World Economic Downturn and Challenges for China

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This paper has 4 parts. Firstly, I put China's economic performance in historical and comparative perspectives. Secondly, I draw upon existing economic theories to explain the country's rapid economic growth in the past 30 years. The third part highlights the structural problems of China's economic growth. In the final part, I comment on the length of the global economic slowdown, and the challenges that China faces both domestically and internationally, with a particular attention to China's stimulus package.

1. China's economic performance in historical perspectives

Since the onset of reforms and opening up program in 1978, the Chinese economic performance has been very impressive, approaching double-digit GDP growth rate on average for the past 30 years. Put in historical perspectives, however, the performance is by no means "miraculous". The word "renaissance" is perhaps more appropriate to describe its recent developments from a low base.

Let us look at some economic and demographic statistics. In the early 19th century, the Chinese population was about 1/3 of the world's total, and at the time China produced about 1/3 of the world's total GDP. A century later, China's share of the world's total GDP decreased to about 10%, and it was further down to less than 5% in the late 1970s.[1] Today, after 30 years of rapid growth from that low base, and with a population about 1/5 of the world's total, China contributes roughly 10-15% of the world's total GDP.[2] This year with massive stimulus measures China's GDP is expected again to grow at about 8% -- an extraordinarily impressive growth rate in light of a significant global economic downturn.

On a GDP per capita basis though, China still is below the world's average.[3] It currently stands at the level that the US was about a century ago, and is similarly right in the middle of industrialization, a process that took roughly 200 years for UK, and

[1] Data based on Angus Maddison, *The World Economy: A Millennial Perspective*, Paris: OECD, 2001
[2] China's official calculation at current price is at the low end. Calculations based on purchase power parity however would be at the higher end.
[3] Calculating on the basis of PPP, and assuming GDP per capita in the US is 1, it is 0.8 for Japan, 0.75 for Germany, 0.7 for UK, 0.4 for South Korea, 0.21 for Poland, 0.2 for Brazil, 0.1 for China, 0.06 for India, 0.04 for Nigeria, 0.01 for Rwanda.

100 years for the US to accomplish. By the World Bank rankings, China now falls into the category of lower middle income countries, with per capita income ranging between US$ 930 and US$ 3,700. However, should China manage to maintain growth momentum at the current rate, it has been projected that its share of the world's GDP will go back to 20% in 2020[4] -- roughly the same relative standing that China was at with the rest of the world in the early 19th century.

In short, in relative terms China performed better in history. Catching up from a low base, it is now in a rapid process of industrialization. As such, it has great scopes for further growth, not of course without structural problems which I will explain in section 3.

2. Explaining China's economic growth in the reform era

According to official statistics by the Chinese National Statistic Bureau, China's GDP grew at an average annual rate of 9.8% from 1979 to 2008, higher than the average annual rate of 6.1 % from 1953 to 1978. The growth rate in the past 3 decades was also much higher than the world average, but slightly higher than Japan's 9.2% and South Korea's 8.5% during their economic takeoff periods.

China's rapid economic growth is often described as a miracle.[5] But does China's growth really defy economic logics? My answer is negative. China may be unique in many policy choices in reforming its economy from plan to market. Yet behind the broad trajectories of reforms and opening-up in the past 30 years, the logic can be explained by existing economic theories. Let me offer three propositions.

The first proposition draws upon the memorable analogy of the "invisible hand" by Adam Smith in his *Wealth of Nations*.[6] It tells the story of market being efficient allocatively. Reforms in China in the past 30 years have indeed been market-oriented. To mention little else, labor for instance was immobile prior to reforms between Chinese urban and rural areas. A change of that means productivity increase. Imagine first: prior to reforms a Chinese peasant worked say 3 months a year,[7] and he had little else to do between planting and harvesting. Imagine again: during reforms he is allowed to come to urban areas to engage in production 12 months a year. Just by counting the total hours of his work, there is great productivity increase, everything else being equal. How many Chinese peasants are now mobile (they are called migrant workers in China)? It is 200-250 millions – a staggering figure compared to many developed economies. For instance, the total population of the US is only about

