

# The Future of China: Soft Landing or a New Economic World Crisis?

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## **Abstract**

The project analyzes the consequences of a downturn in Chinese economic activity and assesses the probability of the feared *hard landing* scenario in China. After analyzing different economic indicators and assessing the main risks the Chinese economy is facing it can be drawn that Chinese economy will slow, albeit giving rise to a more sound, balanced, inclusive and sustainable growth model.

## **Acknowledgements**

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3. I would also like to thank David Dollar, former World Bank China Director and Mr. Kruijs, Chief China Economist at Royal Bank of Scotland, for also giving their time despite being much occupied. Their knowledge was extremely helpful.
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# Contents

<b>1</b>	<b>Introduction</b>	<b>4</b>
1.1	Objectives . . . . .	4
1.2	Methods . . . . .	4
1.3	Structure . . . . .	5
<b>2</b>	<b>China's Economic Evolution</b>	<b>6</b>
2.1	The Chinese Economy before 1949 . . . . .	6
2.2	The Socialist Era (1949-1978) . . . . .	9
2.3	The Market Transition . . . . .	10
<b>3</b>	<b>Economic Outlook</b>	<b>15</b>
<b>4</b>	<b>China's Economy Major Risks</b>	<b>34</b>
4.1	Is there a Bubble in China's Housing Market? . . . . .	34
4.1.1	Context . . . . .	34
4.1.2	Conceptual Framework: What is a bubble? . . . . .	35
4.1.3	An Overview of China's Housing Market . . . . .	36
4.1.4	Indicators of Real Estate Bubble . . . . .	39
4.1.5	Assessing whether a Bubble exists or not in China's Housing Market . . . . .	40
4.1.6	Conclusion . . . . .	42
4.2	Rebalancing from Investment to Consumption . . . . .	44
4.2.1	What is Rebalancing? . . . . .	44
4.2.2	Why is the model unsustainable? . . . . .	46
4.2.3	Looking at past Experiences . . . . .	46
4.2.4	How will it Rebalance? . . . . .	51
4.2.5	China's Rebalancing Progress: Quantitative Analysis . . . . .	55
<b>5</b>	<b>Conclusions</b>	<b>60</b>
5.1	<i>Hard Landing</i> vs. <i>Soft Landing</i> . . . . .	60
5.2	Personal Conclusion . . . . .	62
<b>A</b>	<b>Appendix</b>	<b>63</b>
A.1	Shanghai Pilot Free Trade Zone (SFTZ) . . . . .	63
A.2	Communist Party November Plenum - Overview . . . . .	64
A.3	Interviewing an expert: Louis Kuijs . . . . .	65

# 1 Introduction

## 1.1 Objectives

After two decades in which China experienced impressive growth, with GDP increasing on an annual basis of 9.6% on average <sup>1</sup> now the Chinese economy appears to be slowing. China is facing many risks, such as financial fragilities, the real estate bubble or imbalances such as overinvestment. Some economists believe such risks could lead to an imminent collapse of the economy while others think it will readjust and manage a *soft landing* scenario. Amid this hot debate, this paper will try and assess the possibility of a *hard landing* scenario in China and its implications.

The main objectives of this project are:

- To analyse the main risks the Chinese economy is facing and its future projections
- To analyse the possibilities that in China there is a *hard landing* or *soft landing* scenario
- To understand what is behind China's amazing transformation from a socialist economy to a market oriented economy, especially with such a particular political system

## 1.2 Methods

The way I am going to conduct my research project is through both **quantitative** and **qualitative** methods.

Since this project consists in analysing the Chinese Economy I need to analyse China's economic data. The main data sources I will use are the **National Bureau of Statistics of China** and economic reports from the **IMF**<sup>2</sup>, **OECD**<sup>3</sup> and the **World Bank**, among others.

Also, to understand better how the Chinese Economy works I will use **bibliographic resources** such as text books, magazines (The Economist) and the internet<sup>4</sup> which

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<sup>1</sup>World Bank Database

<sup>2</sup>International Monetary Fund

<sup>3</sup>Organization for Economic Co-operation and Development

<sup>4</sup>Blogs (China Financial Markets), Wall Street Journal Website...

will help me gain a more profound understanding on the Chinese economy and its current risks.

In order to complement my project and help me achieve the stated objectives I interviewed different economists who have specialist knowledge on China's current economic situation:

- Louis Kruijs: Chief China Economist at the Royal Bank of Scotland
- Pedro Nueno, President of CEIBS<sup>5</sup>

### 1.3 Structure

This paper is going to be divided in 3 main sections:

1. **China's historical economic evolution**, to gain an understanding about China's economic history and hence understand better China's present challenges.
2. **Economic Outlook** based on a detailed analysis of different economic data to get a picture of how the economy has done over recent years.
3. **In-depth analysis of the main risks** China is currently facing, namely the real estate bubble and the rebalancing process from an investment-led growth model to a consumer led model.

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<sup>5</sup>China Europe International Business School

## 2 China's Economic Evolution

Before studying China's current economic situation and its future projections, it is convenient to analyze the economic evolution of Asia's Giant Economy, since by studying the past we will be able to understand better China's present and the challenges for the future. In order to do so we will examine three periods of time: **The Chinese Economy before 1949, The Socialist Era (1949-1978) and The Market Transition.** As we will further see, China experienced a fast change in its economy that was very successful in terms of economic growth. One thing I am going to try to answer is what is behind such an impressive growth performance and for how long will it continue?

### 2.1 The Chinese Economy before 1949

The year 1949 is without doubt the turning point in the Chinese History: the year when the Maoist Revolution succeeded. Both the government and the economic growth are radically different after this year. The economic growth experienced after 1949 almost has no precedents in Chinese Economic History, albeit there were some disastrous policies in Maoist times.

What is certain is that this change occurred for some reason. The most common interpretation is that the Chinese economy failed in the nineteenth and early twentieth centuries and, due to the Western pressures, it also disintegrated politically, hence, 1949 was a real turning point.

However it is not clear whether the Chinese economy "failed" before 1949. Some economists believe that the traditional economy and the economic situation in the 1900's actually supported the acceleration of economic growth that was made obvious in 1949, since economic growth is a long-term process<sup>6</sup> On the other hand, others think the aforementioned turning point was a result of the Socialist revolution, which solved problems that threatened the majority of population such as population increase, class division, inequality<sup>7</sup>... The question lies on whether the pre-1949 era laid the basis for the economic growth after 1949 or not. To address these questions

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<sup>6</sup>Thomas Rawski (1989) presented revised estimates of aggregate output that imply slow but steady growth in per capita output after the late nineteenth century. Other supporters of this theory are Brandt and Myers.

<sup>7</sup>Defenders of this view are Richardson, in his paper Economic change in China c.1800-1950 ISBN: 0521 58396 9

I am going to examine the traditional economy during three broad periods of time of this pre-1949 Chinese economy.

### The traditional economy: 1127-1911

**Highly productive Traditional Agriculture** The Chinese traditional society was rural, with 90% of population living in the countryside. The economy was based on a productive traditional agricultural system based on a highly productive agriculture technology. Agriculture was based on individual households (no plantations); hence, China was a household based economy. This system proved to be productive as it supported a growing population for 400 years (between 1400 and 1820 population quintupled, from 72 million in 1400 with the Ming dynasty, to 381 million in 1820). Furthermore, living standards in China maintained stable until the early 1800s. China accounted for about a third of the world GDP in 1820, being, together with Europe, the world economic hegemonic power. In terms of GDP per capita and population China was the economic hegemonic power too, as we can see in the following table:

	China	Western Europe
PIB pc	450 GK\$	400 GK\$
Population	59 million	25,4 million

Figure 1: Comparison between China and Western Europe in the year 1300. Source: MADDISON, *Own elaboration*

**Crisis of the Traditional Economy (19th Century)** During the course of the 19th Century the Chinese Traditional Economy experienced a profound crisis, during the reign of the Qing Dynasty. For over a century both the Qing dynasty and China entered a long period of decline, at the same time that European countries were entering a period of both economic and population growth, owing to the industrial revolution. One reason of this decline was the inexorable population growth: population was growing but resources (that were starting to be scarce) were not. However, the main factor of the decline was the political, military and economic impact of the West. During this period, known as Imperialism, Europe started to expand its control (political and economic) over African and Asian colonies, thus taking over old Chinese Markets. This led to a profound economic, social and political crisis in China.

Moreover, both external conflicts (the Opium War with Britain and the Sino-Japanese war) and internal ones (the Taiping Rebellion erupted in 1860 and lasted 10 years, and the Boxer Rebellion did so in 1890) had dramatic consequences on the Chinese Economy. If in 1820 the overall GDP accounted for 32% of the world GDP, by 1913 it had declined dramatically to 9% of world GDP. The figures go to show China's decline: from being one of the economic powers in the world to a underdevelopment position. It comes as no surprise that the Qing government collapsed in 1911.

**The beginnings of industrialization (1912-1937)** After the collapse of the Qing dynasty in 1911, China changed economically and politically. Modern industry began to develop, albeit not until 1927, when the Nationalist Party unified the Nation after a civil war. For 10 years, until the Japanese invasion in 1937, China enjoyed a period of relative peace and, as I have said, industry began to develop in two distinct patterns: Treaty Port Industrialization (carried out basically by foreign investment) and Manchurian Industrialization (Investment in Manchuria was carried out primarily by the Japanese). This period is known as the Nanjing decade. The Nanjing decade was not only known for the industrial development but also for the gradual increase of literacy due to the investment undertaken by the Nationalist government in education. This literacy increase would lay the basis for future development. Moreover, during this period, China was a quite open economy. <sup>8</sup>

**War and Civil War (1937-1949)** After annexing Manchuria in 1931, Japan launched Chinas invasion. This invasion weakened the Nationalist government. When the Pacific War ended in 1945 the Civil War for power erupted between Nationalists and Communists in a divided country. The war concluded in 1949, with the Communist Victory and the Peoples Republic of China (PRC) was established, under Mao Zedongs government.

The war brought suffering to the population and serious damage to the economy- in order to pay for the war Nationalist government turned into printing money, resulting in hyperinflation. Furthermore, as if the economic imbalances werent enough, war disrupted whatever economic growth started in the 1920's and 30's.

**Legacy for the Socialist Era (1949-1978)** As we can see, the legacy of the war years was a collapsed economy. However, several of the adverse economic pre-1949

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<sup>8</sup>According to John Chang (1969) modern factory production grew at 8%-9% annually between 1912 and 1936.



may have contributed, to the adoption of the socialist model we will further analyze. The foreign aggression (both from Japan and Great Britain) caused an aversion to foreign dominance that led to support for closed-door socialist development strategies<sup>9</sup>. Moreover, the damage and suffering of more than a decade made the Chinese population willing to accept even a repressive government if it could guarantee peace and economic security. More concretely, wartime changes in the economy aided the Communist government in the execution of its socialist industrialization strategy, since wartime had led to an increase in state intervention in the economy.

## 2.2 The Socialist Era (1949-1978)

After the Peoples Republic of China (PRC) establishment in 1949, China turned its back on China's traditional economy and completely orientated its economy to a massive socialist industrialization strategy through direct government control, turning to the Soviet Union as a model.

After 1949 the PRC followed a socialist heavy-industry-priority development Strategy (Big Push Strategy) where rapid industrialization was given highest priority. The economic system of the Maoist China was the *command economy*, where the government directly controls the economy. Government planners decide what goods and services are produced, their price, their distribution... The following chart shows the industrialization strategy China underwent during this era:

	HEAVY INDUSTRY PRIORITY
<b>Savings done by</b>	Government, state-owned enterprises
<b>Investment decisions taken by</b>	Government
<b>Household income</b>	Slow growing
<b>Openness to the world</b>	Low

Figure 2: China's Industrialization Strategy during the Socialist Era. Source: Barry Naughton, *The Chinese Economy, Own elaboration*

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<sup>9</sup>Kirby, William C. (1992). *The Chinese War Economy*

The years through 1978 were also marked by economic instability. China's history since 1949 has been a stormy one. Policies changed and reversed constantly, each period having different economic outcomes, ranging from resoundingly successful to catastrophic. Economic policies shifted in due to political conflicts amongst the Communist Party. Mao Zedong himself repeatedly changed economic policies in accordance with his personal wishes. So, in this period we have to acknowledge the importance of politics (political conflicts repeatedly split Maoist China).

## 2.3 The Market Transition

The legacy left by the Socialist Era was a difficult economic and social situation that led to the initiation of an ambitious reform, starting in December 1978. Deng Xiaoping, transformed the country from an agricultural society to an urban and industrialized one and from a planned economy to a market-based one. The reasons for this transition not leading to famine as it did in the GLF, were that this transformation was done progressively and controlled rather than rushed. The two aforementioned transformations have combined to yield the spectacular results China has experienced over the past three decades. Not only has economic growth soared, achieving nearly 9,5% average growth rate, but poverty rate fell from more than 65% to less than 10%. Since then, the standards of living have improved significantly and the GDP per capita multiplied by 7. China's impressive economic performance during the Market Transition can be seen in the following graph:

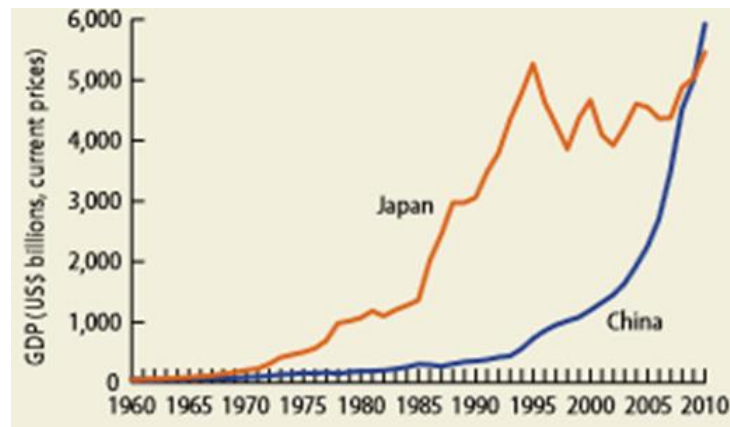


Figure 3: **China has made it the second largest economy in the world.**  
*Source: World Bank*

*Comment: The graph shows that in 1978 GDP started to grow and for a decade it grew moderately. This is because, unlike the Soviet Union, the Market Transition was done very slowly. Then China's GDP starts to grow exponentially until it has become the second economy in the world in 2008.*

**Economic Reforms** But, what factors lie behind China's impressive achievements during China's Reform Era? According to the World Bank <sup>10</sup> the key factors of the reforms included:

1. A **Market-orientated reform** through experimentation: liberalization, privatization, reducing the control of the government in the economy (but without allowing volatility and free market in some sectors). This has created positive incentives in companies to do things better since you have more benefits if you do things well. It also promoted innovated, increasing productivity.
2. **Balancing growth with social and macroeconomic stability:** Keeping inflation low through traditional fiscal and monetary policies in order to protect the poor from price increases.
3. **Incentivise competition** amongst the country's regions led to economic growth, by promoting the need for innovation, thus accelerating productivity and growth.
4. **Dismantling trade barriers** in the national market. Trade liberalization increases economic activity, there is an increase in the movement of capital and goods; hence, it increases economic growth. However, China is not a totally free market because they control capital flow in order to control exchange rates and avoid hot, speculative money. <sup>11</sup>
5. **Integrating with the global economy**, breaking with the Socialist Era isolation. The truth is that this process was slow, progressive and controlled by the government, slowly liberalizing foreign-trade system from a *closed economy* towards an *open economy*. It had to be controlled, for example, a liberalization package was adopted in 1984 with very alarming results: imports suddenly increased more than 50% and the government wanted to protect the domestic market. This is why the process was done progressively and very controlled. In 2001 China entered the World Trade Organization (WTO).The result was a surge in both exports and imports.

