

**Global Economic Forum Videoconference June 30, 2009**  
**Federal Reserve Bank of Boston Presentation**  
**Dwight Perkins**  
**Professor of Political Economy**  
**Harvard University**

Before turning directly to the impact of the global economic crisis on China and how they have responded, a few words are in order as to what explains the high growth of the last three decades and why it was so much faster than during the previous two decades.

There is not time to present the full argument but the basics are as follows:

- (A) China achieved a very high rate of investment early on and so investment as a share of GDP did not rise when the reform period began in 1978.
- (B) What changed were a whole range of policies and institutions that led to a major increase in total factor productivity (from negative levels in the 1957–1978 period). The sources of this TFP growth included:
  - a. Return to household agriculture and freeing up rural markets.
  - b. Opening up to imports and pushing exports to make possible imports of a wide range of essential products.
  - c. In 1984 freeing up industrial inputs for sale on the market rather than for administrative allocation by the central plan. This made possible a boom in township and village enterprises that carried high industrial growth into the 1990s.
  - d. Opening up to foreign direct investment with the boom in FDI happening in the 1990s with a major impact on the quality of products, management practices and much else.
  - e. The decision to join the WTO and use joining to bring competitive pressure on the lagging state owned enterprise sector.

The problem going forward is to find ways of continuing to achieve high TFP, but this will be more difficult because the easy dismantling of the worst features of the command economy has largely been done.

Going forward there are many things that need to change, but the one that feeds directly into the current global economic crisis has to do with the fundamental imbalance in the structure of the Chinese economy on the expenditure side. Put simply, there has been an excessive and growing dependence on exports to support growth, and that dependence on exports is the other side of the coin of the lack of strong growth in domestic consumption. The excessive dependence on exports is why it is such a challenge to keep growth of GDP up in China when exports have fallen so sharply in the face of the world recession.

The nature of the problem:

- (a) Declining consumption levels with household consumption falling particularly sharply.

## GDP Expenditure Shares

<b>Table 1</b>			
<b>Consumption and Investment</b>			
<b>(as % of GDP)</b>			
	<b>Consumption</b>	<b>Capital Formation</b>	<b>Net Exports</b>
1978–79	63.3	37.1	–0.4
1980–89	65.0	34.2	–0.9
1990–99	59.7	37.8	2.4
2000–03	59.8	37.0	2.3
2004–08	50.8	42.6	6.5

## China Consumption Breakdown

<b>Table 2</b>			
<b>China Consumption Breakdown</b>			
<b>(as % of GDP)</b>			
	<b>Final Consumption</b>	<b>Household Consumption</b>	<b>Government Consumption</b>
1978–79	63.3	49.1	14.2
1980–89	65.4	51.2	14.2
1990–99	60.2	45.9	14.3
2000–03	58.9	43.4	15.5
2004–08	50.2	36.6	13.6

## Exports as a Share of GDP

<b>Table 3</b>	
<b>Ratio of Exports to GDP</b>	
<b>(as % of GDP)</b>	
1978–79	5.7
1980–89	9.8
1990–99	17.8
2000–03	22.8
2004–07	33.9
2008	33.0

## International Comparisons of Consumption and Trade

<b>Table 4</b>				
<b>China Consumption Breakdown</b>				
<b>(Year 2007 as % of GDP)</b>				
	<b>Household Consumption</b>	<b>Government Consumption</b>	<b>Capital Formation</b>	<b>External Balance</b>
United States	71	16	19	-6
Japan	57	18	23	1
South Korea	55	15	29	1
Malaysia	50	13	23	14
Thailand	57	10	30	4
Vietnam	67	6	35	-8
Indonesia	63	8	25	4

- (b) The gap has been made up in part by exports (in accounting terms it is net exports, but the exogenous driving force is exports minus imports of inputs needed for export industries which is larger than net exports—the latter includes many imports that rise because of demand by sectors of the economy that do not export).
- a. But in 2008 China's exports were US\$1,428.5 billion having grown by 17.2 percent over 2007 or by US\$209 billion. At that rate China would have a net increase in exports of over US\$800 billion or more than the total exports of Japan within three years.
  - b. With the global recession such a growth rate is highly unlikely and Chinese and other Asian manufactured exporters are all facing an absolute drop in the demand for their products. China's exports year on year were down 17.5 percent in January, 25.7 percent in February, 17.1 percent in March of 2009 after more modest declines in November and December 2008 (-2.2 and -2.8 percent).

