Why China Will Have an Economic Crisis
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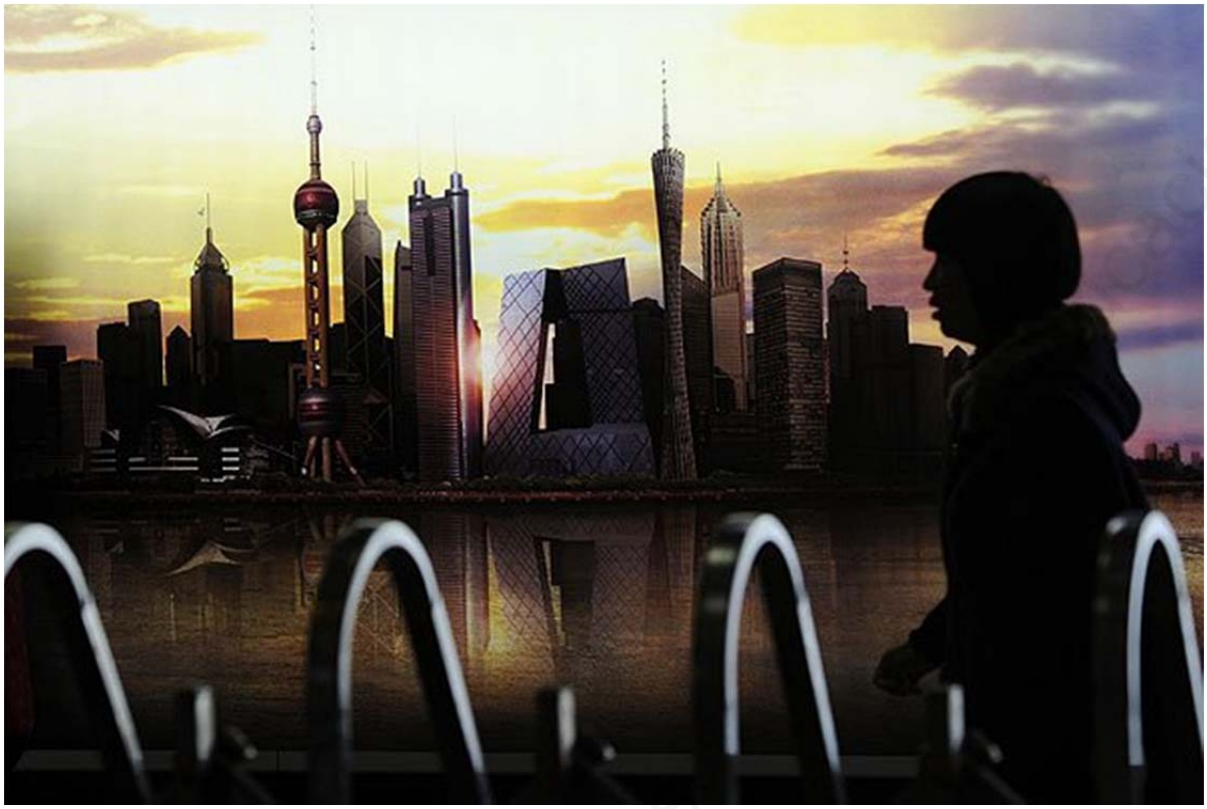

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A passenger passes a photo montage of the Shanghai skyline in a subway station in Pudong, the financial district of Shanghai, on Feb. 3, 2012

The view in most of the world is that China is indestructible. Shrugging off the crises multiplying elsewhere, China seems to surge from strength to strength, its spectacular growth marching on no matter what headwinds may come. It appears inevitable that China will overtake a U.S. mired in debt and division to become the world's indispensable economy. Those businessmen and policymakers looking to the future believe China's "state capitalism" may be a superior form of economic organization in dealing with the challenges of the modern global economy.

My answer to all of this is: think again.

I don't doubt for a second that China will be a major economic superpower with an increasingly influential role in the global economy. In many respects, it already is a superpower. But that doesn't mean the economy is free from problems, a good number of them created by the very statist system lauded by pundits in the U.S. and Europe. And in my opinion, if China doesn't change course, and in a big way, the country will experience an economic crisis.

