

Q & A

Daniel Rosen Gets Situated on the China Bull-Bear Spectrum

The co-founder of Rhodium Group explains why principles like ‘common prosperity’ have nothing to do with policy, why money flows into China are increasingly short-term, and why Beijing desperately needs Wall Street firms to stay in the game.

BY ANDREW PEAPLE — NOVEMBER 14, 2021

Dan Rosen is a founding partner of [Rhodium Group](#), where he leads the China research team. He has nearly three decades of experience analyzing China's economy and investment environment, and was a senior advisor for international economic policy at the National Economic Council and the National Security Council from 2000–01 where he was involved with China's accession to the World Trade Organization.



Daniel Rosen.
Illustration by Lauren Crow

Q: You argued in a piece published in [Foreign Affairs](#) over the summer that Xi Jinping's time as leader has been marked by a series of attempts at economic reform, which the leadership has then backed off from when things have gotten too tough. When you look at the past year — with the crackdown on the tech sector and the decision, so far at least, not to bail out property giant Evergrande — do you think this time could be different?

A: The evidence is that this time is *not* different, but similar to those past episodes. The Evergrande situation was precipitated by the imposition of the three red lines [in 2020, aimed at reducing the indebtedness of major property companies]. And sure enough, just as in the past, the severity of the stress arising has caused the leadership to state that the three red lines had been misinterpreted, and that they weren't meant to be as draconian as they were in

practice. So I think this has played out exactly as other false starts the past eight or nine years have. I don't think that the fundamental problem of being scared off by instability has been resolved.

Do you think, then, that Beijing is simply trying to cut [Evergrande](#) and its boss down to size, by forcing it to sell some of its assets?

In the face of the general property sector crisis, or mini-crisis, that has begun, the immediate steps being taken to deal with Evergrande may or may not be reasonable. But this is no longer just about Evergrande, is it? It's about Evergrande, and Kaisa and everybody else. Most property developers are seeing such high borrowing costs right now that it's really an open question as to whether they'll be able to remain solvent.

Once a particular firm like Evergrande has gotten to this point, then you can look at how you can break it up and sell it off in pieces. But can you do that with the entire Chinese property development sector? I guess, in theory, you could, but that would mean laying off millions and millions of people. We're talking about a sector that was responsible for 20-25 percent of all economic growth, and having to acknowledge that it can't contribute more than a fraction of the growth that it did in the past. So I think the immediate notions around Evergrande are not surprising. But if generalized to the whole system, they portend a growth rate that's lower than anybody's expectations.

There's been a lot of discussion amongst China watchers as to whether what we've seen over the last year adds up to a coherent program, with Xi Jinping and the government now taking the opportunity to genuinely reform the economy. What's your view?

I would say that Xi's first economic reform manifesto in November 2013 — the [60 Decisions](#) — was admirably coherent. It included everything from allowing the markets to play a decisive role in the economy, to reducing the role of the state-owned enterprises, to dealing with the urgency of center-local fiscal reform, and many other things to boot. But when I look at the central focus in policy pronouncements over the past 12 months, I don't see meaningful plans to deal with any of those fundamentals.

For example, when it comes to center-local fiscal reform, the best that we can expect are some more [pilot projects](#) for a property tax, that may or may not be implemented over the course of years to come. This is not remotely coherent or comprehensive: it's not going to do the trick.

What's gotten the most attention is the idea of '[common prosperity](#)', which is not even an economic policy reform. It's a political campaign.

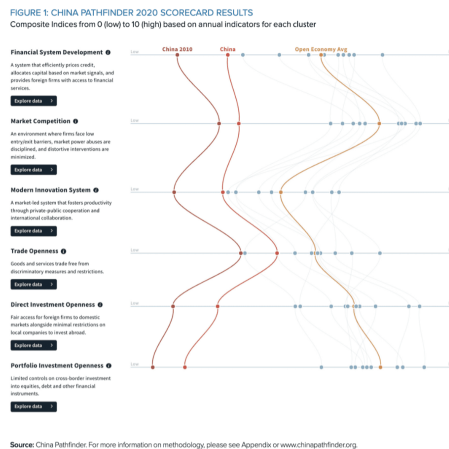
So you don't see 'common prosperity' driving what's happening in the property sector, for example, in terms of trying to make homes more affordable; or driving what's happening in the tech sector in terms of trying to break down the monopoly power of the big tech companies and improving work conditions and so on?

Common prosperity encapsulates the right principles of equity and income distribution, and shared opportunity. But principles are not policy. The necessary policy choices will inevitably create winners and losers, and entail some instability. That is not being acknowledged and hence prepared for.

What would it take for the Chinese government to convince you that it is serious about some kind of major reform to the economy?

I'll offer you 'One General and Three Specifics' — in the spirit of Communist Party policy packages.

