Is the Chinese Growth Miracle Built to Last?

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Cornell University
Outline of Talk

- Getting behind the growth story
- Sustainability versus welfare
- Reforms in a broader context
- Risks, possible triggers for growth slowdown
GDP Growth and CPI Inflation

- **Real GDP Growth**
- **CPI Inflation**
- **PPI Inflation**
CPI Inflation (year on year)
Contributions of GDP Components
(by expenditure) to China’s Nominal GDP Growth
## Weak Employment Growth

<table>
<thead>
<tr>
<th></th>
<th>Average 2000-06</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth</td>
<td>9.6</td>
</tr>
<tr>
<td>Employment growth</td>
<td>1.0</td>
</tr>
<tr>
<td>Industry: output growth</td>
<td>10.8</td>
</tr>
<tr>
<td>Industry: employment growth</td>
<td>2.3</td>
</tr>
</tbody>
</table>
Savings-Investment Balance

- High level of investment financed by cheap credit, retained earnings
- High household and corporate savings
- So still large current account surpluses
Base Lending and Deposit Rates
(1-year rates, in percent)
Base and Actual Lending Rates
(1 year, in percent)
Average Saving Rates by Age of Household Head

Graph showing the average saving rates by age of household head from 1990 to 2005.
Age Effects on Income, Consumption, and Saving Rates

Income and Consumption

Age Effect on Savings
Cohort Effects on Income, Consumption, and Saving Rates

Income and Consumption

Cohort Effect on Savings
Year Effects on Income, Consumption, and Saving Rates

Income and Consumption

Year Effect on Savings
Deposits in the Chinese Banking System
Total Deposits in Financial Institutions

- **Total Deposits Level (LHS)**
- **Total Deposits/GDP (RHS)**

The chart illustrates the growth of total deposits in the Chinese banking system from 1989 to 2006, with the left-hand side showing total deposits in billions of RMB and the right-hand side showing total deposits as a percentage of GDP.
Macro Policy Distortions

• Lack of fx flexibility

• Capital controls

• Financial repression
Exchange Rate Flexibility: Not!

- Renminbi tied to U.S. dollar since 1995
- 2.1% revaluation on July 21, 2005
- About 10% bilateral appreciation to date
- Much smaller in nominal/real effective terms
RMB-USD Exchange Rate
(1999 – present)
Real and Nominal Effective Exchange Rates
The Balance of Payments

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Gross international reserves</td>
<td>168.9</td>
<td>618.6</td>
<td>1072.6</td>
<td>1338.7</td>
</tr>
<tr>
<td><em>(in percent of GDP)</em></td>
<td>14.1</td>
<td>32.0</td>
<td>40.8</td>
<td></td>
</tr>
<tr>
<td>Change in international reserves</td>
<td>10.5</td>
<td>206.3</td>
<td>247.0</td>
<td>266.1</td>
</tr>
<tr>
<td>A. Current account balance</td>
<td>20.5</td>
<td>68.7</td>
<td>249.9</td>
<td>162.9</td>
</tr>
<tr>
<td><em>(in percent of GDP)</em></td>
<td>1.7</td>
<td>3.6</td>
<td>9.5</td>
<td></td>
</tr>
<tr>
<td>Merchandise trade balance</td>
<td>34.5</td>
<td>59.0</td>
<td>217.7</td>
<td>135.7</td>
</tr>
<tr>
<td><em>(in percent of GDP)</em></td>
<td>2.9</td>
<td>3.1</td>
<td>8.3</td>
<td></td>
</tr>
<tr>
<td>B. Capital account balance</td>
<td>2.0</td>
<td>110.7</td>
<td>10.0</td>
<td>90.2</td>
</tr>
<tr>
<td>FDI, net</td>
<td>37.5</td>
<td>53.1</td>
<td>60.3</td>
<td>51.0</td>
</tr>
<tr>
<td>C. Errors and omissions, net</td>
<td>-11.9</td>
<td>27.0</td>
<td>-12.9</td>
<td>13.1</td>
</tr>
</tbody>
</table>

**Memorandum Items:**

- Non-FDI capital account balance
  *(including errors and omissions)* | -47.4 | 84.6 | -63.2 | 52.3 |
- Nominal GDP                       | 1198  | 1932 | 2626  |      |
## Decomposition of the Recent Reserve Buildup

