A Stronger China

https://www.imf.org/external/pubs/ft/fandd/2010/06/yueh.htm

FINANCE & DEVELOPMENT, June 2010, Volume 47, Number 2

Linda Yueh

PDF version

China can emerge from the crisis stronger if it increases domestic demand and promotes global integration

IN the West, countries are facing the fallout from a deep recession and financial crisis. Economic growth is at best tenuous in advanced economies, most of which have large levels of national debt. And the euro is under pressure. Meanwhile, China's growth races ahead. Is China's seeming resilience to the recession the real deal?

China is in better shape than most countries. It averted a recession, confounding expectations by exceeding its targeted 8 percent growth rate in 2009. If it can adapt to a world economy unlikely to be driven by consumer demand from the West for the next few years, China can emerge from the global crisis stronger than ever.

Surviving the crisis

No country was immune to the global financial crisis that began in the United States in 2007. But because China's financial sector does not trade extensively in derivatives, it escaped the devastation suffered by the United States and advanced economies in Europe. China did not experience a "credit crunch" nor did it have to contend with the so-called toxic securities that devastated bank balance sheets in advanced economies. Some of China's large state-owned banks were creditors of the Wall Street investment firm Lehman Brothers, whose failure in September 2008 caused near financial panic. These state-owned banks did experience losses, estimated to be in the billions of dollars, but they avoided ongoing balance sheet impairments, which would have been far more damaging.

Still, China was affected by the second stage of the crisis: a global recession and the first contraction in global trade in 30 years. China's exports—which account for over 30 percent of its gross domestic product (GDP) and about one-third of its annual economic growth—collapsed in late 2008. The plunge in trade cut the growth rate by about 3 percentage points in 2009 and by about 1 percentage point in the first quarter of this year. An injection of funds from the G-20 group of major economies to support trade financing has helped, but exports have yet to resume their role as a strong growth engine.

Stimulus response

As a result of the crisis and the ensuing drop in trade, China is reconsidering the importance of domestic demand as a driver of its economy, instead of relying on more volatile exports. China therefore responded to the crisis in the spring of 2009 with a $586 billion (Y 4 trillion) stimulus package. The government continued to disburse the stimulus in 2010 in the face of continued weak global demand. The People's Bank of China (PBOC) acted earlier, beginning to cut the policy interest rate in August 2008 when it was 7.47 percent. Its most recent cut put the rate at 5.31 percent in December 2008, where it remained as of June 2010.

This combination of stimulus package and lower interest rates helped spark pickup in growth by the second quarter of 2009. It had wallowed (for China) at about 6 percent in the final three months of 2008 and the first three months of 2009. Growth recovered to 8.7 percent for 2009 as a whole and in the fourth quarter registered an impressive 10.7 percent year-

over-year growth. During the first quarter of 2010 growth spurted to 11.9 percent year over year.

China's continued growth will depend on the success of the massive fiscal stimulus, focused largely on infrastructure. Infrastructure spending builds on a large-scale transportation project in the 11th Five Year Plan, which began in 2006. The existing plan allowed the spending to be quickly implemented and provided jobs on roads and rail for some of the millions of workers laid off from export-oriented factories. Indeed, job creation does seem to be occurring, validating China's stimulus spending (Orlik and Rozelle, 2009).

But the social part of the stimulus, representing less than 5 percent of the package, was judged insufficient to stimulate private consumption. It failed to address China's high level of household saving—a major cause of low domestic demand. To discourage precautionary saving, China added $125 billion in spending on health care later in 2009—covering 200 million uninsured citizens as a step toward achieving universal coverage by 2020—and about $400 million toward pensions for rural workers.

Nevertheless, consumption as a share of GDP remained constant in 2009. A 10.5 percent increase in urban incomes helped fuel consumer spending, but that increase was from a low base. Consumption accounts for only 35 percent of GDP in China, compared with 50 percent or more in most market economies. And the majority of the rural population remains poor. As a result, despite a 16 percent increase in retail sales, consumption contributed only about 4 percentage points of China's growth in 2009.

Credit growth

China, like other major economies, used aggressive fiscal policy and loose monetary policy to fight the recession. But unlike those countries, the central government financed only about one-fourth of the stimulus. State-owned banks picked up the rest. Credit grew quickly as a result. In 2009, some $1.46 trillion (Y 9.95 trillion) in lending was granted, with another $1.09 trillion (Y 7.5 trillion) in credit to be issued in 2010. In response, the money supply has grown nearly 30 percent. Nonetheless, consumer prices began to increase only at the end of 2009—after nine months of deflation—suggesting that the liquidity has been directed toward assets. This growth of credit in an economy with capital outflow controls means investments will be largely domestic, increasing the likelihood of asset bubbles in the stock and housing markets and generating concerns about a banking crisis.

