

China's Economic Rise: Challenges and Opportunities

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We really should began to think of China as a major economic power emerging into the almost superpower category. We say that for several reasons: first of all its trade is now enormous. Their trade last year was 2.6 trillion U.S. dollars which is a number you may not remember but here's a number you will remember: that volume of trade was 120 times more than it was in 1978 when Deng Ziaoping started China on the road of economic reform and opening up. So, their trade has grown enormously. In 1978 China wasn't even a significant player in the global trading system; its trade volume was extremely low. Two years ago, China had become the third largest trading economy on the globe. In other words, only the United States and Germany actually trade more than China today.

Trade has become a very large portion of China's economy. If you look at the size of the trade relative to the size of the economy, trade is more important to China than it is to Japan or the United States. It's a very open economy with a very high level of exports and imports relative to the aggregate economic output as a whole.

On the financial side, China has also become a very substantial force in global markets. It began by attracting significant amounts of inward foreign direct investments from firms from the United States, from Asia and elsewhere, that build factories in China to produce either for the global market or for the domestic Chinese market. Cumulatively, China has attracted more foreign direct investments than any other emerging markets economy. More recently we've been reading about China becoming a big outward investor, investing in natural resources whether it's iron or gas or petroleum around the world, as well as taking over a few iconic foreign brands such as the IBM think pad brand when they brought the IBM PC division a few years ago. So, it's become a two-way street. Initially, its focus was in attracting inward investments, but in the last few years China has become a very large outward investor.

In addition to that, somewhat surprisingly, China has become the world's biggest creditor nation. In other words, it has a very large trade surplus and has been lending the difference between what it exports and what it imports. Internationally, it is the world's largest creditor – something in the order of about \$1.5 trillion by the end of last year. The U.S. in contrast, is the world's biggest deficit country. We are a net debtor to the tune of about \$2.4 trillion, again at the end of 2007.

It's really unprecedented for a country of China's relatively early stage of economic development (as measured by per capita income) to become such a large net creditor. We usually think of that as a function of a large high-end economy rather than one still developing. Of course, China has become a major purchaser of our treasury bonds and other financial assets and that's one of the

major mechanisms through which they do lend to us. That's why in the tail end of the Bush administration President Bush called up Hu Jintao, the Chinese president, asking him to please keep buying our treasury bonds. There have been similar kinds of requests coming out of the new administration as well.

So, China really has, I would say, become a superpower by the kinds of standard metrics we use in economics: a very large trade; very large economy; very large participation in the global financial market that's big enough and integrated enough into the global economy that it has a significant impact on the rest of the global economy as its domestic situation changes.

I would like to say something about whether or not China's behavior is yet that of an economic superpower. Bob Zellick of the State Department famously said a few years ago that China should become a responsible stake holder in the global system and that China should support existing institutional arrangements and adhere to typical international norms and guidelines. I would say that China is open to this idea but is still reluctant to fully become a responsible stake holder and exhibit superpower behavior.

One of the main reasons, of course, is their fear that subscribing to the norms of the international system will bring obligations that exceed its capabilities. They are, after all, a country with a per capita income of only \$2,500, roughly, but they're considered to be in the "rich country club" along with the United States, Germany, Japan, etc. With that, they are worried that they will be asked to take on obligations that exceed their capabilities.

One example is in the area of climate change and energy. China is quite concerned about global warming and has taken a number of steps domestically to reduce its energy use. But it still clings, to the view that it cannot afford to take on any obligations on specific quantitative restrictions of its greenhouse gas emissions. It says that if it does so it would like to have advanced industrial economies provide financial assistance to make it profitable for them to undertake these kinds of quantitative commitments.

The first problem is basically that they have become an economic superpower at a very low per capita level of income, which makes them unique not just today but in global economic history. The second problem is that on some issues China's interests align a little bit more with under-developing economies rather than the advanced industrial nations. If you take questions like trade and labor standards, China is sometimes closer to the position of India or Brazil than it is to positions taken by an advanced industrial economy.

A third factor is that in many domains China is in the early stages of developing its own ideas about the structure of the international system. I would say they're somewhat reluctant to sign on to the norms, obligations and principles of the international system that was created before they were at the table negotiating a say in the structure of the system. In other words, it's reluctant to sign up to international norms and institutions that it feels it had no role in creating. So, it's kind of feeling its way in developing alternative ideas, and we've heard some of them in recent weeks in the run-up to the G20 meetings later this week.

