It’s time to worry about China.

On any list of calamities threatening the world economy, a China crash ranks at or near the top. Just what would constitute a “crash” is murky. Already, China’s sizzling rate of economic growth has declined from 10 percent annually — the average from the late 1970s until 2011 — to 7 percent, which is still high by historical standards. The question is whether the deceleration continues and growth goes much lower.

A faltering China could tip the world back into recession. Because China is a huge customer for raw materials (grains, metals, fuels), their prices would remain depressed. China’s surplus capacity of basic industrial goods, such as steel, would be increasingly exported, also depressing prices. This would dampen any recovery in global business investment. Confidence would suffer.

What about political fallout? “The Chinese government has maintained its legitimacy by promising economic progress,” says economist Eswar Prasad of Cornell University. If the promise seems broken, it’s hard to know how China’s masses would react. Or China’s leaders. Would they become more nationalistic and aggressive to deflect attention from economic disappointment?

Americans are exposed to all these potential spillovers. Prasad doubts the worst-case scenario will come to pass; plenty of other experts agree. After all, China’s leaders have repeatedly disproved doomsayers. There are many reasons the economy can flourish. The most obvious: Consumption spending was only 37 percent of the economy (gross domestic product) in 2014, the lowest of any major country (the U.S. figure: 68 percent of GDP). If the Chinese become a bit more spendthrift, their economy could thrive.

Still, there is the example of Japan. In the 1980s, it was widely regarded as the world’s most dynamic economy, overtaking
China’s economic predicament resembles the United States’. It needs a formula for sustainable growth that’s not dependent on repeated bursts of artificial stimulus, whether by deficit spending or prolonged easy credit.

Exports fell, as China’s biggest customers — the United States and Europe — went into recession. To bolster its economy, China announced a $586 billion stimulus package, almost 13 percent of GDP, in late 2008. But unlike the U.S. stimulus plan in 2009, which was part of the federal budget, much of China’s extra spending was channeled through state-owned banks and local governments. What ensued was a credit boom that has now left a large overhang of unsold housing, surplus industrial capacity and questionable debt.

Housing looms as the largest drag on China’s growth because it amounts to about 25 percent of the country’s GDP, including major supply industries such as steel, cement and glass, Prasad says. With housing supply exceeding demand, building is already slowing. Housing prices are down roughly 6 percent from their recent peak. The decline will go to 10 percent, says economist Yukon Huang of the Carnegie Endowment for International Peace.

Compounding this weakness is a slackening of local government spending on infrastructure projects (roads, airports, hospitals). To finance these projects, local government debt surged from about 6 percent of GDP in 2008 to 33 percent of GDP in mid-2013, according to the global bank UBS. The central government is now trying to slow the growth of this debt.

With hindsight, argues Huang, the 2008 stimulus package looks excessive, “They overdid it,” he says — lent too much and “too much money flowed into housing and property [development].”

None of this preordains a full-scale financial crisis. There are mitigating factors. Housing purchases in China are generally made with more cash than in the United States; in most cities, there is no property tax. These practices limit carrying costs and pressures for default. As for government debt, China’s is moderate by global standards, despite the recent increases.

China’s economic predicament resembles the United States’. It needs a formula for sustainable growth that’s not dependent on repeated bursts of artificial stimulus, whether by deficit spending or prolonged easy credit.

Interestingly, Chinese policymakers and foreign economists generally agree on the steps needed to shift spending from investment (now, too much) to consumer spending (too little). The social safety net needs to be strengthened so that people can save less to meet personal disasters. And banks need to be overhauled so that artificially low interest rates don’t subsidize business borrowers at the expense of depositors.

Though the way forward seems clear, it is strewn with political and psychological obstacles — vested interests and ingrained habits. The reasonable fear is that China can’t get from here to there without a major debacle.
Read more on this issue:

Fareed Zakaria: China’s economic crisis

Robert J. Samuelson: China at a crossroads

Robert J. Samuelson: China’s new, better ‘leap forward’

Robert J. Samuelson: Is China’s economic slump on the horizon?