

What Kind of Landing for the Chinese Economy?

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Rarely has the outlook for the Chinese economy been so contested. The financial press widely quotes three alternative perspectives on the short- and medium-term outlook. One school argues that the Chinese government’s recent efforts to rein in overly rapid growth are working and that the economy is now on a glide path to what is referred to as a soft landing. While “soft landing” is usually not fully defined, its chief feature in this case is that Chinese economic growth slows modestly from its current pace of 9 to 10 percent to around 8 percent and that the rate of job creation does not slow enough to constitute a major political challenge for the regime. At the other end of the spectrum is

the hard landing school, which argues that the authorities to date have not tightened sufficiently, that loan and investment growth remain excessive, and that the authorities soon will be forced to take more drastic action that will trigger a sharp correction. Finally, the no landing school argues that China’s efforts to slow growth modestly are misguided since the economy was not overheating in 2003 and early 2004. In this view, China is in the early stages of a secular boom that has several additional years to run.

The soft landing school is clearly the consensus view. Adherents of this school of thought point out that broad monetary aggregates and bank lending have both slowed significantly from the breakneck pace of 2003 and the first quarter of 2004. By September 2004, the growth of broad money and bank loans both slowed to 14 percent, well below the peak levels of over 20 percent in mid-2003. And GDP growth, which was 9.3 percent in 2003 and 9.8 percent in 2004Q1, slowed to 9.6 percent in the second quarter and 9.1 percent in the third quarter (National Bureau of Statistics 2004). Many observers have thus concluded that China’s desired soft landing is almost here. Moreover, the Chinese authorities engineered this outcome without increasing interest rates (the modest adjustment of interest rates was not made until late October 2004) or altering the exchange rate—relying instead on administrative controls on bank lending, new investment projects, and land use. Concerns about a hard landing, with its potentially large, negative spillover effects for China’s regional and global trading partners, seemingly should therefore be cast aside.

Not so fast, we say. China’s economic history over the past 20 years fits better with a “long landing” view of the slowdown. At the heart of imbalances in the Chinese economy is an unsustainable investment boom that has been in the making for at least four years and that will probably take at least several years to undo, even with good policies. Judging from the unwinding of China’s last investment boom, the most likely outcome is that economic growth will decline during this adjustment period—probably on the order of 4 to 5 percentage points from its current rate. Hence, the growth decline will last longer

and may be more gradual than advocates of the hard landing school have envisaged, but its cumulative magnitude may not be much less marked.

Just as important, until the investment overhang is eliminated, the rest of the world will have to live with a China that is significantly less of a global growth pole than in recent years. China alone accounted for one-fifth of global trade expansion between 2000 and 2003. The expansionary effect on the global economy was particularly evident in Asia, where China accounted for a large share of the growth of exports. But China's growing appetite for soybeans, copper, and iron ore contributed significantly to economic expansion elsewhere as well, notably in Chile and Brazil.

On the policy side, we doubt that China can continue to rely primarily on administrative controls to manage the pace and composition of economic activity. Instead, adjustments in the renminbi exchange rate and more meaningful adjustments in interest rates than we have seen to date will need to assume the lion's share of macroeconomic management and of restoring external balance.

EXPERIENCE WITH EARLIER INVESTMENT BOOMS

Figure 1 presents capital investment as a share of GDP over the past 25 years. Note that in 2003 the share hit 42 percent—almost the same as the peak in 1993 during the last investment boom. Monthly Chinese data on investment activity are problematic, but it appears highly likely that fixed asset investment continued to grow more rapidly than GDP in the first nine months, so the investment share probably has risen to the neighborhood of 45 percent.¹ Notice in figure 1 that whenever the investment share got above 36 to 38 percent during the 1979–91 period, it subsequently fell back to the low 30s. In the more recent 1992–2000 period, one sees a similar pattern—albeit with both a higher peak and trough. True, the Chinese authorities intervened “earlier” in this current bout of overheating. This time they initiated restraining measures after five to six quarters of excessive monetary growth and when consumer price inflation was only 3 to 4 percent versus 11

to 12 quarters and an inflation of over 20 percent in the last cycle. But figure 1 illustrates that tightening measures in this cycle start from about the same high investment share. The main message is that nothing in the last 25 years of China's economic growth experience suggests that an investment share above 38 to 40 percent of GDP is sustainable.

