If the Chinese Bubble Bursts…

Who globally would be most affected?

Certainly Chinese authorities might succeed in their effort to safely slow the pace of rapidly rising asset prices. Yet assume this scenario: The authorities fail and sometime over the next several years the asset bubble suddenly bursts. What happens then for the Chinese economy?

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The views of 30 experts.

The surrounding export hubs at first, with global growth hit significantly.

MAYA BHANDARI
Head of Emerging Markets Analysis, Lombard Street Research

The latest financial crisis proved the central role of China in driving global economic outcomes. China is the chief overseas surplus country corresponding to the U.S. deficit, and it was excess *ex ante* Chinese savings which prompted *ex post* U.S. dis-saving. The massive ensuing build-up of debt triggered a Great Recession almost as bad as the Great Depression. This causal direction, from excess saving to excess spending, is confirmed by low global real interest rates through much of the Goldilocks period. Had over-borrowing been the cause rather than effect, then real interest rates would have been bid up to attract the required capital.

A prospective hard landing in China might thus be expected to have serious global implications. The Chinese economy did slow sharply over the last eighteen months, but only briefly, as large-scale behind-the-scenes stimulus meant that it quickly returned to overheating. Given its 9–10 percent "trend" growth rate, and 30 percent import ratio, China is nearly twice as powerful a global growth locomotive as the United States, based on its implied import gain. So while the surrounding export hubs, whose growth prospects are a "second derivative" of what transpires in China, would suffer most directly from Chinese slowing, the knock to global growth would be significant. Voracious Chinese demand has also been a crucial driver of global commodity prices, particularly metals and oil, so they too may face a hard landing if Chinese demand dries up.

In our estimates, China has shifted from growth far above 10 percent in the year to the first quarter of this year, to very little domestic demand growth now. Overheating and inflation have not been addressed with yuan appreciation, but rather by a top-down ordering of banks to cease lending. This is symptomatic of a market economy operating under a communist political structure, and has made the business cycle much more violent. What is clear, however, is that China needs to switch to a more balanced growth model—away from exports and towards domestic demand—in order for the needed global rebalancing to be achieved.

The biggest victims: Foreign companies invested in China.

TADASHI NAKAMAE
President, Nakamae International Economic Research

China has created a bubble in its productive capacity that is even more dangerous than its asset price bubble. The former is the inevitable result of overinvestment in capital expenditure and building an export-led economy. When capital investment is booming, say, when steel factories are being built, this itself creates extra demand for steel that cannot be sustained, especially once the factories become operational and become units of supply rather than demand.

China is a typical case of a capital investment-led boom-and-bust economy. Expansion of investment is mainly supported by exports. Once exports start deteriorating, economic growth halts. Exports decline, as does capital investment, leading to a sharp drop in overall demand. It becomes increasingly clear that the country has huge over-supply in capacity. Prices decline and a deflationary recession develops. Immediately after Lehman Brothers collapsed, China's nominal GDP growth rate fell from its peak of 24 percent in the fourth quarter of 2007 to a mere 3.6 percent in the first quarter of 2009. Its GDP deflator fell from 12.3 percent to a negative 3.7 percent in the same period.

The Chinese government tried to deal with this by stimulating bank lending, mostly for infrastructure projects by regional governments. Banks also lent a considerable amount for speculative real estate investments. The problem with regional governments using bank lending rather than tax revenue to finance public works projects is that these do not create a return on investment. Servicing the debt is all but impossible, leaving banks holding potentially enormous bad loans on their books. Also, speculative real estate investments are turning sour as the asset price bubble bursts. Unless the central government props up its regional subordinates (which would create a huge budget deficit), banks will suffer enormously.

Another way to counter the problem of excess supply capacity is to stimulate consumption by raising wages. However, wage increases reduce corporate profits at a time when prices are falling. This could dampen, rather than stimulate, the economy in the short term. Not willing to take the short-term pain for the long-term gain, China is likely to fall back on its usual strategy of exporting its way out of its problem. China's trade partners will not be happy, as this will entail a cheap renminbi, which could cause some to retaliate with trade protection.

China will also be looking to scrap some of its excess supply capacity. China's social and political situation is already rather tense. Its central authorities are unlikely to force domestic companies to make big sacrifices. Foreign companies, on the other hand, are easier targets. The wave of strikes earlier this year forced steep wage hikes—but only at foreign companies. When foreign companies are forced to sometimes even double wages in China, this could be a sign that authorities are prepared to see them go to other countries in search for cheaper labor.

Thus, while China's asset price bubble is worth monitoring, its capital investment-led boom and bust is far more dangerous, and this looks to be already beyond the control of its central authorities. This will have far-reaching negative effects globally, but the biggest victims will probably be foreign companies already invested in China. If the collapse is sudden, the Chinese government should guarantee the property and all other assets of foreign companies leaving China.

A massive deflationary shock to the world.

CHEN ZHAO
Chief Global Strategist and Managing Editor for Global Investment Strategy, BCA Research Group

At the onset, I believe the odds of a China asset bubble bursting are very low. It is difficult to argue that Chinese asset markets, particularly real estate, are indeed already in a "bubble." Property prices in tier two and tier three cities are actually quite cheap, but for purposes of discussion, there is always the danger that asset values could get massively inflated over the next few years. If so, a crash would be inevitable.

In fact, China experienced a devastating real estate meltdown and "growth recession" in 1993–94, when then-Premier Zhu Rongji initiated a credit crackdown to rein in spreading inflation and real estate speculation. Property prices in major cities dropped by over 40 percent and private sector GDP growth dropped to 3 percent from double-digit levels. Non-performing loans soared to 30 percent of total banking sector assets. It took more than seven years for the government to clean up the financial mess and recapitalize the banking system.

If another episode of a bursting asset bubble were to happen in China, the damage to the banking sector could be rather severe. History has repeatedly shown that credit inflation begets asset bubbles and, almost by definition, a bursting asset bubble always leads to a banking crisis and severe credit contraction. In China's case, bank credit is the lifeline for large state-owned companies, and a credit crunch could choke off growth of these enterprises quickly.

The big difference between today's situation and the early 1990s, however, is that the Chinese authorities have accumulated vast reserves. China also runs a huge current account surplus. In the early 1990s, China's reserves had dwindled to almost nothing and the current account was in massive deficit. As a result, real estate meltdown led to a collapse in the Chinese currency in 1992–93.

