

A Note on the Nature and Sources of Chinese Recovery

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The release of China's macroeconomic data for the second quarter of 2009 became a source of major debate among economists. The cause of debate was 7.1% growth clocked by China in the first half of this year even as GDP in large parts of advanced capitalist world continued to stagnate or shrink. US GDP in 2009, for example, shrank by 6% in the first quarter and by another 1% in the second quarter. Some questioned the veracity of the Chinese GDP figures pointing towards the anomaly of falling electricity consumption with the recovery in GDP growth¹. Others were less uncharitable but pointed out that growth was accompanied by massive speculation in real estate and stock markets fed by nearly 30% credit growth in this period. Zhang Hong, for example, warned in his Aug 28 column in *Guardian*:

“The fast-rising stock and real estate markets suggest a large portion of the new loans have been used in speculative investments, causing another round of asset bubbles in China. This won't much help China's real economy. When the bubble bursts, the banks will be sitting on a huge amount of bad debt. China risks repeating the same game as America after the dotcom boom and burst”².

As growth has recovered even further in the third quarter, this view has intensified and experts are now worried that credit financed expansion of real estate and stock markets will leave Chinese banking system severely impaired. In the doom scenario, banking crisis in China will cause a long recession similar to the one experienced by Japan in the wake of its banking crisis in 1990s³. Moreover, many observers see the current revival, based on 'inefficient' investments by state owned enterprises (SOEs), as being detrimental to the long

¹Brad Setser, “The Chinese Puzzle: Why is China growing when other export powerhouses aren't?”, <http://blogs.cfr.org/setser/2009/06/09/>.

² Zhang Hong, “Too early to hail China's stimulus success”, *Guardian*, 28 August 2009.

³ See, for example, “China Real Estate Burgeoning Bubble Special Report”, *marketoracle.co.uk*, 15 Oct 2009.

term interests of Chinese economy. Credit directed towards SOEs will only increase Non-Performing Loans (NPLs) of the banking system. Since government may have to bail out many of these banks, current recovery will act as a drag on government finances in future. SOE led revival may therefore severely compromise the long term prospects of Chinese economy⁴.

With the help of data for the first three quarters, this note seeks to examine some of these propositions on the nature of Chinese recovery. Examination of Chinese macro data shows that three features of the Chinese recovery process are undeniable: that the recovery has been state led, investment led and tertiary sector led. Stock and real estate market boom has accompanied the growth process but does not seem to be the major driver of growth in this period.

