Is China’s Post-Crisis Growth Sustainable?

William H. Overholt

MAY 2010
China in the crisis: Divergent views

- Extreme 1: China relatively isolated from toxic waste, highly competitive, resilient, strong leadership, will power
- Extreme 2: China dependent on exports, has brittle politics & rising social unrest, is vulnerable to upheaval
- Reality:
  - China is hard hit by a combination of domestic economic transition and global crisis.
    - But Chinese growth drivers are primarily domestic
  - Quality of current leadership is weaker than predecessors
    - But Chinese politics has evolved quickly, is adaptable, and has deep reserves of public support
    - And Chinese leaders have been far more decisive than most others
China’s domestic economic dilemma preceded crisis

- **A Jimmy Carter moment in early 2008**
  - High inflation, wave of bankruptcies

- **Real issue: an obsolete model**
  - Capital-intensive; declining TFP
  - State-intensive/SOE-intensive
  - Resource-intensive
  - Exploitative of labor & rural areas

- **Needed model**
  - Increasingly SME-based, private-oriented, services-intensive
  - Requires freer capital markets, tougher accounting, better deals for workers & rural people

- **Crisis is (temporarily?) driving China in the opposite direction**
Beijing started doing right things too late

- Raising RMB, labor standards,
- China business got hit with perfect storm:
  - Stronger currency
  - Rapidly rising wage costs
  - Expensive labor standards
  - Flight of foreign investors
  - Higher interest rates/tighter bank lending standards
  - Loss of export markets due to global crisis
- Had to reverse and lose credibility
- Current measures temporarily reinforce the old model
China got slammed by the crisis

- Stock market down 60%+
- One quarter of 70,000 Hong Kong Federation-owned companies headed for bankruptcy by October 2008
- 53% of all toy companies bankrupt by October 2008
- 20 million jobs lost—on official statistics
- Dongguan City, known for shoes, lost 4 million population
- Foshan, which specialized in ceramics, shifted to IT, new materials, solar panels
- Qishui, basic aluminum industry wiped out, shifted to high value aluminum products
- Rising unrest along coast
China responded effectively to crisis

- Massive fiscal stimulus: 4 trillion RMB
  - Much more decisive than rest of world
  - Better targeted than U.S. counterpart
- Interest rates reduced—but much less than elsewhere
- Huge flood of bank loans
- Subsidies for inexpensive appliances & cars
- Currency re-pegged to US$; depreciates in global terms
- All major developers bailed out
- Amazing adjustments along coast
- Acceleration of interior development strategy
China’s Recovery

- Economy grew c. 9% in 2009; 11.9% 2010Q1yoy
- Development of China’s interior spectacularly successful
  - **Chongqing & others growing 15%+**
- Drastic structural changes along coast—eg, Dongguan
  - **Govt decisiveness plus Hong Kong/Taiwan flexibility**
- Substantial stock market rebound
- Land prices in major cities near or above peak bubble levels
China’s Post-Recovery Dilemmas I

“Property has hijacked our development”

- Economic growth
- Infrastructure development
- Central government revenues; local government revenues
- Political/social elite determine to maintain gains
- Big SOEs have so much cash that monetary levers are weakened
- Bubbles

Investment diverted to financial games (remember “zaikai”)

- Property development, banks, private equity

Rise of local government debt
China’s Post-Recovery Dilemmas II

- **Dependence on government investment**
  - How to shift to consumption-based growth?
    - In 20 yrs, salaries have risen from 5% of GDP to 13%, vs US 42%
  - Currency rise would shift buying power to big SOEs, not to people

- **Dependence on big state enterprises for jobs, innovation**
  - Current slogan: The big step forward, the small step back
  - Rationalization that innovation requires foreign connections, hence size
  - “Indigenous innovation”: very skeptical on FDI

- **Deflation in numerous industries due to overcapacity**
  - Structural change vs. stimulus/currency help

- **Banks lent too much; now preemptive recapitalization**
Property prices took off in 2009—key cities only

<table>
<thead>
<tr>
<th>City</th>
<th>Dec 2008</th>
<th>Dec 2009</th>
<th>YoY increase</th>
</tr>
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<tbody>
<tr>
<td>Beijing</td>
<td>11881</td>
<td>18401</td>
<td>55%</td>
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<tr>
<td>Tianjin</td>
<td>6939</td>
<td>8122</td>
<td>17%</td>
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<tr>
<td>Shanghai</td>
<td>11913</td>
<td>20144</td>
<td>69%</td>
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<td>Nanjing</td>
<td>6153</td>
<td>9218</td>
<td>50%</td>
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<td>Hangzhou</td>
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<td>20846</td>
<td>61%</td>
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<tr>
<td>Shenzhen</td>
<td>11673</td>
<td>23094</td>
<td>98%</td>
</tr>
<tr>
<td>Guangzhou</td>
<td>8012</td>
<td>11677</td>
<td>46%</td>
</tr>
</tbody>
</table>
Key property measures

