NOW OR NEVER FOR THE CHINESE ECONOMY

Unless China begins to return to the pro-market reform path now, economic stagnation is all but guaranteed, argues **Derek Scissors**

The economic performance of the People's Republic of China (PRC) has been deteriorating for most of the past nine years and now stands as unsustainable. Only pro-market reforms can reverse this course and pave the way for another 15 years of healthy and comparatively rapid development. While this is not the last chance for the PRC, it is the best chance to return to pro-market reform for at least a decade, after which it will be nearly impossible for China to become rich for another generation.

Behind these observations is the idea that we know quite well what makes countries wealthy. The world's wealthy countries assign clear private property rights and generally encourage competition. Although the PRC is far from wealthy, its period of pro-market reforms reinforces this idea. The 1978 foundational set of reforms granted initial property rights to farmers, allowing them to produce for other customers after satisfying obligations to the state. The post-Tiananmen return to reform primarily took the form of allowing, for the first time, a large number of select state-owned enterprises (SOEs) to fail, thus expanding the scope for competition.

The result was the greatest eradication of poverty in history and, given the size of the population, an extremely large economy. This accomplishment should not be minimised. Still, it is obviously incomplete—official statistics show disposable income below US$4,000 annually. And no later than 2008, the PRC stopped moving forward on a net basis in terms of competition and individual economic rights. For nearly a decade, the dominant economic feature has been rising debt, not productivity gains. An increasingly important development going forward will be the shrinking number of workers and more aged dependents. Between debt and aging, time is running out to return to the path of becoming wealthy.

Relevant history

For 25 years, pro-market reform was uneven by sector but persistent. Coming off the Cultural Revolution and being dirt-poor in 1977, China was admitted to the World Trade Organisation (WTO) at the end of 2001 because a WTO without China had become difficult to contemplate. 'Miracle' is overused, but it might well apply.

It is also old news. Policy errors did not begin with capital flight in 2015 or with the Global Financial Crisis (GFC) in 2008. They began in 2003, when the new government under Communist Party General Secretary Hu Jintao decided the core of the economy must remain state-owned banks lending to SOEs, so these firms could continue to serve Party interests, employing

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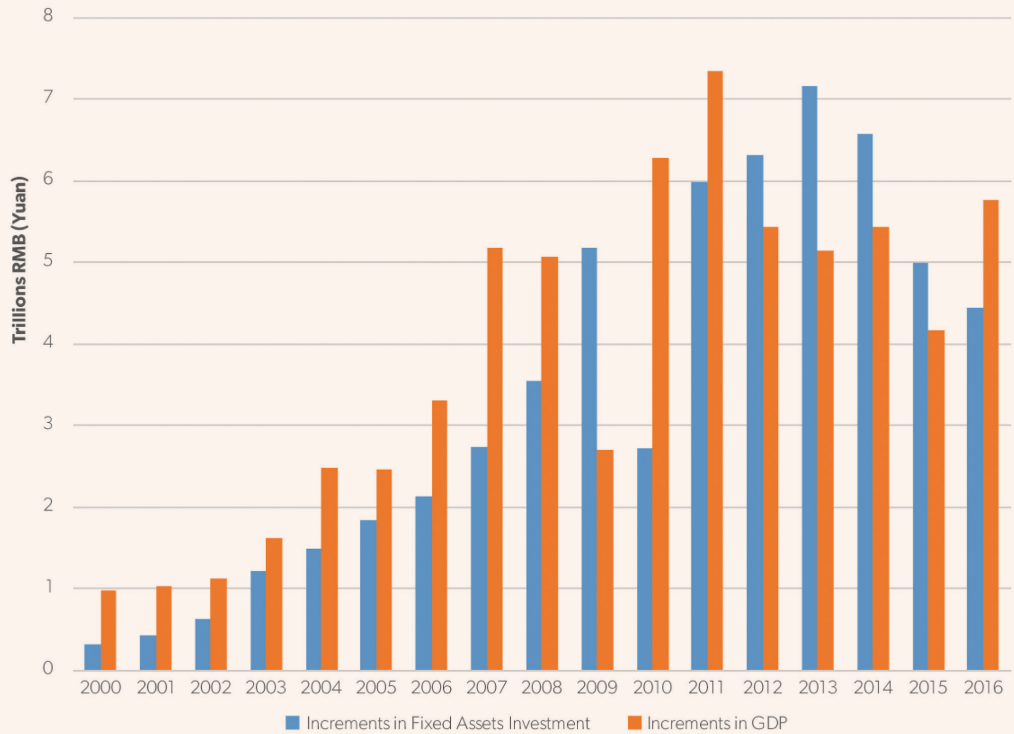
Figure 1: Increments in GDP and Fixed Asset Investment, 2000–15



