



Macro Picture

CHINA'S CREDIT IMPULSE STRIKES AGAIN

Dario Perkins

China is experiencing another of its periodic “Lehman moment” scares. Every time the authorities rein in their enormous credit splurge, their actions damage economic and market prospects in the rest of the world. Major global spillovers – through trade, finance and market sentiment – mean China’s “new policy regime” is a problem for a world lacking secular catalysts.

Chart 1: Tight policy in China to spark another global growth scare?



Sources: Bloomberg estimate of credit impulse, Markit PMI data.

ANOTHER CHINESE LEHMAN

Fears of a Chinese “hard landing” emerge every few years, part of the authorities’ radical stop-go policy cycle. This time, investors are focused on Evergrande and the risks that have appeared in China’s property sector. Since real estate now accounts for around 30% of China’s economic activity, a serious slump in the property sector could have powerful systemic consequences.

CREDIT STIMULUS RESPONSE

Big swings in China’s credit cycle have had an important bearing on global industrial activity over the last decade, with periods of domestic policy tightening usually sparking broader “risk off” episodes in global markets. China’s dominance – which still puzzles many investors – reflects powerful spillovers through trade, commodities, financial markets and risk sentiment.

CHINA'S BIG POLICY DILEMMA

The authorities can contain the fallout from Evergrande, but this latest crisis highlights the crucial dilemma the country is facing. For over a decade, China has used an unsustainable credit splurge to mask an underlying economic slowdown. If the authorities are serious about reining in these excesses, China – and potentially the rest of the world – faces secularly lower growth.

CHINA'S CREDIT IMPULSE STRIKES AGAIN

It is no exaggeration to say China has a “Lehman-moment” scare every few years. This is the result of the country’s radical stop-go policy cycle, imposed on an economy that has developed serious underlying imbalances over the past decade. Whenever the authorities become particularly worried about the fragility of the financial system and try to curb excessive borrowing, they force the economy to slow – often more sharply than they anticipated – which sparks fears of an economic “hard landing”. Usually, the authorities will then panic in the opposite direction, restimulating an economy that has already produced the largest accumulation of debt in modern history. This time, investors are focused on Evergrande, the world’s most indebted property developer. With a financing model that resembles a Ponzi scheme, Evergrande is a systemic threat to China’s entire property sector. Plunging confidence and asset fire-sales could cascade across the industry, causing a collapse in the housing market. Evergrande is not an isolated problem – it is a symptom of a sector that has grown too rapidly in recent years, exhibiting many of the traits of previous housing bubbles (such as in Spain and the US in the early 2000s). According to [a study by Ken Rogoff and Yuanchen Yang](#), Chinese real estate is now responsible for around a third of the country’s GDP. So, a sustained slump would be a serious problem, not just for China but potentially the entire world economy.

China’s domestic policy swings have had an outsized impact on the global industrial cycle over the past decade, a dominance that has puzzled many institutional investors. Episodes of policy tightening in China tend to foreshadow global growth/deflation scares, typically with a lead of around 8-10 months. Conversely, when the authorities in China are trying to stimulate their economy, a period of “global reflation” usually follows. On one level, of course, these links are intuitive. China is now the second-largest economy in the world, with a particularly large appetite for commodities. When traded goods prices are rising/falling, the global macro climate always feels more reflationary/deflationary. Even market-based expectations for long-term inflation tend to track the global commodity cycle. And with a general scarcity of growth in other parts of the world, the sheer size of China’s balance-sheet expansion (the authorities have added \$30 trillion in new credit since 2008) has made the country a major catalyst for global demand. Yet China’s international footprint seems to go beyond conventional trade links. Most Western economies have only limited “direct” exposure to China and a significant part of China’s industrial activity is, in fact, derived from demand elsewhere (reflecting the country’s role in international supply chains). This suggests China’s spillovers also operate through “indirect” channels, including via asset prices, international investment and broad market sentiment.

Those pundits who have spent the last decade (or longer) waiting for China’s “Lehman moment” are likely to be disappointed, again. Since the debt bubble involves largely state-owned banks lending to state-owned (or quasi-state owned) enterprises, there is no real prospect of a “margin call” (necessary for the Minsky crash). [Our China analysts think the authorities will be able to ring-fence Evergrande](#) to protect homebuyers (who are waiting for property to be completed) and prevent a systemic collapse in the real estate market. But officials face a crucial dilemma, one they have repeatedly tried to dodge since the global financial crisis. If Xi Jinping is serious in his desire to create a new macro regime for China – “Common Prosperity”, which aims to pivot the economy away from market capitalism and curb the “excesses” of the last decade – the authorities must halt China’s rapid accumulation of debt and allow the economy to settle onto a more sustainable medium-term growth trend. And this ambition has important implications for the rest of the world. Unless the global economy can discover new secular growth catalysts to replace China’s state balance sheet, it will find it even more difficult to escape secular stagnation. Western countries will struggle to “run their economies hot” if China is “running cool”.

1. ANOTHER CHINESE LEHMAN

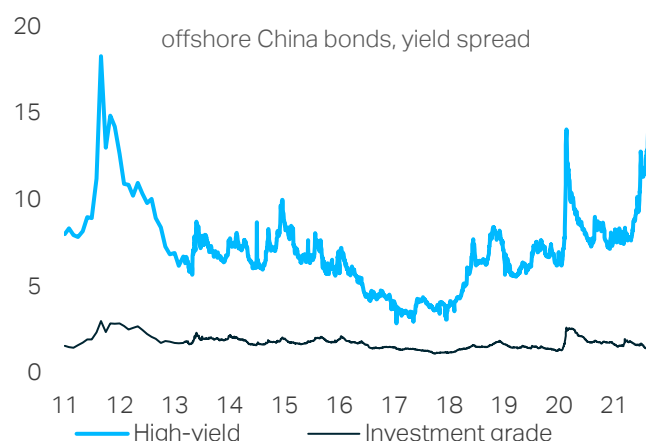
Suddenly everyone is worried about China's financial fragility. Yet this is a hardly a new risk for global markets: in fact, it has been a recurring theme for a long time. Doubts about the sustainability of China's economy first appeared in the mid-2000s, even before the 2008 global financial crisis. FOMC transcripts, for example, show US officials became particularly worried about China's "economic imbalances" in May 2004, when the central bank devoted a section of its policy debate to this risk. One FOMC member summed up the mood, telling his colleagues: "The problem is that by all accounts the boom in China is unsustainable. Money and credit have been growing at an annual rate of around 20 percent for a couple of years. That's about twice as fast as productivity growth." And, he continued, since "the Chinese economy now is a lot larger than it was [in the 1990s], it therefore has significantly greater potential to affect the U.S." In a section of the transcripts that could have been written last week, the FOMC agreed to "make a special effort to determine as best we can the degree to which instability in China's macro economy could affect the U.S and potentially U.S. monetary policy going forward."

Chart 2: Not so Evergrande



Source: Datastream.

