REPORT

The Prospects for Economic Transition in China Are Questionable

May 4th, 2016

William Wilson
Senior Research Fellow

During the financial and economic crisis of 2008 and 2009, Beijing passed a $600 billion stimulus package (representing 13.4 percent of Chinese gross domestic product (GDP)) which allowed China to breeze through the worst global contraction since the Great Depression. With the U.S. mired in depression-like conditions, some believed that the "Beijing Consensus" of state-led capitalism seemed to have eclipsed the "Washington Consensus" of market capitalism.[1]

Although this conclusion turned out to be wrong, an examination of some of China's official statistics does not seem to substantiate current bearishness on the part of some China observers.

The Good

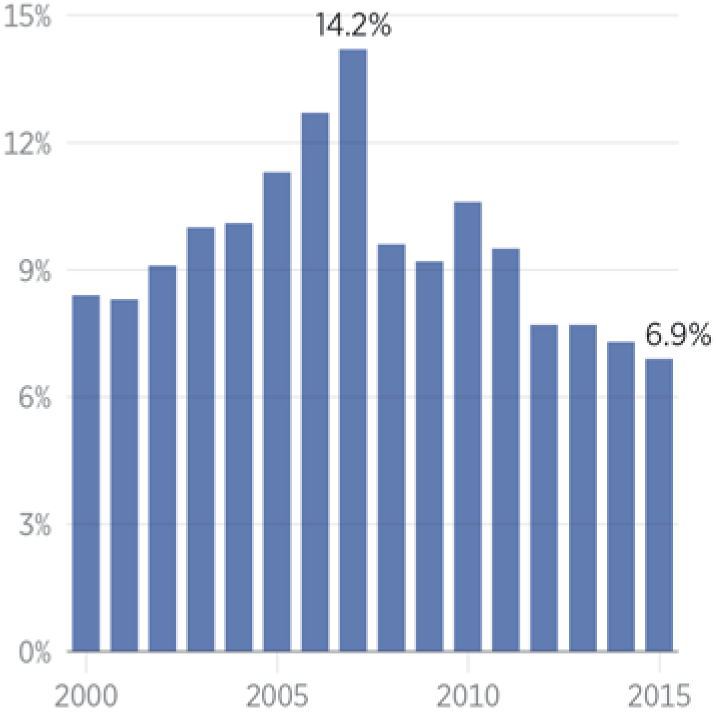
While China's economic growth has decelerated over the past four years, this deceleration is what Chinese policymakers were expecting, although the transition from an export and fixed-investment model toward a service and consumer-based model has barely started. According to the International Monetary Fund (IMF), the economy grew 6.9 percent in 2015, down from 7.3 percent in 2014. In the second quarter of 2014, the IMF announced that the size of China's economy had exceeded the United States' purchasing power (adjusting for differences in the cost of living between both countries) for the first time since the industrial revolution.[2]

This moderation in economic growth from the blistering 10 percent growth rates of the past decade is essentially what Beijing had announced as its target growth rate at its Fifth Plenum in October 2015. Having achieved upper-middle-income status as a developing country in 2010, it was only natural that China'sgrowth rates would eventually have to moderate.

