Written by **Bob Adelmann** on February 9, 2015

China's Economy Headed for a Hard Landing

The China bubble is imploding at an accelerating rate and has caught Wall Street economists off guard, according to the *Wall Street Journal* on Sunday.

Why they should be surprised is hard to fathom, given the predictions offered for months on end about the ending of the great Chinese economic "miracle." As recently as three weeks ago, Minxin Pei, professor at Claremont McKenna College and professional observer of the Chinese economy, said, "If the official Chinese data should be believed at all … China's GDP growth at 7.4% in 2014 … could have been worse."

Indeed, it probably was. Exports in January fell 3.3 percent from a year earlier, down from December's 9.7-percent rise and a full seven percent below estimates by economists polled by the *Journal*. Imports fared even worse, dropping by nearly 20 percent from a year ago and following a 2.4-percent decline in December. This too caught experts by surprise, who had expected just a 3.3-percent decline.

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These numbers provide the economic backdrop for China's growth rate coming in at *the lowest rate in the last quarter century*, with the IMF predicting even further declines in the years to come. On the surface, China's problems have been chalked up by mainstream commentators to the country's ghastly real estate overhang and its vast excess manufacturing and industrial capacities. They refer to the dollar's strength against the yuan, making exports less and less attractive. Not one of the commentators, however, wants to place the blame where it belongs: on a state-managed economy operating under failed Keynesian stimulus programs.

In the beginning, when China's communist leaders were dismayed at being left behind by their neighbors in the mid-'70s as a result of policies imposed by the Gang of Four, they decided to try a little free enterprise. After loosening the state's noose — allowing state-owned companies to operate under modified free market principles and farmers to keep what was left of their products after paying off the state — the moribund economy began to improve. Even the entry in Wikipedia (obviously written by a Chinese statist observer) admitted that the nascent growth was due to market operations freed, however slightly, from the overweening socialist strictures that applied earlier. Said the Wiki apologist:

> The purpose of the reform program was not to abandon communism but to make it work better by substantially increasing the role of market mechanisms in the system and by reducing — not eliminating — government planning and direct control….
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> The [new] system allowed individual farm families to work a piece of land for profit … this arrangement created strong incentives for farmers to reduce production costs and increase productivity….

> [It also] allowed enterprises to produce goods outside the plan for sale on the [private] market, and permitted enterprises to experiment with the use of bonuses to reward higher productivity….
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> Individual enterprise also was allowed, after having virtually disappeared during the Cultural Revolution, and independent cobblers, tailors, tinkers and vendors once again became common sights in the cities.

It didn't take long for the loosening to show up in the numbers. Before the loosening, the combined total of exports and imports represented less than 10 percent of the total Chinese economy. By 1980 they had grown by 50 percent, to 15 percent of GDP. By 1984 they were 21 percent of GDP, and in 1986 they represented more than a third of the country's GDP.

It didn't take long for the world to sit up and take notice, and the pressure to pursue the Chinese miracle by the communist rulers became unbearable. The regime embarked on Keynesian stimulus programs, lowering interest rates, offering incentives to build out the manufacturing and real estate industries. Soon the availability of cheap money without consequences overbuilt both. With 60 million empty apartments and industrial capacity that's nearly 40 percent overbuilt, it was just a matter of time before the inevitable "adjustment to reality" began to take place.

According to Pei, the inevitable unwinding has hardly started:

> Even with last year's 4.5% drop in housing prices — the first in two decades — the unraveling of the overbuilt real estate sector has hardly begun. More than 60 million empty apartments await buyers, and the residential housing market is essentially comatose.
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> [Since] the real estate sector accounts for between 25% and 30% of China's GDP … it is impossible for the Chinese economy to regain momentum without reviving this vital industry.

The goosing of the faltering Chinese economy has led to a debt-to-GDP ratio of a staggering 250 percent, about equal to Japan's, which has labored under it for decades with little improvement.

Left to its own devices, the real estate sector would recover on its own. Buyers would learn that the prices they paid didn't reflect real market conditions, lenders would pay the price for being fooled into thinking their loans were safe and their interest rates were reasonable, and borrowers would learn the same lesson as the cost of servicing their debts would rapidly exceed their ability to pay. Eventually, all distortions that resulted from government interference in the market would be corrected.

But in China that won't be allowed to happen, for the same reasons it wasn't allowed to happen in the United States: political interests overriding the need to clear out the distortions wrought by the interventions. Pei put it well:

> The only way to breathe life into the real estate sector is to liquidate excess inventory. Housing prices need to fall to entice buyers. Unfortunately, plunging housing prices will not only hurt affluent Chinese who have poured their fortunes into investment properties, but it will also trigger defaults by overleveraged real estate developers who can no longer service or repay their bank loans.

Chinese communist politicians, just like statist politicians in the United States, won't allow the clearing of the market. Concluded Pei:

> Unfortunately, this is not going to happen. These measures … crucial to long-term growth, will likely cause an outright recession. For a leadership team that is up for reappointment in 2017, China's government will do just about anything to avoid this.

No matter the lessons of history. The laws of economics, like the law of gravity, will continue to defy politicians who think they can repeal them. The Chinese bubble will continue to implode until either the market is cleared, or the Cultural Revolution is reinstated once again, forcing the Chinese populace back into the 19th century. Indeed, even the IMF is now projecting China's GDP to fall to 6.8 percent this year and to 6.3 percent the next. Like the economists caught by surprise by the latest numbers from China, these firgures might prove to be much too optimistic.

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