

US Economy post #7: China and the danger of a second Asian crisis. Date 2022-08-26

Since the collapse of Evergrande last year, I've warned that China was at the start of a deep restructuring of their economy. China has been growing at extraordinary rates in the last decade, similarly to Japan in the 1980s and Korea in the 1990s. The sheer size and speed of the transformation of a rural country to an industrial powerhouse was always bound to create a certain degree of poorly allocated investments. Stories abound of completely built (but empty) cities, and roads and trains to nowhere.

Until 2020, these investments (in extra capacity) were not a big problem as the population would eventually use the infrastructure and fill the cities. Now, however this is not the case anymore. As I've warned in my book "Economic Cycles, Debt and Demographics"¹, from 2020, China was going to hit a demographic wall and its demographic dividend would disappear. On the positive side, in 2021 China's urbanisation rate was still at 64.7%², which means that China still has potential from productivity gains from further urbanisation. However, China's massive expansion in debt in the last decade could mean that a painful restructuring could occur. I'll analyse these issues in this post.

Furthermore, when looking at a broader context, Asia is currently at a dangerous junction as China hits a demographic wall, Japan starts its second demographic bust and South Korea starts its demographic decline. With geopolitical tensions on the rise, all the elements are there for the emergence of a second Asia crisis, but perhaps bigger than the previous one in 1998.

China:

China's economic transformation mirrored that of post-WWII Japan and then South Korea. China achieved astounding average GDP growth rates above 10% from 1990 to 2012 (See Figure 1). These growth rates, coupled with a large population, led China to become the largest importer of raw materials, steel, and other commodities, and in exchange, it became the factory for the world. The growth was supported by moving vast amounts of a mostly young rural population into cities to work in export-driven industries. Cheap labour costs and economies of scale led to investment by large multi-national corporations in large scale manufacturing plants.



Figure 1 - China's annual GDP growth rate since 1980. Source: World Bank

In order to satisfy the exponentially growing demand, investment was financed by debt, mostly in the private non-financial sector (See Figure 2). Until the 2008 financial crisis, the growing debt levels were not

¹ <https://www.amazon.com/Economic-Cycles-Debt-Demographics-macroeconomic/dp/B09FSCGWRP>

² According to Chinese government statistics at: http://english.www.gov.cn/archive/statistics/202202/22/content_WS62149dc7c6d09c94e48a5517.html

a problem as the growth in demand justified the debt build-up. Until 2008, private debt hovered around 120% of GDP while government debt was only about 30% of GDP. In other words, growth of debt tracked the growth in the economy. The 2008 Great Recession centred in the US and Europe impacted China substantially and the Chinese authorities embarked on a record economic stimulus in 2009/2010. The declining demographic growth in China, coupled with the aftermath of the Great Recession and worldwide debt deleveraging, led to the steady decline in GDP growth from 2010 (see Figure 1). As economic growth slowed, China continued to pile on debt for ever-bigger infrastructure and real estate projects.

