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The Enigma of China's Recovery

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Introduction and Overview

- China's recovery from the pandemic has continued to be decidedly lacklustre. What is behind the failure to bounce back? Is it simply because of continuing waves of Covid, a lack of adequate stimulus, the absence of "animal spirits" due to central government policies, continuing problems in the property sector, or something more fundamental?
- The monetary stimulus implemented in China during the pandemic was minimal, but even so most investors and commentators had expected a stronger recovery because the economy has been operating well below normal.
- In this Newsletter I probe the question of whether China's growth model has hit some kind of barrier.
- After outlining the features of China's growth model, I compare it with other Asian templates, specifically Japan and Korea over the past several decades.
- All three economies have adopted investment-led growth models, and all three have been subject to abrupt slowdowns in their growth rates following financial or other crises. Why is this?
- What is it about the investment-led growth model that makes it so vulnerable to sudden, and sometimes prolonged, downswings of economic growth?
- **Such abrupt downturns are equivalent to the "sudden stops" in capital flows experienced by EM economies when they experience balance of payments crises, often accompanied by deep recessions and major market corrections.**
- The conclusion of this exercise is that not only will China's near-term growth rate will be significantly reduced, but also that the longer-term growth rate will be substantially lower than previous expectations.
- This means that despite monetary stimulus, the real GDP growth rate will remain subdued at 4-5% p.a. at best.
- These considerations have investment implications spelled out on pp. 10-11.

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The IMM Newsletter offers economic research written by John Greenwood, founder and Chief Economist of International Monetary Monitor Ltd. John was also the publisher, editor and lead author of ***Asian Monetary Monitor****, a bi-monthly publication that he operated for 20 years from Hong Kong between 1977 and 1996. He was a pioneer of monetary research in Asia. From 1999 to 2021 he was Chief Economist at Invesco, based in London.*

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1. The Chinese Economic Growth Model.

When Deng Xiaoping initiated the "four modernisations" in 1978 to bring China's economy into the modern world, the Chinese people had missed out on decades of economic development. The new plan, covering agriculture, industry, defence, and science and technology, was intended to mark a departure from the politics of ideology and a shift towards a more pragmatic regime focused on economic development. The reforms would enable China to catch up with foreign, particularly other Asian economies, that had led the way.

However, it was not the sectoral approach that was important; what mattered was the willingness to experiment with market-compatible structures. In pricing, instead relying on Maoist fixed prices, farmers were able to sell any surplus – after meeting pre-arranged quotas – at free market prices. In terms of ownership, a hybrid system was introduced which combined township and village ownership with private investment, safeguarding the rights of the community while reducing the risks for private investors in the absence of secure property rights. For the first time since Mao Zedong's communist take-over in October 1949, farmers and businesses were thus permitted at least partially (1) to set their own prices and (2) to retain a significant measure of the profits they earned. Together these two forces motivated and incentivised a huge expansion of the Chinese economy in the subsequent four decades.

