China Takes Precautions Against 'Financial AIDS'

by Mary Burdman

The debate about China's overdependence upon foreign capital and investment—its vulnerability to catching "financial AIDS," as *EIR* warned many Chinese policymakers before and after the 1997 Asian financial crisis—is a national hot topic again. The new-generation goverment in Beijing has set up a group of institutions to develop a "scientific approach" for the future of the economy, and these discussions are certainly reflected in recent harsh warnings from some leading authorities in China's national financial system. Guo Shuqing, as director of China's State Administration of Foreign Exchange (SAFE), made several very blunt statements in March about the dangers posed by flows of "hot money" into China, the "excessive speculation" in real estate, and the problems posed by China's over-dependence on low-cost exports. In a widely covered interview on March 19 with the national Chinese media, Guo Shuqing—who is also a deputy-governor of the People's Bank of China, and has now taken over the corruption-troubled China Construction Bank, one of the four big state banks—said: "Indiscriminate support of exports and foreign capital influx has created short-term economic problems." These problems include "excessive speculation in the property market and the economic decoupling of the fast-growing coastal areas with the rest of China."

The split between the coastal regions and its impoverished hinterlands, is the classic weakness of the Chinese economy. In the 19th Century, the foreign-controlled "treaty ports" brought the opium scourge into China; and foreign control of trade, industry, and railroads, led to the nationalist revolution of 1910. After World War II, the vast economic gulf between the coastal cities and the interior, and widespread speculation in anything and everything possible, fed into the hyperinflation which spelled the end for the beleagured Kuomintang (KMT) regime of Chiang Kai-shek. The situation was aggravated in 1948, when the United States, under President Harry Truman, began dumping manufactured goods in the cities as "aid" for the collapsing KMT. This killed any possibility that the KMT goverment could salvage what remained of Chinese industry, after the brutal 13-year Japanese occupation. The first measures taken by the new Communist goverment after October 1949 were to bring order to the currency and banking system, and then gradually launch an industrialization program. Despite the turmoil and frequent disasters of Mao Zedong's regime, keeping financial stability has been a fundamental policy of the People's Republic.

Late last year, at the time of the spectacular collapse of China Aviation Oil (CAO) in Singapore, because of speculation on oil price derivatives, Beijing put out a series of warnings about international hedge funds which were speculating on the up-valuation of the Chinese international currency, the renminbi, which has been pegged at a fixed rate to the U.S. dollar since 1994. This time, Guo Shuquing said that the SAFE had traced foreign money getting into China disguised as funds for trade or investment, but used to buy financial assets and property. As just one example, he said the SAFE had "found the phenomenon of one single (overseas) person buying up to 100 houses in coastal cities. This is apparently speculative activity."

Downgraded Delegation to IMF/World Bank

It is well known in Beijing, that the greatest pressure is being put on the renminbi by U.S.-based hedge funds. It is quite possible, that this knowledge is behind China's decision to send only unofficial observers to the IMF and World Bank meetings in Washington this month, as a well-connected Beijing banker told *EIR* on April 8. The U.S. Treasury had announced on April 5 that "senior Chinese officials have told the U.S. Treasury they will not be coming to Washington for the Spring meetings." Chinese Finance Minister Jin Renqing and People's Bank of China (PBOC) Governor Zhou Xiaochuan did participate in the G-7 meeting in London in February, and high-level officials have been invited to observe G-7 meetings in recent years. China is not a member of the G-7, and it is participating with the status of a developing nation, the Beijing banker said. "It is not logical for the G-7 to invite China to meet the developed nations, when it is still a developing nation." This is the last year of China's "transitional" status as a member of the World Trade Organization (WTO), in which it is treated as a developing nation—which is its real status. At the end of 2005, the relative benefits China gets in the WTO, because of this status, will be ended.

