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Posen vs. Pettis

Michael Pettis is a professor of finance at Guanghua School of Management at Peking University in Beijing and a nonresident senior fellow at the Carnegie Endowment for International Peace. He is a well-known analyst of China's economy and financial system. Adam Posen is currently the president of the Peterson Institute for International Economics. He has worked for numerous central banks, including the New York Federal Reserve and the Deutsche Bundesbank. He was a member of the Bank of England's Monetary Policy Committee from 2009 to 2012.

Posen and Pettis have differing views on what ails the Chinese economy. Which view is correct is important in instituting a fix for China's economy and establishing what response the US and other nations should take toward China. In this report, we will outline the respective positions of both Posen and Pettis on China's economy and discuss who we believe is more correct. The latter issue is crucial. If Posen is correct, the answer may be as simple as removing Chinese President Xi from office and returning to the policies that preceded him. If Pettis is correct, fixing the issues will be far more challenging.

The Positions

Last August, Posen authored an article in *Foreign Affairs* titled, "The End of China's Economic Miracle." In this piece, Posen argued that the policies of Xi Jinping had undermined the Chinese economy. Controversially, he contended that the economy was doing just fine before Xi undermined it with his restrictive policies that adversely affected the private sector. The article suggested that the regime's COVID-19 policies had stifled the economy, and the continued restrictions on the economy despite the end of the pandemic were to blame for China's woes. Implied in the report is that the solution would be to either return to the policies practiced pre-Xi, or for Xi to leave office which would probably facilitate a return to earlier policies.

Pettis's position is different. In his opinion, the root of China's problem is that its development policy, which focused on investment and exports, has outlasted its usefulness. The fix for China's economic woes would therefore be to shift policy away from supporting investment and exports and toward domestic consumption. Pettis's solution would be more difficult to implement because it is structural in nature.

The core of Pettis's position is that an underdeveloped economy needs to foster investment in order to expand. There are essentially two paths to acquiring investment funding. The first is to open up to foreign investors who provide funding at the cost of sovereignty and control. Foreigners can be fickle. They can direct investment into areas that domestic policymakers would rather avoid, and they can, in the absence of capital controls, remove funding captiously. The other method is to suppress domestic consumption through consumption taxes, tariffs, financial repression, and an undervalued exchange rate. These measures create household savings, which are used for investment.

Regardless of which method is used, either attracting foreign investment or fostering domestic saving, eventually, an economy reaches a point where investment is adequate. Since economic growth has been driven by investment, when this point is reached, new sources of growth must be developed or the economy will stagnate. The shift away from investment is never politically easy, but the longer the change is delayed, the greater the degree of excess capacity and malinvestment.

One feature that usually develops as the investment base grows is that domestic production exceeds consumption, which then leads to rising exports. As long as foreign economies are willing to absorb these exports, the development model can be extended. Eventually, though, the level of exports begins to threaten the economies of the developing economy's trading partners. These economies will sometimes respond with tariffs to protect their industries. In a floating exchange rate environment, they may demand, or take policy measures, to appreciate the developing economy's currency. Closing off export growth exacerbates the excess production issue.

Finally, another option that has been deployed throughout history is imperialism. As the developing economy's productive capacity grows, acquiring colonies allows the colonizer to "dump" its excess capacity on the colony. By forcing the colony to absorb the excess capacity, the colony's economy is often "stunted" away from industry.

Financially, by suppressing consumption, interest rates are often held below their "natural[1]" level. Excessive saving leads to interest rates below their natural level, which not only fosters excessive investment, but also stifles the transition to a consumption-led economy. Households are usually assigned an interest rate that is less than inflation, and if investing options are limited, then the financial repression provides a pool of cheap savings for investment.

In economies that rely on domestic saving instead of foreign investment, there is a tendency for a buildup of excessive debt. Since interest rates are held below the natural rate, projects that are often not economically justified are completed. Often, developing economies lack sophisticated financial markets; bank lending is usually the primary source of investment funding. The investment-led development model that relies on domestic saving usually ends up with a large debt burden. In the later stages, because an increasing level of debt is funding uneconomic investment projects, not only does debt become excessive, but much of it is "bad" debt in that it cannot be easily serviced.[2]