The proposal, for example, that the role of the dollar as an international reserve currency should be reduced over time and replaced, perhaps, with SDRs or some other alternative arrangements. It's a very interesting idea, one that proponents themselves recognize is a very long-term proposition and not something that could be implemented in the short term or even in the medium term. That's an example, I think, where they're putting forth some ideas of their own about how

the international financial structure should be reformed. They've said that they would like to have a place at the table when those arrangements are being negotiated.

I think it is worth noting that China is much more enthusiastic about the G20 arrangement which brings them to the table not in a limited group of other high-end income countries as was proposed a few years ago. Many people were arguing that they should become a member of the G7, which is all the advanced industrial economies. But in the G20 you do have India and Brazil and a few other countries which fall more into the emerging-market category. So they're much more comfortable with that structure than they are with the G7 structure and they seem to have embraced it quite a bit.

So, in summary on this, it's a rising power. It's verging on being a superpower by some of the metrics. But on the metric of per capita income, China is still relatively far down the list and only \$2,500 per capita may be closer to \$3,000 this year. So, there are high expectations for the role that China should play as an economic superpower. But there is some reluctance on their part to assume the mantle of a superpower for fear that it would bring obligations that they would not be able to meet and also they like to pursue a relatively low profile.

They don't like to be telling other countries – Hu Jintao will not in London bang his hand on the table and tell everybody that they have to spend two percent of GDP on their fiscal stimulus or the global economy will be in trouble. They don't like to lecture. They lead by example, and as I'll say in a few minutes, I think they're doing very well on their own policy response to the global slowdown. But they don't like to be in the mode of placing demands on others, in part because they don't want others to place demands on them.

Now, let me turn to the more specific subject given this background about the global economic crisis and what's happening in China, to try to answer questions such as:

- Is China's rise going to be slowed by the global economic crisis?
- What are they doing about it?
- What are their prospects?
- What are the implications for us?

A year or so ago this idea of “decoupling” was very popular in some circles. This idea was that since the global crisis clearly originated in the United States and a few other western countries, it was not going to seriously affect many emerging market economies, particularly some of those in Asia that had been trading much more among themselves. They might weather the storm. I think that was a bad idea at the time and it has certainly been completely discredited.

Its experience over the last couple of years has shown that China has been very deeply affected by the global economic crisis. Again, it depends upon what metrics you use, but if you look at the extent to which their economic growth has slowed down, China has been more badly affected than any other economy on the globe. They've gone from 14% to under 7%. No other country has lost seven percentage points of economic growth in the last couple of years.

They have been affected in part because their exports have turned down sharply as growth in their major markets in the United States and Europe have slowed, and in part because China is experiencing its own housing correction. They've had a big property boom – not as big as ours or some of the other countries of more advanced industrial countries – but they are having a housing

correction that has reduced construction and has contributed to the slowdown in their overall economy. But I would say that even though their growth has slowed down quite a bit it's likely that China is going to remain the fastest growing economy on the globe. I say that for a combination of reasons that I'd like to spell out in more detail.

Essentially there are two parts to the argument. One is their policy response has been extremely robust and secondly China, compared to both advanced economies and some other emerging markets, has certain structural factors which I will try to explain, that gives a certain advantage in both recovering from the crisis and in converging back towards what we might consider to be their long-term potential growth.

Let me just spell out the policy response and the structural factor. The policy response, I think, is really the gold standard. There's no other emerging market that is doing as much as China to sustain its economic growth and lead to its economic recovery. They have a stimulus program that is very large relative to the size of its economy. If you look at the IMF rankings of stimulus programs that they've been following very closely, China is far and away the largest among developing economies. The only developing economy that comes close to China is that of the United States.

The second aspect of their program is not just government spending but also a very substantial monetary easing; that is, relaxation of credit. Credit is actually growing in China very, very robustly over the five to six months since they began their monetary easing in September of last year.

The third component that's worth knowing is that it not only includes the typical kind of infrastructure – what we call the shovel-ready projects – but they are doing quite a bit to increase expenditures on social programs – very substantial increases in health insurance, for example. In health care, they say that for the next two years they will bring an additional 400 million people into their medical insurance scheme and that the government's share of medical expenditures will increase very dramatically.

