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Why the United States Will Beat China to the Next Minsky Moment

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The outgoing governor of the People's Bank of China, Zhou Xiaochuan, recently warned of a possible Chinese "Minsky moment"—Paul McCulley's term, most recently applied to the 2007 US real estate crash that snowballed into a global financial crisis. Although Western commentators have echoed the outgoing governor's warning, pointing to the recent rapid growth of Chinese debt—which increased from 162 percent to 260 percent of GDP between 2008 and 2016—there has been little discussion of the more probable repeat of a US Minsky moment.

A comprehensive measure of the US debt-to-GDP ratio stands at 470 percent—80 percent higher than China's. These are not strictly comparable, as the Chinese ratio leaves out private finance debt (the debt of financial institutions to one another), but if that were struck from the US numbers, the ratio falls to 390 percent—still 50 percent higher than China's. Both China and the United States have large "shadow" banking sectors—estimated at $2.7 trillion and $14.2 trillion, respectively—but as these are in the shadows, they are rough estimates (and not included in the debt-to-GDP numbers). Because they are closely tied to the banking systems, a crisis that starts in the shadows will spread quickly to the regulated banks.

Who will win the race to Armageddon? To assess the relative dangers, we need to focus on private as well as local government debt. Unlike many pundits, I see sovereign government debt issued by both countries as free of default risk—default on sovereign government debt is a matter of choice, never necessity. China's leaders will not choose default; while Republican control of US government gives one pause, I, like Winston Churchill, believe that the United States will ultimately do the right thing—validate her debts—after toying with all other possibilities.

China has shown its willingness to move troubled private and local government debt into its large state-owned banks. Should it become necessary on a large scale, China will effectively nationalize bad debt, putting the debt "out of sight and out of mind." On the other hand, the United States does not have a similarly protected system—it has a handful of complex and risky financial behemoths that will be the Minsky moment *vector*, not the solution. It will be difficult to hide their problem debt.

Moreover, the last Minsky moment gave birth to the 2010 Dodd-Frank Act, which, if anything, makes it more difficult to bail out big institutions again. And with an administration that appears to enjoy flouting Washington traditions, it is conceivable that it would let Citibank, Wells Fargo, or Bank of America go the way of Lehman Brothers, triggering a meltdown too big to stop.

China already throttled the most dangerous part of its shadow banks—the risky "wealth management products" that essentially operated as special purpose vehicles for banks—just as she has occasionally clamped down on speculation in the stock and real estate markets. Our leadership has studiously avoided such "meddling" since Fed Chairman Greenspan uttered those infamous words about "irrational exuberance" 21 years ago.

Furthermore, China's economy grows rapidly—and at a high enough rate of growth, almost any debt can be serviced. While China's growth rate has declined, it is still nearly three times that of the United States. Further, Chinese leadership has demonstrated its commitment to economic restructuring by rapidly reducing emphasis on exports and building up domestic consumption supported by wage growth—raising living standards and insulating her economy from a downturn in the West.

China's bubbles are largely driven by household savings, not by debt, unlike the case in the United States. US real wages for average workers remain stuck at 1974 levels—a big part of the reason that household debt has risen precipitously, as Americans try to pursue better living standards without pay increases. Our policymakers will not allow the economy to grow at capacity out of fear of the inflation goblins—the Fed has already started to throttle tepid growth—and the current administration's one success (tax "reform") will shift tax burdens in the wrong direction, away from those who have been rewarded by neoliberalism and toward those who have lost ground.

Although finance ought to be downsizing, the big banks are leveraging up. Instead of sustainable growth, we have bubble-ized our economy on the back of an overgrown financial sector. The next Minsky moment will begin in the US financial sector, most likely off the balance sheets of the biggest banks. This will spark a run to liquidity that causes the values of all but the most liquid assets (US Treasuries) to fall, spurring fire sales of assets to cover positions: what Minsky termed "selling out position to make position." To make matters worse, given the current lack of competent leadership, American prospects for handling such a crisis are dismal.

A more detailed discussion of the issues can be found at levyinstitute.org/publications/does-the-united-states-face-another-minsky-moment.

L. RANDALL WRAY is a senior scholar at the Levy Economics Institute. His latest book is *Why Minsky Matters: An Introduction to the Work of a Maverick Economist*, Princeton University Press.