

China's Stall

Testimony submitted to the House Committee on Foreign Affairs, Subcommittee on Asia and the Pacific

For the hearing "China's Rise"

June 17, 2015

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Note: the following represents the views of the author, only, not any organization-wide positions held by the American Enterprise Institute.

It is often forgotten that changes in economic policy can require years to make an impact. Recalling this is important in understanding China's economic trajectory. The most common description today is that China is slowing. In fact, it is stagnating.

In 1978, China began to grant limited private property rights and to permit limited competition. These steps helped create an economic miracle, among other things lifting 850 million people out of poverty over a generation. But for more than a decade now, the Communist Party has chosen not to move forward on private property rights and competition, instead emphasizing an unprecedented amount of state-directed spending. The result is a severely damaged environment, an unbalanced economy, and a painful debt burden.

This is not hindsight. The stagnation path was visible six years ago, when China choose to massively expand credit in response to the financial crisis. Weaknesses in the economy can be traced back to policies initiated six years before that, in 2003.¹ Because the fault lines have been developing for some time, they will require years of difficult reform to address. The current government has pledged such reform but largely lacked the nerve to initiate it, much less sustain it. The single most likely result is that China will share the fate of many other economies and fall far short of being wealthy.

Stagnation, Not Collapse

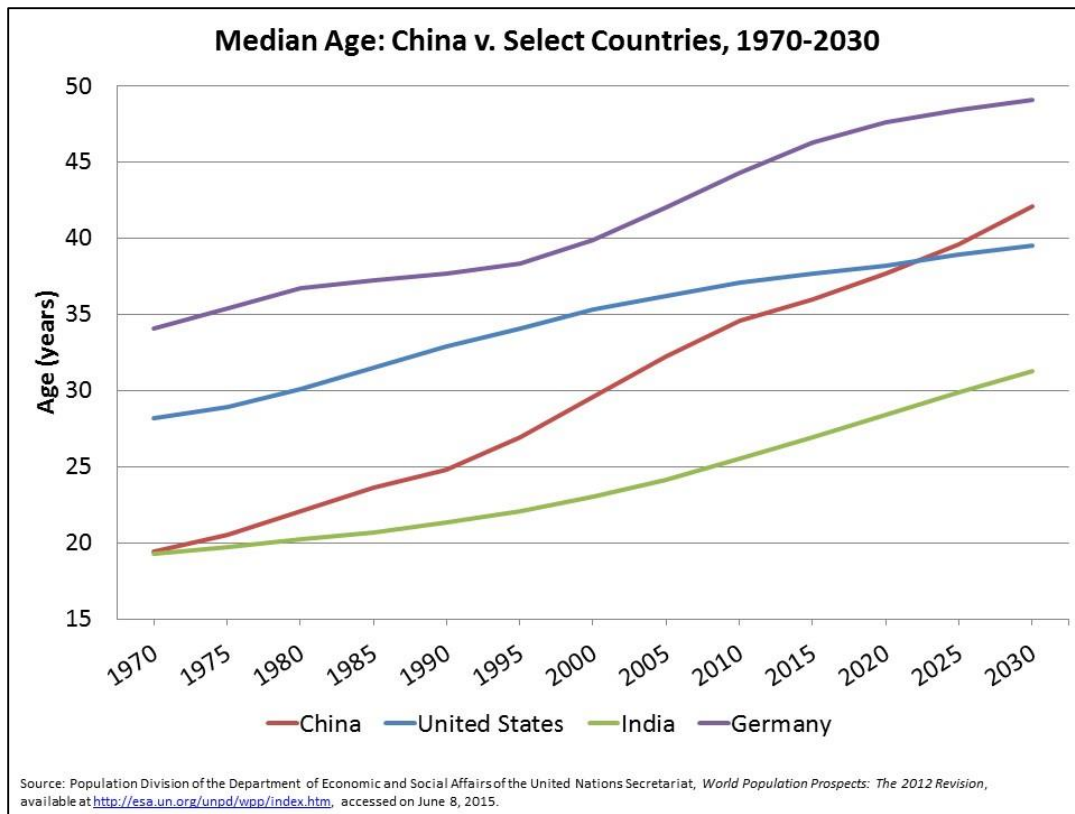
Stagnation does not translate to China becoming unimportant, and certainly not to a collapse. China bulls often criticize bears for predicting a crisis that never occurs.² As a long-time bear, I have never predicted an economic collapse. The reason: a mixed market-state economy is less vulnerable to an acute crisis and more vulnerable to chronic, serious problems. The Communist Party can control the economy and has overwhelming motivation to avoid a crisis. While an economic stall is hardly appealing, it is both less terrifying to the Party and harder to avoid.

As an illustration, China cannot have “a Lehman moment.” Commercial financial systems like those in the West are only as strong as their weakest link. But Chinese finance is dominated by the state.³ Non-commercial financial systems are as weak as their strongest link because the government can, without legal or political delay, order the strongest institutions to save the weakest. The cost, of course, is a financial system that wastes enormous sums of money.

¹ Derek M. Scissors, “China Refuses to Adjust Its Economy,” Heritage Foundation, July 16, 2009, <http://www.heritage.org/research/reports/2009/07/china-refuses-to-adjust-its-economy>; Derek M. Scissors, “Deng Undone: The Costs of Halting Market Reform in China,” *Foreign Affairs*, May/June 2009, <https://www.foreignaffairs.com/articles/china/2009-05-01/deng-undone-0>.

