

Chinese Economic Growth: Is it Sustainable?

**Ian Sheldon
(Ohio State University)**

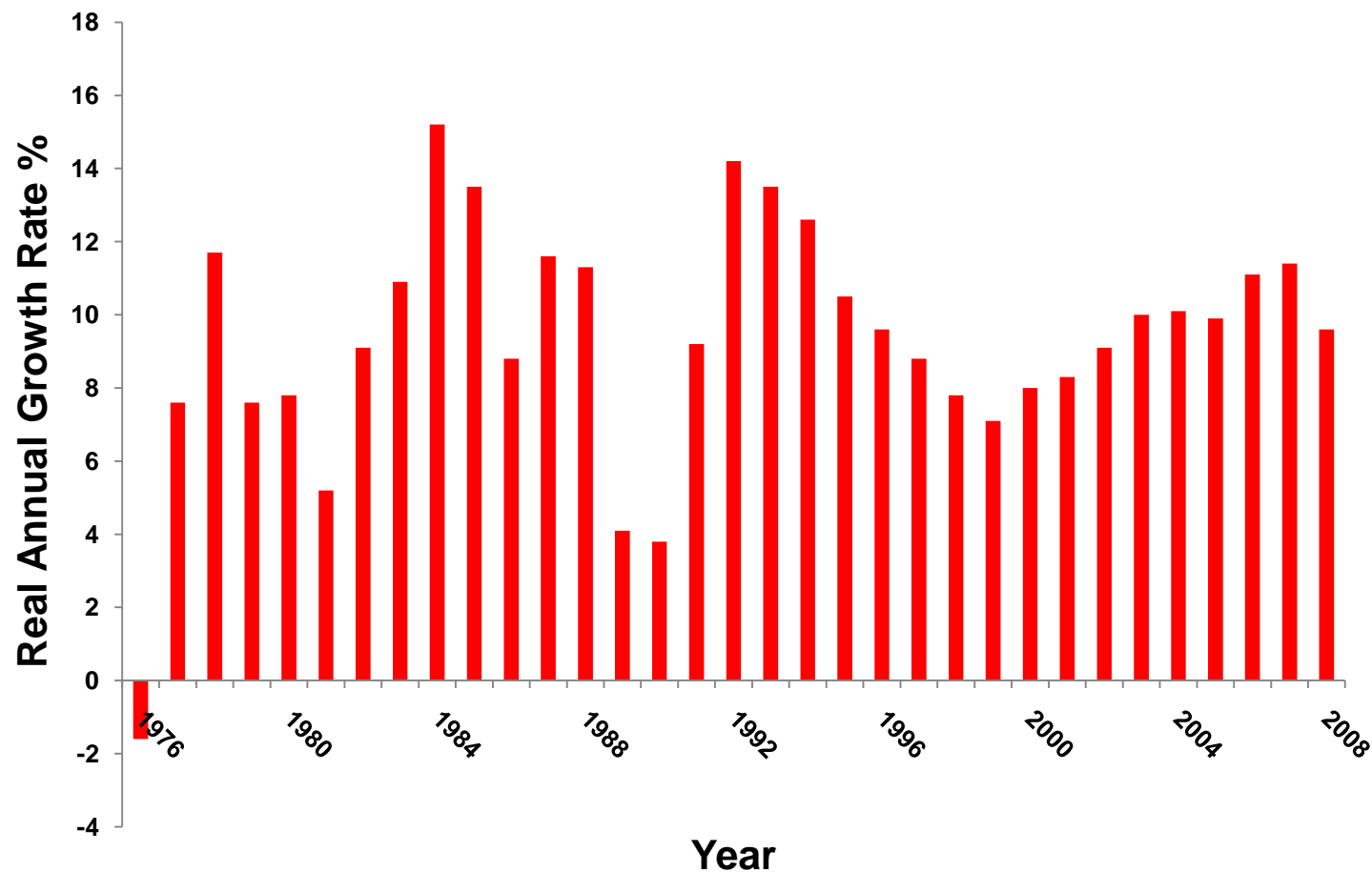
Prepared for Lecture: Tecnológico de Monterrey, Campus