Sources: National Bureau of Statistics of China, *China Statistical Yearbook*, 2001–17.

large numbers of people through rapid investment. The pace of investment in fixed assets jumped from 12% in 2001 past 26% in 2003, initially more than four-fifths by state-controlled enterprises and still overwhelmingly financed by state financial entities. This continued for a decade, with fixed investment increasing more than twice as fast as nominal gross domestic product (GDP).

It seemed to work. Chinese companies borrowed, invested, produced and exported. But developing under the glitter was not the greater productivity that previously arose from pro-market reform but increasing dependence on domestic credit and foreign consumption. The 2008 GFC therefore came as a double blow. First, foreign demand plummeted, forcing the PRC to turn elsewhere for growth. Then, Beijing responded by conducting arguably the biggest stimulus in history through bank loans.

Credit grew 32% in 2009 alone, with the economy slowing sharply, and then more was piled on. Outstanding loans quadrupled in less than nine years from RMB 28.6 trillion in the middle of 2008 to RMB 114.6 trillion by the middle of 2017. The increment is nearly twice the annualised increment to nominal GDP over the same period. And this understates the increase, since non-bank 'shadow' finance is excluded. Data on shadow finance are exceptionally unreliable, but the data show financing tools that essentially did not exist before the second half of 2007 exceeded RMB 4 trillion annually from 2009 on, adding roughly RMB 45 trillion for the period.

Already facing the quickest transition to an aging society in history, China rapidly became highly indebted. When Xi Jinping replaced Hu as Communist Party general secretary, the need for greater efficiency was urgent. In 2013, the Party offered a platform of what many said was profound reform, supposedly giving the market a 'decisive role'. The platform was flawed at the outset. The clearest example concerns competition. The 2013 manifesto went exactly the wrong way, calling for private investment to cooperate with state sector efforts rather than permitting more private competition with SOEs.

Present weakness

Discussion of the PRC's contemporary performance has always been muddled by unreliable official statistics that are least reliable when the economy is most strained, per the Party's obsession with stability. The discussion is now further muddled by cries of pending collapse from those who treat Chinese financial institutions as commercial entities that can fail due to insolvency. In fact, Chinese financials are political tools and cannot fail on commercial terms. Cutting through the confusion, China is neither thriving nor collapsing; it is stagnating.

GDP is a poor measure of economic success. An entirely debt-financed property with no tenants adds to GDP when constructed. So does tearing it down two years later. GDP has little connection to well-being: In 2016, China's official GDP per capita was 125% higher than its official disposable income per capita. The first is an accounting artifact; the second is money people can actually use. And China's conspicuously smooth GDP is a worse measure than GDP in more open societies.

