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China's Growth Transition: Implications and Outlook

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China’s Growth Transition: Implications and Outlook

Abstract

This article examines how China’s growth model has changed and developed since its global economic emergence in the late 1970s, and assesses prospects for China remaining the largest country in purchasing parity terms. Certainly, China has faced many growth transitions as imbalances arose during the phases of reforms, and China has changed the growth model successively to address them, while keeping growth high. However, China’s latest imbalance has persisted since the global financial crisis and is taking longer to address. Internal imbalances arising from credit-and debt-financed investment have overtaken external imbalances from the current account. As a result, since the global financial crisis, as fiscal stimulus rose, and stayed high, and corporate debt doubled, capital efficiency has steadily fallen, with total factor productivity significantly declining and reducing its contribution to overall growth. This reflected China’s rising investment since the crisis being concentrated in less productive sectors such as real estate, and implemented by state-owned enterprises (SOEs) that built excessive capacity in sectors, such as coal, cement and steel. These tensions and imbalances all centre on China’s financial system, that has become large, and opaque, with a proliferation of financial products, and need to be addressed for other structural reforms to take hold, and to sufficiently nurture investment and innovation in globally-surging services sectors. In an important step toward this end, China’s top leadership has recently signaled that it would tighten steps to address financial stability risks by establishing a new Financial Stability and Development Committee under the State Council. How China meets the challenge its growth model now faces is critical for global growth and, equally for China, that also faces the rising reality of changing demographics?

Keywords: Chinese economy, Chinese financial system, economic reforms, financial stability risks, international trade, Renminbi, global financial crisis

Introduction

China is now the second-largest economy in the world—and the largest in purchasing power parity terms. Its global economic emergence in the late 1970s has spectacularly taken China to middle income status within a generation. Although China’s growth has decelerated from double digits in the 2000s to 6.5 per cent in 2017, the economy is now twice as big relative to the level before the global financial crisis and contributes nearly one-third of global growth. In addition, China’s global export share amounts to about 15 per cent, and its share in world imports has almost doubled compared with a decade ago. More than 120 countries count China as their largest trading partner (Fenghuang 2014). The Renminbi’s (RMB) use in global payments has also doubled in recent years and the IMF has included the currency as the fifth in the SDR basket. Estimates point out that China’s integration into the global trading system accounted for 10 per cent of the average overall productivity increase in advanced economies between the mid-1990s and mid-2000s.

Given its importance in the world economy, and renewed uncertainties of global growth, assessing China's growth trajectory is central to understanding the overall prospects for the global economy. Let us start by looking at the challenges and imbalances that China has faced since its global emergence and how it has sought to address them.

The Deng Strategy

China introduced its first economic reforms and opening-up policies in December 1978, sequentially moving from a planned economy to a much more dynamic one (CPC News 2014). China's growth process since 1978 and through 2007 is best seen as a sequence of three phases of reforms, each building on the Deng strategy of gaige kaifang or 'reform and opening-up' of the economy. Through these phases, China transitioned from agriculture to manufacturing, moving quickly up the value chain by diversifying into new sectors, and going global in its foreign direct investment- and export-led development, leading to membership of the World Trade Organization (WTO) in 2001, and quickly becoming the world's leading exporter.

The reforms during the first early phase targeted the agricultural sector, given that the majority of the population lived in rural areas, and food security had been a major problem previously. These reforms successively raised agricultural prices, restructured the household responsibility system, and brought more arable land under cultivation. Through the reforms to the household responsibility system, the agricultural collectives were disbanded and land rights assigned to individual plots of land, effectively privatizing agriculture. As a result, output and productivity significantly increased in the agricultural sector, raising demand for industrial goods, and sparking entrepreneurship through a rising supply of non-farm labor.

The second phase of reforms, after 1984, dealt with the manufacturing sector, building a growth path led by investment in industry and manufacturing. During this phase, a dual-track system was established (in the manufacturing sector) and the Chinese government created a favorable policy environment for the township and village enterprises (TVEs)—business enterprises effectively established and owned by local governments or individuals. During this transition to the emergence of urban private firms, the TVEs laid the foundations of China's industrial development. The process saw the significant growth of light industry, and the growing reallocation of employment from agriculture to manufacturing. However, the resultant wave of consumer demand clearly outstripped industrial supplies, leading to high inflation and rising corruption from the partial price reform, leading to the effective halt of the second phase of reforms.