<b>Table 5</b>						
	<b>Exports 2007</b>	<b>Monthly Export Decline (in%) (y on y)</b>				
	<b>(billion US\$)</b>	<b>2008</b>	<b>2009</b>			
		<b>December</b>	<b>January</b>	<b>February</b>	<b>March</b>	<b>April</b>
China	1218	-2.8	-17.5	-25.7	-17.1	-22.6
United States	1163					
Japan	713	-35.0	-45.7	-49.4	-46.5	-42.5
South Korea	372	-21.6	-34.2	-18.3	-22.0	-19.0
Singapore	299	-20.8	-34.9	-23.7	-17.3	-19.2
Malaysia	176	-20.1	-27.8	-33.8	-15.6	-26.3
Thailand	152	-14.6	-26.5	-11.3	-23.1	
Indonesia	118	-21.0	-36.0			
Philippines	50	-40.4	-41.0	-30.7	-30.8	-35.2
Vietnam	48			-15 (quarter)		

<b>Table 6</b>				
<b>GDP Growth Rate</b>				
	<b>2005–07</b>	<b>2008</b>	<b>4<sup>th</sup> Quarter 2008</b>	<b>1<sup>st</sup> Quarter 2009</b>
Japan	2.2	0.7	-12.1	-4.0
China	11.1	9.0	6.8	6.1
South Korea	4.8	2.5	-4.2	0.1
Singapore	7.7	1.2	-16.4	-11.5
Hong Kong	6.8	2.8	-2.6	-7.8

- c. But even if the global recession ended tomorrow, China would have to curb export growth soon or face either a saturation of global markets for what China can produce, or world-wide resistance to China cutting into the markets of producers around the world by enormous and highly disruptive amounts.
- (c) The rest of the aggregate demand gap is made up by high levels of investment, but investment is a function of expected future demand, which depends on the growth of export demand for investment and the growth of consumption for investment plus the growth of government infrastructure investment.
- (d) The Soviet growth model was investment in investment goods to make more investment goods with the share of investment rising but with consumption stagnant or growing much more slowly. In essence this was China before 1978.
- a. But this model does not work for long in a market driven economy. At some point some investment goods producers decide that the market for machinery to produce machinery is going to fall because the firms buying their machinery are not selling any more refrigerators or cars so they stop buying the machinery. This then leads other investment goods producers to cut back and the economy spirals down.
- b. This did not happen in the Soviet type economy because the government simply ordered the investment goods producers to go on producing whatever the actual need. Inventories were huge as in the USSR was military spending that helped sustain demand for these investment goods.
- c. As we have seen from the experience of China, the USSR and Eastern Europe plus Vietnam, Cuba, and North Korea—this kind of growth has very low total factor productivity growth and hence much slower GDP growth rates.

That brings us back to the current situation and China's current efforts to keep the growth rate of GDP up at around 8 percent per year although the first quarter was 6.1 percent.

I look at what I understand to be China's stimulus goals, both as announced and where I see potential with the conventional macro framework:

$$Y = C + I + G + X - M$$

I start with where there is little potential for government stimulus action:

X – M: Any major effort to stimulate exports or to limit imports will be seen as a beggar thy neighbor policy and will lead to immediate retaliation. Basically China's foreign trade is now so large that even modest moves in this direction will be noticed quickly.

C: This is clearly the key to having long term growth in aggregate demand that does not depend on exports—I am referring here to private consumption that is primarily a function of income. Thus the primary way to raise private consumption is to raise income, in the current situation with various kinds of subsidies to the poor or allocations of goods in kind. The danger is that these subsidies will be hard to remove once they are in place and will violate the temporary criteria (this problem usually appears in places like Venezuela when oil prices are high). Over the longer run, however, as China's labor surplus disappears, wages will begin to rise rapidly as they were doing in the coastal areas until recently and this will raise household consumption. Thus there is a solution in the long run but the problem of excessive dependence on X is now not a decade from now.

Unemployment insurance, pension reform, and health insurance will also all help to reduce China's household savings rate and thus will raise the share of consumption in earned income (and over the much longer run the dependency ratio will rise which will also lower savings), but these reforms take a long time to implement and one does not want a poorly designed pension or health insurance system as a byproduct of the stimulus.