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<sup>10</sup>China 2030: Building a Modern, Harmonious, and Creative Society, World Bank pp.15-25

<sup>11</sup>Dani Rodrik, a Professor of International Political Economy at Harvard, defends that capital controls are beneficial for the economy.

6. **Export led growth:** Exports are without doubt the main factor that lies behind China's economic growth. Exports have been increasing, mainly owing to the aforementioned integration with the world economy and because China attracted foreign capital and, by using a cheap labour force, it has managed to have really low unit costs, hence, Chinese products are very competitive. Moreover, one way China is so competitive is because it manipulates the exchange rate, having a low currency rate that clearly benefits exports. The following graph shows that China's exports have been growing rapidly since 1979, until becoming the worlds largest exporter.

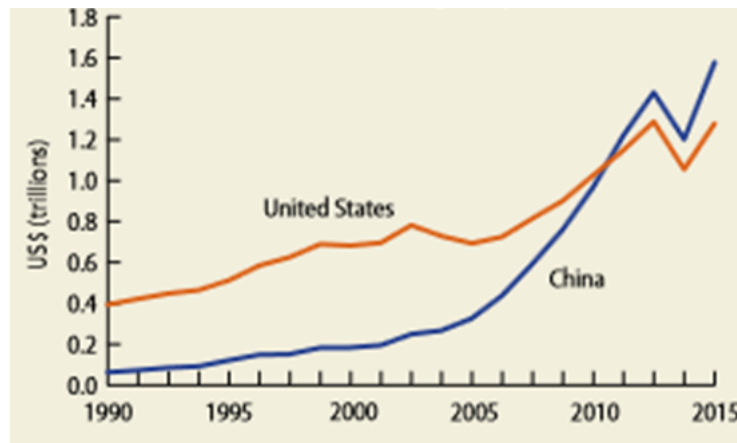


Figure 4: **China has become the worlds largest exporter** *Source: World Bank*

7. **Foreign investment attracted by low wage and productive labour force:** China is today the "world's factory". The industrialization of China had been based on foreign capital that has been attracted by China's low wage massive and efficient labour force. China's workforce costs were very low (one tenth of Europe's) because they lack social policy and workers rights. Foreign investments are, together with exports, the main factor that has led China's economic growth.<sup>12</sup> The high levels of investment were also possible thanks to high private savings.

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<sup>12</sup> *China, 30 anos de crecimiento econmico*, Gloria Claudio Quiroga

## Consequences of the reform: China's impressive economic performance

The main effects of the reforms can be summarized in:

- The GDP grew at an average rate close to 9.5 per cent. Over the past three decades, GDP has multiplied by 130 and per capital GDP has multiplied by 7.

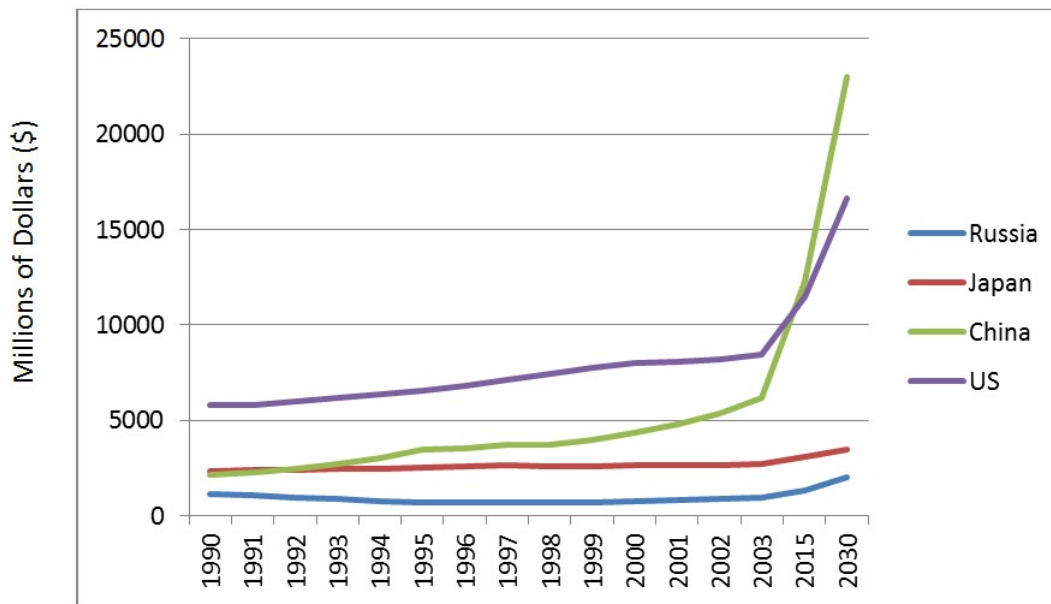


Figure 5: **Comparative GDP Performance of China, Russia, Japan and the US (1990-2030)** Source: Table. *Chinese Economic Performance in the Long Run*, Angus Madisson OECD 2007 p.95

- Poverty rate has fallen from more than 65 per cent to 10 per cent; 500 million people have been lifted from poverty
- China is now the second largest economy in the world and is the world's largest exporter. It is believed it will overtake the USA's economy.
- Other Achievements: 2 of the world's top 10 banks are now Chinese; 61 Chinese companies are on the Global Fortune list; China is home to the world's second largest highway network and 6 of world's ten container ports. The country has also made improvements in education, health, science and standards of living.

However, the benefits of the aforementioned reform have not been free high costs; among them we highlight the difference between urban and rural society, which is especially pronounced in China. While some urban-rural gap is inevitable in a developing economy, the urban-rural gap in China is unusually large. This social problem has its root in the Socialist era, but has been mainly caused by the transition from an agricultural, closed and planned economy to an industrial, open model.

Moreover, macroeconomic imbalances lead to a political crisis during 1988-1989, known as the Tiananmen Interlude. This crisis was caused by the urban discontent caused by rising inflation and anger at corruption.

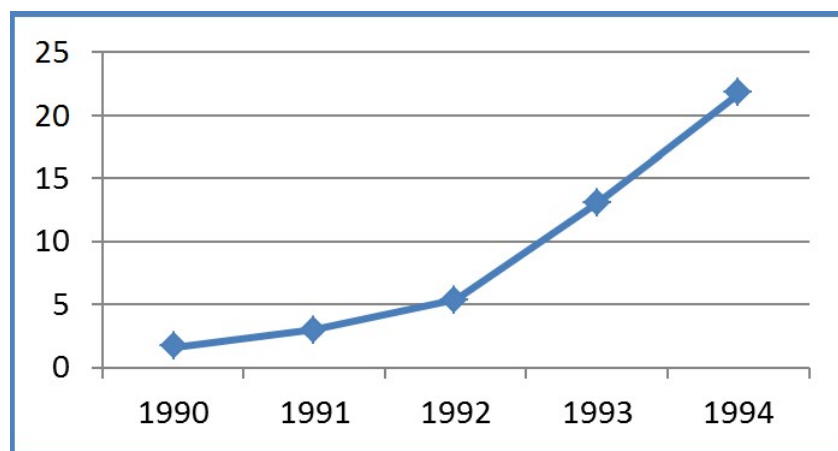


Figure 6: **Average Annual Inflation Rate Evolution in China** *Source: World Bank 1996 Report. Own elaboration*

To sum up, China has successfully moved away from the command economy and adopted a market economy. Nevertheless, even today, the process of market transition in China is far from complete. Actually China is an example of State Capitalism, since, although it has a market economy the government intervenes in the economy through plans that bare resemblance with Stalins quinquennial plans. There is a coexistence of traditional plan and market economy, known as dual track. Planning is still a used instrument in Chinas economy. So, we could say that China is an example of a market economy but not a free market economy, since there is a certain extent of manipulation (for example with the exchange rate).

### 3 Economic Outlook

**Context:** In this section of my project I will analyze China's current economic situation and elaborate an economic outlook based on the analysis of different economic indicators. This will provide useful information when measuring the risks China is facing. For this section I have used reports from the IMF, OECD and World Bank.

Three decades of rapid economic growth go to show China's economic success. However, throughout the past few years there has been persistent fear of a hard landing in China, due to a higher than expected deceleration of growth. Some believe that risks such as the existence of real estate bubble, financial fragilities, high debt and the shift from investment driven model to consumption driven growth model will further slow down further China's Economic growth. Although in 2012 there had been some slight positive signs lately, that suggested China was on the mend, this confidence is now under question due to the slow economic activity (7.7% Q1<sup>13</sup> 2013). Risks are increasing, keeping concerns of a hard landing at bay. Furthermore, it is interesting to point out there's a new leadership team has declared it will tolerate such low growth levels<sup>14</sup>, since it wants to improve overall quality of growth.

**GDP:** *GDP is an important economic indicator. It reflects the size growth of an economy by measuring the percentage change in value of the goods and services produced by an economy over a period*

The first thing that stands out is the fact that China's growth rate is around 9%, which is very high compared to other developed countries, 3 times the US rate growth. We can see that the global financial crisis slowed the economy from double digit growth rate to below 7%. In 2008, though, the economy managed to recover due to an expansionary fiscal policy that consisted in huge government spending. However, over the past three years it has slowed substantially, growing at 7.8% in 2012 and expected to grow at 7.5% this year. Although this growth rate is still impressive for what we are used to in Europe for example, it shows that the economy is slowing, as it is slower than it was used to.

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<sup>13</sup>First Quarter 2013

<sup>14</sup>Premier Li Keqiang responded to the news about modest GDP growth by saying that the government will seek to avoid wide fluctuations in economic activity. He also said that the government should create a scientific macroeconomic policy framework that would provide the market with stable predictability even if that means slower growth.

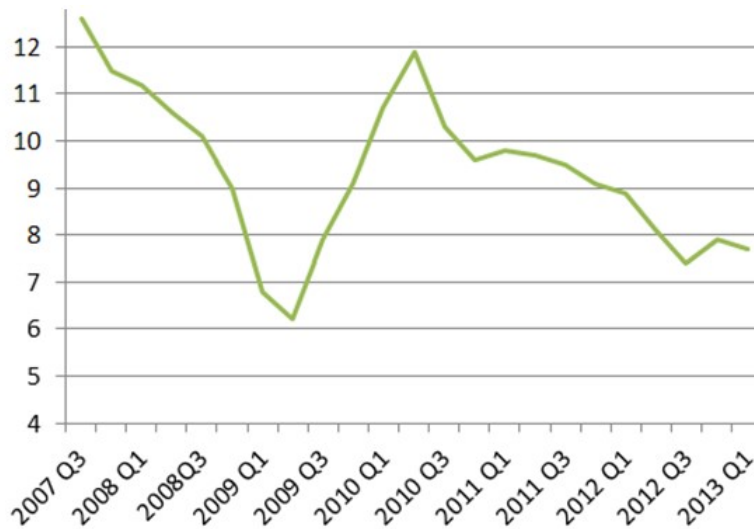


Figure 7: **China GDP Growth Rate (YoY)** *Source: Own elaboration based on NBS database*

In conclusion, the future of China’s economy is still uncertain and a recovery is not yet guaranteed. This slowdown in economic activity is mainly due to sluggish external demand (which has been offset by rise of investment as we can see in the following graph) and, as we will see, weak private investment.

**GDP per Capita:** While the official GDP is an important measurement, analyzing GDP per capita is a better indicator of the Chinese citizen’s standard of living. This measurement is obtained by dividing GDP by midyear population.

At a first glance, in light of the increase in GDP per capita over the past decade, Chinese standards of living are presumably improving. However we should take into account the substantial gap between rich and poor in China, which is a topic of rising concern that will further be analyzed in this report (*See Inequalities in China*)



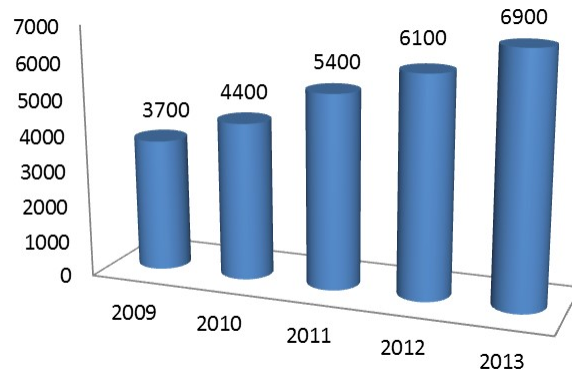


Figure 8: **GDP per capita** *Source: Own elaboration based on NBS database*

**Fixed Asset Investment (FAI):** Finally, FAI was up 1.51% from May to June. However, private investment has slowed, being one of the causes of economic slow-down. The cause of this weak private investment is, as we will further see, RMB appreciation. Since Chinese products are now less competitive, companies are forced to lower prices, thus decreasing profits and eventually investing less. It is important to notice how public investment has offset the weakness of private investment.

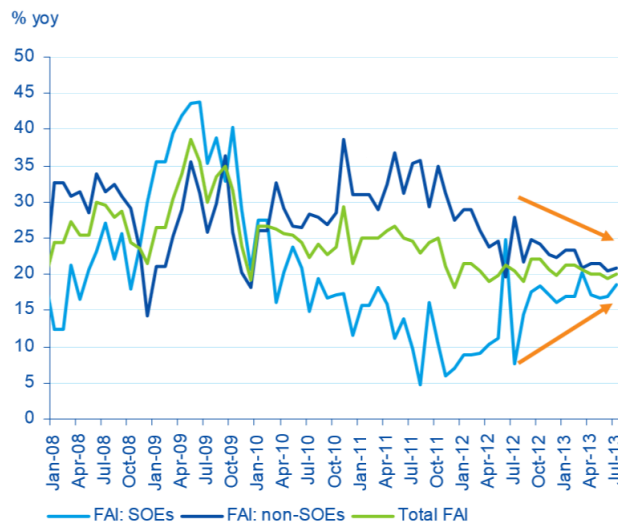


Figure 9: **Fixed Asset Investment Growth (YoY)** *Source: BBVA Research*

**Inflation:** *Measured by the consumer price index reflects the annual percentage change in the cost of acquiring a basket of goods and services.*

As we can see, Inflation has decelerated after it peaked in 2011. Price stability is one of the most important objectives for the Chinese government, since inflation reduces competitiveness. Now inflation is at very comfortable level, which means that the Central Bank could perfectly ease monetary policy in hope of stimulating the economy.

