



## China: The Unplannable, Planned Economy

By John H. Makin

China is intrinsically fascinating. It is at once the world's most promising economy and least promising economy. That contradiction emerges from China's mix of powerful real economic development, complete with rising skyscrapers, smoking factory chimneys, and a rapidly growing system of national highways all thriving alongside a feeble financial sector managed by a central bank designed to operate a staid planned economy. China has become too dynamic to operate as a planned economy, but it hasn't even seriously begun a transition that, it must be said, ultimately may or may not occur, to a market economy.

There are two obvious and important features of the Chinese economy that immediately thrust themselves at a newly minted "expert" on China. First, in the real economy, China is experiencing an overinvestment cycle not unlike the violent cycles observed in the United States during the late-nineteenth century, but also more recently in Japan in the 1980s and the United States in the 1920s and 1930s. Second, China's financial system has some serious difficulties, not uncommon to economies at China's stage of development, which exacerbate the instabilities tied to overinvestment and misallocation of investment that are so obvious in China.

I shall try here to suggest the broad outlines of China's extraordinary economic development and the policy challenges that have become most urgent in the context of that development. China's leaders are well aware of the problems they face in a very rapidly developing economy with a diverse population of 1.3 billion people. The

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specific economic and financial sector problems under discussion here are more a byproduct of the extraordinarily rapid evolution of China's development over the past several decades than they are the result of a lack of attention from China's leaders. That said, it will be very difficult for China to avoid a hard landing this year.

### Extraordinary Chinese Growth

That China has entered a new era as a major world economy is undeniable. The April 2004 assertion by American investment bank J. P. Morgan that "since 1980, China has grown faster for longer than any country in history" will draw few challenges. By 2003, China's economy, with a gross domestic product of over \$1.4 trillion, accounted for about 4 percent of global GDP and for an extraordinary 14 to 15 percent of global growth.

China's contribution to the Asian and global economies is even more impressive. China accounts for 55 percent of Asian exports in the most trade-centered area of the world economy. Japan's economy has recovered from its third recession in a decade, largely with a crucial boost from rising net exports—a substantial portion of which have flowed to China. What little growth the German economy has experienced over the past two years is derived from rising exports, again, primarily to China. Likewise, rising exports to China have helped to lift U.S. growth at a time when substantial excess capacity existed in the aftermath of the 1990s overinvestment boom. By 2003, China had evolved as a major contributor to global demand growth. China's open economy accounted for 7.2 percent

of world imports while accounting for 16.5 percent of global import growth.

## Surging Investment and Saving

China's greatest strengths are also its greatest weaknesses. Rapid economic growth and even faster growth of saving and investment have greatly enhanced China's economic performance. But the attendant surge in saving has boosted investment growth to levels so high that waste and excess capacity have emerged as serious problems.

China's fixed-asset investment grew at a 43-percent year-over-year rate in the first quarter of 2004—up sharply from a 26.7-percent year-over-year rate during 2003 and a 16.1-percent rate during 2002. In 2003, China's capital spending accounted for 47 percent of GDP and grew 2.3 times as fast as GDP. China's incremental capital output ratio is falling. This is a clear sign that investment is rising more rapidly than it can be profitably utilized. China's investment surge through the end of 2002 outstrips that of Japan in the 1970s and of ASEAN economies in the 1990s by a substantial margin.<sup>1</sup>

Since 2000, China's investment surge has accelerated dramatically. Its investment growth since 1980 has exceeded GDP growth by a far greater margin than existed in Japan at the time of its 1990 investment bubble and the United States at the time of its 2000 investment bubble. The rise in China's ratio of investment to GDP since 2000 has taken it to a level five times as high as levels associated with the 1990 Japan investment bubble and the 2000 U.S. investment bubble.<sup>2</sup> China's investment surge mirrors the surge in savings that has accompanied rapid GDP growth. With saving above 40 percent of GDP, the search for ways to store wealth has intensified. Much saving flows into deposits at China's banks and, in turn, to investment in state-owned enterprises and elsewhere. Property development and other "real" investment (as opposed to financial flows to intermediaries) absorbs more saving as concerns about inflation rise more rapidly than do interest rates on saving deposits.