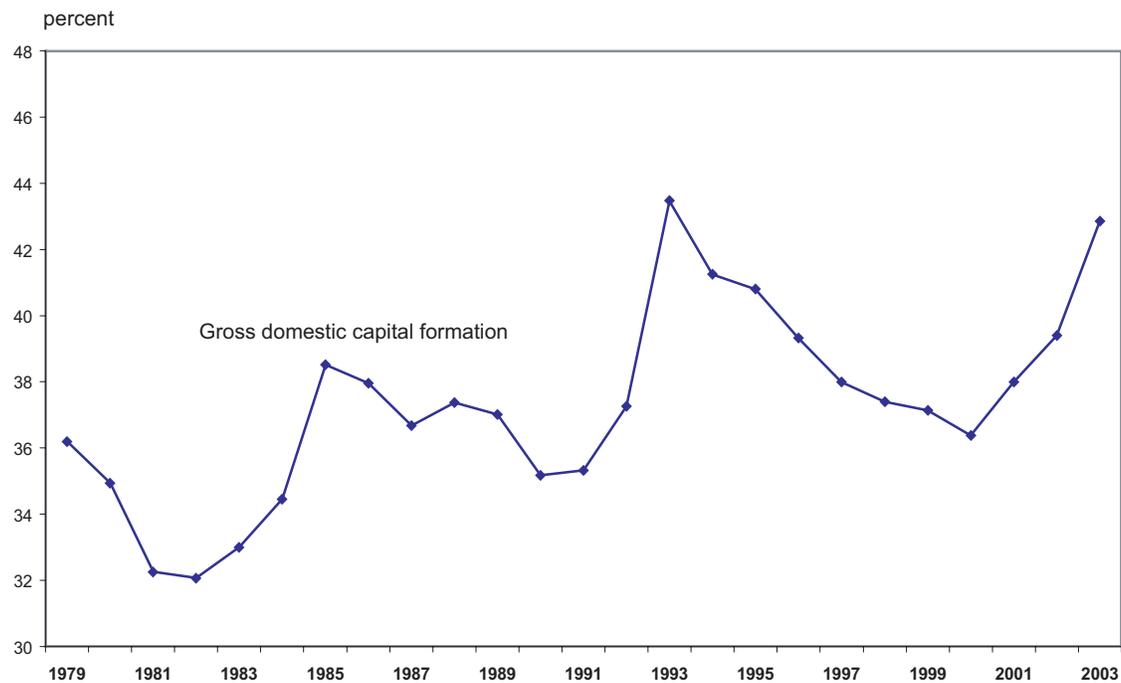
Figure 2 shows the time pattern of real fixed investment growth in China over the past decade. From the peak of the last cycle, the slowdown took four to six years to complete, and real investment growth slowed dramatically during the process. Likewise, figure 2 confirms that it took four to five years for investment growth to reach the overextended levels of 2003–04. Experience therefore indicates that both creating and unwinding investment booms in China is a multiyear phenomenon—not a one- or two-quarter development.

A medium-term decline in investment growth does not necessarily mean that economic growth also has to decline. Private consumption, government consumption, or net exports could grow faster to offset an investment slowdown. Figure 3 gives official data on the weights of these components in China's GDP in 2003. Capital investment and private consumption dominate, with weights far higher than those for government consumption and net exports. Faster growth of private consumption, given its high weight, has significant potential to offset slowing expansion of investment in order to maintain high GDP growth. But when investment growth was declining substantially from its 1993 peak, there was no sustained, large, upward offsetting movement in consumption (figure 4). Indeed, over the decade the growth of real fixed investment and of real household consumption are positively—not negatively—correlated. The same result obtains if the sample of years is restricted to those in which investment growth slowed. To sustain GDP growth when the growth of real investment falls, say, to 7 percent a year, would require a dramatic increase in real household consumption over a medium-term horizon. We doubt this could occur without creating other problems. Korea experienced a credit card-induced consumption boom, but it recently ended in tears when household debt got out of hand, defaults mounted, and the credit card companies collapsed.

Government consumption has less than one-third the weight of investment; even doubling the growth of government consumption from its recent pace would add only three-quarters of a percentage point to GDP growth. But Chinese authorities have been reluctant to run budget deficits beyond a few percent of GDP. Using fiscal pump-priming to counter a short-term shock induced by the outbreak of severe acute respiratory syndrome (SARS) is one thing; running considerably expanded fiscal deficits for several years would be quite another.