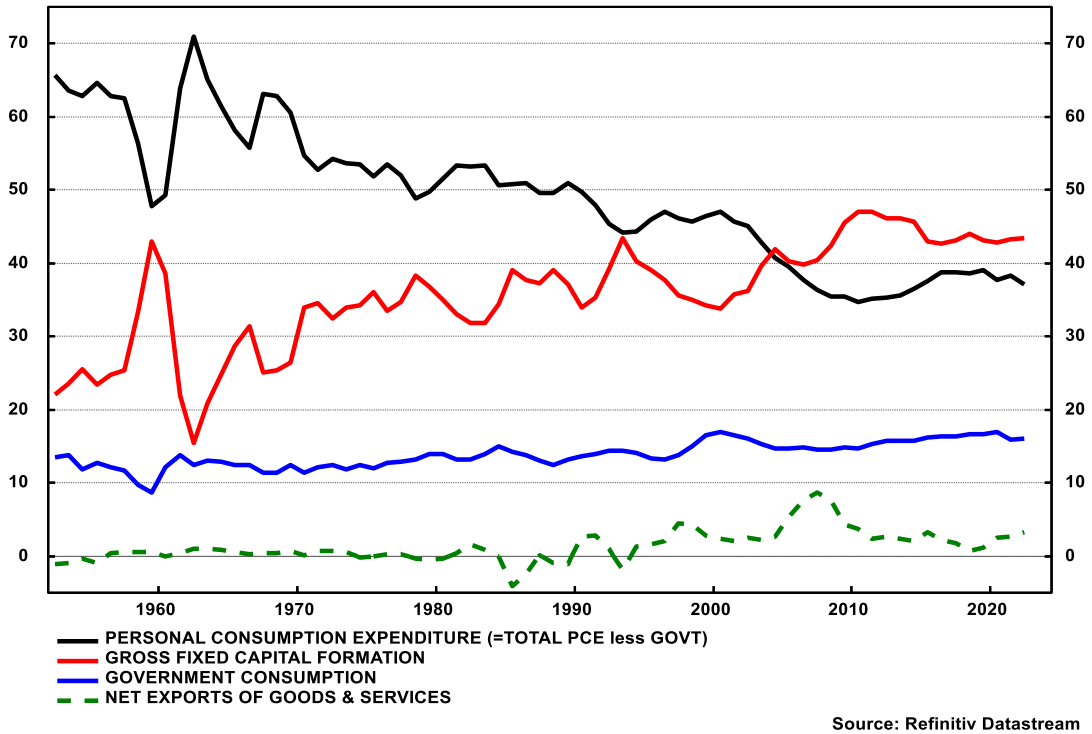
Overlaid on these foundations, a series of new policies were approved and implemented, often starting as an experiment in certain localities, and then rolled out more widely across the economy. A notable example was the early initiative in 1979 to create four Special Economic Zones (SEZs) in Shenzhen, Shantou, and Zhuhai (all in Guangdong province) and Xiamen (in Fujian province). These were followed in 1984 by 14 additional cities. The SEZs were granted exemptions from a wide range of regulations, and were able to attract investment from overseas, especially from Hong Kong and Taiwan. Similar preferential arrangements have subsequently been extended to 15 "free trade zones", 32 provincial-level economic and technological development zones, and 53 high-tech industrial development zones, mostly in or bordering on large and medium-sized cities. Preferential policies included lower tax rates, reduced application of domestic regulations, and easy acquisition of licenses for imports or other inputs.

Viewed through the lens of different models of development China can be considered consistent with numerous academic templates. For example, the Harrod-Domar model says that economic growth depends heavily on the productivity of capital and the rate of investment, which in turn depends on the domestic savings rate. In the early stages of reform and opening, China's high savings and high productivity of capital both contributed spectacularly to China's rapid growth rate. Another growth theory popularised by Arthur Lewis was the idea that if labour could be moved from low productivity sectors such as farming to higher productivity sectors such as manufacturing, overall economic growth would be enhanced. With about 75% of the

labour force employed in rural areas in 1978 but less than 40% today, China's growth over the past 45 years has strikingly illustrated the truth of this principle.

Some economists argue that China's growth model is export-driven, which may be valid for the period from the mid-1990s to around 2010, but I believe this mis-states the problem. Exports are one means of generating income, **but the ultimate end is to raise the standard of living, with the emphasis on personal consumption, not national wealth or GDP,** and this can be done equally well through domestic sales. In the early stages of economic growth after the 1978 reforms, China enjoyed an absolute competitive advantage because the cost of its domestic inputs (such as the level of wages and the cost of land) was low in absolute terms. However, as the income gap between China and the rest of the developed world has narrowed, growth may need to become more reliant on domestic sources. This will require higher levels of consumption in the domestic economy.

Figure 1. China's Investment-Led Growth Model Squeezes Consumption.



However, as Figure 1 illustrates, the share of personal consumption expenditure (PCE) in China's GDP fell as low as 35% in 2010 and was just 37.2% in 2022. Conversely, the investment share of China's GDP is extraordinarily high – peaking at 47% in 2011 – and was 43.5% in 2022. These figures compare with about 70% for PCE and about 17% for private investment in the US; or 53% for PCE and 22% for investment in the eurozone. China's PCE share is therefore close to one half of the US share while the investment share is double the US or eurozone shares.

It follows that China's growth model is an investment-led one, rather than an export-led model. Beijing has long recognised the need for rebalancing of the economy away from investment (and exports) towards consumption. However, such changes are hugely difficult to achieve without dismantling the broad policy framework that entrenches the prevailing investment-led model. This consists of a wide range of measures such as governmental approvals (e.g., for licensing of a particular business activity), lower tax rates, subsidies, preferential lending arrangements, access to government procurement contracts, and keeping the exchange rate undervalued.

