State of the World Economy, 2011-2012:

Whither or Wither?

US·KOREA INSTITUTE AT SAIS
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중앙일보

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On November 18, 2010, the U.S.-Korea Institute at SAIS and the Korea Institute of Finance, sponsored by the Asian Studies Program at SAIS and the *JoongAng Ilbo*, hosted the one-day conference, “State of the World Economy, 2011-2012: Whither or Wither?” at the Paul H. Nitze School of Advanced International Studies (SAIS) in Washington, D.C.

This volume contains the speeches and papers that were presented that day and subsequently further refined by the authors to reflect discussions during the conference.

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China and Global Recovery

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Overview

China applied ample stimulus measures throughout the global financial crisis to bolster short-term economic activity, and by doing so contributed importantly to global economic performance in 2009 and 2010. Inadvertently, as external demand contracted, China's current account surplus shrank over these years from pre-crisis levels, thus "giving back" to deficit countries an equivalent value of net-export GDP activity. However, these growth contributions were inherently short-term in nature, and were not locked in through fundamental policy changes, and hence cannot be counted upon to contribute to world economic recovery in the future. Pro-growth action within Beijing's ability can contribute to near-term growth, but whether China's growth is founded on perpetuating the global imbalances, or rather builds on a reduction of those imbalances, remains to be seen because the outcome depends in part on Chinese policy choices. Rebalanced growth would be higher for both China and the rest of the world in the long-term. The policy changes entailed in rebalancing are multiple and complicated, and include fiscal, structural, and exchange rate adjustment.

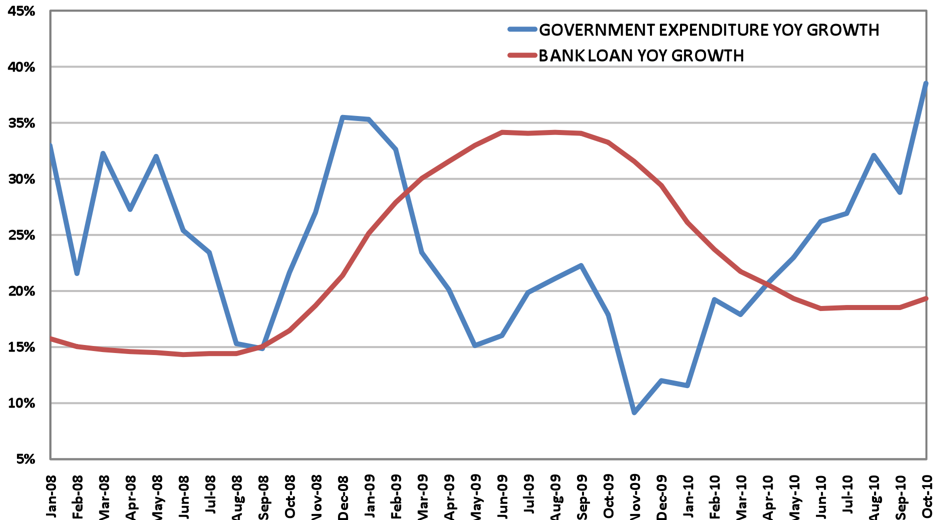
Introduction

During the 1997 Asian Financial Crisis, China played a key role in stabilizing the region by keeping its currency stable. Ten years later, another financial turmoil hit Asia and the world, and China again played an important role in stabilizing regional and global growth. This paper looks at China's reaction to the global financial crisis in 2007–8, its impact on neighboring countries, and its role in global recovery. I begin by summarizing China's reaction to the crisis and the impact of resulting policies on regional and global growth. I then describe why these policies represent a reversion to old patterns of growth and therefore cannot be a recipe for sustaining balanced growth in the future. To contribute to global recovery, China needs to alter its growth model, and I summarize key aspects of achieving that, as well as impediments. Finally, I opine on the most likely scenario for rebalancing China in the medium term, and the implications of this for Asia and the world.

