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Predicting the next few years in China

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For all the furor over recent political events, I don't think we should too quickly assume that political excitement will subside once the new leadership process is concluded later this year. China must abandon a growth model that has generated rapid accumulation of state and corporate assets – probably growing over 15% a year in real terms during the past decade – and this will result in much slower growth, perhaps even negative growth, in the further accumulation of state and corporate assets over the next decade. It is hard to imagine that in this very different environment political disagreements over the distribution of wealth and power will not become trickier.

In the last issue of my newsletter I spoke about the economic constraints that limit China's political options. I argued that regardless of what Beijing claimed it wanted to do, its economic choices were largely limited either to maintaining the existing growth model, thereby running the risk of a debt crisis within four or five years, or altering the growth model radically to keep growth on a sustainable, albeit much slower, basis.

Altering China's growth model means something quite specific. Beijing does not only need to eliminate the transfers from the household sector that have subsidised and underpinned the tremendous GDP growth of the past 10-15 years, but just as importantly it has to reverse those flows and begin transferring wealth from the state sector back to the household sector.

The goal is to increase the household share of total production so that household consumption, and not just investment, can become the engine of domestic growth. The combination of much slower overall GDP growth and a declining state share – compared to the past decade of very high GDP growth combined with an increasing state share – is why I think the politics will get much more complex in the future.

I outlined several ways Beijing could accomplish the transfers in the last issue of my newsletter, but practically speaking it seemed to me that only two were very plausible. Either Beijing privatises state assets, including farm land, and transfer wealth directly or indirectly to the household sector, or Beijing allows a backdoor privatisation by having the government absorb private sector and corporate debt.

The problem with the second way is that it requires much slower growth in order for rebalancing to take place (as government debt balloons it cannot raise interest rates, and so the elimination of the financial repression tax occurs as a collapse in growth rather than a surge in interest rates). Moreover it will leave the country with an unsustainable debt burden after a decade or so.

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The relevant comparison here is Japan after 1990. This is why for several years I have been arguing that as crazy as it might seem, it was in my opinion a virtual certainty that by 2013-14 privatisation would become one of the hottest topics in China's economic policymaking and advising circles.

Until recently this prediction may have seemed a little farfetched. If there was one thing with which everyone in China could agree, it was that Russia proved once and for all the folly of state retreat from the economy. Whenever the topic of privatisation was brought up, most of my Chinese friends, whether or not they supported privatisation, said it could not happen in China because it was politically impossible.

But I was not impressed by this argument. If the rapid contraction in the household share of China's GDP was at the heart of the country's economic imbalances, then the solution had to be a reversal, and the longer Beijing waited (and they waited far too long), the more dramatic this reversal had to be. This really left privatisation as the only efficient alternative, and it would be just a matter of time, I thought, before many analysts realised it. With the release of the instantly controversial World Bank report in late February, this time seems to have come.

So privatisation is now part of the debate, but this doesn't mean that proponents of privatisation will easily win the debate just because economic logic forces us to choose between privatisation and a debt crisis. Minxin Pei, as I pointed out in my last newsletter, argues that political logic rules out privatisation because, as he puts it, "it is hard to imagine that a one-party regime would be willing to destroy its political base".

Pei is right, of course, but I think there is a way in which we can resolve this seeming contradiction. First, we can assume that he is right up to a point, but that changing conditions – i.e. the recognition that the alternative is the very large risk of falling into a debt crisis within the next few years – might refocus attention and cause leaders to "rethink" their position on state control. The question then becomes not whether or not Beijing will permit the destruction of its political base but rather how to minimise it. After all a debt crisis will even more surely undermine the Party than will privatisation.

To a certain extent much of what we have been seeing recently may fit in with the idea that there is a serious "rethinking" taking place – for example the increasingly heated arguments over "vested interests" during the past year or two. If we assume that power in China is highly centralised within a small and monolithic power centre, this "rethinking" could be quite uneventful. One day, in this scenario, the three or four key figures realise that their alternatives are stark and they do what they have to do to prevent the worst outcome.

The Chongqing model

But let us assume a lot more realistically that in China power is widely dispersed, that there are very important groups or families whose power and wealth is far more contingent on a continuation of existing policies than it may be for other families or sectors, and that some groups understand the economic mechanisms that govern the process better than others. In this case it is probably safe to conclude that the process of "rethinking" is likely to be messy, highly unstable, and very unpredictable.

