How vulnerable is the Chinese economy, and China's leadership?

(A review of *A Failure of Leadership, Part III: The Beginning of the End of China*, by Peter Zeihan, a geopolitical strategist whose CV, according to his website, includes a stint working for the US State Department in Australia.)

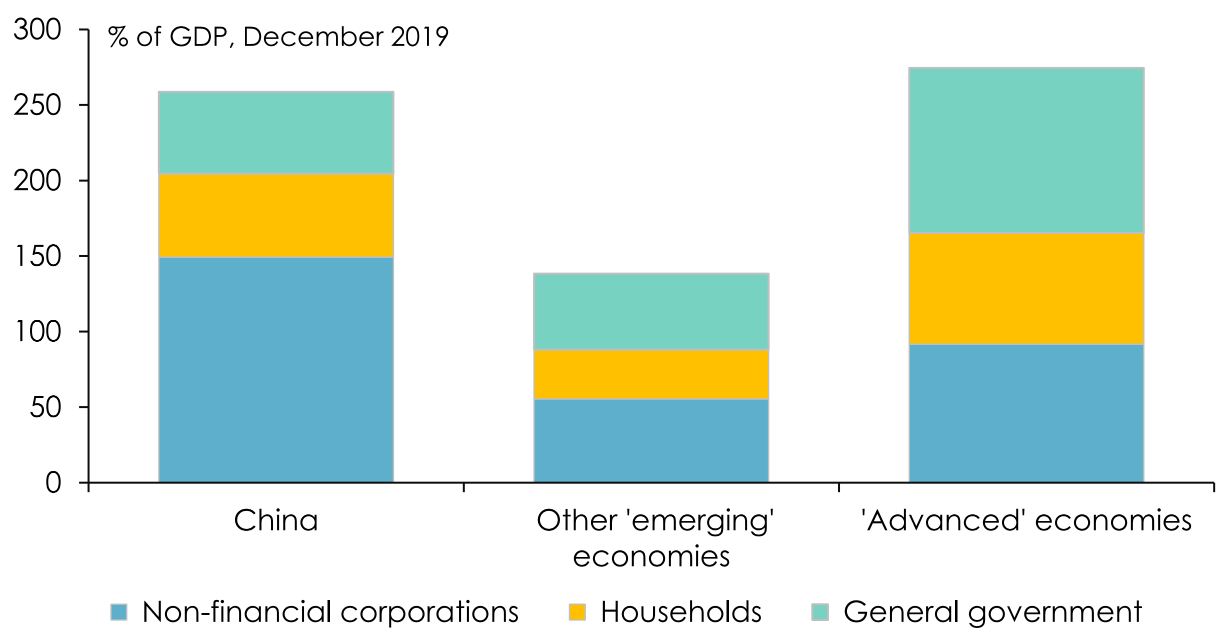
Zeihan's principal contention is that China's recent "spasming belligerency", its "torching [of its] diplomatic relationships with the wider world" is a sign "not of confidence and strength", but rather of "insecurity and weakness"; that its leadership knows "full well" that China's growth model is "unsustainable" and "past its use-by date"; and that "everyone in the top ranks of the Chinese Communist Party" knows that "the day is coming" when "China's entire economic structure and strategic position crumbles".

Zeihan is hardly the first person to say these sorts of things (see, for example, Chang 2001 and 2016; Pettis 2013; Shambaugh 2015; Wilson 2017): and I suspect he won't be the first person to be wrong about them, at least in the near term.

That's not to say that the article doesn't draw on undisputable facts. There's no denying that China has been extraordinarily profligate in its use of capital, and has become progressively more so over the last two decades. Paul Krugman (1994) famously made the same point about the then rapidly-growing smaller East Asian economies a few years before the Asian financial crisis: *The Myth of Asia's Miracle*, though wrong in some important respects, is still worth a read if you ask yourself whether what he said about the 'Asian tigers' back then applies to China today.

Nor is there any denying that China has an enormous amount of debt (relative to its GDP), especially for what is still in many ways a 'developing' economy (Chart 1).