China During the Crisis: A Locomotive of Regional and Global Growth

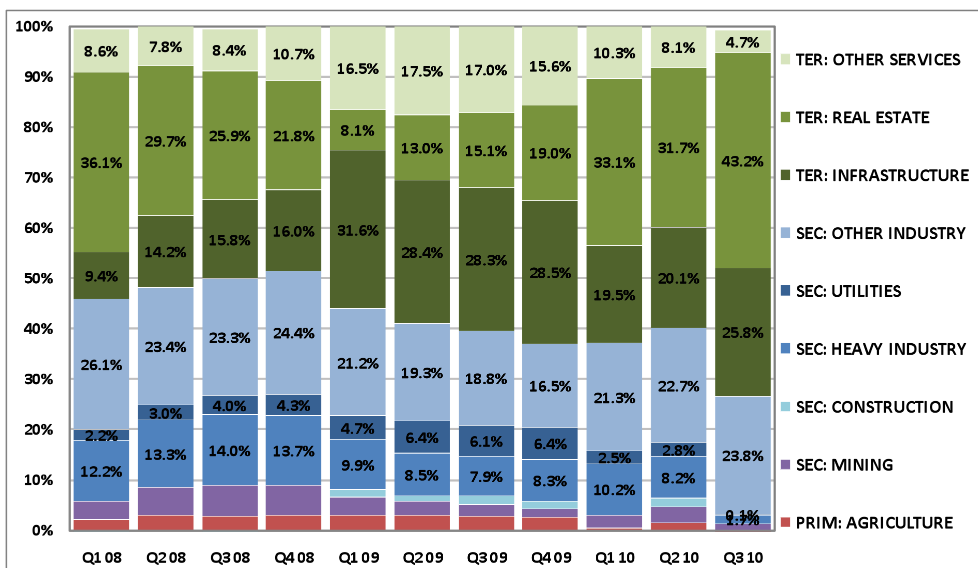
In response to the collapse of external demand in the acute phase of the global financial crisis, China fell back on old patterns of fueling growth through domestic investment. Its stimulus took the form of bank lending facilitated by government guarantees, suspension of lending quota limits, and relaxation of a ban on municipal borrowing. Bank loan growth went

Figure 1. Government Expenditure and Bank Loans
% change yoy, 3 months moving average



Source: Ministry of Finance, PBoC, RHG.

Figure 2. Contribution to Urban Fixed Asset Investment (FAI) Growth
% contribution to total yoy change

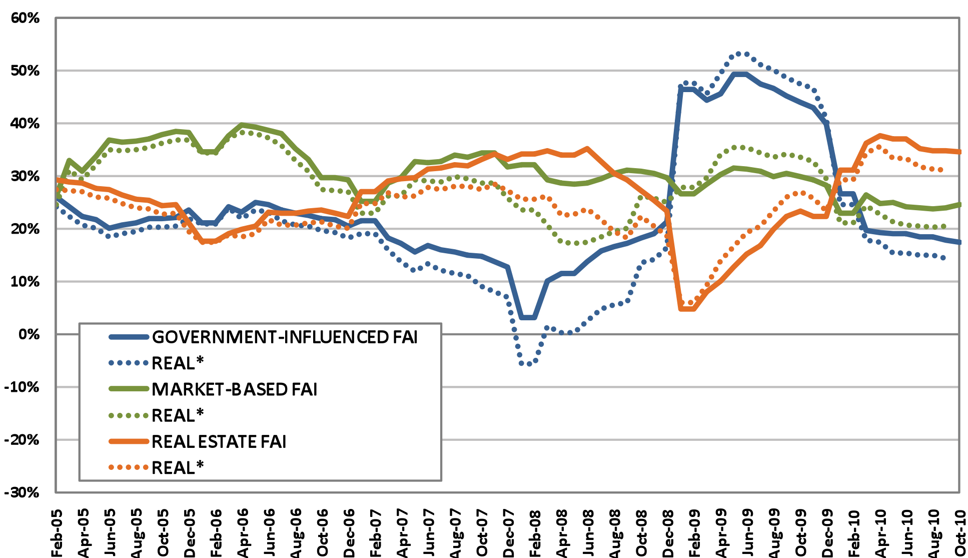


Source: NBS, RHG.

from a pre-crisis growth pace of 15% year-on-year (yoy) growth to a crisis high of 35% (figure 1). This assured a nervous banking system of short-term profit, launched 8–10 trillion RMB of infrastructure projects that kept heavy industrial industries with rampant overcapacity in business while new real estate construction momentarily dried up, and kept commodity-exporting nations around the world in business (figure 2).

The crisis response fell back on old habits, in several ways: First, the sectors led by government intention, rather than market-driven industries such as retail, saw a boom. Real estate fixed-asset investment (FAI) seized up dramatically in late 2008 and early 2009 (figure 3). This differential tells us that profit-oriented firms ran from risk: market-driven actors in China are no different from their cousins elsewhere in the world. It was the state that could and did lean against the wind. Second, with a tailwind of strong global consumption growth pre-crisis, Beijing was willing to allow the currency to appreciate prior to mid-2008. However, once appreciation meant actual pressure to adjust inside China, that appetite for realignment disappeared quickly, and the *renminbi* was re-pegged against the U.S. dollar for the duration of the crisis. Other policy changes to lock in the lower good trade surplus that characterized the crisis were similarly avoided, so that once global recovery (haltingly) began, the same pre-crisis pattern of trade surplus increase returned. Other efforts were made as well, many to sustain the growth rate of consumption inside China. Subsidies for home appliances and electronics were doled out, and purchasing taxes on vehicles were slashed, so that consumption growth exceeded the GDP growth rate in 2009, and hence the share of consumption in GDP increased for the first time since 1999 (figure 4).