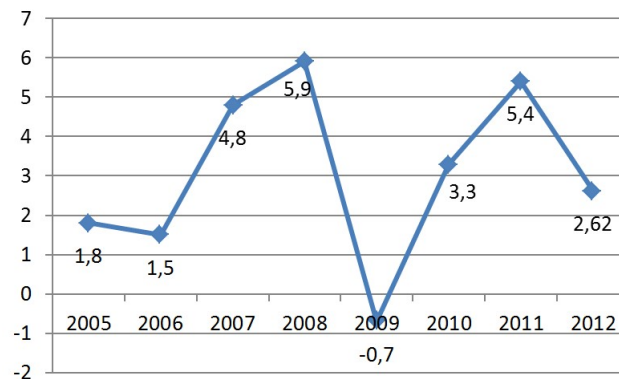


Figure 10: **Consumer Price Annual Inflation** *Source: Own elaboration based on World Bank database*

In 2008 we see that inflation also peaked due to the response of China to the economic crisis: a massive stimulus package launched in late 2008, which was based essentially on infrastructure investment and mostly financed by the banking system and currency easing. The money supply jumped by 30% in the course of 2009 an increase equivalent to over 40% of GDP, far larger than needed to fund the extra public outlays. With aggregate demand exceeding the ability of the economy to supply sufficient goods and services, year-over-year inflation rose to as much as 6.6% by mid-2011.

The inflation was a big problem that led to the government tightening monetary policy to reduce inflation. Moreover, the problem of rising inflation, as the new premier Li Kequang expressed, is rising again, since it reached 3.2 percent in 2013. However, inflation is likely to remain at steady levels this year (around 3%).

The main problem is that the high investments have led to an excess in capacity<sup>15</sup>, thus putting downward pressures on prices. In conclusion, inflation is not something we should worry about right now in China.

**External Sector:** Over the past decades exports in China have increased exponentially, over 500 percent since 1992. Exports became the engine of economic growth in China. Although they are now slowing down they are still a vital component of the Chinese economy, hence a further slowdown of exports momentum would negatively affect the overall economy.

In the third quarter of the year exports weakened although trade surplus remains (exports larger than imports). The reason exports have slowed is that authorities took measures to stop the over invoicing of exporters, which had inflated actual export data in H1<sup>16</sup>, especially in Hong Kong. Such invoicing of non-existent orders exports were done in order to cover up capital inflows and pass the strict controls over capital inflows, since they want to benefit from appreciation of the RMB by speculating. According to the IMF, true export growth in the first quarter was 5% YoY<sup>17</sup>, compared to the "official" 10.4%.

Overall, the picture of exports is grim, mainly due to the government crackdown on the use of misreporting of exports, the appreciating exchange rate and weak external demand. Since exports are so important for the Chinese economy, this raises concerns about the extent of the world's second largest economy slowdown.

Meanwhile imports are also decelerating (they declined 8.6% in May, which is the reason overall trade balance jumped). This shows a weak domestic demand, suggesting that the low exports are not due to a more rebalanced and consumer society (since if that were the case imports would have risen). If the appreciation of the RMB continues, for example, imports will eventually grow, since the purchasing power of Chinese will increase.

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<sup>15</sup>Over investment and its consequences will be further analyzed. See *Rebalancing Process*

<sup>16</sup>First Half of the Year

<sup>17</sup>Year-over-year: meaning March 2013 - March 2012

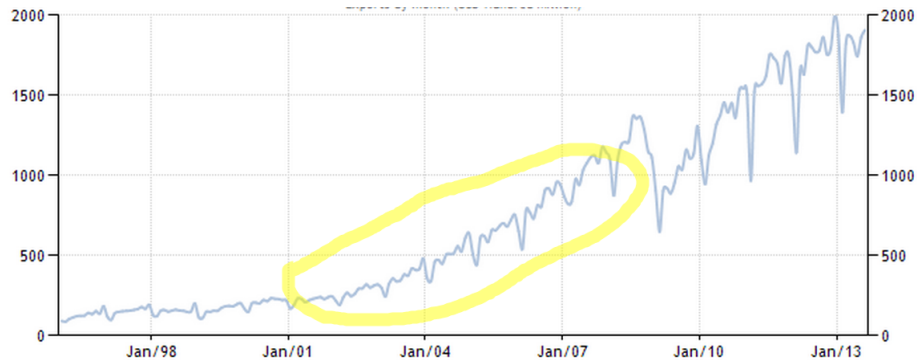


Figure 11: Exports have grown exponentially Source: Trading Economics

## Balance of Payments

**Current Account:** *The current account balance is the difference between a country's savings and its investment or can also be seen in terms of external trade. If the current account is positive, it means the country invests abroad. However, if it is negative it measures the portion of domestic investment which is financed by foreign economies, that is to say, the amount the country borrows. A surplus in the current account is usually associated with trade surplus. It is often calculated as a percent of GDP.*

### Current Account Balance:

$$\begin{aligned}
 &= \text{Net Exports (Exports - Imports)} \\
 &+ \text{Net income (such as dividends and interests)} \\
 &+ \text{Net transfer payments (aid)}
 \end{aligned}$$

Countries with a strong current account surplus have an economy dependent on exports (trade surplus), with high savings but weak domestic demand. This is the case of China.

We can see China runs a current account surplus; hence, it is a lender that invests in foreign markets, such as Africa. The surge in investment with 2008 Stimulus plan budget is the cause of the drastic fall in the current account (which I will further analyze).

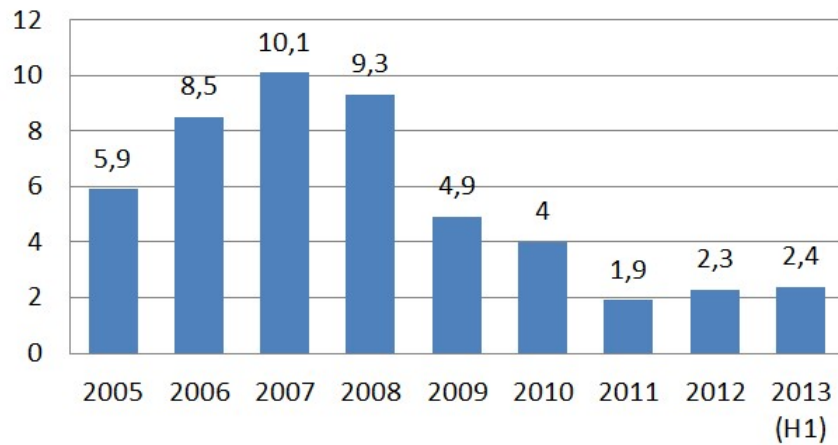


Figure 12: **Current Account Balance (as a % of GDP)** *Source: Own elaboration based on NBS database*

As we can see, the current account balance is narrowing to 2.3% of the GDP, after it peaked in 2007, with 10.1%. This rapid shrinking is due to the rise of imports and deceleration of exports. However, the current account still has a sizeable surplus. Moreover we can expect the current account surplus to narrow further in the future, mainly because if the aforementioned rebalancing process continues, the Chinese will be wealthier and private savings will be lower. This will result in a decline in the current account surplus. Finally, the small increase in current account surplus in the first half of 2013 is due to the trade surplus increase we have seen before.

**Capital Account:** *The capital account is the net result of public and private international investments flowing in and out of a country. For example, a capital account deficit means money is flowing out of the country, or also nation is increasing its claim on foreign assets (FDI).*

In 2012, China experienced net capital outflow, reflecting investors fears on emerging markets amid the global risk context. Despite in Q1 2013 the rapid credit growth of 58% suggests there was resumption in capital inflow, over the past months it has experienced capital outflows (which shows that the sluggish economy deters investors). This capital outflow comes amid concerns about tapering of quantitative easing<sup>18</sup> in the US. Federal Reserve. Finally, if the RMB continues to appreciate this will

<sup>18</sup>Quantitative Easing is the monetary policy the FED was exercising that consists of expanding

attract investors, although there is the risk of uncontrollable capital inflows for speculative purposes (unless it is regulated), instead of long-term investment (which is what they want).

Despite attempts to opening the capital account, strict controls still remain in both inflows and outflows. I strongly believe it should develop further in liberalizing the capital account since it would provide more options for savers, hence, reduce pressures in property market.<sup>19</sup>

**FX Reserves:** *The Central Banks holding of foreign currency assets*

China's Foreign Exchange Reserves have grown exponentially, now holding the worlds largest FX Reserves. They have risen on the one hand on a higher trading surplus, but mainly due to the fact China's Central Bank hold down the value of its currency (to boost exports) by purchasing foreign currency assets (mostly USD and US Treasuries). Although China is in the process of liberalizing the RMB, it still continues to control the pace of appreciation of RMB.

FX Reserves increased to a record 3.53 trillion USD in April. However, in May and June they declined slightly (reflecting capital outflow we have seen before).

According to the IMF, further accumulation would be undesirable. Inherently, they are not bad; actually they're a good cushion to avoid currency fluctuation and give confidence to foreign investors . However, we could say they have too much of a good thing , as FX reserves accumulation has a cost: On the one hand, they provide small return on interest (as they are invested in low-yielding global bonds). On the other hand it brings an opportunity cost as they could have been invested in higher yielding assets.

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money supply and buying bonds (including Chinese assets). Hence, if they stop QE less money will be pouring into China. If there are less capital inflows then China experiences net capital outflow.

<sup>19</sup>Real estate is currently the only profitable way for Chinese to invest their savings. See *China's Bubble*

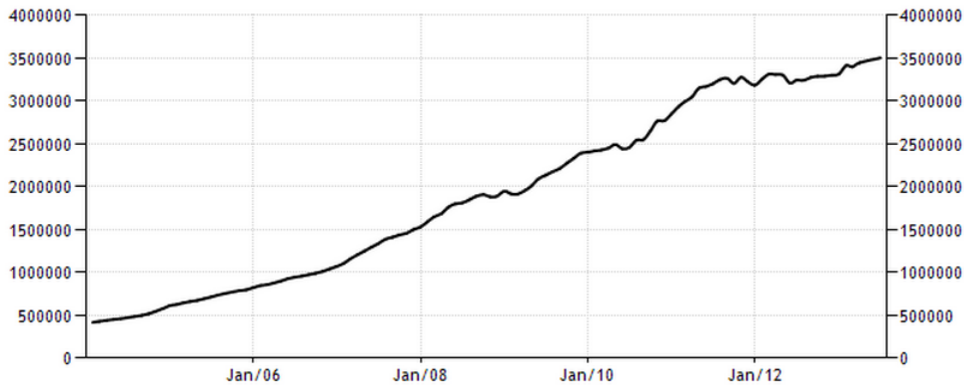


Figure 13: **China Foreign Exchange Reserves (Million USD)** *Source: People Bank of China*

**Exchange Rate:** Firstly, it is important to say the renminbi is a managed currency. Authorities stop it from floating, by making large scale purchases of dollars and keep exchange rate at their desired levels. In addition, it is currently experiencing a process of internationalization as its global usage is growing. However, authorities still exercise controls over the exchange rate. Authorities have been allowing the currency to appreciate since 2005, when it removed the dollar peg. In 2008 it had strengthened 25%, and then it was maintained artificially so that exports did not decline. Since 2011 to 2013 the RMB has appreciated 5% and it is now 25% than in 2005.

In the following graph we can see that after stabilizing in 2012, RMB has appreciated rapidly in the first quarter of 2013 against the USD. Since June RMB has appreciated at a slower pace, though it remains strong. Moreover, if we take into account the fact that the USD has raised in value against major currencies (due to depreciation of Yen) the real effective appreciation is even higher. We can see how authorities are managing a moderate appreciation of their currency, since exchange rate volatility is risky.

The main problem is that the upward trend of the RMB encourages speculative short term uncontrolled capital inflows (opposed to the desired long term foreign investment), that is, investors that seek to make profit from RMB appreciation. The increase in RMB demand puts further pressure to the currency, forcing central bank to buy dollars (and increasing FX Reserves even more). To avoid this, authorities

could internationalize the RMB, that is, allow it to be more flexible, so it can appreciate more rapidly and thus control the pace of capital inflows<sup>20</sup>. This is better than tightening controls again in the capital account, the latter clearly being a step backward in economic policy, opposite to the liberalization process China wants to follow.

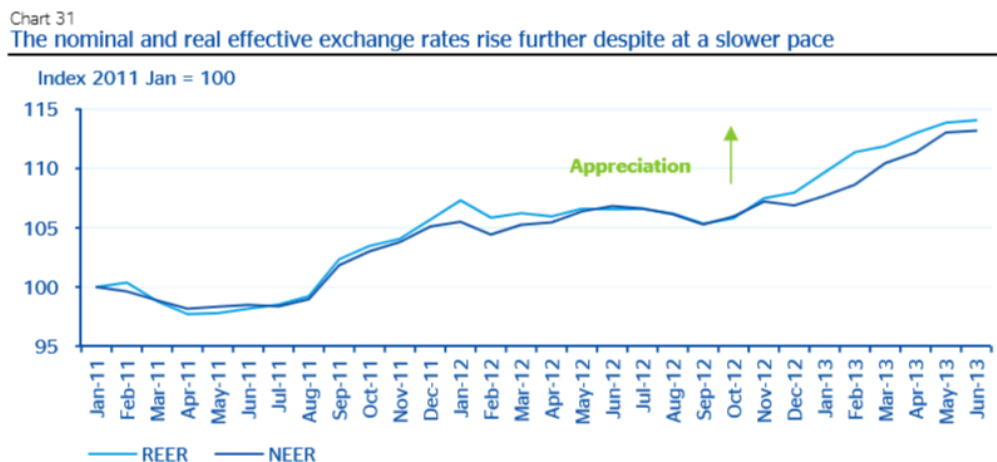


Figure 14: **RMB Exchange Rate** *Source: BBVA Research*

All in all, I think in the end everything comes down to the currency: the non-existent exports invoice was done because exporters wanted to benefit from RMB appreciation. Currency also plays an important role in FX Reserves (since high reserves are due to the authorities managing the currency). Were the RMB to appreciate, everything would become more expensive; trade surplus would narrow, reining FX Reserves. Moreover, the appreciation of the RMB would help with the domestic rebalancing (away from exports) by boosting household purchasing power and making investment in non-tradable goods more attractive. Finally, to see the importance of the RMB in the economy we see that it has been responsible for the recent economic slowdown: one the one hand it has led to a decline in exports and on the other, a decline in private investment (appreciation makes goods more expensive; hence, exports cut prices causing profits to squeeze. Less profit means less private investment).

<sup>20</sup>Another thing it could do is stop currency appreciation expectation. This way capital inflow would slow and reserves would stabilize. This is what happened in 2011. However, controlling the currency exchange rate would raise FX Reserves.



Finally, in the future I expect the RMB will move to a more market-based exchange rate system, namely, reducing intervention and consequently, FX Reserves. In the near future, appreciation will continue but maybe at a slower pace in light of slow exports, slow growth and capital outflow of last months (appreciation would attract capital inflows)

**Labor Markets** The market in which workers find paying work, employers find willing workers, and wage rates are determined.

