The economy

On cloud nine trillion

Our Asia economics editor takes his leave, less worried than many of his peers about the frailties and paradoxes of China's economy

Mar 29th 2014 | HONG KONG | From the print edition

SOME economic journalists are like stormbirds: they come alive when financial clouds gather and the thunder rolls. Your correspondent's career has been different. He has migrated away from trouble, escaping crisis-struck Britain for booming India in 2007, then leaving that country before it sank into its sad, stagflationary funk. This will be his last week covering China's economy—which is just as well, given the whiff of ozone in the air.

This month China's corporate-bond market suffered its first default since it began in its present form, a widely watched manufacturing index fell for the fifth month in a row, and officials in one eastern county rushed to placate worried depositors lining up to withdraw money from two small banks. It would seem a good time for a fair-weather bird to fly away.

But China remains a resilient economy. It still has substantial room for error and a lot of room to grow. Although it is already a very big economy (its $9 trillion GDP is bigger than 154 other economies combined) it is not yet a very rich one. Its income per head (at market exchange rates) is only 13% of America's and ranks below that of more than 80 other economies.

Related topics
Asia
China

Because China is already the world's second-biggest economy, it attracts scrutiny that smaller economies escaped when they were at a similar stage of maturity. Observers expect it to pass financial thresholds that other catch-up economies did not cross until much later in their development. This month's bond default, for example, represents a painful but necessary step towards maturity for China's capital markets. Most

commentators saw it as a woefully belated coming-of-age. But Japan did not record its first bond default until the late 1990s, when its standard of living was 3.7 times China's today. Likewise back when South Korea had the same income per person as China enjoys now, foreigners paid little attention to its monthly manufacturing wobbles.

The heft of China's GDP combined with the modesty of its GDP per person is one of the curiosities of China's economy. But it is not the only one (see box). Another example is China's "financial repression". Its central bank caps the interest rate that banks can pay depositors, imposing an implicit tax on their savings. But in China, unlike other countries, this repression does not discourage saving. In fact, it appears to do the opposite. The country's households are "target savers": they squirrel away money to meet a fixed financial goal, such as the down-payment on a home. If their thrift is poorly rewarded, they simply do more to reach their target.

China's financial repression has therefore proved surprisingly sustainable (although restless depositors have sought higher returns from online funds and wealth-management products). It has contributed to China's remarkably high rate of saving, which reached over 50% of GDP in 2012. This is more than China can invest at home, obliging it to export some of its saving (typically 2-3% of GDP) abroad. This incurs the wrath of its trading partners. But therein lies a paradox. Even as China is frequently lambasted for excess saving, the same critics also accuse it of excess borrowing. Worrywarts point out that credit in China has increased from about 100% of GDP five years ago to about 135% of GDP today. The central bank's broader measure of financing (which includes the bond market and some bits of shadow banking among other items) is 180%.

How can an economy suffer from both excess saving and excess borrowing? This riddle is best answered with a textbook parable. Consider a one-farm economy, which yields a GDP of 100 ears of corn. The farmer gives half to a fieldhand as wages and keeps the rest for himself. The fieldhand eats half of his wages and lends the remainder (25 ears) to the farmer. The farmer now has 75 ears of corn. He eats 25 of them, ploughs 48 back into the field as seed corn for next year's harvest and lends two to a neighbouring farm.