² Tom Orlik, “Crisis, What Crisis? How to Beat Back the China Bears,” *Wall Street Journal*, February 24, 2012, <http://blogs.wsj.com/chinarealtime/2012/02/24/crisis-what-crisis-how-to-beat-back-the-china-bears/>

³ Grant Turner, Nicholas Tan, and Dena Sadehian, *The Chinese Banking System* (Sydney: Reserve Bank of Australia, 2012), <http://www.rba.gov.au/publications/bulletin/2012/sep/pdf/bu-0912-7.pdf>; Derek M. Scissors, “Why China cannot have a ‘Lehman moment’,” *South China Morning Post*, February 24, 2014, <http://www.scmp.com/business/banking-finance/article/1433983/why-china-cannot-have-lehman-moment>.



Demography also argues for stagnation and against collapse. Demography can cause social and political crisis when there are too many young people and not enough jobs. China is aging, instead, and the challenge for aging societies is not riots but stasis.⁴

It is certainly also the case that a stagnant China will remain large and important. It will be one of the world's top manufacturers and traders, and perhaps the leader in absolute size in these areas. For spending overseas, it will still have several trillion dollars in official foreign exchange reserves plus another trillion in foreign exchange at state banks. At home, it will have huge asset and debt markets – especially for property but also for securities. China's growth is vanishing, its size and stability remain.

Climbing Everest

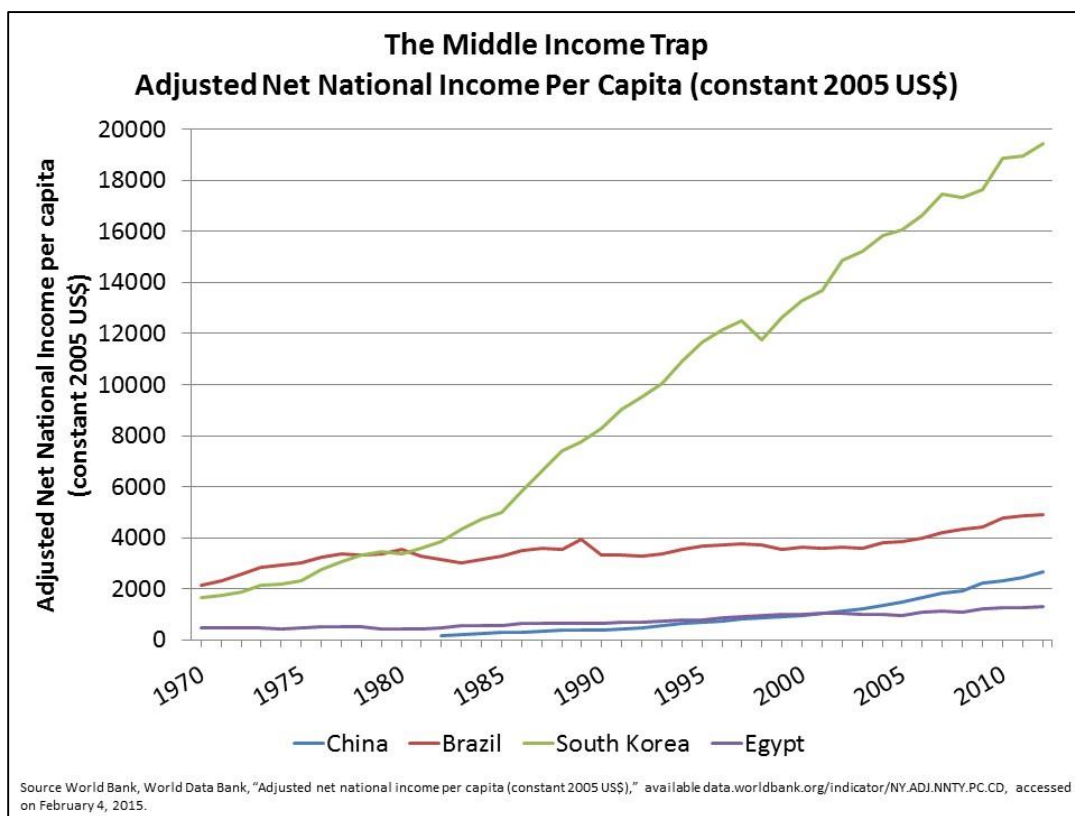
The first step in understanding why stagnation is likely is to consider other countries. While the categories can be fluid, far more economies rise out of poverty than become truly rich. This is sometimes referred to as the middle-income trap.⁵

⁴ Anthony Kuhn, "One Country Provides Preview of China's Looming Aging Crisis," NPR, January 14, 2015, <http://www.npr.org/sections/parallels/2015/01/14/377190697/one-county-provides-preview-of-chinas-looming-aging-crisis>.

⁵ Barry Eichengreen, Donghyun Park, and Kwanho Shin, "Growth Slowdowns Redux: New Evidence on the Middle-Income Trap" (working paper, National Bureau of Economic Research, Cambridge, MA, 2013).

