The Coming China Crisis

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Rapid private-debt growth threw Japan into crisis in 1991 and did the same to the United States and Europe in 2008. China may be next.

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On the morning of September 8, 2016, the Wenzhou Credit Trust, one of the many trust companies in China, went into default. The firm discontinued all new lending and suspended redemption and interest payments on its trust certificates, the equivalent of deposits made by its customers.

At the time, the failure didn't seem all that unusual. A handful of trust companies—"shadow lenders" that make loans, often the riskiest ones, outside of China's conventional banks—had done the same in recent years. But within a week, another trust company went into default, and the following week, so did seven more. Angry trust-certificate holders protested in Wenzhou and Chongqing but were quelled by police. Those protests hardly seemed noteworthy at first—for years, there had been hundreds of protests and disturbances across China—but it turned out they presaged something new.

Within a month, more than 50 trust companies defaulted. The protests escalated and spread throughout the country. In the panic, new real-estate lending plummeted, putting more downward pressure on real-estate prices and hurting local economies. The Shanghai and Shenzhen stock markets plunged. The prices of iron, steel, coal, copper, aluminum, and other commodities—including oil—accelerated their downward spiral.

The government of China, which in recent years had tolerated these failures as part of its attempt to introduce more risk into the system, dramatically reversed course and intervened, injecting funds into these lenders and assuring customers that it would stand behind these institutions. This calmed equity markets, but commodity prices continued to sag and the renminbi fell, bringing the specter of devaluation.

By winter, the impact had shattered markets and companies throughout Asia and Australia, and markets were in retreat in Europe and the United States.

The Great Panic of China was in full swing.

The future, of course, doesn't have to unfold this way. China, the world's second-largest economy, could still act to prevent much of the above from happening.

But what cannot be changed is this: China, fueled by runaway lending, has produced far more housing, steel, iron, and a host of other goods than it knows what to do with, amassing unprecedented levels of overcapacity and, by my estimate, making a staggering $2-$3 trillion in problem loans in the process. And since GDP growth is more a measure of capacity being created than capacity actually needed, even China's high rate of GDP growth, fueled almost entirely by continued ultra-high levels of lending growth, compounds rather than solves China's fundamental overcapacity problem.

Which means that the global economic boost from China, the world's only major growth engine since the crash of 2008 in the West, is rapidly diminishing and will soon largely end. The only question is how.

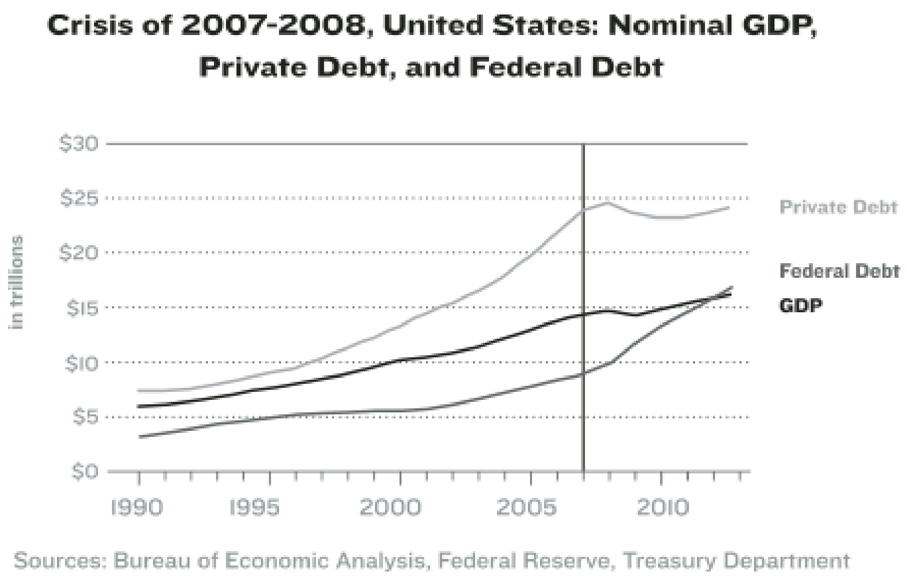
China's bad-debt problem is unprecedented in scale, but not in nature. In the United States in 2007 and 2008, we saw our own economy crumble under the weight of bad debt. And the system didn't know what hit it: On the eve of our own collapse, even though more than $1 trillion of bad mortgages had already been made and major financial fallout was inevitable, banks' loan-loss provisions—the amount they set aside to cover bad loans—were near an all-time low, while consumer net worth and the stock market were at all-time highs.

