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THE SLOWDOWN OF CHINA'S ECONOMY: HOW IT CAN BE THE STARTING POINT OF THE NEXT GLOBAL MELTDOWN

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Abstract

The post US Recession period of 2008-09 resulted every major economy of the world face liquidity crunch. Unavailability of money led to an economic decline of the world markets making it amongst the worst global recessions ever. Therefore, the governments adopted various ways for pumping additional money into the economy. Some of the countries went for excessive borrowings to finance the deficit whereas some went for liquidity infusion in the economy in order to increase the money movement and production. China was one of the second type.

When China was hit by the recession, its annual GDP growth rate was the lowest since 2000. This was enough to prove the high dependency of the nation on the United States. China launched a major liquidity infusion program of almost $600 billion and went to formulate and implement reforms and policies to decrease this dependency. With the focus on the development of the nation internally, the money was invested into infrastructural and real-estate development projects. Liquid creation can be proved to be good for the economy if spent rationally. Generally when the countries go for liquidity infusion they invest money in projects which are not essential and could have been skipped in the absence of the extra artificially infused money. This hence, leads to a growth of a bubble of a substantial volume. And where there is a bubble brewing in an economy, everyone is bound to face the repercussion of its burst.

Keywords: US Recession, liquidity, bubble brewing

I. Introduction

Out of all the bubbles the world has seen, each of them started off having a legitimate purpose. To name a few, the Great Depression of the 1930's was the outcome of mass production which led to the mismatch of supply and demand. The dot-com bubble of early 2000 was because of the booming IT sector throughout and the 2008 Recession was the outcome of the "American Dream" which led to the booming of the housing sector and eventually led to the fall in the index eventually leading to the burst of the bubble. The continuous cycle of recessions and progressions is the way the world economies behave.

With the recent fall of the purchasing managers' index below 50.0, the manufacturing sector is struggling showing signs of a slowdown that will just not impact China but all the economies it has trade links with. China holds almost the same importance as the United States on the other economies of the world because it's the leader of the trading market of the world. The total Chinese trade exceeded the $4.13 trillion mark by the end of 2013.

The policies implemented and applicable in the nation have not been proved to be effective in order to help the nation to come out of the financial troubles it has been facing since the 2008. Debt is a habit that once formed is difficult to break. Moreover the loose monetary regulations regarding the loan-making process to borrowers who may not be able to repay, which is indeed in sync with socialistic ideology are adding fuel to the debt issue of the country leading to the increase in the NPA (non-performing asset) count.

Figure1: Growth rate of China's GDP

- **Objectives**

The study aims at investigating the various measures the developing economies have taken in order to curb the impacts of the US recession 2008. Furthermore, the objectives are

- To critically evaluate China's economic situation to see the various reasons behind its transformation to a highly volatile economy which might be a cause of another global financial meltdown?

- To consider the weak economic and financial situations of other countries which will fuel up the impact China's slowdown will have on the world.

II. Literature Review

- Maria Ma (2013) in the research paper "**China: Shadow Banking and the Global Economy**" described the threat the shadow banking possess for China and the world. It explains the availability of cheap credit in the economy which started off with the post US recessionary phase that questions the quality of the loans that were being made. This allowed the housing prices to rise in 2010 followed by inflation of a housing bubble. But soon due to imposition of strict monetary and banking regulations the prices of the houses started to fall. This resulted to an over-supply of houses in the economy and since mid-2014 the prices have been falling down.

- Raghuram Rajan (2014) made an announcement that the world is soon going to witness a " **global asset bubble burst** "which will be because of the over build-up risk in the emerging economies. Most of the emerging economies are going through a slow-down because of either of the social, political or economic factors. The euro-zone is in a bad shape because of the ongoing multi-nation crisis it has been going through since 2010. The oil producing countries are being impacted badly by the oil price fall and the oil price fall is slowly impacting all the countries round the globe.