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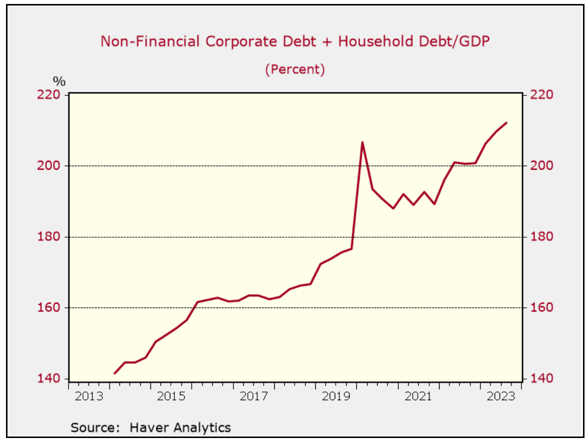
[1] Natural interest rates in the Wicksellian sense. Wicksell postulated that there was a "natural" interest rate where investment and saving were in equilibrium. If the interest rate is artificially held below its natural rate, malinvestment can result.

[2] Hyman Minsky described debt as having three levels: hedge, speculative, and Ponzi. Hedge debt is where the investment that funded the debt provides enough cash flow to service the debt and amortization. Speculative debt occurs when an investment can only generate enough cash flow to service the interest payment and thus requires periodic refinancing to maintain the investment. Ponzi debt cannot service the interest payment or the principal and thus relies on rising asset values to justify the debt. As debt becomes excessive, it usually means that the quality of the debt gravitates from hedge to speculative to Ponzi.

Every nation that has developed has been forced to undergo this adjustment, and the change is always painful. When the British reached this point, they embraced imperialism. When Germany reached this point around the turn of the 19th century, they tried to colonize Eastern Europe and then unsuccessfully attempted to gain colonies in Asia and Africa. America's adjustment is otherwise known as the "Great Depression." After WWII, Germany and Japan had to return to investment-led development. Germany was able to support its economy by investing in higher-value projects (e.g., Volkswagens to BMWs) and through colonization (otherwise known as the eurozone). Japan reached a crisis in 1990 and has faced economic stagnation ever since.

Pettis argues that China has reached the point where investment-led development has reached its "sell-by date," and it therefore needs to restructure its economy away from investment and exports and toward consumption. However, Communist Party of China (CPC) leaders have generally made half-hearted efforts to make this change. It's human nature to want to continue a process that has enjoyed success in the past. Supporting consumption has an air of "decadence," and this reluctance has also been seen in Japan since 1990. For example, Japan has typically relied on consumption taxes, which is exactly the wrong type of tax for a nation that under-consumes. President Xi has been reluctant to support consumption through fiscal measures, fearing it will make workers "soft."

It has become clear that China's debt is excessive.



To measure debt, we prefer to look at non-financial corporate debt plus household debt scaled to GDP. We exclude financial system debt because much of that debt is tied to the non-financial sector, thus counting it may overstate the degree of indebtedness. We also exclude government debt because excessive government debt generally doesn't result in bankruptcy but instead in debasement or inflation. In other words, the debt we prefer to measure has to be serviced through revenue or income and can't be resolved via policy measures. Similar numbers in the US are 148% compared to China's 212%, and the trajectory of China's debt is clearly a problem.

Essentially, China can generate any GDP number it wants as long as it's willing to expand its debt levels. Pettis argues that it's likely that many of China's investment projects are worthless at the time of completion. If so, GDP is overstated and the above debt ratios are worse than they look.

Who's Right?

Overall, we think Pettis is more correct than Posen, but that doesn't mean the latter is completely off base. In a recent podcast, Posen's point about the importance of General Secretary Xi was elegantly explained by Andrew Batson. Governing in capitalist democracies generally isn't based on a teleology; in other words, capitalist democracies tend to have the goal of allowing their citizens to pursue “life, liberty, and happiness” with no natural endpoint. Marxism, but especially Leninism, on the other hand, espouse a teleology as Marx discussed a point where the “state would wither away.” Lenin believed that a “vanguard of the proletariat” would lead the workers to this eventual “nirvana.”

And so, the cadres of the CPC follow the orders of the general secretary to work toward whatever goal is established. During Mao’s reign, the orders often shifted, leading to societal chaos. The “Great Leap Forward,” a crash plan to modernize the industrial economy, led to widespread famine. The “Cultural Revolution” led to a decade of societal upheaval.