Neither of the two dominant economic theories of our time forecast the coming storm. The doves—those more in favor of lower interest rates and government stimulus—were sanguine, unconcerned by rapid loan growth. The hawks—those more focused on curbing the money-supply expansion through higher interest rates—were sounding dire warnings of inflation. Both were wrong, but neither has since changed its theory.

Our 2007-08 meltdown was entirely foreseeable, despite claims to the contrary. It was not a “black swan” event. Examining the historical record leads to the conclusion that major financial crises can be anticipated so long as you’re on the lookout for the red flag of rapidly rising levels of private debt. If we are to avoid repeating history, we would do well to observe the Chinese predicament, understand its implications for the global economy, and apply lessons to our own economy.

Our Private-Debt Problem

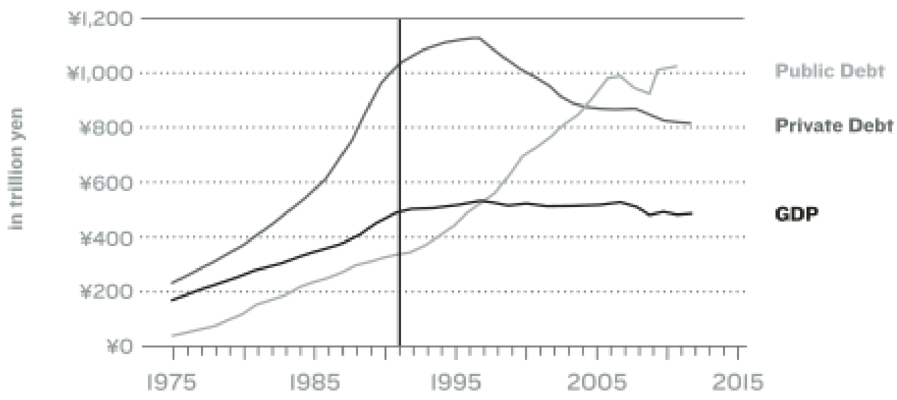
The ongoing debate in Washington over government debt misses the point. In the years leading up to the U.S. crisis, the remarkable fact was not an increase in the level of *federal* debt, but the explosion in the size of *private* debt relative to GDP, which rocketed from 120 percent of GDP in 1997 to 165 percent in 2007. By contrast, federal debt barely changed, declining from 63 percent of GDP to 62 percent during that same period. Private debt is the sum of consumer debt, including mortgages and business debt. In my view, a healthy private-debt ratio would be no more than 125 to 150 percent of GDP.



While many observers missed the signs, some saw that private debt was somehow key to the American crisis, since the rapid increase in home mortgages was widely discussed as a culprit. And a closer look at the historical data shows that this relationship between private data and financial busts appears to be universal: When we examine financial crises in other countries, we see that—even when these crises were attributed to other causes—private debt was the fundamental factor. Private debt can be good when overall levels in a country are low or moderate, and when, for example, it is used to finance projects whose income can repay that debt. The problems come when private-debt growth is too rapid or reaches levels that are too high.

That certainly was the case in Japan in the years before its 1991 financial crisis:

Crisis of 1991, Japan: Nominal GDP, Private Debt, and Public Debt



Sources: United Nations, Bank for International Settlements, ReinhartandRogoff.com

The chart shows a familiar picture. In the years before the crisis, Japan saw a major spike in private debt. And that's the same picture we see in crisis after crisis.