This may seem an unfair description of China's economy, but it is one which senior policymakers have long acknowledged. In 2007, Premier Wen Jiabao famously characterised China's rapid growth as "unstable, unbalanced, uncoordinated, and unsustainable." These "Four UNs" were both a powerful indictment and a call-to-action. At the time, the Premier was worried by a long list of problems that included "*overinvestment, reckless lending, excessive liquidity, unbalanced foreign trade, inequality between cities and the countryside, inefficient energy use, wasteful allocation of resources and environmental ruin*". Many of these problems were blamed on a hell-for-leather investment binge ahead of the 2008 Beijing Olympics. Developers tied construction of everything from shopping malls in Shanghai to new local government offices in Inner Mongolia to the summer Games, largely in the pursuit of cheap financing from state banks, but the underlying problems went unaddressed.

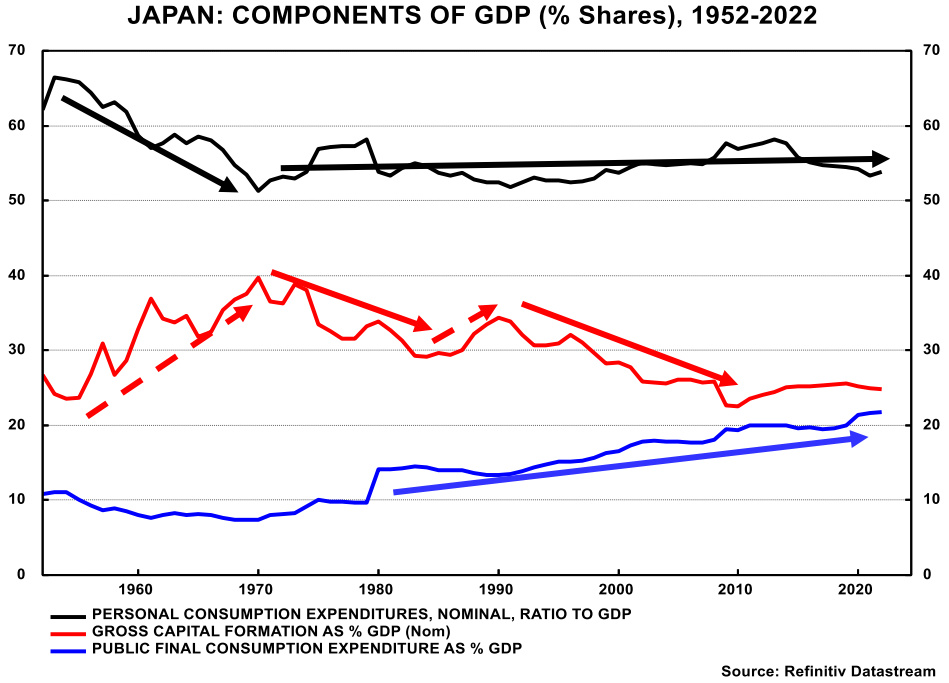
In 2010, Vice Premier Li Keqiang again lamented China's "irrational economic structure" and argued that "uncoordinated and unsustainable development is increasingly apparent." In July 2021, President Xi Jinping similarly called for a "new stage of development" with the specific aim of "pursuing genuine rather than inflated GDP growth." Without reform, China's economy will be stuck with the same instability, inequality and vulnerability it has wrestled with since the early 2000s; but reforms will imply painful restructuring of industries, of employment, and especially of the relation between provincial and central government.

The problem is that when an investment-led growth model reaches a level of investment that matches the development planners' economic goals, the growth rate has typically fallen abruptly. Examples can be seen in other Asian economies such as Japan and Korea. We will therefore probe the nature of this economic model and ask whether China can avoid the sudden drop-off in growth that its regional competitors have suffered. The topic is especially relevant at the present time considering the various western policies of constraining China's access to high tech electronics for civilian or military purposes as well as the domestic problems of the property sector.

2. Japan's Attempt to Change its Growth Model

In the early post-war years and continuing until around 1973-74 and the first oil shock, Japan also operated an investment-led growth model. The relative shares of GDP are shown in Figure 2.

Figure 2. In Japan the Reduced Share of Investment has been Offset by Rising Government Spending.



