FEBRUARY ASIA REPORT

Revisiting the Chinese Curse: May you live in interesting times.

These are quite interesting times for China.

After several decades of unprecedented economic boom, the Chinese central government in Beijing recently acknowledged the gradual decline of economic growth, and that it must take measures. President Xi Jinping expressed the opinion that economic stability is more important to the country than a high rate of GDP growth. The central government subsequently announced its decision late last year to accept GDP growth rates lower than 6.5%.

This statement may have been an attempt to downplay the possibility of a market crash similar to that of 2015. The hope is also that this move will prevent mass unemployment and avert a resulting economic collapse and market crash.

China's decision to address the root of the problem, i.e. unemployment and stability, rather than focusing on GDP growth, will hopefully result in a slower, more mature economic cycle, like Western ones, rather than an economy dependent on periodic booms. The research company, China Beige Book (CBB), explains China's new tactics, saying that instead being obsessed with GDP figures like most investors, the government has decided to target unemployment as its main priority. However, until this is implemented, the danger of a market crash exists.

By allowing even the possibility of GDP dropping below 6.5%, China's highest authorities are effectively issuing a warning. They fear that the Chinese economy can't even cope with six-percent growth. In fact, the economy might fall below six percent by 2020.[1]

Inevitable Implosion

When top economists start warning of the impending collapse of the world's second largest economy, people sit up and listen.

Andy Xie is a former chief economist at the World Bank and Morgan Stanley. Speaking to MarketWatch reporters recently, Xie predicted that China is on course for a collapse more extreme than the 1997 Asian currency crisis and the 2008 U.S. financial crisis – combined. He blames China's problems on inflated stock market and property prices and compares the "eventual" meltdown to the U.S. 1929 Great Depression, when excessive borrowing, inflated property prices and a flawed monetary policy dropped an almighty market crash that reverberated for nearly a decade.[2]

China in 2016 looks much the same, according to Xie, with half of the country's debt propping up real-estate prices and heavy leverage in the stock market — indicating that conditions are ripe for a correction.

"The government is allowing speculation by providing cheap financing," Xie told MarketWatch. China "is riding a tiger and is terrified of a crash. So it keeps pumping cash into the economy. It is difficult to see how China can avoid a crisis."

The Debt Bubble

In a series of point-blank remarks, former International Monetary Fund (IMF) economist Kenneth Rogoff his concerns about a repeat of last summer's worldwide market crash triggered by China's economic slowdown.

Rogoff believes that China's debt bubble and slowing economy is a huge risk to the rest of the world's financial systems. He also accused the Chinese government of fixing measures of

[1] "President Xi Open to Growth in China Falling Below 6.5%," Bloomberg, December 23, 2016.
[2] "This economist thinks China is headed for a 1929-style depression," Marketwatch, July 6, 2016.

growths and said he is worried about what will happen when the credit-fueled growth of the colossal economy eventually comes to an end.[3]

"I think the economy has slowed down much more than the official figures show. And if you want to look at a part of the world that has a debt problem, look at China. They've been a credit-fueled growth, these things don't go on forever," Rogoff said.

Worries over China's slowdown triggered a huge market crash last summer and again at the start of 2016. For now, fears have been calmed. But Mr Rogoff insists that the country IS a huge worry, despite what other critics claim.

"Everyone says China's different, the state owns everything, they can control it - only to a point." But Rogoff does not appear to be convinced, adding, "I definitely worry about China, a hard-landing in China, we're having a pretty sharp landing already, and I worry about China becoming more of a problem. There isn't really a substitute for China's growth."[4]

Worse yet, there is little the world can do to prepare for China's fall, Rogoff warns. "That's a really tough question… you'd like the rest of the world not to be depending on China so much… There are limits to what you can do, when a country that big is slowing down."

These days, government-controlled banks have slowed their lending to private businesses and entrepreneurs. However, much lending has occurred far beyond the sight of official banking watchers. Thus, the debt calculation could be far below actual levels. That means debt could play an even larger role in a slowing Chinese economy. Many analysts have long since issued warnings that uncontrolled “shadow lending” may erode the financial system of the world’s second largest economy and create even greater instability during a prolonged period of any downturn.

Conclusion

Some believe that China’s government fiscal planners can manipulate their economy enough to achieve a soft landing; that they can keep both currency and underlying economic activity afloat long enough to bridge the country’s struggling investments and debt burdens.

However, China has not yet lived through a true economic crash and may not fully appreciate how artificial policies tend to delay the inevitable. As policy makers increase their attention on maintaining political power, they postpone recession and encourage additional debt through new waves of investment. Each cycle requires more manipulation and more bailouts. Meanwhile, productivity from infrastructure improvements will slow. There are only so many empty public housing projects and deserted highways you can build.

[3] “China slowdown is global economy’s biggest threat,” BBC News: Business, September 26, 2016.
[4] “China is the biggest threat to the global economy,” CNBC World Economy, September 26, 2016.

It doesn't take a Harvard economist to see that investors are holding their breath as this Chinese drama continues to unfold. Will mounting debt finally overcome the heroic efforts of Chinese economic planners? Everyone is on the edge of their seats: history has shown us that they can't keep this up forever.

While there is a reason to be optimistic about China's economic longer-run, the short-term may yet yield China's 1929 moment.

Interesting times, indeed.

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