CHART 1

Slower China GDP Growth

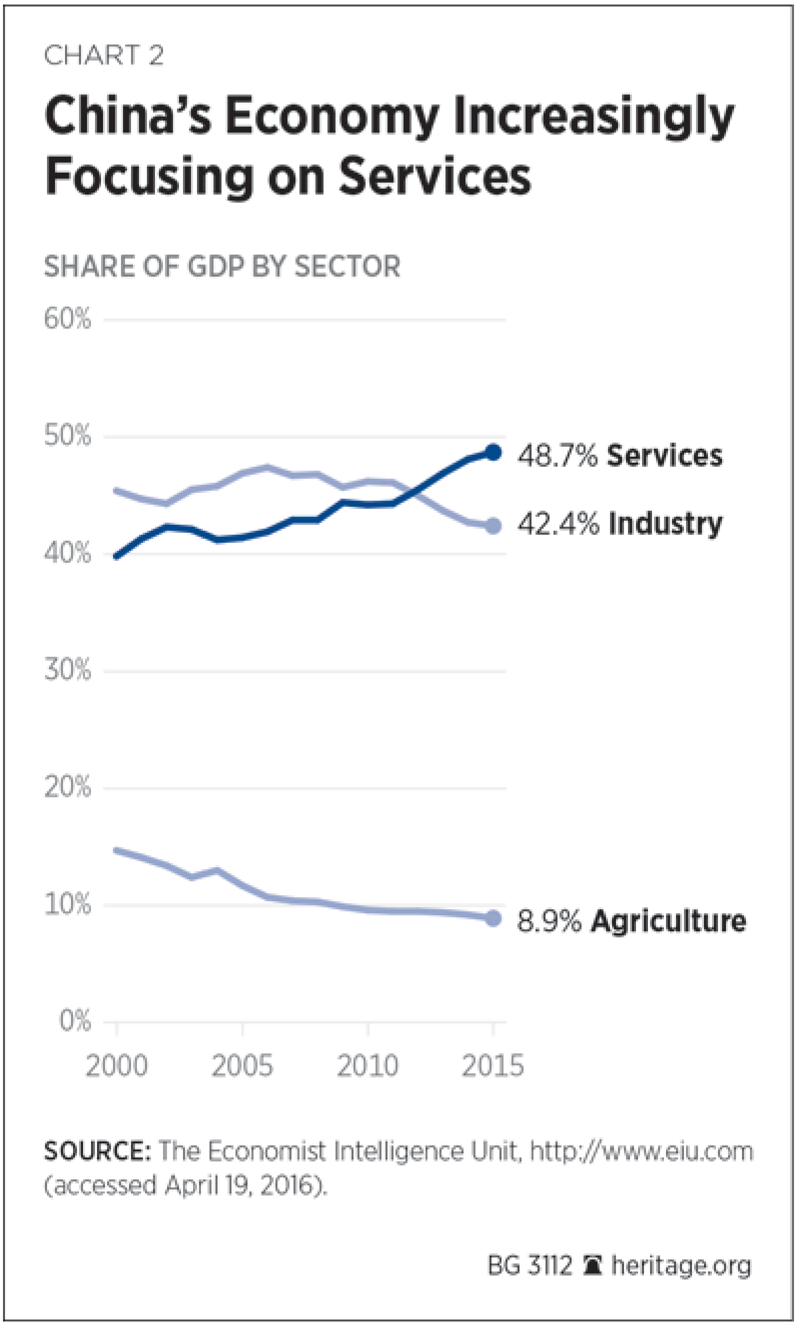
ANNUALIZED REAL GDP GROWTH



SOURCES: The World Bank, "World Development Indicators," http://databank.worldbank.org/data/reports.aspx?source=2&Topic=3 (accessed April 19, 2016), and International Monetary Fund, "World Economic Outlook Update," July 9, 2015, http://www.imf.org/external/pubs/ft/weo/2015/update/02/pdf/0715.pdf (accessed April 19, 2016).

BG 3112 heritage.org

Among the most pessimistic China bears, some have conjectured that Beijing has dramatically overstated China's economic growth since free-market reforms began in the late 1970s. Anyone who has visited China's major metropolises (this author lived there recently for over three years) can verify that the enormous increase in wealth, and reduction in poverty, was not manufactured with 4 percent or 5 percent annualized growth over the past three decades.



