

Risk of China economic collapse overblown

A growing number of economists and analysts have become alarmed that economic growth in China is severely overheated. This overheating has raised concerns that China is on the brink of economic collapse.

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Concerns have been amplified by similar economic booms in Japan, Thailand, Korea and the U.S. that eventually went bust. While the mechanism driving China's current economic boom are certainly similar to the boom-driving mechanisms in these other countries, there is no similar parallel for China's eventual economic bust.

China's economy will continue to grow rapidly for the foreseeable future. The only significant investment risk in China is geopolitical in nature. Increasing geopolitical risk will periodically provide good opportunities to buy Chinese and China-related investment assets in 2004.

According to official government statistics, real gross domestic product growth advanced by 9.1 percent in China last year. Outside observers estimate that economic growth was between two and four percentage points higher than official statistics indicate.

Driving China's economy in 2003 was real credit growth of 21 percent, which rocketed investment nearly 30 percent higher. The rapid growth of investment has led to overcapacity in some sectors of the economy while severely straining China's energy and transportation infrastructure.

Excess capacity and strained resources characterized economic collapses in Japan, Thailand, Korea and the technology sector of the U.S. economy in recent years. In addition, economic collapses in these countries had one critical common factor - the sudden withdrawal of credit by market forces.

In Japan during the early 1990's, monetary policy was aggressively tightened and banks were administratively discouraged from lending. Both the domestic capital markets and the government joined in withdrawing capital from the economy. A very similar chain of events occurred when the technology sector of the U.S. economy collapsed in 2001.

In Thailand and Korea, it was the sudden withdrawal of foreign credit that precipitated each country's economic collapse in 1998. In all of these countries, the heavy net credit position of the banking system aggravated the withdrawal of capital.

China's financial system bears little resemblance to the financial systems in these other countries. Neither the domestic capital market nor external credit inflows are large enough to have any influence on overall capital allocation or its withdrawal.

This leaves the state as the final arbiter of capital allocation. In China, it is unfathomable that the state would suddenly withdraw capital precipitating an economic and possibly social and political crises.

In addition, the banking system surplus of deposits naturally compels China's banks to continue lending.

In Japan, the stock of credit in the financial system is equivalent to 224 percent of the stock of deposits in the financial system. In the U.S., Korea and Thailand, this ratio is 170 percent, 142 percent and 117 percent, respectively.

In China, the stock of credit in the financial system is equivalent to 77 percent of the stock of deposits in the financial system. In addition to the surplus of deposits in China's banks, the country is also awash with liquidity from the current account surplus and foreign direct investment inflows.

This external liquidity has pushed China's foreign exchange reserves above \$400 billion. This combination of domestic and external liquidity suggest that rapid credit and investment growth can continue in China for quite some time.

Because investment and personal consumption each account for about 40 percent of total demand, continued strong investment growth is the key to continued strong economic growth in China's production-based economy.

In contrast, most Western-style economies are consumption-based. Personal consumption and investment account for around 80 percent and 15 percent of total demand, respectively. Instead of consuming goods, China's population prefers to save, which builds deposits used to finance credit growth and investment.

As in other countries that have experienced prolonged periods of rapid credit growth, China's banking system has accumulated substantial non-performing loans. Many feel that this is the country's Achilles' Heel.

Unlike other countries, there is no market or administrative mechanism that restricts credit growth in the face of accumulating non-performing loans. Eventually, China's government will assume these loans. In the meantime, ample domestic and external liquidity will continue to drive rapid credit growth.

This year, the only economic setback likely to affect China will be temporary and driven by geopolitical factors. Electoral politics in the U.S. will prompt increasing tension between Washington and Beijing over trade, North Korea and Taiwan.

This tension will cause periodic equity and debt market weakness, creating good buying opportunities for those wishing to establish or increase long-term investment positions in China and proxy countries.

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