DINNER ADDRESS

Sustaining China's Economic Growth after the Global Financial Crisis[1]

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China has sustained a global beating pace of economic growth before, during, and since the global financial and economic crisis. Yet, both China's President Hu Jintao and its Premier Wen Jiabao, before and since the crisis, have said that China's economic growth is unsteady, imbalanced, uncoordinated, and unsustainable. I will offer an integrated explanation of why China's leaders regard its growth as imbalanced and the policies that must be adopted if China is to sustain its growth in the future.

China's economy is imbalanced by several criteria but the most obvious manifestation is the outsized share of GDP that is devoted to investment and the concomitantly low share accounted for by consumption, particularly private consumption expenditures. In my view the key source of this imbalance is financial repression, as reflected in a negative real return on household savings. Since 2004 the inflation-adjusted return on a one-year deposit in Chinese banks has averaged –0.5 percent. This is a sharp discontinuity with the late 1990s and the first part of the previous decade, when the real return on the same deposit averaged 3.0 percent.

The sustained negative real return on financial savings over the past eight years has had a double-barreled negative effect on private consumption expenditures. The first reason is that, even though the stock of household savings has grown rapidly, household interest income as a share of GDP has declined between these two periods. Thus, for any given saving rate, consumption has been depressed because the expansion of household income has been below what it would have been if the real interest rate on savings had not turned negative. The second reason that negative real deposit rates have depressed household consumption is that negative real rates appear to have contributed to a sharp increase in the rate of household saving from disposable income. In the years 1997–2003, households saved an impressively high 29 percent of their after-tax income. But since 2004, the average saving rate has averaged 36 percent of disposable income.[2] In short, it appears that Chinese households are target savers, and when the return on their savings declines they compensate by setting aside an even larger share of their after-tax income. This is perhaps not surprising in an economy where the pension and health-care systems are relatively underdeveloped and where many households lack access to any retirement or health insurance schemes and thus essentially are self-insuring.

The negative real return on savings deposits has had a second important consequence, in addition to increasing the rate of saving from disposable income. It has had a profound effect on the form that household savings have taken. Negative real deposit rates, combined with other features of the Chinese financial system, have made residential property a preferred asset class and contributed to a sustained rise in residential property investment as a share of China's gross domestic product. Two other features of the system have contributed to the desirability of residential property as an asset class. First, China's capital account is largely closed, meaning that Chinese households cannot invest in foreign currency denominated stocks, bonds, or other financial assets. They are restricted to investing in domestic assets. Second, the Chinese domestic stock market is marked by insider trading, front running, and other abuses. Moreover, the market has traded down by more than one-third since its peak in the fall of 2007. Thus, the average Chinese household does not regard domestic equities as a viable long-term investment class.

The combination of these factors has led households to allocate a larger and larger share of their savings to residential property. Prior to 2004, when rates on savings deposits exceeded the pace of residential property price appreciation, investment in residential property in urban China averaged 3.4 percent of GDP. Beginning in 2004, as real deposit rates turned negative and property price appreciation accelerated, investment in residential property surged continuously to an average of 6.8 percent in 2004–10, double the share in the earlier period. Household investment in residential real estate has continued to surge since 2010 and looks set to exceed 10 percent of GDP in 2011, setting an all-time record high. Contrary to the popular explanation, increasing urbanization does not seem to explain this jump. In the first period the average annual increase in the urban population was 25 million, while in the second period the increase fell to only 19 million.

The rising importance of investment as a motivation for property purchases is suggested by the measures that the government has taken since December 2009 to limit purchases of residential property units by individuals who do not intend to live in the properties. In December 2009 the government doubled to 40 percent the down payment required to qualify for a mortgage on a property that was not the owner's primary residence. In April 2010, the government raised this ratio to 50 percent, introduced higher interest rates for mortgages on properties that were not the owner's primary residence, and in many cities prohibited households from purchasing more than two properties, regardless of how they are financed.

Investment in residential property in China is substantially higher than in other emerging market economies. In Taiwan in the 1970s and 1980s, a period in which Taiwan's economy grew and urbanized rapidly, investment in residential housing averaged a little over 3 percent of GDP and peaked in 1980 at about 4 percent. In India, investment in residential property rose from about 3 percent of GDP in 2000 to a little over 5 percent in 2008. In contrast the share of GDP devoted to residential real estate investment in China now is twice the record levels in Taiwan and India.

The increase in residential real estate in China since 2004 accounts for about half of the increase in the overall rate of investment in China's economy. In the seven years prior to 2004, capital formation averaged 37 percent of GDP; since 2003, it has averaged 44 percent of GDP and hit an all-time record high of 49 percent of GDP in 2011. China's transformation from an economy with an elevated share of resources going to investment to an economy with a super-elevated share of investment in GDP is largely the result of excess investment in residential real estate.