For the 'general', we need an acknowledgement that the current economic model is not capable of attaining China's potential growth in the next phase of development. The Party is insistent that its model is correct, that its overall path is correct, and that there's nothing that needs a fundamental correction. I think that is not borne out by the structural challenges



In October, Rhodium Group and the Atlantic Council launched a new project called China Pathfinder, which tracks whether China's economic system is converging with or diverging from open market economies.
Credit: Rhodium Group

that we're seeing today or the economy's performance, in as much as it's at about 2 percent annualised quarter on quarter growth rates right now, in a year when China should be bouncing. So that's the general thing I'd like to see: a new frankness in terms of the model and the system. Right now we're getting the opposite of that: we're getting insistence that the model is ideal, and that Beijing must preserve it at all costs.

“ **The Party is insistent that its model is correct, that its overall path is correct, and that there's nothing that needs a fundamental correction. I think that is not borne out by the structural challenges that we're seeing today or the economy's performance...** ”

A few specific ideas then: Firstly, capital intermediation. The wellspring of tomorrow's productivity and job growth and tax base is today's lending and credit. Over 90 percent of all corporate bond issuance today continues to be by state-owned enterprises in China. China has learned from its own experience that the state must be less predominant in the economy. That is not a western idea. You cannot have 90 percent of bond issuance going to the state and expect to have a dynamic economy. This has to be acknowledged and addressed urgently.

Secondly, fiscal reform. It was recognized by Beijing ten years ago that if it didn't provide fiscal support for local governments to cover health care and education (and now climate adaptation) then they would sell land to steel mills and property developers regardless of sustainability, and find ways to run up debt.

Xi, in his capacity as General Secretary of the Party, flagged these fiscal reform imperatives in 2013. But it's now 2021. And none of it has been resolved. No reform campaign that does not redirect public expenditure priorities to address unfunded sub-central obligations can be taken seriously.

And thirdly, as an acid test for getting on track at the microeconomic level where real companies live and die, I want to see restoration of corporate governance reforms. I gave Xi Jinping and China high marks for their strides toward improved corporate governance between 2013 and 2016. There was a serious effort to make independent boards of directors responsible for corporate leadership selection and strategy, with the state's role shifting to passive capital manager (following the Singapore model), making sure it got a good dividend from its positions. That was admirable, it was meaningful. It was the reason why I pushed back on many in the United States and elsewhere who were overly cynical about China's *ability* to move in the right direction.

Sadly, since about 2016 that role for boards of directors has been hedged back. Party committees have been re-emphasised and even written into the articles of incorporation of firms on the mainland, and even in Hong Kong. For my optimism on the potential for China's growth to be restored, I'd need to see the nation getting back on track with corporate governance reform.

Meantime, you're predicting quite a hard downturn for the Chinese economy, right?

Well, I was predicting a meaningful downturn. And now I'm just predicting that the current meaningful downturn continues. I anticipated, with my colleague Logan Wright, three years ago, that by late 2021 China's debt driven model as we've known it would reach the end of the line. We got that right, sadly. We've got 2.1 percent annualised quarter on quarter growth

BIO AT A GLANCE

AGE	54
BIRTHPLACE	Manhattan, NYC (a small island off the coast of the United States)
CURRENT POSITION	Co-founder, Rhodium Group

right now.

The question is whether China could again sustain the trend potential growth we knew pre-pandemic — say 5.5–6 percent annually. If you want to attribute a bearishness to me, it's that I think we're not getting back to 5.5–6 percent growth on anything like a sustainable trend level. I think the best that it's reasonable to expect would be maybe 3.5, 4, or 4.5 percent GDP growth through the medium term. And even that would presume that Beijing does everything right, and rebuilds credibility that growth rather than political stability is the priority going forward. I know no one who believes that presently.

That level of growth would be towards the low end for a country at the stage of development that China is still at. How does that figure into your views about, for example, whether or not China can avoid the so-called 'middle income trap'?

For 4 percent GDP growth to satisfy the needs of the Chinese population, a much, much larger share of the country's income would have to be distributed to the 900 million mostly-rural people who are lagging the winners today. That will mean reduced expectations (and higher tax burdens) for urban and higher net worth people. That will demand a lot of social trust and patience. It also begs the question of how much development assistance Beijing can really spread abroad, if they are straining to bring 900 million people up to middle income level at home. [Scott Rozelle's](#) *Invisible China* is masterful on these domestic developmental challenges.

You referred to the work you have done at Rhodium on China's credit-fuelled model coming to the end of its effectiveness. Are you seeing any evidence yet that there is a broad re-pricing of risk underway in Chinese markets? After all, the latest figures show foreign money is still flowing quite strongly into Chinese markets.

The long-term assumption for decades has been that Beijing has the ability to sustain growth at a high target level for as long as it says it's going to. Today this 'China put' — the ability of Beijing to brush back any risks to the growth trajectory — is in question.