In the post-war era, the most impressive economic success stories are in East Asia, which seems to bode well. However, Japan became rich by global standards before World War II and its burst of growth 1946-1990 was in large part regaining previously held ground. Hong Kong and Singapore are not even large cities by Chinese standards. Taiwan's total population is about the same as Shanghai's. Most of the rich oil exporters are also micro-states.

The only country with a population over 30 million that has become rich for the first time in the post-war era is South Korea. Meanwhile, the list of countries that have not gone beyond middle-income is long – Argentina, Indonesia, and Thailand, to name a few. It would not be unusual if there were cities in China with income levels similar to, say France. It would be highly unusual for China as a whole to reach French levels of income.



The second step is to evaluate Chinese growth. The government continues to report comparatively rapid gains in gross domestic product (GDP) and most likely will do so indefinitely. But official statistics are not a reliable indicator of how the economy is doing. The statistics bureau opened its most recent communiqué as follows:⁶

⁶ National Bureau of Statistics of China, "Statistical Communiqué of the People's Republic of China on the 2014 National Economic and Social Development," news release, February 26, 2015.

In 2014, faced with the complicated and volatile international environment and the heavy tasks to maintain the domestic development, reform and stability, the Central Party Committee and the State Council led the people of all nationalities of China to seize the momentum of international and domestic development, adhere to the general tone of “moving forward while maintaining stability”, fully deepen the reform and opening up, focus on the innovation of macro control, tap into the vitality of the market and foster the driving force of innovation.

This is hardly reassuring as to the willingness of government statisticians to publish anything the Party does not like.

Just as important, GDP is wildly overrated as a measure of economic success.⁷ For one thing, it makes no sense to use GDP per person, since no one can spend it. In terms of what people actually have in their pockets, China reported disposable income per person equivalent to \$3360 at the end of 2014 (the US figure was \$41,180). Plainly, there is a long way to go.

Already slowing would therefore be worrisome enough by itself for China’s prospects. And slowing may understate the problem. Credit Suisse reports private wealth figures for all major economies.⁸ From the end of 2011 to the middle of 2014 (latest available), China’s net private wealth grew 10 percent, total. World wealth grew 17 percent; far from being world-leading, China underperformed.

Private wealth is volatile, and Chinese private wealth is likely rising now due to a skyrocketing stock market. Private wealth is also only part of the story, especially in China where the state owns so much in the way of assets. At the core of any notion of economic growth -- GDP, wealth, or others -- is productivity. Productivity is difficult to measure but it may be that Chinese productivity actually declined 2008-12.⁹ If that is accurate, it is far more important than what the government claims GDP is.

With the Wrong Guide

Whether or not productivity did start to decline in 2008, China’s economic problems have been brewing for quite a while. They did not begin this year or last, as some seem to think.¹⁰ They did not even begin with the financial crisis. They began in 2003.

From 1978-2002, pro-market reform was partial and uneven, But it was persistent and it created an economic powerhouse. In 2003, a then-new government under Communist Party General Secretary Hu Jintao decided that state-owned banks lending to state-owned enterprises should lie

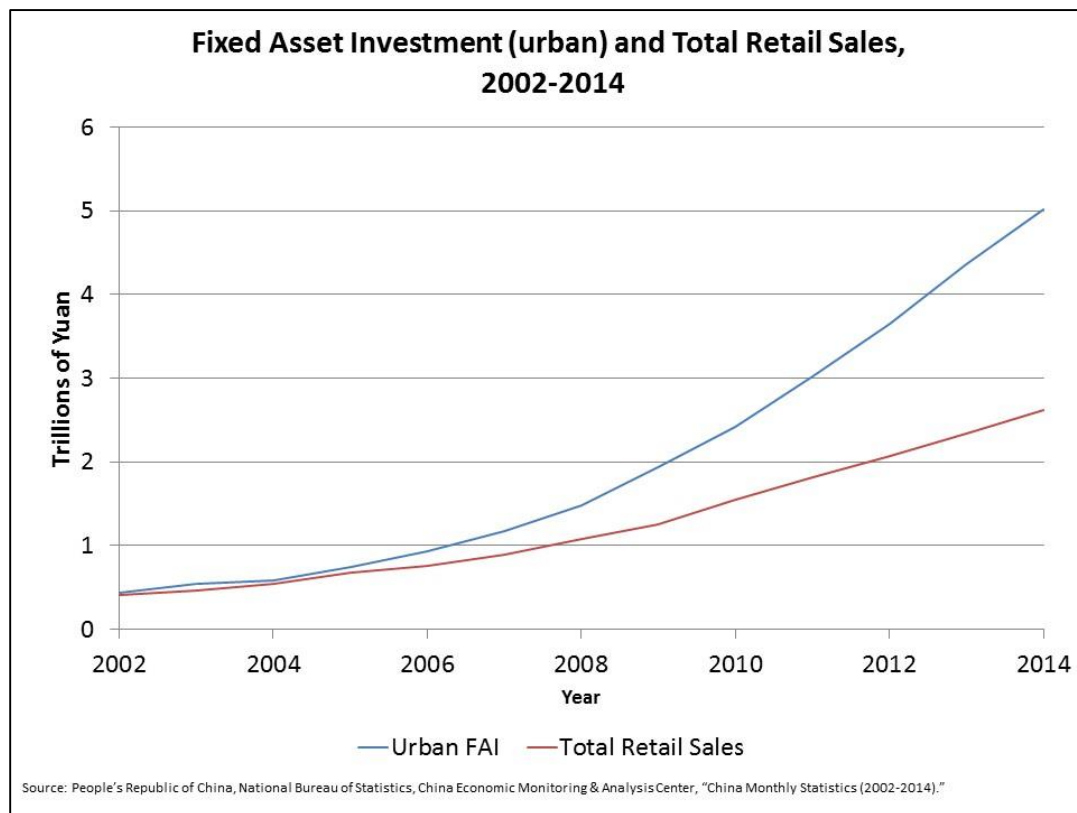
⁷ Michael Pettis, “What multiple should we give China’s GDP growth?” Michael Pettis’ China Financial Markets, May 17, 2015, <http://blog.mpettis.com/2015/05/what-multiple-should-we-give-chinas-gdp-growth/>.