From 1952, the earliest date for which we have data, the investment share of Japan's GDP climbed from 23% of GDP to 40% in 1970 and 39% in 1973 – a near-doubling. As in China today, many of the same features were present in post-war Japan: advantageous governmental approvals (e.g., for licensing of a particular business activity and denial of such licenses to foreign investors), lower tax rates, subsidies, preferential lending arrangements and access to government procurement contracts.

From 1974 until the GFC in 2008-09 the investment share of Japanese GDP moved along a gradual downward path, falling from nearly 40% of GDP to 22.6% in 2009-10, while PCE – whose share had been falling to 1970 – stabilised at an average of 54.5% between 1970 and 2022. Most of the difference was taken up by increased government expenditures as Japan's welfare state (mostly pensions and medical care) was expanded from the 1970s onwards. Current government spending (which excludes capex and transfers) increased from 7.4% of GDP in 1970 to 21.8% in 2022.

But the most important consequences of these changed shares of GDP were the marked downward shifts in Japan's real economic growth rate that accompanied the changes in spending.

Prior to the first oil shock in 1973-74, Japan's real economic growth rate averaged 9.5% p.a. (Table 1), supported by a rising investment-to-GDP ratio. Then, partly as a consequence of the abrupt and adverse shift in the terms of trade due to the steep rise in oil prices, the real GDP growth rate more than halved to 4.4% p.a. for the next decade and a half (1974-90) until the peak of Japan's asset bubble in 1989-90.

Table 1. Japan's Growth Rate has Plunged whenever the Investment-to-GDP Ratio has Fallen.

	Av Real GDP Growth (% p.a.)	Av Investment-to-GDP ratio (%)	Details (from Figure 2)
1956-73	9.5% p.a.	32.5%	Rising from 23% in 1953 to 39.7% in 1970
1974-90	4.4% p.a.	31.6%	Falling from 38% in 1974 to 30% in 1993
1991-2022	0.9% p.a.	27.0%	Av. 1991-2009: 28.4% Av. 2009-2022: 24.5%

Similarly, after the bursting of Japan's asset bubble in 1990, another abrupt fall in the growth rate occurred. Between 1991 and 2022 the investment-to-GDP ratio fell first from 34.3% in 1990 to 22.6% in 2010-11, and then held steady at around 24% between 2011 and 2022. Meanwhile the real GDP growth rate fell from the 4.4% average of the late 1970s and 1980s to just 0.9% p.a.

Of course there were other contributing factors to these two growth slowdowns, the most important being the reduced growth of the labour force (due to aging and the fall in the birth rate) and slowing productivity growth as the Japanese economy's share of manufacturing declined and services took a growing share. But normally (as in western economies) these kinds of changes typically occur over long periods, whereas the declines in Japan's real GDP growth rate after 1974 and 1991 were strikingly abrupt.

A reasonable hypothesis is that a major contributor must be **the suddenly reduced rates of return on capital invested** which occurred immediately following these turning points. In each case, the pre-oil crisis boom of the early 1970s and the asset bubble of the late 1980s produced a boom in investment which is reflected in increases in the share of investment-to-GDP ratio in Figure 2 (dashed arrows). With the recessions that followed each episode, sudden and sustained declines in profitability made it clear to investors or corporate bosses that there had been a substantial - and prolonged - misallocation of capital.

This is the fundamental flaw in top-down, investment-led growth models. Instead of being driven ultimately by consumer demand in the country concerned and adjusting slowly and gradually to changing factor prices on the input side and to the tastes and preferences of consumers on the output side, investment spending in this type of economy is being driven by a mixture of top-down planning, a national political agenda for the economy as a whole, or by a region wanting to have its own corporate champions, and a series of associated incentives built into the tax system and/or the banking system which bias the choices that businesses make. The result, certainly in Japan's case, was two very clear episodes when excess investment produced drastic subsequent downturns in profits and growth, from which the economy never really recovered. Note how slowly the investment share has adjusted after the crisis on each occasion.

An analogy could be drawn with the Biden administration's I.R.A. (Inflation Reduction Act), which despite its name is actually a set of "industrial policies" that offer subsidies for "green" investment or for investments that reduce dependence on China in certain sectors like electronics. Moreover, the Biden plan is much narrower than anything practised by Japan in the past or China today.

