China rise amidst the crisis: the emergence of a new capitalist power.

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Summary

While North America and Europe were hardly hit, China has resisted to the international crisis of 2008 thanks to a rescue plan which combined huge public spending, a low interest rate and consumption subsidies. China growth rate reached 9% in 2009 and 10.3% in 2010 dragging in its wake Asia and Latin America out of the crisis. It has also managed to maintain unemployment to a sustainable level. China even overtook Japan in 2010 as the second economy of the world in terms of GDP and is closing the gap with the US. On the whole, China rise seems unaffected by the subprime crisis. A closer look shows that real problems lie ahead. Chinese workers don’t accept any longer to be overexploited. A wave of strikes has spread during the summer of 2010. Workers were fighting for wages increases, improvement of working conditions and the right to organize and bargain. Inflation, especially of food products, which accelerated since the middle of 2010, is adding a new problem for workers and a concern for the government which fears a wave of discontentment. On top of that, the government is doing its best to prevent any contagion of the democratic revolutions in Arabic countries. Although the overall situation in China is completely different, these democratic revolutions show to Chinese workers that it is indeed possible to topple down even the worst and powerful dictatorships.

China resilience to the international crisis

The impact of the crisis on China and Asia has been so far limited (Sanuk, 2008). Asian banks were not much engaged in subprime loans and toxic products to the contrary of European banks. With the exception of South Korea, Asian countries did not rely on short-term capital and banks loans for financing their economies. They were not caught in a debt trap like Eastern European countries or Greece. Most of them and in particular China had accumulated huge amount of currencies reserves and were able to cope with capital flights that occurred at the end of 2008. Asian countries were primarily hit by the fall of their exports because of the slump in demand in North America and Europe. As a general rule, the recessive impact has been stronger in the most open Asian countries whose exports were concentrated in manufacturing and when the USA was an importer customer. For instance, exports of manufactured products represent around 70% in Malaysia, more than 40% in Thailand and Cambodia, around 30% in China, South Korea, Philippines and Vietnam, but less than 10% in India and Pakistan. These characteristics explain that the three biggest and most populated countries in Asia, China, India and Indonesia have not experienced a single quarter of recession between 2008 and 2009. The resilience of these three countries and most of all, China, which is among the biggest, or the biggest trade partner of Asian countries, led to a quick rebound in the second quarter of 2009 and a much stronger “V” shape recovery than in the rest of the world.

Figure 1 here.

Several factors explain the resistance to the crisis of Asian countries and the speed of the recovery.

First, to absorb the shock of the fall of exports, Asian countries have launched unprecedented rescue plan in the region to the contrary of the “Asian crisis” of 1997-1999 when IMF sponsored structural adjustment plans had worsened the crisis. The Chinese rescue plan calls attention by its magnitude: US$ 585 billion amounting to 13.3% of GDP to be spent on a two-year span. On average, the rescue plans announced by Asian countries amounted to 7.5% of GDP against 2.8% of GDP for the G7 countries. More, Asian rescue plans were more focused on public expenses than tax cuts. On average, Asian countries dedicated 80% to increases in public spending to be compared with 60% on average in G20 countries. The only exception is Indonesia where tax cuts dominate. Those public expenses were accompanied by expansionary monetary policy. The median interest rate of Asian central banks has decreased by 2.25 points which is five times more than during the previous crisis. As the banking system continued to work, this had a positive impact on growth. In countries like Viet Nam and China the expansionary monetary policy played a dominant role. In China, public spending has increased by a modest 26% in 2008 up from 23% in 2007, but it came back to 21% in 2009 and even 17% in 2010 when the rescue plan officially ended. On the whole, public expenses did not play a crucial role to absorb the shock. It is in fact the expansion of credit which took the lead in 2009 with a spectacular increase of 31% (see figure 2). It too fell down in 2010 to -4% when the Chinese government decided to cool down the economy because easy money induced a new speculative bubble (more on this point below).

Figure 2 about here

Second, households’ consumption kept steady as employment did not collapse during the crisis. In times of crisis, there are usually no strong increases in the unemployment rate in Asian countries, for there are no unemployment benefits except in a few countries. Workers who lost their jobs in industry try to find one in services or work as self-workers or return to the family farm whenever it is possible and when there is still one. It is especially the case in China where hundreds of thousands migrant workers went back to the interior in the winter of 2008 or stayed there after the end of the new year in February 2009. But because the economy recovered in spring 2009, a lot of them returned to the cities to find an urban job, which pays more.

