The Internal Roots of Economic Downturn in China

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The economic slowdown in the world today is likely to take a long time to settle. And, the global economy might be moving further downhill in the coming years rather than recovering. As for China, the economic slowdown will affect the country's economy, but not only because of external factors.

In the US the financial crisis has endured and produced a pattern of sluggish growth. The only promising factor behind the American economy is the corporate / business sector. Notwithstanding, high costs of production in the US introduce serious obstacles for the US to return to a manufacturing economy. The work remaining to be done is more a case of political slogging rather than an economic mechanism. If political solutions can be found, growth could increase by 1 or 2 %. Yet, there will be no return to the economy of the 1990s when the American economy boomed at 4%.

On the other hand, the eurozone may take an even longer period to find a solution to its debt crisis. This is not an issue of political consensus alone, but also an issue of economic consistency among major European countries. It is difficult to create a financial and fiscal framework that would create a fundamental mechanism for every eurozone member to follow. It was tried in the past, and it turned out to be an unsuccessful experiment. The fundamental issue underlying the eurozone crisis is the fact that most European countries had already lost their competitive and productive means in the global economy. In comparison with the economies of China and the BRICS countries, European labour costs are much, much higher than in Asia or emerging market economies. Additionally, the labour market is inflexible due to various social policies. Even if the euro can be saved, it will be very difficult for European politicians to navigate these issues.

External factors such as the American downturn and the eurozone crisis are negative for the Chinese economy, but the major reason for economic slowdown is due to structural problems and defects in the Chinese financial system. The structural problems were created by the lack of reforms in the past ten years – which made the economy lose its dynamism and reduced productivity. As a result, the manufacturing sector has been in decline since 2005. Productivity has also declined due to the degradation of the economic structure into two major sectors: state owned enterprises (telecom, energy, oil industries), and the non-state sectors comprising a huge number of small and medium sized firms. State owned enterprises are large and powerful.

The small and medium size firms were originally very competitive and profitable. But over the past couple of years most Chinese non-state enterprises have found it difficult to survive in the market. These firms could not make the sectoral shift since they couldn't access available credit. This occurred via a monopolization of financial resources by the five major banks in China. The banking system thus stymied the development of the non-state sector by prioritising state-owned enterprises and big firms. The non-state elements didn't have the opportunity to re-allocate their capital and other elements of production to the sectors where productivity ranked higher. To survive, the small and medium non-state firms have been driven to speculative industries and even to driven into becoming money lenders in black credit markets.

Without continuous structural change, productivity has inevitably started a descent in China. When facing the quick rise of wages, most private firms began to struggle. While wages are growing about 15% or more since 2005, labour productivity has grown less than 10%. Most firms in the non-state sector cannot remain profitable, and will have no way forward, because access to state-owned finance is prevented. On the one hand, there are the monopolists which make higher profits in upstream industry, and on the other hand, are the small firms in downstream industry.

The entire system in China is unbalanced. Over time, it will become apparent that such a situation cannot benefit the economy and facilitate the evolution of the Chinese economy short of banking sector reform. A state dominated financial system cannot match the structure of an economy where 99%% is comprised of small and medium sized firms. External problems might explain the Chinese slowdown in part – but that is not the real story.

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