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How Might a China Slowdown Affect the World?

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SUMMARY A slowing Chinese economy might be good or bad for the world, depending on domestic savings and domestic investment.

Two years ago it was hard to find analysts who expected average GDP growth over the rest of this decade to be less than 8%. The current consensus seems to have dropped to between 6% and 7% on average.

I don't think Beijing disagrees. After assuring us Tuesday that China's economy – which is growing a little slower than the 7.5% target and, is expected to slow further over the rest of the year – was nonetheless "operating within a reasonable range", in his Tianjin speech on Wednesday Premier Li suggested again that the China's 7.5% growth target is not a hard target, and that there may be "variations" in China's growth relative to the target.

I think every one knows that variations will only come in one direction, and although his stated expectations are still pretty high, most analysts, correctly I think, interpreted his remarks as a warning that growth rates will drop even more. Here is how the *People's Daily* described the speech:

Premier Li Keqiang on Wednesday said China can meet the major economic goals this year and policymakers will not be distracted by short-term fluctuations of individual indicators. Li downplayed the importance of some economic data from the past two months when delivering his keynote speech to the 2014 Summer Davos, which opened Wednesday in north China's port city of Tianjin.

…China has targets of GDP growth around 7.5 percent and a consumer price index (CPI) increase of about 3.5 percent in 2014, with 10 million more urban jobs to keep the urban unemployment rate at a maximum of 4.6 percent.

Inflation is also below target. According to the National Bureau of Statistics Wednesday release, "In July, the consumer price index (CPI) went up by 2.3 percent year-on-year. Prices grew by 2.3 percent in cities and 2.1 percent in rural areas. Food prices went up by 3.6 percent, while non-food prices increased 1.6 percent. Prices of consumer goods went up by 2.2 percent and prices of services grew by 2.5 percent."

Surprisingly, analysts continue to hail lower-than-expected CPI inflation as giving the PBoC room and encouragement to expand credit – largely I guess because this is what analysts say when US or European CPI inflation numbers are low, and although most of us haven't thought through the differences between China and the US in the ways prices respond to monetary policy, we don't want to seem like we don't know what we are doing. The constraint on monetary and credit growth in China is not CPI inflation and never has been.

Monetary and credit growth in China are constrained by the impact of GDP growth on balance sheets.

For me the main information coming out of CPI inflation data is that consumer demand relative to total production continues to be too weak to drive up prices, something confirmed earlier this week by the August trade numbers, which failed to suggest strong growth in domestic demand. According to *Xinhua*:

China's exports in August rose 9.4 percent year-on-year to 208.5 billion U.S. dollars, with monthly trade surplus reaching an all-time high of 49.8 billion U.S. dollars, customs data showed on Monday. China's imports continued to contract last month, with a year-on-year decrease of 2.4 percent, to 158.6 billion U.S. dollars, the General Administration of Customs said in a statement.

Trade surplus in August jumped 77.8 percent year-on-year and hit a record high again, after reaching an all-time high of 47.3 billion U.S. dollars in July, the data showed.

Although in my opinion the current 6-7% medium-term growth expectations are still far too optimistic, and will almost certainly be disappointed within one or two years, the good news is that most analysts at least recognize that the increasing risk of a "hard landing", which they mostly seem to define as growth below 6%. The idea that during the rebalancing process Chinese growth can drop as sharply as it has for every other country that has gone through a similar rebalancing is still hard to accept, even though a little digging would make it clear that analysts underestimated the pace of slowdown during each of the previous cases too.

Still, the fact that we have been consistently surprised on the down side since 2010 has alerted most analysts to the possibility that we may continue to be surprised on the down side. A "hard landing" of growth below 6% is still considered unlikely, but no longer possible to ignore.

This worries a lot of people. A hard landing, we are told, would be devastating for the world economy because China is the world's "growth engine", and if it falters, growth around the world will also slow. There is also rising concern about a baking crisis within China. An economist at Oxford Economics recently told a Sydney audience that "Chinese authorities were understating the extent of bad loans on their banks' books and faced tough choices in dealing with the potential bank failure." In that he is certainly right, but he went on to say: ""We don't know when there will be a China banking crisis and how it will play out but it is almost certain there will be one,"

I am not sure I agree. Insolvency doesn't necessarily lead to crisis, as countries like Spain have made clear. It takes a collapse in liquidity to create a crisis, and if insolvent borrowers remain liquid, we are likely instead to see a long, difficult period of slow growth in which the losses are painfully ground out of the system (and always turn out to be greater than they would have been had they been recognized immediately). A banking crisis in China is always possible, and several people I respect are quite certain that there will be one, but I think that as long as Beijing implicitly or explicitly guarantees deposits, and as long as Beijing's credibility with Chinese households is solid, and I believe it is, I think we are more likely to see many years of Japanese-style "zombie banks" than a banking crisis.