China's sovereign wealth fund, the China Investment Corporation, recently purchased shares in the "Big Four" state-owned banks, including half of the Agriculture Bank of China. This could be viewed as an attempt to stabilize share prices—in light of worries about nonperforming loans, not a new problem in China's state-controlled banking system—and to strengthen the capital adequacy ratio of these banks. Additionally, the Big Four issued a further $11 billion in rights in 2010 to bolster their capital base.

The pace of credit creation thus slowed in the first quarter of 2010, and the PBOC increased the reserve requirements for banks. But to achieve its target of 8 percent growth when exports are unlikely to return to previous levels, China will have to persist in substituting government investment for trade, which will continue to flood the economy with liquidity. It will be difficult to achieve the combination of loose fiscal policy and tighter monetary policy needed to control asset bubbles while stimulating the economy. Moreover, the domestic banking system is not the only source of cash.

China received over $200 billion in capital inflows in 2009, a sizable amount of which is thought to be "hot money," or investment by speculators. China's attractiveness to investors

is enhanced by the undervalued renminbi, which has been pegged to the U.S. dollar since the onset of the crisis. China's reserves grew 23 percent in 2009 to a record $2.4 trillion, two-thirds of which is in U.S. dollars.

China's recent decision to liberalize its capital account by promoting capital outflows is therefore welcome. The reforms will be slow, partial, and largely geared toward supporting China's "going out" or "going global" policy of encouraging Chinese firms to invest overseas. Nevertheless, these measures should help China rebalance its economy and begin to redress the world's macroeconomic imbalances.

New world order

The exacerbation of global imbalances in the 2000s served as a backdrop to the financial crisis. The rise of major emerging economies—China, India, and eastern Europe—in the early 1990s and their accelerated integration into the global economy in the 2000s increased global imbalances while doubling the world's labor force to 3 billion people. When China joined the World Trade Organization and eastern European countries joined the European Union, the lower labor costs in those nations triggered growth in their exports and had a deflationary impact on the rest of the world. But that also drove up commodity—including oil—prices, which led to greater surpluses in the Middle East as well.

Global reserve holdings have expanded fourfold since 1998, resulting in increased demand for the U.S. dollar as the global reserve currency. This boost of liquidity in the United States enhanced its consumption. It was not curtailed by the Federal Reserve, because inflation was low due in part to the growth of the global labor force (Yueh, forthcoming).

These structural changes in the global economy reinforce the need to monitor global capital movements and for central banks, including China's, to set interest rates that acknowledge asset—and not just consumer—prices. The United States in particular must also consider the reserve currency effect: because of demand for the U.S. dollar to be held in other countries' reserves, there will be downward pressure on the yield curve for U.S. treasury bills. Therefore, the cost of borrowing will be influenced not only by domestic but also by international economic conditions. For instance, tightening monetary policy may not be as easy with sustained demand for dollar assets holding down yields and pushing up the price of bonds, which keeps borrowing costs low—just as loose monetary policy led to excess liquidity when global savings helped to fuel American borrowing before the crisis. For surplus countries like China, loose U.S. monetary policy can be transmitted via fixed exchange rates, which causes capital to flow from low- to high-interest-rate economies. Thus, China should gradually reform its exchange rate to prevent domestic asset bubbles caused by liquidity inflows. Increasing the flexibility of the renminbi exchange rate before tightening monetary policy will also be important: an increase in interest rates in China while the United States maintains a near-zero policy interest rate will only worsen the liquidity inflow, eroding the impact of the tightening measure. Diversifying and reducing China's reserve holdings would also help improve global imbalances.

Global imbalances have already moderated somewhat, with the U.S. current account deficit falling from 6 percent to about 3 percent of GDP in 2009. Savings have risen in countries hit by the recession. The IMF predicts that the global economy, which contracted by 1.1 percent in 2009, will grow 4!/4 percent in 2010 and more in 2011. That is higher than the 3.2 percent average global growth rate from 1980 to 1997, when China and other large emerging economies experienced rapid development. At that time, China grew 9 percent a year with a far more balanced current account than today. Correspondingly, during the same period, the

U.S. current account deficit accounted for about 1.5 percent of that country's GDP, or less than 0.5 percent of world GDP, whereas today it is 3 percent of U.S. GDP, or about 0.7 percent of world GDP. Global rebalancing is likely to continue, particularly with U.S. consumption weakened by deleveraging, which implies lower surpluses for other nations. Lower consumption in China's main export markets of the European Union and the United States means that trade growth will slow in the next few years unless there are new high-income markets for China's exports—an unlikely prospect, particularly given the problems in the euro area. If China is to return to the mostly balanced current account it had in the 1990s and sustain its growth rate, domestic demand must constitute a larger proportion of GDP.

