Will China's economy hit a Great Wall?

By Paul Krugman
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The other day I issued a warning about the Chinese economy. It is, I wrote, "emerging as a danger spot in a world economy that really, really doesn't need this right now."

Unfortunately, the other day was more than 6 years ago. And it's not just me. Many people have been predicting a China crisis for a long time, and it has kept on not happening.

But now China seems to be stumbling again. Is this the moment when all the prophecies of big trouble in big China finally come true? Honestly, I have no idea.

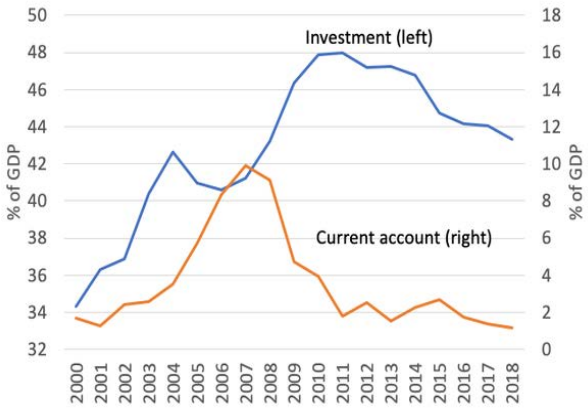
On one side, China's problems are real. On the other, the Chinese government – hindered neither by rigid ideology nor by anything resembling a democratic political process – has repeatedly shown its ability and willingness to do whatever it takes to prop up its economy. It's really anyone's guess whether this time will be different, or whether Xi-who-must-be-obeyed can pull out another recovery.

But maybe this is another example of Dornbusch's Law, named after my old teacher Rudi Dornbusch: The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought. So it seems useful to summarize why people have been worried about China, and why China's troubles are a problem for the rest of the world.

The fundamental problem with the Chinese economy is that it's highly unbalanced: It has extremely high levels of investment, seemingly without enough domestic consumption to justify that investment. You might be tempted to say this doesn't matter, that China can just export its surplus production to other countries. But while there was a period from the mid-2000s to the early 2010s when China ran huge trade surpluses, those days are past.

Figure 1 shows Chinese investment (left scale) and its current account balance (a broad measure of the trade balance, right scale), both as percentages of GDP. That investment number is huge by anyone's standards; it's hard to see how companies can avoid running into strongly diminishing returns.

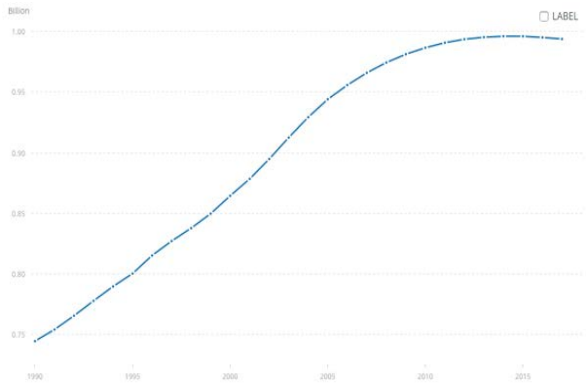
Figure 1: Unbalanced China



It's true that very high investment can be sustained for a long time in a rapidly growing economy (the so-called accelerator effect.) And China has indeed achieved incredible growth. But the potential for future growth is falling, for a couple of reasons. One is that as Chinese technology converges on that of advanced countries, the room for rapid improvement through borrowing declines. The other is that China's one-child policy has produced demography that looks a lot like Europe or Japan. Figure 2 shows China's working-age population, which has stopped growing.

So China really can't keep investing 40-plus percent of GDP. It needs to shift over to higher consumption, which it could do by returning more profits from state-owned enterprises to the public, strengthening the social safety net, and so on. But it keeps not doing that.

Figure 2: Chinese population 15-64

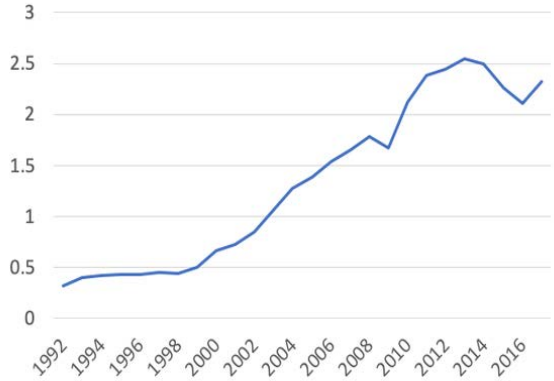


Instead, the Chinese government has been piling on loans to businesses and state-owned enterprises, pushing the SOEs to spend more, and so on. Basically it has kept investment going despite low returns. Yet this process has to have some limits – and when it hits the (great) wall, it's hard to see how consumption can rise fast enough to take up the slack.

However, if this sounds like a compelling case, bear in mind that it's the same case I and others made in 2011. So apply appropriate skepticism.

What are the global consequences if China does get into trouble? The important thing to realize here is that China no longer runs huge trade surpluses with the world as a whole (the U.S. bilateral deficit is exceptional and deceptive.) And as a result China has become a major market. Figure 3 shows China's imports from other countries as a percentage of world GDP; they've gotten quite big. For another perspective, in 2017 Chinese imports were $2.2 trillion, compared with $2.9 trillion for the US; they're almost as much of a locomotive for the world economy as we are.

Figure 3: China's Imports as % of World GDP



What this means is that a Chinese stumble would hit the world economy pretty hard, with special damage to commodity exporters (including U.S. farmers).

In other words, there are scary things out there besides Trump and Brexit.