Figure 3. Government-Influenced vs. Market-Based FAI
% change yoy, Urban FAI, 3 months moving average



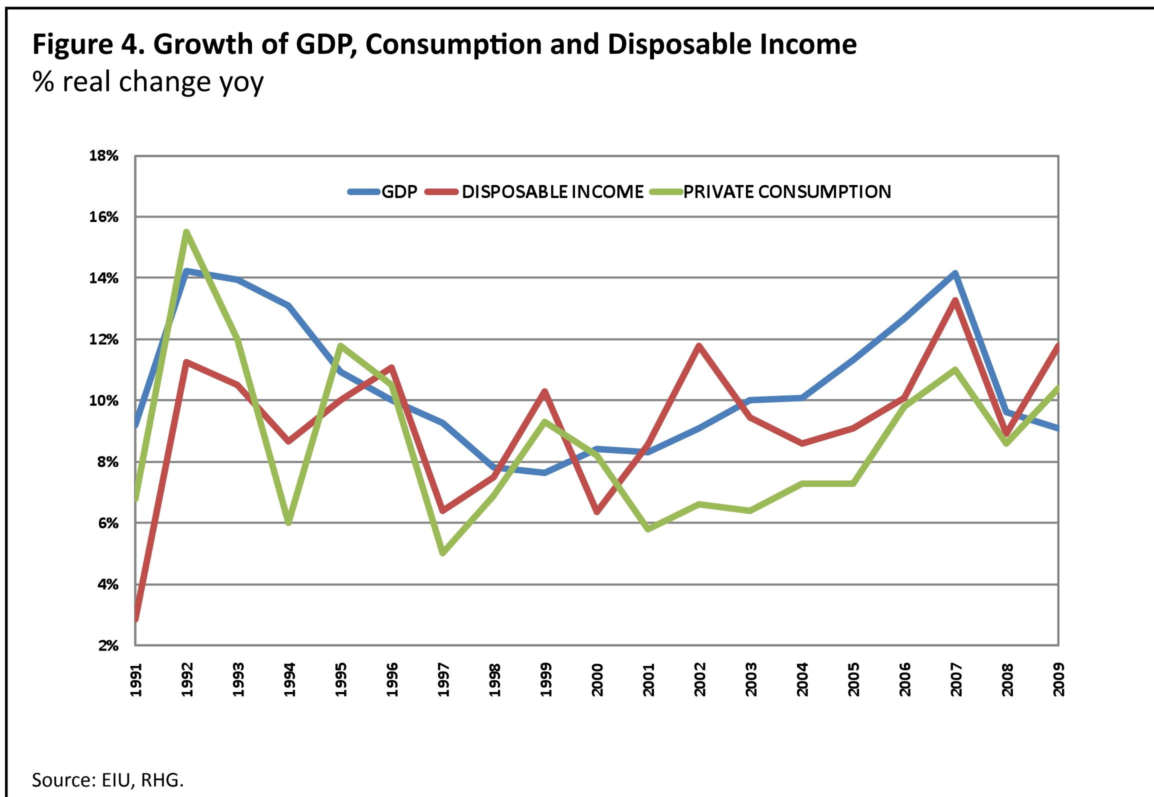
Source: NBS, CEIC, RHG; *adjusted with FAI price deflator.

Impact on Global Economic Recovery

By keeping its economy humming while the rest of the world contracted (figure 5), China saw its marginal share in Asian GDP growth and global GDP growth both shoot up strikingly. Until the eve of the crisis, China was contributing a respectable 15% of annual global GDP growth, up from a level of 10% that had prevailed for the decade to 2002. In 2009 that share surpassed 50%—half of all the growth on earth was attributable to China (figure 6). But of course, from this perspective, even an economy in autarky can contribute to gross global growth, without playing a role in supporting growth elsewhere. In China's case the fall of trade surpluses with some economies, including the United States and Europe—though not by choice—should be counted as real contribution to growth. Accounting for almost a quarter of China's growth in recent years, net exports were a large negative factor in 2009 GDP growth (figure 7), as the trade surplus shrank, and thus corresponded to a positive factor in the GDP of the United States.