Ten curious features of China's economy

1. China is a very big economy (its GDP is ranked second in the world) but not a very rich one (its GDP per person is ranked in the 80s behind Brazil, Mexico and Botswana)
2. In four of the past five years, net exports have contributed less than nothing to China's "export-led" growth
3. China's household consumption rate (36% of GDP in 2012) is among the world's lowest, but its consumption growth rate (12.7% in nominal terms) is among the world's highest
4. China has one of the highest investment rates in history (48% of GDP in 2012), but Chinese workers still operate with less capital (worth less than $58,000 at purchasing-power parity in 2011) than the world average of $82,000
5. In China credit has surged but inflation remains low. Usually fast credit growth contributes to higher inflation, deteriorating competitiveness and trade deficits
6. China has excess saving and excess borrowing. Its savings rate is over 50% of GDP. Its domestic credit amounts to over 180%
7. Banks pay an artificially low interest rate on household deposits, but this has encouraged saving not discouraged it
8. Most central banks have liberalised deposit rates. China's has not. Most central banks seek to stabilise interbank rates. China's does not. So its banks can suffer liquidity crunches
9. China's migrant workers live in overcrowded dormitories, even as many houses remain empty. Landlords view flats as stores of value not sources of rent
10. Signs of abundance (in, say, housing) encourage the bears because they prove "overcapacity". Signs of scarcity embolden the bulls, because "undercapacity" leaves room for further investment-led growth

Source: *The Economist*

To an economist, saving means anything not consumed. Therefore this economy, like China's, has a remarkably high saving rate (the 50% of corn not eaten). But this high saving is combined with heavy domestic borrowing: the farmer has added 25% of GDP to outstanding debt. If, instead of lending corn to the farmer, the fieldhand ate it, saving would fall (because more corn is now being consumed) and so would borrowing (because the farmhand is now consuming his own earnings, rather than lending half of them out).

China's economy last year harvested over $9 trillion worth of goods and services. Almost half of that output consisted of new capital goods (infrastructure, housing, factories and

Follow *The Economist*

Latest blog posts - All times are GMT

The fight for top EU posts: A job for the girl?
Charlemagne - 53 mins ago

The Economist explains: How to measure illegal drug use
The Economist explains - 3 hours 2 mins ago

Rupert Murdoch and Time Warner: Rated "P" for persistent
Schumpeter - 3 hours 53 mins ago

Israel-Gaza: While stocks last
Pomegranate - Jul 16th, 19:57

Winning Scotland: Promises on the doorstep
Blighty - Jul 16th, 17:45

Babbage: July 16th 2014: Big data, small wins
Babbage - Jul 16th, 16:32

America's view of the world: Bauer, Britons and bombs
Prospero - Jul 16th, 15:45

More from our blogs »

Most popular

Commented

1 **War in Ukraine**
A mounting toll

2 **War in Ukraine**: The turn of the tide
3 **Israel and Palestine**: The new normal
4 **Daily chart**: Gaza, in numbers
5 **Scottish independence**: Don't leave us this way

machinery). This investment rate of about 48% of GDP is among the highest ever recorded. Some of this frantic accumulation has been wasteful: building cities without citizens, and bridges without destinations. It is as if the farmer scattered some seed corn on stony ground, where it failed to take root.

Sad but not serious

This "malinvestment" is a pity but it is not enough to undermine China's economic future. The country, as its critics suggest, should have consumed these resources rather than squandering them on ill-conceived ventures. If it had done so, its people would be happier. But, it is important to realise, they would not be any wealthier. Consumption, like malinvestment, leaves no useful assets behind. If the farmhand had eaten the wheat his boss scattered on stony ground, he would be better fed but next year's harvest would be no bigger.

China's high investment has been financed with plentiful credit. One further puzzle is why this surge in credit has not resulted in higher inflation. Investment adds to an economy's productive capacity, which will eventually depress prices. But to build the extra capacity, firms must first hire workers and buy materials. If carried too far, this will push up wages and prices, adding to inflation.

China has escaped this fate partly because a growing portion of credit has been spent on existing assets, including land and property. Because these assets already exist, their purchase does not make any fresh demands on the economy's productive capacity. Buying them does not add to GDP (which only measures the production of new goods and services). Nor does it push up wages and consumer prices.

It will, however, drive up asset prices. These higher valuations can, in turn, raise people's willingness and ability to borrow. In this way, credit and asset prices can chase each other upwards, without any immediate limit. It is as if two farmers were to compete to buy the same storehouse of grain, by offering ever bigger IOUs.