What does it mean if growth slows?

At any rate as far as I can understand, most analysts claim that if growth in China fell much below 6%, we would be likely to suffer the following:

1. The rest of the world would slow, perhaps sharply, as a consequence of China's lower growth.
2. There would be a crisis in the Chinese financial system, which would spread to the global financial system.
3. Political instability would emerge in China as unemployment surges.

I think most analysts may be overestimating the adverse consequences and underestimating the probability of much lower growth. I continue to expect growth rates to fall substantially, probably by 1 percentage point a year or more for the rest of the decade, so that in the best case, during the expected period of President Xi's administration (2013-32), growth rates are unlikely to average above 3-4%.

Higher growth rates are not impossible, of course, but to get the arithmetic to work for me it would take some fairly implausible assumptions – mainly that Beijing engineers the transfer of 2-3% of GDP every year from the state sector to the household sector – for China to achieve growth rates anywhere near 6% for the next decade. I would make two further points about the consensus:

1. Even though most analysts who now think 6% is the likely lower end of China's growth trajectory have already had one or more Damascene conversions, they still think of rebalancing largely as a linear process. It isn't. The longer unbalanced high growth is maintained (and high growth is always unbalanced), the sharper the reversal must ultimately be.

   In the best-case orderly adjustment, growth rates will drop every year, more or less smoothly, as credit growth is constrained and investment growth drops with it. As the reforms proposed during the Third Plenum are implemented, ordinary Chinese households will benefit from direct or indirect transfers from the state sector, so that total household wealth will continue to rise more or less in line with the growth in household income during the past decade. In that case, consumption growth will remain in the 5-8% range.

   As this occurs, the consumption share of GDP growth will, of course, rise over the next few years so that much slower GDP growth does not imply much slower growth in the rate at which ordinary Chinese see an improvement in their standard of living. The two biggest risks to a smooth adjustment are, first, that the Chinese elite are successfully able to prevent the implicit transfers of wealth to the household second implied by the Third Plenum reforms, and second, that the wealth effect of a collapse in real estate prices, or a high correlation between consumption growth and investment growth, result in much slower than expected consumption growth. The second risk is the focus of a recent blog posting in which JCapital's Anne Stevenson-Yang's more pessimistic consumption expectations are contrasted with mine, with a follow up blog posting, and while we disagree, I don't completely dismiss the JCapital position.

   A disorderly adjustment will have a different dynamic. It is likely to occur after another 2-3 years or relatively high (7-8%) GDP growth rates followed by a very ugly contraction once debt capacity is exhausted, which will occur when new loans cannot grow fast enough both to roll over existing bad loans (by which I mean loans that funded projects whose returns were insufficient to liquidate the loans) and to generate economic activity. Average growth rates in the case of a disorderly adjustment will be well under 3-4% but the adjustment will be highly discontinuous.

2. So if GDP growth rates are much lower than current consensus and even much lower than what most analysts would consider a "hard landing", does this mean – especially if China's economy is, as the *New York Times* called it, "the world's main growth engine in recent years" – that the global economy is dire straits?

   It depends on how China adjusts. China is not the world's growth engine and never has been. It is simply the largest arithmetical component of growth, which is a very different thing. Whether China's economy slows, and how quickly it does, matters to specific sectors of the global economy – positive to some and negative to others – and this will depend primarily on the evolution of China's current account surplus. An orderly rebalancing will be good for the world on average and a disorderly one bad.

   The same is true about the effect of a Chinese slowdown on social conditions. People do not generally care about GDP growth rates. They care about their own income growth relative to their expectations. Rebalancing in China means by definition that Chinese household income growth will outpace GDP growth, after many years of the opposite. A best-case orderly rebalancing should result in little change in the growth of household income, even as GDP growth drops sharply. This for example is what happened in Japan from 1990 to 2010, when GDP growth dropped close to zero but household income grew at nearly 2%.

   A disorderly rebalancing, however, could result in negative growth in both GDP and household income, with the former dropping more than the latter. This, for example, is what happened in the US in the

1930-33 period – with GDP dropping by around 35% and household income dropping by around 19%. In the case of China, in other words, while elites will suffer in both scenarios, in the former case there is no reason for popular discontent.

Is China the world's growth engine?

When analysts say that China is the world's growth engine – something they said about Japan in the 1980s, by the way – they are implicitly assuming incorrectly the source of growth. If you multiply China's GDP growth by its share of global GDP, you will find that Chinese growth over the last few years has comprised a larger share of global GDP growth than that of any other country. But this doesn't mean it is the *engine* of growth.