Chart 3: Contagion hasn't spread – yet

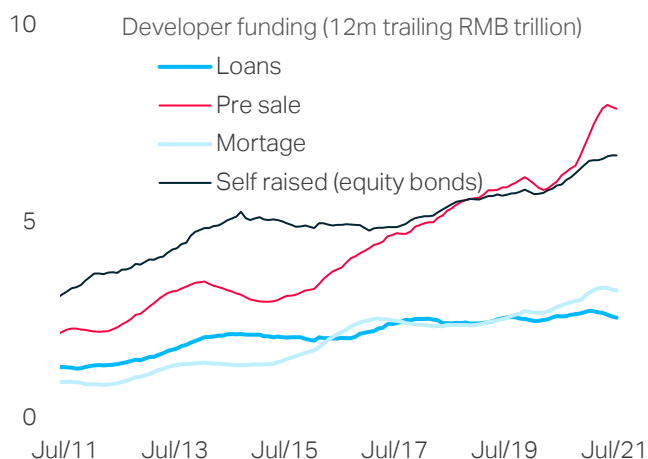


Source: Bloomberg.

China has a 'Lehman' scare every few years

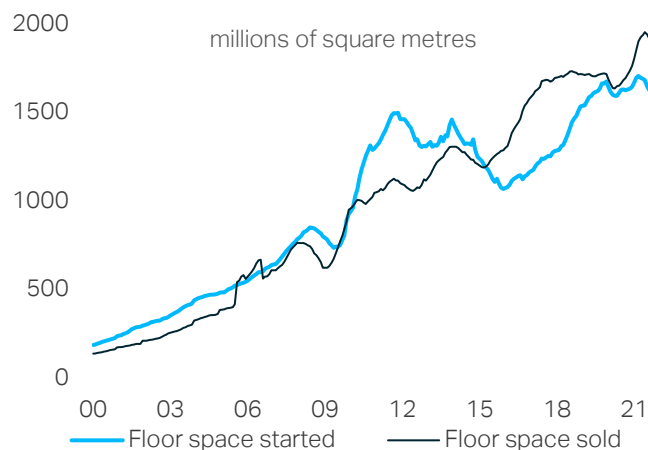
Since then, of course, China has had a serious growth scare every few years. In 2009, investors were worried that the US subprime crisis would break China's "export-led" growth model, causing a persistent economic slump. In 2013, Martin Wolf from the *Financial Times* warned about the serious dangers that had appeared in China's "shadow banking system" and the probability of a "hard landing". 2015 was the year China's stock market plunged ("Black money"), a crash that reverberated around the world, delivering a wider global growth scare and a collapse in commodity prices. And in 2018 there were widespread fears that China would respond to President Trump's trade war by devaluing RMB, making Chinese exports a powerful deflationary force for the entire world economy. Each of these episodes produced speculation that China's was about to suffer its "Minsky" or "Lehman" moment, an event that would expose the country's underlying imbalances and cause a precipitous economic collapse. But it turns out China can remain "unsustainable" and on "the brink of a crash" longer than most investors can maintain a "short" position on China's economy. Minsky still hasn't had his moment.

Chart 4: China developers' Ponzi funding model



Sources: CEIC, TS Lombard.

Chart 5: Construction boom

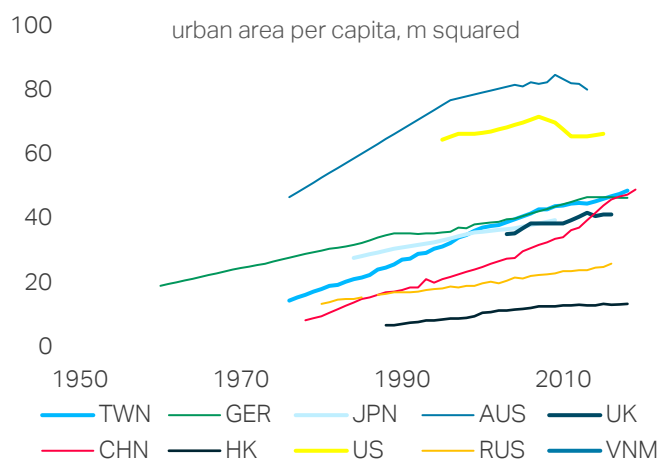


Sources: CEIC, TS Lombard.

The trouble at Evergrande

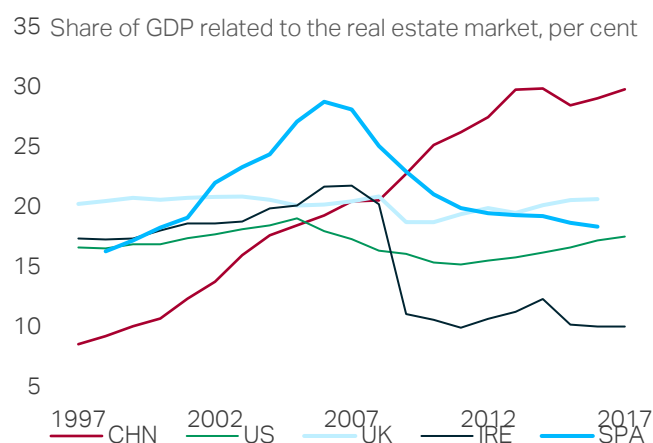
The latest China scare is focused on the property market. The authorities have announced a tough stance on property developers as part of their attempt to slow debt accumulation in the sector. This includes the “three red lines” framework, which imposes tough regulations on developers’ balance sheets. The government is hoping it will stabilize the broader housing market because debt-fuelled competition among developers – as they tried to capture as much land as possible – has been contributing to a speculative frenzy. Naturally, the new regulations pose a serious problem for companies like Evergrande, which is now the epicentre of market anxiety. Evergrande is famously the world’s most-indebted property developer, with total liabilities of at least \$300 billion (more if we include off-balance sheet exposures). It owns around 1,300 projects in more than 280 cities, but its financial footprint extends far beyond the property sector. The problem for Evergrande – indeed, for Chinese property developers in general – is that their business model depends on continuous debt accumulation. They borrow money, buy land, sell properties (sometimes years before completion) and then combine the sale proceeds with more debt to leverage their way into new developments and other lines of businesses. If this financing strategy – which resembles a Ponzi finance scheme – is no longer acceptable to the Chinese state, Evergrande (and other property developers) are facing an existential threat.

Chart 6: China now as urbanized as W. Europe

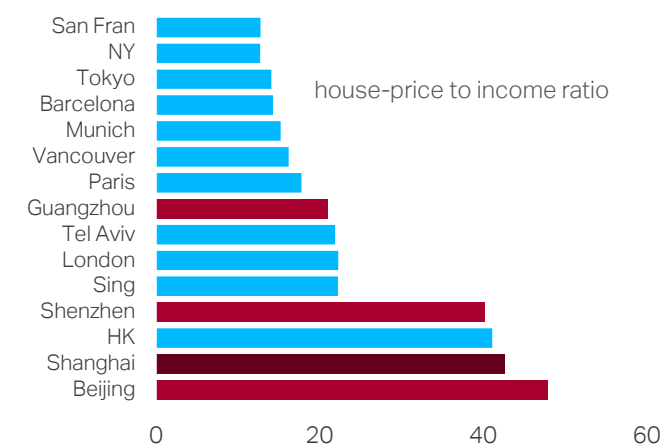


Sources: Katherine Shanae Ellsworth-Krebs, CEIC.

