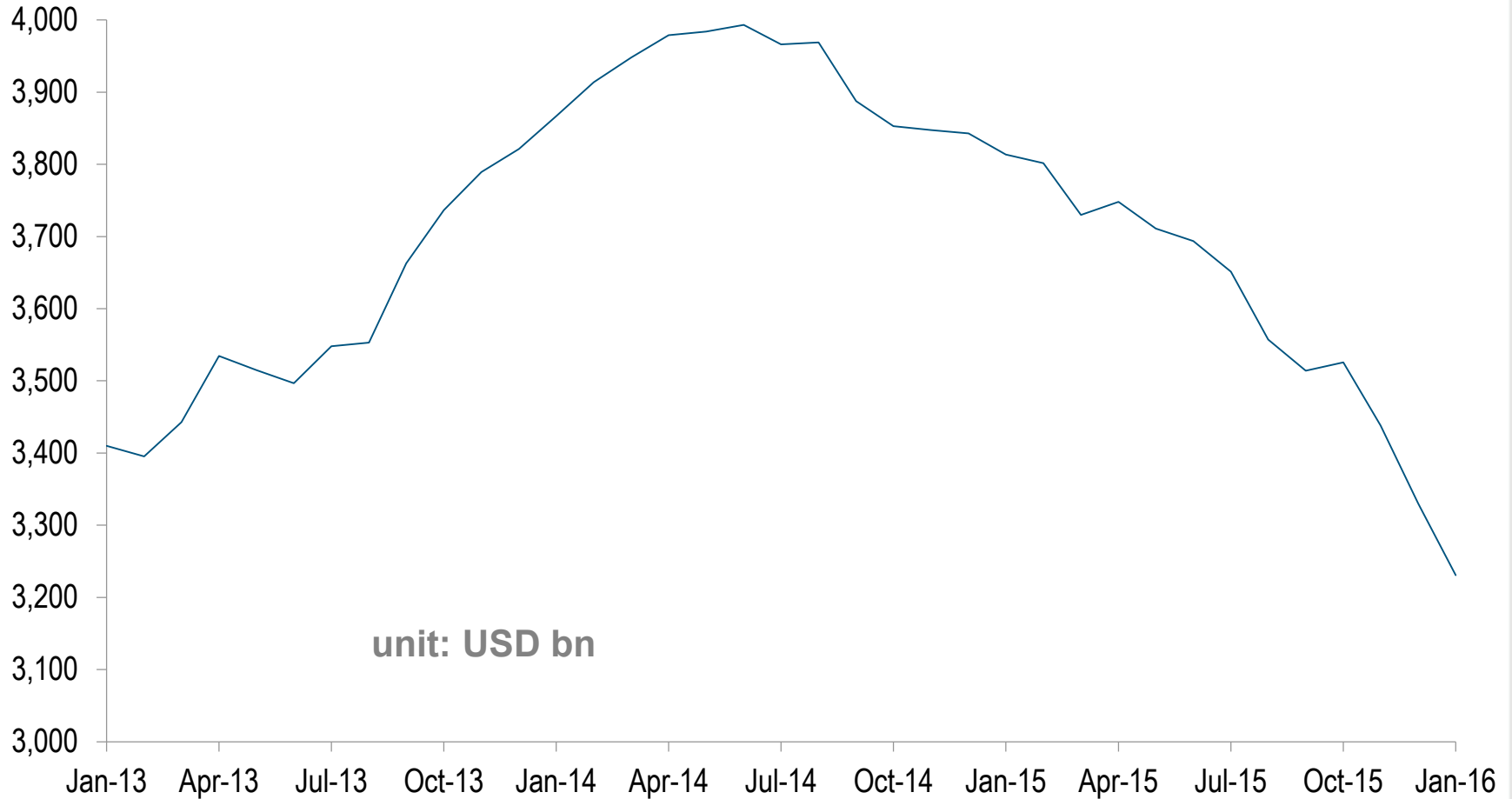# Current Developments of Chinese Economy

