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Tsunami in New York Earthquake in Beijing?

A butterfly in New York flaps its wings, and may finally cause a storm in Beijing. Well, then, how about a devastating tsunami in New York? In the last month, the whole world watched the American financial crisis unfolding day-by-day. Ripples from the Wall Street spread to each corner of the global economy. When this financial tsunami finally hit China, should we expect the shaking of earth and a collapse of the Chinese economy?

At the second half of last year, when there are already clear signals that a severe financial crisis was coming and would trigger a domino falling in the international financial markets, China still watched all these from a far distance. Many Chinese officials as well as scholars remain quite optimistic if not naïve. They were misled by the popular "decoupling thesis" which claimed that developing countries like China are "decoupled" from U.S economy and can achieve a robust growth independently. This optimism seems to be quite legitimate. China's GDP growth rate reached a historical high level of 12% in 2007. Who will believe such a fast growing huge economy, already experienced two-digit growth rate for five years, probably the emerging locomotive of the world economy in the near future, will come to a sudden stop?

There are already unnoticed cracks in the ice in 2007. China's export has kept an annual growth rate of more than 20 percent since 2000. Export became an important driver of growth in the last several years. In 2007, almost one quarter of China's GDP growth stems from the expansion of its trade surplus, the world's largest. But export orders started to drop since the second quarter in 2007 and the growth of export suddenly lose its momentum since 2008. The faltering of export sales, so far, is not infected by the sub prime crisis. It is the sequel of other chronic diseases. Chinese export companies have suffered from continuous increase of its import costs for several years. Prices of Oil, iron, copper, soybean, almost everything China is buying, are soaring. In the last two years, the coastal area in China also had to face up with a shortage of the “surplus labor” from the rural areas. Many Chinese export companies, especially the less competitive ones, were already on the brink of bankruptcy.

The direct losses of Chinese financial institutions from the U.S subprime crisis are not huge in the amount. Chinese commercial banks eagerly defended their slight involvement or noninvolvement in the crisis. Among Chinese banks, Bank of China has the most exposure to subprime related securities. It said in its annual report that its investment in subprime asset-backed securities was 4.99 billion U.S. dollars in 2007. The ICBC, China's largest commercial lender, suffered a loss of1.2 billion U.S. dollars from the crisis. Yet with the meltdown of the international financial markets, a lot of Chinese financial institutions which were too aggressive in overseas investing may be further bruised. The echo off effect from the Wall Street, as well as the domestic tight monetary policy to curb inflation, may led to a rising of bad asset ratio of Chinese banks. The non-performing loan ratio of China's major banks already fell to below 7% last year but started to rise this year.

The American financial crisis would definitely affect Chinese economy through both trade and financial channel. More than 30 percent of China’s exports head for the U.S, if the financial turmoil toppled the U.S into a prolonged recession, the damage to China’s export would be significant. If more and more small export companies fell down next year, China may have to face up with rising unemployment as well. That will be a real headache for the Chinese government. Some analyst argued that China has already diversified its export and this will help China to escape from this storm. But so far what we can see is that EU and Japan have also been dragged to a recession. China’s export to these markets will also slow down. Seeing the downturn risk, Chinese banks becomes reluctant to extend loans to export companies. China is also experiencing credit crunch, although not as serious as the Wall Street. Housing price started to fall since the summer, and it may continue to turn down. Stock markets jumped over 60% since early this year, and it will keep trembling.

And don’t forget China’s huge foreign exchange reserve, this month already reached 1.9 trillion U.S. dollar. The lion’s share of China’s foreign exchange reserves are hold in U.S. dollar denominated assets. Some American politicians worried that China may use this massive foreign exchange reserve as a “nuclear weapon” at its disposal for countering the US. This is far from the truth. The truth is, with most of its foreign exchange reserves invested in dollar-denominated assets, China has been taken hostage by the U.S. If China dumps its dollar, it will create a free fall of the dollar and China will lose immediately. If China sticks to these greenbacks, however, U.S. dollar’s may depreciate further, and China will lose gradually. U.S has prepared a more than 700 billion USD rescue plan. Who will pay for this expensive treatment? It’s almost obvious that China would have to bear a large proportion of the burden of sorting out in the U.S. China has good reason to worry about the safety of its assets.

The world economy is in trying times. The last two decades witnessed a “golden era” of globalization. But the strong economic growth of both the U.S and China is built on an unsustainable relation. China sells cheap products to the U.S and piles up the IOUs from the U.S, and at the same time helps to finance the budget deficit in the U.S. The result is that trade deficit in the U.S. will be become larger and larger, and trade surplus in China will also keeps swelling. There is no convergence that we can finally reach. The seemingly prosperity is built on the sands and will collapse sooner or later.

American financial crisis will force both the U.S and China to change course. The plunge in the real estate market and stock market made Americans poorer. With the unemployment now at 6.1%, likely to rise above 8%, the future of American consumer becomes even more miserable. There is no consumer in the world like the American consumer, but now they are forced to spend less. If the “excess consumption” in the U.S has to be corrected, China will also have to change its development path. The traditional Chinese development strategy emphasizing export growth and FDI inflow, and it has led to an expanding trade surplus and the accumulation of 1.9 trillion foreign exchange reserves. When export and GDP growth are high, there were no incentives for China to take the pains-taking reform. if we want to improve the resiliency of the Chinese economy, we should put more efforts on stimulating domestic demand, investing more on human capital and building stronger social safety networks. As Sunzi said in his *Art of War*, if you put the troops in death ground, they will fight for live. 2009 will be a cold winter for Chinese economy, so we’d better be prepared from now on.