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Can China Avoid the Japan Trap?

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By Arthur Kroeber, head of research, Gavekal Dragonomics; editor, *China Economic Quarterly*; non-resident senior fellow, Brookings-Tsinghua Center.

China today faces more uncertainty about its economic future than at any time since it launched economic reforms three and a half decades ago. The long commodity boom that it drove, enriching Australia and many emerging economies, has collapsed and brought the prices of iron ore, coal and many other resources down to a third of their peak levels. Last June a short-lived stock-market bubble popped, destroying billions of dollars in wealth and prompting massive government intervention to support prices. A few months later a small devaluation of the renminbi caused chaos in global markets, which feared China's economy might be collapsing. The Financial Times is now running a video series on its website called "The End of the Chinese Miracle."

As is often the case in financial markets and media, much of this gloom is overdone. Recently headlines trumpeted that China's economic growth in 2015 was "the lowest in twenty-five years." They failed to note that even at this supposedly slow rate (6.9 percent), China is still growing about three times as fast as the United States, and faster than any other big economy except India.

Similarly, the panic over the "collapsing" renminbi ignored the fact that in 2014 and early 2015, the Chinese currency appreciated by over 20 percent in real terms, as quantitative easing by the European and Japanese central banks caused the euro and yen to fall precipitously. In that context, the five percent or so retracement in the renminbi we have seen since last August seems like a normal adjustment of a somewhat overvalued currency, rather than a harbinger of doom.

But even as we rightly dismiss all the hyperventilation and exaggeration about China's slowdown, we must recognize that:

- first, China's economy is slowing;
- second, this slowdown is secular and not cyclical;
- third, the slowdown reflects difficult transitions that other formerly fast-growing economies failed to navigate;
- and fourth and perhaps most important, it is by no means clear that the overall direction of Chinese policy is appropriate to the challenges at hand.

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What I'd like to do this evening is to describe the economic transitions that China is facing, and then sketch out a few possible scenarios for how the country might develop over the next decade.

We can think of China today as facing three transitions, one that is essentially cyclical or short-term, and another two that are more structural in nature.

The short-term issue is the end of a long housing boom. This is important to understand because most of the extreme market reactions you see about China today are basically delayed responses to this fact.

Between 2000 and 2012, annual construction of housing in China doubled, as the country sought to accommodate the flood of rural migrants into the cities, and to upgrade the living conditions of urban residents. This boom caused urban land values to rise five-fold (from an artificially low starting point reflecting decades of socialist repression of land prices). It also drove a surge in demand for construction materials. Steel demand quintupled; cement demand quadrupled. Coal consumption more than tripled, with most of it going into the electric power plants that fueled the production of steel, cement and other basic materials.

It was a great party while it lasted, but the party is now well and truly over. Housing construction volume began to decline in 2013, and over the next decade it will fall by 15 to 20 percent from the peak. Coal, steel and cement use all started to decline in the past two years; steel industry researchers are now talking about a 20 percent decline in steel demand by 2020. Coal consumption will probably fall by about 10 percent over the same period.

The immediate impacts of the end of the housing boom are an economic slowdown, the emergence of what I call the "two-track economy," and a severe excess capacity problem in steel, coal, cement, glass and a few other industries whose fortunes are directly tied to construction.

Nominal growth in industry and construction last year was close to zero: heavy industry is in effect in recession. This heavy industrial recession is the biggest factor driving the slowdown in economic growth. Yet at the same time, service industries, driven mainly by consumer spending, continue to grow at nominal rates of 10 percent or more. The resilient vitality of consumer spending and services is simply ignored by those who claim that China fakes its statistics and is really growing at no more than the rate of industrial production. China is indeed still growing, it's just that the growth is coming from places other than where we are used to looking.

Big as it is, the housing slowdown is part of a bigger story, part of the second—and most important—of the three major transitions I referred to. I call this the shift from "resource mobilization" growth to "resource efficiency" growth.

What I mean by this is that for most of the last three decades, China's main job was to build up its capital stock: install the roads, railroads, ports, telecoms systems and electric

power networks, and heavy industries that lay the foundation for a modern economy. During this period the crucial thing is to mobilize as much capital as possible and put it to use, safe in the knowledge that almost any capital investment is likely to generate high returns. Obviously, projects need to meet some basic standard of usefulness, but in general it is more important to get the projects built than to worry too much about how efficiently they are used.

China has been extraordinarily effective at mobilizing capital and building out infrastructure, heavy industry and housing. Its problem now is that the capital-mobilization stage of growth is drawing to a close, as it inevitably must. China now has a basic infrastructure comparable to that of industrialized countries. It can no longer generate much growth simply by adding capital to the system. Most future growth must come from extracting as much value as possible from existing assets—in other words, from maximizing the *efficiency of resource use*, instead of simply maximizing the *mobilization of resources*.