There has also been some positive movement in the composition of GDP. At the turn of the millennium, the GDP share for industry and services was 45.4 percent and 39.8 percent, respectively. By 2012, the service share of the economy had eclipsed industry for the first time, and by 2015, the shares had shifted to 48.7 percent for services and 42.4 percent for industry. Agriculture's share has shrunk from 14.7 percent to 8.9 percent of the economy.[3]

Beijing's desire to see its currency become a regional and, eventually, a global reserve currency received a significant boost last December when the IMF allowed the renminbi to join its elite currency club (alongside the U.S. dollar, British pound, Japanese yen, and the euro).[4] Even though the renminbi only accounts for approximately 1 percent or 2 percent of global reserve currencies held by foreign central banks (compared to the dollar's dominant 60 percent share), the IMF was essentially recognizing China's trading status. In 2013, it replaced the U.S. as the world's largest trading nation and is the largest bilateral trading partner for approximately 75 nations.

Additionally, the broad-based crackdown on corruption has had some beneficial effects. By the end of 2014, approximately 270,000 officials had been indicted. Whatever the complex motivations of the authorities, one of many side effects of this campaign has been to reduce infrastructure spending, slowing debt accumulation and reducing excess capacity. Many provincial leaders find it safer to keep their heads down these days. Naturally, another side effect is reduced economic growth.

The Bad

Both inside and outside China, there exists great skepticism about the accuracy of many Chinese macroeconomic indicators. There are significant reasons for this perception. First, any government exercising such a significant role in managing the direction of an economy is most likely manipulating official statistics. In a nation of almost 1.4 billion people, quarterly GDP figures are often released just 14 days after the end of the quarter with no subsequent revisions. (In the U.S., GDP figures undergo two revisions, sometimes significant, spanning out 90 days.) The headline figures often conveniently match Beijing's target figure. To admit that the economy was growing at a 4 percent pace could cause a loss in confidence in the relatively early tenure of Premier Xi Jinping. Second, there are a host of other inconsistencies. While GDP was reported to grow at 6.9 percent in 2015, for instance, electricity consumption rose by only 0.5 percent.[5] These two figures are simply not compatible. Moreover, commodity exporters in Australia, Africa, and Latin America see the slowdown in Chinese imports in their customs receipts for both prices and export volumes.

The bigger question is whether the rebalancing process is occurring quickly enough. An examination of recent trends sheds light on this question.

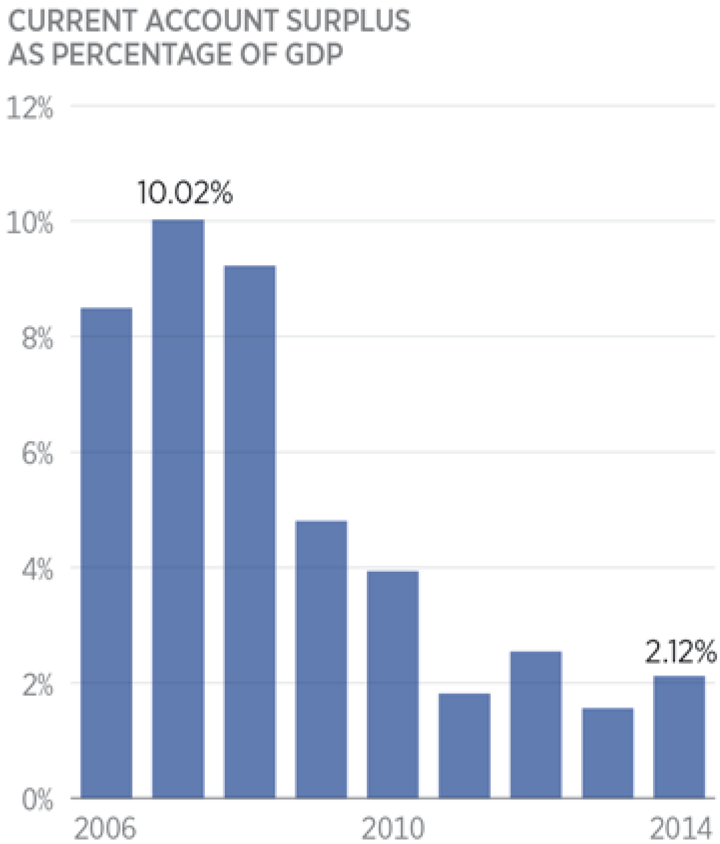
China's Current Account. Contrary to conventional wisdom, China's current account surplus (a broad measure of its balance of trade) has not been a significant source of economic growth since the financial crisis. After peaking at 10 percent of GDP in 2007, it has rapidly fallen to approximately 2 percent of GDP in recent years. Rarely discussed, this contraction (even though China maintains a large trade surplus in nominal terms) has contributed to its recent slowdown.