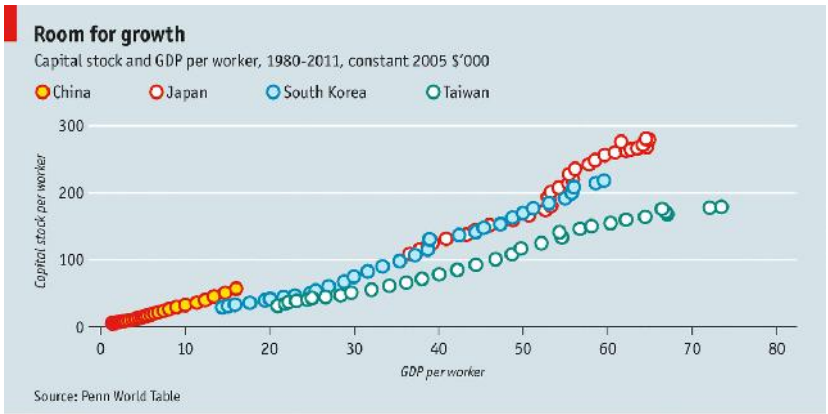
Deflating this credit bubble is the trickiest task China now faces. Stormbirds squawk incessantly about a "Lehman moment". But that disaster was only the second of three acts in America's financial tragedy. The first was an inevitable fall in house prices. The second was a seizure in the financial system after Lehman's bankruptcy, as financial intermediaries lost confidence in each other. The third, interminable act consisted of a prolonged shortfall in spending, as chastened banks and bloodied borrowers licked their wounds.

China will suffer the first of these stages. People will discover they were not as wealthy as they thought. But China should escape the second and third stages. Rather than allowing banks to fail, the central government—or even the central bank—can step in and take bad loans off their balance sheets. Credit will stop growing as quickly. But since China's credit excesses added little to GDP, unwinding them need not subtract greatly from GDP. If a lack of lending or spending does threaten to drive output below its full potential, the government can oblige banks to lend and state-owned enterprises to spend.

This may seem too good to be true. But it reflects the peculiar nature of China's excesses. Asset prices may need to fall. But production does not. China suffers from neither inflation nor a big trade deficit. It is not living beyond its means. It does not need to spend less; it needs to spend differently. For every sunset industry that must contract (steel, solar energy, baroque flats), a sunrise industry should expand (health care, logistics, spartan flats). Otherwise it will fall short of its potential. It must consume more of its harvest and invest less of it. But it should still reap that harvest in full.

Of course, it is not always easy to reallocate labour and capital from oversupplied industries to under-served ones. But this is not a challenge unique to China, nor is it unique to this period in its history. The composition of China's output, like every other economy's, is always changing. In the past six years alone, exports have fallen from 38% of GDP to about 25%, and services have grown from 42% to 46%.

China's excesses should also be kept in perspective. It has indeed accumulated more capital per worker than other fast-growing countries had at a similar stage of development (see chart). But it also has many stages of development ahead of it. Its capital stock per worker is only about a quarter of South Korea's, for example. As the economy grows, big problems tend to diminish in its rear-view mirror. In 1998 up to 40% of China's loans turned sour. Cleaning up the mess cost 5 trillion yuan, or 58% of China's 1998 GDP. But China's growth makes molehills out of mountains: 5 trillion yuan now represents less than 9% of its GDP. New production quickly eclipses the old. Indeed, of all the goods and services ever produced by the People's Republic of China, over 30% were churned out in the four years since your correspondent arrived in 2010.



On a prior visit to Shanghai, he enjoyed a drink at Cloud 9, a bar at the top of the city's then tallest building. He recommended the same bar to his wife a few years later, only to realise (too late) that the tallest tower was no longer the same one. Now Shanghai is conjuring a third tower to overshadow the other two.

This new peak was recently scaled by two foreign trespassers, who posted a video of the climb online. The pair looked woefully ill-equipped, but the view from the top was breathtaking and a little gut-wrenching. This feeling of being overawed, under-equipped but well-rewarded is familiar to anyone lucky enough to write about China's vertiginous economy.

From the print edition: China

The Nordics in charge: A Scandinavian wave