In other words, Beijing today has a lot of resources at its disposal to stimulate the economy or to recapitalize the banking system, whenever necessary. Therefore, the impact of a bursting bubble on growth could be very sharp and even severe, but it would be short-lived because of support from public sector spending.

A bursting China bubble would also be felt acutely in commodity prices. The commodity story has been built around the China story. Naturally, a bursting China bubble would deal a devastating blow to the commodities markets as well as commodity producers such as Latin America, Australia, and Canada, among others.

Asia as a whole, and Japan in particular, would also be acutely affected by a "growth recession" in China. The economic integration between China and the rest of Asia is well-documented, but it is important to note that there has been virtually no domestic spending in Japan in recent years and the country's economic growth has been leveraged almost entirely on exports to China. A bursting China bubble could seriously impair Japan's economic and asset market performance.

Finally, a bursting China bubble would be a massive deflationary shock to the world economy. With China in growth recession, global saving excesses could surge and world aggregate demand would be vastly deficient. Bond yields could move to new lows and stocks would drop, probably precipitously—in short, investors would face very bleak and frightening prospects.

China's local “loan platforms” put the world at risk.

ANONYMOUS
A senior Japanese official

What is a financial bubble? In terms of social psychology, it is explained as a sort of euphoria. However, in order to formulate effective policy, we must clearly define “bubbles” based on economics.

Any investment decision is motivated by the expected rate of return. Sometimes, the expected rate of return deviates from realized rate of return after the fact. When it deviates upward significantly, the financial sector becomes unstable and will eventually damage the real economy. This is a financial bubble.

What causes this upward deviation? The obvious answer is misallocation of financial risk. For Japan, loose monetary policy was the cause, aided by G-5 policy alignment in the 1980s. This convinced market participants that interest rates would remain low for the foreseeable future. Thus, the expected rate of return deviated upward. For the United States, the “Greenspan put” inflated the expected rate of return. Although the U.S. Fed's awkward stance toward the financial bubble has some theoretical justifications, its undesirable side effect is undeniable.

What about China? First, because of the rigid renminbi exchange rate, China's monetary policy loses effectiveness. Unless the United States tightens monetary policy, China cannot do so. What Beijing can do is increase reserve requirements on the banking sector, or strengthen credit rationing through “window” control by the People's Bank of China. Second, the renminbi exchange rate system is unlikely to become freely convertible due to China's continuing high dependency on its export sector. Third, Premier Wen Jiabao has repeatedly declared that “China's appropriately loose monetary policy will remain intact for the foreseeable future.” This policy statement is, of course, “inappropriate.”

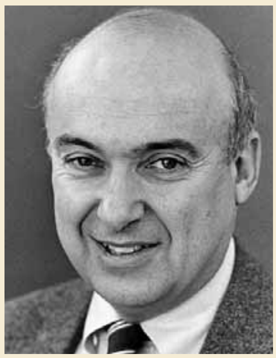
In reality, China's residential property bubbles are obvious. But the real danger lies elsewhere. So-called “loan platforms” established by local governments pose a much more serious risk. In the 1990s, China centralized its tax system and rendered local governments dependent on Beijing's coffers. In order to make up the budget shortfall, local governments established these funding vehicles through which they can obtain commercial loans. In 2008, when Beijing mobilized a massive ¥4 trillion pump priming, it ordered local governments to bear one-third the cost themselves. This triggered a stampede. As of the end of June this year, there are 8,221 platforms and their outstanding loan balance is ¥7.7 trillion, of which 20 percent to 25 percent are deemed “problematic” by the China Banking Regulatory Commission.

Beijing's concern is growing. We have witnessed huge IPOs by several commercial banks. In addition, major commercial banks are now planning to increase their capital by ¥200 billion. Central Huijin, China's sovereign wealth fund, will contribute 90 percent of this capital, and plans to raise necessary funds through bond issuance. (Who is supposed to buy these bonds? The banks!)

What happens then to the Chinese economy if the bubble bursts? Authorities in Beijing say the problem is still within manageable range. This is exactly what Ben Bernanke repeated until mid-2007. The amount of potential non-performing loans is almost comparable to the amount in Japan's case. Any modern financial safety net is not yet established. Can we still be optimistic?

Globally, who would be affected most? This depends on the size of each country's cumulative foreign direct investment into China. Taiwan and Hong Kong, and also the United States, European Union, Japan, and Korea, will be affected significantly.

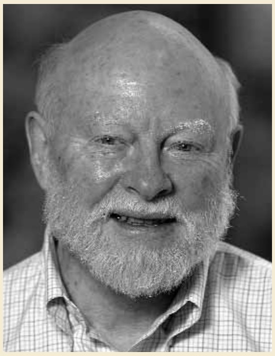
Too grave a scenario? Don't shoot the messenger.



Most affected: the Chinese themselves.

MARSHALL I. GOLDMAN
Senior Scholar, Davis Center for Russian and Eurasian Studies, Harvard University

Were the Chinese asset bubble to burst, likely it would be the Chinese themselves who would be the most affected. Both domestic and foreign investment in China would suffer and result in a sharp drop in production and employment. That in turn might have domestic political consequences, possibly resulting in a governmental upheaval. Over the years, China has experienced several economic upheavals, which has made investors in China fearful of sudden economic change. As a result, it is likely that any sign of another sudden economic crisis would cause fear and uncertainty which would result in the very economic panic that China as well as the rest of the world would prefer to avoid.



Though unlikely, a slump in investment would create trouble for the rest of Asia.

RONALD MCKINNON
Professor Emeritus of International Economics, Stanford University

It is too difficult for me to accept the assumption that China's "bubble" will burst of its own accord.

Currently, the stock market has come down safely from its maximum of more than two years ago. The authorities are taking steps to smooth the rise in housing prices—even as massive new investments in urban apartments are completed to accommodate migration from the countryside. Most importantly, to buy a house or condominium in China, the buyer typically puts down 40 to 50 percent of the sale price. Thus, even if there is a substantial dip in real estate prices, owners are not going to walk away from their properties American-style. (The most important omission in the new U.S. financial reform bill was the failure to include mandatory down payments for home mortgages and automobile loans.) Chinese banks are now relatively safe, although some loans financing the 2008–09 surge in infrastructure investment, which got China and the rest of Asia out of the global downturn, may be questionable. But now the economy is humming along with 10 percent-plus real growth.