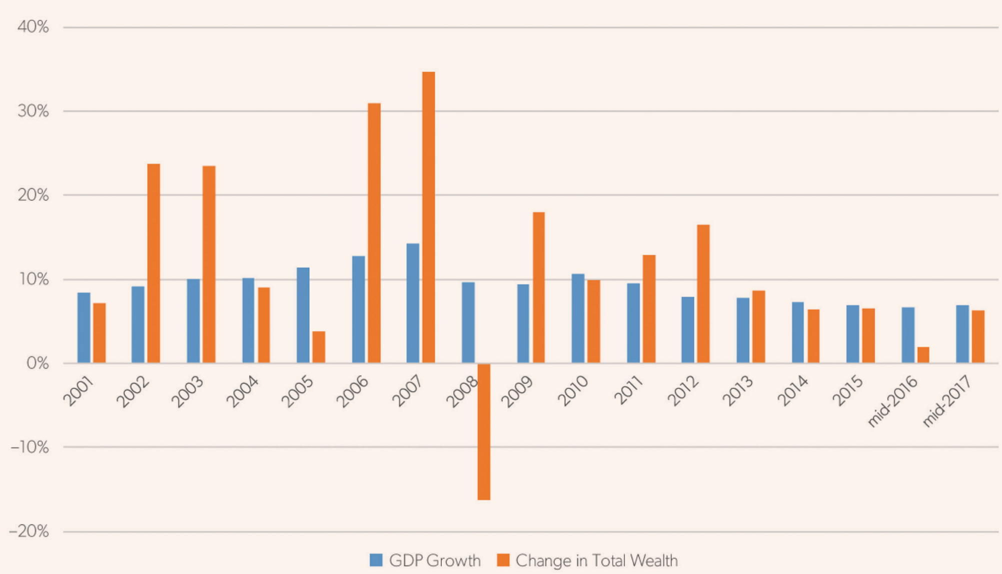
But official Chinese GDP is prominently discussed, so it is worth noting that growth has fallen from 14.2% in 2007 to 6.7% in 2016. This trajectory alone should make 2025 GDP growth of less than 4% plausible. The standard remark is the PRC is naturally slowing as it gets richer. The problem is it remains far from rich: Disposable income is roughly one-eleventh of that of the US. It is too early in the development process for China to be decelerating so sharply. This is the optimistic view.

Wealth is a better measure of prosperity than GDP, and Credit Suisse has compiled a net private wealth series that includes China since 2000. From 2000 to 2007, the PRC's net private wealth soared 225%. There was a steep drop and recovery in 2008–2010. From the end of 2010 to the middle of 2017, the gain was only 75%. The magnitude of the increase was US$10.5 trillion for 2000–07, then US$12.5 trillion on a much larger base from 2010 to the first half of 2017. Over the latter period, US net private wealth rose US$37 trillion. The Chinese economic miracle is over.

Debt. Private wealth is only part of the story. While PRC public sector assets are enormous, their performance does not appear impressive. The problem is fast-rising debt, with national debt concentrated in the corporate sector and, within the corporate sector, in SOEs. Better performance from SOEs would make the debt problem considerably more manageable, but there is no sign of that better performance or the reforms to enable it (see the next section).

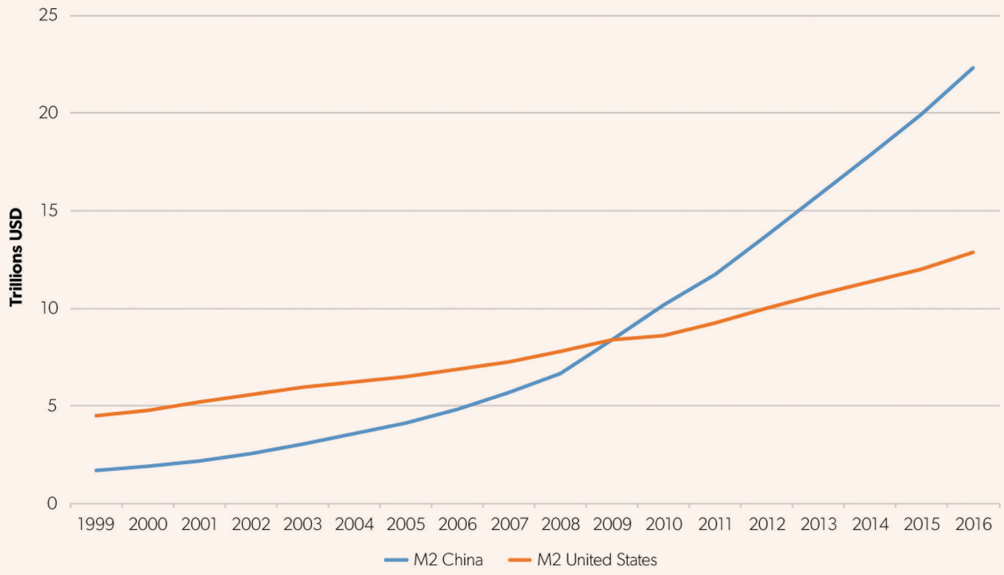
The broadest possible measurement of leveraging is money supply, and Chinese money supply has moved into the stratosphere. From mid-2007 to mid-2017, Chinese GDP rose a hefty US$8 trillion on an annualised basis. Broad money M2 rose US$19 trillion. The ratio of M2/GDP is 0.7:1 in