An engine of growth drives growth around the rest of the world. If an economy is simply growing quickly, and especially if it is growing at the expense of other economies, it can hardly be called an engine of growth. In that case its growth actually constrains growth elsewhere.

Consider the colonial relationship between Britain and India 200 years ago. During the middle of the 18th Century and well into the beginning of the 19th Century India produced far more textiles – and usually much cheaper and of better quality – than did England, but a number of measures aimed at undermining Indian textile producers and protecting British textile producers (tariffs that almost always exceeded 50%, for example, and by 1813 were as high as 85%) meant that at some point in the first half of the 19th Century the British textile industry had become the most efficient in the world and was able largely to eliminate the Indian textile industry from global competition.

There is no question that Britain was the largest component of global GDP growth at the time (the US and Germany did not surpass Britain until the 1860s and 1870s), but it would be foolish to say, at least in the Indian context, that the UK was the "engine" of global growth. In the textile industry, its growth came at the expense mainly of India. I am not suggesting that China's growth relative to the rest of the world is equivalent to Britain's growth relative to India. My point is only that a country's *contribution* to global growth cannot be calculated by measuring its *share* of global growth.

So what contributes to growth? One of the thornier debates in economics is the debate between supply-siders, who insist that increasing production is the only way to increase growth, and the demand-siders (often Keynesians) who insist that increasing demand is the only way to increase growth, at least it is when resources are underutilized. Each statement is one side of an accounting identity, but causality does not necessarily run only in one direction. Growth can be driven primarily either by supply or by demand, depending on circumstances. When savings are in short supply, it is the latter. When not, it is the former.

To put it more explicitly, when investment is constrained by a lack of savings, the best way to generate growth is to increase investment by forcing up the domestic savings rate, in which case the world's growth engine is likely to be the country that exports capital to investment-hungry parts of the world. Of course a net exporter of capital is by definition a country that is running a current account surplus.

In the United States during much of the 19th Century, an erratic and unstable financial system combined with the huge infrastructure needs of a rapidly expanding continental economy meant that the US was almost always in short supply of money and capital*, and so to a large extent its growth rate was constrained mainly by British liquidity. When money poured into the US from Europe, and mainly from England, investments in the US grew apace and the US economy boomed, until some event caused the taps to be turned off (the collapse in silver mining in the 1820s during Latin America's wars of independence, for example, which was followed by the US crisis of the 1830s and, as a matter of interest to those interested in Chinese history, with the replacement of silver exports with opium to the silver-starved Qing government in China). Whereas Britain may not have been an engine of growth for 18th Century India, or at least for the Indian textile industry, it was for much of the 19th Century the world's engine of growth because it supplied much of the capital that a savings-starved world needed to fund investment.

But when savings rates are excessive, which is often a consequence of income inequality and a high state share of GDP, as I show in one of my earlier blog posts, the problem the economy faces is insufficient demand,

not insufficient savings available for investment. In fact as consumption declines with the rising savings rate, it tends to reduce the need for productive investment, so that both productive investment and consumption tend to drop.

Technically you can never have “excess” savings over investment because savings must always balance investment globally. But as I show in another blog entry, the tendency of rising income inequality to force up the savings rate beyond the needs of productive investment must necessarily be balanced by one, or a combination, of three counterbalancing events:

1. As the savings rate tends to rise (or, which is the same thing, as the consumption rate tends to decline) productive investment opportunities tend also to decline, so that excess savings flow into speculative and non-productive investment, including rising inventories, developing countries, risky technology ventures (which can generate huge positive externalities), real estate, stock markets, etc.

2. Perhaps because rising prices in speculative assets causes a strong wealth effect, ordinary households borrow against their rising wealth to increase consumption faster than their income increases, driving down their savings rate in line with the rise in savings that accompanies rising inequality.

3. Rising speculative investment, rising inventories, and rising debt eventually reach a limit, often followed by a crisis, after which unemployment must rise and, by reducing production faster than it reduces consumption, forces down the savings rate enough once again to maintain the balance between savings and investment.

When the world suffers from too low a level of savings to fund needed productive investment, policies that force up savings are positive for long-term growth. For similar reasons, economies with excess savings create growth abroad by exporting the excess to where it is needed. In that case the supply-side insistence on focusing policy on ways to generate additional savings does result both in more growth and in trickle-down wealth expansion.