So what could go wrong here? The threat that China will be forced into a large appreciation of the renminbi still hangs over the economy. In our globalized financial system, firms making large-scale investments are very sensitive to that country's exchange rate—and China's domestic investment is a huge 40–45 percent of GNP. So a slump in investment could cause a major slump in the economy, with the trade surplus (the difference between saving and investment) actually increasing! When Japan was forced into massive appreciations of the yen from the late 1970s to the mid-1990s, investment slumped, the economy and import growth turned downwards, and wage growth eventually became negative.

If China were forced into the Japanese syndrome with its "lost decades," the world economy (particularly the Asian part of it) would lose its most important engine of economic growth.

India would be the winner.

ERNEST H. PREEG
Senior Advisor for International Trade and Finance, Manufacturers Alliance/MAPI

China itself would be most adversely affected, while the impact on others would depend largely on Chinese export performance during the recovery. The bubble centers on highly inflated commercial and residential property prices, deeply linked to the excessively large, export-oriented industrial sector. If these property values begin to crash, China would confront the need for long-discussed structural change away from export-driven industrial growth and toward domestic consumption in service industries. So far this hasn't happened, as industrial growth outpaces GDP growth. Moreover, this change would become more difficult after a bursting bubble, as higher-paid industrial jobs are lost and political as well as economic uncertainty inhibit personal consumption.

This is where the export strategy comes into play. The safety valve for a sagging industrial sector would be stimulation of job-creating exports, perhaps including currency depreciation, despite falling imports and a rising trade surplus. Others, especially the United States and the European Union, would resist this mercantilist response, and the adverse impact on their economies would depend largely on how successful they were in containing their trade deficits with China. Since only 6 percent of U.S. global exports of manufactures go to China, imports (that is, Chinese exports) dominate the extremely unbalanced bilateral trade account, and would be the focus of the U.S. response. East Asian trading partners would suffer more because of their much greater export dependency on China. Oil exporters would be hit from lower oil prices, although this would be a plus for the United States and other oil importers.

The biggest net gainer would be India, with relatively small exports of manufactures and business services to China at risk. India would emerge touted as the new number-one high-growth emerging market, with balanced and therefore sustainable 8–10 percent growth, which would attract increased foreign investment, in part at Chinese expense, to reinforce its new status.

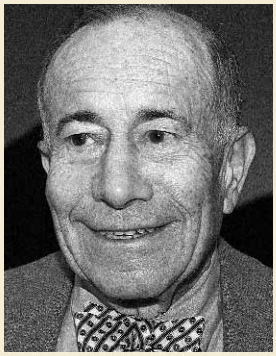
The eurozone's weak sisters could be killed.

BERNARD CONNOLLY
Managing Director, Connolly Global Macro Advisers

A collapse of the China capital expenditure and property bubbles might not have the same counterparty risk impact in western financial systems that the incipient collapse of the U.S. Ponzi game had in 2007–09, or the near-collapse of the eurozone Ponzi game threatened to have earlier this year. But it would have substantial financial effects within China, and global effects on the real economy.

In China, the financial arrangements among municipalities, local banks, collective investment vehicles, and infrastructure projects uncannily resemble those at the state level in the United States in the late 1830s—and that episode ended in widespread defaults on state bonds and a large number of bank failures. Something very similar would be likely in China absent a bailout from the center. If there were a bailout, financed monetarily, the renminbi could weaken sharply. That would be consistent with real-side needs: a collapse in capital expenditure would leave a hole in the economy that could not possibly be filled in the short term by rising consumption, so China would seek a huge rise in net exports. The renminbi would need to depreciate hard, and China's trade surplus would explode upwards. All China's trading partners would be hit, triggering a round of competitive currency depreciations. And, rather like how the United States handled the impact of the Asian crisis of 1997–98, worsened net trade for China's partners would force them to try to support domestic demand through looser monetary policy—in present conditions, through central bank programs of asset purchase.

In short, the bursting of a China bubble would force the creation of even bigger bubbles, notably in bond markets, in other countries. One specific problem, though, would be the eurozone, where central bank asset purchases have particularly significant political overtones. If that meant the euro was left holding the baby of adjustment to a burst Chinese bubble, the eurozone peripherals could be killed.



The global effects would be limited.

CHARLES WOLF, JR.
Distinguished Corporate Chair in International Economics, Professor, Pardee Rand Graduate School, and Senior Fellow, Hoover Institution

The assumed scenario is unlikely, but not so unlikely as to be uninteresting. I'd guess its probability of occurrence is perhaps one in ten—not three in ten, but also not one in a thousand!

What would happen for the Chinese economy? Several likely consequences would follow. The shock to China's already-fragile banking system would sharply squeeze future lending, especially by provincial banks, but China would not suffer anything like the drastic effects of the subprime and alt-A crisis in the United States due to China's fortunate want of securitization, derivatives, CDOs, CDSs, and the like. China's equities markets would suffer a severe setback, perhaps as much as 40 percent to 50 percent in Shanghai and Shenzhen. The effects of the squeeze in lending and the market setbacks would probably shave 2 percent from China's annual GDP growth for several years. Meanwhile, we would see increased efforts by corporate, household, and other holders of ¥25 trillion-plus in savings deposits to circumvent controls and convert some deposits to foreign assets.

Globally, who would be affected most? Global effects likely would be limited because, unlike the large and widespread repercussions from the subprime cataclysm emanating from United States in 2008 and 2009, global holdings of the bubble-bursted Chinese assets have been minimal. In contrast to the perverse signals conveyed by the "full faith and credit" of U.S. backing of Fannie/Freddie securitization, nothing of this sort has obscured the underlying asset risks in China, nor led to large-scale foreign acquisition of property and other vulnerable assets there. Fortunately for China, it hasn't been subject to the baneful effects of a voluble and potent U.S. Congress pushing against and suppressing market signals about asset risks. However, a likely consequence of the assumed bursted asset bubble in China would be an added boost to the already substantial surge in China's recent activities in global mergers and acquisitions markets.

Hardest hit: Beijing's party leadership.

GARY HUFBAUER
Reginald Jones Senior Fellow, Peterson Institute for International Economics

Collapsing Chinese asset values would devastate China and many millions beyond the Middle Kingdom. Hardest hit would be party leaders in Beijing. It's questionable whether the technocrats could survive a 50 percent drop in property values. Beyond China's own borders, manufacturing supply chains across Southeast Asia and commodity producers from Australia to Brazil would all take a drubbing. A new aphorism is born: China sneezes, its partners catch pneumonia. While misery would reach far and wide, some would benefit. Perhaps the biggest beneficiary would be India—lower oil and raw material prices, openings for its manufactured exports, and a burnished reputation for growth and stability.

Japan and Taiwan would suffer the most.