I've been thinking about China's economic future, and the likelihood it will face some sort of terrible collapse, for some time, but I have until now been reluctant to come out with my views so strongly. The reason is that it is very difficult to tell what's really going on in the Chinese economy. Data is sparse or unreliable. And China is in certain ways unique in economic terms — has history ever witnessed a giant of such massive proportions ascend so quickly in the global economy? Valid precedents are hard to find. Then there is the issue of timing. It is easy to say China will have a crisis; it is almost impossible to say when that might happen. Next month? Next year? Next decade? The fact is China could continue as it is for some time to come. So, in other words, when you make the type of prediction I just have, you have a good chance of getting it just plain wrong.

But the more time I spend in China, the more convinced I am that its current economic system is unsustainable. Yes, economists who specialize in China can give you all sorts of reasons why the country is supposedly different, and thus the regular rules of economics don't necessarily apply. But one simple thing I always say about economics is that you can't escape math. If the numbers don't add up, it doesn't matter much how big your economy might be or how fast it is growing or how heavy a role the state might play. And China has lots of numbers that just don't add up.

A big part of the bad math is created by China's state capitalism. China has adopted a form of the Asian development model, invented by Japan and followed, to varying degrees, by many rapid-growth countries around East Asia. The model, very generally speaking, functions like this: 1) capitalize on low wages to spark growth through exports and industrialize quickly with hefty amounts of investment, 2) guide the whole process with the hand of the state, 3) employ industrial policies and state-directed finance to progress into more and more advanced sectors. This system generates fantastic levels of economic growth for a while, but then eventually, it crashes. Japan had its meltdown beginning in 1990 (and it hasn't escaped two decades later); South Korea, the country that copied Japan's model most closely, experienced its crisis in 1997-98.

What happens? The model is based on what Alice Amsden, in her study of the Korean economy, called "getting prices wrong." To spur on the high levels of investment necessary to generate rapid growth, the model depends on state-directed subsidization to make investing in certain industries or sectors more attractive and less risky than it otherwise would be. Cheap credit is made available for industry, or the state outright orders money to be invested in certain preferred projects. The exchange rate is controlled to encourage exporters. All sorts of subsidies, for energy, exports and so on, are dished out. Banks are not commercially oriented but act to a great degree as tools of government-development policy. All of these methods funnel money, private and public, into industrialization, creating the astronomical growth rates we see again and again in Asia.

The problem here is that prices can't stay wrong indefinitely. There is a good reason why classical economists are always so focused on allowing markets to find the correct price level. In that way, markets send the proper signals to potential investors on where money should or should not go. If those price indicators are skewed, so is the direction of resources. The Asian model, by playing around with prices, eventually creates tremendous distortions, in which money is wasted and excess capacity is generated. Subsidized companies don't have to generate returns in the same way as unsubsidized firms, and that leads them to make bad investment decisions to build factories and buildings that are unnecessary and unprofitable. As a result, loans go bad and banking sectors buckle. That's exactly what happened in both Japan and Korea. Though their crises were tipped off in very different ways — the bursting of an asset bubble in Japan, an external shock in Korea — the reason both countries collapsed was the same: weak banks, indebted companies, silly investments.

China is indulging in all of the same excesses as Japan and Korea, and then some. The level of investment in China, at nearly 50% of GDP, is lofty even by Asian standards. The usual argument made in defense of such astronomical investment in fixed assets is that China is a large developing country that needs all of the buildings and roads it is constructing. Qu Hongbin, the very smart chief China economist at HSBC, made that very argument in a recent study:

There is a popular view in the market that China has overinvested and therefore can no longer rely on investment to sustain its growth. We disagree. China's investment-to-GDP ratio is indeed very high (46%) … [But] China is only half way through the process of urbanisation and industrialisation. It still needs to invest more to cope with the rising demand for rail, hospitals and industrial plants. The recent infrastructure boom has boosted the country's transport capacity, but China's railway network is still shorter than that of the US in 1880 … In economic terms, we estimate that China's capital stock per worker is only about 8% of that of the US and 15% of that of Korea. In other words, China's capital accumulation is still far from

reaching the stage of having diminishing returns; we believe the country needs to invest more, rather than less.

I completely agree. Yet the issue is not whether China needs more investment. The issue is whether China is getting the types of investment it requires. The fact that investment levels can be so high and yet the economy is so deficient in certain key aspects makes me think the answer is no. We can see that in the continued problem of excess capacity in China, in which companies go hog wild building too many factories in certain industries, often with borrowing from state banks. That has happened in steel and solar panels, for example. The country is investing hundreds of billions in high-speed railways even though ticket prices are beyond the reach of most Chinese, while many major Chinese cities don't have subways.