- Banks told to reduce lending;
  - Reserve ratio raised to 17%
- Ban on mortgages for third homes
- Large companies forced to divest property divisions
- One measure of effectiveness: 20% stock market decline

Note:
- Prices do strain affordability
- Prices are not outlandish by standards of other major cities
- Ordos empty city and other examples are frequently exaggerated
China’s political dilemma

- Each phase of Chinese growth has required stepping back from political control
  - Deng sacrificed political control of rural economy to accelerate growth
  - Zhu Rongji sacrificed considerable political control of urban economy to accelerate growth
  - Can Hu/Wen sacrifice political control of capital markets to maintain rapid growth?

- China has entered a new phase of politics
  - Driving entrepreneurs have given way to cautious bureaucrats
  - Interest groups have unprecedented influence
  - Provinces are increasingly assertive—successfully so far
  - Premier Wen’s property stabilization commitment—risible?
Some lessons learned from crisis

- China relying too much on foreign demand, FDI
- Pattern of growth is distorted
- Social disparities: Economic growth doesn’t equal social development
- Excessive drain on environment & resources
- Big SOEs remain objectively necessary
- After 30 yrs of rural subsidizing urban development, time to reverse
- Huge controversy over link to US$
Some wrong lessons learned

- Reliance on big SOEs a good thing
- Plaza Accord crippled Japan
- U.S. permanently crippled
- Obama seeking to accelerate crisis in China
  - Predatory export policy to take away China’s global role
  - Currency, savings, export doubling goal
- Loss of central leadership authority equated with democracy
- Failure of Hatoyama government seen as a failed effort to move an Asian country toward U.S.-style democracy
The retreat from FDI I

- “Indigenous innovation” theory
- Abusive interpretation of new competition law
- New national security law based on CFIUS
- Broad shifting of attitude toward FDI
- Central & local officials less accessible to foreign investors
- Some sectors newly closed
  - Foreign delivery companies may no longer deliver local packages
The retreat from FDI II

- New quality standards often favor Chinese companies
  - And are sometimes used to harass foreign companies
- New patent law requires disclosure of technologies
- Government procurement favors locals (emulating US, EU)
- A key outcome
  - U.S. market for corporate control remains open but politically abusive
  - Chinese market for foreign corporate control now largely closed
The great tradeoffs

- Reform vs. jobs
- SOEs vs. private
- GDP vs. environment
- Currency appreciation vs. foreign reaction to FDI outflow
Aspects of the currency issue I

- Minor economic importance to U.S.
- Major importance to China
  - Hot money
  - Shift to domestic consumption
  - RMB 47T domestic savings
Aspects of the currency issue II

- **Optimal policy for China in long-term perspective:**
  - **Immediate float, capital flow liberalization**
    - Kill hot money
    - Reduce (currently large) losses from excess reserves
    - Minimal appreciation due to capital outflow
    - Signal decisive shift of economic strategy
    - Facilitate rapid internationalization through acquisitions
    - Rapid Shanghai progress as international financial center
    - Rapid globalization of RMB
  - **But bureaucratic caution will prevent this**
    - Enhanced by profound fear of second dip in global recession
    - Euro decline may delay revaluation
Drivers of Economic Growth

- Most growth (c. 85%) already derives from domestic demand
- Urbanization
- Development of interior
- “Cultural & educational” development
  - Following French & German models; US a “failure”
- Outward FDI
Scenarios

- **Japan 1975 onward**
  - Interest groups, localities, bureaucrats
  - Protectionism: FDI, currency
  - International hubris

- **Restored dynamism**
  - Reassertion of central control, long-term vision 2010—property
  - Reassertion of marketization 2013
  - Resumption of political reform
Investors: Watch these sectors

- Housing
- Steel
- Cement
- Glass
- Chemicals
- Mining
- Cars
- New Energy
- Environment
- Education/culture
- Services
- Taiwan tech, emerging brands
- Overseas investments: energy, resources, technology, distribution
Dr. William H. Overholt
Harvard Kennedy School
79 JFK St., Box 130
Cambridge MA 02138
617-495-1103
310-880-2089