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Session 4, The China Problem

Peter Garber

Discussion Notes

1. Domestic savers have been attracted with high yielding wealth management products pumped out by the banks as interest rate ceilings have been removed.
2. In turn, these instruments have financed ever more housing construction, now in secondary and tertiary cities. Much of the housing purchases is speculative, so this looks like a bubble. But the investment effort in housing does fit in with a government plan to move hundreds of millions more people from the country to the cities. If only these new migrants can be as productive as the preceding waves of migrant labor, perhaps the scheme can pay for itself ultimately.
3. But this is a harsher world than a decade ago—new output, especially in consumer goods and housing had better be absorbed domestically for this to work. If this fails, the temptation may arise again to force depreciation of the exchange rate to effect a new wave of manufactured exports. In the past, excess capacity could be pushed abroad by letting foreign capital take a big share of the rents from access to cheap labor, thereby splitting and co-opting the opposition to imports in industrial countries. But now, the other industrial economies will block any more floods of cheap goods as their labor forces finally organize to resist through populist movements.
4. Since Japan seems to be the template, there has been a vigil for almost a decade waiting for a big financial crisis in China to starkly reveal all the bad investment. But in the same vein, since Japan itself has not yet collapsed under the weight of ever-rising government debt, does not China possibly have at least another decade or more to keep this line of development going?
5. Although it is still running CA surpluses, China’s reserves have declined by around $900 bn since the peak in 2014. One reason is the sudden run-off in offshore RMB deposits (by half), which mechanistically reduces fx reserves. Offshore deposits evaporate naturally when the RMB is expected to depreciate. Another reason is the surge in net capital exports in the astonishing take-over wave of the last few years. Much of this it to acquire raw material sources, agricultural lands, etc. Much of this has come from rapid expansion of strange companies, which had almost no presence before, certainly in the foreign industries into which they are bursting. A third reason is capital flight money surging into real estate in global, fashionable cities. A fourth is the development spending flowing into the Belt-Road programs. Although these flows do not show on the books as reserves, they are still officially driven via SOEs or government entities and therefore can be mobilized by the government if need be. Finally, there was a significant revaluation effect as the euro depreciated against the dollar.
6. As Hobson and Lenin told us, excess capacity countries have in the past pushed capital out into riskier foreign lands, soon following up to mitigate the risk by exerting political control. In its ventures in Africa, Pakistan, and the Belt-Road scheme, where naval bases follow in train, China seems to be following this insight.
7. Since China’s major excess capacity lies in the industries basic to fixed investment—e.g. steel, concrete, construction of roads railroads, airports, ports, and power generation—this is a natural way to export it. It also avoids exporting financial capital to the countries that will push back against an export surge of manufactures. The receiving countries of these schemes have been capital starved because of their formerly insurmountable political and security risks, which China seems willing to take up.
8. Geopolitics are becoming far less benign. The “roads” to central Asia, Pakistan and through the Indian Ocean also solve the strategic problem of possibly being cut off from key sources of raw material supplies in the ME and Africa via the choke points through the Straits of Malacca and the South China Sea. Island base building has also absorbed some of this excess industrial capacity and created a string of defenses for shipping through the area and a potential to impose counter-blockades.
9. No longer economically closed, China is now itself an island that can be cut off from its markets and resources. To prevent this, it is gradually pushing along the length of the chain —against Japan via N Korea and directly perhaps via the Ryukyus, and against Taiwan via its naval and missile build up. It is constructing reef fortresses, bypassing the Malacca Straits, and swinging the Philippines into line with economic enticements. It could be positioned to blockade Japan as well from ME oil and other raw materials from its south and west.
10. A potential financial or economic crisis could be long and deep if China cannot find a way quickly to stick the bill to its domestic household creditors while still getting them to save. The temptation will be great to divert the severe domestic political hit via a very large external security expansion, although this will be an acceleration of the existing program rather than a complete departure.
11. Fortunately, China can still keep the cork in the bottle for some more years. After all, China still has several hundred million people in the countryside whom it still wants to urbanize, so all that housing construction will be used. However, this new batch—the old folks and children who were left behind in the previous waves of labor migration—will probably be much less productive than earlier waves. They will not produce enough to justify the investment at current prices. A mark-down will be required and the investment will earn quite a negative return. This is not a new situation for China—that is what political crackdowns are for—and at least the return will be far higher—that is, far less negative than that of the Great Leap forward.

Some Facts:

1. China’s current account surplus has declined to about 1.5% of GDP in 2017 from a maximum of 10% and average of 6% from 2003-2009.
2. But real GDP has doubled since 2009. In US dollars, the average CA surplus from 2003-2009 was around $213 billion, while the average from 2010-2016 was $210 bn. In 2016, it was $196 bn, and in 2017 it is expected to be $162 billion. So capital is still “flowing uphill”.
3. The US CA deficit has declined to around 2.4% of GDP in 2017 from a 2003-2009 average of 4.75%. Real GDP grew by 18% and nominal GDP grew by 34% from 2009 to 2017. The Euro area had a current account surplus of above 3% of GDP for the last three years, amounting to $382 bn in 2017, compared to being roughly balanced from 2003-2009. Japan’s CA surplus in 2017 is $175 bn, 3.6% of GDP. When the oil price was high, the MENA countries as a group were the largest net exporters of capital, but they have become large net capital importers in the last three years.
4. So the picture of who is exporting and who is importing net capital has now changed significantly in recent years, with the euro zone being the principal exporter, with Japan second and China now third.
5. Meanwhile, China’s savings have stayed high at around 50% of GDP, only in 2016 and 2017 falling to 45%. The fall in the current account surplus has mainly been offset by investment rising to an average of 46% of GDP from 2010-2017 (44% in 2017) compared to 43% from 2003-2009.