Nurturing the Chinese Economy

by Joe Studwell

THE LIFE OF a contemporary China-watcher may be measured in "prognosis phases." These last about five years and come in only two flavors: ebullient and cataclysmic. In my brief involvement with China, I have so far experienced three prognosis phases: "China Takes Over the World I (1992-1997)", "Oh My God, It's a Disaster I (1998-2002)" and "China Takes Over the World II (2003-2008)." There are now strong indications that we are entering "Oh My God, It's a Disaster II (2009-?)."

The worriers are agonizing over three inter-related fronts. The first is that China is experien- cing the beginnings of an "asset bubble," involving uncontrolled speculation in property and stocks. The culprit here is loose monetary policy and the vast fiscal stimulus program being pursued by the Chinese government to maintain brisk growth in the midst of a worldwide financial crisis. A reinstated currency peg to the U.S. dollar, the argument runs, exacerbates the asset-bubble risk because it links China, inappropriately, to U.S. monetary policy and very low interest rates.

Robert Zoellick, the World Bank president, has flagged the risk of asset bubbles in China and Asia because other countries are following similar monetary policies. The region's best-known horror story in this respect is Japan between 1985-87, when the increase in property and stock values was 25 times the increase in wages and salaries. At the time, Japan had nine out of 10 of the world's biggest banks by assets and, in 1988, the Tokyo stock market became 50% bigger by capitalization than New York's.

Today, Chinese real-estate prices are rising quickly and China's A-share stock-market capitalization overtook Tokyo to become second in the world to New York in July. The country's Big Four banks are presently in the top 25 in the world by assets (a comparison with the 1980s is not really fair, because today's global banking system is much more consolidated.)

The second area of concern is nonperforming loans in the Chinese banking system. Jonathan Anderson wrote in the

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November 2009 issue of the REVIEW that the pace of bank lending in China in the past year has been "crazed," implying that loan quality cannot be good. In the first 10 months of 2009, Chinese banks extended a record 8.9 trillion yuan ($1.3 trillion) in loans, up by 5.3 trillion yuan ($776 billion) from the same period a year earlier. This came as the Chinese government quietly began rolling over—in a move that went almost unremarked—the 10-year bonds that it issued in 1999 in order to write off the vast amount of NPLs generated prior to that date.

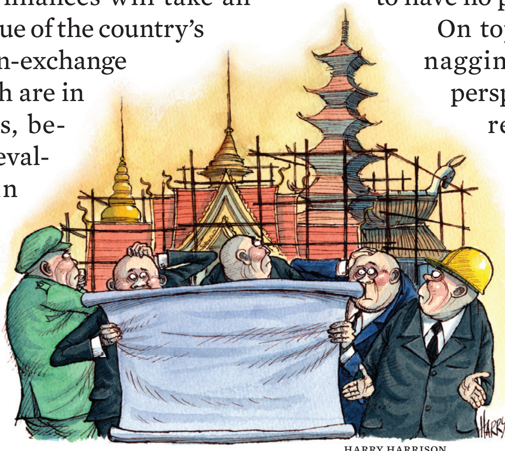
Third, there are accentuated worries about the exchange rate. These come in two conflicting versions. The first says that by repegging to a falling American dollar, Beijing is guaranteeing an asset bubble through dangerously loose monetary policy. The second view concentrates on the perceived impossibility of sustaining a grossly undervalued currency and says that China will be forced to revalue upwards—witness rising pressure from special import tariffs being instituted in the United States and the European Union. This view holds that it will be the "wealth effect" of a revalued currency (Chinese people being richer in global terms) that will lead to an asset bubble.

A corollary of this school of thought is that China's public finances will take an enormous hit by virtue of the country's $2.5 trillion in foreign-exchange assets, most of which are in U.S. dollar holdings, because these will be revalued downwards in yuan terms. This would constitute a kind of giant back-tax payment for years of "currency manipulation."

The most striking point here is that it is unlikely that both arguments about the yuan are correct. There is another Japan analogy: the debate about whether it was loose monetary policy in the late 1980s or the fact that the yen more than doubled in value against the dollar from 1985-88 that was responsible for that country's bubble. (All indications show that the current Chinese government goes for the yen doubling explanation.)

