Feature

China under pressure, a debate

Featuring Adam Tooze of Chartbook

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Robert Armstrong and Ethan Wu 5 HOURS AGO

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Good morning. Today is the first edition of what we hope will become a long-running regular feature in this newsletter: collaborations with our favourite experts on markets, finance and economics. The idea is to introduce Unhedged readers to the best thinkers in our field, and introduce ourselves to new audiences.

Ethan and I are frankly not quite sure why our first collaborator would agree to work with us. Adam Tooze is a serious big shot. He is a Columbia professor and a powerful writer on political economy, with books on Covid, the financial crisis, both the world wars, and more. His Chartbook newsletter is a must-read for its combination of deep historical context and granular attention to economic data and the news of the day.

Our collaboration with Adam will run today and on the next two Thursdays. Today's

topic: China under pressure. Recent events have raised (not for the first time) questions about the sustainability of the Chinese economic model. Can China make the adjustments necessary to sustain growth, and should global investors go along for the ride?

Adam thinks that, with a few provisos, that the answer is yes. Ethan and I think, with a stipulation or two, the answer is no. To lay out these views, we've traded places: Adam gives his view below. To see the Unhedged view, follow this link over to Chartbook. And tell us who got it right: Robert.Armstrong@ft.com and Ethan.Wu@ft.com.

Adam Tooze: China's economic transformation

The common starting point for Chartbook and Unhedged is the view that as far as the world economy and financial markets are concerned China remains the big story.

This is not to say that Russia's invasion of Ukraine is not a dramatic shock and the risk of escalation is not terrifying. The impact on energy and food prices will be felt worldwide. But China is a whale. A serious crisis and long-term slowdown there will affect every market and practically every economy worldwide. China is also far more deeply financially interconnected with the rest of the world economy than Russia and Ukraine. China's economic growth is the driver of what it still the primary geopolitical antagonism in the 21st-century world, that between Beijing and Washington.

So the question of China's growth prospects is a vital one both for policymakers and investors. And this is particularly urgent in light of the signs of serious stress in China's economy and financial markets.

As you can read over at Chartbook today, Robert and Ethan take a pessimistic line heavily informed by the thinking of Michael Pettis and George Magnus.

Their view of the short-term is relatively sanguine. As they put it to me in an exchange of emails:

> The government will apply monetary, fiscal, and regulatory solution adequate to prevent a crisis. Risk of a crisis, financial or economic, is quite low for now.

Their pessimism concerns the medium-term growth prospects. Following Pettis, Unhedged sees no way in which China can hit its 5.5 per cent goal without continually piling on more debt. Add demographic headwinds into the mix and they reach a grim conclusion: In the longer term they foresee Chinese growth progressively slowing and its economic relations with the West increasingly been dominated by geopolitical factors, a scenario sketched by Martin Wolf earlier this week.

Now, if that becomes the prevalent view — and it is certainly a view gaining significant traction — it has huge implications. The policy world has been buzzing for a while with talk of a fundamental realignment. Are we now about to witness a real economic uncoupling between China and the West?

That would be a historic break in global economic development. Look back in 20 years' time and this moment will stand out as an inflection point.

To say the least, this is a big macro call. So, let us stand back a bit to take in the scene.

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Let's start with the point on which Chartbook and Unhedged agree. Despite the $300bn mega-bankruptcy of Evergrande, the risk of an immediate 2008-style crisis in China is slight.

But rather than moving on to focus on the medium-term prospects, let us linger over the significance of this point. What China is doing is, after all, staggering. By means of its "three red lines" credit policy, it is stopping in its tracks a gigantic real estate boom. China's real estate sector, created from scratch since the reforms of 1998, is currently valued at $55tn. That is the most rapid accumulation of wealth in history. It is the financial reflection of the surge in China's urban population by more than 480mn in a matter of decades.

Throughout the history of modern capitalism real estate booms have been associated with credit creation and, as the work of Òscar Jordà, Moritz Schularick and Alan M. Taylor has shown, with major financial crises.

Real estate booms don't generally end in a whimper. They end in a bang. They end with major banking crises.

So, if we are agreed that Beijing looks set to stop the largest property boom in history without unleashing a systemic financial crisis, it is doing something truly remarkable. It is setting a new standard in economic policy.

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What should western investors think about that? Frankly it is not easy to tell because investors have never had to deal with a regime that has attempted anything like it.

Is this perhaps what policy looks like if it actually takes financial stability seriously? And if we look in the mirror, why aren't we applauding more loudly?

