Fiji Sun
Paper | Online | Mobile
Saturday, August 29 2015

The Great “Fall”of China

This past week saw various falls!

They started two weeks ago with a surprise fall in the value of the Chinese currency.

Though seemingly an age-old remedy to promote growth through exports, it had a shocking element as well: it was devaluation in series on three successive days (Aug 11, 12 and 13). The devaluation under the pretext of a liberalization process towards adopting a flexible exchange rate regime was only a cover-up. Something was wrong. It took two weeks to sink in.

In the next ten days, US$ 5 trillion was wiped off global stock prices. With no interventions from government to prop up stock prices, investors became skeptical about the government’s ability to deal with the situation.

The only way the suspicious holders of Chinese stocks could do was to begin selling off their holdings. The biggest of all falls happened on Monday.

August 24, 2015 is now known as Black Monday.

Series of falls

It started with a fall in Chinese stock price: 8.5% fall is the biggest one day loss. That was followed by a fall in the oil price: the Brent crude oil price reached the lowest: US$ 42.51. The British pound recorded the biggest fall against the euro in six years. Uncertainties continued with no interventions.

On Wednesday, China’s central bank finally took the much delayed steps. The lending rate was cut from 4.85% to 4.6%. The reserve ratio was cut by 0.50 percentage point. Banks will have more funds to lend.

In fact, during the earlier periods of similar cheaper credit, investors borrowed from banks for buying stocks. Now, another phase of cheaper credit will help the borrowers to survive their stock sellout losses! At least their re-payment burden will be made less unbearable.

On Thursday morning, the Shanghai Composite fell further. Total fall was 16% this week. The central bank interest rate cuts did not inspire market confidence. Instead, it is feared that with interest rate cut, more funds will flow out of China forcing another round of fall in Chinese currency.

On the other hand, Thursday and Friday, the US stocks rallied. The remarks of New York Federal Reserve President William Dudley were responsible. He hinted that in the context of the Chinese economic slowdown, the Fed would not think of any change in its near zero interest rate policy.

That was sufficient. The Chinese stock prices for the first time in weeks moved into positive territory.

More of a reaction to optimistic sentiments in US!

Reasons behind the meltdown

China's share of world GDP is 15%, second only to USA. Its share of world economic growth is 50%. By heavy public investment into the economy, it came out of the Great Recession by recording 78% growth between 2007 and 2014. During this time, America grew only 8%.

China alone imported 58% of world's trade in iron ore, 31% of copper and 58% of soy bean, and 14% of oil. The beneficiary countries, which enjoyed prosperity and successfully avoided recessionary effects were Chile and Peru (iron ore); Australia (copper ore); and Brazil (soy bean) and Saudi Arabia and Russia (oil). They will now experience loss of export earnings,

The "Chinese flu" has begun.

The reasons for China slowdown are best summed up by *The Economist of London*

- Law of large numbers: the bigger an economy gets, the harder it is to keep growing.
- Long run growth is a function of changes in labour, capital and productivity.
- China's working-age population peaked in 2012 and investment topped out (at 49% of GDP)
- China's technological gap with rich countries is narrower than in the past, implying that productivity growth will be lower, too.

Besides these structural reasons, there are usual danger limits, which have been breached.

Dangers of debt

As Andre Ross Sorkin wrote in New York Times on August 24, it was Professors Rogoff and Reinhart who foresaw in 2008 the coming of China meltdown. Seven years ago, the warning on China, which "seems prescient now", was made on the basis of analysis of eight centuries of financial crises in their book, ***This Time Is Different***.

According to them, every financial crisis stems from one problem: too much debt.

Here are the facts:

- China's debt rose from US$7 trillion in 2007 to US $28 trillion by mid-2014
- Debt (government, household and corporate) is 282% of GDP.
- Half of the total debt is linked to real estate
- There are several ghost towns with housing flats with no takers
- Fall in property prices by a fifth in early 2015

Economists describe this slowdown cyclical than structural. According to them, the past superlative growth rates need correction.

One does not have to be an economist to conclude:

"What goes up has to come down."