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March 1 , 2016

The stock market has been eventful since last year
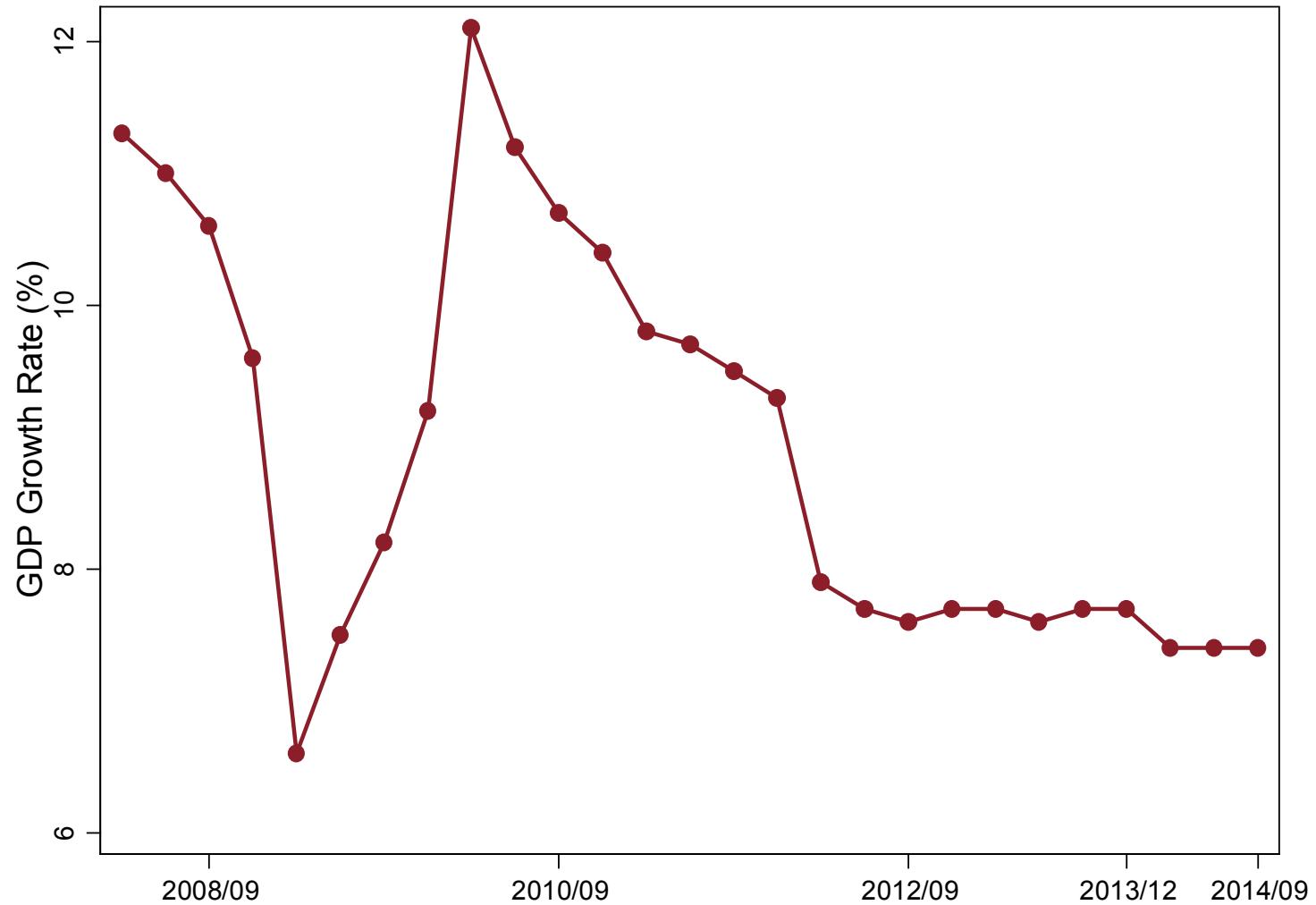

Shanghai Stock Exchange Composite index

Exchange Rate Instability and Capital Outflow Lead to Declining Foreign Reserve

unit: USD bn

Housing Market: Great Divergence

- Even hotter housing market in a few mega cities: Beijing, Shanghai, Guangzhou and Shenzhen, etc.