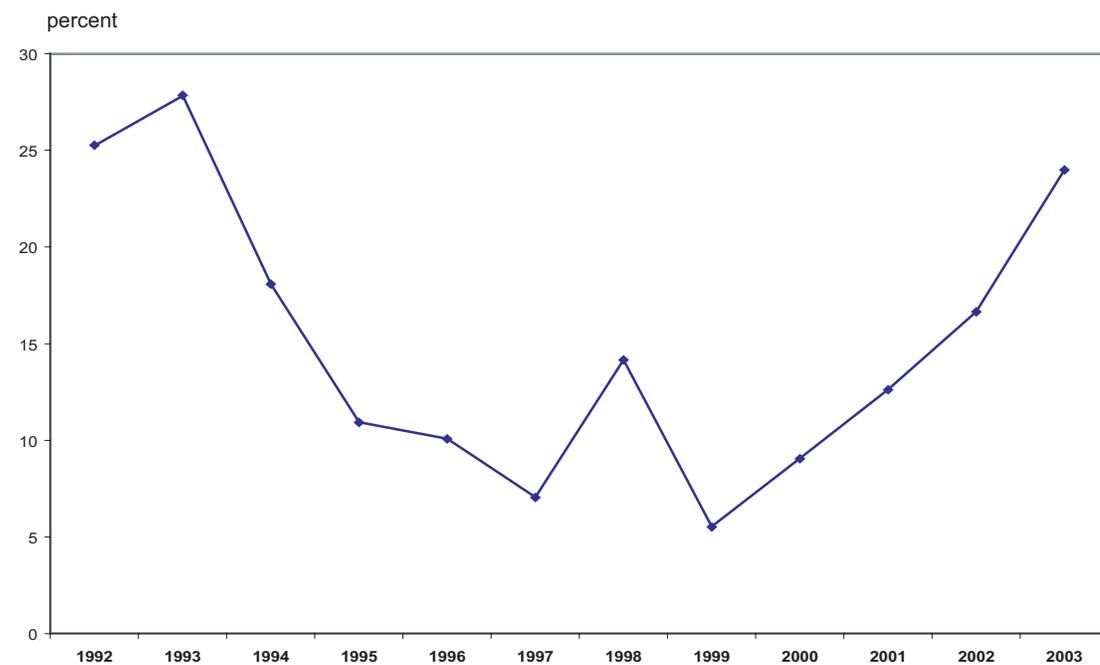
¹ Official data show fixed asset investment grew by 27.7 percent in nominal terms in the first three quarters. Fixed asset investment prices rose by about 6 percent over the same period, so growth of fixed asset investment in real terms was about 20 percent, more than twice the 9.5 percent real growth of the economy over the same period. Unless official data on fixed asset investment are grossly overstated or the growth of fixed asset investment prices is grossly understated, the investment share of GDP must have risen in the first three quarters of 2004.

Figure 1: Capital investment as a share of GDP, 1979–2003



Sources: *China Statistical Yearbook 2003*, p. 67; *China Statistical Communiqué, 2004*; author's estimates.

Figure 2: Increase in real fixed asset investment, 1992–2003



Sources: *China Statistical Yearbook 2003*, p. 316; *China Statistical Abstract 2004*, p. 50.

Net exports have the smallest weight in GDP. But in the last cycle, net exports of goods and services strengthened by 6 percentage points of GDP between 1993 and 1997, providing a significant boost to the economy (figure 5). Net exports are also likely to strengthen with a slowing of the economy from its current peak as import growth slows more than export growth. But the rest of the world would no doubt bring pressure to bear for a correction if China's net export balance climbed too sharply, particularly since the starting point in this cycle is a modest current account surplus rather than the modest deficit of 1993.

Finally, figure 6 displays real GDP growth during 1992–2004Q3. From the peak investment share in 1993 to the troughs in 1997 and 1999, the growth of real GDP declined by 5 and 6 percentage points, respectively. In other words, during the unwinding of the last investment boom, the other components of spending did not provide a sufficient offset to keep GDP growth from declining. Some Western observers have argued that the growth rate at the trough probably was

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significantly lower than is reflected in the official data in figure 6. In either case, the decline in real GDP growth was substantial—even if it did take four to six years to occur rather than a quarter or two.

Is the current cycle likely to be different? Proponents of the no landing school argue that no significant contraction in China's investment share is necessary. They argue that the sustainable rate of investment is now much higher than it was a decade or so ago. They regard China's strong upward trend in urbanization and industrialization over the past decade as important drivers of a rising investment share. Since urbanization and industrialization are expected to continue, so too, the argument goes, will high investment. But, as shown in figure 7, industrialization was well under way during the unwinding of the last investment boom, when the share of manufacturing and closely related activity was at the very high level of 48 to 50 percent of GDP. Yet both the investment share and overall GDP growth fell during that episode. Industry's share of output in 2003 was 52 percent, not high enough to warrant

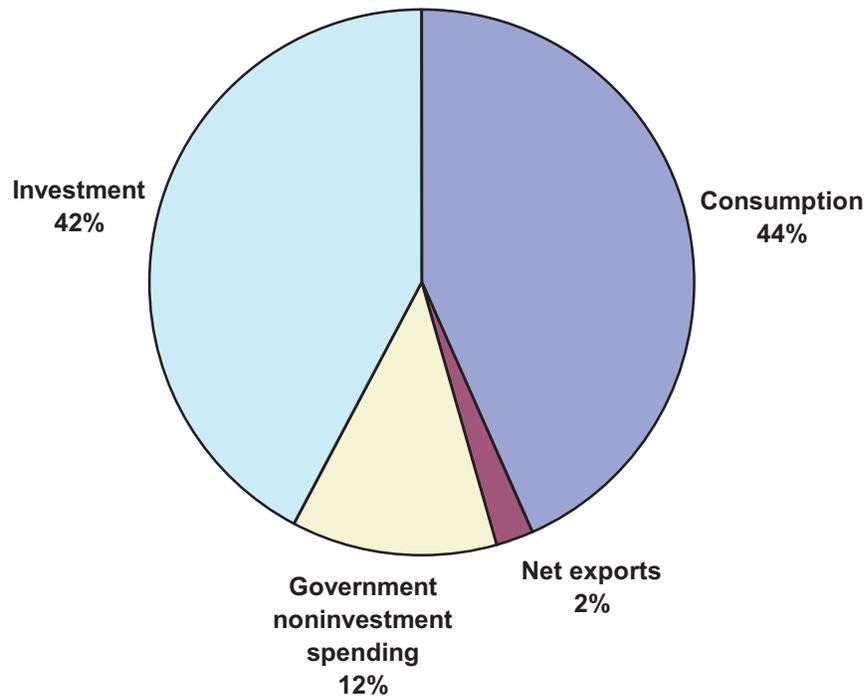
the extraordinarily high share of investment in GDP.

