Soros' Warning of a Hard Landing in China and Tremendous Adjustments to Its Debt Economy

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A hard landing is practically unavoidable," claimed George Soros. His remarks shocked the world and faced strong opposition from China, the brunt of Soros' warning. Observations also suggest that Soros is critical of the policies of the Japanese government and the Bank of Japan and has started to lean toward selling Japanese shares. The Soros shock sent waves through global financial markets.

Soros made the above remark in a television interview in Davos, Switzerland on 21 January 2016.

Well, we are seeing a repeat of 2008. It was a time of financial crisis and a bear market. And you have the same situation today. But the source of the disequilibrium is different. In 2008, the root cause was the subprime crisis in America. But now, the root cause is basically China. So it's not comparable. It is the deflation and over-indebtedness of the Chinese economy. A hard landing is therefore practically unavoidable. I'm not expecting it, I'm observing it.

China can manage it. It has resources and greater latitude in terms of policies, with $3 trillion in reserves. The problem is that China's economic downturn will have spillover effects on the rest of the world. China will survive, even if it chooses to go in the wrong direction for the next few years, and the changeover in China's growth model that it should adopt, from investment and export-led to domestic-led, may fail. China is one of the major root causes of deflation.

China's objection to Soros' remarks was unexpectedly fierce, as vividly described by Nakazawa Katsuji, editor of the *Nihon keizai shimbun*, in his article in the electronic version of the newspaper (3 February 2016).

Asian financial crisis diagnosed as global financial crisis: Soros' insight

In 1997, when the Asian financial turmoil was triggered, Soros was the first to diagnose it as "not just an Asian financial crisis but a financial crisis on the global capital market and a crisis of global capitalism."

When I attended the Davos forum at the end of January 1998, the year after the Asian financial crisis, I had breakfast with Soros. I recall that he pointed out, "Everyone is talking about the Asian financial crisis, but this crisis is not only about Asia. It is a crisis of the global economy and global capitalism." He said, "Unlike the real economy, the equilibrium in the neoclassical concept has no relevance in the economy of capital movements. It makes the real economy instable." It was impressive for me that Soros, a man who has made a fortune from capital market fluctuations, said, "Regulations are necessary for imposing control over capital movements." As Soros pointed out, the crisis triggered in Asia led to the default of Russia in 1998, drove a leading American hedge fund to bankruptcy and spread as far as Wall Street.

Are free capital movements and free trade (goods) compatible?

There was another relevant episode. In 1990, at a symposium commemorating the 200th anniversary of the death of Adam Smith that was held at the University of Glasgow in Scotland, where he was a professor, Rimmer de Vries, an economist at J.P. Morgan, asked the following question: Are free capital movements and free trade compatible?

Under the Bretton Woods system of global economic order following World War II, the liberalization of trade was promoted based on the General Agreement on Tariffs and Trade (GATT), while the International Monetary Fund (IMF) imposed on member states the duties to undertake foreign exchange intervention and macroeconomic policy coordination in order to maintain the fixed-rate system. The liberalization of trade progressed through a number of rounds of multilateral trade negotiations. On the other hand, with regard to capital movements, the suspension of dollar convertibility into gold in 1971 and the establishment of the floating exchange rate regime in 1973 were followed by financial deregulation and the liberalization of capital in the 1980s, which were successively pushed ahead by major nations. However, the world economy remained unstable with intensifying trade friction as well as fluctuations on the foreign exchange and financial markets.

Based on an observation of these realities, de Vries raised the issue of potential compatibility.

Economic uncoupling: P. F. Drucker

In this context, I think back to the article written by the late P. F. Drucker for the magazine *Foreign Affairs* in the mid-1980s. He discussed the divergence or "uncoupling" of the economy of capital movements (he called it the "symbol" economy) and the real economy. The value of foreign exchange transactions on foreign exchange markets around the world has become far greater than that of merchandise trade, and the relationship between the two has been severed.

In this article, however, Drucker himself did not make any further reference to what consequences the economic uncoupling would bring about, but only presented his awareness of this matter.

The developments within economies since then have been a repetition of bloated credit systems and debts on a global scale on the back of the further liberalization of capital movements followed by occasional correction phases and confusion in the markets.

Is the Chinese economy in a long correction phase in response to over-indebtedness and overcapacity?

The high-growth era in China supported by high investment ratios and expanded exports has been brought to an end with the extinction of the favorable conditions, including low labor costs, abundant labor and a demographic dividend, which supported its high growth. China is now facing structural adjustments as a result of these changes. The "new normal" for China is to aim to achieve a domestic demand-led economy, the development of service industries and a change in direction from focusing on quantity to focusing on quality. This means an adjustment of the distortions that resulted from extreme industrialization, namely over-indebtedness and overcapacity. The extinction of the favorable conditions represents the end of the model of China being the world's factory and landing from a demographic dividend and change to a demographic onus. China's working age population has already entered a slowdown phase. The economic adjustments in China are therefore not of a short-term cyclical nature, but are long-term structural adjustments.

One of the recently observed phenomena is a rapid decline in foreign exchange reserves. Despite such a rapid decline, China's foreign exchange reserves are massive and the largest in the world by far. However, China's foreign exchange reserves are different from those of Japan or other advanced countries. Based on the forced settlement system, the foreign currency obligations of the private sector are also included in China's foreign exchange reserves. It is considered that less than half of the amount could be used freely by the authority for foreign exchange interventions, etc.

What has been noteworthy recently is capital flight from China. It is said that private debt is $4.6 trillion, wealth is $2.5 trillion and the difference between them, or the net debt, is $2.1 trillion.

However, it is the debt of $4.6 trillion that is the subject of the pressure for repayment.

As it has been pointed out that China's imports from Hong Kong doubled in January 2016, this may indicate an increase in capital flight.

According to materials published by the China Banking Regulatory Commission, etc., non-performing loans held by the Chinese banks are increasing. As of April 2015, non-performing loans and loans requiring attention together make up 6% of total loans, and are as much as around 4 trillion yuan in value terms.

During the 2008 financial crisis triggered by the collapse of Lehman Brothers, China adopted large-scale demand expansion measures. This took effect temporarily and China became a driver for world economic growth. However, it eventually brought about swelling levels of debt and excess investment, causing a tidal wave of deflation to break over the world economy as well as market instability, as Soros said.

The Washington Consensus was said to be approaching its limits after the financial crisis triggered by the Lehman Brothers' bankruptcy, while the Beijing Consensus, being a model of economic development for China, was considered to be effective. However, both models are now subject to adjustment pressure.

That being the case, the member states of G7 and G20 should not only discuss short-term economic measures, but also need to look squarely at the structural issues of the world economy raised by Soros and Drucker.

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