After Mao’s death, Deng Xiaoping took power and shifted the goals of the CPC from Mao’s attempts to achieve some Marxist endpoint to economic growth. Deng and his successors maintained economic growth as the primary goal of the party. The singular focus on economic growth led to over three decades of remarkable development. However, even before Xi came to power, the CPC had realized that this sole focus carried risks. Premier Wen Jiabao, the second most powerful figure in General Secretary Hu’s administration, was quoted as saying, “The biggest problem with China’s economy is that growth is unstable, unbalanced, uncoordinated, and unsustainable.” Although the Hu government realized it had a growing problem, it did little to change the trajectory or goals of the CPC. In fact, in the wake of the Great Financial Crisis, China engaged in a massive fiscal and monetary stimulus to support economic growth.

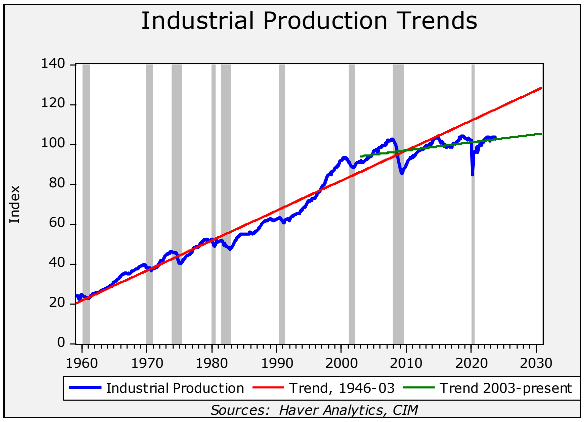
Xi’s mandate was to address this problem. Initially, Xi considered China’s problem to be widespread corruption. A purge of high-ranking CPC officials followed, which, to some extent, continues to the present. But, along with combating corruption, Xi has offered other goals, such as “dual circulation,” which was described as a program to expand consumption and centrally planned growth. This program seemed to argue that market-led growth was the cause of China’s unbalanced economy. Recent remarks suggest that a focus on national security is now the primary goal.

Batson’s argument is that Xi removed economic growth as the primary focus but has not settled on its replacement. This lack of focus has caused a crisis for the cadres of the CPC because they don’t know what they should be doing. Leninism is a top-down model of government, and if the leadership can’t develop a clear path to achieve societal goals, then there is a policy muddle. Simply put, the cadres are lost. In this regard, Posen is correct that Xi is making matters worse.

However, it appears that going back to growth at all costs probably isn’t a workable path either. As Pettis has clearly shown, and Premier Wen noted, China’s economic problems are structural in nature. If the goal was to address the economy’s issues, China would move away from investment and exports and toward household consumption. But, as we noted above, other nations have faced this issue before, and none were able to execute a seamless transition.

Why the Difference in Opinion Matters

Posen’s position is attractive to policy elites. Globalization as it was carried out from 1990 into the Great Financial Crisis had many elements of classic trade economics. Nations that had an advantage in one area should concentrate on that function, which leads to greater productivity and lower inflation. Sadly, this policy stance supported American deindustrialization.



This chart shows the US Industrial Production Index from 1960 to the present. We have calculated trendlines — one from 1946 (red) and one from 2003 (green), when China entered the WTO. Note how the uptrend has flattened since 2003.

The political and societal fallout from America's deindustrialization has been notable. Yet, Posen argues that reindustrializing may not be worth it.

However, if Pettis is right, even if Xi is gone and a new Chinese president were to return to a growth-first policy, it probably wouldn't work. China really needs a wholesale shift from investment and exports to consumption. Doing so will disadvantage the upper echelons of the CPC and thus would require a degree of self-sacrifice that is usually absent outside of war or other calamity.

The key question is what do American policymakers believe? If they view Posen as being correct, then supporting anything to push Xi out of office will bring back the world of cheap Chinese goods. But, if they believe Pettis is correct, merely changing leaders probably won't matter all that much.

Ramifications

Although it appears that the balance of opinion among lawmakers is that Pettis is more correct than Posen, the opposite is likely true among business leaders. The gathering of business leaders to meet Xi in San Francisco at the most recent APEC conference showed that America's large corporations would prefer to maintain access to China's economy.

Since policymakers tend to lean toward Pettis's analysis, the response we have been observing — trade impediments and industrial policy — will likely continue. The idea that China's problems are structural in nature supports a policy of decoupling. If Posen is correct, it might make more sense to simply wait out the current government and hope for a return to a more business-friendly leader. If Pettis is right, then the policies currently in place are better suited for the future, but if Posen is correct, then the current policy mix is inappropriate.

Our take is that Pettis makes a stronger argument. As we noted above, Posen is correct that Xi has made some serious mistakes. In other words, he has probably made a bad situation worse. However, changing the leadership in China isn't a panacea for the country's problems.

Bill O'Grady
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