- Over-capacity and extremely soft markets in the rest of the country:
  - Financially distressed developers
  - Shortfalls of city fiscal revenues
  - Banks and financial institutions

因思想 而光华

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1985-2015
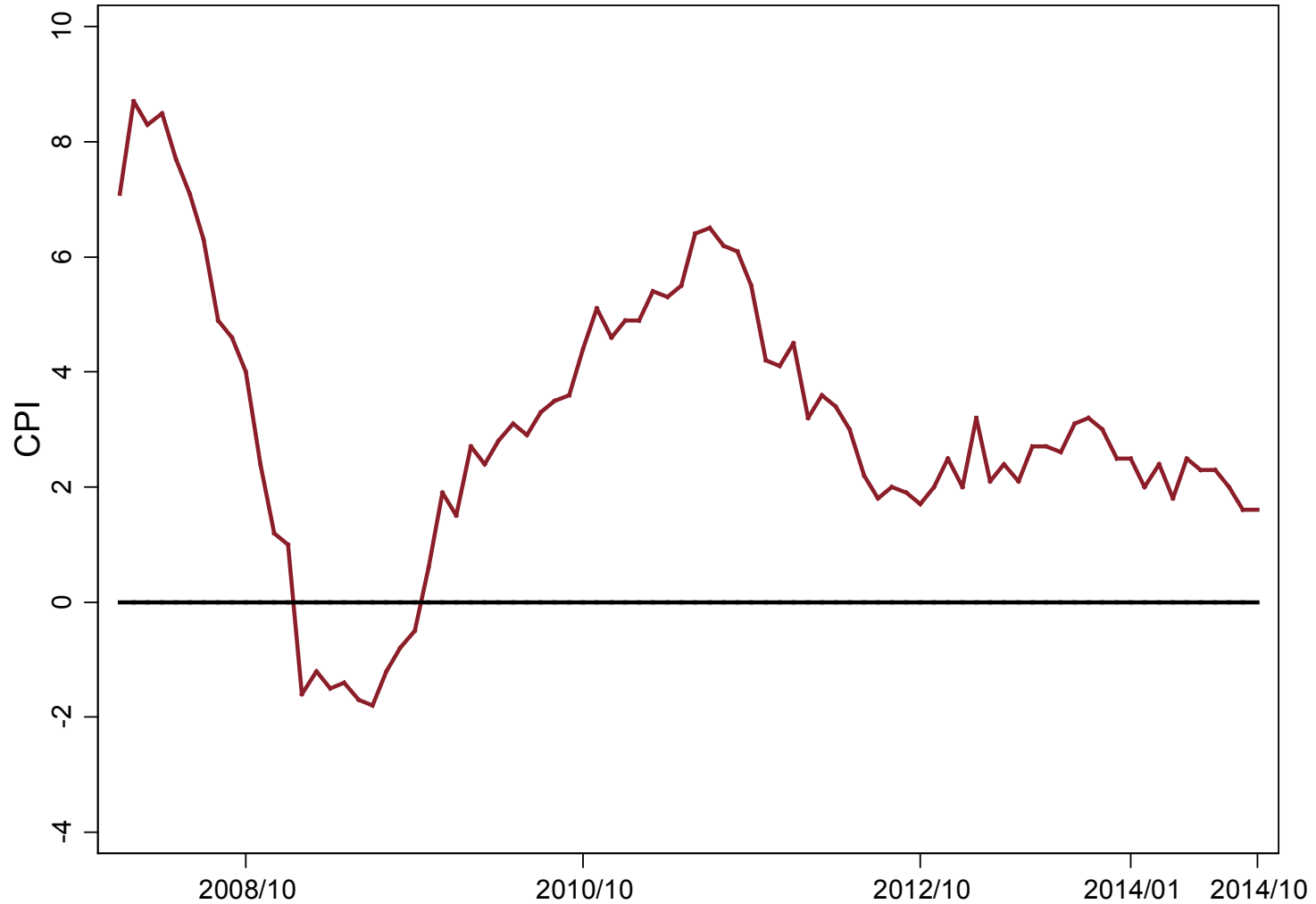
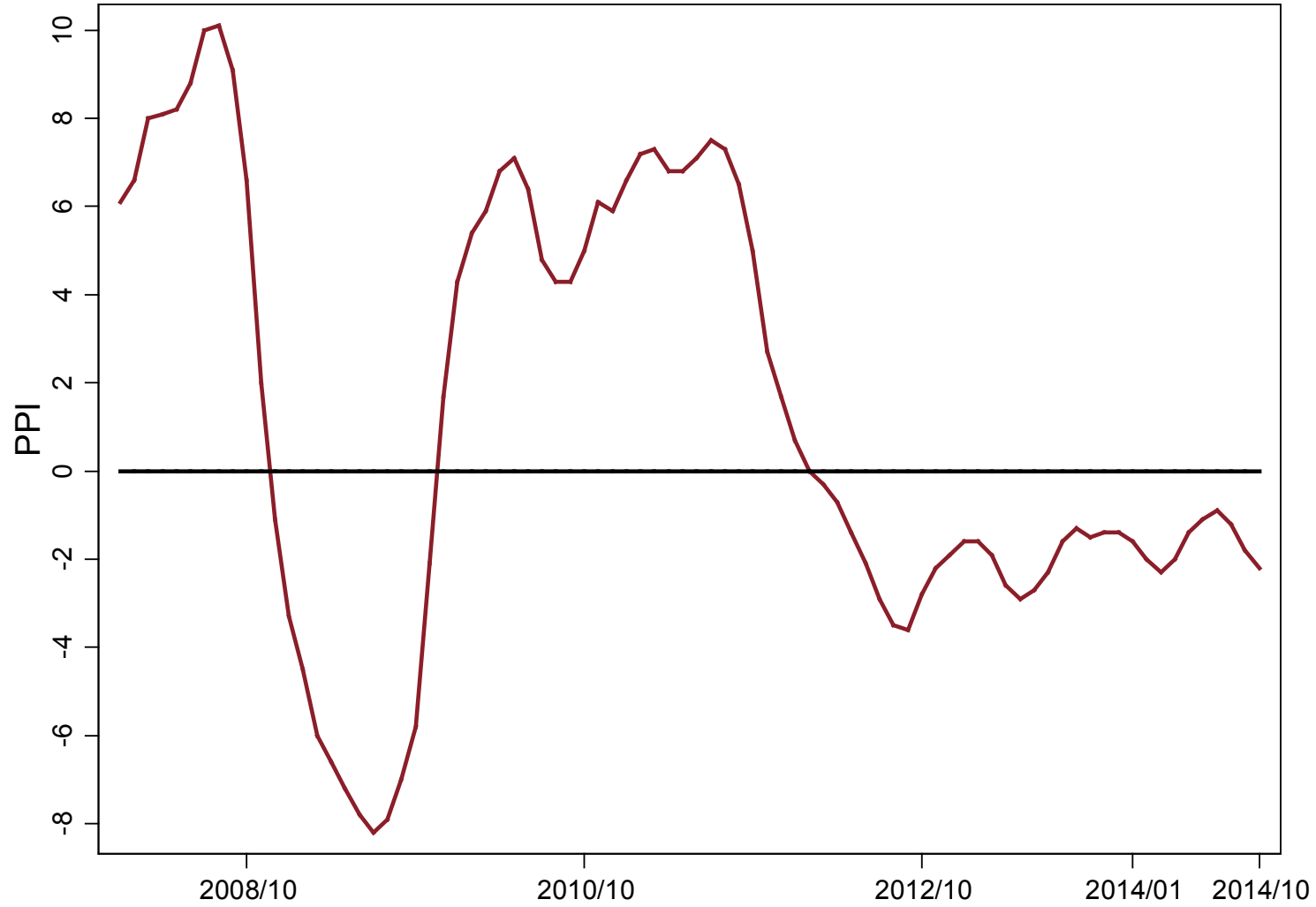# Growth Rate Continues to Slide