This is very important because one of China's problems is that household consumption over the last decade or so has lagged a bit, in part because the social safety net was badly damaged on purpose during the Zhu Rongji years when Zhu Rongji was premier during the second half of the 1990s. They restructured state-owned enterprises when tens of millions of people not only lost their jobs but also their health care. In many cases they lost their pensions, etc., and the response was a very substantial increase in the savings rate among Chinese households.

You can't get into a hospital unless you pay cash in advance and very few people have health insurance. The savings rate went up and household consumption was somewhat new as a result of that. The expansion of these social safety programs today, I think, eventually will lay the foundation for less precautionary saving on the part of households, and people will be willing to spend a larger share of their income. That will contribute to aggregate demand and stronger economic growth going forward.

That's a quick summary of what's happening on the policy side: strong fiscal stimulus, very substantial monetary easing and additional expenditures beyond the traditional investment ones focusing on rebuilding its social safety net.

The other half of the equation is the structural factors that give China a substantial advantage going forward. I'll talk in particular about the financial sector, the household sector and the government sector.

The reason Chinese banks are willing to lend a lot more is that they are in very strong shape. Basically, Chinese banks never purchased any of the toxic assets that were generated in the U.S. and a few European banks. They didn't allow the creation of any indigenous toxic assets as well. In other words, China has a very kind of plain-vanilla banking system. The regulator has never allowed the introduction of derivative products, secured ties products and so forth. So it has not generated any toxic assets.

Let me give a couple of examples; mortgages, for example. When a Chinese bank makes a mortgage it stays on the books of the bank. They don't sell it out. What we call the originate-to-distribute model of home mortgage does not exist in China, and that obviously gives banks a very strong incentive to look at the credit worthiness of their borrowers. (Mortgages) are not something that they're selling on in the next two hours to the next part of the chain. As a result, they have not had a big buildup of toxic assets in their domestic financial system.

So, the central bank has not needed to rescue any domestic banks. There's not been any capital injection. There have not been any guarantees of bank liabilities as we've seen on such a massive scale in the United States. The banks remain relatively strong. They're able to substantially increase the supply of credit which, of course, is the opposite of the situation we face here in the United States. Things are very badly under-capitalized, and even when we inject massive amounts of capital from the government into the banks, the banks are not willing to lend for the fairly obvious reason that their capital is still inadequate. In short, U.S. banks are still too highly leveraged. They need to raise additional capital, not only what they've gotten from the government. Over time, they're going to have to raise a great deal more private capital once they get the toxic assets off their books.

During this whole process, I believe global credit will then be curtailed. There will be less than it should be. As a result, I think our economy will certainly have the potential for-sub par growth, in contrast to China where the banks have been willing to very substantially increase their lending over the last few months. Basically, there is no leverage in the Chinese financial system. If you look at the debt of Chinese banks it's about 15% of GDP. If you look at the debt of U.S. national institutions it's about 85 or 90% of GDP. So, they have not ramped up their balance sheet. There are no institutions in China that are operating with a balance sheet that is 20, 25, 30 or 35 times their capital. Those kinds of institutions don't exist in China.

The second dimension that I'll say something about is the household factor, and here the idea is exactly the same. Household factors in China have very little debt just like the financial sector has very little debt. Households, too, do not need to de-leverage. The average mortgage in China; the down payment is 50%. There are no home equity loans, so if the price goes up for a few years people don't refinance, take out all their equity and spend the money on cars, vacations or whatever we've been doing. Household debt for mortgages is relatively modest, probably as a result of that. There's virtually no credit card debt in China. There are hundreds of millions of debt cards outstanding but very very few credit cards as a revolving type that U.S. consumers have become so dependent on.

China is way behind on the stock of cars compared to the U.S. But as of two months ago, on the basis of sales, China is now the biggest market for cars in the world, going ahead of the U.S. A

combination of continued growth of their sales and a collapse in our sales has meant that in February, for the first time ever, China sold more cars than we did. And 90% of them are paid for in cash. Car loans are virtually unheard of. So, if you take all of this together the average Chinese household has debt that equals 30% percent of their disposal income. In the U.S. our household debt is 130% of disposable income.