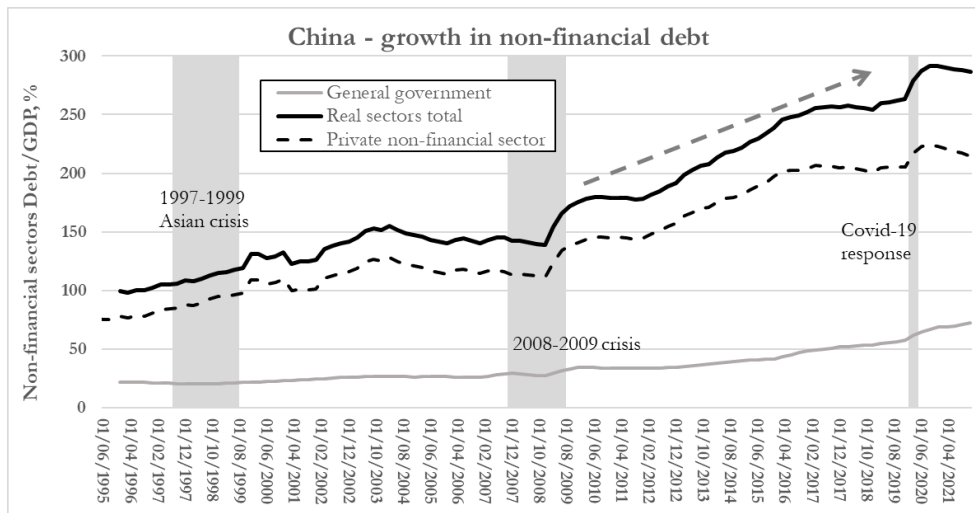


Figure 2 - China's growth in non-financial debt since 1995. Source: Bank of International Settlements.

China's total debt to GDP (in the real sectors of the economy, i.e. government, private non-financial sectors) rose from 150% in 2008 to 250% in 2018 (see Figure 2). Most of the debt was due to the rise in private debt rising from 120% of GDP in 2008 to 200% in 2018. The rise in government debt was relatively subdued rising from 30% of GDP to 50% of GDP. This period of rapid debt build-up is at the core of China's possible malinvestment of capital as if demand for these assets does not materialise, the debt will still be there.

With the advent of the Covid-19 pandemic, China (together with most countries around the world) enacted very austere pandemic controlling measures. To support the economy, massive government stimuli were provided, which led to another jump in government and private debt. As of 2021 government debt-to-GDP stood at 72% while total debt (in the real sectors of the economy) was just under 300% of GDP.

China's debt unravelling. How does China's debt compare with other countries?

China's debt build-up mirrors that of Japan in the late 1980s and early 1990s. We know retrospectively that once Japan hit its demographic wall, it suffered what economists refer to as "the two lost decades" from 1991 to about 2010. Real property prices dropped steadily by about 50% during the period, even with record government infrastructure programs that led Japan's government debt to stand at about 240% of GDP by 2021 (see Figure 3).

When comparing China's debt with other countries across the world we observe that by Q4-2021 China's total real sector debt was about 285% of GDP, which is a similar level to countries such as the UK, US or Spain (see Figure 3). Developing countries usually are not able to sustain such high levels of debt as those observed in developed economies, without a crisis occurring. China's debt is heavily skewed towards non-financial corporations that hold about 153% of GDP of debt, while debt in the household sector is about 61% of GDP and 72% in the government sector. The wealthy countries have higher levels of debt in the government sector and less in non-financial corporations.

China's smaller government debt is likely due to a significant amount of debt in the private sector belonging in fact to government corporations. When a crisis comes, we are likely to see the government intervening in these corporations and quickly expanding government debt to cushion the losses of systemically important corporations.

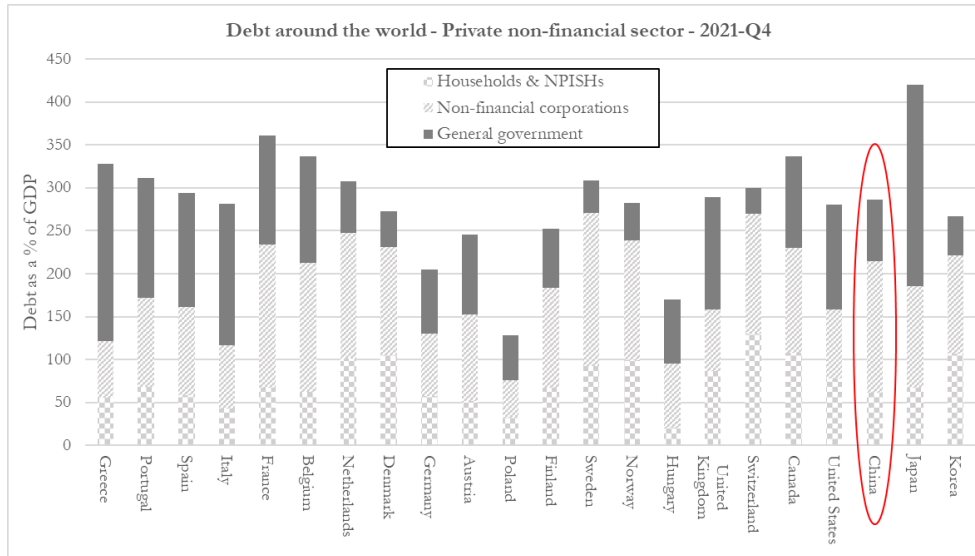


Figure 3 - China's comparison of non-financial debt with other countries around the world. Source: Bank of International Settlements