⁸ *Global Wealth Databook 2014* (Credit Suisse Research Institute, 2014), <https://publications.credit-suisse.com/tasks/render/file/?fileID=5521F296-D460-2B88-081889DB12817E02>.

⁹ Harry X. Wu, “China’s Growth and Productivity Performance Debate Revisited: Accounting for China’s Sources of Growth with a New Data Set” (working paper, Conference Board China Center, Beijing, 2014).

¹⁰ Andrew Ross Sorkin, “A Veteran of the Financial Crisis Tells China to Be Wary,” *New York Times*, April 21, 2015, <http://www.cnbc.com/id/102605452>.

at the core of the economy, so that these badly-run firms could continue to employ large numbers of people and serve as economic tools for the Party.¹¹



Market forces would still play an important role, but fresh market-oriented reforms would be limited, supplanted by ever-rising amounts of investment. Official investment growth jumped from 12 percent in 2001 past 26 percent in 2003, more than four-fifths by state-controlled enterprises. Investment growth then exceeded 25% annually for the next 9 years, doubling the pace of official GDP.¹² The dependence on investment and huge imbalance between investment and consumption was not always a feature of the economy, it was created by the Hu regime starting in late 2002.

And at first it seemed to work. Chinese companies borrowed, invested, produced, and exported, and growth soared. This was in no small part, however, a mirage. Behind the glitter was not the

¹¹ Hu Angang, Hu Linlin, and Chang Zhixiao, *China's economic growth and poverty reduction, 1978-2002* (New Delhi: International Monetary Fund, 2003); Deng Shasha, "Factbox: China's fixed assets investment booms over decade," Xinhua, August 23, 2012, http://news.xinhuanet.com/english/china/2012-08/23/c_131803358.htm.

¹² People's Republic of China, National Bureau of Statistics, China Economic Monitoring & Analysis Center, "China Monthly Statistics (2001-2011)."

greater productivity that arises from market reform but increasing dependence on domestic credit to finance investment and on foreign consumption to buy the goods ultimately produced.¹³

The global financial crisis therefore came as a double blow. First, foreign demand plummeted. Then, on top of the intervention through public investment starting in 2003, the Party conducted what was arguably history's biggest stimulus through bank loans. Bank credit grew 32 percent in 2009, even as profit opportunities disappeared. Credit expansion has slowed but remains staggering. In a smaller economy, China's broad money supply M_2 is now no less than 75% larger than America's.¹⁴

There are many people who urge the extension of enormous amounts of credit when demand falls. Using official numbers, however, China did not need to respond in such terror in 2009. Even assuming official numbers at the time were useless, the inevitable outcome of borrowing to avoid a downturn is too much capacity and growth-killing debt. In 2003, the government identified 3 industries as suffering overcapacity; in 2013, that number had ballooned to 19.¹⁵

It gets worse. China's debt may now be the world's largest, where the highest estimate has it closing on \$30 trillion. Two-thirds of that has been accumulated in the past 8 years. There are two complementary and powerful consequences. First, when a country has already spent so much, the return on yet more spending is low. This is the main reason growth is slowing. Second, when a country's debt is so large, a good deal of capital is spent paying it back.¹⁶ This is the main reason growth will slow further.