- World Bank (2014) announced that the world is facing a **global job crisis** that is acting as an obstacle for the global economic development. A survey was done on the **G20 economies** and the result says that more than 100 million people were unemployed and 447 million were considered "working poor" i.e. they have an income level of $2 per day depicting the huge income and wealth disparity seen in the economies. Emphasis on the need for implementation of social protection and public policies was done as it will help in the growth of job creating economies.

- Michael Schuman (2014) as a form of article in Time magazine talked about the ways how there is a very high possibility **that China might be headed towards a Japanese style economic crisis**. Japan has been facing a stagnant economy for the past 25 years and walking on the same path Beijing is pursuing policies which Tokyo did right before Japan got stuck in the financial meltdown. But the impact China's slowdown holds is way more than the Japan's because China is suffering from not just an asset bubble, but also a credit bubble, infrastructure bubble and a series of poor monetary policies.

III. Research Methodology

Type of Research: Exploratory Research

Exploratory research is a type of research conducted in order to create a study based on establishing explanatory relationships between the data and drawing a conclusion eventually. Drawing definite conclusion should be done with extreme caution.

This method often relies on secondary data analysis and research such as reviewing the work and literature available and/or data, or qualitative approaches such as informal discussions with consumers, employees, management or competitors

Sampling plan: The sample taken for this project is China, Euro zone countries, Japan and various other emerging and developed nations. Most of the research is done on the economy of China along with which a brief economic overview of the rest of the sample.

Types of data-

Primary Data: For this kind of research work, it was not possible to gather primary data.

Secondary Data: Secondary data sources used for this study includes large data repositories like economical websites of the countries, organisational records and data collected through qualitative methodologies or qualitative research.

In addition to the data available it also considers the various economic, political and social changes that affects the study.

The study done for this project consists of secondary data that is collected from different journals, magazines, web sites and research papers. An exploratory research is conducted on the economy of Chinese and few other nations to analyze the present economic situation that will be responsible for the next global meltdown.

Statistical tools: Statistical tools used for this project are Graphs and Pie Charts. Graphs are used to show the changes in trends of different economic factors over a time period. Pie Charts are used to show the distribution of the data with respect to others datasets.

IV. Analysis

Shadow Banking in China

Shadow Banking is the non-traditional type of banking system that doesn’t come under the gamut of the regular banking system of the economy. This means the transactions done under this system doesn’t follow any mandate which is followed by the regulated financial institutes. These shadow banks are involved in lending money to the people at a favourable rate (sometimes more than 20%) and are not regulated by the regulatory bodies of the country. It consists of risky lending products consisting of derivatives and securities lending.

Shadow Banking as a concept has become popular after the recession of 2008 in which it played a major role. In 2013 alone China has $7 trillion invested in the shadow banking system which is roughly 69% of its Economy. Since these banks don’t come under the regular banking system the Government is not able to control the liquidity flow that is happening because of these banks. In China the interest rates are set by the banks and not by the market forces. They possess a systematic risk for the economy and in case of China that would impact the whole world.

In case of China the Shadow Banking is categorised into Trusts and Wealth Management Products which are lend to the people and the investors promising them high yield. Then the money is invested into a risky business or avenue which wouldn't have been financed by a traditional bank because of the risk factor.

Shadow Banking was one of the most important factors of the US Recession 2008 which was majorly involved in the various financial instruments that led to the shut-down of many shadow banks in the US. Shadow banking with time has become a very important part of the Chinese Banking Industry. The recent problem that's brewing in the economy is the concept of 'entrusted loans' which is the process of lending of loans between two parties but the arrangement is to be done by a regular bank. The WSJ says that a whopping 1.4 trillion Yuan ($220 billion) was issued by the China Construction Bank (CCB) in outstanding entrusted loans by the end of 2013. The concern is not the huge numbers of this type of loans but the rate at which it is growing. These entrusted loans constitute 25% of the total loans that are given in the economy.