The real point is, that the United States, Japan, and other developed nations are demanding China accept the equivalent of a "Plaza Accord"—the forced upvaluation of the Japanese yen which led to the Japanese crash in the early 1990s. China will "eventually" give "more flexibility" to its exchange-rate mechanism, the banker said, first by widening the band at which the renminbi trades, and the target could be within 18 months to two years. However, as Prime Minister Wen Jiabao has emphasized, "We will change the exchange-rate mechanism—when it is not expected!" To protect the financial system, the PBOC has set up departments to deal with money laundering and speculative inflows, under deputy governor Li Ruoguo, noted for his strong statements to the United States earlier this year, to get its own financial house in order before it pressures other nations. The PBOC is particularly concerned about U.S.-based hedge funds, as well as the "underground" funds getting into China, to speculate on black market exchange rates and interest rates. "China wants to avoid the possibility of financial crisis, especially due to speculation," the Beijing banker said.

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To make the point clear for those reluctant to understand it, on April 7, Foreign Ministry spokesman Qin Gang said at a Beijing press conference that "the U.S. should find reasons from its own country to address the economic imbalance" with China. He was reacting to the U.S. Senate proposal to use tariffs to force a renminbi upvaluation. If a country such as the United States cannot support its deficits with domestic savings, "it can only depend on the savings of foreign countries," Qin said. "When determining whether the currency is or is not undervalued, you do not only take into consideration bilateral trade, but multilateral trade as well. China has trade surpluses with the United States, yet is experiencing a big trade deficit with many of its Asian trading partners." A large portion of Chinese exports are produced by China-based factories funded by foreign companies, including U.S. companies—which take most of the profits.

Systemic Risks

The situation also has to be cleaned up on the Chinese side. On March 11, Guo Shuqing made what the Chinese press called a "rare, stern" admonition to regional and local governments not to encourage foreign investment "haphazardly." Some officials and economists had previously been dismissive of the impact of speculative inflows, but Guo was frank and clear. Speaking during the yearly session of the National Committee of the Chinese People's Political Consultative Conference, he said China might see "no end of trouble for the future" unless local governments become acutely aware of risks. "China pays great attention to speculative funds," Guo said. "Foreign exchange administration departments and other macro-economic departments are investigating the issue and will punish illegal activities severely."

The overall inflow of capital into China is "normal and legal," Guo said, but there are "worrisome" problems, especially "fake foreign investment." The balance of payments statistics for 2004 showed, under "net errors and omissions," an inflow of some $20 billion. Once inside China, speculative investment means trouble. Very high housing prices might make the cities look "prosperous," but do not encourage real investment, he said. Rising prices pose great risks for local financial institutions, enterprises, and individuals, who will "suffer huge losses" when the bubble bursts. "Capital inflow is an important part of China's overseas economy. We hope relevant sides join hands with us to restrain speculative capital," Guo said.

He also cautioned on the rapid growth of outstanding foreign debt, which went up 18% year-on-year, to $228.6 billion by the end of 2004. Of this, 45.6% is short-term. While China's foreign reserves, at $609.9 billion, could cover the national debts, for individual companies, too much foreign currency debt could snowball to a level posing "systematic risks."

Correct the Globalization Mentality

Guo Shuqing is also taking on the fundamental question of China's economic future. Over-reliance on the "processing" trade, and cheap exports, has been a "hot topic" for years in China, and has certainly not cooled down since China entered the WTO. In his March 19 interview, Guo emphasized that China "should gradually reduce the preferential treatment to exports and seriously review our foreign investment policy." Excessively favorable policies to exports and foreign investment were useful right after 1979, when Deng Xiaoping launched the "opening-up" policy to bring China into the world economy. But the opening-up methods have brought problems, including the "erroneous" belief that a consistent trade surplus was desirable.

"This mentality should be corrected," Guo said. Prosperity has grown in the coastal regions, but not China's economy overall. Most exports are low-added-value, from foreign-owned and controlled firms. Exports of relatively higher added-value, and particularly of Chinese inventions, are a "persistently low" proportion of the total. "This kind of export growth is not sustainable," Guo said.

China's overall dependence on exports and imports has skyrocketted in recent years. In 1970, its foreign trade dependence ratio was minuscule, at only 5.0%. By the end of 2004, the rate had surged to 70%. In the first ten years of the "opening-up" policy, 1978-89, there was relatively stable growth, from $20.6 billion to $111.7 billion over ten

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years, and the ratio of trade dependency rose from 8.9% to 24.8%. Things were much more turbulent during the 1990s, which culminated in the Asian financial crisis. But since 2000, with China's accession to the WTO, dependence on trade shot up, from 43.8% in 2000, to 60% in 2003, and to 70% in 2004.