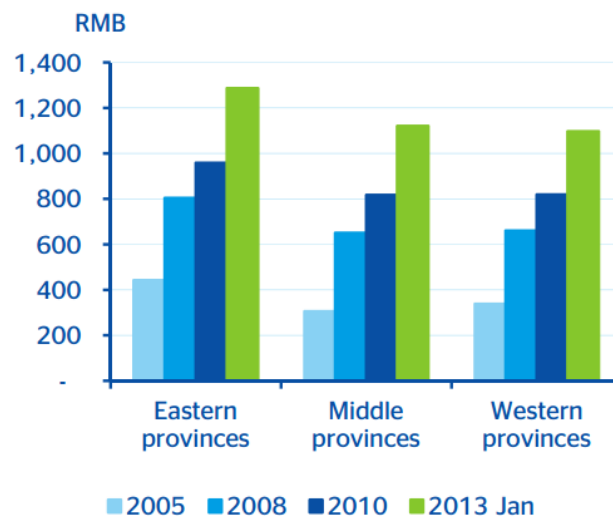


Figure 15: **Minimum Wage Growth in China (RMB)** *Source: BBVA Research*

**Rising Wages** As we can see, wages are increasing. We can also see that in Eastern provinces, urban provinces, the salary is much higher. This is the reason for the migration from the rural area to urban areas that Chinese society is experiencing. The question is: how will the economy change as wages increase? Rising wages will definitely contribute to boost consumption, which is the chief goal of the Chinese authorities. They want to shift from investment and export led economy to a more domestic economy. Rising wages will thus increase if this is what they want.

**Unemployment Rate** Interestingly, although economic growth in China has decelerated employment remains strong and stable. It has been reported that in first semester 2013 China created 7.25 million new jobs. Unemployment is one of the

biggest fears of the Chinese leadership, since employment is key in order to boost domestic consumption and achieve their desired transition towards a consumer based economy. I think the government will be willing to cope with growth deceleration as long as people can find work.

However, despite being strong employment growth has stagnated, due to the low mobility of immigrants from the countryside to urban areas caused by the *hukou system*<sup>21</sup>. Hence, we can say that the job situation is neither great nor awful.

**Stock Market Evolution** Although Shanghai stock exchange isn't open to foreign investors since the government exerts strict control over it, it is always a good indicator for the economy, as it reflects the expectations about the future economy.

Although during the economic recession the Shanghai Stock Exchange Composite Index had fallen, it rebounded in 2010 due to the stimulus package, pointing to improvement. However, it has fallen ever since authorities applied restrictive monetary policy to curb the real estate market in 2011. In January 2013 it picked up, although due to the low profit expectations of companies (due to the RMB appreciation and the fact they lower prices) it has fallen again. Overall, the indicator shows confidence and expectations are quite bad in China.

It is important to mention that the Chinese Stock Exchange Market is extremely volatile. This is why households don't use it, unlike in other countries, to invest their savings and have to then invest them in the real estate sector, leading to the bubble I will further analyze.

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<sup>21</sup>Chinese system of residence permits, which was created by Mao in 1958. The permits indicate where one person resides. Many rural migrants living in cities are not entitled to many free services (health and education) because they are classified as rural.

Gráfico 17  
El rendimiento del mercado de valores de China ha sido inferior



Figure 16: **Stock Market Index.** Note that that the Shangai Stock Exchange is the Index SHSZ300 *Source: BBVA Research*

## Government Policies

**Context** In 2005-2007 the government exercised strict monetary and prudent fiscal policy, in order to prevent the overheating of the economy and bring down inflation. After the 2008 financial crisis, external demand was extremely sluggish, hence, exports decreased. To mitigate the impact of the crisis, policies shifted from a prudent policy to an easy monetary policy and proactive fiscal policy, focused on stimulating the economy. The policy consisted on a huge stimulus package and easy monetary policy, which led to an overheated property market (credit controls loosened). Since 2011, the government has undergone proactive fiscal and prudent monetary to stimulate economy and, at the same time, prevent bubbles and guard themselves from financial risks. This policy mix, officially described as proactive fiscal policy and prudent monetary policy balance up<sup>22</sup> effectively, the latter playing a countercyclical role.<sup>23</sup>

<sup>22</sup>This was said by Fan Gang, an economist and former advisor for Chinas central bank

<sup>23</sup>Moreover, it is interesting that Wang Tongshan, an economist of the Chinese Academy of Social Sciences said another macroeconomic objective is environmental protection

**Fiscal Policy** On the fiscal front the new leadership will carry out a proactive fiscal policy, which is a *moderately* expansionary policy that creates demand and stimulates the economy primarily by expanding domestic demand. It will intend to reduce taxes to SME's<sup>24</sup>, facilitate exports and encourage private investment in the railway infrastructure and public services. Public expenditure will continue in infrastructure (especially railway), public housing construction, and will be complemented with selected tax cuts.

Such policy will eventually cause fiscal deficit to be slightly higher than the 2.0% of GDP budget objective, mainly due to a lower than expected revenue in economic slowdown. The projected deficit increase is of 400 billion Yuan, to 1.2 trillion Yuan in 2013 from 2012. This means in 2013 the expected government deficit is of 350 billion Yuan. As a result debt will also increase.

In the following graph we can see the evolution of fiscal policy over the past decade. In 2007, before the financial crisis, China had a budget surplus. But with the huge stimulus package it launched as a response to 2008 financial crisis China had a deficit of 0.4%. In 2009-10 fiscal support came through local government spending on infrastructure that increased local government debt. This is why the deficit increases these years (2.2% and the latter 1.7%). In 2012, although the objective was 2.0%, higher than expected revenue made the fiscal deficit rise to 1.6% of GDP. This year, as I said, due to lower than expected revenue it is expected a 2.1% of GDP, returning to the high levels of 2009.



Figure 17: **Fiscal Policy** *Source: BBVA Research*

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<sup>24</sup>Small and Medium Enterprises

In light of the deficit, this years lower revenue and local government high debt<sup>25</sup>, it is normal to doubt of the financial ability of the Chinese government to continue proactive fiscal policy. I strongly believe the Chinese government should try and optimize government spending and above all improve management over local government borrowing.

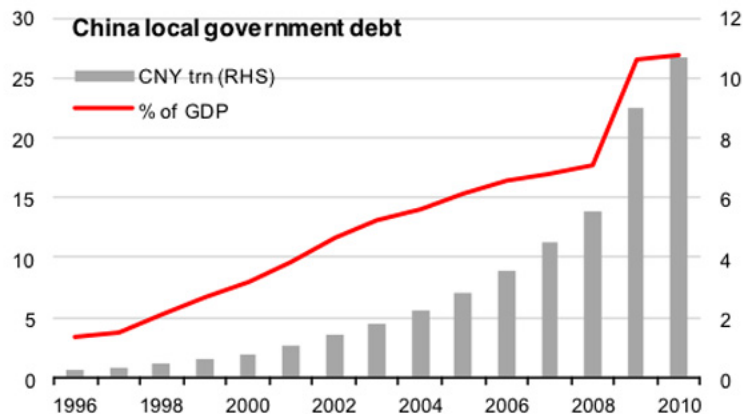


Figure 18: **Local Government Debt Growth** *Source: China National Audit Office*

Finally, I think public expenditure should transform: be less credit fueled, less local government funded but also less infrastructure oriented if they want to build a more sustainable and inclusive model. Actions it could take in order to build a more balanced economy could be further tax cuts, social welfare spending and other social expenditure. Such policies would really meet the necessities of the population and create an inclusive growth model.<sup>26</sup> Moreover, social spending such as pension schemes would certainly contribute to the rebalancing process, since there would be no need for the Chinese to save for their retirement, hence consumption would increase.

<sup>25</sup>2009-2010 fiscal came through local government spending, which is now out of control. There are fears hat local governments may not be able repay. More information: [HTTP://WWW.BBC.CO.UK/NEWS/BUSINESS-23486466](http://www.bbc.co.uk/news/business-23486466) or [HTTP://WWW.THEGUARDIAN.COM/LOCAL-GOVERNMENT-NETWORK/2013/AUG/09/CHINESE-LOCAL-GOVERNMENT-DEBT-TIMEBOMB](http://www.theguardian.com/local-government-network/2013/aug/09/chinese-local-government-debt-timebomb)

<sup>26</sup>I think that the high growth rate is not inclusive with the society because there is no welfare state and there is still a lot of poverty.

**Monetary Policy:** The proactive fiscal policy has been accompanied by a prudent monetary policy, which plays a countercyclical role. The ultimate goal of such policy is to maintain price stability. Put simply, when an economy turns sluggish (such as now) it is relatively expansionary but relatively tight when it's overheating.

The main problem is that in China has relied too much on lending from big banks<sup>27</sup>. As China banking regulator said, some lending in infrastructure and local government (bear in mind fiscal stimulus was credit fueled) could end up being a problem. The question is whether it will suffer from so much borrowing? To avoid it the government has cut back on this lending. For example, the target of money supply (M2) growth is 13%, the lowest since 2009. But a 22.9% growth in *total social financing*<sup>28</sup> in 2012 shows that it is not working. *Why?* Because of the big and growing shadow banking system that is keeping money flowing out through the economy.

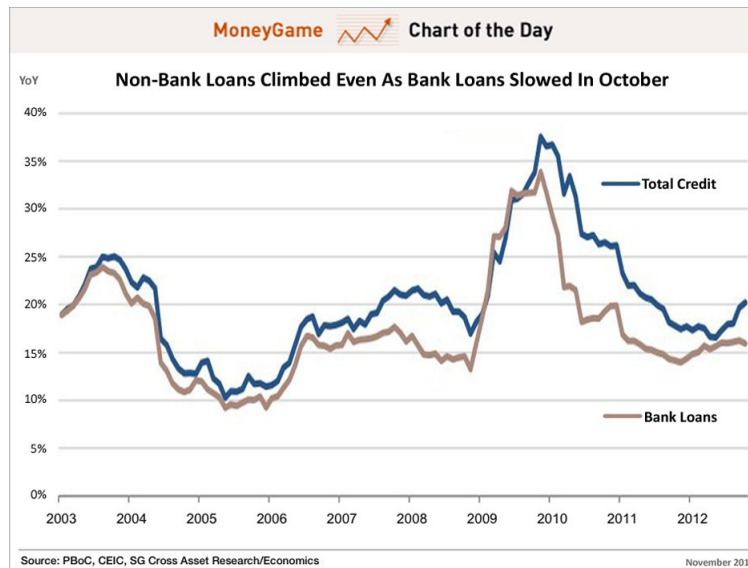


Figure 19: **Credit Growth** Source: *People Bank of China*

So, what is the shadow banking? They are lenders that are not banks and take the form of *trusts* and *wealth management products* (these are a type of financial product). Although the banks don't lend the money themselves, they are sponsored by banks. These non-bank lenders take money from investors promising higher yields

<sup>27</sup>Chinese banks are very big, (4 out of 10 biggest world banks are Chinese)

<sup>28</sup>A broader measure of credit that includes both bank and non-bank forms of credit

than if they invest their savings in banks. Then they lend that money to companies that are too small or risky for the big banks (who cant lend the money themselves due to the controls there is in credit).

The main issue is that they it is too big. According to Fitch Ratings so far banks have lend 5.6 trillion Yuan, shadow banking alone has lent 7 trillion Yuan. What's worse, they have been pumping money into the economy even though the government has tried to slow down credit growth. So, put simply: authorities have problems regulating shadow banking, hence, have problems exercising monetary policy, they cant control it directly. <sup>29</sup>

Moreover, another risk is that all those loans could go bad. If that happened, then who would take the loss? Would banks bailout investors? Or would investors be left to suffer alone for investing for investing in higher yield without knowing what was done with their money? Well, as has happened before, what would happen is that the central government would step in and bailout all the bad loans. The problem is that this time, numbers are going to be very big and such bank bailout would have drastic consequences in the economy and confidence of investors.

The good news however is that the government is aware of this and is trying to curtail shadow banking lending activities. It has done so by squeezing interbank market in June, which is the market where banks lend money to each other. By doing so the PBoC signaled they would not tolerate risky lending behavior by any financial institution. The effect of this liquidity crisis in June was that interbank rates rocketed to 30% (compared to the normal 3%). This added a wave of pessimism about growth outlook. So, eventually, to contain negative repercussions of the credit squeeze, in July the PBoC re-opened the tap in order to stabilize interest rates. According to *Wall Street Journal*, this liquidity crisis bears resemblance with the US financial crisis, where short term lending dried up.

Overall, despite the surge this June, interest rates have remained unchanged and stable, as have reserve requirements. It is important to note that China has the highest reserve requirement ratio, freezing a great sum of credit. Authorities are concerned about preventing real estate market, thus they are reluctant to cut interest rates further, and despite it could bring economic growth.

Furthermore, despite the liquidity squeeze in June, PBoC is moving towards interest

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<sup>29</sup>Shadow banking is created precisely to try and evade government controls on credit

rate liberalization. For example, on July 20 it has removed floor on lending rates (except mortgage). Such interest rate liberalization will increase return on savings and curb the property market (since now savers will be able to invest their saving in banks instead of real estate market).

Finally, through its monetary policy authorities are trying to curtail financial fragilities by maintaining restrictions on housing purchasing, increasing regulation of shadow banking activities, even though growth is slowing. Moreover, inflation provides further room to ease monetary policy, although interest rates are expected to stay the same throughout the year and 2014 in order to contain rise in housing prices and curb shadow banking lending.

**Inequalities and poverty in China:** Inequality is high in China, but stopped rising a few years ago. The way of measuring national inequality in per capita incomes is through the Gini coefficient. The Gini coefficient between 0, which reflects complete equality and 1, which indicates complete inequality (one person has all the income, all others have none). The next figures show how most indicators of inequality have declined somewhat in recent years.

This showed that national inequality peaked in 2008 and has been declining slightly since then. This is due to several factors, mainly due to the aforementioned increase of wages in urban areas. Moreover the gap between urban and rural incomes has also diminished as migrants transfer income to their families in the countryside. At a national level, this gives rise to the increase of people with middle income, thus inequality lowers.

Moreover, the inequality between regions has also been declining in the past years. As the graph shows the regional inequality has fallen back to the level of the 1990s. This is mainly because new industries are locating in poorer areas, since the land is much cheaper. The truth is that the government intends to further reduce inequality in order to achieve the well desired transition to a more consumer-led economy. It has done so by:

- Raise the minimum wage to 40% of the average wage (from 37% in 2011)
- Increase by 0.6% of GDP the total social spending (although its still very low)
- Interest rate liberalization, to increase return on savings



However, although it is improving, the inequality of income in China is still a concerning issue. What mainly contributes to inequality is the Chinese system of residence permits, the so-called *hukou system*, which was created by Mao in 1958. The permits indicate where one person resides. Many rural migrants living in cities are not entitled to many free services (health and education) because they are classified as rural. This is a source of inequality, since the migrants are forced to pay from their pocket services that for residents are completely free. Moreover, they try to save money to buy a house, something impossible with China's housing bubble...

