

Reflections on Dinny McMahon's Book on China's Great Wall of Debt

The debate over the longevity of the economic boom in China has long divided economists and financial market participants. On one side are believers that China's economic miracle will continue, which will soon make the Chinese economy larger than the US. The other side sees China's economic growth as largely fake, built on rapid credit expansion and the dominant hand of an authoritarian government, neither of which can last forever. In the middle are many observers who question the sustainability of the growth, but also struggle to reconcile how a boom that has lasted this long could be a mirage.

Whilst I've read hundred of articles from both sides of the debate, nothing I've seen approaches the wholistic discussion in Dinny McMahon's book "China's Great Wall of Debt". The subtitle of "Shadow Banks, Ghost Cities, Massive Loans and the End of the Chinese Miracle" gives away which side of the debate Dinny falls on. Unlike most who write about China's economy (myself included) Dinny lived and worked there for a decade as a journalist with the Wall Street Journal and other publications. His on the ground experience brings a treasure trove of examples and anecdotes that explain not just the economic story but also the motivations of the key actors.

After reading the book my biggest takeaway is that China's economic miracle has many similarities with other emerging market growth stories, but one key difference. This difference explains why China has been able to sustain its growth far longer than other debt fuelled booms. Dinny explains this in the introduction with:

"The Chinese economy is exceptional albeit not in the way that we have collectively come to assume it is. Rather than being immune to crises, recessions and funks, it's unique in that Beijing is willing and able to intervene on a scale that allows it to postpone a reckoning indefinitely, albeit at the cost of storing up greater pain for the future. (Jim) Chanos and (George) Soros weren't wrong, it's just that China's authorities have an unparalleled capacity to kick the can down the road. But with every kick, the can gets bigger and doesn't go as far. At some point it will go no further."

Whether you are new to the debate or have long been part of it, I can't recommend this book more highly. At just over 200 pages it's a fairly quick read yet comes with an enormous amount of relevant detail. Dinny's combination of journalistic skills, on the ground experience and economic understanding make this an engaging and entertaining read. It contains an array of relevant data, explanations and retellings of his life experiences in China. I enjoyed this more than any book I've read recently and unlike many other recent books I never found myself questioning why the author decided to write a book, rather than a long form article.

Structure of the Book

In the introduction Dinny briefly describes his family's history with China, which segues into the rise of China's economy in the last three decades. The first chapter details the black box that is financial reporting in China, with false accounting of both public and private entities egged on by an authoritarian government that punishes non-conformity. The second chapter shows how the authoritarian hand and government subsidies are necessary to prop-up zombie companies, which market forces should have killed off a long time ago. The book then discusses zombie cities, which required mountains of cheap debt to be built and exist because of the misguided growth expectations imposed on local and regional governments.

Dinny then details the obsession with and dependence upon land development, with land sales generating enormous revenue for local governments and the property boom generating enormous wealth for citizens. The fifth chapter explains the disaster in waiting that is China's financial system. By imposing artificially low interest rates, the government has incentivised citizens to chase returns on risky investment products. As some of these investments

inevitably fail, there's been pressure to bailout the investors which the government has so far mostly done, conditioning investors to expect that above average returns are guaranteed.

In chapter seven, Dinny discusses the problem of trying to fix all of the imbalances detailed in the earlier chapters. It's not that China's national government doesn't understand the problem it faces; rather the national government simply doesn't have control over what happens at the local government level. Even with the corruption crackdown, there is too much money and prestige at stake for local officials to implement economic reforms. Ageing demographics, protectionist tendencies and a culture that struggles with innovation are other roadblocks to reform.

In the final chapter, Dinny doesn't put forward a definitive view on how China will resolve its economic, environmental and social problems, but he is sure that the runway is running out. He notes how dependent upon China's growth much of the world has become. The demand for agricultural and mineral resources, tourism and education by Chinese citizens have been a boom for Australia in particular. The evidence suggests that China and its trading partners aren't ready for the change that lies ahead.

Going Beyond the Book

What the book doesn't explicitly argue, but certainly opens up for discussion is the narrative around China seeing a gradual slowdown. If China follows the pathway of other emerging market busts, it will be a sharp deceleration with a multi-year recession. China is different in that it isn't a wave of overseas investment that has driven growth, but rather an internal credit boom. This makes the Japanese experience instructive, where the economic correction has been playing out over decades. If the Chinese government can maintain its grip on power, a long period of flat or slightly negative growth would seem more likely as the economy reforms.

As China makes up around one-third of global GDP growth, the rest of the world will catch a cold if China sneezes. This won't be evenly distributed; a rapidly shrinking number of countries have limited trade with China. The US and Europe have significant links across agriculture, technology and services as well as significant investment flows. China's near neighbours, Taiwan and South Korea, and China's major resource suppliers, Australia and Brazil are particularly exposed to a slowdown.

It is easy to foresee the impact of a Chinese slowdown on mineral resource demand. The majority of demand would disappear quickly as the resources required for growth (particularly property and infrastructure development) are a multiple of those required for maintaining the status quo. The loss of high paying mining services jobs and the massive reduction in company tax revenues would severely damage the Australian budget and decimate the regions dominated by mining activity.

Second level thinking is required when considering a slowdown in services demand. A rapid exit of Chinese students could see a wave of apartments made available for rent, doing further damage to the already suffering property market. A slowdown in tourism will impact hotels, retailers, restaurants and many other labour intensive businesses. There's a lot of low paid workers that directly or indirectly hang off these two sectors that would also be impacted.

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