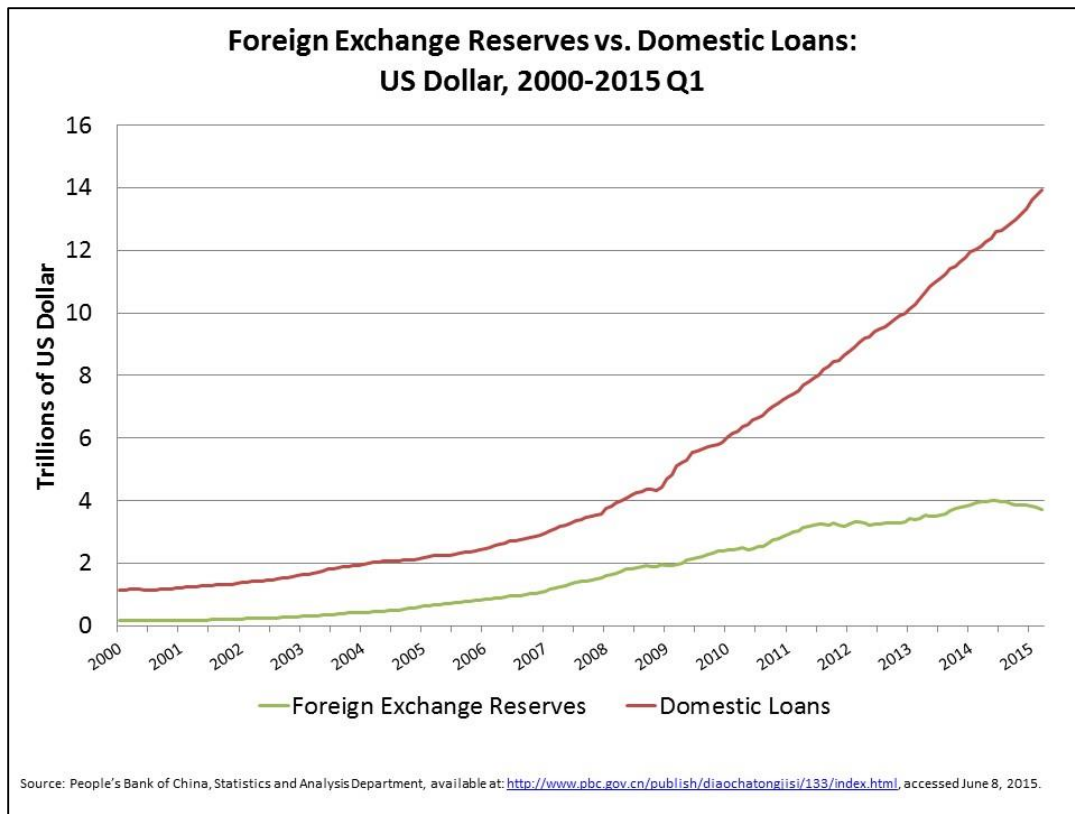
¹³ Li Cui, "China's Growing External Dependence," *Finance and Development* 44, no. 3 (2007).

¹⁴ Xiong Tong, "China reports record 9.59 trln yuan in loans in 2009," Xinhua, January 1, 2015, http://news.xinhuanet.com/english/2010-01/15/content_12816059.htm;

People's Republic of China, National Bureau of Statistics, China Economic Monitoring & Analysis Center, "China Monthly Statistics (2001-2011)."; Board of Governors of the Federal Reserve System (US), *M2 Money Stock*, June 12, 2015, <https://research.stlouisfed.org/fred2/series/M2/>

¹⁵ US-China Economic and Security Review Commission, *China's Role in the Origins of and Response to the Global Recession*, February 17, 2009 (statement of Nicholas R. Lardy, Peterson Institute of Economics).

¹⁶ Richard Dobbs, Susan Lund, Jonathan Woetzel, and Mina Mutafchieva, *Debt and (not much) deleveraging* (McKinsey & Co., 2015); James Kynge, "China's real interest rate surges to post-crisis high," *Financial Times*, May 18, 2015, <http://www.ft.com/intl/cms/s/0/74990c3e-fd69-11e4-b072-00144feabdc0.html#axzz3cbzIB1Jr>.



There are other reasons. Best-known, China is moving rapidly from a young to an old country. The government says the number of working age people started to fall in 2012 and has fallen more sharply each year since. This may not be entirely accurate but it is certain that the work force will shrink during this decade and throughout the next. The contribution of labor to growth will fade until labor actually detracts from growth, as it does in Japan and parts of Europe. It is not inevitable, but old countries tend to stagnate economically.¹⁷

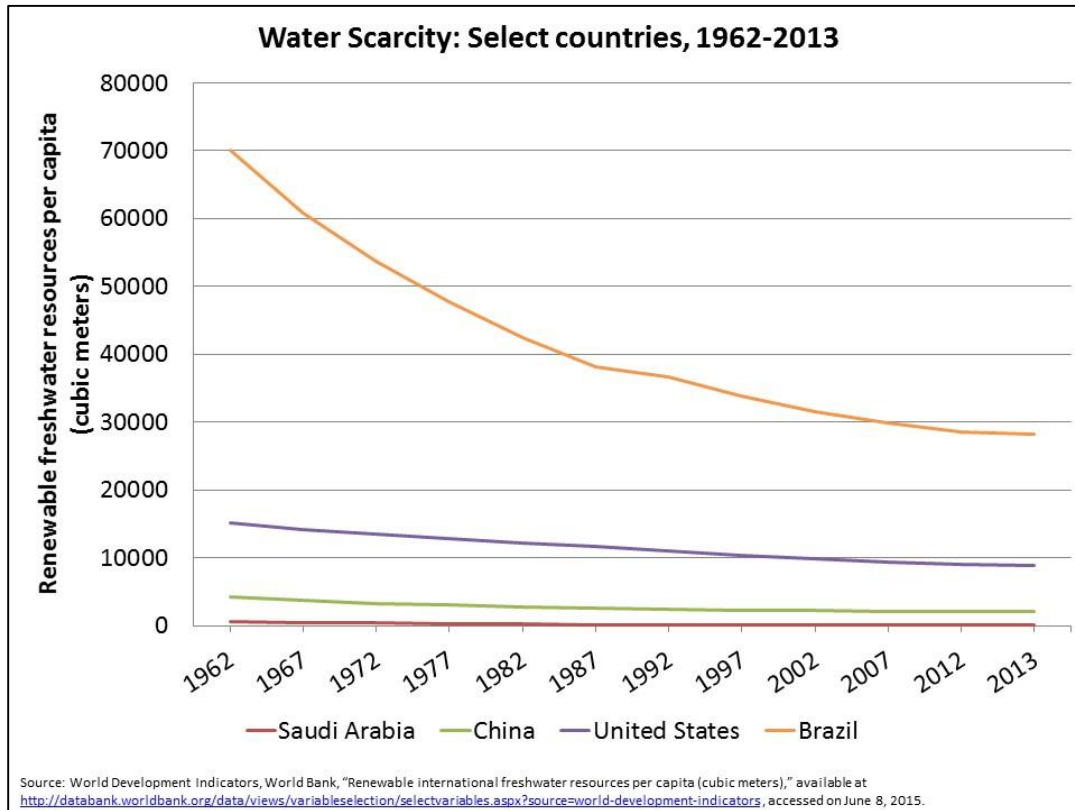
In addition, growth based on natural resources has disappeared. In the 1980's, farm productivity soared, permitting what were unnecessary farmers to become manufacturing workers and helping create the world's new factory. Land and natural resources will not spur economic growth again for the foreseeable future, as China has badly depleted its resource endowment.¹⁸

