FT Alphaville chat with Michael Pettis

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[Cardiff Garcia] Our special guest today in Michael Pettis, professor at Peking University; he blogs at mpettis.com. Michael, welcome to New York.

[Michael Pettis] Thanks very much.

CG You just published a 20,000-word blog post, a magnum opus of your views on China. Here's where I want to start: A lot of people look at the slowdown in the Chinese economy in the past year or so as part of the rebalancing process, shifting away from investments and exports and towards consumption.

You don't necessarily disagree with that, but in your writing you tend to emphasise the importance of debt and debt sustainability and, specifically, the problem that debt continues to accelerate in China at a rate that is exceeding China's ability to service it. So why don't you walk us through your argument, starting with the sources of rising debt in China, where it comes from, who's owed, and who owes. And then tell us why it's such a big problem.

MP Ultimately it's very hard to disentangle any of the debt from the banking systems and from the government, so you can pretty much assume that much, if not most, of the debt is government debt, ultimately.

It's owed by the government, because if it's owed through the banking system they're not going to let the banking system collapse. There are two reasons why I worry a great deal about the debt.

Part of it is historical and part of it is conceptual. In my next book I plan to explore the conceptual part as much as possible. I argue that once you have an excess amount of debt, which I define as straight financial definition, when the debt levels are high enough that there's uncertainty about how debt servicing costs will be allocated, then you have too much debt.

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And when you have too much debt, because of that uncertainty, all of the stakeholders in the economy change their behaviours in ways that adversely affect the economy.

And I want to explain this much more in my book, but the basic argument, which a lot of economists don't understand, but in finance it is pretty well understood, is that when you have too much debt, that itself acts as a constraint on growth.

But the historical part is something that more economists should be asking and that is when you look at the dozens and dozens of countries that have had too much debt as I define it, in the last couple of hundred years, I can't find a single one that was able to reform the economy, improve productivity and grow its way out of debt without implicit or explicit debt forgiveness.

And the explicit debt forgiveness, of course, is you default and you get formal debt forgiveness. The implicit debt forgiveness is that you monetise it or your inflate it away, which means basically that you force the household sector to pay for it.

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But I haven't found any exception and that should at least puzzle us, because if it's the debt that prevents your ability to grow out of the debt, then it means that you cannot grow out of the debt and you must address the debt problem and you must explicitly allocate those debt servicing costs.

CG And in the context of China, the government has in the past few years made pledges to reform its supply-side policies, right?

MP Right.

CG But you distinguish between two kinds of supply-side policies: those that are meant to raise productivity and efficiency and those that do exactly what you just said, which is address the debt directly. So tell us a little bit about those reforms and what you think is the likely outcome.

MP This is going to be pretty controversial, because basically I'm going to argue or I am arguing that reforms aimed at improving productivity have never worked and they can't work. If you want to resolve this problem you have to do two things.

First, of all, in order to slow the grow in debt you've got to bring investment down, because investment is being misallocated more than ever. If you bring investment down unemployment goes up, which nobody wants. So if you don't want unemployment to go up, you need another source of demand. And there are three sources of demand: investment, consumption and net foreign investment in consumptions.

CG Exports.

MP Net exports. Net exports aren't going to work; China is too big, the world is in bad shape, so I think we can pretty much write that off. Investments; for awhile people were saying if we sufficiently reform the financial sector then the financial sector will stop misallocating capital. There are real uses of capital in China and it will begin to allocate capital correctly.

CG It will find better projects to investment in.

MP Yes, that there are good projects and what we need to do is reform the financial sector so that it stops doing what it does and moves towards these good projects. And I say yes, of course, if we do that then we don't have a problem.

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But that's like saying if I win the lottery ticket I don't have to work anymore. It's true, but it's not very likely and it's more than not very likely. I can't find a single case in history in which that kind of reform happened quickly enough.

The only possible exception might be Chile at the end of the '70s and beginning of the '80s. But, remember, they had a political collapse, an economic collapse, and a banking sector collapse before they did that.

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So I think that's very unlikely. I think we can write off investment; that's not going to replace...that investment as a source of demand. So we're left with consumption. That's the only way to do so.

But why is consumption so low in China? I think by now we all know; it's because household income is such a low share of GDP. So you've got to get household income up and the only way you can really get household income up quickly is through explicit or implicit transfers from the government sector.

So, one way or the other, we have to do those transfers. The same thing applies to debt. The only way really to pay down debt, because it's all ultimately government debt, is to liquidate government assets and use that to pay down the debt.

So we have the same answer to both problems which is, by the way, not a coincidence; it's always how it happens. And the answer is to transfer government assets to pay down debt and to increase household wealth. But that's a political problem and that's why it's so difficult to do. That's the vested interest problem.

CG How would you do that? What's the best to avoid all of those other problems you just mentioned while also redistributing wealth towards the household sector?

MP Any economist can tell you how; it's not very hard. You can privatise state-owned enterprises, use the money to fund a stronger social safety network or to give directly to the residents, to citizens.