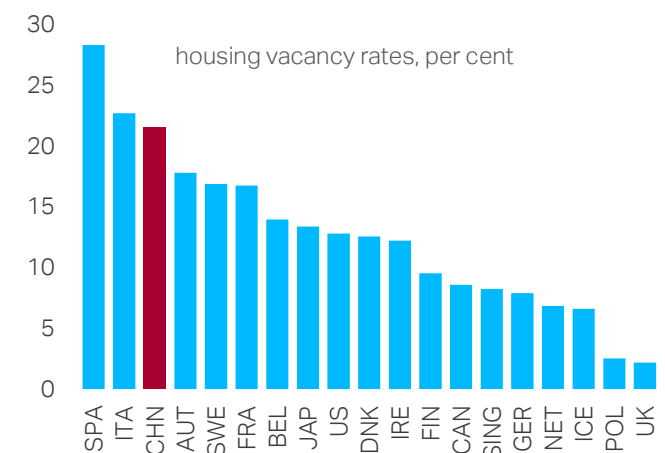
Chart 7: Real estate – macro spillovers



Source: Rogoff and Yang (2021)

Chart 8: Chinese cities are expensive


Source: [Rogoff and Yang \(2021\)](#)

Chart 9: Still lots of vacant properties


Source: [Rogoff and Yang \(2021\)](#)

Systemic impact from Evergrande

Evergrande poses a systemic threat to China's entire property sector. The company's collapse – shares are already down more than 90% since the recent peak – could unleash contagion through various channels:

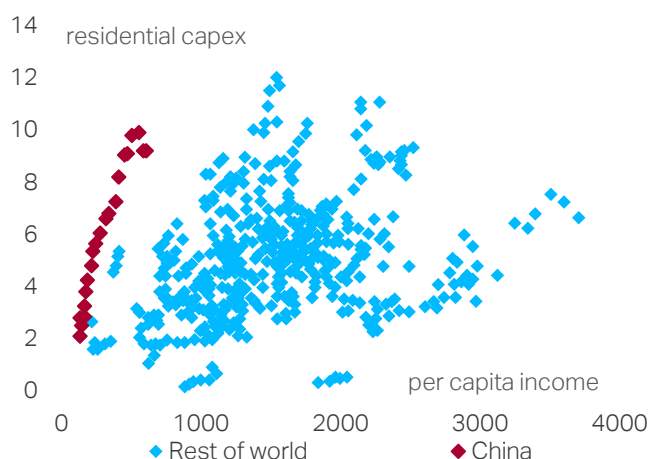
- (i) **Property prices:** There are reports that Evergrande is dumping its property holdings at steep discounts (up to 30%) in order to raise cash (although officials in some regions have tried to ban large discounts). Meanwhile, negative news stories about the company and the risks to the property sector have already triggered a sharp decline in demand for property. Unchecked, asset fire sales and skittish homebuyers could produce a sizeable decline in property values. In China, housing accounts for around 60% of households' asset holdings.
- (ii) **Suppliers:** Evergrande's failure is obviously a threat to its extensive supply chains and, unfortunately, property development is a resource-heavy activity. Worse, many of these suppliers have been investing in Evergrande securities, accepting commercial paper/trade receivable instead of cash. Default would damage both future earnings and current balance sheets.
- (iii) **Banks:** 30% of Chinese bank loans are directly attributable to the property sector. Land is also the primary source of collateral for a broader range of loans (around 40% of total borrowing). A collapse in the sector would prompt a rise in non-performing loans and could destroy the banking sector's assets. This, in turn, could force a more generalized tightening in lending standards, even a credit crunch.
- (iv) **Shadow banks:** Some estimates suggest that around 45% of Evergrande's liabilities are with trusts and shadow lenders. Its financing arm even sold credit products known as wealth management products to retail investors – mainly, it seems, to employees, banks and local suppliers.
- (v) **Local governments:** Proceeds from land sales accounts for 40% local government revenue. Moreover, local government financing vehicles are often capitalized via land transfers from their respective municipality/province. Falling land sales/prices will squeeze both on and off balance sheet funding governments.

- (vi) **Risks to offshore debt markets:** Chinese developers are relatively large issuers of USD-denominated debt. Since holders of these bonds are unlikely to get priority in any debt restructuring – the authorities will focus on protecting homebuyers and domestic suppliers – we are likely to see a number of defaults. China's foreign debts are not huge (around 5% of GDP) but it could mean losses for overseas lenders, which would cause a more generalized increase in the risk premium for Chinese securities, especially if investors see a more dangerous regulatory regime.

Risks to China's property sector

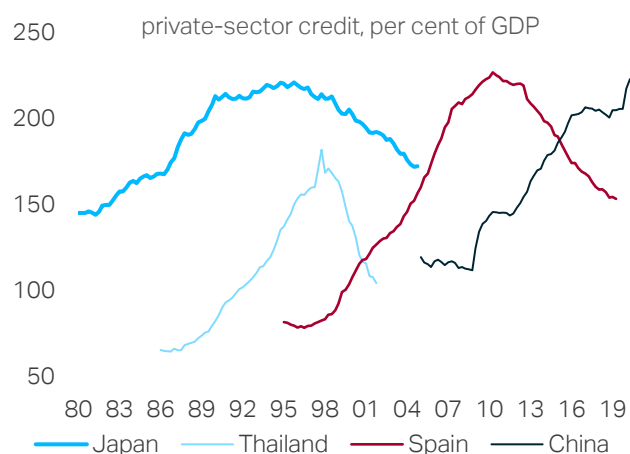
While the systemic risks associated with Evergrande are troubling, the underlying issue is not China's largest property developer per se but rather the difficulties China will face as the authorities try to transition away from the economic model of the last decade – a model heavily reliant on unsustainable debt accumulation. This is where the comparison with Lehman is more meaningful. Evergrande is a symptom of a massive credit and housing boom, much like the US investment bank during the subprime crash. Indeed, [a recent paper by Ken Rogoff and Yuanchen Yang](#) argues there are strong parallels between China's housing market today and many of the classic real estate bubbles of the past, including what happened in the United States and in Spain in the early 2000s – booms that ended in a precipitous collapse. Rogoff and Yang (2021) point to similarities not only in the evolution of house prices and debt accumulation but also in the share of resources that have been devoted to the property sector. Including upstream and downstream linkages (everything from the resources used to build houses to the maintenance/sale of existing buildings), they estimate that Chinese real estate is responsible for around a third of the country's GDP. If their analysis is correct, it will be hard for the authorities to replace the income and jobs that might be lost if there were to be a slump in this sector.

Chart 10: Too much housing too soon?



Sources: [IMF working paper](#), CEIC.