Figure 2: Percentage Change in China's Wealth vs. GDP



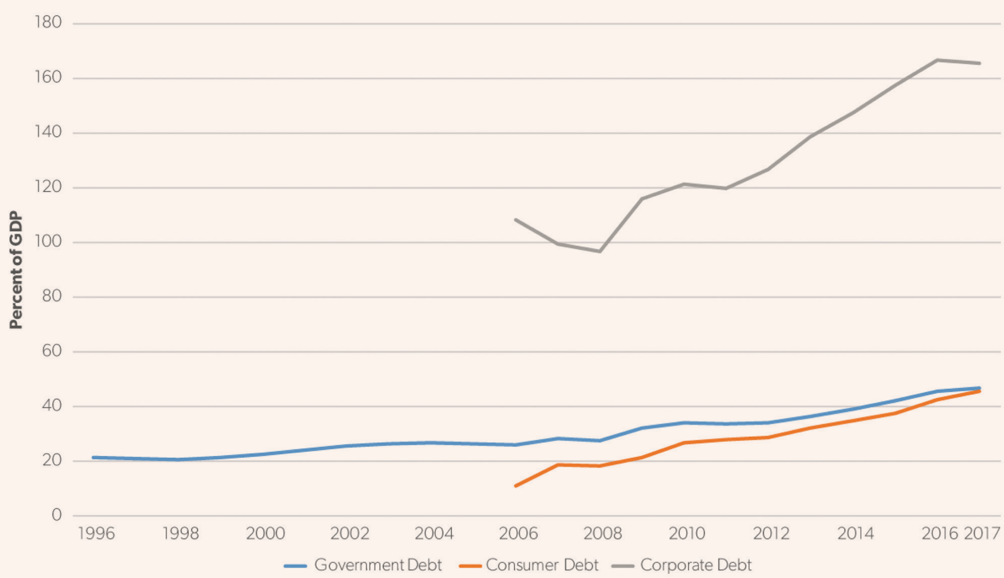
Sources: World Bank, "GDP Growth (Annual %): China," https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG? locations=CN; and Credit Suisse, *Global Wealth Databook 2016*, November 2016, http://publications.credit-suisse.com/tasks/ render/file/index.cfm?fileid=AD6F2B43-B17B-345E-E20A1A254A3E24A5.

Figure 3: China and United States M2, 1999–2016



Sources: Federal Reserve Bank of St. Louis, "M2 for China (MYAGM2CNM189N)," https://fred.stlouisfed.org/series/ MYAGM2CNM189N; and Federal Reserve Bank of St. Louis, "M2 Money Stock (M2)," https://fred.stlouisfed.org/series/M2.

Figure 4: China's Average Government, Consumer, and Corporate Debt, 1996–2017



Source: Bank for International Settlements, long series on total credit to the nonfinancial sectors, updated August 20, 2017.

the US; after the surge, it is 2.2:1 in China. Using wealth would make the ratios look far worse. Nor are China's vast savings sufficient any longer. Total credit now exceeds deposits, with the ratio of credit to deposits also rising sharply. Growth since 2009 has relied on flooding the economy with money.

Not all of it turns into debt, but the debt pattern is similar. Data from the Bank of International Settlements (BIS) indicate China saw total nonfinancial credit rise by 75 percentage points of GDP over 15 years (1997–2011). It then rose another 75 percentage points over the next five (2012–16). At 257% of GDP, the ratio is only slightly above the US ratio. However, the American figure remained essentially unchanged in the recent five years while China's rose its 75 points.

More specifically, according to the BIS, roughly two-thirds of both the historical credit/GDP ratio and the frenzied increase since 2011 is due to corporations. The corporate ratio has levelled off in the past few quarters but is already more than twice as high as US corporate leverage, putting China in uncharted and unpleasant territory for a large economy in this respect. (American consumer leverage, especially, remains higher.)

The Chinese government acknowledges SOEs account for 60% of corporate debt. (Moody's puts it closer to 70%.) It brags that the private sector generates 80% of new jobs. Thus, according to Beijing's own hype, SOE debt constitutes a spectacular misallocation of capital. If SOEs had borrowed from 2012 to 2016 at a pace fitting job creation claims, they would have been denied more than US$2 trillion in loans already, and debt projections would look far better. It bears restating that China is nowhere close to rich—it cannot afford to toss away US$450 billion annually on loans to unproductive firms. There is, understandably, much talk about overcapacity. But overcapacity is the symptom; unwillingness to curb corporate borrowing is the disease.