You can eliminate the hukou system, which immediately makes migrant workers wealthy, wealthier, but now it makes the municipalities poorer, so they would have to fund that by selling off assets. There are many ways you can do it.

In March of last year Shandong Province transferred state-owned enterprises, shares in SOEs, to the Shandong pension fund. That's not very efficient because I don't think the Shandong pension fund is terribly credible, but you can do that. There are a million ways to do it, but all of them involve opposition from those who control those assets.

CG From vested interests. One last question before I let Matt get in here, because I want to tie what you're saying to the recent move in the currency. A lot of people thought that when China allowed the currency to depreciate recently that part of the motivation was to reinvigorate its exports in order to cushion the slowdown in growth. Your explanation is a little bit different; it has to do with liquidity. Can you take us through that?

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MP In this trip I kept getting asked over and over again what is their strategy and why aren't they articulating it more clearly? And I think it's a mistake to think there's a strategy. It's really not clear what to do with the currency, because I think one of the goals is to stop the outflows.

So how do you stop the outflows? If you don't let the currency depreciate and you try to rebuild credibility, that's very expensive. That causes a significant reduction in reserves and the reduction in reserves undermines credibility. So it's not clear that that's going to work.

If you let the currency depreciate 5% or 6% a year, you're basically telling people what the cost of leaving their money in the country is, so it's hard to imagine that will stop outflows.

Maybe you can do a maxi-deval and a peg, but I don't think that's credible any longer. Or maybe you can stop intervening altogether, but I don't think the currency goes 10% or 15%; I think it overshoots.

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So it's not really clear that there is a strategy. If you really want to stop the outflows you've got to have a big positive shock to confidence and I suspect, since everybody is so afraid of debt, the only positive shock to confidence would be a really aggressive programme to address the debt.

For me, the way I see it, depreciating the currency doesn't really increase growth because it...we don't think unemployment is very high.

Wage growth still seems reasonably strong, so if you depreciate the currency you strengthen the tradable goods sector, but you probably weaken the services sector, the capital-intensive sector, by causing wages to bid up.

I would argue that depreciating the currency is a form of wealth transfer and it's probably part of the political horse-trading domestically, which makes it really hard to predict.

[Matt Klein] I'm just following up on this; over the past 15 or 20 years private capital inflows into China were very positive and the reversal has been extremely recent and is very vicious and violent. I'm curious if you'd give some sense as to what changed and why, the sudden ways the net flow reversed to the extent that it did?

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MP I kept hearing people ask me isn't this just normal diversification? If you're rich, you've got to own assets in other countries. And if it hadn't been, as you described, so sudden, because, really, until 2014, there was a surplus on the capital account as well as a surplus on the current account. And then in 2014 we suddenly got a huge deficit on the capital account, which more or less matched the current account.

And then last year the deficit on the capital account was significantly greater, as you know. That doesn't strike me as diversification; that strikes me as something else. And as someone who started his career trading the defaulted and restructured debt in Latin America in the 1980s, it strikes me as capital flight and there's anecdotal evidence that suggests the same thing. We can't really prove it but the anecdotal evidence seems pretty strong.

MK Just following up on that, if you have any sense of why; what might have prompted capital to leave in that way and in that time frame?

MP If people are worried about the financial sector, people are worried about debt, if people are worried about the political consequences of the anti-corruption campaign, all of those things should drive capital outflows. So it doesn't seem to me very irrational; it seems to me pretty normal.

CG I want to go back to something you said a little bit earlier, because one of the constant themes in your work is that finance theory is able to capture something a little bit more fundamental than economists and their models are often able to capture about the Chinese situation in particular, especially when economists use their equilibrium models. Can you just elaborate on that a little bit?

MP This risks becoming a very long answer, but I think there's a difference between managing the asset side and managing the liability side. And when debt levels are low or when the balance sheet is not significantly distorted, most growth can be explained by the growth that comes out of the management of the asset side, but when debt levels are high or when there are significant distortions, the liability side can actually cause growth to be higher than otherwise or lower than otherwise. And I think that that's not really included in much of the analyses that we've seen.

I would go so far as to say that any attempt to project Chinese growth rates that doesn't explicitly deal with the debt, you might as well just throw away, because it's gotten everything wrong about China so far but, more important, it's been wrong about every country with a lot of debt. They've never got that right.

Debt is a significant constraint and I think I have a reason to explain it but even if my reason is wrong, it has to be more than coincidence that every single country with a debt problem has had ultimately to get some kind of debt forgiveness before it could grow.

MK Following up on that, you also make a distinction which I think is directly related to this, about what we call economic activity or GDP and debt servicing capacity, expansion or wealth-creation.

And I know you've written about this in the past and in some countries these things are roughly analogous, such as in the US and China they're clearly not. Could you give some more explanation of what these differences are and how we can measure them?