It is in this context perhaps we should be thinking about the debate over the Chongqing model and the astonishing events of the past two months. The supporters of the Chongqing model, after all, implicitly argue that China does not need to change the existing growth model. This may seem a little strange because the Chongqing model is often presented as a new development model for China. For example Chris Buckley in a very interesting article for Reuters, writes about "red Chongqing as a bold alternative model for China".

But I don't think it is an alternative at all. It seems to me that the Chongqing model is simply the existing Chinese growth model taken to even greater extremes than it already has. In Chongqing in the past few years there has been a massive amount of public expenditure and investment that has generated huge amounts of jobs and GDP growth, but this makes it fundamentally no different from the growth model China has followed in the past two decades.

More importantly it doesn't extend the sustainability of China's growth model. The cost of the surge in investment in Chongqing was spread out to the entire country through the banking system, and if the cost exceeded the benefits, we wouldn't be able to tell simply by looking at growth in Chongqing. Here is how François Godement described the Chongqing model five months ago in a good article in a publication for the European Council on Foreign Relations:

[Bo Xilai] has used massive state subsidies to woo flagship foreign firms such as Apple, Foxconn and BASF; launched a giant social housing program that is also predicated on migrants turning in their native land for development by the city; fought the local mafia; and promoted a new version of the PRC's collective ethos.

What is "new" about the Chongqing model (besides the red singing and the popularity of very expensive ginkgo trees) is, at most, the focus on distributing wealth downwards to the poor, but this is only new in the sense that Bo seems actually to be accomplishing it in Chongqing. As a stated goal, however, it is not new. President Hu has made clear many times his concerns about rising income inequality and under him there has been far more pressure than under his predecessors to redress the problem.

But at least Bo has succeeded in improving the relative position of the poor, and so that must differentiate the Chongqing model from the Chinese growth model, right? Maybe, but perhaps not in a way that can be extrapolated to the country as a whole. One way of describing what has happened in Chongqing might be that the authorities there have been extremely successful in drawing resources from the rest of the country to benefit growth and income distribution within the municipality, but it is not at all clear that the net impact for the country as a whole was wealth creating.

For example if it is true that Chongqing has been successful in using state subsidies (paid for by all of China, presumably) to draw foreign companies away from other parts of China to Chongqing, as Godement claims, it is pretty clear to me how Chongqing benefits and how the foreign companies benefit, but it is less clear to me how China as a whole benefits. After all what was Chongqing's gain was, presumably, an equivalent or greater loss for the province from which the company moved, and once you add the subsidies, the total gain for Chongqing was less than the total loss for the rest of China.

Likewise if the rest of the country, through state grants and the banking system, can be forced to subsidise the poor in Chongqing, for example through increased spending on social housing, it means more rapidly rising debt for the country even as Chongqing benefits. And while more social housing might be a good thing for China, the real problem is that if the value of the housing does not justify the cost, we still have the very worrying problem of rising debt. Chongqing exacerbates the problem rather than resolves it.

“Resolving” the problem by passing the cost on to the rest of China, in other words, can work for a municipality, but it cannot work for China as whole. I wonder if the Chongqing model isn’t just the Chinese version of Venezuela’s Chavismo – it addresses the serious problem of income distribution without worrying too much about how to pay for it.

Everyone’s doing it

My point here is to suggest, as delicately and abstractly as I can, that those of us who have been very skeptical about the sustainability of the current growth model and its tendency to lead to a debt crisis are probably not as surprised as some of the more optimistic China watchers about the sudden and “unexpected” deterioration in the political environment. Sharp political confrontation was almost inevitable as it became increasingly apparent a development model that has led to a ferocious growth in assets controlled by certain sectors might lead to an outcome that is not acceptable to others.

The urgent need to reform the economy, in a way that Minxin Pei points out is politically unlikely, puts us in the position of an irresistible force meeting an immovable object. Something, in this case, must break, and the breaking process has to lead to political confrontation. The underlying conflict hasn’t yet been resolved.

On that note let me refer to two recent articles that may one day in the future be cited by amazed economists (and college students) when they wonder how our generation could have possibly been so dumb as not to see “it” coming (whatever “it” turns out to be). The first article is a New York Times article, “Building the American Dream in China”, about the joys of being a young architect in China. It’s a little long, and perhaps being a non-economist the author (along with many of the interviewees) isn’t always aware of how astonishing some of the things he says are, but it’s well worth a read to see just how far you can go down the yellow brick road in the land of no budget constraints.

