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Will China's 'Doom Loop' Economy Trigger the Next Great Depression?

by Gordon G. Chang | October 2024

"We have faced the worst pandemic since the 1920s, the worst conflict in Europe since the 1940s, and the worst energy shock since the 1970s," Christine Lagarde said last month to the IMF in Washington.

"Two specific parallels between the 'two twenties'—the 1920s and 2020s—stand out," the president of the European Central Bank added, referring to "setbacks in global trade integration" and "strides forward in technological progress."[1]

The *Financial Times* summarized her talk this way: "The global economy is facing rifts comparable to the pressures that resulted in 'economic nationalism' and a collapse in global trade in the 1920s and ultimately the Great Depression."[2]

Despite the historic challenges, Lagarde, referring to the tools available to central bankers, was optimistic: "We are in a better position today to address these structural changes than our predecessors were."[3]

She may be right, but those tools, no matter how ably wielded, are not able to deal with the damage that a China in distress can cause to others.

Distress? "We have the confidence and capability to achieve the growth target of around 5% for this year," Premier Li Qiang told the World Economic Forum's Annual Meeting of the New Champions, in the Chinese city of Dalian in late June.[4]

The official National Bureau of Statistics reported that growth in the second quarter of this year was a robust 4.7%. "Chinese Economic Collapse Not Happening," a *China Daily* headline from August 29 states.[5]

There are, despite the assurances, concerns both inside and outside China. As the *New York Times* reported in September, "China's economy is confronting a crisis unlike any it has experienced since it opened its economy to the world more than four decades ago."[6]

The crisis is evident. More than a million restaurants in China have closed since the beginning of this year according to Canguanju, a news service for China's catering industry.[7] "Chinese Offices Emptier Than During Covid Pandemic as Slowdown Hits," a *Financial Times* headline from late August tells us.[8] In the all-important property sector, the value of new home sales of the 100 biggest developers fell 37.7% year-on-year in September, steeper than August's 26.8% drop.[9] Duty-free sales in Hainan Island, a major tourist destination, in the first seven months of the year plunged 30.4%.[10] Summer box office revenue was down 40.9% from last year.[11]

China's technocrats are evidently worried. At the end of last month, the Ministry of Civil Affairs announced one-time cash handouts to "people in extreme poverty, orphans, and others in need."[12]

The measure will undoubtedly boost consumption, but it will only be a sugar high for a short period. "The problem is that the amounts are likely to be too small to matter and, more importantly, that these are one-off fiscal transfers that don't really address the underlying income distribution that has created the imbalances," wrote the widely followed Michael Pettis of the Carnegie Endowment for International Peace on X. "Until structural reforms are implemented that eliminate the implicit and explicit transfers that force households to subsidize production and investment, the underlying imbalances won't really change."[13]

Don't except the change that is absolutely needed. China, as Nobel laureate Paul Krugman told Bloomberg Television in early June, "seems bizarrely unable" to take "even modest steps towards a refocusing on domestic demand."[14] "The chance of structural reform in Xi Jinping's China is," as Anne Stevenson-Yang of J Capital Research USA told me, "none."[15]

Without reform of that type, consumer spending cannot recover. China's economic system is geared to depressing consumption. For instance, deposit interest rates at banks have been kept artificially low to support state lending for uneconomic projects now scarring the country. Furthermore, the nationwide *hukou* system of household registration, which prevents rural Chinese from obtaining residency in urban areas and thereby earning higher wages there, also undermines consumer spending.

Xi Jinping certainly does not believe in empowering citizens. Moreover, as Zongyuan Zoe Liu writing in *Foreign Affairs* notes, the Communist Party leadership also abhors consumer spending, believing "consumption is an individualistic distraction that threatens to divert resources away from China's core economic strength: its industrial base."

By bolstering manufacturing, China's leader is pleasing core Communist Party constituencies, helping struggling state banks, and building China's capacity to wage war. As Liu points out, Beijing's policies are currently aggravating the overcapacity problem, not mitigating it.[16]

When Beijing "uncorked sweeping stimulus measures"[17] last month, Beijing's technocrats resorted to their old tactic of lowering the cost of funds to help industry. The People's Bank of China, the Chinese central bank, announced deep rate cuts, what Julian Evans-Pritchard of Capital Economics termed "the most significant PBOC stimulus package since the early days of the pandemic."[18]

Although foreign investors cheered the move, it's not evident that cheaper money is the answer. Extremely weak demand for credit from both businesses and consumers means that even lower rates cannot stimulate economic activity. Moreover, it's unlikely, as James Mackintosh argues in the *Wall Street Journal*,[19] that more state intervention in the economy is going to cure the ails caused by previous state intervention. The central bank rate moves along with other measures, therefore, are not the "bazooka" that observers and market participants have been looking for.

Xi Jinping, as is evident from last month's moves, wants to continue building industrial capacity even though China's factories produce far more than the Chinese people can consume.

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China's plan is to export its way out of its economic difficulties, but as Krugman points out, the world is not big enough for Xi's plan to succeed. "We can't absorb," he says. "The world will not accept everything that China wants to export."[20] As he suggests, countries are not willing to let China decimate local industries. The U.S., the EU, and even the Global South are beginning to restrict access to their markets with tariff increases and other moves. China's leader, as is already evident, is exacerbating tensions and contributing to the delinking of economies as he employs predatory and criminal trade policies.