When a country has borrowed and spent a great deal recently, the return on yet more spending is low because good projects are harder to find. This is the main reason Chinese growth has slowed. When a country's debt is large, a good deal of capital is tied up in servicing it. This is the main reason Chinese growth will slow further. There are two other notable reasons.

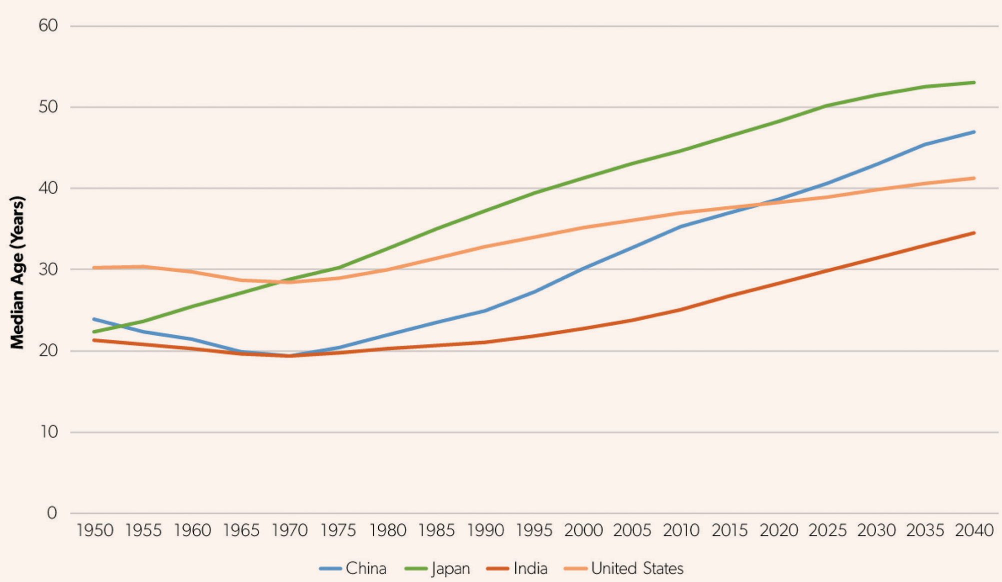
More growth constraints

First, China is tightly resource constrained. It is dependent on energy imports and, while oil prices are currently tolerable, thus subject to supply volatility over time that has been shown to be harmful for growth. The PRC is also intensely dependent on imported metals, which will likely have a similar, if smaller, effect. A third major area of import dependence is food. The latter certainly does not trace to Beijing's love of food imports but rather to water scarcity. The World Bank estimates Chinese freshwater per capita at about one-third the global average, where water availability is statistically associated with national wealth.

The second reason is well-known: China is not yet old but is aging rapidly. The ratio of older dependents to the working-age population has doubled in the past 40 years and is accelerating. The acceleration stems from an under-15 population and a birth rate that are barely half of what they were 35 years ago. For now, the PRC still has a moderately growth-positive demographic profile. But the same people that powered a generation of world-beating economic gains will not only leave the workforce; they will need support from a progressively smaller number of replacement workers.

The good news is fears of mass unemployment are a thing of the past, and the appearance of a labour shortage means wages will continue to rise. The

Figure 5: Median Age for China, Japan, India, and the US, 1950–2040



Source: UN Department of Economic and Social Affairs, Population Division, *World Population Prospects, 2017 revision*, DVD ed., 2017, https://esa.un.org/unpd/wpp/Download/Standard/Population/.

bad news is the drop of at least 3 percentage points in potential growth due to demographics alone, compared with the period of rapid demographic expansion. This fall is from a very high base, but it will only intensify.

At least as important, there are broader human capital limitations, particularly education in rural areas. These enable a sharper prediction than just declining growth: Per capita GDP growth (in an environment of shrinking population) could be capped at 3% annually for the next generation. And such calculations do not incorporate the diversion of financial capital to wasted projects and debt repayment. If the PRC does not change course, financial diversion away from productive uses will lower growth still further.

