China *Under* Attack

An economy amazingly vulnerable to bad news.

BY K. PHILIPPA MALMGREN

On January 31, 2014, one of China's many trust companies, the China Credit Trust, nearly went bankrupt and had to be bailed out by unknown sources. Some say it was China's Lehman Brothers moment. In late December 2013, Foxconn, the Chinese assembly firm with 1.2 million Chinese workers, announced its intention to build a production facility in the United States. On December 5, 2013, China's new aircraft carrier, the *Liaoning,* was sailing in the South China Sea when a vessel from its carrier group came less than 1,400 feet from the USS *Cowpens,* a *Ticonderoga*-class missile cruiser. The near-collision was the result of an ever more apparent game of "chicken" between the United States and China. The three seemingly unrelated events may be individually important, but they are symptomatic of changing dynamics affecting China's interaction with the United States and the West more generally.

China's competitiveness has been deeply eroded in recent years. The old revenue and cash inflows China had enjoyed disappeared when the financial crisis damaged consumption in the industrialized world. Since then, Chinese workers have been

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U.S. NAVY PHOTO BY MASS COMMUNICATION SPECIALIST 1ST CLASS ELLIOTT FABRIZIO

Access to the shipping lanes in and out of China has become an increasingly high-priority issue. That's how 90 percent of critical food and energy supplies arrive in China and also how most things leave China. Yet all China sees is the ever-increasing presence of the U.S. Navy encircling them and rendering sea access less certain.

Left, the **USS *Cowpens,*** *nicknamed "the Mighty Moo," departs San Diego for a seven-month Western Pacific deployment on September 17, 2013.*

hurt by both the deterioration of a powerful export engine and the rapidly rising cost of living.

Chinese official data shows inflation is not too bad. But the Chinese government wants to maintain the façade that markets are functioning favorably and the GDP deflator is small, ensuring high "real" growth rates. The actual inflation rate faced by locals is far higher than the data shows. Of course, some argue a gap exists in the United States as well. The reality though, is that the prices of energy and food have been high and rising rapidly in recent years. Food and fuel account for 40 percent to 70 percent of a Chinese worker's expenses. Consider the price of beef, which, like most proteins, has kept hitting all-time record highs in the last few years. Failure to provide the Chinese public with protein at a moderate price is a recipe for serious social unrest. Oil may not seem expensive in the West, but anything over $100 per barrel translates to fuel and other energy expenses high enough to warrant moving production to the United States where energy is increasingly cheap, leading to job losses in China.

These pressures have generated demands for higher pay. Wage demands for skilled Chinese workers are running at a 70 percent annual increase, according to people who run real businesses in China. The government has actively tried pushing up low-end wages by 30 percent per year. Wage demands have escalated to the point that wages in Mexico are already 20 percent cheaper than in China. Meanwhile, China's workers demand more, but in weak job markets Western workers are prepared to work much harder for much less, thus narrowing the wage differential. This is one reason that many manufacturing firms are leaving China for Mexico, the United States, the United Kingdom, Germany, and Eastern Europe. Cheaper energy, better quality control, and shorter shipment times are additional incentives for geographical shift at a time when margins need to be protected.

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In the West, a debate rages about whether there is a manufacturing revival, but the facts are clear: not only is Apple leaving China for the United States, but now Foxconn, the Chinese assembler of Apple products, is building its first production facility in Harrisburg, Pennsylvania, citing cheap energy as a primary reason for the move into a fracking area. Companies, American and Chinese alike, that make simple, low-value-added items such as Hula Hoops (Wham-O) and yarn (Keer Group) are now migrating from China to the United States as well.

In other words, the old Chinese export-driven business model is breaking down. This is not just a technical economic problem. It is a political problem. After all, if the

Continued on page 68

Continued from page 11

leadership in China cannot make people rich before they get old, then the public will ask questions like: "Why is the wealth in this society being distributed to someone else, not me?" The Chinese are well aware that this dangerous question underpinned the Arab Spring and now continues to fan the flames of social unrest that has appeared from Brazil to South Africa, and threatens China itself. Failure to provide the already agitated public with food and energy at a tolerable "right price" could evolve into an existential threat to the current political order.

China's competitiveness has been deeply eroded in recent years.