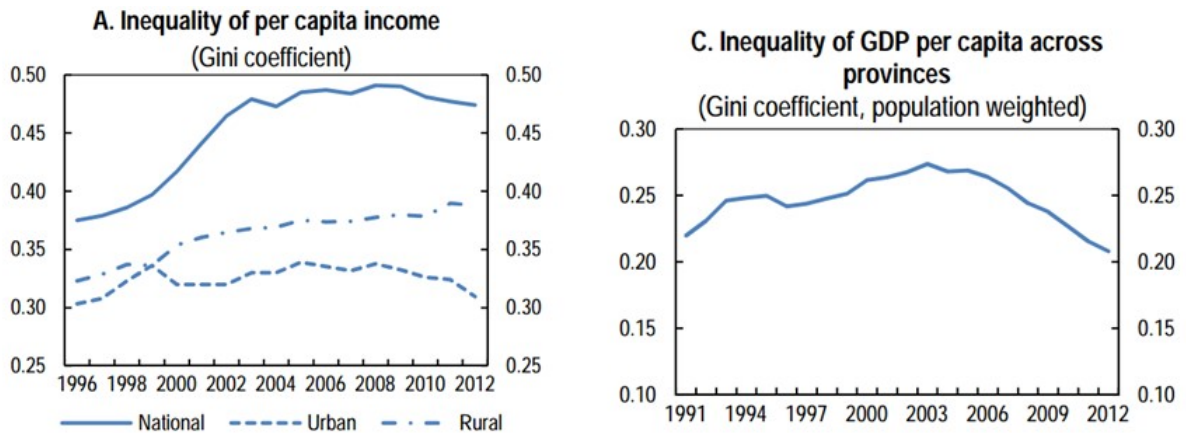


Figure 20: *Source: OECD Economic Survey China March 2013*

## 4 China's Economy Major Risks

### 4.1 Is there a Bubble in China's Housing Market?

#### 4.1.1 Context

China's real estate market has recently been showing signs of a bubble that could be about to burst. The effects of a pop would certainly not only impact China, but also impact other global economies, something that would have drastic consequences given the current economic situation many countries are going through. It comes as no surprise then that some economists have described China's property market as the *most important sector in the known universe*.<sup>30</sup>

Over the past decades, other bubble bursts have gone to show that such situations really pose a risk to the overall economy. For example the recent burst of the US real estate bubble triggered a financial crisis that led to the worst recession since the Great Depression. Many other countries, namely Spain and Ireland, have suffered this same problem and are all facing severe economic problems. History proves real estate bubbles to be a clear drag on economic growth.

China has managed to weather the global financial turmoil to a certain extent, mainly due to the enormous stimulus 2008 package.<sup>31</sup> However, this stimulus package led to the banks loosening their lending standards giving rise to excessive lending to individual purchasers, a successive increase in demand and, hence, a rapid rise of housing prices. The main issue is whether this situation has created a housing bubble that is about to burst.

The housing market in China has certainly grown over the past decade and, at the same time, property prices have also increased. As a result, despite the government's attempts to support home ownership, owning a home has become less affordable.<sup>32</sup> After 2010, there were some signs that the government had managed to curb the housing market, albeit house prices continue to go up sharply. So whether there is a bubble in China's housing market is a very worthy of concern issue, not only because

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<sup>30</sup>Analyst, Jonathan Anderson former economist at UBS

<sup>31</sup>The 2008 stimulus plan was a RMB 4 trillion (US\$ 586 billion) stimulus package announced by the Central People's Government of the People's Republic of China on 9 November 2008 as an attempt to minimize the impact of the global financial crisis

<sup>32</sup>Barth, James, Michael Lea, and Tong Li. "China's Housing Market: Is a Bubble About to Burst?"

it could put the world's second largest economy at stake but also affect the global economy.<sup>33</sup>

#### 4.1.2 Conceptual Framework: What is a bubble?

Before discussing whether there is a bubble in China's housing market, we need to define what a bubble is. It is often referred as a situation in which "*excessive public expectations of future prices increases, which causes prices to be temporarily elevated*". Another definition is a "*market price of the asset deviated significantly from its fundamental value*".<sup>34</sup> However, since the fundamental value of an asset is very difficult to observe, many believe it is not possible to identify a bubble until it bursts.

The main factors that may lead to bubble are:

- **Expectation:** During a bubble, homebuyers think that a house that they would normally consider too expensive is now acceptable, since they believe the high price will be compensated by price increase in the future. Also, since in a bubble prices increase, this even causes more homebuyers to buy a home since they believe they might not be able to afford a house in the future. The soaring demand eventually leads to further increase of prices.
- **Speculation:** Financial action that involves the purchase of assets but in a manner that has not been given thorough analysis or does not promise to be safe.
- Sharp **increases of prices** of an asset, like real estate
- Public excitement about those increases
- Stories of people earning a lot of money, luring others to do the same
- Interest in real estate market among the public
- Unprecedented **high prices**

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<sup>33</sup>The process would be as follows: Bubble burst prices will fall rapidly → houses go bankrupt → lending crisis and a credit crunch → Chinese investment falls → lack of confidence → general financial panic and a downward financial spiral

<sup>34</sup>Joseph E. Stiglitz

- A decline in **lending standards**: Credit has an important role for asset price bubbles.<sup>35</sup> There is a causation relation between generous lending and the formation of real estate bubbles.

As we have seen, in light of the aforementioned list, it can be concluded that a bubble does exist in some of China's regional housing markets, despite the actions taking by the government to curb the housing market sector.

#### 4.1.3 An Overview of China's Housing Market

Since 1978 China has gone a long way towards commercializing homes for its citizens, which before were completely state-owned. In 1988 the Constitution was amended to allow for land transaction, a landmark transformation of the housing market, which set the stage for privatization in China.<sup>36</sup>

Currently, more than 80% of homes are privately owned – evidence of successful privatization policies during the 1980s and 1990s. The current housing can be divided in 3 types: **Commodity Houses** (prices determined by market), **rental properties** and **economically affordable houses**. The price of the latter is determined by local governments before the project starts. They are usually sold for 3% to 5% above costs and targeted at families with low and medium income. To purchase affordable houses applicants must have *hukou*<sup>37</sup>. Once purchased, it can't be sold for five years.

If in 1990s affordable houses accounted for 25% of homes built, in 2010 it was only 3%. This is mainly because, although the demand of affordable houses is high, the supply is not forthcoming, owing to the fact that the other alternatives are much more profitable.

It is important to note that until recently, restrictions on commodity house purchases were few, but that since 2010, the governments have limited the purchase of homes by non-residents to curtail speculation, one of the causes of bubbles.<sup>38</sup>

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<sup>35</sup>Kindleberger (2003)

<sup>36</sup>In China, ownership of residential properties is limited to a term of 70 years. After this period, the right to use the land and property will no longer belong to the current owner. There is lots of debate about this law.

<sup>37</sup>Hukou is a household registration system used in China. A hukou record officially identifies a person as a resident of an area and includes information such as name, parents, spouse, and date of birth. Social welfare benefits are usually tied to a person's hukou

<sup>38</sup>There have been rising concerns that such administrative measures may lead to distortion of prices in the housing market.

The real estate market started to heat up since 2000s due to various reasons. China had high rates of inflation; hence, real rates on deposits were negative. As a result, the ONLY profitable place where average Chinese citizen can put their money is real estate (all others are either off limits as a result of government intervention, high entry costs, or volatility) . Moreover, land selling is the main source of income for municipal governments, thus they had incentives to sell land to developers and encourage state controlled banks to happily lend money. So, we can see that the bubble was driven by public development.

The increase in demand pushed for higher prices. From 2000 to 2007 prices rose from 20000 RMB to 47000 RMB (per square meter). By 2007, for fear of a housing bubble, the government tried to cool the property market by increasing interest on mortgages, higher down payments and credit restrictions. The result was a decrease of housing volume of 10%. However, in 2008, the global financial crisis led to a huge stimulus package launched by the government. This stimulus required loose lending policies that eventually home prices.

Many cities were built in order to keep the economy growing. It was assumed that if they built people would come (since there is a very high urban immigration from rural areas), but nobody comes (since they cannot afford them). The result? Dramatic ghost cities: thousands of inhabited miles. No nation has ever built so much in so little time.

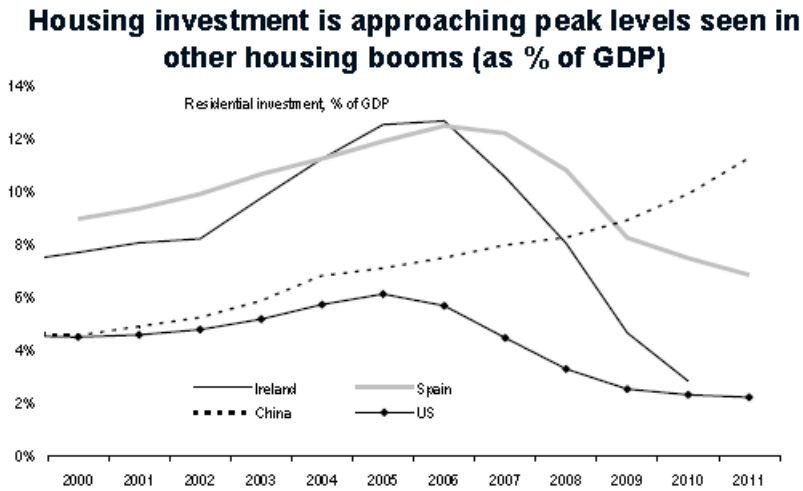


Figure 21: *Source: Credit Suisse*

As we can see, real estate market grew at a very high pace. Now it has become the motor of the economy, amounting for about  $\frac{1}{5}$  of Chinese investment<sup>39</sup>. Proof that the sector has grown is that housing investment as percentage of GDP has been growing unabated, even approaching levels that other nations experienced at the peak of their housing bubbles.

Finally, an important question is how is the source of funding house market investments? A large portion of funding comes from households own savings, which helps explain the relatively low consumption rate as a share of household income.<sup>40</sup>

The following graph shows recent changes in funding sources for real estate developers. As of 2011, 41% of all real estate project funds were raised by developers themselves. The share coming from bank loans, by contrast, has been declining. This is partly due to the fact that banks have recently tightened their lending standards under pressure from the government, who attempt to curtail the bubble.

<sup>39</sup>China is an investment led economy

<sup>40</sup>China is the country with the highest saving rates in the world

FIGURE

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*Sources of funding for real estate developers, 1998-2011*

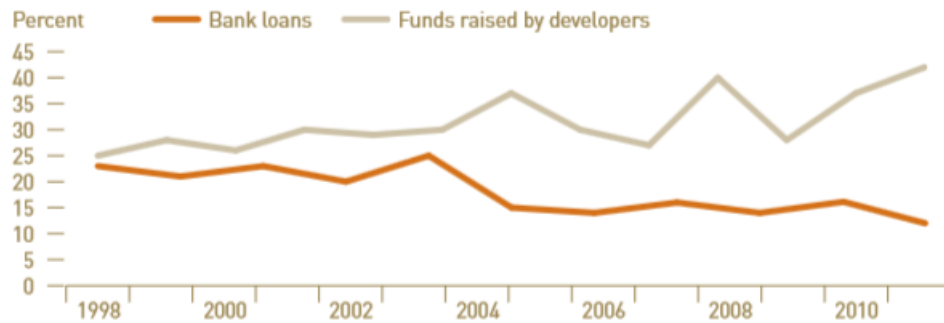


Figure 22: Sources of Funding of Real Estate Developers *Source: Credit Suisse*

#### 4.1.4 Indicators of Real Estate Bubble

To say the price of housing market increases at an excessive rate is the way one can evaluate whether there is a housing bubble. But to determine this is hard, and to do so we need to analyze if the price has been higher than the theoretical price level. Some indicators can be useful to do so:

1. **Housing Price-to-Income Ratio (%)**: Ratio of median house prices to median household disposable income. It is one of the most common indices to measure real estate bubbles. The greater the ratio, the lower households ability to pay for houses.
2. **Housing Price-to-Rent Ratio**: refers to the housing price divided by monthly rate. It is a very important index that shows to what extent the housing price has deviated from its original value. The warning line is 1:3000.
3. **Vacancy rate**: Indicator that shows the demand of real estate, and influences investors expectation and judgment. High vacancy rate is viewed as a sign that the market is struggling. So, this rate counts the total number of livable but unoccupied units, and determined what percentage of the total available housing is vacant.

#### 4.1.5 Assessing whether a Bubble exists or not in China's Housing Market

To assess whether a bubble exists or not in China's housing market I am going to carry out an analysis based on the criteria explained in the previous sector:

**High Prices:** The following chart shows that nationwide home prices had an upward tendency over the past decade. After declining in 2008 (due to the attempts from the government to cool the market). In 2009 home prices peaked, raising concerns about the potential rupture of the housing bubble. The next graph shows that prices continue to increase after price decrease in 2010.

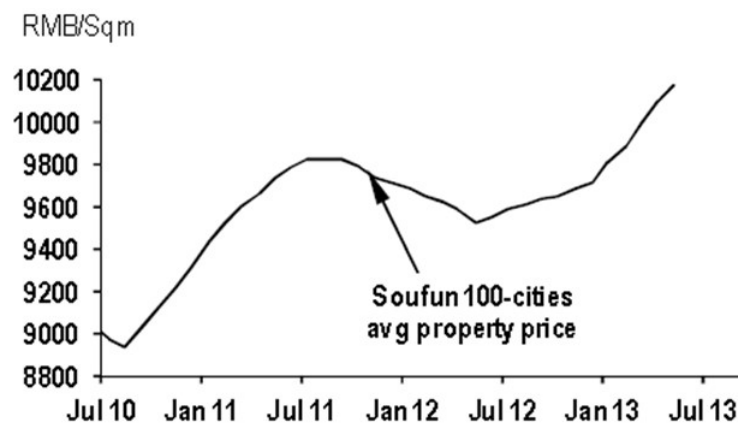


Figure 23: **China: Average housing price** *Source: Soufun*

**Expectations:** Expectations of an expanding housing market led to a growth in the sector. The main arguments were:

- The Economic Unit Intelligence predicted increase in urban population of 26% in the next decade, creating a strong demand for residential housing. However, though it is true there is immigration from rural area, they cant afford residential housing.
- Increase in per-capita disposable income and a growing middle class (expected demand that pushes the price upwards)
- Expected population increase, albeit at a slower pace with the one-child policy.



**Price-to-rent ratio** We can see in the graph how home prices in Beijing have increased much faster than rental prices (measure in RMB per sqm). This shows that prices are rising at unsustainable rates, creating a bubble.

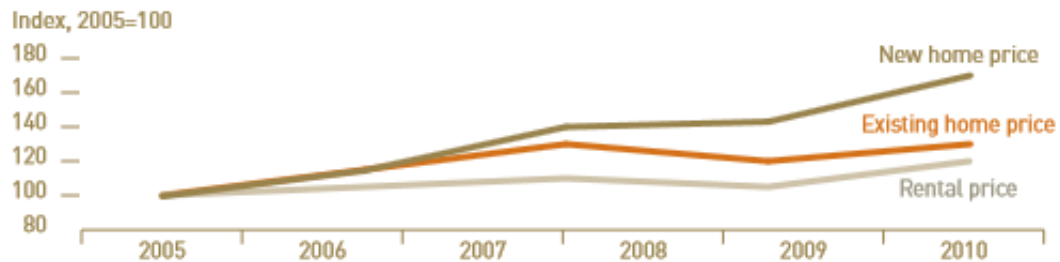


Figure 24: **Home price increases in Beijing have far exceeded rental price increases** *Source: NBS*

**Price-to-income ratio** As we can see in the following graph, household disposable income is growing much faster than growing prices, which shows that the increase in prices actually has strong fundamental support.