I: Because of state control of the main banks and a substantial portion of industry and services, it is possible to increase investment with direct government orders and that is in fact occurring (bank lending was one trillion yuan in February (CNY 1.07 trillion, up four times over February last year and CNY 1.87 trillion in March). (In February and March 2008, loans of financial institutions increased by CNY382 billion and CNY334 billion respectively). It is not entirely clear what this increase in lending is intended to accomplish in eyes of the government (of the RMB 4 trillion package, only RMB 1.3 trillion was to be financed directly by the government budget with the rest financed by local governments and banks):

The first question one can ask about this large jump in loans is whether it is actually being used to stimulate real economic activity:

- (a) 40 percent of this lending has been in the form of short term bills that were lent to SOEs a few days before the end of the month and paid back soon after the end of the month.
- (b) Much of the rest was lent to SOEs, but corporate profits in China have been high and one of China's demand problems is the high rate of savings by the SOE/corporate sector. So why are they borrowing if they have more than adequate retained profits to finance their activities? Since they clearly don't need it to expand capacity, are these loans being used to speculate on the stock and real estate markets? Does this partly explain the recent run up in stock prices?
- (c) To the extent that this is financing government infrastructure projects, I will discuss it below. To the extent it is pressuring enterprises to keep on investing and raising output in the face of declining demand, and is pressuring banks to finance same, this could become a partial return to the

problems of the 1980s with lots of bad loans for bad projects. Put differently, the Soviet style command system did not have much unemployment because firms kept on producing regardless of demand—producing machines to produce more machines with a high proportion ending up in inventories as I pointed out earlier. How much more steel-making capacity does China need given that it already produced 588 million tons in 2008? U.S. steel production peaked in the 1970s at around 150 million tons per year.<sup>1</sup>

This does not constitute proof that this massive increase in lending (and maybe investments using those loans) is bad for future high growth but certainly that is a real possibility.

G: That leaves government expenditures mainly in the form of investment (consumption was discussed above) and that means first of all investment in what in the US we call “shovel ready” projects. In China that would mean projects that the ministries and construction companies know how to do, that are already designed, and where it would be possible to start a well designed project within the next 12 months (many in the US will not start until 2010).

I am not familiar with what is being considered in this regard other than a few high-speed railway projects that are no doubt needed but will take a long time to complete.

But one wonders just how many more multilane, limited-access highways China really needs given that the inter-province highway system seems to be largely completed, and away from the big coastal cities these highways are not heavily trafficked. And how many more high quality airports does China need—the provincial airports (e.g., Jiangxi, Guizhou) I have seen are lovely and were rather underutilized when I was there.

China is a long way from the Japanese situation where there are useless airports and bridges to nowhere built as stimuli. In Japan the Postal Savings Banks have 200 trillion yen in deposits (US\$2 trillion), and the government regularly taps these very low interest deposits to finance the country’s useless infrastructure projects using them as a fiscal stimulus particularly during the decade plus of stagnation. China is not there yet, but is a major further effort on these kinds of activities likely to produce a high rate of return investment? I do not know but I am skeptical.

What could the government spend large amounts on that it is not currently already doing?

China has had an impressive housing construction program in urban areas for the last 30 years, and the stimulus package calls for more housing investment for the registered urban poor and that is not doubt useful.

But what about housing for the migrants most of whom do not want to go back to their villages but have little choice now? Last year I gave a figure for what this would cost to house all migrants and that figure

---

<sup>1</sup> American iron and steel institute.

(US\$200 billion a year for 20 years) was not doubt exaggerated since migrants would provide their own housing in some cases, etc.

But could housing for migrants serve as a major component of a good stimulus package? The major drawback is that the plans are not already on the drawing boards, and clearly some thought and experimentation would have to go into designing the first major efforts in this area. But if these experimental plans could be started relatively quickly, the rest would clearly meet the stimulus needs. The construction companies and workers who know how to build housing are all in place. The materials (cement, steel, bricks, etc.) are produced in abundance domestically. Once going, the pace could be speeded up or slowed down as the aggregate demand situation required.

These short-term measures do not create a major problem for the long run if the massive expansion in lending and state enterprise investment returns to normal in the not too distant future. But if this becomes a more sustained process, China faces the danger of sliding back into the kind of policies that loaded the banks down with non-performing assets in the 1980s and the state-owned enterprises performing with large losses once the reform of prices revealed these losses in the 1990s. Under those circumstances, sustained growth in productivity will be very difficult.

- If in addition the country is busy building bridges to nowhere, that too will make high sustained growth in productivity very difficult.
- Thus a policy of 8 percent growth in 2009 at any cost does not make sense. If it can be done while producing really needed infrastructure, then it will be consistent with continued rapid growth over the longer term.

Will China's continued growth through the global recession help pull the world out of that recession?

- (a) China's economy measured using the exchange rate is still only US\$4 trillion, a large figure but far below the US or the EU.
- (b) The better stimulus ideas (e.g., migrant housing) rely mainly on domestic resources and hence will not be a major import stimulus.