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Transcript

CHINA IN THE WORLD PODCAST

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Guest: **Yukon Huang**

Episode 43: Debunking Myths About China's Economy
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Haenle: You're listening to the Carnegie–Tsinghua China in the World podcast, a series of conversations with Chinese and international experts on China's foreign policy, international role, and China's relations with the world, brought to you from the Carnegie–Tsinghua Center here in Beijing. I'm Paul Haenle, the director of the center, and I'll be your host.

Today we're delighted to be speaking with Yukon Huang, senior associate in the Carnegie Asia program. Yukon's research focuses on China's economic development and its impact on Asia and the global economy. Previously, Yukon was the World Bank's country director for China and for Russia. He was an advisor to the World Bank team that prepared the joint Chinese government-World Bank China 2030 report. He was also an A-list commentator for the Financial Times and is working on a new book to be published later this year, entitled *Why Do Views on China Differ So Much?* and we're going to preview some of his answers to that question on our podcast today. Yukon, thank you for joining us in Beijing, where we consider you here an honorary member of the Carnegie–Tsinghua team. Thank you for joining the podcast today.

Huang: Pleasure to be here, Paul. Come here three or four times a year, have an apartment here, I love it when I'm here.

Haenle: We do as well, because you have a lot of important things to say, and as I mention, we are interested in understanding why Chinese economic issues generate such different and extreme views. Why is the commonly accepted wisdom on these big issues often misguided? How incorrect are assumptions by economists and policymakers? How can these impact Chinese economic policy?

One of the things you do very well when you come to China is you take that conventional wisdom, and you examine it closely, and sometimes turn it on its head. And, we want to do a little bit of that today, by starting with the prediction by some economists that China's rapid debt buildup and credit boom will lead to the imminent financial crisis and an economic collapse. You examined this issue in a recent Carnegie paper called "China's Debt Dilemma: Deleveraging While Generating Growth." So, my first question, is China dealing with a debt crisis, or rather a property-related financial deepening?

Huang: Most analysts in the media look at China's rising debt levels, it's soared by 50 percent of GDP, 80 percent of GDP over the last five to six, seven years. When you look at the past history of what's going on globally, every country where the debt-to-GDP ratio has increased that rapidly have all crashed. So, it's a very easy assumption to say, "Why not China?" And here, I like to say, China is different. And, why is it different? First of all, its soaring debt, which began around 2008-2009, was the result of a deliberate government stimulus program, the injection of about $600 billion into the economy, a lot it into the financial system. It was not the consequence of years of financial or fiscal mismanagement, it was not the consequence of deteriorating balance of payments, it was a government intention.

And the second thing to happen during that time is that China's property market, private property market, really began to take off. You have to realize that private property in China 15 years ago did not exist, and then, it slowly developed. Just about the time of the global financial crisis, a serious private property market began to emerge in China. When you have all this credit in the system, a lot of it shows up in buying and transferring of property, and this is all showing up in the debt indicators. This is not the normal kind of debt crisis that we see in other kinds of countries.

Haenle: So, you mentioned the property market. This is another area where we see in the press a lot of coverage of this, economic analysis on this, pointing to China's excessive housing construction, ghost cities that people read about. Followed by predictions that a property bubble could trigger a string of default. In your opinion, are China's debt problems a financial issue or a fiscal issue, and should we expect to see a string of defaults here in the near future?

Huang: This combination of credit expansion, the emergence of a private property market, soaring property prices, and concerns about the debt problem, they're all interrelated. So, what is unique about China? Primarily, if you go into the financial markets 10 or 15 years ago and the construction numbers, you do not see much private construction of property. You couldn't buy or trade. An auction market for land, for example, was created around 2004 and 2005. For the first time, developers could bid on land, and so, land essentially had very low value and then started to soar. So, land prices have soared seven to eight times over the last eight or nine years, and therefore, many think, "Surely, this is a bubble," that prices here must be excessive, it's going to crash.

Now, the interesting thing here is that land and property prices in China, for example, in major cities like Beijing and Shanghai, which are the highest priced cities, they're still only one half the levels of New Delhi and Bombay in India. They're comparable to other Asian capitals. So, in a global comparison, property and land prices in China are not excessive. What has happened, however, has been excessive building because it's become so profitable, and a lot of this has been in the smaller cities. So, that's where your problem is, an excess supply. But that's not a bubble or a collapse problem, that's a getting the stock back in line with demand.

So, we are going to see prices fall or moderate over the next couple years. We're going to see construction scaled back. We're going to see that this is going to impact the GDP growth numbers, which will probably moderate from the current seven and a half down to maybe six and a half, and maybe even six. But if China gets its policies correct, then you could potentially see a resurgence back to a trend line, and that trend line might be seven or seven and a half.

Haenle: What kind of timeframe are you talking about here?

Huang: Well, the trend line in terms of the adjustment to this over-building, I think it’s a couple of years. But we don't know what happens after that. Will it continue to decline or will it bounce back and then stay on a steady path? And, this is the question of what kind of financial and fiscal policies are important. A lot of the focus of the media has been on the financial sector, interest rates, exchange rates, capital movement, the banks, but they've actually overlooked the issue. The fundamental problem in China is that its fiscal system is not appropriate for this newly emerging market economy. China's budget as a share of GDP is lower than most middle-income countries; it's much lower than the high-income countries.