As I've previously written, there is a formula to predicting these crises. A financial meltdown is probably on the horizon if the ratio of private debt to GDP rises by roughly 17 percent or more over the course of five years and exceeds 150 percent. That rise in private debt will likely fuel runaway growth before the crash (think the 1920s, or Japan's boom in the 1980s). But those gains will be evanescent. Driven by private-debt growth, they'll eventually give way to a financial crisis.

In past crises—1929, Japan in 1991, the United States in 2008—high government debt was *not* the culprit, since in each case the ratio of government debt to GDP was generally flat or declining. Nor did they correlate with any o the long list of other widely cited causes, including current account deficits and interest rates. (Rapidly rising government debt generally becomes an issue *after* a crisis, as tax revenue plummets and deficits rise, government "safety net" programs get higher use, and governments counteract declining private spending with higher government spending.)

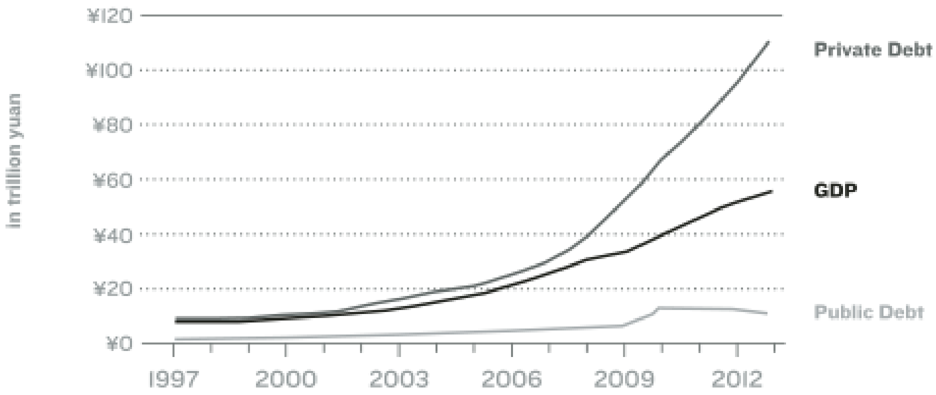
Why does runaway growth in private debt lead to financial crisis? First, because it means that far too much of *something* has been built or produced. It was primarily housing in the United States in 2008; in Japan in 1991, it was primarily commercial real estate. And second, because it means far too many bad loans have been made in the process. By 2007, for example, the U.S. banking system had roughly $1.5 trillion in total capital, but an estimated $2.5 trillion in problem loans.

If too much capacity and too many bad loans are the problems, the solutions are time and capital: time for organic growth to absorb the excess capacity, and capital to repair banks and borrowers. Monetary and fiscal policies might soften the blow, but since they do not address those two fundamental issues, they cannot solve the underlying problem.

The Potential for Crisis in China

The problem for China in 2015 is that it looks a lot like the United States in 2008 or Japan in 1991.

China: Nominal GDP, Private Debt, and Public Debt



Sources: United Nations, Bank for International Settlements, CEIC, International Monetary Fund

The growth in the ratio of private debt to GDP over the last five years is an astonishing 60 percent, and that ratio now exceeds 200 percent. China's runaway debt growth has primarily been in business loans, and now its total business loans are greater than in the United States, even though, based on exchange rate, U.S. GDP is 82 percent larger than China's. (For China, we use the term "private debt" for the sum of business and consumer debt, though some analysts refer to it as "non-government debt.")

Quite simply, China has produced and built far too much capacity, through overinvestment in steel and cement firms and in accelerated housing development. In the process, it has amassed the largest buildup of bad debt in history.

