



China, the Debt Trap and the Future Prospects for its Economy

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Few economies have been able to grow rapidly on a sustained basis. Countries grow rapidly for short periods and then because of various constraints and imbalances that develop, their growth process comes to a halt. Rapid growth does tend to lead to various imbalances. This can be seen most clearly in the case of Latin American countries, including large emerging economies such as Brazil and Mexico. They grew rapidly since the 1950s to about the mid-1970s and then have faced a prolonged period of slow growth. The Southeast Asian economies have not been able to go back to the high growth rates they had experienced before the Asian financial crisis.

Furthermore, apart from the potential for a crisis because of imbalances, economists seek to analyse whether any particular case of high growth is sustainable. In particular, since we do not understand the process by

which an economy moves from being an imitator of technologies developed elsewhere, to being a generator of technologies, it is always an open question whether an economy will be able to make such a transition. The clearest example of a failed state in this sense is Argentina. Per capita income in Argentina in the 19th century was about 90 per cent that of the United States and Canada. Today, it is about a quarter. It is because of such concerns about the transition that Paul Krugman had argued in a paper in *Foreign Affairs* (1994) that South Korea would not be able to sustain its high growth rates. In this vein, questions have been periodically raised about the potential for a crisis in China as also its ability to sustain high rates of growth.

A recent addition to this growing body of writing, is by Steve Keen (2014) and Derek Scissors (2014), expressing concerns about

the sustainability of China's high growth rate. Keen has two main concerns. One is the unreliability of official data, which in his view would prevent the leadership from adopting appropriate policies as they would not know what the true situation is. The other is the rising debt-to-GDP ratio because of the housing bubble. Scissors, while sharing Keen's concern about the rising debt to GDP ratio, is also worried that growth may stutter because of declining total factor productivity growth between 2007 and 2012 and the declining labour force. We discuss these issues below.

Data Issues in China

Data is collected for policy making to provide the information that is important in terms of the theory that is being applied. However, very often there is a gap between the theoretical constructs and the data. As J. R. Hicks said in his book *Value and Capital*, at a time when national income concepts were only beginning to be developed, 'The income he can calculate is not the true income he seeks; the income he seeks cannot be calculated' (1964: 179). Little progress has been made since to bridge this gap. However, it is the job of the national accounts statisticians to narrow the gap as far as possible.

Questions have been raised frequently about China's ability to sustain high rates of growth.

Generally speaking, it is difficult to judge the reliability of data. For instance, R. M. Solow (1969), when trying to analyse the relation between unemployment and the rate of inflation, came across some puzzling behaviour in American data. However, he was able to explain it because he said that he knew how the US data was collected. But

he could not explain certain features of the behaviour of the British economy because he said that he was not familiar with how the UK data was collected. It was therefore not the question of a difference in the *reliability* of the US and UK data.

The above problem becomes acute when comparing two very different economies. The US, for at least the past half a century, has been a developed market economy, very largely urbanised. China was an underdeveloped agrarian economy based on Marxian principles that has been transforming itself into a more developed market economy. The process of transition creates problems for the statisticians. In Marxian theory, only the commodity-producing sectors created value, so the output of the service sectors was not counted in GDP. So the statisticians would have to adjust their data collection techniques as well as their mindsets after the liberalisation process was set in motion.

It is more difficult to estimate the value of activities which are not conducted through the market than those that are undertaken through the market. For instance, it is difficult in India to estimate the income of people providing domestic help. But if all this help was provided through agencies, as is beginning to happen, more precise information about the value of this activity would be available. All transition economies that are going through the process of becoming market-oriented face this problem.

Keen recognises that the Chinese government has been very successful in steering the economy since the opening up process began more than three decades ago. *If the data had been that unreliable and geared to tell the policymakers what they wanted to hear, it is highly unlikely that they*

would have been so successful in managing the economy (author's emphasis). Neither is it the case that the Chinese economy has not faced challenging times. The transition process has run much more smoothly in China compared to almost any other transition economies. Furthermore, it would be very difficult to explain its export performance, ability to attract FDI and reserve accumulation, for which Chinese data can be checked with other sources.

