Luncheon Address

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Thank you very much, Esther, for inviting me. A few months ago when I got the email from you inviting me to give a talk on China, I thought I should come. But, I thought maybe people might be mostly interested in Greece. Sure enough, China became the spotlight, right? And I guess when I go back home, I should propose to our central bank that we invite you as our external expert, focusing on China's influence in the world. Anyway, I thought my talk would be short, because in this room, we have tremendous knowledge about China, and opinions about China. So I should give you the opportunity to ask questions and to voice your views on China. It's also a learning experience for me.

The central point I want to make is that the Chinese economy has entered a very tricky and difficult period—hopefully only three years, maybe shorter—when policies will be very critical. The right policies, right reforms will shape the future of the Chinese economy.

First, let me explain what's going on. I know you have your views; you follow China very closely. Then, I will explain what may happen next in terms of a policy package from China. And in between, to explain my view of the possible policy to come, I will also explain, in my view, the long-run potential of the Chinese economy, because that's very important. When you design policy today, you have to have a long-run perspective on the economy, especially in an emerging market economy like China.

So, first, what has been going on? We all know the stock market has been coming down, but before talking about the stock market, which I will come back to, let me explain several things that are going on in the economy.

First, exports have been coming down this year. From January to June, exports only grew at 0.8 percent. That's not the Chinese number we're used to. The government target is 5 percent, and in July, exports declined by 8 percent. No one knows whether this is a bit of bad luck, or some seasonal thing. No one knows, but that number is quite alarming. Imports also declined by 15 percent for the first six months. Part of this can be explained by the price change—terms of trade. In my calculation, I took the impact of the terms of trade out of the total decline of imports. Still, there is a real decline in imports of the magnitude of 7 percent, so as an implication, the trade surplus is rising again. My forecast for the end of this year is the trade surplus will amount to 5-6 percent of GDP. That is, $500 billion to $600 billion. So, international trade is not helping the Chinese economy. It also is not helping the rest of the world with the big decline in imports.

The second thing going on is in the property market. Prices and transaction volume have been declining for the last year. This year, some signs of life have come back. Since March, month on month, property transactions and prices have been increasing. And by May, year on year, transaction volume and prices have been increasing. Most of the increases have been in large cities, the superlarge cities—Beijing, Shanghai, Guangzhou and Shenzhen. By the end of this year, the property market most likely will see increases in investment, that is, investment in the form of new construction. So far this year, what you in the United States call new construction housing has only been growing at 5 percent. Again, not a Chinese number. Not when it used to be 20 percent, or at least 10 percent.

And, the third thing, which I think is even more important than the first two, is the slowdown in investments other than housing construction. What we call fixed asset investment came down from 15 percent last year to 12 percent. And it's still declining. And more worrisome is that new project investment, among all fixed assets, in June came in at only 5 percent, year on year. New projects are indicators of the future of fixed asset investment. Fixed asset investment usually accounts for 40 percent of GDP. This is an economy you may not be used to, 40 percent of fixed asset investment, but that's it for the economy. So there already are depressing signs.

Very quickly, I'll tell you about some positive signs, mainly in the area of structural change. Private consumption, for example, is increasing as a share of GDP; now it is 47 percent by my calculation. By the way, this is my reconstructed number, because the National Bureau of Statistics is not, in this regard, doing a service to the policymakers. They are relying upon household surveys to tally private consumption. By their calculation, it's only 38 percent. The fact is Chinese households do not want to deal with issues when it comes to income and consumption. Only the poor households are willing to report truthfully about their consumption because they receive money from the National Bureau of Statistics in exchange for their cooperation. Anyway, consumption as a share of GDP by my calculation has been increasing since 2007 by about 1.2 percent per year. The reason is that there has been a 9 percent increase in nominal wage rates for the past years, which is not bad. Blue-collar workers are having a good time, although they haven't gone to the street to cheer. In a way, I'm oversimplifying our two economies; the United States and China somewhat are mirror images of each other. In China, the capital owners are not particularly happy—I also talk about this in the stock exchange. Well, blue-collar laborers are finally having a good time. Their wage rates are increasing. Perhaps at the risk of misunderstanding the U.S. situation, it's the opposite of here. Anyway, consumption goes up because wage rates are increasing, household disposable income is increasing as a share of GDP and behind that is a labor shortage.