Urbanization was also well under way during the last downturn. One major potential difference from the last cycle is that the quality of residential housing in most cities is now improving rapidly, primarily because it is increasingly private. Consequently, the level of sustainable investment in housing might be somewhat higher than the last cycle, when urban housing was almost entirely provided by work units and city governments. But by 2003, real estate investment as a share of GDP had risen sharply for six consecutive years and was already half again as high as the previous peak in 1993, suggesting adjustment over the next couple of years is much more likely to be on the downside rather than the upside (figure 8). In short, continued urbanization and industrialization are unlikely to make the sustainable rate of investment significantly higher than in the previous cycle. Thus, we believe that the share of investment in GDP needs to fall, despite urbanization and industrialization, and that this decline will likely lead to a decline in GDP growth over the next several years.

An analysis of trends in the efficiency of investment also leads us to believe that China's sustainable rate of investment is well below its current level. Barry Bosworth (2004) calculated the sustainable investment rate associated with alternative future GDP growth rates, based on the observation that there has been no discernable trend either upward or downward in the incremental capital-output ratio during the past 10 to 12 years. He concluded that the sustainable investment share was 30 to 35 percent—far below the present level. Finally, neither the 2003 behavior of aggregate bank credit (discussed further below) nor the investment excesses in steel, aluminum, cement, and real estate suggest to us that banking reform has progressed to the point where an investment share of 42 percent or more can be invested profitably. The People's Bank of China (2004a) explicitly criticized what it characterized as “the blind expansion of seriously low quality, duplicate projects” in steel, aluminum, and cement, all likely to lead to excess capacity and declining profitability.

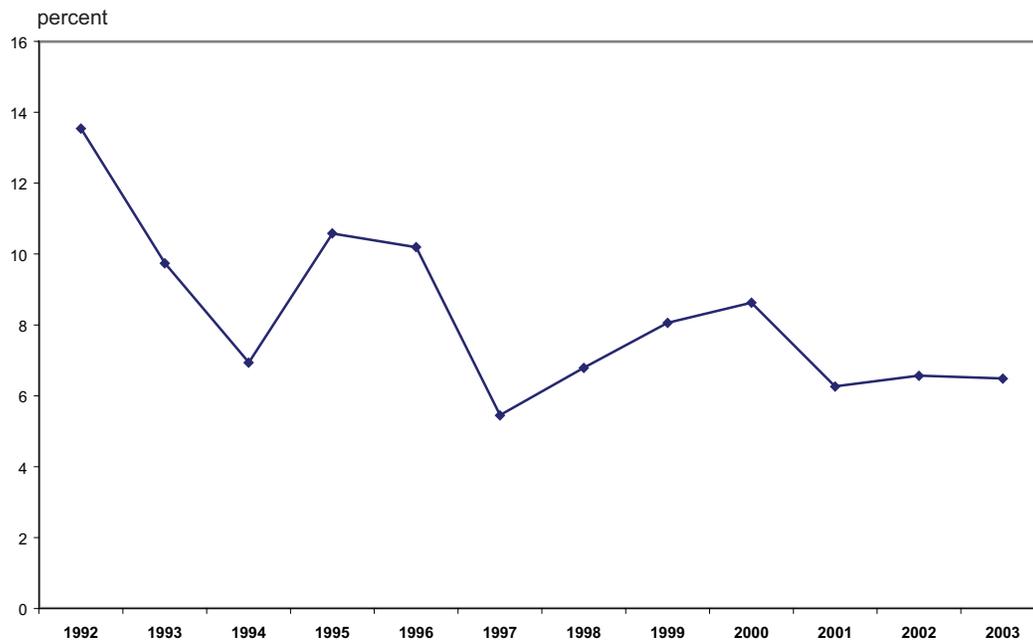
A second argument advanced by the advocates of no landing is that while the past behavior of the Chinese economy may not indicate that an investment share over 40 percent is sustainable, a high and rising investment share is not so unusual for other Asian emerging economies during their periods of rapid industrialization. We disagree. Yes, Singapore recorded an average investment share above 40 percent during 1980–85, but Singapore is a city-state, not a continental economy. In Taiwan, which has an unparalleled record of 8 percent average GDP growth over a 50-year period, the ratio of capital investment to GDP never stayed at 30 percent or above for more than three consecutive years (Council for

Figure 3: Expenditure shares of GDP, 2003



Source: *China Statistical Yearbook 2004*, p. 65–66.