For GDP, that would put China in the American growth range, although Beijing would report nothing of the sort. Depending on how the remaining deceleration unfolds, the PRC might not ever surpass the US in GDP or might surpass and then be overtaken by the US. China would remain tens of trillions of dollars behind in aggregate wealth indefinitely. More important for Chinese prosperity, hundreds of millions of people would remain essentially poor.

While comparing an all-America price level, for instance, with an all-China price level is a herculean task, the buying power of a dollar in the US is generally lower than a dollar-equivalent in China. Even granting that, at a 2.5% annual growth rate for income, ordinary Chinese will have little additional buying power in 20 years. At the 7.5% growth rate reported in the first three quarters of 2017, a pace that is essentially impossible to maintain, the PRC in 2037 will still trail the US of today. This wildly optimistic 2037 income level for the PRC only matches 1990 for the US, although buying power may be higher than that.

Policy reforms

Debates over past performance aside, that China needs another generation of roaring success should therefore not be controversial. To get close to 7.5% disposable income growth over two decades requires income to well outpace GDP. That implies a shift to supporting individuals away from supporting firms with subsidies at the expense of individuals. Shrinking the state, as the Party chose in agriculture in 1978 and urban commerce in 1993, could accomplish this. In contrast, status quo ambivalence to private property rights and hostility to market competition will not. The policies that slowly brought China from a miracle economy in 2003 to indebted, older and still far from rich in 2017 cannot sustain growth.

In addition to pro-market reform and continued quasi-statism, a third policy path partly reverses financial excess through deleveraging. The three options contrast in how they treat land, finance, the corporate sector and innovation. It should be stressed that long-term development depends considerably on improved rural education, but that could and should be pursued under any set of policies.

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Land. Land ownership receives relatively little attention now, but limited rural land rights launched the reform era, and the right to own urban property has transformed the economy over the past 20 years. The Party is aware that rural land rights are weak but refuses to grant full ownership due to ideology and fear of instability. Instead, it has tried to finesse the issue with rights to transfer, bequest and so on. Despite rumours, there has been no preparation for full ownership, and the partial steps have yielded few results. Even with central and local governments fervently attempting to boost rural disposable income through other means, it will only reach US$2,000 this year. The 600 million rural Chinese are not middle income; they are poor.

In stark contrast, all rich countries have private ownership of rural land. It is ownership of their most valuable asset that allows rural citizens to become wealthy—China is leaving transformative gains on the table: (1) With private ownership, agricultural productivity would rise, as it always does when farmers have more rights; (2) this should free farmers for other work, easing coming labour shortages; (3) land allocation would improve as farmers only sell for competitive offers; and (4) all this means higher rural income, which would boost consumption as Beijing claims it wants. It should also reduce income equality, and education inequality could follow over time. True land reform alone would sharply change China's development trajectory, if the Party had the nerve.

Finance. With regard to finance, the PRC is so overloaded with liquidity that deleveraging is more important than pro-market reform in the short run. Without deleveraging, still more money stock sloshes around, there is more borrowing, more asset bubbles, and more financial instruments are created when old ones are curbed. But the crisis many observers expect remains highly unlikely. Arguments for a crisis assume market-based forcing mechanisms that do not exist. To put it simply, most Chinese banks are not banks; they are arms of the state. They cannot fail.

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Continuation of the status quo is therefore more an indirect than direct restraint on growth. Japan has run up seemingly impossible levels of debt in the past 25 years with no crisis, but also little growth because the return on capital is so low in the home market and because the labour contribution to growth is negative. As Chinese debt and demographic positions turn more Japanese, the PRC's growth profile will as well.

Reform alone is a risky bet to fix this problem. The PRC is permitting private actors to erode the financial role of the state but very gradually, with the private share of assets currently still trivial. Moreover, with wildly loose monetary conditions, privatising some state banking assets would likely lead to harmful behaviour by new, inexperienced private actors.

Monetary excess also constrains the value of a new opening to foreign players. At the macro level, there is no prospect of drawing enough funds to make even a small dent in the debt profile over the next few years. What needs to happen first is a draining of the system so that less money is wasted, and China can at least potentially return to high capital yields, as seen through the mid-2000s. This, in turn, would mean less need for labour contributions to growth. Leveraging has been clearly slower at points in 2017; this will need to be consistent and sustained for at least three more years (less if outright deleveraging is permitted). The ensuing step, circa 2021 or so, would be the market reform element, allowing profit-seeking entities to direct more capital.