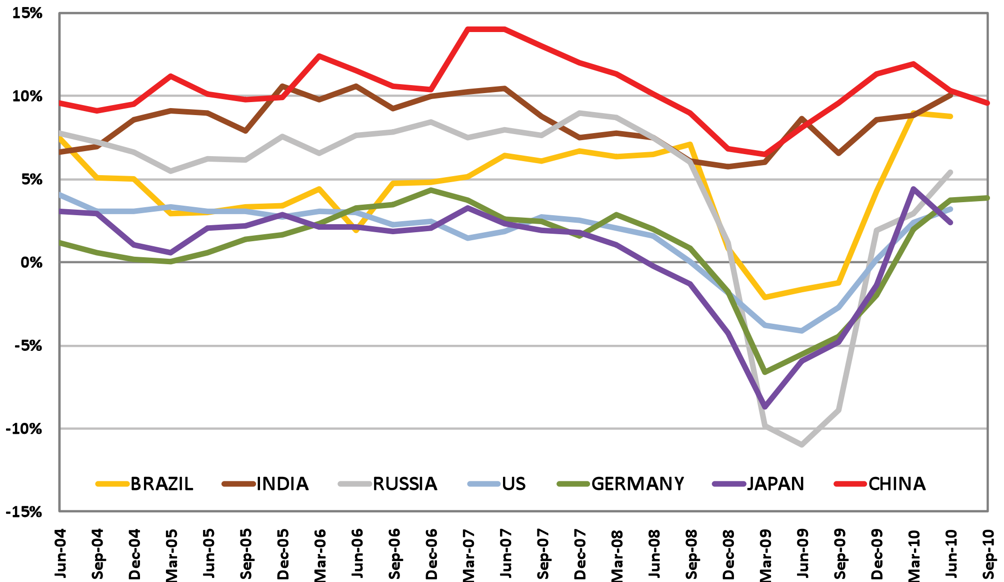
In addition to shipping less to deficit economies, China bolstered global growth by continuing to support output in the economies from which it imported. Commodity exporters did very well during the crisis by virtue of China's continued consumption of raw materials for infrastructure build-out and, after the initial anxiety, the resurgence of confidence in property as an investment class. China conferred benefits on specific exporters of intermediate goods as well, notably Taiwan, by granting generous subsidies for consumer electronics at home, to partly offset the drop in demand from the United States and other western markets. And as Chinese officials have asserted, it is not entirely unreasonable for them to claim credit for maintaining high growth inside China too, even if it delivers no other benefits, since China represents one-fifth of humankind.

Figure 4. Growth of GDP, Consumption and Disposable Income
% real change yoy



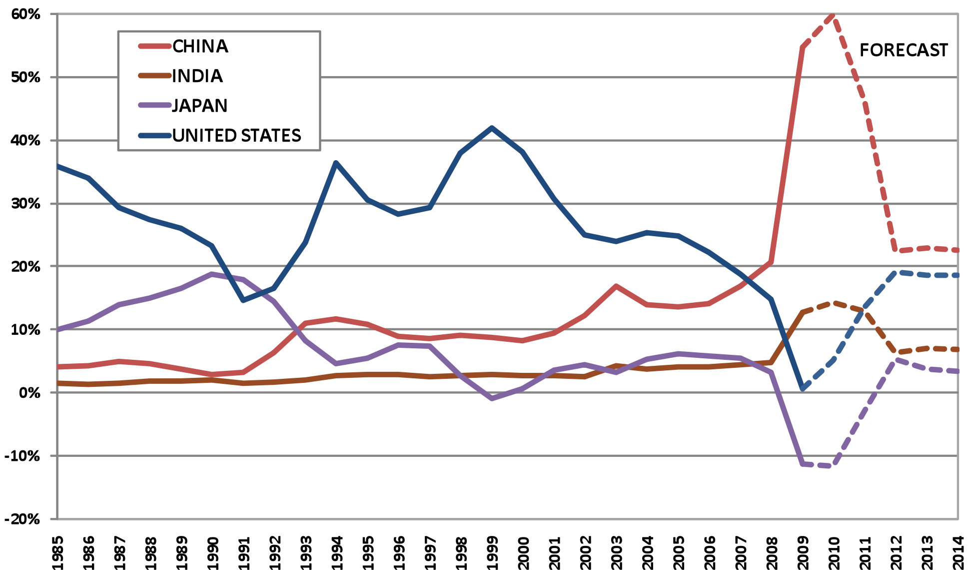
Source: EIU, RHG.