Chart 1: Debt as a pc of GDP



Source: Bank for International Settlements, *Credit to the non-financial sector*, June 2020.

But, and this is an important 'but', most of that debt is owed by state-owned enterprises to state-owned banks – which can be thought of as two entries on opposing sides of the same ultimate parent company balance sheet, ie that of the People's Republic of China. If a lot of that were to turn 'bad', which is by no means impossible, then the ensuing 'crisis' could be solved by writing it off, and then re-capitalizing the state-owned banks by drawing down on the foreign exchange reserves of the People's Bank of China (China's central bank).

China has actually done this twice before, in the late 1990s as part of the state-owned enterprise reforms pushed through by then-Premier Zhu Rongji (Bartel and Huang 2000; Peresa and Vidon 2019); and again between 2003 and 2005, when the big four state-owned banks were 'cleaned up' ahead of their (very) partial-privatization and listing on the Hong Kong Stock Exchange (Allen, Quan and Quan 2006). The 'bad assets' were transferred into an entity called Central Huijin which subsequently became the nucleus of China's sovereign wealth fund, the CIC.

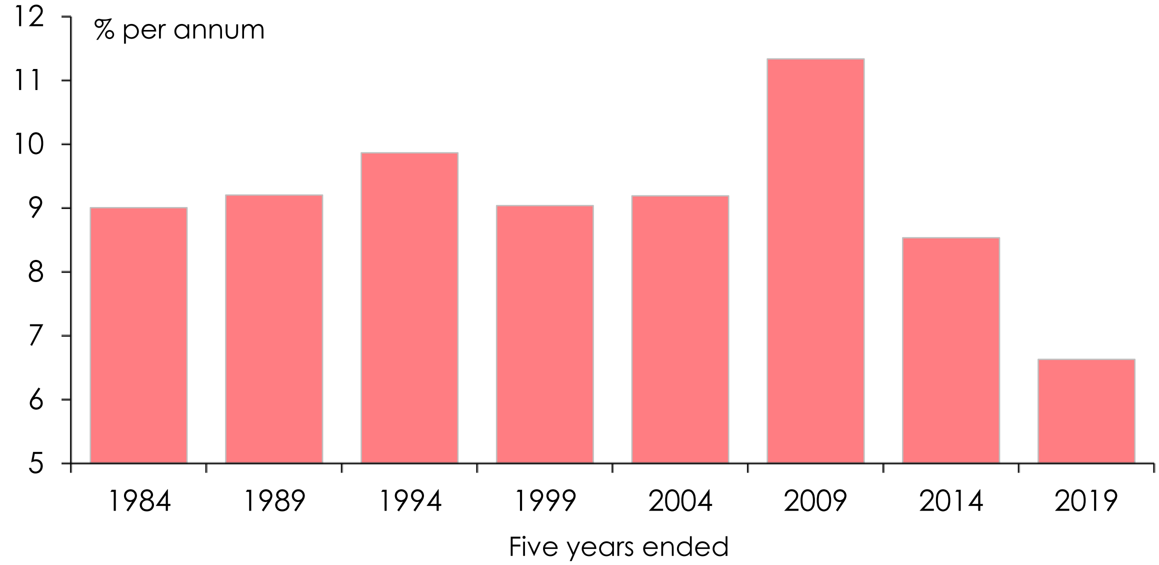
An unknown question is whether the PBoC's FX reserves would be sufficient for what could be a much larger task in such circumstances than it was in the two earlier ones. The PBoC lost one quarter of its reserves (almost US$1 trillion) defending the renminbi's parity between June 2014 and December 2016 – after which they imposed very strict controls on capital outflows, which have remained in force ever since – and are easier to maintain in an authoritarian regime which knows how to deploy modern technology for surveillance purposes (Ross Anderson 2020) than in other countries that have resorted to capital controls such as Argentina.

Since that time the ubiquitous 'Chinese authorities', as they're always referred to by Western economists, have been acutely aware of the risks to financial stability posed by the growth of 'shadow banks' and their 'wealth management products', or of the way that Chinese banks have become more dependent on 'wholesale funding' and less on deposits for the liabilities side of their balance sheets – as US and European banks did, to a much greater extent, in the years leading up to the global financial crisis of 2008-09 (Weinland and Wildau 2016).

