

Meet the Man Who Predicted the Chinese Economic Collapse

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And find out what will happen next

Back in 2012, when oil prices were above \$100 per barrel and the Chinese economy was growing at over 10% per year you'd be hard pressed to convince anyone that a commodity price collapse, fueled by a sputtering China, would be the event that finally brought the world back into recession.

Unless, of course, that person followed the writings of Michael Pettis, a former Wall Street trader and professor of finance at Peking University's Guanghua School of Management. For years, Pettis has been warning of the growing imbalances in the Chinese economy, [and he called the commodity price collapse](#) as early as 2012.

Pettis argues that the Chinese economy is following the example of many countries that came before,

like the Soviet Union following World War II, the Brazilian economy in the 1970s, and Japan in the 1980s. In each of these cases, national governments put forward policies that artificially boosted investment and suppressed consumption, policies that led to a fast buildup of growth and large trade surpluses. But eventually these imbalances go into reverse, and that is what is happening now. *Fortune* reached out to Pettis to get his take on what will happen next in China, and how it will affect the U.S. economy. The interview has been edited for length and clarity.

Fortune: At what point did you recognize that China's growth model was unsustainable?

Michael Pettis: Pretty early on—by 2006, it was obvious. **What made you realize that China's growth model was like the failed experiments in places like Brazil?**

[Economist] Alexander Gerschenkron argues that there are two fundamental parts to an investment-led boom. First, you have to force up the savings rate, which you do by constraining growth in household consumption. And next you have to direct the investment process. But if you look at all the investment growth miracles, they all did that.

One of the things that really struck me was that during the miracle periods, at first when growth rates are really high, everyone is shocked. And then during the adjustment period, it slows so quickly, we're all shocked. There's been no exceptions. It's always like that. We're shocked on the way up and shocked on the way down. This happens to individual companies, too. Take a company like Enron, which is a very common story. Before Enron fell apart, it was just growing spectacularly. I think it was the most admired company in America eight out of 10 years before it went under. When a company or country has an inverted balance sheet [i.e. one with an asset structure that doesn't hedge bets, but amplifies them] it's really like you have your correct balance sheet with a very speculative overlay on top of it. All you're doing is exacerbating underlying conditions. It's like if you invest in the stock market, but you margin write it to the hilt. If the market goes up, you make more money than anybody else, and you and everyone else start to think you're a genius. And when the market goes down, you get wiped out. And it seemed to me that these economies were doing something very similar. They were growing much more quickly than we had any right to expect. And then suddenly they were slowing much more quickly than anyone believed possible. **For years, you have been predicting a collapse in commodity prices. Most economists don't see the crash infecting large economies like the United States. Why are they wrong?**

In places like China and Germany, we're seeing high income inequality while the household share of GDP is quite low. The inequality has the same impact. It pushes up the savings rate because the rich save more than ordinary people. Is that good or bad? Supply siders tell us that it's always good to increase the savings rate. Keynesians will tell us no, we have to increase demand.

The truth is they are wrong, or that they are both right only under very specific conditions.

For much of the 19th century, there was a huge "problem" of income inequality in England, and so the savings rate was too high. But you had ... the United States, which was credible and urgently needed excess savings from England to fund productive investments. That's where the excess savings went, and the English got richer, and we got richer.

If you have productive investment that's credible and that's being constrained by the lack of savings,

then income inequality is actually good for the economy. But if you don't, then you have the problems that you saw in the 1930s, where excess savings forced down the savings rate in the middle class by forcing up consumption. The savings go into speculative markets. Stock markets go up, real estate goes up, we all feel richer, just like during the real estate bubble. But once that game stops because of debt, then you still have to balance savings and investment. But because nobody is investing, then you've got to bring savings down. And the way you bring savings down is firing workers.

And that's what we're seeing around the globe, with job losses beginning in the commodity sector. I think Larry Summers is right [in saying that the globe is starved for demand](#).

You see this as the beginning of a long period of slow global growth?

Yes, we're in a period of weak global growth, in which trade is going to get worse. And we're going to see a wave of sovereign defaults. What really worries me is that the Europeans have been incredibly irresponsible. The huge German problems, which first bankrupted Europe, were then forced abroad. And China also has a huge surplus, Japan has and needs a rising surplus. Who's going to absorb it? In the last few years it has been the metal producers and the energy producers—their trade deficits grew. But they can't do that anymore. In fact, Brazil will run a surplus this year from a deficit last year. So something's gotta happen. And arithmetically, only two things can happen: either the surpluses of Europe and China go down, or somebody else's deficit has to go up. And that country is always the most open economy that allows capital inflows: The United States, Canada, Australia, and the U.K. And my really big concern is that we're going to see a soaring trade deficit in the U.S. which could derail the U.S. economy, which is the only bright spot right now.

Would it be rational for American policy makers to enact protectionist policies to prevent a soaring trade deficit?

We all know from [economist David] Ricardo that free trade is wealth enhancing, but in the 1920s and 1930s, when countries, rather than create domestic demand, tried to expand their share of global demand, they actually ended up reducing overall demand. If you lower wages or depreciate your currency, total global demand actually goes down but you get a bigger *share* of global demand. And when you get caught up in that spiral, you get yourself caught up in what happened in the 1930s.

The best thing would be for the world to get together and say we can't allow this to happen, it would be incredibly stupid. But I'm not confident that this will happen.

How do you feel about the Chinese government's attempt to soften the landing?

From an abstract point of view, it's easy to tell the Chinese what to do. You must put forward reforms that are consistent with the two most important objectives. Objective No. 1 has to be to find a new source of demand that doesn't come from debt, and objective No. 2 is to bring debt levels down.

They need to increase the household share of GDP. It's rising slowly, but they need to speed it up, and the only way to do that is to transfer wealth from the state sector. But as you know, politically, that is really tough.

How do you practically transfer wealth to Chinese households?

In principle, you could cut taxes on the poor, but they don't pay a lot of taxes so that's not going to help much. You could eliminate the [hukou system](#). That would make poor migrants immediately richer because now they can send their kids to school and find better paying jobs. That's really politically tough to do.

You could privatize corporations and simply give the shares to households, [as they did successfully in Austria](#).

You could transfer ownership shares to the local social safety net. Shandong province did that in March. The problem is that the pension fund has very low credibility.

If you look at the [3rd plenum reforms in 2013](#), almost all of them aim to [boost consumption] But to actually accomplish these goals, you have to reduce somebody's wealth, and guess whose wealth it is? The government and the wealthy. So there's a lot of opposition.

The economists keep giving the administration terrible advice, like if you improve the efficiency of, say the peanut business, that's going to make a difference. They have to recognize that reforms that don't reduce debt or increase household wealth are simply not going to matter. And that's the end of the story.

If GDP growth is 1/10th of a point higher than expected, instead of applauding, we should be groaning. You can get any level of growth you want as long as you increase debt. Obama could get 7% growth if he wanted, if he tore Chicago to the ground and rebuilt it. It's just a stupid way of getting growth.

A pedestrian walks past an electronic screen displaying the closing figure of the Hang Seng Index in Hong Kong, China, on Wednesday, Jan. 20, 2016.

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