Figure 5. Quarterly GDP Growth
% yoy change



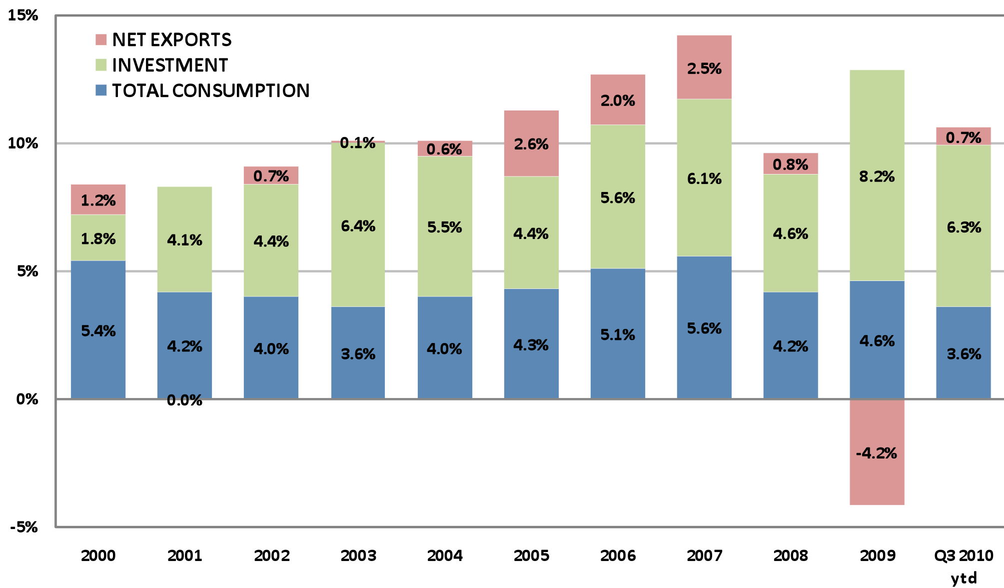
Source: NBS, CEIC, RHG.

Figure 6. Share of China and India in Global GDP Growth
% of real GDP growth, 2005 USD, 3 years moving average



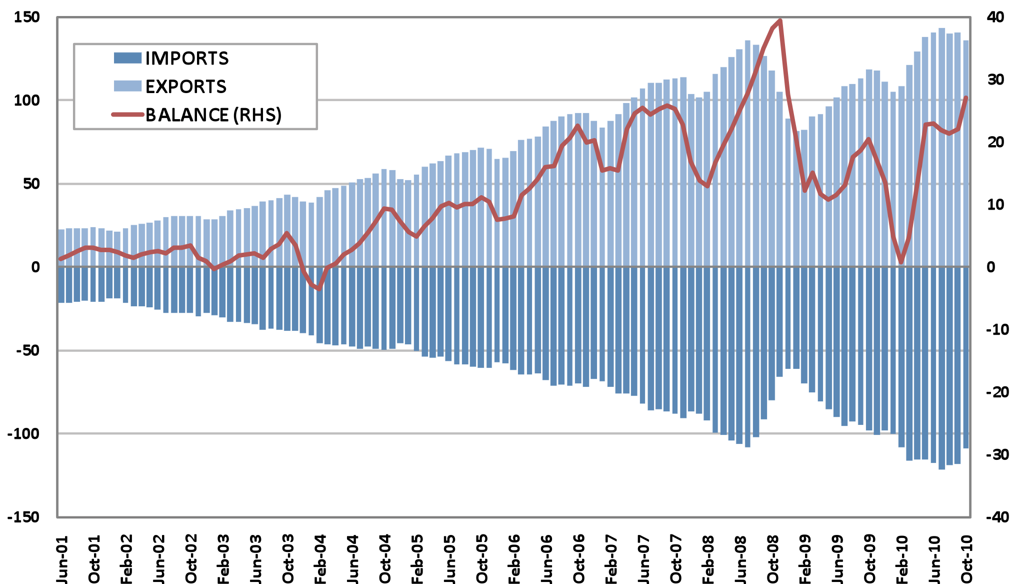
Source: EIU, RHG.

Figure 7. Composition of China's GDP Growth
% contribution to total GDP growth



Source: NBS, CEIC, RHG.

Figure 8. China's Trade Position
USD bn, 3 months moving average



Source: China Customs, CEIC, RHG.

The Limits of the Old Growth Model

The growth contributions China made during the crisis were short-term in nature, and the pattern in growth they delivered (lower net-export dependence) was not locked in for the future through fundamental policy changes. Thus, they cannot be counted upon to contribute to world economic recovery in the future. The strength of domestic investment activity was supported by government guarantees, which are now being unwound and have led to trillions of *yuan* in non-performing loans, which must now be restructured or written off. This is not to say such support wasn't worth it, given the critical social stability it bought; but it is not a natural state of capital allocation. More "normal" investment activity has come back, helping to offset the withdrawal of government-directed lending; but this hand-off has over-relied on property sector exuberance, giving rise to acute and urgent worries about a real estate bubble, which Beijing has to lean hard against. In the third quarter of 2010, 43.2% of all urban FAI went into real estate (figure 2). This is not mission accomplished. And the contribution of diminished net exports to corresponding world growth was an accident of falling world consumption, not an act of Chinese will. As developed world consumption started to recover in the first half of 2010, the old pattern of rising Chinese trade surpluses returned along with it (figure 8).