Finally, there is a shortage of labor, which I really think is good news for the rest of the world. If you look at the U.S. situation, there is a lot of research that shows in the last 30 years labor share as GDP has been declining. In the U.S., there is some research that explains the decline in U.S. labor income share by increasing capital elasticity. I have a Ph.D. student in China. He did research showing the very simple fact that increases in China's exports to the United States in the past 30 years can explain at least 20 percent of the decline of the U.S. labor share. Because, look at China in the past 30 years, about 300 million farmers entered the non-farm sector. That number is as many as the stock of labor in the United States, Europe and Japan combined. Many Chinese workers are doing exports. That's got to be an impact on the U.S. economy, crowding out a lot of supply of tradable goods and lowering wages of blue-collar workers in the United States.

Anyway, Chinese wage rates are increasing and disposable income is increasing; there is a labor shortage and services most likely will be higher than 50 percent of GDP. And services have been contributing something like 3.6 percent of GDP growth in the last year. Services are really booming. And Internet business is really booming. It's very hot. So, when I give talks in China, I have to be supercareful, especially with my students. If I'm not careful, if I'm boring students, with them looking at their mobile phones, they begin to do mail order. The next day or next morning, the goods will be at their doors. And then students don't go to the dining hall. They do mail order and then the food is delivered to their desk. So this is the Internet to our students—decreasing dividends of the students.

Tourism is booming. As many as 100 million Chinese nationals go abroad, and the number is still increasing. And increasingly, they are coming to the United States because the U.S. is giving them a 10-year tourist visa with multiple entries. It's a big business because each of them spends on average $4,000 to $5,000 shopping. You can't imagine. So, 100 million tourists—and that number is still increasing—each spending $4,000 to $5,000, so that's $400 billion to $500 billion. That's Chinese import. So, lots of services are shifted overseas. And some people estimate that in five years that number will increase to 200 million tourists. I was joking once to some Greek friends: If Greece is opening up its tourism to China, so that only 1 percent of Chinese tourists go to Greece, China can bump up your GDP by 0.9 percent.

Despite the good signs of structural change, the traditional sectors are not doing well. For example, power generation declined 2 percent during the first seven months compared with last year. And cement, which is basically a locally-produced-and-used product, decreased 2 percent during the same period. Iron and steel increased only about 2 percent to 3 percent; copper increased 5 percent. Copper is doing relatively better than the other things. The aluminum sector is miserable. There's too much extra capacity production in aluminum Overall, the traditional sectors are not doing well and the new sectors are doing well. This has implications for the stock market, because most firms in the stock market are old firms in the old sectors. Therefore, in late June to early July, there was a big, 28-percent drop in the Chinese stock index. That drop, I think, arguably can be perceived as a healthy price adjustment. By my calculation, the PE ratio of the Shanghai index dropped from 30 in mid-June to around 20 in early July. Twenty is the historical median of the PE of the Chinese stock index PE. It's the median, not the average because the average is much higher, pushed up by the 2007 increase when the PE was 70. Now, just one week ago, the Chinese stock market had a second round of declines, another 15 percent drop within three trading sessions. The first run can be attributed to overleverage because many novice retail investors borrowed money under the illusion the market was capable of moving up further. When the stock dropped quickly, these investors were forced to sell due to margin calls. The second drop, in my view, must have been triggered by a lack of confidence. The market especially responded to the release of a PMI number (it had been called the HSBC-PMI; HSBC sold the PMI to a local media). The PMI dropped to the lowest level in six and a half years. PMI is mainly for small media enterprises, not big enterprises. Anyway, people say that signal is a bad sign for the economy and investors in the stock market are really scared. That was the reason for the big decline.

In the first decline, the government response was to make sure the stock market would not decline further because of self-fulfilling expectations. Indeed, they put in some measures. Judging by the recent performance, it's not been that effective. Now, the second round drop I think is scarier for policymakers because it's not due to margin calls on the inexperienced investors in the stock market, but it's due to a lack of confidence in the overall economy.

Before moving on to what will happen next, let me mention one other thing. The behavior of local government has changed. The Chinese economy in the past three and a half decades has been growing very fast. I think, by far, the most important secret is local governments were behaving like CEOs of holding companies—competing with each other trying to do business, trying to have multiple banquets every night, talking to investors, talking to multinationals, trying to acquire land to create industrial parks. That culture is changing because local governments now are more concerned about doing things kosher, not doing things wrong. They don't want to be blamed for doing things in a corrupt way. Let me give you one example. Land. We're talking about agricultural land. China has very strict restrictions on agricultural land. The Chinese central government's idea is to maintain a fixed amount of arable land in order to have food security, so that if a local government wants to build an industrial park on arable land, the local government has to develop the same size of arable land elsewhere to replace the one used by the industrial park. And in past years, local governments oftentimes used very poor arable land, claimed it is good arable land and then they occupy good land for building an industrial park. It's not completely kosher; it's against government regulations. But now they are supercautious. They want to make sure they are not blamed, not demoted, not under investigation. Every week on the Internet there were reports of the Chinese premier criticizing local governments for inaction. And that, I think, is very, very worrisome. Something has to be done to get back the good spirit of the local officials.