The cause of the accelerated rise in private debt starting in 2008 was the collapse of the export market that had fueled China's growth to that point. From 1999 to 2006, China's exports-to-GDP ratio had exploded by 95 percent. China's *net* exports, as measured in dollars, were the highest in recorded history. But they were growing on the shaky foundation of the debt-fueled expansion of the West that led to the crash of 2008. When that demand evaporated, China's exports evaporated too. Addicted to its rapid expansion, China built a lot of real estate and produced lots of goods—both unjustified by actual demand—to fill the export hole, all financed by an unprecedented rise in private debt that is almost certain never to be fully repaid.

As a result, China is now sitting on top of the greatest accumulation of bad debt and overcapacity in history. According to the Survey and Research Center for China Household Finance, more than one in five homes in China's urban areas is vacant, with 49 million sold but vacant units, and 3.5 million homes that remain unsold. Behind those vacant and unsold units is private debt, both loans to developers and mortgage debt. Housing values in China increased on the same perilous trajectory as in the United States before 2008 and Japan before 1991—and they have now started a similar decline. Meanwhile, real estate was 6 percent of U.S. GDP at the peak in 2005; today, it is as much as 20 percent of China's GDP.

There are other red flags. China produced 8 percent of the world's furnace iron in 1980; it now produces 61 percent, even though the rest of the world still continues to produce every bit as much as it has in the past. As China's iron production accelerated in the period from 2002 to 2011, iron prices increased twelvefold in response to debt-fueled demand. (Increases in debt *cause* increases in prices.) But now that iron capacity has piled up beyond need, prices have tumbled by over 50 percent, and the excess capacity is so great that even the demand generated by rapid credit growth can no longer prop prices up. Also, China used more cement in the period from 2011 to 2013 (6.6 gigatons) than the United States did *in the entire twentieth century* (4.5 gigatons).

These are but a few of many examples. Researchers at a Chinese state planning agency said recently that China has "wasted" $6.8 trillion in investment. Overcapacity is so significant in many sectors that it will take years for it to be absorbed by organic demand. Ironically, this problem is compounded by China's own continued high growth rates, since high GDP growth is a measure of the creation of additional capacity even if that capacity is not needed.

Good and sound loans, by definition, result in commensurate GDP growth. So when private-loan growth outstrips GDP growth, much of that excess—from one-quarter to one-half, based on evidence from other crises—will be problem loans. Based on this formula, China today is likely to have an estimated $1.75 trillion to $3.5 trillion in problem loans—a figure well in excess of the $1.5 trillion of total capital in China's banking system.

Of course, China's banks and shadow lenders are not reporting bad loans close to this amount. But neither did U.S. banks: On the eve of the U.S. crisis, banks were making loan-loss provisions at very low levels. Lending booms create the false appearance of prosperity, and fraud and corruption can make the picture even prettier.

Some dismiss these warning signs, noting that many economic prophets wrongly made the same dire predictions for China during the late 1990s. But there's a big difference: In 1999, China's overall level of private debt was 111 percent of GDP; today, it's almost double that, at 211 percent. In 1999, it had plenty of room to power growth through continued private-debt expansion, and the debt boom in the West fueled unprecedented export demand. The opposite is true today.

China's Future—and the World's

China's slowdown is already underway. Nominal GDP growth has already slowed from over 15 percent in 2011 to around 7 percent in the last year—and some analysts believe it's actually closer to 4 percent. The decline will continue to play out, perhaps dramatically, over the next three to four years. How well or badly it plays out, however, depends on the approach the government takes to simultaneously managing both the short-term problem (slowing growth) and the longer-term problem (the overhang of private debt).

The trouble for China is that these two challenges summon conflicting responses. GDP growth in any economy is largely dependent on private-credit growth, yet the Chinese private sector is massively overleveraged. Ramping up credit might reverse the slowdown but will further increase bad debt and compound the ultimate problem; reining in debt, on the other hand, would help the debt problem but slow down growth.