The frustration arising from the reassertion of patterns of global trade imbalance was clearly evident at the tense November 2010 G-20 Summit in Seoul. The arguments over culpability for these imbalances, which amounted to about $1.7 trillion in 2009 (the cumulative value of trade deficits, which must correspond to symmetrical surpluses), and the appropriate tools to resolve them (whether fiscal policy, exchange rates, tariffs, or other means) are as far from settled as they have ever been following Seoul. But the simple mathematical reality that deficit economies cannot shave their over-consumption without there being a corresponding reduction of surpluses on the other side of the ledger cannot be argued with.

Since the prospect of sustaining U.S. and other high-surplus nation imports is increasingly challenged (let alone continuing to *grow those imports*!), a Chinese model contingent on sustaining the share of net exports in GDP is equally unrealistic for external balance reasons, unless China can somehow convince all the other economies in the world to bear the burden of adjusting net exports down (whether they begin with surplus, like Brazil, or deficit, like India) without China having to share that task.

Even if external balance were not an impediment to Chinese growth as we know it, the internal balance would pull the plug on the machine. Internal balance is the condition of full employment and stable prices. Macroeconomic research by the World Bank (He and Kuijs 2007) and Chinese government economists (see the 12th Five Year Plan), and projections using a growth accounting framework (Perkins and Rawski 2008) describe diminishing marginal returns from investment in China: the amount of product that China is getting out of the investment it puts in is falling, and maintaining the role of investment in the future would demand more and more vast shares of national income. Devouring more capital just to support the kind of industrial activity that exists today means none left to create new jobs in new sectors in the future. In other words, rebalanced growth means more employment-intensive growth.

It is not revealing state secrets to say that the investment and net-export channels of China's GDP growth are both under severe short-term pressure and that the country has not yet implemented the policy reforms necessary to transition growth to a more sustainable pathway.

This is all Chinese economists—officially and privately—talk about.

In sum, for reasons of both external balance and internal balance, the current engines of GDP should not be expected to support global recovery in the medium-term. Rather, it is the transition *away* from current growth patterns that holds the potential for contributing to global growth outside China, and for maintaining strong growth inside in the future as well. So the question is whether the goals of that transition are clear, what the timing could be, and what distribution of growth inside and outside China is likely to arise from the transition.

Contours of Rebalancing

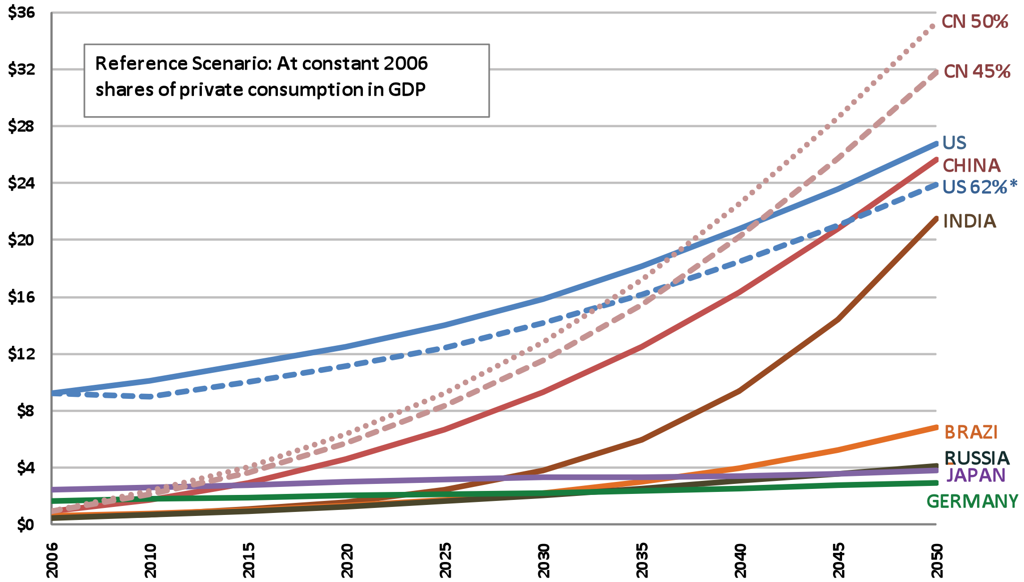
The details of China's potential growth rebalancing are enormously complex, fill large volumes, and take up whole multi-day conferences. This paper can only summarize my view of the likely path ahead for this systemically important country, so as to help take stock of the global economic outlook.