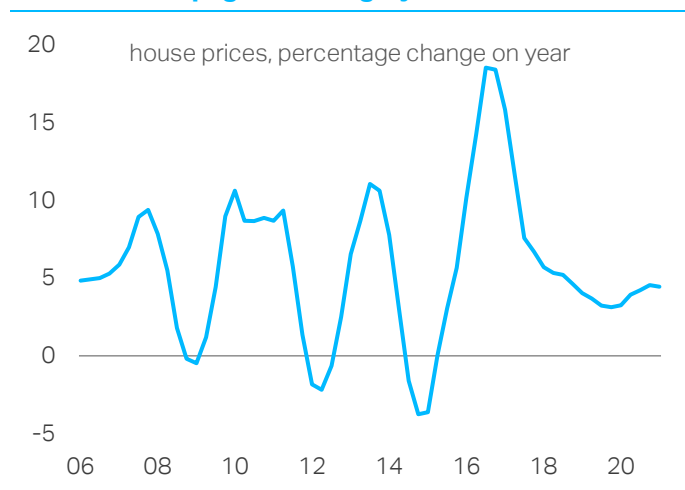
Chart 11: China credit splurge



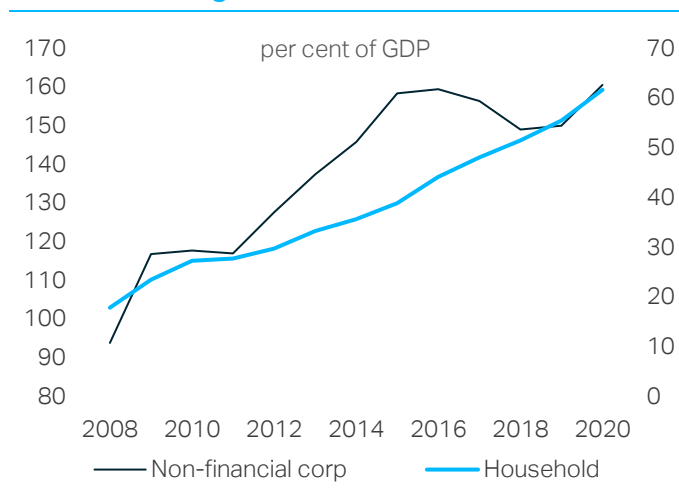
Sources: BIS, TS Lombard.

On one level, it is not surprising that a rapidly developing country – with a strong urbanization drive – is devoting a larger share of its resources to real estate. China's initial housing stock was low as there was no private market until the mid-1980s. The issue is whether this process has gone too far – too much has happened too quickly – causing a bubble to form. There are several warnings signs. First, total urban footage is already in line with that of many developed European economies. Second, property is now relatively expensive, especially in Tier 1 cities, where affordability looks stretched and vacancy rates are high (property is often held by speculative buyers who have no interest in either moving in or renting out.). Third, current housing valuations make sense only if China can continue to grow at a rapid pace. But the economy appears to be

suffering a structural slowdown. Demographics are looking less favourable, urbanization is slowing and productivity has lost momentum (the “catch-up” potential has gone). Like Evergrande’s financing model, China’s property market probably requires continued rapid economic growth and ever-increasing leverage to be sustainable over the longer term.

Chart 12: Stop-go housing cycles


Sources: BIS, Datastream, TS Lombard.

Chart 13: Rising debt levels


Sources: BIS, TS Lombard.

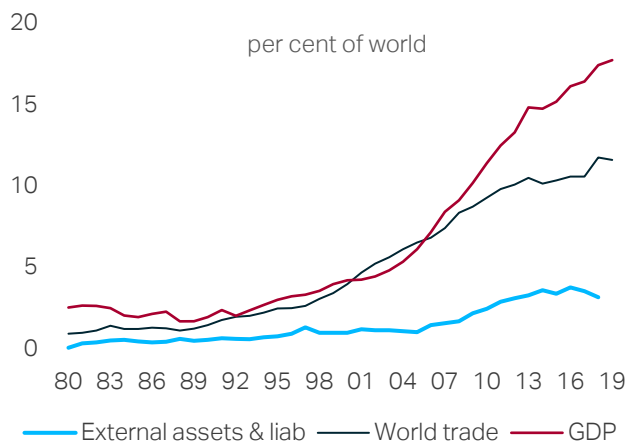
China needs new growth model

The underlying problem is that China needs a new growth model. After the 2008 crisis, the authorities essentially replaced their previous “export-led investment” strategy – untenable in a world of subdued international demand – with a domestic credit splurge. They kept investment high by leveraging up various balance sheets across the economy – starting with those of state-owned enterprises and then pushing the debt into the government and household sectors. This is where the property sector was useful: it became a vehicle for government stimulus, with land sales allowing regional officials to hit ambitious GDP targets. The expansion in leverage over the past decade has been huge, perhaps the largest and fastest debt accumulation in history. Yet, at the same time the authorities are aware of the risks such an approach creates, particularly in terms of the fragility of the banking and financial sectors. And this is the reason why the run-up in China’s debt has been uneven and policy has been “stop-start”. Whenever the authorities have tried to damp excessive borrowing, the economy has slowed more sharply than they expected, forcing them to restimulate and thereby compounding the economy’s imbalances and creating new sources of financial fragility. The Evergrande saga is a reminder of this underlying policy conflict. And what China chooses to do always has a powerful impact on the rest of the world.

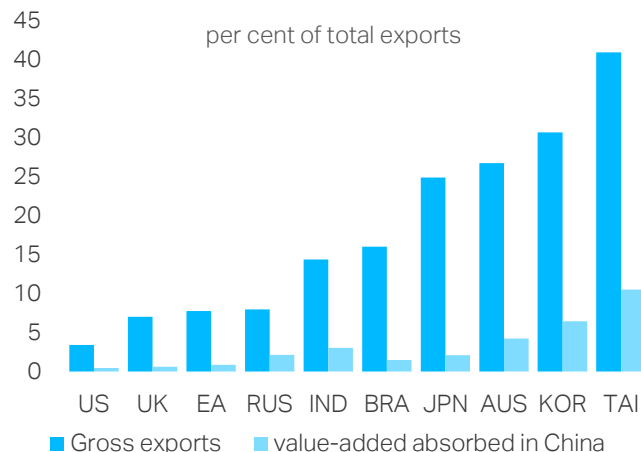
2. CREDIT IMPULSE

If there is one piece of analysis that has surprised investors over the past decade, it is our front-page chart (Chart 1), which shows the impressive correlation between China’s domestic policy cycle – proxied with the “credit impulse” – and global industrial activity. Whenever China stimulates its economy, the rest of the world eventually experiences a cyclical recovery – typically around 8-10 months later. When China tightens policy and domestic credit becomes scarce, the rest of the world experiences a cyclical downturn (with a similar lag). By now, of course, this correlation is widely known and totally mainstream – there are rigorous analytical reports, produced by some of the largest asset managers, explaining how investors can take

advantage of this information. But it still requires an explanation, not least because it is difficult to pin down China's apparent dominance of the global cycle through conventional macroeconomic analysis. Since these mini-cycles in global industrial activity have defined the "reflationary" vs "deflationary" temporary episodes that were a feature of the pre-COVID economy, it is hard to escape the idea that China's domestic policy is a crucial driver of global market narratives.

Chart 14: China's global exposure


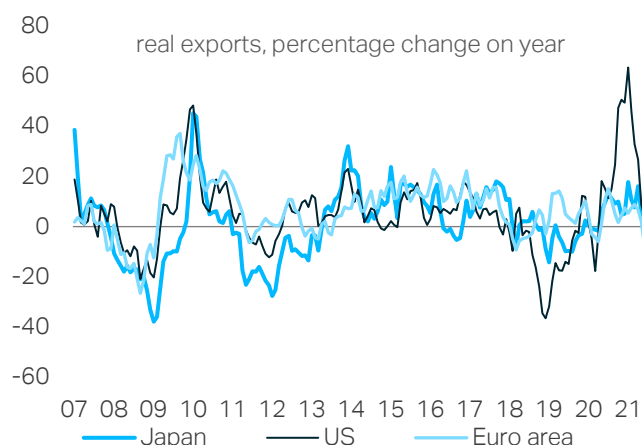
Sources: IMF, BoE, TS Lombard,

Chart 15: Trade links to China still modest


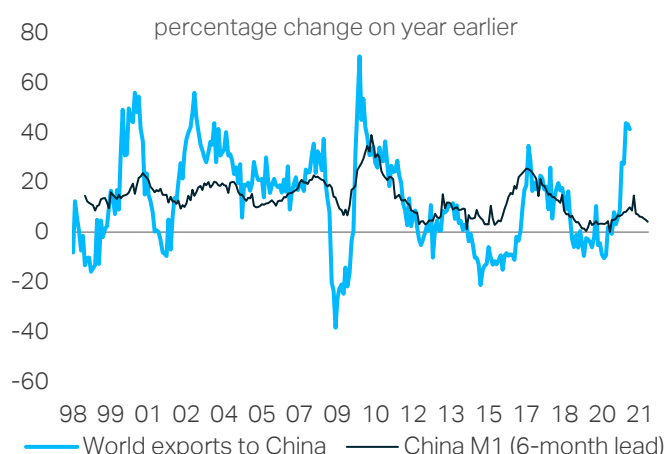
Source: ECB analysis on China spillovers.