Third, defying many sombre prognostics, Chinese exports did fall from September 2008 to February 2009 but did not collapse and soon recuperated thanks to recovery in world trade. Given the high import content component of Chinese exports (about 50%) imports fell in the same proportion so that the current account stayed almost always positive although by a smaller magnitude (see figure 3). This reveals both the resilience of China to external shocks and its weakness at the same time. For it is the processing trade which makes up for the bulk of the Chinese trade account surplus. Classical trade activities are chronically in deficit due to their high-import content of primary products. To keep processing trade competitive, the Chinese government has decided to peg the exchange rate of the renminbi to the dollar and to avoid excessive wages increases. This is the reason why new labour laws which have been announced in 2007 have been suspended at employers’ request. Another difficulty with the fixed exchange rate is that the price increases of commodities are fully transferred to the Chinese economy. As we will see, these two contradictions weigh heavily in the room of manoeuvre of the Chinese government.

Figure 3 about here

The consequences of the rescue plan: a worsening of previous contradictions

Expansionary budget and monetary policies cannot be extended indefinitely. Officially the Chinese central government is not heavily indebted: its debt to GDP ratio is a modest 19% of GDP. It means that the central government has ample leeway to expand public spending. In fact, the central government made another choice. Of the RMB 4000 billion public spending programme announced for the years 2008-2009, 1180 billion were actually financed by the central budget, the rest being carried by local authorities. These have competed to make the most spectacular announcements of investment projects for an astonishing cumulated total of RMB 20 000 billion. Most of these announcements have been realised thanks to the expansionary monetary policy. Local authorities have been encouraged to take debt indirectly because they are not officially allowed to take debt directly. Special financial vehicles have been created at the local level to bypass this prohibition. Local authorities pump capital in the financial vehicle which then uses it as collateral to take loans from banks. Different kind of capital have been brought by local authorities: land; cash obtained by the sale of financial assets sold by investment funds controlled by local banks; disguised short-term loans which are then used to get a bigger and medium-term loan which serves to reimbursed the first ones. These fragile financial set-ups have multiplied in 2009. Local authorities had on average 2 to 4 special vehicle funds before 2008. In 2009 after the launch of the rescue plan, they controlled 10 on average. Most of the investment projects financed in this way were in real estate and in infrastructure and operated by state companies. This had several perverse effects.

First, it has fuelled speculation in real estate and housing. One fourth of investment growth in 2009 comes from investment in real estate whose prices have soared by 24% in 2009 and 11% in the first five months of 2011.

Second, it has created a vast amount of potential non-performing loans since many projects are not profitable. Banks, which finance 90% of investment, are getting fragile. It is not the first time. In 1999, non-performing loans had reached 36% of total loans. Four asset management companies had been formed by the state to buy them from banks in order to clean their balance sheets. At the end of 2007, non-performing loans still accounted for 6.7% of the total. The monetary authorities would like to avoid a repetition of the same story.

Third, it has increased public debt. According to Victor Shih (2010), the consolidation of local authorities’ debt into the national public debt lead to a debt-to-GDP ratio of 71% in 2009 to be compared with a ratio of 19% for the sole central government. It is still manageable but it means that either local or national taxes will have to increase.

The problem is that once a speculative bubble has formed it is very difficult to deflate it without damage. Local authorities depend on real estate for around 20% of their fiscal revenues. The value of the land they expropriate from farmers to use it as collateral or to sell it to developers depends on real estate market prices hence to speculation on this market. Raising the interest rate of the Bank of China is a powerful instrument to reduce bank loans and cool down the economy, in a country where local politicians and powerful leaders of the communist parties do not always agree with the central power. But it would reveal a lot of non-performing loans and put local finances at risk. Most of all, in a country where investment is the major component of growth, raising the interest rate too much could have a too strong recessionary impact. Instead of raising the interest rate, the Bank of China has preferred to increase the reserve obligations that banks must maintain at the central bank. Between January 2010 and January 2011, the Central Bank has increased seven times the reserve obligations while the interest rate was raised modestly in October and December 2010 only. The monetary authority has also re-established a quota system for credit. The problem is that banks have find ways to circumvent the quota by multiplying off-sheet balance operations. On the whole, it seems that bank loans have maintained the same pace in 2010 in comparison with 2009 which was a record year. The difficulty in controlling bank credit is compounded by the exchange rate policy. China has decided to re-establish in July 2008 a fixed exchange rate between the Yuan and the US dollar. But because the trade account is always in surplus, the Bank of China has to buy dollars with Yuans. This pumps more Yuan in circulation in the Chinese economy that the Bank of China tries to take out by issuing bonds. This so-called sterilisation is proving even more difficult due to the huge amounts involved. The result is that there is more money in circulation which adds another source of speculation and inflation. Investors have in particular speculated in the market for food products contributing to push food prices up these last months.

