July 2, 2013

Risks of a hard landing for China

By Martin Wolf/Financial Times

Beijing might need to do what its leaders neither want nor expect

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The new Chinese leadership is trying to manage one of the most difficult of economic manoeuvres: slowing down a flying economy. Recently, difficulties have become more apparent, with the attempt of the authorities to bring "shadow banking" under control. Yet this is part of a bigger picture: the risk that a slowing economy might even crash. Indeed, the expressed desire of China's new government to rely on market mechanisms raises the risks.

In a recent note, David Levy of the Jerome Levy Forecasting Center has asked the crucial question: what is China's stall speed? The general view is that it is straightforward for China to move from 10 per cent to, say, 6 per cent growth over the coming decade. The implicit assumption is that "a rapidly expanding economy is like a speeding train; let up on the throttle and it slows down. It continues to roll along the track as before, just not as rapidly." He argues, instead, that China is more like a jumbo jet: "In recent years, a couple of engines have not been working well, and the pilot is now loath to keep straining the remaining good engines. He is allowing the plane to slow down, but if it slows too much, it will fall below stall speed and drop out of the sky."

Thus, after 2008, net exports ceased to be a driving force for the economy. Investment took up the slack, particularly in 2009. That led to a further jump in the share of spending on investment in gross domestic product, from an already extraordinarily high 42 per cent in 2007 to an absolutely amazing 48 per cent in 2010. The jet fuel driving this investment engine was an explosive growth of credit: loans rose at an annual rate of close to 30 per cent during 2009. The policy was highly successful. But, with booming net exports a thing of the past, the Chinese authorities now also wish to reduce the reliance on credit-fuelled investment. The engine that the Chinese economy now has left is consumption, private and public.

In fact, figures for quarterly contributions to the growth of demand suggest that the desired slowdown has gone impressively smoothly, so far (see charts). But the challenges of a move to annual growth of 6 per cent remain huge.

First, investment in inventories must fall sharply, since its level depends on the growth of an economy, not on the level of activity. Think about it: in a stagnant economy, inventory accumulation would normally be zero. Again, other things equal, an economy growing at 6 per cent would need 60 per cent of the investment in inventories of one growing at 10 per cent. The immediate impact of this adjustment would be a sharp decline in investment in inventories, before their growth resumed at 6 per cent a year, from the now lower level. Moreover, businesses might well fail to anticipate the economy's slowdown altogether, particularly after years of far higher economic growth. They would find themselves burdened with rapidly rising inventories and would then be obliged to slash inventories, and so levels of output, even further.

Second, investment in fixed capital must also fall sharply. Investment might have to fall by 40 per cent: all other things equal, in China that would imply a 20 per cent decline in GDP, which would evidently entail a deep (and unexpected) recession. Those responsible for investment might well fail to adjust quickly, because they expected the 10 per cent annual rate of growth to return. That would support the economy for a while, but at the expense of soaring excess capacity. As in the case of inventories, that would then cause a still bigger investment fall.

Third, an investment-induced reduction in demand and activity is also likely to have a large downward impact on profits. That would impair corporate solvency and lower investment still further. Finally, a decline in the rate of economic growth, particularly one preceded by a very large credit boom, might have unexpectedly grim effects on the state of balance sheets. China's private sector is already relatively highly indebted (see chart). Such debt should be manageable, provided the economy continues to grow at

10 per cent a year. In such a dynamic economy, the timing of new projects hardly matters. But, in a more slowly growing economy, the jump in bad debts might prove huge.

The World Bank's latest Global Economic Prospects argues that "ongoing rebalancing efforts remain a priority as does engineering a gradual decline in its unsustainably high investment rate". But, "should investments prove unprofitable, the servicing of existing loans could become problematic – potentially sparking a sharp uptick in non-performing loans". Even if the government rescued the financial sector, those responsible for lending would surely become more cautious. The growth of off-balance sheet finance, to which the authorities have recently reacted, seems certain to make this even harder to manage.

None of this is to argue that China cannot continue its catch-up growth, in the medium to longer term. The point is, instead, that the structure of an economy growing at 6 per cent will, inevitably, be quite different from that of one growing at 10 per cent. One must not think of such an adjustment as proportional. On the contrary, the economy that would emerge might have consumption at, say, 65 per cent of GDP and investment at just 35 per cent. So consumption would have to grow substantially faster than GDP, while investment would grow far more slowly. This would mean a different distribution of income: substantially higher shares of household disposable incomes and lower shares of profits in GDP. It would also necessitate a different structure of production, with relatively fast growth of services and relatively slow growth of manufacturing.

The new Chinese government is, in effect, now engaged in the task of redesigning the jumbo jet, as it comes into land, with half of the engines working poorly. The market is most unlikely to deliver such a huge change smoothly. The sole reason I find to trust the landing will work as hoped is that the authorities have handled so many arduous tasks in the past. But it is going to be very tricky. In order to sustain demand, the government might find itself compelled to do some things – run very large fiscal deficits, for example, – that its new leaders neither want nor now expect. At least, forewarned is forearmed.

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