China's global footprint

On one level, it should not be surprising that China has become crucially important for the rest of the world. Its economy has grown rapidly over the past decade – GDP has increased by 6-11% in every year since the global financial crisis – and is now the second largest in the world. With GDP growing by 6-11% in every year since the global financial crisis, China is directly responsible for a significant part of the global expansion and, in particular has become an important source of international commodity demand, totally dominating many of these sectors (see Chart 18). Inevitably, this has had a powerful impact on many other emerging economies (in aggregate, those economies are now a larger share of GDP than the developed world). Yet, "direct" trade exposures with China are only part of the story. China's global "spillovers" seem to go well beyond the amount of commodities and other imports the country consumes – especially as some of China's demand is derived from other parts of the world.

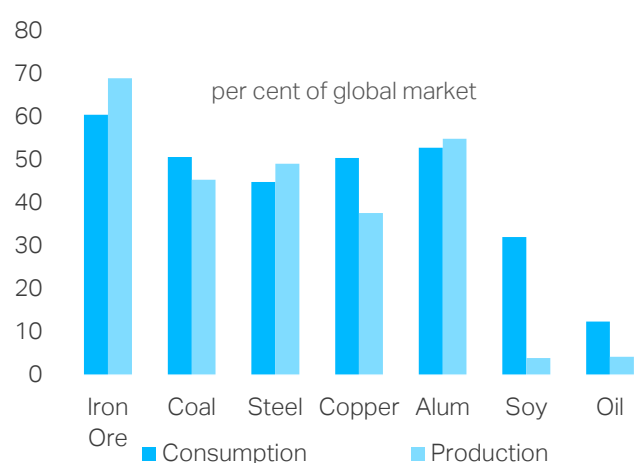
Chart 16: Exports to China


Sources: national sources, TS Lombard estimates.

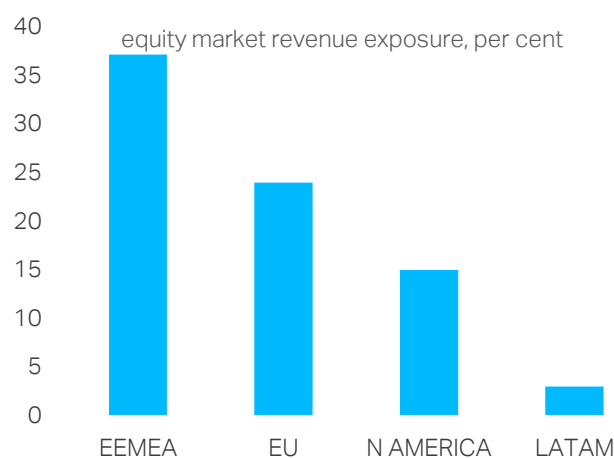
Chart 17: Stop-go import cycles


Sources: Datastream, TS Lombard.

Traditionally, China has been a processing hub, assembling components and parts produced in other countries (notably the rest of Asia) in order to meet demand from the US and other international markets. [Smartphones are one obvious example](#): China imports huge quantities of components from other Asian markets (such as Korea) and then exports the finished handsets to the US and Europe. Statisticians have developed useful ways to adjust standard trade data to reflect these processes, by calculating the “value added” at each stage of production. While China’s role as a processing hub has declined somewhat over the past decade (domestic consumption has increased), most major countries’ value-added exposure to China is even lower than their total export exposure. Based on ECB data, Chart 16 shows that when we adjust for processing imports, China remains a [much smaller source of demand than the US](#).

Chart 18: China dominates commodities


Source: Bank of England.

Chart 19: Stock market exposure to China


Source: [World Economic Forum](#).

Beyond trade effects

Economists often model trade exposures to China using large-scale econometric models. They typically impose a “shock” on Chinese consumption and then trace the effects through imports into global export patterns and industrial activity. The IMF, the OECD, [the Federal Reserve](#), the Bank of England and the ECB have all tried to simulate the impact of a China “hard landing” to assess the impact on the rest of the world. But when they conduct this exercise, they quickly run into a problem: the spillovers they record, based mainly on direct export links, are several orders of magnitude smaller than those that seem to hold in reality. These models cannot explain why, for example, China “Black Monday” equity crash rattled global markets or why episodes of tight credit in China always spark fears of a global slowdown. To get around this problem, econometric modellers always have to include “additional spillovers”, which, basically, are a matter of art rather than science. They include “confidence effects” or “financial spillovers”, which hurt asset prices and investment in other parts of the world. In the Federal Reserve’s analysis (Chart 23), these indirect channels are far more important than direct trade linkages.

Financial spillovers and confidence effects

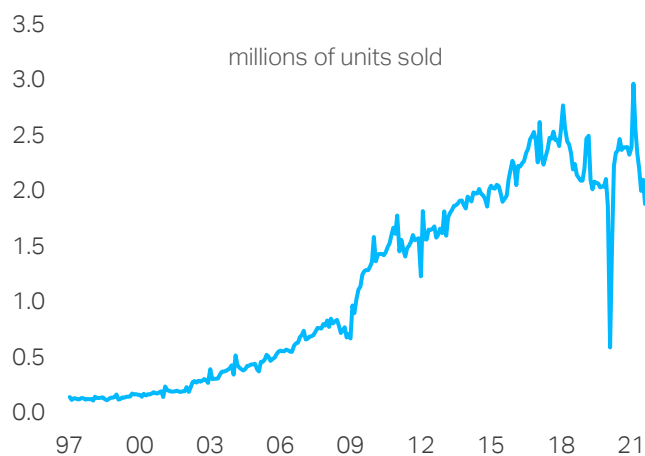
China has a famously “closed” capital account. While it now holds a significant share of global GDP and trade, its overseas assets and liabilities are tiny compared with those of other large economies (especially the US). And despite a large and rapidly growing financial sector, the rest of the world still has limited banking exposure to China (with the notable exception of the UK –

Chart 24). Yet, there are several channels through which the impact of China's macro policies extends beyond that of its trade with the rest of the world:

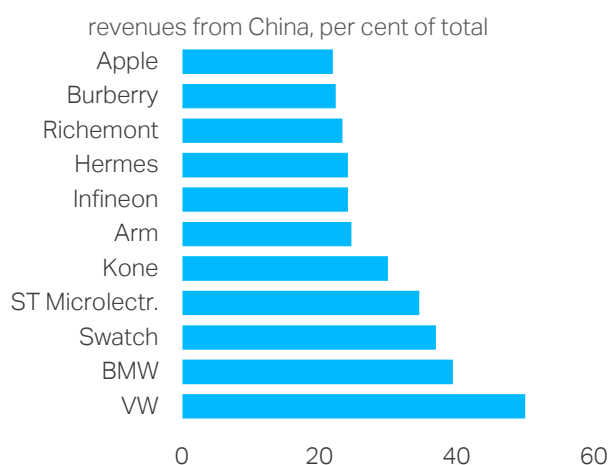
- (i) **Spillovers from commodity prices:** Rising commodity prices can influence investors' perceptions about the medium-term inflation outlook. Both bond yields and breakeven inflation rates closely track energy prices and the global industrial cycle. There are also spillovers from these prices to the investment and employment decisions of energy producers (which now includes the US). When commodity prices crashed in 2015 – in response to China slowdown fears – there was a significant hit to US industrial activity, capex and high-yield credit markets. Even employment contracted in the US states most exposed to falling energy prices. Meanwhile, consumers of these commodities generally gain from lower prices.
- (ii) **Revenues from Chinese operations:** Many large multinational companies now make a substantial proportion of their revenues in China, either through foreign direct investment or joint ventures with Chinese companies. The big auto manufacturers produce vehicles in China for the domestic market. [Recent estimates](#) suggest China accounts for up to 40% of revenue for some EU auto manufacturers, notably VW and other German brands. Some luxury consumer brands make more money in China than they do in many developed markets. These revenues are often not part of official trade data – they may not appear in China's current account – but they are vital for the financial health of the parent companies. This is why many Western economies have a much larger equity exposure than their typical GDP exposure (another case of “the stock market is not the economy”). A deterioration in China's economy would have a significant impact on their revenues and stock prices.
- (iii) **Exchange rates, especially via USD:** Whenever China slows, there is always a risk the authorities will devalue the currency as part of their attempt to resuscitate the economy. Since RMB accounts for around 15% of the trade-weighted USD index, such a move could lead to a significant appreciation of the dollar. But a rising US currency is not a threat to the United States alone – it is a problem for the entire world. As we have explained in [previous analysis](#), [a rising USD is usually deflationary for the global economy](#). The majority of exports are invoiced in dollars and there is a huge offshore dollar-denominated debt market (the Eurodollar system). Periods of acute USD strength are associated with contractions in world trade, reduced cross-border lending and “risk off” in financial markets. There is even evidence to suggest [tighter USD funding conditions can damage international housing markets](#).
- (iv) **Neutral interest rates and the zero lower policy bound:** [Recent studies](#) show that neutral interest rates – the level of rates consistent with full employment and stable inflation – are increasingly determined at the global level. They reflect the *global equilibrium of savings and investment*. And since China now accounts for around a quarter of global capex, it is easy to see why swings in Chinese policy – which always has a large infrastructure component – could affect global neutral rates. Put another way, when Chinese officials stimulate their economy, neutral rates rise and global policy becomes “looser”. When the Chinese tighten, reducing global capex, neutral interest rates decline. This is one reason why international investors worry much more about DM monetary policy becoming “too tight” when activity is slowing in China and global investment rates are under pressure.
- (v) **Capital outflows:** Capital outflows are another important way in which Chinese policy shifts can create financial contagion to global markets. While China's capital

account is technically closed, capital controls have been porous at times, allowing huge amounts of cash to exit the country. These flows were particularly large during the 2015-16 stimulus. While it is hard to track Chinese capital flows using official data, our estimates – based on China’s balance of payments – suggest \$1 trillion in funds abandoned China during this period. Anecdotal evidence points to Chinese companies being big purchasers of foreign assets, particularly in areas such as real estate, finance, digital technologies, manufacturing, entertainment (e.g., soccer) and pharmaceuticals. Bank of England data show Asian demand was responsible for 40% of London commercial property transactions in 2017, up from 6% in 2010. And companies like Anbang Insurance, Hainan Airline Groups and Dalian Wanda, along with thousands of others, were snatching assets globally using domestic leverage. So, a large part of China’s credit easing might have been “leaked” to the rest of the world, lifting asset prices and boosting broad market sentiment.

- (vi) **Confidence/sentiment effects:** Perceptions about the strength/fragility of China’s economy can influence broader risk appetite and sentiment in less tangible ways, which, in turn, can influence spending decisions in other parts of the world. The promise of a tougher regulatory regime and insufficient protection for foreign investors from defaults have already raised the risk premium on Chinese assets. Wider EM securities, too, have become more volatile and highly correlated. But global markets are themselves vulnerable to a more generalized reassessment of risk, especially as Western central banks attempt to exit their QE programmes.

Chart 20: China’s auto boom-bust


Sources: Datastream, TS Lombard.

Chart 21: Luxury brands and auto exposure


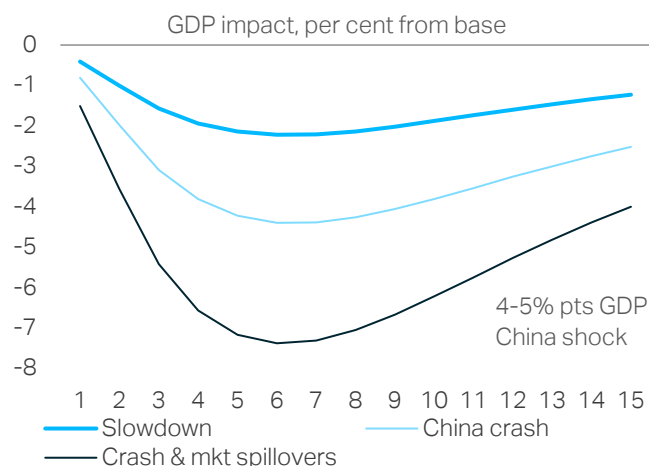
Source: *Financial Times*.

Post-COVID economy remains vulnerable

When China’s credit impulse started to contract in 2020, we thought the world economy would be well placed to shake off this latest swing in China’s policy cycle: COVID-19 had caused a massive contraction in GDP, but the deployment of highly effective vaccines would allow a swift economic recovery and the rebound in domestic consumption would comfortably dwarf any negative spillovers from what was happening in China. But with the virus still among us, it turns out that the vaccines may not be the “silver bullet” everyone was assuming: the economic recovery is more hesitant and less complete than the consensus was assuming. And it is against this backdrop that China’s problems start to matter again. The world economy is especially

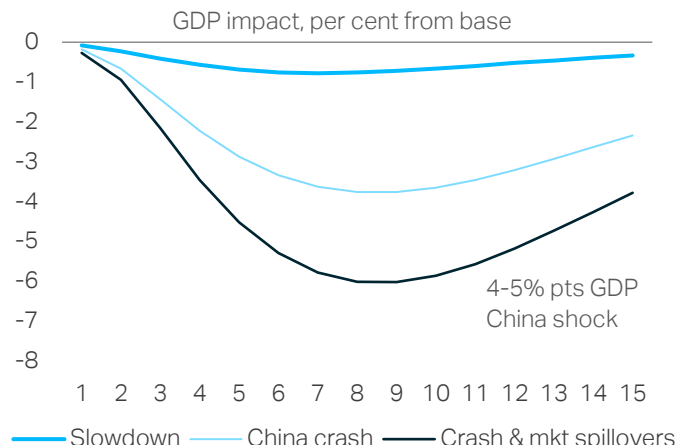
vulnerable to a China slowdown when there is a scarcity of growth elsewhere. Unfortunately, we do not have the “You only live once” (YOLO) global boom the bulls promised.

