

15 IS THE CHINESE ECONOMY HEADED TOWARD A HARD LANDING?

Dwight H. Perkins

IT IS NOW widely accepted that China's three decades of high-speed, catch-up growth has ended. Catch-up growth ends in all countries long before they reach the income levels of the most advanced economies, and China has been no exception. The migration of surplus labor from low productivity jobs in the countryside to higher productivity jobs in urban areas has largely ended, except for the children of migrants who were left behind with their grandparents. The rapid expansion of China's exports has also come to an end, partly because of the world recession, but mostly because China has saturated the markets for goods dependent on cheap labor—which in fact are no longer cheap. China's future growth will depend increasingly on its own ability to innovate and compete internationally in sectors such as automobiles, where others have a long head start.

Over the past year or two, this economic slowdown has stoked fears that China could be headed toward a "hard landing." That term is seldom defined but, if it means anything, it presumably refers to a fear that China is heading for a recession for several quarters or longer. These fears seem to multiply every time something unexpected happens in the economy—for example, a small percentage-point drop in the *renminbi* exchange rate, or the collapse of a large stock market

bubble, to mention recent events. In and of themselves, these events had little impact on China's overall economic performance, but there was concern that they signaled the beginning of what could become a much wider crisis. Fears of a crisis usually begin from the rapid and unsustainable buildup of debt, particularly corporate debt, or the expansion of the largely unregulated shadow financial markets, such as moneylenders who operate outside the regular banking system.

The unsustainable debt expansion and the problems of the shadow financial markets are real enough, but the possibility of these leading to a financial collapse and a major recession is not very realistic. The real danger facing the Chinese economy lies elsewhere and is caused by current trends in Chinese policy that involve much more than just the financial sector.

The reason a financial collapse is not likely to result in a sharp recession starts from the fact that almost all of China's debt is owed to other entities in China, notably but not exclusively the large state-owned banks. These banks, among others, have begun to experience a rise in bad loans (called non-performing loans), and it is widely believed that their share of total bank assets could rise further by a large amount. Formally, many of these banks could become bankrupt if the non-performing loans exceed their total capital, which is possible and perhaps likely. But China in the 1990s had an even worse situation with non-performing loans, which officially equaled a quarter of total state bank assets (and unofficially may have reached 40 percent). The government formed asset management companies to take over all bank non-performing assets, followed by a government refinancing of the banks.

More recently, the government has reduced the non-performing assets by trading bank debt for equities. In essence, these and other methods involve the government restoring banks to economic health by printing and distributing money. It has done this in the past, and

it is unthinkable that it will not do it in the future, given that a financial collapse or a sharp recession would have major implications for political stability. Printing money could lead to unwanted inflation but, in the context of a threatened recession without a bail-out, that does not seem likely.

The one way a financial crisis in China could lead to an unveritable recession is if much of the debt were owed internationally and denominated in foreign currencies. Even this would not be much of a threat if China's foreign-exchange reserves stayed near the \$4 trillion level of the recent past. However, a decline of Chinese reserves of more than \$700 billion during the past year suggests that China might not always have such a robust foreign-exchange total. In all likelihood, that particular decline mainly involved corporations and others that had for a long time held large *renminbi* reserves in hopes that the Chinese currency would continue to rise in value. With the partial liberalization of China's international capital flows, it appears that the currency is now more likely to fall (devalue) than rise (revalue), and it no longer makes sense to hold large *renminbi* reserves. But in the future, China could experience a currency run for other reasons that, in turn, would reduce its reserves to dangerously low levels, causing a sharp devaluation. If at the same time China had accumulated a large foreign debt denominated in foreign currencies, there could be widespread bankruptcies that the Chinese government could do little about. That happened in Thailand, Indonesia, Malaysia, and Korea in the 1997–1998 financial crisis. China today, however, is far from any such danger. Its reserves remain large, and its foreign debt is small.

The real danger for China is not a hard landing but a significant slowdown in growth to well below the 6.5 percent rate projected in the 13th Five-Year Plan covering the years 2016–2020. Poor lending policies and more bad bank loans could cause such a slowdown, but

the major threat is only indirectly related to the financial sector. China's major structural problem is that its investment rate, as a share of gross domestic product (GDP), is much too high. Total investment peaked in 2011 at 47.3 percent of GDP, but it was still at 44.1 percent in 2015. There are no readily available statistics on how much investment is required to produce all of the goods that China consumes and exports (and to produce the machinery to make those goods), but it is not likely to be much over half of what China actually invests each year. In order to maintain full employment of its resources, China must find additional investments amounting to roughly 20 percent of GDP.

Until the last year or two, China had little problem finding productive investments to fill this gap in aggregate demand. The Soviet-style investment policies of the pre-1978 period had largely ignored investment in both housing and transport. The result was that urban housing in China was wholly inadequate (only 7.2 square meters—about seventy-two square feet—per capita in 1978), and the transport system was straining to handle the comparatively modest traffic volumes of the early 1980s. In the late 1990s, and particularly since 2000, the Chinese government and the private sector began a massive investment drive to overcome this neglect. This investment drive was further reinforced by China's use of large government-stimulus measures to avoid being dragged down by the world recession of 2007–2009.

These massive investments transformed the Chinese transport system. High-speed limited-access highways did not exist prior to 1988, but there were 16,000 kilometers (slightly less than 10,000 miles) of these highways by the year 2000 and 123,500 kilometers (77,200 miles) in 2015, longer than the interstate system of the United States. Passenger cars rose from 1.6 million in 1990 to 141.3 million in 2015 (127.6 million privately owned). Most of the two-lane roads that reach

into many remote towns and villages are now paved all-weather roads. Every large city, including all provincial capitals, has a large modern airport, and the number of commercial aircraft has reached over 1,900. The high-speed rail system is also now the longest in the world, crisscrossing the country. No doubt some portions of the transport system still could be improved, but the country's major needs have been met at first-world standards, and the major expenses ahead will be for maintenance rather than new highways or airports.