In the early stages of industrialisation or in an economic recovery from a prolonged growth lapse such as China experienced from the 1940s to the 1970s, such top-down investment-led growth models may appear to work because the pathway to a higher standard of living has already been mapped out by other more developed economies that have previously pursued such development, with or without a plan. In Japan and China, the path was clear: start with iron and steel furnaces, follow with basic chemicals, an electrical machinery industry, then autos, electronics and robotics – and so on. But after following the "path well-trodden" and reaching the frontier, the planned economy can be left in limbo, its businesses unsure in which direction to grow **because the planners have run out of cards to play**, and market signals have been so distorted by long years of top-down management.

3. The South Korean Growth Model

South Korea is another example of an economy that has experienced heavy-handed, top-down direction in some of its leading sectors, accompanied by extreme levels of its investment-to-GDP ratio followed by abrupt slowdowns in the growth rate of the economy when an investment boom has ended.

Figure 3. South Korea's Investment-to-GDP Ratio has Declined Only Modestly

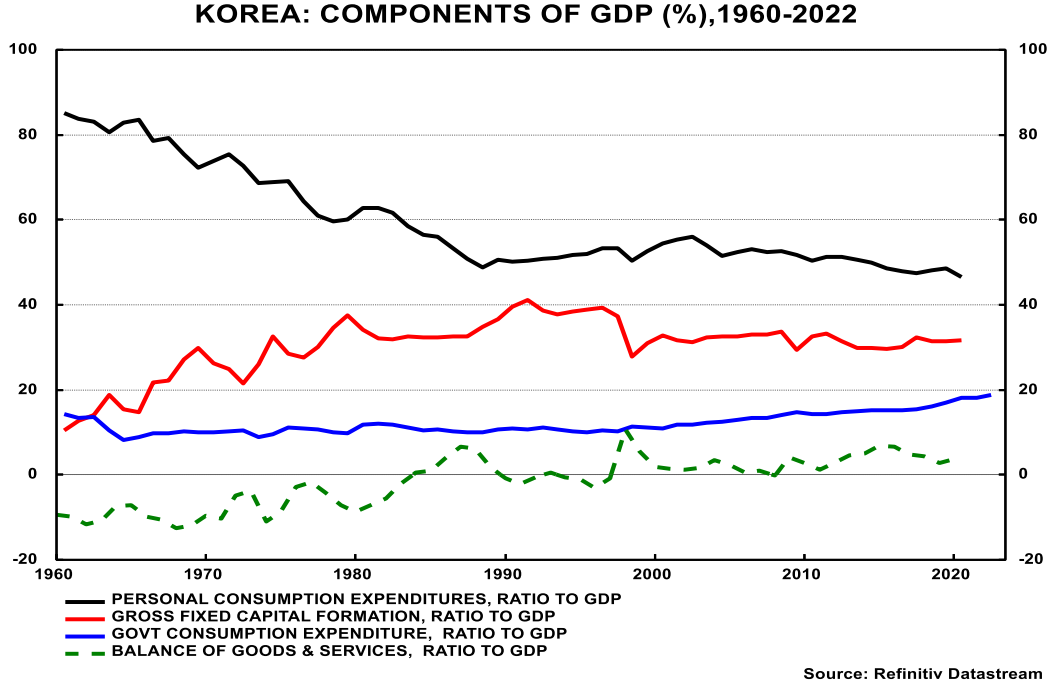


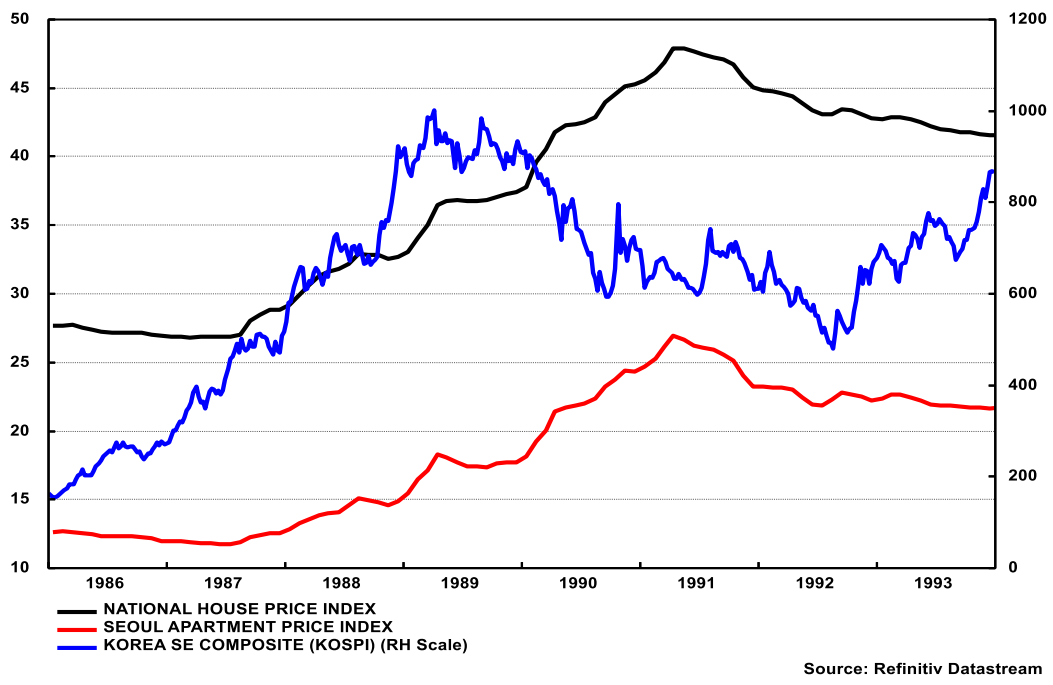
Figure 3 shows the somewhat erratic upward path of South Korea's investment-to-GDP ratio between 1960 and 1990 accompanied by a steeper decline in the ratio of PCE to GDP. The reason for the discrepancy is mainly due to the shift from a substantial external trade deficit to a trade surplus by the mid-1980s. The decline in the PCE-to-GDP ratio (or demand from consumers) was offset by a gradually increased Investment-to-GDP ratio (or demand for investment spending at home) as well as by growing demand for Korean exports overseas (shown by the green dashed line). As in the case of Japan before it and China subsequently, this shift in demand was largely engineered by the long list of government policies spelled out at the top of p. 4.

Table 2. Korea's Real GDP Growth Rate Fell after Investment Shocks.

	Av Real GDP Growth (% p.a.)	Av Investment-to-GDP ratio (%)	Details (see Figure 3)
1961-90	9.7% p.a.	25.4%	Rising from 10.5% in 1960 to 41.2% in 1991