Chart 22: China hit to EM economies...



Source: [Federal Reserve model simulations.](#)

Chart 23: ...and to DM economies

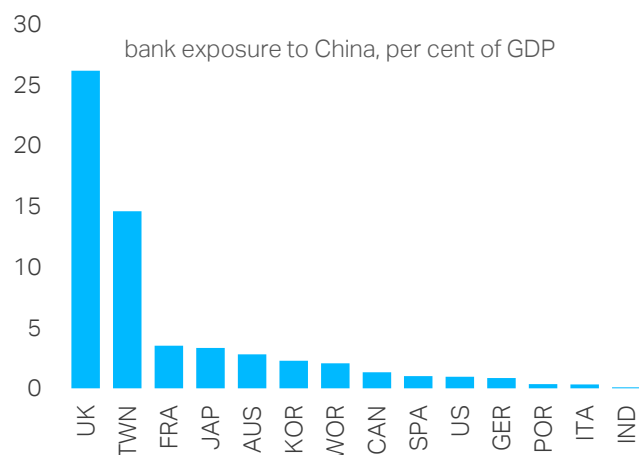


Source: [Federal Reserve model simulations.](#)

3. CHINA'S BIG POLICY DILEMMA

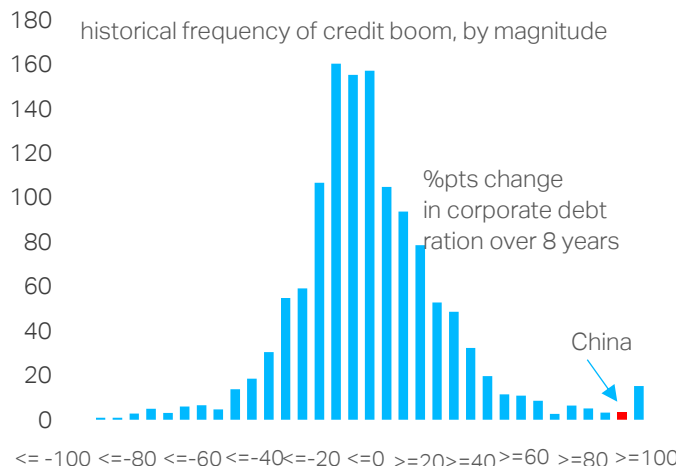
After a decade of vigorous stop-go policy in China generating a succession of “hard landing” and “Minsky moment” scares, it seems trite to point out that Evergrande is not China’s Lehman Brothers. Financial pundits should have realized by now that there can be no “margin call” when state-owned banks are lending to state-owned (or quasi state-owned) enterprises. Evergrande was not under strict state control, but it works in partnership with local authorities (inevitable when property sales are 30% of China’s local government revenues). Our China analysts believe the state will ring-fence the Evergrande’s problem to prevent immediate contagion and protect homebuyers who are waiting for the completion of Evergrande projects. They will do this by ensuring the company can fulfil existing orders, shielding suppliers and preventing a rapid collapse in the property market. This, in turn, will limit the hit to China’s economy. This does not mean that the current situation won’t deteriorate further. It is always dangerous to assume that policymakers – even those in China – are in complete control. Sometimes they make mistakes

Chart 24: Banking exposure limited (outside UK)



Sources: BIS data, TS Lombard estimates.

Chart 25: Credit boom in China



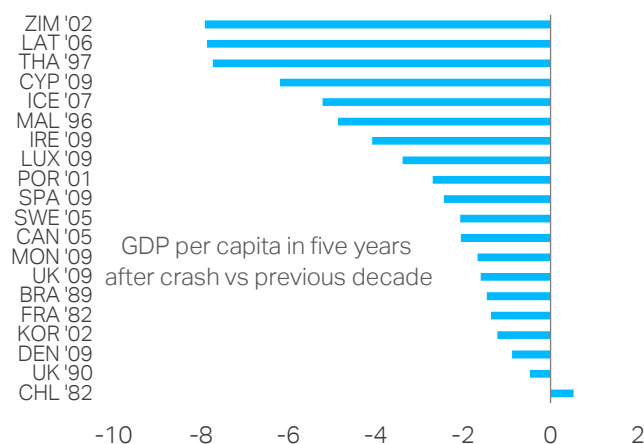
Source: ECB staff analysis.

and are operating without all the necessary information. The good news is that the world's financial system has relatively limited exposure to China's property market – this is not like the subprime crisis, where the global banking system was leveraged on US mortgage securities.

Controlled default

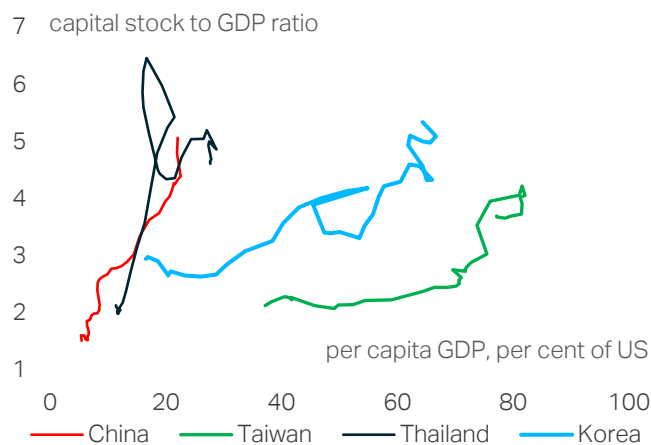
Evergrande exposes China's dilemma: there is an inherent contradiction between "Common Prosperity" and an economy running on a speculative, credit-fuelled housing bubble. Bailing out Evergrande and unleashing another credit splurge – which is what the authorities have done in response to every previous Minsky scare – would only compound the moral hazard that has helped to inflate China's bubbles. It would totally undermine the Common Prosperity agenda. This is why the authorities are proceeding cautiously. They must contain the risks a disorderly default would pose to household wealth, social stability and the rest of the property market, while ensuring that Common Prosperity becomes the overarching objective of Xi Jinping's third "term", which starts in the second quarter of 2022. Our China analysts believe that for this reason, China's leader is now more determined than ever to deliver slower, more sustainable and more equitable growth than that of the last decade¹. There will be a special focus on raiding middle incomes, lowering carbon emissions, upgrading manufacturing/tech and reducing financial-sector risks. In practice, it is clear China's economy has "wanted" to slow for some time, so the authorities are bowing to the inevitable. In fact, greater state control over the economy may compound this structural slowdown, by further undermining long-term efficiency. China's state-owned businesses are notoriously less productive than those that remain in private hands.

Chart 26: When credit bubbles burst...



Source: ECB staff analysis.

Chart 27: Is China over-invested?