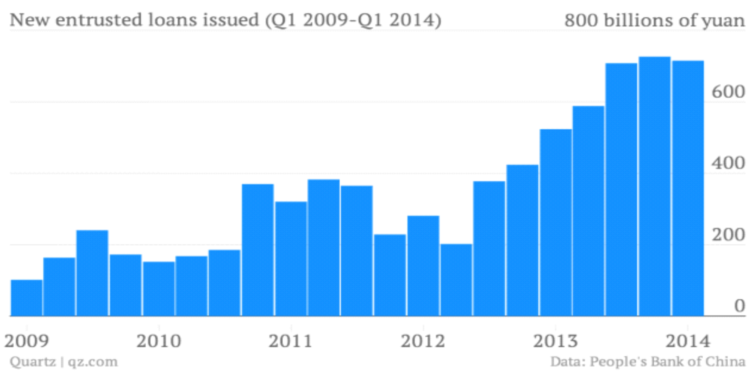

Figure 2: Entrusted loan in China

These shadow banks or the entities outside the conventional banking systems of China are able to serve a large portfolio of wealth management products that could potentially be the epicentre of another crisis. Shadow banks in China are involved in the provision of long-term loans like mortgages. Due to the complex structuring of the products they provide using Derivatives and other financial aspects, these banks are able to provide credit to the traditional banks in a more cost-efficient manner which is the reason that they get to cater such a huge customer base.

Transition to Capitalist Economy

Change in Economic System

China has always been a communist country with the aim of spreading economic equality and mutual co-operation amongst everyone. The theory doesn't spread privatization, competition, de-regulation, fixed currency system in the economy. But since the inception of the 21st century the economy has been following the capitalist model which includes profits in the private sectors, government intervention in currency or liquidity crisis, over-production and trade surplus. In 2003-04 the debt of the country was 80 times that of in 1981 i.e. from 870 million to almost 40,000 million Renminbi.

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This was also one of the outcomes of the opening up of the trading of the economy especially after becoming a member of WTO in 2001. The majority of the economy's business is privatised and it is one of the top economies to be a hub of foreign investments. Privatization and globalization has partially destroyed the economic equality of the economy leading to widening of the gap between the rich and poor. The country has economically grown to levels which show that China might overtake the US economy by 2020. This has led to the growth of poverty and social problems in the economy. The country mints more millionaires than any other emerging economy in the world.

Economic Inequality and Wealth Disparity

Recently China surpassed the income gap between the rich and poor of US. The economic and wealth disparity which was in China in 1980 has doubled by 2010. The currency system of the economy was regulated by the Central Bank which devalued it for a really long time. The home currency was devalued to a stable limit so that the economy doesn't face a macroeconomic issue like inflation. Also a devalued currency helps in China's trade aspect. This attracts the foreign countries since they get to buy the goods at a cheap rate. But with the changing markets and international markets the currency is regulated by the market forces partially which shows that the country might adopt the concept of Flexible Currency System in the near future. Since 2006 the Remninbi has been allowed to float in the narrow margin and since then the government has been gradually increasing the flexibility of the currency.

According to the GINI Index (Measure to calculate the economic inequality of a country) if the value is more than 0.4 then there is wealth disparity in the nation. In the year of 2000 the coefficient breached the value of 0.4 and became 0.412. China's statistical institute National Bureau of Statistics (NBS) stopped releasing the data henceforth saying that the household incomes are incomplete. From 1980-2012 the GINI value of China has gone up from 0.3 to 0.55 surpassing the US' coefficient of 0.45. The major reason for the increase in the income gap is because of the government reforms that majorly favours the urban class of the country. The government has failed to frame out reforms that can reduce the urban-rural disparities. In 2012 a lot of people have put inequality as the biggest problem for the country even before corruption and unemployment.