The challenge in managing this transition is that the tools needed for the new task are not the same as the tools used in the old task. During the resource mobilization phase, a strong and well organized state is an advantage, and state-owned enterprises can be effective agents. But when efficiency is the focus, you need to put markets in the driver's seat. The state can still ride shotgun and navigate. But it should resist the urge to be a backseat driver, micromanaging every twist and turn of the route. The risk is that you distract the driver and cause him to veer off the road and into a ditch—or, in the language of development economics, into the middle-income trap.

The shift from resource mobilization to resource efficiency is hard, and many countries have failed to make it. Unfortunately, China has to make this shift while undergoing another transition: the demographic transition from a young society to an old one.

Today, China has about six people of working age for every one of retirement age. This is the ratio that Japan had in 1980. By 2040, the worker-retiree ratio will be down to two—about the same as Japan today. Think about that for a moment. In a single generation, China will have the same age structure as Japan does now. This makes the growth challenge even tougher: as Japan and most European countries show, it's hard to sustain rapid growth when your population gets that old.

So how is China responding to these challenges of a slowing housing market, the need to transition to more efficiency-driven growth, and an aging population?

The good news is that president Xi Jinping and his leadership team seem to recognize all three challenges, and have begun to develop policies to address them.

The bad news is that they seem increasingly unwilling to make the basic tradeoff—less state, more market—that is required to sustain high rates of growth over the next decade or two. Instead they have papered over the problems by allowing a huge increase in debt, most of it taken on by cash-strapped local governments that cannot

meet their infrastructure bills, and by state-owned enterprises suffering from poor profitability. Since the global financial crisis year of 2008, the gross debt of China's government, corporations and households has risen from about 140 percent of GDP to nearly 240 percent. And it is still growing, with no slowdown in sight.

More than half of this debt, and most of the increase since 2008, is on the books of state enterprises. On average, state firms borrow twice as much as private companies and deliver less than half the return on assets. China's state enterprise sector accounts for about a third of national output and is more than twice as big, relative to GDP, as any other state sector in the world. So if you want to know why China's economy keeps slowing, and its debt keeps rising, you really need look no further than here.

The solution to this problem is pretty obvious: slash back the state enterprises, open more sectors to private competition, and subject the remaining state firms to fierce financial discipline, through more open, transparent and competitive financial markets.

Unfortunately, the longer Xi stays in office, the more he seems committed to keeping a dominant role for state firms, and the less he really seems to wants to give the market a "decisive role in resource allocation," as he promised two and a half years ago when laying out his economic reform agenda. China is a strong and resilient economy, so this course is sustainable for a few more years. But over the longer term—a decade or more—it is hard to see how China can make the leap to a more efficiency-driven economy if the political leadership demands that the state maintain its dominance over the market.

As we look ahead, we can think about three main scenarios for China's economy. As all of you who have participated in scenario-planning exercises are aware, the one thing we can know for sure about any given scenario is that it will never come to pass. But scenarios can provide a helpful structure for organizing our thoughts, and for identifying the key variables we need to monitor.

The first scenario is the one Xi Jinping and his government would like us to believe. China's economic problems can be solved by technocratic tinkering. State enterprises do not need to be trimmed down or forced to face more competition; instead they need to be consolidated into even bigger entities, and given more financially minded (state owned) shareholders. Productivity can be pushed up by the government spending hundreds of billions of dollars on technology venture funds and on soft loans for Chinese companies to buy up more innovative foreign firms. Since China's per-capita GDP is only one-fifth that of the United States, and since Japan kept growing rapidly until it exceeded 80 percent of US average income, it is obvious that with a few adjustments China can still grow at 6-7 percent a year, or even faster, for another generation.

This vision, frankly, is not very credible. The prescription of most independent Chinese analysts and foreign economists is that much more drastic reforms are required: the state sector must be cut in half; private companies must be allowed to compete freely in the many sectors, especially services, where they are now blocked or fettered; and the

financial industry must be recapitalized and made more open and competitive. If these reforms are achieved—and many people inside the Chinese bureaucracy are pushing for most elements of this package—then growth can probably be sustained at 6 percent for the rest of this decade, and 5 percent for most of the 2020s, and the debt level can be stabilized.

The third scenario is that these reforms don't take place—or not enough of them, anyway—and something bad happens. Most people think this "something bad" will take the form of a financial crisis or a sudden collapse of growth. This is possible: indicators of financial stress are rising rapidly, along with the debt level.

My own view, though, is that this "something bad" would probably be less dramatic, and more like the long slow slide into stagnation that Japan suffered in the 1990s. Although the political systems of the two countries are very different, the underlying issues are similar: the end of a long and successful growth phase, an unsustainable buildup in corporate debt, the accumulation of hidden losses (thanks to the end of the "bubble economy" in Japan, and to the end of the housing boom in China), the inexorable aging of the population, and most important, the refusal of government and corporate elites to transform a state-led economic model into a more market-driven one.

China has time to avoid this outcome. Financially, it looks a lot like the Japan of 1990, and demographically it looks like the Japan of 1980, but developmentally it looks like Japan circa 1973. There is still a lot of potential growth that can be unleashed, so long as the impulse to state control gradually gives way to a greater tolerance of free choice and market-led innovation. China may be able to avoid the Japan trap, but only if its rulers learn to lighten up.