China could suffer a lost decade in the coming years starting with an implosion in the property market which could lead to bank failures and bank runs. Does this ring a bell? A series of bank runs in April of 2022 in the Chinese province of Henan have made headlines, and the danger is that the problems faced by these small rural banks might spread³. At the moment, reports of China's demise and the implosion of its economy abound.

However, even though I've warned in my book⁴ that China would hit its demographic wall from 2020 and that China would likely suffer a real estate crisis similar to the 2008 US housing crisis, I am surprised by some of the more bearish predictions for China. As I'll explain below, even though the crisis will be a painful adjustment, I believe that China is well positioned to manage it.

I also believe that the high single-digit or double-digit growth rates are over for China and that investors should expect much lower growth potential in the coming decade. China can still benefit from expanding its urbanisation rate in the coming decade from its current value of 64.7% to perhaps close to 70%. The urbanisation dividend is likely to continue providing a boost to productivity. On the negative side, as shown in my book, China's workforce growth rate dropped from 1.7% in 2013 to 0% in 2020 and is set to decline from 2023 onwards. Additionally, China has built up large amounts of internal debt, particularly in the private sector, which will be an anchor for future growth. On top of the already high debt levels China has, it will probably go through a period of debt deleveraging which is likely to put further pressure on growth. Everything considered, I believe that in the coming decade, China's real GDP growth rates will average about 2% to 4%.

³ <https://carnegieendowment.org/chinafinancialmarkets/87664>

⁴ <https://www.amazon.com/Economic-Cycles-Debt-Demographics-macroeconomic/dp/B09FSCGWRP>

China’s external debt, is it a problem?

China is probably in its beginning phases of a real estate and financial crisis that is likely to be similar in scale to the 2008 Great Recession in the US. The late 2021 implosion of Evergrande, China’s second largest developer, was the canary in the coal mine for the Chinese real estate market. Even though Evergrande only accounted for a small market share of the overall real estate market, it likely provided a template for the rest of the market. With record high debt levels and China hitting a demographic wall in 2020, a painful readjustment was likely.

Some economists are pointing to China’s 2021 external debt level of \$2.4Tn as a serious risk for financial contagion into international markets. I believe this is misguided because, as shown in Figure 4, China’s external debt only represents about 16% of GNI (Gross National Income), which, even after possible currency devaluations, is a manageable amount.



Figure 4 - China's historical external debt in \$ and as a % of GNI. Source: World Bank

Furthermore, in 2021, China’s Net International Investment Position was positive at about \$2Tn, as shown in Table 1. China is a Net creditor nation against the rest of the world. If that was not enough, China’s currency reserves (liquid assets) were about \$3.25Tn which is enough to pay the entire external debt if needed.

China, International Investment Position (IIP) and External Debt.

IIP: Assets	IIP: Liabilities	IIP: Net Assets	IIP Assets: FX Reserves	External Debt (2020)
\$Tn	\$Tn	\$Tn	\$Tn	\$Tn
9.32	7.34	1.98	3.25	2.35

Table 1 – China’s International Investment Position and external debt, Sources: Chinese Government SAFE⁵, World Bank (External debt)

Taking into account these considerations, I believe that China’s real estate crisis won’t spread to external financial markets. However, as shown by Reinhart and Rogoff in “This time is different”, internal defaults or crisis tend to be more painful than external ones. The Chinese government will decide how to spread the losses of investment excesses amongst the various market participants (the real estate companies, lenders and/or their depositors and bond holders). In 2008 the US dealt with the losses by saving the banks and their creditors, which avoided the risk of a systemic implosion, but increased moral hazard in the system.

