# How China Fell Off the Miracle Path

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By RUCHIR SHARMA JUNE 3, 2016

227

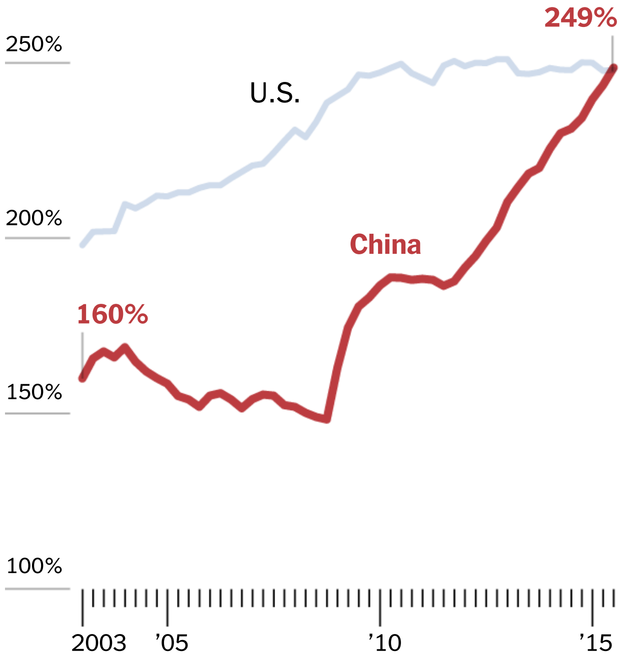
A vendor waits for customers at a market in an urban village under demolition in Zhengzhou, Henan province, in May. China Stringer Network/Reuters

FOR years now, Donald J. Trump has been sounding the alarm on China, calling it an economic bully that has been “eating our lunch.” The crux of Mr. Trump’s attack is that Beijing manipulates its currency to keep it cheap and give Chinese exports an unfair advantage. But that narrative is so last decade. China is now a threat to the United States not because it is strong but because it is fragile.

Four key forces have been shaping the rise and fall of nations since the 2008 financial crisis, and none of them bode well for China. Debts have risen dangerously fast in the emerging world, especially in China. Trade growth has collapsed everywhere, a sharp blow to leading exporters, again led by China. Many countries are reverting to autocratic rule in an effort to fight the global slowdown, none more self-destructively than China. And, for reasons unrelated to the 2008 collapse, growth in the world’s working-age population is slowing, and turned negative last year in China, depleting the work force.

## Soaring Debt

China’s total debt as a percent of G.D.P. — public and private debt, including both commercial and household — has risen sharply. Total U.S. debt has stabilized.




Source: Bank for International Settlements

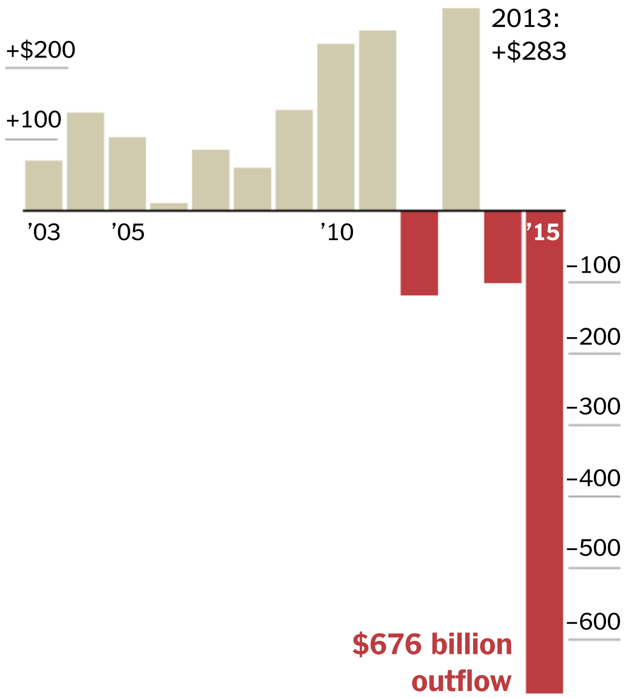
Charts by Bill Marsh/The New York Times

It will be difficult for any country to grow as rapidly as 6 percent, and all but impossible for China. Nevertheless, in an effort to exceed that target, Beijing is pumping debt into wasteful projects, and digging itself into a hole. The economy is now slowing and will decelerate further when the country is forced to reduce its debt burden, as inevitably it will be. The next step could be a deeper slowdown or even a financial crisis, which will have global repercussions because seven years of heavy stimulus have turned the world’s second largest economy into a bloated giant.