Given all that, imagine how vulnerable China is to any more bad news. Yet bad news keeps coming. Bad news came on January 31, 2014, when an ICBC trust called "Credit Equals Gold Number 1," which supposedly had some ¥$3 billion worth of assets, came within hours of becoming China's Lehman Brothers. It received a last-minute bailout from a still-unidentified backer.

The problems are by no means solved. Some 43 percent of all of China's trust products come due in 2014 and 80 percent mature before 2016. Most are collateralized by property or raw materials such as iron ore or copper. It has been said that at least 40 percent of the iron ore and a similar amount of the copper in storage within China's ports serves as collateral for these trusts. Obviously, the collateral is not worth what it was during the boom, so cash calls are in play. The next spot of trouble came on February 7, 2014, when "Songhua River #77 Shanxi Opulent Blessing Project," which was backed by iron ore, failed to repay investors the nearly ¥300 million it had raised from them. There will be more such problems given that China's shadow banking system seems to have grown by the size of the entire U.S. financial system in last year alone. In the main, the fast-growing, highly leveraged financial system has been used to fund more and more building and infrastructure projects with dubious cash flow-generating ability.

With all this bad news, and given China's inability to provide sufficient food, energy, or raw materials at tolerable prices to its public, it starts to become apparent to Chinese leaders that there is a need to shift blame abroad and do whatever is necessary to protect the national interest. As Oscar Wilde said, "It is not whether you win or lose but how you place the blame." It is worth dissecting the ways in which blame is being allocated today in China.

The United States is a prime target. It is perceived to have "caused" the crisis through mismanagement of not only its own economy, but the world economy. Now it is said that the United States threatens the world by attempting to foment and export inflation. Many in China argue that the reason hard asset prices have exploded upward since the crisis began is because of America's quantitative easing policy. Not only did free money in the West work its way into emerging market asset prices from property to stocks, but the prices of critical soft commodities, namely food, have also been driven upward by quantitative easing. The Fed can claim that emerging markets should have raised their own interest rates and allowed their currencies to appreciate earlier to counter any fallout. But the Chinese know that a stronger yuan and higher interest rates cannot make more pork or more oil, and would have shut down the already faltering export engine.

From a Chinese point of view, it is argued that America always defaults on its debts through inflation. That's how America paid for the American Revolution, the Civil War, and the war in Vietnam, when the currencies of each era—the consols, the continentals and greenbacks—became devalued or worthless.

And, some Chinese are quick to note, such inflation is not a victimless crime. They echo the sentiment that the villain Goldfinger expressed to the mythic hero James Bond when he said, "Mr. Bond, they have a saying in Chicago: 'Once is happenstance. Twice is coincidence. The third time it's

Wage demands for skilled Chinese workers are running at a 70 percent annual increase.

enemy action.'" And enemy action it is. For China, and many other emerging market governments, a default by the United States and other industrialized economies is not just an economic event. It is a national security issue. The problem is not simply that these investors are going to be paid back in pieces of paper that are losing value. The Chinese fear they may be losing money on their massive holdings of U.S. Treasury bonds.

But these worries are just part of a growing concern. A bigger worry is the price consequences when large economies start inflating faster.

There is a reason, they believe, that the prices of beef, pork, shrimp, and other core proteins have hit record highs since quantitative easing began. There is a reason the oil price has stubbornly remained above $100 per barrel. There is a reason the stock markets and property markets around the world have soared, thus widening the gap between the rich and the poor. The attempts by the largest economies in the world to engage in record efforts to debase the currency are seen by many Chinese as working. The value of paper fiat money is declining and the value of hard assets is rising. Central banks in the industrialized world are succeeding in their efforts to create inflation. Inflation is occurring. It is just occurring in the weakest, poorest part of a highly integrated world economy: the emerging markets.

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As the Chinese saying goes, "Wars are fought with silver bullets." The opening salvo in this new war has been fired, in their view, by the export of inflation from the United States and other industrialized economies to emerging markets.

So access to food and energy at the right price has now become a national security requirement. It is not only about averting an Arab Spring. The political leadership also need a new peg to hang their hat on. If they cannot make the Chinese rich before they get old, then they can be seen to be protecting vital national interests in the face of growing efforts by the most powerful nations to push economic pains on to vulnerable economies such as China's.