It took Deng Xiaoping's Southern Tour in 1992 to spark the third reform phase, establish special economic zones, and reinforce the commitment to the open-door policy. The next milestone was in 1997 when the 15th Congress of the Communist Party of China officially endorsed the role of private firms in the economy. The third phase was crucial in China deepening its integration with the global economy; it fostered foreign direct investment (FDI), especially in manufacturing, and the further liberalization of trade across the economy, opening the inland regions to FDI and preferential policies (Brandt, Ma, et al. 2014). In anticipation of China's WTO accession in 2001, the government lowered tariffs and reduced restrictions on trade in services, among other measures to boost export competitiveness. These reforms brought in foreign investments, advanced technologies, and managerial expertise, anchoring the steps to open the international market for China's goods and services (Lardy 1995).

By the time, China joined the WTO in 2001, the economy had already experienced more than two decades of opening up and reform. Following WTO membership, the rise of China's exports was spectacular. By 2008, China's exports successively overtook Japan, the United States, and Germany to become the world's leading exporter. Average real GDP growth rate between 2000-2007 was 10.5 per cent per year (Singh, Nabar et al. 2013).

The structural changes in China's economy and society were immense through the three reform phases, creating successive macroeconomic imbalances, especially external imbalances that grew significantly through the period leading to the global financial crisis:

- External imbalances grew over this period, as growth was highly driven by net exports. Thus, exports doubled as a share of GDP to 32 per cent by 2007, the current account surplus reached 10 per cent of GDP, and foreign reserves rose to a level higher than necessary by any criteria (Singh, Nabar and et al. 2013)

- These imbalances reflected rising internal imbalances. Capital investment increased continuously during the reform period, especially after 1992, when China intensified its efforts to open to the world and attract FDI. Thus, investment growth continued to be much faster than consumption. The falling consumption share reflected both the high savings rate and the declining share of household disposable income

- These imbalances mirrored substantial changes in China's export structure. At the start of the reform period in 1978, the shares of manufacturing and agriculture in exports were approximately equal. Since then, and especially since the mid-1980s, the export structure gradually shifted away from agriculture and towards manufacturing. During the same period, there has been a growing share of agricultural imports and a declining share of manufacturing imports.

- This strategy, especially after 1992, led to an excessively large share of the industrial sector and to overcapacities in the manufacturing sector. As a result, the market returns from industrial investment progressively declined, with a corresponding decline in the sectoral and overall productivity.

- Since the mid-2000s, the Deng strategy has been labeled as unsustainable, even within China's leadership. Premier Wen Jiabao warned, in 2007, that the growth of the Chinese economy would be 'unstable, unbalanced, uncoordinated and unsustainable' (Consulate General of the People's Republic of China in San Francisco 2007).

- In response to the surging external current account surplus and rising international concerns about an undervalued RMB, China started to appreciate its currency in 2005 and make it more flexible through a managed floating exchange rate regime based on market supply and demand and adjusted with reference to a basket of currencies. However, by 2007, the RMB was still believed to be undervalued and the current account surplus had risen to 10 per cent of GDP. Meanwhile, the consumption share kept declining.

During the reform phases, as overall poverty declined greatly, there were substantial implications for the regional development of the country, leading to rising inequalities. China could raise its economic growth rate by profiting from the huge migration flow from the west to the east. During this process, some 250-300 million migrants moved from rural agricultural areas to cities for more gainful employment, and 600 million people escaped poverty. As living standards rose, China's middle-class rose to being second in size only to the United States (World Bank and Development Research Center of the State Council 2013). Life expectancy and literacy jumped and the urban-rural income gap shrank, particularly in the decade after the turn of the century, and relatively more in the eastern part of China.

However, the stepwise regional development led to an increasing discrepancy of wealth and rising income inequality between eastern and western China. In 2015, the average per capita income of the western provinces was only 55 per cent of that of the eastern provinces. The economic transition of China has been accompanied by increasing income inequality—even within the urban sector (Zheng et al. 2011).