That's in part why China's economic growth rate has been steadily slowing over the course of the past decade, from an average of 11.3% in the five years to 2009, to 8.5% in the five years to 2014, and to 6.6% in the five years to 2019 (Chart 2). Another important reason has of course been that China's working-age population peaked in 2014 and has since shrunk by almost 1½%.

It also helps explain why the PBoC hasn't done nearly as much 'monetary stimulus' as it did during and after the global financial crisis or in 2015-16. There *hasn't* been an significant acceleration in credit growth in recent months (Chart 3) nor has there been a surge in property development activity or property prices, as there would have been if the PBoC had unleashed another spurt of credit growth (Chart 4).

Chart 2: Average annual growth in China's real GDP over five-year intervals



Source: China National Bureau of Statistics.

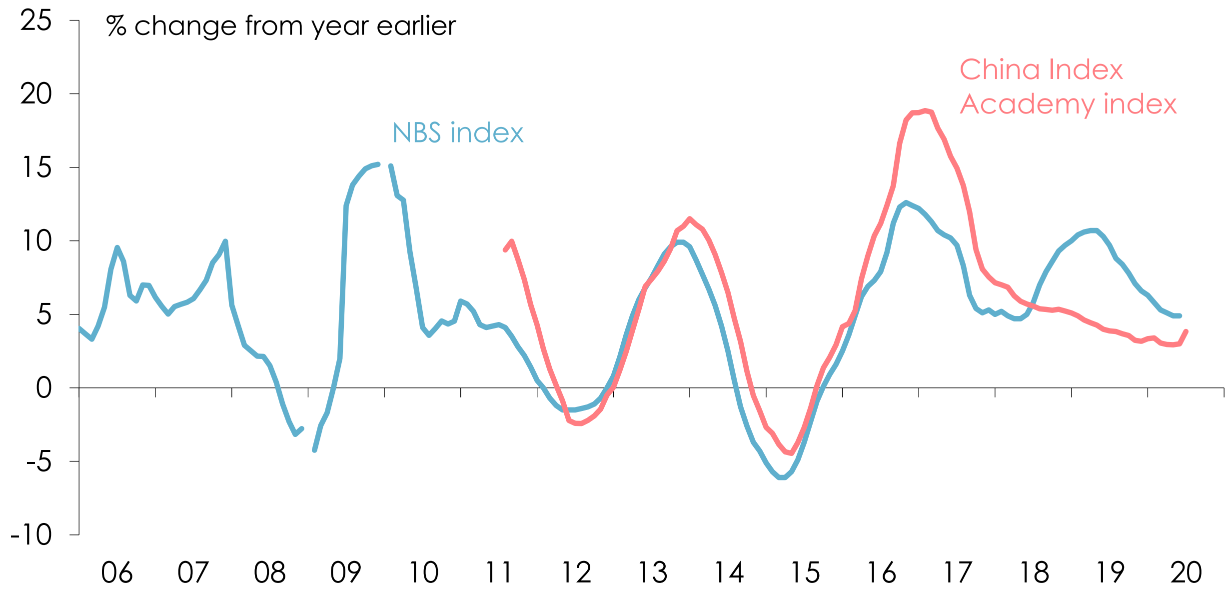
The 'Chinese authorities' do seem to be doing more fiscal stimulus than they did 12 years ago, although it is taking a very different form from the construction-intensive programs that it implemented then (Koty 2020).

The potentially most worrying development – albeit not from the perspective of the next year or so – is the one depicted in Chart 5, which shows a marked divergence between the level of FX reserves and the rate of growth in domestic credit since the mini-crisis of 2015-16 (I'm indebted to Jonathan Anderson (2020) for drawing this to my attention).

Chart 3: China's domestic credit growth

Source: People's Bank of China, [Depository Corporations Survey](), June 1990.