MILTON EZRATI
Partner, Senior Economist, and Market Strategist, Lord, Abbett & Co.

I confess I am skeptical of the assumption implicit in this question. Though possible, a bursting bubble is by no means probable, because, among other things, China has such powerful underlying growth potential and because the authorities in Beijing are more than likely, as they proved in 2008–09, to take swift, effective remedial action. Still, the probabilities are great enough to make the exercise more than purely academic and surely useful.

A Chinese asset price collapse, though undoubtedly an ugly prospect, would likely have less devastating global implications than the recently burst real-estate bubble has had. For one, China operates on a far smaller financial scale than the West. But more, Chinese financial institutions are closely aligned with government, a link which, for all its other drawbacks, should help the authorities manage a crisis more directly and quickly than the West could its recent crisis. The strong government link—ownership, in fact—should help especially in controlling a short-term panic of the sort that so compounded the effects of the subprime crisis.

Still, a burst bubble would slow the Chinese growth engine significantly, and accordingly slow the pace of global growth. Given relative trade patterns, the economic shortfall would hit China's near neighbors in Asia first and hardest. Japan in particular would suffer as it depends heavily on exports to China. Taiwan's economy is, if anything, even more closely tied to mainland growth. The rest of the Pacific Rim would suffer only slightly less. As the economic pain emanated out from Asia, its intensity would dissipate, not because of distance, obviously, but because the United States and Europe depend less for sales to China than do its near neighbors and because the financial connections are far less complete. Since Beijing in such a situation would surely strive to sustain growth by artificially depressing the yuan's value, the burst bubble would add considerable strain to already tense Sino-American relations.

The Chinese banks and other institutions.

MICHAEL J. BOSKIN

Tully M. Friedman Professor of Economics and Hoover Institution Senior Fellow, Stanford University, and former Chair, President's Council of Economic Advisors

While a softer landing is possible, if Chinese asset prices suddenly collapse, the most harm would befall the owners of the assets, who are primarily, but not exclusively, Chinese. Lenders, most especially Chinese banks and other institutions, would be stuck with sharply devalued assets. Policymakers, from the People's Bank of China to local authorities, would be faced with the usual dilemma of finding the best route out of a financial crisis. To the extent the financial turmoil spilled over to the real economy of output, income, and employment, Chinese workers would suffer. China's major trading partners would be negatively affected as well. China is now such a big player in global trade and finance that we all have a stake in a successful outcome.

Asia's developing economies.

CATHERINE L. MANN

Barbara '54 and Richard M. Rosenberg Professor of Global Finance, Brandeis International Business School, Brandeis University

Although the political heat from Washington will be intense, developing countries of Asia will be the worst hurt by a China asset crisis. When faced with a collapse of true and aspirational wealth, China will resort to export-led growth to stave off economic and political catastrophe. With the renminbi depreciating, other Asian economies will be pushed off their rung of the development ladder, only recently relinquished by China.

In stage one of the crisis, the upwardly mobile middle class sees their wealth vanish—portfolios, but most important, housing wealth. Even though the share of the population that owns real estate is small, the aspirational class is large, and their economic future goes poof. The nascent move toward domestic-demand driven economic growth in China halts.

An asset crash reveals shady debt on the balance sheets of banks. But unlike in the United States, private access to and valuation of bank credit has not been an important foundation for growth in China. Moreover, with some $2 trillion worth of liquid international assets at the central bank, some bad condo loans are not a big deal.

The political fallout from the wealth shock means a flight to exports to bolster jobs and economic activity, and to prop up export-related commercial properties, warehouses, and private housing. At this point, the asset crisis spills over to the rest of the world. The renminbi will return to full state control and be pushed to depreciate.

The U.S.–China bilateral trade deficit will rise as foot-loose exporters that had started to move to cheaper Asian locations flock back to China. China will buy dollar-denominated securities to keep export jobs flowing and asset prices from free fall. While this is not a scenario that is good for the United States, the damage to the development prospects of other developing countries in Asia will be far worse.

The immediate impact: the jump in U.S. Treasury yields.

PAUL J. ALAPAT

Managing Director, Amba Research

The consequences of a bubble bursting in a state capitalist economy may be very different from the consequences in a free market system. In all likelihood, state-directed spending would be ramped up to fill the hole in demand, and accumulated government reserves channelled to rapidly re-capitalize and bail out the banks.

Moreover, with China extensively and intimately enmeshed in the global supply chain, multinational companies and global banks would ensure that critical funding was quickly restored.

However, assuming for a moment that the weakened banking system following the bubble burst leads to a cutback in domestic credit, with consequent contraction in economic activity, collapse in aggregate demand, and a jump in unemployment in China, some of the potential global impact could be as follows.

The immediate impact of a collapse in economic activity in China is likely to be a jump in U.S. Treasury yields both due to repatriation of Chinese holdings and a rise in risk premia. Global supply chains, particularly those for electronics and a variety of consumer goods, will get disrupted and will pressure prices of manufacturing goods higher. Globally, the disinflationary impact from having China's vast resources being deployed into manufacturing will be suspended, adversely affecting consumers around the world. Terms of trade would shift in favor of tradables away from non-tradables. Geographically, the disruption of production in China is likely to impact the countries in East Asia and the commodity-exporting countries in the Middle East, South America, and Australia the most. The rise in unemployment in China could threaten social and political stability, and escalate border tensions with neighboring countries.

In all probability, however, the government, and foreign savings, will not let the bursting of an asset bubble in China damage economic activity materially; whether that would be the right response is another matter.

The losers: global exporters of non-essential items.

HONGYI LAI
Associate Professor and Ph.D. Program Director, School of Contemporary Chinese Studies, University of Nottingham

Hypothetically, if the real estate bubble in China grows out of control and bursts, it will hit hard real estate developers, housing owners, housing speculators, the banks and financial sectors, as well as the construction and building materials sectors in China. Housing owners and developers will find their assets depreciating rapidly. Banks and financial institutions that lend heavily to home buyers and real estate developers will struggle with mounting bad loans. A host of sectors closely associated with the real estate market, including construction, building materials, interior decoration, and even steel and power generation, will be hit hard. The slump will severely hurt urban consumption. It could also drain government revenue, especially local government revenue.

Globally, as Chinese urban consumers tighten their belts, Chinese imports will shrink, especially commodities mostly related to construction such as iron and steel, timber, and certain energy inputs. Imports of non-essential consumer items such as personal luxury goods and high-end home appliances will decline. In addition, China's purchase of overseas financial products and investments abroad may also decline. Countries which produce these goods and which have benefitted from the Chinese financial purchases or investments will suffer.