Guadalajara, Guadalajara, Mexico, February 2011

China's Economic Growth

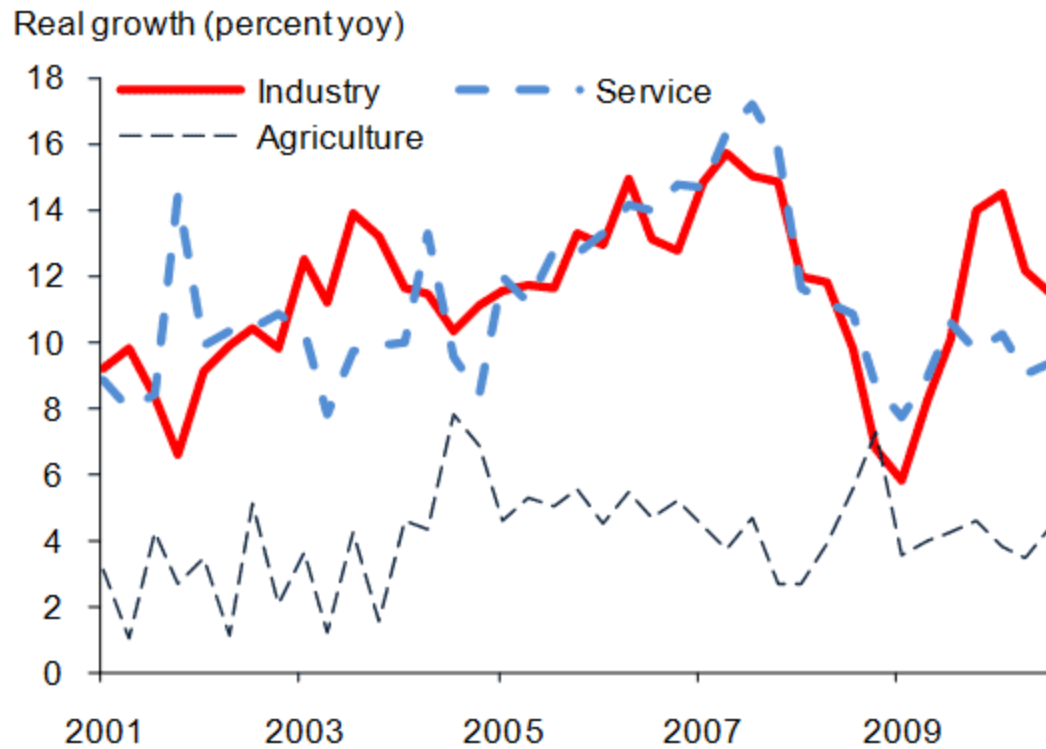
- ◆ **By end of 2009, China was world's 2nd largest economy, and 2nd largest trader**
- ◆ **China has grown on average at 10% a year in real terms for over two decades**
- ◆ **Held up well during both Asian financial crisis and recent global financial crisis**
- ◆ **Recent concerns about inflation, mostly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

China's Real Growth Rate



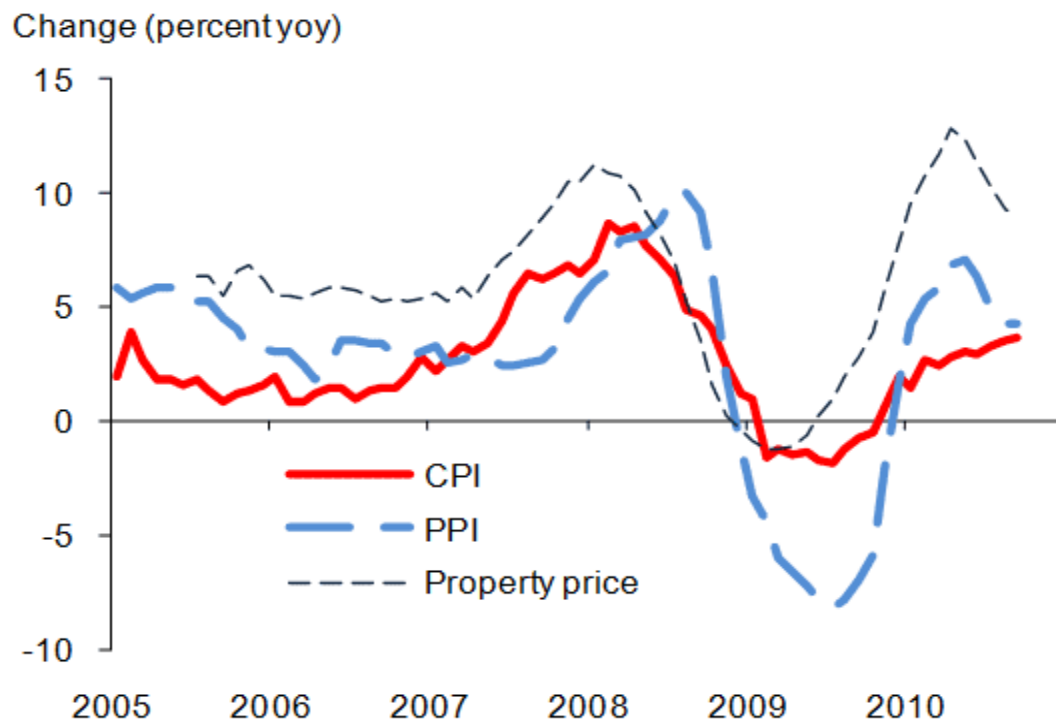
Source: National Bureau of Statistics, *China Statistical Yearbooks*