## The Lagging Financial Sector

As already noted, China's banking system and, more broadly, its financial sector have developed far more slowly than its real economy. While probably unavoidable, the underdevelopment of China's financial system during a period of extraordinary growth of the real economy carries with it substantial risks both for China and for the global economy. For example, should disruptions in the financial sector cause China's growth to falter, Japan's recovery, Asian growth, and the growth of the global economy and global trade would slow rapidly. A sharp slowdown in Chinese growth would have even more serious immediate consequences for stability inside China.

China's vulnerability to its own financial sector reflects a number of factors including its high saving rate and a steady, rapid flow of funds into savings at banks that have been unable to deploy profitably all of the funds at their disposal. Standard and Poor's estimates that problem loans by China's banks largely to state-owned enterprises are equal to over 40 percent of China's GDP or about 5 trillion yuan. While the actual figure may be less or greater,

China's banking system, as the major alternative for storage and enhancement of China's accumulated wealth, is worthy of close attention. It is reasonable to suggest that China's rapid economic growth and even more rapid growth of investable funds has outstripped the ability of its banking system to channel those funds to consistently profitable uses. The danger exists that China's savers will suffer substantial losses at an early stage of their experience with placement of savings in the hands of financial intermediaries, either through higher direct taxes required to bail out insolvent banks or through higher inflation that reduces the real value of depositors' holdings at the banks.

The basic problem emanating from a dichotomy between rapid growth of income and investable savings and a financial system at an early stage in its development arises from an inability to generate market signals to guide investments to their most profitable uses inside and outside of China. Securitization, the sale of non-performing loans to investors at market-determined prices—by auction—is reportedly under consideration by the Chinese government. Such a step would provide

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valuable information on the relative attractiveness of non-performing loans. The information gleaned from securitization would be enhanced by allowing foreign banks, or other financial institutions such as insurance companies to participate in the auctions. As insurance companies accumulate long-term contingent liabilities denominated in renminbi, their need for long-term renminbi assets may make them active bidders for non-performing loans currently held by China's banks.

Problems tied to the tendency for China's investable savings to grow faster than profitable investment opportunities inside China can be mitigated by letting some Chinese savings flow abroad. While China may not be ready for such a step on a large scale, the lesson from Japan and other episodes of rapid growth is to move as quickly as possible to broaden investment opportunities for a population with a rapidly rising need for diverse options concerning the storage and enhancement of growing wealth. As foreign banks and insurance companies become better established inside China, their ability to help Chinese savers diversify will grow, as will the learning process whereby Chinese banks acquire the same skills.

## Currency Regime

A more immediate problem exists with respect to China's ability to control its money supply and level of inflation. China's exchange rate regime, it should be emphasized, raises issues of control of the money supply and China's overall inflation rate that are more important than the trade issues that arise in connection with China's currency peg.

Over the next few years, China's currency, left to market forces, may rise or fall. Until recently, China's peg to the U.S. dollar has been inflationary due partly to factors inside and outside China. Outside China, the U.S. Federal Reserve has been pursuing a highly accommodative monetary policy that, through the fixed-exchange rate regime, has been transmitted to China. The rising flow of funds aimed at purchases of China's currency raises China's money supply unless sterilized by the central bank. However, such sterilization requires the sale of assets by the central bank at higher and higher interest rates as

inflation boosts the interest rate desired by Chinese savers. As expectations of either higher interest rates on renminbi assets or, ultimately, of a renminbi appreciation become more firmly fixed, funds flow even more rapidly into China, making it even more difficult for the People's Bank of China to retain control of China's money supply. Capital inflows to China during 2003 surged, rising by

nearly 40 percent to approximately \$120 billion. As a result, inflationary pressure in China is rising even in the presence of increasing excess capacity in some sectors.

China should consider alternative exchange rate arrangements. A simple float or revaluation of the renminbi in response to outside complaints is not the answer. Rather, China should explore the possibility of continuing what amounts to a managed float of its currency by adopting a currency basket—perhaps modeled after the successful currency basket arrangement in Singapore. The goal of stabilizing while not fixing the value of the renminbi against a basket of currencies whose weights reflect China's global trade and investment position deserves serious consideration.

If China pegs the renminbi to a basket of currencies (given about an 11-percent trade weight for the U.S. dollar), it could

allow a 10-percent renminbi appreciation or depreciation versus the dollar with only a 1.1-percent implied movement of the weighted exchange rate. The renminbi would also appreciate or depreciate versus other currencies whose value remained pegged to the dollar, and an offset would require a modest renminbi depreciation against non-dollar currencies. However, by keeping weights and targets hidden (as Singapore has done), China has leeway to allow more dollar flexibility while continuing to hold onto a closely managed float.