Clearly, worries abound. Ten years ago, I would have signed up to "Oh My God, It's a Disaster II" and marshaled the same macro data that everyone else is playing with to try to prove the point. But since I am already in my fourth prognosis phase, and may have another six to go before retirement, I wonder if this game is worth the candle.

The macro data we employ are incredibly fungible. On the one hand, what is the real quality of the GDP growth being recorded in China? To what extent does it reflect an economy that is genuinely developing? On the other, the share of Chinese bank debt that turns bad depends on a host of imponderables, not least ones in the wider world economy. And the real degree of yuan undervaluation? Exchange rates constitute the least understood subject in macroeconomics (as reflected in the fact that academic studies show exchange-rate futures to have no predictive value).


HARRY HARRISON

On top of all this, there is a nagging sense of historical perspective that comes with reflection on development experiences elsewhere in the East Asian region. Perhaps the most potent example, South Korea, broke all the macroeconomic rules: massive foreign debt, serial domestic banking

crises, high inflation. And yet it is one of the world's few true developmental success stories, with current GDP per capita around $20,000 (six times that of China's).

The lesson is that we need a more comparative, more historical and more institutional approach to judging the present condition of the Chinese economy. One way to begin is by reflecting on the realities of post-World War II developmental success stories.

A 2008 World Bank study led by economics Nobel laureate Michael Spence shows that since 1950, 13 economies managed to grow at 7% or faster for at least 25 years. However, once one strips out three offshore financial centers and ports that are not fair points of comparison (Hong Kong, Singapore, Malta), an oil field and an enormous diamond mine with small populations (Oman, Botswana), there are really only eight case studies of interest. Of these, four economies grew and then stalled: Indonesia, Thailand, Malaysia and, earlier, Brazil. One is a huge, fast-growing, lower middle-income state where everyone is just now trying to decide whether it will keep growing or stall: China. And the last three economies define the true gold standard of development: Japan, Korea and Taiwan.

The problem in China is that public-sector banks are largely funding public-sector corporations.

These three provide a benchmark against which the current condition of the Chinese economy can be assessed. The key is to make an institutional comparison of what repeatedly prove to be the three critical areas of policy in developing economies: land, finance and industry.

In terms of land policy, there is a big dotted line to be drawn in Asia which separates Japan, Korea, Taiwan and China from the rest of the region. In the first three locations, almost all agricultural land was subdivided under American supervision into household plots in the wake of World War II. The same thing occurred in China as a result of a murderous campaign against landlords by the Communist Party after 1949 and then a transition to household farming in the late 1970s. South and Southeast Asia, by contrast, are a story of patchy and largely ineffectual land reform attempts which have meant that the region is home to tens of millions of landless and capital-less peasants. Simply put, there exists an Asia where everybody has a shot at development and an Asia where many people do not.

Since the mid-1990s, China has looked like the poor relative of the land reform club. Unlike Japan, Korea and Taiwan, which maintained a strong political commitment to relative income equality between rural and urban dwellers, China has shown itself willing to accept far higher levels of rural-urban income inequality. This trend was reinforced in 2001 when China repealed much of the tariff protection it afforded farmers as part of its accession to the World Trade Organization. Chinese communists, brought to power by a rural revolution, have moved to the cities and no longer care about peasants. Judged by the Japan-Korea-Taiwan yardstick and a substantial amount of academic research, their newfound tolerance for relative rural poverty will be bad for development.

As the world turns more bearish on China, however, there are clear signs of a political change of heart. Hu Jintao, the Chinese president, is driving a series of policies and experiments which would give farmers actual ownership of their land (previously all land belonged to the state, with peasants granted farming rights.)

Farmers can then mortgage their land or sell it and use the capital elsewhere. The experiment is enormously risky, which is why China has not tried it before.