Recent Growth Experience



Source: CEIC and World Bank

Chinese Inflation



Source: CEIC and World Bank

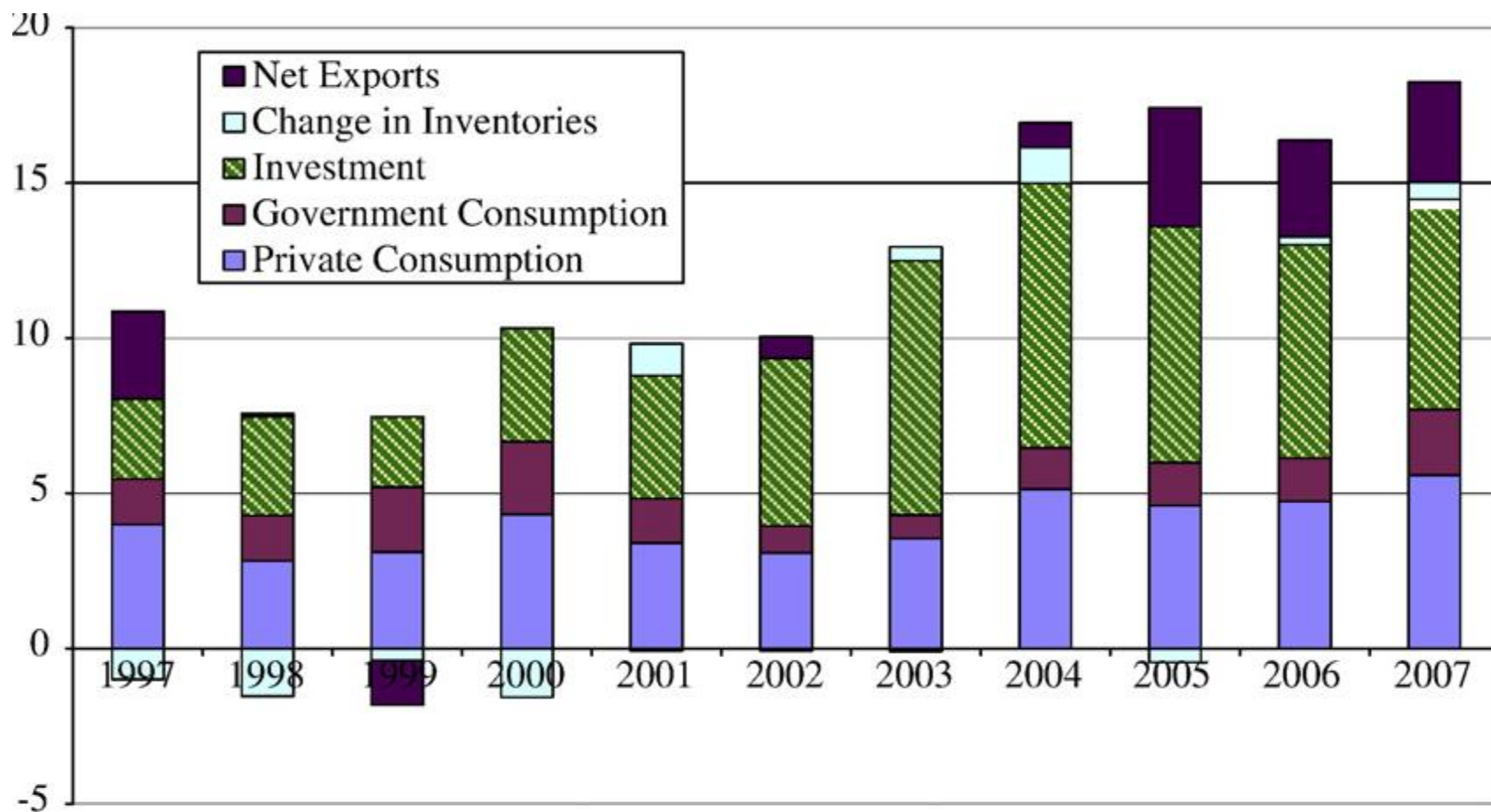
Future of Chinese Growth

- ❖ **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**

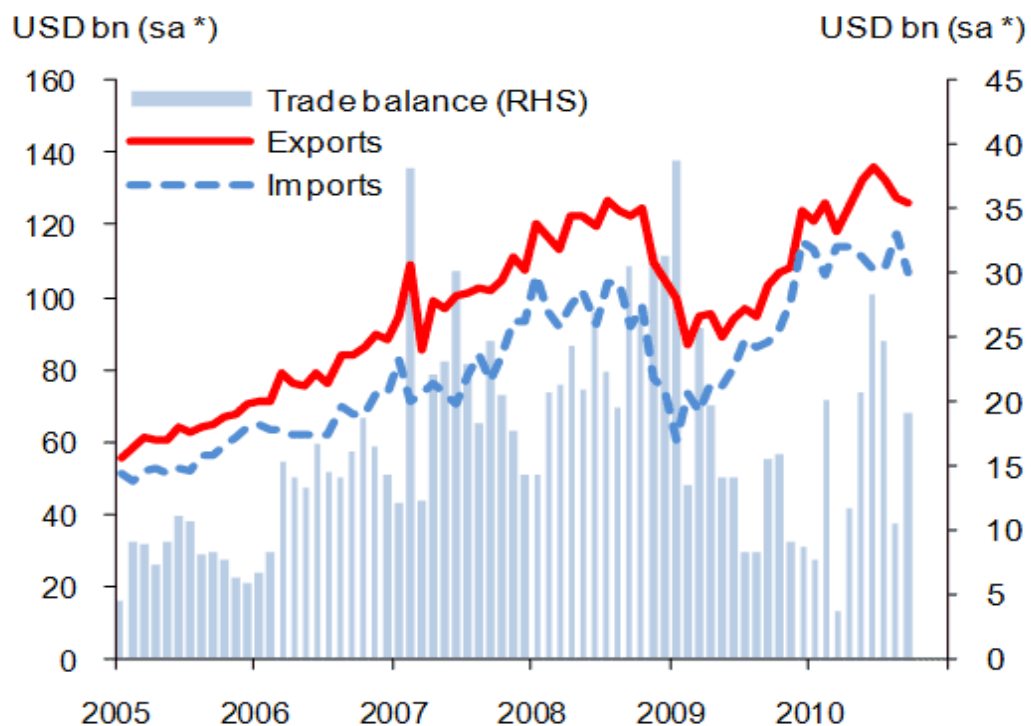
China's Savings

- ❖ **High due to: (i) uncertainties about transition; (ii) few instruments for borrowing; (iii) lack of opportunities to diversify internationally**
- ❖ **Savings channeled into state-owned banks due to financial repression**
- ❖ **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

