Will China be the new Greece?

By George Athanassakos

I am bearish on China, but unlike other market commentators who compare China to Japan in the late eighties, I think China compares more closely to Greece.

Between 2000 and 2008, Greece's GDP grew by an average of 7 per cent a year, spurred by bank debt that grew by 16 per cent annually and private and government debt that grew even faster, at rates exceeding 20 per cent and 34 per cent, respectively. Debt fuelled growth in the Greek economy.

The government was borrowing to pay higher wages and satisfy union bosses who voted for them. Banks made loans that had political rather than business motivations. And individuals wanted to keep up with the Joneses in a mostly consumption-driven economy encouraged both by the banks and government. Bad debts were rolled over to new that paid old debt without any consideration of what was going to happen when the music stopped. And the music did stop.

Greek GDP fell by about 4 per cent a year between 2009 and 2013, while private debt and bank debt plummeted.

Debt has also fuelled growth in China. Private debt has grown by over 80 per cent a year between 2007 and 2013. Bank debt has grown by over 18 per cent and government debt by over 12 per cent over the same period. Debt is still rising at rates that exceed nominal GDP growth – and this does not even include the shadow banking that is estimated to be in excess of $5-trillion (U.S.).

Most worrisome is that a lot of growth has been in non-productive assets, like real estate and excess capacity in manufacturing and commodities: Productivity gains have thus slowed down. But in China, debt-driven growth is needed for political reasons and to stave off unrest, and so banks are prompted to lend. At the same time, a lot of growth has been supported by government direct investments as reported by the International Monetary Fund. Debt as a result has skyrocketed to 200 per cent of GDP. And just as the music stopped in Greece, so it will in China.

GDP growth and borrowing have collapsed in Greece with the concomitant consequences for social and political instability. Does the same fate await China? This is the $64,000 question. I am on the side of the bears.

Bad loans for China's biggest banks have already risen over 22 per cent since the start of the year according to Wall Street Journal. The same is the case for non-performing loans in the real estate and in manufacturing sectors where overcapacity in coal production, steel and textiles has become problematic, with many smaller firms facing difficult times.

Legendary fund manager Robert Rodriguez in a recent interview <http://www.thinkadvisor.com/2014/10/27/bob-rodriguez-new-great-recession-coming-in-3-year?page=3> with ThinkAdvisor pointed out that one of the indicators he follows, the Shanghai "reinforced steel bars" pricing indicator, which parallels the strength of construction activity in China, "has been going through the floorboards for the last six months," falling recently to a new low – lower than its 2009 level.

But Greece is a small country and such a collapse has not had dramatic implications for the rest of the world, but the story will be different in the case of China, the second largest economy in the world. A China collapse will have a noticeable impact on countries that supply it with raw materials such as Australia, Brazil and Canada, with a lot of collateral damage for the rest of the world. Chinese demand for commodities led to increased investments in iron ore, copper and oil production that they are all coming into the market as economic growth has slowed down. Excess supply means lower prices at a time when Europe is already facing disinflation, if not deflation, and economic growth is slowing down on a global level, according to estimates by the International Monetary Fund.

China bulls discount all this evidence and similarities to Greece and argue that despite all this, China will soft land and continue to grow by over 6 per cent in future years. They put a lot of faith in China's leadership to make the necessary reforms and successfully change its economic model. But as the case of Greece shows, such reforms are difficult to make in an environment of political alliances and strong special interest groups or, as is the case for China, in a country that may also face a high probability of public upheaval.

George Athanassakos, gathanassakos@ivey.uwo.ca, is a Professor of Finance and holds the Ben Graham Chair in Value Investing at the Richard Ivey School of Business, The University of Western Ontario.