Figure 4: Growth of real household consumption expenditure, 1992–2003



Sources: *China Statistical Yearbook 2003*, p. 68; *China Statistical Abstract 2004*, p. 16.

Economic Planning and Development 1997). Even in Korea, which followed a more capital-intensive growth path, fixed-asset investment as a share of GDP never reached 40 percent (World Bank 2004). More generally, we can find no examples of large developing economies that have attained an invest-

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ment share of 40 percent, much less maintained a 40 percent or more share for three consecutive years or longer.

We conclude that the investment share in China will have to fall markedly from its present heights. This implies that real investment will have to grow more slowly than real GDP for several years. While other spending components of GDP can perhaps take up some of the slack, it seems unlikely that they can expand enough to keep China's growth close to the current 9 percent plus rate.

DANGERS OF OVERLENDING AND OVERCAPACITY

Taking such a medium-term perspective also makes it clear why short-term indicators that the economy is cooling should not lead to what could be premature celebration and why policy levers that produce impressive short-term results may not do the job over a multiyear period. Consider, for example, the growth of total bank lending, which has appropriately been a major concern of the monetary and banking authorities since the middle of 2003. After increasing at an average annual rate of RMB 1.2 trillion in 1998–2001, the increase in bank loans outstanding jumped to RMB 1.9 trillion in 2002 (largely because of an acceleration of lending in the fourth quarter) and then mushroomed to RMB 3.0 trillion in 2003. This brought the increase in bank lending relative to GDP to an all-time high of 25 percent. 2003 is thus best characterized as a full-scale “blowout” of bank credit that could generate large future fiscal losses. Approximately 40 percent of the increase

in loans during the last credit boom subsequently became nonperforming. If, say, a third of the increase in loans from 2002Q4 through 2004Q1 eventually meets the same fate, the losses (about RMB 1.8 trillion) would amount to 15 percent of China's GDP.

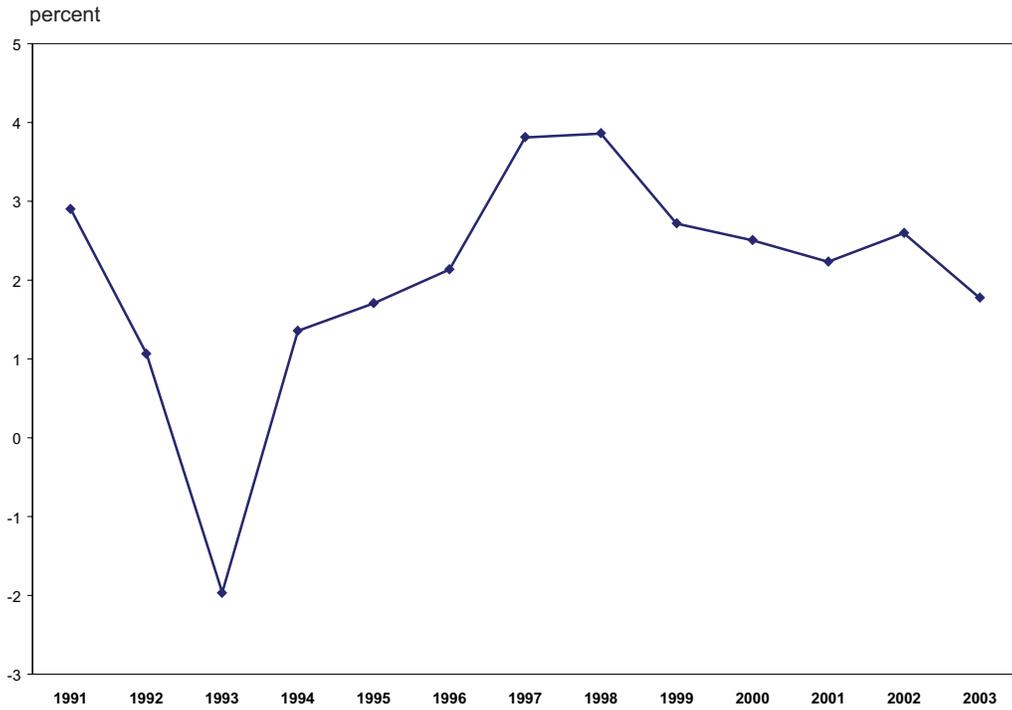
After evidence mounted that bank credit growth was out of control, the authorities lowered their target for domestic currency credit growth in 2004—but very modestly—to RMB 2.6 trillion, only 6 percent below the unsatisfactory 2003 outcome (People's Bank of China 2004a).² Through September 2004, domestic currency loans outstanding increased by RMB 1,790 billion, an amount RMB 670 billion less than in the same period of 2003 (People's Bank of China 2004b). While the rate of credit growth has been curtailed significantly compared with 2003, the increase in domestic currency credit extended in 2004 will almost certainly be the second highest ever. It will take additional years of moderating credit growth to get the investment share down to a sustainable level. The government may wish to spread out the pain of reducing the share of investment, but it can do so only at the risk of wasting more investment resources.