Let us hope this will not happen. On the positive side, the Chinese government has introduced a series of measures in the recent years. It has indeed caused pauses in the upward soaring of real estate prices. However, many observers in China complain that these measures have not stemmed the upward spiral of real estate prices. This will not be an easy battle. The government needs to increase supplies of affordable housing within a short period, tighten purchases of extra homes by rich home owners, and declare war on special interests and parties that benefit from an overheated real estate market.

U.S.-China relations would be in crisis.

BOWMAN CUTTER
Senior Fellow and Director, Economic Policy Initiative at the Roosevelt Institute, and former Managing Director, Warburg Pincus

The most important consequence of a major "China Bust" would be an almost inevitable political and economic crisis in the China-U.S. relationship.

I should be clear that I am specifying a major economic and financial crisis in China, in relative terms approximately the same size as that just experienced by the United States. Such a crisis is extremely unlikely.

The economic consequences of a bust are straightforward. But the inevitable policy moves China will feel it will have to take, and the consequences of those, could easily create enormous political problems.

The crisis itself will cause the renminbi to fall in value. As it hits, China will move both with substantial stimulus and with a TARP-like bailout policy. But its real policy focus will be on an export-led recovery. Why? Because it is by far the best policy lever China has.

This policy emphasis will involve substantial new export subsidies, and a strong policy focus on a weaker renminbi. This, in turn, will export more of the crisis to the rest of Asia and will prolong the weak recovery the United States and Europe are already seeing.

As these developments become apparent, any Administration would have to act with a much harder line toward China. At the same time, the overall political mood in the United States *vis-à-vis* China will become even uglier. These U.S. political responses could easily interact with Chinese politics to produce a long-term rupture in the China-U.S. relationship.

This is a low probability/high consequence scenario—exactly the kind of policy management problem governments are least likely to be able to prepare for. And both the U.S. and Chinese governments have enough high probability/high consequence problems to fill up their time. But my experience is that it is almost always the combined and interacting political-economic environment that is mutually misunderstood as tensions between nations increase.

Hong Kong and Taiwan, with Korea not far behind.

RICHARD JERRAM

Head of Asian Economics, Macquarie Capital Securities

Who globally would be most affected if the Chinese bubble burst? You see different assertions about bubbles in China—for example, in real estate, or investment—but for simplicity I will assume we are talking about the growth "bubble" bursting.

Economic geography has taught us the importance of propinquity. The intensity of trade and investment relations tends to decrease with distance, so unsurprisingly Hong Kong and Taiwan are the most vulnerable—close neighbors with very open economies, and a high proportion of exports to China. Korea is not far behind. Japan would also hurt, though it is a much less open economy than Korea or Taiwan, because the domestic economy is stagnant, making it reliant on exports for any growth dynamic. Presumably, commodity-exporting countries would suffer from a terms-of-trade shock and exchange rate depreciation if Chinese demand slowed sharply.

Stepping back twenty years, we could have asked the same question about the Japanese bubble. With hindsight, the answer is that the global effects are relatively hard to find. The world economy prospered even as Japan sank into deflation. The global financial system barely noticed as Japanese equity and real estate prices lost up to three-quarters of their value and the banking system flirted with insolvency. Admittedly, the Japanese bubble deflated relatively slowly—stock market aside—and China should be more meaningful as its economy is much more open than Japan's, but any disruption in China is likely to be relatively short-lived. You would not expect a developing economy like China to have a perfectly smooth growth path, but nor would you expect any crash or recession to result in prolonged damage.

Bursting of the bubble is a big "if."

SASHA GONG

Candidate for the 46th District of the Virginia House of Delegates, 2009, and author,* Born American: A Chinese Woman's Dream of Liberty *(Nimble Books, 2009)

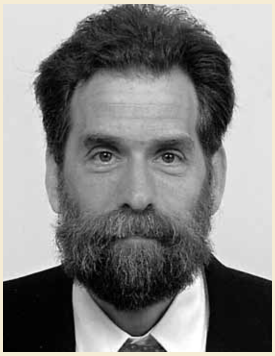
China's asset bubble has been the talk of many towns for a long time. Every once in a while, pundits predict the bursting of the bubble, and the crumbling of the economy that will follow.

Start with a little history. The Chinese government did not understand the value of land as a commodity until too late. After the communist takeover in 1949, all private land was either confiscated or collectivized by the government. A whole generation of government policymakers had little concept of the value of land. Therefore, in the early 1990s, when a real estate market began to develop, the power to sell and lease land was left to local governments. Land sales became the main source of local government revenue and the major mechanism contributing to GDP growth. In some coastal provinces, income from selling land accounts for most of the government's revenues. Continuing to expand the bubble is strongly in the interest of local authorities, although that interest is not necessarily aligned with the interests of the central government.

If the central government greatly tightens its controls, the asset bubble may burst. This has been on its agenda for a few years, but until now, legislation and regulations initiated in Beijing to that end have been met with massive resistance from the localities. In some coastal cities, 60 percent to 90 percent of land use granted by the local governments is considered illegal according to the current law.

If the bubble bursts, China's image as a vibrant engine of world economic growth may change. In 2009, land sales accounted for ¥1.6-1.9 trillion, or more than half of the revenue of local governments. A severe reduction in land sales could greatly hamper China's impressive two-digit annual GDP growth.

But that is a big "if." After all, the central government is not all-powerful, as it was in the era of the planned economy. Local governments, meanwhile, have so far managed to avoid most shake-ups initiated from the center in the past decade.



Emerging markets would bear serious watching.

GARY KLEIMAN
Senior Partner, Kleiman International Consultants

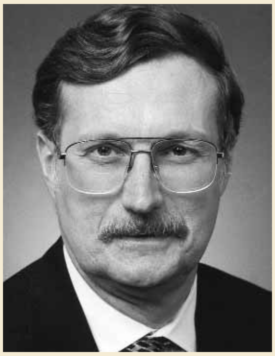
The "Shanghai Surprise" market drop in early 2007 signaled credit and economic excesses that set the stage for global crisis. But a future financial and real asset market correction may be even more seismic, given China's central role not only in trade but as a direct and portfolio investment provider, particularly in fast-growing developing regions.

The state has encouraged this outward push to access natural resources and higher returns through government-controlled banks and enterprises. Businesses would be forced to curtail plans and turn homeward under a quasi-crash scenario. Expansion in worldwide mining projects that came to $15 billion in 2009, often in poor countries in Africa and elsewhere, could be halted.