There are several reasons to believe that the residential investment boom of the past seven to eight years is not sustainable. First, household debt as a share of disposable income doubled between 2008 and 2010, an extraordinary increase. If households decide that they have become overextended, investment in residential property will moderate. Second, over the past decade the share of urban household wealth in the form of real property doubled to 40 percent. It seems unlikely that this share will double again since households will wish to maintain some diversity in the forms in which they hold their wealth. Relatedly, improved governance of the Shanghai Stock Exchange might change the widespread perception that equities are not a viable long-term investment class, leading to an increase in the now relatively depressed share of household wealth held in the form of stocks. Third, banks at some point may decide that their exposure to residential property is sufficiently large that they will choose to curtail property lending. The share of bank loans outstanding to property, either in the form of mortgages to individuals or loans to property development companies has almost doubled to 20 percent since 2004 and these loans relative to bank capital have increased from 150 percent to over 200 percent. Finally, high-ranking Chinese government officials are talking openly about achieving capital account convertibility within the next five years. That would raise the possibility that households could invest in foreign financial assets that have more attractive returns than domestic financial assets, again eroding the preferred asset class status that residential property has enjoyed in China since the mid-2000s.

For an explanation of why China adopted the low interest rate policy that has put it on what appears to be an unsustainable growth path, we need to shift our focus from the internal to the external. Again, it is useful to divide the last 15 years into two periods. From the mid-1990s until about 2002 China's currency appreciated in real effective terms by almost 5 percent per year;[3] China's external position, as reflected in its current account balance, averaged a relatively moderate +2 percent; central bank intervention in the foreign currency market was an amount equivalent to about 3 percent of GDP, so modest that there was little need for sterilization operations to offset the resulting increase in the domestic money supply.

After February 2002, the renminbi depreciated along with the U.S. dollar for several years until the government depegged in July 2005. But the subsequent pace of appreciation was barely sufficient to offset this depreciation so that in the years 2002–09 on average the pace of appreciation was only half a percent per year, one-tenth the pace of appreciation from the mid-1990s through February 2002. As a result, the current account surplus exploded, reaching a peak of more than 10 percent of GDP in 2007 and averaging almost 7 percent of GDP in 2004–10. The central bank, charged with limiting the extent of renminbi appreciation, intervened in the foreign exchange market equivalent to the tune of 10 percent of GDP annually on average in 2004–10, in the process building up the world's largest-ever hoard of foreign exchange reserves, \$3.2 trillion. To keep inflation under control, the central bank had to engage in massive sterilization operations, first selling off its entire holdings of government debt and then issuing massive quantities of central bank bills, with bills outstanding by year-end 2010 standing at roughly 4 trillion renminbi, or 10 percent of GDP. The central bank also raised the required reserve ratio to 21.5 percent by the first quarter of 2011 (compared to the 6 percent ratio that prevailed in the early 2000s), forcing the banks to place an additional 12.5 trillion renminbi on deposit at the central bank, thus limiting banks' ability to lend. To hold down the cost of these sterilization operations, the central bank paid extremely low interest on required reserves and only slightly more favorable rates on central bank bills. Thus, sterilization operations constituted a massive tax on banks. But the central bank made it up to them by setting a very low-level ceiling that banks could pay on customer deposits and a fixed floor on lending rates. Thus, in effect, the cost of the central bank's massive sterilization operation was shifted onto the household sector.

In conclusion, I believe that the single most important policy instrument available to the Chinese government to stimulate domestic consumption and thus alleviate the imbalances in its economy is to resume the process of interest rate liberalization that was halted in 2004. This does not mean immediately eliminating all remaining central bank control of lending and deposit rates but resuming the process of allowing successively larger bands around the rates that the bank sets. In particular, the asymmetric liberalization that occurred through 2004, in which the benchmark interest rates set by the central bank on loans are floors while benchmark rates set on deposits are ceilings, should be modified with the goal, long officially embraced by the government, of moving toward market-oriented determination of interest rates. This would have a doubled-barreled positive effect on consumption, by raising household income and simultaneously reducing the average household saving rate, and would also reduce the share of investment in GDP. The latter would be because lending rates in general would go up and because the preferred asset class status of residential property would gradually end, specifically reducing investment in residential housing to more sustainable levels.

The imperative for domestic financial market liberalization along the lines just outlined has never been stronger. Given the weakness of economic recovery in China's major external markets and the already overdeveloped investment in residential property in China, only more robust private consumption expenditure has the potential to preserve China's high rate of economic growth.

NOTES

1 These remarks are drawn from a book of the same title published by the Peterson Institute in January 2012.

2 Data for the second period are for 2004 through 2008. The saving rate is calculated from China's flow of funds data, the most recent year for which data have been published is 2008. Evidence suggests the saving rate has continued to rise after 2008, so the average saving rate in the second period is almost certainly somewhat understated.

3 The renminbi was pegged to the dollar during these years. But on a real trade-weighted basis, the dollar was appreciating steadily until February 2002, thus the renminbi also appreciated on a real trade-weighted basis.