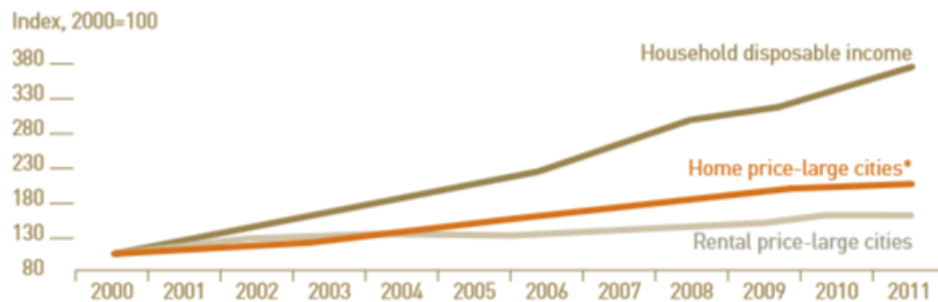


Figure 25: **Price-to-income ratio** *Source: NBS*

**Inventory of homes** However, there are strong signs that the housing market is beginning to encounter problems. The inventory of unsold homes has increased dramatically, by 35.8% in 2011<sup>41</sup>. Many cities have been built with nobody living in them, that is to say, there are hundreds of ghost cities in China.

<sup>41</sup>Source: NBS China

**Interest on mortgage rate** If interest rates are higher, it will increase developers investment costs and peoples purchasing costs, which will cool the property sector.

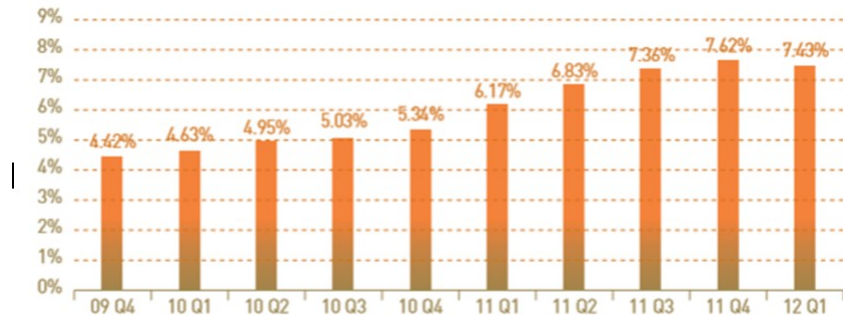


Figure 26: **Average interest rate on home mortgages** *Source: NBS*

#### 4.1.6 Conclusion

Since 2003, China’s housing prices have been roaring in China, especially in big cities. High housing prices have raised a lot of complaint nowadays and there are concerns that a bubble in the housing market has formed. Were it to collapse it would have knock-off effects not only to China’s but also the worlds economy.

This section has investigated whether there is a housing bubble in China recent years. Although it is not possible to provide a definite answer, the findings and analysis of different index (such as housing price-to-income ratio, high housing price-to-rent ratio, huge amount of vacant houses...) all suggest there is substantial mispricing in China’s housing market. However, we should emphasize that the main problem can be found in China’s ghost cities.

Since in 2009-2010 banks increased their exposure to the housing market via loans to developers and mortgages, a fall in property prices might have a significant impact on the banking system and impact the balance sheets of banks, leading to a credit squeeze and banking crisis.

Unlike the US bubble however , were China’s bubble to burst, it would not hit as hard, mainly because China has a large surplus that it could use in that case. Moreover, the government debt level is still fairly low (40% GDP). Furthermore, China has \$3 trillion in FX Reserves that it can access whenever it is needed.

Finally, I strongly believe that under the lead of Chinese government, with powerful persistence and determination, it will be possible for the real estate industry to develop in a healthy and stable way in the near future. I suggest the following actions:

- Increase mortgage down-payments required when buying a house
- Increase interest rates, so that the costs of borrowing money is higher and hence less people ask for a mortgage
- Legislation such as taxes on second residence houses to avoid people buying property for speculative purposes
- Open capital account so that Chinese savers have other ways of saving that is profitable and thus less people would be investing in property market, now the only profitable way to invest ones savings

## 4.2 Rebalancing from Investment to Consumption

China today faces a challenge. It has grown very rapid, a capital intensive <sup>42</sup> growth based on investment. China's rapid growth led to distortions and imbalances and it has to rebalance its economy. If it doesn't, it will face the kind of crisis suffered by almost every country with this investment led growth model, either in a debt crisis (with negative growth) or a lost decade of slow growth and increasing debt.

In this section we will address the following points:

- Analyze China's growth model, heavily reliant on investment
- How has it reached its levels of imbalances
- Lay some solutions ways China could rebalance

We will see that China has no choice but to rebalance its economy, the only question is the manner in it will do so.

### 4.2.1 What is Rebalancing?

Why do we say China's economy is imbalanced? Put it simply, we say that because it has a very low GDP share of consumption<sup>43</sup>, reflecting that China's growth model forces up savings rate and represses consumption growth. It does so by transferring wealth from household sector (through, as we will see, undervalued currency, low interest rates, low wage growth), in order to subsidize investment and generate rapid growth. So China's has a growth model driven by high investment that has eventually resulted in overinvestment (due to price distortions in cost of capital) and in turn, led to unsustainable increase in debt.<sup>44</sup>

To manage this debt China continues to repress interest rate at the expense of household depositors, who have to increase savings thus decrease consumption. This is a vicious cycle.

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<sup>42</sup>According to Michael Pettis and other economists, China's growth is capital intensive rather than labor intensive, contrary to popular belief. The labor market may be cheap but capital for most large borrowers is free or have a real negative cost (taking into account inflation)

<sup>43</sup>We will further discuss other reasons we say Chinas Economy is Unbalanced

<sup>44</sup>IMF Report *Is China Over-investing?*

In addition, experience tells us that every country followed this consumption represses investment driven growth model like China ended unsustainable debt burden caused by wasted debt financed investment: debt crisis or lost decade.

If it reaches debt capacity, investment will drop and China's Economy will crash (*hard landing*). However, the collapse is not inevitable, as it can reverse gradually, though ending up with lower levels of growth (*soft landing* scenario).

The good news is that the new leadership, as expressed in the Communist Party November Plenum, is aware of the cost of these imbalances; hence, it is likely that they will begin to rebalance before China reaches debt capacity limit. Political awareness of the problem is of paramount importance in an economy largely controlled by the state authorities.

If we agree that the fundamental imbalance in China is very low GDP Share of consumption that reflects a growth model that represses consumption (actually, it represses household income growth which is related to consumption), then what is needed to rebalance the economy is increase household share of total wealth.

China's growth model is driven by investment. This can be understood by looking at the components of aggregate demand:

**Demand of an Economy:**

$$= \textit{Domestic Investment} + \textit{Domestic Consumption} \\ + \textit{Foreign consumption and investment}$$

China's trade surplus was so high that it isn't expected to generate more growth, especially in the global context of crisis. Consumption being limited, this is why the motor that generates growth is investment.

Let me underscore the fact that it is an investment led model. People's general misconception is to say China is an export led economy when it is not. It is investment led economy. However, since domestic demand can't absorb excess production, it is external demand that absorbs it. So exports are, in a way, residual result necessary to keep investment.

## 4.2.2 Why is the model unsustainable?

It is unsustainable because overinvestment and increase in debt, as there have been political incentives, along with price distortions, that favored increase investment regardless of cost<sup>45</sup>.

Moreover, as we have said, consumption is very low: 34-35% of GDP. This is very low compared with USA (70%) or Europe (60-65%). Globally it is also relatively low as it is roughly 65%. The reasons of such a low consumption share of GDP are:

- Cultural reasons
- Lack of social safety net that forces households to save for retirement, medical care...
- Demographic dynamics Young people show propensity to save as they need to finance marriage, medical, retirement costs...

If the economy has 3 sources of demand: *Consumption+Investment+TradeSurplus*, the low consumption rate leaves us with an economy that depends on exports and investment. Then the economy is very vulnerable as the government cannot control the willingness of foreign nations to consume Chinese products. Only if it shifts towards domestic consumption will it reduce vulnerability and ensure continued sustainable growth. But doing so won't be easy.

## 4.2.3 Looking at past Experiences

If we look at China we see policies that soared savings such as financial repression, undervalued currency, slow wage growth, weakening social safety net, environmental degradation All of these policies force households to subsidize investment, generating rapid growth at the expense of household income growth.

Figures speak for themselves. In 1990-1992 Household Income ranged from 65-72% GDP. After peaking in 1992 inflation brought it down until in 2002 it reached 66%. Then it plunged to less than 50%. However, we should consider that some economists assume there is substantial hidden income in China that is not captured in surveys<sup>46</sup>.

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<sup>45</sup>Some academics at Fundan University and China Europe Business School

<sup>46</sup>Financial Times

But growth miracles are not something new. If we examine earlier versions of this investment-led model we can understand what's going on in China.

At the heart of all these investment led growth models there are massive *subsidies* for investment aimed at generating rapid growth building, infrastructure, manufacture capacity. We will now look at one of these experiences: **The Brazilian Miracle** in the 60's.

**Brazilian Miracle:** The *subsidy* must be paid by someone, and in most cases that someone is the household sector. In the Brazilian model, costs are explicit, that is, the government directly taxed household income that was heavily invested. So, in a nutshell, governments taxes household income to subsidize public investment that led to impressive growth for over two decades.

But excessive investment led to misallocation of resources and resulted in an increase in unsustainable debt. Ultimately, in the 80's Brazil reached its debt limit, resulting in a debt crisis and almost a decade of stagnated growth: the Lost Decade.<sup>47</sup>

As we will see debt is the Achilles heel of any investment led growth model. China is no exception:

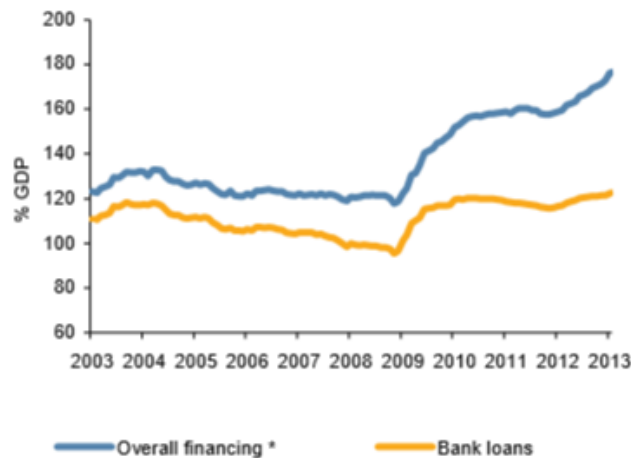


Figure 27: **China's Leverage is on rise** Source: CEIC, Royal Bank of Scotland

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<sup>47</sup>Period for economic stagnation

China has a similar investment led model. However, the Chinese model relies on less explicit taxation than Brazilians to accomplish the same thing: subsidize investment. Rather than confiscate household wealth it does so through more implicit mechanisms. These mechanisms are mainly:

#### 1. WAGE GROWTH BELOW WORKER PRODUCTIVITY

In theory, wages should be similar to the productivity, however in China there is a clear divergence between productivity and wages, as the latter has only doubled when productivity has almost tripled. In the graph we can appreciate a clear divergence:



Figure 28: **Wage growth vs. Productivity Growth in China** *Source: GraveKal Economics*

Why is this? The reasons are:

- There is a huge surplus of labor in the countryside that compete for jobs
- Workers cant organize in unions
- Migrant workers are unable to get residence permit (huoku) so there have little protection as they are in theory illegal

As a result, there is a transfer of wealth from workers to employers. A larger share of what workers produce goes to employers that generate more profit and thus more investment. This is an effective subsidy and in a way acts like an implicit tax.



## 2. TRANSFER INCOME FROM HOUSEHOLD TO MANUFACTURERS

China has an undervalued exchange rate. This is a "consumption tax" imposed on imports, which affects households by increasing cost of imports and hence decreasing household income. This is a way of increasing the gap between Production > Consumption.

## 3. FINANCIAL REPRESSION

This mechanism is the most powerful and is at the heart of Chinas rapid growth and imbalances. Economist Carmen Reinhard describes financial repression this way:

*"One of the main goals of financial repression is to keep nominal interest rates lower than would otherwise prevail. This effect, ceteris paribus<sup>48</sup>, reduces government's interest expenses for a given stock of debt and contributes to deficit reduction. However, when financial repression produces negative real interest rates and reduces existing debts, it is a transfer from creditors (Savers) to borrow and, in some cases, governments."*

***Carmen Reinhard, Financial Repression Back to Stay,  
Bloomberg. March 12, 2012***

So, China's financial system is represses and this acts like a hidden tax.

It is important to consider that almost all savings are in the form of bank deposits. Why? Basically because there are little alternatives as we have mentioned before:

- Restrictions on foreign investment
- Stock / Bond markets are very volatile
- Only alternative: Real estate and Shadow banking, both of which have limited liquidity and high transaction cost).

In other words, Chinese have to accept low deposit rates on their savings, they cant opt out.

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<sup>48</sup>Other things being equal

What happens is that the PBoC<sup>49</sup>, China's central bank that controls credit and interest rates, sets interest rates low, resulting in a transfer of a large share of resources from depositors to borrowers. Moreover, because they set the minimum spread between deposit and lending rate high, profits of banks increase also at the expense of depositors.

The logic behind this is that by lowering borrowing cost substantially, it encourages investment (in infrastructure, real estate, manufacturing capacity), albeit at the same time reducing the amount of interest income depositors receive. So it is again a "*hidden tax*" that reduces overall income households should be earning.

These three mechanisms all do the same thing: tax household's income to subsidize producers, manufacturers, investors, real estate developers, local governments and central government borrowers.

In addition, other policies that also have the same result are environmental degradation, which is a severe problem of China's growth model that won't be discussed in this paper.

All these transfers make profitable investments, even if returns don't justify the cost; igniting in investment boom and spectacular growth rates.

It is important to note that some economists and also the well-known institution *The Economist*, argues that household income tax generates growth, leading to higher employment rate and resulting in a surge in income. Be that as it may, this investment- led growth model still cant continue, as it can't be sustained.

The reasons behind this are:

- (a) When investment is low, investment makes sense and is economically productive. A way to see this is that if you have no roads, a simple dirt road is productive. However, if this longer subsidized investment continues, the cheap capital will be used to fund economically wasted projects. The dirty

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<sup>49</sup>Chinas Central Bank

road turns to a paved road, then into a highway and so and so forth. So rather than wealth being created, it is destroyed, but still showing profit as the losses are assumed by households

- (b) Another constraint is that the external demand is weak, mainly due to the financial crisis. So the world is having difficulties to absorb excess. The alternative is to focus on the domestic market.