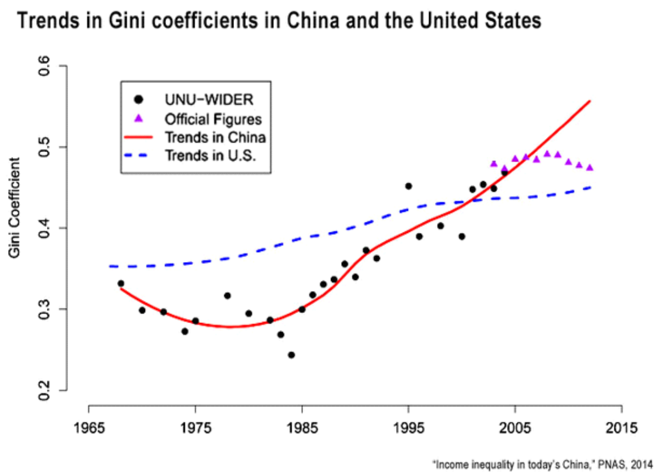

Figure 3: Trends in Gini coefficients in China and USA

China has been suffering from deflation for the past few months. The recent data of China states that the consumer prices' inflation rate of the country is a little less than 2% and the target inflation rate set by the government is 3.5%. The producer price has been going through a deflationary spiral where the value has been falling since January 2012 showing the surplus production of the commodities and the weakening demand.

Figure 4: Inflation rate of China

Huge Private and Public Debt

The monetary stimulus packages introduced in the economy post 2008 era led to the flow of cheap credit in the economy. Loans were given without much of stringent regulations like credibility of the borrower or the collateral kept against the loan. This system of lending led to over piling of NPAs for the banking system. According to PBOC's (People's Bank of China) report the non-performing loans has accounted for more than 25% of the total lending of Chinese banks. This shows that out of the 4 loans given out by the Chinese banks, one defaults.

Bad loans held by Chinese banks rose by the largest amount in eight years in the third quarter of 2013, the China Banking Regulatory Commission was reported saying in November. The nation's 10 largest lenders have reported a 21% increase in the overdue loans which is an indication of the asset-quality deterioration showing the increase in the liquidity of the economy. The auditors have reported that the local governments of the country owe $3 trillion in outstanding debt which is an alarming figure.

China is presently is at the late stages of bursting of a debt-fuelled investment bubble. China has always or rather any emerging economy per se has always suffered from rising bubbles and the corresponding bursting of it. But this time the scale at which the bubble has grown is a little concerning. The amount of assets that China holds is as huge as $27 trillion which is almost double that of US'. The nation has huge debt that is responsible for the various investment avenues which to certain extend shows that the economy is favourable for investments. The economy is highly leveraged because of the huge amount of private and public debts out of which the proportion of private debt taken by the economy has been increasing exponentially in the past few years. Soon after the recession, the economy in order to pump money in the real estate was into a lot of debt borrowing that led to increase of 60% debt to 200% of GDP in the mere time span of 5 years (2008-13).

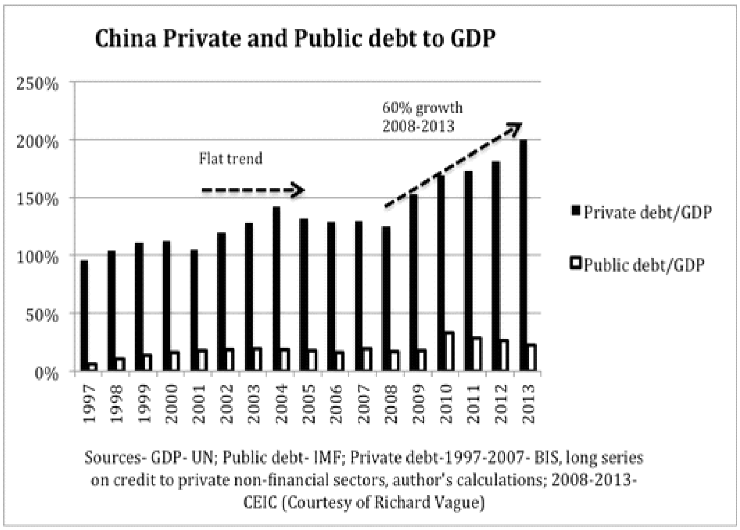

Figure 5: Ratio of private and public debt to GDP in China

Burst of the Asset Bubble

China has a huge credit exposure of around 280% of the GDP. Most of this amount is used up to finance and re-finance real estate projects which is now suffering an over-capacity. The fact that the real-estate projects have taken up a lot of loans puts the economy in a slightly risky situation. The reason being that if they default on the loans then it can cause a ripple effect in the global economy which already is facing a slowdown.