Add to real estate the other domestic factor roiling the Chinese financial markets: Beijing's remarkable humbling of China's platform businesses, the second-largest cluster of big tech in the world. That too is without equivalent anywhere else.

The Biden administration and Congress are now talking about big tech, but so far the results are modest. The EU is a serious regulator, but it is nowhere near as menacing as Beijing.

If you went all-in on China tech stocks, this is going to hurt. But that is the point. Beijing's aim is to ensure that gambling on big tech no longer produces monopolistic rents. Again, as a long-term policy aim, can one really disagree with that?

So we have two dramatic and deliberate policy-induced shocks of the type for which there is no precedent in the West. Both inflict short-term pain with a view to longer-term social, economic and financial stability.

Then there is demography. For obvious reasons, demography is normally treated as a natural parameter for economic activity. But in China's case the astonishing fact is that the sudden ageing of its workforce is also a policy-induced challenge. It is a legacy of the one-child policy — the most gigantic and coercive intervention in human reproduction ever undertaken.

So, Beijing's challenge right now is to manage the fall out from the two most dramatic development policies the world has ever seen, the one-child policy and China's urbanisation, plus the historic challenge of big tech — less a problem specific to China than the local manifestation of what Shoshana Zuboff calls "surveillance capitalism".

So, yes, Beijing has its hands full. That creates turbulence for investors. And, no, Xi's regime has not yet presented a fully convincing substitute plan. But, as Michael Pettis has forcefully argued, China has options. There is an entire range of policies that Beijing could put in place to substitute for the debt-fuelled infrastructure and housing boom.

First and foremost China needs a welfare state befitting of its economic development. As Brad Setser explained before he disappeared into the boiler room of the Biden administration, rebalancing the Chinese economy needs to start with a stronger

domestic safety net.

China needs to spend heavily on renewable energy and power distribution to break its dependence on coal. If it needs more housing, it should be affordable. All of this would generate more balanced growth. 5 per cent? Perhaps not, but certainly healthier and more sustainable.

Nor is Beijing unaware of these options. Indeed they have been repeatedly mapped out. If it has not so far pursued an alternative growth model in a more determined fashion, some of the blame no doubt falls on the prejudices of the Beijing policy elite. But even more significant are surely the entrenched interests of the infrastructure-construction-local government-credit machine, in other words the kind of political economy factors that generally inhibit the implementation of good policy.

The problem is only too familiar in the West. In Europe and the US too, such interest group combinations hobble the search for new growth models. In the United States they put in doubt the possibility of the energy transition, the possibility of providing a healthcare system that is fit for purpose and any initiative on trade policy that involves widening market access.

Ultimately political economy determines the conditions for long-run growth. So if you had to bet on a regime, which might actually have what it takes to break a political economy impasse, to humble vested interests and make a "big play" on structural change, which would it be? The United States, the EU or Xi's China?

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On balance, if you want to be part of history-making economic transformation, China is still the place to be. But it is undeniably shifting gear. And thanks to developments both inside and outside the country, investors will have to reckon with a much more complex picture of opportunity and risk. You are going to need to pick smart and follow the politics and geopolitics closely.

Investing in the old model of growth in China is no doubt a dubious proposition. You have to ask what motivated all the smart folks at Western banks and asset managers to continue to build their positions in Evergrande even in 2021.

If on the other hand you want to invest in the green energy transition — the one big vision of economic development that the world has come up with right now — you simply have to have exposure to China, whether directly or indirectly by way of suppliers to China's green energy sector. China is where the grand battle over the future of the climate is going to be fought. It will be a huge driver of innovation

future of the climate is going to be fought. It will be a huge driver of innovation, capital accumulation and profit, the influence of which will be felt around the world. Significantly, it is one key area that both the Biden administration and the EU would like to "silo off" from other areas of conflict with China.

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In the meantime, I worry that we may be too focused on the medium-term. Given the news out of Hong Kong and mainland China, Covid may yet come back to bite us.

Here too China is boxed in by its own success. It has successfully pursued a no-Covid policy, but due to the failing of the rest of the world, it has been left to do so in "one country". That now comes with serious costs. Authorities in Shanghai are frantically denying rumours of a citywide lockdown.

Anyone who shows any schadenfreude at this situation demonstrates only that they have learned nothing. A Hong Kong-style outbreak could mean a terrible toll of excess deaths and the risk of incubating new and more dangerous variants. Until China finds some way to contain the risks, this is a story to watch. A dramatic Omicron surge across China would upend the entire narrative of the last two years, which is framed by Beijing success in containing the first wave.

One good read

No, really, read Chartbook!

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