

China's Economic Development: A Forty-Year Perspective

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I'll take the remaining time to talk about what's changed since the global financial crisis, and my basic argument here is that I think China has reverted more towards a state-driven economy. The role of the market has been attenuated and the role of state companies has expanded quite significantly. China is now in the longest period of slowing growth since 1978. There have been other years, other periods when the economy slowed down for several years, but the peak growth was in 2007. It was 14 percent down, down, down, down, down until 6 percent in the fourth quarter of last year, 6.1 percent for the year as a whole. So, the question I want to ask is, "Why, after 30 some years of extraordinary success, has the economy slowed down so dramatically?" I know six percent's not so bad, but it's a very substantial slowdown compared to what came before.

So, I'm going to talk about several possible explanations. The first one is, well, we shouldn't be surprised—a slowdown after 30 years of unprecedented growth is just a natural evolution; it's a richer place. You can't grow so fast when you get rich.

A second theory is that the growth in the earlier period, especially after 2007, 2008, was driven by very, very substantial surpluses in their trade with the rest of the world. If you sell more to the rest of the world than you buy, that's an increase in aggregate demand and it contributes to economic growth. And we know that China's external surplus has declined quite substantially since that time. So that could be a second reason for the slowdown.

The third reason for the slowdown that a lot of people point to is the frictions, the economic, especially the trade frictions between China and the United States. I think if you go back and read the press in 2019, every time China reported a slightly less favorable number for reflecting its economic growth or economic conditions in general, the comment in *The New York Times* and *The Wall Street Journal*, always was, "Oh, this is primarily due to the economic frictions with the United States. That's causing the slowdown." So, I want to look at that one.

A fourth one is the fact that credit growth has slowed down. Up through around 2017, China had very rapid credit growth. The leadership has become concerned about financial risk from overextension of credit, so they are slowing it down. If you slow down credit growth, your economy is going to slow down. And the fifth thing to look at is the misallocation of credit.

So, I want to take each of those in turn. They've had earlier slowdowns, but if you look at it in terms of the length of the slowdown, they're more years in this slowdown since 2000—I think 2007—was the peak at around 14 percent GDP growth, and we're now down to 6.1 last year. So, the first one. Larry Summers has been telling us for years China is going to slow down. This is the most consistent pattern after a period of rapid economic growth—you slow down. Back in 2014, [Summers] said, "China's long overdue to correct and they're going to be just like everybody else." After a period of very rapid growth, which he defined various ways, they're going to converge to the median global historic rate of 2 percent per capita. So, Larry can say, "Well, I told you this was going happen, and we're well on the way. We're going to 2 percent and it's inevitable. Doesn't have anything to do with policy or the nature of the global economy or trade frictions with the United

States. It's baked in." Well, as you can probably tell, I don't agree with that. And I don't agree with it because it underestimates how poor China was in 1978. And there's a diagram that tries to look at this potential for catch-up.

So you can see the four rapid modernizers, the big East Asian success cases, all began their periods of rapid economic growth when they were about 25 percent of the US level in per capita terms. And then they grew rapidly in various periods. Japan obviously starting much earlier, South Korea, Taiwan, Singapore a little bit later. And at the end of these periods of twenty-five years or so of rapid economic growth—and these numbers here are the growth rates that they achieved in their periods of rapid economic growth, and the triangles are where they were relative to the U.S. at the end—you can see Japan did the best getting up to something around 60, 65 percent of the U.S. level. Then they slowed down.

This is the inevitable, "You're going to 2 percent, Japan, and you'll be happy to have 2 percent. The other three countries shown here got up to around 50, 55 percent of the U.S. level. It's always the U.S. level at the end of the rapid growth period. China has had this extraordinary rapid economic growth, but it's only at 30 percent of the U.S. level. And in part, it's because they began way down here. They began at 5 percent of the U.S. level. In other words, China's per capita, (and all this is in terms of purchasing power parity, which we probably don't want to go into today) was only at 5 percent of the U.S. level when their rapid economic growth began. So, they have grown faster for longer than any other country for which we have data. But they're still only a 30 percent of the U.S. level.

So, my view is there is substantial potential for additional convergence. Now we can talk about convergence. Obviously, convergence is not automatic. You have to have the right set of policies and so forth. But I don't think it's quite time to declare that China is doomed to go to 2 percent growth. So, I'm a skeptic about the first hypothesis, that this is inevitable natural evolution of an economy that has grown so fast for so long.