So it is clear that China needs to rebalance, that is, abandon this investment led growth model because debt is raising unsustainable debt, and were it to reach debt capacity, the economy would crash (*hard landing* scenario).

#### 4.2.4 How will it Rebalance?

China has no choice but to rebalance its economy soon by reducing its reliance on investment and increasing its reliance on consumption. To put it in another way, consumption must become a greater share of GDP.

It is not impossible and there are different scenarios. I have tried to summarize briefly different alternatives proposed by the Michael Pettis, amongst other economists.

1. **China can continue with the existing model, that is, maintain high investment growth rates and hence, maintaining growth rates, until it reaches debt limit capacity , there is a sudden stop of investment and the economy collapses.**

This is the worst-case scenario of rebalancing. In this scenario Beijing refuses to cut investment rates sharply because it is politically impossible for example (especially at the elite level). In this case, GDP growth rates will remain very high while debt levels continue to grow unsustainably.

At some point, however, Beijing reaches its debt capacity limits and is no longer able to fund investment. Investment drops and GDP collapses and GDP collapses. But the story doesn't end here. A fall in investment and GDP collapse causes businesses to hire workers, resulting in an increase in unemployment that in turn leads to consumption to drop, and GDP growth falls even further (resulting in a bigger crisis and in a downward spiral).

**2. China can quickly reverse transfers that create imbalances by:**

- (a) **Raising interest rates**
- (b) **Raising value of currency**
- (c) **Pushing up wages**

This path simply means the very rapid reversal of the process over the last decades, during which imbalances were created (especially during 2000-2010). If China were to reverse these transfers quickly, the wealth transfer that created the imbalances would immediately reverse, and this in turn would begin to eliminate the imbalances.

The advantage of this process is that it adjusts very quickly and puts a stop to the worsening of the domestic imbalances. On the other hand, exports would struggle with a more expensive currency, borrowers would be unable to service their debt, and employers, especially the labor-intensive sector, become suddenly uncompetitive due to rise in wages. This would certainly create a surge in unemployment as exporters and borrowers are forced to close down operations.

**3. It can do the same as [2] but more slowly and progressively**

In this scenario transfers would be eliminated gradually and slowly, to give time to exporters, borrowers and employers time to adjust. As businesses adapt, the adverse employment impact of removing subsidies on export competitiveness can be counterbalanced by the positive employment impact of rising household consumption, so that there is no surge in unemployment.

But this strategy has a serious drawback: it accomplishes its objectives too slowly, and so it may already be too late to implement. Michael Pettis argues that "Beijing no longer has enough time".

4. **China can transfer wealth from state to private sector by privatizing assets and using the proceeds directly or indirectly to boost household wealth.**

This is the most efficient way to increase household wealth quickly as a share of GDP, although this comes at the expense of the state sector. There are many ways in which wealth can be transferred including:

- Farmers can be granted full title to their land
- Migrant can be granted huoku residency, which gives there legal status and rights to urban services, so would act as increase in their wealth.
- Strengthen social safety net
- Eliminate monopoly pricing power through greater competition
- Impose charges for environmental degradation, since environment degradation imposes future health and production costs on household, which must respond by increasing their savings rate.
- SOE's can be sold to locals or foreigners

If any of these transactions result in a reduction of SOE's ownership and increase in the wealth of Chinese households, the resulting increase in the household share of GDP will automatically increase the consumption share of GDP.

**5. China can indirectly transfer wealth from state to private sector by absorbing private sector debt. This is what Japan did.**

This was what Japan did as a fundamental part of its rebalancing after 1990, when government debt rose from roughly 20% of GDP to the current 200-250% of GDP<sup>50</sup>. The government absorbed bad loans in the banking sector. Government debt expanded rapidly, while private sector debt contracted.

Taking over your debt has the same net impact on your wealth as my gifting you my assets. In either case I am transferring wealth to you. But this strategy has an important cost: As we saw in the case of Japan<sup>51</sup>, after a decade or so, this strategy leaves the government struggling with debt too much. The debt burden becomes an impediment to growth. Moreover, China is very difficult it can do this since banks are too big and it can't absorb all the bad loans.

**6. China can cut investment sharply, resulting in a collapse of growth. It can mitigate employment consequences by creating state jobs out of state resources and paying their salaries out of state resources.**

Hiring unemployed by state sector is a way of transferring wealth from state to workers. This will only work if salaries are paid out of state assets. On the other hand, if government increases taxes in order to pay salaries this would have a minimal impact on household consumption.

As we can see, each case the state share decreases while household income increases. One of the main challenges these reforms faces is political difficulty, especially among the political elite that benefits from the existing model. From the aforementioned scenarios, in my opinion, I think China will follow number 3, in light of reforms announced in the November Plenum (*see Annex*).

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<sup>50</sup>Japan had a similar investment led growth model that started in the 60s and eventually lade to the Lost Decade during the 90's.

<sup>51</sup>More information on Japan please visit: [HTTP://BLOGS.REUTERS.COM/BREAKINGVIEWS/2013/09/03/THE-LESSONS-FOR-CHINA-FROM-JAPANS-LOST-DECADE/](http://blogs.reuters.com/breakingviews/2013/09/03/the-lessons-for-china-from-japans-lost-decade/). To put in a nutshell: Japan had the same investment led model that lead to misallocation in investment and resulted in an increase in unsustainable debt. The result was 10 years of slow growth as it adjusted to a new growth model (The Lost Decade).

#### 4.2.5 China's Rebalancing Progress: Quantitative Analysis

Until now, we have talked about the rebalancing process in a qualitative way. In this section, however, we are going to use some economic indicators that will show the progress of China's economy in rebalancing towards a more sustainable growth model, that is, higher levels of consumption and less investment.

As we have described, without such a shift China's growth is likely to slow further over the medium term, as investments cannot be indefinitely sustained and exports are insufficient to drive growth. Hence, consumption **must** emerge.

We are now going to look at some rebalancing indicators:

**Consumption and investment as GDP** The following graph proves that consumption is extremely low and that there is high investment in China. However consumption seems to be having an upward trend and investment is slowing down; hence there is a very small amount of progress towards rebalancing.

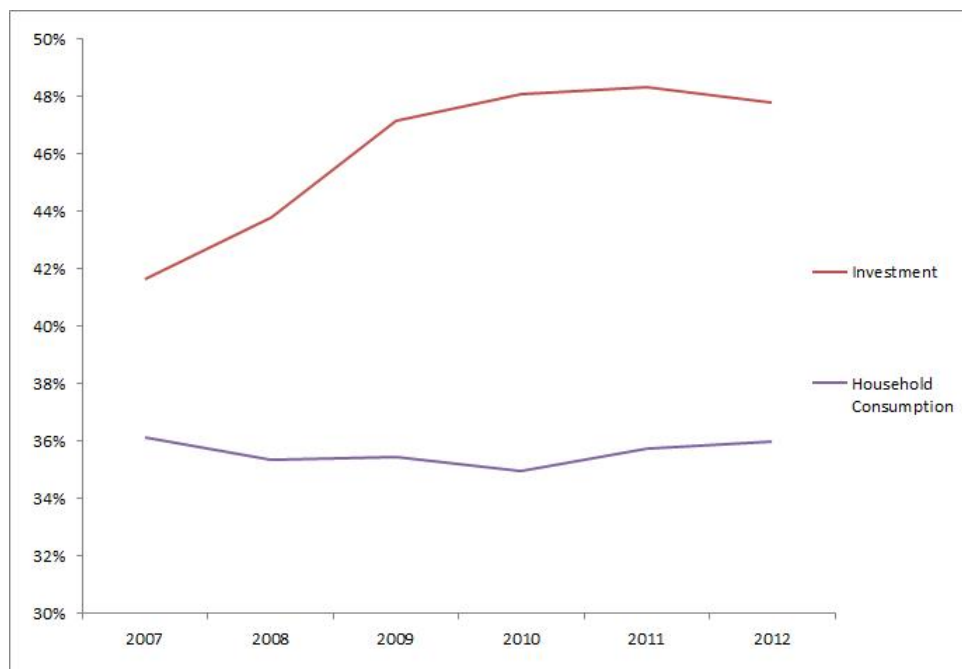


Figure 29: **Evolution of Consumption and Investment as GDP, 2007-2012**  
*Source: Own elaboration based on NBS Database*

**Disposable Income growing faster than GDP** If disposable income is growing faster than GDP it indicates that the household income share of GDP will be increasing, hence, consumption will be increasing.

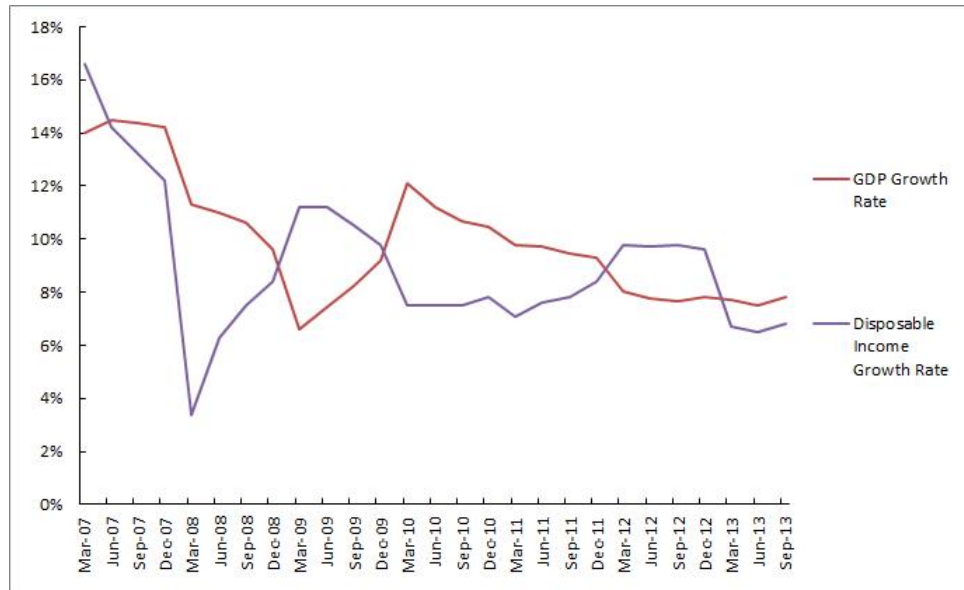


Figure 30: **GDP and disposable income percent growth, year over year**  
*Source: Own elaboration based on NBS Database*

As we can see, there is a slower growth of disposable income in the last year and on general terms it is lower than GDP growth.

The graph shows that the gap between GDP growth and disposable income growth in the third quarter remained constant at 1 percent. Hence, the indicator is slightly negative as, ideally, disposable income should be growing faster than GDP.



**Positive Real interest rate on deposits** This is very important to show if China is rebalancing. As we have described, negative interest rate over the past years have been a blow to household income and wealth and has encouraged speculative investment bubbles (such as in the real estate sector). If interest rates are kept above inflation it will not only boss incomes but also dissuade savers from taking money out of the bank into speculative investment.

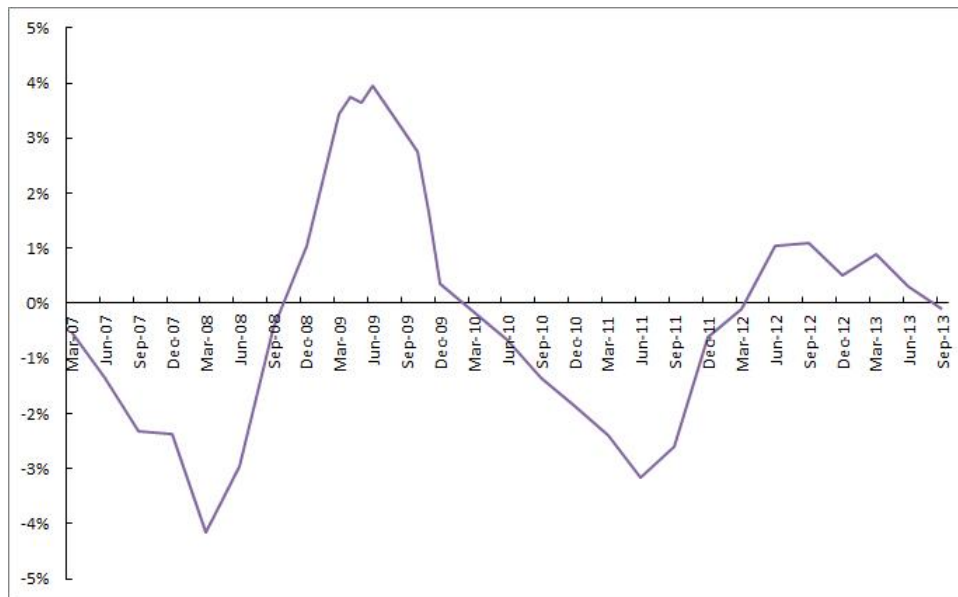


Figure 31: **Real interest rate on one-year deposits** *Source: Own elaboration based on NBS Database*

Real interest rates on deposits fell once again in the third quarter, dipping down into slightly negative territory (-.1 percent). Inflation has ticked up steadily throughout the year, but there has been no corresponding increase in the deposit rate. As a result, the real interest rate is now a full 1.2 percentage points lower than it was a year ago.

However, as the new leadership after the Plenum has announced liberalization of interest rates I expect that interest will rise in the near-future.

**Loans to small enterprise growing faster than total enterprise loans** Economic growth needs in China to shift away large industrial firms (State Owned Enterprises) towards small firms. Smaller firms pay higher percentage of their profits in wages instead of being more capital intensive as large firms are. As we can see in the following graph: Small enterprise loans are growing somewhat faster than large enterprise loans, making this indicator slightly positive.

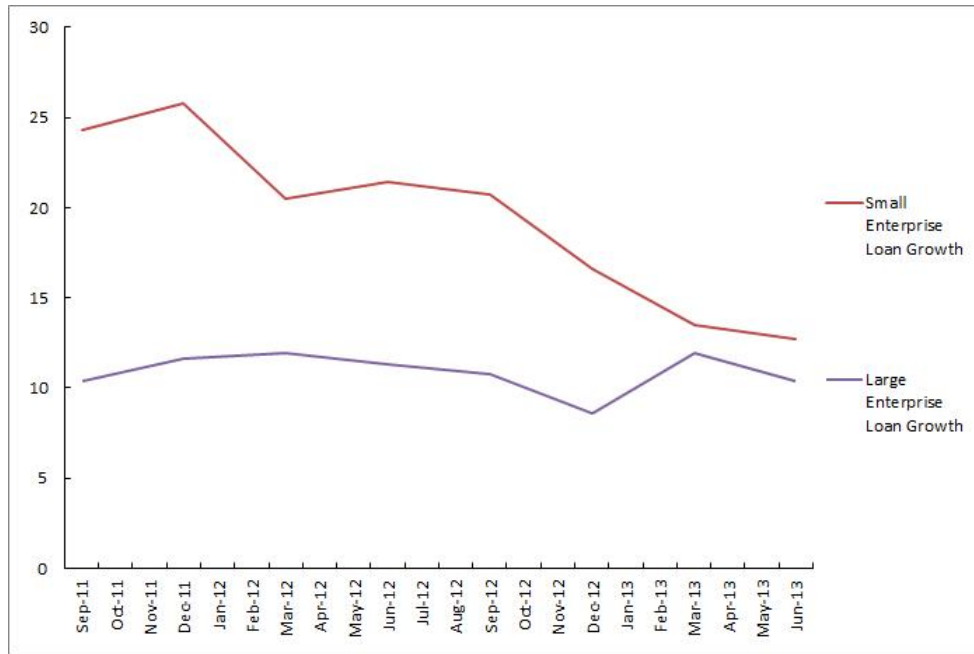


Figure 32: **Total enterprise and small enterprise loan percent growth, year over year** *Source: Own elaboration based on NBS Database*

**Faster growth of Tertiary Sector than Secondary** The tertiary sector continued to grow slightly faster than the secondary sector in the third quarter, 8.4 percent vs. 7.8 percent. While the gap is somewhat smaller than the previous quarter, this is still a good omen for economy rebalancing.