Another big problem is rating exports as more important to the economy than imports. Policies excluding high-grade imports, have actually discouraged Chinese manufacturers from upgrading production with imported equipment and technology, Guo said.

Meanwhile, an entire "foreign" economy has grown up, physically based in China, but in reality only one branch of the globalized system. "More than half of China's exports, and an overwhelming majority of high-tech manufacturing and trade, are generated by foreign companies," Guo said. This "separate" economy has far more transactions with other foreign companies—inside China and outside it—than with the domestic Chinese economy.

One result is the explosion of China's forex reserves and trade surplus. China's foreign reserves have shot up 300% since 2001, and such huge holdings can cause problems. After the Asian fiancial crisis, there was a national debate in China at the highest level, on whether foreign reserves were essential to protecting the financial system, or whether strong exchange and other financial controls—under the government's sovereign control—were the better guarantee. Now, with the huge reserves making China vulnerable to the financial crisis in the United States, the answer is becoming clear.

Guo emphasized that managing these vast holdings "reduces the independence of the country's monetary policy." The People's Bank of China has been spending excessive amounts of renminbi to buy the big foreign currency holdings of commercial banks, amassed due to the trade surplus and investment inflow. This has dominated PBOC policy, which had been to try to control money supply. The whole situation is becoming unbalanced, and "China needs a strategy for more of a balanced development," Guo said.

He put forward some beginning measures for balancing that development. Due to its rapid growth from a very poor level, China has an energy crunch; in its own interests, it should cut production of energy-consuming exports. It should also cut exporting the resources China needs. As of April 1, Beijing ended its 13% tax rebate on steel billet and ingot exports, which will considerably reduce these exports this year. Iron ore is urgently needed in China, the world's biggest steel producer, and it is facing 70% price hikes from the international cartels.

But of greatest importance in what Guo said, is that he stated that China—while restricting low-level, redundant, or speculative investments—must call on the industrial nations to relax restrictions on their technology exports to China. This is, at least in approximation—the basis for the "Eurasian Land-Bridge" approach of Lyndon LaRouche.

German Investments in Russia Reach New Phase

by Rainer Apel

The "Week of Russian Industry" at the Hanover Industrial Fair, which began on April 10 with speeches by German Chancellor Gerhard Schröder and Russian President Vladimir Putin, and ended on April 16, brought considerable progress in economic relations between Germany and Russia. Among the deals signed in Hanover, the joint ventures in the railway and natural gas sectors mark a new phase in cooperation: Whereas relations in the past were predominantly characterized by Russia being the raw materials supplier and Germany the supplier of machines and other industrial equipment, now German companies are beginning to make long-term investments in Russian industry.

Not only because Russian natural gas covers 40% of Germany's needs, is the partnership agreement between Germany's Wintershall firm and Russia's Gazprom important. The agreement, which gives Gazprom a 49% share in, and the respective revenue from, the 2,000-kilometer German pipeline grid owned by Wingas, a daughter company of Wintershall, is mirrored by the same share granted by Gazprom to Wingas in the Baltic underwater pipeline, which will be built between Vyborg and Greifswald during the next five years. An even more substantial aspect of the Gazprom-Wintershall agreement is that both firms will jointly explore the new giant Siberian gas field at Yuzhno Russkoye, which has enough reserves to cover all of Germany's natural gas needs for five or more years. Gas will also be exported from there to other European countries.

High-Speed Rail

The other outstanding German-Russian deal is the one between Siemens and RZD (Russian Railways) on the realization of the high-speed railway route between Moscow and St. Petersburg. The route will be completed by the Spring of 2008, and will be served by 60 trains, travelling at speeds of up to 300 kilometers an hour. The trains will be based on Siemens' Inter City Express (ICE) system, modified for the wider Russian track gauges and made of special materials that can resist the harsh Arctic climate in Russia's northern regions. Most of the components of the trains will be produced at Russian firms, which belong to a joint Siemens-RZD venture. According to RZD director Gennady Fadeyev, the joint venture will create up to 100,000 jobs in the Russian rail-tech sector, and enable Russia to build up a modern machine-building industry. This will lay the groundwork for future