When land reform goes wrong—as, for instance, in large parts of the Philippines since the end of the Marcos era—farmers either blow their capital or are swindled and end up as landless wage laborers. This could happen on a large scale in China, but the timing of the reform—after 30 years of farmers working and learning the value of their land—is more propitious than with the shotgun reforms attempted on some of the latifundia and plantations of Southeast Asia. In addition to land privatization, the Chinese government began the first phase of instituting rural pension coverage on Oct. 1, 2009. This affected one in ten Chinese counties.

For the first time in a while, a trip to the Chinese countryside can be a source of optimism. With the majority of the Chinese population still living in rural areas, it is worth reflecting on just how significant this fact is. Land distribution in Asia has been a critical determinant of developmental outcomes because, done right, it leads to the best kind of growth—the bottom-up kind. For all its problems, China today is on the right side of the historical divide in land distribution.

In the financial realm, China's big policy choices have also been the right ones. The country switched from a grossly overvalued exchange rate in the late 1970s to an undervalued one today, and has maintained its capital controls. The Spence report cited above points to an historic truth that one rarely hears repeated: "None of the sustained, high-growth cases that we know about were particularly quick to open their capital accounts." The report could have gone further. Among its 13 case studies, it is notable that the fast growth economies which stalled—Brazil, Thailand, Malaysia, Indonesia—were ones which surrendered capital controls relatively early in their development compared with the success stories.

China has resisted, and is resisting, calls to dismantle its capital controls. This is entirely sensible and a reason to believe that the economy can continue to grow quickly. The problem with the financial sector in China is not that the capital account is protected, but that the country is the first fast-growth economy in Asia to pair a state-owned banking system with a state-dominated industrial structure. The risk is that this wastes capital.

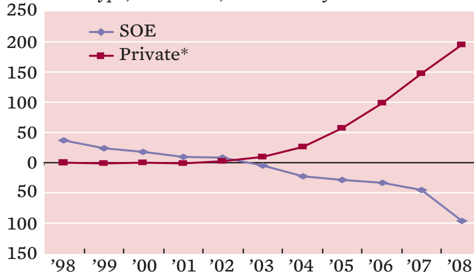
Taiwan kept most of its banks as publicly owned entities during its rise to prosperity. Korea bounced its banking sector back and forth between public and private ownership. What mattered in both cases was that the Taiwanese and Korean governments avoided the "capture" of banks by narrow corporate interests. The opposite happened in Southeast Asia, where banks were privately held. In Indonesia and Thailand, and to a lesser extent in Malaysia, leading businesses were able to operate in-house financial institutions which they plundered. This process led to taxpayer rescues and contributed heavily to the stalling of development in those countries.

There is nothing wrong with China's determination to avoid bank capture, though broad-based private-sector ownership can achieve this just as well as public ownership. The problem in China is that public-sector banks are largely funding public-sector corporations, in what constitutes a rather cozy arrangement. When the state ran the banks in Taiwan and Korea, most of the money went to private firms subject to real commercial discipline.

This is not the case in China. If anything, the situation is becoming more risky. The term *guojin mintui*—meaning that the state advances while the private sector retreats—is the latest fashionable Chinese expression to describe the in-

INVERTED RELATIONSHIPS

Trade balance of Chinese firms by enterprise ownership type, 1998-2008, in billions of dollars



*PRIVATE IS SHOWN IN CHINESE DATA AS THE RESIDUAL AFTER ALL STATE-OWNED, COLLECTIVE AND FOREIGN-INVESTED FIRMS HAVE BEEN SUBTRACTED

SOURCE: CHINA GENERAL ADMINISTRATION OF CUSTOMS

creasing dominance of state industrial interests in recent years.

There is no theoretical reason why state-owned banks funding large, state-owned corporations cannot be the basis for developmental success. The rise of the French industrial economy after World War II is the obvious historical example. But few people would argue that the bureaucratic capacity of China—which claims to be centralized but in fact is widely diffused—measures up to that of France, western Europe's most centralized state with a long tradition of national economic management. For China, the risks of state banks funding state corporations are considerable.