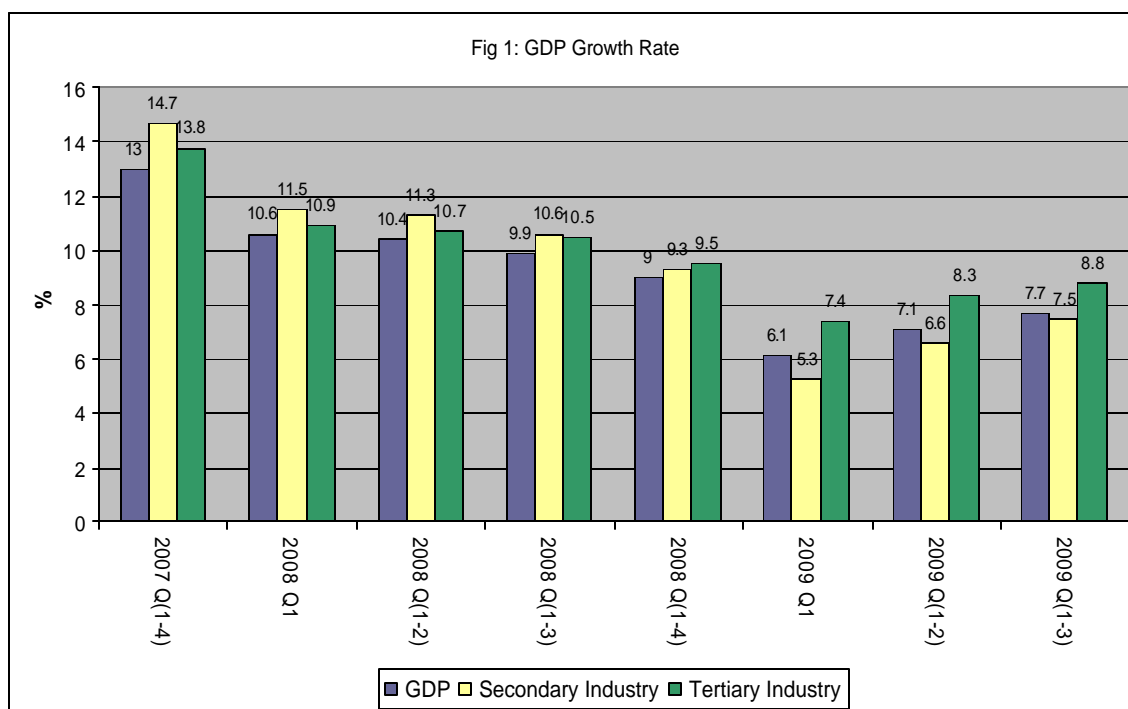
GDP Growth

The decline in the Chinese growth rates due to global recession started in the last quarter of 2008. Growth rate for the first three quarters of 2008 was 9.9%. For the full year 2008, growth rate was 9%. There was some decline in the growth rates even in the first three quarters of 2008 compared to the 13% growth rate achieved in 2007. However, this was an outcome of domestic policies to prevent overheating of the economy. The impact of the global crisis is felt beginning fourth quarter of 2008. While the growth of 9% p.a. for the full year 2008 appears respectable even by Chinese standards, the picture changes when we limit focus to the last quarter of 2008, when the growth of GDP was just 6.8%. The growth then dipped further in the first quarter of 2009 when it stood at 6.1%. Since then the recovery has been well on its way. The growth rate of GDP in the first three quarters of 2009 stood at 7.9%.

Close observation of fig 1 clearly reveals the role played by tertiary sector in the current recovery. Growth rate in tertiary sector in the first three quarters of 2009 was only 1.7 percentage points lower than its growth in first three quarters of 2008. On the other hand,

⁴ The view that SOEs act as a drag on banking system and government finances can be found in Wing Thyee Woo, 2006, "The Structural Nature of Internal and External Imbalances in China", *Journal of Chinese Economics and Business Studies*, Feb 2006.

growth rates in secondary sector fell by more than 3 percentage points over this period. Clearly, tertiary sector has behaved less pro-cyclically when compared to the secondary sector. As we shall see, services sector growth in this period has been sustained by huge increase in government fixed investment in areas like transportation.



Source: National Bureau of Statistics of China

Note: 1. Growth is over the corresponding period in previous year, 2. Q1 refers to first quarter, Q(1-2) refers to first half, Q(1-3) refers to first 3 quarters and Q(1-4) refers to full year.