Is a High Debt-GDP Ratio a Problem?

The debt-GDP ratio issue has generated lively controversies ever since Rogoff and Reinhart (2009) concluded that debt-GDP ratios above 90 percent had a very adverse effect on growth rates. The conclusion from this controversy has been that their analysis is seriously flawed and no such cut-off debt GDP ratio can be inferred from the data (Herndon, Ash and Polin 2013). Compared to the US, China is a land-scarce country undergoing rapid urbanisation. This would lead to land prices rising faster in China and so a higher land value-to-GDP ratio. If both economies have similar mortgage provisions, the debt to GDP ratio would be higher in China. For instance, if the costs of higher education are borne by students through student loans, the ratio of student loans would be higher in an economy undergoing rapid expansion of tertiary enrolment compared to another economy with a slower expansion. But this higher debt would only be a problem if no jobs were available to the students after they graduated.

One has to examine the reasons for the debt accumulation. In the US, the debt was used for consumption purposes; the savings ratio was negative. Since it was used for consumption purposes, the problem arose

that when the housing boom evaporated, there was a drop in consumption and no other demand was able to replace it. Also, the debts could not be repaid when the indebted persons lost their jobs.

If Chinese data had been as unreliable as claimed, its policymakers would not have been so successful in managing the economy.

The debt-GDP ratio in an economy also depends on the structure of the financial system. In the US and UK, investment is financed through retained profits and share issues on the stock exchange. Companies do not finance investment in machinery and equipment, namely long-term investment, through borrowings from the banks. Banks are reluctant to finance long-term investment as they raise money through deposits most of which are short term. Over the last two to three decades, companies raise money even for working capital purposes in capital markets, through arms-length transactions. These are mediated through a host of institutions including credit ratings agencies. But most other countries do not have such active capital markets nor have they developed the institutional network needed to make such a system work. In these countries, banks provide long-term funding. But to protect their investments, the banks are also intimately involved in the working of the enterprises. There is no evidence to show that either system is more efficient than the other (Allen and Gale 1999).

In many East Asian economies, governments were also involved in ensuring the viability of the system. Problems arose as in the case of South Korea, for instance, when it sought to shift from the bank financing system to an

arms-length system as it did not have the appropriate infrastructure (see Allen and Gale 1969 for an analysis of the problems that may arise in the transition).

In the case of China, the high debt-to-GDP ratio has not been used to finance consumption. Furthermore, it is also a reflection of its lack of market organisations to mediate the savings investment process. The effect of the debt depends on whether the debt was in the country's own currency and whether it was owned by foreigners or citizens and the purpose for which it was used. Countries with a high debt-to-GDP ratio run into problems when the debt is denominated in a foreign currency which it cannot print and must earn. Many Latin American countries had a debt crisis in the 1980s as their debt was denominated in American dollars. It was a problem because they could not earn the dollars required to service the debt. There was a similar problem in the Southeast Asian economies in 1997-98 because the debt was in US dollars. It will obviously be a problem if the debt is used for consumption purposes because then the debt is not financing an increase in production that can be exported to service the debt. It also matters whether the central bank had control of the currency and could engage in monetary policy, or not. Thus, the debt-GDP ratio was not a problem in Japan. The UK had a very high debt-GDP ratio for almost a century and a half after the Napoleonic wars without any problem.

Unlike in the case of the US, in China, the high debt-to-GDP ratio has not been used to finance consumption.

More recently, the high debt has been a problem in a number of Eurozone countries even though it was denominated in Euros,

their currency, as the countries themselves had no control over monetary policy which was controlled by the European Central Bank. This debt however, became much less of a problem once the European Central Bank announced its intent to support the debt of countries in trouble; the interest rate on the debt of these highly indebted countries of the Eurozone immediately fell to almost the level of interest rate on German debt.