In this context of thinking about the future, access to the shipping lanes in and out of China has become an increasingly high-priority issue. After all, that's how 90 percent of critical food and energy supplies arrive in China and also how most things leave China. Yet all China sees is the ever-increasing presence of the U.S. Navy encircling them and rendering sea access less certain. Let's not forget that 10 percent of the world's fish supply comes from these "near seas." The massive new gas fields in the disputed island territories also take on new value given the rising economic and political pressures. Can it really be any surprise to see China becoming much more aggressive in asserting its rights to the "near seas" given the picture a home? Nose-to-nose standoffs between the People's Liberation Army and America, or America's allies in the region, such as the *Liaoning/Cowpens* incident, are only just beginning. China announced an Air Defense Identification Zone in November 2013. The Chinese insist that all aircraft and ships must comply with their procedures for entering this space, which stretches to Taiwan and Japan. America responded by sending in B-52 bombers within hours of the announcement without any effort to demonstrate recognition much less compliance. Japan has said it intends to nationalize some 280 of the 400 islands, most within the ADIZ, whose ownership it disputes with China. Japanese Foreign Minister Fumio Kishida intimated on February 14, 2014, that it will permit U.S. nuclear weapons within Japanese territory if there is a "clear and present

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threat." The United States meanwhile persists with the rhetorical "pivot strategy" while continuing to build up weapons capabilities in the region. And China pursues a defense strategy that aims to deny any opponent the ability to utilize its own weapons. This drives China's efforts to deepen control over space, satellites, cyberspace, and communications hardware and software.

It is all too human, and especially easy for politicians, to look for ways to divert attention from domestic pressures to externally imposed disruptions, especially when the cauldron of domestic pressure is intensifying. After all, the more China bails out domestic institutions and stimulates the domestic economy, the more they risk stoking the very inflation that would further foment social protest. China has a finer line to tread than many other places. Too much inflation and too little growth can also inflame the public.

The Fed's view, in theory, is right. China and many other emerging markets should just let their currencies appreciate to offset any inflationary impulses. But the political reality is that you cannot expect policymakers to hit the public when they are already down. More likely, the Chinese will let their currency fall in order to slow the deterioration of their export engine.

China and other emerging markets no doubt need to take responsibility for their own economic situation. However, the industrialized world should not be surprised if the policy response aims to avoid inflicting more pain on their citizens. If anything, we should expect China to devalue, not revalue. Yes, this would be inflationary. But how can China compete when so many emerging markets are devaluing and when they believe the United States is heading down that path ultimately as well? Looked at from another angle, why would anyone expect the yuan to remain strong in light of their loss of competitiveness, their rising inflationary pressures, and the revelations that the domestic financial system is filled with losses rather than rich with savings?

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Nor should anyone be surprised to see China using other policy tools to protect its citizens from the adverse impact of global economic forces. The United States might want China to revalue but there are other options for exploitation with state power. Beefing up the military and intensifying the acquisition of valuable assets around the world is a viable policy choice, too.

Remember that it is not only blame that needs allocating when the world economy weakens. Pain also needs to be distributed. China deeply disagrees with America's view that Chinese workers should just tighten their belts and accept the pain. They have already revalued by 40 percent against the U.S. dollar since 2005. It is outrageous to most emerging markets that the United States and the industrialized world want China to take more pain given their own unwillingness to pursue austerity. To the emerging markets, it is deeply ironic that the U.S. authorities expect China to raise interest rates and to revalue when U.S. officials deny U.S. monetary policy has any spillover effects, especially when many emerging markets experienced historic capital outflows and devaluations once U.S. monetary policy began to reverse.

Similarly, the Chinese cannot be blamed for being suspicious that the United States and the West might be choosing inflation as a means of defaulting on debt, especially given that U.S. policymakers seem committed to avoiding any risk of deflation—which implies taking all the risk with inflation. And they wonder, what if the inflation rate the industrialized world needs to resolve its debt kills or severely damages emerging markets along the way? China cannot be blamed for fearing the normal consequences of inflation: higher prices. Nor can they be blamed for being paranoid. By one measure, China is being defaulted upon, encircled, and threatened on multiple levels. One cannot really be surprised that China may respond to their rising duress using whatever means necessary. ◆