The second article is from the Financial Times:

As China’s construction boom slows, steel mills across the country are scrambling to find ways to bolster profits, and one has hit on an unusual strategy: raising pigs. Faced with a bleak outlook for its core business, Wuhan Iron & Steel, China’s fourth-largest by production, is investing RMB30bn (\$4.7bn) over the next five years in non-steel sectors including pig, fish and organic vegetable farming as well as logistics and chemicals.

Wuhan’s pig farm has quickly become the talk of the industry, but many of China’s powerful steel groups – which account for more than 40 per cent of global steel production and about 8 per cent of China’s gross domestic product – are also quietly expanding beyond their core business.

... Exact statistics are hard to come by given limited disclosure by China's state-owned steel groups, but "there's no doubt that the diversification trend is growing," says Zhang Changfu, deputy head of the China Iron and Steel Association, an industry representative body. "The reason for diversification is weak profits [at the steel mills]," says Jiang Feitao, a steel industry specialist at the Chinese Academy of Social Sciences, a government-backed think tank.

The vast economic stimulus package that Beijing unleashed in 2009 fuelled loans to state-owned enterprises including steel mills. In the second half of last year, steel margins began to slump as China's construction sector came off the boil, and as steel profits turned negative many groups became even more eager to look elsewhere to bolster revenues.

For Baosteel Group, the world's third-largest steelmaker, half of its net profit of Rmb18.7bn (\$3bn) last year came from non-steel businesses – up from 20 per cent the previous year. Outside of steel, where it has long dominated the market, Baosteel has extensive non-steel subsidiaries that span a wide range of industries ranging from real estate to telecommunications to manufacturing.

So there you have it. When global growth is slowing and there is way too much capacity in your core business, rather than cut back on capacity the best thing to do is expand capacity elsewhere.

Most of China's big steel producers are state-owned companies, giving them access to cheap loans. When steel making becomes unprofitable, as it is now, steel groups can get higher returns by taking loans and investing the funds in other sectors, including real estate or financing vehicles that re-lend the money.

They can also invest in pigs, and why not? They can always make profits if their funding costs are low enough, and these profits allow them to continue destroying value in their core businesses. Unfortunately they are using their cheap funding, subsidised by Chinese households, to put more efficient Chinese producers out of business. Notice furthermore that they are not only reducing efficiency, but by entering into these industries they are also lowering the cost of capital relative to labour and so forcing the industry to become less labour-intensive than it should be under optimal conditions.

But there's more. The most worrying part of the article to me was this paragraph:

"Baosteel started to diversify early, especially in financial and investment areas ... In these areas Baosteel has advantages over private companies because it can get market entry permits more easily, primarily because of their identity as a large state-owned enterprise," says Mr Jiang.

So Baosteel has "advantages" over private companies because it can get permits more easily than smaller companies that are in the business? But surely this is a political advantage rather than an economic one. In other words Baosteel will be successful not because it is more efficient at creating value, but because it is a lot more efficient at getting government approvals. This is great for Baosteel and other large companies with the proper connections, but how much more can you stack the deck against efficiency and not become systematically inefficient?

Revisiting predictions

In 2006 I started making a number of predictions based on what I thought was the necessary and logical development of China's growth model. Some of these predictions seemed fairly outlandish, especially to China analysts – Chinese and foreign – who had very little knowledge of economic history or other developing countries, but many of them so far have turned out quite well.

As more and more analysts are beginning to understand the constraints of the Chinese growth model I think it might be useful to list some of these predictions to get a sense of what might be still to come. Perhaps my bet with The Economist has caused me to throw caution to the winds, as a smart economist never makes his predictions explicit, but here they are:

1. China will be the last major economy to emerge from the global crisis. My basic argument was that the global crisis was caused by the necessary reversal of the great trade and capital imbalances of the past decade, and a country can only be said to have emerged from the crisis when those underlying imbalances had been resolved.

As China's contribution to the global imbalances has been its excessively high savings rate, China could not emerge from the crisis until the high savings rate had been reduced to a more reasonable level. Since 2007-08, of course, the opposite has happened, as Beijing has exacerbated its domestic imbalances in order to keep growth rates high. But without infinite debt capacity this cannot go on. I think it is pretty clear that over the next few years China will be forced to address and reverse the high savings rate, and it will only be after this happens that China can be said to have emerged from the crisis. This may take a decade or more.