China's peg to the dollar exposes it to risks associated with changing financial conditions in the United States. Should inflation pressure build in the United States, requiring the Federal Reserve to tighten and raise U.S. interest rates (as appears increasingly likely by late June), the incipient pressure for capital outflows from China could rise. This would amount to incipient pressure for a renminbi devaluation that could come at an inconvenient time when global growth is slowing due to a Fed-induced growth slowdown in the United States. While China maintains controls on capital outflows, experience shows

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that such controls are difficult to maintain effectively as incentives for funds to flow out of the country increase.

A currency basket, with currency weights unannounced and variable, would give China an extra instrument of economic policy with which to lessen the risks of financial instability. The major lesson of the 1997–1998 Asian crisis, articulated well by former IMF deputy managing director Stanley Fischer after the crisis was over, is to avoid currency pegs and to allow exchange-rate flexibility to buffer the monetary system of developing countries against pressures arising from financial flows into and out of the economy. While the rapid surge of Chinese savings is largely domestically generated so that Chinese financial markets are not as vulnerable to a rapid withdrawal or injection of funds by foreign investors, it is important to recognize that Chinese savers have the largest stake in the stability of China's financial system. Beyond that, capital inflows to China are accelerating so the externally driven need for a buffer that currency flexibility affords is growing.

## Looking Ahead

China's creaky financial system, coupled with its wild-west style economy, seems destined for an economic hard landing this year. Signs pointing to that outcome have already begun to appear. Most important, the Politburo, China's most powerful body, appears already to have mandated credit quotas meaning that additional credit (or in some cases, rollover of existing credits) is simply unavailable in some overheated sectors like construction and real estate. China's central bank has mandated higher reserve requirements and interest rates. Meanwhile, industrial commodity prices and precious metals prices have dropped sharply since March, suggesting an abrupt end to hoarding that characterized the last phase of the bubble.

The emergence of a hard landing in China has already reverberated in Asian financial markets. Stock markets in China, Japan, Taiwan, South Korea, and Australia, to mention only the largest, have already dropped sharply. Since March, China's stock markets are down over 20 percent, Korea's is down 20 percent, and Japan's is down over 10 percent. The rush of Chinese and foreign money out of

Asia and into U.S. cash has also sharply depressed Asian commodity currencies like the Australian dollar against the U.S. dollar. The Japanese yen has dropped by nearly 10 percent against the U.S. dollar since March even as the Japanese government has ended its first-quarter massive dollar-buying spree. Private sector Asian dollar-buying is boosting the dollar even as the U.S. external deficit rises.

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The fact that China has not experienced a large foreign capital inflow as the Asian Tigers had done prior to the 1997 crisis does not preclude emergence of sharp capital outflows from China. Local Chinese investors control vast funds. During the booming first quarter of this year, "unrecorded" capital flows into China totaled about \$30 billion. That represents an annual rate of \$120 billion or about \$1 trillion in U.S. terms given that the U.S. economy is just over eight times as large as China's. One trillion dollars is nearly twice the annual U.S. current account deficit.

As China's savvy, wealthy investors search for a place to protect their wealth, rising U.S. interest rates (as the Fed tightens) offer a tempting refuge. China's heavy capital inflow and incipient currency appreciation will reverse and become an outflow, unbuffered by any currency flexibility given the rigid peg of the renminbi to the dollar. Pressures for a hard landing in China will intensify as money and credit contract given the outflow of funds.

A possible sharp change from boom to bust in China would underscore the instability inherent in the combination of a volatile economy and an inflexible financial system. China's emergence as a major force in the global economy might be likened to inserting a very powerful racecar with poor brakes and steering into a race that normally includes Formula One cars whose brakes and steering are as remarkable as their engines are powerful. Everyone envies the extra speed of the powerhouse on the straightaway but wants to avoid it on the corners.

## Notes

1. International Monetary Fund, "The Global Implications of China's Growth," Chapter II of *The World Economic Outlook*, April 2004.

2. Estimates based on data from the U.S. Bureau of Economic Analysis, Japan's Cabinet Office, and Morgan Stanley.