<table>
<thead>
<tr>
<th></th>
<th>Annual averages</th>
<th>Changes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1998-2000 (1)</td>
<td>2001-04 (2)</td>
</tr>
<tr>
<td>Increase in foreign reserves</td>
<td>8.5</td>
<td>112.4</td>
</tr>
<tr>
<td>Current account balance</td>
<td>24.4</td>
<td>41.9</td>
</tr>
<tr>
<td>Capital account balance</td>
<td>0.3</td>
<td>57.7</td>
</tr>
<tr>
<td>FDI, net</td>
<td>38.5</td>
<td>46.1</td>
</tr>
<tr>
<td>Errors and omissions, net</td>
<td>-16.1</td>
<td>12.1</td>
</tr>
<tr>
<td>Non-FDI capital account balance (including errors and omissions)</td>
<td>-54.4</td>
<td>23.6</td>
</tr>
</tbody>
</table>
Money and Credit Growth
(year on year, in percent)
Required Reserves and Excess Reserves Ratio (in percent of total deposits)
PBC Bill Rates vs. U.S. Treasury Yields
(in percent, annualized)
Lack of Exchange Rate Flexibility Complicates Macro Policy and Reforms

- Inflexible exchange rate
  - No independent interest rate policy
  - Large current a/c surpluses, more capital inflows

- Domestic macro management harder
- Financial sector reforms more complicated

Unbalanced growth: Reliance on exports, investment growth

Risks:
1. Inflation/overheating in short term
2. Deflation + new NPLs in medium term
3. Asset price bubbles
4. Trade sanctions if trade surplus widens

Domestic macro management harder

Financial sector reforms more complicated

Unbalanced growth: Reliance on exports, investment growth

Risks
1. Inflation/overheating in short term
2. Deflation + new NPLs in medium term
3. Asset price bubbles
4. Trade sanctions if trade surplus widens
Making the Right Connections

- Exchange rate flexibility
- Monetary policy independence
- Better macroeconomic management
- Balanced and sustainable growth
- Safer capital account liberalization
- Financial sector development and reforms
A Framework for Independent Monetary Policy

- A long-run low inflation objective
- Macro and financial stability
- Fx flexibility would evolve naturally
- Would assist in financial sector reforms
- Good time to put new framework in place
Independent Monetary Policy

- Flexibility, not revaluation
- Flexibility, not free float
- Capital account liberalization not solution in itself
The Reform Process

- Incremental approach not easy
- Controlled experiments harder
- Reforms are connected
- Need a framework for reforms
Risks:
External and Internal Shocks

• Sudden stop/reversal of capital inflows
<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Position</strong></td>
<td>293</td>
<td>423</td>
<td>662</td>
</tr>
<tr>
<td><strong>A. Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserve assets</td>
<td>930</td>
<td>1223</td>
<td>1627</td>
</tr>
<tr>
<td>Other</td>
<td>311</td>
<td>397</td>
<td>554</td>
</tr>
<tr>
<td><strong>B. Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI</td>
<td>637</td>
<td>800</td>
<td>965</td>
</tr>
<tr>
<td>Other</td>
<td>369</td>
<td>472</td>
<td>544</td>
</tr>
<tr>
<td>Other</td>
<td>268</td>
<td>329</td>
<td>420</td>
</tr>
</tbody>
</table>
Risks

• Sudden stop/reversal of capital inflows
• Plunge in value of US dollar
• Collapse of external demand
• U.S. trade sanctions
China-U.S. Relations

• The exchange rate issue
• Opening up of the financial services sector
• Common interests not often emphasized
• Strategic Economic Dialogue needs benchmarks
• Risks of the legislative process
• Legislation in motion in Senate, House
Risks

- Sudden stop/reversal of capital inflows
- Plunge in value of US dollar
- Collapse of external demand
- U.S. trade sanctions
- Loss of confidence in banking system
Risks

- Sudden stop/reversal of capital inflows
- Plunge in value of US dollar
- Collapse of external demand
- U.S. trade sanctions
- Loss of confidence in banking system
- Asset price busts
Stock Market Capitalization

- Shenzhen Market Cap
- Shanghai Market Cap
- Total Market Cap/GDP (RHS)
Risks

• Sudden stop/reversal of capital inflows
• Plunge in value of US dollar
• Collapse of external demand
• U.S. trade sanctions
• Loss of confidence in banking system
• Asset price busts
• Social instability
Looking Ahead

- Economy has many fundamental strengths
- System rigid; some shocks could trigger growth slowdown (but meltdown unlikely)
- External pressure could help, if done right