Ann Lee

Will China's economy collapse?

"Bold and flexible leadership is likely to sustain bright economic prospects for China despite its slowing growth rate and aging population. That is the bottom line of this illuminating analysis of how challenges in the world's second largest economy are being met."

James Hoge, Editor of *Foreign Affairs*, 1991–2010

"In this well-informed book Ann Lee asks: 'Will China's economy collapse?' To answer this profound question, she looks deep below the surface to examine the stability of China's governance structure, economic growth model, financial system, and geopolitical situation. Anyone interested in China's future and its global implications would do well to read this book."

Alan B. Krueger, Princeton University

The recent downturn in the Chinese economy has become a focal point of global attention, with some analysts warning that China is edging dangerously close to economic meltdown. Is it possible that the second largest economy in the world could collapse and drag the rest of the world with it?

In this penetrating essay, Ann Lee explains both why China's economy will not sink us all and the policy options on which it is drawing to mitigate against such a catastrophic scenario. Dissecting with realistic clarity the challenges facing the Chinese economy, she makes a compelling case for its continued robustness in multiple sectors in the years ahead

Ann Lee is a former visiting professor at Peking University and a partner of two multibillion-dollar hedge funds. She is a recognized authority on China's political economy and author of the award-winning international bestseller *What the US Can Learn from China*.

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Steve Keen, *Can We Avoid Another Financial Crisis?*
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Preface

Will China's economy collapse? Many informed people have publicly stated that they believe it will. Books that have prognosticated this outcome declared this state of emergency over a decade ago. While China has not yet collapsed as of this writing, many hold on to the belief that such a calamity remains imminent. There are numerous logical and compelling reasons to support a scenario of collapse. Without doubt the growing uncertainties around the world have added to this fear. Moreover, as China is the largest trading nation in the world and second largest economy as of 2016, there is an underlying fear that, according to the popular saying, if it sneezes, the world will catch a cold. Events such as China's stock market crashes during the summer of 2015 and January 2016 in addition to the well-publicized existence of its ghost cities and its shadow banking industry have investors and politicians alike increasingly worried.

Although there is no specific definition of economic collapse, there is a general consensus that it is a situation in which there is a sudden occurrence of extreme negative conditions that then persist in the economy for a prolonged period. Various manifestations of an economic collapse could include any combination of the following conditions: an unusually high number of bankruptcies, high unemployment, breakdowns in civil society, increasing mortality rates, and widespread famine. History is littered with such scenarios.

While the reasons behind the collapses vary across continents and centuries, there appear to be some common themes and cycles. One common pattern is that when countries or empires undergo disruptive social change like growing liberalization, economies often experience high growth. This was the case both in the ancient world and in medieval times when growing social and economic liberalization paved the way for the Greek and Roman empires and the Spanish Empire, respectively. However, when these countries and empires overstretch themselves in military adventures, economic collapses often follow. In the case of the Roman Empire, once the army took control (ca. AD 276–401), they taxed the middle class out of existence to fund expensive wars so that all that remained was a slave underclass. Spain's ongoing wars also led to its collapse as a global power in the seventeenth century. In more recent examples, Great Britain's empire began with the nation's industrialization, which likewise coincided with growing social and economic liberalization during the eighteenth and nineteenth centuries. Similarly, the end of *Pax Britannica* coincided with involvement in two world wars. The Soviet Union also experienced rapid growth following the Communist takeover, which liberalized its society from generations of feudalism. However, its economy collapsed in the 1980s after engaging in a decades-long Cold War against the United States.

Whether China will undergo an economic collapse comparable to the examples above is something to explore. Like the aforementioned cases, it has experienced growing economic liberalization in the last few decades that has enabled it to attain its current superior economic status. However, many in the West now wonder whether China is on the brink of collapse since they believe its financial system, military program, and growth model are opaque and unsustainable. While it is impossible to cover all possible scenarios given the infinite number of variables that would need to be taken into account for a truly comprehensive analysis, in this book we will explore the most probable causes of economic crisis in China. Common arguments for an imminent collapse will be dissected and subsequently found to be grossly exaggerated. Years of working in the financial markets and countless discussions with policymakers and regulators have shown me time and again that reality does not necessarily line up with academic theory. But let's first begin by analyzing the vulnerable aspects of China's economy to discern whether they are indeed sufficiently weak to generate forces that could have catastrophic domestic and global consequences.