[4] A Deutsche Bank Group study puts the size of China's economy then at 14 trillion USD, whereas that of the United States is 18 trillion USD, and that of India is 7 trillion USD.
[5] "Qiji" is the Chinese term for miracle. A key word search on Chinese economy in connection with "qiji" in google would yield over 3 million entries. See also Justin Lin, Fang Cai, and Zhou Li, *The China Miracle: Development Strategy and Economic Reform*, Hong Kong: The Chinese University Press. 2003.
[6] Adam Smith, *An Inquiry into the Nature of Causes of the Wealth of Nations*, New York: Random House, 1985 (first published in 1776).
[7] The figure is not precise, as crop terms vary across the country. But the point is to illustrate the logic.

300 millions, and that of Japan 120 millions.

Our second proposition goes beyond the parameters of neo-classic economic modeling and draws upon the wisdom of the Austrian School economist Joseph Schumpeter. By the memorable phrase of "creative destruction", Schumpeter reminds us of the role of technology as a fundamental driver for long-term economic growth.[8] What has happened in China in terms of technological progress? By opening up to the rest of the world in times of globalization, China has been able gradually to narrow the technological gaps with advanced countries. One example is to send students to study overseas. The number of Chinese students studying overseas totaled 1.21 million from1978 to 2007, with 319,000 already returned to China.[9] If the Schumpeterian model is correct, the closing of technological gaps with advanced countries would mean additional source of productivity increase for China. This indeed is amply reflected by the increasing competitiveness of Chinese products in international markets.

Technology is said to come often with tacit (as opposed to explicit) and dispersed knowledge that is not readily transferable to individuals and therefore calls for collective "learning by doing".[10]The implication is that privatization in itself is not a sufficient condition for corporate viabilities. For firms to be viable in competitive markets, effective learning has to take place. What has China done to facilitate learning? Beyond strengthening property rights and corporate governance, the logic of Robert Lucas' endogenous growth model applies here,[11]and from which we derive our third proposition to explain growth. In the Chinese case, to bridge local labor with advanced technology -- both hardware and software including international market networks, foreign direct investment (FDI) has played an important role. During the reform era China has been very successful in attracting FDI,[12]and by 2008 the realized amount of FDI reached US$ 560 billion. US investors alone had poured a total of US$ 56 billion into over 51,000 enterprises in China. Indeed, as the world becomes increasingly "flat", to borrow Thomas Friedman's phrase,[13] China has become a "world factory" with its low-cost labor advantage.

As is obvious, the above three propositions are all based on existing standard economic theories. Put together, they largely cover the ground in explaining the rapid economic growth in China during the past 30 years. What then are the challenges that

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[8] Joseph A Schumpeter, Capitalism, Socialism, and Democracy, New York: Harper and Brothers Publisers, 1942. In 1992, Schumpeter's idea of "creative destruction" was put into formal mathematical terms by Philippe Aghion and Peter Howitt in their paper "A Model of Growth through Creative Destruction," in *Econometrica*.

[9] http://cn.chinagate.cn/education/2008-04/03/content_14187388.htm.

[10] H. Tsoukas, H. "Do we really understand tacit knowledge?" in *The Blackwell handbook of organizational learning and knowledge management*. Easterby-Smith and Lyles (eds), 411-427. Cambridge, MA: Blackwell Publishing, 2003.

[11] Robert Lucas, "On the Mechanics of Economic Development," *Journal of Monetary Economics*, 22, no. 1, July 1988, pp. 2-42.

[12] Jun Fu, *Investments and Investments: Foreign Direct Investment in China During an Era of Reforms*, Ann Arbor: The Michigan University Press, 2000.

[13] Thomas Friedman, *The World is Flat: A Brief History of the Twenty-first Century*, Farrar, Straus and Giroux, 2007.