As shaky Greece courts Chinese infusions to sustain its international rescue program and thwart insolvency, more advanced emerging European markets may again be bypassed. Such is the case with Hungary, which garnered sudden interest with the sovereign debt threat and where a telecoms deal was recently signed.

In Argentina, Brazil, and Venezuela, sizable trade finance facilities could disappear. These facilities accompany vital commodity exports—with the Chinese mainland the prime destination—and promote external use of the renminbi as part of a gradual liberalization program.

In Asia, the neighborhood effect would of course be strongest, but cross-border monetary as well as industrial links fostered over the last several years could magnify the fallout. Authorities have reinforced decade-old currency swap arrangements with over $2 trillion in reserves, and doubled holdings of Korean bonds as a means of G-3 diversification and better returns. Under the Qualified Domestic Institutional Investor regime, domestic banks and institutional investors within strict limits were to follow this regional allocation path, but would likely be blocked under post-bubble emergency conditions.



Most affected: Taiwan and Hong Kong…and global equity markets.

GEORGE HOGUET
Global Investment Strategist, State Street Global Advisors

Chinese macroeconomic policy in recent years has been skillful. China has handled well domestic challenges and the Asia crisis, the Great Panic, and the Great Recession. An asset price bubble and subsequent bust in China is not a foregone conclusion, the more so as

Chinese policymakers will likely act preemptively. But China's exchange rate policy clearly has led to distortions. Furthermore, retail investors dominate the Chinese A-share market, now one of the world's largest stock markets. At one point, it sold in excess of 75 times earnings.

The global impact of an asset price collapse in China depends on many factors, including the initial conditions leading up to the collapse, the Chinese sectors and regions that are most seriously impacted, the magnitude and duration of output declines in China, the domestic and global policy response, and China's exchange rate regime at the time. Such a crash could potentially impact the world economy through multiple channels, including global trade and commodity prices. Global monetary and exchange rate channels could see the renminbi possibly depreciating and capital outflows accelerating, along with reduced credit flows to emerging Asia and smaller foreign direct investment flows to China.

In terms of the real economy domestically, China's migrant workers and emerging middle class on the coast would be negatively impacted. Globally, Taiwan and Hong Kong likely would be among the most seriously affected, as would Malaysia, the Philippines, and Korea. Brazil and other commodity producers along with China's neighbors such as Mongolia and Japan would also feel the impact.

These are first round effects only; there surely would be more. In terms of global equity markets, the Chinese A-share market is lowly correlated with major global developed equity markets. A crash in the A-share market is unlikely to impact immediately global developed markets. But financial contagion risks are ever-present and continue to present analytical challenges.

The most affected: internal politics in China.

GREG MASTEL

Managing Director, Dutko Worldwide

The Chinese economy is now unquestionably an important source of strength for the world economy, and the rest of the world has good reason to hope for China's continued success. But there are reasons to worry. As the long-running battle over China's undervalued currency demonstrates, Beijing's leaders seem committed to following a largely export-led policy for growth rather than a more sustainable one led by domestic demand.

Recent troubles demonstrate starkly that oversight and transparency in the U.S. banking system was less than assumed, but what is hiding on Chinese balance sheets could be even more unsettling. There is good reason to wonder about macroeconomic data, which is largely controlled by Chinese authorities. Given endemic corruption, there is even more reason to wonder about the solidity of the balance sheets of Chinese companies—particularly state-owned companies.

Beyond that, China's leaders seem to be demonstrating an increasingly confrontational attitude on the world stage. China's recent clash with Japan is disturbing, but hardly out of character. A serious overreach by Beijing regarding Japan, Taiwan, or any of a list of other countries could send economic shockwaves (and perhaps worse) around the globe.

Of course, the immediate victims of China's bubble bursting would be the hundreds of millions of Chinese who would plunge further into poverty. Particularly now, a global recession is also a distinct possibility.

Perhaps the most disturbing issue is the reaction of Beijing to a bursting of the bubble. Increased political unrest in China is almost certain if the economy went seriously sour. Would China's leaders take drastic measures to maintain control? Would those same leaders provoke international confrontation in hopes that an external enemy could be blamed for economic troubles and distract domestic attention? Unfortunately, both seem like all too real possibilities.

The most affected: Japan and Korea.

ROBERT JOHNSON

Former Managing Director, Soros Funds Management, and former Chief Economist, U.S. Senate Banking Committee

A bursting bubble would be unwelcome in this world of deficient aggregate demand and mercantilist competition. A downturn in China would add to the deflationary stress and loss of confidence that challenges every region of the world economy. It would most powerfully impact Asia, notably Japan and Korea. It would also likely lead to a decline in the terms of trade (relative price) for commodities, and commodity-producing countries in Latin America, Asia, and the Middle East would experience balance-of-payments difficulties.

A collapse in asset values, whether real estate or stock prices in China, would primarily have negative wealth effects at home as China's capital market is not widely open. The decline and ensuing wealth and confidence impact in China could be significant. If social unrest were to result from the disappointment caused by a sharp decline in wealth, then domestic politics could become unsettled and give pause to foreign direct investment thereafter. China's growth is very dependent on investment spending and exports, and a confidence and political crisis could derail the current juggernaut of growth.

Chinese officials with over $2 trillion in reserves could respond with fiscal programs to compensate for the loss of investment spending and dampened consumer confidence, and thus mitigate the severity of the downturn.

Internationally, the propagation of a bubble bursting in China would be felt in many ways. First, Chinese weakness could heighten the risk premium in financial markets and lead to worldwide equity market pessimism and loss of value. Slower growth within China could inspire the Chinese government to resist any exchange rate appreciation that the West is calling for currently as domestic troubles would lead to more reliance on their export machine to maintain growth. The result would be continuing deflationary pressure on manufacturing firms around the world.

Slower growth within China could also dampen the order books of capital goods producers in Germany, Japan, and Korea who presently supply many sophisticated machines to the rapidly modernizing Asian giant. Exports of everything from elevators to construction cranes would be curtailed as the cold chill of pessimism replaced the belief in a boom as far as the mind can imagine.

The developing economies.

BANNING GARRETT

Director, Asia Program, Atlantic Council of the United States

A faltering China would have enormous economic and geopolitical implications as well as unpredictable but likely negative effects on China's own future.