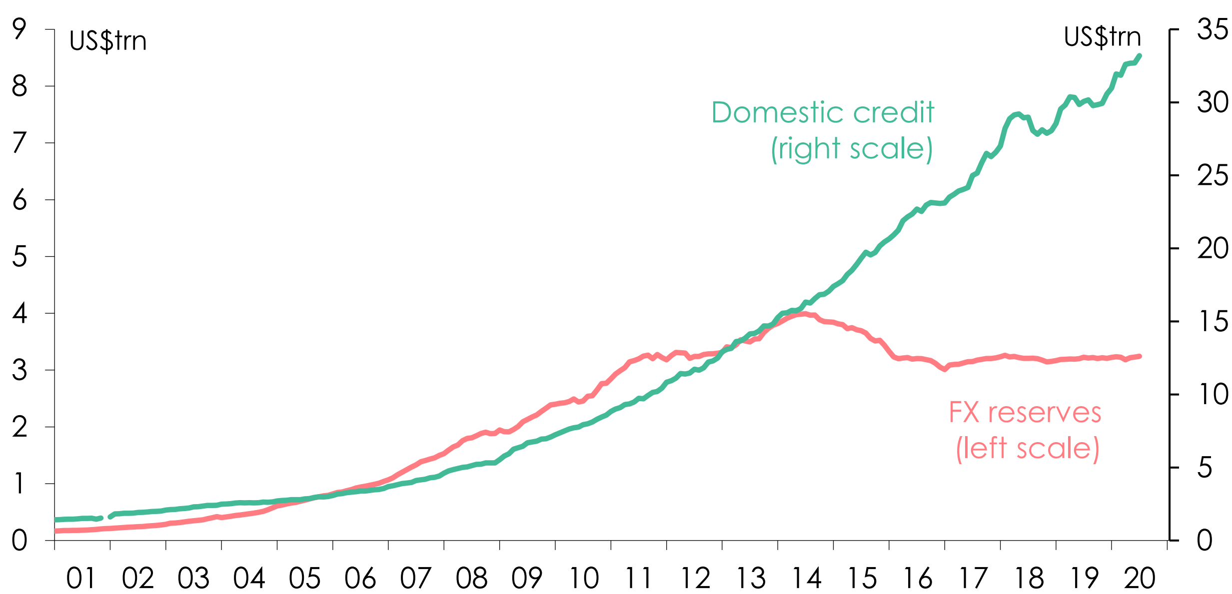
Chart 4: Chinese residential property prices



Sources: China National Bureau of Statistics; China Index Academy.

For a fixed exchange rate system to be sustainable, the two ordinarily need to maintain a fairly close and stable relationship – which they do under a 'currency board' system like the one Hong Kong has had since 1984 (or that the Baltic states had before joining the euro, or which Bulgaria still has), where the monetary authority is explicitly precluded from issuing currency unless it is backed by FX reserves (or, in HK's case, FX reserves plus the Land Fund) (Hong Kong Monetary Authority 2013; Wong 2019).

Chart 5: China's domestic credit and foreign exchange reserves



Note: Domestic credit converted from yuan to US dollars using month-average market exchange rates.
Sources: People's Bank of China; Jonathan Anderson (2020); author's calculations.

And that's why the collapse of fixed exchange rate regimes (such as Thailand's in 1997, or Argentina's in 2001) is usually precipitated by a surge in capital outflows, and a sharp decline in FX reserves.

China's FX regime is of course no longer completely fixed, but rather is 'carefully managed' around a peg to a trade-weighted index (as the A$ was between 1976 and the 'float' in 1983) (Das 2019). But the PBoC's capacity to maintain that peg is dependent on the 'credibility' of its implicit promise to buy or sell renminbi (RMB) in whatever quantity is required to keep the currency close to the peg.

Obviously they can *sell* the RMB in whatever quantities they like, since they are the ultimate source of RMB, so they can always prevent it from appreciating 'too much' (as can any country which is prepared to accept the potentially inflationary consequences of a sudden large increase in the domestic money supply).

But they don't own or operate a US dollar factory, so they can only prevent a big depreciation (if one were to be in the offing) for as long as they have sufficient FX reserves to satisfy everyone who wants to convert RMB into dollars (or some other foreign currency).