As a result of Xi's policies, China is entering, as some say, a "doom loop."[21] Many put it this way: China now has a "garbage economy." "China's economy is in a slow grind downwards," Andrew Collier of Hong Kong-based Orient Capital Research told me.[22]

"It's a grim situation for Chinese people," says Stevenson-Yang, also author of *Wild Ride: A Short History of the Opening and Closing of the Chinese Economy*. "The sad thing about China is that the economic model has reached the end of its useful life, and there is nothing to do but change the model or incur great suffering."[23]

Xi faces another problem. No matter how fast it is growing—the economy could even be contracting at this moment—China does not appear to be producing sufficient output to service indebtedness it incurred, especially since the latter part of the first decade of this century. Then, the country embarked on a massive stimulus program to avoid a downturn in 2008.

Beijing succeeded in maintaining growth but only by making the country overly dependent on government spending. China built too many skyscrapers, high-speed rail lines, and apartment blocks. For instance, He Keng, a former senior statistics official, in 2023 gave a public speech revealing that the country had enough vacant apartments to house the entire population of 1.4 billion people. He noted that some put the figure at three billion.[24]

Now, China is undergoing its long-delayed 2008. Debt defaults, beginning with the high-profile failure of Evergrande Group in 2021, threaten to derail the economy. The defaults are now rippling from property developers to associated businesses. As Caixin Global reports, "China's construction industry is reeling from a wave of defaults and financial turmoil as delayed payments and rising bad debts cascade through the sector."[25] China's "cement production has been collapsing ever since the real estate bubble popped in 2021," writes Bloomberg Opinion's David Fickling,[26] and companies are failing.

More defaults are virtually inevitable because China's total-country-debt-to-GDP ratio is dangerously high. After taking into account the so-called "hidden debt" and adjusting for inflated GDP reports, the ratio could be, according to my estimate, 350%.

Given simultaneous challenges, China has an extremely small chance of avoiding a financial crisis. As President Joe Biden said in August of last year at a private event for Democratic Party donors in Salt Lake City, China is a "ticking time bomb."[27] In his May 28 *Time* interview, Biden said China's "got an economy that's on the brink."[28]

Now, there is little that the world can do, in large part because almost all of China's debt is internal. When a country, such as Argentina, owes money to outsiders, the world can help, by forgiving debt or rescheduling payments.

Moreover, it is politically easier for the Argentinas of the world to resolve debt than the Chinas. When a country with foreign debt has trouble repaying, the government sends its well-dressed finance minister to New York, negotiates debt relief, and accepts applause for making foreigners take the losses.

China can't do that, however. Any resolution of its debt crisis necessarily requires domestic parties suffering losses. So far, the Communist Party has not exhibited the political will to enforce painful solutions. Its continual failure to resolve the debt situation has meant

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the government has had no option but to resort to short-term measures, such as September's one-time payments and more debt-fueled stimulus. Stimulus is losing its effect, however. China, incredibly, now incurs about nine yuan of debt in order to produce one yuan of gross domestic product.[29]

Many don't worry about China because of its large foreign exchange reserves, officially reported to stand at $3.29 trillion at the end of August. That confidence, however, is misplaced. For one thing, foreign currency has only limited utility in a local debt crisis, and in any event it appears Beijing's technocrats have stuffed non-portfolio investments and loans in the reserves so the country does not have all the liquid assets claimed.

Ms. Lagarde faces another challenge in managing the crises she foresees. "For too long, central banks and governments have been rigging financial markets to manufacture the appearance of prosperity, all the while piling up monumental debt mountains," Charles Ortel, a retired banker and private investor who comments on financial markets and geopolitics, said to me in September. "So a reckoning looms and likely involves bankruptcies and restructurings that may prove more devastating than what happened in America from 1929 through 1941."[30]

In the next global reckoning, China will be especially vulnerable. As in the Great Depression, the current-account-surplus countries have the hardest time adjusting to deteriorating economic conditions and declining trade. China, a surplus country, is extraordinarily dependent on foreign markets, especially because Xi Jinping has rejected consumption as the basis of his economy and is relying on China's export factories. The Chinese state, for all its apparent strength, cannot solve its own problems. Its fate is now in the hands of the world.

China accounted for around 30% of the world's growth last year, Peng Sen, president of the China Society of Economic Reform, told the China Economic Outlook session of the Annual Meeting of the New Champions.[31] The IMF's Steven Barnett believes China will be the single largest contributor to global growth in 2024, accounting for over a quarter of it.[32]

Many are impressed by China's heft and think the country's decades-long upward trajectory will last forever. That belief, however, defies the history of economic development across societies. The Chinese state is big, but that does not mean it is immune to the laws of economics.

Despite what Christine Lagarde announces, she and other central bankers have no tools to stop the panic a Chinese failure will almost inevitably cause. Central bankers are especially helpless because, while the world is at a particularly vulnerable moment, its second-largest economy is led by a strongman who, for deeply held ideological reasons, refuses to take commonsense advice and is relentlessly determined to lead his country in wrong directions.

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