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Michael Pettis - Can China Save Itself?
By Robert Huebscher
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Most analysts predict China's growth will slow; they disagree only as to the depth and timing of its eventual recession. A rare exception to that group is Michael Pettis. Pettis, who describes himself as a skeptic, believes China can rebalance its economy.

Pettis is a senior associate at the Carnegie Endowment for International Peace and a finance professor at Peking University's Guanghua School of Management, where he specializes in Chinese financial markets. He is author of the recently released and widely acclaimed book, The Great Rebalancing. He spoke at the Wine Country Investment Conference April 5. That event was sponsored by Mish Shedlock and his firm, California-based Sitka Pacific Capital Management, as a benefit for ALS, the disease which claimed Shedlock's wife last year.

China's policy decisions will produce stress in various sectors of its economy, and political factors will ultimate dictate the direction its economy takes.

China commands a pivotal position in the global economy. Its exports drive consumer spending in the developed world, and its industrial sector uses a disproportionate share of the world's commodities. Few things will matter as much in the coming decade as the fate of China.

I'll look at the options Pettis laid out for a well-managed rebalancing and their implications. First, let's review the conditions China faces in its economy today.

Why China is a mess

Debt is the key problem for China, according to Pettis, due to China's investment-driven growth.

No one should be surprised at China's excessive leverage, which Pettis said substantially exceeds its published number of 80% debt-to-GDP. "We have seen these investment-driven growth models before and they all end up exactly the same way," he said. The initial spate of economically viable projects is ultimately displaced by less viable ones, and then by unviable projects. When that happens, he said, debt-servicing capacity becomes unsustainable.

"That is why we always run into a debt problem," he said.

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One of the least understood issues, Pettis said, is that urbanization will exaggerate China's debt problems. Urbanization is highly pro-cyclical, he said. It supports growth in good times: Migration to cities spurs consumption and employment, providing a source for cheap labor. But urbanization can also accelerate recessionary forces during bad times, because it leads to higher unemployment and crime rates.

"Urbanization is now the default bull argument for China," he said. "But is only a bull argument when things are going really well."

Pettis said that China faces its biggest investment problems in the interior of the country. China's westward migration has been driven by government-built infrastructure, with the hope that the population will follow. But that model has proven to be unsuccessful – it failed when the Soviet Union went east in the 1950s and 1960s, as it did when Brazil went northeast in the same time frame. Those efforts were a "huge waste of money," Pettis said.

Chinese are moving west only because the government is building infrastructure, and Pettis said they will move back when the government stops.

Westward migration in the U.S. succeeded, Pettis said, because the private sector led the process. The government then followed, creating the needed support.

The western portion of China suffers extreme poverty that Pettis said rivals conditions in the worst parts of Haiti, where he lived for four years.

Pettis highlighted two other challenges. Environment degradation in China is so severe that it results in GDP being overstated by 3.5%. Second, as anyone who saw the recent 60 Minutes report knows, China has a real estate bubble. Excessive liquidity, fueled by global quantitative easing, is pushing real estate prices unsustainably high, Pettis said.

The obstacles to rebalancing

After laying out the problems China faces, Pettis turned to the question of what a rebalancing would look like.

The dilemma is that if China reduces its investment – for example, but curtailing the funding of marginal projects – GDP will contract. Any reduction in investment must be offset by an increase in consumption, Pettis said, in order to sustain China's high growth.

But consumption is limited by China's savings rate, which Pettis said is among the highest ever recorded in a country.

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Pettis dismissed the argument that the Chinese over-save because saving is a Confucian virtue. China's savings rate has gone up not because the Chinese over-save, Pettis said, but because the household's share of GDP has declined dramatically. At approximately 50% of GDP, the household share is among the lowest ever recorded. GDP has been growing at 11% to 12% annually, but household income has been growing at just 7% to 8%.

China's saving problem is really an income problem, according to Pettis. "The problem is that household income is too low," he said. "And if household income is too low, household consumption is too low."

Savings is GDP minus consumption, he said, which explains why the Chinese savings rate is so high.