As growth slows in the overheated sectors of the economy—steel, aluminum, cement, autos, and some parts of the property market—it doesn't mean there is no longer a problem. As we learned during the dot-com bubble in the United States, slowing growth is not equivalent to eliminating existing overcapacity; the latter takes time and typically requires sharply lower investment in future years. Growth of automobile sales, for instance, slowed from a pace of over 70 percent in 2003 to only single digits (year over year) in June and July. By September, sales actually fell by 4 percent compared with September 2003 (Wonacott 2004). But General Motors and Volkswagen alone reportedly plan to increase their capacity to 3 million units by 2007—50 percent more than the total market size in 2003. BMW, Mercedes, Honda, Hyundai, Nissan, Toyota, and a few domestic car companies are all in the midst of expanding their capacity as well. Unless demand picks up significantly, the industry will have significant excess capacity and sharply declining profitability. A similar excess capacity situation may emerge in the steel industry. Steel plants currently under construction will add 150 million metric tons of capacity to the industry, about half of the 310 million ton capacity of the industry at year-end 2003 (Yu 2004).

In a similar vein, the continued primary reliance on

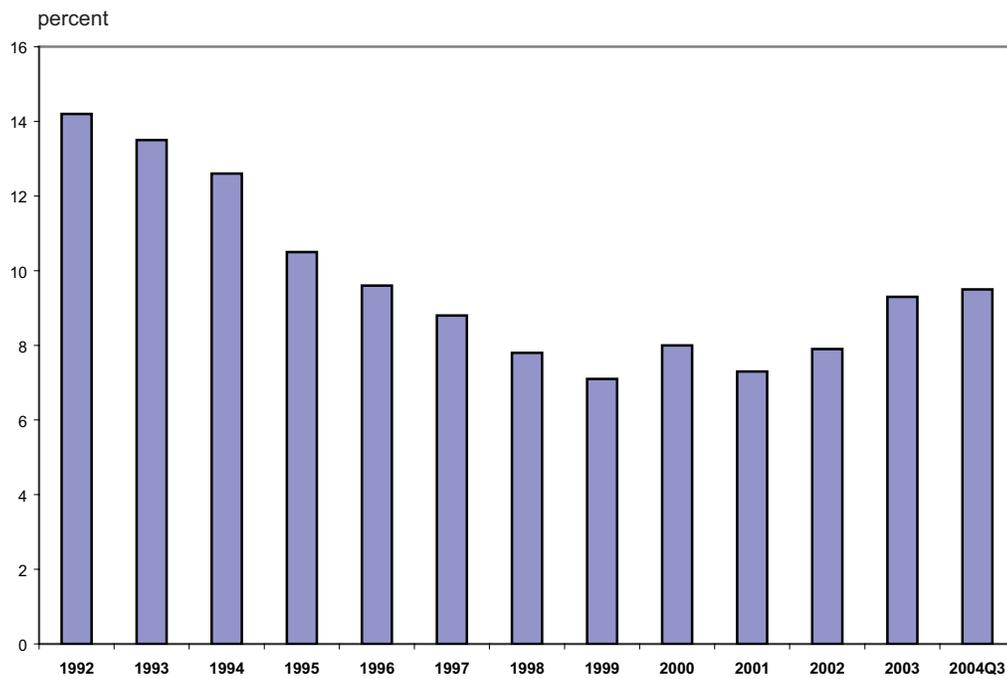
² The People's Bank does not disclose a target for increased foreign currency-denominated lending. The stock of domestic currency-denominated loans increased by RMB 2.77 trillion in 2003; the balance of the RMB 2.99 trillion increase in total credit was foreign currency-denominated.

Figure 5: Net exports of goods and services as a percent of GDP, 1991–2003



Source: *China Statistical Abstract 2004*, p. 29.

Figure 6: China's real GDP growth, 1992–2004Q3



Sources: *China Statistical Yearbook 2003*, p. 57; National Bureau of Statistics of China, www.stats.gov.cn.

administrative controls will entail mounting difficulties that are apt to diminish the effectiveness of those controls over time. Provinces and ministries complain that credit controls limit their ability to pursue “good” investment opportunities, thus reducing growth and job creation. And highly negative real deposit rates (discussed below) cause funds to flow into informal, unregulated credit markets rather than into the banking system. In addition, detailed instructions from Beijing on the pace and subsector allocation of bank lending are inconsistent with ongoing efforts to reduce state interference in bank lending decisions and with plans to privatize two of the four largest state-owned banks (including selling strategic stakes to foreign banks). On the other hand, if “victory” on overheating were declared soon and administrative controls were relaxed, overheating could reappear quickly. And administrative controls have no positive effect on China’s external imbalance. Indeed, to the extent that they reduce overheating, they also slow the growth of imports, thus increasing the current account surplus.