Fixed-Asset Investment. More ominous has been the level of fixed-asset investment (such as residential and commercial construction, physical infrastructure). While it has recently fallen very modestly as a share of GDP, since the global financial crisis, it has run at approximately 45 percent of GDP. Historically speaking, this level is unprecedented among the emerging-market economies, even those in East Asia during their rapid growth periods.

This elevated level of fixed investment has long passed its expiration date. Many industries, such as steel, cement, rare-earth minerals, energy refining, and housing are operating at three-quarters capacity. This is precisely why wholesale prices have fallen for three consecutive years. It is a marked contrast from a decade ago when the primary concern was inflation.

CHART 3

China's Current Account Surplus Shrinks



SOURCE: The World Bank, "World Development Indicators," http://databank.worldbank.org/data/reports.aspx?source=2&Topic=3 (accessed April 19, 2016).

BG 3112 heritage.org

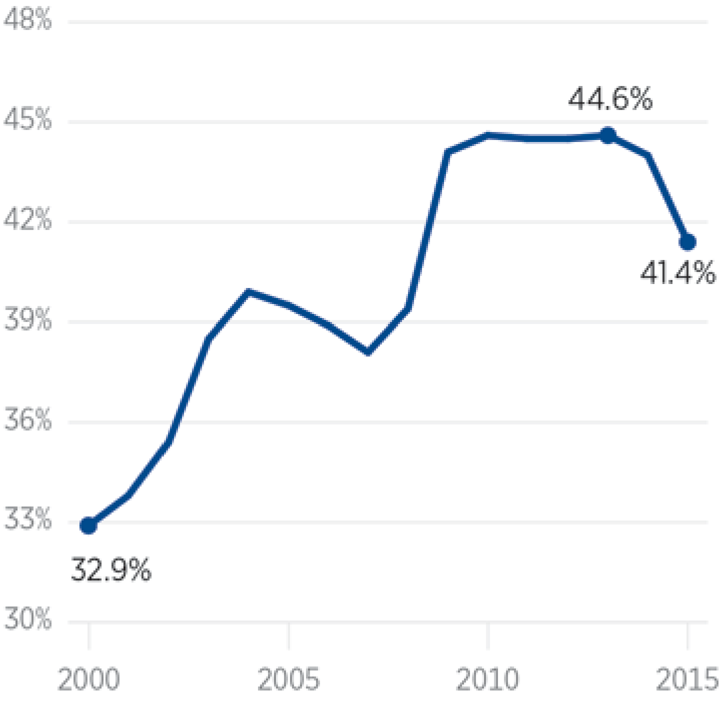
A large drop in fixed-asset investment (as a share of GDP) will be a necessity for two distinct reasons. First, the return on these investments has been rapidly declining. The amount of capital needed to generate an extra dollar of income has roughly doubled over the past decade. The lower returns on investment have been recently reflected in stock prices. Second, as of February 2016, the Shanghai stock index is down 48 percent from its June peak. The sharp fall in stocks is a result of deterioration in the economic fundamentals, not just speculation, as it is often portrayed.

Debt. The investment spending, particularly since the beginning of the global recession, has severely indebted the Chinese economy. According to McKinsey, total debt (government, corporate, and household) increased from $7 trillion in 2008 to $28 trillion in 2014. Also, according to *The Wall Street Journal* and ratings firm Standard & Poor's, corporate debt now amounts to 160 percent of GDP, up from 98 percent in 2008 (compared to a current U.S. level of 70 percent). These are unprecedented—and unsustainable—debt increases.