In rough terms, rebalancing will entail a large decline in China's current account surplus, from roughly 5.5% today to 4% soon and half of that level in perhaps five years. In terms of domestic investment flows by industry, a redirection toward service sectors and public services needs to take place, anchored by significant new government consumption expenditure commitments within the coming two years. Both measures would add to consumption activity directly and facilitate stronger household consumption growth indirectly by reducing the precautionary savings imperative that afflicts individuals confronting liabilities for healthcare, retirement, education, and other time-shifted needs. The shift to new horizons for domestic investment (trillions of USD for hospitals, water treatment, environmental remediation, quality control in manufacturing, etc.), the continuation of investment expenditure that is both sensible and needed for decades more (trillions of USD for agriculture upgrading, affordable housing, high-public-return infrastructure not yet built), and the further promotion of domestic consumption (see figure 9) all necessitate diverting labor and capital away from the export sector to serve domestic demand growth.

Standing in the way of this desirable-sounding outcome is the reality that there are winners and losers in any structural adjustment. Shifting investment flows, including through a fundamental reform of the interest rate system, will stoke growth in some firms and industries and diminish it in others. A more consumer-oriented, consumption-led growth story inherently means handing producer surplus back to consumers; but most of China's producers are not accustomed to the notion that the consumer is king and can sue them into bankruptcy if they do not take those consumers seriously. Another way of saying this is that the rosy future cannot eventuate without a degree of political reform that changes the balance of power in China between state and state-owned interests, on one hand, and individuals and private household interests on the other.

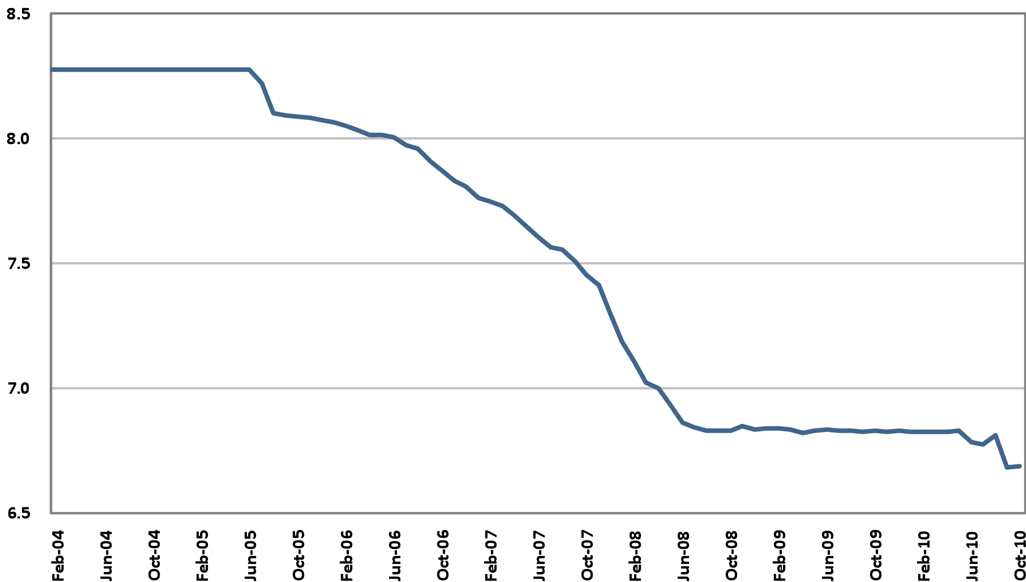
The political anxiety over such a redistribution of power of course delays the advent of rebalancing, especially while the old model is still paying dividends, even if they are diminishing. Some modest initial steps in the direction of the rebalancing described above have been taken, but the more fundamental steps have not yet begun. Consider the question of exchange rate adjustment in this light. A significant appreciation of the *yuan* against trading partner