China now faces, especially in the wake of the global economic crisis, the severity of which is said to be the greatest since the Great Depression in the 1930s? To shed light on this question, let us turn to take a quick look at the structural features of China's economy in connection with the world economy, the US economy in particular.

3. Unsustainable structure of Chinese economic growth

For many countries -- emerging markets in particular, the negative impact of the world financial crisis triggered by the sub-prime lending meltdowns in the US is by way of sudden systemic liquidity crunch, leading subsequently to a rise of insolvency, unemployment, and an eventual downturn in the real economy. Such is not exactly the case for China, with the country's foreign exchange reserves reaching a record of US$ 2.1 trillion in July 2009. Looking back, and in light of the overwhelming evidence that capital flows are pro-cyclical and thus exacerbate rather than dampen booms and recessions,[14]the massive "self-insurance" in the form of high foreign exchange reserves is a rather rational response by emerging market economies. Although costly and a source of instability to the global economy, it is nevertheless a second-best choice for individual countries against balance of payments crises in an international system that ultimately lacks a "lender of last resort." Any improvement, or the reform of the current IMF, is not a job for individual countries, but instead calls for global solutions.[15]

While China does not suffer from lack of liquidity, it is by no means immune from the unprecedented external demand shock, resulting from synchronous recessions in the developed world. The negative impact is being transmitted to China through export declines, albeit not direct through finance.[16] Why? As is reflected in its comparative advantage of low-cost labor, a fundamental reason for China's trade imbalance is that income growth for domestic labor has not been proportional to its productivity increase,[17] such that a growing surplus of manufacturing goods has to be consumed

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[14] Eswar S. Prasad, Kenneth Rogoff, Shang-Jin Wei, and M. Ayhan Rose, "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence," International Monetary Fund, *Occasional Paper*, 220, 2003. Jose Antonio Ocampo, "Capital Account and Counter-cyclical Prudential Regulations in Developing Countries," In *From Capital Surges to Drought: Seeking Stability for Emerging Economies*, ed., Richardo-Davis and Stephany Griffith-Jones, Basingstoke, UK: Palgrave Macmillan, 2003, pp. 217-244.

[15] An ideal system of international system should be both stable and balanced – stable in exchange rates, and balanced in sense that individual economies suffer neither from the deflationary effects of chronic external deficits nor the distorting effects of chronic external surpluses. Both features are essential to the efficient cross-countries movement of capital, but neither seems to have met by the current dollar-based reserve currency system, witness the repeated crises and high levels of global financial instability. Developing countries in Asia, Latin America and

by international markets.[18] The very high trade dependent ratio -- reaching 57% of its GDP in 2008 -- has left China quite vulnerable to growth slowdowns elsewhere in the world, and particularly in the US, which accounts for more than 20% of China's exports. China's trade surplus with the US increased 4.6% in 2008 from a year earlier to US$170.85 billion (even though the value of RMB has appreciated more than 20% since 2005).[19] The growth, however, was 8.6 percentage points lower than 2007.

As such, even without the world economic crisis, the growth model of the Chinese economy is not sustainable from a long-term perspective. It has depended too much on investments (over 50% of GDP) and exports (net exports over 10% of GDP), but not enough on domestic consumption (below 40% of GDP). By contrast, consumption is above 70% of GDP in the US. Earlier, Chinese premier Wen Jiabao warned of a Chinese economy that was becoming increasingly "unstable, unbalanced, and ultimately unsustainable." Now a severe external demand shock only exacerbated the unbalanced structure of China's export-led economy. Chinese exports fell 17% in March 2009 from a year earlier, the fifth straight monthly decline, although less severe than February's 25.7% plunge, the sharpest in a decade. That triggered sackings of more than 25 million migrant workers in China's export-intensive coastal regions. Long fixated on social stability, Chinese policy-makers moved quickly in attempt to arrest this deterioration with massive fiscal and monetary stimulus, to which we now turn.