However when savings are high enough and mobile enough that balance can only be achieved in the form of high unemployment, the world does not need more savings to fund more productive investment, as the supply-siders argue, but rather more demand, as the Keynesians insist. More sustainable demand (in the form of needed infrastructure or of higher consumption by wealthier workers) will lead to more productive investment by redeploying underutilized resources, including unemployed workers.

If there is such a thing as a global engine of growth, in the latter case, it is the country that is able (or is forced) to import the most amount of capital and export the most amount of demand (i.e. run the largest trade deficit). In that case countries with large trade surpluses that have to export excess savings do not cause growth abroad. As an aside Kenneth Austin recently published in *The Journal of Post Keynesian Economics* what I think is a very important paper on how capital exports affect the global economy. His paper is summarized in a recent *New York Times* article.

What will drive China’s contribution to global growth?

So what kind of world are we in – one with excess savings, or one with excess demand? I would be truly surprised if anyone suggested that we are in the latter world and not the former. A world of excess savings is prone to bubbles, and either debt-fueled consumption or high unemployment, and this pretty much describes the world we have been living for the past two decades. For this reason I would argue that countries that are absorbing excess savings – i.e. running current account deficits – are generating growth abroad while countries that are exporting excess savings – i.e. running current account surpluses – are weakening growth abroad.

China, in other words, is not the world’s growth engine. Behind Germany and ahead of some of the oil producers, it runs the largest current account surplus in the world, which means that it is exporting its excess savings in a world that has nowhere to put the money, and so the world must respond either with speculative asset bubbles, unproductive investment, debt-fueled consumption binges or unemployment.

This means that to assume slower growth in China will reduce growth abroad is wrong. As the growth rate of China's economy drops, the fact that its share of global GDP growth will drop does not presage anything bad for the global economy. What matters is what happens to China's current account surplus. As long as the world suffers from weak global demand, if China's current account surplus declines relative to global GDP, China is adding net demand to a world that needs it. This is positive for global growth. If on the other hand China's current account surplus rises, China will be adding more savings to a world already unable to absorb total savings productively, and the world will be worse off.

This tells us how China's rebalancing will affect growth abroad. China's contribution to global growth over the next decade depends on the relative pace at which savings and investment decline. If savings declines faster than investment, China's excess savings will decline and with it its current account surplus. China in that case, will be adding net demand (or reducing negative net demand, to be more precise) to a world that needs it. If on the other hand China's investment rate declines faster than its savings rate, its current account surplus will by definition grow, and the world economy will be worse off.

So which will it be? I think it depends on how orderly the rebalancing process will be.

1. In an orderly rebalancing, China will take steps to reduce investment growth. Instead of causing unemployment to surge, however, the reforms proposed during the Third plenum, most of which involve direct and indirect transfers from the state sector to the household sector, should keep consumption growth rates relatively high.

   In order to keep the process as stable as possible and to prevent a surge in unemployment, my guess is that investment will decline more slowly than consumption will rise, so that in effect the gap between savings and investment narrows. This is just another way of saying that China's current accounts surplus will narrow as a share of global GDP and the effect for the world will be positive (this is what occurred during Japan's rebalancing between 1990 and 2010).

2. A disorderly rebalancing can occur in a number of different ways so it is hard to predict the impact on the current account, but the most likely outcome would be a surge in the current account surplus. Assume, for example, that a disorderly rebalancing occurs because Beijing waits so long to force through the reforms that it runs into debt capacity limits (i.e. the growth in debt cannot exceed the growth in the amount of bad debt that must continually be rolled over). In that case investment will drop quickly. At the same time unemployment will rise, which will partially reduce the savings rate, but worried Chinese households with jobs will cut back on consumption, which will increase the savings rate.

If the combination of the two causes the savings rate to rise, or to fall more slowly than the rapidly declining investment rate, the automatic corollary is a rise in the current account surplus. This would reduce demand in a world already suffering from low demand.

A slowing Chinese economy might be good or bad for the world, depending on how it affects the relationship between domestic savings and domestic investment, and this itself depends on whether Beijing drives the rebalancing process in an orderly way or is forced into a disorderly rebalancing by excess debt. My best guess is that Beijing will drive an orderly rebalancing of the Chinese economy, even as it drives growth rates down to levels that most analysts would find unexpectedly low, and this will be net positive for the global economy.

* To the point, where counterfeit money was often accepted as real, even though it was known to be counterfeit (Stephn Mihm, *A Nation of Counterfeiters: Capitalists, Con Men, and the Making of the United States*, Harvard University Press, 2009). This, by the way and for those who find this kind of think interesting, was also true in China during the late Ming Dynasty, and explains China's huge demand for silver, which was soon to be supplied by Spanish silver discoveries in the Americas.

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