Chinese Economic Growth: Is it Sustainable?

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China’s Economic Growth

- By end of 2009, China was world’s 2nd largest economy, and 2nd largest trader
- China has grown on average at 10% a year in real terms for over two decades
- Held up well during both Asian financial crisis and recent global financial crisis
- Recent concerns about inflation, mostly due to higher food prices
China’s Real Growth Rate

Source: National Bureau of Statistics, *China Statistical Yearbooks*
Recent Growth Experience

Source: CEIC and World Bank
Chinese Inflation

Source: CEIC and World Bank
Future of Chinese Growth

- China has contributed to global economic imbalances (Lardy, 2007)
- Costs to current growth model require attention (Prasad, 2009)
- Rebalancing China’s economy a key target in next 5-Year Plan (2011-2015)
- China’s typical approach of incremental reforms in isolation from each other probably will not work well anymore
Basis of China’s Growth

- Expansion of an economy based on $\Delta \text{GDP} = \Delta \{C+G+I+(X-M)\}$

- China’s growth, until recently, driven by investment *not* net exports

- Investment based on high total savings – 42% of GDP, households (16%), firms (20%), government (6%)

- Consumption low by international standards
Components of China’s Growth

Source: CEIC and Prasad (2009)
Investment Growth

- For country that is labor-rich and capital-poor, high rates of investment should be good for capital accumulation.

- Much investment financed by state-owned banks at low interest rates.

- Skewed capital-labor ratio, and held down employment growth.

- Has made it harder to absorb workers laid off by state enterprises and excess rural labor.
China’s Savings

- High due to: (i) uncertainties about transition; (ii) few instruments for borrowing; (iii) lack of opportunities to diversify internationally

- Financial repression has meant few alternatives to channeling savings into state-owned banks

- Despite weak banking sector, households willing to hold bank deposits due to implicit deposit insurance

- Abundant liquidity for lending, much of which has financed state enterprises
China’s Exports

- Exports clearly part of China’s growth strategy – tax incentives for foreign direct investment (FDI) in export sector, use of special economic zones (SEZs)

- Exports stimulated by WTO accession in 2001

- 50% of China’s exports low value-added – end of Asian supply chain

- Benefit of exports to GDP more due to technological and efficiency gains from greater international integration
China’s Trade Surplus

Source: CEIC and World Bank
China’s Exchange Rate

- China’s exchange rate policy has received considerable attention – especially in US
- Renminbi (RMB) pegged to dollar 1994-2005, has appreciated by 24% since July 2005
- Despite relaxation of peg, China has continued to conduct intervention in foreign exchange market
- Along with high export growth and large current account surplus, basis for claims RMB is undervalued – range from 12-50%
China’s Exchange Rate

* NEER – nominal effective exchange rate index based on trade weighted average of RMB exchange rate with basket of other currencies
Real vs. Nominal Exchange Rate

- Nominal exchange rate now 6.67 RMB/US$ compared to peg of 8.28 in July 2005
- By comparison, much larger appreciation in real exchange rate - 50% relative to US$
- Real exchange rate takes account of price movements in each country
- China’s unit labor costs have risen 25% since 2005 compared to 4% in the US
- China’s firms less competitive abroad
Real vs. Nominal Exchange Rate

Reality check
China’s yuan-dollar exchange rates
Q1 2005=100

Sources: The Economist; Bureau of Labour Statistics; CEIC; Thomson Reuters
*November 2nd
Foreign Exchange Reserves

- Massive surge in China’s foreign exchange reserves over past decade – reached in excess of US$ trillion in 2010

- 2001-2004, inflows of speculative capital increased in expectation of appreciation of RMB

- After 2005, rate of reserve accumulation due to growth of trade balance

- Capital inflows added to liquidity in Chinese banking system, complicating control of credit
Foreign Exchange Reserves

Source: CEIC and Prasad (2009)
Impact of Capital Inflows

- Surprising inflows of capital have not resulted in rampant inflation
- People’s Bank of China (PBC) able to “sterilize” inflows through reserve requirements, “window guidance”, and sale of bonds
- Emerging market economies normally run up against budget constraints as bond yields have to increase
- In China, demand by banks for PBC bonds has been high, and yields low prior to US recession
PBC Bond Yields

Source: CEIC, PBC and US Treasury
Potential Costs of Policy

- Lack of exchange rate flexibility hampers banking sector reforms, as well as undermining independent monetary policy
- Bank lending under administrative control of PBC rather than driven by market forces, leading to inefficiencies
- Extensive use of capital controls also protected domestic banking system from competition
- State-owned banks only game in town for both borrowers and savers
Connections among Reforms