Chinese debt is not in a foreign currency and in any case, it has huge foreign exchange reserves. Furthermore, it has not been used for consumption purposes but has been used to support production and output has been growing rapidly. Domestic debt would only be a problem if the banks no longer wanted to hold it as an asset, an unlikely contingency, or public savings rates declined precipitously, and again it is not clear why that would happen. So it is very unlikely that its high debt-to-GDP ratio would be a problem. Nevertheless, a very low probability event obviously does not mean that the probability is zero. The Chinese government will have to be careful if it decided to shift from its bank-financed investment system.

The high level of leveraging in the US became a problem when the Federal Reserve Bank decided not to support the Lehmann Brothers as the financial system is very inter-connected and the failure of Lehmann Brothers caused distress to many other financial institutions. The US authorities had underestimated the repercussion of letting Lehmann Brothers collapse. There is considerably less of lending between Chinese institutions so that the collapse of one institution would not jeopardise the financial health of other institutions. Furthermore, even the highly interlinked American financial system stabilised once

the Federal Reserve and the US federal government decided to support financial institutions in distress. So there should not be a major crisis unless the Chinese central bank does not act to stabilise the financial system. Given the US experience, the Chinese are, however, unlikely to underplay the significance of letting a major financial institution collapse.

Even if Beijing had to bail out the banks, this would not be as much of a problem as in other countries, as the budget does not have a large deficit nor is the public debt-to-GDP ratio very high; Chinese provinces also have limited financial capabilities. But it is difficult to see that the central authorities would not help a province if the price would be the collapse of the system and a severe financial and macro crisis. There is nothing in the economic management of the past over three decades to suggest that they would make such a catastrophic mistake particularly given the experience of other countries. The conclusion is that the similar debt-GDP ratio in China as in the US before the 2008 financial crisis is not a problem.

Future Prospects for the Chinese Economy

Scissors (2014) argues that China's future prospects are poor because of declining total factor productivity (TFP) as well as a declining labour force. Since welfare depends on per capita income, the declining labour force is irrelevant to this discussion about whether the Chinese economy can keep growing so that the living standards of its people continue improving. Calculation of TFP is fraught with problems. Even for the same period, one gets different estimates depending on what assumptions one makes about the production process. Since the TFP is calculated as a residual after one has taken account of all the inputs, it depends on the

inputs that are used in the analysis. Solow (1956), who initiated this area of research found that about 80 percent of US growth could be attributed to productivity growth. But in a later study Denison (1962) included many more inputs and reduced productivity growth to zero.

Similarly, Abramovitz and David (1962) note that studies of TFP conclude very slow growth of TFP in the US in the 1920s, whereas all analysts of the period note the rapid shift to using electricity in the production process which should show up as large increases in productivity. Given that per capita income has been growing very rapidly, it is astonishing that productivity increase is negative. For instance, the analysis by Fuglie at the US Department of Agriculture (2010) finds that China has experienced very rapid growth in agricultural productivity. Furthermore, many others including Bosworth and Collins (2008) find a rapid growth of productivity in the economy as a whole and in the industrial sector. Also, Chen and Whalley (2015) find that there is still considerable scope for China to keep growing rapidly.

What about the middle income crisis, namely growth rates declining once an economy reaches a certain level of income? Japan and South Korea managed to avoid such a hiatus so it is not that countries have not made a smooth transition from a situation where they were mainly technology imitators to where they started generating their own technologies (Chen and Whalley 2015). China is very conscious of the need to prepare for such a transition. Policymakers have taken steps to improve its educational system. The number of papers published by Chinese scholars in internationally recognised journals has been increasing at a very rapid rate. Furthermore, patents filed by Chinese innovators in the

US have also shown a large increase (Chen and Whalley 2015). Given these factors, the continued high savings rate and the proven ability of its government in managing the economy it can be safely concluded that the Chinese economy will continue to grow rapidly. Of course, some slowdown from its unprecedented high growth rates over the past three decades is to be expected. ■

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