Weak Demand Leads to Deflation

- Price level has been low or going down

- CPI has been falling from 2013, and has been below 2 since June 2012.

- PPI has been negative since March 2012.

- Cumulatively, PPI has declined more than 15%.

Consumer Price Index

Producer Price Index

What is going on? ??

- According to the Chinese, it is the year of the Monkey. ☺

- It is an integrated world, so you can always blame your problems on others.

- "Five little monkeys jumping on the bed,….."

Key Factors for Chinese Economy

- China's ability or inability to manage the ever more complex economy

- Success or Failure in rebalancing the economy (too much investment, too little consumption)

China's inability to manage the economy?

- Paul Krugman : "China's Naked Emperors" (NYT, 2015-07-31)

- "China's remarkable success over the past 25 years notwithstanding, the nation's rulers have no idea what they're doing".

- "Forget everything you've heard about their brilliance and foresightedness. Judging by their current flailing, they have no clue what they're doing".

Economic policy-making in China is quite different

- **Mature Market Economy**
  - strong micro-foundation: labor and capital markets, R&D, human capital, innovation, ….
  - weak macro-control: monetary (Central Bank), fiscal (Congress)

- China:
  - weak micro-foundation: systematic reforms are needed
  - strong macro-control: a very large tool box
    - Monetary policy (PBOC)
    - Fiscal policy (MOF)
    - State-controlled Banks
    - Local governments
    - SOEs
    - ………..

Economic policy-making process in China

- A model of lobby at a higher level?

When decision-making can be effective

- Given the unusually large tool box, effective economic policy-making requires:
    Clear and coherent policy direction by the decision maker
    Timely and objective information about the economic situation
    Good balance among diverse interests (incentive compatible)
    Capacity to coordinate actions by various regulators

- Examples: growth stimulus (1989-1991, 1998-1999, 2008-2009)

- This is the "brilliance and foresightedness" referred to by Paul Krugman.

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Ineffective economic policy-making

- In this model, economic policy-making can be ineffective if any of these fails to hold
    - Clear and coherent policy direction by the decision maker
    - Timely and objective information about the economic situation
    - Good balance among diverse interests (incentive compatible)
    - Capacity to coordinate actions by various regulators

- In particular, if information is very scattered and interests are very diverse (as in the case of the stock market), effective policy-making can be enormously difficult.

- It is not "they have no clue," they have too many clues!

How does China improve on economic policy-making

- Decision-maker's tool box is way too large, systematic reforms are needed (e.g., SOE reform, Banking sector reform, local government reforms, …)

- Economic policy-making process needs to be simplified.

- Some consolidation is needed to coordinate better

- Better communication with the market is needed.

"Rebalancing" is a Wrong Diagnosis

- "Too little consumption, too much investment" was the universal diagnosis for the Chinese economy for a long time.

- " Rebalancing the three wheels (consumption, investment and exports)" had been the main theme of China's economic policies for the last decade.

- But it was based on a myth based on the wrong understanding of Chinese statistics.

Rebalancing is a myth.

- US housing consumption is almost 20% of household consumption, and 14% of GDP. In contrast, China housing consumption is only 8% of household consumption, and 3% of GDP. The difference is largely due to different methods in calculating imputed rents.

- Service sector: advanced economy over 70% of GDP, India 57%, China 45%. Main reasons: (i) health care expenditure (China, 5% of GDP; the US, 18% of GDP); (ii) cash economy; (iii) under-reporting (2006 census, 16% of GDP up revision largely due to service sector)

- Consumption is underestimated by at least of 10% GDP

Rebalancing is a myth.

- Creative accounting in China puts a lot of consumption (cars, travel, meals and entertainments) in operational costs: (i) government agencies and SOES: (ii) private firms (Cai, Fang and Xu (2011): entertainment and travel Costs of Chinese firms twice as high as in South Korea).

- On the other hand, investment is significantly over-estimated in China: (i) double counting in investment: 1+1>2, the sum of provincial GDP is 2 trillion more than the national total; (ii) underestimation of price deflator (Young (2003)).

- *With all these statistical abnormalities, China's "true" investment-GDP ratio should be below 40%.*

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A Change of Course from "Rebalancing"

- As China's national statistical bureau improves and adjusts its statistical methods, the so-called "imbalance" will be automatically balanced.

- But "rebalancing investment and consumption" led to the wrong policy prescriptions, sometimes at the terrible timing (2013-14).

- A change of course: the main theme of economic policies is changed to "**supply-side structural reforms**"., instead of rebalancing.

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"Supply-side Structural Reforms"

- The emphasis on supply-side is to deviate from the demand-side (consumption, investment and export) analysis of the balance of three-wheels.

- The emphasis on structural reforms is to deviate from "structural adjustments" which often referred to industrial policies stemming from the need to "rebalance".

- "Supply-side structure reforms" are not "supply-side Regan economics", or simply tax reduction.