Illustrations of this range from arable land to zinc deposits, but perhaps the clearest is water. The World Bank cites water stress as occurring below 1000 meters³ of water per person per year; northern China is at one-fifth that amount. Three-fifths of monitored groundwater sites are rated

¹⁷ Laura Zhou, "China's workforce shrinks by nearly 4 million amid greying population," *South China Morning Post*, January 20, 2015, <http://www.scmp.com/news/china/article/1683778/chinas-workforce-shrinks-nearly-4-million-amid-greying-population>; Phil Coggan, "Secular stagnation," *Economist*, November 3, 2014, <http://www.economist.com/blogs/buttonwood/2014/11/secular-stagnation>.

¹⁸ Zhun Xu, Wei Zhang, and Minqi Li, "China's Grain Production: A Decade of Consecutive Growth or Stagnation?" *Monthly Review* 66, no. 1 (2014); *Report on Ecological Footprint in China* (China Council for International Cooperation on Environment and Development and World Wildlife Fund, 2012).

by the central government as unfit for drinking.¹⁹ Just as China will be forced to make hefty payments on its financial debt, it will be forced to on its environmental debt, also making economic growth more difficult.



A final way to achieve growth is through innovation, which is the hardest category to measure. China has successfully imported foreign technology, legally and illegally (though theft of intellectual property).²⁰ As countries climb the technological ladder, however, they can no longer merely absorb what others offer. Fresh innovation becomes more challenging. Moreover, weakness in other sources of growth means that China must increasingly rely on innovation if the economy is to continue to expand.

The government recognizes all this but its strategy is exactly wrong. Sustained, broad innovation that drives growth must be bottom-up, but the somewhat infamous indigenous innovation

¹⁹ "Rivers are disappearing in China. Building canals is not the solution," *Economist*, October 10, 2013, <http://www.economist.com/news/leaders/21587789-desperate-measures>; "Over 60% of underground water substandard: report," *China Daily*, April 24, 2014, http://www.chinadaily.com.cn/china/2015-04/24/content_20529263.htm.

²⁰ *The IP Commission Report* (Commission of the Theft of American Intellectual Property, National Bureau of Asian Research, 2013), http://www.ipcommission.org/report/ip_commission_report_052213.pdf.

program is top-down, as if the government can anticipate all the needed changes for years to come.²¹ This is not how innovation occurs in computing, telecom, energy and elsewhere.

The policies that support innovation are also deeply flawed. Intellectual property even within China is not protected well, reducing the incentive to innovate. Continued regulatory protection of state-owned enterprises (SOEs) means the private sector is simply not allowed to succeed in the two dozen industries that SOEs dominate, which also reduces the incentive to innovate.²² In innovation, as in capital, labor, and land, China must have profound reforms or it will stall.

Reform to the Rescue?

State intervention into the economy brought China to this point. More state action, such as interest rates cuts or yet more infrastructure spending, will not reverse it. Reversal requires a resumption of market reform. The Party claims to have recognized this under current General Secretary Xi Jinping. Its November 2013 plenary meetings promised to give the market “a decisive role.” Current premier Li Keqiang, far from claiming the economy has solid prospects, has repeatedly said needed reform will be as painful as cutting one’s own flesh.²³

This is certainly better than the burst in public investment that inaugurated the Hu Jintao government. And a reforming, thriving China can still be achieved. But strong words are hardly enough. Neither the reforms implemented to date nor those promised will reverse stagnation. In fact, the reform re-start praised by many was fundamentally flawed from the outset.²⁴

Greater labor mobility could mitigate aging’s blow to growth by letting the right workers move freely to the right jobs. China still discourages labor mobility by denying education, pension and other benefits to those living and working in the ‘incorrect’ place. Pledged changes to this system retain many barriers between rural and urban areas until 2020 and keep the most popular urban centers cordoned off to those born elsewhere.²⁵ This may be due to continued fear of labor migration breeding social instability. If so, the Party will restrict labor markets indefinitely despite China aging.