Haenle: This is the national budget?

Huang: The national budget, and local—a combination of Beijing and the central. Because the budget is so small that, in fact, localities are not being given enough money from Beijing and the center, they rely excessively on borrowing from the banking system to finance roads, power plants, things that should not be borrowed, they should be financed through the budget. Therefore,

you have what I call "excessive commercial borrowing" for activities that shouldn't be going through the banking system at all, they should be going through the budget, and that's why you have this debt buildup. So, this kind of infrastructure financing, combined with the financing for property is largely the reason for this excessive monetary expansion in China. To solve this, however, is not a financial issue; to solve it you must strengthen your budget, and basically get the revenues so that you don't have to borrow for these purposes. So, that's why I say the major reform initiative that everyone should be focused on is fiscal reform, yet popular media attention has always been on financial issues.

Haenle: Let's take a closer look at China's economy. Common wisdom is that China's economy is unbalanced, and that its economic growth needs more consumption, needs to be more consumption-driven. We often hear that China should curb its investment, China's repressing its households because interest rates are too low. In your view, is China's growth unbalanced, and is this unbalanced growth a vulnerability or is it a benefit?

Huang: Again, I think there's the misleading impression that unbalanced growth is a problem, and it's certainly true, of course, that by common indicators, consumption as a share of GDP in China is around 35 percent, the lowest in the world. Its investment as a share of GDP at around 47 percent is the highest in the world. So, it's very easy for people to say "if it's so imbalanced and its extreme, that this must be a problem." What they forget, of course, is that unbalanced growth is actually a sign of success. If you go back over the last 30, 40 years, the only countries that moved from middle to high income status—Korea, Taiwan, Singapore, Japan—all have the same kind of unbalanced growth process. This is actually even true of the United States 150 years ago. It had a very unbalanced growth process. The only successful countries, historically, have been countries which are unbalanced in their growth at this particular stage. Therefore, Latin America, the Middle East, Africa, even Philippines, and Indonesia just don't do well; their economies are balanced, but they don't grow.

So, why is it, therefore, that rapid growth leads to unbalanced growth? Why does consumption as a share of GDP fall when you are successful? And the answer is urbanization: the movement of people from low-production agricultural activities to the urban industrial areas. Take a farmer, who's sitting in the far west of China, he's growing crops. Whatever he grows, he consumes a lot of it. So, in the national accounts, his activity shows up as high consumption in relation to the value of agricultural production. He moves to the cities, he moves to Guangzhou province or to Shenzhen, gets a job with Apple, producing iPhones. His salary triples, yet he's in a manufacturing process which brings in capital, property, equipment, spare parts. The share of his income, his labor income, as a share of the cost of the industrial activity is relatively small. Even though he consumes two to three times what he used to, consumption as a share of industrial value added is relatively low. So, the national accounts, consumption as a share of GDP falls, but personally he is much better off. His income, his consumption standards increase rapidly. The company is doing very well, they're making huge profits, they reinvest it, they export, China grows at double digits for three decades. This is essentially unbalanced growth.

Now, it eventually solves itself, actually. As the economy matures, as it becomes more urbanized, as people have left agriculture, more balanced growth emerges. That's the same thing that happened in Taiwan, South Korea, Japan, even the United States. Consumption then, as a share of GDP, begins to rise. But, that rebalancing takes place over decades and generations. Media are looking at one-year changes, and it's not going to happen.

Haenle: And, in your analysis, you have talked about countries reaching a certain level of per-capita GDP before the economy will begin to balance. Has that been consistent as you look back at these cases? Is there a certain level of per-capita GDP that a country has to reach before it begins to balance out its economy?

Huang: The empirical studies have shown that upper-middle income countries whose per-capita GDP, adjusted in purchasing power terms—that turning up occurs between around $12,000 to $15,000 per person. China's in the $8,000 to $9,000, $10,000 range.

Haenle: They still have a ways to go.

Huang: It still has a few years to go. And, therefore, when people say it needs to rebalance or it should rebalance, if it follows—it's actually too soon. If it rebalances too soon, it essentially means its growth rate is not as high as it could have been. It's actually not investing enough in things it should be doing. It's actually consuming more and not investing in the future. So, the key question then becomes, well, if it has to invest in the future, the government must make sure that money's going to be spent on sensible projects. Now, some of these ghost towns and other places are the result of poor policies which encourage bad investments. So, you need to solve that problem, you need to invest in better things, but the issue is not unbalanced or balanced growth, the issue is make sure you invest properly.

Haenle: Well, as usual, Yukon, you offer different views outside of conventional wisdom and I find it fascinating to talk with you. Thank you so much for spending time with us today here at the Carnegie–Tsinghua Center, you're welcome to come back as often and as much as you'd like. That's it for this edition of the Carnegie–Tsinghua Center China in the World podcast. If you'd like to read Yukon's new paper on China debt, you can find this and other articles on the Carnegie website at www.ceip.org. I encourage you to visit and see the work of all our scholars at the Carnegie–Tsinghua Center. Thanks for listening and be sure to tune in next time.