Opinion Chinese economy

China's economic ills are serious but not incurable

Unfortunately, policymakers have made things worse by resorting to temporary palliatives

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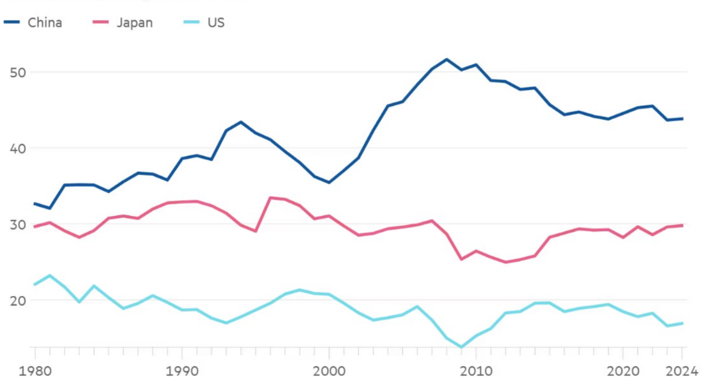
Martin Wolf YESTERDAY

Need China turn into Japan? No. Might it turn into Japan? Yes. Moreover, the longer it waits to tackle its ailments, the more likely it is to fall seriously ill, with slow growth and chronic deflationary pressure. Some outside analysts believe this is inevitable. But wanting to believe something does not make it true. China's disease is not incurable. But it is serious.

It is vital to distinguish causes from symptoms, before seeking the cure. Because Chinese policymakers have refused to recognise the nature of the disease, they do not cure it. Over time, they have made it worse, by resorting to temporary palliatives. That happened to Japan in the 1980s and 1990s and has been happening to China in the past two decades. But China retains important strengths. It can still avoid stagnation.

China and Japan have vastly higher savings rates than the US

Gross national savings as a % of GDP



Source: IMF

The Chinese government has now announced monetary and fiscal stimulus. That was predictable. It is what, willy-nilly, Japan needed to do. It is also why Japan has had near-zero interest rates for three decades and its net public debt is 159 per cent of GDP. Just as is true of China's policies now, this was the result of an underlying condition of "underconsumption", or structurally deficient demand. Given that condition, demand needs to be stoked. Huge property bubbles are a feature of such economies, not a bug, as is the desperate need to intervene manically when they burst.

Between 2000 and 2024, China’s gross national savings averaged 45 per cent of GDP and Japan’s averaged 28 per cent. Meanwhile, those of the US averaged only 18 per cent. When investment opportunities are superb, these high savings rates can finance superfast growth. In China, as with Japan, the high savings rates financed incredibly fast growth until the early 2000s. Yet after a long period of such growth, the supply of high-return investments inevitably declines. So investment weakens, as does demand. What was a strength turns into a weakness.

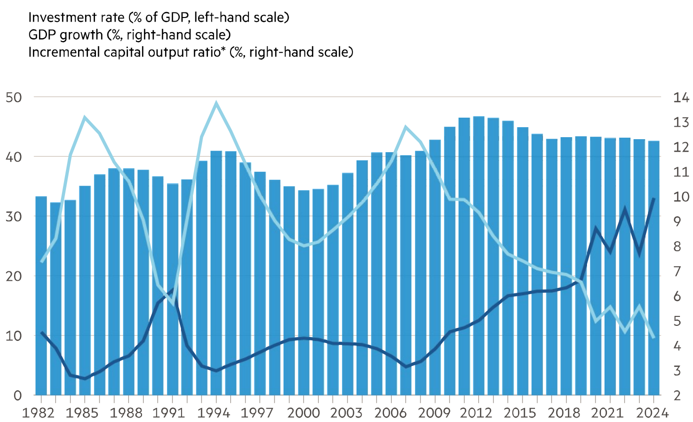
One solution, taken by both Japan and China, was to run a huge current account surplus, alongside the high investment. But, in both cases, this encountered external resistance, notably from the US — in the 1980s, for Japan, and in the 2010s, for China. In both cases, monetary policy was loosened, credit exploded and a huge boom in real estate was unleashed, again in the 1980s in Japan and the 2010s in China. This rapid growth of credit-fuelled investment in real estate became the new engine of demand. According to a recent paper for China Leadership Monitor by Logan Wright of Rhodium Group: “Property construction represented around 23-27 per cent of GDP from 2011 to 2021.” If so, it absorbed about half of China’s savings.

The huge defect of the “let us have a real estate bubble” solution to excess savings is that its bursting leaves a residue of falling asset prices, unpayable debt, damaged finance and unhappy people. Worse, it also leaves still weaker demand, as the impact of the collapse further undermines investment and so exacerbates excess savings. Without strong policy action, the latter is almost certain to deliver a deep depression.

Analytically, the solutions are threefold: temporary boosts to demand, to stave off the depression; cleaning up the financial system (which, in the case of China, includes local governments); and, above all a new, potent and long-term source of demand. The Chinese authorities will do the first two, in the end, even though it will mean parking a lot of debt on the government’s balance sheet (which they will hate). But they are, alas, wrong-headed on the third.

China's persistently high investment rate brings ever less growth

Incremental capital output ratio (average of previous three years)



FINANCIAL TIMES Source: IMF • * investment share in GDP divided by GDP growth. 2024 = IMF forecast

Minxin Pei, editor of the China Leadership Monitor, argues that the Chinese leadership believes that the long-term solution lies with new “high quality productive forces”. It is true that technological upgrading is a necessary condition for rapid growth. It is true, too, that since China is still a relatively poor country, with real GDP per head at about a third of US levels, it has good potential for catch-up growth. It is also true that even though its population is ageing, the quality of its labour force will improve and a reservoir of rural labour also remains. The pension age can also be raised. Again, recent attacks on the private sector can be reversed. In all, there are reasons to believe that the economy’s supply-side potential remains decent, with the right policies.

Yet the big problem is not the potential of the supply side. It is the weakness of the demand side. An economy whose potential growth rate is 5 per cent at most will not invest more than 40 per cent of GDP productively. Already, the growth generated by a given level of investment, or credit expansion, has collapsed. China is far too big to hope that investment in brand new manufactures, a significant part of which would then pour on to world markets, can — or will be allowed to — replace the gigantic investments in real estate of the past decade. On this point, Wright’s analysis is compelling.

The real estate boom was, quite simply, the last throw of the dice of the ultra-high savings economy. That economy is now going to deliver chronically weak demand. According to Wright, the share of household income in GDP is only 61 per cent. The resulting low share of consumption is too small to absorb China’s potential output. But the rest of the world will not make up the difference. But trying, instead, to invest 40 per cent of GDP is sure to lead to waste and yet bigger mountains of bad debt.

China needs higher consumption. But that reality creates a challenge to Chinese leaders. They seem to feel that investment and production are virtuous, while consumption and income redistribution are frivolous. Yet, as Adam Smith wrote, “consumption is the sole end and purpose of all production”. Xi Jinping needs to embrace this truth.

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