Dealing with the Global Financial Crisis

During the global crisis, China was mainly hit in the external sector. As trade finance dried, export growth quickly decelerated and eventually declined in late 2008. The decline was mainly driven by lower demand from advanced economies (EU, US and Japan). Later on, the declining pattern started to spread to exports to other trading partners. Because a substantial fraction of China's export is actually re-export, the imports of intermediate goods also fell. Because export had been a main driver of growth since 2001, growth momentum turned weak in the second half of 2008, as China's exports as a share of GDP fell sharply, and net external demand began to detract from China's growth. The current account surplus fell to 2 per cent of GDP by 2011. The negative impact on employment, especially in the export-oriented factories, was immediate.

It helped that China's financial system was less vulnerable – compared with the advanced countries – to the financial contagion from the crisis. China's financial system had recovered from the high level of non-performing loans in the late 1990s, was mainly funded by household deposits, and continued to be protected by relatively tight capital controls.

Other economic factors were also favorable at the time, such as a relatively low household debt, a healthy fiscal profile, and a declining trend in the government debt/GDP ratio. Although corporate debt as a share of GDP was substantial compared to countries with similar level of per capita income, it was still much lower than most middle/high income countries.

These factors gave space for fiscal stimulus and China announced its stimulus plan in November 2008. China's fiscal stimulus totaled about 4 trillion RMB (equivalent to about US$600 billion at the exchange rate then), or about 12 per cent of GDP (Kroeber 2016). China's stimulus turned out to be the largest among the countries responding to the international call for stimulus to cushion the growth implications of the global financial crisis. China's stimulus was clearly aimed at maintaining China's growth at 8 per cent.

Although the stimulus plan included some increase in social spending (healthcare, education and low income housing support), much more weight was put on investment, especially infrastructure spending. As a result, the fiscal deficit in 2009 was much larger than previous years. The on-budget deficit, increased by 2 per cent of GDP in 2009, but over two-thirds of the stimulus package was financed by local government through off-budget financing. To measure the full impact of the stimulus, the IMF compiled the 'augmented net lending and borrowing' definition, which includes local government off-budget borrowings. This augmented net borrowing deficit increased from three per cent in 2008 to close to 10 per cent of GDP in 2009.

Among other measures to ensure growth, the People's Bank of China cut interest rates and the required reserve ratio multiple times, and the quota on bank lending was also relaxed. As a result, the flow of total social financing, a measure of the credit flowing into the real economy, almost doubled in 2009 (over 2008).

The most significant stimulus support measures were in the real estate sector. The minimum down payment requirement was halved to 20 per cent (it had been increased to 40 per cent in 2007). The lending quota was also relaxed. The real estate sector benefited the most from the relaxation in the quota on bank lending (through loans to real estate developers or loans to households), and the accompanying decline in the usual discount on the mortgage interest rates. As a result, real estate sales went up and the inventory ratio went down quickly in 2009, indicating that the policy support was very effective from both sides. However, this policy support created some serious long-term problems, with real estate becoming a key driver of growth.

The fiscal stimulus in 2008-2009 was probably necessary to quickly stabilize the economy. Indeed, the fiscal and monetary stimulus quickly improved business sentiment and stabilized the growth momentum. Real GDP growth rates were over 9 per cent in 2009, then well over 10 per cent in 2010, significantly above the 8 per cent growth target. However, the global call was to gradually unwind the stimulus after the growth momentum improved. This was not the case in China as the government continued to set challenging growth targets subsequently, and pressures remained on local governments to persist in off-budget financing and meet quantitative targets. Augmented net borrowing remained at about 7 per cent of GDP per year and local government debt continued to increase after the global financial crisis abated.

As a result, China reduced its external imbalance but compounded its domestic imbalance, with growth being driven by high, credit-financed investment since the global financial crisis. As China's investment rate reached historic highs close to 50 per cent, capital efficiency steadily fell, with total factor productivity significantly declining and reducing its contribution to overall growth (OECD 2015). This reflected China's rising investment since the crisis being concentrated in less productive sectors such as real estate, and implemented by state-owned enterprises (SOEs) that built excessive capacity in upstream sectors, such as coal, cement and steel, that had significant effects on related global commodity prices.