In dealing with the crisis, I believe Chinese government debt will quickly rise to absorb losses by the private sector in core companies, and due to the government embarking on renewed infrastructure projects to

⁵ <https://www.safe.gov.cn/en/ExternalDebt/index.html>

attempt to stimulate demand. I believe government debt will rise quickly to 100% of GDP or more, similarly to debt levels of developed nations such as the US or UK. On the positive side household debt is still at relatively low levels (when compared to developed nations) and China could “unleash” its internal market to increase productivity and demand. However, this would likely come at the cost of social cohesion, which will be a fine line to balance.

Korea and Japan’s demographic decline.

China’s slowdown in the coming decade and its immediate real estate crisis will have repercussions in the broader region (Asia). However, China is not the only country in Asia to hit a demographic wall. As I’ve shown in my book, South Korea also hit its demographic wall in 2020 and will see a demographic decline in the coming decades, dwarfing Japan’s demographic decline in the 1990s. If that was not enough, in 2020 Japan started its second demographic decline, which is much greater than the one it experienced in the 1990s. Japan faces three “lost decades” as its recent (from 2008 to 2019) resurgence in growth will fade away (see Figure 5).

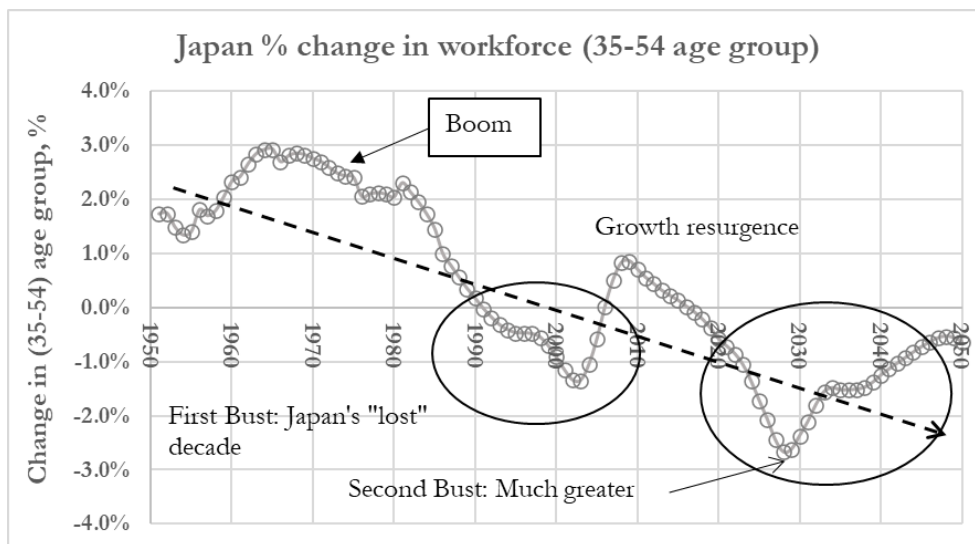


Figure 5 - Japan historical growth in the most productive workforce aged (35-54) from 1950 to 2050. Source: Taken from the book “Economic Cycles, Debt and Demographics” by Carlos Alegria

If we add the economic problems that South Korea and Japan will be facing in the coming decades to China’s unfolding real estate crisis, there is potential for some drama in the region. Korea, Japan and China have interlinked economies and therefore, the China real estate crisis and slowdown in growth will spill over into the broader region. The possibility of the outbreak of an Asian crisis which has the potential to dwarf the 1998 Asian crisis is one of the main macroeconomic risks I identify in my “Red Card” of macroeconomic risks⁶. Investors and corporate decision makers would be wise to tread with caution.

Finally, I must add that demographic shifts are dangerous periods, as with declining economic growth, internal tensions arise. At these times the danger is that governments try to maintain internal social cohesion by pointing to an external threat. Geopolitical tensions in the region over Taiwan and the rise of nationalist sentiment are manifestations of these internal tensions. The outbreak of a geopolitical conflict in the region could be disastrous for the global economy and global supply chains.

Thank you for reading. I hope this post was not too controversial and helped clear up the noise instead of adding to it.

⁶ <https://www.phinancetechnologies.com/content/Red%20Book%202022-3-10.pdf>