2. Chinese consumption will continue to stagnate or decline as a share of GDP until the growth model is abandoned. By "abandoning" the model I mean that transfers from the household sector to subsidise rapid growth must be eliminated and reversed.

This is really a continuation of the first prediction. It is too early to say, but 2012 may be the first year in which consumption growth will outpace GDP growth, but only if GDP growth turns out to be much lower than expected – say below 7%. As long as GDP growth rates exceed 7%, there can be no real rebalancing of consumption.

3. Although there were many factors that explained both rapidly rising GDP and the contracting consumption share, financial repression would eventually be recognised to be the key factor. It took many years to make this point, but it has become pretty clear to everyone that financial repression is at the heart of China's problem. This may explain Premier Wen's recent and rather shocking attack on the banks, although in my opinion it will still be at least another year or two, if ever, before we see any real liberalisation of interest rates.

Remember that the more debt there is, the harder it is to raise interest rates, and the longer we take to raise interest rates, the more debt we run up. In the end I suspect that financial repression will be eliminated not by an increase in nominal rates but rather by a decline in GDP growth (remember that the size of the financial

repression tax is a function of the difference between nominal GDP growth and the nominal lending rate).

4. Investment is being misallocated on a massive scale and this was not due to any special Chinese characteristic but was rather a fundamental requirement of the way the system operated. Although there are still some economists who disagree that investment is being massively wasted, I think this is so well understood by now that there is no need to belabor the point.
5. Debt is rising at an unsustainable pace and debt levels will become unsustainable well before the end of the decade. This follows from the above point – if investment is debt funded and if it is being wasted, then by definition debt must be increasing at an unsustainable pace – i.e. faster than debt-servicing abilities.

In the past three years this warning about rising debt has become much more widely accepted, especially since Victor Shih started counting local government debt in late 2009. There is still some disagreement on the sustainability of debt, with some analysts, like Arthur Kroeber of Dragonomics, saying that China doesn't have a serious debt problem. I suspect nonetheless that in another year or two no one will doubt that the Chinese growth model tends towards unsustainable debt and that we are rapidly reaching the limit.

6. When specific debt problems are indentified, resolute attempts by Beijing to resolve them would be warmly welcomed by analysts but wholly irrelevant – because the problem of debt was systemic, not specific. This follows from the above. The issue is not that specific borrowers may run into debt problems. It is that the run-up in debt is systemic and cannot be prevented as long as China maintains the existing growth model. If there is rapid GDP growth, say anything above 6% or 7%, debt within the system must be rising at an unsustainable pace.
7. Privatisation, a topic all but forbidden in polite company, would become a very hot topic of conversation by 2013-14. I have discussed why in this issue of the newsletter.
8. As some policymakers gradually became aware of the problem with the growth model and the risk of crisis, a fundamental political split would emerge between those that demanded rapid reform and those that wanted to maintain control of resources. The problem is that continuing the growth model will lead to a debt crisis, but abandoning the model will lead to much slower growth, and especially to much slower growth in the accumulation of state sector assets. This is politically very difficult for many to accept and will lead to more political conflicts over the next few years.
9. Chinese government debt will continue to balloon through the rest of this decade. Privatisation is the best way to effect the transfer of wealth from the state sector to the private sector, and would be especially efficient if privatisation proceeds were used to extinguish debt, but for the reasons discussed above it will be extremely difficult to do it. This means that debt build-up and the state absorption of private sector debt will continue for many years.

10. If the transition is not mismanaged, average Chinese GDP growth rates will drop to 3% for the 2010-20 decade. As my bet with The Economist suggests, this is one prediction that is still an outlier. The Economist (and many others) still believe that Chinese growth will make it the largest economy in the world before the end of the decade, but much slower growth is what rebalancing requires and it is hard to make the numbers work at growth levels much above 3%. By the way if I am wrong and Chinese growth this decade is materially higher than 3%, my prediction is that the “lost decade” of much lower growth stretch out over two decades.
11. If China rebalances correctly, then much slower GDP growth rates will be accompanied by only slightly slower growth rates in household income. In that case there need be no social instability. The political risk comes from instability at the top, not at the bottom.
12. Non-food commodity prices are set to collapse over the next three to four years. “Collapse” is not too strong a word. China’s share of global demand for such commodities as iron, cement, copper, etc. is completely disproportionate to its size and almost wholly a function of its very high growth in investment. As investment growth drops sharply, as it must, global demand for non-food commodities will plummet.

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