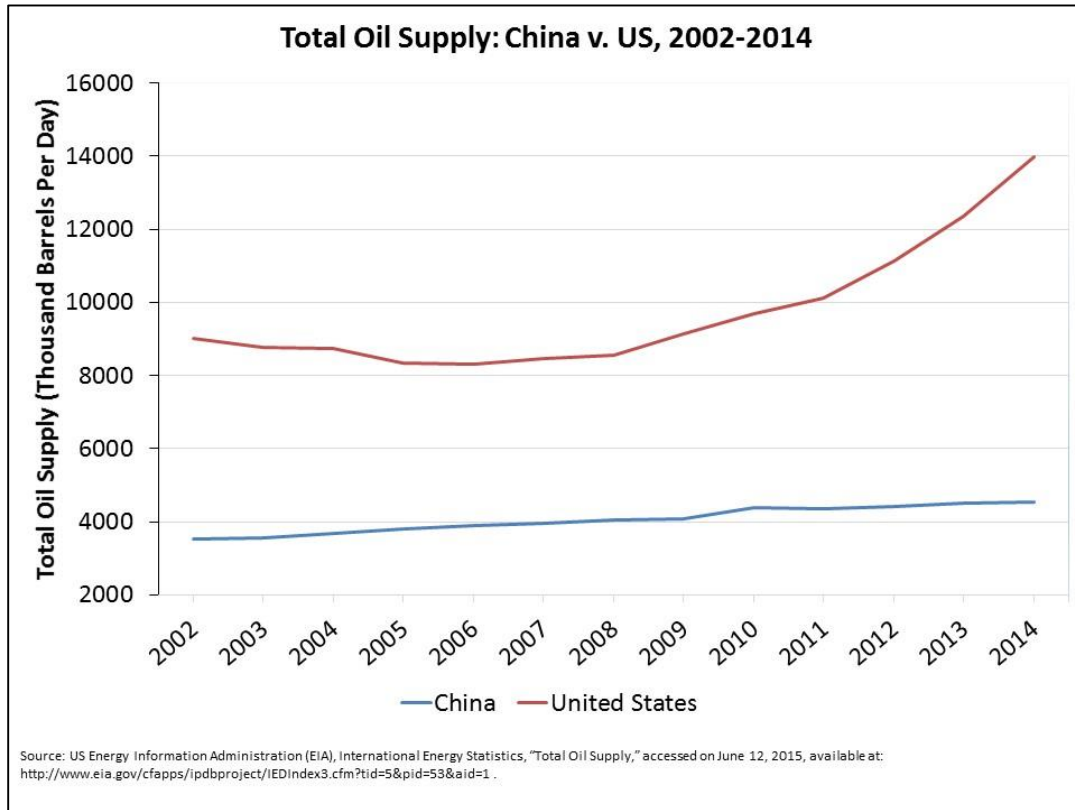
²¹ Regina M. Abrami, William C. Kirby, and F. Warren McFarlan, “Why China Can’t Innovate,” *Harvard Business Review*, March 2014, <https://hbr.org/2014/03/why-china-cant-innovate>.

²² Kristijan Lucic, “ZTE Decided To Sue Huawei Due to The Alleged Camera Tech Infringement,” *Android Headlines*, April 22, 2015, <http://www.androidheadlines.com/2015/04/zte-decided-sue-huawei-due-alleged-camera-tech-infringement.html>; Derek M. Scissors, “Making the new normal meaningful,” *China Policy Review*, March 2015, <https://www.aei.org/wp-content/uploads/2015/02/Making-the-new-normal-meaningful.pdf>

²³ Jason Subler and Kevin Yao, “China vows ‘decisive’ role for markets, results by 2020,” *Reuters*, November 12, 2013, <http://www.reuters.com/article/2013/11/12/us-china-reform-idUSBRE9AA0YB20131112>; Emma Rowley, “China’s new premier Li Keqiang ‘to cut state control over economy’,” *The Telegraph*, March 17, 2013, <http://www.telegraph.co.uk/finance/china-business/9936059/Chinas-new-premier-Li-Keqiang-to-cut-state-control-over-economy.html>

²⁴ Derek Scissors, *China’s economic reform plan will probably fail*, (Washington: AEI, 2014), https://www.aei.org/wp-content/uploads/2014/02/-chinas-economic-reform_130747310260.pdf

²⁵ Jingxi Mo, “China introduces guidelines for household registration reform,” *The State Council of the People’s Republic of China*, July 30, 2014, http://english.gov.cn/news/news_release/2014/08/23/content_281474983030658.htm; Richard Silk, “China’s hukou reform plan starts to take shape,” *The Wall Street Journal*, August 4, 2014, <http://blogs.wsj.com/chinarealttime/2014/08/04/chinas-hukou-reform-plan-starts-to-take-shape/>.



Reform could sharply increase the value of China's natural resources, along the same lines as in the U.S. China has the shale to vitalize its energy industry and curb import dependence. But this would require mimicking the American model at least in part, involving private ownership of rural land, an end to the state's energy monopoly, and legal protection of innovators.²⁶ The reform platform and actions to date show no progress in any of these areas. It is true that outright environmental damage is being reduced but this translates to less harm to future growth, rather than a boost.

There has been some market reform in finance. The most important element is the issuing of bank licenses to private companies. While interest rate liberalization wins headlines, it has little value when so much of the financial system still must follow the Party's orders.²⁷ What is needed is the truly commercial, not political, lending that can only come from independent institutions. The licenses could bolster the return on capital, and thus growth.