Now, the second hypothesis is the declining surplus. And it is true back here; one of the reasons China can be growing at 14 percent back in 2007 is that they had a massive, massive current account surplus that exceeded 8 percent at the peak. And for those of you that have studied other parts of East Asia or know anything about Japan, remember when the senators were taking sledgehammers and smashing Toyotas up on the Capitol steps? Japan's surplus at that time was a little over 3 percent of their GDP. So, China is at over 8 percent. It's unprecedented; no large economy has ever had such a large surplus, and it was adding a lot to GDP growth. But of course, now it's been going down, down, down. And so, it is true, that one of the reasons for the slowdown is the shrinkage of the surplus. But as you can see from the diagram, most of this shrinkage occurred between 2007 and 2010 or 2011. So, it may have contributed to the slowdown in the early part of the period that we're looking at, but it can't have been a really big factor in the slowdown from 2012 up to the present. I think it's significant and should be taken into account, but I don't think it explains, as a big contributor, to the slowdown from this part; it might have been a big factor back here.

So, the first hypothesis, I'm kind of pretty negative on. The second one has some partial explanatory power, but mostly for the earlier period, not for the last five years. Now, what about the trade frictions? I think there has been so much bad analysis of what happened in the trade frictions with the U.S. This is what happened to China versus the rest of the world. We're all talking about how badly they've been affected.

Their exports last year grew half a percent. Global exports were down 3 percent. China's exports to the U.S. were down at a double-digit rate—I can't remember exactly, 12 percent, 15 percent—but they managed to increase their exports to the rest of the world by so much that their exports actually increased. So, despite the trade friction, China's share of global exports went up last year, not down. The second aspect I want to call your attention to is direct investment, foreign direct investment.

Every day you could read, “Oh, everyone's moving their supply chains out of China. They don't want to invest there anymore. They need to export to the U.S. and they can't face these tariffs.” Trump was saying all this manufacturing is coming back to the U.S. This is what happened to foreign direct investment in China last year; it went up by 2.6 percent which, incidentally, is almost exactly the rate of growth of inbound foreign direct investment into China, on average, over the previous five years. It's no longer growing at double digit rates, but it hasn't been; there's a lot of foreign investment in China already, but a lot of the firms that are there are reinvesting profits. Some new funds come in, so the number is growing at well over 100 billion dollars a year. What happened to foreign direct investment globally last year? Well, according to an early estimate of the OECD, it's down 20 percent. So, take with a grain of salt these arguments that no one wants to invest in China anymore because of the Trump tariffs. I think China has done pretty well under some pretty severe constraints. So, I'm rejecting the trade war, and the economic friction. If the tariffs stay on, and it looks like they will stay on for a long time, it could have more of an effect going forward. But I think to date, the effects have not been very large.

So that takes us to number four. And that is the credit growth story. You can see back in response to the global financial crisis—as I mentioned, there was a massive increase in credit from China's financial system growing well into the double-digit rates, leading to a very large ratio of credit to GDP. I'm sure most of you will read the numbers, have different estimates out there, but by the end of 2017, we are about a two hundred and seventy percent. Some people estimate even higher numbers. That is the total amount of credit outstanding, the debt of the government, of households, and corporations was closing in on three times the level of GDP. That's much higher than most advanced industrial economies. Obviously, the exception is Japan, which has even somewhat higher amount, but it's much, much higher than most emerging markets or upper middle income economies.

And lots of people have pointed to this, and some people are still pointing to this, as a reason that China is going to go off the rails, that there's going to be a financial crisis, that there's going to be a meltdown. And starting roughly in 2017 or so, even Xi Jinping was getting religion. He was convinced by Liu He and others around him that this massive growth of credit had to end, and they began a period of what is referred to as “deleveraging.” Now, it wasn't really deleveraging in the sense of reducing the total amount of credit. But it has meant that the credit to GDP ratio has now plateaued for the last two or three years. And you can see a rate of growth of credit is now down to around 10 percent, more or less, and GDP growth in these last two or three years in nominal terms, taking into account inflation, has been about 9 percent. So the credit, instead of growing at two or three or four times the pace of the economy, is growing in recent years at roughly the pace of the economy.

Now, we can dig down into the details. Those of you that follow China at all know that a lot of this slowdown in credit has been in the shadow banking system, which has been particularly squeezed in this de-leveraging campaign. And that was a very large source of credit for private companies. So, private companies have had grave difficulties in recent years because of the slowdown in credit growth, and the concentration of the slowdown on shadow banking. Which, from an economic-financial point of view, was perfectly justified and should be applauded, because shadow banking is less well-regulated, and has more risks than credit coming out of the banking system. So, I think this is important. This is the most important thing I've mentioned so far in terms of explaining the slowdown, particularly in the last few years.