True, China's economy is largely a closed system that can make—and suspend—its own rules, which means China's leaders can prop up their lending system for a time. (Even Japan was able to prop up its banks for several years after its stock market collapse.) What they can likely no longer do, however, is effectively prop up real estate and commodity prices. Over time, because the decline in real estate and commodity prices is evidence of China's overcapacity and those assets are collateral for so much debt, it will be China's Achilles' heel.

The fundamental problem is that China has misused debt to grow far faster than income growth prudently allowed. While on the surface the choices look bad, China—with its vast assets and low central government debt—in fact has the tools to navigate this crisis yet. China's impulse is to return to practices that have succeeded in the past, so it's difficult to imagine it abandoning the three pillars of its past growth strategy: exports, business credit growth, and infrastructure spending. But there is now a diminishing return from each: exports are constrained by low global demand; businesses are already overleveraged; and China has already built too many roads to nowhere.

Since these will not suffice, China will likely consider other growth channels: increasing consumer credit growth; ramping up other categories of government spending such as military spending; encouraging continued migration of rural populations to the cities; and perhaps even renewed devaluation. But these options, if employed, will still collectively fall short.

China's consumers reportedly do have low leverage, but household debt is already growing much more rapidly than is prudent, and is ultimately limited by household income. And consumer debt in China may be higher than indicated due to high levels of unreported, informal consumer lending. Further, China's consumers have put a major portion of their savings in real estate—many own several apartments—so the ongoing decline in housing values will discourage consumers from taking on significant new debt.

Increased government spending could help pick up the slack, especially if it is focused on areas where there is not already too much capacity, such as military spending. But even here, the scope and pace of additional spending are inherently limited by operational realities. China hopes to bring hundreds of millions more rural Chinese citizens to the cities, to increase both wages and housing demand. But these plans crucially depend on job growth to support these migrants, and job creation has been a leading casualty of slowing exports. Finally, devaluation works best when matched with high global demand, risks driving out badly needed foreign capital, and, in any event, would likely be matched by competitive devaluations from other nations.

Both “rebalancing” and “reform” are cited as important parts of the solution. Rebalancing is needed—China’s growth has been far too dependent on investment by its businesses as compared to consumption by its households. But rebalancing is hard work that will take years, not quickly enough to reverse China’s decelerating growth. Reform of business practices is needed as well, but that too will be very difficult, and likely won’t happen fast enough.

Some believe that through continued high productivity gains, China can sustain high growth without worsening its private-debt picture. But in recent years private-debt growth has almost equaled China’s increased productivity, calling into question the sustainability of those increases absent continued high private-debt growth.

Panic and the Path of Contagion

Because there are few good choices to adequately boost growth, the continued decline in commodity prices and real estate will make the problem loans in China’s banks worse, as a massive amount of the country’s private debt is secured by commodities and real estate. Based on its recent behavior, the Chinese government will likely address deteriorating bank loan quality with an overt and broad guarantee to consumers for deposits and possibly also wealth and trust certificates. It will also quietly fortify these lenders with capital. If China pursues these policy choices, it will indeed avoid an immediate financial crisis. But it ultimately cannot reverse the trend of decelerating growth over the next three to four years—perhaps to a level approaching zero—and China will be left facing a “lost” generation of very low growth similar to the last 20 years in Japan.

The question facing the rest of the world is whether there will be a crisis in other countries because of China’s troubles. What will the path of financial contagion be?

Financial contagion is not some mysterious force that overtakes the healthy and unsuspecting. Any impact on non-Chinese companies and countries will come from: 1) overlending to troubled Chinese banks and businesses; 2) an overconcentration of exports to China; 3) a dependence on high commodity prices; and 4) a currency devaluation necessitated in an export-oriented country because of a devaluation by China.

Most countries in the Asia-Pacific region have significant export concentrations to China and will be adversely affected by China’s slowdown, as will many countries in Africa and South America. Europe has exposure too, especially in the area of high-end automobiles and luxury goods. The United States has more limited exposure, but some sectors such as high-tech and construction have significant sales in China.