²⁶ U.S. Energy Information Administration, *Technically recoverable shale oil and shale gas resources: An assessment of 137 shale formations in 41 countries outside the United States*, (Washington DC: US EIA, 2013), <http://www.eia.gov/analysis/studies/worldshalegas/> and Dan Blumenthal *et al*, *Too much energy? Asia at 2030*, (Washington, DC: AEI, 2015), <https://www.aei.org/publication/much-energy-asia-2030/>

²⁷ "China readies for private banks," *China Daily*, March 11, 2014, http://www.chinadaily.com.cn/china/2014npcandcpc/2014-03/11/content_17340179.htm; "China tells banks to step up lending to lift flagging growth," CNBC, December 11, 2014, <http://www.cnbc.com/id/102262475>.

Nonetheless, by themselves they are completely inadequate. It could take decades for private banks to substantially erode the state's 90 percent share of banking assets; all the while, unsound lending will be creating a colossal amount of debt. Much more radical action is necessary. One possibility is allowing money to leave the country freely, which would pressure financial institutions to be more responsible or lose assets.²⁸ For this to greatly improve financial efficiency, however, liberalization must be total. Fearing rapid and heavy capital outflow, the Party has to now always opted for only partial liberalization.

The state sector is the clearest area of reform failure. The Party's pledges here go in precisely the wrong direction. Rather than shrinking the state sector to make room for private competition, they call for private investment in SOEs and state-led projects. This is essentially an attempt at a private bailout of the public sector's mistakes. Further, rather than being allowed to fail or be sold off, SOEs are being merged with each other to get even bigger.²⁹ There is no sign of the market being given a decisive role in the corporate sector, quite the opposite.

This error affects innovation. Beijing sees super-large SOEs as offering advantages in competition overseas.³⁰ But faced with no competition at home, these firms have no reason to innovate. Chinese consumers will therefore continue to be discouraged by inferior products and prices and the state giants will progressively lose ground overseas, no matter their size. Only private Chinese firms, forced to compete both at home and overseas, will succeed fully. If reform does not include a smaller state sector, innovation will be stunted.

20 State-led Industries

Autos	Armaments
Aviation	Banking
Coal	Construction
Environmental technology	Insurance
Machinery	Media
Natural gas	Non-ferrous metals
Oil	Petrochemicals
Power	Railways
Shipping	Steel
Telecom	Tobacco

²⁸ "China to push on with capital account opening: central bank deputy chief," *Reuters*, November 3, 2014, <http://www.reuters.com/article/2014/11/03/us-china-economy-capital-account-idUSKBN0IN09R20141103>

²⁹ "China encourages private capital," *Xinhua*, November 15, 2013, http://news.xinhuanet.com/english/china/2013-11/15/c_132891965.htm; "China's Huafu Group swallowed by COFCO Corp.," *Xinhua*, November 26, 2013, http://news.xinhuanet.com/english/china/2014-11/26/c_133816435.htm.

³⁰ Michael Lelyveld, "China mulls major industry mergers," *Radio Free Asia*, April 11, 2015, http://www.rfa.org/english/commentaries/energy_watch/mergers-05112015101557.html.

Brief Implications

China began to wander off the market path in 2003 and has not yet returned. Unless it does, growth will halt by the end of this decade, regardless of what the government claims. This has many economic and political implications. While stagnation is far from certain, it is likely enough that the U.S. should be preparing.

An indispensable, if perhaps boring, step is to avoid making the same mistake made with the Soviet Union, whose decline was missed until very late. The U.S. needs a concerted effort to compile statistics on the Chinese economy that are as independent as possible of those published under the Party's auspices. This will help explain Chinese behavior that will otherwise seem mysterious or, worse, surprising.

A stalled China will be more a lost opportunity than a dangerous development for the U.S. economically. American financial exposure is comparatively minor. China's trade role as a gigantic but low-margin manufacturer is a luxury, rather than a necessity; other countries played this role before and can again. The enormous opportunities many hoped for as China grew wealthy will not materialize but the country will still be very large and have nearly bottomless needs for elderly care and environmental technology, among other things. American companies will see fortunes shift, but government action is unnecessary.

An interesting twist is that stagnation could induce heavier Chinese investment in the U.S. than if the country was thriving. Lack of opportunities at home could push Chinese firms and individuals to seek greener pastures elsewhere, forcing American policy-makers to decide how much Chinese investment is wanted and in what fields.³¹

Some American friends and allies will suffer more from Chinese economic weakness; indeed, energy and metals exporters around the world already have. The obvious policy response is for the U.S. to try to build its trade and investment ties with countries such as Australia and Brazil, as well as large parts of sub-Saharan Africa.

In strategic terms, a stagnant China does not guarantee American global leadership. Instead, it guarantees that either the U.S. provides global leadership or there is none. The dollar provides the most prominent example. A China that does not fully liberalize capital movement is more likely to stall. The RMB will then fall well short of challenging the dollar and the dollar's future as the world's reserve currency will remain almost entirely in American hands. This implication applies broadly.

³¹ Derek Scissors, *China's outward investment healthy, puzzling* (Washington, DC: AEI, 2015), <https://www.aei.org/publication/chinas-outward-investment-healthy-puzzling/>