4. Chinese stimulus measures and challenges ahead

As officially announced early this year, the Chinese government enacted RMB 4,000 billion (US$585 billion) stimulus package, roughly 72% of which are earmarked for infrastructure including Sichuan earthquake reconstruction. To implement these stimulus measures, the government urged the state-controlled banks to step up and fund the package, resulting in a flood of money into the economy. In the first half of 2009 alone, money supply (M_2) was sharply up by 27%, with bank loans totaling RMB 7,400 billion – a record high that is three times the pace of last year. To be sure, developing countries always need better infrastructure, but China seems to have taken this to extremes, especially in the wake of the last round of huge investments in inter-provincial highways and airports just 10 years ago.

If the rule-of-thumb formula for appropriate money supply [i.e., M_2 = (targeted GPD growth rate) + (CPI adjusted) + (3-5% for the unexplainable)] is any indication, and

[18] Another implication is that a moderate exchange rate adjustment will not fundamentally correct trade imbalances between China and developed countries such as the US. On the US side, it will have to change its low-savings and excess consumption model. Now the model is in serious trouble because the asset bubbles that have long supported it have burst. In other words, the "irrational exuberance" proposition is indicated. As early as in 1996, in a speech entitled "The Challenge of Central Bankers in a Democratic Society", Alan Greenspan asked a rhetorical question: "But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?" Prescient words! Also see Robert J. Shiller, *Irrational Exuberance*, Princeton University Press, 2000.

[19] In July 2005, China abandoned a decade-old peg to the US dollar and allowed RMB to appreciate. Since then, RMB has strengthened gradually against the dollar by more than 20%.

assuming that the GDP growth rate reaches the officially targeted 8% in 2009,[20] money supply at 27% growth rate seems excessively high, giving rise to concerns about inflationary pressure down the road, if not immediately. For the moment, as exports declined sharply, CPI at -1.1% for the first half of 2009 only reflects overcapacity and a lot of inventory leftovers. This is more directly indicated by PPI at -6.5% for the same period of time. Accordingly, profit margins for many firms deteriorated as a result. At the same time, as the scope for business expansion remained limited because of spare capacity especially in the manufacturing sector, the quality of quick and massive bank lending could suffer from the rapid credit disbursements in the first half of 2009, sowing the seeds for a new wave of non-performing bank loans in the future.

There are additional structural challenges. As highlighted above, the structural problem of China growth model is its excessive reliance on investment and exports and weak domestic consumption. By 2007 investment and exports already accounted for about 80% of GDP. Now, the stimulus package, although intended to pop up a rebound, seems also to have compounded the very problems that Premier Wen Jiabao had warned of by injecting massive liquidity at its most unbalanced sector. Rather than engineer a pro-consumption rebalancing, surging investment in the first half of 2009 accounted for over 85% of GDP growth, twice the average contribution of 43% over the past decade. As exports declined, and business continued to suffer from overcapacity and slim profit margins, excessive money supply gave rise to concerns about equity and real estate bubbles.[21] And perhaps worse, since investment funds are being channeled mostly through the state-sector, they are likely also to have a crowding-out effect on the very productive non-state sector. China's financial system is still biased again the non-state sector. While the non-state sector contributed roughly 80% in terms of employment, 70% in terms of exports, and 60% in terms of GDP, it received only about 20% of bank loans. Better access to financing in rural areas and for MSEs has remained a promise unfulfilled.

Against this backdrop, the concern is that as many of these investments are often arranged through local and regional political authorities, corruptions aside,[22] they would turn out to be unprofitable or unproductive, adding to the cost of China's financial system in the form of non-performing loans a few years down the road.

[20] The official target of 8%GDP growth rate reflects tremendous employment pressure in China. According to a study by the Chinese Ministry of Human Resources and Social Security, 1% GDP growth rate means one million jobs. In 2009, there are additional 15 million people in urban areas waiting for jobs.