A good part of this misdirected investment seems to be headed into the property sector. Real estate development has become the key driving force of Chinese economic growth. In theory, China's very rapid urbanization makes such construction a necessity — but that depends on what is being built. In Wenzhou, a real estate agent recently offered free BMWs to anyone who bought a high-end apartment — a clear sign of overbuilding — while there is an obvious shortage of housing affordable for most Chinese. On either side of my Beijing apartment building are three big malls that hardly ever seem to see real shoppers. Rents for top-quality office space in Beijing are now pricier than in New York City — despite the fact that China's capital is one big construction zone. Many of the buildings going up are of a quality unsuitable for major corporations.

Even worse, much of the investment in China is being financed with debt. The level of debt in the Chinese economy has been rising with frightening speed. Rating agency Fitch estimates bank credit in 2011 was equivalent to 185% of the country's GDP — an increase of 56 percentage points in a mere three years. Though that surge has not yet had a significant negative impact on China's banks, many analysts fret that banks will eventually experience a rise in nonperforming loans. In an indication of what is to come, the Financial Times reported recently that the government has ordered banks to roll over the $1.7 trillion of loans owed by local governments. If true, this tells us two key things: 1) these governments invested money raised from banks in projects that are not generating the returns necessary to pay them back and 2) the quality of loans on the banks' books are more questionable than official statistics suggest. On top of that, the fact that local governments amassed so much debt in the first place shows a complete lack of rule of law in China's financial sector. Technically, local governments aren't permitted to borrow money at all. Meanwhile, as government entities run up loans they can't pay, many small companies, especially private ones, are unable to raise sufficient funds and remain starved of capital.

So we can see the pieces of a crisis falling into place: excessive, misguided investment, including a giant property boom, propelled on by debt and the decisions of government bureaucrats. Sound familiar? A crisis, of course, is not inevitable — if China's leadership takes action and reorients the direction of the economy. The positive thing is that at least some top policymakers understand the need to change. In policy pronouncement after policy pronouncement, the government pledges to reform. The problem is that China's government is not taking its own advice. The economy needs to rebalance away from investment and exports to a more consumption-driven growth model with a primary focus on quality of growth, not high rates at any cost. That's not happening, or not happening quickly enough. Yes, the Chinese consumer is gaining in global importance, but savings in China remains too high and consumption as a percentage of GDP still way too low. Steps that the government could take to spur on the needed rebalancing — reducing lofty taxes on many imported goods, for example — are nowhere to be found. More importantly, the government is doing nothing to set prices right. The currency remains firmly controlled, interest rates unreformed. So investors within China are still acting based on the wrong price signals.

Why won't China's policymakers pursue more fundamental reform? They are afraid that growth might slip. Sure, the latest five-year plan targets 7% annual GDP growth, but it seems to me that every time growth drops under double digits, the leadership goes into panic mode and revs up the economy again. GDP surged 8.9% in the fourth quarter of 2011, but that's not fast

enough for China's leaders. They've already started loosening credit again — slathering yet more debt onto the economy.

When I bring up these issues with China watchers, I'm usually scolded — Beijing's policy mandarins have it all figured out, I'm informed. It is true that China's policymakers have done a superior job managing the rapidly changing economy in recent years. But as any stock investor knows all too well, past performance does not ensure future performance. Back in the 1970s and '80s, analysts in the West considered Japan's bureaucrats near supermen as well. Now the stodgy Japanese bureaucracy is considered one of the main impediments to an economic revival. Chinese bureaucrats today suffer from the same problem that led Japanese bureaucrats astray — they believe the economy can be managed by fiat. The tools of classical economics — getting prices right — are secondary. Why guide an economy with abstract measures like interest rates when you can just tell the banks what to do?

That attitude is what killed Japan's economic miracle, and now I see China slipping toward the same fate. Japan could not escape the forces of basic mathematics. China can't either, no matter how brilliant its policymakers might be. When would a meltdown happen? It is interesting to play with a bit of history. Both Japan and Korea suffered their crises roughly 35 years after the Asian development model was switched on — the early 1950s to '89 in Japan, and 1962 to '97 in Korea. That puts a China crisis at around 2014-15 or so. I'm not predicting a firm date here. What I am saying is that China is running out of time to fix the problems of its economy.

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