One option is to break the financial system in two: one component behaving as nearly all the financial system does now, where the primary responsibility is to fulfill state objectives, and the second genuinely shielded from Party interference and fully inclusive of foreign capital. Of course, the second component cannot merely comprise 8–9% of total assets. Deleveraging will be economically painful but can be managed without causing financial or political instability. Market reform would be harder because it ultimately denies the Party use of a large amount of financial assets. It therefore seems improbable.

SOEs. If pro-market financial reform is unacceptable, another option is to improve the corporate sector. The immediate parallel to a financial sector split into tightly state-controlled and truly independent is a corporate split, but here the process has advanced farther. There is an extensive debate over what constitutes 'private' in the PRC, where some foreign observers effectively categorize listed subsidiaries of state-owned parent enterprises as private. Regardless, there is a substantial (genuine) domestic private sector, accounting for 32% of fixed investment in 2016 and outperforming that in output and profits.

In addition to deleveraging, allowing the private sector to expand would ease financial pressure and improve the return on capital. Private entities already have more than three times the market share on the corporate side as they do in finance, for the obvious reason that the Party considers many sectors less crucial than finance. The pathway to corporate reform is simple: fewer sectors deemed 'strategic' and hence fewer protected from competition. Major sectors where private firms could be allowed to outcompete SOEs include the grossly oversized steel industry, machinery, and aviation services outside aerospace.

This would be vital reform, capable of boosting growth in liberalised sectors and thus driving national growth higher. It is quite conceivable, but it is not the current policy direction. Rather than shrink the state footprint, Beijing has engaged in a campaign to create even larger SOEs. This is being done both to improve accountability of firms to the Party and in line with the old 'national champions' idea, where SOEs are sheltered in the large home market and have guaranteed revenues and economies of scale to be used in global competition.

The consolidation list is extensive: metals, power, shipping, steel and so on. The Party calls it reform, but it is anti-market. Not only does it lead directly to fewer firms, but the private sector is 'encouraged' to take minority stakes in SOEs (read: bailouts), promoting collusion. Financial analysts often praise the mergers because they are good for share prices, but this is hardly the same as good for the economy. Mergers are supplemented by re-emphasis on the requirement of a Communist Party secretary at every large enterprise, including private entities and multinationals. No firms or major subsidiaries owned by the central government have been privatised.

Innovation. The intense regulatory and financial support given to SOEs and their nonetheless uneven profitability make clear the state model works poorly at the level of individual firms. However, there is still an ongoing debate over whether subsidies plus the large, shielded home market create a positive environment for innovation. The Party understands correctly that debt and demographic challenges make innovation increasingly important for economic success.

China can manifestly acquire and successfully modify innovations developed elsewhere on a broad scale. The acquisition will continue through both overseas investment and cybertheft. However, as countries climb the technology ladder, what is foreign is no longer always innovative and homegrown efforts must improve. The PRC's approach is top-down, aimed at specific projects and technology the central government identifies as vital. It sharply contrasts with the idea that competition and secure private property rights spur sustained, economy-wide innovation, and governments cannot anticipate breakthrough sectors.

Resolving disputes over which model is superior may be impossible, but China certainly suffers because SOEs are not in themselves innovative. This is no surprise—they do not fail for commercial reasons and in some cases cannot lose market share. They have little incentive to innovate. The importance of this failing is demonstrated most clearly in shale, where US production is dominated by (initially) small independent exploration firms not permitted in the PRC. Even with the American example to copy and its own grand ambitions, shale output by the huge Chinese energy SOEs continues to be minor. Broader comparisons of SOEs to American peers are also unflattering.