And that's why the capital controls are so important at the moment: because they limit the demand for foreign currencies – so that the level of FX reserves *is* more than adequate, and widely regarded as such.

If something were to happen that resulted in a tsunami of capital outflows, and the 'Chinese authorities' didn't have any other ways of stopping it (such as confiscating the assets of, imprisoning or executing people who tried to get their money out of the country, something which I am sure they wouldn't baulk at), then there *would* be a 'currency crisis'; the RMB would fall a lot; and the weakness in the domestic financial system (resulting from the accumulation of so much bad debt) would be fully exposed.

But you have to ask, how likely is it that that's going to happen in the foreseeable future? And I can't really see any reason to answer that question with anything other than 'not very'.

It's worth remembering, in this context, that the lesson which the Chinese Communist Party drew from the collapse of the Soviet empire is that brutal authoritarian regimes can only survive – once they have clearly failed to deliver on the implicit or explicit promise of delivering ongoing improvements in people's well-being (for which many people will regard the surrender of individual freedoms as a price worth paying) – for as long as they are willing to kill their own people in sufficient numbers *pour encourager les autres*, or that there is someone else who is willing and able to do it for them.

Thus the Communist regimes of Eastern Europe, most of which had been demonstrably willing to shoot their own people (or allow the Soviets in to do it for them) at various times in the 1950s, 1960s and early 1980s), collapsed when they lost the will to shoot their own people, and the Soviets under Gorbachev lost the will to do it for them (Taubman 2017: 462-499).

And the Soviet Union itself collapsed in 1991 when neither Gorbachev, nor the cabal of drunken fools who briefly tried to overthrow him in August of that year, were willing to shoot their own people.

It's worth noting in passing that Vladimir Putin has repeatedly demonstrated that he has no such scruples about killing his own people – whether they be ordinary Russians in high-rise apartments around Moscow, middle-class Muscovites attending the theatre, schoolchildren and their parents in Beslan, troublesome journalists, former KGB agents living in the UK, lawyers for aggrieved hedge fund managers, or prominent opposition figures (Gessen 2012; Browder 2015; Myers 2015; Blake 2019; Belton 2020).

By contrast with their contemporaries in Eastern Europe and the Soviet Union, Deng Xiaoping and Li Peng demonstrated that they were perfectly relaxed about the idea of shooting, or running over with tanks, large numbers of their own people in order to ensure that they remained in power (Fenby 2008: 618-637; Pantsov 2015: 407-416) – and even more competent than Josef Stalin in air-brushing those events out of the collective memory of the people who remained alive (Lim 2014).

And I suspect nothing has changed, at least in that regard, since then.

Indeed Xi Jinping has repeatedly shown that he's prepared to do whatever is required to entrench the CCP as the source of all power in China, to sideline potential rivals (Choi 2018; Minzner 2018) and to remain in office for as long as he is capable of drawing breath (not least because he's smart enough to know that he's made a lot of enemies, and that they would take their revenge on him and his family and supporters as soon as he was out of power – as Putin did to Boris Yeltsin's wealthy supporters) (Ott 2018).