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The Modern Chinese Economy: The Good, the Bad, and the Ugly

China's modern economy is an intricately complex web of state capitalism, laissez-faire capitalism, Keynesian economics, Austrian economics, Soviet-inspired planning, and good old-fashioned entrepreneurialism. Contradictions are a fact of life in the Chinese economy, and no simple definition or ideology can adequately describe everything that it encapsulates. One of the reasons for this complexity is that China is simply too large to manage uniformly. With 56 recognized ethnic groups practicing close to 300 living languages and spread over 3.7 million square miles among over 1.3 billion people, China gives rise to as many variations in economic activity as there are on the planet.

Despite such variability, China managed to modernize as one country with a speed that truly was unforeseen. For the past quarter-century, its miraculous growth has resulted in bringing the equivalent of the entire US population into the middle-income bracket. This remains the biggest economic news of our lifetime. China largely achieved this feat through a combination of exports and investments, which, as a percentage of gross domestic product (GDP), remain among the highest in the world. While other nations such as South Korea and Japan have also grown rapidly in past decades to achieve developed country status, the scale and duration of growth that China has achieved remain unparalleled. Some of the factors that distinguish China from other countries were the subject of my prior book, *What the US Can Learn from China*.[1] As noted there, China's leaders adopted a number of approaches that minimized problems and enhanced the probability of better outcomes for the nation as a whole.

However, there have been some developments in China that many find concerning. From strong capital outflows to volatile stock markets, a rising chorus of pundits such as David Shambaugh predict an economic crisis for the country. When China began developing, it was a small trading state and thus had tremendous room for growth by taking market share at the expense of other countries. Initially, it followed the same growth model adopted decades earlier by the four Asian Tigers of South Korea, Hong Kong, Taiwan, and Singapore. As they demonstrated, economic growth is primarily determined by (1) domestic economic competition, (2) infant industry protection, (3) state control of financial resources and international capital flows, (4) incentives that promote industrial production and exports, and (5) labor movement from rural to urban settings coupled with productivity increases. The principles driving growth haven't changed. Today, as the largest trading nation in the world, China is nonetheless constrained by the size of the world economy. It can no longer grow faster than the world economy through trade alone.

The problem of overcapacity emerged more severely in China since the world was unable to absorb its exports, resulting in a slowing of its export engine. This overcapacity led to even more severe price cuts and eventually massive layoffs of workers, who, during the 2008 financial crisis, were no longer needed in factories for everything from textiles to steel. For instance, China has the capacity to export two-thirds of the world's steel, but the world only needs half of China's steel production. Thus, in an attempt to forestall worker unrest, Chinese policymakers created a second engine of growth by inducing heavy investment domestically in the years immediately following the financial crisis of 2008 in order to rehire the unemployed workforce. China's second growth engine was characterized by infrastructure investments of all types, from sophisticated water treatment systems to rampant real estate investments that created entirely new cities out of the blue. Yet, even domestic infrastructure investments that were needed to offset the drop in exports have hit their limit for China. High-speed trains have now been constructed all over the country, and real estate expansion among third-tier cities lacks the residents and commercial activity to sustain it. A third engine of growth is now needed to keep China growing in order to lift the rest of its population out of poverty.

Developing a third engine of growth while the two former engines are slowing dramatically is challenging in itself, but the difficulty is compounded in China by its ballooning debt.

The problem with China's credit growth is that the country had already accumulated vast amounts of both public and private debt in order to fund its second leg of growth following the 2008 financial crisis. China's debt increase since 2009 has been faster than the debt buildup that occurred in the United States before the global financial crisis. Since China's GDP did not grow commensurately, its