LOW INTEREST RATES AND AN UNDERVALUED CURRENCY

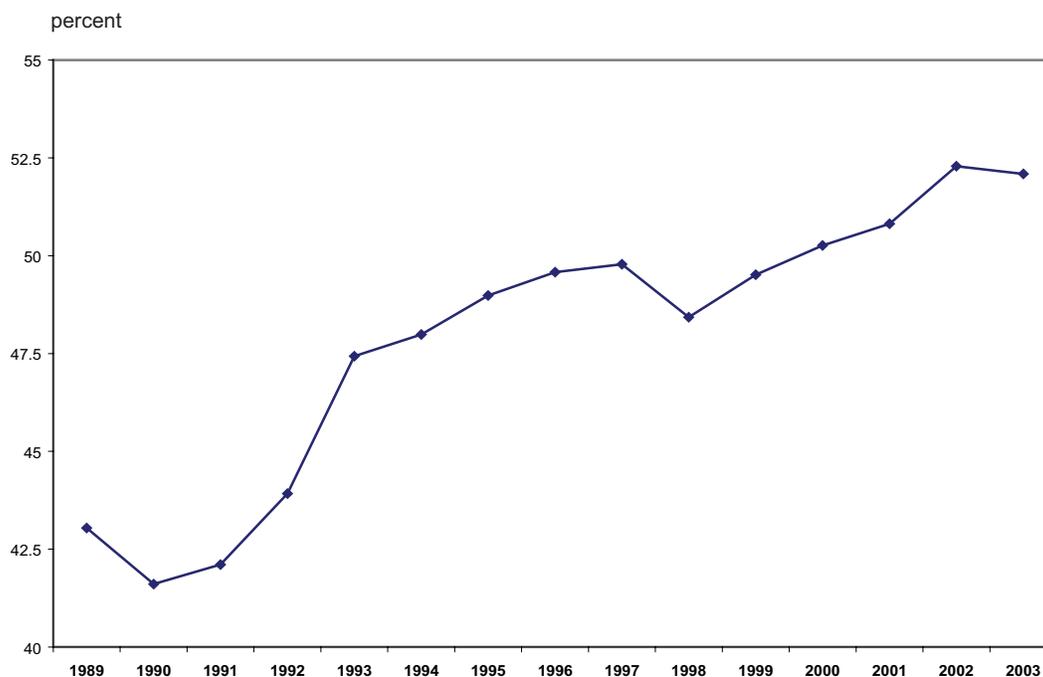
Administrative controls look even less appealing over the medium term because they fail to address two other key

disequilibriums in the Chinese economy—namely, real interest rates that are too low and a real renminbi exchange rate that is still significantly undervalued.

As of the summer of 2004, consumer price inflation was still on the rise, reaching an annual rate of over 5 percent. The inflation rate for corporate goods prices was considerably higher—over 9 percent. Before the October 2004 rate increase, the central bank had fixed the nominal interest rate on (one-year) bank loans at 5.3 percent, so the real interest rate was significantly negative—on the order of 4 percent. A negative real interest rate meant that the demand for credit was high, complicating the authorities’ drive to slow the growth of lending. High inflation relative to deposit rates also constituted a danger to maintaining a healthy growth of bank deposits. Since the nominal interest rate on (one-year) deposits was only 1.98 percent, savers earned an increasingly negative real return, causing deposit growth to slow for the seven consecutive months (year over year) through September 2004. The slowdown in deposit growth reflected not only a diversion of funds into the unregulated lending market but also fueled the growth of real estate investment, where prices have been rising at double-digit rates in many cities over the past two years (Liu and Wang 2004; Hu 2004).

The central bank’s small increase in posted deposit and

Figure 7: Manufacturing as a share of GDP, 1989–2003



Sources: *China Statistical Yearbook 2003*, p. 67; *China Statistical Abstract 2004*, p. 16.

lending rates in late October 2004, unless followed by additional interest rate moves or a large decline in the inflation rate going forward or both, is unlikely to contribute much to a more durable cooling of the economy. The increase represents a modest shift in the mix of administrative and economic measures used to moderate aggregate demand. But the slight interest rate move, only 27 basis points for one-year deposits and loans, left real rates lower than they were a year ago.

The continued undervaluation of the renminbi makes it difficult to increase interest rates more meaningfully and achieve medium-term control over excessive bank lending. Between early 2002 and late summer 2004, the real, trade-weighted value of the renminbi depreciated by 8 percent. China's current account surplus in 2003 was more than 3 percent of GDP. More striking, expectations of a renminbi revaluation stoked large inflows of portfolio capital and substantial unrecorded capital inflows so that China's international reserves increased by an astonishing \$162 billion, or 11 percent of GDP. That increase in international reserves in turn made it more difficult for the Chinese monetary authorities to rein in the excessive growth of bank lending and broad monetary aggregates.