Figure 9. Private Consumption under the BRICs Scenario
2006 USD trillion



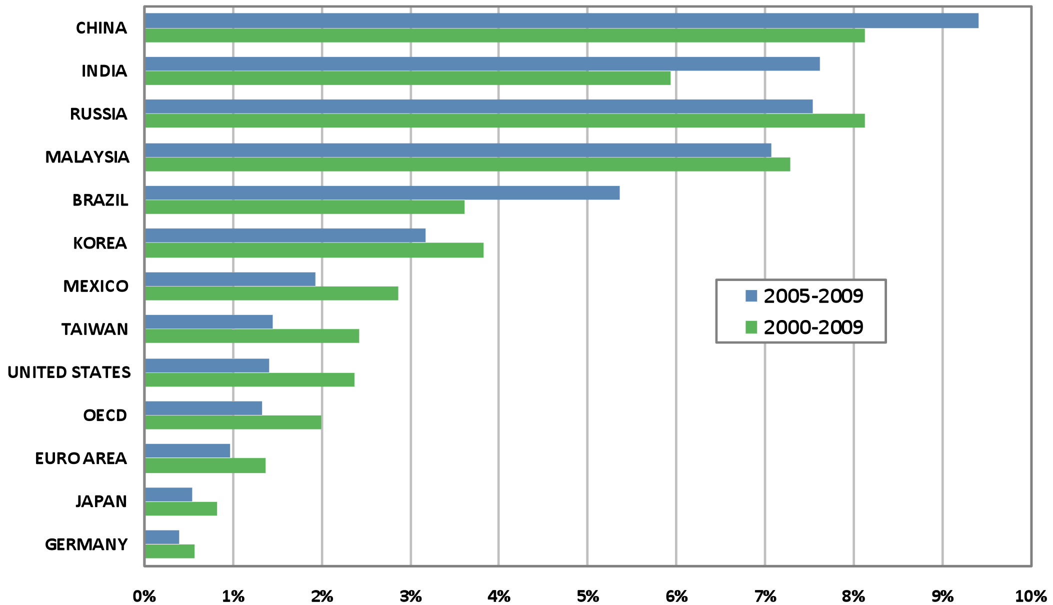
Source: Goldman Sachs (BRICs and Beyond, 2007), EIU, CEIC, RHG, *OECD average.

Figure 10. RMB/USD Nominal Exchange Rate
Daily spot rate



Source: SAFE, RHG.

Figure 11. Annualized Growth of Household Consumption
% real change yoy



Source: EIU, RHG.

currencies would eliminate an effective subsidy currently benefitting the export-oriented sector. As the size of final consumption demand inside China increases, the relative difficulty of dismantling subsidies for the export sector diminishes. But while consumption in China is growing substantially, the size of domestic demand compared to global consumption is still modest (figure 9). China's leadership is reluctant to precipitate a big-bang rebalancing of growth toward domestic demand, preferring to let domestic demand grow up further first, cushioning the adjustment pain. The problem is that China's growth in the meantime is based on producing to meet foreign demand at a time when others want to increase production to *meet their own* demand, and doing so with the help of interventions in currency markets of $1–2 billion a day, on average, to manipulate the prevailing exchange rate (figure 10).

Conclusion

So which scenario is most likely over the medium-term horizon, in terms of the adjustment of China's growth at home and its effect on others' growth prospects? One can expect China to accept the inevitability of shifting export sector income streams into other sectors, as the urgency of U.S. and EU rebalancing of their own growth becomes more acute. I foresee nominal Chinese exchange rate appreciation between 7 and 10% annually for the coming two to three years, combined with factor price equalization at home—inflation—which adds to the effective adjustment. I do not think household consumption can grow much faster than it is currently growing. As shown in figure 11, China has had virtually the fastest household consumption growth in the world for the past decade. That is not bad news, given the significant level this

consumption has reached, times 9% a year. However, I do see dramatic potential for higher government consumption growth, thus dis-saving (government is a net saver in China), which would add to China's GDP and make up for diminishing net exports.

I foresee investment at a high level, but declining from trend, yet generating a higher rate of return thanks to better allocation and hence delivering both good capital stock growth and lower depreciation, and paying more interest income to household savers and labor income to workers in new sectors.

I do not expect to see the fruit of all this structural adjustments within two to three years, but I do expect to see public commitment and partial implementation of the policies that would lock in these outcomes in China. A thick haze of ambiguity may well hang over the outlook due to the Chinese preference for gradualism: but the timing will not be entirely up to China on the external side and, given the internal and external sources of inflation built into China's current model, the internal timing is not entirely under Beijing's control either.

This scenario has a number of implications for the rest of the world. First, it implies continued strong domestic investment in property and infrastructure in China, not some sort of radical shifting of capital away from materials-intensive sectors to more intangible services overnight. Therefore soft and hard commodities exports will continue to see growing export volumes and—most likely—pricing. The exchange rate adjustments in this scenario do provide a tailwind for exporters of higher-value-added capital and consumer goods, and services, to China from developed economies, including the United States. They do not guarantee any such performance, however. U.S. export competitiveness has more to do with getting policy and incentives right at home in America than with Chinese exchange rates, though those have been an important aggravator. Reducing U.S. trade deficits will require fiscal and structural adjustment at home, and this is equally true of China.

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