The betting around risk is no longer just a function of whether China says, 'Read my lips, we're going to keep it going'. It's a question of the *methods* by which it deals with these current emergencies. The method for Evergrande may be to break it up, causing it to sell off assets, and to have healthy property companies absorb its unhealthy obligations. That method cannot work for the whole system of course; it only works if the broken bits are rare. You can't take everything that is non-performing in China, and parcel it out to everything that is performing and expect growth to continue as before. It simply cannot hold up that way. And so we have to wait and see whether China chooses to simply write down these past mistakes in one fell swoop to try to reset expectations to the upside, or rather attempt a controlled soft landing that causes a muddle for some time to come.

“ **There's money going into China, but it's predominantly short-duration money... Portfolio flows into China are increasingly short-term relative to what they should be at this point.** ”

There's money going into China, but it's predominantly short-duration money. Yields on the expanding universe of at-risk firms are up onshore and offshore. Portfolio flows into China are increasingly short-term relative to what they should be at this point.

We have seen this year an interesting debate on Wall Street, personified on the one hand by the likes of [Ray Dalio](#) of Bridgewater and [Blackrock](#) who have been positive on China, and on the other hand, by the likes of [George Soros](#), who have been warning about China's future. What's your sense of the mood among investors, particularly in the U.S.,

about whether it's time to get out of China or whether it's time to double down?

Some economists believe the best leading indicator for reform is a serious economic crisis, and that as long as China *can* push crises down the road it will defer reform. There is a common view that only coming to the end of the line of growth as we know it can give rise to required policy shifts.

Unfortunately, the debate between investors counselling increasing China exposure and those who advise reducing it is not really that discussion. Instead, it's more of a discussion of whether Chinese policy as we know it, and policymakers as we know them, are on the right track to steward additional growth relative to the messiness of markets in the West.

Projecting future profit streams from China based on the past performance of policymakers is exactly the sort of thing you are warned not to do in disclaimers at the end of every investment prospectus. I caucus with the China skeptics here: before going 'long China', we need a more transparent and critical discussion about the policies and policy making skills required to make growth possible.

One other question related to Wall Street: Despite all the tensions between the U.S. and China we've seen the likes of [Goldman Sachs](#) and JP Morgan getting more access to Chinese markets over the past year. What do you make of this apparent anomaly in U.S.-China relations?

It's not just U.S. financials, it's others too. China wants fiduciaries the world over to validate its model, by advocating increased China exposure. Beijing isn't content with opportunistic investors taking short duration positions in high-yield debt; they want long-term capital to validate their policymaking and the Chinese model, and to be a part of the story for years and years to come.

China has the world's highest level of savings, with an extremely high home bias — perhaps 95 percent of all savings are deployed inside China, with 70 percent of all household net wealth deployed in just one sector, domestic property. This is a terribly unbalanced portfolio. It's therefore hardwired that Chinese capital wants to diversify abroad. That's not capital flight, that's just normal portfolio rationalisation: Maybe 15 percent of the Chinese investment pool should be outside China rather than all inside.

That's normal, that's healthy. But for it to be sustainable from a balance-of-payments perspective, there have to be concomitantly large inflows as well. Given China's potential to contribute such a large part of marginal global growth in the years ahead, there's good reason why there should be similarly large amounts of global capital going into China.

But that is not hardwired. It is contingent on basic financial reform work that Beijing has not done yet. For example, exchange rate normalisation is needed, so that currency derivatives and futures products are available for firms to hedge their risk; interest rate normalisation is needed too, so that firms have the ability to properly assess the outlook for inflation and so on. In the Chinese context, those things are quite incomplete.

To maintain balanced expectations of money flows, Beijing is actively encouraging foreign financial institutions to come in, with better terms than previously available. Beijing needs these players to stay in the game. If they were to quit, it would be virtually impossible for China to maintain a sense of stability. There would be the spectre of a balance of payments

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BOOK REC	No favorite, but Fundamentals: Ten Keys to Reality by Frank Wilczek is an invigorating antidote to the plague of defeatism about separating fact from hogwash.
FAVORITE MUSIC	I wish there were more albums like <i>Any Other City</i> by Life Without Buildings.
FAVORITE FILM	<i>Zardoz</i> (it's a long story).
PERSONAL HERO	Truth-tellers, everywhere.

problems that would change the narrative in extraordinary ways.

You do acknowledge in your *Foreign Affairs* piece that China bears have been wrong often in the past. Would you identify yourself as a China bear? And if so, why do you think you're right this time?