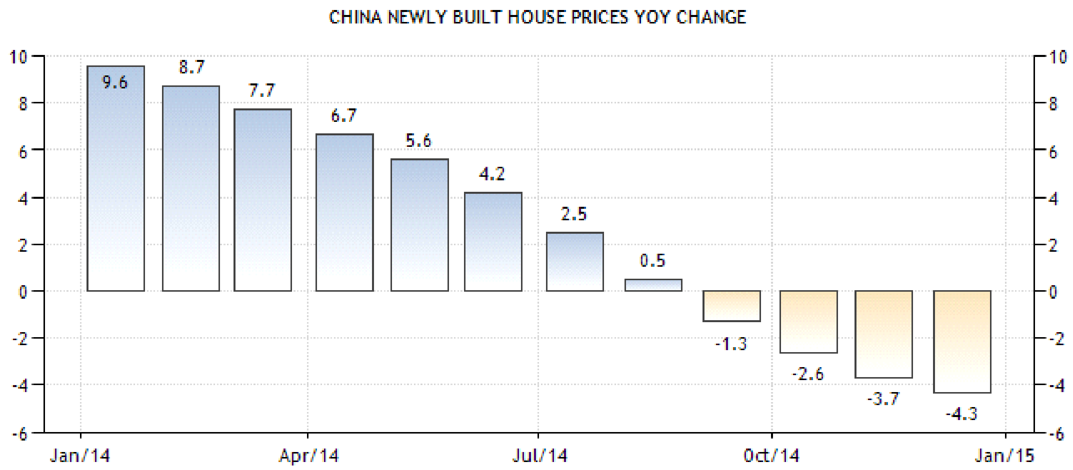

Figure 6: Change in house prices in China

Recent data shows that the number of new homes under construction has fallen down by 25% and the number of vacant houses is increasing thus, leading to a splurge in the prices of these houses. There are societies where the occupancy rate of the rate is as low as 30%. Due to the overvaluation and oversupply of properties right across in China a bubble was created in the past couple of years.

And, from the housing prices it is pretty evident that the bubble has burst. Since the real estate industry is almost equivalent to 40% of the GDP, the falling growth of this sector is impacting the growth figures. Fresh data estimates the GDP of the country is going to be less than 7% for this year, lowest in the past 25 years.

V. Conclusion & Suggestions

The dependency of the Chinese economy on the shadow banking is huge and it's high time that the government should start taking measures in order to curb its growth. 69% economic dependency on a non-traditional banking system speaks volume about the vulnerability of the country's financial system. Since the size of this system is huge, putting a full stop all of a sudden will not serve a purpose or rather is practically not possible. The development of the SME sector in the country along with the economic growth is majorly because of the Shadow Banking system and this impact can't be over looked. Hence, it's important that the government should come up with a regulatory body that will at least try to contain the growth before it explodes.

China's credit to GDP ratio has increased by 56% since 2009 which happened because of the excessive monetary stimulus that was done after the recession 2008. Moreover the loose monetary regulations regarding the loan borrowings have added fuel to the debt issue of the country. The system needs to make the policies more stringent so that the NPA count decreases in the country.

Shifting the focus from China to the other economies, almost all the other countries are going through a slow-down in terms of low inflation, weak monetary policies, low foreign investments etc. The euro-zone is battling with the turmoil of the possible "grexit". Russia is dealing with the US sanctions and the oil price crisis. Though US has ended the Quantitative Easing in the late 2014, still it has not reached the target inflation rate after which it will increase the interest rates. Australia's economy is affected since China is its biggest trading partner. For years Asia and the globe has been worried about a rising China, now it seems the worry will be about a declining China.

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