CHART 4

China's Domestic Investment Tapers Off

FIXED-ASSET INVESTMENT AS SHARE OF GDP



SOURCE: The Economist Intelligence Unit, http://www.eiu.com (accessed April 19, 2016).

BG 3112 heritage.org

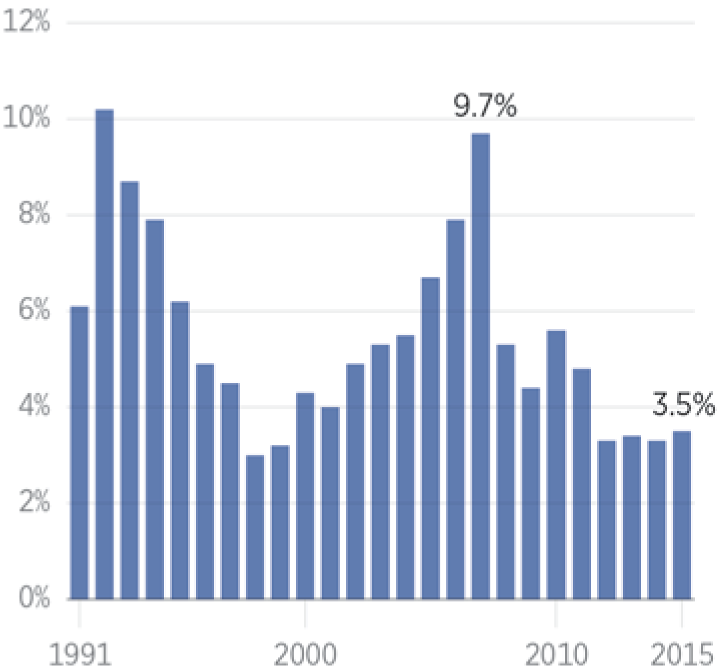
There are many similarities between China's economy today and Japan's during the 1980s. Japan's mistake in creating and handling the bubble economy during that decade obviously had long-term consequences. The same can be said of the credit bubble in the West over the past decade.

Demographics, Innovation, and Productivity. In 2012, China's working-age population shrank for the first time in seven decades (the great famine of the 1950s). Aging is expected to reduce the working-age population by at least 15 percent by the middle of this century. Without labor expansion and investment to propel growth, China must rely more heavily on innovation that can improve productivity. Yet, the contribution to GDP of multifactor productivity has been falling in China. From 1991 to 2000, it averaged 5.9 percent, then declined to an annual average of 3.6 percent between 2011 and 2015. To reach a GDP growth target of 5.5 percent to 6.5 percent per year, multifactor productivity growth will need to contribute to between 40 percent and 50 percent of GDP growth.