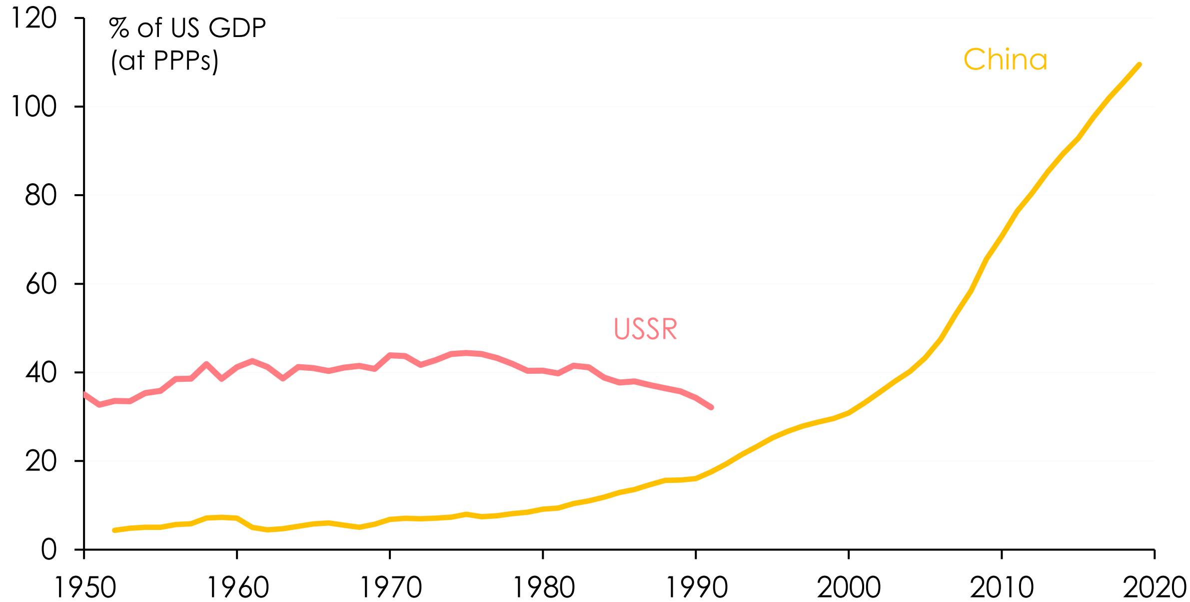
Far from feeling 'weak and insecure', I think China feels strong and emboldened – not only by its apparent success in stopping the spread of the virus, admittedly after a number of initial serious mis-steps (McGregor 2020), but also by the manifest incompetence of the US administration in dealing with Covid-19, and its almost complete abdication of its traditional global leadership role (something that, to be fair, didn't start under Trump).

That's why Xi has explicitly discarded Deng Xiaoping's dictum that China should 'hide your capacities and bide your time' – much as, Woodrow Wilson and, more forcefully, Roosevelt and his successors all the way to George W Bush – were prepared to discard George Washington's advice, in his 1796 farewell address (which was actually written by Alexander Hamilton) to 'avoid foreign entanglements' (Smith 1993: 273-283; Chernow 2004: 505-508).

Xi (and, as far as one can tell, most of the Chinese population) think that 'now' is China's 'time' – that's what he means by phrases like 'the great rejuvenation of the Chinese nation' and 'the Chinese dream' (Hass 2017).

And of course China's economy, notwithstanding its burden of debt, is much stronger than the Soviet Union's ever was.

Chart 6: GDP of the USSR and China as a pc of the US



Note: Comparison between the USSR and the US is based on estimates of GDP in 1990 US dollars at purchasing power parities (PPPs); comparison between China and the US is based on 'official' estimates of GDP in 2019 US dollars at PPPs. *Sources:* The Conference Board, Total Economy Database ™, September 2015 and July 2020; author's calculations.

The closest the USSR's economy ever got to matching the US' was 44% of US GDP between 1974 and 1976; by the time Gorbachev took office in 1985 it was down to 38%, and in 1991, when the USSR collapsed, its GDP was only 32% of the US' (Chart 6).

By contrast, China's economy (measured in the same way as Maddison did) surpassed the US's in 2017, and this year will likely be at least 10% bigger than the US's (of course measured in US dollars at current exchange rates, rather than at 'purchasing power parities', the Chinese economy is still only about two-thirds of the size of the US economy, but that's a lot closer than the Soviet Union ever got).

It's perhaps also worth noting, apropos of something that Zeihan over-emphasizes, that China isn't really all that dependent on exports any more – in 2019, exports accounted for only 18.4% of China's GDP (according to World Bank data), down from a peak of 36% in 2006 and less than in any year since 1991. Big economies, like China's now is, tend to be relatively 'closed' – thus exports only represent 12% of the US' GDP, or 18.5% of Japan's (cf. 24% of Australia's, for example).

So, to summarize, I *don't* really agree with Zeihan's proposition. Of course, in the long run (when, as Keynes (1923) famously wrote, we're *all* dead), he may turn out to have been right. But it's not something I'm going to lie awake at night wondering if I will wake up next morning to read that it's happened.

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