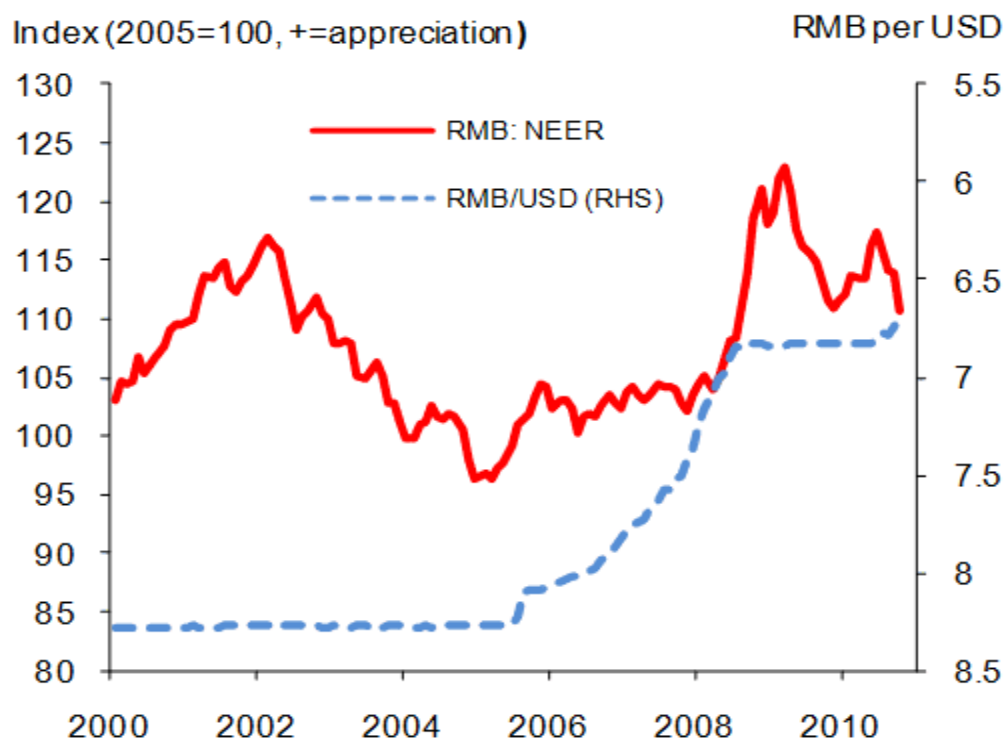


Source: CEIC and World Bank

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



Source: CEIC, BIS and World Bank

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



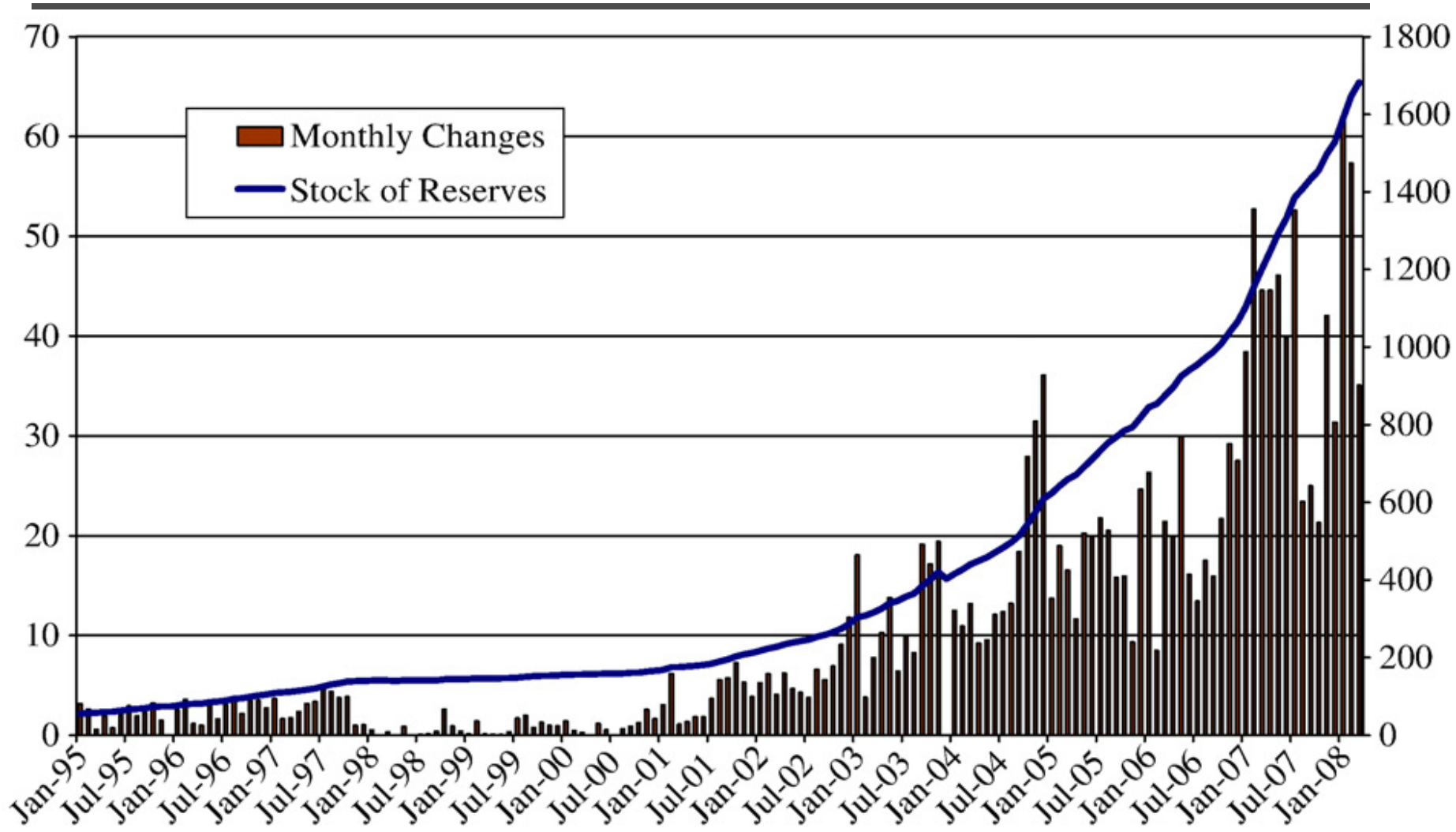
Sources: *The Economist*; Bureau of Labour Statistics; CEIC; Thomson Reuters