- China’s currency policy good example of interconnectedness of reforms
- Macroeconomics tell us if nominal exchange rate does not adjust to fundamentals, relative prices will
- Combination of financial repression and closed capital account can delay adjustment
- May maintain export competitiveness, but there are costs in terms of economic welfare and ability to deal with shocks
Exchange Rate Inflexibility

- Inflexible exchange rate
  - No independent interest rate policy
  - Large current a/c surpluses, more capital inflows
  - Domestic macro management harder
  - Financial sector reforms more complicated
  - Resource misallocation
    - Unbalanced growth-led by exports, investment
  - Risks
    1. Inflation/overheating in short term
    2. Deflation + new NPLs in medium term
    3. Asset price bubbles
    4. Trade sanctions if trade surplus widens

Source: Prasad (2009)
Exchange Rate Flexibility

Source: Prasad (2009)
Benefits of Flexibility

- Independent interest rate policy – key to improving macroeconomic management, and promoting stable Chinese growth and inflation
- As Chinese economy becomes more market-oriented, harder to use command and control
- Rising trade and financial linkages to world economy expose China to external shocks
- Monetary policy important in dealing with shocks – but fixed exchange rate policy undermines its independence
**Benefits of Flexibility**

- Capital controls partially insulate monetary policy - usually leaky/less effective over time
- Independent monetary policy also key input into reforms of financial sector
- Use of interest rates to guide credit expansion encourages banks to become more robust financial institutions
- Banking reforms will not work if PBC’s ability to manage interest rates constrained by exchange rate objective
Benefits of Flexibility

- With lack of flexibility on interest rates, liquidity flows into Chinese economy could result in asset bubbles

- Opening up capital account could help develop financial sector: (i) inflows - new instruments, and better corporate governance; (ii) outflows – creates competition for Chinese banks

- Risky to open up capital account without more flexibility in exchange rate, e.g., stop/reversal of capital flows – large currency depreciation
Macroeconomic Policy

- China should switch from fixed exchange rate to inflation-targeting
- Targeted range for rate of inflation
- Key focus of monetary policy is inflation
- Benefits: price and employment stability, tying down of inflation expectations
- Requires strong fiscal, financial and monetary institutions
Fiscal Stability

- There has to be fiscal stability, i.e., no large government deficits
- If large deficits – either have to be underwritten through increase in money supply or eroded via currency devaluation
- Monetary policy cannot be subservient to fiscal policy – “fiscal dominance”
- As percentage of GDP, China’s fiscal deficit (2.8%) and government debt (17.5%) are low
Banking Reforms

- Also necessary to have a sound financial system, especially banking sector
- If banking sector is weak, central bank will be constrained in its ability to raise interest rates
- Fear of provoking a collapse of financial system – “financial dominance”
- Serious issue in many developing countries
- China clearly needs further banking reform to deal with this issue
China’s Financial System

- Under central planning, financial system was “shallow” (dominated by government-run banks) and “passive” (dominated by plan).

- China now has most institutions of a modern financial system, e.g., central bank, commercial banks, stock markets.

- System “deeper”, i.e., money supply 162% of GDP in 2005, but “narrow” with banking system dominating – 78% of funds raised from banks in 2005.
China’s Financial System

- 2006, banking system worth 43.9 trillion RMB:
  - state-owned commercial banks “big-4” (53%):
    (i) Industrial and Commercial Bank of China
    (ii) Agricultural Bank of China
    (iii) China Construction Bank
    (iv) Bank of China
  - joint-stock commercial banks (JSCBs), 11 set up 1986-2001 (15%)
  - post-1998, 100 city commercial banks (5%)
  - credit cooperatives, rural banks (27%)
Reform of Financial System

- 1978-1993 saw bank lending to unviable firms – growth of NPLs
- Spread between lending/savings rates narrow and often negative – financial repression
- Low profitability, erosion of capital
- Banking system in poor shape by mid-1990s
Reform of Financial System

- Policymakers recognized frailty in late-1990s - two key issues:
  
  (i) “Stock” problem of clearing up existing NPLs - extensive efforts to write-off NPLs and recapitalize banks since 1998

  (ii) “Flow” problem of ensuring new loans are commercially sound - banks still inefficient at providing funds and enabling transactions
Reform of Financial System

- 2005, further bank restructuring and reform program started
- Foreign-bank entry mandated late-2006 under WTO accession
- Citibank and HSBC partnering with JCSBs
- Likely to be period of bank shakeout
- System has to be financially robust to withstand fluctuations in interest rates
China’s Reform Priorities

◊ China needs to shift economy away from growth based on investment and trade, to one led more by domestic demand

◊ Rebalancing key to resolving issues relating to China’s social and environmental sustainability

◊ In particular, more health and education spending, change in China’s income distribution, and shift in economic activity from coastal to inland areas