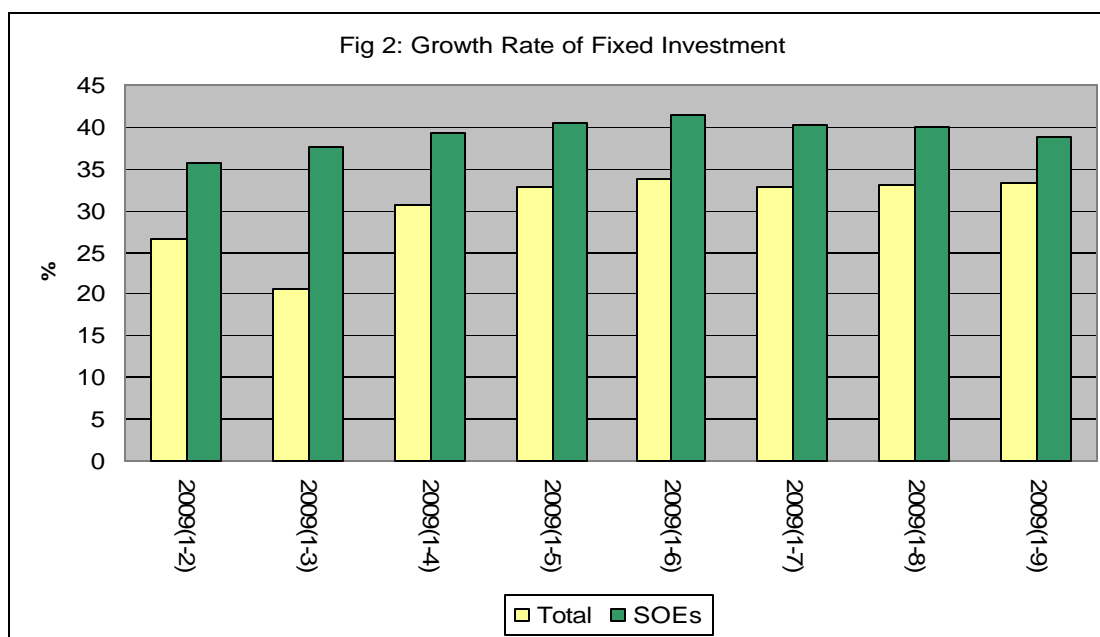
Fixed Investment Led Recovery

If we look at the expenditure composition in the period of revival, we get a very clear picture of the dominance of fixed investment. For the first three quarters of 2008, the share of fixed investment in GDP was 49.4%. In the first three quarters of 2009, the share increased to 61.1%. While total retail sales of consumer goods also grew in this period by 15.5%, the growth in fixed investment was much higher at 33.3%. Investment has thus played the most dynamic role in the current recovery⁵. There are at least two features of this massive growth

⁵ It is needless to point out that the decline in GDP growth was caused by a fall in trade surplus. Investment and consumption are now replacing trade surplus as a source of aggregate demand. China's trade surplus in the first three quarters of 2009 was US\$135.5 billion, down by US\$ 45.5 billion year-on-year.

in fixed investment that deserve mention. Firstly, the increase has been led by SOEs. Secondly, in a very large part, this increase has been directed towards the tertiary sector.

It is evident from Fig 2 that this massive increase in fixed investment has been led by State Owned Enterprises. For the first three quarters of 2009, growth rate of fixed investment by SOEs was 38.8% whereas total growth of fixed investment was 33.3%. It can be noted from Fig 2 that in the first two months of 2009, the gap between growth of total and SOE investments was quite large. Probably, the gap has closed down with time because investments by SOEs, by preventing demand from falling drastically, have pulled up private sector investments as well.



Source: National Bureau of Statistics of China

Note: 1. Growth is over the corresponding period in previous year, 2. (1-2) refers to first two months, (1-3) to first three months and so on.

A very large share of fixed investment in the recovery period has gone to the tertiary sector. Fixed investment in tertiary sector in this period has grown by 38.1% whereas total fixed investment has grown by 33.3%. Within the tertiary sector, highest growth rate was recorded by Health, Social Security and Social Welfare (Table 1). However, given the small base on which this high growth has been achieved this category makes only a small contribution to

the overall increase in fixed investment within the tertiary sector. In terms of nominal change, the largest increase can be witnessed in the category of transportation where fixed investment increased by 553 bn yuan in the first three quarters of 2009 (over the same period in the previous year). Transportation was followed by real estate and water conservation, environment and management of public facilities with the increase of 546 bn Yuan and 406.5 bn Yuan respectively. Besides these items in the tertiary sector, China has also witnessed a very large increase in fixed investment in the secondary sector including that in the production and supply of electricity, gas and water.

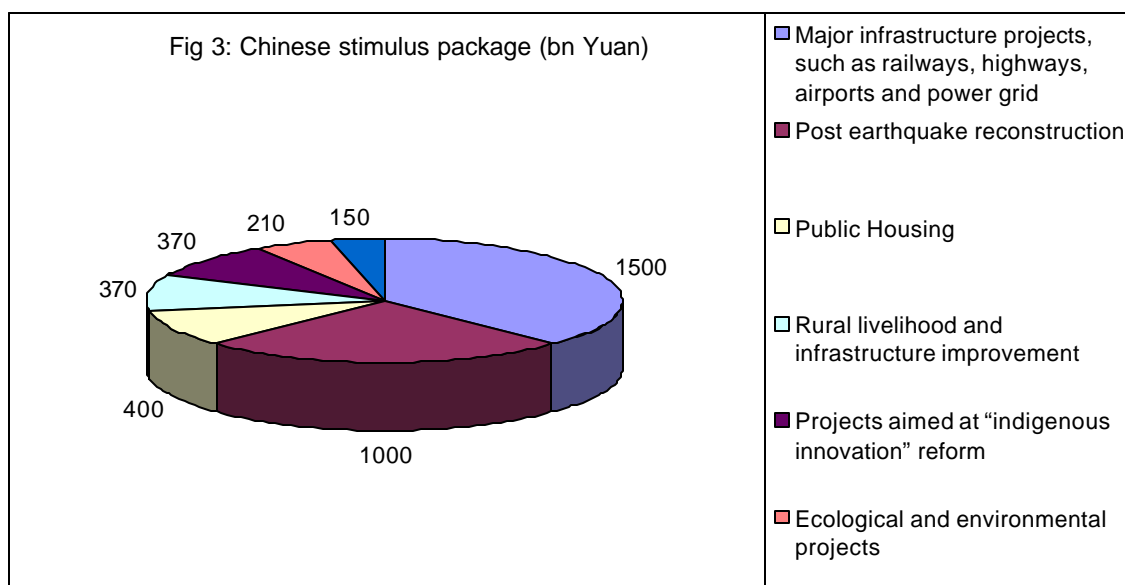
Table 1: Composition of Fixed Investment in First Three Quarters of 2009		
	% Growth in first three Quarters	100 mn Yuan
Total	33.3	133177
Primary	54.8	2365
Secondary	26.9	57044
Production and supply of Electricity, Gas and Water	27.3	9001.56
Tertiary	38.1	73768
Transportation, Storage and Post	59.3	14856.28
Railway transport	87.5	3535.53
Real estate	22.4	29877.01
Water Conservation, Environment and Public Facilities	51	12037.24
Health, Social Security and Social Welfare	72.9	1175.74
Education	42.4	2280.84