In Beijing, confidence has given way to a case of nerves. Local residents often sense trouble coming before foreign investors and are the first to flee before a crisis. Chinese moved a record $675 billion out of the country in 2015, some of it for purchases of foreign real estate. If China were eating America’s lunch, its people would not be rushing to buy safe-haven apartments in New York or San Francisco. Far from conspiring to cheapen its currency, as Mr. Trump charges, Beijing is struggling to keep the weakening renminbi from falling more, which would further erode local confidence and make a crisis more likely.

## Money Talks, and Walks

Net capital flow to or from China, in billions of dollars.




Source: Institute of International Finance

The seeds of China's current problems were planted in the months after the global economic crisis of 2008. When I visited Beijing in September of that year, just before the Wall Street implosion, the country's economy was slowing, but the city was calm. Beijing had hosted the Summer Olympics, and in preparation had temporarily shuttered smokestack industries and eased censorship. The skies were clear, the conversation much more candid than it is today.

The nation had good reason to feel confident. Like Japan, South Korea and other Asian "miracle" economies, China had generated a long run of double-digit growth by investing in export industries. But Wen Jiabao, then prime minister, was not complacent. He was warning that after three decades of heavy industrialization, China was "unstable" and "unbalanced," with too many factories belching too much smog. Many prominent Chinese recognized that with per-capita income rising above $8,000, their nation would face a natural slowdown, as Japan and South Korea had when they reached a similar middle-income level. Meanwhile, among outsiders, there was hopeful talk of how China would evolve into a democracy as it grew richer — again following the path of earlier Asian miracles.

Then, two weeks after I left, Lehman Brothers filed for bankruptcy in the United States, tipping the global economy into recession. Demand collapsed across the world, crushing export growth in China. The leadership in Beijing panicked, apparently fearing that if the recession reached its shores, social unrest would follow. Mr. Wen reversed course and doubled down on the old industrial model — fueling investment in factories with trillions in state lending and spending.

At first, the bet appeared to work. In 2009, China managed once again to beat its longstanding growth target of 8 percent, as the West struggled to recover from its deep recession. The rapid spending unleashed by Beijing contrasted sharply with the relative gridlock in Washington and the global elite, gathering for their annual confab in Davos, Switzerland, in 2011, marveled at the benefits of state capitalism. China, they said, was proving that unchecked autocracies had an advantage in managing the economy, particularly in a crisis.

But looking back, we can see that this was the moment China began to fall off the miracle path.

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## A Rising Currency, a Less Competitive China

As the renminbi becomes more valuable, China's exports get more expensive. Percent change in the real effective exchange rate since 2003.


2016 figures through April 30.

Source: Morgan Stanley Investment Management analysis of data from the Bank for International Settlements and the International Monetary Fund

As its debt mania progressed, more of the lending was diverted into wasteful speculation. Normally, frenzied borrowing occurs amid excitement about a new innovation like the internet. But this spree spread on conviction that Beijing, obsessed with hitting its growth target, would not let lenders or borrowers fail. More and more unqualified players got in the game. The state banks soon had to compete with "shadow banks," including crowdfunding websites that offered ordinary people a chance to invest in debt for as little as one renminbi (15 cents), promising fantastic returns.

Try as the Chinese authorities might to steer the money into industry, they could never fully commit to stopping shadow banks from financing an increasingly questionable array of borrowers speculating in real estate. When I visited Shanghai in August 2010, I was stunned to see apartment blocks rising two to three rows deep all along the 110-mile route to Hangzhou. Many of the biggest debtors are front companies set up by local governments to evade national regulators. Small cities are borrowing to build futuristic museums, aquatic centers and apartment blocks that exceed local demand and are often as empty as ghost towns.

My research shows that during the 30 worst debt manias of the past 50 years, private debt — which in China is often held by local governments — rose over five years by at least 40 percentage points as a share of gross domestic product. In all 30 cases, the economy slowed sharply, typically by more than half, in the next five years.