1991-2010	6.0% p.a.	34.2%	Falling from 41.2% in 1991 to 29.4% in 2009
2011-2022	2.8% p.a.	31.2%	Fluctuating in narrow band between 29% and 33%

In Korea's case the first abrupt slowdown occurred from 1991 onwards. Like Japan and Taiwan, there had been an asset bubble in Korea during the late 1980s which culminated in an asset price "bust" from 1990 onwards (see Figure 4).

Figure 4. Korea's Slowdown in the 1990s Resulted from the Bursting of the Asset Price Bubble.



As is normal in asset price bubbles and busts, stock prices led real estate prices. In the case of Korea between 1986 and 1993, the KOSPI (in blue) first surged by 546% between January 1986 and April 1989, before falling by 48.7% between December 1989 and August 1992. The boom in real estate as measured by the National House Price Index (in black) was more sedate, and – as in Japan – the peak came somewhat later. Prices increased by 77% between August 1987 and April 1991. In Seoul, apartment prices (in red) rose more steeply, rising by 127% over the same period and peaking in the same month. The subsequent declines in property prices were also more moderate than for stock prices but continued for considerably longer.

For our purposes here, we simply note that the bursting of the Korean bubble in 1989-91 brought about the first significant reduction in the real GDP growth rate from 9.7% p.a. to an average of 6.0% p.a., a growth rate that prevailed until the GFC of 2008-09. Under our investment-led growth hypothesis, there would have been a re-appraisal of investment priorities away from real estate but continuing the national focus on an investment-led – but now largely manufacturing-oriented – model. The Korean Investment-to-GDP ratio declined moderately, falling from 41.2% in 1991 to 29.4% by 2009, with most of that decline occurring as a result of the Asian Financial Crisis of 1997-98 – another "shock adjustment".

Korea's second slowdown came after the GFC, and this time it was much more drastic in terms of the growth rate. Again, like Japan, the slowdown in the growth of the labour force and the aging of the population were no doubt material factors, but the key trigger was the financial crisis and the associated global credit crunch because these conditions undermined global trade and the official philosophy that such high rates of export-related investment spending were sustainable.

