

Is China's Post-Crisis Growth Sustainable?

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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

2009 Average Selling Price, RMB/sq m

City	Dec 2008	Dec 2009	YoY increase
Beijing	11881	18401	55%
Tianjin	6939	8122	17%
Shanghai	11913	20144	69%
Nanjing	6153	9218	50%
Hangzhou	12933	20846	61%
Shenzhen	11673	23094	98%
Guangzhou	8012	11677	46%



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**

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