The policy support also resulted in the substantial increase of corporate leverage. China's corporate debt quickly rose well beyond that of most peers. With its declining productivity, and consequently falling industrial profits, the capacity to service this debt has been deteriorating, with a rising fraction of debt being owed by firms with weak interest coverage—compounding the implications from the increase in the corporate debt-to-GDP ratio.

The Xi Strategy and Policy Outlook

When Xi Jinping came to power in 2013, China's internal imbalances were fully apparent. China was at a critical juncture in its reform phases with the growing need to address the rising problem of excess capacity in heavy industry and transform its growth model. The success of fresh reforms was internationally seen as crucial, with significant global implications given China's economic size, trade links, and increasing financial integration.

Xi announced a new package of reforms in November 2013 to move more forcefully forward the strategy of 'rebalancing' that was first announced in the 12th Five-Year Plan of the Chinese Government in 2011. These reforms were laid out in the comprehensive 'Third Plenum Reform Blueprint'. Since then, the reforms have been anchored and developed in a number of ways, especially with the approval of the 13th Five-Year Plan in 2016. The main economic aims are to rebalance the economy towards a consumption- and service-led growth path, protect the environment, open up markets, expand public services, reduce poverty, reduce overcapacity, and reform SOEs. These reforms aim at better integrating the western regions of China into the country's development strategy, with the main reform areas to be achieved by 2020 (Wagner 2017). They also seek to make China a pre-eminent science and technology power as explained in its 'Made in China 2025' plan.

Progress is certainly being made in these directions. Already, consumption is contributing more to growth in China than investment. The services sector has been growing faster than the industrial sector, and now accounts for close to half of GDP and 40 per cent of employment (IMF, Article IV Consultation 2017). However, this raises risks from the implications of an economy increasingly running at two speeds.

Among the main policy areas, significant progress has been achieved in moving towards a market-based monetary framework, improving the fiscal framework, advancing urbanization, and identifying many of the SOEs (especially the 'zombies') that need fundamental restructuring (Kang et al. 2016):

- The monetary policy framework has liberalized interest rates and abolished the cap on the loan-to-deposit ratio for commercial banks. The People's Bank of China (PBC) has started to establish an interest rate corridor centered on the seven-day repo rate.

- The new budget law improves local government transparency and accountability and recognizes the mismatch at the local level between spending and revenue responsibilities; in addition, the value added tax (VAT) has been extended to all services.

- Regarding urbanization, pension portability has improved and provinces have been developing a new household registration system whereby migrants can qualify for basic social welfare and residency benefits in cities.

- About 350 central SOEs needing fundamental reforms have been identified, and restructuring has started for provincial enterprises, especially for the zombie SOEs (Lam, Rodlauer, et al. 2017).

However, reform progress has been uneven, especially in transforming the financial system, strengthening its governance, imposing hard budget constraints, and tackling excessive corporate debt. Indeed, since the global financial crisis, China has seen rising financial innovation, new ways to transform China's high savings, and a migration of resources out of banks and into shadow credit products (such as trusts, wealth management products, and corporate bonds). As a result, China's banking system is now among the largest in the world (at over 300 per cent of GDP) with its rising complexity and regulatory arbitrage (IMF, Article IV Consultation 2017). Thus, China's financial system now needs commensurately higher regulatory and supervisory standards.

Why has it taken longer to transform the financial system and stem rising financial stability risks, despite successive reform commitments by the Chinese government and the PBOC? There are several reasons.

- Lack of policy clarity has, likely, been the central problem, with seeming alternation between prioritizing reform or growth, given the official target to double 2010 real GDP by 2020.

- These policy alternations have led markets periodically to question the commitment to reform (such as through the relatively clumsy response to stock market correction in 2016).

- The lack of policy clarity also reflects tension in the strategy that aims to give the market a 'decisive' role, but also affirms the 'dominant' role of the state.

- The central problem has been of rising moral hazard, in that the high level of savings, rising leverage, the closely managed capital account, and the web of explicit and implicit guarantees continue to distort risk and drive asset price booms.

- To keep growth at the officially set level, the allocation of resources has been set by government direction, and domestic credit has been growing about twice as fast as nominal GDP since the global financial crisis.

- China's credit-financed investment share has surged especially in housing, infrastructure, and manufacturing, and this has resulted in rising corporate debt.