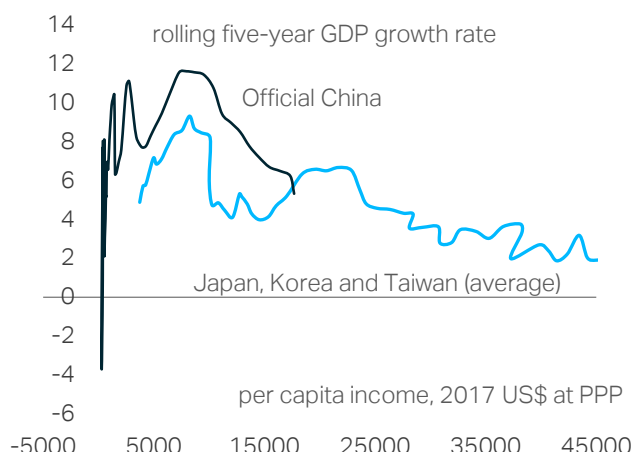
Sources: Penn World database, TS Lombard.

The world's last balance sheet

If China is set to run its economy "cooler" over the next decade, this is a problem for the rest of the world. China has added more than \$30 trillion to global debt since 2008, a period during which there was a distinct scarcity of growth catalysts elsewhere. In effect, the Chinese state was an important source of new "balance sheet" for the global economy. This is clearly relevant to the debate about whether the world can escape secular stagnation during the 2020s. Unless new global growth catalysts appear, there is a chance that secular stagnation will, in fact,

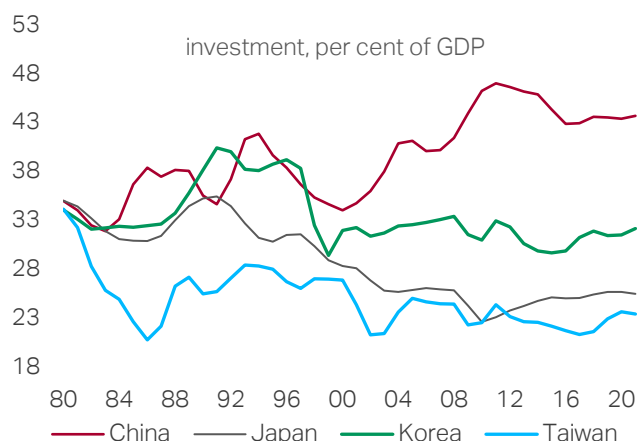
¹ Xi Jinping makes the distinction between "fictional" growth and "genuine" growth. In recent years, China's economy has been overly reliant on fictional growth (notably a property market where houses have been for "speculation, not living in"). If Common Prosperity eliminates the fictional part, the economy must slow.

Chart 28: Time to accept structural slowdown?



Sources: Conference Board database, TS Lombard.

Chart 29: China needs to cut investment?

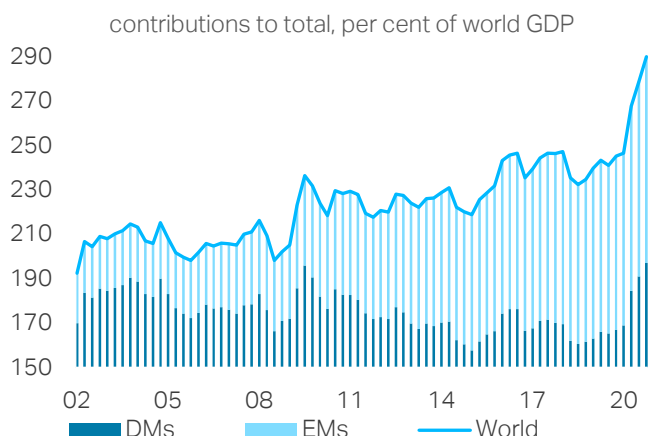


Source: IMF, TS Lombard

become worse. In previous Macro Pictures (see, [here](#) and [here](#)), we have outlined several potential new growth drivers for the 2020s. Perhaps Western households – which have deleveraged since the subprime crash – will start to borrow again. New hybrid work patterns have already caused a powerful boom in housing markets, which could become a secular story if housing in areas outside city centres creates a new marginal buyer of property (people who previously could not afford to live close to their workplaces). There is even a possibility that COVID-19 will prompt a revival in productivity, by accelerating the transition to digital technologies and closing the gap between the “superstars” and the corporate laggards (full technological diffusion). But we must admit that our optimism remains somewhat speculative.

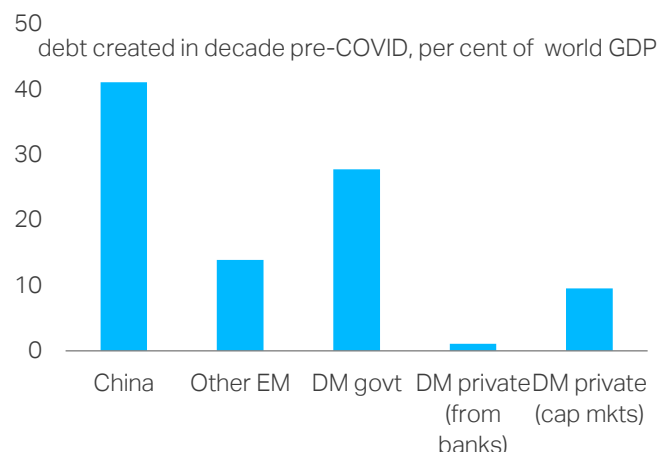
Should these new private-sector growth catalysts not appear, it will be up to Western governments to decide whether they want to play “the China role” in the 2020s. Will the US and Europe, for example, be willing to use their state balance sheets in a more activist way? There are certainly issues they need to address, such as climate change, inequality and public infrastructure. In simple terms, China has been having a (sort of) “romance” with MMT-type policies over the past decade. It has levered up its state balance sheet to support a powerful boom, one that arguably went beyond China’s natural resources (it took MMT too far). But now – because the authorities are worried about a Japanese-style debt slump – this romance seems to be coming to an end. To have any chance of escaping secular stagnation, the developed world may need to start its own romance with MMT. Certainly, support for aggressive fiscal

Chart 30: EM economies provided the debt



Sources: BIS, TS Lombard.

Chart 31: China was world’s balance sheet



Sources: BIS, TS Lombard.

action and more state intervention has been gaining traction in Western countries (under the “build back better” mantra). But it may be premature for supporters of MMT/Keynesian economics to claim total victory, especially with President Biden’s latest infrastructure plan running into problems, continued uncertainty about the US debt ceiling, fiscal tightening in the UK, and no clear outcome in the recent German elections. And without this new fiscal regime in the West, it is harder to imagine an escape from secular stagnation. With a sustained slowdown in China, the “Roaring 20s” seems a more distant prospect than it did a few months ago.

Bottom line

China has a “Lehman moment” scare every few years – they always occur during the “tight” phase of China’s vigorous stop-go policy cycle. And the impact of Chinese policy tightening on the rest of the world invariably ends up much greater than investors were expecting – certainly more than makes sense from traditional trade links. China’s macro reach clearly extends beyond its impact on world trade and industrial production, with powerful spillovers through commodities, financial markets (especially equities – multinationals now earn a significant share of their revenues in China), market sentiment, inflation expectations and currencies (especially USD strength). Like every previous Lehman scare, Evergrande is unlikely to be China’s Minsky moment. The authorities will ring-fence the company and prevent an immediate collapse in China’s property sector. But this episode highlights the dilemma the country is facing. The state’s new Common Prosperity regime is not consistent with an economy overly reliant on debt and speculation, which means China will probably need to accept structurally lower growth in the 2020s. And this is a problem for a world economy that lacks alternative secular growth sources.