Although there are allegedly low levels of foreign debt in China, these levels may be underreported; banks that have lent to companies or banks in China face real risk as growth decelerates. Hong Kong, Singapore, and the UK are among those with the highest lending exposure to China. Countries dependent on high oil and other commodities prices are also at risk. If China devalues its currency, many of its export-oriented Asian neighbors would be forced to follow suit—and in fact may act to devalue ahead of China—bringing the specter of a banking crisis to these countries.

Reckoning with Private Debt

In the 1980s and early ’90s, my formative business years, the media regularly trumpeted the news that Japan was ascendant and would eclipse the United States as the world’s business leader. When Japanese firms purchased iconic properties such as Rockefeller Center in New York and Pebble Beach golf resort in California, it was confirmation of that trend. In the 1980s, Japan reached 18 percent of world GDP. Today its share of GDP has fallen to 7 percent. We now know that its seeming path to dominance was paved with runaway private debt.

While China’s trajectory might not be the same as Japan’s, there are profound similarities. China has had years of runaway private-debt growth, and its GDP growth is now decelerating. There is no doubt that China, with a population over 1.3 billion, will be an increasingly important player in the world, economically and otherwise. But there has been a tendency to overestimate what China can achieve economically over the near term. America's economy is almost twice the size of China's, and our relative influence will continue to reflect that difference.

Indeed, we should take a more balanced view of China. With its growth, China has had a significantly higher profile in a variety of policy areas. It has been more assertive in military matters. It has expressed a desire to have the renminbi take its place as one of the world's reserve currencies—in essence competing with the U.S. dollar for a bigger role in the world's economy. U.S. policy-makers have struggled with how to respond to this assertiveness. Much of it should be unsurprising, given China's rise to its current position as the world's second-largest economy. But even with its successes, China now presides over enormous and in some respects unprecedented internal problems, and we should understand the limitations they impose on what the country can achieve in the near term and resist making policy blunders by overestimating its relative strength.

So what should China do? My recommended course is for the country to directly address not slowing growth, which is only a symptom, but the real problems: overcapacity and excessive private debt. In this scenario, China would prudently slow both lending and growth, allowing demand to begin to catch up with overcapacity. What's more, China would also preemptively recapitalize its lenders.

However, my recommendation goes well beyond China's past cosmetic bank cleanups. It needs to take the further step of requiring lenders to *broadly, quickly, and decisively restructure debt* with overburdened corporate borrowers—to provide, in other words, real debt relief and restructuring that allows those corporations to resume productive investment, not simply accounting sleight of hand. Otherwise, high debt will linger for years as a long-term drag on China's economic prospects.

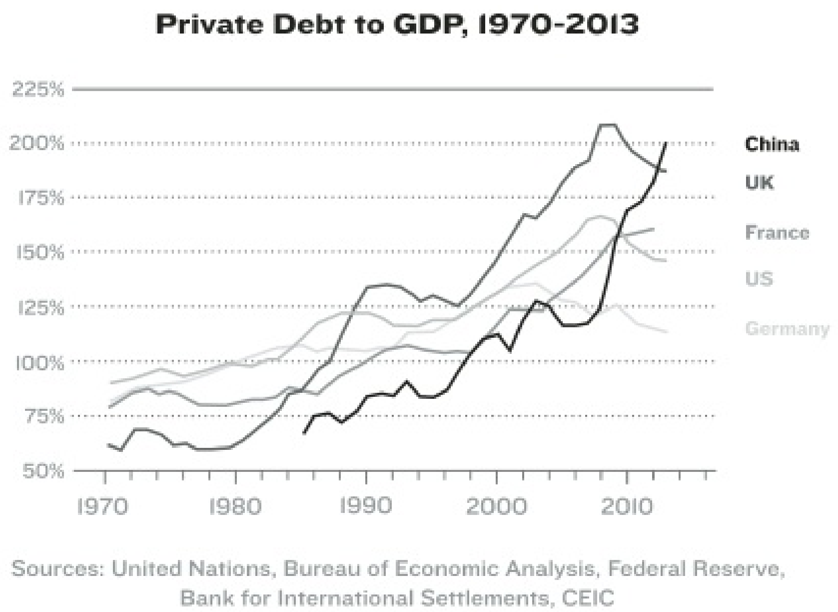
Large-scale corporate debt relief would be complex and difficult. But the lesson from Japan's experience, where the private-debt-to-GDP ratio reached a staggering 221 percent, and timely and meaningful debt restructuring was not adopted, is that it's necessary. A generation later, Japan's private-debt-to-GDP ratio is still a stifling 170 percent and remains the neglected central issue in Japan's lackluster growth.