Chinese policymakers understand the need to increase the household income share of GDP, Pettis said. One way to accomplish that is to do nothing, he said, and let debt levels rise until the economy collapses. That would achieve the needed rebalancing, but in a highly chaotic manner, like what happened in the U.S. during the 1930s.

China has less chaotic choices – three of them, according to Pettis. China could reverse any of the three primary contributors to its overinvestment: an undervalued currency, low wage growth relative to productivity growth and financial repression.

China's undervaluing of the renminbi amounts to a tax on consumption, Pettis said, because it raises the cost of imports. The country subsidizes the tradable goods sector, accelerating GDP growth but pushing down the growth of household income and the savings rate.

The productivity of China's workers has grown much faster than workers' wages have over the last 20 years, according to Pettis. That, too, is a tax on workers' wages, and it has the same effect of reducing the savings rate. The productivity increase subsidizes all employers, not just exporters.

Financial repression is the third and most important concern, according to Pettis. He said interest rates are at least 500 to 800 basis points too low. That has translated to an artificially low cost of capital, which has served to justify uneconomical projects. It is also a tax on savings, Pettis said. The beneficiaries are those who borrow – primarily the government and government-related entities. Savers – the household sector – bear the cost.

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Reversing the imbalances

If China reverses those three factors too quickly – for example, by raising the value of its currency by 20% to 30%, increasing interest rates by 300 to 400 basis points or raising wages sharply – Pettis said it would "spread financial distress throughout the economy."

Pettis said that China tried some of this in 2010 and 2011, when wages went up rapidly. "Massive bankruptcies" resulted, he said, and the policy was aborted.

Politics will influence China's choices. Raising interest rates would hurt state-owned enterprises and state and local governments, all of which are extremely powerful, Pettis said. Exporters would fight an increase in the value of the currency. Raising wages would hurt labor-intensive businesses, which tend to be smaller and less powerful. Pettis said that is why China initially took that direction in 2010 and 2011.

China also cannot attempt to address all three factors very slowly, say over the next 10 years, Pettis said. That won't work, he said, because China will face debt-capacity constraints in three or four years.

Pettis outlined a bold approach to address the dearth of household savings. The government sector could transfer wealth to the household sector. Peasants could be granted title to their land, or industries could be privatized and their debt burden reduced. That could be followed by an increase in interest rates, he said.

Pettis said Chinese policymakers are considering this possibility, but there is tremendous political resistance to it. Local governments, for example, would lose tax revenue on land holdings.

Privatization worked for Russia in the early 1990s, Pettis said, when its government sold business for less than their underlying value. There is tremendous resistance to privatization in China, he said, but it could achieve the desired transfer to the household sector over many years.

Pettis offered a second alternative for China's policymakers – transfer debt from the private to the public sector. Japan did this, beginning in 1990, when government debt was only 20% of GDP, according to Pettis. Japan's debt-to-GDP ratio now exceeds 200%. It is also what happened in the U.S. after the financial crisis in 2008, when the government took on much of the private sector's debt.

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A good rebalancing

Pettis said he expects debt to be transferred to the government balance sheet. “We are going to start seeing some privatization and other tinkering at the edges,” he added. “Currency, wages and interest rates will go up. That is a good rebalancing.”

But rebalancing will have its downsides.

China’s export competitiveness will erode, Pettis said. “China is competitive not because of any natural reasons,” he said. “It is competitive because borrowers get free or negative capital, wage growth has been restrained and the currency is undervalued.”

Rebalancing means those things have to change, he said. That will hurt Chinese exporters, but it will be great news for countries whose exporting sectors have been decimated by China, like Mexico, Pettis said.

Investment growth rates will slow or go negative, according to Pettis. Commodity prices could drop by over 50% in the next two to three years.

“If China doesn't bring investment rates down quickly enough, they are going to run into debt capacity constraints, so it has got to happen,” Pettis said.

If China could focus on one tactic, Pettis said it should raise its interest rates significantly. That would reverse the relative undervaluation of its tradable goods sector.

“But the key point is that in the aggregate, all three of those things have to go up,” he said. “Which one goes up more than the others is a political question and not an economic question.”

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