So what has happened and what are the implications for consumption going forward in the United States versus China? Well, we know the main reasons that U.S. economic growth has not just slowed down but turned negative is that households have started to spend less – not in absolute terms. In other words, their savings are going up, they’re paying down debt, they’re not taking on additional debt – or the banks won’t give them any more credit – and the result is that our economy is shrinking at a fairly rapid rate. I think that is possibly going to continue to be a factor going forward because, after all, we know that households have lost an enormous amount of wealth in the decline of houses.

Housing prices have declined in equity and, going forward, households are going to be rebuilding their balance sheets. That means that instead of spending more than their disposable income they’re going to spend less than their disposable income in a positive real savings. But that means there will be less demand and the economy – even when it gets off the bottom and begins to grow – will not grow as fast as it otherwise would.

In China, on the other hand, consumption remains fairly robust. This places a floor on their economic growth. Chinese economic growth is not going to turn negative. I think it will probably remain in the 6% to 7% range, in part because households do not need to de-leverage and are not going to curtail their consumption.

The third structural factor is the government. I have already mentioned that in the U.S. the problem is that government debt is increasing dramatically. It was 50% of GDP before the crisis began. The deficit of our government this year is going to be 12.5% of GDP, and maybe a little bit more. If the growth projection on which the Obama budget is based turns out to be too optimistic, we’re going to have a big government deficit in the following fiscal year as well.

Two or three years from now we will emerge with debt of GDP that’s 90% ratio and that creates this problem that economists euphemistically refer to as “medium-term fiscal sustainability,” which basically is a phrase that means eventually the government is going to have to raise taxes or cut expenditures – that we cannot have our debt as a share of GDP continuously rising. We’re going to be in the Italian category pretty soon.

China, on the other hand, began the crisis with a debt-to-GDP ratio of only 20%, so that’s much less than our 50%. They also had a fiscal surplus. There was no deficit spending in the years running up to the crisis and their deficit that year is only going to be about 4% of GDP. Two years forward from now their debts and GDP will perhaps be in the neighborhood of about 30%, which will be a third of the level of the United States. When the crisis ends and growth resumes they’re not going to have to raise taxes or cut certain expenditures in order to reduce their debt to a more sustainable level.

So, for all these reasons – and here I’m coming to the implications – I think China potentially will be one of the first economies to emerge from the global crisis. Their fiscal stimulus is strong. Their monitor stimulus is strong. Their restructuring the nature of expenditures will encourage household consumption and they have the advantage that households don’t need to de-leverage

the way they do in the United States and many other advanced industrial economies. Secondly, China has the potential to converge back to its long-term potential growth more rapidly than many other countries. The U.S. recovery, when it does come, is likely to be sub-par because households will be de-leveraging for a number of years, raising their savings rates, spending less, and a result slowing down economic growth. Similarly, banks are going to be in the process of rebuilding their balance sheets for a number of years. This is not something that's going to be completely handled by the new initiatives that are being announced in Washington. Banks need to strengthen their balance sheets, which means their lending will grow relatively slowly when it does resume, and that will also constrain our emergence back toward long-term potential growth.

Finally, the government factor. Eventually, we will have to raise taxes further or cut government expenditures which will probably be negative for growth. China is not going to have to do that. So, again, China may emerge relatively earlier from the crisis than many other countries, and it may convert back toward its long-term potential growth sooner than many other economies. I could expand on this. This is not just the United States which I've used in a lot of my comparisons. Certainly the U.K. and many other advanced economies have the same problems, and many other emerging markets have some of the same problems.

India has a much bigger government debt, for example, roughly the size of the United States, for example, compared to China, etc. So I think that China will emerge two or three years from now when the global crisis is finished with an even bigger global footprint. In other words, its growth is going to be strong whereas we're going to have a period of sub-par growth in the advanced industrial economies.

So, China's global footprint is going to expand and I think China will ultimately make a significant contribution to global recovery, in part because of this rebalancing of economic growth that I mentioned. They're going to have a little more coming from the consumption side. Their exports are not going to grow so rapidly, so they're not going to be a source of global imbalances as they have been over the past few years. So, China will not only tend to contribute to global recovery, it will tend to be less of a contributor to the imbalances that have, at least in part, contributed to the financial crisis in which we are currently engulfed.

So, I'm relatively optimistic about China. I think their policy responses are excellent and I think they have the advantage of the structural factors in the household sector, the financial sector and the government sector that work to their favor in the current economic environment.

Thank you.

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