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# A Warning on China Seems Prescient

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Photo



Kenneth Rogoff, a crisis expert. CreditGleb Shchelkunov/Kommersant Photo, via Getty I



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DEALBOOK

Kenneth Rogoff has long warned of a potential financial crisis in China.

Mr. Rogoff, a professor of economics at Harvard University, accurately predicted the eurozone debt crisis and for years has been

telling anyone who would listen that China posed the next big threat to the global economy. He is starting to look right, again.

“In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could,” Mr. Rogoff said on Monday from Cambridge, Mass., repeating a favorite line from Rudi Dornbusch, the German economist. (Mr. Rogoff sat in on Mr. Dornbusch’s class at M.I.T. in 1977.)

Mr. Rogoff, who is a chess grandmaster, has made a career of studying financial crises. After the 2008 financial crisis, Mr. Rogoff co-wrote “This Time Is Different,” a seminal book that examined eight centuries of financial crises.

To understand the wild machinations of the stock market in recent days in the United States and abroad, you need to look no further than China’s astounding debt load and sputtering economy — and its ability to infect the rest of the world.

“China is the classic ‘This time is different’ story,” Mr. Rogoff said, rattling off all the different rationalizations for why the country convinced itself — and many others — that it could load up on debt but was somehow immune to the laws of economic gravity. He cited the government’s control over the markets, the hundreds of millions of workers migrating to cities and the country’s saving rate of about 30 percent of disposable income as just some of the reasons China was said to be impervious to a severe downturn.

“It’s very vulnerable,” Mr. Rogoff added. “There is a lot of debt.”

How much debt remains an open question, given the opacity of China’s market. The country’s debt load rose from \$7 trillion in 2007 to \$28 trillion by mid-2014, according to a report published earlier this year by the consulting firm McKinsey & Company, China. “At 282 percent of G.D.P., China’s debt as a share of G.D.P., while manageable, is larger than that of the United States or Germany,” said the McKinsey study. “Several factors are worrisome: Half of loans are linked directly or indirectly to China’s real estate market, unregulated shadow banking accounts for nearly half of new lending, and the debt of many local governments is likely unsustainable.”

The question then becomes how interconnected China’s economy is to the rest of the world. That’s exactly what investors have been

trying to determine over the last several weeks as China's government has devalued its currency and tried — and failed — to stabilize its plummeting stock market. The drop has been worsened, in part, by debt as overextended Chinese speculators who borrowed money to buy stocks are now being forced to sell, creating a vicious cycle.

“How does all that ricochet to emerging markets?” Mr. Rogoff said in discussing the effect of China's slowdown on commodity producers like Brazil, whose economy is in a tailspin. “Look at Russia. It's amazing they haven't had a financial crisis yet.”

Mr. Rogoff is not the first person to identify China as a potential risk. Earlier this year, this column highlighted the views of Henry M. Paulson Jr., the former Treasury secretary and a Sinophile, who said, “Frankly, it's not a question of if, but when, China's financial system will face a reckoning and have to contend with a wave of credit losses and debt restructurings.” And the hedge fund manager James Chanos has been sounding the alarm on China for years, recently declaring, “Whatever you might think, it's worse.”

There are, of course, significant political reasons China needs to convince the world and its own citizens that it can manage its convulsing financial markets and slowing economy. “Financial meltdown leads to a social meltdown, which leads to a political meltdown,” Mr. Rogoff said. “That's the real fear.”

Mr. Rogoff pointed to another factor that has contributed to China's financial woes.

“The crisis in Tianjin fed into the mix,” he said, referring to the deadly explosion on Aug. 12 in the port city, which killed more than 100 people. Mr. Rogoff said the explosion had undermined the credibility of the Chinese government because so many questions remained unanswered, and the response had been inadequate.

So does Mr. Rogoff believe that China is headed for a terrible “hard landing” that will lead to a global recession?

Well, despite the market tumult and his persistent warnings, Mr. Rogoff says he believes that the last several weeks have raised the prospects of a meaningful crisis. But with China's trillions of dollars in reserves, he thinks the country may have sufficient tools to prevent a calamity that spreads across the globe — at least for now.

“If you had to bet,” Mr. Rogoff said, “you'd still bet they'd pull it out.”

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