaceful friendships every year, Japan will not be criticized anymore. It may be important to establish memorial facilities in Asian countries not only for Japanese but also Asian people. Based on such efforts, Japan's other role in the War—to release Asian countries from European countries' control—will be understood. The practice of using differing interpretations of history to start political fights can be stopped.

What Japan should request of China now is the full disclosure of information. It should not be limited to the Chinese bubble but should include the overall economy, history issues, and social problems. Disclosing the facts both domestically and internationally will also increase domestic sympathy. It is a national strategy that can gain support from the world. If China is honest with the world, then even after the truth is revealed, there will be hope left in Pandora's box.