Well, what's next? What may happen to policy and then, therefore, the economy? First, let me share with you my views on the long-term potential of the economy, because that's important. What you should do today depends upon what's the potential of the economy. Now, there are debates in China about the long-term growth potential of the Chinese economy. Some people argue that the natural rate of growth of China will come down to some level lower than even 6 percent. The main argument is the labor supply will decline, because indeed the total labor supply has reached a peak. I do not fully agree with this analysis for several reasons. One is that total labor supply does not take into account the increase of human capital. People are learning. Also, total labor supply does not take people's health into account. Today, a 60-year-old person in China is as healthy as a 50-year-old was 20 years ago. So, potentially there is room for reform to implement a flexible retirement age. And that's particularly meaningful for a poor country like China, because people are still poor and people are healthy. If given a chance to work a few more years, people are willing to work, they would do so as long as their pension remains intact or increases with the retirement age. So also, methodologically I disagree with this line of research because it tends to rely on production function, total factor productivity (TFP). How can you predict TFP for the future, a span of 20 years? It's very difficult. Also TFP is pro-cyclical. Do you know when the Chinese economy had the highest TFP? The Great Leap Forward. Those were crazily fast-growing years. Anyway, my view is that we have to look at history. Look at Japan, Korea and European countries that have made it. They have broken through the middle income trap. In my recent research, I found three conditions that are very critical. All of them should be satisfied in order for the economy, like today's China, to continue to grow. First, institutions and government policies should be reasonably pro-market, whether politics are open or not. Russia does qualify in this regard. But, in today's China, in general, governments, central and local, all know that markets are the engines of economic growth and market institutions have to be further improved.

The second condition is education, or, human capital. And in this regard, China is reasonably well-positioned. I think young kids, even from poor areas, are working hard. And education is steadily improving.

The third condition is also very important. In order for a country to grow, the country has to deal with advanced economy countries. Our Japanese friends invented the phrase, the flying geese. Now Japan is the leader; Korea, Taiwan being the followers. Well, I agree with that metaphor, however, I think we can take that one step further. Why? Look at Israel, for example. Israel is the middle of a not-so-developed market economy environment. However, Israel did well in the past 30 years because Israel has been doing business: import, export, investments with Europe and the United States.

I found in my cross-country empirical study that these three conditions combined become a necessary and almost sufficient condition for a middle-income economy to grow. And China should be able to satisfy these conditions in the coming decades. Today's Chinese per capita GDP is only 20 percent of the United States. What is China's potential growth rate? I looked at data from Japan, Korea and Taiwan, when they were 20 percent of U.S. per capita GDP. They were able to grow 8 percent in the ensuing 10 years and 7 percent in the ensuing 20 years. Based on this, I would say China's growth potential should be 7 percent for the coming decade.

Now, if you believe me that China still has a pretty high growth potential, then what are the possible new engines of growth? I can see three new engines replacing the old engines of property markets, replacing exports. First is consumption. As I mentioned, consumption is steadily increasing because wage rates are increasing. Second is urbanization. Forty-eight percent of the Chinese population still lives in the countryside. The Chinese countryside is not Kansas, you know, it's really, really countryside. People are stuck with low incomes; people do want to go to the cities. There is potential for growth. Reforms are needed because farmers have land, but the land is not freely tradable. There are lots of restrictions on using land as collateral at a bank. And many cities have not realized that population is the key to their future growth. Instead, they only look at public finance. They ask: In order for us to absorb more population, we need more primary schools. Where is the money? This mentality has to change. Reform is needed.