China may never undertake such systemic private-debt restructuring, but it is the surest path to revitalizing its beleaguered business sector, remedying overcapacity issues, stabilizing prices, and restoring reasonable growth. By alleviating rather than simply disguising China's high private-debt-to-GDP problem, it would leave corporations in a much better position to lead renewed (and, hopefully this time, more measured) growth after the slowdown.

Lessons for America

Runaway private debt brought America to its economic knees in 2008. It did the same to Japan in 1991. And it is in the process of doing the same to China. Yet the schools of economic thought that dominate thinking and policy-making in Washington pay scant attention to private debt. And so our economists and politicians will continue to err in forecasting crises, and will also make inadequate repairs after the fact. Just as runaway private debt causes crisis, the overhang of private debt after the crisis constrains growth. Private debt has been underemphasized by economists in some measure because of the view that for every borrower there is a lender, and thus private debt "nets" to zero. This view neglects consideration of the distribution of debt: Lenders tend to be institutions, and borrowers tend to be those middle- and lower-income households most needed to sustain economic growth. Private debt has also been underemphasized because public debt seems more our public responsibility, and private debt seems more off-limits—the domain of the private sector and "the invisible hand."

Seven years after our own crisis, private debt in the United States stands at 143 percent of GDP—lower than its apex of 167 percent in 2008, but still high. The high level of private debt in the United States represents a drag on economic growth, most starkly evident in the almost nine million of the nation's 53 million mortgages that remain underwater. In fact, private-debt levels across the globe remain sky-high—not that anybody's paying attention. The piling up of private debt over decades smothers demand and dampens economic growth.



China's economic challenges offer the United States an opportunity to learn and recalibrate our economic thinking. Like China, we should now concentrate on scaling back private debt (which we did not do in the aftermath of the 2008 crisis). We need to act differently this time around if we are to avoid having our recovery swamped by the next slowdown (from China or anywhere else). Debt relief in the form of restructuring or partial debt forgiveness should be seriously considered as an option. What if we were to let lenders write down underwater mortgages over an extended time frame (30 years)? While less necessary today, if this had been done in 2008, it would have made an enormous difference in the trajectory of the recovery.

Our policy-makers should move beyond the fixation with public debt and turn their attention to the true problem of private debt. They should recognize the inadequacy of the timeworn tools of monetary and fiscal policy and lead a discussion of strategies—especially restructuring—to address the key issue of historically high private-debt levels. Indeed, low private debt, combined with low capacity (the supply of housing, factories, etc.), was the precondition for the economic boom we experienced in the post-World War II decades.

China's downturn will only add to our challenges. The modern world has had four major economic engines—the United States, China, Europe, and Japan—which together constitute 60 percent of world GDP. While the United States moves toward respectable growth, both Europe and Japan—also hobbled with high private debt—are struggling to show any progress.

But it is China we should be worried about. China is facing a generation of dramatically slower growth. Its slowdown will cause trouble for its trading partners and lenders across the globe. And while the economic impact in the United States will be softer than in any other major country, China is now so large that we too will feel it.

The question is whether we will also learn from it.

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TAGS: China, economy

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