The housing experience has been similar. Investment in housing already was large before 2010, but between 2010 and 2014, China built 6.78 billion square meters of housing space, or enough for sixty-seven million three-person families, each in apartments of one hundred square meters. By 2010, there were 31.6 square meters per capita, and that figure rose over the next several years. Demand could not sustain this level of building and inventories rose, particularly in second- and third-tier cities. China might be able to continue adding one-billion square meters of residences a year if a major effort were made to house cities' rural migrants, but the 1.36 billion square meter pace of 2010–2014 was not sustainable. Prices in all but the largest cities fell.

Compounding the problems created by this enormous transport and building construction boom was that key supplier industries kept expanding capacity, apparently on the assumption that the boom would go on indefinitely. China, by 2014 and 2015, had the capacity to produce over half of the world's steel and cement, far more than domestic demand needed. Steel producers tried to solve the problem by rapidly increasing exports, leading to worldwide anti-dumping actions to curtail them and keep North American and European steel mills operating. There was also excess capacity in sectors such as ship building, in both private and state-owned enterprises.

Table 15.1 Supply Side Sources of Growth in China

Period	GDP	Fixed Capital			Growth Rate (%)	
		Raw Labor	Enhanced Labor	Education	TFP	
1953–1957	6.5	1.9	1.2	1.7	4.7	
1958–1978	3.9	6.7	2	2.7	–0.5	
1978–2005	9.5	9.6	1.9	2.7	3.8	
2006–2011	11	15.1	0.4	2.1	3.3	
2012–2015	7.4	11.9	0.4	2.1	1.1	
1953–2005	7	7.7	1.9	2.6	2.1	

Sources: This table was used by the author in a meeting of the Chinese Economists Society in Shenzhen in June 2016. The estimates through 2005 are from Dwight H. Perkins and Thomas G. Rawski, "Forecasting China's Economic Growth to 2025," in Loren Brandt and Thomas G. Rawski, *China's Great Economic Transformation* (Cambridge: Cambridge University Press, 2008), pp. 829–886. The 2006–2011 educated labor figures were compiled by Dr. Zhang Qiong using the same methodology as the earlier figures, and the capital stock and total factor productivity estimates for 2006–2015 were completed by the author of this chapter using the same methodology.

These investments were profitable for many years, and the argument was sometimes made that the construction boom was not becoming a dangerous bubble. But, as Chinese researchers have reported, the extraordinary investment rates from 2010 caused profits, or the national rate of return on capital, to fall from over 10 percent to 6.6 percent by 2012 and likely has fallen further since. Of equal importance, the overall rate of productivity growth (total factor productivity or TFP) fell sharply in 2012–2015 (see Table 15.1). A decade ago, it appeared that China would need total factor productivity growth of at least 3 percent per year, if the country were to sustain an annual economic growth rate of 6 percent after 2015, and that a higher rate was probably not attainable because it would require an unlikely total factor productivity growth of well over 4 or 5 percent. As it turned out, China achieved only a 1 percent growth rate in

total factor productivity from 2012 to 2015, though its impact was somewhat offset by large increases of capital investment.

There are future investments the government could make use fully, notably to clean up the environment. These could keep up the productivity rate provided progress was measured in a way that reflected environmental improvements. China could also shift from relying on high investment rates to lower rates combined with increased household consumption as a share of the total economy. Shifting to a more consumption-based economy, however, is extremely difficult, and China has had only limited success in this regard, despite considerable effort.

Finally, a higher rate of total factor productivity could be achieved if China vigorously implemented the long list of reforms announced after the Third Plenum of the Communist Party Congress in 2013. Many reforms it announced are likely to increase productivity significantly, provided they are vigorously implemented. To date, however, despite action in such areas as the financial sector, progress overall has been slow. Furthermore, arguably the most important announced reform was to force state-owned enterprises to face full market competition. There was even some speculation that some big corporations would be cut loose to succeed or fail on their own. The evidence so far, however, is that these enterprises now play an even larger role than in the past, both at home and abroad, and will continue to enjoy strong backing from the central government that controls them. This continued reliance on state enterprises, combined with slow market-oriented reform for the rest of the economy and a continuing high rate of investment, could sustain a national 6 percent growth for a time. But it is also possible that total factor productivity and the rate of return to capital will continue to fall, and the GDP growth rate will fall with them.

16 WILL URBANIZATION SAVE

THE CHINESE ECONOMY OR DESTROY IT?

Meg Rithmire

IN 2011, for the first time ever, more than half of China's population of 1.35 billion people lived in cities. On the one hand, observers are touting the emergence of a new, urban middle class in China, causing global business to look to Chinese urbanites as a source of demand and consumption. On the other hand, many point to over-investment in infrastructure, rapidly rising real estate prices in top-tier cities (think Shanghai and Beijing), and falling prices elsewhere, plus the existence of "ghost cities" as evidence that urban China is not the engine of global growth but, rather, a bubble readying to burst.

At the heart of these differing visions of the future of urban China is a fundamental economic contradiction: China over-invests in urban areas, yet China is also under-urbanized relative to other countries at its level of development and industrialization. Although now half of all Chinese live in urban areas, 200 million of these urbanites, or 17 percent of the urban population, are formally registered as rural residents and therefore lack access to urban public- and social-welfare services. Outside of urban areas, a staggering 300 million rural residents are underemployed in the agriculture sector, working around 150 days per year, yet unable to relocate to urban areas. This contradiction is a product of unique political economic institutions that