- It (hopefully) refers to a reform program that aims to improve market efficiency (SOE reforms, regulation reforms, factor market reforms, and local government reforms).
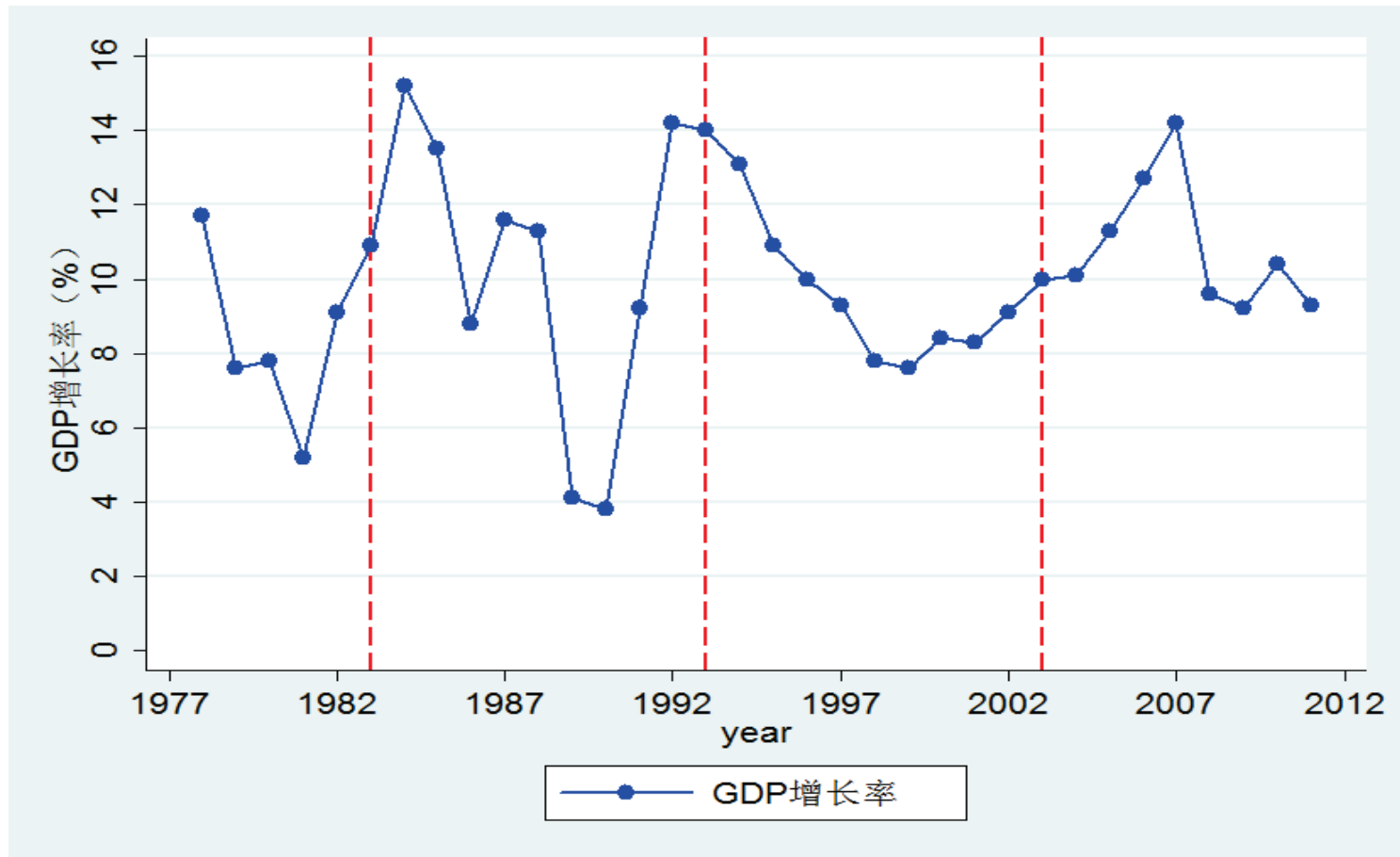
Will the Chinese Economy Turn Around