[21] In July 2009, Chinese regulators issued orders to banks to ensure that the unprecedented volumes of new loans are channeled into the real economy and not property and stock and markets. China's benchmark stock index has already more than doubled the low it reached in November 2008 and property prices have also risen very dramatically.

[22] According to a recent study "Corruption Threatens China's Future" by Pei Minxin, a senior associate with Carnegie Endowment for International Peace, the amount of money stolen through corruption scandals in China has risen exponentially recently. Corruption in China is concentrated in sectors with extensive state involvement, such as infrastructure projects, real estate, government procurement, and financial services. The direct costs associated with corruption are estimated as much as US$ 86 billion each year. See: www.carnegieendowment.org/publications/index.cfm?fa=view&id=19628.

Delivered in a fashion of quantity rather than quality, the stimulus package may have staged a fragile and tentative economic rebound, but China faces a prospect that the structure of its economy might end in a shape structurally worse than it is now a few years down the road. With the excessive money supply at a rate that is more than 3 times the officially targeted 8% GDP growth this year, the focus has shifted from Chinese economy being unsustainable over the long term to that being unsustainable for any more than one year. Unless corrected in a timely fashion with a successful appropriately phrased "exit strategy" and by a booming domestic consumption, the prospect does not augur well for self-sustaining growth. In any case, the government fiscal and monetary stimulus of the current magnitude has to decline next year, and market based investment and consumption may continue to feel pressure.

By way of conclusion, let me comment on the length of the global economic slowdown, as it will affect the prospect of the Chinese economy during and beyond the stimulus package. Unfortunately, good news on the international front won't come anytime soon for China. Instead, serious challenges lie ahead. That US household has reportedly taken up sayings from almost nothing to 7% means dramatic shrinkage of foreign markets for Chinese exports at least in the near future. Government intervention across the world seems to have led to significant improvements in financial market conditions and stabilization in the real economy. But the world economy at best is stabilizing, but not stabilized. And I don't see a V-shaped recovery soon. Moving forward, a long L trend is more likely and, recovery, if any, is subject to risk, for there is no real driver for robust growth.

On a final analysis, the ultimate source of growth is productivity increase. But for developed countries that have already accomplished industrialization, a critical question to ask is: where is the additional source of productivity increase in post-industrial era? Previously we were told that the answer lies in IT and high value added services such as investment banking. Now, with the burst of the dotcom bubbles and the collapse of financial institutions, we have realized that their productivity-enhancing effects have been exaggerated.

Thus, while the US -- currently "the consumer of last resort" and also "the deficit of last resort" of the world economic system[23] -- will have to readjust its economy in terms of over-spending and over-reliance on the financial sector, a necessary and painful process that may easily invoke protectionist tendencies,[24] China for its part must work to redirect economic growth towards domestic private consumption, a process that will have to involve the designing of better institutions to deal with educational, health, social,[25] and income distribution issues.[26] To say the least, China

[23] Joseph Stiglitz's phrase. See Stephany Griffith-Jose Antonio Ocampo, and Joseph Stiglitz, eds., *Time for a Visible Hand: Lessons from the 2008 Financial Crisis*, Oxford University Press, forthcoming.

[24] For example, earlier in 2009, the US Steelworkers Union, which presents workers at major US tire manufactures, filed a petition against Chinese tire imports for import relief and won a favorable ruling from the US International Trade Commission. If imposed, this would mean 55% tariff on Chinese tire imports in the first year, to be reduced to 45% in the second year and 30% in the third year before being removed.

[25] Inadequate social security and high costs of education and health relative to income growth are believed to be a

will have to reduce structurally its current account surplus by having domestic demand grow faster than production capacity.

Sure, on both sides of the Pacific Ocean, the tasks are very daunting.

cause of China's high savings rate -- a drag on private consumption.

[26] China's National People's Congress, for instance, is now considering more presentations from the rural areas based on population distribution.