*November 2nd

Foreign Exchange Reserves

- ◇ **Massive surge in China's foreign exchange reserves over past decade – reached in excess of US\$ 2 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

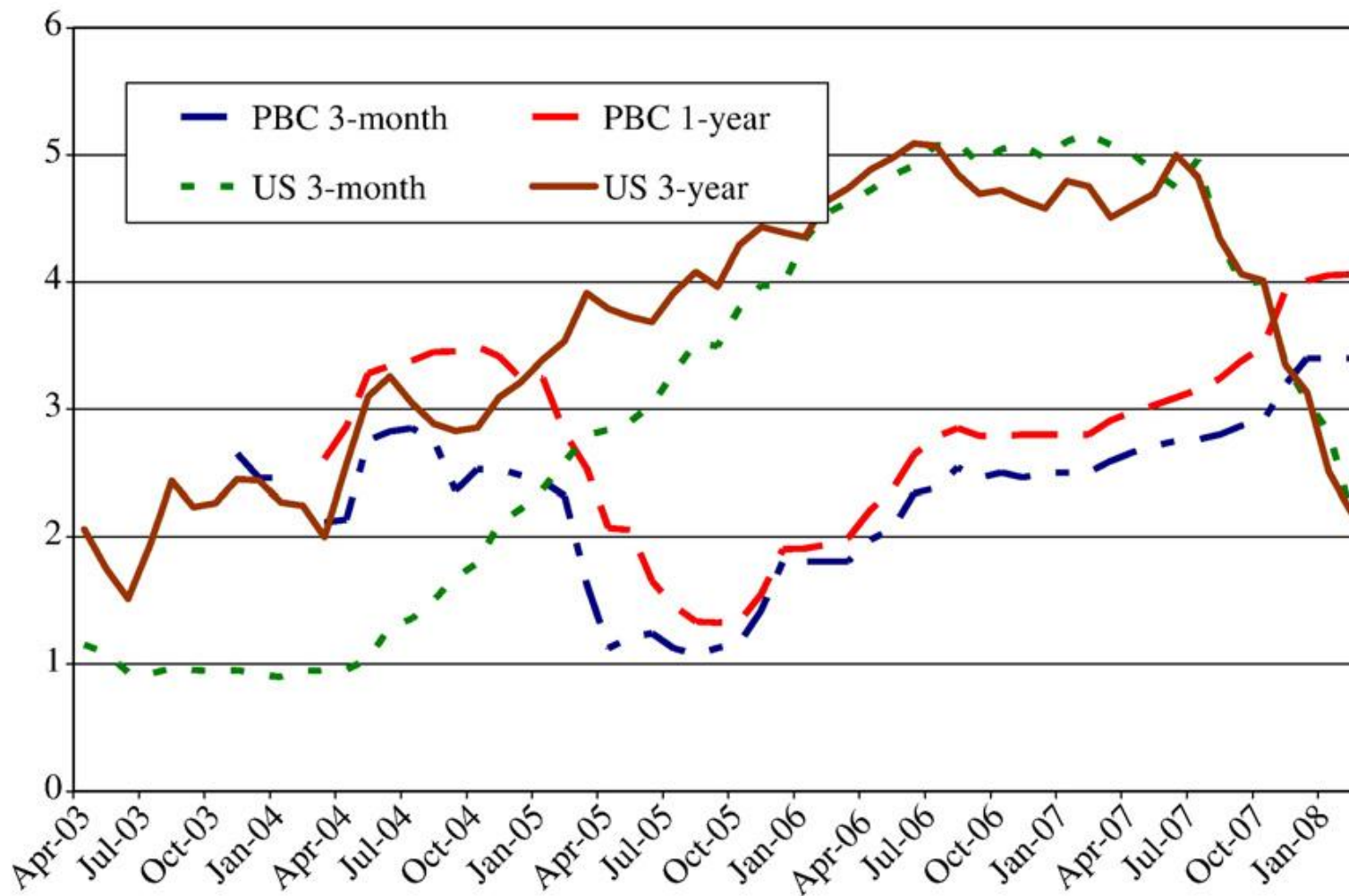


Source: CEIC and Prasad (2009)