A serious stumble perceived as a long-term slowing of the Chinese juggernaut would be a shock to the international system. Despite naysayers about China's future, most policymakers in governments, business, and international institutions as well as the public at large—in China as well as the rest of the world—are operating on the assumption that China's growth in economic, political, and military power will continue indefinitely, leading to the world's largest economy and comprehensive power to rival that of the United States.

A faltering Chinese economy would ease pressure on resource scarcity as well as commodity prices and presumably lead to a reduction of global greenhouse gas emissions as global economic activity declined. It would also reduce concern in both the developed and developing world about the rise of China and the decline of the United States.

But a significant slowdown in China, or even negative growth, would likely reverberate throughout the world economy, including that of the United States. The end of China's role as an engine of growth would be a blow to global economic growth, affecting investors in China, purchasers of Chinese goods, and exporters to China. This would not only hurt growth in developed countries increasingly dependent on both imports from and exports to China for keeping prices of consumer goods low and markets expanding for high-tech and industrial goods. Developing countries benefiting from both high commodity prices and cheap imported goods could also suffer gravely.

The impact of a country with nearly a quarter of the world's population beginning to fail would be exacerbated by the effects on China itself. Although the "grand bargain" between the Chinese Communist Party and the public has been about more than just political quiescence in return for continued economic growth, the perceived end of the Chinese century by the Chinese people would likely lead to political instability accompanying economic decline. The emergence of a more democratic and accountable Chinese political system is a possible outcome of such a crisis. But more likely, at least in the near and medium term, would be strengthened authoritarian rule to maintain order—a widely supported goal in China—and perhaps much more belligerent nationalism as the Beijing regime sought both explanations for its failures in foreign conspiracies and renewed political support through more assertive international behavior.

China's economic success presents the world with great economic and geopolitical challenges. A Chinese failure could reduce some concerns about Beijing's growing power, but it could also be a major setback for global economic growth in an interdependent world, integration of China into the global system, and global cooperation to address key strategic challenges, including climate change, energy security, food and water scarcity, proliferation, terrorism, and other non-traditional security challenges.

Germany and Japan.

CARL DELFELD
Director, EPFR Global, and Chairman, Center for Economic Diplomacy

A moderate slowdown of the Chinese economy to the 5–6 percent annual growth range might actually hit markets such as Germany and Japan hardest since combined they account for just under 50 percent of China's imports. A very sharp decline in China's economic growth rate would likely have a devastating impact on many commodity prices and the companies and markets dependent on them. The repercussions on global markets of a collapse in Chinese economic growth would likely be very substantial, but over time uneven. Emerging markets, especially in Southeast Asia, would be the hardest hit in the near term, but Indonesia's economy, which is two-thirds driven by consumer spending, would be the least affected.

On the other hand, as the dust settled, perhaps pressures would be lessened on companies and countries competing with China, leading to a more positive view of their earnings and profitability.

A sharp slowdown in Chinese growth could spark a spiral of Chinese nationalism, since the ruling Chinese Communist Party really only has two levers to maintain its legitimacy: high economic growth and Chinese nationalist sentiment. Just as dangerous to global growth and markets as a collapse in Chinese growth would be incidents that provoked escalating and prolonged periods of Chinese nationalism. Many believe that China was the victor in the recent confrontation with Japan regarding the Senkaku island chain. Actually, it was damaging to China, since it highlighted how quickly China would escalate tensions to appease nationalist sentiment.

Commodity producers and low- to mid-end manufacturers.

CHI LO
Author,* China After the Subprime Crisis: Opportunities in the New Economic Landscape *(Palgrave Macmillan, November 2010)

Commodity producers and low- to mid-end manufacturers who compete with Chinese producers will suffer the most in case of a Chinese bubble bursting. But the impact is still likely to be limited. First, the Chinese bubble is cash-funded through huge savings, unlike the U.S. bubble which is credit-funded. If a saving-funded bubble bursts, the damage to the financial system is limited. This is because there is a lack of deleveraging pressure stemming from a saving-driven bubble. So there is much less systemic damage, thanks to the "disconnect" between the asset markets and bank lending. Second, China's administrative measures are capable of fending off a collapse in public confidence and, hence, an economic implosion. Beijing can even boost growth by brute force—through directed lending and investment. Third, its closed capital account bars capital flight. Hence, the resultant contraction in Chinese demand would be small. But due to its significant demand momentum, any fall in China's growth will have a direct negative impact on global commodities.

If the bursting of the Chinese bubble causes a larger-than-expected negative impact on Chinese growth, that might risk policy panic in China, prompting it to open the spigots on exports to grow its way out even at the expense of other trading partners. A more export-focused China would mean more cheap goods flooding the world market, posing an extra and significant competitive pressure and margin squeeze for other, especially low- and mid-end, manufacturers. However, I still think a Chinese bubble burst is a low-odds outcome. And even if there is a bubble in China, it may last much longer than most of us expect due to its cash-funded nature.

It would set back America's plans to rebalance the global economy.

JOHN LEE
Director of Foreign Policy, Centre for Independent Studies, Visiting Fellow, Hudson Institute, and author of* Will China Fail? *(CIS, 2009)

In China's state-led political economy, the Chinese Communist Party and state-controlled entities are the primary dispensers of capital, land, and business opportunity. The CCP knows it will likely remain in power so long as it can continue to nurture the state-controlled sector; and by doing so, underwrite prosperity for the tens of millions of well-connected insiders who continue to benefit disproportionately from China's rise. In the event of a Chinese asset bubble bursting (such as in the property market), the paramount objective will be regime preservation. The CCP will act quickly and decisively to restrict and then reverse the damage—to the short-term benefit of commodity-exporting countries like Australia and Brazil, but at greater long-term cost to countries like the United States looking to lower its reliance on exports from Asia.

Indeed, if the onset of the global financial crisis in 2008 is any guide, we already know what Beijing will do in the event of a bursting of its bubble.

First, it will immediately force its state banks to massively increase lending so that other state-controlled entities can buy any distressed assets and prop up asset prices as long as possible. Ignoring the build-up of hidden non-performing loans on the banks' balance sheets, the CCP will order the huge state-controlled sector to continue investing and building within China—providing a temporary fillip for commodity exporters.

Second, China will rely increasingly on offering even more advantages to the export manufacturing sector in the form of increased currency manipulation, subsidies, tax deductions, and other incentives. It cannot do otherwise, since some 250 million Chinese depend directly and indirectly on this sector for a job. Beijing cannot afford to have tens of millions of unemployed workers in once-thriving coastal provinces venting their anger against the regime. Paradoxically, China's increased reliance on exports means that it will be an even more reliable buyer of American debt, since it will not convert its burgeoning surplus U.S. dollars back into yuan in order to maintain a weak currency. But more generally, the bursting of the Chinese asset bubble would seriously set back America's plans to improve its domestic export manufacturing sectors and rebalance the global economy in the process.