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MP I was reading Diane Coyle's book on GDP. I really recommend it; it's a quick read, you can read it on a single flight. And it deals with a lot of these questions, but GDP measures economic activity. It doesn't measure wealth creation and it doesn't measure debt servicing capacity.

We all know that. And what really matters, particularly when you're worried about debt, is not so much how much activity there is but, rather, how much debt servicing capacity you're creating.

We could get 5%, 6% growth in the US if we raze Chicago to the ground and rebuild it. It doesn't make us any richer, but it does increase, temporarily, economic activity.

That kind of stuff isn't helpful at all, so when we have this big debate about whether Chinese GDP growth is really 6% or 5% or 4%, I'm not terribly interested in that debate, because that's a debate about economic activity and I don't really care about that. What I care about is debt servicing capacity, how fast is that growing? And I don't have an answer. But I think most people agree that it's growing more slowly than GDP.

CG Matt solicited some questions from Twitter earlier and we're going to read you a couple of those and hopefully you can field them as well.

MK In your view, does it help or harm both the world and China in particular if the Fed is trying to be more international in the way it sets policy?

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MP That's really tough. I think that the Fed should no longer be the global central banker. I don't think the US economy is big enough that it can continue doing that. I think the Fed should be focusing primarily on the US economy.

But having said that, it seems to me that the biggest problem in the world now, something we've seen many times before, is that there is significant income inequality. And we know what the impact of income inequality is: it forces up the savings rate.

But the savings rate can only go up if productive investment goes up. It can only go up sustainably if productive investment goes up. And productive investment isn't going up, so that means something else has to bring the savings rate down because ultimately they must balance. And there are two ways you can bring the savings rate down.

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One way is what we had before 2008, which is that soaring real estate and stock markets make the middle class feel rich and so they go out on a consumption binge, debt-fuelled consumption binge. That's one way.

But once you reach the limit then you can't do that, so the only other way and Keynes told us this in the 1930s, in unemployment goes up. So, to me, that's the problem we're stuck with. We have a significant income inequality problem.

Now, in the middle of the 19th century, we also did… there was a great deal of income inequality in England and a very high savings rate. But there was a place for all of these savings to go productively, and that was the United States.

It needed foreign savings and it had plenty of room for productive investment. And I don't see what the equivalent is today. There are countries that need investment and have insufficient savings but they're not credible, so they won't get the money. Maybe India will move into that position, but we'll see.

There is plenty of necessary productive investment in places like the United States, clearly. I took the train to Washington on Monday and it's almost easier to go from Beijing to Shanghai by train than from New York to Washington. This is absurd. So we have plenty of room for that, but for political reasons we're not doing it. So I don't really see how...whether loose monetary policy or tight monetary policy, I don't see how it can possibly help.

MK What are the top five Chinese bands that you recommend for our listeners?

MP It's like asking a mom who's her favourite son.

CG Let's limit it to top two or three, if you don't mind.

MP That's even worse. Our most successful band is clearly Carsick Cars; they're the ones that have gotten the most critical acclaim. They played around the world and people like Sonic Youth or ex-Sonic Youth love them and then Chui Wan is a young band that's really blowing everybody away. So I love those two bands, but we have tons.

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CG Final question: a lot of this discussion has essentially been about what might happen in China for the next five years or maybe the next decade or so. I saw a casual point made by an economist not long ago about what would happen after that.

And he said that essentially the next decade might be difficult, as this rebalancing happens. We don't know exactly what it's going to look like but it's probably not going to be pretty, but that in the long term China has, at least throughout the last couple of decades, made fairly substantial investments in human capital and so when it emerges from this process it should have a fairly well-educated workforce and that is at least a source of longer-term optimism. I guess I wanted to ask if you agree and to talk about that.

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MP The real key is how they manage the rebalancing process because, historically, some countries have gone through the very difficult adjustments quite quickly and then they start growing very quickly again.

Other countries have not and the classic case is probably Japan. Japan I think used to be 17% of the world and today I think it's 6% or 7% of the world, which I have trouble...I couldn't find any country that didn't do that or that did that in times of peace. During times of war you can see that, but I think Japan has been pretty exceptional there and that's what we don't want for China.

I would argue that the way they manage the adjustment process is going to determine that, because the adjustment could be a 10-, 20-year process, in which case a highly-educated workforce today might not matter so much.

So, to me, that’s really the key and historically that’s always been the key. The countries that adjust quickly and successfully can continue growing and the countries that don’t never catch up.

CG Michael Pettis, professor at Peking University, blogs at Mpettis.com. Thanks so much for being here.

MP Thank you.

CG And before you go, Michael, what is your long-form recommendation for our listeners?

MP One of the great things about crises historically is that an awful lot of good books come out after a crisis. But I was really blown away by Adam Tooze’s book on the First World War. I’m trying to remember the title of it… The Deluge. It’s an absolutely brilliant book.

It ties together not just the US and Europe, which is...they star in almost every history of the First World War, but also Asia and Latin America. And it lays a wonderful foundation for understanding the Second World War and the post-War period. I was really impressed by it.

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