This time Korea's real GDP growth rate slowed much more – from its pre-GFC average of 6.0% p.a. to an average of 2.8% p.a. between 2010 and 2022. However, in contrast to the case of Japan, in Korea there was no comparable decline in the Investment-to-GDP ratio which has remained above 30% since the Asian Financial Crisis. As in Japan, however, the Korean PCE-to-GDP ratio declined steadily (from 50.4% in 2010 to 46.6% in 2020) in the aftermath of the GFC, the main counterpart being a gradual upward trend (from 14.2% to 18.7%) in government current expenditure as a share of GDP.

4. Implications for China's Recovery.

China today is facing many of the problems faced in the past by Japan and Korea. China has shared a very similar growth model that appears to be hitting numerous barriers to growth simultaneously:

- The migration of workers from farms to factories has slowed dramatically.
- The population is aging, meaning the growth of the labour force will slow and the dependency ratio will rise.
- The birthrate is declining, which also implies that the labour force will not grow as rapidly in the past. Indeed, it is likely to decline (as in Japan).
- There has been massive over-investment in several sectors, notably housing and heavy industry (steel, petro-chemicals, etc)

- The consumer sector has been squeezed for the benefit of corporate China, meaning that wages as a share of national income are far below what they would be under a different growth model. This also means that it is unlikely that consumer spending could surge sufficiently to compensate for reduced demand for investment in the real estate and industrial sectors.

On this occasion the combination of the growth slowdown due to Covid and the crisis in the real estate sector seem to be having similar effects on China as the first oil crisis had on Japan after 1973-74, or the bursting asset bubbles had in Japan and Korea in the early 1990s, or the Asian Financial Crisis of 1997-98 and the GFC of 2008-09 had on Korea. The lesson from these case studies is that an economy will avoid abrupt shifts in its growth rate only if it avoids over-commitment to a centralised, investment-led growth model.

Summary and Investment Implications

- China's recovery from the pandemic has continued to be decidedly lacklustre. What is behind the failure to bounce back? Is it simply because of continuing waves of Covid, a lack of adequate stimulus, the absence of "animal spirits" due to central government policies, continuing problems in the property sector, or something more fundamental?
- The stimulus administered in China during the pandemic was minimal, but even so most investors and commentators had expected a stronger recovery if only because the economy has been operating well below normal.
- In this Newsletter I have probed the question of whether China's growth model has hit some kind of barrier.
- The findings are that like Japan and Korea, China has pursued an investment-led growth model. Investment as a share of GDP has been extremely large (over 40%) while the consumption share of GDP has been squeezed.
- Just as Japan and Korea have both experienced abrupt slowdowns in their real GDP growth rates following a financial or other crisis, China is now facing a similar set of obstacles to its next phase of growth.
- The key problem with investment-led growth models is that they tend to experience abrupt downturns in the return on invested capital, requiring far-reaching structural shifts in the economy. But because the entire economic system – interest rates, access to credit, tax system, operating licenses etc. – is geared to the investment model, the ability to adapt subsequently is reduced.
- The conclusion of this exercise is that not only will China's near-term growth rate will be significantly reduced, but also that the longer-term growth rate may be substantially lower than previous expectations.
- This means that despite monetary stimulus (i.e., faster M2 growth) since early 2022, China's real GDP growth rate could remain subdued at just 4-5%.
- The lags in the transmission of monetary growth are long enough that inflation could remain low through all of 2023, although there could be a mild upturn of inflation in 2024-25. However, even this is not guaranteed, especially if caution persuades Chinese households to hold higher than normal cash balances. ***This would reduce velocity, leading to smaller boost from any given increase in the broad money supply.***

- All this suggests that the Chinese authorities could lower interest rates further in 2023, probably weakening the yuan. But the monetarists at the People's Bank of China will be aware that without faster money growth the effects of lower rates would be quite limited.
- Fixed income securities should be safe enough for the balance of 2023, though vulnerable to mild yuan depreciation, but investors will need to be prepared for modestly higher inflation in 2024.
- In the past two years equities have been shaken by several unexpected interventions by the authorities. This tendency does not seem likely to disappear any time soon, despite some tentative signs of a return to greater consistency by some of the regulators. Even with a modest overhang of excess money balances, Chinese equities are no slam-dunk.