North Korea would be hit the worst.

YOSHIHIRO SAKAI
Executive Vice President and Chief Financial Officer, Microfinance International, and Adjunct Fellow, Center for Strategic and International Studies

It would be better for all involved in the global economy for China to fare well. China will enter a deep economic slump that will affect the global economy, but it is not a bad sign for the Chinese economy nor the global economy. A communist regime can introduce combined efforts of both economic and financial policy immediately by aggressive government spending, increased bank lending, and lowered interest rates. Through government regulation, China can pull itself out of a recession in two years.

In times of global recession, world commodity prices will be down 20 percent at the very least because of the most powerful buyers dropping out. This in turn signals an easing in competition for capturing resources, allowing countries such as China, which still requires a great deal of new infrastructure to build access to its huge reserves of iron ore and other resources, to buy what it needs. We must remember that more than two-thirds of the Chinese population still lives in rural and undeveloped areas with low incomes, which means that government spending is still very welcome in many places.

A slowdown in the Chinese economy is better than overheating. Strong Chinese leadership in controlling the market will be crucial in avoiding a Japanese-style decade-long deflation following a decade-long recession.

North Korea will likely be affected worst by a global recession because of its economic dependence on China—China accounts for more the half of North Korea's cross-border trade—and because of its inability to identify and engage alternative trading partners to maintain its trading volume. Both Japan and Taiwan could also suffer a large negative impact, but they will fare much better than North Korea.

Japan, South Korea, Singapore, and the United States.

ALLEN SINAI
Chief Global Economist and Strategist, Decision Economics

China's economic slowdown appears to be over. The Chinese economy has stabilized and the restrictive policies used by the government will eventually give way to more supportive growth-oriented policy. China needs a boom-like economy to keep enough Chinese employed to avoid social and political unrest as the country vaults to the top of the world leadership league.

In such a situation, bubbles in property prices, the stock market, credit, and bank assets are almost inevitable. A lesson of history is that bubbles eventually burst. A bursting of stock and real estate bubbles in China would be disastrous for the Chinese economy, for the banks, for Chinese individuals, and for the ability to tap into foreign-financed domestic activities and business development. Heady years of growth and asset price appreciation would end and Chinese policymakers be ill-equipped to deal with the fallout.

The declines in credit, cutbacks in consumption, increases in unemployment, and drying-up of external finance that would ensue would take China's growth down to the low single digits, leading to social and political unrest. The direct and indirect demands for the exports of other countries would hugely contract—Japan, South Korea, Singapore, and the United States, for example. A global recession and stock market collapses could well occur. In turn, numerous economies in Asia, central Europe, some in Latin America such as Brazil, and the United States would fall into recession.

A bubble-driven Chinese economy that bursts ultimately would prove the undoing of any global expansion.

China's Asian neighbors would be hit hardest.

NORBERT WALTER
Managing Director, Walter and Töchter Consult, and Chief Economist Emeritus, Deutsche Bank

For a number of years, my best economist friends—with very close ties to China and much knowledge of the situation there—predicted a collapse in Chinese asset prices, a brutal bad loans problem for Chinese banks, and an ensuing recession. They have all been wrong for over a decade. Of course, this does not rule out the possibility of such a downturn occurring.

When most observers talk about asset bubbles, they focus on real estate, both commercial and residential. Few talk about bubbles in the stock market. For my part, I feel much less comfortable with the market's assessment for Chinese banks since their capitalization seems to be considerably out of proportion. It's not that I consider the real estate sector to be balanced. Prices for offices that are too spacious and too luxurious are heavily inflated in the metropolitan coastal cities, and it is difficult to achieve high occupancy rates in some of the high-rent apartment buildings. But the country at large is under-served with residential and office buildings. Since incomes continue to register annual double-digit growth, any oversupply is absorbed by additional demand in the space of just a few years. If oversupply is a medium- and long-term problem, it applies to countries such as Spain with an aging and shrinking population. For the next five years, such a scenario is ruled out for China.

Assuming the Chinese real estate and stock bubbles burst, this would result in weak investment and a slowdown in consumption. The banks as the main financiers would find themselves in deep trouble, with piles of bad loans. Lending would be tightened as a consequence, which would reinforce the above-mentioned trends. Unemployment would rise dramatically. The authorities would extend low interest rate policies and would step up government spending programs. The People's Bank of China would use all levers (including capital controls) to limit appreciation of the yuan.

A Chinese downturn would hit its Asian neighbors hardest. Japan would be the number-one casualty due to its extensive deliveries of capital and consumer goods to China. Another major casualty would be the developing world, especially countries that supply China with natural resources. The manufacturing sector and suppliers of agro-products both would be major casualties. Africa would lose a very important engine of growth.

Commodity prices would take a hit.

STEVE H. HANKE
***Professor of Applied Economics, Johns Hopkins University, Senior Fellow, Cato Institute, and Contributing Editor,* TIE**

If there is a Chinese bubble to burst, it is in the property market. Faced with negative real deposit rates, the Chinese have poured speculative funds into property development and property speculation. In consequence, it is estimated that 64 million apartments are lying empty in China. Assuming a family size of three, that is enough housing to accommodate 192,000,000 Chinese. Talk about excess capacity!

The bubble appears to be a whopper. But for those who fret about the bursting of the housing bubble, it is a bit of a tempest in a tea cup. Most of the speculative activity is occurring in the first-tier cities: Beijing, Shanghai, Guangzhou, and Shenzhen. However, these cities accounted for only 3 percent of the total floor space completed in 2009.

When the bubble bursts, it will therefore be "limited" in relative terms. Chinese banks will take a hit because they are the main source of financing. To the extent that off-balance-sheet financing has been used, the government has recently ordered banks to transfer it back to their balance sheets. Accordingly, a bursting real estate bubble will blow a hole in banks' balance sheets.

The hole would be around 8 percent of total bank assets, or less. The government will certainly support the banks with bailout funds, if necessary. Banks won't be allowed to go to the wall, and given the government's strong fiscal position, it will be able to take a hit without missing a beat. In terms of policy, however, it will be more difficult for the government to dial back on export-led growth. After all, to meet growth targets, more, not less, export juice will be desired.

The external collateral damage will put downward pressure on commodities, commodities, and commodities. ◆