Source: National Bureau of Statistics of China

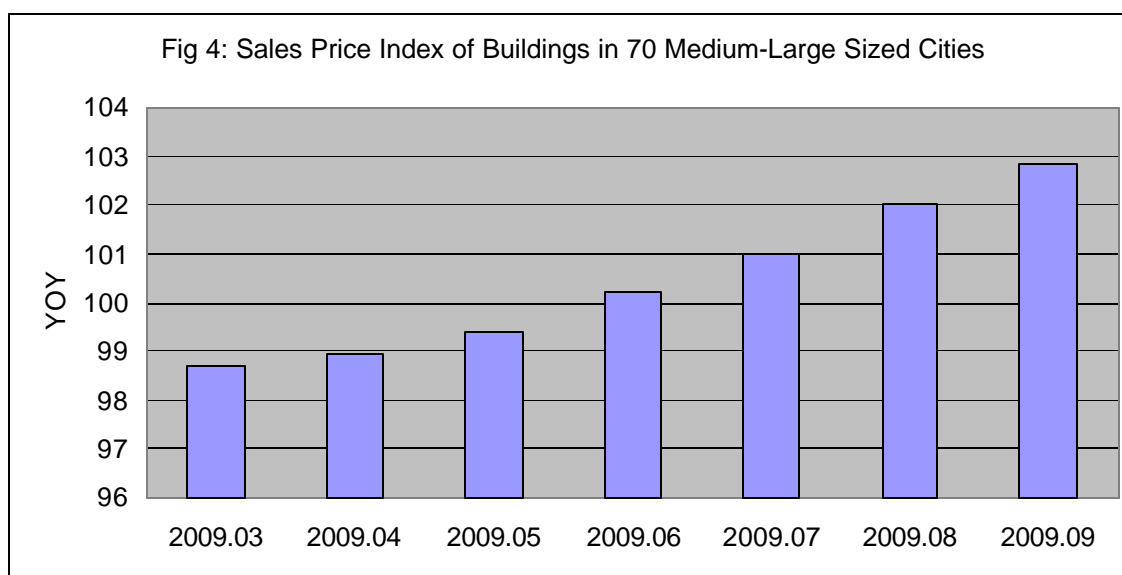
Examination of China's November 2008 stimulus package shows that recovery has been taking place according to priorities set in this package (Fig 3). Largest amount within the stimulus package, nearly 1.5 trillion yuan, was set aside for investment in transportation and power grid. Not surprisingly, in the first three quarters of 2009, most significant increase in

fixed investment has taken place in these areas. Increase in health, education and environment has also taken place according to direction of recovery set in the package.

In the backdrop of these data, what can be said about the view that the Chinese recovery is unsustainable since it is feeding a dangerous bubble in the stock and real estate markets? Going by the number of newspaper stories and anecdotal evidence about booming property markets in China, there must be some truth in this view. However, there is a need to temper this view with some hard facts. Firstly, real estate investment forms only 16% of the increase in total fixed investment over this period. Secondly, public housing is stipulated to be 10% of the stimulus package of 4 trillion yuan (\$ 585 bn) announced in November 2008 (see fig 3). Since a part of increase in real estate investment is likely to have been directed for this purpose, it will be wrong to treat entire increase in real estate spending as being speculative in nature. Thirdly, as fig 4 shows, while some recovery of real estate prices has taken place in China in recent months, real estate prices have increased by only 2.9% between September 2008 and September 2009. This is, of course, not to deny the existence of any problem in China's real estate market. Real estate prices were probably too high even before the recovery started in China. However, in the light of facts presented here, it would also not be an exaggeration to state that recovery in China would have been on a strong footing even in the absence of this bubble.