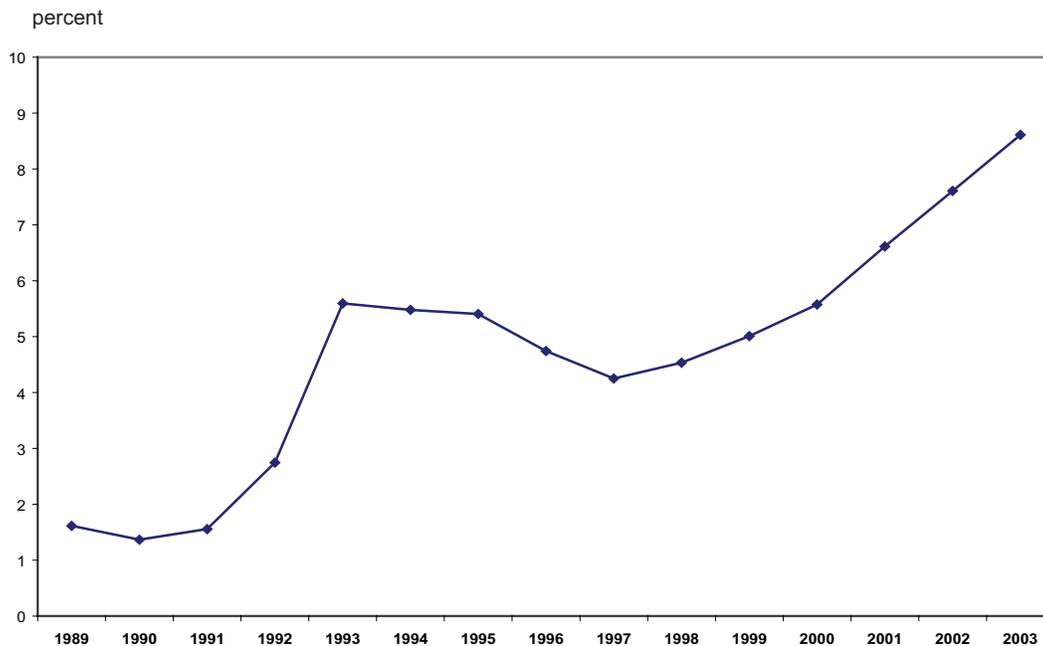
In the first four months of 2004, the overheating of the economy was sufficiently strong to turn the trade balance

into deficit. But as overheating moderated, China recorded steadily expanding monthly trade surpluses from May through September. A tentative forecast for 2004 is a small current account surplus of about 2 percent of GDP. Moreover, while the current account surplus will likely be lower than in 2003, the capital account surplus is growing rapidly. In the first half of 2004, the recorded capital account surplus was 50 percent greater than in the first half of 2003. Thus, even though the errors and omissions component of the balance of payments shifted back to outflows after two years of inflows, the increase in China's international reserves in the first half was \$67 billion (State Administration of Foreign Exchange 2004).

From the standpoint of promoting adjustment of global payments imbalances, particularly correction of the excessively large and rapidly growing US current account deficit, an appreciation of the renminbi—as a catalyst for wider appreciation of the currencies of Asian emerging economies—is still very much needed. Indeed, predictions for the US current account deficit in 2004 and in the next several years are now more adverse than they were six to nine months ago. All things considered, the renminbi is still probably undervalued by roughly 15 percent—the lower end of the range we first estimated a year ago (Goldstein and Lardy 2003a and 2003b).

In the medium run, China needs to move toward greater

Figure 8: Real estate investment share of GDP, 1989–2003



Sources: *China Statistical Abstract 2004*, p. 50; *China Statistical Yearbook 2003*, p. 191.

exchange rate flexibility so it can obtain greater independence for its monetary policy. For example, if China increased interest rates while the renminbi remained undervalued and was still tied rigidly to the US dollar, the larger interest-rate differential in favor of Chinese assets could suck in enough capital to handicap the objective of tightening monetary policy.

For all these reasons—to increase the likelihood of a durable slowdown in credit and investment and thus overall economic expansion, to reduce international payments imbalances, and to provide greater independence for domestic monetary policy—we maintain our earlier policy prescription that China should opt for a two-stage currency reform. Stage one entails three elements: a shift from a unitary peg to the dollar to a currency basket, a revaluation of the renminbi (by, say, 15 percent) relative to the basket, and a widening of the bands (say, to 5 to 7 percent) around the new parity.³ The existing controls on capital outflows are basically retained. In stage two, to be undertaken as China's banking system is put on a stronger footing, China transitions to a "managed float" for the

renminbi and opens up its capital account to larger outflows.

To sum up, we are *not* arguing either that preliminary signs of a slowing of Chinese economic activity in recent months are unwelcome or that administrative controls have been counterproductive. Nor can we estimate with great precision the sustainable investment rate or the amount of overshooting that could occur once the investment share begins to fall. But it appears that the needed unwinding of the current investment boom is far from over and that it is premature to herald a soft landing. A long landing is the more likely outcome.

³ According to the recently published staff report for the IMF's 2004 Article IV consultation with China, the Chinese authorities expressed concern on the one hand that a small initial move of the renminbi in present circumstances could exacerbate capital inflows. On the other hand, they also expressed concern about the impact that a large change in the renminbi might have on employment.

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