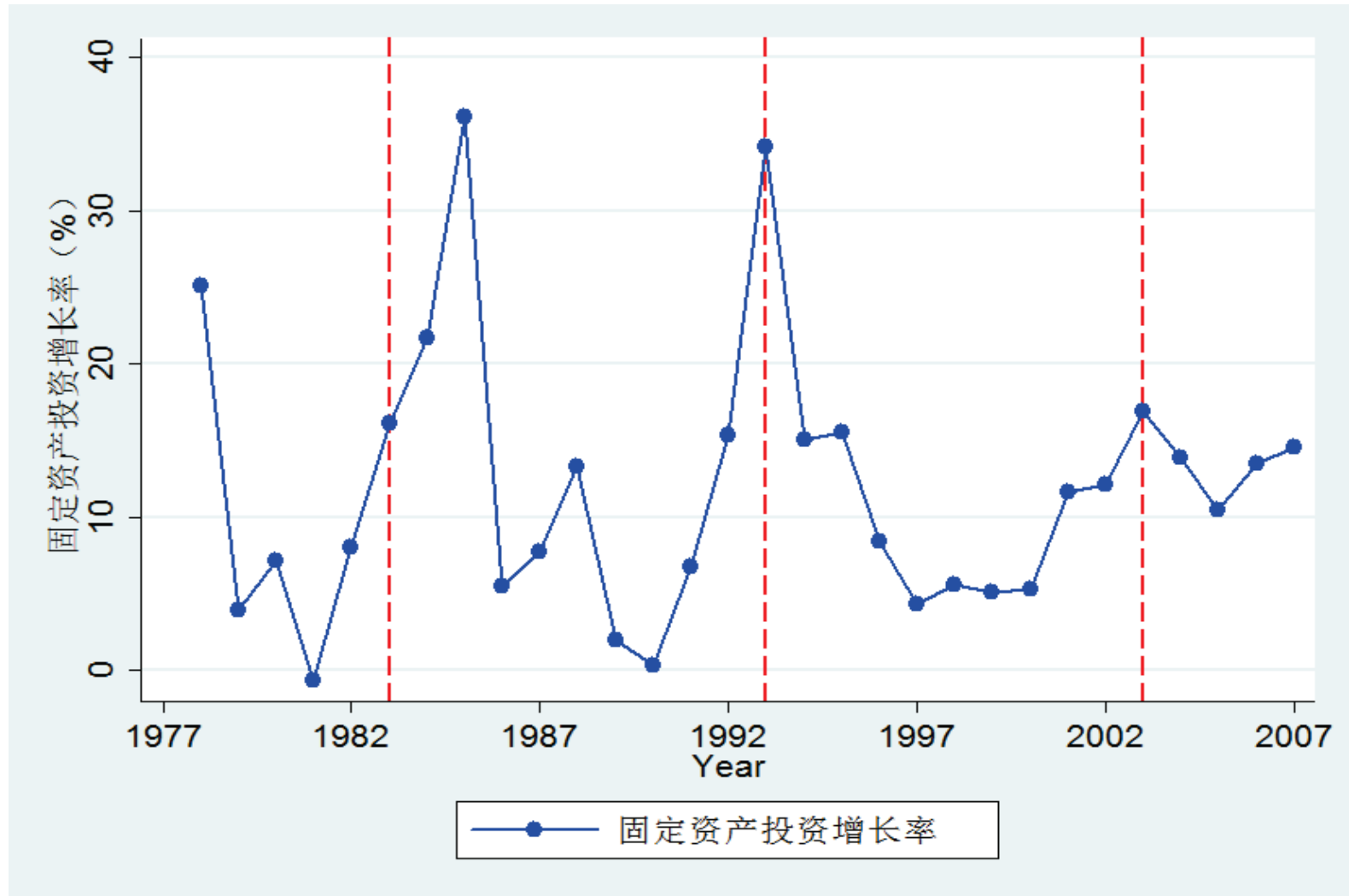For the Chinese economy to get back on track, all of these factors will be necessary

- Effective and efficient decision-making of economic policies in an new era.

- Right diagnosis of problems, right set of policy priorities in the short-run and long-run, implementation

- Restoration of confidence, domestic and international

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Patterns of Economic Growth in China

Years in trouble: 8 or 9;   strong growth: 3 or 4.

Cycles of Fixed Assets Investment Growth

The Resilience of the Chinese Economy

- Growth potentials remain strong, per capita GDP is only $7,000.

- Demographic dividend in quantity is disappearing, but in quality is coming strong (hundred of millions of college graduates)

- Incredible amount of entrepreneurship everywhere

Concluding Remarks

- 2016 will be an eventful and critical year

- It will be extraordinarily challenging.

- But for all the above reasons, I am still hopeful, and remain (*Cautiously*) optimistic.

- "The man who is a pessimist before 48 knows too much; if he is an optimist after it, he knows too little." (Mark Twain)

Comments Welcome!
Thank You!