Source: Economist Intelligence Unit, "China's Stimulus Package: A Six Month Report Card"



Source: National Bureau of Statistics of China

Understanding Explosion of Credit

One of the factors that have made economists skeptical of the recovery process is the massive increase in credit. Out of the outstanding loan portfolio of 39 trillion Yuan of all financial institutions in September 2009, 8.7 trillion Yuan was added since Jan 2009. This means that nearly 25% of the outstanding portfolio of Chinese financial institutions has been built in last nine months. Needless to say such a rapid increase in credit supply has raised apprehensions about the sustainability of growth in China. It is however necessary to understand why credit is growing so rapidly in China. Out of the 4 trillion Yuan stimulus package, Central government will reportedly contribute only 1.18 trillion Yuan and local governments another 1.23 trillion Yuan⁶. Rest of the increase in expenditure is supposed to take the form of bank loans to SOEs. To ensure increased availability of credit for stimulus financing, State council increased credit quotas of the state owned banks (SOBs) and directed them to increase lending. In fact, Bank of China and Agricultural Bank of China signed co-operation agreements with railway ministry to support the increase in railway infrastructure. Therefore, much of the observed increase in social and economic infrastructure is currently being financed by the banking system. Banking system's

⁶ Economist Intelligence Unit, 2009, "China's Stimulus Package: A Six Month Report Card".

participation in the stimulus package has resulted in huge growth of credit. Of course a part of this credit has been leaking out of the banking system to stock and real estate markets, but this was not the intended outcome of the strategy of credit loosening. Zhang Hong's comparison between post-dot com bust US, intentionally feeding bubble in the real estate market with loose credit, with China today therefore seems rather exaggerated.

Credit Financed Expansion of SOEs

There is however another view that argues that the central problem lies with the low profitability of SOEs. Growing indebtedness of low profitability SOEs will only serve to exacerbate the future problems of Chinese banks and government that will be forced to bail out these banks. It is important to note relevant historical facts in this regard. Dic Lo (2005) has pointed out that, historically, pre-tax profit rate in China's SOEs has not been lower than average profit rate in Chinese industry⁷. It was higher than average in the eighties and slightly lower than average in the recessionary conditions of the late nineties. However, the gap between pre and post tax profit rates is higher in case of SOEs. Lo (2005) therefore concludes:

“In contrast to the allegation that SOEs have been a drag on the economy in the form of taking up state subsidies and generating bad loans for state banks, the distributive relationship between the state and SOEs has been characterized by surplus transfer from the latter to the former ”.

Comparison also needs to be drawn between high debt-high investment model of Chinese SOEs and corporates in other East Asian countries in their stage of industrialization. High debt-high investment model of corporates in these countries remained sustainable till many of them undertook ill-advised programmes of financial liberalization. For example, short term borrowings from abroad by merchant banks in Korea made the entire corporate model of high debt-high investment unsustainable. As foreign capital stopped flowing in and depreciation of won increased debt burden in domestic currency terms, highly indebted corporates in Korea collapsed. Taking clue from the experience of these countries, China

⁷ Dic Lo, 2005, “China, the ‘East Asian Model’ and Late Development”, Paper Presented at the Conference on Comparative Political Economy of Globalisation, SOAS, London.

should resist opening its borders for short term finance capital. However, it is precisely in this direction that some disturbing trends have emerged recently.

Disturbing Trend of Hot Money Inflows

In the second quarter of 2009, large amount of hot money capital flew into the Chinese economy. China added an unprecedented \$178 bn to its forex reserves in the second quarter of 2009. Reportedly, China's trade surplus and FDI in second quarter of 2009 were \$34.8 bn and \$21.2 bn respectively⁸. This means that bulk of reserve accumulation in the second quarter of 2009 has been on account of speculative inflows. This huge increase in hot money capital has found its way into the Chinese stock markets. Since the beginning of the year, Shanghai Composite Index has risen by more than 50% (fig 6).