CHART 5

China's Multifactor Productivity Growth Drops

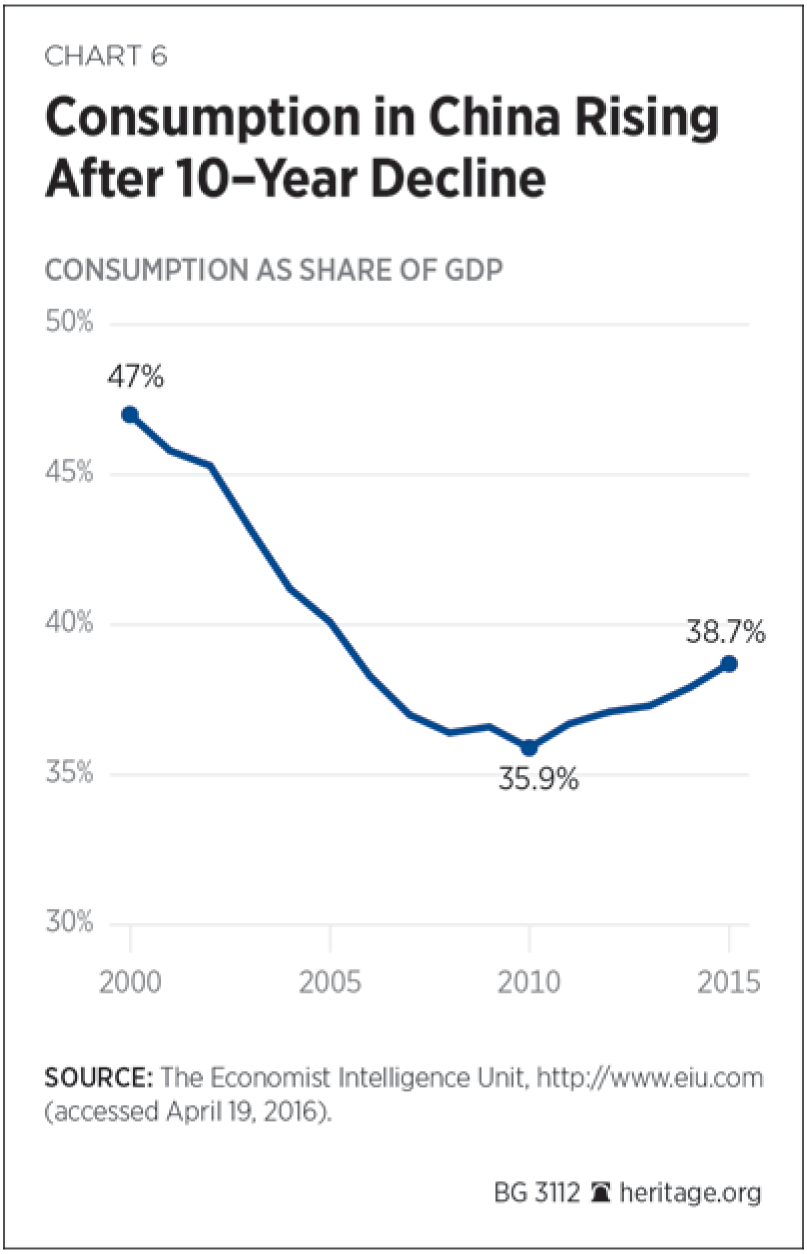
AS PERCENTAGE OF GDP



SOURCE: The Economist Intelligence Unit, http://www.eiu.com (accessed April 19, 2016).

BG 3112 heritage.org

Consumption. China essentially faces a Catch-22 scenario. To complete the transition from an export-led and fixed-investment economy to a service-based and consumer-led economy without experiencing a precipitous decline in growth, China must dramatically decrease savings and investment while increasing consumption. (As discussed earlier, fixed-asset investment remains elevated but services are playing a bigger role.) The question is whether consumption is beginning to take a larger share and the recent pace of change.



The Chinese consumer is finally showing some signs of life. Consumer retail sales in China were up 10 percent in 2014. Since 2010, private consumption as a share of GDP has risen almost 3 percent—but hardly reverses the sharp decline since the beginning of the century. At just 39 percent of GDP, consumption spending represents too small a fraction of GDP to compensate for a sharp decline in fixed investment, which is essential over the next few years. In contrast, in India, which currently possesses a quarter of China's per capita income, consumption accounts for 60 percent of GDP. According to *The Wall Street Journal* and the World Bank, China is ranked 106th globally in household consumption, at $3,900 per capita, behind Swaziland, and accounts for approximately 10 percent of U.S household consumption.[6]

Capital Flight. Perhaps the most significant economic development in China over the past year has been the exodus of capital, despite stringent capital controls. According to data compiled by Bloomberg, capital outflows jumped to $1 trillion last year. In short, what is occurring is the greatest episode of capital flight in history.