The risk can be ameliorated via a third, vital area of policy choice: industrial strategy. Here, academics argue interminably whether—with respect to Japan, Korea and Taiwan—it was the market or the plan that made the difference. The answer, when we consider the stalled fast-growth economies of Southeast Asia, is that it was a combination of the two. In the three case studies, government heaped bureaucratic and financial largesse on chosen firms, but then made them prove their worth by selling their output in export markets. It was this "export discipline" that linked industrial planning to the free market. In Southeast Asia, by contrast, governments indulged entrepreneurs who ran power stations, mobile telephone systems, toll roads, and other domestic services. Manufacturing exports were left to foreign multinational companies.

China's choice appears to be to back state manufacturers, but not to subject them to consistent export discipline. The graph shows this in aggregate terms. China's (favored) state enterprises are net importers, and rapidly becoming bigger net importers. Net exports are generated by (unfavored) private domestic firms and by foreign firms.

To understand this at a micro level, consider the manufacture of wind turbines for electricity generation. In the span of a few years, the sector has become dominated by a handful of state-owned firms, much to the chagrin of their international competitors. These companies are generously financed by state banks and have already built considerable manufacturing overcapacity. The wind-turbine makers show little interest in exporting their surplus production. In order to do so, they would have to upgrade their products to achieve international quality certification (a prerequisite for the international project financing that would pay for their turbines). In China they can compete for government wind-farm projects that require no certification.

Government, in short, is failing to implement export discipline for the country's most favored companies. State companies that export tend to be the ones making commodity products such as steel, rather than the ones facing greater technological competition.

Overall, the condition of the Chinese economy is not so bad in comparative institutional terms. Growth is broad-based as a result of equitable land distribution, and government is reapplying itself to issues of rural development. In general, the nation's wealth is managed by the state to developmental ends and protected by cap-

ital controls which, though increasingly porous, still work. The problems lie more in the nexus between financial and industrial policy, specifically as they relate to China's capacity to upgrade technologically. These problems are still serious enough to put China in the category of developing countries that "get stuck."

What the Chinese government needs to do first and foremost is resume upward revaluation of the yuan before trade relations with the U.S. and Europe turn nasty, something which could happen in the next year. The trade disadvantage that comes with a rising currency should be offset by Chinese banks focusing more of their attention on public- and private-sector domestic firms which can and do compete internationally.

This is the major lesson missed from Japanese, Korean and Taiwanese development: Let the international marketplace tell you who to support, not past relations or ideological prejudices about ownership. In addition to favoring firms that compete internationally, the Chinese government needs to be much more ruthless about withdrawing support—and making provincial governments withdraw support—from firms that do not.

It is a myth that Japan, Korea and Taiwan developed solely by "picking winners"; in reality, much of their success came from culling losers. In Korea from the 1950s to the 1980s, for instance, only about half the cohort of largest *chaebol* survived from one decade to the next; there was far more corporate turnover than is usually realized.

If the above sounds like an invitation for China to undertake a modest currency adjustment and then continue with interventionist trade policy, to a significant extent it is. Development is not the pure win-win experience that some economists like to pretend, and it never has been. The Spence report states this final, awful truth: "Developing countries cannot grow without the support of the advanced economies. In particular, they need access to the open global trading system. They may also need some latitude to promote their exports until their economies have matured and their competitive position has improved." In other words, developing countries need more market access in return for less market access.

Herein lies the fourth vital ingredient that characterized the development of Japan, Korea and Taiwan. Each was indulged and supported by the United States, and to a much lesser extent Europe, as it rose to prosperity. In this respect, any discussion of the Chinese economic outlook is as much a political as an economic one. China is unlikely to be a genuine development success story unless the West indulges its need for a somewhat (but less) undervalued currency and for continued capital controls.

It might be better to be more open and public about this. Such an approach would allow the developed countries to debate what they expect from China more candidly. Western nations may conclude that China's minimal progress on human rights and its improving but patchy cooperation in international political affairs and climate change is not enough. In that case, it is not illogical for the rich world to decide that it will not meet its side of the developmental bargain. But we should make no mistake: peaceful economic development does require political bargains. The notion that politics and economics can be separated is the biggest myth of all.