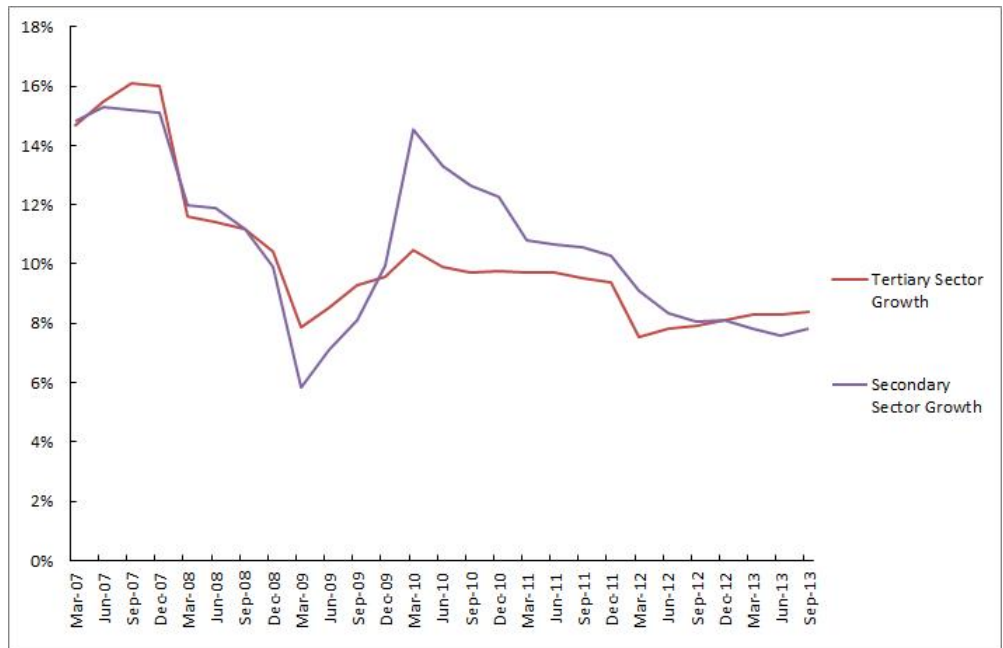


Figure 33: **Secondary and tertiary sector percent growth, year over year**  
*Source: Own elaboration based on NBS Database*

**Overall Outlook of Economic Rebalancing Process:** In light of the data shown, we see no dramatic shift towards rebalancing. If it is occurring, it is only at the very initial stages. China urgently needs to find ways to keep disposable income growing at a higher rate, boost deposits rates without imperiling banks, slow down investment. These are all difficult tasks.

## 5 Conclusions

### 5.1 *Hard Landing vs. Soft Landing*

The main objective of this research project was to determine whether China will experience a *soft landing*<sup>52</sup> or a *hard landing*<sup>53</sup> Overall it can be concluded that:

1. Over the past two decades China has experienced extraordinarily high levels of growth since it transitioned from a socialist economy to a market-oriented economy (with large controls of the state). This impressive growth has been driven by high levels of investment and exports, which have grown at an exponential rate for the past decades. However, such levels of growth have led to some imbalances (since consumption only accounts for 36% of GDP), inequalities and environmental degradation.
2. Many indicators show that China is doing pretty good. There has been continued strong growth and inflation is moderate (showing the economy is operating in its potential). However, now growth appears to be slowing from its previous double-digit levels and, combined with leverage increase, many economists are being perturbed, fearing a future crisis. The credit crunch in June, for instance, is a sign that the economy is not healthy.
3. China responded to the financial crisis with a huge fiscal stimulus package, which is the reason why it maintained high levels of growth while the rest of the world was in the midst of a recession. China's current policy is a proactive fiscal policy (moderately expansionary), in order to stimulate the economy, combined with a prudent monetary policy, which plays a countercyclical role and achieves price stability as well as trying to curb the property market.
4. In this project we have identified two main risks:
  - (a) **Real Estate Bubble:** Though there are slight signs, on a local level, of a Real Estate Bubble, some indicators such as income growth and urbanization makes us think the increase in property prices is justified. However, even if there was a bubble it is not a big risk as the economy isn't as exposed to this sector as other bubbles, such as Spain. This view is shared with an expert on China's Economy, Louis Kuijs, who says:

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<sup>52</sup>Gradual slowdown from high output growth levels to a more sustainable one

<sup>53</sup>Economic situation when the economy collapses and goes drastically down.

*"I think there are serious problems in China's real estate sector, a lot of which stemming from the problematic incentives and behavior of local governments. However, given the rapid rate of household income growth and pace of urbanization, fundamental demand for housing is pretty strong and I am less convinced than many others are about the existence of a bubble on the housing market"*

- (b) The main risk is that the economy needs to **rebalance from unsustainable investment towards consumption**. The reason it has to rebalance is that China is now overinvesting in inefficient projects such as huge ghost cities and other property developments and this has led to an increase in unsustainable debt. I think the transition will imply lower growth on the short and medium term though it will help build a more sustainable and inclusive growth model. The transition from investment led growth to consumption led growth is critical in order to project the future of China's Economy. I believe it all comes down to how the rebalancing is done. According to Louis Kuijs *"the historical experience suggests that processes such as a change in the pattern of growth are not easy to manage and that changes in the economic structure often happen suddenly and in conditions of a crisis or something close to it, rather than gradually. The government would like it to be smooth, of course."*
5. Overall, some economists, such as Paul Krugman (Economics Noble Prize laureate 2008), claim that when China brings down investment, consumption won't compensate and demand will fall, leading to a collapse in the economy. Some even talk of a depression. However, for this project I have interviewed and asked for the opinion of expert economists on China (see Annex) and they all agree that China's Economy is strong and that it will manage to adjust and experience a soft landing scenario. As Louis Kruijs says China's economic fundamentals are in my view strong enough to overcome some of the problems that there are. Thus, I expect a soft landing. Pedro Nueno also expects China to maintain its levels of growth over the short and medium term.

In my opinion, I think that the hard landing scenario is highly unlikely and I expect a soft landing, that is, a progressive slowdown of the Chinese economy over the next decade to a more sustainable and inclusive growth models. Although there are some signs that suggest China is facing problems, at least the new leadership is aware of the problems and will try and address them, as we have seen after the November Communist Party Plenum. For example, the leadership is progressively liberalizing

the economy<sup>54</sup> and internationalizing the Chinese currency<sup>55</sup>. We can see that the government is moving towards the right direction in the rebalancing of the economy, hence, I expect a smooth transformation of the Chinese economy. As Louis Kuijs said: *"The transition will require a lot of competence, and some luck on the side of policymakers."*

We can see that the future of China is not absolutely clear. If it has to depend on luck though, then let the odds be in Chinas favor, not only for China's sake but for the sake of the rest of the worlds economy.

## 5.2 Personal Conclusion

Personally, despite being very challenging I have really enjoyed this research project. Not only was the topic really interesting and current, but also I learnt many things, such as analytical, communicative and synthetically skills. I was amazed by how different economists can have so diverse opinions about one same subject; there is never a whole truth and you have to try and look at both sides of the coin. The fact that there are many factors you have to take into account makes it very complex but at the same time really exciting!

However, I must say I did encounter many difficulties which can be summarized in the following points:

- It was such a current issue, that for every statistic showing economic recovery there is another which indicates that growth is still slowing.
- I lacked the specific knowledge; so many economic terms were new to me. At first, it was very hard because I had to look up almost every economic-related word.
- Finally, the hardest part, without doubt was finding someone to interview for my project, trying to contact economists without success but in the end I managed to interview leading experts on China's economy, which was very fulfilling.

All in all, this project has been very challenging and at the same time really interesting. I have truly enjoyed it.

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<sup>54</sup>see Shanghai Free Trade Zone in *Appendix*

<sup>55</sup>Early in December the Yuan became the second more used currency in international currency, advancing the Euro

## A Appendix

### A.1 Shanghai Pilot Free Trade Zone (SFTZ)

In September 29th a Pilot Free Trade Zone was launched which has been considered by many a landmark moment and a step towards the future opening of the whole Chinese Economy.

Liberalization is needed in the economy for two main reasons. First, it has to gain competitiveness in the service sector (mainly controlled by SOE's<sup>56</sup>). Internally, rising wages and ageing population are pushing China into *Middle Income Trap*<sup>57</sup>. It is in the process of liberalization that this zone is important as it will spark further liberalization in a broader scale.

Its purpose is to test some economic reforms that the government is considering to apply to the whole territory, such as interest rate and currency liberalization, opening to foreign investment.

However, the government has not allowed access to uncensored internet nor cut corporate taxes, and has restricted many sectors to invest. But still, it shows that the government is going in the right direction as at least there is an attempt to reform.

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<sup>56</sup>State Owned Enterprises

<sup>57</sup>The middle income trap is an economic development situation, where a country which attains a certain income (due to given advantages) will get stuck at that level. As wages rise, manufacturers often find themselves unable to compete in export markets with lower-cost producers elsewhere. Yet, they still find themselves behind the advanced economies in higher-value products. The problem in a nutshell is that countries can get stuck at a level of development in which its populace has been generally lifted out of poverty but hasn't been elevated to the income levels of more advanced economies.

## A.2 Communist Party November Plenum - Overview

Key reforms were announced following the Third Plenum of the Communist Party early in November, whose dates have been set for 2020.

- Relaxation of the one-child policy, as China is running out of workers working age population will soon start to fall <sup>58</sup>
- Liberalization of the economy: Market forces will play a *decisive role* (rather than the usual *basic role*)
- Liberalization of interest rates
- Liberalization of the Yuan, making it a fully convertible currency
- Reform of the *huoku system*, which denied rural immigrants access to urban welfare
- Farmers will be able to sell non-agricultural land directly to the market
- Private sector will compete freely with State Owned Enterprises (SOE's)

As we can see, the market will gain force and there will be a shift away SOE's towards private companies that will result in less investment. Of course, the result of this reforms are not expected to be immediate growth but they will "reduce the threat of a hard landing caused by misallocation of capital", says Mark Williams of Capital Economics.

Many of these measures (interest rate liberalization, liberalization of the currency, giving more strength to private sector) will eventually increase the share of income that goes to household and thus support consumer spending. This is a good step towards the rebalancing of the economy.

Such reforms will face much opposition from local governments, a political elite that has benefited from the investment model and middle class who don't want to share services with outsiders from rural areas.

The main risk of this reforms, Yao points, is that if the government loses control, the chances of things going wrong will rise.

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<sup>58</sup>OECD Avoiding the Middle Income Trap 2013



### A.3 Interviewing an expert: Louis Kuijs



Figure 34: Louis Kuijs is Chief China Economist at Royal Bank of Scotland

*Three decades of rapid economic growth go to show China's economic success. However, now such rapid expansion is starting to loose pace. Some believe the Chinese economy is facing many risks that will slow down the economy further. There's even the fear of a hard landing. To discuss this David Dollar, a leading expert on China's economy will answer some questions.*

*First of all, thank you for giving your time to answer these questions.*

**A question I ask myself is how can we be talking about 7.5% growth, which is triple United States growth rate, and say the Chinese Economy is doing badly?**

*Answer:* We should not say China is doing badly just because its growth has come down from 10% per year to 7.7% (my estimate for 2013) per year. 7.7% is still pretty rapid growth.

But we should also not say that China is in a much better shape than the US because it is growing much faster. They are at a very different stage of development. With still a lot of room for catch up, China is supposed to grow quite fast. Of course, many poor countries are not able to grow fast, but that is another issue.

**Do you think we should be worried about this slowdown or welcome it? How can the government say it will tolerate low level of growth?**

*Answer:* We should not really worry. Growth has already increased again anyway. I would not expect growth to be much faster than 8% in the coming years. But that is solid enough to create enough urban employment.

**It is being said that a shift from investment led model to consumption is badly needed to make Chinese growth path more sustainable and inclusive. Do you agree? What is the problem with the investment-led model? What is been done to foster this rebalancing process?**

*Answer:* I feel less strongly than most other foreign observers about the level of the investment to GDP ratio and what it says about the problems in China's economy. However, I think that China's industry and investment led growth model have led to several imbalances, including inequality, problems in the social sphere, and environmental and energy issues.

Because of this, and also in order to prepare for slower growth ahead, and despite the fact that China still needs a lot of investment, I think it makes sense to reduce the investment and industry intensity of the growth model.

**What are the risks of this transition? Will it be a smooth process?**

*Answer:* The historical experience suggests that processes such as a change in the pattern of growth are not easy to manage and that changes in the economic structure often happen suddenly and in conditions of a crisis or something close to it, rather than gradually. The government would like it to be smooth, of course. It will require a lot of competence, and some luck, on the side of policymakers.

**Many economists compare China's situation with Japan back in 1989. Do you believe theres an analogy between China and Japan?**

*Answer:* I think it makes more sense to compare China now with Japan in the 1960s. In 1989 Japan was virtually finished with its catch up. It had little room for fast growth any more. That is quite different in China now. China, and Japan in the 1960s, still have a lot of room for catch up growth. That means that many things, including overcoming financial risks and bubbles, are much easier than in the case

where growth is low. Also, at that earlier stage in the development process, the scope for investment is still high.

**Another risk that the Chinese Economy is facing is the real estate bubble. First of all, is there a real estate bubble in China? What makes you think so?**

*Answer:* I think there are serious problems in China's real estate sector, a lot of which stemming from the problematic incentives and behavior of local governments. However, given the rapid rate of household income growth and pace of urbanization, fundamental demand for housing is pretty strong and I am less convinced than many others are about the existence of a bubble on the housing market.

**Do you think it will burst or has the government adopted the necessary policy to address the situation and contain the real estate market?**

*Answer:* I would expect many individual projects to have problems in the coming years. However, the key question is: will we see a systemic crisisone that is large enough to cause significant macroeconomic or financial problems? I do not expect a systemic crisis in China caused by the property market.

**Finally, the big question. All in all, what are your future projections for the Chinese Economy? Will we have a *hard landing* or will China manage a *soft landing* scenario?**

*Answer:* Chinas economic fundamentals are in my view strong enough to overcome some of the problems that there are. Thus, I expect a *soft landing*.

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