There are a number of important factors for this epic exodus. Outward-bound investment by Chinese companies has sharply increased in recent years. (In fact, in 2016, outward-bound investment will likely exceed inward-bound direct investment for the first time.) More Chinese than ever are also sending their children to American schools and colleges, which is another source of long-term capital outflows. But the greatest source of the recent surge has been driven by the lack of confidence in the Chinese economy and capital markets. The government is also cracking down on capital flight, which is only increasing the desire of wealthy Chinese to get their money out of the country while they can. Chinese citizens are currently restricted to moving $50,000 a year offshore.

While Chinese policymakers announced new rules in February to loosen capital controls for foreign investors, in an effort to signal their commitment to open their capital account, the reverse has been the case for Chinese outbound capital. Beijing foreign exchange (FX) reserves are not actually that large, considering the scale of the economy. If just 5 percent of China's 1.4 billion people sent the maximum $50,000 allowed out of the country, it would deplete the entire $3.2 trillion in FX reserves.

The surge in capital flight is causing China to hemorrhage reserves in an attempt to prevent the yuan from falling even more sharply. China's foreign-exchange reserves fell by an astonishing $700 billion last year. In January this year, they fell by almost $100 billion, to a total of $3.23 trillion, the lowest level in more than three years.

The central bank is beginning to find itself in a vicious circle—the more it draws on foreign reserves to defend the yuan, the more skepticism grows about its ability to maintain its foreign exchange value—which only increases the impetus for capital to leave the country. This scenario was unimaginable only a short time ago.

Moreover, the FX reserves appear even smaller when measured by the ratio of the FX reserves to the M2 money supply, a popular measure used by both the World Bank and IMF, as well as by many analysts. According to Zhang Ming, a senior economist at the Chinese Academy of Social Sciences, China should be maintaining between $2.1 trillion and $4.3 trillion in FX reserves to prevent any significant capital outflows.

CHART 7

Chinese Foreign Exchange Reserves Drop Rapidly

IN TRILLIONS OF U.S. DOLLARS

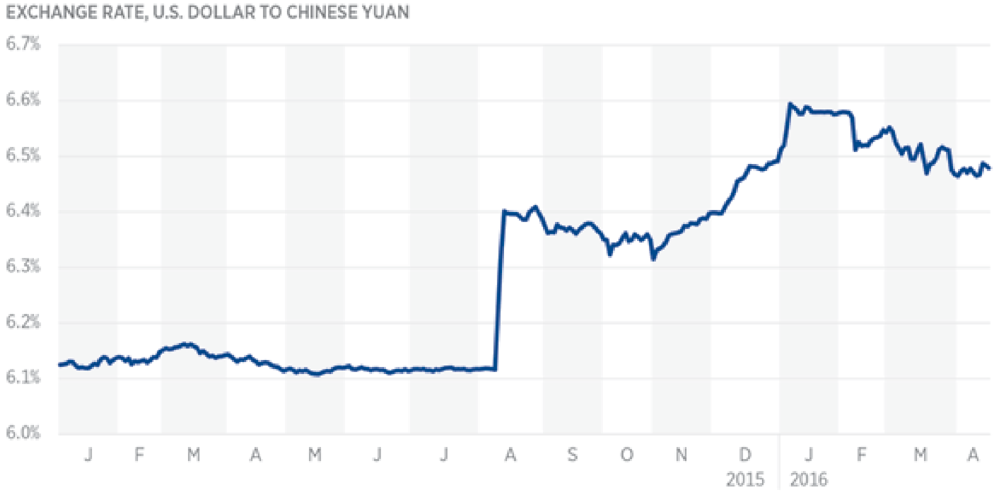
SOURCE: The World Bank, "Total Reserves Minus Gold (Current US$)," http://data.worldbank.org/indicator/FI.RES.XGLD.CD (accessed April 19, 2016).

BG 3112 heritage.org

All this is having an impact on the value of the yuan. Once widely perceived as undervalued, the yuan is now quite possibly overvalued given the recent developments in the Chinese economy and the level of capital flight.

CHART 8

Yuan Loses Value to U.S. Dollar



SOURCE: International Monetary Fund, "IMF Exchange Rates," http://www.imf.org/external/np/fin/ert/GUI/Pages/CountryDataBase.aspx (accessed April 19, 2016).