There are two ways in which this boom (and, perhaps, also the much talked about real estate bubble) can harm the real recovery in China going forward. Firstly, sooner or later, this boom will burst and the accompanying financial dislocation will definitely harm real economy to some extent. For example, given China's fixed exchange rate regime, capital outflow may lead to contraction of credit and put a spanner in the works of recovery led by debt financed investment. Secondly, hot money inflows are aggravating China's long standing problem of unduly large forex reserves. Despite the reduction in trade imbalances, the reserves have grown and so has the expected loss due to fall in the value of dollar. Chinese government will therefore need to consider some curbs on inflow of speculative capital into its economy.

Conclusion

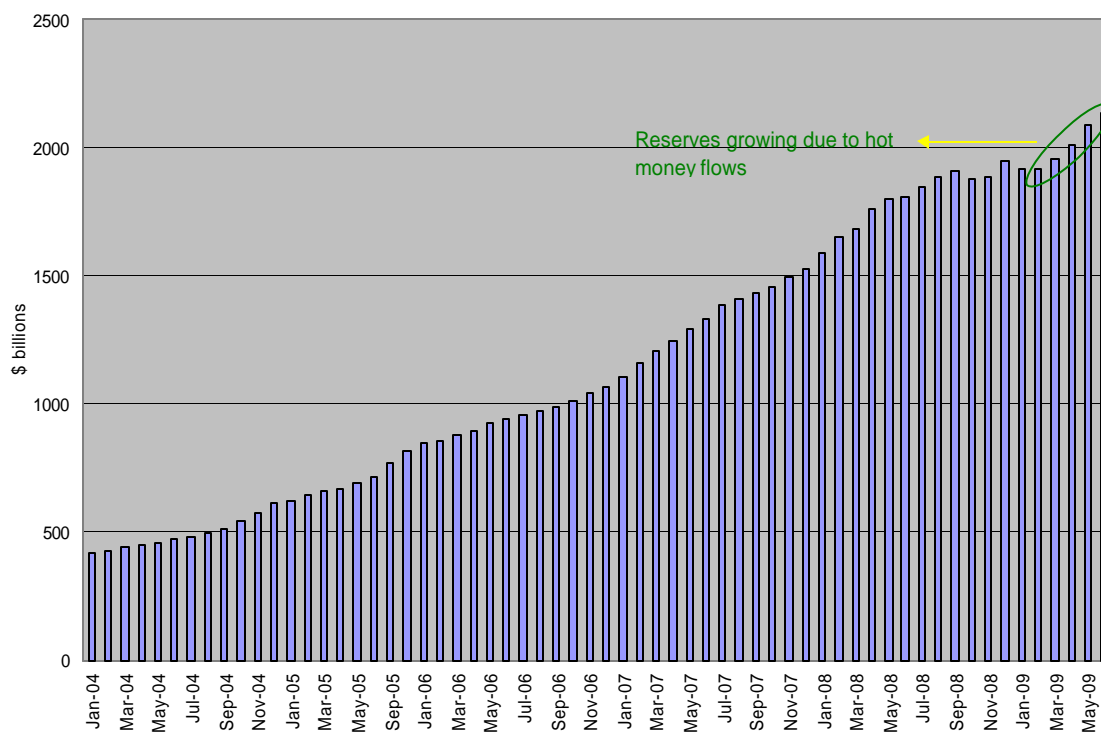
Large and timely fiscal stimulus implemented by China has ensured that downswing in its economy has neither been steep nor painfully long. A good point of contrast would be the United States, where GDP growth hovered in the negative territory for a good part of 2008 and 2009. It is true that the recovery has been accompanied by some irrational upswings in real estate and stock markets. However it would be a mistake to view China as being a

⁸ "China's Foreign-Exchange Reserves Surge, Exceeding \$2 Trillion", *bloomberg.com*, 15 July 2009.

bubble ridden economy akin to Japan in the eighties or US prior to the recent housing market crash.

At a deeper level, China's ability to undertake a large fiscal stimulus shows the relative autonomy of the Chinese government from the pulls and pressures of finance capital. In other countries, especially the US, vested interests in the financial sector have opposed any major programmes of revival through government spending. Government intervention was acceptable to these interests only to the extent that it involved bailing them out. On the other hand, financial system in China has played an important role in implementing government's stimulus package. Despite some adverse trends in its financial markets, China still stands out as a country that can direct its financial sector resources towards goals of national development.

Fig 5: Foreign Exchange Reserves



Source: State Administration of Foreign Exchange

Fig 6: Shanghai Composite Index



Source: Bloomberg