

Where did China's Economy go wrong?

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Four bubbles and a politicized banking system could become big problems for Beijing.

With the recent **crash** in China's major stock market and the overall slowdown in the Chinese economy, some analysts **have been predicting** a repeat of the type of crisis that occurred in 2008 in the United States and Europe. Don't panic; countries with over \$3 trillion in foreign exchange don't fall apart quickly. And a little context is useful.

In 1980, China's gross domestic product was **just under** \$200 billion — roughly the same size as the economy of the much smaller Taiwan. Today, China is a massive \$10 trillion behemoth while Taiwan's annual GDP is \$495 billion. Over the last three decades, as Beijing's leaders **developed** their “socialist market economy,” the average annual growth rate has been about 10 percent per year. No other large economy in history has grown so fast for so long. So, before casting calumny on China's economic policymakers, we need to acknowledge their historic feat.

Nevertheless, some of the methods used to maintain that rise are now proving counterproductive. The central question is: Can China maintain steady, solid growth (in the 4 to 6 percent range) while transitioning to a globally integrated market economy? The signs are mixed. To understand why this transition will be so fraught, it's useful to explain why the sources of China's surge over the past 35 years are no longer viable as sources of growth.

China's economy has been force-fed for so long that each of the major sectors stimulating its growth has developed a bubble. Declining exports and overbuilt real estate are the most serious immediate problems, but excess infrastructure and gargantuan state-owned enterprises will be an anchor dragging the economy down for a long time. To transition to a new growth strategy, China will need to deflate bubbles in each of these areas.

Bubble 1: Exports

Now at 23 percent of **national income**, exports have been the mainstay of Chinese growth since the early 1980s. However, exports could never have achieved that status without subsidized credit from the government-controlled banking system

and an artificially low exchange rate. Interestingly, China combined this quasi-mercantilist approach with considerable openness to foreign direct investment. The problem is that the world will no longer absorb Chinese exports growing at 20 percent annually, and the credit subsidies have led to overcapacity among exporting firms. The dilemma is how to shrink these firms without creating widespread unemployment or further impairing the banking system with non-performing loans. Since exports won't be growing rapidly in the future, China will need to concentrate on getting more yield from its new investments.

Bubble 2: Real Estate

The oversupply of housing and commercial real estate in China's major cities is a direct result of government policy.

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A comparable phenomenon occurred in China regarding office space. Province and city leaders created new office towers as a way to attract companies and entrepreneurs who would employ local residents and pay taxes. An added attraction was that builders usually shared their profits — corruptly — with government officials who supplied permits and provided land, energy, and water.

Over the past two decades, the speculative fever has been such that there has been a nearly continuous “build” signal for contractors. Only in the past few years, as the oversupply of housing and office space became egregious, did prices **fall** in major urban areas. Despite all the unsold apartments and homes, new home prices in 70 medium and large Chinese cities reportedly **declined** only 3.7 percent between 2014 and 2015. It will take a much bigger drop in prices to clear these markets.

One saving grace about the Chinese housing bubble is that the mortgage market is underdeveloped, so most of the funding for housing came from private savings. Thus, private individuals will lose money as housing prices decline, but the mortgage industry will not collapse as it did in 2008 in the United States and Europe.

Office space is different: It is too expensive to be privately funded, so it has depended upon bank loans. Banks that made loans for underutilized buildings could face a new crisis in non-performing loans. So, there are big problems ahead for the banks and developers, especially of commercial office space.

Bubble 3: Excess Infrastructure

The third major distortion in the Chinese economy relates to excess infrastructure — especially the new roads, ports, airports, and tunnels built over the last two decades. This pattern relates to overbuilding in real estate, but has different causes. After the early 2000s recession and the Great Recession in 2008, Beijing **maintained** its country's growth rate by a massive public works program. The problem is not that China doesn't need new infrastructure: It's that many of these facilities are underutilized, and the capital could have been invested in more productive ways. China's toll roads reportedly **lost** \$25 billion in 2014. Many of the costly Olympic facilities in Beijing lay fallow (though Beijing may be able to use some for its Winter Games in 2022).

Worse, party officials pressured state-affiliated banks to lend billions for these projects. Since the main way that local governments bring in large sources of income is through long-term leases of land, this leads to a vicious cycle: A local government gets control of land and leases it to private developers so they can build apartments and office space. This incentivizes government officials to collude with private developers — but neither are constrained by normal budgetary or market signals.

Bubble 4: Rigid State-Owned Enterprises

State-owned enterprises, or SOEs, exist in dozens of sectors, employing tens of millions of people and **generating roughly** 40 percent of China's GDP. In many cases, they are either monopolies or oligopolies. The central concern with the SOEs is their inflexibility: They have trouble adapting to new market conditions. Continuing to build new government-owned steel plants, for example, when there was already oversupply created pressure to dump steel overseas.

In addition, political connections often determine employment of management and laborers in the SOEs, so it is extremely difficult for even the central government to cut them back. In the 1990s, Premier Zhu Rongji had both the courage and the power to trim and consolidate SOEs; but successive administrations undercut his efforts by allowing SOEs to start growing again. Like the real estate and infrastructure bubbles, many analysts agree on what should be done to remove these distortions, but Beijing does not have the

wherewithal to make the relevant changes. Since many of the SOEs are uncompetitive in an open global economy, and are getting deeper in debt, they will ultimately require a bailout similar to the refinancing of the state banks in the 1990s.

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Chinese President Xi Jinping **has launched** a wide-reaching anti-corruption campaign that is making some headway in shrinking these bubbles, but dealing across the board with all four bubbles would cut at the power base of the ruling Chinese Communist Party and is unlikely to occur.

The final piece of this puzzle is how to make the state-affiliated banks independent and efficient allocators of capital. Because of their current political connections, the state banks cannot say “no” to low-return or unnecessary projects. This maintains the current bubbles and only increases the non-performing loans that will, ultimately, have to be paid off by the central government.

China’s savings rate — roughly 50 percent of national income — facilitates the country’s growth, but the bubbles have become so widespread that a painful readjustment is necessary. Will China crash? No. But it will move to a much lower, long-term growth trajectory while these bubbles are popped.