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 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

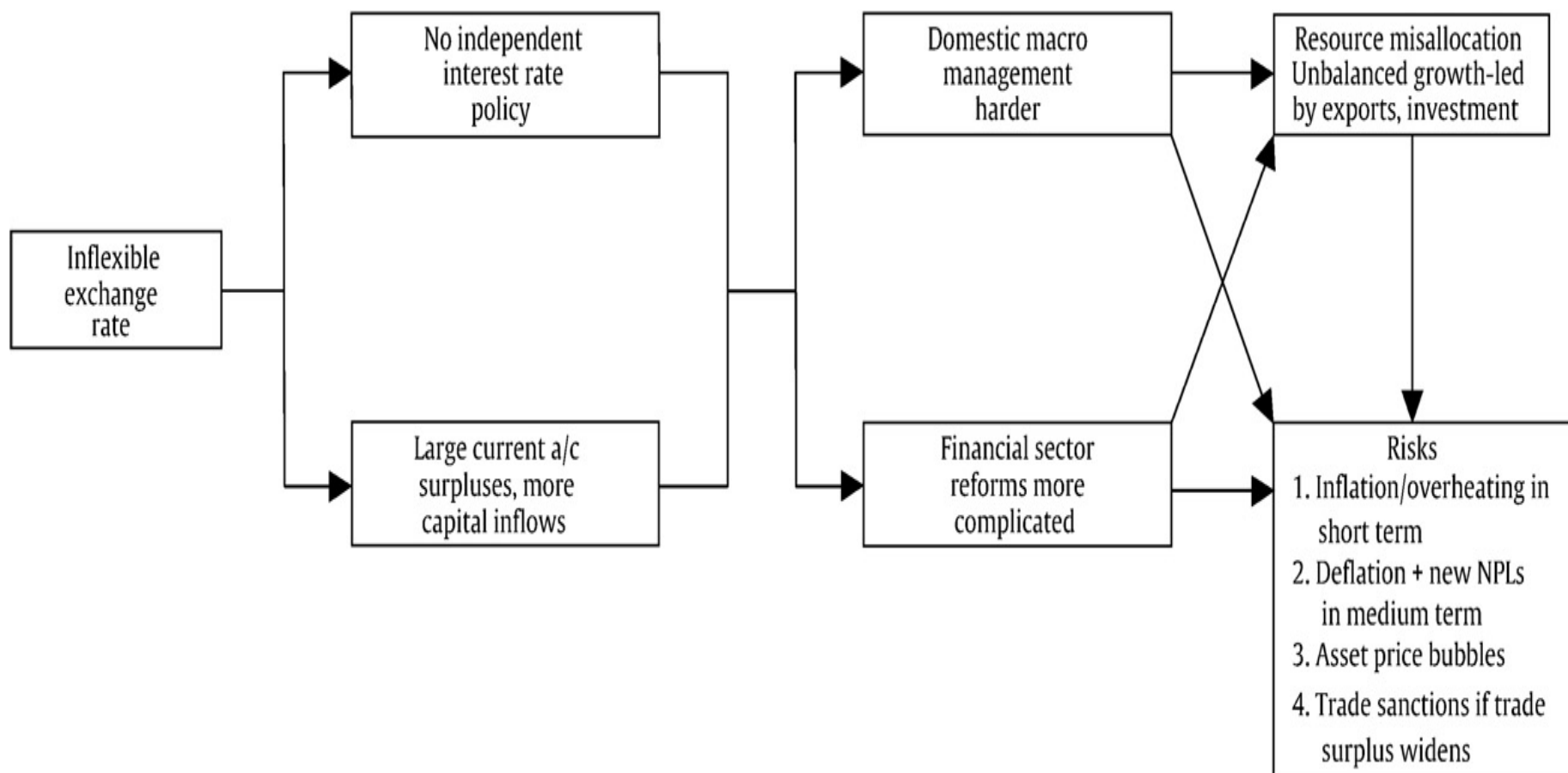
Potential Costs of Policy

- ❖ **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

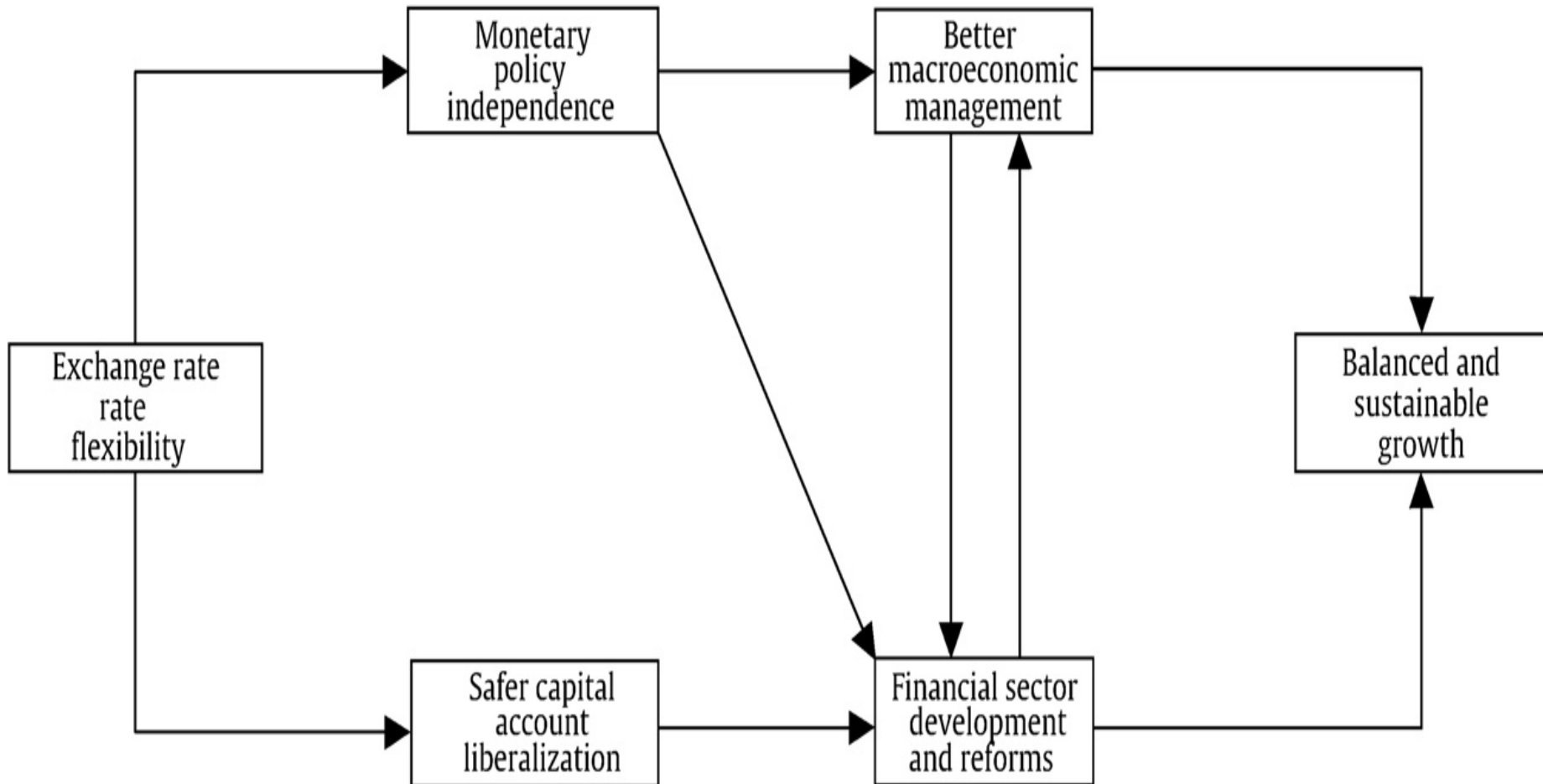
- ❖ **China's currency policy good example of interconnectedness of reforms**
- ❖ **Macroeconomics tell us if nominal exchange rate does not adjust to fundamentals, relative prices will**
- ❖ **Combination of financial repression and closed capital account can delay adjustment**
- ❖ **May maintain export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

Exchange Rate Inflexibility



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 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**