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## The nightmare of a Chinese economic collapse

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The early spring market correction of the Shanghai Stock Exchange sent a shiver round world markets. And some people started pondering the unthinkable; could the relentless China growth story be the great illusion of our age?

In 2001, Gordon Chang authored a global bestseller "The Coming Collapse of China." To suggest that the world's largest nation of 1.3 billion people is on the brink of collapse is understandably for many, a deeply unnerving theme.

And many seasoned "China Hands" rejected Chang's thesis outright. In a very real sense, they were of course right. China's expansion has continued over the last six years without a hitch. After notching up a staggering 10.7 percent growth last year, it is now the 4th largest economy in the world with a nominal GDP of \$2.68trn.

Yet there are two Chinas that concern us here; the 800 million who live in the cities, coastal and southern regions and the 500 million who live in the countryside and are mainly engaged in agriculture. The latter – which we in the West hear very little about – are still very poor and much less happy. Their poverty and misery do not necessarily spell an impending cataclysm – after all, that is how they have always have been.

But it does illustrate the inequity of Chinese monetary policy. For many years, the Chinese yen has been held at an artificially low value to boost manufacturing exports. This has clearly worked for one side of the economy, but not for the purchasing power of consumers and the rural poor, some of who are getting even poorer. The central reason for this has been the inability of Chinese monetary policy to adequately support both Chinas.

Meanwhile, rural unrest in China is on the rise – fuelled not only by an accelerating income gap with the coastal cities, but by an oft-reported appropriation of their land for little or no compensation by the state.

According to Professor David B. Smith, one of the City's most accurate and respected economists in recent years, potentially far more serious though is the impact that Chinese monetary policy could have on many Western nations such as the UK. Quite simply, China's undervalued currency has enabled Western governments to maintain artificially strong currencies, reduce inflation and keep interest rates lower than they might otherwise be. We should therefore be very worried about how vulnerable Western economic growth is to an upward revaluation of the Chinese yen. Should that revaluation happen to appease China's rural poor, at a stroke, the dollar, sterling and the euro would quickly depreciate, rates in those currencies would have to rise substantially and the yield on government bonds would follow suit. This would add greatly to the debt servicing cost of budget deficits in the USA, the UK and much of Euro land.

A reduction in demand for imported Chinese goods would quickly entail a decline in China's economic growth rate. That is alarming. It has been calculated that to keep China's society stable – ie to manage the transition from a rural to an urban society without devastating unemployment - the minimum growth rate is 7.2 percent. Anything less than that and unemployment will rise and the massive shift in population from the country to the cities becomes unsustainable. This is when real discontent with communist party rule becomes vocal and hard to ignore.

It doesn't end there. That will at best bring a global recession.

The crucial point is that communist authoritarian states have at least had some success in keeping a lid on ethnic tensions – so far. But when multi-ethnic communist countries fall apart from economic stress and the implosion of central power, history suggests that they don't become successful democracies overnight. Far from it. There's a very real chance that China might go the way of Yugoslavia or the Soviet Union – chaos, civil unrest and internecine war. In the very worst case scenario, a Chinese government might seek to maintain national cohesion by going to war with Taiwan – whom America is pledged to defend.

Today, people are looking at Chang's book again. Contrary to popular belief, foreign investment has actually deferred political reform in the world's oldest nation. China today is now far further from democracy than at any time since the Tiananmen Square massacres in 1989. Chang's pessimistic forecast for China was probably wrong. But my fear is there is at least a chance he was just early.

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## Dan Lewis



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