- Although general government debt is still around the average for emerging markets, nonfinancial private sector debt, of households and corporates, has reached about 180 per cent of GDP (IMF 2017). As a result, China's total debt has almost doubled since the global financial crisis.

- The cumulative deviation from its trend is very large by international comparison and has been seen by many as a key indicator of potential crisis.

- In addition, the returns to state investment, especially in SOEs, have been consistently lower than the private sector. They have been falling sharply with declining contribution of productivity to growth.

- Credit is not just going to the real economy, but is growing rapidly within the financial sector itself, reflecting a complex network of links between banks, non-banks and a proliferation of investment products. Reflecting the intra-financial flows, bank assets in China have been growing faster than credit in recent years, creating still greater leverage and financial fragility in the economy.

These tensions and imbalances all centre on China's financial system, and need to be addressed before further capital account liberalization, and for the other structural reforms to take hold. To reverse the trend of falling productivity, and to nurture investment and innovation in globally-surging services sectors, the first step is to urgently address the legacies of credit- and investment-led growth. These include, especially, the interlinked problems of heavily leveraged financial and corporate sectors, from the rapid rise in (mainly domestic) corporate debt of SOEs and real estate-related firms. In particular, in China, we are seeing weakening fundamentals in corporate balance sheet that are translating into rising bank vulnerabilities.

These domestic imbalances mirror the fault-lines in other emerging market countries that have also experienced rapid rise in credit growth, corporate and bank debt, and consequent declines in total factor productivity and potential growth. Certainly, India's stress tests of corporate and banking vulnerabilities confirm the risks from its high corporate leverage and the potential need to recapitalize state banks. Other emerging markets have also built up debt as they turned to capital and financing to drive domestic spending and deliver higher headline growth, and in turn, leading to reduced productivity.

The need for such restructuring plans to act across multiple fronts undoubtedly faces political resistance, especially because of the likelihood of slowing growth in the transition. In China, as in many emerging market countries, the test is to harden budget constraints, remove implicit guarantees to state banks and enterprises that distort the pricing of capital, and to improve resource allocation to higher productivity sectors.

The Chinese government is developing a reform plan for the SOEs, has announced capacity reduction targets in the coal and steel sectors, and is working on a strategy that includes debt equity conversions to address the problems of excessive corporate debt and vulnerable bank loans. Such solutions have been successful internationally and could be important drivers for other needed reforms provided they build new corporate and bank governance safeguards.

Importantly, China's top leadership also recently signaled that it would tighten steps to address financial stability risks by establishing a new Financial Stability and Development Committee under the State Council. The main aim is to coordinate the regulatory agencies under the likely leadership of the PBOC and to better target informal financial products. Together with other recent regulatory and supervisory measures, financial conditions have been tightened, with increases in policy interest rates. While the monetary stance still remains accommodative, this should help in the overall strategy to reduce excessive leverage and limit pressure on the RMB.

These challenges facing China are complex but it possesses the buffers to correct these fault-lines and undertake reforms without social dislocation, especially if these are carried out as soon as possible. Most importantly, these reforms need to bolster potential growth through productivity gains by encouraging the more efficient allocation of resources, reducing barriers to entry (especially in services), and building a more competitive economic environment—and not from just increasing physical investment. Rather, China needs to build new soft infrastructure that would better underpin and guide the functioning of markets (Lam, Rodlauer, et al. 2017). Overall, the macro-policy mix also needs to build in higher public social spending, especially on health and education, while making the tax system more progressive

Conclusion

China clearly has the potential to sustain strong growth over the medium term. However, the urgency of reforms arises from the looming demographic changes that will raise labour costs and reduce corporate profits unless matched by rising productivity. Among the policies needed to do this, China needs to be on a firmer trajectory toward a more modern financial system capable of addressing the challenges of a more mature and complex economy. Most importantly, it needs to increase the role of market forces, as successively promised by the authorities, by reducing implicit subsidies to SOEs, sparking competition in the banking system and, thereby, helping open more key sectors to private entry, investment, and credit. Immediate steps include deleveraging the private sector with continued regulatory and supervisory tightening, much greater recognition of bad assets, and more market-based credit allocation. Financial liberalization must be the next big wave of reforms in China and can help lay the foundation for complementary reforms and continued strong growth in China over the medium term.

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