Inflation has turned into a political problem because the population is complaining about the cost of living and starts to protest. Having in mind that the democratic revolutions in Arabic countries have started as a protest against food price hikes, the Chinese government is sensitive on the subject. In November 2010, the State Affairs Council has published a series of measures aimed at stabilising the prices of food products. If these measures are not sufficient, the government will have to resort to a more significant interest rate increase in order to cool down the economy, which is reluctant to do for the reasons exposed above. Whether it will do it or not and to what extent will depend much on the political situation and the intensity of workers protests. It may be the reason why the government has tolerated the wave of workers strikes in the summer of 2008, first in Honda and Foxcon and then in tens of other companies, mostly foreign. Workers were demanding wages increases, an improvement of their working conditions, the respect of basic rights and the right to bargain. The government, which is usually quick in repressing workers, especially when they claim the right to self-organise, decided to let the workers strike. It tried to distract workers from the real problems by underlining that most of the companies were foreign by titillating the nationalist nerves of the population. As if workers were better treated and paid in Chinese firms, a tale that nobody believes. A more serious reason is that it was a way to loosen the social pressure mounting around the question of inflation and to pave the way for a rebalancing of growth in favour of the domestic market in a context of uncertain foreign demand for Chinese products.

Rebalancing growth in favour of the domestic market

Rebalancing growth is a recurrent topic in most East Asian countries which tied their fate to an export-promotion strategy. After the Asian crisis of 1997-1999, there were already discussions about the necessity to reduce the dependence of growth on massive exports to western countries. But the export-led recovery of the most stricken countries (Thailand, Malaysia, South Korea, and Indonesia) plus the success of Chinese products on foreign markets in the 2000 decade put an end to the debate. It is now coming back because there is a consensus that the recovery from the crisis in the US, Europe and Japan will slow and tentative. There will be a prolonged period of reduced demand for Asian export products. As a consequence East and Southeast Asia is now more seriously confronted to the necessity to reorient its growth strategy towards its domestic market. Western countries are in favour of this reorientation because they would benefit from it. They hope to export more to Asian markets. This is why they insist so much on the necessity for China to revalue the Yuan. It would give a boost to western exports to China and would reduce the price competitiveness of Chinese exports. This is why many official reports from the World Bank, the IMF and the Asian Development Bank are discussing the best way to rebalance growth by boosting internal demand and reducing the importance of exports.

Due to the importance of its domestic market, but also because China is the biggest trade partner of many Asian countries and the central hub of international and regional production networks, China is the country where rebalancing growth is of the outmost importance. It is true that China combines the most blatant imbalances. It is the country where trade surplus and its corollary, foreign reserves are massive, where savings as a proportion of GDP are the highest and households' consumption the lowest. In 2007, last year before the crisis, the share of households' consumption in the GDP had reached an historical low point with 35%, the share of investment was very high with 40% of the GDP and the current account surplus registered a record level of 10% of GDP (see figure 4).

Figure 4 about here

Rebalancing growth obviously means reducing the importance of investment and of the current account surplus, and increasing households' consumption. The crux of the matter is how? The economic proposals made, under their false appearance of technical neutrality, have social and political consequences.

For instance, abandoning the peg of the Yuan to the dollar to revalue the exchange rate of the Yuan would benefit more to the Chinese bourgeoisie and the middle class which has the purchasing power to buy imported consumption goods at a lower cost, while the vast majority of Chinese workers cannot have access to them because it is too expensive. Another topic which is at the centre of the debate is the question of the high savings rate in China. Reducing savings is considered by many mainstream economists as the best way to increase consumption. Behind this simple and apparently neutral proposal lie social and political stakes. The first question is to determine who save most in China.

The most frequent explanation is that the high saving rate of households is the main cause of the high saving rates in general (Blanchard and Giavazzi 2005; Modigliani and Cao 2004). Some economists add the importance of the saving rate of the State (Wiemer, 2009), while others insists on the importance of corporate savings and of the state (Prasad, Eswar 2009), (Jha, Prasad and Terada-Hagiwara, 2009) (Hofman, and Kuijs 2008), or even the sole importance of corporate savings (Anderson, Jonathan 2009). More generally, the growing importance of corporate savings would not be a unique feature of Chinese capitalism but a common feature of many East Asian countries (Chandra, Sonali, Nabar Malhar, and Porter Nathan 2010).