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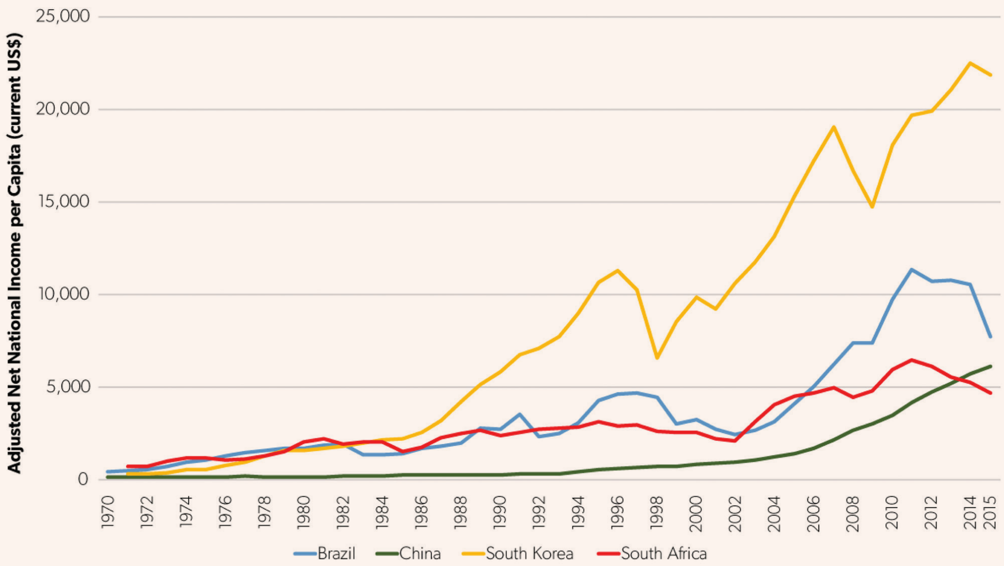
The future is now

Policy must shift toward competition and secure private property rights. If this year does not see the first steps in a genuinely pro-market reform program, it will be all but impossible for China to become rich for at least the next 30 years.

The timeline is as follows. A Xi Jinping regime that refuses reform or rolls back the market writes off the next five years. The 2022 Communist Party Congress will be dominated by the extent to which Xi remains in power, in particular how many of his supporters populate the Political Bureau and Standing Committee. At that point, barring reform, Xi will have established himself as a statist, and a sharp turn toward the market can only be seen as repudiating him, with all that entails. If Xi does not act now that he has plainly consolidated authority, strong pro-market reform is plausible only when he is a far less important political factor.

Figure 6. The Middle-Income Trap: Adjusted Net National Income per Capita



Source: World Bank, "Adjusted Net International Income per Capita (Current US$)," https://data.worldbank.org/indicator/ NY.ADJ.NNTY.PC.CD.

When will this be? 2027? Even later? By then the PRC's median age will be considerably higher than the US and still rising quickly. Further, if extensive deleveraging has not occurred, the debt situation will be as bad as the demographics or worse with respect to harming growth. Japan already easily qualified as a rich country when it stagnated in the 1990s; China will not.

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China failing to become rich also fits the historical record. In the postwar era, the largest country to become rich for the first time is South Korea, whose population recently breached 50 million. It is almost unimaginable that the PRC as a whole could become rich. To see even parts of the country become rich, the combination of low income and comparatively rapid aging—long anticipated by the central government—means the PRC cannot first afford to spend eight years incurring more than US$20 trillion in debt and now continue to funnel resources into inefficient SOEs. This is an enormous challenge, and China has been shooting itself in the foot.

Again, the opposite of success is not collapse. The gargantuan stock of money translates to years of more yield-chasing, bond defaults and the like but no systemic financial threat. Property busts are an inevitable result of a lack of investment options and have occurred many times before. A few developers falter, but this cannot trigger a wave of failures because the financial obligations of both borrowers and lenders are secondary to their political obligations. The human capital effect is similar: Young people without jobs breed crisis, but not enough productive workers to support the elderly merely breed relative decline.

Nor is the process of Chinese stagnation devastating to the global economy. The more than one billion people in the PRC will continue to buy what Beijing allows them to buy; their income growth will just be at the global average or below. Certain sectors—such as those tending to cleaner ecology, distressed debt or consumption by the elderly—will boom. The idea that China drives the rest of the world's growth is nonsense: Raising average global GDP growth is not a contribution, especially with a trade surplus that subtracts from everyone else's GDP. In a decade, the world will face the same problem it does now: how to sustain growth without debt or prohibitive inequality, while China continues to divert resources to its state sector.