But finally, I want to talk about the fifth possible explanation, and that is something I call a resource misallocation. I showed you before, I think, the data for 2010 through 2013, which you can see after 2013, the private sector got squeezed out. Their share of credit went from about half or a little bit more to, in the most recent year that they published data, down to 11 percent. And the share going to state companies, which back here was 25, 30 percent, but in the most recent year is up over 80 percent. So, there was a massive shift in the locus of bank lending in favor of state companies. Keep in mind, state companies are generating returns that are between a half and a third of those of private companies. So if you want to know why the economy is slowing down: massive credit misallocation.

Why is this happening? Well, I tend to agree with Liz Economy, who's written this great book about Xi Jinping. She's gone back over all of his speeches and documents how many times since Xi Jinping came to power in 2012 kept saying "We need to make our state companies bigger." It took a little while for the banks to respond, but the banks got the message. Part of the message also was, "If you lend money to a state company and it can't pay you back, don't worry about it; you have an implicit government guarantee." So the credit crawling to private companies just plummeted, and 11 percent of credit in 2016 compared to 50 percent some five years earlier is a huge, huge decline. The amount of credit going to private companies in 2016 was only \$600 billion R&B, and you got to get into the trillions in China before you're talking about anything significant from a macro perspective. I don't remember the number, but back here I think they were getting about 3.6 trillion. So, they went from 3.6 trillion in credit to 600 billion in credit over a period of three or four or five years. So, misallocation of credit.

Now, the unfortunate thing is that the Chinese government quit publishing these data after 2016. There should have been more recent sets. These are coming straight out of a Yearbook. It was very interesting. I got an email a month or two ago from the International Department of the People's Bank inquiring as to where I got the data on lending by ownership. If you look in the *Almanac of China's Finance and Banking*, it's published nominally by the Chinese Banking Society. But the Chinese Banking Society is a wholly owned subsidiary of the People's Bank, and if you look at the editor and the editor-in-chief and the sub editors, they all work in People's Bank. So, this is a People's Bank publication, which is what I had to tell them. So, we don't really know what's happened in 2016. But a few weeks ago, they published new data on the assets of state companies.

So they've gone from you know, they're now up at and closing in by the end of 2018 on something like 250 trillion. Remember, you have to be in the trillions before you get to something significant. So, it's closing in on 250 trillion, which I think is about 2.3 times GDP. But the key thing here is that from 2012 or 2013 on, the assets of state-owned, non-financial companies has been growing twice as fast as GDP. I don't have the actual data on lending after 2016, but it looks to me like the only way this rapid growth in assets of state companies could have continued is if they're still getting an unusually high share of bank loans. If the return on assets is going down, and that's retained earnings, how can you grow your assets so rapidly? Well, if you're getting more credit.

So, my conclusion is that of these five hypotheses: the natural evolution hypothesis I don't believe in, and I think we can dismiss; I think the declining external surplus was particularly important in the first few years after 2007, but has become less important more recently (indeed, in 2019, China had a little surplus in its trade account and it contributed to growth); I think that economic frictions have not helped China, to say the least, but I don't think they're as damaging as a lot of the analysis in the financial press would have you believe. I think the two big problems are the last two, the slowing of credit growth and the massive misallocation of credit.

And, I'm sorry to say that it doesn't seem to me that these two things are going to change, because Xi Jinping is still talking the same line about strong party control, the importance of the state sector. Oh, they pay lip service; they have special meetings now and then about how the private sector needs to get more money, and Xi Jinping even met with private entrepreneurs and told them how important they were. But we can't see any results yet. So, I think slowing credit growth and resource misallocation are likely to prevail. I think the risk for China is that growth will continue to slow. I do not share the view that has been advanced in some quarters that China's growth is likely to pick up quite a bit because of the Phase One trade deal with the United States. I think that overemphasizes the importance of the trade frictions in the slowdown, and also fails to recognize that the tariffs are still on the vast majority of goods that China exports to the United States.

It also doesn't take into account the fact that I think we will increasingly see friction not on tariffs, but on technology transfer and issues of technology, where there seems to be a very strong view in large parts of the Washington establishment that the United States needs to take more steps to restrict the flow of technology to China in the form of exports, in the form of Chinese acquisitions of

U.S. technology companies, or in the form of Chinese scientists', and so forth, ability to do research in the United States. That's my view. The Phase One I don't think is going to make enough of a difference. The key thing to watch is whether or not Xi Jinping gets serious about reforming state-owned enterprises and having a financial system that allocates credit more efficiently.