Those who stress the importance of households' savings conclude that it is necessary to create or strengthen a “social safety net”. Chinese households save too much for precautionary reasons: they have to save to pay for their health expenses, for the education of their children, to buy a house or a flat and because of the absence of a significant pension system. They pledge for more public spending in education, health, social housing and pension. For instance, a permanent increase of one percentage point of public spending equally share between education, health and pension would lead to an increase of households' consumption by 1.25 percentage point of GDP (Baldacci et ali, 2010). According to the same authors, a one percentage point increase of public spending in pension only would have a higher impact on consumption, 1.6 point because the reduction of precautionary savings would be higher. These proposals go in the right direction because there is an urgent need for a better education and health system and because the majority of Chinese do not have pension benefit. But what is proposed is a “social safety net” not the creation of a full social security system whereby citizens are guaranteed social rights. Furthermore, it does not say anything about the kind institutions to be created. To give just one example, the creation pension funds could be proposed as the best solution. This is what the World Bank has proposed or imposed in many countries. It would increase the power of finance in China, where it is still not dominant as in advanced capitalist countries. What are at stake are the final steps in the complete conversion of China to capitalism. Those studies do not explain too how these social spending would be financed. If the bulk is financed by households' income tax increases, the positive effect on consumption will be diminished.

The Chinese government has announced in January 2009 a “social plan” to complete the stimulus plan. Education, health and pension are supposed to be improved or established with a special focus on rural population. But it remains to be seen how comprehensive these measures will be. The budget dedicated to these measures is small in proportion and the government has not explained how they will be financed. Its impact on consumption is uncertain. In any case, it will take time. Chinese people will have to experience by themselves the reality of these announcements before starting to change their behaviour, save less and consume more.

Regarding corporate savings, the social and political issues are also very important. Corporate savings are in fact non-reinvested profits. The fact that corporate savings are high in China means that a high share of labour-value does not accrue to workers in terms of higher wages but goes to profit which is invested only in part. The fact that this feature is encountered not only in China but also in many Asian countries tells a lot about the overexploitation of Asian workers. One simple way to increase consumption and rebalance growth is to reduce excessive corporate savings by increasing wages. But it is not the proposal made by many economists, in particular those of the World Bank (Chandra, Nabar and Porter, 2010). They propose instead to develop and improve financial markets so that more companies would get listed on the stock markets. The Chinese government could change the law to improve corporate governance so that firms would pay dividends to their share owners which is not the case yet. Finally, workers would become shareowners of their firms’ capital and receive dividends instead of wage increases. The conversion to Anglo-Saxon capitalism would be complete.

We believe that these proposals are not serious and credible. Wages increases are a much simple, more equitable and a more certain way to boost consumption, in particular in China where the income labour share has decreased these last years as in many countries (IMF 2007), (Ellis and Smith 2007), (European Commission 2007). In the Chinese case, the labour income share of GDP has lowered to 57.5% in 2007 down from 69.2% in 1992 (see above figure 4).

This fall of 11.7 points has benefited firms whose profit has increased to 18.4% in 2007 up from 11.5% in 1992 and to the state whose revenues has increased to 24.1% up from 18.4%. The impact of this negative evolution of the labour income share is often neglected in the debate on rebalancing growth in China and in Asia in general. In the case of China, following a simple calculation made by Aziz and Cui (2007), one can show that if the labour income share of households has stayed at the level reached in 1992 during the whole period of 1992-2007, and if households’ savings had followed the same evolution as the one actually observed, the consumption would have stayed constant at around 46% of GDP in 2007 (see figure 5). Instead, the consumption has lost nearly 10 percentage points and reached 36.4% in 2007, which is very low by international standards. One may conclude that the fall of the labour income share and the corollary profit increase is a much more serious factor in explaining the fall of households' consumption than the increase of households' savings.

Figure 5 about here.

Conclusion

Rebalancing Asian growth can only be achieved by a concerted wage increase and the establishment of a social security system in Asian countries, although China is powerful enough to do it on its own. This would pave the way for a more self-centred economy at the regional level which would be less dependent on export and therefore less sensitive to international crises. It would also be a measure of social justice for Chinese and Asian workers have suffered for decades from low wages, dirty and dangerous jobs for the sake of exports competitiveness. The recent wave of strikes in China, but also Vietnam, Bangladesh and Pakistan show that there are social forces available even in countries where the political context looks at first hand unfavourable. It is an element of hope.

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