BG 3112 heritage.org

Short-Term Reforms

While it is unlikely that the Chinese Communist Party will unveil any major political reforms in the near future, there are a number of critical economic reforms over the short run that would go a long way toward accelerating the rebalancing process. Beijing should:

- **Replicate** the partial privatizations of state-owned enterprises that were initiated during the 1990s. This would redirect capital to private enterprises and increase the return on domestic capital.
- **Allow** a much greater role for foreign financial institutions, which currently own only 2 percent of banking assets.
- **Accelerate** the opening of the capital account. As shown, capital is already exiting China due to investors' concern over further restrictions, but liberalization would ease the concerns of both domestic and foreign investors.
- **Establish a moratorium on borrowing for infrastructure projects by provincial governments.** Excess capacity and debt will eventually undo China's economy unless the excess is first leveled off, and then reduced.

Conclusion

Despite some of the ugly indicators, China is not currently in recession. The canary in the coal mine is the enormous migrant workforce which experienced 25 million layoffs in 2008 before Beijing enacted its enormous stimulus package. No such layoffs are currently occurring. The current debate is largely over the rate of slowdown and future prospects.

So where does China stand economically?

The outlook is not favorable for China's short-to-medium-term economic prospects. The economy is currently experiencing the slowest growth in at least 25 years. Equity markets are often a leading economic indicator, and China has had two bear markets in the past year. The Chinese authorities injected $20 billion in the equity markets in an attempt to stabilize the market. It amounted to a vast waste of capital, which is the essential story in the Chinese saga.

Then there is the issue of fixed-asset investment. Some economists state that China's need for capital accumulation is essential since it is still in the developmental stage, and that the capital-to-GDP ratio is not a problem. This argument is seriously flawed. First of all, with a per capita income of less than $10,000, China's capital-to-labor ratio is historically high. Developed countries are "capital intensive." China is still a developing country. Second, most of the economy's primary industrial engines are operating at significant levels of overcapacity. The return on invested capital has been sharply dropping in recent years. This is *prima facie* evidence of excess capital.

Most ominously for now, capital outflows are greatly accelerating. There cannot be a surer sign of a collapse in confidence in China's economic fundamentals. Capital, despite strict controls, will go where it is welcomed and stay where it is treated well. For the first time in modern history, India has surpassed China as the fastest-growing major economy.

The state-owned sector is another major drain on capital. Shortly after becoming Communist Party chief in 2012, Xi Jinping made a pledge to give market forces a bigger role in the Chinese economy. But reality has been different. Promised overhauls of state-owned enterprises unveiled one year ago were never enacted, and the bureaucrats in Beijing decided instead to merge companies suffering from excess capacity, rather than let such companies fail.[7] State-owned companies account for 30 percent of the country's total corporate assets, and receive 80 percent of total bank loans, which is $16 trillion (roughly 150 percent of China's GDP).

For the longer term, perhaps the most ominous problem is the extraordinary rise in debt. The West, mired in slow growth since 2008, should be a sign to the Chinese of the consequences of rebalancing.

There has been a major swing in perceptions about the health and competitiveness of the Chinese economy since 2008. Often, however, perceptions are wrong—driven as they are by many non-economic factors. That was true in 2008 when commentators in Beijing and abroad heralded a revolution in the global economic hierarchy. And, it is likely true today. What really counts are the numbers. When one looks at the numbers, one finds a very complex situation at play. It is too early to draw definitive conclusions. China still has time to make the necessary policy adjustments in order to rebalance to a more market-driven model. But without the political will, and with continually delayed reforms, the bleak short-term and medium-term prospects will only extend farther into the future.

—William T. Wilson, PhD, *is Senior Research Fellow in the Asian Studies Center, of the Kathryn and Shelby Cullom Davis Institute for National Security and Foreign Policy, at The Heritage Foundation.*