Over my career I have been bullish while the trend potential of Chinese GDP growth was holding up or getting stronger. I've shifted bearish as trend potential has eroded. It's not a question of one's principles, it's a question evolving analytic conclusions fit to the time period. Over the past decade, I have used the ratio of the value of annual debt service on liabilities to marginal GDP growth in China as my litmus test for how bearish I should be. At the start of Xi Jinping's tenure, the ratio of those two numbers was approximately one, the annual marginal growth of the Chinese economy was about the same as the annual cost of servicing debt. Today, debt service is two to three times annual marginal growth. That's what I needed to know to situate myself on the spectrum between bull and bear.

To move into the realm of politics, there's obviously a lot of debate around whether or not we're in a 'Cold War' with China. Regardless of how we define our current situation, do you think a sensible approach for the U.S. would be one similar to that we had during the U.S.-Soviet Union Cold War, i.e. waiting things out until the contradictions and the weaknesses of the Chinese economy eventually reveal themselves?

For most of the past 50 years, China made bold efforts to converge with market-oriented norms, including at the beginning of the Xi era. In response to that, U.S. strategy on China was to engage, benefit from, and encourage those Chinese choices. Over the past six years the increasing challenges of reform choices at the middle income level have caused Beijing to stumble, and then shrink back from taking the next steps toward market norms. That sea change necessitates a reconsideration of U.S. strategies — both grand posture toward China as a great power, and more narrow strategies to manage economic and commercial interests.

It's too soon to try to lock down U.S. policy for the ages. China is in an in-between period: growth as we have known it is ending, but Beijing hasn't decided what will come next. The most recent policy planks — like the Three Red Lines — have been rolled out and rolled back (in part) all within a year.

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Given that Chinese indeterminacy, I believe present U.S. policy, with its emphasis on protecting against distortive Chinese spillovers, focusing on competitiveness at home, and better alignment with other market economies, makes pretty good sense. We can't base strategy on conversations with Beijing if Beijing hasn't worked out a workable strategy for itself, on the basic question of how the economy functions. There's only so much we can do to push Beijing in terms of how they deal with their self-created problems. We are acknowledging that our strategy is one of preserving what works well in the market world, rather than one that aspires to change China. It's about bolstering our own systems, our own economies, rather than trying to punish China for the things that we don't like about the way it runs itself.

After all, China is a sovereign nation. Every nation gets to choose what systems and policies are right for themselves. China is no exception to that. But China's freedom to swing its statist fists stops where our noses begin. And I think that's the principle that, by and large, has informed the Biden administration's thinking so far. I think it's the right one.

Do you see the problems around global supply chains and the trend towards decoupling between the U.S. and China as something that's more temporary or permanent?

When economists talk about decoupling, they are often talking about whether business cycles synchronize or not, and whether economic trends are complementary in terms of supply and demand. Economists still find the term 'decoupling' useful in thinking about what the opportunities are for getting to a better global production possibility frontier.

The term has been repurposed to talk about a political choice to close the doors with the People's Republic. That's made the term fraught. Maybe we should retire it for that reason.

But if we can just use 'decoupling' one more time before we say goodbye, we should understand it, first and foremost, as an economic phenomenon. It speaks to how much we can be engaged economically given different systems. The U.S. and Canada have almost exactly similar economic systems, and so there are few limits to our interoperability. China and the U.S. have increasingly dissimilar systems because of different sovereign choices that are being made in Beijing. That forces us to ask, how much of what we have been permissive about in the past must we be less permissive about in the future?

And that's where we are. That, and the reality of China's macroeconomic slowdown, are shrinking the room for 'coupling'. It's too soon to say where we will finish, between maximal and minimal engagement. Directionally we know that smaller shares of our economic futures are going to be tied up together than would have been the case if China were still on the economic reform track it aspired to in 2013.

Are you finding that interest in China is still as high as ever amongst the investment community that you speak with?

Oh, I think it's higher than ever. The U.S. business community alone has perhaps \$600 billion in interests on the ground in China. And a huge part of the American consumer basket draws efficiently from production in China. Companies, consumers, and interest groups of all sorts, as well as strategic audiences, need to consider the options for managing this relationship in the years ahead. Corporate leaders and government officials in Europe, Japan, Australia, Canada, Korea and elsewhere have an even trickier task, since they have to figure out not just China but U.S.-China dynamics, so they can make necessary decisions.

This requires thinking and analysis. Like it or not, those doing that can't retire for a little while yet.



Andrew Peaple is a UK-based editor at The Wire. Previously, Andrew was a reporter and editor at The Wall Street Journal, including stints in Beijing from 2007 to 2010 and in Hong Kong from 2015 to 2019. Among other roles, Andrew was Asia editor for the Heard on the Street column, and the Asia markets editor. [@andypeaps](https://twitter.com/andypeaps)

● COVER STORY



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BY LUKE PATEY

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● THE BIG PICTURE



Semiconductor Shakeup

BY ELIOT CHEN

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● Q & A



Hal Brands On Navigating America's "Danger Zone" With China

BY BRENT CRANE

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