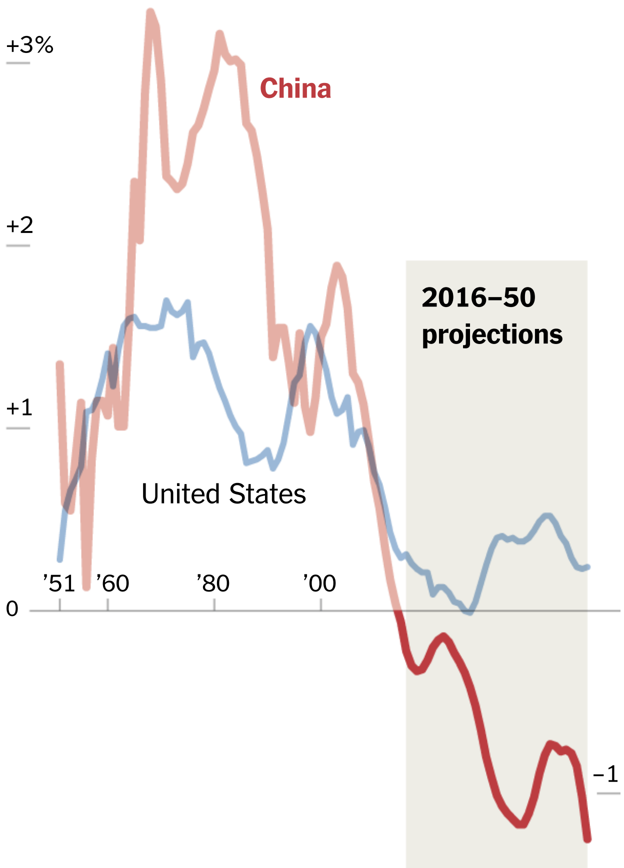
China’s mania is now the largest ever in the postwar emerging world. After holding steady at around 150 percent of G.D.P. for much of the boom, China’s public and private debts surged after Mr. Wen’s about face in 2008, rising to 230 percent of G.D.P. by 2014. That 80-percentage-point increase is also more than three times the increase in the United States before its bubble collapsed in 2008. Since then, United States debt has held steady as a share of its economy. Though many Americans still think the nation is drowning in debt, its burden is much less worrisome than China’s because it is not growing.

Paradoxically, the authoritarian form of government that helped guide China to those years of economic growth may now be undermining its economic stability. My research suggests that compared with democracies, autocracies generate far more unstable growth, and that’s the risk in China now. Looking at the available records going back to 1950 shows that extreme swings between fast and slow growth are much more common under autocratic regimes. On a list of 36 countries that have been whipsawed between rapid growth and recession throughout the postwar era, three out of four were autocracies.

Because these governments face no check on their powers, they can force feed periods of strong growth. But they can also veer off in the wrong direction with no one to set them straight. In the early stages of China’s boom under Deng Xiaoping, Beijing did what authoritarian governments do best, suppressing opposition to breakneck development, steering the people’s savings toward building export factories and commandeering land to build the roads and bridges to bring the manufactured goods to market. But the same decision-making process, centralized in a small circle in Beijing, allowed the government to impulsively shift course in 2008 and push through the lending campaign that put China on the increasingly unstable path of more debt, and less growth.

## A Future Labor Shortage

Year-over-year percent change in the working-age population (ages 15-64).




Source: United Nations

ON my recent trips to China, I keep looking for Beijing to snap back to reality, but in vain. As the economy grows more unstable, the authorities have tried to control the business cycle with an increasingly heavy hand that extends into its financial markets. In late 2014, hoping to give its struggling companies a new lift, Beijing began to praise buying stocks as a patriotic act. Millions of ordinary Chinese signed up to play the market for the first time, many unaided by a high school degree, and started borrowing to buy shares as prices rose. When the bubble burst last June, Beijing did not let it implode, as it had in 2008. It ordered people not to sell or even to speak critically of stocks. The market collapsed anyway.

Afterward the Davos crowd finally started to question whether Beijing could simply command its economy to grow. It looked as if the lesson might be learned in China, too, but when I visited this April, authorities had begun a new stimulus campaign, and debt was still growing three times faster than the economy. Against this backdrop, residents spoke of dizzying price rises in Shanghai and Beijing real estate and in obscure markets like steel rebar futures. Their intention was to keep dancing until the borrowed money stopped flowing.

The sputtering global economy is one shock away from slipping into recession. In the postwar period, every previous global recession started with a downturn in the United States, but the next one is likely to begin with a shock in China. Through heavy stimulus, China was the largest contributor to global growth this decade, but it is fragile. China's miracle growth period is over, and it now faces the curse of debt.

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Ruchir Sharma is the chief global strategist at Morgan Stanley Investment Management. This essay is adapted from the forthcoming "The Rise and Fall of Nations."

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