The third new engine of growth, which is my favorite, is upgrading industry. Take for example, the iron and steel industry. The iron and steel industries are highly polluting. Whenever Beijing has sports events or international events, people in Beijing cheer because neighboring iron and steel plants are shut down three weeks ahead of the event. Whether it's for APEC or the recent track and field international tournament, whenever the iron and steel plants near Beijing are shut down, the air quality improves instantly. Keep in mind that China is the world's largest producer of iron and steel, producing 65 percent of the world's steel. A third of the production is in the region neighboring Beijing. So, here's a very simple way to improve air quality and enhance GDP growth. First, put on stronger, stricter pollution standards, and second, force out the polluting facilities, and this reduces supply. Then the prices of iron and steel will go up because there's not enough international supply to fill the gap. Then, when prices go up, import the German, Japanese, Korean technology and build new plants along the coast with imported coal and iron ore, which are cheaper than domestic supply. That's the new model of iron and steel. By my calculation, if China can do that, replacing 10 percent or upgrading 10 percent of its iron and steel facilities, then each year there will be a growth of 1.5 percent in GDP. And the beauty of that is private investment would go in because the new plants face higher iron and steel prices and use cheap imported coal and iron ore. OK, that's the third engine of growth.

Of course, all these engines of growth are for the future. Right now we are stuck with today's economy. But what may happen then? What's next? Well, some people say "the policymakers are very comfortable with the current situation." They claim to be comfortable. I do not share this view. I think, based on my interaction with many policymakers, that Chinese decision makers are worried about the current economic situation. They are worried for both economic and political reasons. For economic reasons, it's because this is a bicycle economy; when the economy slows down, many problems become bigger. Many economic problems are measured against the GDP. The GDP is the denominator and the problem the numerator. When GDP grows at a nominal pace of 10 percent, that is 7 percent of real term plus 3 percent of inflation, a lot of problems are dissolved. Whether it's debt or bad loans. Otherwise, if nominal GDP growth slows down to say 7 percent, many problems would be amplified. Now, politically it's also important because the Chinese government has stated that the country wants to be a moderately prosperous economy by 2021. That means GDP per capita should be higher than $12,000 by 2021. Today it's $7,500. In order to do that, they have to maintain at least 6.7 percent between now to 2021.

But aiming at 6.7 percent is risky. What if the world slows down and sends bad shocks to China? So, all in all, 7 percent is still, in my view, where policymakers will aim.

OK, now given that, what may happen? I think as we speak, policymakers are busy because of the last big drop in the stock market and international attention to Chinese economic issues, so there's a very high chance, that a ministimulus package will be put together, which I call acupuncture stimulus. Rather than stimulate the whole body, only stimulate the key nerve points.

What are nerve points? First, lowering financing costs. Here is something you may not know. China's savings rate is one of the highest. So is its total savings. Almost 50 percent of national GDP is saved. Still, the financing cost is easily 50 percent higher than the United States Local governments have been borrowing at a rate of 8 percent or 9 percent and often double digits to finance their ongoing infrastructure investment. This is ridiculous, and moreover the local governments are borrowing short-term money—one year, two year and they have to roll over. This is suicidal, I told them. A simple solution would be to set up several mini world banks within China. Use central government guarantees to float long-term debt, 20-30 year maturity debt, having the interest rate close to the Chinese central government debt. Use this to finance those long-term infrastructure investments, which are still needed, by the way. China's per capita infrastructure stock is about 17 percent of Japan and Korea and is still needed. It is still a poor economy. So this way, banks' credits can be relieved to support enterprises. Enterprises will be able to borrow at much lower interest rates than now from commercial banks to do their technological upgrading. That's the first acupuncture point. Of course, I have to mention that central bank's interest rates and deposit reserve ratios still have room to cut. The interest rate now is 4.6 percent, lending rates and the reserve rates something around 14-15 percent, still very high.

The second acupuncture point is to make sure all those scheduled infrastructure investments are implemented by local governments. Local governments should be given mandates to finish whatever is already planned. Don't shirk; make it a mandate. This is a country in which local governments are evaluated, promoted, rather than elected directly.

The third acupuncture point is reform, especially two things. Reform of state-owned enterprises (SOE), which was already announced and the blueprint was written beautifully two years ago in a Party document, which is almost like a law, but the SOE reform blueprint has not actually been implemented. Now, at least announce something concrete about the SOE reform so that those investors in the stock market can look forward to. The SOE reform should be substantiated and details of the reform should be announced. Also, tax cuts should be done as planned. For example, in China if you hire a worker you have to pay easily 60 percent extra for labor insurance, for medical insurance, for housing contribution fund and for retirement funds. The taxes are ridiculously high. And that part of the tax is a contribution to various funds which are deposited in commercial banks. This is like forced savings. China does not need this. Taxes should be cut.

To summarize, I would say that the Chinese economy is going through a tricky and uncertain period, and I do hope that the uncertainties can be resolved before long. I do have hope for a relatively quick recovery of the economy, but proper policies must be in place. The good thing is that there are signs of upcoming actions in the form of acupuncture stimulus.