Two sides to the question

For China to emerge stronger in the postcrisis world economy, it must institute reforms that boost domestic demand while promoting global integration, allowing China to continue to catch up in its growth rate. Given the weak global economy, reform has to transform China into a large, open economy and ensure stability during its economic transition by protecting against external shocks while increasing integration with world markets.

The Chinese economy should become more like that of the United States—a large country that is a major global trader but whose growth is driven primarily by domestic demand. If China strengthened both internal and external demand, it would be less subject to volatility in the world economy; its growth could be driven by domestic demand even as its trade expands in absolute terms. Because China affects the global terms of trade, it can redefine itself as a large, open economy that recognizes the benefits of global integration while maintaining a strong base of domestic demand to shield it from the worst external shocks.

Consumption and government spending

Consumption constituted about half of GDP until high rates of household and corporate saving drove it down to a historical low of just over one-third. But it could return to the 50 percent level of the early 1990s if the incentives for saving are addressed. For households this could be achieved by increasing social security provision, and for firms by easing credit constraints to free up lending, eliminating the need to use retained earnings for growth.

There is plenty of room for increased government spending on social security. As a share of GDP it was 13 percent in 2008 and approached the 20 percent mark in 2009 only because of the massive fiscal stimulus package. This is still below the precrisis average for Organization for Economic Cooperation and Development countries and much lower than in most other developing countries.

The government should also speed up urbanization, which could promote service sector growth. This would further develop the nontradable component of the economy and create jobs at the low and high ends of the skills spectrum. This fits well with the profile of the Chinese—urban and migrant—labor force. The increased income resulting from urbanizing portions of the rural population would boost consumption.

Corporate savings and financial liberalization

A series of reforms are necessary to reduce corporate savings. Savings of firms—state-owned and non-state-owned—are even higher than those of households. This was evident when China's current account surplus surpassed 10 percent of GDP after 2004. Investment maintained its share of GDP, even though investment is typically squeezed when countries develop a significant current account surplus.

China's distorted financial system forces private firms to save—mainly through retained earnings—in order to grow because they have trouble obtaining credit. But even state-owned enterprises, which have easy access to credit, save—because their profits are taxed so lightly. State-owned enterprises should pay higher taxes and dividends.
Complete liberalization of interest rates would both improve credit allocation to private firms and further reduce the savings incentive. Although interest rates were partially liberalized in 2004, when the ceiling on interbank lending rates was lifted, there are still limits on the floor of such rates, as well as a ceiling on deposit rates, distorting investment decisions. If interest rates were liberalized, it would reduce financing costs for firms and thus the need to save.
Gradual capital account liberalization, in particular the "going out" policy, will also help reduce savings if firms can operate in global markets and are allowed to access funding from better-developed overseas credit markets. In other words, firms can raise money in capital markets and not just rely on China's banking system with its controls on credit. This will not only reduce the motive for corporate saving but also cut the portion of the current account surplus that is funded through the purchase of U.S. treasury securities by allowing capital outflows in the form of investments instead of accumulated as foreign exchange reserves.
The external benefits do not end there. Capital account liberalization should also result in increased exchange rate flexibility because of increased demand for the renminbi. With enough capital outflows, appreciation pressures on the currency may even ease. The combination of exchange rate and interest rate reforms should result in a better balance between China's internal (savings-investment) and external (balance of payments) positions. The result would be a more balanced Chinese economy that would also help reduce liquidity buildup from global imbalances, as is fitting for a large, open economy.
Improving regulatory oversight will also be important. Liberalization should be accompanied by further domestic and international institutional reforms to deepen financial markets. For instance, active participation in the global regulatory body, the Financial Stability Board, could increase stability if capital markets are increasingly governed by transparent rules and laws generating more certainty and depth. This would have positive implications for household and firm behavior.
As a major economy, it is in China's interest to recognize its impact and help shape the governance of global and integrated markets because its decisions are affected by international conditions and in turn will influence the wider global context. For instance, China is an engine of growth for Asia and for commodity exporters around the world, and its exchange rate affects global prices, while its monetary conditions are affected by world financial markets.

Becoming a large, open economy

China has the capacity to become a fast-growing, large, open economy by encouraging domestic demand and developing globally competitive firms. Especially given China's still-low level of development, integrating into the global economy would benefit both China and the rest of the world. It can do so by implementing macroeconomic reforms that position China strategically in a changed, uncertain global economy. By doing so, China can emerge stronger from the global financial crisis. It is too good an opportunity to miss.